The UK Risk Settlement Market

A Review of 2022 and Looking Ahead into 2023

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2022 — The Year in Review

For pension risk settlement, 2022 has been one of the most turbulent, busy and eventful years on record.

The trend of steadily increasing funding levels continued for most pension schemes throughout the year. This in turn created a growing appetite to prepare for buyout, with affordability accelerating more quickly than many thought possible. But inevitably, the mini-Budget in September had a profound impact on the market.

For many schemes, while the ensuing Liability Driven Investment (LDI) crisis created huge volumes of work to test investment portfolio resilience, the underlying impact of rising interest rates propelled many schemes to a position of being fully funded on a buyout basis. Even for schemes that are not quite there, higher interest rates and consequent lower liability and lower deficit positions, in nominal terms, mean that the actual cheque writing distance to address any shortfall is much smaller. As such, from a sponsor's perspective, it's now a very appealing environment to pursue a full scheme buy-in or buyout transaction.

The good news is that the insurance market has the capacity, with insurer balance sheets proving resilient through the market turbulence and solvency positions reaching record highs in the second half of the year.

Set against this market context, it already seems clear that 2023 will see a strong focus on full scheme transactions, driving significant volumes. However, the outlook for pensioner buy-ins seems rather more mixed. While market pricing is still very supportive of 'exchanging gilts for annuities', a consequence of the newly emerging 'LDI 2.0' environment is that actual availability of gilts to support these deals is now far more challenging. While pricing might look attractive, more cautious views on leverage reduce headroom for partial annuities and are likely to dampen volumes in this sector of the market.

The other notable casualty of the changing landscape in 2022 has been the commercial consolidator market. More schemes who were actively pursuing this, are now likely to be closer to buyout or on course to do so within the foreseeable future. Indeed, many of the pipeline consolidator cases during the year have changed lanes and turned their attention to buyout deals instead.

Elsewhere, there has been the usual buzz of activity in the longevity swap market, with reinsurance capacity and pricing continuing to support a steady flow of transactions — with the Barclays £7bn deal demonstrating that capacity is available to support event the largest of schemes.

Across all transaction types, we have seen a resurgence of the 'mega deal', something we expect to continue into 2023. This will of course consume large portions of capital capacity and assets at both insurers and reinsurer, but with increasing use of new sources of capacity (including funded reinsurance, capital market money and potential more flexibility within the Solvency II framework to come), we expect to see a greater volume of mega deals in 2023 and beyond.

As ever, with an increasing number of schemes nearing their endgame target, a key focus continues to be strong preparation. Insurers risk being overwhelmed by the volume of schemes coming to market at an accelerating rate. This means — more than ever — that it is important for schemes to stand out in a busy marketplace. As well as the usual need to have good quality data and clarity over benefits to be insured, it is now vitally important to have the right assets in place as well. In particular, many investment portfolios now have significant allocations to illiquid assets, which are generally challenging to transition to the insurance market. The LDI crisis shone a light on the challenges (and costs) of selling these assets in short order. This in turn highlighted the importance of having a clear plan of how to deal with asset transition as part of any insurance transaction.

This will certainly be a major theme in 2023, both for schemes in their preparation, and for the insurance market in terms of developing innovative solutions to help address these challenges.

The final note of the year is saved for the much anticipated reform to Solvency II. After a long period of consultation and data gathering, the Government published the outcome of its review in November and set out its intended package of reforms. From a bulk annuity perspective, as expected, this included a focus on encouraging investments in the real economy, both through changes to the so-called matching adjustment, and a relaxation of capital through amendments to the risk margin requirements. There remains an important balance to strike between stimulating economic growth through greater investment flexibility and ensuring policyholder protection through a robust and well capitalised insurance regime. It will therefore it will be interesting to see how the Prudential Regulatory Authority (PRA) responds in 2023 and makes use of its supervisory tools to ensure the 'safety and soundness and policyholder protection'.

2022 — a turbulent, busy and eventful year indeed! It is now time to focus and prepare for another high tempo year ahead.

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Is It Time To Get off the DB Rollercoaster?

The effects of the current economic volatility are being felt around the world but no more acutely than by those running defined benefit (DB) pension schemes here in the UK. The aftermath of the mini-Budget delivered on 23 September sent pension schemes into a spin and caused chaos for many trustee boards and sponsors.

With long-term gilt yields at an almost 15 year-high in the immediate aftermath, liabilities dropped significantly for many schemes since the start of 2022 and in turn, improved their funding levels. But even the most thrill-seeking trustees are likely to have found the pace and volatility uncomfortable.

