UK Risk Settlement Bulletin Impact of COVID-19

19 March 2020

Executive summary

- We do not expect the bulk annuity or re-insurance market to make any explicit allowance for COVID-19 in longevity pricing over the short term.
- We believe pensioner buy-in pricing, in particular, is currently much more attractive (relative to gilts) than it was throughout 2019.
- There will be attractive pricing opportunities for schemes currently seeking insurance quotations, and it could well be a buyers' market in H2 2020 for schemes willing to proceed with projects.
- For schemes not in a position to transact over 2020, redirecting efforts onto other aspects of transaction preparation is likely to pay dividends later.

Early days impact of COVID-19

This paper gives our initial viewpoint on the early days impact of the coronavirus, and what it means for the UK pension scheme risk settlement market, the viability of transactions in current conditions and focus points for pension schemes planning future transactions.

The outbreak is a major current concern for all of us and is highlighting the risks in pension schemes and in our wider lives. The knock-on volatility in financial markets is providing both material challenges but also potential opportunities.

It is important to remember that the current impact on markets may represent temporary disruption, and, in most cases, should not affect long-term objectives and the case for focussing on planning the activities required to achieve those.

Further, the impact of the virus on financial markets is highlighting the risks involved in defined benefit schemes and the attractions of risk transfer, if value can be achieved in the insurance market.

The coronavirus

Coronavirus is an umbrella name for a group of viruses first discovered in the 1960s. The current outbreak of respiratory disease is known as COVID-19. The impact of an infectious disease depends on:

- How easily it spreads;
- How long people are infectious for; and
- How severe it is, not only how many people die, but also how many require hospitalisation.

COVID-19 appears both to spread easily and to have a relatively high mortality rate compared to common diseases (e.g. seasonal ‘flu). In addition:

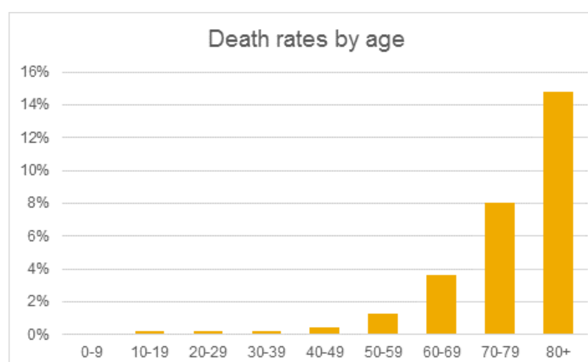
- Humans have no immunity to COVID-19 (because it transferred from animals);
- It may have a long incubation period which means that people can spread it before they display symptoms; and
- A vaccine is not expected to be available in the first 12-18 months of the outbreak.

COVID-19 may therefore have at least a short-term impact on overall mortality rates.

Initial longevity impact

Best estimates of the true mortality rate from COVID-19 range between 0.5% to 4%, with **a central estimate of around 1%.** By comparison seasonal 'flu generally kills around 0.1% of those infected.

Analysis of rates from early cases suggests that mortality is heavily skewed towards older ages as shown in the chart below.



Source: preliminary analysis of mortality in early cases in China, published in the Chinese Journal of Epidemiology

The picture is still rapidly evolving and hence estimates may change materially. In particular, the following are still unknown:

- How easily COVID-19 spreads;
- How well different mitigation or suppression strategies will work in practice; and
- To what extent COVID-19 is seasonal – if it is, delaying its spread into summer will also help to reduce its overall impact.

Impact on scheme liabilities

It is too early to forecast the impact on scheme liabilities. We expect the UK to take action to prevent the virus from spreading unconstrained through the population. The effectiveness of this action cannot be reliably predicted, but there are also knock on effects to consider that are both complex and potentially material:

- If there is material COVID-19 mortality then individuals most at risk of dying may be the most affected, resulting in a temporarily more healthy surviving population and lower than expected mortality for a few years.
- The measures being employed to suppress COVID-19 could result in reduced deaths from other causes, e.g. normal 'flu. So 2020 could, in theory, be a light mortality year.
- Most significantly – and commonly overlooked – is the potential indirect impact on mortality. The economic impact of the 2008 financial crisis is widely implicated in the ensuing dramatic fall in mortality improvements. If actions taken to tackle COVID-19 result in a severe recession then mortality in the following, say, five years may similarly be affected. This indirect effect is potentially as significant as deaths from COVID-19 itself.

We do not expect the bulk annuity or re-insurance market to make any explicit allowance for COVID-19 in longevity pricing over the short term, noting:

- Deaths are expected to be focussed on older ages and those at the greatest risk of dying in the next 12-24 months;
- To the extent deaths occur prior to signing an annuity or longevity swap contract, the relevant members would not be included as part of the insurance cover anyway.

Market impact of COVID-19

The investment markets have been heavily impacted by the outbreak, with substantial falls in equity and credit markets, increased credit default risk, and reduced liquidity in even deeper areas of the market. Actions have already been taken by central banks to reassure markets and provide additional liquidity.

