HYMANS ROBERTSON

Future demand outlook for the bulk annuity market

The last decade saw the pension scheme bulk annuity market nurtured from its infancy to the impressive £40bn+ of premiums written in 2019 – an eight-fold increase compared to 2010.

Bulk annuity insurers started 2020 with a strong pipeline of new business but, like many businesses, the developing COVID-19 pandemic will necessitate insurers revisiting their forecasts. In the short term, we might expect dampened demand from pension schemes for a variety of reasons, such as:

- Schemes putting the hedging of longevity risk on hold due to the potential for a one time spike in mortality;
- Corporate led transactions stalling as businesses look to preserve their cashflows or from a heightened sensitivity to the accounting implications of transactions; and
- Volatile market conditions widening pension scheme deficits and increasing transaction execution risk.

However, despite these short-term headwinds, buy-in and buy-out transactions are continuing to flow, helped by attractive pricing following the fall in corporate bond prices. So, with a potential £1trn+ of DB pension liabilities looking to approach the market in the future, what can be expected from this market over the next decade and beyond?

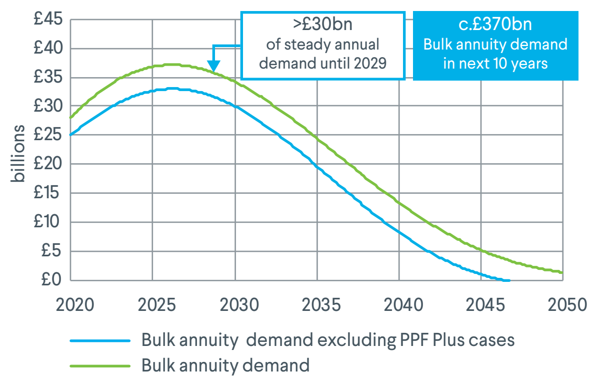
Future bulk annuity volumes

Schemes will typically approach the bulk annuity market to either transact a scheme buy-in, a full buy-out, or a PPF Plus buy-out. A PPF Plus buy-out looks to secure benefits with an insurance company above the minimum level of PPF compensation when a full buy-out cannot be afforded following a sponsor insolvency.

Using accounting data from the c200 FTSE350 companies who sponsor DB schemes, we have analysed the expected rate of buy-out funding level progression and combined this with data from the PPF purple book and other pension market data sources to estimate the future bulk annuity demand for the entire UK DB universe[1].

The results of these projections after smoothing are shown in the chart below.

Projected bulk annuity demand



[1]Schemes with liabilities in excess of £35bn have been excluded from this analysis as it is debatable whether these largest schemes will ever buy-out in a way that brings this business to the bulk annuity market.

All DB schemes in the analysis are assumed to buy-out once buy-out becomes affordable using the pension scheme's assets. Schemes that achieve PPF funding but not buy-out under their existing contribution strategy are assumed to transact a PPF Plus buy-out.

Key observations

50%

of schemes are projected to reach buy-out over the next twenty years, with transaction demand averaging £37bn per year for the next decade, meaning market demand is unlikely to waiver for the foreseeable future.

2/3rds

of bulk annuity volumes will be driven by schemes with in excess of £1bn in liabilities, meaning smaller schemes may continue to find it harder to gain engagement in the market for many years to come.

1 in 5

schemes are expected to not reach full buy-out funding unless additional contributions are committed, but could otherwise transact a PPF Plus buy-out in the future.

1 in 5

schemes are expected to never reach PPF funding unless additional contributions are committed.

What could accelerate demand?

Whilst our projections show there will be healthy bulk annuity demand in the future, there are a number of factors which could accelerate the rate at which schemes look to transact and/or increase the number of pension schemes that are ultimately able to buy-out. These include:

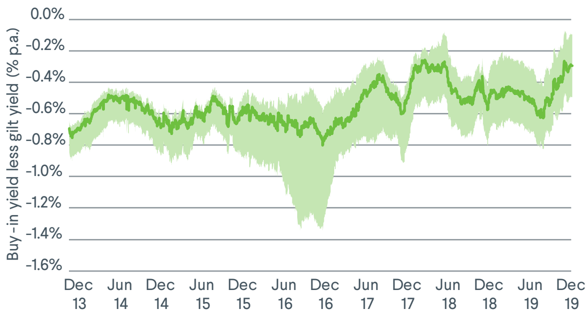
- Improvements in bulk annuity pricing
- Improvements in market conditions
- A fall in projected life expectancy
- Use of member options to manage risk
- Use of a commercial consolidator, such as Clara Pensions, as a bridge to buy-out
- The Pension Regulator's toughening stance towards scheme pace of funding and increased focus on schemes working towards a longer term objective

The first two factors are likely to be the most pronounced drivers of increased bulk annuity demand, and we consider each of them below.