Not only did it result in sudden collateral calls for those with leverage in their portfolio, but many schemes also saw potentially huge changes to their endgame planning. Is this a good thing? Well, yes, but the sudden improvements have now given schemes a new set of challenges to consider.

Investment Considerations

The repercussions of the mini-Budget placed investment consultants on speed dial to deal with collateral calls and, in some circumstances, bank the funding level gains. However, while this market shock prompted immediate actions, many schemes will have already watched their funding level climb throughout 2022, making their endgame look closer than ever before.

Schemes which are getting closer to their endgame, should be turning their attention to hedging against insurer pricing. Unfortunately, the investment strategy for each insurer varies, which means making a perfect match is almost impossible. However, it is possible to find a happy medium and track ‘average’ insurer pricing to make the transition to buyout easier. This is an approach that requires specialist risk settlement experience and knowledge, and one that Aon has successfully implemented, assisting many schemes to achieve buyout.

Preparation for Buyout

It is no surprise that there has been an increase in the number of schemes trying to get off the DB rollercoaster, given the recent funding level improvements. However, it is a ‘single file only’ exit queue, due to insurers having limited resources available to meet the demand. This means, at least in the short-term, that only those who are the best prepared will be given the green flag into the fast-track exit lane. Realistically, this means those with good quality data, an insurer-ready benefit specification and alignment from the trustee board and sponsor are the only ones likely to make the short list.

If schemes have not yet ticked off these items, a strategic plan needs to be formulated so they are completed before an approach to the risk settlement market can be made.

It should also be noted that it is not just insurers who are busy, but also administrators, therefore these plans need to be carefully designed to integrate other projects such as the Pensions Dashboard and GMP equalisation. Integrating these important projects in an efficient, cost-effective manner for the administrators will help you avoid an increase to the queue time.

Reaching the End of the Track

So, is it time to get off the DB rollercoaster? Many schemes think so and are seeking to exchange the highs and lows for the safer ground of the insurance regime.

For the schemes that are not quite ready to make the final step, they may find themselves strapped in for a while longer. But by working with a specialist risk settlement advisor, making the necessary changes to asset strategy and strategic plans, the final stages to the nearest exit should be much smoother.

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Buy-Ins and Buyouts — Challenges and Opportunities in the Current Market

In line with recent years, 2022 is expected to be a tale of two halves for the bulk annuity market as we expect to see more pension scheme risk transferred to insurers in the second half of 2022 than the £12 billion volume to 30 June 2022.

The question is how much more? While a number of larger transactions are expected to be completed before the year-end, yield rises are expected to dampen overall volumes as the size of each individual transaction has reduced. In some cases, we have seen scheme sizes more than halve over the course of 2022.

We expect the mix of transactions completed over the year to include both partial buy-ins (mainly for pensioners) and full scheme buy-ins/buyouts. However, the unprecedented rises in yields (and corresponding collateral calls for pension schemes) following the mini-Budget in late September has meant that many pension schemes have re-directed their focus to their interest rate and inflation hedging strategies and ensuring appropriate liquidity.

Therefore, for a small number of schemes considering partial pensioner buy-ins, some have paused to reconsider hedging positions and to ensure that there is sufficient scheme liquidity before proceeding. Conversely, a number of other schemes have been able to move quickly to capture highly attractive pricing which has resulted from rising yields. This is a further endorsement of the importance of transaction readiness in a market where the best pricing opportunities are often short-lived. In some ways, this is a similar situation to 2020 when COVID-19 first impacted financial markets, albeit with different factors driving scheme decisions. At that time, we saw some schemes put projects on hold due to concerns about liquidity, while others were able to capitalise on a short window of highly attractive pricing — but at that time largely due to widening credit spreads.

Now, due to yield rises, many schemes have also seen their solvency positions improve dramatically as:

- Absolute values of assets, liabilities and therefore deficits have fallen.
- Funding levels have improved due to many schemes not being fully hedged against solvency liabilities.

On the face of it, this suggests more schemes are now closer than ever to achieving their endgame objective and have achieved this much more quickly than they could previously have anticipated. Some key questions for these schemes will be:

- Can they lock in the solvency funding level gains they have seen?
- Is now the right time to approach the bulk annuity market for quotes (given they are now either in surplus or cheque writing distance for the scheme employer)?

