AON

The UK Risk Settlement Market

A Review of 2023 and Looking Ahead into 2024

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A Bird's Eye View of the Landmark Year of 2023

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With the dust beginning to settle on 2023, and the final deals of the year being hurriedly squeezed into insurer targets, it seems only right to reflect on what has been another incredible year for the risk settlement market.

Bigger and More Complex

From the outset of 2023, we expected a hive of activity following the surge in funding levels for many schemes towards the end of 2022 — and the market certainly delivered! Starting the year with a bang, we saw the largest ever bulk annuity deal executed, with £6.5 billion of liabilities insured with PIC in a combined transaction for two schemes sponsored by RSA.

The Aon Risk Settlement team were proud to have been part of this landmark transaction, with a true team effort required to ensure the absolute success of the project across the variety of stakeholders involved. The complexities in this deal provided challenges that many large schemes now find themselves facing — including the hugely complex transition of assets to the insurer. Our Investment Risk Settlement colleagues played a highly crucial role in agreeing innovative solutions for the RSA schemes to exit their unintendedly high proportion of illiquid assets, successfully navigating these issues to achieve an excellent outcome for the schemes, cementing themselves as true experts in this area. We expect continued innovation to deal with the 'illiquid challenge' as insurers and third parties look to provide solutions. In particular, a key theme over the coming years will be how to unwind illiquid assets as part of a risk transfer transaction without destroying value.

Landmark transactions have dominated the headlines this year, including the largest ever single bulk annuity transaction with the Boots Pension Scheme securing £4.8 billion in a full-scheme buy-in with Legal & General. It was announced on the same day as the £4 billion transaction securing almost 50,000 members for the Co-op Section of the Co-operative Pension Scheme — and with Aon advising the trustees on both transactions. This was a truly record-breaking day for the bulk annuity market. Indeed, alongside other confidential transactions, the Aon team secured **over £10 billion of liabilities in a single week**, something we are particularly proud of as it truly demonstrates the strength and depth of our growing and highly skilled team. As with the RSA project earlier in the year, each of these transactions solved complex illiquid asset challenges and further underlined that innovation is continuing rapidly and at scale.

Small Schemes — Still Room at the Inn

While the largest deals often dominate the headlines, small and mid-sized deals continue to contribute significantly to the buoyant risk transfer market. In fact, the smallest end of the market remains by far the busiest sector, with 67 percent of all deals completed in the first half of 2023 being those under £100 million, proving that small schemes are by no means being crowded out.

In response to this high demand, insurers operating at this end of the market are developing further streamlined approaches to continue to support schemes on their journey to buyout. One aspect of streamlining is for schemes to partner exclusively with a single insurer from a very early stage in the project, with the intention of focussing efforts for both the scheme and the insurer, and thereby increasing deal certainty. Although this requires some careful consideration and early planning — including how to address the perceived loss of competitive tension — this approach can, in the right circumstances, lead to better outcomes for schemes. Expect to see more of this in 2024.

Market Overview — It's All About the Numbers

Looking across the bulk annuity market, the average deal size in the first half of 2023 was c.£222 million, compared to c.£150 million for 2022. This was largely due to the six £billion+ deals totalling £12.5 billion for the six-month period to the end of June 2023, compared to only five such deals taking place in the whole of 2022. We expect these 'jumbo' deals will be a continuing trend as we move into 2024 and beyond.

Another trend we expect to continue in 2024, is the focus on full scheme transactions, which are now the most common transaction type. Only three of the 95 deals in H1 2023 were pensioner-only deals. This reflects that many schemes are unexpectedly closer to buyout than planned, both from a timing and affordability perspective. It also reflects that, in current market conditions, partial solutions have become more finely balanced from an investment headroom perspective — particularly in relation to collateral and leverage management following the market turmoil of late 2022.

With increasing complexity, comes increasing pressures on resource and an increasing need for innovation. In fact, our 2023 UK Insurer Survey revealed that insurers deem the number one risk to the bulk annuity market to be resource — whether for the insurers themselves, administrators who have a huge variety of projects in their pipeline or indeed the advisory market. With limited bandwidth to process deals, insurers are focusing their efforts on only the best prepared schemes, while recruiting additional resource into their teams to meet demand. Similarly, as Aon's Risk Settlement team helped schemes to **secure more than c.£20 billion of liabilities in 2023 to date**, our team grew by over 20 percent and we will continue to do so to support ongoing demand for our services.

One key development which may act to somewhat reduce concerns about capacity constraint is the emergence of new entrants to the UK bulk annuity market. In September this year, the number of active insurers grew from eight to nine with the addition of M&G, who completed a £330million transaction for the M&G Group Pension Scheme — another deal proudly led by Aon. With rumours continuing to circle about further entrants, we expect to see more to come. That said, while there has always been talk of this, new entrants have been slow to emerge. And there are good reasons for that, as aside from just assembling a suitable team and structure, there are — rightly — many regulatory hoops to get through. So, it will be interesting to see how this develops.

Alternatives to Bulk Annuities

Turning to alternative risk settlement options, longevity swap transactions had another busy year, with more than £10 billion of liabilities secured across four transactions. While the pension longevity swap market has always been somewhat 'lumpy' in nature, typically seeing a relatively small number of mega-deals, the longevity reinsurance market itself has seen huge growth, with very significant demand directly from the insurers, who have relied on reinsurance capacity to support the bulk annuity market over the course of the year. Just as the bulk annuity market continues to grow, we see no sign of a slowdown in the use of longevity reinsurance as we head into 2024.

2023 also welcomed the long-awaited first ever pension superfund transaction, with Clara reaching agreement to enter into its first transaction with Sears Retail Pension Scheme. We wait in anticipation to see whether this opens the floodgates for this type of transaction, particularly against the backdrop of such a buoyant bulk annuity market, but it is pleasing to see proof of concept for another type of de-risking option.

Final Remarks

2023 has undoubtedly been one of the most exciting and innovative years on record. The industry continues to evolve and rise to the occasion to meet demand. And with no sign of this demand slowing down, we are already looking forward to another busy and challenging year in 2024, and hopefully, further innovation emerging to continue to support schemes achieve their de-risking goals.

