COVID-19: considerations for pension scheme risk transfer

24 March 2020

With the continued development of COVID-19, we look at some of the implications for UK pension schemes who are considering transferring risk to insurance companies through buy-in, buy-out or longevity insurance.

Schemes will have already seen volatility in their assets, with significant changes in rates and widening of credit spreads, coupled with equities falling back to levels not seen since 2011. Schemes who are well hedged may have seen their funding position hold steady, but this will not necessarily have immunised them against movements in buy-in and buy-out pricing.

Pricing

Insurer pricing for buy-in and buy-out will generally be improved by widening credit spreads, as this means that the credit assets that the insurer will use to back the liabilities will have lowered in price. However, the reason that credit spreads have been widening is likely due to market concerns regarding potential defaults. It's already clear that the impact on businesses of the coronavirus will be far-reaching – from airline to retail to service industries, most sectors are exposed in some way. Insurers are likely to make a larger allowance for default risk than in the past, which will mean that wider credit spreads will not fully make their way into buy-in and buy-out pricing.

Low interest rates will require insurers to hold more capital, which will increase price, and this will be more acute for longer duration business – think buy-outs or buy-ins covering deferred pensioners.

For most insurers, we would expect the widening of spreads to lead to a net improvement in price when compared to a gilts benchmark, but this will not be consistent across insurers as each insurer uses a different investment strategy, nor will it be consistent across different schemes as it will depend on the duration of the liabilities being insured.

Capacity

A number of corporates are already being impacted by coronavirus, and others will be concerned about secondary impacts that are perhaps yet to be understood. The general climate of uncertainty, coupled with the higher yields on corporate bonds that investors are demanding, means that primary issuance of corporate bonds is drying up, especially in the UK, which is already a relatively small market. So, insurers will be even more reliant on non-UK markets such as the US, as well as on secondary trading of corporate bonds that are already in issuance. The secondary markets are less liquid than many would imagine, as most purchasers are typically buy and hold investors, though the current environment may create buying opportunities for insurers as other investors try to reduce credit exposure.

Insurers don't just rely on corporate bonds to deliver attractive pricing and use a number of other asset classes including infrastructure, equity release, and commercial real estate lending. The current climate of uncertainty is likely to lead to a number of these opportunities drying up, at least over the short term. This could act as a slight dampener on short-term market capacity for bulk annuities.

People capacity at insurers will also provide some limit on the volume of new business they are able to take on. We saw during 2019 how insurers were needing to turn down new business, as their pricing and transaction teams were at capacity at times. The industry is generally well set up for remote and flexible working, but some temporary fall in available workforce is almost inevitable.

Although there are additional pressures on capacity, we also expect pension scheme demand to dip in the short term. Some pension schemes will need to pause and reassess whether the transaction remains appropriate for them. For example, where a sponsor contribution is required and sponsors now have more pressing concerns, or where funding level falls call for a reassessment of whether buy-in remains appropriate, or just generally to consider whether insurance is offering good value when we could be heading towards a spike on mortality (more on this below). At a high level, we expect demand to be sufficiently slowed or sufficiently flexible for the capacity challenges to not be a material issue.

Longevity impact

The mortality rate for those infected by COVID-19[1] is currently estimated, based on the experience in China[2] to be around 0.7% overall, and 3.3% for those aged 60 and over. Attempts to put these estimates into a UK context[3] increase them slightly, implying rates in the region of 3.9% for those aged 60 plus. The same research found that without any control measures, 81% of the UK population is likely to be infected (consistent with the UK government's worst-case modelling), but that optimal mitigation policies could halve this figure. This gives us a range of 1.5-3% mortality for those aged 60 plus.

There are strong correlations between coronavirus deaths and pre-existing health conditions. Many defined benefit pension schemes have pensioner populations that are healthier than the general UK population, and so may observe lower than average mortality rates in relation to COVID-19. The liabilities of most pension schemes will be weighted towards the more affluent members, who are likely to have both higher pension amounts and longer life expectancy. In addition, the surviving pensioner population is likely to be healthier and therefore may have longer life expectancy on average (this is known as the remaining pensioners having "select" mortality). For these reasons, a 1.5% mortality rate within the pensioner population would not necessarily reduce pensioner liabilities by 1.5%.

There is a lot to be said for holding off hedging longevity risk until the passing of the initial wave of COVID-19. There is considerable uncertainty over the impact and reinsurers will not have sufficient data to confidently predict the scale of a short term mortality spike in current pensioner populations. Without data on the impact of this type of event, quite understandably, reinsurers will need to price prudently for uncertainty. Once the initial wave of COVID-19 has passed, the impact will be clearer. At that point, more will also be known about whether the virus is expected to return in winter and its ongoing future impact (e.g., reaching of herd immunity, effectiveness against any observed mutations).

In the context of a buy-in, it may be possible to de-risk now but agree a future date on which the insurer takes on mortality risk, for example after the greatest impact of the virus is expected to have occurred. However, considering the "select" effect, schemes should read the small print here to ensure that they understand the level of price certainty obtained for the remaining pensioners.

Conclusions

- For schemes who are well progressed towards longevity insurance, there would appear to be compelling reasons to pause and wait until the impact of COVID-19 is better understood.

- For buy-ins, the market conditions could create favourable pricing opportunities for schemes, though schemes will need to consider whether these outweigh the challenges in longevity pricing, or if longevity can be dealt with by deferring the point at which this risk is passed to the insurer.

---

[1] The proportion of those who contract the virus that is expected not to survive.
[2] Estimates of the severity of COVID-19 disease (medRxiv 2020, Verity et al)
[3] Impact of non-pharmaceutical interventions (NPIs) to reduce COVID19 mortality and healthcare demand (Imperial College COVID-19 Response Team, Ferguson et al)

However, schemes should bear in mind two key factors:

1. De-risking projects take time, and a fair amount of that time is spent setting objectives, strategy and preparing, prior to actually engaging with insurers or reinsurers for pricing. Schemes who were considering embarking on such projects should generally not use this as a reason to delay, as by the time they are ready to seek pricing the issue may well have subsided.
2. Given market volatility, some of the buy-in pricing opportunities may be fairly short term. For schemes to avail themselves of these opportunities they need to have spent the time preparing and have engaged already with insurers. If you do nothing until the opportunity arises, by the time you are ready it will likely have passed.

Get in touch

If you have any questions about anything covered, please don't hesitate to get in touch.

Michael Abramson
Partner and Risk Transfer Specialist
Michael.Abramson@hymans.co.uk
020 7082 6155