Prepare for lift off

Summary
- This year has been a strong year for buyouts as gilt yield increases improved scheme funding positions.
- Preparation is key for schemes, including benefits specifications and data cleansing.
- Small as well as large schemes have been able to transact with streamlined processes.

With DB pension schemes' funding levels continuing to improve, Maggie Williams investigates what this means for the buyout market

"If you were to travel back in time a couple of years and ask what the impact on defined benefit (DB) pension schemes would be of a global pandemic, followed by a war in Europe, high inflation and market instability, most people would have said it would be a disaster. But actually, for the majority, it's been the complete opposite," says K3 Advisory managing director, Adam Davis.

The whirlwind in markets that accompanied some of those world events has driven major improvements in the funding position of most DB schemes over the past year. As a result, many have found themselves far closer to buyout than they could ever have expected. According to analysis from Barnett Waddingham, FTSE 350 DB schemes' time to buyout reduced by around four years over the course of 2022.

"Many schemes will have seen their funding level improve as gilt yields have risen," says Zedra client director, Louisa Harrold. "Schemes that had been hedged to 100 per cent of technical provisions might have had a slight under-hedge on a buyout position. Therefore, as gilt yields went up dramatically, they closed that gap to buyout. That's meant the timeframe of their journey has shortened, in some cases quite dramatically."

"Ironically, some DB schemes that were less well-prepared have also fared well in 2022, due to their much lower interest rate and inflation hedging," adds Cartwright director of investment consulting, Sam Roberts. "If those schemes were also able to move quickly, they could lock in a buyout surplus they could have only dreamt of before."

Widening corporate bond spreads have also made 2022 an attractive year from a buy-in and buyout perspective, says Davis. "Corporate bond spreads have been wider this year than in 2021, so buy-ins makes more sense than in a tight credit spread environment. But, buy-ins have been overtaken in many cases by improvements in funding positions that mean schemes have looked at a full buyout instead."

A busy year for buyout

These factors mean that total buyout business is likely to be brisk for 2022. The first half of the year saw £12 billion of bulk annuity deals completed, but it's too early to identify the full volume of deals in 2022. Estimates are between £25 billion and £35 billion depending on whether some larger transactions complete before the end of the year.

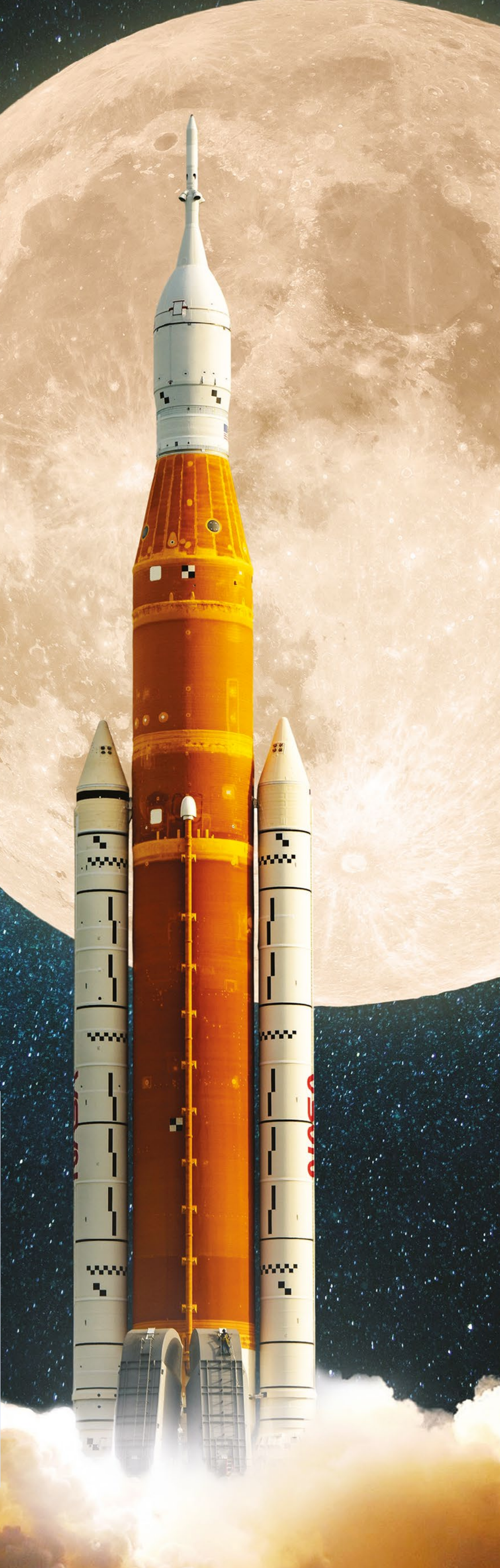
This is roughly on a par with the £27.7 billion written in 2021. However, almost every scheme's liabilities will have shrunk as a result of rising gilt yields. So, while the total premiums may look consistent, behind the headline figure the volume of deals being struck has increased. "There were around 75 to 80 transactions in the first half of 2022, and I would expect as many if not more in the second half," says Mercer head of risk transfer and DB journey planning, Andrew Ward. "There is a strong pipeline and insurers are likely to be signing deals most days between now and Christmas. And, although the first quarter of a year is usually quite quiet, the early part of 2023 is looking very busy indeed."

