UK Risk Settlement Bulletin

July 2019

Insuring pension increases

The cost of securing members' benefits with an insurance company can be significantly affected by the type of pension increases covered under the policy.

The graph below illustrates the differing cost of insuring pensioner benefits that increase in different ways.

It breaks down the annuity premium cost into:

- The typical funding reserve;
- The cost of hedging the future inflation uncertainty (where an investment which provides cashflows matching the pension increases costs more than the estimated funding costs); and
- Other costs (for example insurers' views on longevity assumptions, and their allowance for expenses).

This shows that pension increase hedging costs can be a significant proportion of the gap between funding reserves and annuity pricing.

Pension Increase Exchanges

A potential solution for schemes is to offer members a benefit restructure, awarding a higher pension which increases in a way that is more cost-effective to insure. This is known as a Pension Increase Exchange (PIE).

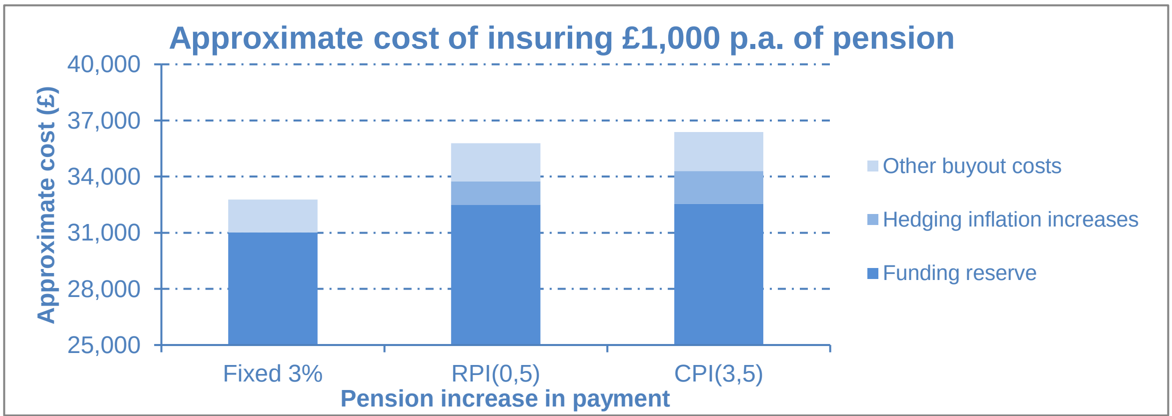
2018 saw a number of bulk annuity deals completed, where a bulk annuity transaction was made possible by altering a scheme's pension increase design to a simpler structure.

GMP Equalisation and conversion

In late 2018, the Lloyds Banking Group case confirmed the need to equalise GMPs, and identified 'GMP conversion' as a way to do this.

GMP conversion will present opportunities for schemes to restructure pension increases in a way that offers fair value to members and also make annuities more affordable.

Crucially, GMP conversion does not require member consent, only a consultation, so benefits may be changed for a wider group of the membership, simplifying administration.



Source: Benefit cost for a male pensioner aged 65, based on typical funding reserve and Aon's solvency basis

Insurer bulk annuity cost

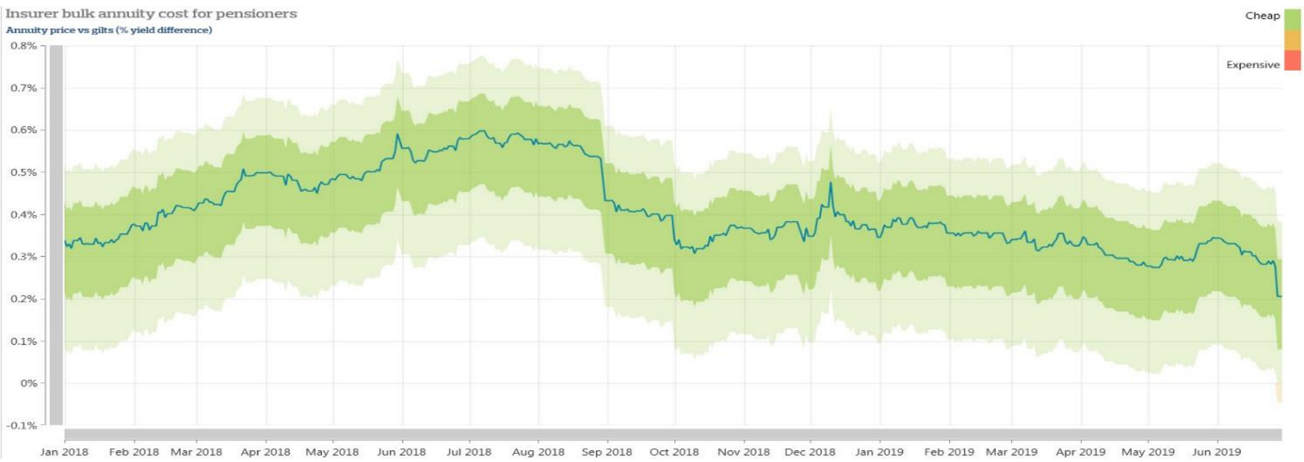
The chart below indicates the expected range of best pensioner pricing available in the bulk annuity market, for a typical scheme.

The market has been busy in the first half of 2019, and commentators are predicting another record year of business placed.

The chart shows that pricing has fallen away marginally over 2019. This is largely due to contracting credit spreads. The credit spread is the additional yield expected over the 'risk free' investment return, available from investing in corporate debt. Movements in credit spreads are traditionally a good indicator of changes in bulk annuity pricing.

Despite these market movements we have seen some excellent bulk annuity pricing, equivalent to a yield of around 0.70% p.a. above gilts, on recent cases.

To capitalise on pricing opportunities, it is crucial for schemes to be 'transaction ready'. This means having a clean proposition for insurers, to stand out in a busy market - good quality data for pricing, a strong governance framework and robust decision-making framework giving line of sight to a 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.
- 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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