UK Risk Settlement Bulletin

Q3 2020

New normal for Risk settlement

The rapid development of the COVID-19 pandemic in March had a big impact on the bulk annuity and longevity markets. Since then, market dynamics have substantially shifted. Risk settlement transactions have moved to a 'new normal'.

Please get in touch with your usual Aon contact if you would like to discuss any of this material.

Small schemes ready to seize the new normal

Over 2019 the bulk annuity market was dominated by the multi-billion transactions. From the outbreak of the pandemic, there was a shift in preference by insurers towards small and mid-sized deals.

This reflected reduced market liquidity leading to concerns from insurers around deploying large pools of assets in one go. Market volatility also led to increased risk regarding large scale asset transitions.

At the smaller end of the market (i.e. sub £100M transactions) we are continuing to see a shift towards streamlined processes involving standardised information packs for insurers and using pre-negotiated annuity contracts. This gives insurers increased confidence of a deal, allowing them to dedicate resource and assets to the project to support better pricing.

Asset transition planning and deal size will remain key themes in the market for the remainder of the year. Whilst we expect some larger transactions to complete during 2020, the rest of the year should present many opportunities for smaller sized deals.

The need for speed

Heightened market volatility during the onset of COVID-19 meant that some schemes had to move quickly to complete transactions over Q2 2020. The window for schemes to assess and accept insurer pricing proposals was very short, less than one week in some cases.

We experienced insurers trying to accelerate processes with short-term competitive proposals. In normal market conditions, insurers tend to provide price locks (i.e. a period where the underlying quotation changes with market conditions in a pre-agreed way) of 6-8 weeks, the period when contracts are agreed. Due to the market volatility, typical price lock periods were at most 3-4 weeks over March and April.

These factors meant that schemes needed to have an appropriate governance framework in place to enable fast decision making. Some schemes, for example, run risk settlement projects with a joint working group of Trustee and sponsors representation, with delegated authority to make decisions. Over recent months it is the most 'transaction ready' schemes that have accessed best pricing and terms.

As market conditions have stabilised, we are seeing more insurers become comfortable executing transactions according to more typical timelines. However, as always, the specifics will depend on the nature of the transaction, the assets being proposed for premium payment and market conditions at that time.

Schemes will continually need to be set up to act quickly to increase their chances of capturing market opportunities in a busy market. We expect this to be a continuing theme over the rest of 2020, with the possibility of further market disruption arising if there is a 'second wave' of the virus.

The starting gun is fired for commercial consolidators

The Pensions Regulator recently published DB Superfunds guidance, which provides a framework within which commercial consolidation solutions can operate. This signals that the market is now open for business.

In essence, commercial consolidators offer sponsors and trustees a full risk transfer of liabilities out of a scheme without the need to purchase annuities with an insurer. The key features of consolidators are:

- The consolidator is required to meet the future benefit payments from the scheme.
- There is no longer a link between the scheme and its past sponsor and trustees.
- A one-off premium, typically cheaper than a bulk annuity, is required on entry.

The Regulator's guidance applies in full to consolidation solutions that involve a sponsor severing their link to a pension scheme. They do this by transferring all liabilities to a new scheme and replacing the existing sponsor. The new sponsor provides a capital injection to support funding of member benefits. Clara and the Pension SuperFund are two examples of consolidators.

How much capital will commercial consolidators be required to hold?

Consolidators will be required to hold a sufficient "market risk" capital buffer so that there is a 99% chance of the arrangement being fully funded on a Technical Provisions approach over a five-year period. In addition, a "longevity risk" capital buffer must be held (see chart below).

This test represents a reasonably high bar, giving a high degree of confidence that benefits will be paid in full, but is expected to result in a lower level of security (but at a lower cost) when compared with the UK insurance regime.

To further protect the security of member benefits, the Regulator has initially placed restrictions on profits being extracted before member benefits are secured with an insurer, as well as the level of fees that the consolidators can charge.

Assessing consolidation options

Having more settlement options available to trustees and scheme sponsors can only be a good thing. The challenge for schemes will be to articulate their objectives and assess which of the many available end game options is most appropriate for their members.

