LCP's predictions for the de-risking market in 2023

What's on the cards for the de-risking market in 2023?

Charlie and Catherine, supported by LCP's longevity de-risking team, have considered what might lie ahead for the de-risking market in 2023. Here, they share their key predictions for 2023 and discuss how this might impact schemes that are considering insurance through a buy-in, buy-out or longevity swap.

Our top 5 predictions

The rollercoaster ride of 2022 makes it challenging to predict what is in store for the buy-in, buy-out and longevity swap market but we have identified five top predictions for 2023 as follows:

- Buy-in/out volumes in 2023 will reach a new record, breaking the £44 billion record set in 2019
- Pricing will continue to be attractive for schemes preparing properly, but schemes will need to work harder than before to secure active insurer participation
- There will be fewer partial buy-ins, more full buy-ins and some longevity swaps
- New innovation will help to address the illiquid asset challenges faced by some schemes ahead of insurance
- The chance of a new insurer entering the buy-in/out market is the highest for some years

To put this in context, our report issued in October 2022 projected a huge shift upward in demand for buy-ins and buy-outs in 2023 and beyond. This is on the back of a significant improvement in funding in 2022, with the average full buy-in/buy-out funding level improving by c15% and schemes leaping over 5 years forwards towards being fully funded against the cost of full insurance.

Our latest de-risking report:

Charlie Finch
Partner

Catherine Hopper
Partner

Buy-in and buy-out volumes set to increase to record levels

1. Buy-in/out volumes in 2023 will reach a new record, breaking the £44 billion record set in 2019

Predicting market volumes is notoriously tricky. We predicted a "new normal" of £30bn pa in late 2019 which proved to be on the money with 2020, 2021 and 2022 buy-in/out volumes all around this level.

So, on the back of our report in October 2022 projecting volumes of £30bn to £60bn for 2023, do we expect a new volume record to be set in 2023?

In short, yes we do. The current record stands at the £43.8bn volume achieved in 2019 and we think it is odds-on that this will be broken in 2023. This is despite gilt yields being much higher today than in 2019, thus reducing the size of schemes and transactions.

We do however expect buy-in/out volumes to be below the upper end of our £30-60bn projection for 2023, as although many schemes are now funded at around a buy-out level there is a reasonable lead-in time to a transaction. Key reasons for this include:

- Many schemes are well ahead of schedule in their funding plans, but have not yet landed on whether insurance is the right solution for them or done the preparation needed to approach the market effectively – this will take time to do properly (and assets can be de-risked whilst this is being done).
- There is limited capacity particularly among pension administrators to help schemes prepare for a transaction, potentially extending the time until schemes are ready to approach the market.
- Illiquid asset allocations are a roadblock to some transactions and schemes may need time to find an optimal solution that preserves value (but see our fourth prediction on the next page).

In addition, some schemes may continue to target self-sufficiency even if they can afford full insurance. This could be driven by specific beliefs regarding value for money or other factors such as retaining the ability to fund inflation protection above pension increase caps or a trustee/sponsor package that includes using surplus in a Defined Benefit ("DB") section to fund Defined Contribution ("DC") section accrual. In all cases, the scheme rules and specific sponsor and trustee views will need to be carefully considered. That said, we expect continued growth in the trend towards insurance, particularly for sponsors and trustees of larger schemes who may once have considered that self-sufficiency was the only show in town.

In 2023, we also expect to see new individual transaction size records, particularly as the number of large, well-funded schemes – and the sizes of the transactions they contemplate – continues to increase.

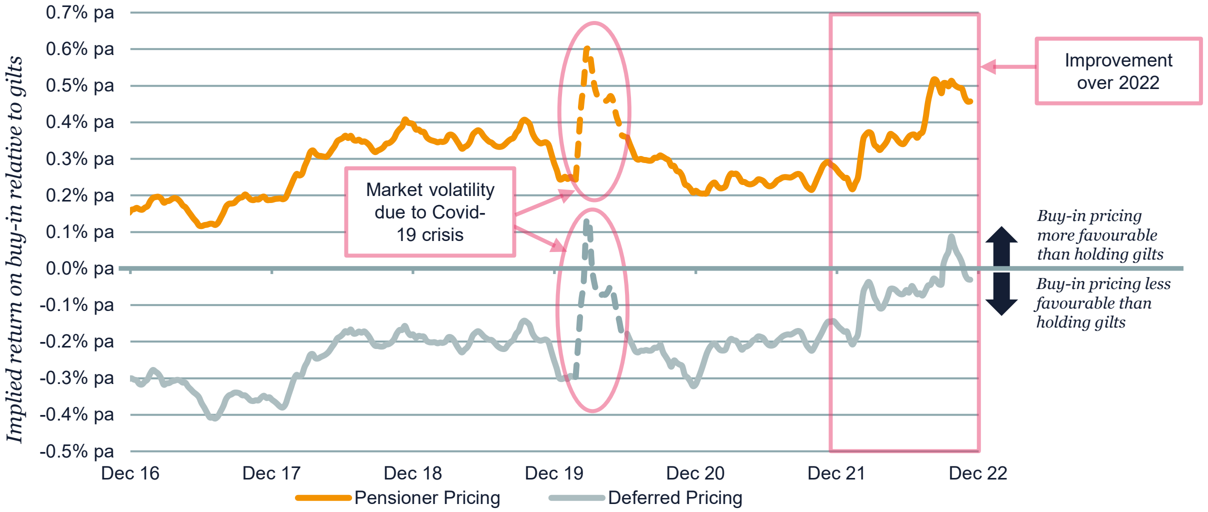
For further info see this blog which asks "Will there be a bottleneck as DB schemes rush for the exit via insurance?"