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The UK Bulk Annuity Market — The Insurers' View

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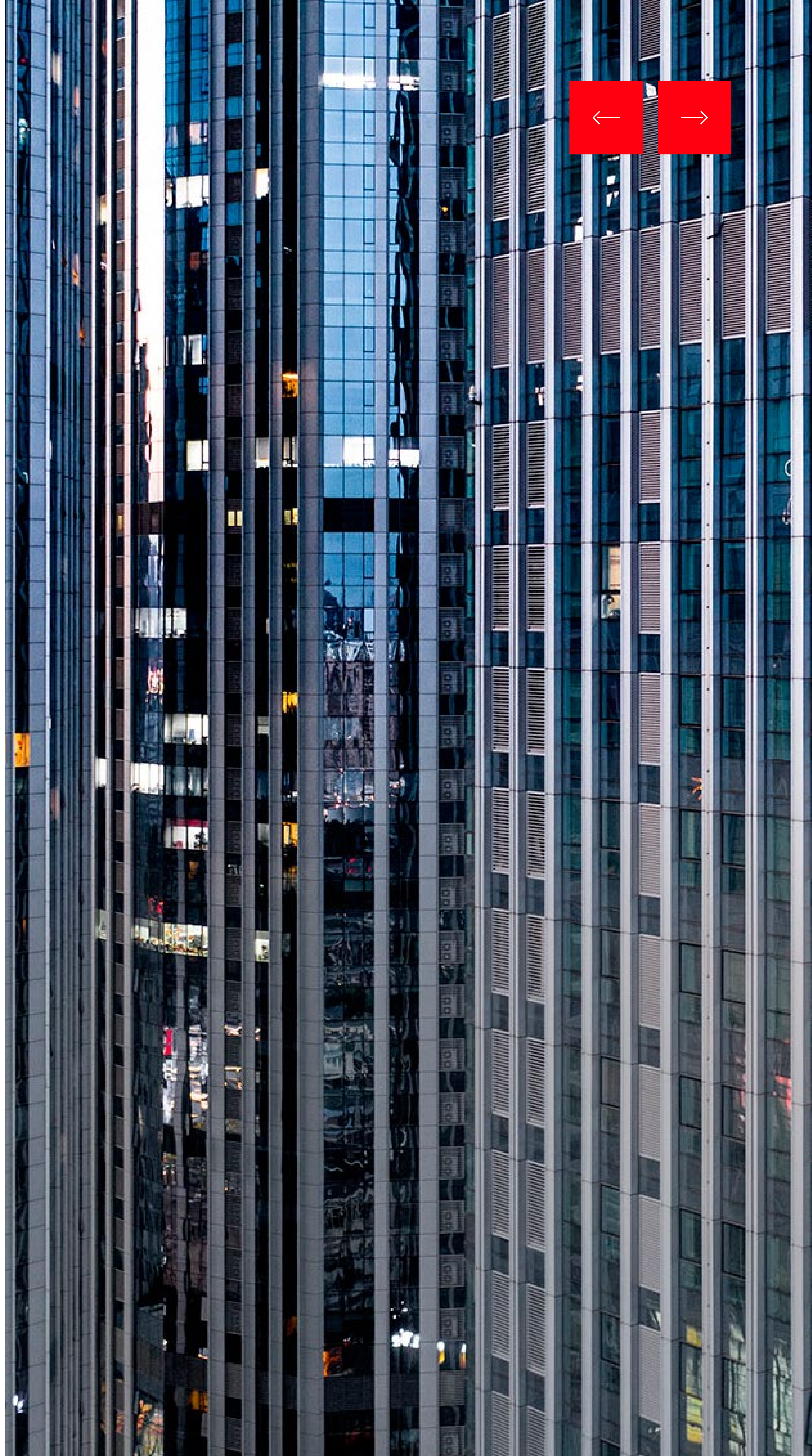
Earlier this year, we invited all eight active UK bulk annuity insurers (prior to M&G entering the market) to participate in our 2023 Risk Settlement Insurers Survey. The survey covered a series of topics, including business volumes expected in 2023 and beyond, preferences for specific scheme types, asset portfolio considerations and potential headwinds (and solutions) in the market.

We combined the research responses with information gathered on insurer volumes for all active insurers up to H1 2023, as well as the insurers' positions on some of the key topics affecting many pension schemes.

Managing Business Volumes

It is widely predicted that 2023 will be a record year for the bulk annuity market, with full year volumes potentially exceeding £50 billion, compared to the previous high of £43.8 billion in 2019. As we look beyond 2023, we asked insurers to indicate the volumes of business they expect to write in the next five years. 85 percent of responses received indicated that they intended to increase their business volumes in a sustainable way to meet demand, while the remainder suggested they would seek to retain stable targets. This will be much welcomed news by schemes targeting buyout as their endgame. In addition to this, we have already seen one new entrant with M&G announcing their first transactions in September, with further new entrants expected.

When asked about potential headwinds against their businesses, all the insurers identified capacity constraints as one of the key challenges in meeting demand, with a limited pool of people available to prepare schemes for market and to execute a transaction. This resource is facing even greater pressure as a result of the rapid acceleration of funding levels and increased appetite from pension schemes to make inroads towards their endgame.



Another common reported headwind was asset sourcing. While there are guidelines for the assets in which insurers can invest, each insurer positions their portfolio differently to suit their back book of liabilities as well as their plans for future business. A hot topic in the risk settlement market over the last 12 months has been the unexpected position in which many schemes found themselves, where the proportion of illiquids they held had suddenly increased following the mini-budget in September 2022. Efficiently re-structuring a portfolio after this in an attempt to match insurer pricing can be difficult. To do so, it continues to be important to enlist the help of a risk settlement investment specialist who understands the underlying insurer portfolios and can advise accordingly.

Insurers are employing a combination of approaches to combat any market issues, including:

- **Recruitment**
  Insurers have told us they are looking to increase their headcount to meet market demand, allowing them to quote on a greater number of transactions.
- **Streamlined processes**
  In order to keep up with the number of cases coming to market, insurers are investing heavily in streamlining processes both internally and for the schemes coming to market, to create efficiencies and release capacity.
- **Exclusive transactions**
  For smaller deals insurers are now in many cases, stipulating that they will only quote on an exclusive basis, i.e. working with a single insurer from the outset to achieve a transaction.
- **Illiquid Holdings**
  Helpfully, more than 80% of insurers suggested they would consider illiquid holdings as part of a transaction, and many of them are creating solutions to allow this hurdle to feel much easier to overcome. Having said that, we expect it would be unlikely that insurers will accept large proportions of these on every deal as these assets currently do not align with the reserving requirements placed on insurers.

Focus on Triaging

With the unprecedented number of schemes looking to transact with an insurer and the identified capacity issues, insurers are being more selective about the cases they quote on.

We asked the insurers to identify the key factors that they consider in their triaging process when deciding whether to quote on a case. The top three factors insurers consider for all types of scheme are:

- Quality of data
- Benefit structure
- Timescales to transact

Does the Process Vary with Scheme / Transaction Size?

The short answer is yes.

At the smaller end of the market (sub-£100 million pension schemes), and since insurer resource is very limited, only the most well-prepared schemes will generate significant traction with insurers. This means making sure the data is of good quality, the benefit specification has been legally signed off, the trustees and sponsor are aligned in their objectives and there is flexibility to work to insurers' required timescales as they juggle resource to meet existing (and future) commitments. In our survey, these areas were the overwhelming drivers for insurer triaging for small schemes, with little mention of other factors.

