BUYOUT MARKET WATCH

JLT EMPLOYEE BENEFITS BUYOUT TEAM Q2 2016

KEY DEVELOPMENTS
Market developments over Q1 2016 and beyond

THE MARKET IN NUMBERS
New business volumes, market shares and large deals

SPOTLIGHT ON PRICING
Affordability trends and regulatory pressures

BUY-IN CASE STUDY
Top-sliced buy-in incorporating PIE

We are now well into 2016 and the insurers seem to be coping with the introduction of Solvency II – the number of quotations produced remains very high and we have seen evidence of competitive pricing, including prices for deferred members.

The hard work that insurers have put in over the past year, planning for the changes and looking for investment opportunities which may offer more favourable terms, has paid off and, while the number of transactions in the first few months of the year has been low compared to quotation activity, we expect the pace to pick up considerably over the remainder of the year.

The merger between Partnership and Just Retirement was completed in early April – this proved well planned and the joint enterprise (which will write business as Just Retirement Limited) has been able to quote on a business-as-usual basis with no disruption. This is encouraging as we anticipate further growth in the medically underwritten market, particularly as the traditional insurers, with a couple of exceptions, appear to be focussing their efforts more on larger cases. There are a large number of sub £20m schemes wanting to de-risk and we expect a good proportion of these will follow the underwritten route to market.

The market environment has remained volatile and the outlook continues to be uncertain, not least following the UK's vote for 'Brexit' on 23 June 2016. However, demand for bulk annuities remains high, and insurers have proved apt to deal with issues thrown in their way. We therefore remain confident that this will be another successful year for insurers active in this section of the market.

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HOW IS 2016 SHAPING UP?

The long awaited Solvency II European-wide insurance supervisory regime came into effect on 1 January 2016 and all eyes were on how this would affect bulk annuity pricing and transaction levels. Quotation activity during 2016 has been very high so far, with pricing levels similar to 2015, although this activity is not being matched by transaction levels, possibly due to market volatility created by uncertainty in the run up to the Brexit referendum.

2016 SO FAR

- LV= announced that they will not enter the Medically Underwritten Bulk Annuity (MUBA) market this year so that they can focus on their core strategy, albeit they retain an interest in this market and haven't ruled out entry at some point in the future.
- Just Retirement and Partnership Assurance finally completed their merger on 4 April 2016 to form the JRP Group. All bulk annuities will be written by Just Retirement Limited for the foreseeable future.
- Where does this leave the MUBA market? As both Just Retirement and Partnership Assurance have been the main drivers of this market, writing the vast majority of transactions to date, it is likely that there will be a lot less multi-insurer MUBA broking exercises during 2016. However, we expect to see Just Retirement participating in traditional broking processes by quoting on a post-deal underwriting basis instead.
- There has been a lot of quotation activity during Q1 2016, with all insurers managing resources and workloads, leading to some schemes struggling to get even one insurer to provide a quotation. Insurers continue to consider each transaction on merit – size is significant; however, more important is how well prepared a scheme is to transact, including the likelihood of a deal being completed.
- Although quotation activity is high, completed transactions are not.

The largest transactions published over 2016 to date include:

- Rothesay Life - £6bn reinsurance of Aegon's annuity book (April 2016), expected to lead to a transfer of the underlying assets and liabilities to Rothesay Life subject to regulatory approval
- PIC - £300m pensioner buy-in for the VA Tech UK Pension Scheme (April 2016), sponsored by Siemens
- PIC - £900m pensioner buy-in for the Aon Retirement Plan (May 2016), following which PIC re-insured longevity risk for £760m of the liabilities with Prudential Insurance Company of America (PICA)
- Scottish Widows - £630m pensioner buy-in with the ICI Pension Fund (June 2016) taking the scheme's total liabilities insured to over £1.25bn.

WHAT WILL H2 2016 BRING?

