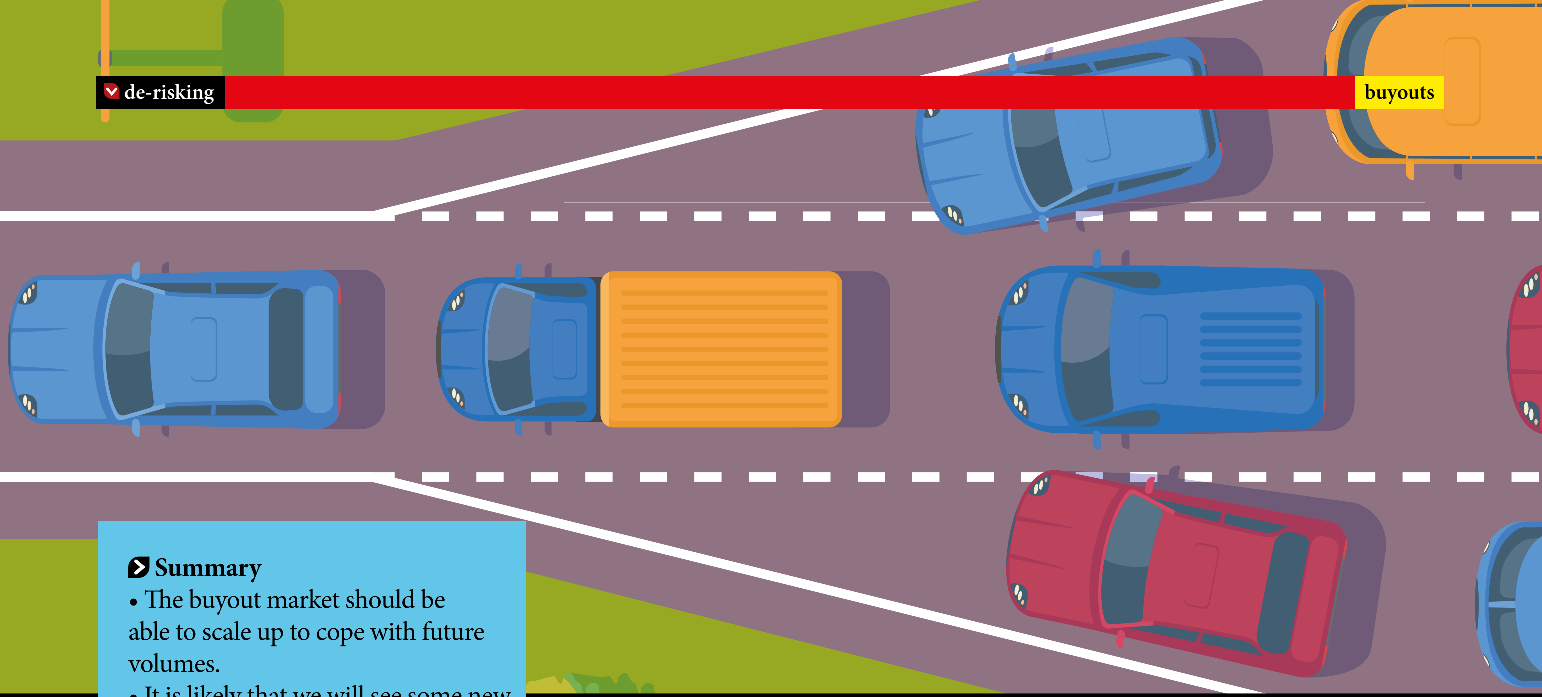


Summary
- The buyout market should be able to scale up to cope with future volumes.
- It is likely that we will see some new entrants, but the bulk of business will be with existing insurers.
- Pricing is likely to remain competitive.
- The market is likely to be worth £40 billion p.a. over the next five to 10 years.

Buyout bottleneck?

As a buyout is increasingly the end goal for DB schemes, Maggie Williams explores the capacity of this market to meet demand

The next decade could see a revolution in defined benefit (DB) pensions. According to Aon's recent *Global Pensions Risk Survey*, buyout is now the leading long-term aim for DB schemes, with 47 per cent of schemes in the survey planning to transact, in an average of 8.8 years. That could mean a very different DB landscape by the end of the 2020s.

However, intention and reality can be very different. For schemes to achieve those long-term aims, funding levels, scheme governance and insurer capacity will all have to align.

The statement of schemes' intent shown in Aon's findings is backed up by projected funding levels: "We anticipate a large increase in the number of schemes reaching buyout funding level in the next 10 years, with a significant proportion in a five to 10 year period," says Barnett Waddingham partner, Gavin Markham.

However, he cautions, "that depends on investment performance being as expected, along with contributions and insurer pricing as well. So, this is just an expectation – it will be subject to individual schemes' position and experiences."

