UK Risk Settlement Bulletin

Q4 2020

Mortality assumptions in the midst of a pandemic

Mortality in the UK in 2020 had initially followed the trend towards lighter mortality, which started in 2018 and continued throughout 2019. However, March saw the first deaths related to the COVID-19 outbreak. It is now estimated there have been c.60,000 excess UK deaths (i.e. actual deaths compared to typical deaths) in 2020 based on analysis by the Continuous Mortality Investigation (CMI).

The CMI publishes its Mortality Projections Model annually. Nearly all pension schemes and insurers use this model to estimate life expectancy when valuing their liabilities – it is considered as the UK standard.

The CMI Model works by measuring current mortality improvement rates using the most up to date data. But the model was never designed to cope with a pandemic of this magnitude, which equates to a single year of mortality improvement of around minus 10%.

As the chart below indicates, this degree of annual variation is unprecedented in recent times.

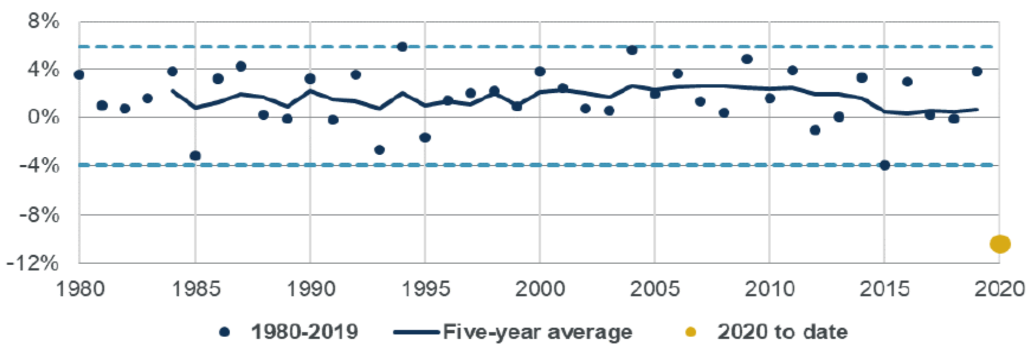
The CMI estimates that if the full-year improvement stayed at −10% and the model's normal annual calibration process were followed, there would be around a 4% reduction in assumed life expectancies.

This is widely regarded as unrealistic, including by the CMI itself. As such, the CMI is proposing the next version of the model, 'CMI_2020' (due to be released in March 2021) will attach zero weight to 2020 mortality data while leaving the rest of the model broadly unchanged.

As such, liabilities for a typical pension scheme may be unchanged (or possibly see minor reductions) compared with the 2019 version of the CMI model. This aligns with both Aon's current view and also the current market consensus, which is that best estimate long-term mortality has not changed significantly as a result of the COVID-19 pandemic.

Longevity risk remains significant for pension schemes but competitively priced insurance solutions, such as bulk annuities and longevity swaps, are available to mitigate the risk.

Chart 3C: Mortality improvements for 1980-2019 and cumulative improvement for 2020 to week 36 (males and females combined for ages 20 to 100)



Source: CMI Working Paper 137 CMI_2020 consultation

Buy-ins and the assets left behind

There are many considerations for trustees and sponsors when assessing the attractiveness of a buy-in transaction. Amongst these is understanding the implications the transaction would have on the residual assets (those not used to fund the buy-in).

Leverage levels

Leverage (essentially the ratio between your hedged liabilities and your underlying hedging assets) is a key feature of many pension schemes' risk management toolkit.

As buy-ins are effectively fully matching unleveraged bonds, pension schemes' residual hedging assets must work harder (i.e. have a higher leverage ratio) to achieve the same objective following a buy-in. It is imperative that this resulting leverage ratio is maintained within acceptable tolerances, ensuring that the transaction does not lead to an increase in risk.

Impact on investment return

Investment portfolios can typically be thought of in two components: return-seeking assets and risk reducing assets.

If leverage can be maintained at acceptable levels post-transaction, schemes may fund a buy-in from their risk reducing assets (e.g. gilts). This approach will generally have little impact on the return required from the return-seeking assets.

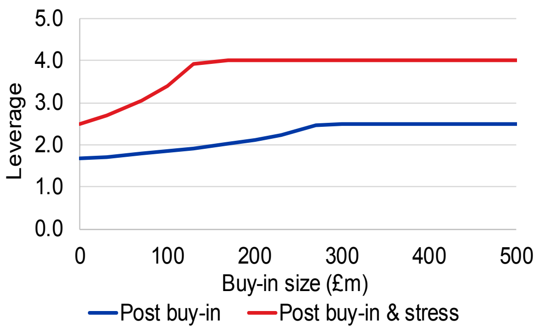
In some cases, part of the premium may be funded from return-seeking assets. In this instance, it is important to understand the impact on the return required from the residual return-seeking assets. These assets may need to be reshaped to maintain the same level of return, or stakeholders must be comfortable with the alternatives (e.g. lower return over longer time horizons, or larger contributions).

