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beyond the expected

Bulk annuities

Delivering de-risking in challenging times

Welcome to Barnett Waddingham's de-risking report on the buy-in, buy-out and longevity swap market.

In preparing this report we received feedback from the insurers currently active in the bulk annuity market, together with a number of longevity re-insurers, gauging their views on a range of key areas for the market and potential future developments. We would like to thank the following participants:

Aviva | Just | Legal & General | Pension Insurance Corporation | Phoenix Life | Rothesay Life | Scottish Widows | Hannover Re | Prudential Retirement

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2020 has proved to be an extremely challenging year with some inconceivable changes to our everyday lives. Throughout this period, the bulk annuity market has demonstrated its resilience; not only in operational terms, but also in its ability to deliver attractive opportunities, with total buy-in and buy-out volumes for 2020 set to become the second highest on record.

Whilst medical developments provide a more optimistic outlook for 2021, this has been a year like no other for pension scheme trustees and sponsoring employers, where navigating these uncertain times and managing the risks effectively has been paramount.

> Following a record-breaking 2019, the onset of the Covid-19 pandemic and its associated effects on the financial markets, has provided the backdrop for 2020. In section 1 of this report, we consider the recent market activity. This, includes both the insurer supply and pension scheme demand sides of the market, with each faring remarkably well taking into account the circumstances.

Insurers have adapted well from an operational perspective to the new working environment, with their business appetite essentially unchanged by the pandemic and willing to accommodate a full range of transaction profiles. For those schemes looking at a potential transaction in the shorter-term,

GAVIN MARKHAM

Partner and Head of Bulk Annuity Consulting

who may typically have a lower risk investment strategy, funding positions have also held up relatively well during a period of significant financial market movements maintaining affordability.

Barnett Waddingham's bulk annuity specialists are proud to have helped numerous schemes successfully navigate these volatile conditions over the course of the year, including the completion of the high profile £2bn transaction for the Old British Steel Pension Scheme in October 2020.

The onset of the crisis in the spring and the associated movement in credit markets provided some highly attractive bulk annuity pricing opportunities, albeit relatively short-lived. Whilst pensioner pricing has since returned more closely to the pre-pandemic position, it has continued to be at highly competitive levels relative to gilts. We explore the impact of market movements on pricing and some of the current issues which may influence pricing levels in section 2.

Alongside the bulk annuity market, it has also been a strong year for the longevity risk transfer market with over £15bn of transactions having been completed, including the £10bn transaction completed by the pension plan of Lloyds Bank at the start of the year. In section 3, we discuss the possible impacts of Covid-19 on longevity expectations and how both the bulk annuity insurers and longevity reinsurers have been reacting.

For both trustees and employers, having robust journey planning in place, including appropriate practical preparation steps within a holistic strategy, can help support the delivery of the scheme's long-term objectives and optimise any potential transaction outcome. We outline in section 4, how having these measures in place and proactively monitoring progress towards the endgame objective can enable schemes and sponsoring employers to achieve their aims more effectively and be better placed to take advantage of any potential market opportunities for de-risking.

Finally in section 5, we highlight some areas which may be of particular importance to the sponsoring employer, recognising it is the employer who is ultimately responsible for the financing of the scheme.

> Looking forward into 2021 and beyond, we expect a continuing busy marketplace, where careful planning and preparation are fundamental in achieving the best outcome, and in doing so, meet trustees and sponsoring employers' objectives.

01

Market activity:

OPERATING IN A COVID-19 WORLD

Written by
GAVIN MARKHAM
Partner and Head of
Bulk Annuity Transactions

2020 has been an unprecedented year with the global onset of Covid-19 and its wide-ranging impacts on both the financial markets and the underlying businesses of sponsoring employers. Whilst significant uncertainty remains around how the Covid-19 crisis will continue to unfold, insurers have responded positively and the bulk annuity market has continued to function effectively. How has buy-in and buy-out market activity fared during this period? What are the possible implications going forward?

Buy-ins and buy-outs

A look at 2019

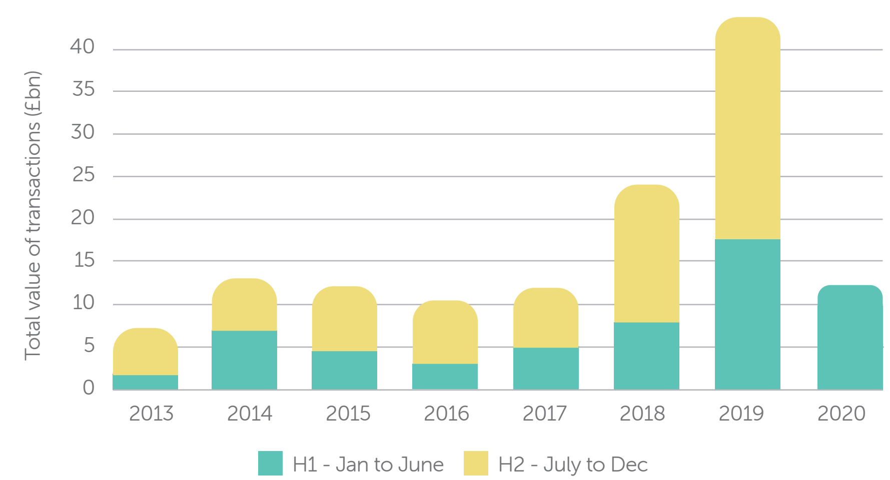
The bulk annuity market hit new highs in 2019, with the total volume of pension scheme transactions exceeding £40bn for the first time. This compares to the £24.2bn of business written in 2018, which itself had been a new annual record.

This step-change in total market volumes was largely driven by the marked increase in the number of very large transactions (over £1bn). The total value of the 10 transactions of £1bn+ completed in 2019 accounted for around two-thirds of the total market volumes for the year.

These included the largest transaction for an individual pension scheme, the £4.7bn full buy-in for the GEC 1972 Plan and the £3.8bn buy-in for the Allied Domecq Pension Fund, where Barnett Waddingham acted as the adviser to the sponsoring employer Pernod Ricard.

Whilst the completion of the very large transactions primarily remains the domain of three insurers – Legal & General, Pension Insurance Corporation (PIC) and Rothesay Life – both Aviva and Phoenix Life carried out £1bn+ transactions for the first time in 2019 in relation to their own pension schemes.

PENSION SCHEME BULK ANNUITY TRANSACTION VOLUMES



Source: Insurers and Barnett Waddingham research

Allied Domecq Pension Fund – £3.8bn buy-in

Barnett Waddingham advised Pernod Ricard, the sponsoring group company, on the £3.8bn buy-in of the Allied Domecq Pension Fund (the "Fund") completed in September 2019 with Rothesay Life, covering c. 27,000 pensioner and deferred members.

Securing the buy-in, the largest buy-in transaction in respect of deferreds and pensioners, removed the vast majority of the pension risk associated with the Fund – a positive outcome for all parties. By capturing competitive market pricing, the desired de-risking was delivered well ahead of schedule and without the need for any incremental funding.

Our multi-disciplinary team of corporate actuarial, investment and bulk annuity specialists, supported the company throughout 'its de-risking journey, ultimately leading to the successful completion of the buy-in transaction. By working closely with the company to develop their key transaction objectives, we were able to help deliver the desired outcome, including providing support for the negotiation of contractual terms which addressed the priority areas for the sponsor and successfully navigating the corporate accounting implications, a crucial aspect for the company.

"We are delighted with the outcome of the transaction which is a significant positive step for both members and the company. Barnett Waddingham's help in supporting the company throughout the process has been invaluable, particularly with short timescales for action given the need to take advantage of the market pricing available."

FLORENCE TRESARRIEU, GROUP TREASURY DIRECTOR AT PERNOD RICARD:

Progression of 2020

At the start of the year, our expectations were for the bulk annuity market to complete around £30bn of transactions. Whilst not at the exceptional volumes seen in 2019, the market was still set to be extremely busy, albeit with fewer multi-billion pound cases featuring in insurers' 2020 pipelines at the start of the year.

As the first quarter progressed and the pandemic began to spread, the bulk annuity market quickly adjusted to operating in a Covid-19 environment. Given the response of the market, our expectations for volumes written in 2020 has not changed significantly.

> We estimate that the overall total buy-in and buy-out volumes for 2020 will be of the order of £25-£30bn, demonstrating the resilience of this market.

During the first half of 2020, £12.6bn of buy-ins and buy-outs were completed, showing the bulk annuity market has been able to successfully navigate the challenges thrown up by the Covid-19 crisis during this period. Whilst this first half of 2020 volume didn't quite match 2019's record high, it was the second busiest first half of the year in history, which given the backdrop is notable.

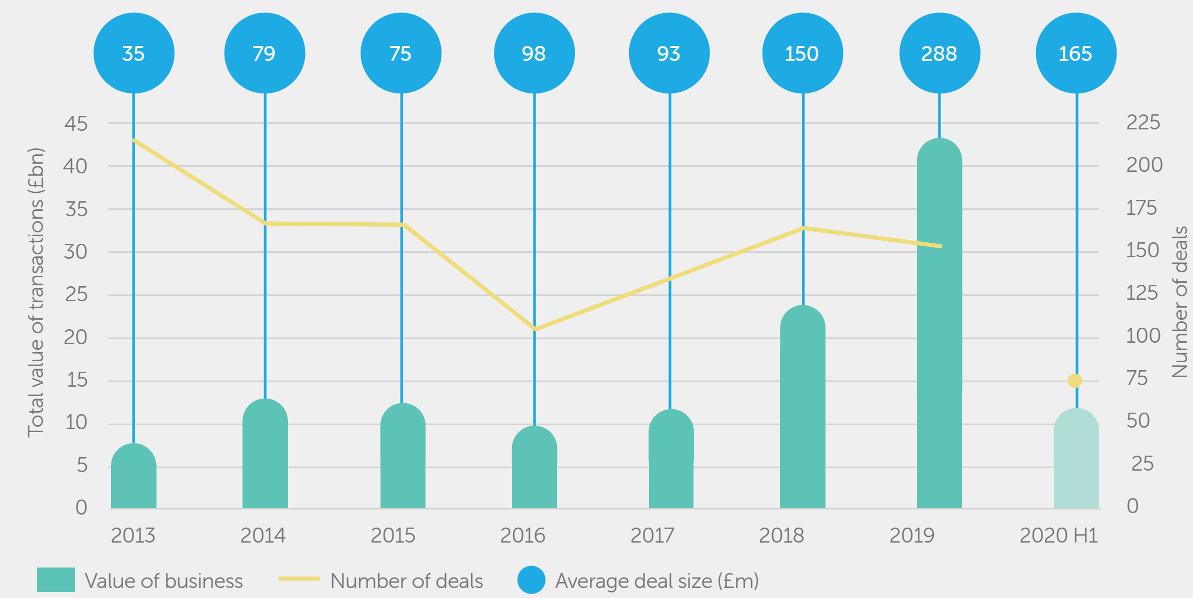
As discussed in section 2, some of the schemes transacting in the spring were able to take advantage of attractive pricing (relative to gilts) offered by certain insurers reflecting the material widening of corporate bond credit spreads in response to the developing Covid-19 crisis, both in relation to UK and US corporate credit. This encouraged some schemes with existing buy-ins to complete follow on transactions. In practice, it is those schemes that were already in the market, or had much of the transaction infrastructure in place, who were able to take advantage of this relatively fleeting opportunity.

