Risk Transfer Report 2021

Your annual overview and analysis of the risk transfer market

Welcome to our unique insight into the risk transfer market

2020 was an extraordinary year. Despite a global pandemic, the total value of risk transfer transactions was around £30bn - the second biggest year for the bulk annuity market.

Although most of us were glad to wave goodbye to 2020, it was still a successful year for defined benefit (DB) pension schemes looking to transfer risk. Whilst there were less "mega-deals" in 2020, compared to 2019, smaller transactions and schemes returning to the market boosted demand. Attractive pricing was available from insurers for schemes able to move quickly and longevity swaps increased in popularity for large pension schemes, despite any concerns arising from the pandemic.

2020 was also a significant year for non-traditional risk transfer options. This came in the form of new TPR guidance on the superfund regime, the development of capital-backed solutions and the first transactions with insurance products that share some of the risk with pension schemes.

Looking forward, 2021 is unsurprisingly set to be another busy year. It's now more important than ever to be transaction-ready if you want insurers to view your pension scheme as a high priority case in 2021 and beyond.

I'm delighted to share our fifth annual report as we track the key changes in the bulk annuity market and look at what these changes could mean for your DB pension scheme.

We explore the following five key areas:

1. **Bulk annuity insurers overview** (pages 4-9) – an update on changing market dynamics.
2. **The trustee perspective** (pages 10-18) – how to prepare as you move along your journey plan.
3. **External influences** (pages 19-23) – what's new and what this means for you.
4. **Longevity risk update** (pages 24-27) – the latest trends and approaches to managing longevity risk.
5. **Getting buy-out ready** (pages 28-31) – considerations for getting your scheme prepared for buy-out.

Proven experience and unrivalled innovation

We have proven experience in all areas of risk transfer, with unrivalled insights into insurers and reinsurers. Here is a snapshot of our deal credentials.

We have led:

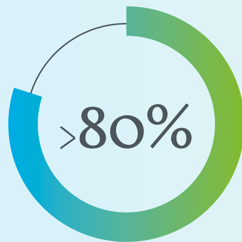
of risk transfer transactions

transactions for pension schemes with **FTSE 100 sponsors**

transactions **over £100m**

The largest buy-in to include **deferred members**

Over the last two years we have been appointed lead risk reduction adviser to:



of the schemes we've tendered for

of schemes where we're not the existing scheme actuary

We also provide an overview of how transaction volumes have changed since the market took off in 2007 and share insights on each insurer in the market.

I hope you find our report helpful for your journey towards your pension scheme's long-term goal and together, we can build better futures for your pension scheme members.

We'd love to hear from you if you have any comments or questions about anything covered. Please don't hesitate to get in touch with me, or one of the authors listed on page 32.

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1 Bulk annuity insurers overview

2020 in review

By Kate Sinclair, Risk Transfer Specialist

The backdrop of market turmoil and uncertainty did not put a stop to bulk annuity transactions, which continued to flow within the risk transfer market. In fact, c£30bn of buy-ins and buy-outs meant that 2020 was the second biggest year for transaction volumes.

We saw fewer multi-billion-pound mega-deals than in 2019, but plenty of smaller transactions propped up the demand for bulk annuities throughout 2020.

Opportunities for schemes

Throughout 2020, market volatility presented pricing opportunities for well-prepared schemes, particularly when credit spreads widened at the onset of the pandemic. Whilst credit spreads did narrow in the latter half of the year, pricing for pensioner buy-ins remained as good value as it has been since 2018. Total transaction volumes being lower than insurers' pre-COVID-19 expectations helped to maintain some downward pressure on pricing this year.

Longevity swaps – back in fashion

Despite the uncertainty over the long-term impact of COVID-19 on mortality rates, longevity swaps were an increasingly popular choice for schemes looking to transfer longevity risk during 2020. Longevity swaps in 2020 covered over £24bn of liabilities, including a £10bn swap covering the Lloyds Bank pension schemes. Various 'ready-made' transaction structures, which have been developed over the last few years by intermediaries, have made it easier for schemes to access the longevity swap market.

New risk transfer solutions

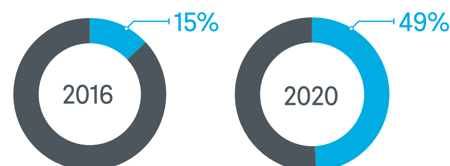
Buy-ins, buy-outs and longevity swaps are no longer the only options for schemes looking to transfer risk. New risk transfer propositions had their first transactions this year, including Legal & General's (L&G) Assured Payment Policy and the Aspinall Capital Partners (ACP) capital-backed journey plan.

