Our latest views and insights on pensions risk transfer in the UK

LCP pensions de-risking update

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Calm before the storm

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Early 2022 has seen a big jump in funding levels on full buy-in/out for many schemes – in some cases by over 5% – with a number of factors moving in the right direction. This has led to a flurry of activity as schemes have sought to lock in gains by reducing investment risk, extending existing buy-ins or exploring full scheme insurance. A good example is the Heathrow Airports scheme which we helped to complete its second buy-in earlier this year – see our case study on page 7.

Key factors that have helped affordability for buy-ins and buy-outs over 2022 include:

1. Intense competition between insurers as they vie for business (see page 3)
2. Improved insurer pricing particularly for deferred pensioners (see page 4)
3. Reinsurers incorporating lower life expectancies due to the indirect effects of the pandemic, thereby reducing pricing
4. Rising long-term interest rates and higher inflation improving funding positions

With many schemes finding they have made a big step forward on their journey plans it is worth reviewing the preparatory steps they have planned and whether some of that work should be accelerated.

2021 saw a surge in buy-in/out activity later in the year with almost half of the whole year's £28bn of business closing in the final quarter.

2022 looks sets to follow a similar pattern, with the second half set to see a significant increase in volumes on the back of the improved scheme funding in early 2022.

The first half of 2022 has seen a continuation of the trend of mid-sized pension schemes driving volumes and few "mega transactions" above £1bn. However, we expect to see several multi-billion transactions close over the second half of the year. There are also a number of large schemes considering their long-term strategy in light of improved funding positions, which could lead to a flow of larger transactions over 2023.

Preparatory steps

Examples of key preparatory steps schemes may wish to consider include:

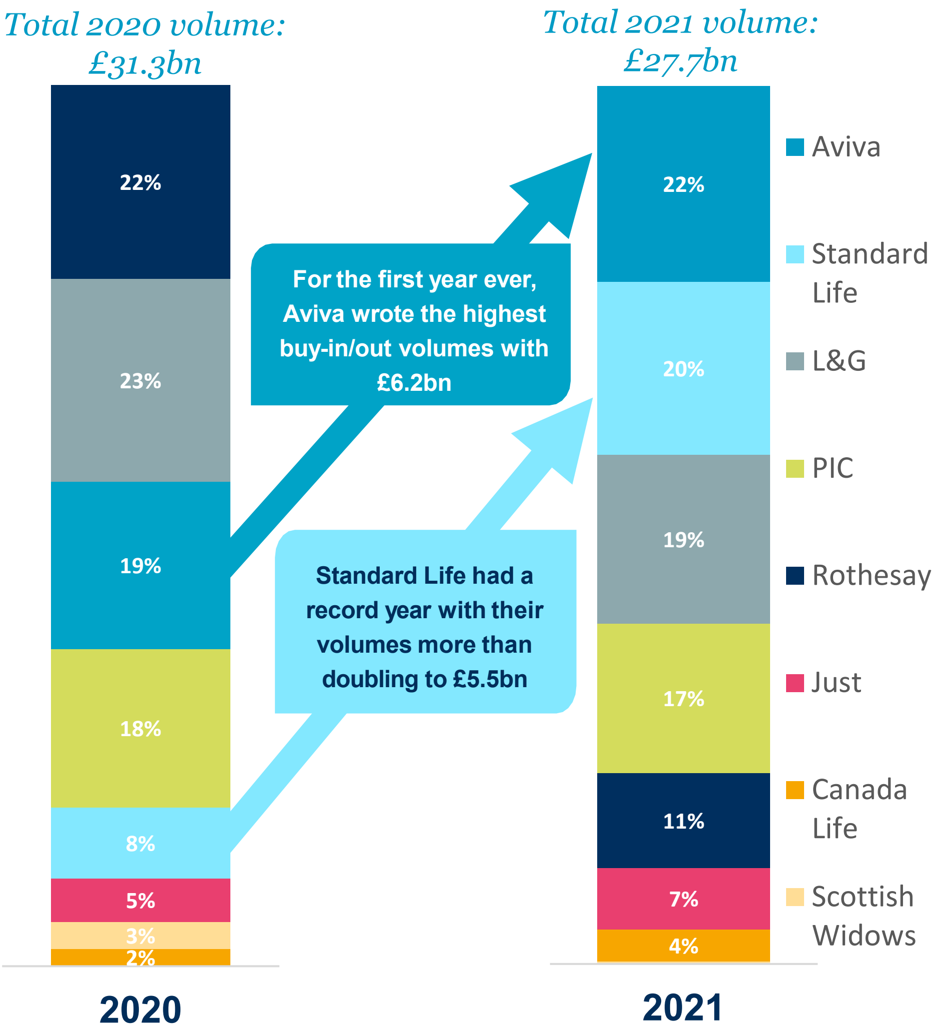
1. **Journey plans:** Monitor buy-out funding and consider timescales under a range of scenarios
2. **Benefits:** Prepare benefit specifications, review historic rules, commission "seller" or "buyer" legal reports for residual risks and review member option terms
3. **Data:** Review the quality of mortality experience data and obtain marital status data
4. **Investments:** Consider de-risking actions and manage down illiquid holdings
5. **Governance:** Ensure suitable training for trustee boards and suitably experienced advisers