As transaction size increases, there is often more flexibility from the insurer on when to quote and on what other factors to take into consideration. For example, almost half of the insurers in the survey noted governance arrangements as a triaging factor for mid-sized schemes (£100 million – £1 billion). This size of scheme is often more complex and so a key driver for insurers is reassurance that a transaction is likely to complete. Insurers will want to know that trustees and sponsor have agreed key objectives and that there is an efficient decision-making structure in place, e.g. a joint working group with trustee and sponsor representatives.

At the large end of the market (£1 billion+) the relative importance of the various triaging factors varies and can provide more flexibility to large schemes. In some cases, the appeal of writing a large transaction can be sufficiently important that any complex aspects of the transaction picked up in the triage process may be viewed as less significant by the insurer. One important factor that insurers do consider at this size is any requirement for additional security arrangements, e.g. termination rights or collateral. Insurers will consider how onerous any requests such as this are when deciding on whether to quote or not.

The key lesson for schemes is that they need to be prepared to attract insurer engagement including having agreement between the trustees and sponsor on the journey to settlement strategy, and to have developed a comprehensive plan to avoid missed opportunities along the way.

For more details on the points raised in this article, and to view the full survey report, please click here.

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Large Scheme Transactions Blaze a Trail in 2023 — And Beyond

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The demand for bulk annuities continued to grow over 2023, with H1 2023 volumes reaching record levels. This year also saw the UK's largest annuity transaction on record, RSA's £6.5billion buy-in with PIC, with new ground being broken in respect of complexity and timing. But it was not the only large scheme to transact this year.

One reason for the marked increase in volumes is the number of £1 billion+ transactions. During H1 2023, there were six £1 billion+ transactions (half of which were advised by Aon). This compares to five £1 billion+ transactions over the whole of 2022. With a flurry of activity due to happen in the final few weeks of the year, as deals of all sizes are executed before the year-end, we expect there will be more major deals announced, making it a bumper year for the £1 billion+ deals.

But what are the key strategic considerations when taking a £1billion+ scheme to the insurance market?

One of the most powerful is the 'negotiating power' of the trustees / sponsor and their advisers — the bigger the scheme, the larger the premium, and the more negotiating power the trustees and their advisers will have.

This also proves extremely useful when navigating the complexity of the deal. The larger the scheme, typically, the more complex the transaction will be. With greater scope for unusual benefit structures, bespoke commercial requests or illiquid asset holdings in large deals, this can provide an advantage to the insurer when negotiating, with the scheme looking to solve a complex problem only willing insurers can provide. The balance of these powers ultimately leads to a more complex transaction and requires an experienced risk settlement adviser to help navigate the best outcome for your scheme.

With this dynamic, many would agree that future innovation will emerge from these very large transactions. As we look towards 2024 and beyond, we consider three areas where transaction complexities for the largest of schemes can lead to innovation via solutions created for the wider market.

Commercial Terms

Schemes of all sizes can access competitive pricing and commercial terms but the keys to unlocking certain aspects can vary by scheme size.

The very largest of schemes are expected to be able to benefit from contractual terms that smaller and mid-sized schemes can rarely achieve, for example:

- **Termination rights** would allow trustees to terminate the annuity policy during the buy-in phase, under pre-agreed conditions, such as the insurer failing to make payments to the scheme on time and insurer fraud. Should the trustees terminate the policy under one of these conditions, a payment will be due from the insurer to the trustees and the buy-in policy will cease from the date of termination.
- **Collateral** — an extension of termination rights, whereby the trustees still have some control over a ring-fenced portion of the assets held by the insurer. If the policy was terminated, trustees would get these assets back under the conditions of the termination rights.

Investments

For larger schemes, the investment portfolio will tend to be more complex. For instance, it will often include some illiquid holdings, which may not be expected to run off over several years. In recent years, schemes holding these types of assets may have had insurers declining to take them on, leading to potential delays in the transaction, or the asset being sold at an unfavourable rate in the open market. However, for the largest of schemes, insurers are increasingly more flexible in their approach. For instance, they may be willing to take on the illiquid holding as part of the buy-in, or they may be willing to accept a deferred premium until the asset has been run off. While this innovation began for large schemes only, with the illiquid problem impacting smaller schemes too, insurers are developing solutions for the whole market. We expect to see more innovation in this area in 2024 and beyond.

Data and Benefits

The smaller end of the market is rapidly changing and, as the bulk annuity market gets busier, there is increasing pressure from a data and benefits perspective on smaller schemes to be ‘ready' at the point of transacting. However, for larger schemes, there is still scope to address data and benefit actions, such as data cleansing and GMP equalisation, after the buy-in transaction.

In addition, as the market gets busier and administrators come under increasing resourcing and capacity constraints, there may be scope for bigger schemes to consider more innovative ways to get data and benefit actions completed. For instance, we have started to see insurers be more willing to take on some of this work themselves. This may involve insurers hiring data and benefit resource into the business in order to provide dedicated resource to the transaction. Insurers may also consider taking on a scheme's incumbent administration function to help with data and benefits actions during the buy-in to buyout phase.

With the bulk annuity market predicted to continue its upward trajectory, we expect the number of mega deals will increase in 2024 and beyond. Given the complexities of schemes still to come to market, insurers will have to adapt to be able to meet the demand. With the largest deals having more levers to pull, we expect them to blaze a trail for the greater good of the whole market.

For further information on how insurers are working with larger schemes, please see our 2023 UK Insurer Survey.

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Small Scheme Transactions — A Year of Evolution

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This is a year where two words have dominated proceedings for smaller transactions 'streamlined' and 'exclusivity'.

With the whole settlement market extremely busy, and insurer capacity to provide quotes needing to be carefully managed, insurers and advisers alike have needed to work harder than ever to evolve and ensure that smaller transactions have remained viable.

This hard work has paid off. In fact, this section of the market has flourished, and we have continued to see a steady flow of smaller scheme transactions being completed at attractive levels of pricing. This has largely been achieved by the implementation of two things:

1. **Development of insurer processes**
   Several insurers introducing new simplified pricing mechanisms which have 'streamlined' the insurer's internal processes and reduced the resource required to provide a quotation. While this process is simplified from the insurer's perspective, it does require more work up front for schemes, through the provision of data and benefits in a pre-specified format (which varies from insurer to insurer).
2. **Targeted market approaches (Exclusivity)**
   Schemes are increasingly selecting a single insurer to work with on an exclusive basis, with that insurer providing a quotation for consideration (rather than a traditional auction-style process where multiple insurers might provide a quotation). In the past, this has typically been a requirement from insurers for sub-£10 million transactions, but insurers are now seeking exclusive broking processes on a wider range of transactions. This increases the certainty of a transaction completing, subject to them putting forward compelling pricing, and therefore allows insurers to prioritise resources.

In our recent Bulk Annuity Insurer research, all insurers indicated that their resource is stretched more than ever before. However, many insurers are working hard to develop and refine their own internal processes to allow them to continue to service smaller transactions.

