UK Risk Settlement Bulletin

September 2019

Behavioural Insights to Help You Navigate Through Pension Risk Settlement

In conjunction with behavioural insight agency Behave London, Aon carried out research in early 2019 to explore trustees' understanding and views on longevity risk, the options available to reduce that risk, and identify behavioural biases that could impact these decisions.

Ambiguity

One of the core findings of the research was that there is a lack of clarity around the end-to-end process of what de-risking involves. What is needed to complete a transaction and who does what? Human beings are prey to a cognitive bias called the ambiguity effect, where our decision making is affected by a lack of information, or ambiguity. In essence we will tend to pick known outcomes over unknown ones.

To help trustees understand what is involved at each step, we have produced a guide that maps out the risk settlement process over four stages:

- Deciding strategy – should you reduce or remove longevity risk?
- Engaging with the insurance market to obtain pricing
- Selecting an insurance provider
- Completing your transaction and transferring risk

Our guide also highlights the behavioural biases that you may encounter at each stage. Examples include:

Status quo bias

People can have a strong tendency to want to stick with the status quo, as anything which involves change or disruption is more uncomfortable for our brains.

One way around this is to think about potential actions as already being reality, and then argue for the original position, to see if that still stands up to scrutiny. For example, imagine that a scheme has no longevity risk. Now explore the argument for ADDING longevity risk into that scheme. Can this be justified?

Pain of paying

People do not like to spend money, and commonly experience the "pain of paying". In the context of risk settlement, trustees may feel uncomfortable paying money out of the scheme now in order to reduce risk.

To reduce the pain of paying it's necessary to be comfortable with choices, by setting a clear decision-making framework so that all options can be evaluated consistently.

Further information

If you would like more behavioural insights to help you navigate through pension risk settlement, please contact your risk settlement contact or click on the link below.

https://retirement-investment-insights.aon.com/defined-benefit/behavioural-insights-to-help-you-navigate-through-pension-risk-settlement

HSBC longevity swap

HSBC announced in August that it had insured £7Bn of its UK pension scheme’s longevity risk exposure through a longevity swap. It is the second largest pension scheme longevity swap to date – so what was interesting and what does it tell us about the market?

Unprecedented transaction

The transaction uses a sponsor-owned Bermuda captive insurer to access reinsurance capacity from the Prudential Insurance Company of America (PICA). This structure was a complex undertaking to set up and establish – but it benefited greatly from the existing HSBC team in Bermuda.

The deal was implemented with the support of a multi-disciplinary Aon team, including longevity experts and a local team in Bermuda working with HSBC to liaise with the Bermudan Monetary Authority to obtain the necessary license and approvals for the deal.

The chart below gives an overview of the entities and roles involved with a longevity swap, some of which were outsourced to third parties by the HSBC captive team.

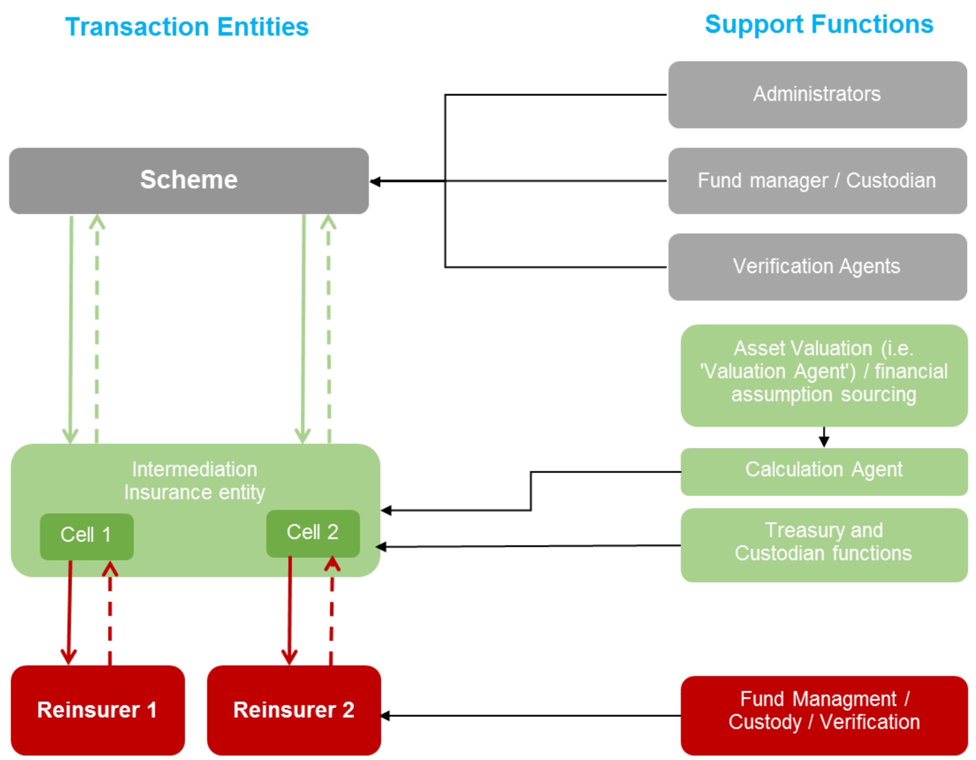


Chart source: Aon's internal library

Wider longevity market trends

It is also interesting to note that this is the first major UK bank to execute a longevity swap deal. This is surprising in some respect as longevity swaps typically have a positive impact on bank capital requirements, unlike bulk annuities which are generally more capital intensive.