Even with those caveats, it is clear that demand for buyout is set to increase substantially in the next decade. With just eight key providers in the market to handle the volume, can the market cope?

"There has been some scaremongering and concerns that capacity will dry up," says Aon head of bulk annuities, John Baines. "I think that's overstated. We have seen the market scale up very quickly in the past in response to doubling of demand between 2017 and 2018, and again between 2018 and 2019."

But Baines admits that there will be risks: "From an administration point of view, taking on what will be huge swathe of schemes over the next few years will be challenging for insurers, and so will raising the appropriate capital. However, the market has shown time and time again that it can rise up to these challenges and deliver."

The next few years could also see multi-billion pound 'mega schemes' start to transact, which could have a temporary impact on capacity, says Baines. "There will be peaks and troughs – capacity won't be a steady figure. We've not seen any very large schemes come to market yet, and if one or two decided to transact in the same year, that could have an effect on overall capacity. But that is a short-term, not a long-term, issue."

Baines believes there could be new entrants into the buyout market, hoping to benefit from the projected surge in transactions. "To date, capital has tended to flow to existing insurers rather than new insurers setting up, and I think most of the capacity needed will continue to come from existing insurers. But I think it's inevitable that we'll see some new players."

The Pensions Regulator's recent

authorisation of Clara-Pensions will open up new long-term options for schemes, which could also help to alleviate capacity issues in the buyout market. And River & Mercantile group co-head of solutions, Ajeet Manjrekar, believes there will be future innovation as well: "We expect more entrants and alternatives to buyout – beyond commercial consolidators – to cope with emerging demand."

While insurer capacity may not be an immediate issue, there are other roadblocks that could affect transaction volumes and timings. The most significant of these is insurers' investment strategy. "Insurers need to source sufficient suitable assets to support the level of demand. Although they are increasingly looking at a wider range of investments that may deliver the required risk adjusted returns, there may need to be regulatory action that helps increase the flexibility of assets that insurers can use," says Markham.

"The main pinch point is likely to be availability of high-quality assets that provide good yields," says PIC chief origination officer, Jay Shah. "Currently we are in a very low-yield environment for both government bonds and public corporate bonds."

Shah says PIC currently invests £10.9 billion in privately sourced debt, such as social housing, renewable energy and universities, which provide the yields the insurer needs. "But we would like to invest much more." He cites regulatory barriers, such as Solvency II, as a structural issue that limits further investment, as well as "the government's approach to infrastructure planning, which is not focused enough on the long term. Resolving these issues would give us high quality assets to help secure future pension liabilities".

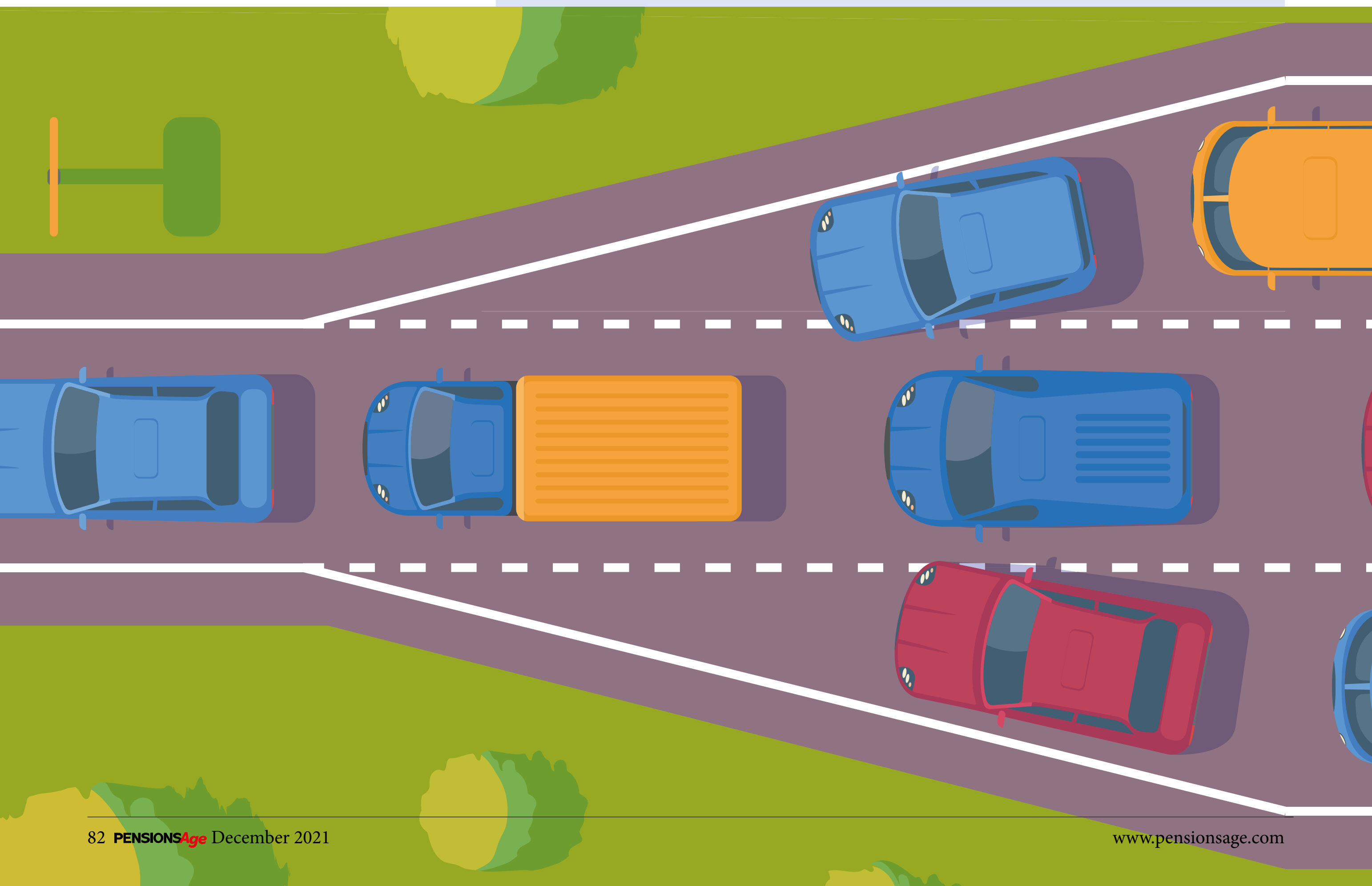
In addition to asset availability, Shah also sees potential shortages in