- **Further growth:** 2015 saw liabilities in excess of £12bn transferred to the insurance market through either buy-ins or buyouts. We expect to see this level or more of new business over 2016.
- **More new entrants:** The second half of 2015 saw transactions completed by two new insurers, Canada Life and Scottish Widows, and although LV= have postponed their market entrance, other insurers are closely monitoring the development of the market. It is likely that some of these will develop their bulk annuity propositions over 2016. This can only be a positive development from a pension scheme's perspective, with new entrants driving prices down and increasing innovation.
- **Use of top-slicing:** An improved understanding of longevity risk has led to many schemes identifying significant concentrations of liabilities within a relatively small number of individuals. Through a combination of different de-risking strategies, insurer interest (Just Retirement, Legal & General and also Aviva) and highly attractive pricing seen in the MUBA market, we would expect a number of top-sliced MUBA transactions to complete during the year.
- **Increase in purchasing power of smaller schemes:** A number of insurers concentrate their resources on the large bespoke transactions, which can leave smaller schemes finding it difficult to obtain quotations. However, as the larger transactions are more complex, they generally have a long lead-in time to transact, with only a few transactions taking place at any time. Some insurers therefore remain keen to work with smaller schemes. An increased standardisation of contracts and processes has made the bulk annuity market more accessible and affordable for smaller schemes; albeit as all insurers have limited capacity to provide quotations (due to finite resources), smaller schemes must make themselves attractive through clean data, an agreed benefit structure, and setting a clear affordability trigger.

THE MARKET IN NUMBERS

Figures are reported to 31 December 2015 as a number of the insurers have switched from quarterly to bi-annual reporting of their bulk annuity results. H1 2016 results will be published in our next edition.

NEW BUSINESS VOLUMES

Chart 1: Bulk annuity and longevity swap market volumes since 2005

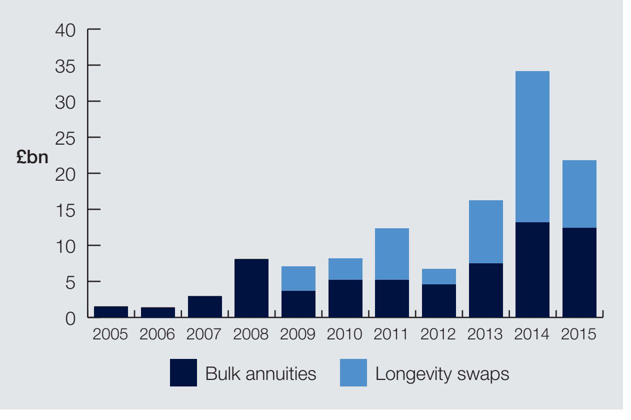
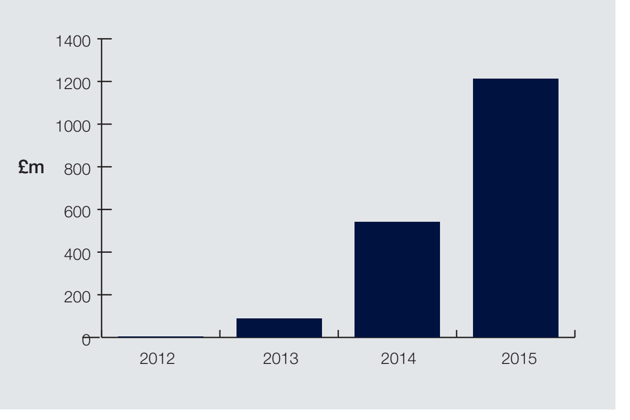


Chart 2: Medically underwritten bulk annuities market volumes since 2012



Note: The 2014 figure in chart 2 (£542m) differs from the estimate of £700m reported by other commentators, since it excludes two deals written by Just Retirement which were in fact transacted on a non-medically underwritten basis.

