Spaghetti junction: Pension de-risking

Summary
• The pension de-risking market is growing, with another £30 billion of bulk annuity transactions expected in 2021, in what could be another record-breaking year.
• Despite Covid-19, the market still performed strongly in 2020, with widening credit spreads providing opportunities for well-prepared schemes.
• A 'spaghetti junction' of options are now available to schemes, in addition to the traditional buyouts, buy-ins and longevity swaps; choice is good for schemes.
• When it comes to de-risking, preparation is key.

2020 was the second biggest year on record for bulk annuities, with transactions totalling £30 billion and new de-risking options coming to the market. Natalie Tuck looks at what is in store for the pension risk transfer market in 2021

The pensions de-risking market is showing no signs of slowing down. According to Hymans Robertson's *2021 Risk Transfer Report*, 2020 was the second biggest year on record for bulk annuities with transactions totalling £30 billion.

That does not include other types of transactions, such as longevity swaps, which recorded around £24 billion in 2020. According to Hymans Robertson's report, buy-ins, buyouts and longevity swaps have insured £0.3 trillion of risk from DB pension schemes since 2007. This is expected to increase by £0.7 trillion between now and the end of 2031.

Covid-19 impact

Reflecting on 2020 is not possible without mentioning Covid-19, but what was its impact on the pension risk transfer market? Speaking at a recent webinar, Prudential Retirement head of international transactions for longevity risk transfer, Rohit Mathur, said widening credit spreads resulted in attractive risk transfer pricing during the year.

"We believe that those pension schemes and sponsors that were in a position to transact and were actively monitoring the market, were able to execute their transactions despite the market turmoil we saw last year."

Mercer head of risk transfer, Andrew Ward, expands on this, stating that such schemes were able to "secure more

advantageous terms on bulk annuities than they ever thought was possible."

For Legal & General (L&G) head of origination and execution, pension risk transfer team, Dominic Moret, last year demonstrated the "fundamental purpose of insurance and the strength of the regulatory regime", which he thinks should give comfort to trustees and sponsors looking to de-risk their pension schemes.

Whether there is any long-term impact on longevity as a result of Covid-19 remains to be seen. However, in a press statement, Aon's Risk Settlement Group head of demographic horizons, Tim Gordon, said a poll conducted at a recent Aon webinar for insurers and reinsurers found around 40 per cent of participants thought the longevity outlook from mid-2021 onwards was broadly the same as before the pandemic, with 30 per cent thinking it was slightly worse and 30 per cent thinking it was better.

Striking a more cautious note, Mathur said that as we look ahead the long-term impact of the pandemic is unclear: "The risk is heightened, there is more uncertainty on the path that future longevity improvements can taken. Each time that happens, each time there is greater uncertainty, we believe hedging is more valuable, whether by longevity swaps, or pension risk transfer transactions."

2021: A record year?

While the jury is still out on whether this year will see more records broken, Mathur said many consultants that Prudential Retirement works with predict the market will be around £25-£30 billion this year, which is roughly in line with 2020's figures.

Other experts back this up. However, Moret warns that current market conditions, consisting of low interest rates and tight credit spreads, may affect affordability for some schemes. Appetite remains though for schemes that are well hedged and well funded.

Mercer UK head of bulk pensions insurance, David Ellis, says that 2021 started "a little slowly" but there is every expectation from insurers that business will pick up. "Our pipeline is strong, I imagine others' pipelines are strong… It's just going to grow, so again we're predicting another strong year as part of a strong decade." Ward adds that there is every possibility that 2021 could be a record year, as the "latent demand" is so big.

There is also the question of insurer capacity. Canada Life director of retirement propositions, Nick Flynn, says the firm has seen "significant activity" in February, which he expects to continue. "This may reduce insurer availability later in the year, however, it is too early to tell at the current time."

However, Ward says the industry should be careful with the message of "buy now, while stocks last". Ultimately, he says, capacity centres on assets, and he believes that insurers will be able to "find capital from backers in the medium and long term".

"There may be times where there is a squeeze in demand, that might be driven as much by people capacity as much as anything. All you really need to do is make sure that the process is well run, well managed and well thought through so you can get the attention of insurers. What we say to schemes is the better we can position them in the market, the more competition there will be and the better outcomes they will get," Ward explains.

Long term, the market may look a little different. As Ellis notes, currently there are only eight insurers in the market. However, he does not believe any other companies are planning on entering the market in the short term, with current development centring instead on existing insurers expanding their offerings. Long term though, this may change.

"To think that hundreds of billions or even one or more trillions of assets over the next 50 years will transfer to just eight insurers – it might, but it's quite a concentration. They are of course spreading it out to lots of reinsurers and there's more reinsurers in the market, but we are seeing some of the existing insurers upping their game, taking on different types of liabilities, so there's growth within that part of the market. For example, some insurers were only insuring pensioners; now they are taking on deferred members as well."

Spaghetti junction

Full buyout is often the endgame for schemes on a de-risking journey with some schemes undertaking several buy-ins or longevity swaps in order to get there. However, the market has seen some new types of transactions come onto the scene.