Importantly, meeting affordability criteria is only one aspect of transaction readiness, as full scheme transactions have wide-ranging considerations, and many of these schemes will not be able to act now due to not having:

- Invested time in preparing underwriting information for insurers regarding their data and benefits.
- Considered wider aspects of full scheme transactions, such as the impact on member experience or approach to managing residual risks.
- Considered how illiquid asset holdings will be managed.

For many schemes, illiquid assets have become a greater proportion of overall assets due to recent yield rises and therefore a proportionately bigger problem to solve as part of any insurance transaction. While there are market solutions which we have utilised on many transactions, they are typically limited to situations where illiquid assets represent a lower proportion of overall portfolios.

For schemes that are able to work through the above issues quickly, there may be opportunities in the current market, but for others they should focus on preparation to ensure that future opportunities are not missed. They should also consider doing what they can from an investment perspective to lock into a newly improved position.

We would caution against rushing to market because of funding level improvements unless transaction readiness can be demonstrated in other areas, as this can ultimately be counterproductive. An aborted approach to market can be damaging for a scheme's credibility with insurers if it then looks to transact in future.

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The Jar of Buyout

As the philosophy lesson goes, if you fill a jar to the brim with golf balls, it is full, right? But what if we add a handful of pebbles to fill the voids between the golf balls? Is it now full? What if we then pour in sand to fill the smaller gaps between the pebbles — is it full now? In fact, there is still some room to top the jar off with water, before it is sealed with a watertight lid.

Golf Ball Funding Level

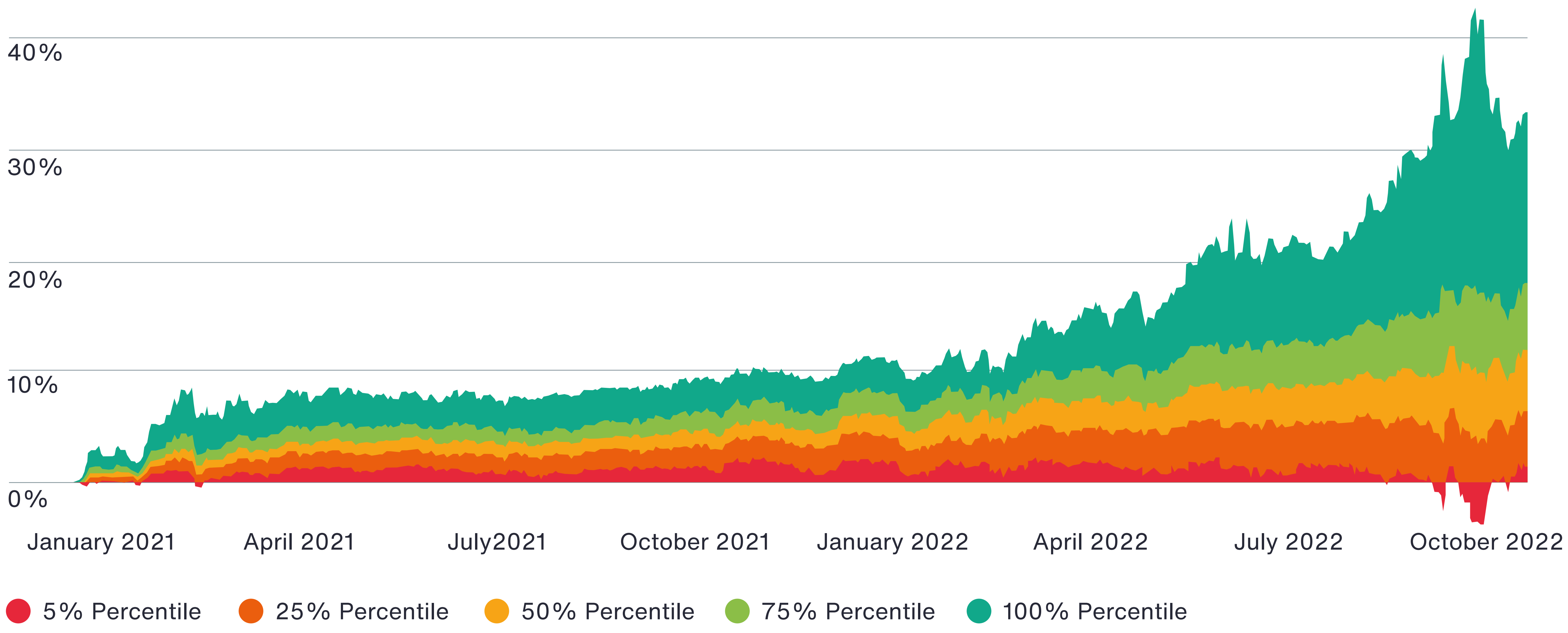
In the case of reaching buyout, the first scenario of filling the jar with golf balls is much like estimating your typical solvency funding level. It is based on the available building blocks of your current scheme data, a good understanding of the scheme's key benefits and will get the job done to provide an indication of your proximity to full buyout funding, or in other words, how full your buyout jar is. However, inevitably there will be gaps in the data and benefits which need to be filled before an insurer is willing to price the risk. So how do we fill these gaps and what needs to be considered to achieve buyout?