2020 is set to be the second highest year in terms of annual volume of pension scheme business written. Recognising that 2019 was exceptional, the volumes for 2020 are expected to continue the steep growth in this market since 2017. The underlying direction of travel for the vast majority of pension schemes is towards a greater level of de-risking as they continue to mature. However, total market volumes will reflect the number of very large transactions coming to market which will tend to vary from year to year, albeit influenced to some extent by certain factors such as changes in the financial market conditions and insurer pricing levels.

The number of buy-in and buy-out transactions completed in the first half of 2020, has remained broadly on track with previous years, suggesting that the number of transactions over the full year will again be of the order of 150 or so.

In addition to the bulk annuity market, 2020 has also been a strong year for the longevity only risk transfer market, as discussed further in section 3, including the completion of the £10bn longevity swap for the pension plan of the Lloyds Banking Group.

NUMBER AND VALUE OF PENSION SCHEME BULK ANNUITY TRANSACTIONS



Source: Insurers and Barnett Waddingham research

> "The bulk annuity market has continued to operate smoothly through 2020 and all parties have responded well to the challenging conditions."
>
> AVIVA

Navigating the Covid-19 crisis – over six months on

Insurers – supply side of the market

There were some headwinds to the smooth functioning of the market for the insurers at the start of the lockdown period in spring, not least related to the associated volatility in the financial markets. However, in general this led to relatively little disruption as insurers sought to effectively mitigate the impact.

Three insurer key areas which have helped support the supply side of the market during this period are:

OPERATIONS

Insurers transferred to remote working where necessary, effectively supporting both the new business process and delivery of services for existing policies

APPETITE

Insurers' appetite for new business has remained largely unaffected by crisis and remains high, with continued access to suitable levels of capital

PRICING

Insurer pricing (relative to gilts) has continued to be attractive, reverting more closely to recent pre-pandemic levels following the significant spiked improvement in some insurers' pricing in March and April

In light of Covid-19, there has also been a heightened focus on the insurers' financial strength and potential future resilience, an important consideration for both the trustees and the sponsoring employer in the selection of a suitable counterparty. In practice, whilst the impact on the individual bulk annuity insurers' financial positions will vary depending on their specific investment strategy (e.g. exposure to credit and property risks), over the six months since lockdown, any impacts have been fairly limited and mitigated by the insurers' highly risk managed approach. As part of good governance generally, and given the potential for future market volatility, this will continue to be an important aspect of the due diligence process in selecting a provider.

Over six months on from the initial outbreak of Covid-19 in the UK, the insurers within the bulk annuity market are essentially operating as normal, or at least the "new normal". It remains to be seen what further impacts or challenges emerge from the developing pandemic and the impact of positive medical developments in relation to vaccines moving into 2021. Insurers may for example, face some additional challenges in sourcing attractive illiquid assets that are often used to support competitive pricing, with insurers increasingly selective to control risk. We also consider longevity risk and the reinsurance aspects in section 3.

Pension schemes – demand side of the market

From a pension scheme perspective, or effectively the demand side of the market, feasibility is generally influenced by changes in the funding position of the scheme and the ability, or willingness, of the sponsoring employer to meet any additional funding requirements in order to transact. The financial impact for schemes during the Covid-19 crisis has depended strongly on their specific investment strategy and how well this matches the underlying nature of their liability profile.

> For those schemes which have typically been relatively well-hedged in anticipation of a transaction (i.e. in relation to movements in gilt or swap yields and inflation), any impact on the funding position has been fairly minimal, or even potentially positive.

As a result, the vast majority of our clients have continued to progress their transaction preparations and bulk annuity processes, with some accelerating their plans in order to be better placed to take advantage of any future pricing opportunities. In a small number of cases, processes have been paused. An example of this is where the overall scheme funding position may have deteriorated, or where additional funding to support the transaction was expected and this financing is no longer readily available due to the impact generated by Covid-19 on the sponsor's wider business and economic uncertainty.

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Wider economic impact

The wider impacts of Covid-19 on the economic environment moving forward are likely to be around for a number of years and play a significant role in the nature of some of the cases coming to market. For example, the direct consequences of continuing the pandemic restrictions and broader effects on peoples' behaviour can already be seen to be having severe implications for certain areas of the economy, including the aviation, leisure and hospitality, and high street retail sectors. These challenges may also be set to increase when the Government looks to unwind its business support measures depending if, and how quickly some of these areas are able to revert back to more normal circumstances.

For a small number of businesses, Covid-19 may have simply served to accelerate the inevitable, however for others the issues have effectively sprung up overnight. Either way, the number of companies which may have severe financial difficulties or enter into administration as a result of the crisis is likely to increase.

Where there is a DB scheme involved, a higher number of business restructures or insolvencies increases the potential for scheme rescue or PPF+ transactions. The structure of scheme rescue or PPF+ transactions is highly dependent in the individual circumstances. In the absence of any further employer support, a PPF+ transaction is where the scheme is able to deliver a greater value of benefits than those payable in the Pensions Protection Fund (PPF), but does not have sufficient assets to secure the scheme benefits in full.

In practice, it is likely to take some time for these transactions to emerge following economic downturn, as schemes go through the relevant processes. However, this may well become a more prevalent part of the market over the next few years as the financial consequences of the pandemic impact particular business areas.

Barnett Waddingham provided the advice for the recent £2bn transaction of the Old British Steel Pension Scheme completed in October 2020, this is anticipated to potentially be the largest transaction of 2020.

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Old British Steel Pension Scheme - £2bn buy-in transaction

Barnett Waddingham is delighted to have advised the Old British Steel Pension Scheme (OBSPS) on its £2bn buy-in with insurer, Pension Insurance Corporation (PIC). This transaction is expected to pave the way for the Scheme to exit its Pension Protection Fund (PPF) assessment period and secure a full buy-out next year. The buy-in secures the liabilities of over 30,000 members at or above PPF levels of compensation.

The OBSPS entered a PPF assessment period on 29 March 2018, as a result of the restructuring of the UK operations of Tata Steel UK Limited agreed with the Pensions Regulator and the PPF. During the Scheme's PPF assessment period, Barnett Waddingham worked closely with the Trustee to identify and then explore the potential feasibility of a transaction. Through this detailed assessment, we were able to establish the potential to insure members' benefits at or above PPF levels of compensation. The buy-in should ultimately result in a better outcome for members than they might otherwise have been expecting.

Whilst all members' benefits have now been secured at or above their current PPF levels of compensation with PIC, the exact outcome for each member will not be known until the buy-out occurs. This is expected to happen towards the end of 2021, as further work is still required before the OBSPS can be fully transferred to PIC. During this period, the Scheme will remain within its PPF assessment period and continue to be protected by the PPF.

The transaction required bespoke contractual flexibility coupled with an innovative approach to accommodate the Scheme's specific requirements.

"We are delighted to have entered into this buy-in policy with PIC. This transaction will eventually see OBSPS members receive benefits either at the same PPF level as those currently provided or, for many members, an uplift above that amount. It has been difficult for the OBSPS members over the last few years. Whilst the PPF provides a valuable safety net and a significant level of protection, many members will now receive higher benefits than they might otherwise have expected had the Scheme entered the PPF. OBSPS members can take comfort that their benefits will be looked after by an insurer, which is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority, as well as being committed to the highest levels of customer service."

JONATHAN HAZLETT, MANAGING DIRECTOR OF OPEN TRUSTEES

"This is a significant transaction, guaranteeing the benefits of the more than 30,000 pension scheme members who have faced a long period of uncertainty about the level of their benefits, and providing many with an uplift over PPF levels. We are delighted to have been able to work so closely with the Trustee and Barnett Waddingham and ultimately deliver what was required in the biggest and most significant transaction of the year."

UZMA NAZIR, HEAD OF ORIGINATION STRUCTURING AT PIC

Outlook for 2021 and beyond

The future development of the Covid-19 outbreak means that there is more uncertainty around the potential outlook for 2021 and the factors which may influence the market. This is in addition to the effects of the UK leaving the European Union and the US election result, which in more normal circumstances would be centre stage.

However, the ultimate aim for the majority of schemes remains unchanged and the strong demand for de-risking is set to continue. For those schemes which are well advanced in their journey plan, any further financial market volatility may only have a limited impact and even provide some opportunities, if for example credit spreads were to widen again and feed through to reduced insurer pricing.

> Therefore, we anticipate any impact on bulk annuity demand to be reasonably muted in the short-term, and the medium to longer-term demand to be driven by the positive de-risking appetite of schemes.

From a broader de-risking perspective, and recognising the Pensions Regulator's existing desire before the onset of Covid-19 for pension schemes to put in place long-term plans, the pandemic and associated economic crisis may lead to a heightened focus by schemes' on their long-term objectives and risk management. In the short-term, schemes may well have specific challenges together with potential further market volatility to navigate. Looking into the medium-term, having an established journey plan in place, is expected to help schemes be better prepared to recognise and capture de-risking opportunities. In turn, this is likely to lead to increased demand, either through full buy-out or partial buy-ins where these are used as a mechanism for reducing the level of risk along the scheme's endgame journey.

