A seismic shift onto shaky ground?

With bulk annuity deals reaching record volumes at the same time as the Solvency II revisions will come into force, Laura Blows explores how much consideration DB schemes looking to buy out should give to these changes potentially increasing risk within the insurance sector

Summary

- The insurance sector is going through seismic change, through both the increased incoming volumes of DB pension money through bulk purchase annuity deals, and the upcoming reforms to Solvency II legislation.
- Concerns have been expressed as to the capacity for insurers to cope with the influx of DB scheme responsibilities and whether the Solvency II reforms may generate a sightly increased risk of insurer failure.
- The risk of insurer failure is still extremely unlikely and, while pension funds looking to buyout should be aware of the changes and challenges to the insurance sector, the increased protection to DB members and the removal of risk for the sponsor should allay any concerns.

Defined benefit (DB) pension fund money is currently cascading into the insurance market. The first half of this year has already seen transactions totalling £21.3 billion, according to the Association of British Insurers (ABI), and it is expected to reach a record-breaking £50 billion by the end of the year. Estimates also suggest that the market has the potential to hit £70 billion over the next few years.

The fallout from the mini-Budget, which generated gilts turmoil last year, has a large part to play in 54 per cent of UK DB pension schemes being able to bring forward their endgames over the past year, research from WTW found in September. This matches analysis from LCP in October, which revealed a more than 50 per cent increase in the number of DB schemes approaching insurers for buy-in/out quotations compared to a year earlier.

In addition to this, LCP projected that a further 1,250 schemes will reach full funding on buyout within the next five years, further accelerating the boom in the pension buy-in and buyout market.

As a result, it estimated that volumes of assets transferring to insurers over the next five years could reach up to £360 billion, marking a "substantial uptick" on historic levels, with volumes over the past five years totalling £155 billion.

At the same time as insurance firms handling this increased influx of DB scheme money, they are also getting to grips with regulatory changes to Solvency II (to be known as Solvency UK once the changes take effect). Of particular interest to pension schemes are the risk margin changes, to be in place by year end 2023, and the matching adjustment changes, to

be in place by half year 2024.

The risk margin reflects the cost of transferring liabilities that the insurer cannot hedge to a third party. For buyouts, this mostly applies to longevity risk. Insurers add the risk margin to their best estimate of the liabilities.

