UK Risk Settlement Bulletin

Q3 2021

The Q3 bulletin delves into the story of the bulk annuity market so far in 2021, explores the latest pricing trends, and investigates longevity swaps as an alternative option for schemes.

Bulk annuity market in 2021

A story of two halves

Insurers typically look to hit annual targets before the year end, and utilise any spare capacity built up in the year. At the same time, risk appetites and business strategies also tend to be reset in the new year. This sometimes encourages a spike in business completed just ahead of year end.

And that trend is seen in the chart below. For each of the past five years, the second half of each year has witnessed significantly higher volumes of bulk annuities placed than in the first six months.

COVID-19 exacerbated this trend further. Some transactions were postponed in the first half of 2020, as trustees and / or sponsors focussed on other issues arising in the uncertain environment. Many of these transactions restarted in the second half of 2020 and raced to completion before the new year.

The story so far in 2021

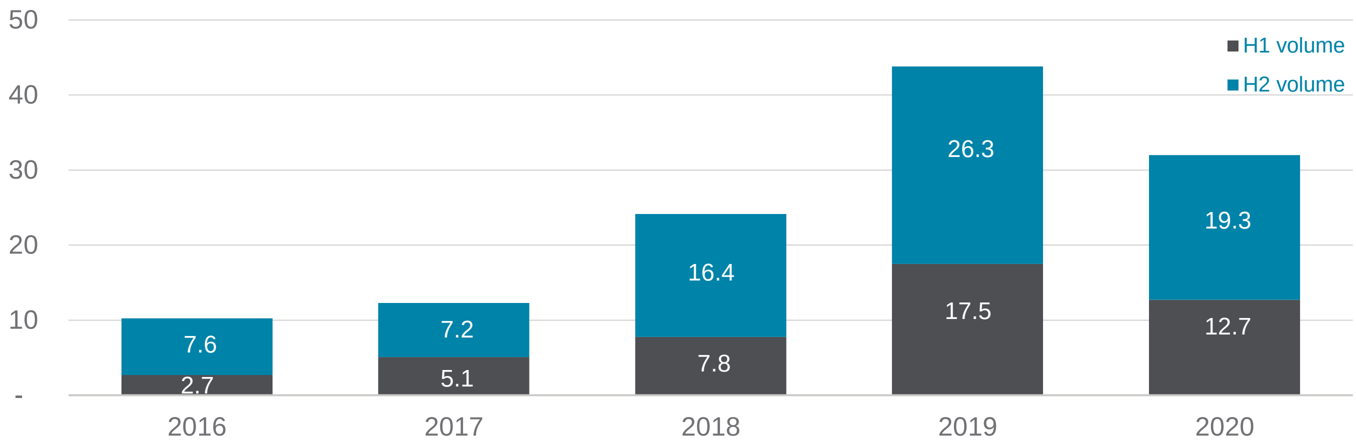
Insurers are yet to release 2021 half-year reporting to confirm the volumes of deals completed. But it is expected the first half of the year has been a relatively quiet period for placements.

It is perhaps not surprising that fewer schemes pressed ahead with preparation for risk settlement projects in 2020, given the financial stress and uncertainty due to the pandemic. This appeared to create a lull in the market in the first quarter, with relatively few schemes in the market and ready to transact.

Since then, we have seen more schemes get ‘transaction ready’, now taking advantage of the excess insurer capacity and stronger pricing this may bring. That suggests a busy end to the year, and we expect that this momentum will spill over into 2022.

Aon's mid-year Market Update will be published in early September, following release of insurer half-year reporting.

Bulk annuity volumes by half year (£Bn)



Source: Aon’s Due Diligence team

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Longevity swaps – On the rise

Over the past couple of years, pension scheme longevity swap deals have become more prevalent. Last year £24Bn of publicised swaps were written.

While multi-billion-pound longevity swaps continue to dominate the headlines, increased flexibility and a wider range of structural options for these swaps have started to open the door to more pension schemes.

With longevity swaps becoming an increasingly viable risk settlement option for a greater number of schemes, it is important for trustees and sponsors understand the key features of this solution.

This is a key part of the feasibility study for a settlement project: to consider all the different investment / insurance solutions available to the scheme, the advantages and disadvantages of these, and how they may meet the objectives for the exercise.

What is a longevity swap?