Preparation, preparation, preparation

Being preparing for buyout is about more than an improved funding position. "Over the past few years, there has been increased focus on schemes being well prepared, nimble and able to make decisions quickly when market opportunities appear," says Aon partner, John Baines.

"Back in September and early October 2022, buyout pricing was spectacular, but only lasted for a few days. It really tested that preparedness to the max, along with whether schemes and their advisers were able to think and make decisions quickly."

Baines says the experiences of the



Five stages to become buyout ready, according to Mercer head of risk transfer and DB journey planning, Andrew Ward

- Feasibility: Are trustees and sponsors confident that the buyout proposal makes sense? Have a realistic target price so that you are not wasting insurance time with transactions that are at best very speculative.
- Due diligence: Does the scheme have an accurate benefits specification? Have any issues around scheme rules been resolved? Increasingly there may be surplus considerations to think about as well.
- Data: Is data fully prepared, including addressing any gaps such as spouses' data.
- Assets: How will the scheme address any illiquid assets and exit these if necessary?
- Governance: What is the scheme's preferred decision-making structure? Will the process need a sub-committee and/or joint working group with the sponsor? Is there a clear timescale and good project management?

past few months will have had a long-lasting impact on trustees and sponsors: "It has influenced mindsets and inspired schemes to genuinely start putting in place governance structures that allow them to capture opportunities if and when they occur."

"Lots of schemes are looking to take action even if they haven't closed the funding gap fully and aren't necessarily going to the buyout market in the next 12 months," says Harrold. "They will be carrying out preparation such as benefits specifications, which take time and involve a team of advisers and administrators. But they are a vital step: Ultimately you want to make sure you are insuring the right benefits when you do go to buy-in or buyout."

Ward identifies five key stages of preparation for buyout *[see boxout]*. "These make sure that you can tell a compelling story to insurers and give them confidence that a deal is likely to happen and won't cause excessive headaches in operational terms."

"Insurers are now certainly looking at some very large transactions and these will inevitably attract lots of competition because of the size"

The people puzzle

Scheme preparedness and efficient governance are likely to become increasingly important from an insurer perspective. "If you look at insurers' balance sheets, it's clear that they have the capital to write a huge amount of business, a multiple of anything that's been written so far," says Baines.

"I also don't see reinsurer capacity running out," adds Ward. "And Solvency II reforms will make it easier for insurers to invest in long-dated stable cashflow assets such as wind farms, solar panels, social housing, infrastructure – many of the opportunities that the UK economy also needs over the next decade or more. So, I don't see any major constraints from an asset perspective either."

"But a potential issue is the people and skills insurers need to write transactions and implement administration in the back end," explains Baines. "That could be the biggest challenge for the industry over the next few years if the buyout market is to continue to grow."

Davis believes that people capacity is an issue from a scheme perspective as well. "The pensions industry is dealing with a lot of initiatives that have to be done, such as GMP equalisation. That is taking up administrator capacity, which is really important for buyout."

He argues that both schemes and insurers need to work more efficiently in order to minimise this risk. "We've worked out ways to work more smartly with a number of insurers. It's also meant we can transact small schemes more quickly with streamlined processes."

Roberts adds that small scheme deals have been a major success story in 2022: "There has been an acceleration in the ability of small schemes to transact quickly and safely, destroying some previous assumptions that such schemes cannot get quotes or transact."

"Different insurers will have different priorities," adds Ward. "Insurers are now certainly looking at some very large transactions and these will inevitably attract lots of competition because of the size. But that doesn't mean there isn't interest for small and medium schemes too, if you can make the process efficient and be realistic about the terms. For example, there may be an acceptable good quality set of standard contractual terms on offer from insurers."

The economic chaos that has characterised 2022 will have a long-lasting impact on the buyout market, with many schemes either unexpectedly able to transact or moving significantly closer to that goal both in terms of funding position and overall preparation. Schemes that have been able to lock in the funding gains they have made will benefit, especially as gilt yields could start to fall again next year. "Those schemes that act first are likely to get the best deals," concludes Roberts. "Those that delay may find themselves with the same frustrating buyout shortfall they had a year ago."

Written by Maggie Williams, a freelance journalist