We focus on preparation by smaller schemes on page 6. Further details on preparation can be found in LCP's annual pension de-risking report.

Two key changes in market dynamics

An increasingly competitive landscape

2021 saw a shift in market share. Competition for buy-ins and buy-outs increased substantially as insurers chased volumes towards the end of the year. For the first time, five insurers secured a 10%+ market share in 2021, up from four in 2020 and three in 2019. The intense competition has continued into 2022.

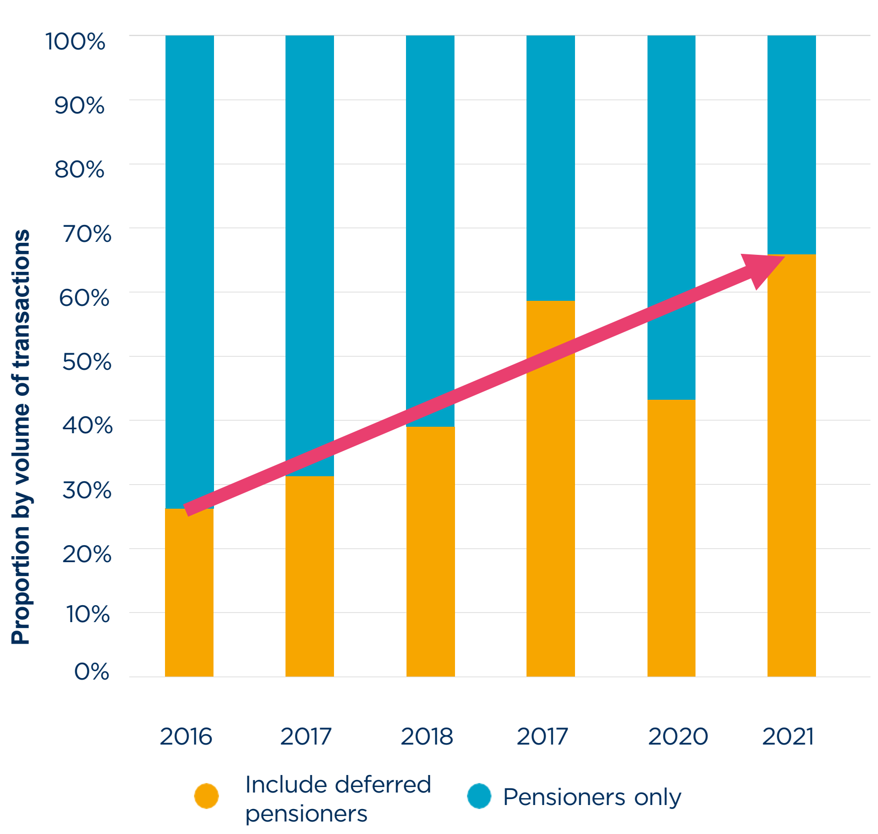


Source: Insurance company data. Only buy-ins and buy-outs with UK pension schemes are included. Data therefore excludes the APP transactions by L&G in 2020 and 2021.

A shift to full scheme transactions as affordability has improved

As shown in the chart below, in 2016 only around a quarter of buy-in and buy-out volumes included deferred pensioners; by 2021 this had increased significantly to two-thirds. This shift towards full scheme transactions has been driven by rising scheme funding levels, and insurers increasingly being able to offer attractive pricing for deferred pensioners (see next page).