More risk transfer alternatives on the horizon

In June 2020, The Pension Regulator's (TPR) interim superfund regime was published, paving the way for superfunds such as Clara Pensions and The Pension SuperFund. We expect to see the first superfund transactions later in 2021. For more info, read pages 10-13.

More trustees look to buy-out

Our survey of 100 trustees of DB schemes found that, in 2020, 49% of schemes are targeting buy-out as opposed to self-sufficiency, compared to 15% just four years ago:



As schemes mature and the gap to full buy-out funding narrows for many schemes, it's likely that demand from pension schemes for buy-ins will outstrip insurer capacity at times. Therefore, it's more important than ever that pension schemes are well prepared and 'buy-in ready' when they approach the market, to demonstrate to the insurers why they should be a priority case.

Check out the table on pages 5 and 6 for more details.

Summary of pension scheme risk transfer solutions

	BUY-IN	LONGEVITY SWAP	BUY-OUT	L&G ISS[1]	L&G APP[2]	CAPITAL-BACKED	SUPERFUND
Think of it a bit like…	...a special asset owned by a pension scheme that fully matches and insures a portion of the liabilities within the scheme	...a special asset owned by a pension scheme that insures longevity risk for a portion of the liabilities within the scheme	...full insurance of all members' benefits	...a buy-in without 1-in-200 downside risk protection	...a buy-in without longevity protection	...an investment product with capital backing to underpin returns needed for agreed journey plan	...a buy-out without insurance protection
Most suitable for pension schemes…	...keen to fully insure all the risks for part of their scheme to start their journey to buy-out, or those wanting an efficient matching asset	...keen to insure longevity risk but don't have free assets available for a buy-in	...who expect to be able to afford buy-out in the future and are happy managing and accepting the risks in the meantime	...keen to benefit from investing like an insurer, avoid losses and happy to take longer to get to buy-out	...targeting buy-out, running a low-risk investment strategy and looking to reduce risk of buy-out prices rising in the future, or those wanting to remove basis risk from LDI	...looking to reduce uncertainty around timescales to buy-out or reliance on sponsor to fund downside risks	...with weaker sponsoring employers but who can afford a one-off contribution to fund around 90% of buy-out
Required funding level (% of buy-out)	Not materially restricted by funding level	Not restricted by funding level	100%	>85%	Not materially restricted by funding level	80% to 90%	90% to 95%
Insurance protection?	Yes	Yes	Yes	Some (up to 1-in-200)	Yes	No	No
Employer covenant retained?	Yes	Yes	No	Yes	Yes	Yes	No

[1] Insured self-sufficiency [2] Assured payment policy

	BUY-IN	LONGEVITY SWAP	BUY-OUT	L&G ISS[1]	L&G APP[2]	CAPITAL-BACKED	SUPERFUND
Can it be done for part of the scheme?	Yes	Yes	Possibly via partial buy-out	Yes	Yes	No	Possibly via partial transfer
Risks not covered relative to full insurance	All risks for liabilities not covered by the buy-in	Financial risks and longevity risk for liabilities not covered by swap	None	1-in-200 tail risks, some buy-out pricing risk	Demographic (longevity and spouse existence/age)	Risks that de-rail journey beyond the capital buffer	Same risks covered as insurance but with lower member security
Ease of transition to buy-out	Essential first step before buy-out	Helps buy-out as longevity risk already covered	Done	Some level of termination costs for other insurers, more straightforward with L&G.	Material level of termination cost for other insurers, more straightforward for L&G	Buy-out pricing risk backed by capital, insurer chosen for trustee	N/A
Accounting impact for employer[3]	BS and OCI, 2nd order P&L	Neutral on day 1, gradual OCI impact	BS and P&L impact	Neutral	Neutral	Neutral	BS and P&L impact
Public transactions to date	100s	50+	100s	None	Two: AIB, Feb 2020, £250m for deferreds and L&G, Dec 2020, £400m	One: April 2020	None
Member engagement	Optional	Optional	Member communication programme needed	Optional	Optional	Optional	Member communication programme needed