Asset trading has significantly reduced, and transitions need to be handled particularly carefully, as the realisable values and trading costs are less predictable than usual.

Depending on investment strategy and hedging levels, schemes' funding levels may have worsened in the very short-term from falls in growth asset values and from losses where interest rates are not fully hedged, as gilt and swap yields have fallen further since the start of the year.

Some of the relationships between asset classes have also been distorted in the current environment, with the spreads between credit, gilt and swap yields more variable than usual. It is changes in these specific relationships that can improve the affordability of an annuity, measured relative to a gilt-based liability benchmark. Hence at the time of writing (18 March 2020), **pensioner buy-ins in particular are expected to be more affordable (relative to gilts) than they had been throughout 2019**, while accepting the position remains changeable and completion of a transaction relies on agreeing the asset transition carefully between the insurer and scheme investment managers.

Investment impact for insurers

Insurance companies back annuities with a mixture of government debt, investment-grade credit and more illiquid investments such as mortgages and ground rents, infrastructure and private debt. These assets are bought to hold for the long-term, and so temporary falls in values should not encourage portfolio changes or lasting concern if the assets are still expected to deliver the same expected income, as is normal.

There is some exposure to asset defaults, although there will be an existing contingency reserve for these. Downgrades can also trigger an increased reserve and potentially a sale, particularly if the security becomes a "fallen angel" falling out of investment grade. So far there has been little experience of this, but insurance companies will be carefully monitoring their exposure to sectors more at risk from the fall in travel and social interaction, such as airlines.

The greater credit spreads available since March represent a buying opportunity for insurers, to improve the yield on their annuity book. This could enable them to favourably invest assets not yet redeployed from the high volume of deals in autumn 2019, although exceptionally low market liquidity may make this a challenging and slow process.

The impact later in the year is less clear, even putting aside the uncertainty over subsequent moves in market yields and prices. A continued economic slowdown will result in less issuance of new securities. Even where insurance companies create their own debt investment opportunities, such as through commercial and equity release mortgage sales, there may be a fall in takers for this lending temporarily. Hence a fall in asset supply could eventually impact appetite. However, some insurance companies will take on deals and find permanent backing assets later, initially holding gilts for example – as long as the annuity price can be both appealing to the pension scheme and supportable by the expected returns achievable from later asset purchases.

Insurer solvency positions

Most insurance companies have published solvency coverage information at end 2019, and these figures showed a significant margin over the required contingency margins – typically in the range of 140-200% of the Solvency Capital Requirement.

Since then there is a possibility that solvency coverage has fallen for insurers. Lower interest rates will have hit these ratios, for insurance companies that do not hedge their entire position including the disclosed surplus. In the short-term, this is likely to have acted as a "leveller", with the insurers with the highest solvency coverage not needing to hedge surplus but seeing a greater temporary fall in coverage as a result, albeit to a level still well above regulatory requirements.

Insurance companies do not publish regularly updated figures, noting this is particularly market sensitive information.

However, we have surveyed the market in March, and the settlement market providers gave positive responses about the position of their annuity books, with the messages in summary being:

- The providers remain well capitalised and they are continuing to bid on new business across the market, looking to provide balance sheet security for pension schemes that are less able to protect themselves in these conditions.
- The sensitivities that are publicly disclosed as part of solvency reporting set out the impact that adverse scenarios would have on surplus levels. Several providers pointed to these as the reassurance that annuity books remain resilient to market risks.
- Providers have successfully come through other periods of dramatic market volatility without any underpayments ever arising for their annuities and longevity swaps.

Clearly no system can give absolute protection and the lasting impact of this environment on asset defaults and property values (noting property underpins some asset classes in annuity books) is not known. But there are no signs that the "safe house" status of annuity books is coming under challenge so far.

Insurers' operational resilience

We also asked providers about their ability to continue to meet customer needs in this difficult time. The response was positive with business continuity plans in force, and most teams having switched to largely home-based working temporarily. While this is inevitably a new step for some parts of the teams, and will inevitable make the completion of more complex deals (that rely on continual interaction across multiple counter-parties and advisory firms) more challenging, the feedback was that supporting systems were well-built for this situation already, and this new approach is so far working.

Implications for completing transactions

For schemes already in the market

As we would expect, current market volatility is impacting insurer pricing. The impact will differ by insurer but for some schemes **there will be attractive pricing opportunities**, as has been the case in previous periods of heightened market volatility.

For some insurers, pricing may have improved versus pension scheme benchmarks (which may be typically gilt or swap-based) due to widening credit spreads. However, the extent of any improvement will depend on how much of the spread widening insurers put through to their pricing (informed by their views on how much of it relates to expected defaults and whether they expect to be able to actually trade at current yield levels). There are also offsetting factors, such as falling interest rates, which generally lead to increased insurer capital requirements (due to the long-tailed nature of capital stresses) which are generally detrimental to pricing.