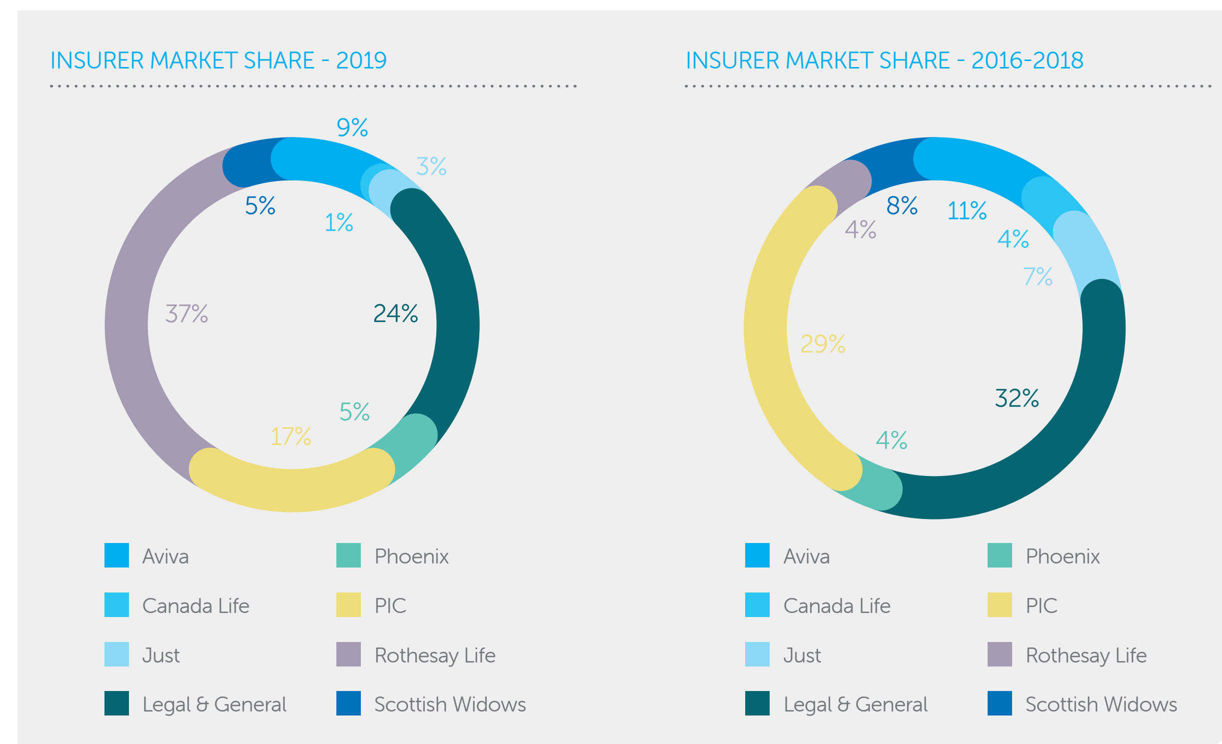
In looking to achieve the best outcome in this busy market, the messaging to pension schemes remains the same. Be proactive and engage with the market in a well-prepared and considered manner. Clear objectives, demonstrating transaction readiness and having a good understanding of the insurers' perspective and operations will be key in maximising insurer engagement and being an attractive proposition compared to the other schemes coming to market.

> "We are entering a period of significant uncertainty with Brexit and the ongoing Covid situation, however to date this has not affected demand. There is a healthy pipeline of deals coming to market, and appetite from insurers remains strong. We expect trustees and sponsors to have another busy year within the bulk annuity space."
>
> PENSION INSURANCE CORPORATION

Provider landscape

Insurer market share

Legal & General, PIC and Rothesay Life were the leading players in 2019 by market share, driven by the completion of the very large deals. Legal & General and PIC have consistently represented a significant proportion of the overall market volumes, having accounted for over half the total value of pension scheme transactions in prior years between them. 2019 was a particularly strong year for Rothesay Life in terms of pension scheme transactions, having previously completed a number of high profile insurer to insurer back-book annuity deals.



Source: Insurers and Barnett Waddingham research

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In line with previous years. Aviva completed the highest number of transactions in both 2019 and the first half of 2020. During these periods, Legal & General completed the second highest, partly reflecting an increased willingness to participate in a number of smaller transactions.

The average deal size provides a broad indication of the insurers' range of appetite – Aviva, Canada Life and Just writing a significant proportion of their business in the sub £100m transaction size band.

INSURER TRANSACTIONS - 2019

Insurer:	Transaction Volume (£bn)	Number of Transactions	Average Transaction Size (£m)
Aviva	4.0	54	74
Canada Life	0.4	8	55
Just	1.2	22	56
Legal & General	10.3	31	333
PIC	7.2	17	427
Phoenix Life	2.2	5	448
Rothesay Life	16.2	10	1,629
Scottish Widows	2.0	5	406

Source: Insurers, Barnett Waddingham research

Insurer appetite

Insurers have differing preferences for transaction size and profile. These preferences, and so their underlying appetite, will vary over time due to commercial influences and competing demands. The figure below provides an indicative illustration of the insurer's appetite by transaction size for each of the eight bulk annuity insurers currently active in the market. Several of the insurers have looked to enhance their proposition for deferred members and full scheme buy-outs where they have historically been focussed on pensioner buy-ins. This is in recognition of the increasing trend for maturing schemes looking to effectively de-risk via full scheme buy-outs or buy-ins.

Figures provide an indicative illustration of the current insurer appetite by transaction size. Whilst it is intended to provide a reasonable guide to the insurers' preferences, each insurer will consider a range of factors in deciding whether to participate, including any scheme specific features and competing pipeline cases.

Source: Insurers, Barnett Waddingham research

02

Written by
ANDY SMITH
Associate

Pricing and affordability

Pricing movements

Despite the uncertainty created by Covid-19, insurer appetite for bulk annuity transactions has remained strong in 2020, with transactions of £12.6bn written in the first half of the year.

This reflects continuing strong appetite from market participants to write new business and significant opportunities for well positioned schemes to take advantage of improved pricing.

The impact of the Covid-19 pandemic created significant turbulence within investment markets in the first half of 2020 with the main implications for pension schemes including:

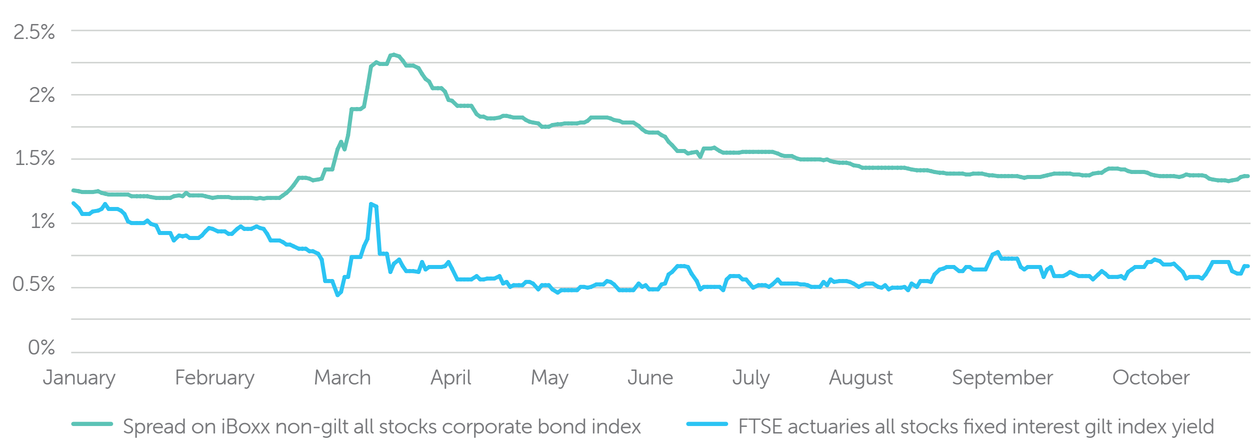
- Government bond yields continued the downward trend seen over the last decade, hitting all-time lows and remaining close to 0.5% pa between March and July.
- The credit spreads implied from corporate bonds valuations increased sharply in late March, before returning gradually towards recent levels over the subsequent five months. This created a three month window during which credit spreads moved outside of the typical range (1% pa to 1.5% pa) that they had occupied since last reaching 2% pa in 2012.
- During this time, the behaviour of the credit spread index shown below compared to individual bonds varied significantly, and importantly it was not always possible for insurers to invest and lock into the implied spread due to market liquidity challenges. This, coupled with differences in insurers' investment strategies and their pricing approaches, caused pricing from individual insurers to behave differently during the period of extreme volatility in the spring.
- Growth assets fell significantly, with global equity markets falling by more than 30% before recovering those losses over the next five months (albeit with some indices or sectors faring substantially better than others).

> The widening of credit spreads in particular led to improved bulk annuity pricing with the implied margin relative to gilts increasing significantly in the spring.

This allowed schemes, which were transaction-ready and cautiously invested (well hedged against movements in government bond yields and with limited equity exposure), to take advantage and secure benefits at attractive levels. This movement in insurer pricing is shown in the chart below, showing the estimated margin above gilts based risk-free rates achievable on pensioner transactions since the start of the year.

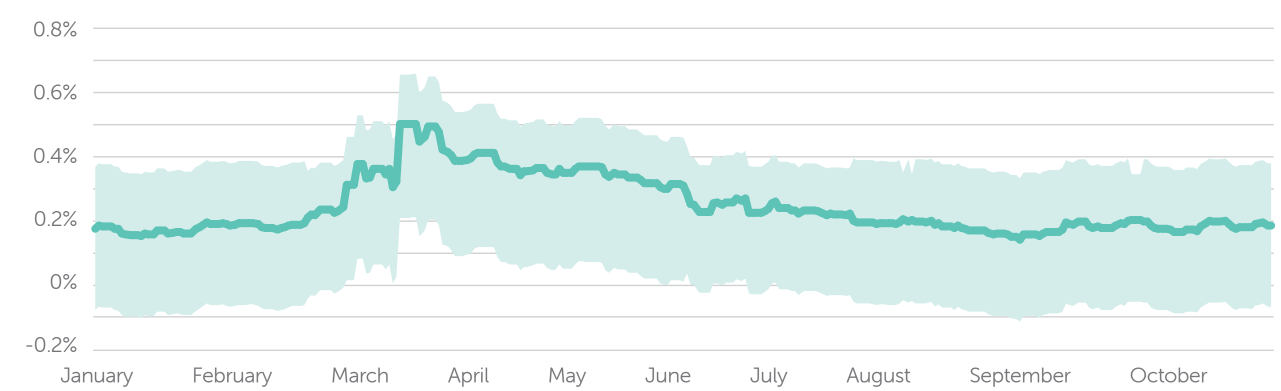
Of particular note is the significant range of pricing seen following the spike in credit spreads. This reflects significant variations in insurers' investment strategies, their ability to source credit assets which took advantage of the short-term increase in spreads, and their willingness to pass improvement in yield into their pricing. Pricing levels continue to remain attractive, albeit below the level that might have been achievable earlier this year.

GILT AND BOND YIELDS 2020



Source: Data from iBoxx and FTSE

YIELD DIFFERENCE BETWEEN GILTS AND BULK ANNUITY PRICING FOR PENSIONERS 2020



Source: Insurers, Barnett Waddingham research

Full buy-out pricing

Whilst deferred pricing has been more attractive than historically, the opportunities presented by the market volatility were not as significant as for pensioner pricing, particularly since deferred pricing tends to be less sensitive to traded credit. This is illustrated on the chart to the right, which shows the estimated funding levels of two illustrative schemes – one mature and one immature - on both funding and buy-out bases since the start of the year . These schemes are in different positions, both in terms of relative funding levels, but also in terms of their respective investment risk profiles.