Data and Benefit Pebbles

The first step is to consider the quality of data and accuracy of benefits in payment through a data cleanse and benefit review. In terms of benefits payable, a summary document known as a benefit specification is provided to the insurers in place of the full scheme rules to administer the scheme. Preparing this document at an early stage for the full scheme and comparing against scheme rules and administration practice will mean that insurers and trustees can be confident the benefits are clear and understood. In conjunction with this, a data cleanse can highlight the missing or incorrect data to be rectified and provide peace of mind for trustees at the ultimate wind-up, that their members are receiving the benefits they are due.

It has been well documented in recent months that solvency funding levels for the majority of defined benefit (DB) pension schemes have improved significantly and more schemes than ever before are approaching full funding on a buyout basis — good news! In fact, recent analysis across Aon clients indicates median improvements of around 10 percent in funding levels since January 2021, resulting in a surge of schemes approaching insurers for quotations.

Change in solvency funding level for Aon clients since January 2021



Source: Aon 2022

However, limited insurer resource and more schemes coming to market means insurers are likely to be more selective than previously. This means that only schemes with the right level of preparation (the data and benefit pebbles) can capture current favourable pricing after the unexpected upswing in their funding levels.

Granular Detail of GMP Equalisation

GMP equalisation is then the sand between the pebbles. At the buy-in phase, this can be a work in progress, but as the scheme transitions to buyout, equalisation needs to be agreed and implemented before an insurer will issue individual policies to members. If a the GMP method is still to be agreed, consideration should be given to each prospective insurer's appetite and administration capabilities for each method to ensure a smooth transition to buyout.

Watering Down the Residual Risks

At buyout and eventual wind-up, schemes aim to be as watertight as possible, with clean data and benefits to ensure all members receive exactly their entitled benefits. Despite best efforts, it may be almost impossible for schemes to achieve perfection. This is where residual risks cover, trustee indemnity insurance and employer indemnity strategies will trickle through to fill the remaining tiny gaps and create an avenue for unknown benefits to be paid in the future. Early discussion of which option is right for your scheme will reduce the likelihood of leaks. Smaller schemes will tend to focus on trustee indemnity insurance and employer indemnity strategies while larger schemes often add residual risks cover. This requires more preparation with detailed due diligence being carried out on the scheme's data and benefits.

Filling Your Buyout Jar

If you get the sequence of filling your buyout jar wrong, the task to fill it with all the contents may seem like a doomed game of Tetris. You may need a reset to achieve the desired result. However, if done correctly and with a clear strategy in place, it creates the best outcome. At a time when buyout may be in touching distance, it has never been more important to set this strategy for success.

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Opportunities for Small Schemes

Bulk annuity market volumes have increased significantly in recent years, and there was no slowdown in this growth during 2022. There are a number of factors behind this increase in volume, one being the number of larger deals coming to market, which has driven an increase in the average deal size.

As schemes mature and funding levels improve, this level of activity is expected to continue throughout 2023 and beyond, meaning more schemes are nearing their endgame and considering bulk annuities. This leads to the age-old question, how do smaller schemes (typically deals ranging from £1M to £100M in size) fit in to the wider bulk annuity market?

With market demand rising quickly, insurers — unsurprisingly — are being more selective on which transactions to quote. This is largely due to the resource capacity crunch they are experiencing, with their recruitment drives not yet producing the personnel required to meet the volume of requests received. This leads to a challenge for smaller deals to compete for insurer engagement and to avoid being pushed out by the larger transactions in the market.

Smaller schemes — fear not! Insurers are not expecting to shift their focus solely to the larger transactions in the market. On the contrary, insurers still like a steady flow of business, which is much more achievable by quoting across a range of transaction sizes, and something we have seen play out over 2022. It does mean, however, that insurers concentrate on those that that approach the market in the right way and are therefore more likely to transact.

