UK Risk Settlement Bulletin

Q3 2023

For Professional Clients Only

QAS Institute and Faculty of Actuaries ®
Quality Assurance Scheme

Post-Pandemic Mortality Trends

During 2020 and 2021, the UK saw very high numbers of deaths as a direct impact of the COVID-19 pandemic.

Since then, mortality in England & Wales has continued at elevated levels – compared to the last pre-pandemic year (2019), mortality rates were 13.9% higher in 2020, 9.2% higher in 2021, 6.2% higher in 2022 and continuing at high levels in the first half of 2023.

The extent of this heavy mortality when moving out of the pandemic period has been somewhat surprising, and there are a number of possible reasons that could explain this excess.

Mortality Rate Increases
Relative to 2019 levels

13.9%
higher in 2020

9.2%
higher in 2021

6.2%
higher in 2022

Source: ONS data

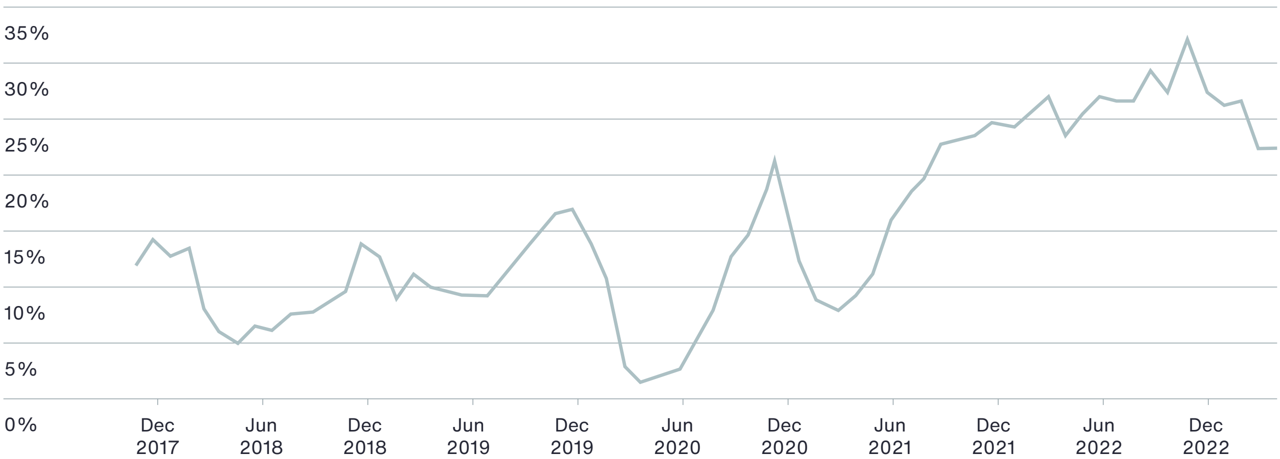
UK Healthcare

The fact that the NHS has been under extreme pressure recently is no secret. The charts below show Accident & Emergency waiting times – where research has shown a clear link between lengthy waiting times and subsequent mortality.

The percentage of people waiting over 4 hours between the decision to admit them to a ward and the time they're actually admitted has recently been running at around 25%, whereas pre-pandemic this figure was 10-15%.

The number of people waiting more than 12 hours increased significantly at the end of last year, reaching over 50,000 people in December – an unprecedented number. There are signs of things improving over recent months, although numbers are still significantly higher than their historic norms - pre-pandemic the corresponding figure was close to zero.

