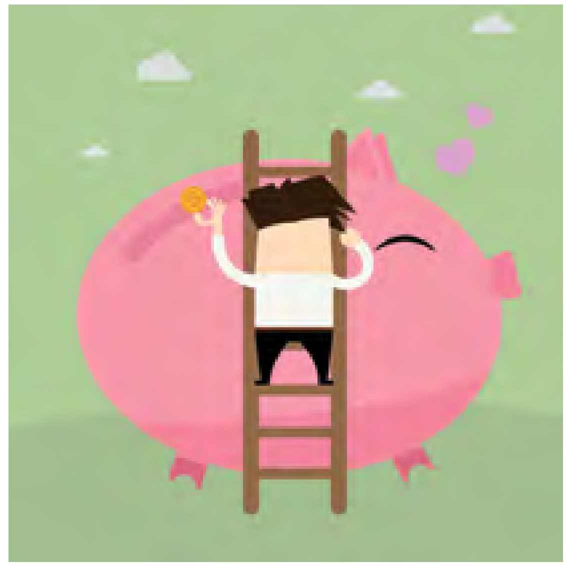
Bigger than ever

Laura Blows explains why 2018 is a record year for bulk annuity transactions



£20 billion of UK bulk annuity transactions completed in the first half of 2018, making it already the biggest-ever year for bulk annuities. It seems only fitting then that the largest-ever bulk annuity transaction took place this year – the £12 billion back-book transfer between Prudential and Rothesay Life.

This growth is set to continue, with Aon principal consultant Michael Walker predicting the year to end with around £30 billion worth of bulk annuity deals completed.

"The second half of the year is traditionally the most active, and we expect that it will be the same in 2018," Legal & General managing director, UK pension risk transfer, Chris DeMarco states.

But why is this year so much more spectacular for bulk annuity deals – why now?

Lower costs for buyouts and buy-ins is a major factor, as both insurance pricing has softened and scheme funding levels have improved, not least due to the freedom and choice reforms having increased the number of people transferring out of DB schemes. Mortality improvements have slowed over recent years, which has also reduced costs, Integrated Actuarial managing director Marian Elliot adds.

"The FTSE 350 DB pension deficit has more than halved over the first six months of 2018. This, coupled with attractive pricing from insurers over the past 12 months, means that we are seeing a surge in demand as pension scheme trustees and their corporate sponsors capitalise on the improved funding positions within their pension schemes," DeMarco explains.

In particular, the pricing for deferred members has improved over the past six months, Willis Towers Watson head of transactions Ian Aley notes, as insurers optimise their asset strategies and reinsurers become more comfortable with taking non-pensioner longevity risk from insurers.

For trustees wanting to be involved in this buoyant market, it is key they understand current market pricing and where deals are closing, Aley states, as "it's common for actual buyout costs to be 5 per cent lower than the scheme actuary's solvency estimates, based on running a competitive tender process".

However, there is only so much capacity for these deals.

"The elephant in the room is capital adequacy," Altus Consulting consultant Rory Gravett says. "With some books dependent on lifetime mortgages, the challenges on the *[DB]* superfund capital adequacy requirements, and the general headaches around free capital ratios, there is the potential for pressure to build up and limit the exercises that bulk annuity providers can undertake."

DeMarco notes that the four principal factors that affect insurer supply are capital, reinsurance, assets and people power.

"We do not believe that the first two are a major constraint in the short term, but the availability of assets and insurers' capacity to produce quotes means insurers are being increasingly more selective in the quote processes in which they participate."

To counter this, "it will be interesting to see if rumoured new bulk annuity insurers get to market. Likewise what effect the consolidators, assuming they go live," Altus Consulting principal consultant Will Watling muses.

Despite capacity concerns, the bulk annuity market is expected to keep growing.

