

Bulk Annuities

An Update on the Year and an Annuity Back-Book Cedant's View

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Agenda

Bulk Annuities – An Update

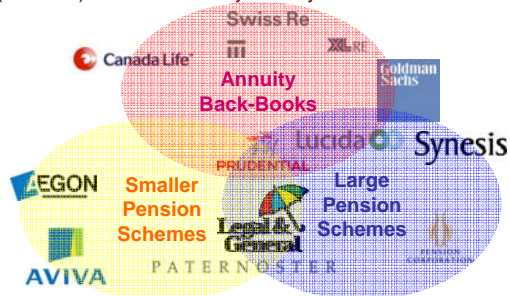
- The Current Players
- Innovation in Structures
- Innovation in Investment
- Some example deals

A Cedant's view

- Timeline
- Criteria
- The process
- After the deal

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(Some of) The Current Players – by Market



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Activity of Some of the Players

Pension Schemes

- Paternoster >£400m assets transferred
- Indications that the established names continue to write bulk annuities for smaller pension schemes.
- Pensions Corporation have successfully acquired several companies for their pension schemes.
- Citigroup acquired a pension scheme.
- Rothesay Life (Goldman Sachs) authorised
- Lucida, Synesis no announcements of deals yet.
- Signs of a lot of quotation activity currently, although this has been present for much of the year.

Annuity Back-Book Deals

- £1.7bn non-profit annuities reinsured from Friends Provident to Swiss Re.
- £3.7bn annuity portfolio transferred from ZFS to Swiss Re.
- £4.6bn non-profit annuities transferred from Equitable life to Canada Life.
- £1.8bn with-profits annuities transferred from Equitable Life to Prudential.

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The Opposition

Tactica Assurance

Founded on the principle of providing an option for managing assets in DB schemes in such a way that these assets are closely matched to the liabilities.

Pensions First

Will issue longevity bonds, tailored to each scheme's individual liabilities.

The impact will be :

- the availability of cost effective, scheme specific investment solutions
- access to a new source of scaleable capital; and
- complete immunisation of all risks.

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An Update on the Market

This year has seen a movement towards the decision to seek a scheme buyout being driven by the sponsor rather than the trustees:

- Pension schemes are now regularly cited as major considerations in transactions.
- A recent survey by PensionsFirst indicated increasing preference to remove the exposure to DB schemes by analysts
 - 49% believe companies would be better off transferring risks and management to a third party
 - 60% believe exposure to DB schemes negatively impact the market's perception of a company
 - 65% would more positively value a company which has immunised its exposure to DB risks.
- Management time spent on pension schemes is an increasing concern.

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What Pension Schemes are looking for from Buyout Providers

Pension scheme buyouts are increasingly being driven by sponsors rather than trustees.

This has changed the criteria a buyout customer is seeking:

- Brand Name
- Administration abilities
- Transfer of risk
 - Level of indemnification
 - Covenant
- Low price
- Financial Strength
- A share of profits
- A smooth process

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Innovations in Structure – Reducing the Price

A lot of innovation has taken place in the year to bring buyout solutions further into contention:

- Enhanced transfer value exercises
- Phased transfer
- Partial Buyouts
- Phased premiums
- Trivial commutations
- Fees paid to cedants rather than a refund of surplus
- Member options written in insurance contract using scheme factors not insurance factors
- Assumption review
- De-risking pension schemes before transfer

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Innovations in Structure – Separating the Risks

Risks are increasingly being identified, quantified and hedged. Methods used are:

- Risk Register exercises
- Interest rate swaps
- Longevity swaps / indices
- Separate investment solutions for longevity, inflation and duration matching
- Insurance of selected risks

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Innovations in Investment – Better Matching

Liability Drive Investment and other methods of better matching the liabilities are being used by Pension Schemes to remove the investment risk.

Moving towards the approach Insurance companies historically use...

- LDI
- Bond matching
- Interest rate swaps
- Inflation swaps

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Innovations in Investment – Better Yields

Buyout companies are increasingly seeking higher yields to bring down the cost of buyout and taking carefully selected investment risk. Moving towards the approach pension schemes' historically use...

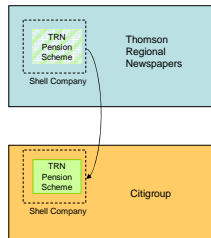
- Liber+ investments – backing floating for fixed swaps
- Short-term vs Long term matching
- Increased appetite for speculation
- Holding equities
- Transferring offshore
- Use of mortgages
- More appetite for risk, more capital

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The Deals – Citigroup and Thomson Regional Newspapers

Transfer of a pension scheme from one company to another

- Pension scheme in surplus
- Citigroup have stated this is a one-off transaction with TRN meeting certain criteria check criteria
- Pension scheme transferred within a shell holding company
- Citigroup has a very large balance sheet and this helps satisfy the pensions regulator and trustees
- How will further surplus be extracted?
- What will happen next is not clear
 - Would expect transfer to an insurance company – within Citigroup or without.
- Only Citigroup have taken this approach. But watch Goldman Sachs, Bank of America and other highly rated banks.