Pensioner transactions as a proportion of total volumes

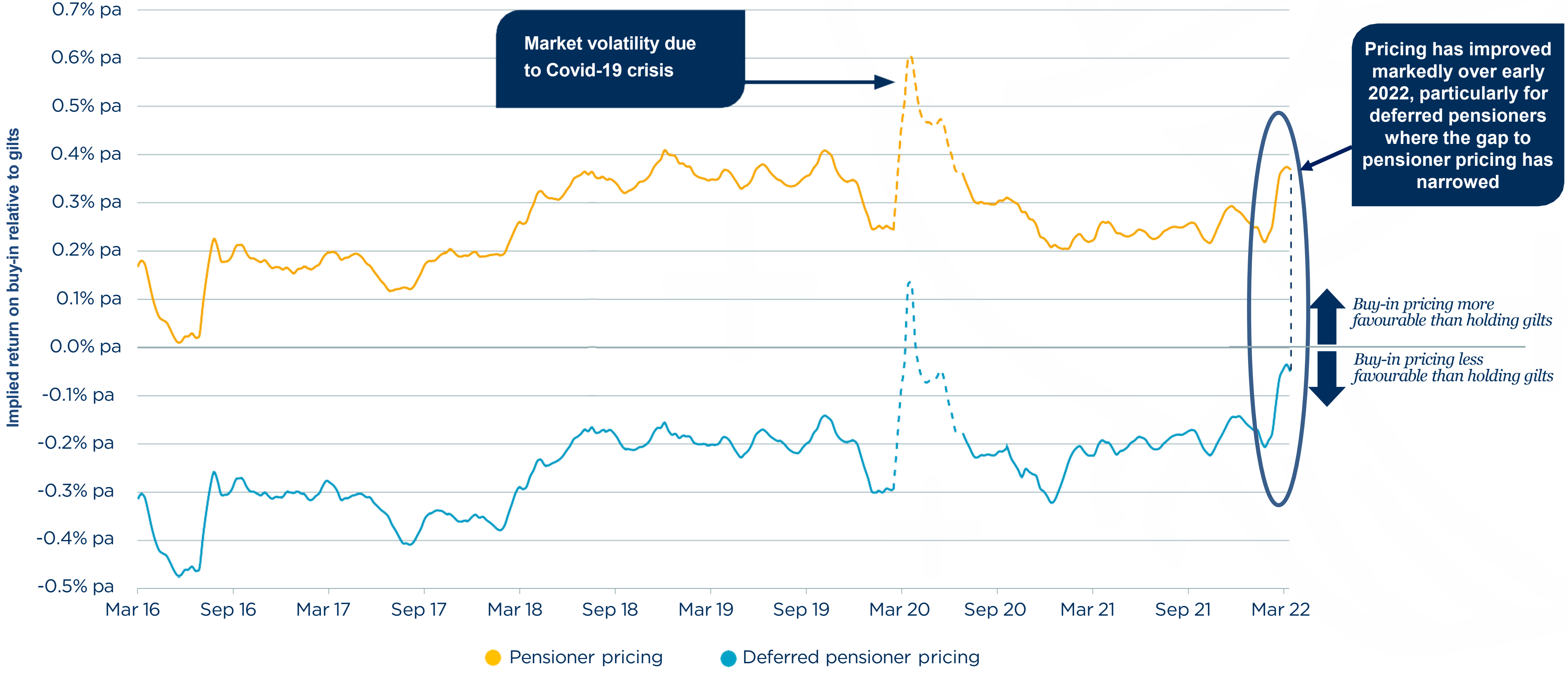


Insurer pricing has improved markedly in 2022

Over recent months insurer pricing has improved markedly. Geopolitical events have pushed up yields on the long-dated assets the insurers purchase to back their pricing and, alongside intense competition amongst insurers, this has increased the attractiveness of buy-ins compared to holding gilts. The improvements for deferred pensioners have been particularly strong driven in addition by improved reinsurer pricing and increased insurer appetite. For a typical scheme deferred pensioner pricing is now broadly in line with a gilts valuation.

The improved insurer pricing combined with wider funding improvements means almost all schemes have taken a big step forward in 2022 towards being fully funded on buy-out. This has opened opportunities to de-risk investments, enter into or extend buy-ins and an increasing number of schemes exploring full scheme insurance.

Pensioner and deferred pensioner buy-in pricing relative to gilts



Source: LCP insurer pricing model. The model is calibrated against live quotation and final transaction pricing. Buy-in pricing depends on a wide range of factors such as transaction size, benefit structure, membership profile and insurer appetite and can differ materially from that shown

What does Solvency II reform mean?