The key focus of schemes that are in the market should be on careful planning for transaction execution, premium payment and asset transition to mitigate financial risks, such that if attractive pricing opportunities do arise, these are not missed.

For schemes where a transaction is being planned

Where transactions remain potentially viable because it is not dependent on the overall funding position or the scheme is well-hedged, we would generally suggest proceeding to the market. To the extent there is any slowdown in general levels of bulk annuity market activity in the coming months, the potential unused insurer capacity could create strong commercial opportunities later in 2020. As the market in 2020 is not expecting to see the same level of multi-billion pound transactions as last year, these opportunities could be available at all transaction sizes.

For other schemes considering a transaction, the impact of recent market movements may have worsened the funding position to the extent that a transaction ceases to be viable in the short-term. However, these market conditions could later reverse quickly, and it is truer now more than ever that a future settlement transaction needs to follow a period of adequate market preparation. While asset de-risking steps may be on hold for some schemes, redirecting efforts onto other aspects of transaction preparation is likely to pay dividends later.

We will provide a further update once the situation has developed further. If you would like to know more about the implications for your particular scheme or for specific insurers, please contact us.

Contact Information

John Baines
+44 (0)121 262 6944
john.baines@aon.com

Martin Bird
+44 (0) 121 335 3727
martin.bird@aon.com

Hannah Cook
+44 (0)20 7086 8115
hannah.x.cook@aon.com

Phil Curtis
+44 (0)20 7522 8276
phil.curtis@aon.com

Mike Edwards
+44 (0)20 7086 0437
mike.edwards@aon.com

Karen Gainsford
+44 (0)20 7086 9071
karen.gainsford@aon.com

Tim Gordon
+44 (0)795 632 4415
tim.gordon@aon.com

Dominic Grimley
+44 (0)121 262 5094
dominic.grimley@aon.com

Ben Harris
+44 (0)121 230 6828
ben.harris.2@aon.com

Joe Hathaway
+44 (0)121 262 6986
joe.hathaway@aon.com

Rhian Littlewood
+44 (0)121 230 6891
rhian.littlewood@aon.com

Tiziana Perrella
+44 (0)161 687 2014
tiziana.perrella@aon.com

Stephen Purves
+44 (0)113 394 3510
stephen.purves@aon.com

Tom Scott
+44 (0)121 262 5073
thomas.scott@aon.com

Michael Walker
+44 (0)1372 733027
michael.walker.3@aon.com

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance. For further information on our capabilities and to learn how we empower results for clients, please visit: http://aon.mediaroom.com/.

Disclaimer

This document and any enclosures or attachments are prepared on the understanding that it is solely for the benefit of the addressee(s). Unless we provide express prior written consent, no part of this document should be reproduced, distributed or communicated to anyone else and, in providing this document, we do not accept or assume any responsibility for any other purpose or to anyone other than the addressee(s) of this document.

Notwithstanding the level of skill and care used in conducting due diligence into any organisation that is the subject of a rating in this document, it is not always possible to detect the negligence, fraud, or other misconduct of the organisation being assessed or any weaknesses in that organisation's systems and controls or operations.

This document and any due diligence conducted is based upon information available to us at the date of this document and takes no account of subsequent developments. In preparing this document we may have relied upon data supplied to us by third parties (including those that are the subject of due diligence) and therefore no warranty or guarantee of accuracy or completeness is provided. We cannot be held accountable for any error, omission or misrepresentation of any data provided to us by third parties (including those that are the subject of due diligence).
This document is not intended by us to form a basis of any decision by any third party to do or omit to do anything.

Any opinions or assumptions in this document have been derived by us through a blend of economic theory, historical analysis and/or other sources. Any opinion or assumption may contain elements of subjective judgement and are not intended to imply, nor should be interpreted as conveying, any form of guarantee or assurance by us of any future performance. Views are derived from our research process and it should be noted in particular that we can not research legal, regulatory, administrative or accounting procedures and accordingly make no warranty and accept no responsibility for consequences arising from relying on this document in this regard.

Calculations may be derived from our proprietary models in use at that time. Models may be based on historical analysis of data and other methodologies and we may have incorporated their subjective judgement to complement such data as is available. It should be noted that models may change over time and they should not be relied upon to capture future uncertainty or events.

To protect the confidential and proprietary information included in this material, it may not be disclosed or provided to any third parties without the prior written consent of Aon Hewitt.
Aon Hewitt does not accept or assume any responsibility for any consequences arising from any person, other than the intended recipient, using or relying on this material.

Copyright © 2020. Aon Hewitt Limited. All rights reserved.

Aon Hewitt Limited Registered in England No. 4396810 Registered office: The Aon Centre,
122 Leadenhall Street, London, EC3V 4AN.

Aon Hewitt Limited is authorised and regulated by the Financial Conduct Authority.

Aon Hewitt's Delegated Consulting Services (DCS) in the UK are managed by Hewitt Risk Management Services Ltd (HRMSL), a wholly owned subsidiary, which is authorised and regulated by the Financial Conduct Authority.

Compliance code: A71-310920