UK Risk Settlement Bulletin

Q4 2022

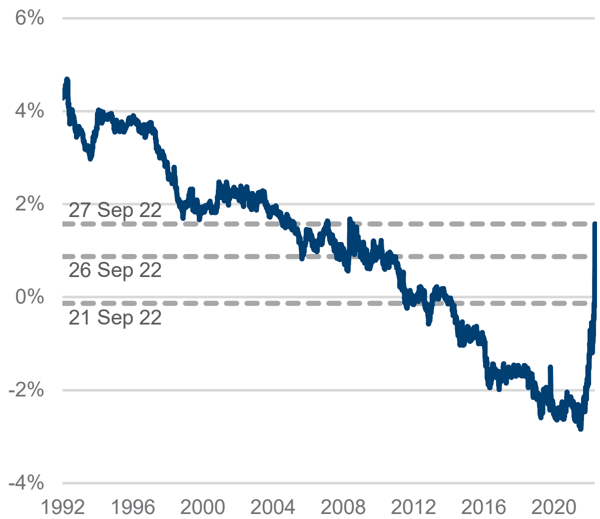
The Q4 bulletin takes a look into the recent volatility in the market, including the effects on DB scheme investments, insurer resilience, and bulk annuity pricing.

Recent investment market turmoil

The interest rate payable on UK Government bonds, know as Gilt yields, have been steadily rising over the past 6-9 months. The yield has been driven up by increasing inflationary pressures, associated expectations that interest rates will rise both further and faster than previously forecast, and the expectation of the Bank England shifting to a programme of Quantitative Tightening (selling gilts).

These trends were accelerated on Friday 23 September 2022 following the Chancellor's "mini-budget" announcement. What followed was a rapid rise in yields, with daily moves far in excess of historical norms.

20 year real gilt yields



Source: Bank of England

Bank of England intervention

On Wednesday 28 September, the Bank of England ("BoE") stepped-in to calm markets, agreeing to carry out a temporary programme of gilt purchases in order to stem the sell-off.

Before the BoE's intervention, real yields on gilts had risen almost 250bps in a matter of days, and by around 11am on 28 September were up 70bps for the day. Following the intervention, real yields fell by an extraordinary 170bps, ending the day 100bps lower.

The magnitude, and speed, of this rise in yields has placed enormous pressure on the liquidity of many Liability Driven Investment (LDI) portfolios, which need to maintain leverage within specified limits. This has meant pension funds selling large volumes of liquid assets to meet collateral calls resulting in a higher allocation to more illiquid assets.

Implications for risk settlement transactions

One possible benefit of rising yields has been the improvement in pension scheme solvency funding positions, putting many schemes in a position where their buyout target could now be a lot closer.

However, the market turbulence has also created significant stress for pension schemes:

- Reduction in return - Increasing collateral requirements have constrained growth as LDI managers reduce leverage

- Funding volatility – where clients' hedging has been reduced in the absence of collateral
- Reduced liquidity – following forced sales of liquid assets

The impact will vary depending on a Scheme's position:

- Schemes that are now fully funded on a solvency basis with good liquidity and a flexible low risk investment strategy are in a good position to work towards a transaction. The investment strategy should be designed to have high solvency hedging levels and an allocation to investment grade credit to broadly replicate the key drivers of insurance pricing.
- Schemes that are well funded on a solvency basis but with illiquid assets can explore solutions for selling illiquids through a broker (something we have experienced with many schemes) or explore options such as deferring part of the insurer premium. In other cases, schemes may want to wait until illiquids run-off or can be sold over extended periods. Adjusting the investment strategy to reduce risk versus insurer pricing is still appropriate although it should be noted that a number of factors drive insurer pricing including supply/demand of insurer friendly assets.
- Schemes that are not at full solvency funding yet (and not expected to get there within 2-3 years) but with a low-risk investment strategy, low LDI leverage and a low allocation to illiquid assets, will find that partial buy-ins could still have a role to play particularly for larger schemes looking to take a phased approach to transactions. However, the risks and residual asset considerations need to be carefully considered.
- For other schemes targeting buyout, managing investment strategy with an appropriate level of risk to close the gap but being aware of mismatch between assets and insurer pricing and maintaining flexibility for if the target or timeframe changes are key. Within this, managing liquidity to support LDI hedging with lower leverage as well as being prepared for getting to buyout early should be considered.