Further Market Segmentation

In previous years insurers have typically viewed the smaller end of the market as being transactions of c.£100 million or less. The recent changes in market dynamics have seen this figure creep up to £150 million, with further differences in broking approaches being preferred by insurers within that range too.

As a result of this, the segment of the market where we have seen some of the largest changes over 2023 is for transactions of less than c£50 million. The main areas of change here are as follows:

- Some insurers who have traditionally been highly active at this end of the market are becoming increasingly selective, because of the pressure on where to deploy their resource
- Exclusivity has increasingly been the ‘norm' for transactions of this size during 2023. While we have completed transactions of this size over 2023, with multiple insurers providing a quotation, there has been an increasing trend towards exclusive processes (with attractive pricing being put forward in both scenarios)
- A significant number of cases of this size which successfully transacted during 2023 will have done so using one of the new insurer simplified processes.

For schemes that are between £50 million to £150 million, the preferred broking process has been more case specific. Insurers continue to triage cases before quoting and while competitive auction processes remain more common here (particularly as the transaction size increases), there are some instances where insurers may require either exclusivity and/or to use their own simplified processes, to get internal sign-off to provide a quotation.

Looking Forward

Looking forward to 2024, if you asked me to pick what I think the word for the year might be, I think it will be ‘flexibility'.

The combination of the simplified insurer pricing processes and exclusivity has introduced greater complexity into the broking process, particularly for smaller schemes, requiring more up-front decisions to be made by trustees/sponsors. Schemes will need to have flexibility in both their approach to market and the timing, so that they can adapt and work closely with insurers

This all means that schemes need to be better prepared and nimbler with their decision making. This may mean changing course, having to make decisions earlier than planned or reformatting data and benefits to fit the templates required by a certain insurer.

The message from insurers for small scheme transactions is clear — work with us so that we can help you.

It is important that you work with a specialist settlement adviser to set your strategy early and focus your energies where it will have the most impact on getting insurer engagement and ultimately completing a transaction.

We have a dedicated team who specialise in smaller transactions via our Pathway solution. Nearly £2 billion of liabilities have been successfully transacted using Pathway since 2014, and we continue to adapt and refine the process to ensure it continues to provide the best solution for clients in an ever-changing market.

Further information on our Pathway services can be seen here.

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Insurance Market and Asset Allocation When Moving to a Bulk Annuity

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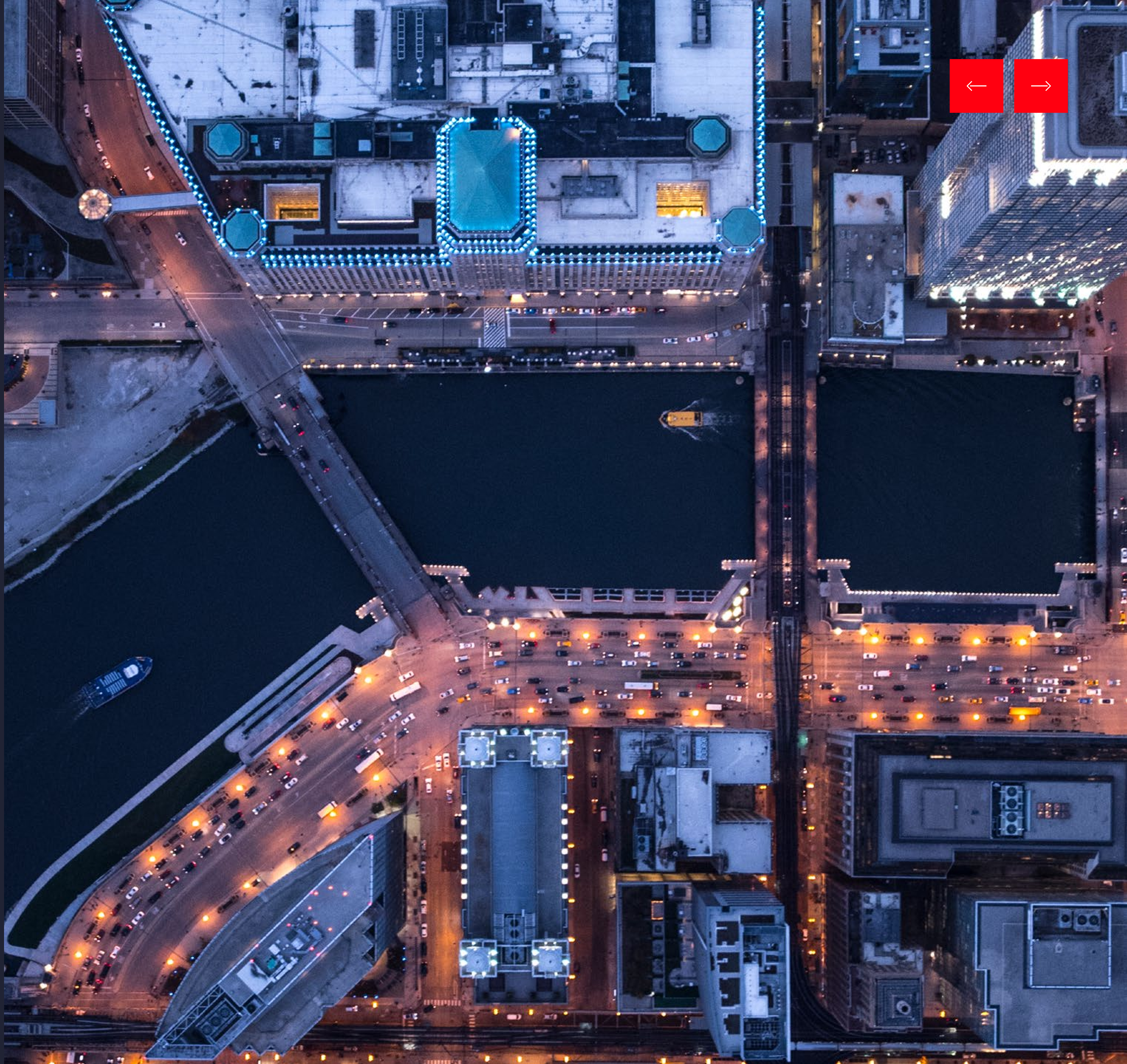


Despite it being another year of significant volatility in the investment markets, 2023 is set to be a record year for bulk annuities. This is a huge testament to how pension schemes and advisers have prepared to take advantage of transaction opportunities to secure member benefits.