So, as well as being attractive to trustees from a risk management perspective, longevity swaps can also be very attractive to the sponsor. With this in mind, we expect to see more banking sector settlement activity over the coming years.

The size of the transaction also demonstrates the continued substantial capacity and appetite of the global reinsurance market to take on UK longevity risk, from both pension schemes and insurers.

Structures of longevity swaps

Are offshore captive structures the new norm for longevity swaps? Put simply – no! As the 2018 National Grid transaction with Zurich demonstrated, the appropriate structure will vary from scheme to scheme.

Different intermediation structures for accessing reinsurance capacity each come with different pros and cons. Various factors including deal size, risk appetite, costs and governance preferences will all have a say in what is right for a specific deal.

In the case of HSBC, the existing team in Bermuda and the resource and expertise to leverage for the day-to-day operation of the longevity swap were key contributors in the decision to use the captive structure.

The table below shows the different structures used by several notable UK longevity swaps.

Structures of some notable publicised UK longevity swap deals

Size	Scheme	Structure	Date
£7Bn	HSBC UK Pension Scheme	Bermuda-based sponsor-owned captive	August 2019
£2Bn	National Grid	UK insurer	May 2018
£1.6Bn	British Airways Pension Scheme	Guernsey-based trustee-owned captive	August 2017
£0.9Bn	Phoenix Group	UK sponsor insurance entity	August 2014
£16Bn	BT Pension Scheme	Guernsey-based trustee-owned captive	July 2014
£4.9Bn total	BAE Systems	UK insurer	February and December 2013

Information source: Aon's Risk Settlement Group Due Diligence team

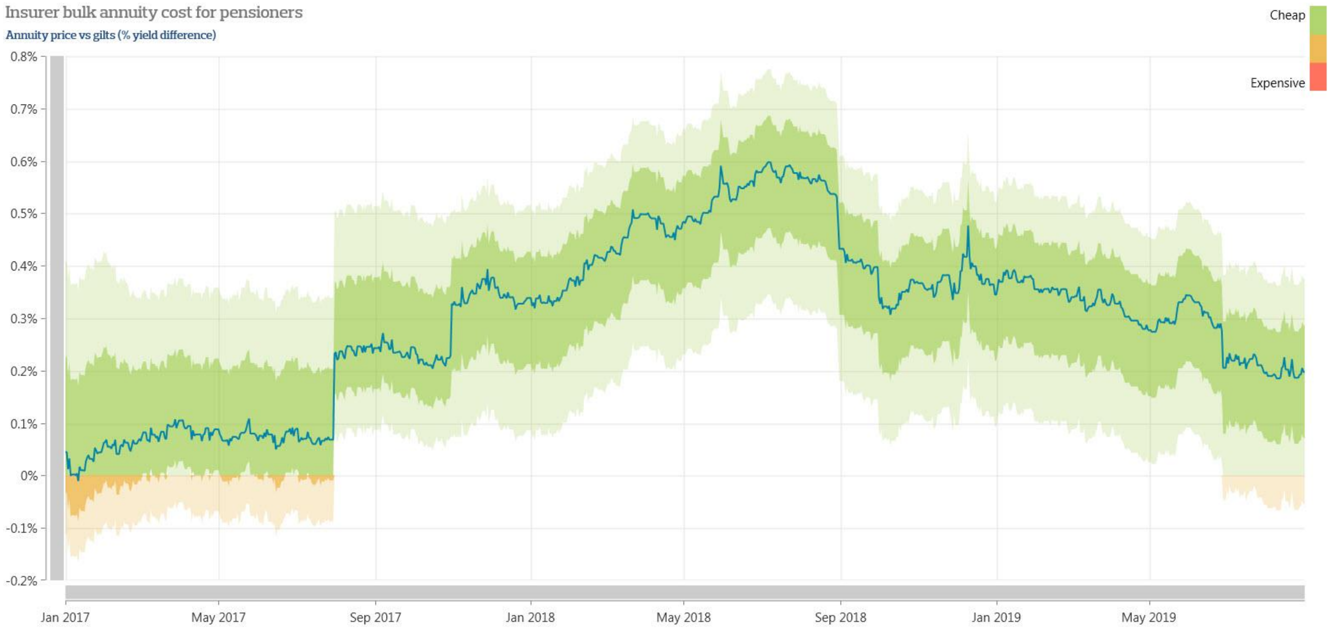
Insurer bulk annuity cost

The chart below indicates the expected range of best pensioner pricing available in the bulk annuity market, for a typical scheme.

You can see that the *average* pricing spread relative to gilts has narrowed during 2019. This is partly due to market movements (e.g. falling credit spreads) and partly due to the greater demand for annuities. However, attractive opportunities do remain, with deals possible to provide significant risk reduction at a margin comfortably in excess of gilt yields.

In recent months some providers have neared capacity as they are busy digesting some large deals that have completed during the year. But insurers have also been successful at raising new capital to support the continued demand from pension schemes.

We expect 2020 to be another busy year – and ultimately, a busy market means that the best prepared schemes will stand out from the crowd, attain the most engagement from insurers and therefore be in the strongest position to negotiate good pricing and terms.



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.
- Annuities shown as 'cheap' if giving a better return than gilts.
- 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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