How big? The projected size of the buyout market

To date, the growth of the buyout market has been an uninterrupted success story. A decade ago in 2012, just £4.4 billion of business was written. In 2020, even against the backdrop of Covid-19, transactions took place worth £30 billion.

As for the future, PIC chief origination officer, Jay Shah, says: "some of the most experiences pension consultancies are doing lots of work to estimate the size of the buyout market in the long term." They will be considering scheme funding levels, company contributions and investment returns, understanding how long schemes will take to get to buyout and their appetite for transacting at that stage.

"Their results are consistent with our view that this is likely to be a £40 billion p.a. market over the next five to 10 years, increasing in the longer term as more schemes reach buyout. We saw 2019 reach a peak of around £40 billion, followed by £30 billion in 2020 and there will probably be a similar figure for 2021."



specialist, experienced professionals – both at insurers and advisers – as a future concern, as well as the possibility of increased demand for longevity insurance.

Bottlenecks such as availability of assets and skills will inevitably raise questions over pricing. "The impact of these limitations on buyout pricing will largely depend on how they are overcome," says Shah. "But it is likely that some pressure will be mitigated by the competition between insurers and the need to keep pricing affordable."

Baines is also confident that pricing will remain consistent "In the recent busy years, pricing has been as good as it's ever been. Even if we see a meaningful increase in activity as anticipated, I would expect pricing to remain competitive."

"When we've had busy periods in the past, it hasn't flowed through into increased levels of pricing," adds Markham. "However, if demand does become very high, a pricing increase is an obvious brake. From a scheme's perspective, that probably means just waiting a bit longer. As populations mature and a greater proportion become deferred members, then that will typically reduce insurance costs anyway."

Baines adds that, while Aon's research shows an 8.8 year average time to buyout, across all schemes that is likely to mean transaction within one to 15 years.

"That's not quite as intense as expecting everyone to transact at once," he says. However, market conditions will mean many schemes make positive gains at the same time. "Most schemes de-risk in a similar way, using similar sorts of assets. If we have a year where market pricing or economic conditions are particularly attractive, or longevity moves in a certain direction and that reduces liabilities, it will affect all schemes in a similar way. That's one of the reasons why we think next year will be very busy. A lot of schemes this year have seen a meaningful improvement in their funding position which will drive a lot of activity."

As well as market conditions, schemes' general readiness to transact will also have an effect. "A major roadblock can be that a scheme is ready from a funding standpoint, but still needs to clean up its data, complete benefit specifications and deal with GMP equalisation. Our advice to schemes looking at buyout in the next 10 years is to start getting ready now," Manjrekar says.

The volume and size of schemes now targeting buyout means that the bulk annuities market will remain as buoyant as ever over the next decade. But, despite the potential for temporary disruptions from mega-transactions and market conditions, schemes have little cause for concern over capacity, pricing or insurer availability over the long term.

Written by Maggie Williams, a freelance journalist