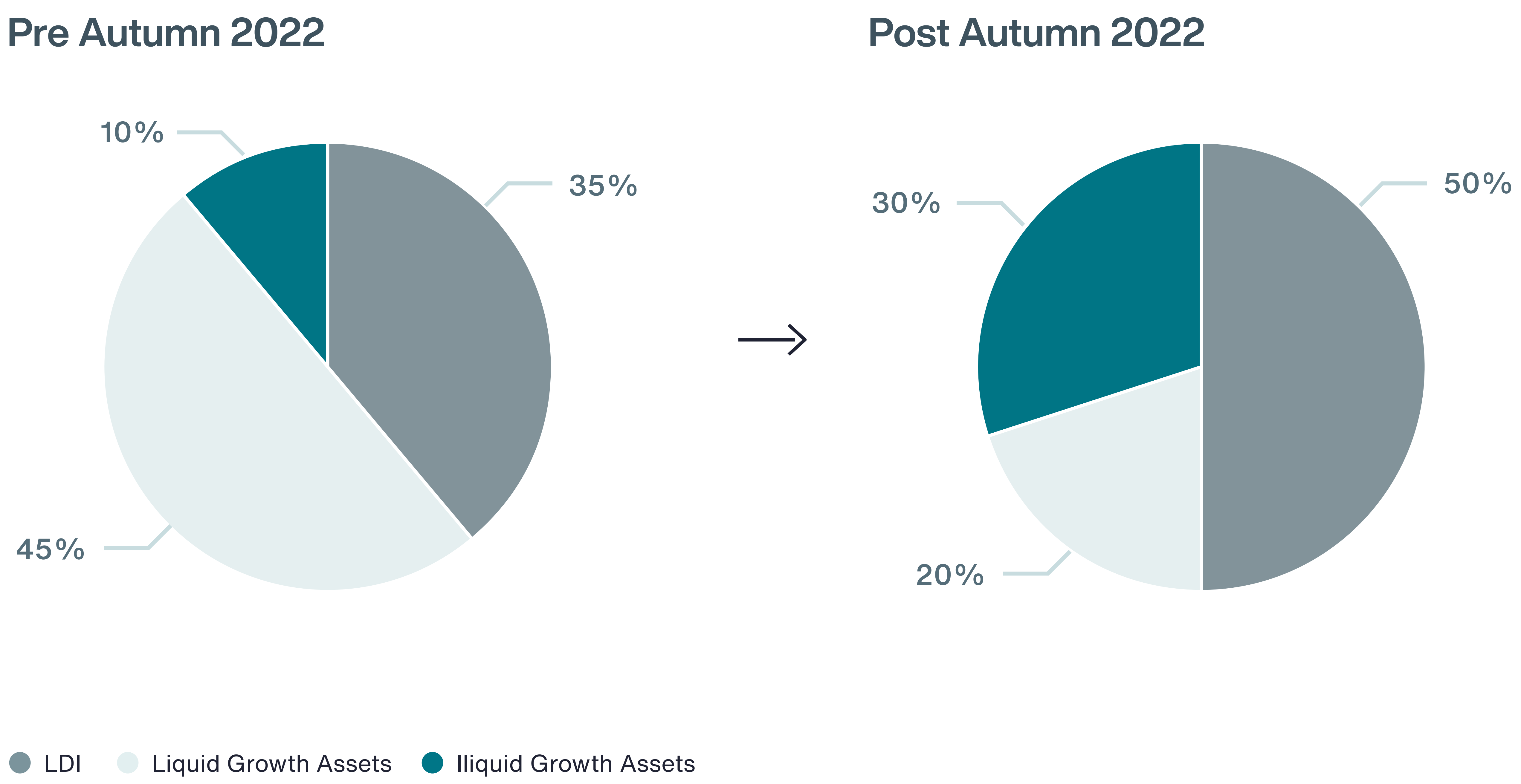
Coming into 2023, the interest rate payable on UK Government bonds, (gilt yields), was significantly higher than levels we have seen for many years. This has continued throughout 2023 and is expected to be the case for the foreseeable future. This has largely resulted in the improvement to pension scheme solvency funding positions, putting many schemes in a position where their buyout target is a lot closer than was previously expected and creating two common scenarios:

- Schemes fully funded on a solvency basis with good liquidity and a flexible low risk investment strategy have found themselves in a very strong position to transact with an insurer in 2023.
- Schemes well-funded on a solvency basis but with illiquid assets which require innovative solutions so they too can transact.

Therefore, it has been vital for advisers to consider carefully the pre- and post-buy-in risks:

- For **partial buy-ins**, this means considering residual assets post-transaction and additional liquidity constraints.
- For **full buy-ins**, this is largely whether sufficient assets can be realised in order to pay the premium.

One of the biggest challenges for schemes of all sizes in this new environment, has been an unintended higher allocation to illiquid assets. This 'illiquids problem' has become a more prominent issue where scheme asset sizes have shrunk, and hence illiquid assets have become a larger proportion of the overall allocation. A typical portfolio before and since last year is illustrated below.



Insurers are aware of the impact this is having on otherwise 'transaction ready' schemes, and there have been innovative solutions coming to market throughout the year. In recent deals we have seen a combination of approaches used by schemes and insurers:

- Deferred premiums are often available to cover the run-off (or orderly disposal of) illiquid assets over a specified period.
- Insurers have been increasingly receptive to taking on, or locking pricing to, illiquid assets held by large schemes as further shown in our 2023 UK Insurer Survey.
- Other innovative solutions have been emerging including loans from financial institutions secured against illiquid assets as an alternative to deferred premiums.
- Sponsors have also had a role to play — for example, loans have been structured from sponsors to schemes to allow run-off or orderly sale of assets, or instead assets have also been sold to the sponsor.
- And finally, schemes have used specialist brokers to find best pricing for assets, where they needed to be sold on the secondary market.

There are options for schemes looking to achieve a managed exit from illiquid assets, the key is to consider this early and explore the market to find the best solution.

The Considerations by Scheme Size

Larger Deals (£1 billion+)

There are more large schemes and complex transactions in the market than ever before, including the UK's largest bulk annuity transaction, RSA's £6.5 billion buy-in with PIC. Innovative asset solutions were a vital part of this transaction, with a large illiquid portfolio to negotiate. Key learnings have been taken from this and all different types of deals throughout the year, both by Aon as adviser on RSA, and the wider market.

Indeed, our investment expertise was also a major factor in the recently announced largest ever single scheme transaction — Boots Pension Scheme's £4.8 billion buy-in with Legal & General. A key element in achieving this transaction, was dealing with the significant portfolio of illiquid investments held by the scheme. Working in close partnership with the sponsor and trustees, we applied our experience, innovative solutions and lessons learned from other deals of similar size such as RSA and Telent, ensuring this was not a barrier to securing benefits of all 53,000 retirees and deferred members of the scheme.

The Middle Ground (£150 million – £1 billion)

The majority of transactions, by deal volume, take place in the mid-market space. The recent trend is that insurers have been increasingly selective when pricing new business and are focusing on cases where they perceive a competitive advantage.

Ensuring schemes do their asset preparation early — so they hold low risk, liquid assets and have a clear picture of the timeframes for adjusting and selling assets – has meant they can negotiate with the insurer on pricing and the terms and approach for rolling forward the pricing early in the market engagement process.