To help with this preparation, there has been a marked increase in schemes seeking risk settlement advisers with tried and tested solutions at this smaller end of the market, as insurers favour schemes approaching the market with a streamlined approach.

This ensures robust pre-transaction preparation and flexibility in the process. Our experience confirms this, successfully supporting eight schemes through smaller transactions with six different insurers so far this year (at the time of writing).

Actions for schemes to become transaction-ready include:

- Putting in place a robust governance process, to enable nimble decision making.
- Considering appropriate data cleansing activities and completing these in advance.
- Preparing a benefit specification, and ensuring there are no benefit uncertainties, or issues left unaddressed.
- Considering any investment constraints, agreeing which assets will be used to support a transaction and planning the transition process to minimise costs and risk to the scheme.

The right preparation demonstrates to insurers that the scheme is serious about transacting and helps mitigate new issues emerging either during a transaction or worse still, after a transaction has taken place.

Flexibility in transaction approach and timescales is increasingly important in the current market too. While this is true for transactions of any size, it is a particular advantage for smaller deals, as their size means insurers can more easily use short term capacity to price these deals (compared to larger transactions that take more structuring and resource).

We have partnered with Eversheds Sutherland to create pre-agreed bulk annuity contracts with insurers. By using this jointly developed and streamlined process to approach the market, schemes can minimise the resource requirements for insurers to provide a quotation and execute a transaction. Again, a big plus for insurers.

This in turn allows for shorter transaction periods and, in some cases, we have been able to reduce the execution period to two weeks, leading to greater price certainty. This has been particularly helpful in recent volatile markets.

The good news is that, in our experience, if schemes prepare in the right way and are flexible in their market approach, really good opportunities are available for smaller transactions. However, it is vital that the right preparation, the right advisory team and the right approach to the insurance market all come together to help ensure a successful outcome for pension schemes and their members.

For further information on how Aon can help smaller schemes on their journey to settlement, please read here.

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The Conundrum of Predicting Future Longevity

The UK has seen high levels of mortality since the start of the COVID-19 pandemic in March 2020. The Continuous Mortality Investigation (CMI) estimates that, between the start of the pandemic and the end of 2021, there were over 120,000 more deaths in the UK than their baseline, which is based on the death rates that were seen in 2019. For context, a typical year would see around 600,000 deaths in the UK, so on average, mortality in 2020 and 2021 was around 10% higher in the UK than might have previously been expected.

During 2022, the number of deaths caused directly by COVID-19 has been lower than in the previous two pandemic years. Indeed, for the first few months of 2022, deaths were roughly in line with the numbers seen in 2019, leading to hopes that mortality was returning to more typical levels. However, in around April of this year, the numbers of deaths started to increase significantly. The CMI now estimates that there have been around 25,000 more deaths in 2022 to date than their 2019 baseline.

This increased number of deaths was not widely expected, especially because death rates in the summer months are usually more predictable than in the winter. This has led to considerable analysis and investigation into the likely causes. Principal candidates are:

- COVID-19 infection having a negative long-term impact — i.e. after individuals have apparently recovered — on health, in particular circulatory diseases
- Knock-on impacts of the pandemic on the healthcare system, with data showing that the NHS is under severe pressure
- Disruption to diagnoses and cancellation or delay of treatments during the pandemic period
- Additional deaths arising from very high temperatures in the summer months

The extent to which these factors are expected to continue into the long-term remains a subject of intense speculation, however it is becoming clear that the short to medium-term outlook is less positive than might have been anticipated at the start of 2022.

Projecting Life Expectancy

In non-pandemic years, higher-than-expected numbers of deaths in national data would flow through into pension scheme funding assumptions because they would affect the mortality trends projected by the industry-standard annually updated CMI Mortality Projections Model. All else being equal, if recent years have higher-than-expected deaths then this leads to lower-than-expected life expectancies, and hence reductions in liabilities. But in the face of the extremely high mortality resulting from the pandemic, the CMI elected to (in effect) exclude data for 2020 and 2021 from its model to avoid distorting its mortality projections.

The next version of the CMI Model (CMI_2022) will be published in mid-2023. (This is later than normal because the CMI is awaiting final adjustments to historical population estimates from the ONS following the 2021 Census). Our estimates suggest that simply incorporating these adjustments will reduce pension schemes' liabilities by around ½%.