MARKET SHARES

Chart 3: Bulk annuity market shares (2008-2015)

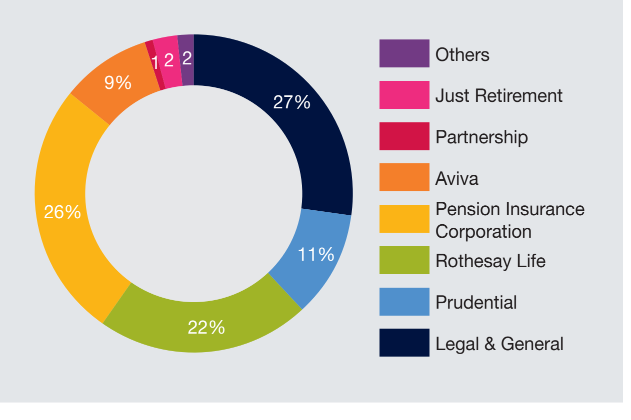
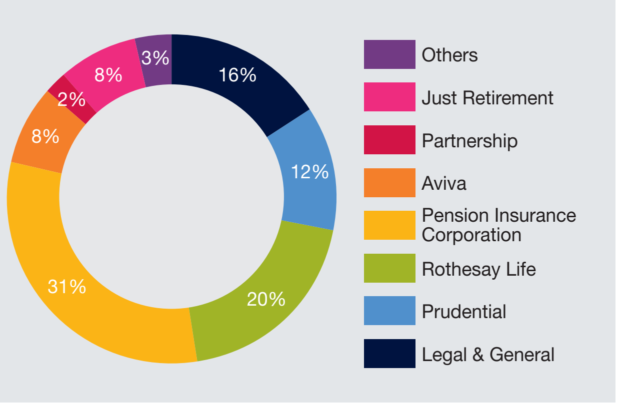


Chart 4: 2015 bulk annuity market shares



Note: Market shares in chart 3 include historical acquisitions (e.g. Legal & General's share includes business written by Lucida).

LARGEST DEALS

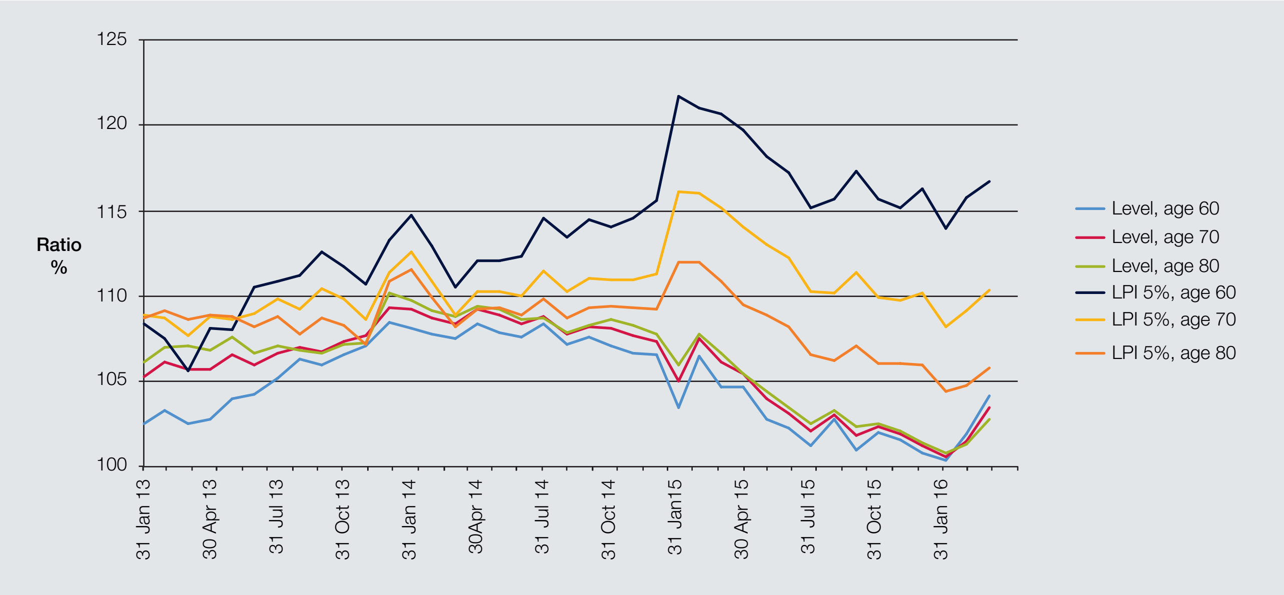
	Buy-ins	Buyouts	Longevity swaps
Largest deals pre 2014	Cable & Wireless £1.0bn (Prudential, 2008)	EMI £1.5bn (PIC, 2013) T&N £1.1bn (L&G, 2011)	BAE Systems £3.2bn (2013) Rolls Royce £3.0bn (2011)
Largest deals in 2014	ICI £3.6bn (£3.0bn L&G, £0.6bn Prudential) Total UK £1.6bn (PIC)	TRW £2.5bn (L&G)	BT £16.0bn (PICA) Aviva £5.0bn (Swiss Re/ Munich Re/SCOR)
Largest deals in 2015	Civil Aviation Authority £1.6bn (Rothesay Life)	Philips £2.4bn (PIC)	AXA UK £2.8bn (RGA)

