Bulk annuities focus:

New ideas for changing needs

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Made to measure

Pensions Age speaks to Tim Coulson about the changing nature of the bulk annuity market

The Just brand stands out in the world of DB, how are you different?
At Just we aim to positively disrupt markets by being different. Within the defined benefit de-risking market we have focused on introducing solution innovation and a flexible service model to respond to the complex challenges facing scheme trustees. That's one of our many strengths, tailoring the delivery of the de-risking solution to make the transactions highly personalised and to ensure implementation is achieved as efficiently as possible for trustees and administration teams.

At Just we have experience of working with very large and very small schemes. We have completed £200+ million segment transactions in multi-billion pound schemes and arrangements to secure the total liabilities of smaller schemes.

About half the business we wrote last year was medically underwritten and the remainder was standard. We do both buy-in and buyout, with a buyout being a wind-up of the full scheme, so we take full responsibility for all the scheme members, including deferred members.

We've successfully completed over 120 transactions since our first deal in 2013, and we are very pleased that nearly 10 per cent of this activity is repeat business. We have conducted multiple transactions advised by every single major employee benefits consultancy (EBC). Just is now an established player in the market with strong credentials.

As a major defined benefit de-risking player, how would you describe current conditions within this market?
There's predicted to be plenty of demand, with £2 trillion of pension scheme liabilities out there for around 6,000 schemes. There's regulatory and market pressure on schemes to de-risk and economic pressure on employers. So you can see that the forces to transfer defined benefit liabilities off corporates' books and onto insurers is relentless.

Some market forecasts have projected that the buy-in and buyout market activity may reach £350 million over the next decade *[see graph]*. So a doubling of the current market size in the next few years is well within the realms of possibility.

In the short term, I think we're going to see the usual upturn in transactions for the second half of this year.

So why do you think the market is growing?
From the finance director's perspective, these schemes are usually closed to new members and closed to future accrual. Nobody who's working for the company currently – or very few – have an interest in the pension scheme. It's a significant unrewarded risk on a balance sheet that the finance director would naturally want to remove. So there's a huge desire from FDs and trustees to transfer these liabilities into an insurance environment.

Most schemes are working to a plan to achieve full funding and then to get to buyout. For some, that might be 15 or 20 years away, others may be close to the 'finishing line' ready to transact. For the latter, as the conditions in investment markets improve, for instance if interest rates rise, the relative affordability of insurer pricing for buy-in, compared to scheme technical provisions, will present opportunities to transact. Trustees and employers will be keen to grasp these opportunities, and move quickly to protect themselves from the risk of increasing deficits. They've been disappointed in the past by waiting for too long to transact only to see the opportunity disappear.

Are there any trends you are seeing within the defined benefit de-risking market – for instance a preference for buy-in or buyout?
The majority of our business is buy-in, where the pension scheme removes risk but still pays for the running costs of a scheme. If they do a buyout, they can wind-up the pension scheme and save the running costs. Now clearly for a small scheme, those running costs are disproportionality larger than for a bigger scheme. That's why buyout is more common at the smaller end of the market, because of the economies of scale.

However, the reason buy-in is more common is because insuring pensioner payments through a buy-in will be very similar to the cost of technical provisions, which the scheme has to eventually achieve. But at least with a buy-in, their liability risks, such as pensioners living for longer than expected or markets moving against them, are removed. So the cost to the corporate to make the deal happen and remove that risk might be zero, or very small.

Another trend we are seeing are schemes removing risk by insuring in tranches. For instance, they may insure their current pensioners and then return in three years' time to insure deferred members who have become pensioners since then. That's one way of slicing and dicing to achieve an effective buy-in transaction with the assets available and moves the scheme part way along the journey to winding-up. This has become a lot more popular over the past few years.

Another way to slice and de-risk some of a scheme's liabilities is through medical underwriting, something Just is well known for providing to schemes. Could you explain the process of medical underwriting?