Liquidity and stress scenarios

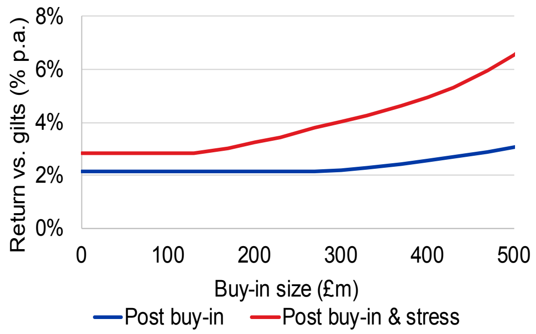
It is also important to ensure that, following a buy-in, the scheme's portfolio remains robust and resilient to any subsequent stresses or calls on liquidity. Can funding goals still be obtained if yields rise and there is a call for capital for the liability hedging portfolio? Can the hedge be maintained if transfers out are greater than expected? What if markets sell off and return requirements increase?

Speak to your Aon consultant to learn more about our investment framework and the modelling undertaken when planning a buy-in.

Post-buy-in LDI Leverage



Post-buy-in required return



Source: Example scenarios derived by Aon's investment team.

Bulk annuity market remains resilient

Despite the unprecedented challenges posed to trustees, sponsors and insurers by the COVID-19 pandemic, the UK bulk annuity market has remained busy with £12.7Bn of business written in the first 6 months of 2020.

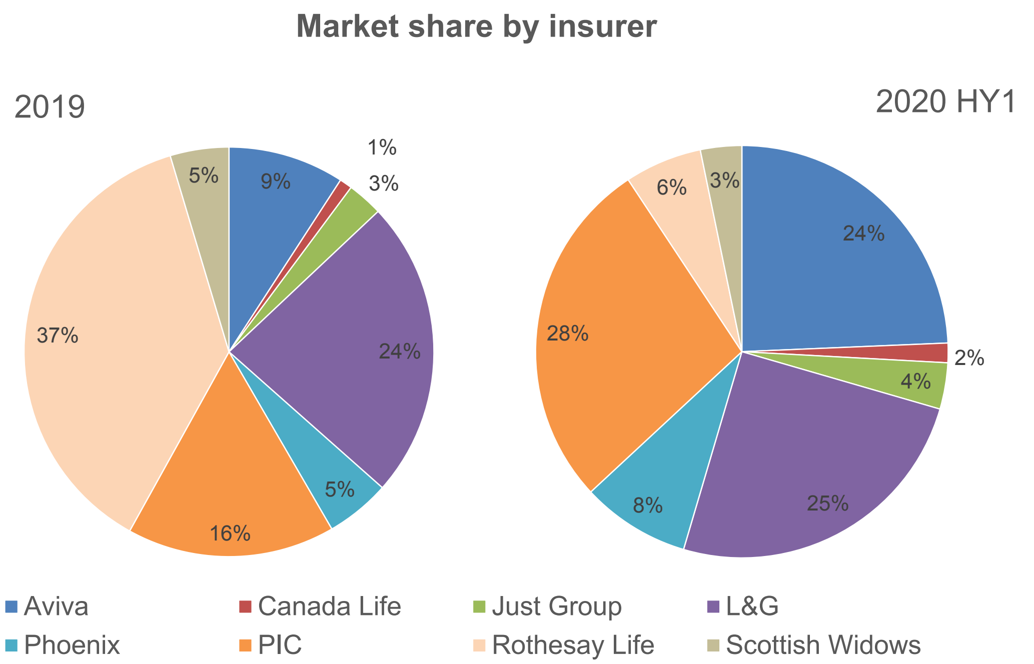
This makes 2020 already the fourth largest year for the amount of business written in the bulk annuity market, demonstrating its resilience despite the significant complications presented by the pandemic.

All this follows a record-breaking year in 2019, where £43.8Bn of bulk annuity business was placed. Despite lower volumes of business written so far in 2020, the number of deals completed in the market has remained stable, with 77 deals written in the first half of 2020, compared to 150 over the whole of 2019.

This has been partly due to the pace of 'smaller' deals (particularly those sub-£100M) which has remained similar to 2019 levels. Alongside this, there has been an increase in the number of £100-£500M deals, with this section of the market growing from 18% of the deals written in 2019 to 30% in the first half of 2020.

