UK Risk Settlement Bulletin

Q2 2022

The Q2 bulletin provides an update on climate emissions reporting, a case study on asset preparation ahead of a buy-in transaction, and a look at current pricing trends.

Climate change reporting requirements

Climate change is one of the most concerning risks facing the world over the next 10 years, as identified by the World Economic Forum in its last five annual risk assessments. All pension schemes are susceptible to climate change risks, including:

- *Transitional risks* – arising from the movement of the economy towards low-carbon and climate-resilient solutions, e.g. resulting in a fall in value of high-carbon investments.
- *Physical risks* – arising from the direct impacts of climate change that occur as the global average temperature rises, e.g. resulting in damage to property investments.

The Task-Force for Climate-related Financial Disclosures (TCFD) developed a framework to help businesses/organisations disclose climate-related risks.

What do trustees need to do?

From 1 October 2021, the Department for Work and Pensions (DWP) made it mandatory for pension schemes with over £5Bn of assets to publish TCFD disclosures annually, with a link to the disclosures included in the trustees' Report and Accounts.

This will change to become mandatory for all schemes with over £1Bn of assets from 1 October 2022. A consultation is due in 2023 on the extension for schemes with less than £1Bn of assets.

Among other actions under the TCFD requirements, Trustees are expected to report the carbon emissions of their investment portfolio.

How does this relate to buy-ins?

A buy-in is held as an asset of the scheme, and so must form part of the carbon emissions metrics reported annually within the TCFD disclosures. So, how do trustees go about trying to determine the carbon emissions of a buy-in policy?

The 'Governance and reporting of climate change risk' guidance, issued in July 2021, suggests the following approach:

"Trustees should use insurer emissions data. Where data is available, they should take a proportionate share of the emissions of the insurer's total assets backing their UK pension bulk annuity book."

Availability of insurer data

UK bulk annuity providers are now beginning to publish TCFD disclosures, with several issuing their first TCFD disclosures report in the last year. Since the reporting of carbon metrics is relatively new, there is some initial inconsistency with the metrics reported by each insurer.

The TCFD has acknowledged that having a consistent set of metrics is important but recognise that the ability of different businesses to report on different metrics will vary at present, needing to evolve over time. They have issued 'broad' guidance to 'allow flexibility' at this time.

Through our long-standing Insurer Due Diligence service, we provide assessments of insurers' ESG credentials. We are working with bulk annuity providers to obtain data and encourage consistent reporting of emissions metrics. Please contact us for more information.

Case study – good asset preparation can get you to buyout more quickly

At the end of 2021, Aon advised a client on a successful c.£400m buy-in project where advanced asset preparation was key to completing a transaction when affordability was tight.

The Scheme was aiming for full funding on buyout by c.2025, but strong investment returns meant that buyout became potentially affordable in late 2020.

Asset preparation protects funding position

The Trustee was aware of significant data and benefit issues to work through before approaching insurers. However, it was agreed that prioritising and preparing the scheme's assets could protect the funding position while this work was carried out.

As a result we advised the Trustee to:

1. Quickly sell equities and less liquid credit to protect the funding position;
2. Better align the credit and LDI with a proxy for insurers' asset strategies;
3. Simplify the LDI mandate to give more price certainty and reduce transaction costs;
4. Ensure there was a flexible investment toolkit for future changes; we also negotiated pre-prepared instructions with the asset managers to ensure that, if the deal was affordable, we could lock into pricing quickly with less risk and cost.

After significant work on data, benefits and two rounds of insurer pricing, the Trustee selected an insurer.

Reduced trading opportunities late in 2021 meant that the Trustee had to closely collaborate with the selected insurer, investment managers and custodians.

Through this collaboration, we were able to agree a transaction date that met the sponsor's need to transact in 2021.

Due to the effort put into good asset preparation, **within one day** of the Trustee selecting an insurer we had moved the assets to precisely match the specific insurer's price lock – this made sure the buy-in remained affordable until completion.

Market movements at the time of transaction meant that, if it had taken one week rather than one day to match the selected insurer's pricing, the mismatch would have added **more than £1m** to the cost of the transaction. This cost could have been **4x higher** if the transaction had happened in the most volatile period in 2021.

This clearly demonstrates why, especially when affordability and timescales are tight, it is even more important to minimise risk by planning your investment strategy with your endgame in mind.

Here are our **3 top tips for preparing your assets** for buyout:

1. **Consider synthetic credit** – cheap and nimble to adjust credit exposure to hedge insurer pricing more closely and quickly (synthetic credit can be cheaper to implement and then to adjust exposure once the insurer is selected - without interfering with the LDI hedging)
2. **Liquidity** – ensure assets are available for the transaction, low cost to transfer and your exit strategy from less liquid asset classes is planned well in advance
3. **Hedging** – ensure you are hedging the correct cashflow benchmark but avoiding over-hedging compared to the insurer premium as you approach the transaction

We provide advice on asset preparation for bulk annuity projects. Please contact us for more information.