Smaller Schemes (sub-£150M)

Many insurers now require exclusivity to engage with any transactions under £100 million. It has therefore, been vitally important to be clear from the outset regarding the structure of a transaction, and how the scheme's assets are aligned for it, as well as considering the requests of insurers around the price-lock (the way the premium moves as a result of changes in market levels and conditions).

Agreeing these structuring and asset related items early in the process leads to less risk and cost for schemes and ultimately greater transaction certainty.

Looking Ahead to 2024

The key for all schemes going forward is asset preparation. Early consideration should be given to all possible barriers and the options to overcome them. The best prepared schemes will always stand out in a very busy bulk annuity market, giving trustees more certainty for insurer interest and a smooth transaction.

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Are Alternative Risk Transfer Solutions Right for You?

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The past year has seen a huge improvement in funding levels for the majority of UK pension schemes, with many now re-assessing their endgame. The best funded have the luxury of either targeting an insurance transaction, or alternatively looking to 'run-on' to generate surplus to share with members and the sponsor.

But what about those schemes who, despite improvement to their funding levels, still need a helping hand to reach their endgame target?

This is where alternative risk transfer solutions — such as superfunds and capital backed funding arrangements — could help. Not only will some schemes now find themselves sufficiently funded to properly consider these solutions for the first time, but the past year has also seen notable developments in these alternatives to bulk annuities.

Superfunds

Essentially, superfunds are defined benefit (DB) pension schemes that accept bulk transfers of assets and liabilities from other DB schemes. Following a superfund transaction, the responsibility of the original company to support the pension scheme is removed, and support is instead provided through additional assets (the 'capital buffer') that are provided by the superfund's investors.

Clara-Pensions is currently the only superfund within the UK (after a five year journey successfully negotiating regulatory and practical hurdles). It completed an approximately £600 million transaction with the Sears Retail Pension Scheme earlier this year. Clara has indicated its ambition is to build up to managing around £5 billion of pension scheme liabilities by 2025, with pricing for non-pensioner members expected to be broadly 15 percent cheaper than the traditional insurance market.

Is a Superfund Right For My Scheme?

Typically, superfunds are likely to appeal to schemes which are relatively well funded (or could be with a one-off contribution), but where the sponsor covenant is weak and may not be able to support the scheme through to a traditional buy-in over a short-term period. Indeed, The Pensions Regulator has introduced gateway tests to ensure that schemes that wish to pursue a superfund meet these criteria.

Capital Backed Funding Arrangements

Capital Backed Funding Arrangements (CBFAs) are a solution by which a third party provides additional capital to protect a scheme against adverse experience. Unlike superfunds, the assets and members remain in the pension scheme, with the existing trustees retaining their responsibility. The added capital protection supports the scheme's journey to a pre-agreed funding target, over a pre-agreed timeframe and using a pre-agreed investment strategy.

If the CBFA goes to plan, the provider expects to have its capital buffer returned along with a share of the returns in excess of the funding target. If the funding target is not met, the capital buffer is used to top-up the scheme assets. The funding target is typically buyout, but some providers offer flexibility to target a specific investment return above liabilities.

The last 12 months saw Pension SuperFund ‘mothball' its superfund proposition until relevant legislation or regulator guidance is in place. However, its backers (PSF Capital), launched a CBFA known as CovenantPlus. This led to its first transaction for an undisclosed scheme, joining Aspinall as the only two providers known to have completed a CBFA. However, an increasing number of providers are entering the market and are keen to explore opportunities to deliver CBFAs for pension schemes.

Is a CBFA Right For My Scheme?

CBFAs can be designed flexibly to target schemes’ specific circumstances. Ultimately, the additional capital provided can:

- Reduce downside risk from a higher return investment strategy — this might be appropriate for schemes which are willing to exchange some potential upside of a higher risk investment strategy to reach buyout sooner, or with more certainty over the time to reach buyout.
- Provide additional security on the scheme's journey, reducing the chance of the scheme calling upon the sponsor for future contributions and increasing the chance of members being paid benefits in full. This might be appropriate for schemes seeking to reduce reliance on the sponsor.

In all cases, the downside protection is typically limited to the agreed amount of capital buffer (although the CBFA provider could choose to top this up). The sponsor remains responsible for tail-risks, with schemes needing to weigh up the benefit of additional capital against the risk of passing control of the investments and journey timescales to the CBFA provider.

Navigating the Options

The increasing range of support is a welcome development for many schemes. The challenge for trustees and sponsors is understanding which of these options might be the most suitable for their specific circumstance and assessing the associated risks and rewards.

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New Normal for Longevity?

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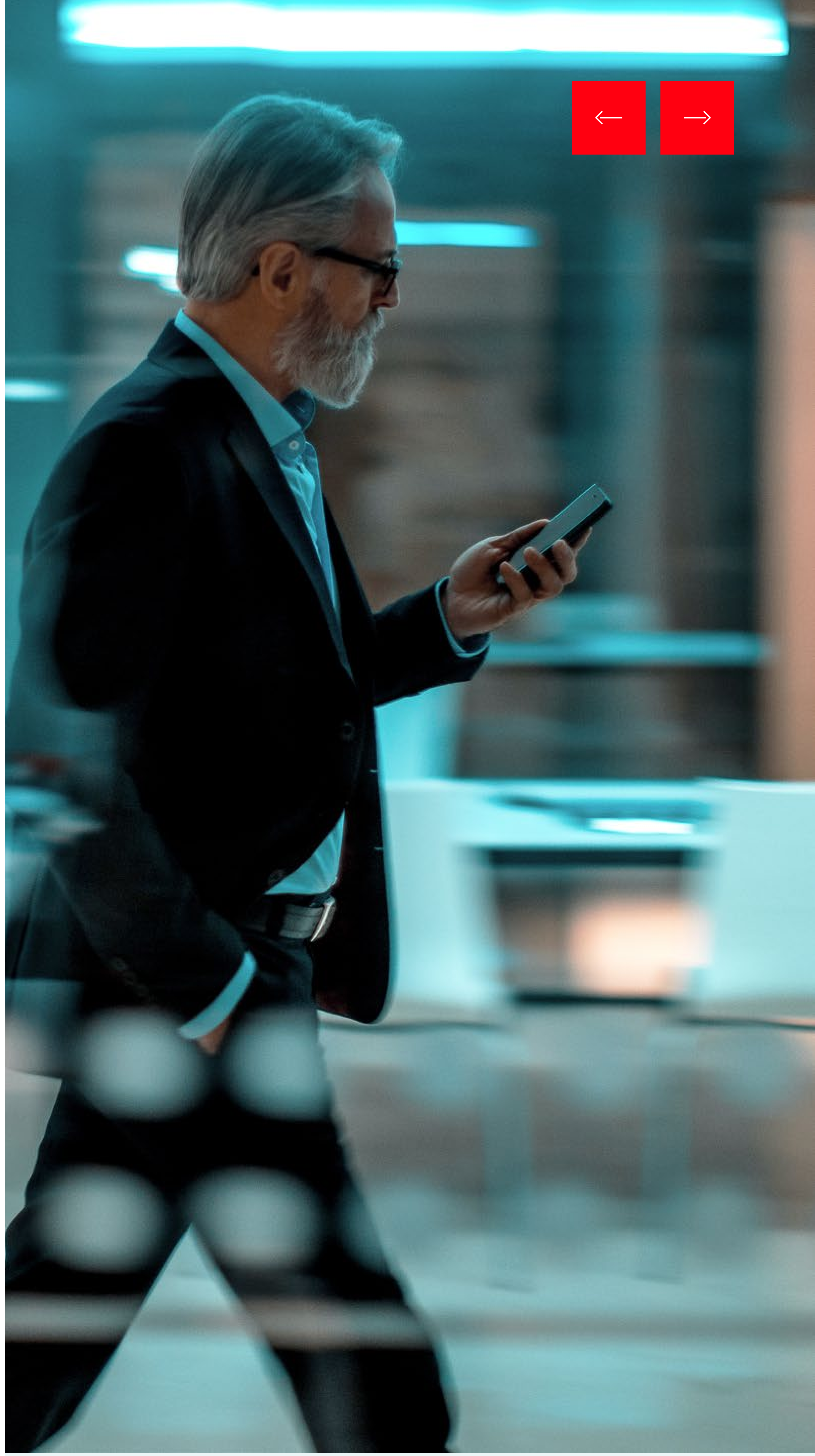
It is well documented that the UK saw very high numbers of deaths through 2020 and 2021, due to the direct impact of the COVID-19 pandemic. Mortality in England and Wales has continued at elevated levels. In fact, when compared to the last pre-pandemic year (2019), the numbers of deaths reported in England and Wales were 13.9 percent higher in 2020, 9.2 percent higher in 2021, and 6.2 percent higher in 2022. The first months of 2023 also saw higher than expected numbers of deaths reported. However, to date, the second half of this year has been closer to pre-pandemic levels.

