Rothesay life

Great expectations

Sammy Cooper-Smith, co-head of business development, David Land, chief information officer, and Graham Butcher, chief underwriting officer at Rothesay Life, expect de-risking and buyout volumes to soar in the new year

Sammy Cooper-Smith

***Buy-side Risk*: What are your expectations for the pensions de-risking market in 2017?**
Rothesay Life: It looks as if it will be a busy year, with volumes – excluding insurer-to-insurer deals – surpassing those of 2016.

Buyout volumes specifically, as in the full settlement of schemes, should be higher as we see a continued desire for sponsoring employers to settle a liability they have little control over and remove volatility from their balance sheets. And the demand we are seeing from overseas sponsoring employers that can now afford to meet the full liability cost due to the weakness of sterling will crystallise in 2017.

It is also possible, in light of the events surrounding British Home Stores and Tata – as well as the UK Work and Pensions Committee inquiry headed by Frank Field – that we will see more pension compromise deals where schemes secure benefits in excess of those provided by the Pension Protection Fund, but not quite as far as securing full benefits.

Furthermore, the relative lack of longevity swaps completed in 2016 may mean a glut of deals in 2017 or that the reinsurance market turns its attention to providing its capacity to funded – buy-in/buyout – business allowing for higher volumes of buy-ins and buyouts.

***Buy-side Risk*: What challenges and opportunities are emerging as insurers become familiar with using the Solvency II matching adjustment (MA), and how do you see firms using MA, going forward?**
Rothesay Life: The great challenge created by Solvency II in the pensions de-risking market, which has a direct impact on pension schemes and trustees, is with respect to member options such as cash equivalent transfer value (CETV) and tax-free cash.

Graham Butcher

When purchasing a bulk annuity, trustees have an understandable desire to replicate the basis they use for calculating member options. In order for insurers to achieve MA, they need to demonstrate that no-one, neither individual scheme member nor trustee, can enact an option within the contract that would result in the insurer having a requirement to pay an amount in excess of the technical provision held to meet the annuity.

This issue is most stark for CETV. As scheme funding improves, the trustees have a tendency to provide a more generous basis for calculating CETV. This creates the scenario where, upon purchasing a bulk annuity policy, the CETV basis needs to worsen as the scheme basis pays an amount in excess of the Solvency II technical provisions. The potential gap in value means that some trustees feel that a careful member communication exercise is needed ahead of transacting to explain the upcoming change to the members of the scheme.

David Land

One challenge of running a matching fund is working to the rule that its assets may not be used to support other parts of the business. When this is combined with the rule that the only derivatives permitted in an MA fund are those that convert an asset's cashflows to fixed sterling, it is clear how liquidity becomes harder to manage. Your risk management derivatives are all in the non-MA fund and require you to post collateral when they move against you, but most of your potential collateral is tied up in the MA fund and unavailable for posting.

As a result of these complexities, the main opportunity seems to be the growth of insurer-to-insurer transactions, where existing annuity books sitting with multi-line insurers are transferring to annuity specialists. Where annuities make up a small proportion of an insurer's balance sheet, it may conclude it is simpler and more cost-effective to transfer the annuity portfolio to a firm that specialises in this area rather than meet the complexities already mentioned.

***Buy-side Risk*: What are your hopes and expectations regarding possible revisions to Solvency II, and how might Brexit affect the regulation of UK firms in future?**
Rothesay Life: Our expectation is that nothing much changes in the short term. Solvency II has been adopted under statute in the UK so will continue to operate 'as is'. As and when Brexit is triggered – whether hard or soft – we assume the UK will apply for equivalence and that this will be granted, but will probably be governed by the tone we take in our overall negotiating strategy.

Over time we would expect the UK to follow and implement the rules as they change; however, without representation at the negotiating table and then to say categorically we would follow all new rules would seem to give hostage to fortune. Our hopes probably revolve around changing the formulation of the risk margin to reduce the interest-rate sensitivity, such that the risk margin has a similar duration to the underlying liabilities and reduces balance-sheet volatility.

***Buy-side Risk*: Where do you see attractive opportunities in holding assets that are especially suited to an annuity firm?**
Rothesay Life: Given the long-term nature of annuity liabilities, our primary focus is on asset-liability matching via investments in long-dated assets with a high level of security derived from their creditworthiness, as well as additional security features. This has led us to make significant investments in government, government-guaranteed and supranational bonds, which are relatively attractive from a return-on-capital perspective in a tighter-spread environment, and highly secured investments such as residential ground rent loans, senior commercial real estate financing and lifetime mortgages.