In October 2020, the UK Government launched a review of Solvency II, the rules governing the capital requirements for insurers. With the UK leaving the EU, the review provided an opportunity to diverge from the European-wide rules and for the UK to set its own course.

Below we consider the four key themes emerging from the latest Government proposals announced in April 2022 and the implications for pension schemes' de-risking plans.

Key proposed changes

Risk margin and longevity reinsurance

The proposals will reduce the "risk margin" element of capital reserves by 60-70%. Currently insurers are achieving similar reductions in the risk margin by reinsuring longevity risk. This change means it will be less necessary for insurers to use longevity reinsurance. However, we expect many insurers to continue to do so given current reinsurer pricing offers good economic value, particularly for pensioners, and still reduces insurers' risk capital requirements.

Wider asset eligibility

The proposals will relax some of the rules around which assets qualify for favourable capital treatment under the "matching adjustment". This will make it easier for insurers to invest in assets such as callable bonds, commercial real estate lending, housing association bonds and loans, infrastructure assets and local authority loan portfolios.

Investment default reserves

The proposals will revise the way reserves are calculated for possible defaults on insurers' assets. Currently the default allowance (the "fundamental spread") is set centrally across Europe and updated only quarterly.

This change the assets that are optimal for insurer pricing and, to an extent, "smooth" out the price opportunities that arise when a market shock pushes up credit spreads (such as occurred in April 2020 in the wake of Covid-19).

Overall capital levels

The UK Government suggests the proposals will reduce insurer risk capital by 10% - 15%. This would increase insurer capital coverage ratios from current levels of 150% - 200%.

Implications for pension schemes

Policyholder security

Whilst the proposals may result in a reduction in overall capital requirements, the extent will be dependent on the final details and is likely to vary by insurer. Our current expectation is the implications for policyholder security will be modest but this is an area to monitor. The wider asset eligibility also potentially introduces new risks that the insurers will need to manage.

Longevity swaps

If insurers use less longevity reinsurance this should increase capacity from reinsurers for writing longevity swaps with pension schemes. But overall the proposals are less significant for longevity swaps than for buy-ins/outs.

Buy-in/out pricing

At this stage there is not sufficient detail confirmed to be definitive on what the proposals mean for pricing. We expect overall it is likely to be neutral to positive with the greatest potential benefits for the largest transactions where increased flexibility around reinsurance and asset eligibility should be helpful. For the majority of schemes the impact is likely to be small and we see no reason to amend current timelines or journey plans.

Buy-in/out capacity

We expect a number of the changes (lower capital, wider asset eligibility and less reliance on longevity reinsurance) will all be helpful for insurers' capacity to write increased volumes at current pricing levels. It may also encourage new insurers to enter the market. The changes should help contain upward pressure on pricing as we project volumes to grow significantly over the next few years as scheme funding levels improve.

Timeline

2020	HM Treasury issues "Call for Evidence" (October 2020)
2021	Regulator (PRA) undertakes initial quantitative study
2022	HM Treasury consultation issued (April 2022)
2023	
2024	Potential implementation of reforms (through legislation and PRA guidance)
2025	

How small schemes can avoid being crowded out

When an insurer provides a buy-in quote it goes through a detailed process for c8 weeks to model the benefits and data – this upfront work remains significant for even small schemes. Prior to 2016, smaller transactions dominated the market, but in recent years there has been a significant drop-off in market share. With no signs of the buy-in/out market quietening down, small schemes are facing challenges in securing insurer engagement, with many insurers pulling away from smaller deals to focus at the larger end.

What does this mean in practice for smaller schemes?

The key to getting insurer engagement for smaller schemes is the pre-transaction planning and preparation.

Planning

Plan the right process in terms of timing and simplicity in order to maximise engagement in the project. This could involve approaching insurers through a streamlined proposition, with pre-agreed contractual terms to offer simplicity of process and give the insurers confidence around certainty of execution.