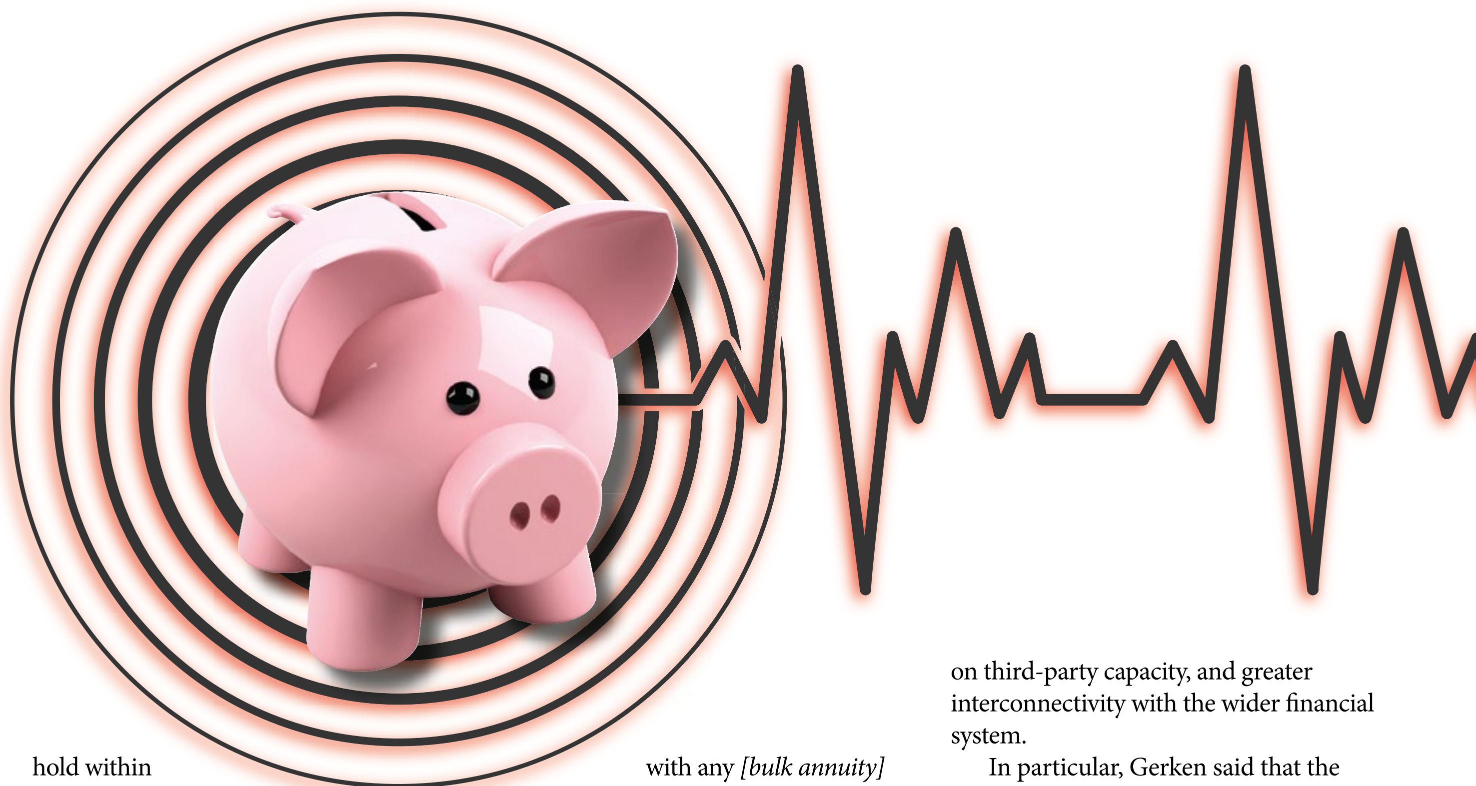
The new approach would reduce the capital required to cover the risk margin by 60-70 per cent.

The new rules would also broaden the range of assets that insurers can hold within matching adjustment portfolios. Matching adjustment enables insurers to recognise a part of the excess returns from eligible assets above the risk-free benchmark in their reserving calculations.

To qualify for matching adjustment under the proposed new regulations, assets will need to provide 'highly predictable' cashflows. This is an important change of wording from the 'fixed' cashflows required by the current Solvency II legislation (which effectively restricts matching adjustments to bond-like assets) and opens up a wider potential range of investments.

Concerns

This period of change for insurers has sparked some concerns. For instance, in January, the insurance regulator, the Prudential Regulatory Authority (PRA), announced that it would undertake a thematic review of the bulk annuity market to "seek assurance that… risk management disciplines are keeping pace with any *[bulk annuity]* growth ambitions".



In April, Bank of England (BofE) executive director for insurance supervision, Charlotte Gerken, warned insurers against over-indulging in new business in the short run amid a period of accelerated growth in the bulk purchase annuity (BPA) market.

Gerken explained that this structural shift in the provision of retirement income has given insurers an increasingly important role as long-term investors in the UK real economy, emphasising the need to exercise moderation in the face of "considerable temptation".

"Insurers need to balance the short-term financial and reputational incentives to grow rapidly, with long-term and enduring financial strength, to meet the long-term needs of policyholders and the economy," she stated.

Gerken also highlighted three key areas where a trend for insurers to stretch their supply capacities in the short term was already being seen in practice, including an expansion of BPA insurer risk appetites, an increased reliance on third-party capacity, and greater interconnectivity with the wider financial system.

In particular, Gerken said that the BofE's supervisory work found that there is an increased appetite to insure deferred pension scheme members – the younger, not yet retired individuals.