So far in 2020, no one provider is dominating the market. Instead we have seen market share being more evenly spread between the larger providers. The amount of business written by each provider so far in 2020 compared to 2019 can be seen in the charts below.

This spread of deals is largely due to pensioner-only transactions being more prevalent since lockdown began, creating strong competition amongst insurers and often delivering excellent pricing.



Source: Data derived from Aon's survey of insurers.

Bulk annuity market outlook

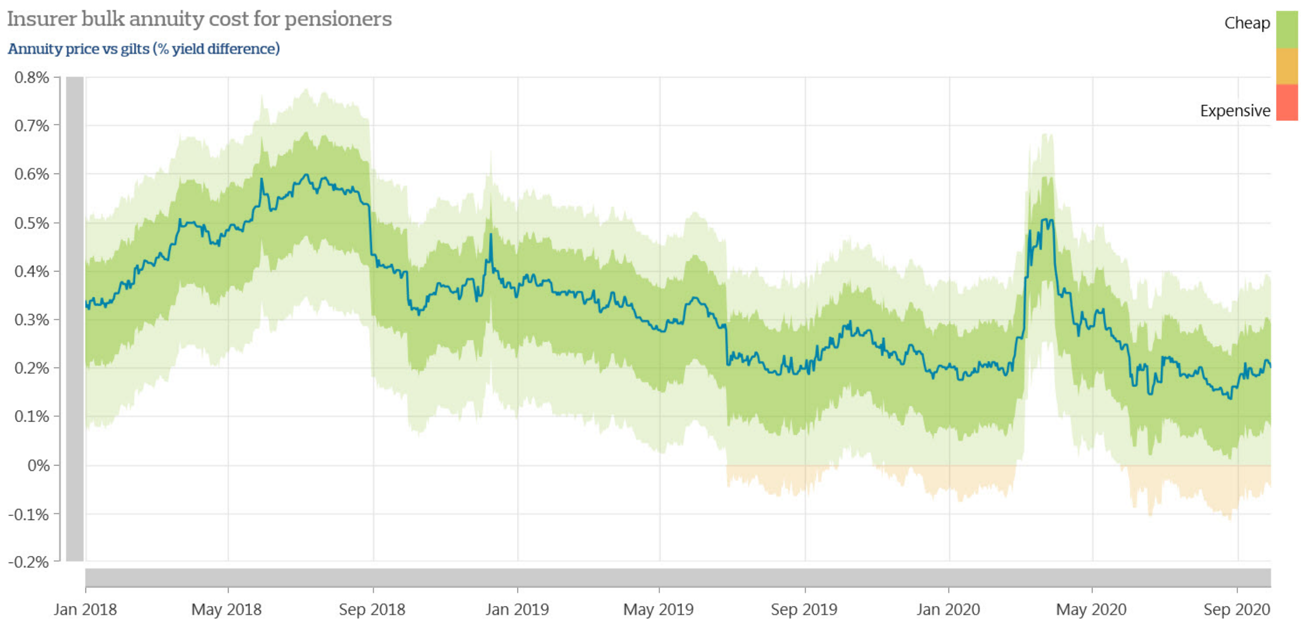
The outbreak of COVID-19 created volatile market conditions, but typically led to an improvement in bulk annuity pricing in March and April 2020.

This spike, which can be seen on the chart below, was driven by a rise in the yields available on assets commonly used by bulk annuity providers, such as corporate bonds.

Market volatility dampened towards the middle of the year and we have subsequently seen bulk annuity pricing stabilise. That said, there remains a large range of pricing available, and we have seen pricing more than 5% better than the central estimate (blue line below) on recent well-planned auctions.

It is possible that strong pricing opportunities will be available for the remainder of the year as some insurers try to hit business targets for 2020. In particular, this may be the case for transactions that stalled due to operational restrictions arising from the COVID-19 lockdown. These schemes may be 'transaction ready' and well placed to exploit pricing opportunities arising in the short-term.

Traditionally, the bulk annuity market also experiences strong pricing at the start of the new year as insurers will have new capital opportunities and business targets will be reset. Schemes looking to capitalise on opportunities in early 2021 should prepare now. Please contact your usual Aon contact if you would like to explore risk settlement opportunities further.



How to read this chart

- This shows the return from a bulk annuity for pensioners, relative to the yield on a comparable gilt portfolio, assuming insurer-type assumptions beyond the discount rate.
- A higher position represents a better price.
- This comparison ignores the material value from annuities giving a better hedge than gilts, including longevity cover.
- Expected pricing for a typical scheme is shown by the blue line.
- Prices typically fall in the darker shading, and some auctions fall in the lighter shading. Pricing outside the shading typically represents an unusual liability profile.

Chart sourced from Aon's Risk Analyzer

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