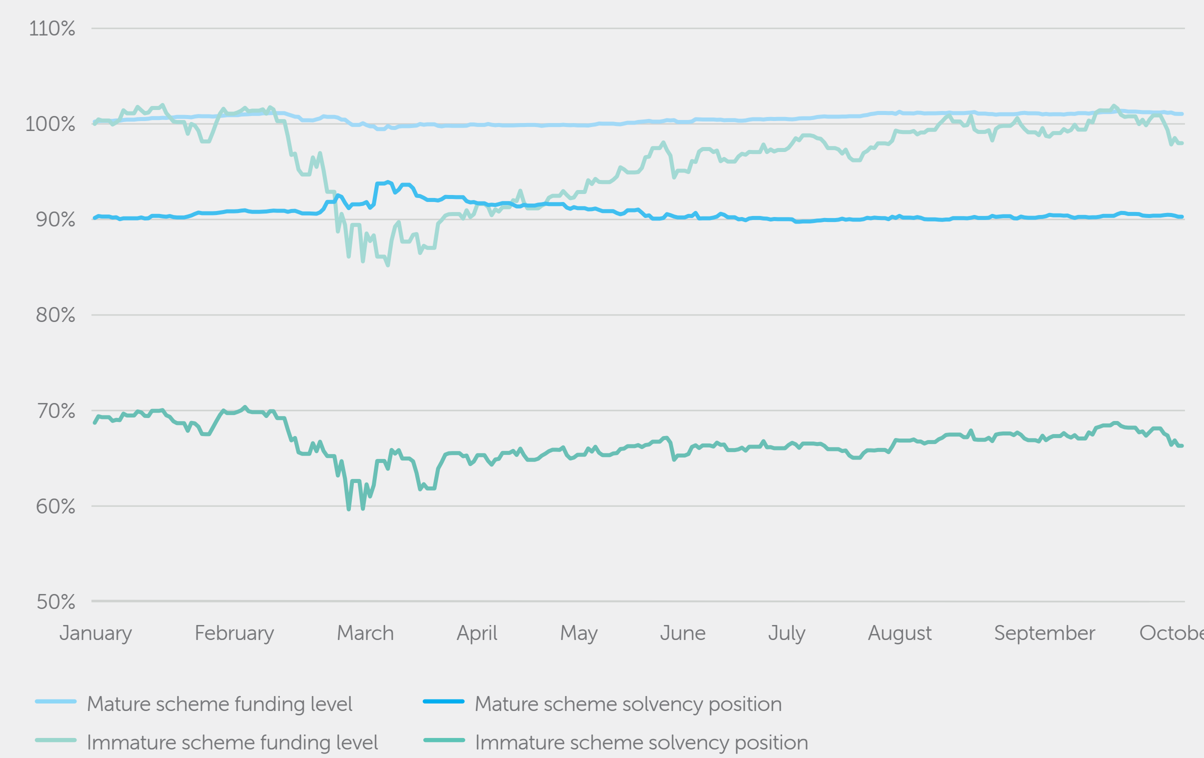
> The mature scheme's funding position has remained fairly stable. In March the buy-out position improved due to widening credit spreads, protection from hedging assets and limited equity exposure. The chart shows a fleeting window where the buy-out deficit narrowed as a result of the attractive pricing level.

The brief nature of this particular window highlights the importance of being transaction ready, monitoring the market for potential pricing opportunities, and being able to make decisions quickly. As the Covid-19 crisis continues, the stage is set for potential future volatility. That said, this illustration shows the mature scheme would likely have needed a top-up to make the buy-out affordable. The scale of top-up needed and whether the employer had appetite to commit to additional funding at that time would have played into transaction viability.

In contrast, the immature scheme's funding position deteriorated substantially in March (by c. 15%) before starting to recover over the subsequent months. Widening credit spreads did not present such a substantial pricing opportunity, as this was coupled with losses on the growth assets and unhedged liability exposures. The buy-out position actually fell in the spring by c. 10% from the start of the year and has not yet fully recovered. This lack of recovery reflects the under-hedged position, with the impact of falling yields offsetting the recovery in global equity markets. The majority of the immature scheme's buy-out funding performance has been driven by the inherent level of risk in its buy-out position.

> "Despite the ongoing pandemic, bulk annuity pricing, when viewed as a yield relative to gilts, remains at very attractive levels. This is being driven by many factors including strong competition in the market and insurers being able to source good, high yielding direct investments as an alternative to credit given the recent tightening of spreads from the highs of March/April."
>
> LEGAL & GENERAL

FULL BUY-OUT PRICING 2020

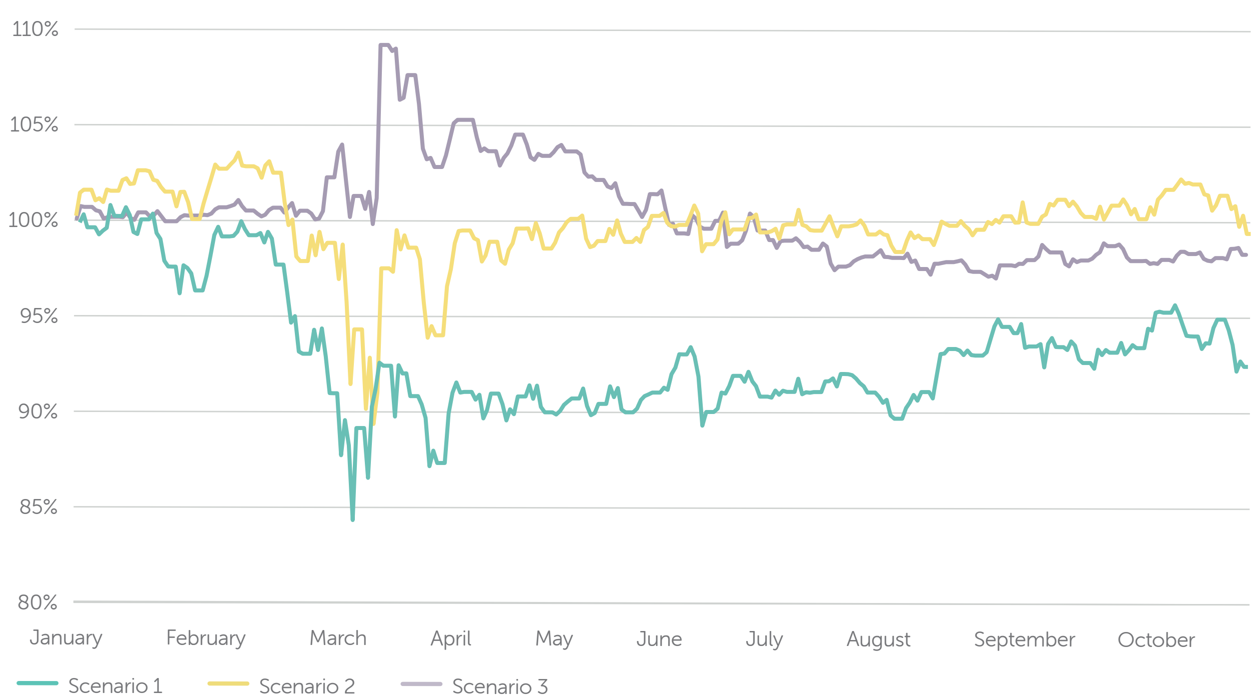


Source: Insurers, Barnett Waddingham bulk annuity pricing model

[1] The mature scheme has 90% of liabilities in respect of pensioners, 25% of its assets invested in DGFs and 75% in government bonds which hedge 100% of its inflation and interest rate exposure. The immature scheme has 25% of liabilities in respect of pensioners, 60% of its assets invested in global equities and 40% in government bonds which hedge 80% of its interest rate and inflation exposure.

We can explore this further by considering some different investment scenarios for the immature scheme. For ease of comparison the buy-out funding levels has been rebased to 100 at the start of the year.

INVESTMENT STRATEGY COMPARISON 2020



Source: Insurers, Barnett Waddingham research

Scenario:	1	2	3
Level of hedging	50%	100%	100%
Asset allocation:			
- Global equities	50%	50%	0%
- Corporate bonds	25%	25%	25%
- Government bonds	25%	25%	75%

The chart highlights that:

- The reduction in bond yields over the year had a detrimental impact on schemes with limited hedging in place.
- Schemes with material equity exposure experienced a significant funding deterioration in March. As equity markets subsequently recovered, this exposure had a positive impact.
- Schemes with no (or lower) equity exposure were able to benefit from the pricing opportunity in March and April, particularly if significant liability hedging was in place. This is highlighted by the different funding progressions under scenarios 2 and 3.
- The recovery in equity markets was not sufficient to offset the impact of falling bond yields for underhedged schemes. This is highlighted by the by the different funding positions under scenarios 1 and 2.

Other pricing influences RPI reform

The UK Statistics Authority intends to align the Retail Prices Index ("RPI") with the Consumer Prices Index including owner occupiers' housing costs ("CPIH"). They are not able to revise RPI prior to 2030 without the consent of the Government, who, following a consultation process recently confirmed that they would not provide their consent to an earlier alignment and would not provide compensation to holders of index-linked gilts. Whilst this has removed uncertainty over the timing of RPI reform, there is the best part of a decade until 2030 and so clearly the position could change.

CPIH is expected to be c. 1% pa lower than RPI (in its current form) and so the planned reform has significant implications for pension schemes. These were discussed in detail in our note on the RPI reform proposals. The specific impact on the feasibility of bulk annuity transactions will depend on:

1. The inflation linkage of scheme benefits (i.e. whether they are linked to RPI of CPI inflation)
2. The level of inflation hedging in place
3. The index to which inflation hedging is linked
4. The level of any caps or floors that apply to inflation linked pension increases
5. The availability of assets to insurers which are linked to the relevant inflation measure

Putting movements in the general level of inflation expectations to one side, schemes with under-hedged RPI linked liabilities will have fared best (particularly where increases are subject to higher inflation caps) and schemes, which hedge CPI liabilities with RPI instruments will have fared worst as those hedging instruments are now expected to pay out lower cashflows without a corresponding liability reduction.

> Between March and April 25 year RPI expectations fell by c. 0.5% pa before increasing as markets anticipated increased inflationary pressure. The reduction in March may have partly reflected the pricing in of RPI reform. It occurred at the same time as widening credit spreads, creating a significant opportunity for schemes with limited inflation hedging in place.

Since the spring, long term inflation expectations have increased to near start of 2020 levels. Whilst the result of the consultation was expected to some degree, it is interesting that there has been limited immediate reaction in the index-linked gilt market since the Government's November announcement, which may be influenced by the wider supply and demand position.

BANK OF ENGLAND 25 YEAR MARKET IMPLIED RPI INFLATION 2020

Source: Bank of England

Regulatory changes

2020 has been a relatively quiet year in terms of regulatory change for insurers. The Prudential Regulatory Authority (PRA) and the Financial Conduct Authority have been actively engaging with market participants to monitor and manage risks associated with Covid-19. This engagement is to be expected and should be reassuring for actual and prospective annuity policyholders.

That said, Brexit is around the corner and many questions remain regarding the UK's relationship with the EU.

Over time, it is likely there will be some degree of divergence in UK insurance regulation relative to Solvency II within the EU. It is clear that these developments will take time to emerge, and so there is expected to be little immediate change from the start of 2020 as insurers have prepared to maintain operational functionality.

