Risk publications

Risk.net Buy-Side Awards 2016

Insurer of the year

Risk.net December 2016

Rothesay life

Insurer of the year

Rothesay Life

Tom Pearce, Rothesay Life

Rothesay Life's agreement to buy Aegon's UK annuity book in April was a turning point for the insurer that came at a turning point for the market. Amid uncertainty about the effect of Solvency II on annuity firms and buy-ins, Rothesay closed the biggest insurer-to-insurer buy-in so far – a deal that boosted its book by one-third – and the first such deal under the new capital regime.

The transaction, which is structured as reinsurance to be followed by a Part VII transfer, makes Rothesay the fourth-largest annuity provider in the UK, adding 180,000 customers and providing the impetus for the insurer to boost its team from 100 to 150 in the space of 12 months. It called for the first discussions with regulators about recalculating Solvency II transitional measures, a topic of critical importance for similar deals in future.

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>
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"This moves us up the scale dramatically," says Sammy Cooper-Smith, co-head of business development at Rothesay in London.

"With that, you get more people knocking on your door with ideas because they realise the scale of the assets available is bigger."

Closer to an IPO

The deal also moves privately owned Rothesay closer to a possible initial public offering (IPO), says Cooper-Smith: "One of the things we have said is we need to be IPO-ready. To get to IPO, you need scale – and that scale comes with the amount of capital the back book throws off. The Aegon deal is a big step towards what is required."

Aegon UK's chief financial officer, Stephen McGee, says he planned to split the trade into a number of tranches of roughly equal size when the firm first approached buyers in September 2015: "Annuities are a capital-intensive business under Solvency II. We knew there was a competitive market, and saw an opportunity to de-risk."

Rothesay would have taken on the full £9 billion ($11.2 billion) portfolio, he says. But Aegon wanted more than one counterparty for such a big deal. During the period from the buy-in to a Part VII transfer of liabilities – planned in 2017 – Rothesay reinsures the risk, but the liabilities remain on Aegon's books.

Rothesay, therefore, took on £6 billion, while Legal & General subsequently reinsured the remaining £3 billion.

Rothesay was "crystal clear about what it could and couldn't do" – the most "credible" of participants in an open tender process, McGee says.

Scaled back offerings

A combination of capital requirements under Solvency II and low rates is forcing insurers to ask themselves whether annuities is a business they want to be in, with insurers such as Standard Life, LV= and Prudential scaling back their offerings.

"An annuity business sitting within a multi-line insurer can look like a drain on the rest of their business," says Cooper-Smith. "The process and effort of managing an annuity portfolio with the matching adjustment [MA] means you may be better off finding a new home for even large back books if they are a small proportion of the balance sheet – freeing up capital and putting that capital to work in your core business."

For specialists such as Rothesay, though, unwanted back books have particular appeal, he says: "Because it is old business it works quite neatly under Solvency II because transitional relief can transfer from the current owner to the new owner, whereas new pensions business does not come with any transitional benefits any more."

That was uncertain to be true, however, when negotiating the deal. Rothesay needed clarification from the UK's Prudential Regulation Authority (PRA) that the transitional would apply, but had to agree exclusivity and terms with Aegon before the PRA would take the question to its policy committee.

Some of the negotiations were difficult, but we always knew why they were doing what they were doing," says Aegon's McGee. "It felt like they had thought everything through and showed real expertise on the risks of an insurance-to-insurance transfer under Solvency II." ■

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

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.

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.

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.

Graham Butcher

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.

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.

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.