However, she warned that this can bring several additional risks for insurers, including much greater uncertainty in longevity risk, as assumptions have to be made over a much longer period of time, together with risks stemming from policyholder options, such as cash commutation, flexibility on retirement age and transfers.

Looking at the Solvency II changes,

in February, BofE governor, Andrew Bailey, said to parliament's Treasury Select Committee, that, using firms' reported figures at end-June 2022 as a basis, the risk margin for the life insurance sector was £22 billion, but post-reforms that is expected to shrink to £8 billion by 2032.

He explained how the bank has tried to equate this capital release figure to an estimate of the increase in the probability of insurer failure.

"In the round, we think that over a one-year period, it is likely that the estimated capital release of £14 billion could lead to an increase in the annual probability of failure for this sector of approximately 0.1 percentage points. This means that over a one-year period (if a firm just met the minimum regulatory standard), the probability that a life insurance firm would hold sufficient capital to withstand the solvency standard stress level will be 99.4 per cent when compared to the current level *[of 99.5 per cent]* – a relative increase in the probability of failure of around 20 per cent," Bailey said.

The Solvency II matching adjustment reforms will also enable insurers to invest in a wider range of assets.

In October, the *Financial Times (FT)* reported that US private equity investor J Christopher Flowers warned that the 'dramatic increase' in private credit investments by life insurers is creating systemic risk for investors. He said investors were underestimating the risks resulting from a flood of money into private credit loans and a push by insurers into these assets in search of higher investment yields.

"Too many people have piled into private credit and it has a special feature that a chunk of it is funded with life insurance assets," Flowers told the *FT*. "One of these days, some life insurance company is going to get whacked on their private credit… You can have a run on a life insurance company."

However, the *FT* has also noted that while UK insurers have not piled into private credit to anything like the extent of their US counterparts, the BofE should be vigilant. "That's especially true given proposed regulatory changes that will make it easier for insurers to invest in a wider range of assets to match their liabilities. This approach is meant to help unlock long-term investments in UK assets, but it will also make evaluating the risks lurking in insurance balance sheets that much harder," it warned.

These systemic risks for the sector were highlighted in the Society of Pension Professionals (SPP)'s research, published in September.

According to the SPP's *Vision 2023* report, the 20 per cent increased risk of insurer failure highlighted by the BofE shows that "assuming an insurance covenant will always be stronger than that of a strong corporate might be imprudent. It is not beyond the realms of possibility that the next black swan event is an insurance crisis".

It also explained that most pension funds measure their liabilities with reference to the gilt market, whereas there is no such 'mark-to-market' mechanism within insurance regulation.

"If corporate bond default rates rise by more than expected and reserved for, this could have a significant impact on insurers' ability to fund their liabilities," the report stated.

"As credit spreads increase within a pension scheme portfolio, the reported funding level would decline, triggering deficit repair contributions at a valuation if this decline is material enough."

Context

However, as Hymans Robertson partner and risk transfer specialist, Michael Abramson, says, context is important. For instance, he states that "it's important to understand that insurance is not a zero-failure regime, otherwise it would be prohibitively expensive".

It may not be zero-failure, but it is still extremely low-failure, as the SPP highlights that the 20 per cent increased failure risk represents an increase in the probability of insurer failure (over one year) going from 0.5-0.6 per cent – "i.e. still a small likelihood".

"It's also really important to understand that *[the BofE's increased insurer failure risk figures]* apply to insurers holding the regulatory minimum levels of capital, and in practice all insurers hold surplus capital, so the probability of failure is in reality lower," Abramson states.

LCP partner, Charlie Finch, adds that just because the minimum capital required has reduced slightly "that doesn't mean necessarily that they will be holding less capital going forward. They will still have a significant amount of capital, just more of it will be 'excess' and slightly less of it will be the 'required' capital".