The key reasons for greater than expected numbers of reported deaths over 2022 and 2023 are likely to be related to:

- **UK Healthcare**
  The NHS was under pressure. This was most severe at the end of 2022 (in December, over 50,000 people waited for more than 12 hours at A&E between the decision to admit them to a ward and their actual admission — before the pandemic, the number waiting this long was close to zero).
- **Deaths Directly Involving COVID-19**
  COVID-19 was mentioned as a main or contributory cause of death on around one death certificate in every 30 in 2023; this compares to more than one in 20 across 2022.
- **Deaths Indirectly Involving COVID-19 Due to Past Infections**
  There is evidence that those who have had COVID-19 in the past are more at risk of many other diseases, in particular heart disease.
- **Seasonal Flu**
  A large wave of flu which hit the UK and Europe at the end of last year and the beginning of this year.



Predicting Longevity

A general expectation of higher mortality rates compared to pre-pandemic projections has been recognised by the Continuous Mortality Investigation (CMI), a specialist company wholly owned by the Institute and Faculty of Actuaries.

In its latest model — CMI_2022 (published in September 2023, and calibrated using England and Wales population mortality data), an underlying assumption is that 2022's experience is at least partially indicative of a new trend of higher mortality rates, and as such, the CMI_2022 model makes partial allowance for 2022's mortality data. Adopting this model could mean pension scheme liabilities decreasing by over 2 percent, compared to pre-pandemic projections.

Looking ahead, the next version of the model (CMI_2023) will include 2023's mortality data. Based on what CMI have disclosed to date, a business-as-usual update would be likely to see greater weight being placed on 2023's data than 2022's — and a further reduction in projected liabilities. However, there are several issues for CMI to consider when producing the new model. In particular, it appears that there was a significantly longer delay than normal in registering deaths that occurred in December 2022. This means that 2022's mortality appears lighter than it would otherwise have done, and mortality at the start of 2023 appears heavier. If mortality experience from 2023 was given the same weight in the model as experience from 2022, this change in registration delay would only have a small impact, but if more weight is placed on 2023, then assigning the deaths to the 'wrong' year could have a material effect on liabilities. CMI will need to consider whether and how to adjust for this.

What Should We Expect in the Future?

It is important for pension schemes and the insurance industry to reach a view on the likely level of longevity improvements in the future, and in particular, whether and by how much expectations have changed from pre-pandemic levels. This will influence insurer pricing when schemes are ready to transact.

Overall, 2023, has seen views across the industry moving to build in higher levels of mortality than allowed for pre-pandemic, at least in the near-term. At this stage, it is not clear whether this consensus will shift towards CMI_2023 when it is released, and whether there will be any change in views on long-term improvements. For the time being, we are not seeing large changes in long-term views across the industry.

Given the continuing levels of uncertainty in future mortality, along with the recognition of higher mortality and lower improvements across the industry, bulk annuity transactions and longevity swaps remain effective forms of protection against longevity risk.

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Longevity Swaps

Author
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While the bulk annuity market often grabs the headlines, there remains a healthy demand and supply for longevity swaps, which has resulted in another busy year for the longevity swaps market. With four publicly announced transactions, and a combined value exceeding £10Bn for the fifth year in a row, this provides further evidence that longevity swaps continue to provide a valuable risk reduction tool for pension schemes.

Activity continues to be dominated by large schemes with all four 2023 transactions in excess of £1Bn, and with most longevity hedges also continuing to be for pensioners. However, we are also seeing an increase of longevity reinsurance for non-pensioners, which provides hedging over a much longer term and addresses the increasingly dominant longevity risk for many schemes.

For some, the plan to mitigate this, and broader demographic risk exposures, is to fully insure and ultimately buy out — with this being a nearer term prospect than expected for many. However, what about those schemes facing a long-term process to unwind illiquid asset positions, constraining the ability to purchase bulk annuities? Or schemes who wish to run-on?

For these, longevity swaps provide a flexible, cost-effective option to mitigate longevity risk. As such, we fully expect pension scheme demand for longevity swaps will continue for the foreseeable future, backed by strong appetite and capacity from reinsurers to facilitate these transactions.

This appetite and capacity has helped to drive very attractive pricing versus historic levels, allowing schemes to hedge their longevity risk exposure for a relatively marginal cost above best-estimate liabilities, often within existing funding reserves.

Investment Flexibility is a Key Attraction

A key driver for schemes looking at longevity swaps over bulk annuities is that longevity swaps are *unfunded* — by this we mean that schemes do not need to set aside £1 of assets to hedge longevity risk for £1 of liabilities. As a result, schemes retain investment flexibility.

This can allow a scheme to target a higher investment return while maintaining a high level of hedging of rates and inflation exposures, which simply would not be possible with bulk annuities.