> The PRA has previously indicated that there are some aspects of the Solvency II regime that could be refined, and as the UK separates from the EU, the PRA is likely to have more latitude to adjust the UK regulations.

HM Treasury is currently consulting on how the Solvency II rules can be better tailored to take account of the structural features of the UK insurance sector. The stated objectives of this consultation are to:

- spur a vibrant, innovative, and internationally competitive insurance market
- protect policyholders by ensuring the safety and soundness of firms
- support insurers to provide long-term capital to support economic prosperity, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets, in a manner that is consistent with the Government's climate change objectives.

The consultation suggests that some aspects of the existing Solvency II regime may move in favour of insurers – for example, there is acknowledgment that the determination of the Risk Margin could be refined. We await the outcome of the consultation, recognising that it will then take time for any changes to insurance regulations to filter into legislation and ultimately be implemented. As such, we do not anticipate short term changes to pricing, but the stage is set for longer-term developments.

> “The pricing of demographic risks is largely driven by reinsurer views - and we have not yet seen any movement in longevity reinsurance pricing as a direct response to COVID-19.
>
> PHOENIX LIFE

Dynamic market

Insurer pricing is dynamic. It ebbs and flows between insurers as their appetite changes in response to winning new business and performance across their wider business, As well as being impacted by the balance in supply and demand for bulk annuity transactions across the market. In addition to this, insurers may target particular transactions. This could be because they believe their pricing approach will be competitive and so allow them to win the business on relatively strong profitability metrics. Alternatively, it could offer a good complement to other aspects of their book, such as having the cashflows match a newly acquired asset or combine with another liability-side win to make an easier-to-hedge profile.

Beyond this, insurers will assess the longevity risks associated with a particular block of liabilities. As insurers typically tend to relay a good portion of their longevity risk into the reinsurance market, the bulk annuity market is intrinsically linked to the longevity insurance market. We discuss how longevity risk transfer and wider longevity risks have fared over 2020 in section 3.

03

2020

AN UNPRECEDENTED YEAR FOR LONGEVITY

Written by
SIMON BRAMWELL
Principal, Head of Longevity Risk Transactions

2020: an unprecedented year for longevity

Many things can be said about 2020, but one lesser-considered aspect is quite how familiar the public has sadly become with charts and statistics in respect of national death data.

> For many months, Government briefings, news reports and social media have bombarded us with increasingly detailed information regarding Covid-19 and deaths in this country and elsewhere (even extending to some appreciation amongst the general public for how logarithmic charting can help demonstrate trends).

In the space of a few months, the weekly death data from the Office of National Statistics morphed from a simple spreadsheet that has changed little in the last few years to one with multiple new lines of granularity and categorisation. This has been driven by a significant interest in accurate and timely information, with regional and national policy responses to the pandemic being shaped around this data.

Why is this relevant? It means that mortality statistics and the discussion on life expectancy is an incredibly hot topic. There is a substantial amount of new data and nuance for trustees and sponsors of pension schemes to consider when setting the longevity assumptions for their own specific scheme. This is particularly important when approaching the insurance market as a thorough understanding of the scheme's longevity profile will help to inform the setting of suitable objectives for any transaction.

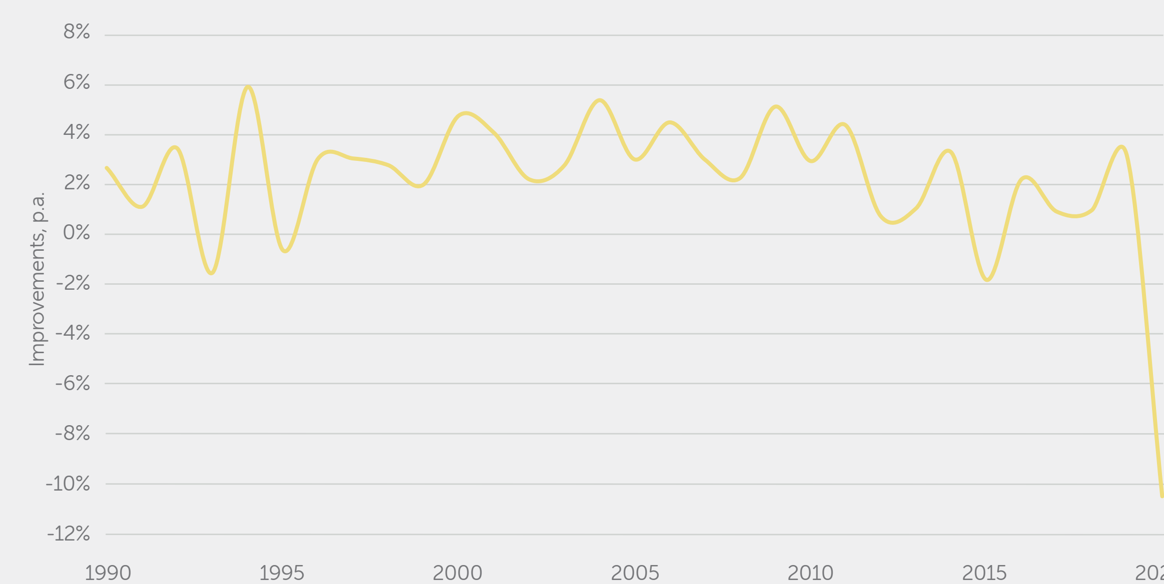
Looking at the current picture, in this section we consider how the pensions industry is reacting to the emerging mortality data and what factors may influence future longevity experience and also assumption setting, including the responses of both insurers and reinsurers.

Recent developments in longevity

After nearly a decade of relatively little improvement in longevity in the UK, 2019 turned out to be a very strong year for improvements, with overall average mortality rates lower than in any of the prior ten years. Indeed, 2020 started positively too, with fewer deaths in the first three months than compared to the five-year average, thus implying the trend for improvements in life expectancy from 2019 was set to continue.

Of course, subsequent events mean that 2020 will be a much bleaker picture with an unprecedented level of negative improvements in UK mortality rates. Simply updating pre-existing mortality projection models for the significant increase in deaths over 2020 would lead to a sharp fall in projected life expectancy. Given the potential impact for pension schemes in considering their own membership's life expectancy assumptions there has been much industry debate as to how this data should be incorporated.

STANDARDISED MORTALITY IMPROVEMENTS, AGES 65 TO 85



Source: Barnett Waddingham calculations based on the CMI dataset

Industry reaction

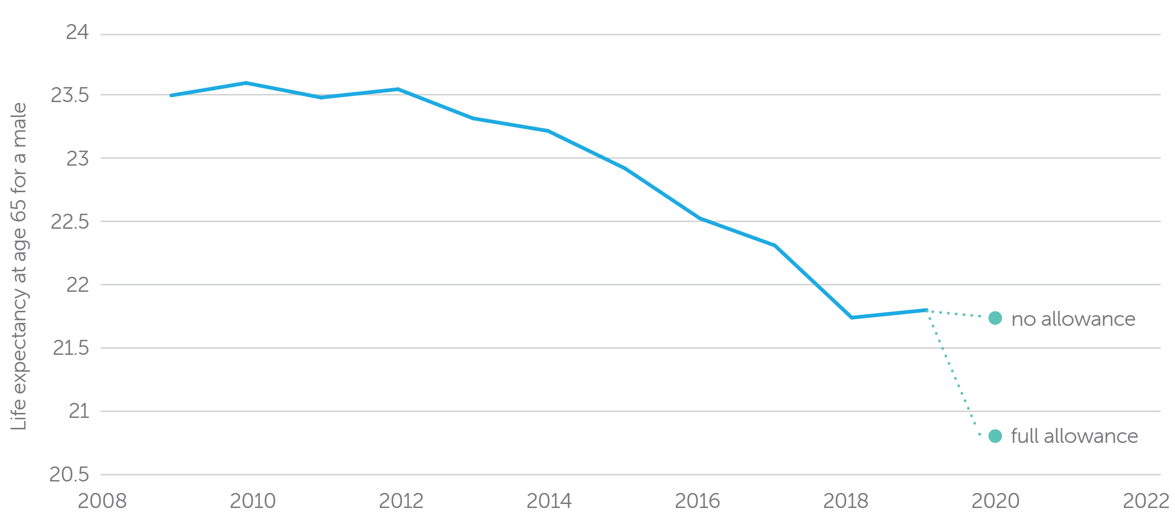
In September, the Continuous Mortality Investigation (the "CMI"), supported by the Institute and Faculty of Actuaries, released a consultation outlining their views on how their mortality improvement projection model would allow for the exceptional experience seen in 2020. This is particularly relevant for pension schemes as this is the predominant model used to predict the future course of life expectancy when setting scheme assumptions.

In summary, the CMI have proposed that no "weight" is placed on the 2020 death data and it is effectively ignored. However, as their model is released in March 2021, and allows for the full year's worth of data, they may review this guidance nearer the time depending on how the remainder of 2020 plays out.

The chart below shows the potential change in future life expectancy in the next version of the model (CMI_2020) versus last year's model (CMI_2019), assuming that the 2020 data (to date) is fully allowed for or ignored.
The model will allow users to exercise their own judgement and either make no, partial or full allowance for the 2020 data when setting their own scheme's life expectancy assumptions.

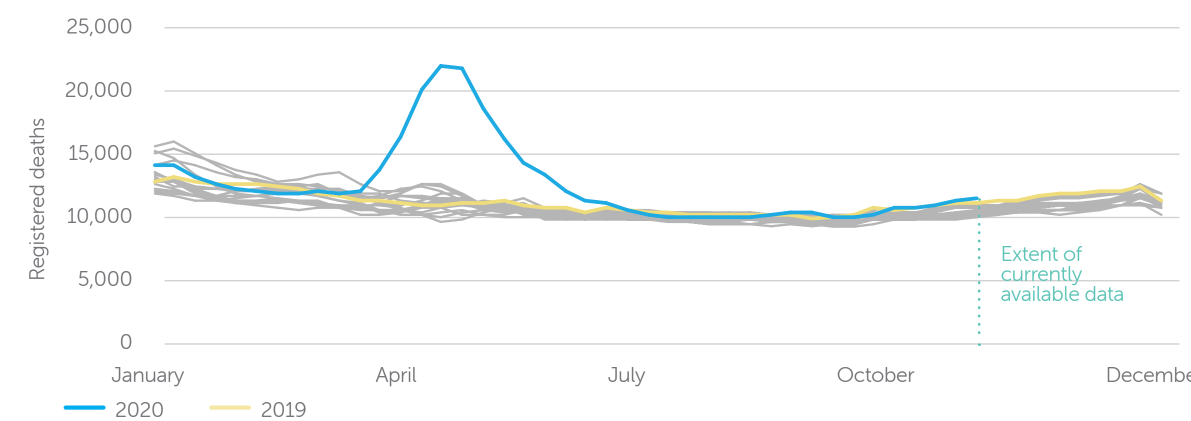
> The impact could be considerable: at the extreme end, it could result in a 4-5% reduction in pension scheme liabilities.