SPOTLIGHT ON PRICING

AFFORDABILITY

The JLT pensioner buy-in affordability index tracks the relative cost of insuring pensioner liabilities against proxy Technical Provisions. Chart 5 demonstrates that affordability improved for level benefits (i.e. those not increasing in payment) over Q1 2016, but remained about the same for index-linked benefits.

Chart 5: JLT pensioner buy-in affordability index



Note: The figures given are for illustrative purposes only. Trustees' own Technical Provisions assumptions are scheme-specific and hence may differ from those assumed in our analysis. The buy-in price(s) obtained for a given scheme will vary according to a number of factors at the time of approaching the market, including financial conditions and outlook, expected longevity of membership, and insurer appetite and capital requirements.

REGULATORY UPDATE

- Following the abolition of contracting out with effect from 6 April 2016, all trustees should be looking to reconcile their GMP records with HMRC if they have not already done so. This is generally a pre-requisite to finalising a buyout and, given the 2018 deadline for completing this, we would suggest that trustees do not delay what can be a lengthy and time-consuming exercise. There are a number of other aspects that trustees need to consider and potentially to seek legal advice on, including clarifying GMP revaluations for members still in pensionable service, as JLTEB's Client Alert #7 explains.
- In the 2015 Budget, the government announced its intention to create a secondary market for consumers to sell their annuity incomes. HMRC, HM Treasury and the Financial Conduct Authority (FCA) have all issued consultations (in March/April 2016) on the proposed details. These include a requirement for all firms wishing to "buy" rights under an annuity to be regulated by the FCA, meaning that most pension schemes are unlikely to be able to do so. However, investment opportunities may arise for pension schemes through the securitisation of annuity income streams purchased in the secondary annuity market. Trustees will need to take advice on the suitability of these instruments as, for example, a match for their pension scheme liabilities. Trustees may also need to decide whether to assign individual annuities held in the trustees' name in order to allow individual scheme members to sell their annuity income.
- The Pensions Regulator's annual defined benefit (DB) funding statement (PN16-24) was published in May 2016. This highlighted key principles of the DB funding code and provided an insight into what tPR expects of trustees and sponsors in the prevailing economic climate – described generally as one of increased scheme deficits, but also one of improved corporate profitability and, in tPR's opinion, increased affordability of additional contributions. It also makes clear the importance tPR places on a proportionate Integrated Risk Management approach to understanding a scheme's exposure to different funding risks. We are seeing an increase in trustees using their triennial funding valuation to assess the affordability of a buy-in solution (to fully hedge the funding risks in respect of liabilities covered) and secure additional funding (where required) for this through their funding negotiations. Sponsors are generally supportive of diverting some funding contributions to achieve a significant and measurable reduction in scheme risk.