"What's interesting about this year is that in previous years we were talking about those three options, now there is a whole spaghetti junction of different approaches, we've got a spectrum of consolidation options out there," Ward notes.

New options include a capital-backed solution, which is like an investment product with capital backing to underpin returns needed for an agreed journey plan. L&G has also introduced two new products to the market, known as an Assured Payment Policy (APP) and Insured Self-Sufficiency (ISS). An APP, Moret explains simply, is a buy-in without longevity risk cover – the opposite of longevity insurance.

"In return for a premium it provides a pre-agreed series of cash flows which don't vary with longevity or other demographic experience (so the demographic risk stays with the pension scheme). As a result, an APP can be around 15-20 per cent more affordable than buy-in for deferred members," he explains.

"An ISS brings together the toolkit from across L&G – giving access to the investment management and asset sourcing capabilities of LGIM and the risk management framework of the insurance business. Unlike a bulk annuity, the assets and liabilities stay within the pension scheme. Then we introduce two support pillars: a low-risk and holistic cashflow-matched strategy… and a substantial capital buffer on top of that to protect against adverse experience." Moret adds that L&G typically expects ISS to be 10-15 per cent more affordable than a bulk annuity, but adds that it does provide a different form of risk protection.

Since their launch, L&G has completed two APP transactions, covering £650 million of pension obligations, and has a growing pipeline of potential new clients ranging from less than £50 million to around £1 billion. It is also in discussions with a number of schemes in relation to ISS that may result in a first transaction in 2021.

Superfund impact

Although not part of the de-risking market, pension superfunds could soon offer an alternative for some schemes. In 2020, The Pensions Regulator issued new guidance on the superfund regime, which was welcomed by many in the industry. But what impact will they have on the de-risking market?

"I expect the additional competition will continue to help with competitive pricing for buy-ins that cover deferred members. The competition is also likely to create more innovation as insurers, and other capital providers, develop solutions that remove the majority of risks but still share some of the risks with the pension scheme and so can be more affordable than a full buyout," Mullins says.

However, Canada Life director of retirement propositions, Nick Flynn, says that superfunds are targeted at a different sector of the market than bulk annuities. "Superfunds may be the right choice for schemes where buyout is not a realistic prospect over the long term, but where schemes and employers can afford to reach buyout over time the security of an insurance policy is the best way to protect members benefits."

Ward thinks that superfunds could have the biggest impact on schemes that may otherwise end up in the Pension Protection Fund (PPF).

"In a normal circumstance the choice is between employer covenant and potentially getting to buyout or going into a superfund… If the choice is the PPF, or you can exit the PPF, and the key bit, members get a higher level of benefit by going into a superfund… then members could actually get real higher benefits and they have still got a secure regime behind them," he explains.

Choice is positive

With an ever-expanding choice, is this a good thing or will schemes get lost in spaghetti junction? "We like the choice because no one size fits all and every scheme has a unique set of circumstances," Ellis responds. "This is serious stuff, this is individual's livelihoods in retirement, so choice is good. I don't think that the whole market will split, I still think there'll be these main ideas of the bulk annuities and longevity swaps but there will be plenty of schemes that want something just a bit different."

Despite these new products entering the market, the experts agree that buyouts and buy-ins will remain the most popular transactions for schemes. Hymans Robertson head of risk solutions, James Mullins, predicts a "growing trend" of pension schemes being able to afford full buyout. He also expects to see more repeat transactions, where a pension scheme completes its second or third buy-in.

On the longevity swap side, he believes transactions will likely increasingly cover deferred members, as well and pensioners, and the trend of converting historic longevity swaps into buy-ins is likely to continue.

Preparation is key

Fail to prepare, prepare to fail, as the old saying goes, is vital when it comes to pension de-risking.

"Insurance companies hold 'triage' meetings each week to discuss the quotation requests they have received over the last week. Pension schemes need to demonstrate to the insurers why they are a brilliant case for them to focus their efforts on and deliver their best pricing to," Mullins says.

Moret offers schemes some practical advice such as establishing a joint working group between the sponsor and the trustee, which helps ensure that interests are aligned and leads to more efficient decision-making as the project reaches a conclusion. Related to this, he says, is a nimble governance process, which will be essential to take advantage of pricing opportunities that may be short lived.

Schemes are also advised to carry out a feasibility exercise and enlist help from a specialist de-risking adviser, as well as having a clear plan of execution in order to bring together the governance plan and pricing targets. Clean an accurate data is also key and a legally reviewed benefit specification can reduce the risk of benefit errors arising after the transaction, he notes.

Moret adds that working with a specialist adviser to ensure the scheme's asset portfolio is as insurer friendly as possible can deliver pricing benefits and ensure a more efficient transaction process. In addition, early engagement with insurers can assist with knowledge on the process and build relationships ahead of requesting a formal quotation.

Preparation is clearly key. The de-risking journey is no small feat and full buyout, equivalent to closing down the scheme, is often the end goal, which as Ellis concludes is "usually the biggest decision that pension trustees will make".

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