Proportion Waiting Over 4 hours



Number Waiting Over 12 hours

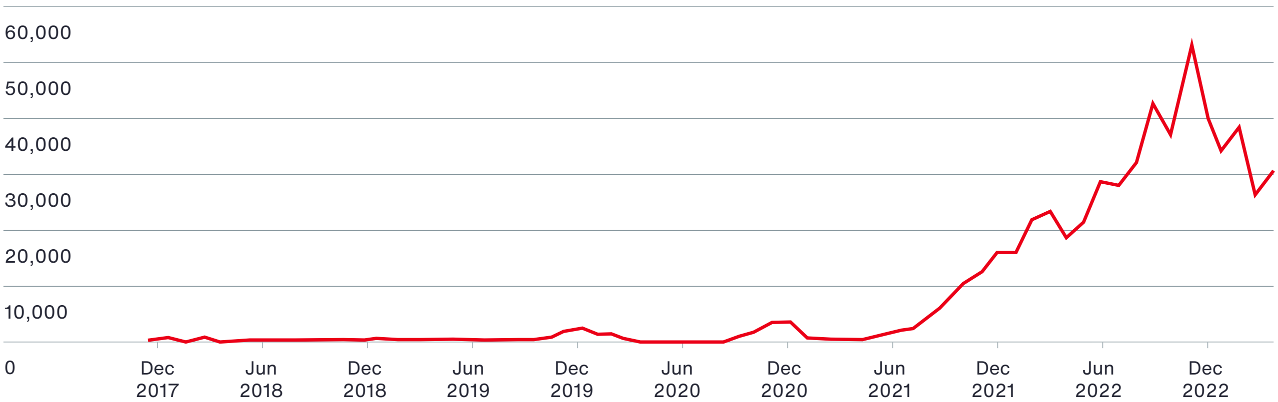


Chart source: NHS England, A&E Attendances and Emergency Admissions

Outside the UK

However, excess mortality hasn't been confined to the UK. We are seeing higher-than-expected deaths in other comparator countries such as Spain, Germany, France, and Italy. So what factors have also been affecting these other countries?

Part of the answer will be the ongoing effects of the pandemic, both directly as a result of current infection, and indirectly due to past infections.

Another factor is a large wave of flu which hit Europe at the end of last year and beginning of this year. But even if we adjust for the impact of flu, it is clear that we are seeing more deaths than expected pre-pandemic, and the general expectation now is that this higher level of deaths is likely to continue, at least to some extent.

Future Projections

This expectation has been recognised by the Continuous Mortality Investigation (CMI), a specialist sub-group of the Institute and Faculty of Actuaries, in their latest model ("CMI_2022").

This model is expected to be used across the pensions and insurance industries as the basis for assumptions on mortality improvements. As 2020 and 2021 are considered to be outliers, the model doesn't allow for these when projecting mortality improvements forwards.

However, 2022 is seen as at least a partial indication of a new trend in mortality rates, and so CMI_2022 makes partial allowance for 2022 experience leading to a fall in life expectancies. Compared to pre-pandemic projections, pension scheme liabilities could decrease by around 2.5 to 3%.

When it comes to bulk annuity transactions, insurers and reinsurers don't wait for a new CMI model to change their prices – they will look at emerging deaths and take a view. This reduction in life expectancy has been widely anticipated for some time, meaning that we wouldn't expect a step-change in pricing now the model has been published, although there may be variation on the timing and extent to which this change in expectations is allowed for.

If you would like to learn more about the latest mortality trends, please contact your usual Aon Risk Settlement consultant.

Investment Strategy Evolution

As financial markets have developed over time, we have seen growth in the range of assets used to back pension scheme liabilities. New asset classes have formed, more sophisticated strategies have emerged, and trustee objectives have become more complex.

Whilst each individual scheme continues to follow its own journey, it is crucial that trustees adapt to the maturing of their membership and react to external factors.

Today, some schemes have already reached a stable and well-hedged position, and may be targeting buyout in the relatively near future. However, for others, if buyout is the agreed endgame, there are a few key stages that are explained on the next page.