Preparation

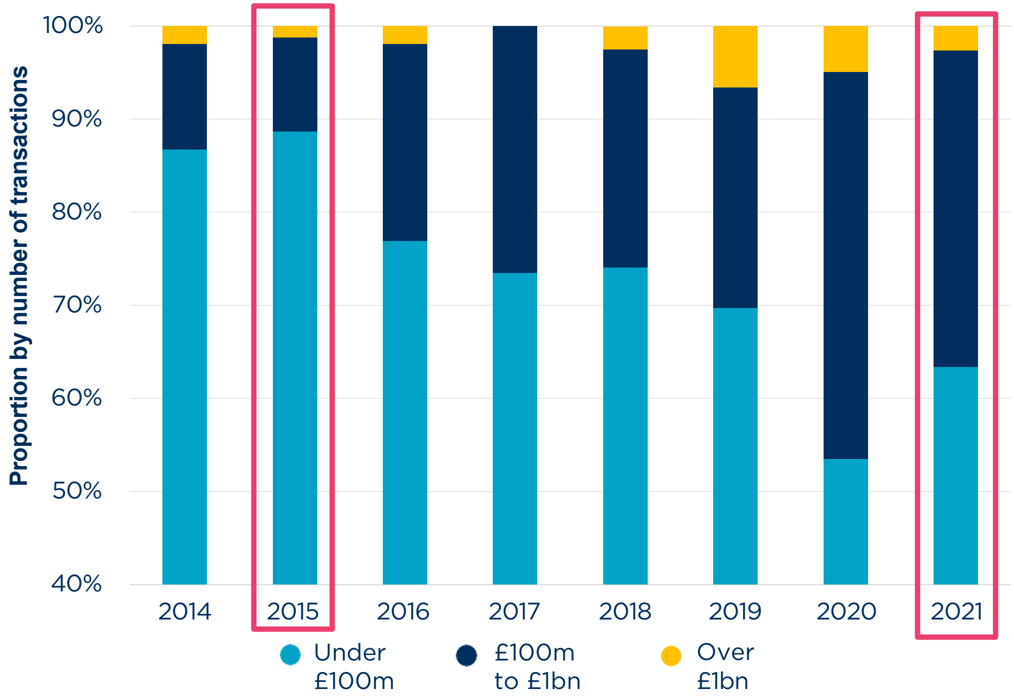
1. **Data and benefits** – thorough preparation work on data and benefits is essential. This means have a benefit specification drafted with legal sign-off and data cleansed as far as possible before approaching the market.
2. **Investments** – it is crucial to ensure the investments being transferred are liquid and low-risk to make for a straightforward asset transition to an insurer.
3. **GMP equalisation** – plan and structure this exercise in a way that ensures the best engagement from insurers (taking into account the fact that the key insurers for smaller transactions have varying capabilities of administering potential methodologies). (Note GMP equalisation does not need to be completed before approaching the market)

Click here for a guide to LCP's streamlined buy-in/out service.

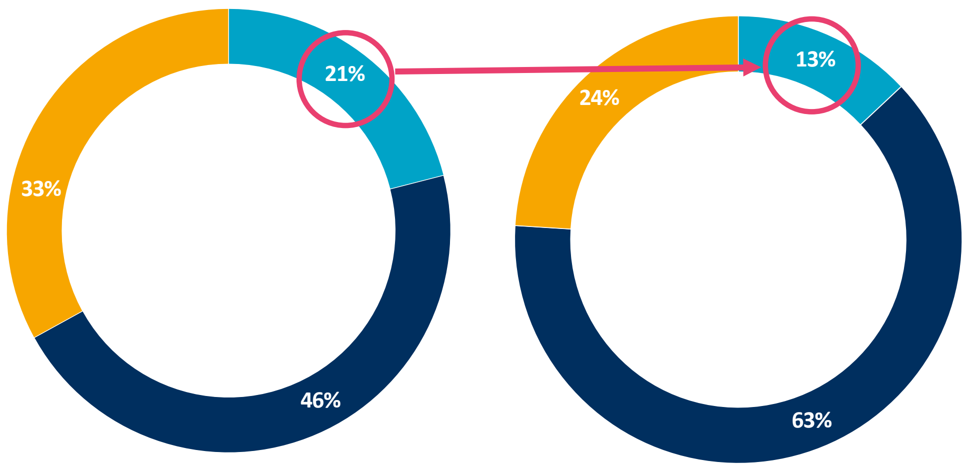
How the Oldham Pension Plan navigated through larger schemes to fully insure

Despite only being £10m in size, the Trustee managed to secure insurer engagement to fully insure the full Plan benefits at an affordable price in March 2022. The Trustee spent significant time upfront in preparing the scheme, drafting a thorough benefit specification and completing a detailed data cleansing process before approaching the market, including a write-out exercise to members to fill in gaps in marital status data. The Trustee used LCP's Streamlined Buy-in and Buy-out Service to secure attractive pricing and commercial terms.