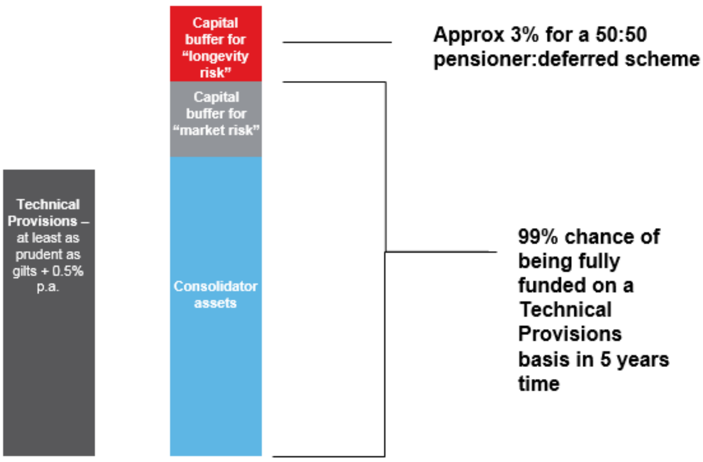


Chart source: Aon's Risk Settlement - Commercial Consolidators team

Bulk annuity market outlook

Financial market volatility, primarily due to the effects of COVID-19, typically led to improved bulk annuity pricing in March and April 2020.

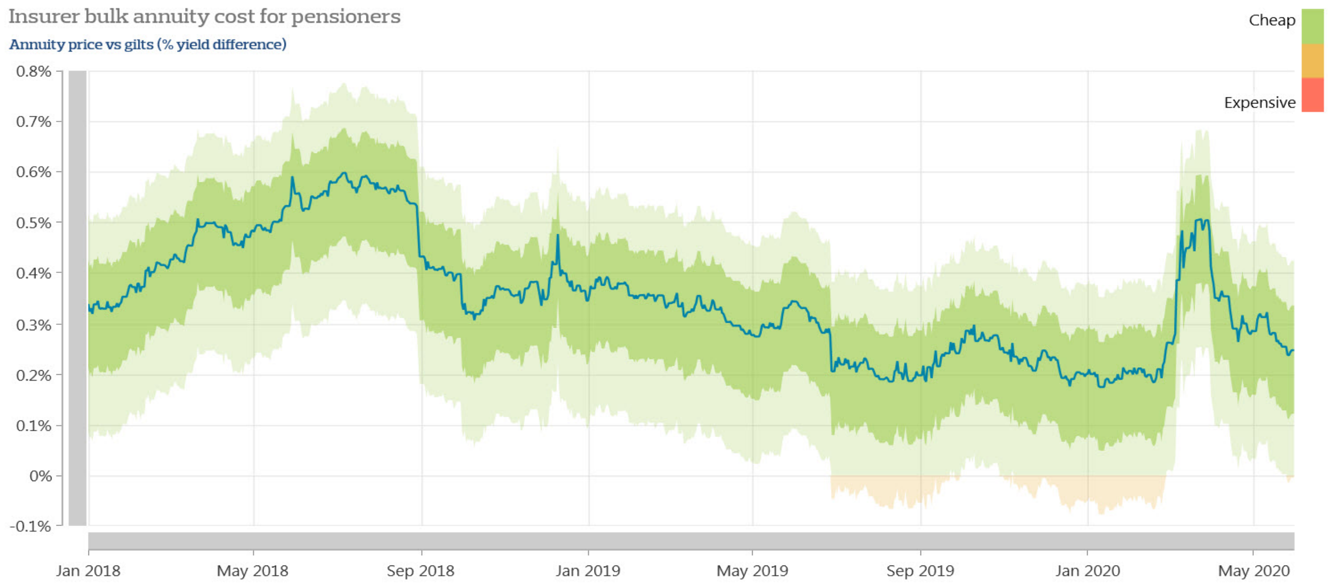
A key driver of this was sharp increases in yields available on assets used by insurers to back annuities, particularly the widening spread on corporate bonds (i.e. the additional return available in excess of government bonds). This effect can be seen on the chart below, around March and April.

Around this time, we witnessed bulk annuity pricing ranges between insurers of up to 10% on some auctions, more than double what would have been expected in past years. Pricing has subsequently stabilised through May and June as markets have settled, also shown on the chart below, yet pricing remains well in excess of gilt yields.

To some extent, this may be seen as a “missed opportunity”. However, short periods of volatility have continued (lasting a matter of days in some cases) and we have witnessed a number schemes using innovative processes to allow them to capture these opportunities.

Moreover, some schemes paused transactions following the outbreak of COVID-19. For example, due to falls in funding levels, increases in gilt collateral demands for LDI programmes, or scheme sponsor or operational constraints.

The relatively low volume of business placed in recent months is expected to increase commercial appetite from insurers (and reinsurers), as they focus on meeting business targets for the year, wanting to make up lost ground where transactions have stalled. The second half of 2020 might therefore be a "buyer's market" for schemes ready to act.



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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