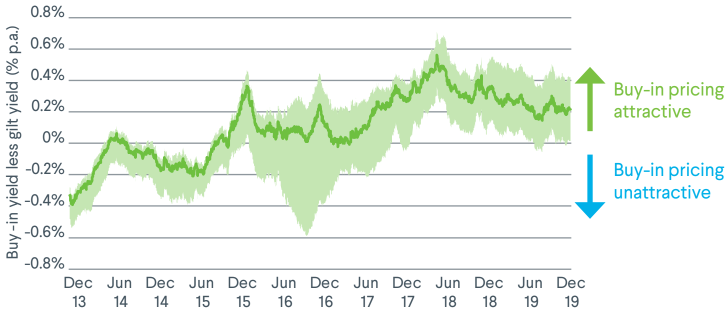
Improvements in bulk annuity pricing

When considering the attractiveness of buy-in quotations, pricing is often best assessed against returns on other low risk assets. The charts below plot the relative yield difference overtime between hedging pensioner or non-pensioner liabilities with a buy-in policy versus a portfolio of gilts.

Non-pensioners



Pensioners



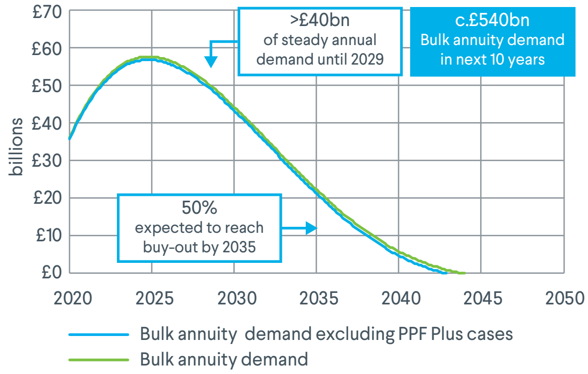
Pricing varies depending on each schemes' characteristics, the social and economic context, and insurer commercial trends; this variation is reflected on the charts, with the solid green line the position for the "typical" scheme.

Attractive pricing has been available for buy-ins and buy-outs since mid-February 2020, due to insurers taking advantage of market volatility to source corporate debt at attractive prices. Whilst we expect market volatility over the short term to provide opportunities for well-prepared pension schemes, insurer pricing has generally improved over time.

The chart on the right shows how bulk annuity demand could accelerate if buy-in yields improved by 0.2% p.a. above the yields seen towards the end of 2019.

Whilst improved pricing would be a positive outcome for pension schemes, the question remains whether the bulk annuity market has the capacity and can consistently support this level of pricing at

Projected bulk annuity demand after a 0.2% p.a. improvement in buy-in yields



Key observations

Annual bulk annuity demand averaging

£54bn

per year for the next decade.

72%

of schemes expected to attain full buy-out.

1 in 7

schemes expected to never reach PPF funding unless additional contributions are committed.

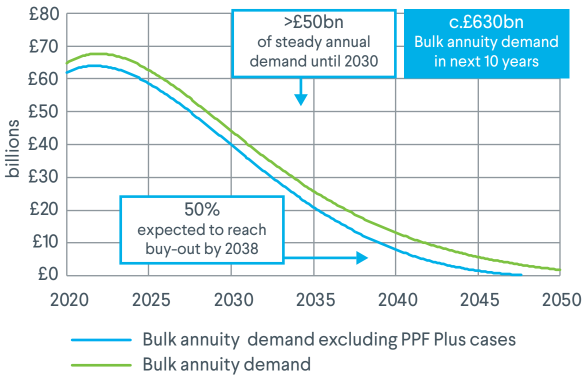
Improvements in market conditions

With gilt yields continuing to fluctuate around record lows, pension schemes with significant exposure to yields and inflation are likely to be behind on their funding plans and securing members' benefits with an insurer may seem like a pipe dream.

However in a rising yield environment, these same schemes which are not fully hedged could see rapid improvements in funding levels, allowing their recovery plan contributions to go further and bring buy-out into reach. Alternatively, pension schemes with significant RPI exposure not fully hedged could see a similar funding improvement catalyst should the government decide to align RPI with CPI faster than currently anticipated by the market.

The chart below illustrates what impact an increase in government bond yields of 1% per annum could have on bulk annuity demand:

Projected bulk annuity demand after a 1% per annum increase in bond yields



Key observations

Annual bulk annuity demand averaging

£63bn*

per year for the next decade

64%

of schemes expected to attain full buy-out

6 in 7

schemes expected to transact some form of bulk annuity, whilst

1 in 7

schemes expected to never reach PPF funding unless additional contributions are committed.

*Although higher yields will decrease liabilities and increase the number of schemes able to afford a bulk annuity transaction, the £ amount premium value for each deal would fall between 10-20% due to insurers expecting higher future investment returns on the premium.

Final thoughts

Whilst the exact future of the bulk annuity market is uncertain, early signs are that we are set for a bumper decade for risk transfer activity. Although market volatility and uncertainty caused by the COVID-19 outbreak has the potential to temper bulk annuity demand in the short term, over the medium to long term our analysis suggests there looks to be no wavering of appetite from DB schemes.

With such a busy market, pension schemes need to be well prepared before approaching insurers if they want to get on the front foot. Pension schemes will need to have a clear broking strategy, and a good understanding of how insurance companies think and operate, to stand out from the crowd and become more attractive to insurers.

The increased pressure on schemes by TPR to formulate long term objectives offers a good opportunity for pension schemes to review their strategic journey plans. Where targeting buy-out, considering the best approach to market should form an integral part of any strategy review.

If you have any questions about anything covered in this article, or would like to discuss how risk transfer could benefit your scheme, please don't hesitate to get in touch with one of the Hymans Robertson Risk Transfer team.

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