Therefore, it's vital that the risks (pre and post buy-in) are carefully considered. For partial buy-ins, this includes residual asset considerations and additional liquidity constraints.

For full buy-ins, this is largely whether sufficient assets can still be realised in order to pay the premium.

If you are currently considering a risk settlement transaction and want to know how recent market events have implicated your investments, then please get in touch with your usual Aon contact who can put you in touch with one of our investment risk settlement specialists.

Insurers prove resilience in volatile times

The recent market volatility has not only created significant challenges for pension schemes, but has also provided a test for the resilience of UK insurers and the underlying prudential regulatory regime.

Insurer investment strategies

Annuity funds are ring-fenced asset pools held within each insurer that write bulk annuities in the UK.

Insurers seek to accurately hedge 100% of their liabilities, and with significant ongoing monitoring, against interest rate and inflation risks. Currency risks are also hedged using currency derivatives to manage risks associated with non-UK assets. The market volatility and impact on the value of sterling may impact the appetite of insurers in seeking non-UK assets in the future.

Due to insurers' overall asset strategy, they do not need significant leverage from these assets to generate sufficient risk hedging from their overall portfolio. This means that exposure to collateral calls on their derivative holdings is much more contained than for pension schemes that have, in some instances, had to adjust their strategy in the light of recent events.

While insurers will hold a large proportion of illiquid assets, annuity funds also keep substantial pools of liquid assets as normal policy and have specific disclosed strategies on liquidity management. This usually includes significant additional back-up sources of liquidity such as a bank borrowing facility.

This approach has proved robust through previous periods of market volatility over 2020-22, such as the impact of the emergence of COVID-19 and concerns over the implications of the Russia-Ukraine conflict.

Solvency levels

Insurer solvency levels have generally been at relatively high levels over 2022, with coverage well above the statutory requirement for all insurers.

Although insurers do not typically publish solvency ratios outside of half-yearly reporting cycles, a rise in interest rates tends to increase the coverage level.

For example, rises in interest rates reduce the impact of certain capital stresses, which depending on the insurer's hedging strategy is positive from a balance sheet perspective. We would therefore expect current solvency levels to be typically higher or similar to those reported earlier in the year.

Wider implications

Clearly there are further implications for any institutional investor for continued market volatility or perceived weakness in the UK economy. This might for example impact asset performance (while appreciating that annuity funds are very long-term investors with illiquid liabilities), annuity pricing stability and the flow of new asset opportunities to support further new business.

The more immediate focus for bulk annuity providers is on current planned annuity transactions, and continued viability from a pension scheme, rather than insurer, viewpoint.

While most current processes are expected to continue as planned, there is an increased need to consider the asset transition process to pay the insurer for the annuity, and how affordable the transactions can remain over this period, as well considering the impact on any residual scheme portfolio for partial transactions.

But overall experience has been supportive of annuity funds as an appropriate de-risking target destination for schemes. Insurer resilience through volatile periods in recent years have so far strongly supported insurers' annuity funds status as a safe harbour.

If you would like more information on what recent market volatility might mean for insurers or for your scheme, then please get in touch with your usual Aon consultant.

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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, pensioner pricing has continued to be very attractive, as seen over the whole of 2022 so far. In particular, we have also observed increasingly favourable pricing for deferred members over the course of the year, with more insurers now competing for whole scheme transactions.

We've therefore observed a surge in whole scheme buyouts in 2022, with many schemes taking advantage of strong pricing and rising funding levels.

