Risk transfers in 2023 and beyond

Rosie Fantom looks at recent developments within the bulk annuity market

Many more DB pension schemes are now expected to be able to fully secure their liabilities with an insurer, whether due to steady progression of their de-risking journey or unhedged positions leading to an unexpected funding improvement during 2022.

We are expecting to see the market top £40 billion in 2023. In absolute terms, this may not break 2019's record for bulk annuity volumes. However, if adjusted for recent long-term interest rate changes, this would represent far more than that seen in past years.

In reaching a funding position where a transaction is affordable, schemes must act quickly to lock-in these improvements in scheme funding and protect against potential subsequent falls in yields over 2023.

Failure to do so could mean some of the significant funding level improvements seen over 2022 could be lost.

Improved insurer pricing

Following a gradual improvement over the second half of 2021, pricing improved significantly in early 2022. This reflected an increase in the additional yield available on corporate bonds compared to gilts resulting in a sustained period of attractive pricing. Although credit spreads narrowed towards the end of 2022 and into 2023, pricing remains attractive compared with historical levels.

While demand for transactions is set to be high, healthy insurer competition should support attractive pricing.

Given the outlook for a busy marketplace, it is more important than ever that schemes are well-prepared for a transaction before approaching the market. Data readiness, comprehensive benefit specifications, and effective governance structures will help gain greater insurer engagement.

Gilt crisis impact

Liability-driven investments (LDI) were particularly challenged during the gilt market volatility over September/October 2022. Rapidly falling gilt prices caused leverage levels to increase and collateral payments were needed at very short notice to maintain hedging levels. In some cases, hedging exposure had to be reduced, either at a scheme level because insufficient collateral was available or within the pooled funds themselves where there wasn't time for collateral to be called from investors.

As a result, LDI managers have permanently reduced leverage levels to make the funds more robust in the event of future market volatility, considering communications from the regulators and market trends.

This has implications for investment strategies which could impact the speed and certainty of buyout journeys. Schemes will now have to:

• invest more in LDI to achieve the same level of hedging and therefore less in return seeking assets; or

• retain the same allocation to LDI but accept lower hedging levels, and therefore more volatility in funding position.

Schemes should use leverage with caution when building a buyout-ready investment portfolio.

Alternative transaction options

Superfunds

Given the lack of transactions announced in 2022 in this space, the industry will be watching to see whether 'superfunds' can get off the ground with their first transactions, and indeed whether we will see other capital-backed solutions utilised by more schemes.

With Clara-Pensions having completed its regulatory assessment in late 2021, there has in theory been no barrier to transactions, although the first deal is yet to be announced: Schemes initially considering superfund transactions may now be in the zone where an insurance transaction is achievable may account for this. That said, we can see some merits in these options for schemes where insurance transactions are not viable.

The industry will be paying attention to challenges faced by other providers in this market, noting the well-publicised failure by The Pension SuperFund to emerge from its own regulatory assessment process.

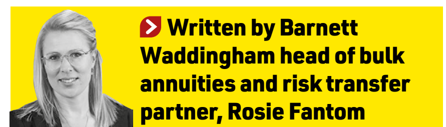
Other capital-backed solutions

Similarly, 2023 will be a year in which the market for other forms of capital-backed risk transfer may take off. Only one capital-backed journey plan (CBJP) transaction has been completed, in 2020, but several new providers have entered the market and commenced detailed discussions with scheme sponsors and trustees.

CBJPs are primarily investment products, meaning there are fewer regulatory barriers to transaction. Scheme specific circumstances tend to be key for these deals, rather than a blanket solution for all schemes.

The CBJP providers will continue to progress conversations with schemes and sponsors during 2023, with every possibility of further deals being announced.

• This article was adapted from BW's 2023 Risk Transfer Report.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