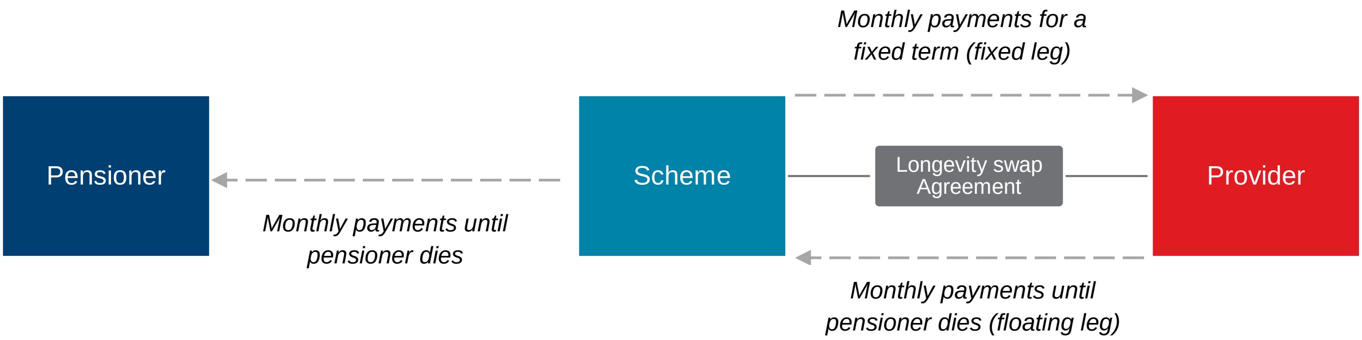
A longevity swap policy hedges the risk of scheme members living longer than expected.

The scheme's longevity risk (for the insured lives) is transferred to an insurer / reinsurer, via an exchange of "fixed" and "floating" payments (the structure is explained below).

Crucially, longevity swaps do not transfer investment risk to the insurer (unlike a bulk annuity). Some schemes value this solution, with the flexibility to continue to manage their own assets (and potentially benefit from upside investment risk).

Longevity swaps can be converted into a bulk annuity in the future, for example once a scheme has matured or is well-funded enough to secure all liabilities with an insurer.

Structure of a Longevity Swap



Longevity swap structure

The chart above shows a high-level overview of the structure of a longevity swap arrangement.

Unlike a bulk annuity, there is no upfront premium payment to the provider. Instead, the Scheme and provider exchange a series of cashflows over the lifetime of the policy.

The Scheme commits to pay the provider a schedule of fixed payments relating to the payments of benefits based on ***expected*** policyholder mortality (the "fixed leg").

The Scheme will also pay a fee to the provider with each fixed leg payment.

In return, the provider pays the cost of these benefits to the insurer based on ***actual*** policyholder mortality (the "floating leg").

If, in general, the policyholders live longer than expected, then the floating leg will be paid for longer than the fixed leg and the Scheme will benefit from the swap.

When might a longevity swap be suitable?

Carrying out a longevity swap allows a scheme to reduce longevity risk held within the scheme and, given the unfunded nature of longevity swaps, allows the scheme to retain investment flexibility.

Longevity swaps are likely to be particularly attractive to Schemes in the following situations:

- Longevity is a material unhedged financial risk in absolute terms or relative to other risks;
- Investment flexibility within the scheme is desirable;
- The scheme has a complex investment strategy and/or a sizable amount of illiquid assets;
- Bulk annuity purchase is currently unaffordable; or
- Where corporate accounting impacts are a key decision-making factor for the Sponsor.

For some schemes, a longevity swap is a useful steppingstone on the way to a buy-in or buyout. There have been several cases of longevity swaps being converted to bulk annuities in recent years, including:

- £1.2Bn buy-in for the PGL Pension Scheme in 2016, which converted a swap completed in 2014.
- £1.6Bn buy-in for the Merchant Navy Officers Pension Scheme in 2020, which converted a swap completed in 2014.
- £4.6Bn partial buy-out for the Rolls Royce UK Pension Fund in 2019, which included conversion of a swap completed in 2011.

If you would like more information on longevity swap solutions, then please contact your usual Aon settlement consultant.