Asset Allocation Evolution

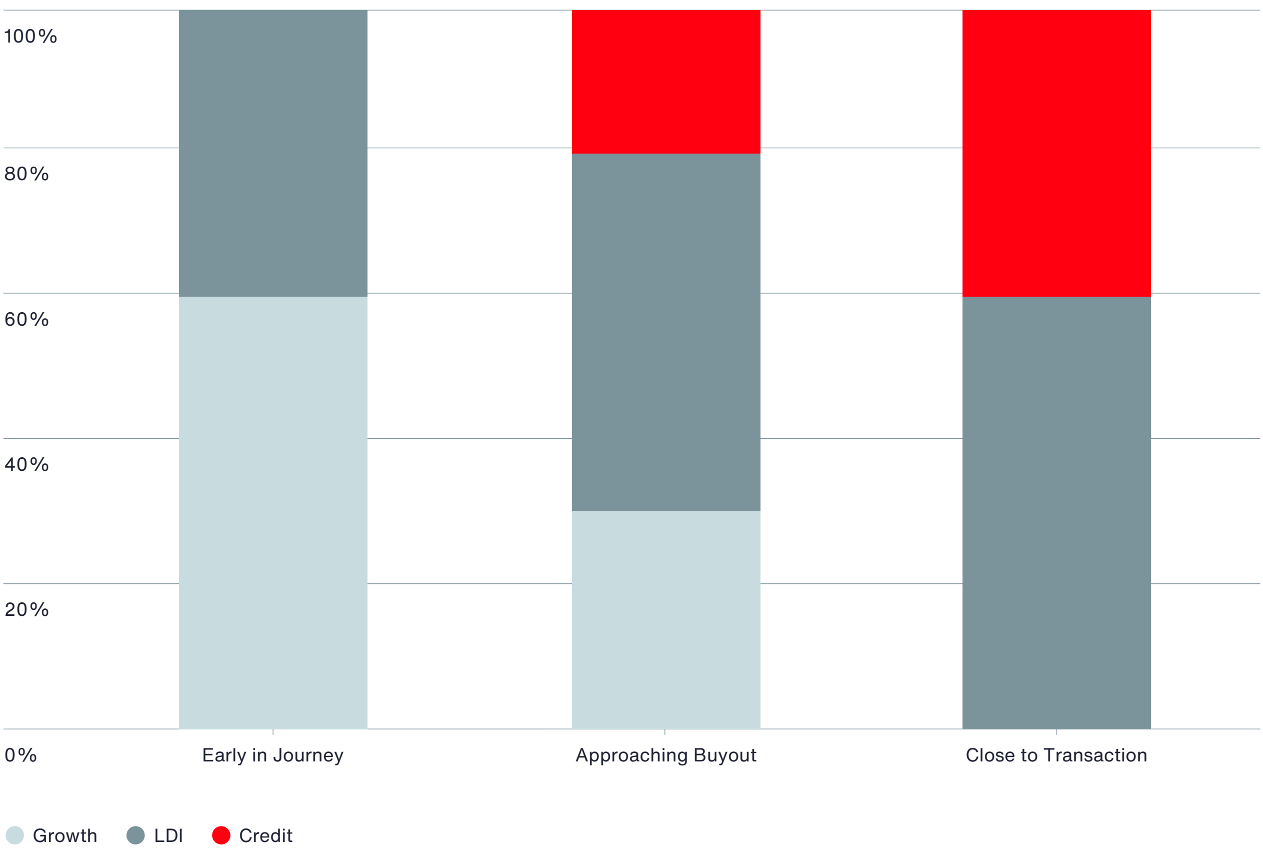


Chart source: Indicative only

Early in Journey

Schemes early in their journey, where the sponsor may still be paying ongoing or deficit reduction contributions, the investment strategy will be critical to protecting the funding level and avoiding market turmoil.

This could involve investing in a wide range of assets and hedging to reduce funding level volatility, while simultaneously maintaining growth to narrow any funding gap.

Approaching Buyout

As schemes get closer to buyout, it is important to start transitioning to a portfolio that better matches insurer pricing, with more liquid assets to pay the buyout premium.

This should involve reducing the allocation to growth assets (such as equities, diversified growth funds, and illiquid assets) and instead investing in an element of credit.

Over the past 12 months, many schemes have experienced an increase in the proportion of illiquid assets in their portfolios. This has been mainly due to rising gilt-yields placing a lower value on other investments, whilst illiquid assets have more stable values.

Creating an exit strategy for illiquid assets at an early stage will help schemes to maximise the impact of the value of their illiquids, without incurring large exit fees or reduction in sale price from being a forced seller.

Close to Transaction

For those schemes with a transaction planned in the short term, the investment strategy should now focus on position protection; ensuring assets are closely aligned with insurer pricing and in a liquid form to fund the premium. This will mean both the scheme and insurer can have more certainty a transaction will proceed.

