Capturing the pricing peaks

Michael Walker explains why a phased approach in the bulk annuities space can help pension scheme funding

Volatility in financial markets can play havoc with pension scheme funding – but has also provided fantastic de-risking opportunities for the well prepared. In recent months, several pension schemes have secured exceptionally priced bulk annuities as the next step of their phased buy-in strategies. But why should you adopt a phased strategy and how do you decide which members to insure?

Single transaction or phased approach?

A key consideration when establishing your bulk annuity strategy is whether you plan to buy out your entire scheme in a single transaction when that is affordable or whether you prefer to purchase a series of buy-ins over a number of years along the way. Waiting for a single full scheme buyout transaction is often perceived to be simpler and to incur lower costs, but for many pension schemes this approach may not deliver the best outcome.

Phased bulk annuities can have the following advantages:

- Earlier risk reduction
- Improved returns
- Improved insurer engagement
- Faster follow-on transactions

A first bulk annuity transaction requires extensive groundwork – trustee and sponsor education, data cleansing, insurer due diligence and contract negotiation. Follow-on transactions benefit from this preparation, resulting in simpler and quicker deals. Insurers also have greater confidence that a follow-on proposal will transact, potentially leading to better pricing being offered.

However, the main benefits of a phased approach are the earlier risk reduction and the potential to capitalise on the favourable pricing that arises from time to time.

Aon acted as the broker on follow-on transactions for Smiths Group, Alcatel-Lucent, the Civil Aviation Authority and Pilkington between June 2016 and January 2017, in each case delivering very favourable pricing and facilitating a significant increase in each scheme's existing insurance coverage. It was no surprise that the preparation and initial transactions completed by these schemes allowed them to be some of the first to benefit from the improved pricing.

By securing tranches of a scheme's liabilities in phased transactions, the interest rate, inflation, asset and longevity risks are all removed at an earlier point, delivering materially improved risk reduction.

Bulk annuity pricing has been volatile in recent years. In early 2016, a typical pensioner bulk annuity transaction delivered a return of around gilts + 0 per cent p.a. Following the Brexit referendum it was possible to purchase a bulk annuity with returns of around gilts + 0.4 per cent p.a. equivalent to a reduction of £4 million to £6 million for a £100 million bulk annuity premium. By adopting a phased strategy, pension schemes can dip in and out of the bulk annuity market, capturing the favourable pricing peaks.

Which tranche to insure?

Trustees and sponsors need to decide which members to insure under a phased approach. Pensioners are cheaper to insure than non-pensioners as they pose less risk to insurers, mainly due to the shorter expected cashflow duration. As a result, almost all phased bulk annuities cover pensioners. The tranching approaches used when deciding which pensioners to insure include:

- Largest pensions
- Oldest members
- Youngest members
- Specific benefit structures
- Random sample

The choice of approach depends on the interaction of the risk held for each member within the scheme and the pricing available from insurers, with simpler, older populations offering the best price but lower risk reduction. In 2015, medically underwritten top-slice transactions that insure the largest pensions were particularly popular. Since then, a wider variety of tranching approaches has been adopted, with some schemes even offering a range of options to the insurance market to determine where insurer pricing was most favourable.

The future

As funding levels improve, demand for insurance solutions will increase. Schemes that have carried out initial bulk annuity transactions will gain greater traction with insurers for later transactions and be able to complete faster transactions, capitalising on favourable pricing. Crucial to success is planning and preparation – trustee and sponsor education, as well as data cleansing, cost small amounts up front but will pay significant dividends.

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