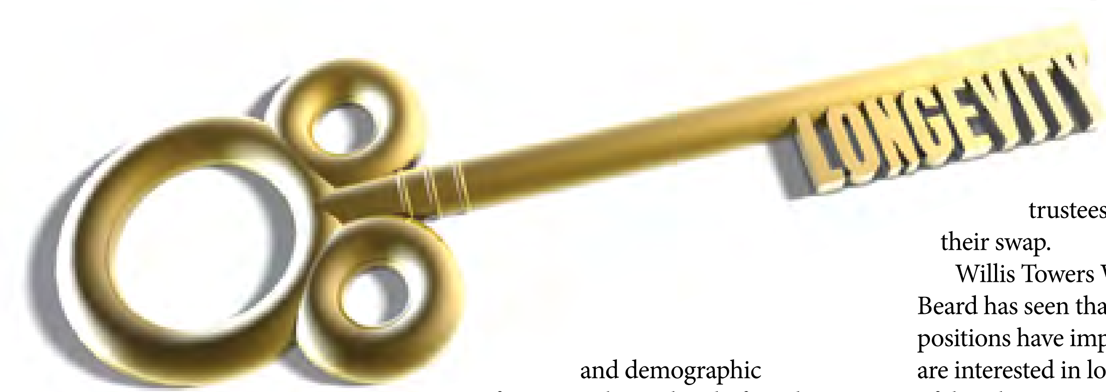
As the balance of pension liabilities will shift towards pensions in payment over the next 20 years, and as it is cheaper to insure pensioners than deferreds under current pricing structures, the greater proportion of 'in payment' pensioner members should mean that buyout becomes more affordable over time, Elliot notes.

"There are nearly £2 trillion of DB liabilities in the UK, with only around 5 per cent of them insured to date," DeMarco adds. "The vast majority of pension scheme trustees are now on structured journey plans designed to deliver them to a fully-funded state over the next decade. Many of them will hit that point within a fraction of that time."

Written by Laura Blows

Unlocking longevity swaps

Laura Blows finds out why longevity swaps are back in focus for pension schemes



Longevity swaps were traditionally only the niche preserve of large DB schemes due to their complexity. However, longevity swaps are now having their moment in the spotlight.

The first half of 2018 saw National Grid complete a massive £2 billion transaction with Zurich and Canada Life. Aon principal consultant Michael Walker notes that reinsurers are now at advanced stages in pricing further deals, which will complete in the second half of the year.

"The longevity insurance market is back open for business, with opportunities to insure longevity risk at substantially improved prices," he states.

Walker notes that since Aon publicly called out reinsurers in 2016 for not reflecting the recent slowdown in longevity improvements in their pricing, material cost improvements have been made. For instance, by delaying their transaction until 2018, National Grid saved £40 million, "delivering cost-effective risk reduction for the pension scheme", he says.

Schemes should leverage on-demand, real-time information in order to drive a better understanding of their funding position and sensitivity to both market and demographic factors, RiskFirst head of product management Simon Robinson recommends.

The slowdown in longevity improvements, and therefore the subsequent improvement in longevity insurance pricing, is a key factor in the increased attention of longevity swaps lately. However, as longevity improvements have slowed faster than expected, are longevity swaps even needed still?

For Mercer principal Chris Hawes, the answer is yes.

"Whilst generally expectations of increased longevity have slowed down in recent years, there is still evidence that members with DB pensions have not seen such a slowdown and hence longevity risk remain a key factor for DB schemes to recognise and manage," he explains.

Insight Investment head of insurance Heneg Parthenay has also found this to be the case. "Over the past decade pension schemes have hedged increasing amounts of their liability-related interest rate and inflation risk, and for many schemes longevity is now the dominant source of liability-related risk", Parthenay says.

A benefit of implementing a longevity swap is that is an 'unfunded' transaction, with no need to pay cash upfront, Integrated Actuarial managing director Marian Elliott explains. Instead, there is a periodic exchange of cashflows between the provider and pension scheme, depending on the mortality experience trustees 'locked into' with their swap.

Willis Towers Watson director Shelly Beard has seen that as schemes funding positions have improved, more of them are interested in longevity swaps as part of their long-term portfolio run-offs or as a stepping stone to buy-in/out.