The Solvency II proposed changes in principle give insurers the additional investment freedom that they have been pushing for, Finch notes, and "certainly, the PRA states that it believes the changes will improve the safety and soundness of insurers and will improve policyholder protection".

"We should not forget that insurers much more proactively monitor their assets and liabilities and take actions

to proactively manage risk, and they do this better than pension schemes," K3 Advisory managing director, Adam Davis, states.

"For example, take the recent LDI crisis," he says, "that caused major issues within the pension community – in the same period you'd notice just business as usual from insurance companies."

The ABI highlights that the very robust calibration of the regime will not change, stating that the UK insurance sector is "one of the most secure and highly regulated sectors in the world" and that "insurers are currently required to hold sufficient additional capital to absorb losses that would only be expected to occur once in every 200 years, and will continue to do so".

So, while it is such a low (albeit ever so slightly increased under certain scenarios) likelihood of insurer failure, why the note of concern from bodies such as the BofE?

According to Zedra Governance client director, Alan Greenlees: "The market and financial watchdogs are likely still bruised from the aftermath of the gilt crisis last year, and the wave of criticism they faced for not anticipating such a systemic event. As such, they are probably more sceptical and nervous around the pensions landscape than previously."

Davis notes that "all the noise and concerns *[about DB schemes moving to buyout]* now being raised weren't being raised when the clients decided on their destination, but they are now being challenged as it is an inconvenient truth for many advisory firms whose incomes depend upon such schemes running on for longer".

Challenges

Insurer failure may still seem extremely unlikely, but the slight relaxation of Solvency II rules and increased volumes of DB money moving to insurers must still generate some challenges?

One such concern has been that of capacity, the ability for the nine insurers in the sector to be able to 'absorb' the huge amount of DB assets – and liabilities – flowing their way.

Hymans Robertson research in October found that 48 per cent of DB sponsors have buyout as their endgame strategy, but 45 per cent of those are worried about a lack of insurer capacity or interest.

"Assuming an insurance covenant will always be stronger than that of a strong corporate might be imprudent. It is not beyond the realms of possibility that the next black swan event is an insurance crisis"

The increased demand for deals may lead insurers to being more selective as to which schemes to quote on, reviewing their processes, for example looking at streamlined processes for smaller/less complex scheme structure, Davis says. However, the ABI states that its members are not aware of any scheme that has come to market and not been able to get an insurer to quote.

One aspect of how insurers manage the liabilities they receive from a DB scheme is by passing on the longevity risk to a reinsurer.

However, in some instances, insurers look to pass asset risk, as well as longevity risk, to the reinsurer – so-called 'funded reinsurance'. "This accentuates the counterparty risk, as if the reinsurer defaults, the insurer's exposure is much greater than for pure longevity risk – this risk is also managed using collateral arrangements," Abramson notes.

"Funded reinsurance is an area where the PRA has expressed some concerns, in particular if it were to become de rigueur for the majority of buy-in business; this is not something we actually expect to happen," he adds.

According to LCP, the PRA has stressed that funded reinsurance should not be used simply to expand capacity to meet the accelerating demand noting this could create "a systemic vulnerability in the form of a concentrated exposure to correlated, credit-focussed reinsurers".

Another concern is that of 'operational capacity'. For instance, Greenlees notes that admin capacity is a real crunch point for insurers implementing bulk annuity deals, "but that comment can be equally applied across the whole pensions industry".

"Increased demand for buy-in and buyout may slightly accentuate operational risks as well, for example is there greater risk of pricing incorrectly if your teams are busy, or of failing to deliver robust pension administration," Abramson warns.

Finch has seen this in practice, with some DB scheme clients "not entirely happy with the service levels delivered by insurers". "We have picked up more errors by insurers in the past 12 months than we have previously – nothing that has proven to be a problem in practice but you do get the feeling that some of the insurers are under strain with this rapid increase in demand," he explains.

Response

The insurance sector is responding to these challenges though.

For instance, Davis has seen insurers increase their capacity for both pre- and post-transaction teams, outsource some tasks that have previously been insourced and streamline processes to enable them to increase the volume of business they can write.