For other schemes who now find themselves with illiquid asset holdings representing a higher proportion of assets than intended, and in some cases with pressure on liquidity for rates and inflation hedging, longevity swaps can be a valuable tool. With the timeframe to run off / sell down illiquid assets and relieve these pressures potentially being around 5–10 years, during this period longevity swaps offer a ‘capital light’ option to mitigate longevity risk.

Structural Flexibility to Future-Proof is Also Important

The volatility in investment markets and resulting impacts on scheme funding levels has demonstrated the need for schemes to develop investment and insurance strategies that are flexible, and capable of adapting to changing circumstances and objectives. A key element of such 'future-proofing' for a longevity swap is the ability to efficiently and cost effectively restructure into annuity at a later point.

This has long been a key structural requirement for transactions, with the different forms of **'intermediation' options** available for accessing reinsurance capacity having evolved accordingly.

Understanding Intermediation Options

There are two main intermediation structures:

- **Pass-through**
  A UK insurer sits between the scheme and the reinsurer, with the credit risk exposure between the two principal counterparties 'passed-through' by the insurer. The insurer also acts as 'calculation agent' to run the transaction. Zurich remains the primary insurer in this market.
- **Offshore captive-based structure**
  The scheme or sponsor owns an offshore (e.g. Guernsey or Bermuda-based) insurance cell entity through which the scheme accesses the reinsurance.

During 2023 both options have been utilised by schemes, with the Nationwide Pension Fund and Yorkshire and Clydesdale Bank Pension Scheme opting for Zurich's pass-through solution, and BT Pension Scheme and MMC UK Pension Fund opting for the captive approach.

An Alternative Approach

While the stellar growth of the bulk annuity market dominates pensions news, schemes should not forget about alternative risk management structures available. The continued steady level of longevity swap activity during 2023 provides evidence that this option remains an important risk management tool for many schemes. As such, we expect the market to remain active for several years to come, utilised by schemes with objectives and constraints which are most effectively managed by these types of arrangements.

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Life After Buy-In: The Road to Buyout and Wind-Up

Author
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Any bulk annuity transaction is typically a cause for celebration; LinkedIn articles are shared, champagne emojis are sent, headlines are grabbed — but it is by no means the end of the journey for the scheme. In fact, life after transaction can be complex and tricky to navigate. The work required before a scheme can be fully bought out or wound-up involves multiple stakeholders and intricately linked workstreams being completed in tight timescales and with many interdependencies.

With the unexpected rise in funding levels over the last 18 months, many schemes have now found themselves in the fortunate position of being able to consider their plans for life after transaction much earlier than planned. This is shown by the fact that only three of the 95 deals in the first half of 2023 were pensioner-only transactions, with full scheme deals instead dominating the market. This is in contrast to the structure prevailing until recently, where schemes used partial buy-ins on their journey to eventual buyout, and we expect the trend to continue for the foreseeable future.

So, what does this mean for the market?

While some schemes may seek to use their full-scheme buy-in as a longer-term investment, the vast majority are using it as a stepping-stone to buyout and wind-up. Increasingly, we are also seeing schemes which have reached this fully bought-in stage that are looking to accelerate the timescales to buyout and wind-up, as part of a single project. This can be an efficient route to ultimately completing the project - however, it can rely on running a number of workstreams alongside one another. The success of this depends upon the adviser being skilled in executing these types of projects — and therefore choosing a partner for this stage of the journey should be one of the most important choices in the planning of the project.

With many complex workstreams to navigate and key milestone decisions to be made, it is important to consider the options and outcomes for the three main stakeholders: members, trustees and sponsors.

Member experience

The move to buyout and breaking the link to their pension scheme involves lots of change for members and can often be unsettling despite the extensive due diligence carried out by trustees and sponsors to ensure security and high-quality service after the handover. It is important therefore to ensure you have a strong and effective communications strategy to support your membership through this period of change, particularly since some of the member options previously offered may no longer be available.

As part of this communication strategy, many schemes are likely to communicate benefit changes following data cleanse work or GMP equalisation. While it can be preferable to complete these tasks ahead of transaction — not least since it helps with gaining insurer attention and more attractive pricing — the majority of schemes will carry out these stages in the period between buy-in and buyout. This is something which is facilitated by all active insurers in the market; they are willing to support these data cleansing actions after buy-in, as our 2023 UK insurer survey demonstrated earlier this year.

Later in the process, and closer to reaching buyout and wind-up, schemes will begin to consider winding-up lump sums or consultations on the use of any surplus. At this point, queries from members may increase as a result of nervousness about the trustee no longer being around. Communicating this well in advance, using a variety of media and signposting in each communication, can prevent your membership from being overwhelmed.

The Role of the Trustee

With a trustee's primary responsibility being to ensure the security of members' benefits, it is important that any buyout and wind-up project is thoroughly planned and well executed. This will involve overseeing all overlapping workstreams to ensure their membership's benefits are settled accurately and efficiently. It also means that consideration needs to be given to the possibility of errors having been made before wind-up, or indeed members being missed and no pension entitlement insured. Both of these are examples of risks that may present themselves after the scheme is wound up and trustees are no longer responsible for the scheme — they do represent a real concern for trustees and sponsors alike.

To help manage these risks, schemes have options available to them either via residual risks cover with the insurer responsible for members from the point of buyout, or via an indemnity provided by the sponsor. Additionally, many schemes will seek trustee liability run-off insurance to cover the costs associated with any claims arising. While the risk of any such claims being made may be perceived to be low, having post wind-up protocols and cover in place can allow trustees to feel more comfortable with relinquishing their responsibility to members.

Sponsor Considerations

While sponsors may be the last-man-standing in the form of a company indemnity to the scheme, the wind-up of a scheme can potentially lead to an upside for the sponsor in the form of a refund of surplus. If a surplus remains after the buyout and wind-up is complete, this can be returned to the sponsor (subject to the provisions in the scheme rules) following a surplus consultation period with members. However, messaging for any such consultation should be carefully managed to ensure members are comfortable that their benefits are being paid in full and that the sponsor has fulfilled its obligations before any surplus is refunded.

This refund of surplus scenario may become more common with greater funding levels, and also following the 2023 Autumn Statement which reduced the tax payable by sponsors from 35 percent to 25 percent on any such surplus with effect from 6 April 2024. Indeed, this may also have the effect of pushing projects to complete on an accelerated timetable to expedite the return of the cash to the company. Watch this space as we move into 2024 and beyond.

Completing a settlement transaction does not mark the end of a scheme's life and in fact many of the members covered will have not yet reached pensionable age, meaning there is much work to do to ensure security for all members. Trustees and sponsors will need an experienced adviser to navigate the pitfalls of the final phase of the journey. Aon's Buyout and Wind-up Services team are the largest and most experienced in the market and have extensive knowledge to help you achieve an efficient wind-up and minimise risks to you and your members. Find out more here

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

About

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