	Longevity Swap	Buy-in
Risk transfer (insured lives)	Demographic risk transfer only	Financial and demographic risk transfer
Complexity	More complex, several structuring and bespoke options	Less complex, well-trodden path
Accounting impact	No initial balance sheet or P&L impact	Typical immediate balance sheet impact, often no direct P&L impact
Investment	No upfront transfer of assets, so full investment freedom retained	Restricts future investment flexibility given premium payment to insurer
Counterparty risk	Potential exposure to overseas reinsurer	Exposure to UK regulated insurer

Bulk annuity market outlook

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

Current pricing levels

On this measure, pricing remained relatively stable, and at an attractive level in the first six months of 2021, despite credit spreads remaining relatively narrow compared to historical norms.

The market has been fairly quiet in the first half of 2021. This spare capacity has led to increased competitive pressures between insurers seeking to win new business, which has in some cases resulted in very attractive pricing.

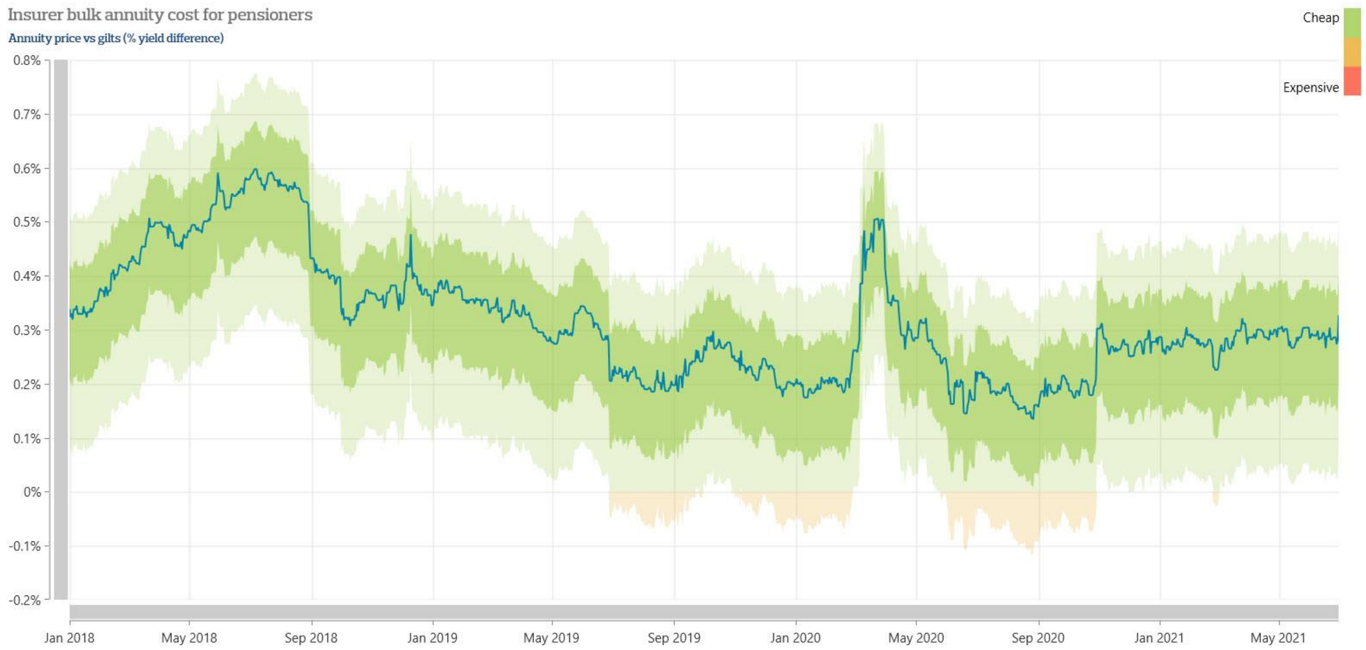
Pricing opportunities in 2021

At certain points this year we have seen insurers identify particularly attractive asset opportunities, as well as spare capacity in the reinsurance market. They have been able to use this to enhance their pricing. Such opportunities may arise at short notice, so schemes need to be ready to move quickly to access the best deal.

The market is showing signs of increased activity towards the end of 2021, as schemes complete preparatory work to formally approach the market.

We expect that strong pricing opportunities will continue to emerge but standing out in a busier market will be more of a challenge.

Please contact your usual Aon settlement consultant if you would like to discuss de-risking opportunities and ways to prepare you scheme for an insurance transaction.



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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