If the scheme is yet to choose an insurer, it will be beneficial to understand the range of investment strategies insurers employ. A risk settlement investment specialist, who understands the nuances between insurers, can support with aligning the strategy to optimise the outcome for the scheme.

If the scheme is in exclusivity with an insurer, a specialist can help the scheme to enter into a 'price lock' using the scheme's actual assets. This gives trustees the peace of mind that, despite any market movements prior to signing on the dotted line, they have safely matched their assets to the insurer's price and will emerge insured.

If you would like to hear more about how to evolve your pension scheme investment strategy with a target of buy-in/buyout in mind, please contact your usual Aon Risk Settlement consultant.

Insurance Market Update

Scaling Up to Meet Demand

With funding levels rising across many pension schemes, the bulk annuity market is facing ever greater demand that is putting pressure on insurers. The market is advancing however, and the industry is finding solutions to help insurers meet the demand:

Tooling Up

Insurers across the market are working internally to boost their capacity for new transactions. All providers are building out their existing teams and services to accommodate full scheme transactions and finding ways to make broking processes more efficient.

Increasing Capacity

Insurers are optimising their investment and reinsurance strategies to maximise the capital available for writing new business. This has included a growing demand from some insurers for 'funded reinsurance', allowing them to transfer asset risk as well as longevity risk to the reinsurance market.

Solvency Coverage

Rising interest rates in 2022 have boosted insurer solvency levels, with over £30Bn of surplus capital. This comes at an ideal time, as insurers are able to call on available capital to write new business.

The market is developing and expanding, from a number of angles, to alleviate current capacity constraints.

Supportive Legislation

The Government released draft regulations in June 2022 for the proposed changes to the UK insurance regime, as part of wider plans to 're-energise' the UK economy. This includes reforms to allow investment in a wider range of UK assets and technical changes designed to release capital.

This was followed by a Prudential Regulatory Authority (PRA) consultation paper released in late June 2023 – the first of three consultations expected over 2023-24. This included further detail on some technical aspects of the UK insurance regime and the streamlining of administrative / reporting requirements.

The changes to the regime are expected to be implemented over 2023 and 2024.

The PRA is very supportive of market developments generally, and is monitoring insurers closely to manage any risks of over-expansion. In particular, the PRA has highlighted structuring considerations to ensure that funded reinsurance is used in a suitably controlled manner.

New Entrant

Yet another market response to the current wave of demand for bulk annuities is the entrance of a new provider to the market.

M&G is selectively considering some new, larger transactions, with a team recruited from within the bulk annuity market.

Under its previous Prudential branding, the group wrote both bulk and individual annuities in the UK, mainly for pensioners, up until 2016. Now, primarily focussed on asset and wealth management, the group continues to manage a significant book of insurance policies including historic annuities.

Any new annuities written will be supported by their considerable existing in-house skills for asset sourcing and annuity management.