For further info see this blog which considers "What does Solvency II reform mean for pension schemes' de-risking plans?"

2. Pricing will continue to be attractive for schemes preparing properly, but schemes will need to work harder than before to secure active insurer participation

Pricing has improved significantly over 2022 and is currently at historically attractive levels for both pensioners and deferred pensioners. This can be seen in Chart 1 below showing an improving investment yield on buy-ins compared to investing in gilts. Deferred pensioner pricing is currently similar to a typical gilt valuation, closing the gap between full insurance pricing and the technical provisions used in a typical funding valuation.

Chart 1: Buy-in pricing reaches record attractiveness in 2022



For those schemes that have properly prepared and positioned themselves attractively to insurers, we believe pricing similar to that seen in 2022 is achievable if current market conditions continue. However high demand will mean that schemes will have to work much harder than in the past to secure active insurer participation. For schemes that haven't completed a high level of preparation, the result is likely to be fewer insurers willing to participate and much less chance of insurers targeting those schemes with their very best pricing.

There is also the question of whether Solvency II reform will lead to pricing improvements. Based on the Government proposals in November 2022 and our latest discussions with insurers in December 2022, we believe the reforms are likely to be neutral for most schemes and slightly positive for some. The reforms will give insurers more options to optimise the assets they invest in and more flexibility to manage longevity risk through reinsurance. Both of these factors should be helpful for insurers seeking to optimise their offerings to cater for an increasingly busy market, but it is likely to be 2024 at the earliest before the new rules are in place.

Partial buy-ins may reduce but innovation and a new entrant may help

3. Fewer partial buy-ins, more full buy-ins and some longevity swaps

One consequence of the "LDI crisis" is that schemes are now operating with higher collateral levels to provide improved resilience to future gilt yield rises. All else equal, this means there is less capacity to undertake partial buy-ins at an early stage in a scheme's journey. For such schemes, this may tilt the balance from using buy-ins to using longevity swaps to hedge longevity risk, but care needs to be taken as longevity swaps themselves typically require collateral (eg if life expectancies fall in future).

That said, many (but not all) schemes have seen their funding improve and so need less return-seeking assets. This itself creates more capacity to undertake partial buy-ins, as the need for leverage and return is lower, but if schemes are close to being fully funded they may decide to move straight to full insurance over the next few years.

4. New innovation to help address the illiquid asset challenges for schemes

For some schemes, a potential barrier to full insurance is that a proportion of their assets are illiquid. This has been exacerbated by the LDI crisis with illiquid asset allocations growing in percentage terms as schemes have shrunk in size.

Newer areas where we are working to help schemes address their illiquid asset challenges include:

- **Transferring illiquid assets to insurers as premium payment** – Insurers have historically struggled to take on illiquid assets as they typically do not qualify as eligible assets under Solvency II. We have had real success in this area in recent months, including transferring property to an insurer as part of a buy-in. Solvency II reform should also help widen the types of illiquid assets insurers can receive.
- **Designing innovative deferred premium structures to accommodate illiquid assets being run-off over time** – Deferred premiums largely disappeared when Solvency II came into effect in 2016 but more recently we have worked with insurers to develop structures with attractive terms (including loan arrangements) for staggering premiums. This is especially important for full buy-ins where the scheme holds illiquid assets.

> *Insurers have shown a remarkable ability to innovate and develop new solutions. This will be important as we enter a new phase of the market over 2023.*
>
> Charlie Finch, Partner

5. The chance of a new entrant entering the buy-in / out market is the highest for some years

This is the most speculative of our predictions but the chances of a new entrant joining the market in 2023 are the highest for some years. This reflects interest from investors and other parties in establishing a direct presence in the bulk annuity market. There has not been a new entrant since Phoenix Life in 2017 (now rebranded as Standard Life).