Evolving transaction sizes



2015 by market volume **2021 by market volume**



Source: Insurance company data to end 2021

Case study – How to run an effective phased buy-in strategy Heathrow Airport: £370m pensioner buy-in

Background

LCP was appointed as a specialist de-risking adviser in 2021 to the c£4.5bn BAA Pension Scheme (which is sponsored by Heathrow Airport) to help implement their de-risking framework, following an initial £325m buy-in the Scheme completed with L&G in 2018.

A Joint Working Group (JWG), including senior Trustee and Company representatives, was set up to run the project with advice from LCP. We helped the JWG agree clear metrics up front for the success of the project, defining both the size of the transaction and the pricing levels at which it could be incorporated into the Scheme's current funding and investment strategies.

Approach

All insurers were presented with clear and complete data and information, facilitating the process of pricing the buy-in in a busy market.

Following insurer feedback, we provided detailed analysis of the mortality characteristics of the section being insured, which were different to the Scheme as a whole and thus not represented by the full Scheme mortality experience data. This was used by the insurers to leverage better reinsurer pricing, which they could pass onto the Scheme.

Following initial pricing we moved forward with a shortlist of the two most competitive insurers. A clear price hurdle was agreed with the JWG which met the transaction metrics defined up front.

Following final submissions, the JWG selected L&G. As key terms were already agreed we could complete the transaction efficiently under the protection of a negotiated price-lock mechanism, which fully protected the economics of the transaction to the point of signing.

Outcome

Final pricing exceeded the transaction metrics so the buy-in was incremental to the Scheme's overall de-risking journey. An umbrella contract was established, enabling the Scheme to insure further liabilities with L&G quickly and efficiently under the existing terms should the JWG wish to do so in future.

The Trustee is delighted that this transaction continues to de-risk the overall scheme. It is a testament to the great teamwork between L&G and the Trustee's excellent advisory team.

Phil Wilbraham, Chair of Trustee, BAA Pension Scheme

Our latest de-risking thinking

Longevity report 2022

The impact of the Covid-19 pandemic has introduced more focus on mortality assumptions whilst creating significant uncertainty around longevity trends. In our latest report we have considered both the direct and indirect impacts of the pandemic to help trustees and sponsors assess mortality and the implications for wider scheme strategy.

+ Explore the report

Our investment thinking

Vista Spring 2022

Turning points & uncharted territory

In this edition of our investment magazine, we bring you 9 articles exploring the idea of turning points while staying focused on core investment practices.

+ Read Vista

Investment Uncut podcast

Our weekly investment podcast gets beyond the jargon to try and bring sense to the world of investing and bring clarity to your investment decisions.

+ Risk revisited with Allison Schrager

+ A new inflation era with Jon Camfield

Strategic journey planning

No matter your starting point or destination, your journey can move forward with the right strategic and implementation plan. Explore our practical resources here.

+ Find out more

Corporate journey planning

Leading the way

With strong funding levels for FTSE100 sponsors, but uncertain headwinds, how can Sponsors drive collaborative journey planning with trustees?

+ Learn more

Pension de-risking report

Finding a safe landing

Our report on the buy-in, buy-out and longevity swap market encourages schemes to grasp the nettle when it comes to making their strategic decisions so that they don't miss out in a busy market.

+ Find out more

Selected LCP transactions

+ Heathrow Airport: £370m buy-in between Heathrow's BAA Pension Scheme and Legal & General

+ Northern Bank: Two buy-in transactions between Aviva and the Northern Bank Pension Scheme totalling £257m

+ Church Workers: £160m pensioner buy-in by the Church Workers Pension Fund

+ PerkinElmer: Standard Life's first full scheme buy-in with PerkinElmer

LCP appointed to new PPF+ Advisory Panel

The new specialist panel will provide transaction advice to schemes in PPF assessment which are overfunded on a PPF basis (PPF+).

+ Find out more

How is climate risk being addressed by bulk annuity insurers?

Our review into how the eight bulk annuity insurers approach Environmental, Social and Governance (ESG) factors and stewardship.

+ Read the 2021 report

+ Read the 2022 update

Contact us

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We've been lead adviser on 40% of all buy-ins and buy-outs over £500m between 2014 to 2021.

At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in pensions, investment, insurance, energy, financial wellbeing and business analytics.

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