Capacity may also be increased by M&G returning to the BPA market in September with two buy-in transactions totalling £617 million. Also, in October, Resolution Life announced that its Bermudian reinsurance platform, Resolution Re, had entered into the UK

pension risk transfer market with its inaugural reinsurance agreement.

Protection

Pension funds looking to potentially undertake a BPA should also consider the protection provided for their members, if the worst-case scenario was to happen, and the insurer failed.

The Pension Protection Fund (PPF), which provides protection to DB scheme members if the sponsoring employer becomes insolvent, only protects up to 90 per cent of benefits and with potentially worse terms on indexation and spousal benefits than would have been promised in the DB scheme.

However, the ABI points out that if an insurer fails, which has never happened in this market, then the benefits are protected 100 per cent under the Financial Services Compensation Scheme (FSCS) rules, "which is a better position than they would have been in a DB scheme".

However, the SPP's V*ision 2030* paper warns that "FSCS protection is contingent on future policy and political appetite".

"Coverage could fall back from 100 per cent if circumstances change; if insurers fail, the FSCS may not be able to charge sufficient levies on the sector to cover the funding required," it explains.

"Depending on the wider political and socioeconomic context, considering intergenerational inequality, it could be very difficult for a future government to bail out pensioners through financial support to the FSCS."

The BofE in its February letter also expressed similar concerns about translating any increase in the probability of *[insurer]* failure into potential future costs to the FSCS.

"If a future failure occurs, it would be difficult to predict the quantum of losses, nor is it certain that it would be limited to a single firm. For example, as corporate pension schemes continue to transfer their pension liabilities into the life insurance industry, the insurance sector might in future have larger and more concentrated exposures to similar types of risks. This could impact the capacity of surviving insurers to take on significant additional liabilities of a failed annuity writer," it stated.

Finch highlights that as the FSCS is not pre-funded like the PPF, "you are relying on the government to provide liquidity", and that we have not seen in it in action in this scenario as there has not been a failure of a large insurer since its implementation in 2001.

However, Abramson stresses that "it is important to understand just how much needs to fail in order to even call on the FSCS".

"As well as the 1 in 200 capital they need to hold, they also need to hold enough assets for another insurer to step in and take on the liabilities if need be. Bearing in mind that insurers do not face a 'run on the bank'; the circumstances where the FSCS might be called on are very extreme," he states.

Weighting

So, just how much weight should DB schemes put on these concerns when contemplating a buyout transactions?

Finch says states that these changes are one to watch, but "not to be fundamentally concerned about".

Instead, he recommends DB schemes considering buyout comfortably understand how insurers work, "knowing what the risks and potentials are".

"It is quite common for schemes to have concerns when they embark on the buyout process and if they have strong sponsors, whether it is actually stronger to move to an insurance company.

"In my experience in almost all cases, once you go through the process, trustees get quite happy that the insurance regime is extremely strong and that even if you have a strong sponsor that is not necessarily going to be the case forever," he says.

"The benefits of insurance is because it is invested in long-term assets, it is much more secure and predictable over the long term and much more robust than relying on a trading company that is subject to the whims to the market and future trading performance," Finch adds.

Greenlees agrees that "pension schemes have never viewed a BPA as being a free lunch".

"They recognise that transferring the responsibility for paying a member's pension to an insurer is a very good outcome. It provides additional security and certainty, over and above what is readily available in the pension scheme.

"But decision makers are cognisant that insurers are never 'too big to fail' and that there is concentration risk, given that there are nine active participants to meet this surge in demand. Trustees are alive to these risks, but it is a stretch to say that pension schemes are concerned by them and is not dissuading them from the buyout path. It should be noted that trustees still undertake insurer due diligence and receive professional advice before embarking on such an irreversible deal."

As Finch says: "In many ways it's like buying a house. People buy a house all the time but it doesn't mean you shouldn't do your due diligence before you go ahead with it."