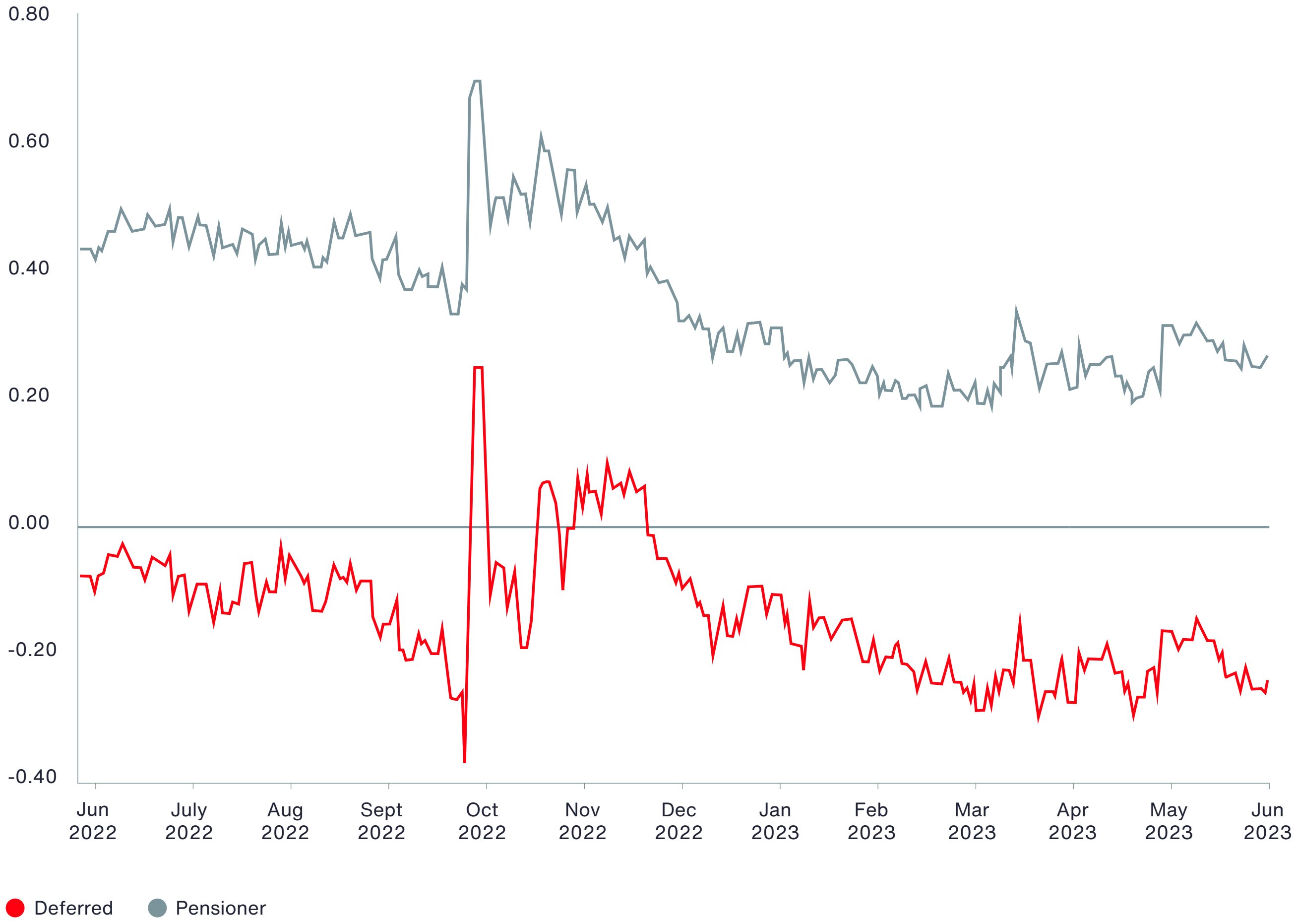
Pricing

Despite significant demand across the market, available pricing continues to be attractive for schemes. The chart shows that typical pricing has remained broadly stable over 2023, evidenced through attractive quotes for many schemes and competitive transaction processes in the year to date.

The 2023 market has already seen over £18Bn of bulk annuity transactions written. Strong preparation and clear objectives will give the best chance of securing a successful outcome for schemes of all sizes.

Bulk Annuity Pricing Relative to Gilts

Return relative to gilts % p.a.



How to Read this Chart

- The graph compares the estimated annuity cost with a value on a gilts basis, where the other elements of the gilt basis beyond discount rate are assumed to be exactly the same as those under the solvency basis, and the discount rate relative to gilts is derived to give the same value as the annuity cost.
- In practice most comparator gilt bases use different assumptions, in particular for determining inflation-linked pension increases, and this can mean that the discount rate on comparator basis is materially lower relative to gilts than the level shown here.
- This graph should not be used for direct comparison with scheme funding bases without scheme specific modelling.
- There is variability in solvency pricing beyond market conditions that isn't picked up in this model. At times of high market volatility this uncertainty is likely to increase. Accurate pricing can only be achieved by going to market.

Chart source: Aon's Risk Analyzer

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 and sovereignties with advice and solutions that give them the clarity and confidence to make better decisions to protect and grow their business.

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