Key asset preparation steps taken along the journey ahead of selecting insurer

Growth / illiquid assets	Interest rate and inflation hedging	Credit
Remove equities and less-liquid credit	Re-cast liability cashflow benchmark Target 95% hedging of interest and inflation	c.30% exposure to credit from corporate and synthetic credit

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Bulk annuity market outlook

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

Current pricing levels

On this measure, pricing remained relatively stable at an attractive level over Q1 2022, despite a challenging political and economic backdrop.

The conflict in Ukraine has exacerbated rising inflationary expectations as well as having a far more significant human cost. This of course follows a long period of economic difficulties from the pandemic.

However, the annuity providers have all reported healthy solvency positions in recent annual reports.

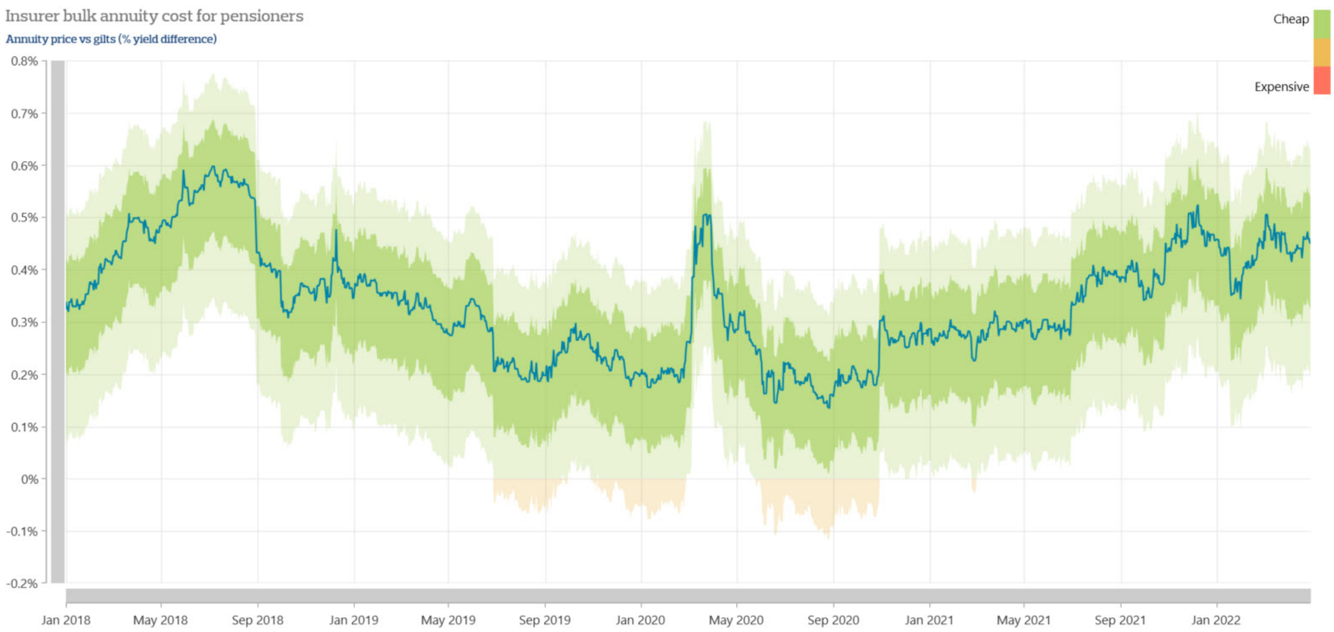
Insurer annuity funds are conservatively invested with very little direct exposure to assets more associated with the conflict, and a high degree of risk hedging, enhanced in the lockdown period.

Reacting to high inflation

For most schemes, a set of liability cashflows are produced every three years, following a valuation, which are then used as a benchmark for the LDI manager to set-up the scheme's hedging.

With recent increases to inflation expectations, caps on pension increases are now biting, meaning the proportion of liabilities that are assumed to be linked to inflation will have decreased. Therefore, some schemes may now be over-hedging inflation, which can increase funding level volatility and reduce expected return by needlessly tying up assets.

We suggest that trustees consider updating the benchmark now, rather than waiting until the next valuation. The most accurate way to do this is for the Scheme Actuary to generate new cashflows from an updated data set. A less expensive approach is to adjust the existing cashflows specifically to reflect changes in inflation expectations.



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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