The CMI faces a difficult decision on how to treat 2022 mortality. On the one hand, the CMI Model must start to incorporate new mortality data at some point, otherwise it will be seen to be out of date — and variations in mortality similar in size to those seen in 2022 have been incorporated in previous versions of the model. On the other, 2022 still saw relatively large numbers of COVID-19 related deaths, as well as elevated deaths from other causes. While it is possible that this higher level of deaths represents a 'new normal', at least in the short term, it is not clear how long this higher level may last. Finally, the impact of 2022 data on the Model is even greater because 2020 and 2021 data have been omitted — in effect the model has been coasting based on pre-2020 trends and so including new higher-than-expected deaths data has the potential to pull it abruptly in a different direction.

Looking Ahead to 2023

There is no single good option. The CMI Model plays a critical role for pension schemes and life insurers, and deviating from the CMI's core model can prompt difficult questions from auditors. At Aon, our view is that the most appropriate approach is for the next version of the CMI Model to place partial weight on 2022 data. This would have the effect of:

- reducing life expectancies to reflect lower expectations following the pandemic, but not over-reacting to the higher-than-expected numbers of deaths in 2022, but
- at the same time, signal that, although 2022 may not be a completely 'normal' year for mortality, the CMI's intention is to revert to placing full weight on future years' data.

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Longevity Swap Market Update

2022 has been another bumper year for longevity swaps. The total value of business written is expected to exceed £15 billon for the third year in a row and with a busy end to the year, it is likely that 2022 will be second only to 2020 (£24 billon) in terms of total liabilities reinsured.

We continue to see a focus on larger, £1 billon+ transactions — which takes up much of the pricing resources of reinsurers. That, in turn, means smaller schemes still struggle to get reinsurers' attention .

Key Factors Driving Demand

Longevity improvements are arguably more uncertain than ever in the post-pandemic environment, with the medium and long-term impacts of COVID-19 still unknown, and thus strengthening the case for longevity hedging. This is reflected in the longevity swap market, with a strong and stable flow of schemes seeking to hedge pensioner longevity risk.

With scheme funding levels improving in recent years, longevity exposure has become an increasingly dominant risk for many schemes, particularly for those who have already taken steps to reduce their investment risk. The unfunded nature of longevity swap transactions means that schemes retain investment flexibility after entering into a swap, which is an important factor for schemes with illiquid assets and / or limited low risk assets available for annuity purchase.

The longevity swap market has become increasingly competitive and has seen new entrants come to the market, this has resulted in particularly attractive pricing. Schemes taking advantage of this have been able to reduce their longevity risk exposure at a small premium above best-estimate liabilities, and often within long-term funding target liabilities.

Evolution of the Deferred Longevity Swap Market

Historically, longevity swaps have focused on pensioner members. However, given the growing number of full scheme buyouts completed over the last few years, reinsurers have continued to develop their capabilities to hedge non-pensioner longevity risk, enabling them to reduce their longevity risk exposure across full scheme transactions.

2022 has shown signs that reinsurers are prepared to extend this non-pensioner longevity risk protection directly to pension schemes via longevity swaps. There are now more reinsurers who are active in the longevity swap market and actively quoting on deferred transactions, albeit with varying requirements (e.g. around the proportion of pensioner / non-pensioners being hedged).

Unsurprisingly, pricing for deferred transactions is still far more varied compared to pensioner-only deals, given the longer duration of liabilities. This, alongside some additional practical considerations for deferred members, adds to the complexity — namely incorporating the various methods of 'at retirement' and transfer optionality for deferred members.

Looking forward...

It remains to be seen how the financial markets will evolve over time. If the current market conditions persist, then schemes faced with lower LDI leverage and higher illiquid asset allocations might turn their attention to longevity swaps rather than opting for a partial buy-in strategy.

We expect the deferred longevity swap market to be a significant growth area for the longevity reinsurance market over the coming years, one which will provide innovative and cost-effective solutions for pension schemes looking to hedge longevity risk across their entire scheme.

However, there are no signs that reinsurer appetite for UK pension scheme longevity risk will subside, and while pricing remains at such attractive levels, longevity swaps will continue to be an attractive risk reduction tool for pension schemes. All of which means the longevity hedging market looks set to remain buoyant in the years to come.

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For our latest research and resources visit our Risk Settlement Insight Hub or contact the team for more information.

About

Aon plc (NYSE: AON) exists to shape decisions for the better—to protect and enrich the lives of people around the world. Our colleagues provide our clients in over 120 countries with advice and solutions that give them the clarity and confidence to make better decisions to protect and grow their business.