PROGRESSION OF CMI MORTALITY IMPROVEMENT PROJECTIONS



Source: Barnett Waddingham calculations based on the CMI dataset

WEEKLY REGISTERED DEATHS BY YEAR (3-WEEK AVERAGE), 2005 TO 2020



Source: Barnett Waddingham calculations based on the ONS data set

There is no simple answer as to what allowance, if any, should be made. As we discuss later in this section, there are a number of direct and indirect consequences from the pandemic that may have both positive and negative impacts on future life expectancy. Our view is that pension schemes should:

- Seek to take a measured, long-term, approach to the volatility, recognising the unprecedented nature of 2020 (and not forgetting there were far fewer deaths than expected over the course of 2019 and early 2020).
- Review and understand the profile of their own membership and mortality experience where applicable - which may differ to the wider population's.
- Have a plan for monitoring emerging mortality experience and refine their assumptions where appropriate to do so.
- Consider de-risking options as the degree of uncertainty may potentially lead to advantageous pricing opportunities in the bulk annuity and longevity hedging markets.

Furthermore, our discussions with the insurers and reinsurers (essentially the companies that insurers use to transfer or "insure" part of the risk) suggest that their longevity experts are currently making little to no allowance for the 2020 data when setting their own life expectancy assumptions. As providers of risk cover, this is understandable. They have to manage their business prudently and with sound judgement. Over or under reacting to emerging experience, especially in unprecedented times, can have long-term consequences for them. On the face of it, this would suggest we will not see any significant falls in insurance pricing because of lower life expectancy alone. However, in practice, the picture may be slightly different for some schemes as we have seen very competitive pricing, potentially driven in part by insurers justifying at least some level of reduction in life expectancy.

> "This has clearly been an exceptional year for mortality risks (and many other risks) and it has shown that, despite all the advances in our knowledge and methods, future mortality developments still hold great surprises in store for us in either direction. Moreover, the medium and long-term effects of Covid-19 are still unclear. Uncertainty in future mortality prevails, and recent developments only act to enhance this"
>
> CORD-ROLAND RINKE, MANAGING DIRECTOR, HANNOVER RE

What lies ahead?

One thing is for certain, there are more questions than answers arising from the outcome of the pandemic. We have summarised some of the key factors resulting from the pandemic that may have a positive or negative influence on mortality – recognising these will be influenced by future developments in medical treatment and mitigation.

Direct impacts on mortality	Indirect impacts on mortality
Further waves continue to add to the death toll	Delayed treatments and reduced hospital admittance?
Survivors of the virus more frail than before?	Economic recession effects and impact on healthcare spending?
Healthier population left behind?	Better public awareness of health and social behaviour changes?

Some of these factors will become clearer in the next 12-18 months as the severity and frequency of any further waves become more apparent and the likelihood of a working and widely distributed vaccine increases. Early news on the efficacy and availability of new vaccines is encouraging. The economic impact – which typically has an adverse impact on life expectancy – is likely to persist for longer than initially had been hoped, with very high levels of government borrowing and increased unemployment likely for some time. Other factors, such as the wider impact on the general health of the population, will take many years to fully emerge and be understood.

In short, it seems likely we should expect to see plenty of ongoing uncertainty and developments in this area. The key message to pension schemes is to understand the characteristics and experience of their membership, bearing in mind the factors that may affect them in the longer term, and to act and plan accordingly.

The longevity risk transfer market

Bulk annuity and longevity swap transactions involve the transfer of longevity risk: the risk that pension scheme members live longer than expected. Reinsurers support the pension risk transfer market by taking on the vast majority of this longevity risk for the direct insurers.

Despite the pandemic, the longevity risk transfer market – which we classify as bulk annuities and longevity swaps – has been exceptionally busy. The key reasons for this are:

1. Insurers and reinsurers have spent a lot of time analysing the emerging death data during 2020 to ensure they can understand its impact as far as possible, so as to be in a position to set their price appropriately and competitively.
2. Longevity risk is a long-term and unrewarded risk (i.e. unlike asset risks, you do not expect to generate additional return by holding longevity risk): one year's bad experience does not diminish either its longer-term impact or the benefit in managing it.
3. Schemes have adjusted their investment strategy to reflect their risk/return preferences, with longevity risk as an outstanding significant risk to manage.
4. Some favourable financial market movements, differing views of the impact on longevity and fewer very large cases in the pipeline have helped to support competitiveness in the market.

As highlighted in section 1, alongside the £25bn-£30bn of bulk annuities we expect to see transacted in 2020, we've seen a further £16bn of longevity swaps completed – ranging from as small as £150m in size to the second largest ever at £10bn.

A noteworthy development from the reinsurers over the last year or so is their increased ability and willingness to take on the longevity risk for members not yet in retirement. This has paved the way for insurers to provide pension schemes with better pricing and terms for bulk annuities with non-pensioner members, in the knowledge they can pass on the longevity risk for those members to the reinsurers.

Another emerging theme in this market is the increasing frequency of pension schemes with existing longevity swaps subsequently converting them into bulk annuities (commonly called a "novation"). Whilst the flexibility to do this has always been a benefit to those with a longevity swap, it had been rarely tested in practice. However, at least eight bulk annuities have now been completed in this manner and it demonstrates how longevity swaps can act as a stepping-stone to further risk reduction.

Reinsurers tell us that their pipelines remain very busy, with demand from pension schemes (either directly through longevity swaps or indirectly through insurers providing bulk annuities) far outstripping supply. Of course, the pandemic is ongoing, its impact on pricing and reinsurer business plans are uncertain, and hence we may see more selective or cautious behaviour from the reinsurers in the short-term at least.

> In summary, our key message remains that longevity risk is still a long-term and unrewarded risk that, viewed in the context of a scheme's overall profile and journey plan, should be a priority for pension schemes to understand and manage where it's feasible to do so.

> "Despite the uncertainty and disruption created by the pandemic, we're seeing no drop in demand for longevity hedging solutions in all transaction sizes as pension schemes and insurance companies act to manage a complex and material long-term risk in the face of rising volatility"
>
> TOM CAHILL, VICE PRESIDENT, INTERNATIONAL REINSURANCE, PRUDENTIAL RETIREMENT

04

Written by
ROSIE FANTOM
Partner

Delivering the endgame

Buy-out may seem a way off for some schemes. Rather than look at this as a negative, we encourage pension scheme stakeholders to utilise the experiences of other schemes to be better prepared.

A key facet of these preparations will be the financials: navigating the scheme to a position where buy-out is affordable.

This includes considering any opportunistic investment options, and responding to unexpected developments that could cause the scheme to deviate from its planned course.

Alongside this, schemes should undertake detailed preparations to support the ultimate buy-out transaction, making sure these dovetail appropriately with the expected progression of the financial position. In this section, we draw from aspects of Barnett Waddingham's DB Navigator to look at how schemes can chart a course towards buy-out.

Designing a journey plan

Many trustees and sponsoring employers are formalising their journey plans, not only in anticipation of the Pension Regulator's new code of practice for scheme funding, but more fundamentally because it can help improve schemes chances of reaching their long-term objective. Pension schemes have often had informal future aspirations: a general sense that one day buy-out will become affordable for example. However, it is clear that those schemes with a well-defined plan are better able to align decision-making with their longer-term objective, respond positively to opportunities and minimise the negative impact of any unexpected developments.

> For the majority of schemes, buy-out is expected to be the target destination, recognising that some schemes may ultimately end up taking a different course.

Depending on the specific circumstances of the scheme or employer, this could be transfer to a DB consolidator. In reality, some sponsoring employers will ultimately fail or become unable to support the pension schemes. In those situations the pension scheme will be left to either enter the PPF or, if it has sufficient assets, undertake a scheme rescue style transaction with a bulk annuity insurer or potentially a DB consolidator.

"The impact of DB SuperFunds remains unclear. The SuperFund offering needs to be considered through a number of different lenses by Trustees, most importantly the impact on member outcomes is key. We expect in the current economic climate an increase in the number of distressed sponsors with SuperFunds potentially offering an alternative solution to buy-out for removing pension scheme liabilities from balance sheets which could see this market grow."

SCOTTISH WIDOWS

BARNETT WADDINGHAM
beyond the expected

What are DB consolidators and when might schemes utilise this new option?

An alternative destination for certain schemes may be transfer to a capital-backed consolidator, allowing the link with the sponsoring employer to be cut. A capital-backed consolidator is a pension scheme, established to operate as a commercial entity, with investors providing additional funds to act as a capital buffer and accessing profits over time, assuming these do emerge in line with the business model.

There are two such funds currently, Clara Pensions and The Pension Superfund, but more are waiting in the wings. In June, TPR set out an interim regulatory regime to govern the operation of these vehicles in the short to medium-term, which paves the way for these transactions. We are expecting to see the first DB consolidators to be approved by TPR shortly, with the first transfers expected to follow soon thereafter.

The regulatory framework gating these transactions is structured to make this option accessible only to those schemes who are not expected to be able to afford to buy-out with an insurance company over the next five years. These vehicles aim to offer pricing at a discount to insurers' terms. This recognises that the liabilities are being transferred to another pension scheme, rather than an insurer, and so, such options do not come with the same regulatory protections associated with an insurance policy.

Clara Pensions and the Pension Superfund are both consolidators, but operate in varying ways. They have different structures, business models, plans for profits to be extracted, and long-term objectives where the ultimate destinations for the liabilities differ. Clara Pensions targets transfer of the liabilities to an insurer in the longer-term. The Pension Superfund plans to retain the liabilities and effectively operate as a "run-off" vehicle. These differences affect their respective risk profiles.

Transfer to either of these vehicles cuts the link to the sponsoring employer, so trustees must be satisfied that such a transfer is in members' interests. A key consideration will be the sponsor employer's ability to support the fund in the years to come compared to any potential improvement in security provided through the transfer. As such, there are challenges associated with targeting transfer to a consolidator as part of any form of longer term planning, with the factors affecting decision making being time dependent including the changes in the scheme's financial position and the sponsoring employer's covenant. In some cases, it may be influenced by any corporate incentive offered to the scheme in order to complete the transaction.

In practice, we anticipate for most schemes' their ultimate long-term target will be buy-out, or possibly self-sufficiency for some schemes. But for some, circumstances could arise where transfer to a consolidator may make sense for all stakeholders.

Measuring progress

Buy-out pricing varies over time as discussed in section 2. Added to the mix is the fact that the scheme's assets are also changing, and not necessarily in line with insurers' pricing. The sponsoring employer's ability or willingness to provide any further contributions to achieve buy-out can change over time too. This is why it is important not only to monitor progress towards the endgame objective, but also to use this information proactively to support decision making.

We invest time to understand bulk annuity market pricing and the underlying drivers, using a wide range of information from insurers and reinsurers. We help schemes assess how attainable a transaction may be, and monitor the position through our Illuminate software. Illuminate dashboards are tailored to give quick access to the headline information that matters, based on the scheme's specific journey plan and how it is fairing against key metrics such as buy-out.