For schemes with larger memberships, medical underwriting is effective via top-slicing. We segment the pensioners with the largest liabilities to create a tranche ready for medical underwriting. For smaller schemes, under 300 members, we normally medically underwrite the entire population. If you price members with the largest liabilities under the traditional standard approach, such as checking their postcodes, they usually live in affluent areas, and may be considered to be in the most healthy group. But by individually underwriting members we are able to achieve a more robust assessment of life expectancy by understanding their underlying lifestyle factors such as height and weight measures, activities such as smoking and relevant medical conditions. Because the starting assumption using standard underwriting is that most of the members are healthy, the impact of the individual medical underwriting can be very significant. Starting from this healthy assumption means we might observe a 15 per cent improvement in price for a smoker, which can reduce a buy-in premium materially.

I believe you've helped evolve the medically-underwritten defined benefit de-risking market through post-deal underwriting. How does this work?

We've evolved the proposition so that we undertake the underwriting activity post-transaction. So, before the transaction, we agree a price which will never increase, but can go down. This gives the trustees certainty that individual underwriting won't increase the premium. Then post-transaction, we contact members, starting with those with the largest liabilities, where uncovering lifestyle factors or medical conditions will have the greatest impact.

We write to them, requesting they complete a short questionnaire with easy-to-answer questions, such as whether they are a smoker or have been admitted to hospital in the past 10 years. We then call those that have lifestyle factors or medical conditions to conduct a short phone interview. Members are not obliged to respond. It's entirely up to them. We would normally expect somewhere between 60 and 80 per cent to respond.

Once we've done that, depending on the proposition, we can share the benefit delivered by the medical underwriting. It doesn't take many members to have a lifestyle factor or medical condition to have a positive impact on the premium charged and it's not untypical to observe a £10 million transaction receiving a £250,000 reduction in the premium.

Smaller populations benefit most from such individual underwriting, where the result tends to be cost savings in the mid-single digits percent.

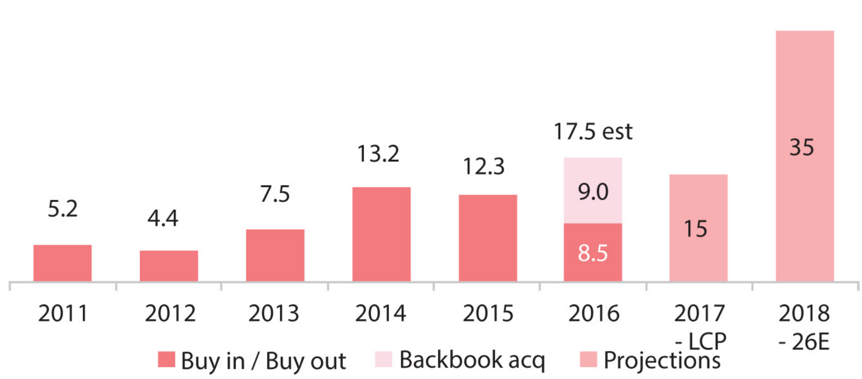
How do you recommend schemes prepare for a medically underwritten transaction?

For medical underwriting, trustees are not required to undertake additional preparation beyond that for a traditional transaction, because we at Just do all the work. Trustees need to allow a small amount of time for Just to contact the members. We can't do that instantaneously, but if we're doing that post-transaction, there is much less time pressure.

Thanks Tim, so if schemes want to find out more, what should they do?

We're happy to talk to trustees any time if they want to understand more about our standard and medical underwriting propositions; the benefits and how we can segment their membership to get the best results. But they should also talk to their EBC, who will know the scheme well and are equipped to assess the appropriateness of medically underwritten transactions. We recognise the challenges facing trustees and Just is committed to helping trustees develop and maintain their technical knowledge by working in partnership with EBCs to offer relevant continuous professional development opportunities.

Expected growth in DB de-risking transactions(£bn)



Source - PPF, Hymans Robertson

Summary
• Pensioner buy-ins can now potentially be transacted for less than the cost of matching those liabilities with gilts.
• Full scheme buyouts remain less common, though this could be changing.
• New players are expected to enter the market by the end of 2017, increasing competition.
• Only well-prepared transactions receive quotes.
• There has been £10 billion worth of defined benefit liabilities bought in or out in 2016 – out of a total potential market of £2 trillion.