BUY-IN CASE STUDY

BACKGROUND INFORMATION

The trustees of the scheme, supported by the sponsor, wished to partially de-risk the scheme via the purchase of a bulk annuity policy covering the liabilities for a group of pensioner members. The trustees intended to use a proportion of their "matching" assets (i.e. gilts and bonds) to fund a transaction.

Investment in a bulk annuity policy was supported by the sponsor, a multi national employer operating in the industrial sector. The UK operation is a successful entity but the size of the pension scheme (and the associated risk) is disproportionally large in comparison - from this stemmed a desire to cap the risk in respect of the pension scheme, subject to an acceptable price.

WHAT WAS THE CHALLENGE?

The trustees had set up a trigger for a bulk annuity transaction linked to the value of the relevant Technical Provisions, and, implicitly, linked to the yield of the assets earmarked to pay for the transaction. An early feasibility assessment suggested that market conditions were such that this trigger could be hit relatively quickly.

The trustees were also considering offering members a Pension Increase Exchange (PIE) option, enabling members to receive an increased pension in exchange for lower annual increases going forward. Running the exercise in advance of approaching the market would have meant potentially missing out on favourable bulk annuity market conditions; both exercises therefore needed to be run in parallel. This meant that the broking exercise had to be carefully managed, as the broking data was subject to change while the exercise was ongoing.

THE JLT SOLUTION

The JLT Buyout Team was able to engage four insurers, who were all able to meet the scheme's specific requirements. Quotations were sought for the full pensioner population on a tranched (age banded) basis, with a view that the trustees would secure a policy in respect of the tranches that looked better value for money, within their budget for the transaction.

Two of the insurers provided quotations which hit the financial trigger. As the scheme had substantial concentration risk in respect of a small number of members, the trustees decided to secure a policy covering the members with the top 25 liabilities by size (i.e. a "top-sliced" structure). These members represented under 10% of the population by number but almost 50% of the total pensioner liability - a significant concentration of mortality risk.

WHAT WAS THE OUTCOME?

- The trustees were able to secure a bulk annuity policy at well below the maximum price they would have been willing to pay. To the extent that the yield on the assets used to purchase the policy compared favourably to the yield underlying the policy, the trustees effectively de-risked their longevity in respect of the members covered by the policy for free.
- As the policy covered the scheme members with the largest liabilities, the mortality concentration risk in the scheme was substantially reduced.
- By carrying out a PIE at the same time as the bulk annuity broking exercise, the trustees were able to complete a transaction quickly, taking advantage of positive market conditions.
- Good governance from the trustees, and a thorough understanding of both the PIE and bulk annuity broking processes on the part of JLT, were essential to secure a great outcome.

KEY FEATURES

£29m
pensioner buy-in secured

25
members with the largest pensioner liabilities insured

4
insurers quoted for the business

Canada Life
the successful insurer

PIE
Top-sliced structure incorporating a PIE

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THE JLT EB BUYOUT TEAM

Our team have advised on over 160 buy-in and buyout deals, covering more than £2.7bn of liabilities and transacted with 11 separate insurers. We have a strong record for closing deals, with a conversion rate consistently around 60% or above, as measured by one leading insurer; significantly higher when deals that transact within a further 24 months are included.

Over 2014-2015:

- The team advised on 33 buy-ins and buyouts, including 9 medically underwritten transactions
- We brokered deals with 7 out of the 9 insurers trading regularly in the market over this period, including the first bulk annuity transaction with Canada Life following their entry into the market in early 2015.

Unless otherwise stated, the data on which the analysis in this report is based is provided by insurers on a regular basis. Market data is sourced from Thomson Reuter, FT.com and Google Finance Beta. We have also referenced JLT's internal valuation assumptions guidance. All analysis has been undertaken by JLT. We have relied on the data provided and have not independently verified this information.

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