Illuminate can help schemes to see how flexing these levers is likely to alter the course towards buy-out. This could be in response to recent experience or developments e.g. to help the scheme get back on track, take advantage of an opportunity or inform the longer-term planning.

Schemes have four main levers to achieve buy-out:

TIME

Simply by waiting you might expect buy-out to come towards you, owing to the maturing of your scheme and recognising that insurers' pricing reflects the shorter duration of the liabilities. Extending the journey plan can therefore sometimes allow a lower cost or lower risk approach.

INVESTMENT RETURNS

This reflects the risk or return balance the scheme's stakeholders choose to run – a dynamic consideration through the varying stages of the journey plan and influenced by the scheme's funding position and strength of sponsoring employer's covenant. Running a higher risk strategy may be expected to reach the endgame sooner, but with a wider range of potential outcomes.

CONTRIBUTIONS

Progression towards buy-out can be enhanced by increasing the pace of funding via additional contributions from the employer. If an employer is ultimately expecting to provide a material top-up payment to achieve buy-out, there is an argument to bring this forward, so that the scheme can benefit from additional returns or further reduce risk on the approach to buy-out. There is a balance to be struck here, to provide sufficient funds to allow the pension scheme to control its risks. Whilst from the employer's perspective, limiting the risk of a surplus arising, which becomes trapped or at least subject to penal tax treatment.

ACCELERATORS

These are other options schemes can undertake to accelerate progress towards buy-out, such as member option exercises or providing ongoing support for members to help them consider their choices.

Optimising your journey

Armed with a journey plan, trustees and sponsors are better placed to be able to make decisions and assess the potential options. Some of these opportunities are well-established options for schemes, but we are also seeing some alternative options emerge. Below we consider the more established or traditional partial transaction routes, as well as some developing capital-backed investment options.

These options have similarities in that they are investments of the pension scheme, and leave the sponsoring employer's obligation to support the scheme unchanged. Each come with their own risk and return profile:

Traditional partial transactions

Pensioner buy-ins and longevity swaps can be used as stepping stones towards buy-out. These transactions see an insurer or reinsurer take on specific risks in relation to the insured liabilities. It is important to assess:

- the impact of the transaction on the scheme's overall risk profile, taking into account how the transaction is funded
- the effective rate of return offered by these investments, measure how investing in one of these options affects the timescales for reaching buy-out and any immediate impact on the scheme's technical provisions
- a partial transaction changes the scheme's risk profile as it targets buy-out, and should reduce the overall level of risk and ideally lock into favourable pricing (shown through the implied return offered)
- whilst pensioner buy-ins can be converted directly to individual annuity policies, the path for converting longevity swaps into buy-in policies has become more established and it is possible secure terms to future-proof the swap in this regard.

Capital backed investments

- Unlike the capital-backed consolidators, these investments made by the pension scheme in a structured arrangement do not break the link to the employer. They are typically aimed at managing the underlying pension risks and delivering sufficient funds to achieve buy-out within a particular time horizon. There are different versions available from different sources.
- For example, Legal & General have their Insured Self Sufficiency and their Assured Payment Policy offerings.
- Beyond this, we are seeing similar offerings emerge that seek to achieve buy-out funding within a target time period, backed by external capital to provide some degree of downside risk protection, in exchange for handing over control of the scheme's investments.
- It is clear that this is a developing area, and having a carefully considered journey plan allows schemes and sponsors to assess any opportunities in an appropriate framework, assessing whether it may help or hinder their overall objective.

For all of these options, trustees and sponsors should consider the degree of future flexibility being sacrificed. Whilst a particular route may be appealing with, for example, the benefit of a strong covenant, it may not seem as attractive in the years to come, if this were to weaken. In this scenario, the scheme would be more restricted in its ability to tailor its investment strategy to reflect the new circumstances.

Getting ready

The expected length of journey plans will vary by scheme. We will see some achieve their long-term objectives ahead of plan and there will be some where it will ultimately take longer. It can pay for schemes to have an understanding of the scenarios in which they could achieve buy-out quicker or more slowly and to ensure that they are ready when the time comes.

For example, it makes sense to plan to be transaction ready by the earliest point buy-out might reasonably be achievable, rather than necessarily the expected timing. Journey plans, by necessity, will focus on funding and investment aspects in the first instance, but these plans should be holistic and look to truly support the buy-out transaction and ultimate scheme wind-up.

For a bulk annuity transaction, schemes need to set out the liabilities to be insured. This is done through a combination of the following:

BENEFIT SPECIFICATION

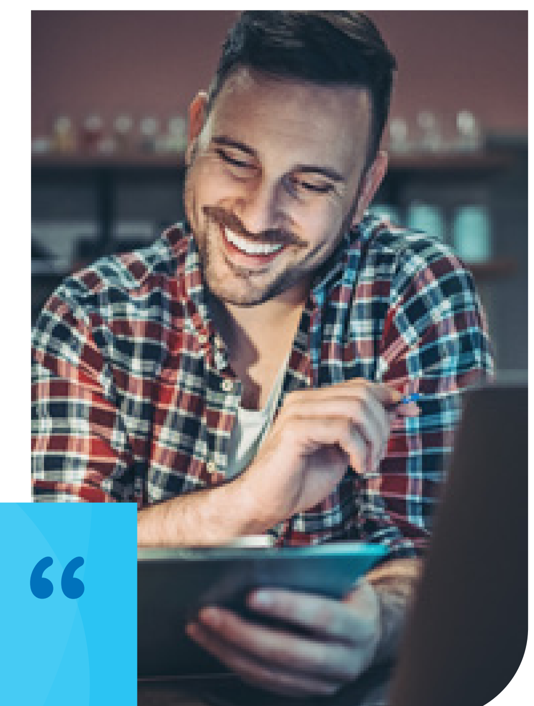
- Detailed document providing information on benefits to be insured, which should be legally reviewed.
- Trustees and sponsors need to consider how to codify any practices so the information regarding the benefits provided to the insurer is clear and prescriptive.
- Specified benefits should appropriately reflect scheme administration practice.

MEMBERSHIP DATA

- Detailed data listing containing individual member data, dates and benefit amounts.
- Insurers expect schemes to take steps to collect marital information for members to support their pricing.
- For medium and larger schemes, providing experience data (e.g. mortality) will be important to enable insurers and their reinsurers to tailor their assumptions.

Membership data is one area that can lurk in the background until it is clear that a transaction is on the cards in the shorter-term. This can result in undesirable time pressures or constraints for resolving potentially complex and interlinked data issues. By incorporating a review of the scheme's data at an early stage, scheme stakeholders can make sure that the journey plan incorporates the necessary data cleansing activities in a timely way so that the scheme is fully positioned to insure its liabilities at the right time. It will also enable the activities to be undertaken in a logical order, taking account of materiality and for these steps to supplement other planned activities that may form part of the journey plan, such as having information for member option exercises or GMP equalisation.

> By incorporating a review of the scheme's data at an early stage, scheme stakeholders can make sure that the journey plan incorporates the necessary data cleansing activities in a timely way so that the scheme is in a position to insure its liabilities at the right time.



> "Making sure the data is as clean as possible, and also easy to interpret and understand with a clear benefit specification are crucial. Also, for smaller schemes, flexibility around timelines is also an important factor that we consider when deciding whether to quote."
>
> ROTHESAY LIFE

Why does good data matter?

Improve insurer engagement

- Insurers focus on the schemes most likely to transact
- They recognise that schemes with good data are well-prepared and more likely to execute
- Schemes can improve their chances of getting compelling pricing by being well prepared

Obtain a more accurate quote

- Quotations based on comprehensive data allow insurers and their reinsurers to refine pricing
- This improves certainty of cost for securing liabilities, by reducing the scale of any balancing premium ultimately payable
- Minimising areas of uncertainty can also reduce the potential for insurers to make any conservative assumptions

Trustee warranties in the bulk annuity contract

- Trustees need to be in a position to confirm accuracy of data and benefits as part of the transaction
- Being unable to give suitable warranties is likely to cause problems, as insurers and their reinsurers require these as part of the policy terms in order to be able rely on the information provided

Post transaction data cleansing window

- It can be costly to make material corrections to the buy-in at a later date
- The sponsoring employer may seek a high degree of certainty regarding the balancing premium, to be willing to support the transaction
- If unexpected issues arise post transaction, the scheme is likely to be forced to seek additional funding

05

Employer perspective

Written by
CHRIS HAWLEY
Partner

A significant number of bulk annuity transactions, especially full scheme buy-ins or buy-outs, rely on financial support from the sponsoring employer to bridge the final gap. In practice, the underlying objectives of the employer and the trustees will be largely aligned. However, there are a number of areas where the considerations, or the relative weight placed on them, may well be different for the employer.

Some areas have direct impact on the ultimate cost of securing the scheme's benefits, and so the level of any additional employer top up contributions needed. For example, in relation to the way any discretionary benefit practices are actually crystallised for insurance purposes, or the treatment of member option terms under the transaction.

From an employer perspective, it is important to keep a very keen eye on the transaction and stay fully engaged in the process. This includes establishing a governance structure which provides suitable visibility of the process as it progresses and also enables input into the relevant decision-making at the right time.

Whilst the trustees will ultimately be securing the transaction with the insurer, the employer will want to ensure that it is comfortable during both the build-up to the transaction, as well as the final negotiations and premium payment. Having certainty that the transaction will be executed in line with expectations (both in terms of timing and pricing) will be important. The timing of the transaction can sometimes be critical for the employer, being linked to corporate accounting deadlines, cashflow considerations or other commercial drivers. Further, it can pay to have a good understanding of the scale and variability of any balancing premium that may be due post transaction to avoid any unexpected cash calls.

The completion of a buy-in transaction effectively gives the sponsor direct exposure to the insurer's covenant, meaning that employers must have keen regard for the financial strength of the selected insurer and the due diligence undertaken. They will want to be satisfied that the financial position and business model of the selected insurer are appropriately strong to help protect against any possible future insurer default.

Over the last few years Barnett Waddingham have worked with a wide range of sponsoring employers, covering transactions of up to c.£4bn down to less than £10m.

The issues facing each sponsor will be specific to both their own business and the scheme's circumstances, meaning the key considerations can vary significantly. Whilst affordability is typically a key criteria, this can manifest itself in different ways; whether the focus is upon cashflow, the level of top up needed, the certainty of ultimate cost, along with any additional challenges relating to overseas parent companies supporting the transaction.

For schemes seeking to maximise the best possible engagement from the insurance market, having great support and drive from an employer is fundamental in demonstrating the strong likelihood of completion. Ultimately, this can heighten interest from insurers, helping to generate competition and deliver a positive outcome for all the stakeholders.

> "Having an engaged employer, together with the trustees, demonstrates the seriousness of the transaction process and helps support our potential appetite"
>
> JUST

Key Employer Considerations

FUNDING
How is the transaction going to be financed and what are the expected costs?