The de-risking landscape

Stuart Anderson examines the current state of the bulk annuities market and what schemes need to do to prepare to transact

For many pension schemes, bulk annuities are more affordable now than at any time in almost a decade.

Insurers are currently offering rates, particularly for pensioners, which represent a meaningful discount to the cost to schemes of matching these liabilities themselves. Defined benefit (DB) funds that have substantial gilt holdings may, therefore, be able to permanently transfer some or all of their investment and longevity risk to the insurance market at no additional cost, or even a saving.

Schemes usually match their liabilities for pensioners with gilts, which remain at historically expensive (many say 'bubble') levels thanks to record low interest rates and the continued appetite among investors for high-quality sovereign debt. Investment in gilts is no longer a risk-free option, and is certainly not cheap.

Bulk annuity providers, by contrast, back their liabilities with a broader range of higher-yielding, low-risk assets.

These can include investment-grade corporate bonds, infrastructure investments, airport landing slots, solar and wind farms and lifetime mortgages. Insurers can currently secure a good flow of such investments.

But this availability of assets may not last forever.

The marketplace

The bulk annuity market has eight current participants: Aviva; Canada Life; Legal and General; Pension Insurance Corporation (PIC); Phoenix Life; Just Group; Rothesay Life; and Scottish Widows.

During 2016, Prudential, while previously a major player in both bulk annuities and individual annuities, withdrew from the market, while Just Retirement and Partnership merged to form Just.

Scottish Widows entered the market in 2016, completing four transactions, as did Phoenix Life, which carried out a £1.16 billion buy-in of its parent company's back book and is now in the market for medium-to-large transactions.

Consultants expect another one or two players to enter the market before the end of 2017, which will increase competition and, all things being equal, should further improve the terms available to pension schemes.

Buy-in or buyout?

Bulk annuity transactions are structured either as a buy-in or a full-scheme buyout.

In the latter case, the insurer takes on all of the liabilities for pensioners and deferred members, enabling the sponsor to remove the scheme from its balance sheet. The insurer then becomes responsible for ongoing administration and payroll.

With a buy-in, the scheme secures an annuity to cover the liabilities for a particular tranche of members – usually pensioners. The investment and longevity risks attaching to those pensioners are transferred to the insurer but the scheme remains responsible for administration and payroll.

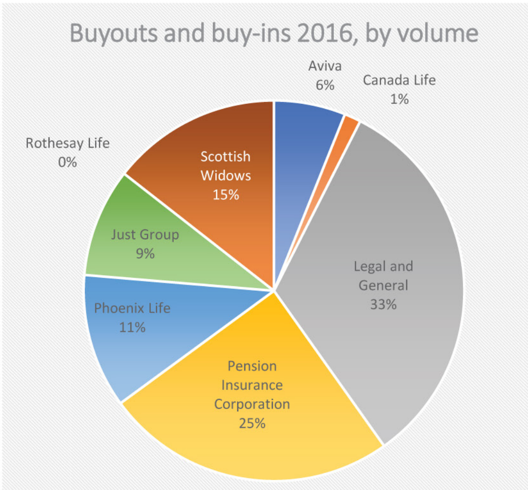
Costs differ dependent on the population being insured. Existing pensioners are less expensive than deferred members, partly because of their 'shorter duration' but also because deferred members carry a range of uncertainties, including the possibility they could opt to take a transfer value, which means the insurer needs to be prepared for one-off hits.

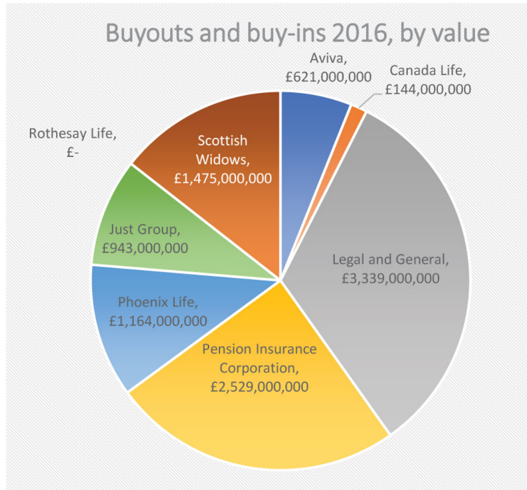
It can, therefore, be beneficial to prune the number of deferred members. "Before buying them in or out it may be worth offering transfer values to deferred members aged over 55 because it could be less expensive," suggests JLT Employee Benefits senior consultant Dave Barratt.