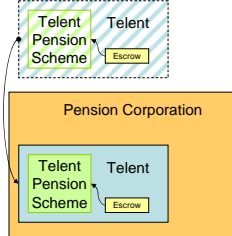


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The Deals - Pension Corporation and Telent

Telent bought for the pension scheme

- Originally carved out from the Marconi Group
- Supported by an escrow account that was also transferred
- PC executives to be installed on board of trustees
 - This has not been achieved and PC have been given the option to walk away from the deal.
- Would have expected Telent to be sold on (less pension scheme)
- Will any additional value be extracted?
 - Likely transfer of liabilities to an insurance company.
- Only carried out by PC so far, who have used this model on the Thorn and Threshers schemes



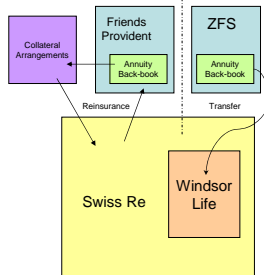
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The Deals – Swiss Re and ZFS/Friends Provident

Two different large annuity back-book deals, one reinsurer

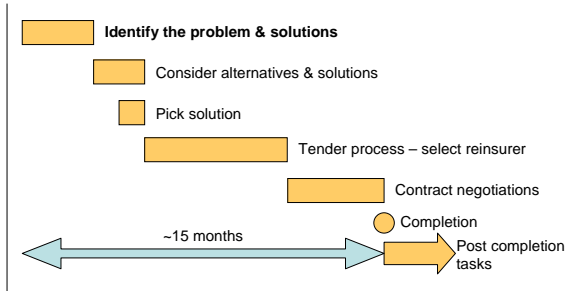
- Swiss Re have dominated the market this year
- ZFS annuities £3.7bn
- Friends Provident annuities £1.7bn
- ZFS chose to fully transfer the annuities and pass over administration.
- Friends Provident continue to administer the business and reinsure the business
 - Need VERY strong collateral arrangements in place.



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The Cedant's View

Timeline



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Identify the problem

- In 2003 we recognised that longevity was increasingly becoming an issue for us, put into focus by:
 - Increasing pensioner longevity / cohort effect
 - ICA
 - Acceleration of vesting annuities
- It was clear that it would be prudent to reduce our exposure to annuitant longevity

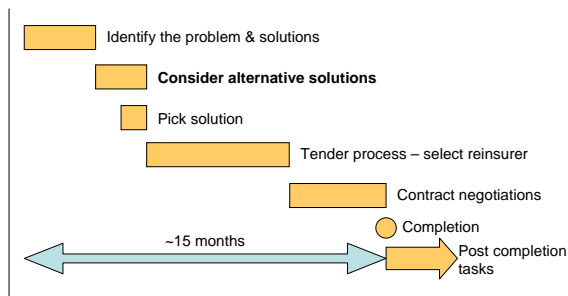
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Identify the solutions

- We identified 3 potential approaches to reducing our longevity exposure
- Bulk Annuity Reinsurance
- Part VII Transfer
- Alternative Risk Transfer

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Consider the alternatives – Bulk annuity reinsurance

Advantages

- Relatively quick to effect
- Competitive market should mean good price
- We can retain the relationship with the customer

Disadvantages

- Gain significant credit exposure to the reinsurer

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Consider the alternatives – Part VII transfer

Advantages

- No residual credit risk
- No administration

Disadvantages

- Lose link with customer
- Need to go through court process. Slow and costly.
- Potential reputational risk

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Consider the alternatives – Alternative risk transfer

- This covers things such as mortality swaps, longevity bonds and other innovative instruments

Advantages

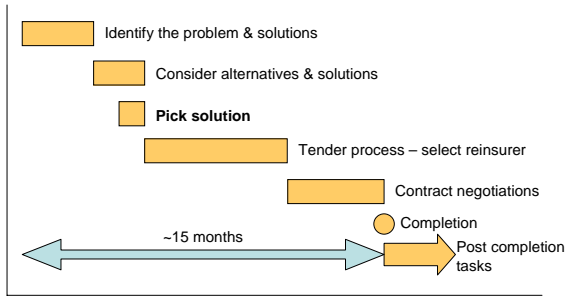
- Interesting!
- Potential to get better price
- Could potentially leave assets on our balance sheet

Disadvantages

- Untried
- Not a perfect hedge
- Could be difficult to put in place

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Consider the alternatives – decision time

- Reinsurance was the appropriate choice for us
- We had experience of standard protection reinsurance, but bulk annuity reinsurance was something different
- To reinsure our liabilities we would:
 - Pass over the assets backing the reserves
 - Recognise the reinsurer's share of liabilities in our accounts
 - Continue to pay annuity claims to policyholders
 - Reclaim payments from the reinsurer

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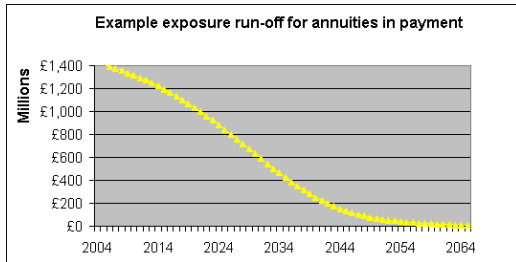
Decision made - Reinsurance