CERTAINTY
How certain is the cost and how can this be managed effectively?

REPORTING
What are the corporate accounting implications of the transaction?

RISK
Are there any risks following the transaction?

Each of these areas is considered further in the remainder of this section.

Transaction funding

For an employer assessing potential affordability, it is important to understand the overall transaction balance sheet when looking at a full scheme buy-out. As mentioned above, transactions tend to require two premiums:

1 the initial premium

2 followed by a final balancing premium.

It is important not only to consider the initial premium, but to also factor in any future expected costs associated with remaining data and benefit work post transaction, such as GMP equalisation. In addition, there should be reserving for the expenses associated with moving from buy-in to buy-out and subsequent winding-up of the scheme.

> Having a robust estimate and budget for these additional items helps provide transparency of cost and enable any additional financing requirements to be managed effectively.

For some employers, the additional funding needed to deliver the transaction may be viewed in the context of the capitalised value of any agreed deficit contributions under an existing recovery plan and/or the removal of future running expenses of the scheme after wind-up. In addition to the underlying risk reduction, and ensuring the pricing is competitive, these can help support the business case for transaction.

Robust pricing is crucial to support high quality decision-making. The reliability of the insurance premium depends on the quality of the information provided to the insurers. In section 4, we considered the importance of the preparation work required for data and benefits. If these areas are not materially correct, then this will represent an area of uncertainty around the ultimate cost which is undesirable for the employer. Therefore, the employer needs to:

- understand the level of preparatory work carried out;
- be satisfied with it; and
- understand any outstanding issues or potential risks to the size and certainty of the estimated balancing premium.

Where decisions are made around the treatment of benefits for insurance purposes which may influence pricing, such as discretions or member option factors, the employer will again wish to have appropriate visibility and input, particularly where any decisions mean additional financing may be required. Even where the overall premium may not be all that sensitive to such matters, a small increase in the premium can have a significant impact on the scale of any top up payment and so directly impact affordability.

It is important to think about the financing matters early – as part of the journey planning and well ahead of any ultimate transaction. The bulk annuity market is an active commercial market and the cost of insuring liabilities at a particular point in time can only truly be known by obtaining formal insurer quotations. This means that, even where effective monitoring is in place, due to the dynamic nature of the market there is a risk that pricing is more favourable than expected. Whilst this is a “nice problem to have”, it can lead to potential trapped surplus issues. This is where any surplus may not automatically be repayable to the employer under the rules of the scheme, or even if it is, is subject to unfavourable tax treatment. Depending on the negotiations and structure of the transaction, it may be possible to effect the transaction by paying a marginally lower proportion of the initial premium. This can be beneficial where there is additional funding from the employer and outstanding data work could lead to a favourable movement in the final premium.

> A number of schemes have put in place alternative funding solutions, such as escrow accounts or other contingent funding arrangements to manage potential surplus concerns and help avoid the issue arising. Understanding the detail of how these solutions may be triggered and how they will be released in the context of financing the bulk annuity transaction, is important to avoid accidentally constraining the business or the completion of the transaction.

Enhancing certainty

On the approach to a transaction there is significant potential for the surplus or deficit position to change. Any relative movement in the value of the scheme’s assets and insurer pricing, for example due to market movements or changes in insurer appetite, can have a highly geared effect on the difference between the two.

Minimising this potential volatility effectively, especially where there is a shortfall and so additional funding expected, will be a key aspect for the employer. Any material uncertainty around the financing needed makes corporate planning and management of the various business stakeholders more difficult.

Prior to selecting a preferred insurer, the employer will want comfort that the investment strategy is being managed in a way which looks to stabilise the position as far as possible, for example through appropriate interest rate and inflation hedging levels and credit exposure. For a full scheme transaction, liquidity is also important not only to meet the premium and cashflows, but also to have scope to flex the asset holdings on the approach to transaction and avoid being constrained in the choice of insurer.

CERTAINTY

Premium payment and price movements

Once the preferred insurer has been identified, there will be detailed focus on delivering execution certainty and the actual mechanics of paying the premium, including any additional funding required from the employer. Appropriately managing the relative movement in the value of the scheme's assets and the insurer pricing is critical in delivering the desired execution certainty.

PREMIUM PAYMENT

Considered in conjunction with the price movement mechanism, how are the scheme assets and any top up amount going to be delivered to the insurer? To what extent can assets be transferred in-specie and which asset need to be disinvested?

With some investment funds having limited dealing dates, and the interaction with any additional funding from the employer, it is important to ensure that these points are carefully considered with the logistics fully understood and clearly mapped out.

PRICE MOVEMENT

Price movement clarity between exclusivity and execution of the transaction can be achieved through a price-lock mechanism. In practice, the nature of the price-lock available will depend to some extent on the size of the transaction.

It is possible to convert the premium into an equivalent portfolio of assets ("price lock portfolio" or "asset lock"), with price movements then being linked to changes in the value of these assets. If this is aligned to the existing assets of the scheme, or small changes are made to do so, this can provide increased or full premium certainty. Both the time period for any price-lock and any attaching boundary conditions will also need to be considered carefully.

In addition, where there is a significant top-up needed from the sponsor, consideration should be given to the timing. Whilst it might be tempting to avoid making the payment until the last moment, this can actually increase execution risks, as the scheme may not have sufficient assets to invest in line with the price movement mechanism and so is unable to fully guard against adverse market movements.

REPORTING

Corporate reporting

One of the key issues for the employer will be the treatment of the transaction in the company accounts, this is an area for early consideration. Understanding the accounting implications at the outset can help avoid any potential undesirable blockers later in the process.

The significance of the accounting issue for the employer will depend on their own position, for example the degree of importance placed on any external reporting or the materiality of the pension scheme in the context of the overall business. Managing any stakeholder messaging is a key aspect, so that the underlying benefits of the risk reduction achieved by the transaction are understood.

The treatment under the international accounting standard or UK Generally Accepted Accounting Practice (GAAP) will depend on the specific circumstances of the transaction, but in broad terms, will depend on whether it is viewed as a buy-in or a buy-out as outlined below. In practice, the employer should engage with the auditor at an appropriately early stage to confirm the approach.

BUY-OUT

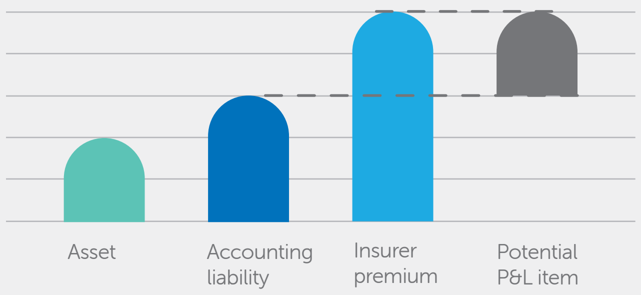
If the transaction is structured as a buy-out, or the buy-in is viewed to be automatically leading to a buy-out, then this would result in an accounting "settlement" impacting the employer's profit and loss (P&L) account in the financial period. The P&L charge reflecting the difference between the insurer pricing and the accounting reserve for the liabilities.

Under the international accounting standard there is also now a requirement for a split in the reporting period based on updated actuarial assumptions at the date of settlement.

BUY-IN

If the transaction is viewed as a buy-in then this would not generally be deemed to be an accounting "settlement". As a result, there is no direct P&L impact; the difference between the insurer pricing and accounting reserve flowing through the employer's balance sheet via Other Comprehensive Income.

BUY-OUT - ILLUSTRATION OF POTENTIAL P&L CHARGE



Following a transaction, and before the policy is converted to buy-out, the assets are typically reported as being equal to the value of the liabilities, removing any further volatility. If the employer has previously recognised an accounting surplus, this may have been reflected in an expected profit and loss credit, and so this would also be removed going forward.

Finally, where there are overseas accounting requirements, such as US GAAP, there may be additional P&L implications and the employer should ensure that the accounting impact is fully understood and managed appropriately.

Residual risks

The detailed transaction preparation work, including any data cleansing activities, seeks to ensure that all the scheme's liabilities are fully insured. However, it is not possible to be absolutely confident that the scheme is totally free of potential remaining risks relating to any unknown issues which may subsequently arise. In particular, there are risks associated with data, benefits and missing beneficiaries, where scheme members could come forward to claim additional benefits post wind-up.

Together with the trustees, the employer will want to consider the scheme's risk profile, which will be influenced by the scheme's size, its history, and the scale of the work done prior to buy-out to identify and address potential issues. The employer will be in a better position to make decisions on how to deal with the perceived residual risks by understanding any trustee indemnities within the scheme's rules that are provided by the employer. These might remain even after wind-up, or the trustees might look for these to be a condition of scheme wind-up.

> In practice, there are a limited number of options for dealing with residual risks, and the availability will largely depend on the scheme's size.

For smaller schemes, the most likely option for dealing with these risks is run-off cover to give the trustees protection against negligence claims, potentially coupled with missing beneficiary cover and an indemnity from the employer. For the employer, this effectively means bearing these risks.

For larger schemes, another option may be residual risk cover from the bulk annuity insurer. This additional risk cover can include areas such as data or benefit errors coming to light or missing beneficiaries emerging after the transaction has been finalised. Any additional risk cover clearly comes with a price tag, and so its potential value to the employer, taking into account their risk appetite in the context of the residual risk profile, needs to be considered carefully. Understanding the scope of the coverage, any exclusions and also the point from which it would apply are also important factors to consider if this option is pursued.

Tate & Lyle – £930m buy-in

Tate & Lyle is a global provider of solutions and ingredients for food, beverage and industrial markets. As corporate adviser, Barnett Waddingham provided actuarial, investment and specialist bulk annuity advice in relation to their £1bn+ UK DB pension scheme – culminating in the £930m buy-in of the scheme in 2019 for the remaining 4,800 pensioner and deferred members.

The successful completion of this second buy-in transaction with Legal & General in summer 2019, secured the liabilities for the remaining members, removing investment, longevity, interest rate and inflation risk from the scheme – de-risking the scheme seven years ahead of their original plan.

Supporting executive decision-makers, we advised on key bulk annuity transaction structuring considerations from a corporate perspective and potential levers to enhance insurer pricing and affordability, as well as advising on the detailed accounting implications of entering into the transaction. Our corporate investment advice included review of the re-shaping of the assets to align with insurer pricing and entry into price-lock mechanism, and strategy for residual assets and liabilities.

"The completion of the second transaction with Legal & General represents a good outcome for both our pension scheme members and the company. Barnett Waddingham's support and expert advice, throughout the de-risking journey and transaction process, helped the company to successfully meet its' objectives and achieve a full scheme buy-in well ahead of schedule."

STEVE AMOR, HEAD OF GROUP PENSIONS AT TATE & LYLE

Our specialist team would be happy to discuss any of the issues relating to the bulk annuity or longevity risk transfer markets, or any broader aspects of de-risking, with you.

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