Figures published by consultant Hymans Robertson show that the total value of buyouts completed during 2016 was approximately £2.2 billion, compared to buy-ins totalling around £8 billion. Last year was something of an outlier in terms of the extreme disparity but, looking back as far as 2009, the trend is clearly toward buy-ins.

Buy-ins, though, are usually stepping stones on the way to an eventual full buyout. By insuring smaller tranches of liabilities on a phased basis, schemes are able to monitor the market and transact when pricing is particularly favourable, while also staging the accounting impact on the sponsor.

Results for Just Retirement and Partnership, which merged in 2016, have been combined under Just Group. Some insurers, notably Rothesay, have their results skewed by the their concentration on insurer back book deals at the expense of buyouts and buy-ins during 2016.





Source: Hymans Robertson

Willis Towers Watson senior consultant Shelly Beard says: "Buyouts tend to be reserved for situations where the sponsor wants to remove the scheme from its balance sheet. This could often be in preparation for M&A activity, or it could be that they are in a very good funding position and can afford to do it – however, many schemes still have deficits in relation to deferred members."

Aon Hewitt principal consultant Michael Walker believes that the buy-in/buyout status quo could be about to change. He says: "Some scheme sponsors that were planning a full buyout at some point in the future are beginning to ask how big a cheque they would have to write to have the pension scheme off their balance sheet now. Several are finding that it is surprisingly affordable."

Doing the deal

Despite the current benign conditions, not every transaction that comes to market is quoted for by insurers. According to Just Group director of defined benefit solutions Tim Coulson, there are £2 trillion of liabilities on corporate balance sheets in respect of schemes that are closed to new members and, in many cases, future accruals. In 2016 the total value of UK DB scheme buy-ins and buyouts was just north of £10 billion.

In order to quote, Coulson says, insurers need to be confident the transaction will complete.

"Is it prepared?" he asks. "Is it well enough funded, is the corporate sponsor on board and does it have good, experienced advisers?

"Has it set a target price which, if achieved, means it will definitely transact? Is its data in good shape and is the benefit structure clear and unambiguous?"

Preparation is clearly key, both to getting a quote in the first place, and to achieving the best price. The size of deal can also have an effect – transactions in the £100-400 million range are attractive to the broadest range of insurers and should, therefore, lead to the greatest competition among them.

There are also softer issues to consider because these are not arms-length, automated transactions. PIC head of strategic development David Collinson says: "If we get the feeling that one group of trustees is going to be difficult to deal with as a counterparty while another has great processes and gives the impression they will be responsive and good people to deal with then we are likely to offer better pricing to the second group."

Medical underwriting

Just Group is the only insurer currently actively offering medical underwriting.

Because life expectancy tends to revert to the mean across larger populations, medical underwriting is often used for 'top-slicing', where a large volume of liabilities is concentrated in a small number of members. However, Just Group director of defined benefit solutions Tim Coulson recalls a recent transaction in which it was used to great effect with a group of retired mariners in receipt of pensions from a company based in many of the major ports across the UK and Northern Ireland.

"Being a member of a maritime crew is a challenging job, so they're paid pretty well, which means their final salary is quite high and so is their pension," he explains. "That means they can afford to live in better postcodes, which would normally be an indicator of above-average longevity.

"However, when we did the medical underwriting it turned out their lifestyle factors were skewed in terms of levels of smoking, drinking and the physical demands of the job. So their actual mortality experience was worse than average.

"We transacted two medically underwritten buy-ins for the trustees and employer, covering just over 280 lives for a premium in excess of £70 million in total. Medical underwriting delivered savings over standard underwriting, so when the trustees were ready to insure a second tranche of pensioners, they came back to Just."

Written by Stuart Anderson, a freelance journalist

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