With supply and demand dynamics changing, now is potentially an opportune time. The most likely candidate is an existing insurer with capabilities to write life business as the barriers to setting up a brand new insurer are high (the last such new entrant was Rothesay in 2007). Even for an existing insurer, there will be a considerable lead-in time as they recruit and develop capabilities, so a transaction would be unlikely before 2024.

We would welcome a new entrant to the market, having helped many of our clients consider and transact with previous new entrants over the last 15 years. Additional competition will help alleviate pressure on pricing and, particularly at the smaller end of the market, there is space for further insurers.

> *Going into 2023, it is more important than ever for schemes to do their homework ahead of approaching the market. Being properly prepared will maximise insurer engagement and achieve the best price and terms.*
>
> Catherine Hopper, Partner

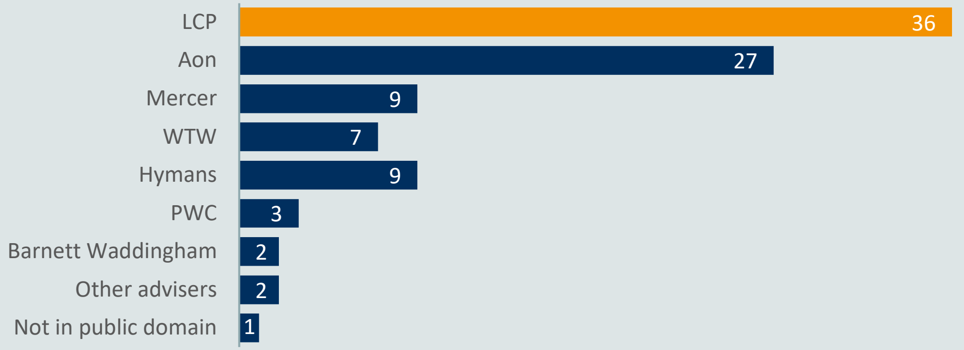
LCP highlights from 2022

We are proud of the work we do for our clients in the de-risking market. Our achievements over 2022 include:

- Completing £12bn of buy-ins and buy-outs in 2022, which is around 35-40% of the estimated total volume. This includes notable transactions for Heathrow and WHSmith.
- Helping the new British Steel Pension Scheme complete over £4bn of buy-ins through an innovative strategic partnership with Legal & General.
- Implementing a longevity swap for the pension scheme of a major high street bank
- Being appointed to the Pension Protection Fund's new PPF+ Buy-out Advisory Panel.
- Reaching £2.5bn of transactions through our streamlined buy-in/out service across 67 completed partial and full buy-ins for smaller schemes

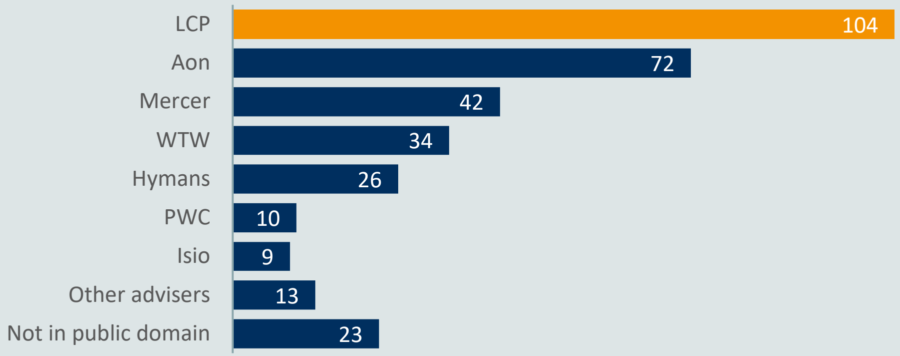
LCP is a trusted market-leader in all segments of the buy-in and buy-out market

Over £500m: Lead adviser on buy-ins/outs over £500m since 2014



Source: Insurance company data up to 30 June 2022. Data excludes L&G Assured Payment Product (APP) transactions.

Over £100m: Lead adviser on buy-ins/outs over £100m since 2014



Source: Insurance company data up to 30 June 2022. Data excludes L&G Assured Payment Product (APP) transactions.

Under £100m: Lead adviser on buy-ins/outs under £100m since 2014

Insurance company data shows that LCP has been the lead adviser on **30% of all buy-ins and buy-outs under £100m** between 2014 to 2021.

LCP has now completed 67 transactions through our streamlined buy-in and buy-out service for smaller schemes, bringing the total liabilities insured through this service to over £2.5bn.

LCP has been the lead adviser on

30% **of all buy-ins and buy-outs under £100m**

Contact us

If you would like more information please contact your usual LCP adviser or one of our specialists below.

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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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