Buy-out Briefing
May 2016

First Actuarial LLP

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Introduction

Welcome to First Actuarial's review of the latest developments in the buy-in and buy-out market.

In this briefing, we look back at the activity in the market over 2015 and look forward to how the market might continue to develop during 2016.

One of the key innovations in the market over the last year has been the development of "top-slicing", where only a relatively small number of high-liability individuals are insured. Top-slicing can be a cost effective way to substantially reduce the concentration of longevity risk in a pension scheme.

We explain more about top-slicing later in this briefing.

Some definitions:

Bulk annuity

A single annuity policy supplied by an authorised insurance company to pay for pensions for a group of people, typically members of the same scheme. The premium is usually paid in full, at outset.

Buy-in

A bulk annuity policy that is owned by the trustees, and which remains an asset of the scheme. The insurance company pays pension payments to the trustees. The trustees still have legal responsibility for paying members' benefits.

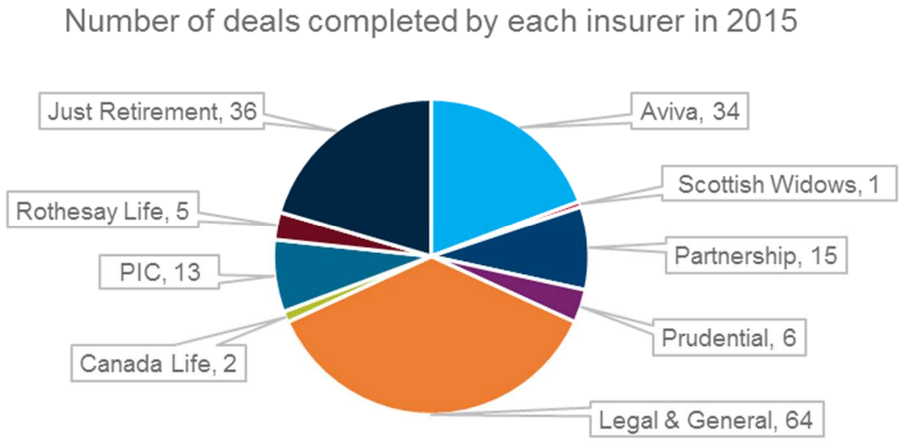
Buy-out

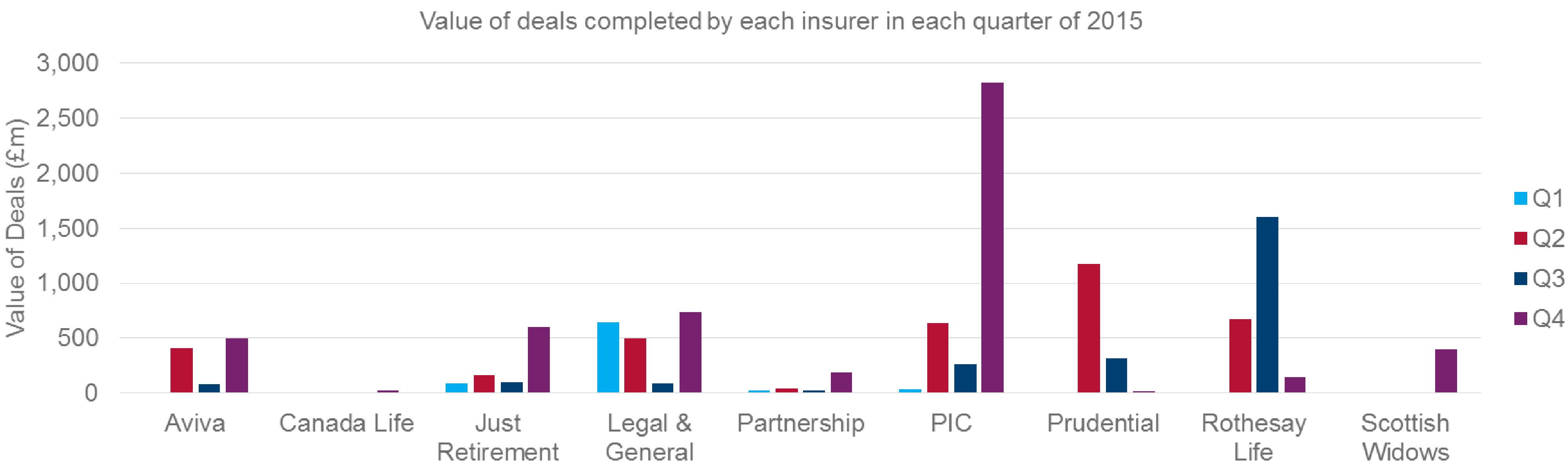
Each individual holds their own policy with the insurance company. Legal responsibility for paying members' benefits passes to the insurance company. Once all the liabilities of the scheme have been transferred to the insurance company, the scheme can be wound up.