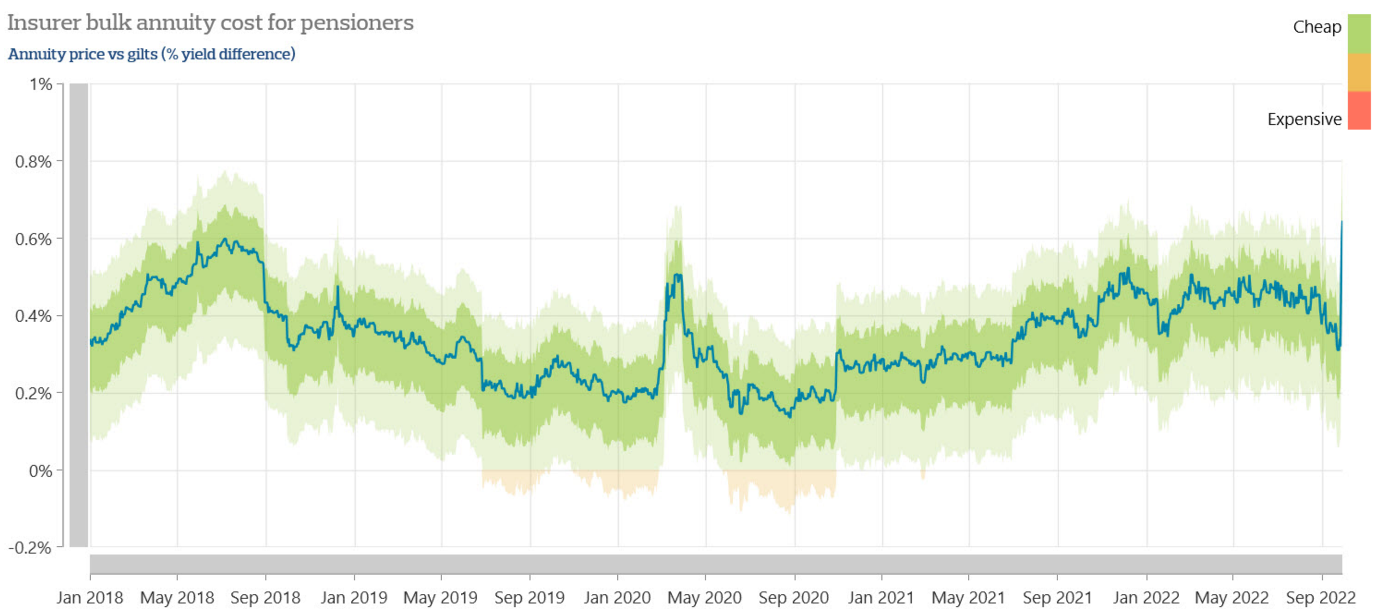
Market volatility

Insurer pricing had generally been very stable over 2022 until mid-September. Since then, it has been impacted, perhaps unsurprisingly, by the significant market volatility.

As can be seen in the chart below, there was a significant spike in favourable pricing at the end of September. The main driver for this was an increase in swap yields, which increased even more than gilt yields in late September.

We are cautious over the reliability of price tracking during a period of such market stress. The pricing levels shown on the chart may not have been attainable in practice, depending on schemes' and insurers' ability to trade when markets were less liquid.

The sudden improvements in pricing levels over September has resulted in many schemes experiencing an improvement in solvency funding levels. However, for some schemes this partially reversed in October as market conditions have stabilised.



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

Contact Information

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

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

Lucy Barron
Partner
+44 (0)20 7086 0532
lucy.barron@aon.com

Colin Cartwright
Partner
+44 (0)20 7086 9044
colin.cartwright@aon.com

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

Tim Gordon
Partner
+44 (0)7956 324 415
tim.gordon@aon.com

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

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

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

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

Ross Mitchell
Associate Partner
+44 (0)207 086 9204
ross.mitchell@aon.com

David Thompson
Associate Partner
+44 (0)121 230 6835
david.x.thompson@aon.com

Charlotte Quarmby
Associate Partner
+44 (0)207 086 2961
charlotte.quarmby@aon.com

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

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