- Having selected reinsurance, we looked to see how we could mitigate the risks involved, particularly the credit risk
 - Multiple reinsurers
 - Collateral
 - Credit rating
- Calculating credit risk:
 - Likelihood of default
 - Loss given default

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Run-off of exposure



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What we were looking for from a reinsurer

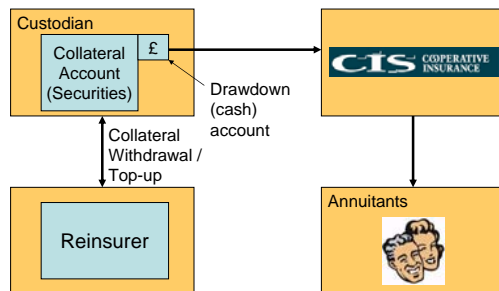
- Financial strength of chosen partner
- Structure to mitigate our credit exposure
- Transfer of risk (amount of business they will accept)
- Low price
- Experience of previous transactions
- Brand name
- Willingness to be flexible over terms



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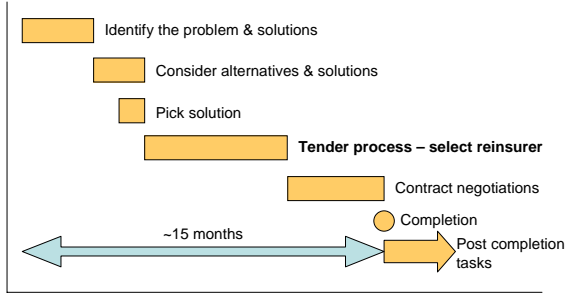
How bulk annuity transaction would work



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Tender process

- Define Terms
- Contact potential reinsurers
- Get responses and indicative quotes
- Shortlist reinsurers
- Complete detailed due diligence
- Select reinsurer

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Terms

- **Identify things that you can't live without:**
- Security
 - Default events
 - Recapture rights
 - Ringfenced collateral account
 - Investment policy
- Structure of transaction
 - Retaining administration of policies (or not)
 - Administration and operation of transaction
 - Minimum quota share
- Reinsurer
 - Geographical location of reinsurer
 - Structure of reinsurer (Pure reinsurer? Part of group?)

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Tender process - results

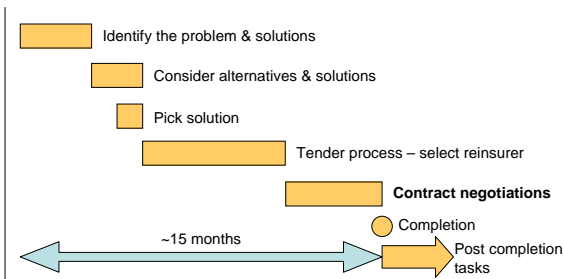
- We shortlisted several quality reinsurers
- Selection criteria included:
 - Likelihood of default
 - Consequences of default
 - Other structural features
 - Price
- We reinsured the block as 75% quota share, then reinsured the remaining 25% with another reinsurer
- The reinsurer selected to take the larger share had a better credit rating
- Now it was time for contract negotiation – and that means lawyers!



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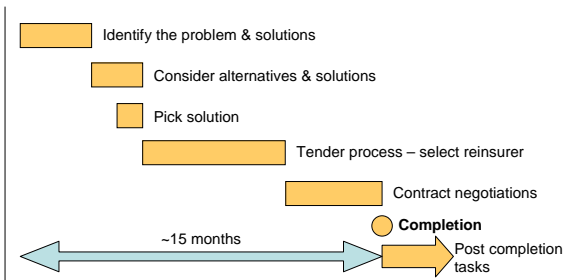
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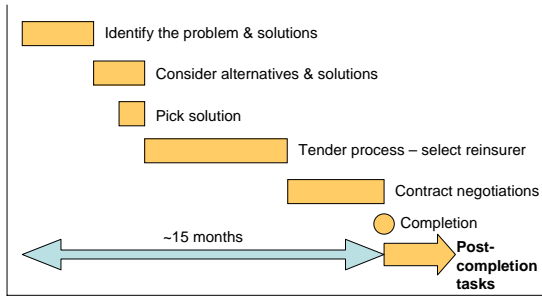
Timeline



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Post-completion



- On-going requirements:
 - Monitoring collateral account
 - Monitoring reinsurers – credit rating, share price, news etc
 - Events of default
 - Operational issues
 - Valuation methodology

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The changing marketplace

- We have now completed 3 reinsurance transactions:
 - In 2004 we contacted 11 potential reinsurers
 - In 2006 we considered over 30 potentially interested parties
 - Much more competitive market
 - Bidders seeking to differentiate not only on price but on structure and on additional features
- Although we have now significantly reduced our longevity exposure to a point where we are comfortable, we will continue to monitor the bulk annuity market, with a particular interest in new innovative structures

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ANY QUESTIONS?

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