Review of 2015

The bulk annuity market remained extremely buoyant during 2015, with around £12 billion of bulk annuities purchased, of which £5 billion was purchased during the final quarter of the year.

For the first time, nine different insurers completed bulk annuity transactions over a calendar year including two new entrants, Canada Life and Scottish Widows who both completed their first deals in Q4.





Top Slicing

A buy-in covering a small number of individuals with the highest liabilities, top slicing can significantly reduce the risk in a pension scheme despite insuring only a few members.

For many pension schemes, the cost of buying-out the benefits will be significantly more than the assets set aside to fund the scheme on an ongoing basis, especially where the scheme contains a lot of deferred members.

For these schemes, it is possible to buy-in a subset of members. For example, a buy-in could be secured for pensioners, where the cost of the insurance contract is likely to be closer to the amount held by the scheme for those members. It is possible to purchase multiple buy-ins as and when the scheme can afford to do so, slowly de-risking the scheme over several years, rather than in one single transaction. And the buy-in policy or policies can ultimately be converted to a buy-out policy, when the trustees wish to wind up the scheme.

A top-sliced buy-in only covers a small number of individuals with the highest liabilities. For example, the largest 10% of pensions in payment can often account for 40% or more of the total pensioner liabilities. Top slicing can therefore significantly reduce the risk in a pension scheme despite insuring only a few members.

Traditional underwriting factors are less useful for underwriting a top-sliced buy-in. By definition, these members are likely to be affluent and live in the most exclusive postcodes. In practice this means that insurers would need to include margins for prudence, over best estimate.

Underwriting can therefore be improved by asking these members for information about their health and any medical conditions they might have. Since traditional underwriting would assume these individuals are likely to be long-lived anyway, the impact of collecting this additional medical information will usually reduce the cost of the buy-in.

For example, learning that an affluent individual is in good health may not change the insurer’s assumption for future life-expectancy significantly whereas learning that the member smokes or has a health condition probably would.

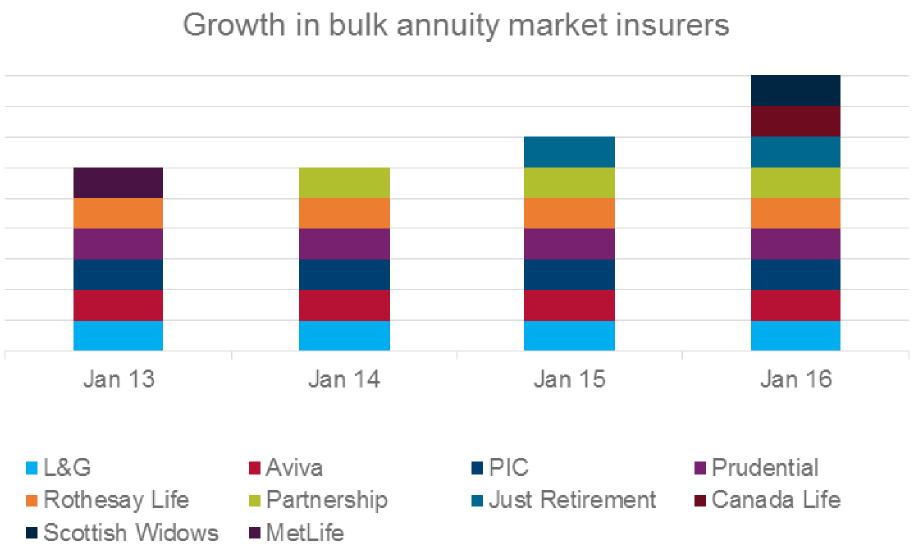
Views on 2016 – Will the market continue to grow?

Despite record low bond yields making some de-risking options look expensive, many trustees and sponsoring employers are still looking to de-risk.

In particular, the popularity of pensioner buy-ins is likely to continue to grow for a number of reasons:

- pension schemes don't have to be fully funded to carry out a pensioner buy-in and therefore don't require a cash injection from the sponsoring employer.
- the cost of a pensioner buy-in is often similar to the amount held by the scheme for those members and may in some circumstances even improve the overall funding level of the scheme.
- a pensioner buy-in may make the remaining liabilities easier to manage as trustees can then focus on the longer duration deferred liabilities that remain uninsured.
- as the pensioner buy-in is held as an investment by the trustees it doesn't mean that pensioners are being treated more favourably than deferred members.

With effect from 1 January 2016, insurers have needed to comply with a new regulatory regime, known as Solvency II. Initial indications are that Solvency II has left pricing for pensions in payment relatively unchanged compared to 2015 prices, but that deferred member pricing has increased (particularly for younger deferreds).



Following the merger between Just Retirement and Partnership in April 2016, there are now eight insurers competing in the bulk annuity market.

Overall, the outlook for 2016 is that the bulk annuity market remains strong, with all the existing insurers continuing to commit to the market and the possibility of further new entrants joining during the year. The increase in competition is great news for UK pension schemes looking to de-risk.