However, Elliott warns that longevity swaps can complicate a scheme's journey towards buyout, but that the market is starting to address this complication. Indeed, some of Beard's clients have even found that they achieved better value from 'unbundling' the longevity protection from the asset risk.

Mayer Brown partner Jane Childs has also found that, although not commonly understood, longevity swaps can, like bulk annuities, be structured flexibly to enable trustees to 'exit' when desired in the future.

"The key is to set clear exit objectives at the outset and incorporate them into the swap's design," she says.

It is therefore not surprising that Elliot expects to see further improvements in the link between longevity swaps and buy-ins and buyouts in the future.

Also looking ahead, Walker expects continued growth in longevity insurance into 2019 and beyond, both for pension schemes that are adopting a long-term self-sufficiency strategy, and as a stepping stone towards annuitisation.

Written by Laura Blows

Stick or twist

Laura Blows explores the take up of bulk member option exercises, such as enhanced transfer values and pension increase exchanges

Last year saw record numbers of people moving out of DB schemes due to the freedom and choice reforms and the low gilt yields creating record transfer values.

However, this was not necessarily something to just be celebrated.

Take, for example, the case of British Steel, which saw pension scammers prey on members to transfer out of its troubled pension scheme and into their criminal hands.

"This has always been a hot topic, and the recent British Steel fiasco has made things very challenging", Altus Consulting consultant Rory Gravett says. However, the problem is not the product/exercise itself, he explains, "as there will always be those people for which the bailing out of a DB scheme is the right thing for their circumstances – it is the reason these exercises exist."

Indeed, last year Mercer saw as much as 25 per cent of deferred liabilities transfer out in some schemes – on occasion without any incentive to do so or financial advice being offered by the trustee or sponsor, its principal Maurice Speer states.

Members over 55 approaching retirement may have started to request transfers themselves, but for years schemes have been offering members the chance to take an enhanced transfer value (ETV), a lump sum of money, to leave the DB scheme and therefore untie the scheme to the member's pension obligations.

Speer states that there was a significant increase in the take up of ETVs last year, with the average take-up rate being 30 per cent – having averaged below 20 per cent for the previous few years.

According to Integrated Actuarial managing director Marian Elliott, the extent to which members take up pension transfers or exchanges depends upon the membership profile of the scheme, in particular how big it is and how geographically spread out the members are, and therefore how easy it is to run a communications campaign.

The generosity of the offer will also understandably have a big impact on take-up rates, especially as most members will require access to an independent financial adviser (IFA) before making their decision, meaning the terms will have to be attractive enough for the IFA to recommend they take the deal.

In terms of offers, transfers may be getting all the attention right now, but a pension increase exchange (PIE), where a member is offered a higher initial pension rate in exchange for giving up future contractual pension increases, is actually far more common, Willis Towers Watson (WTW) director Stewart Patterson says.

The reasons for this could be that the PIE offer of a higher starting pension does not require an additional monetary injection from the employer, while still protecting them from inflation risk, with the member gaining from an increase in 'real' income at the start of retirement (accepting that their pension's purchasing power will decrease over time due to inflation), Elliott suggests.

WTW's *2018 DB Member Choice* survey revealed that three times as many members were written to by their schemes about a PIE option than a transfer option over the past three years.

The take-up rate of PIE, the survey found, was 27 per cent in 2015, 35 per cent in 2016 and 33 per cent in 2017, with scheme liabilities reduced by around 1-2 per cent.

For some pension schemes, these reductions in liabilities through bulk member option exercises, be it ETVs or PIEs, can help them achieve the dream of buyout.

"Although we have not seen so many PIE and ETV exercises in recent years, they may be useful in a number of contexts," Mayer Brown counsel Beverly Cox says. "In particular, with keener pricing of insurance products, employers and trustees who have not considered such exercises before might now look at this sort of liability-reduction exercise as a way of bringing a buyout within reach."

Liability management such as ETVs and PIEs can help close the gap between scheme assets and the cost of buyout, Elliott agrees. So, "as more schemes target buyout, we may therefore see an increase in these exercises".

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