[3] Subject to auditor opinion

Market outlook for 2021

By Tim Weir, Actuary and Risk Transfer Specialist

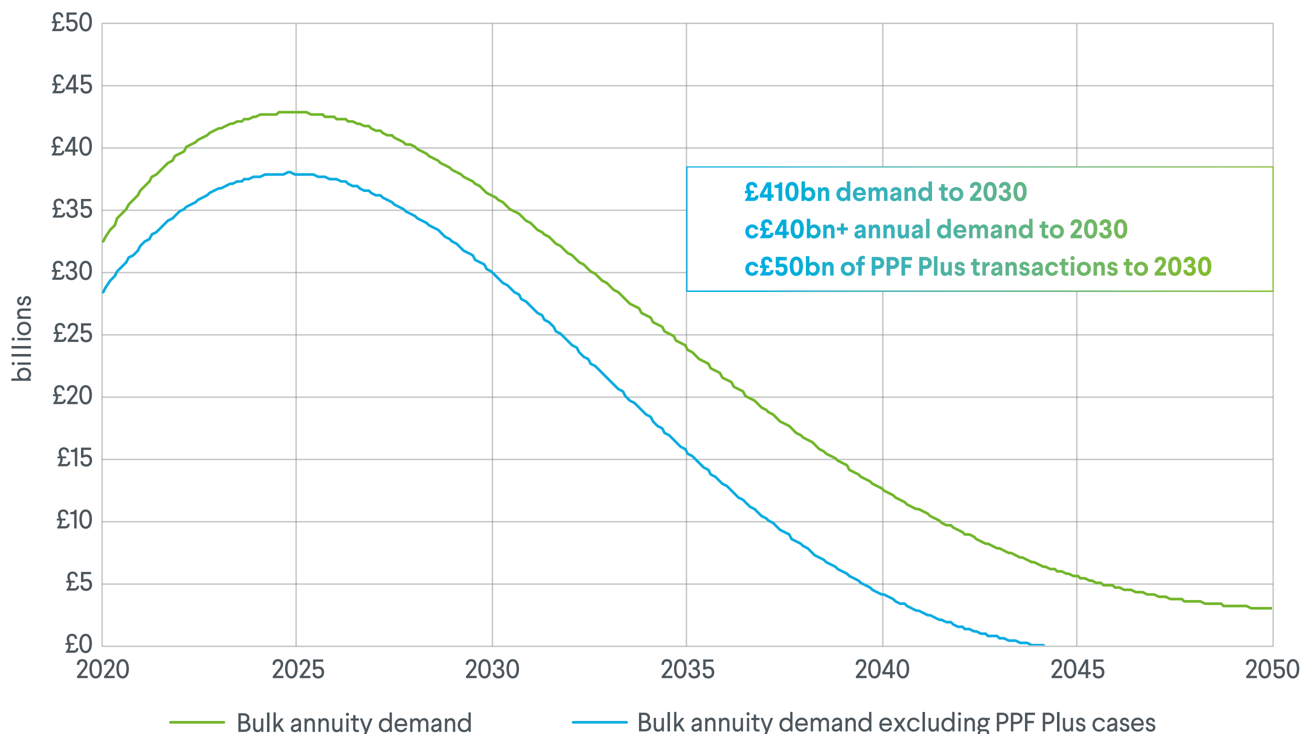
Market volumes for the year ahead

As an increase in pension scheme maturity and strengthened funding positions continue to fuel demand, insurers will aim to keep up by expanding their capacity. We expect bulk annuity volumes will continue to rise, with an average of over £40bn a year being written until the end of the decade.

As a result, we expect 2021 to continue its busy start. Some of the schemes that have experienced COVID-19 related challenges during 2020 are likely to engage with the market again in 2021. Our current expectation is that we'll continue to see mid-sized transactions (£100m - £500m) make up a large part of the market, with mega transactions (over £1bn) also playing a significant role. Following the 2020 trend, many of these will be follow-on transactions in schemes' phased buy-in strategies, with prior insurer engagement and streamlined governance processes making these transactions attractive to insurers.

While the majority of buy-ins and buy-outs will be planned as part of a scheme's de-risking strategy, we also anticipate an increased number of buy-outs being the result of sponsor insolvency. In these cases, where a pension scheme has enough assets to secure benefits in excess of those paid through the Pension Protection Fund (PPF), they are likely to seek to insure 'PPF+' benefits in the bulk annuity market. For more details, see pages 14-16.

Chart 1: Projected bulk annuity demand



Current insurer appetite

The table below shows, for each insurer in this market, how likely they are to provide a quote for buy-in or buy-out transactions of different sizes.

	Deferreds?	<£50m	£50m - £100m	£100m - £0.5bn	£0.5bn - £2bn	>£2bn
Aviva	✓ Able to write	More likely to quote	More likely to quote	More likely to quote	More likely to quote	Unlikely to quote
Canada Life	✗ Unable to write	More likely to quote	More likely to quote	More likely to quote	Unlikely to quote	Unlikely to quote
Just	? More selective	More likely to quote	More likely to quote	More likely to quote / More selective	Unlikely to quote	Unlikely to quote
Legal & General	✓ Able to write	More selective	More selective	More likely to quote	More likely to quote	More likely to quote
Phoenix	? More selective	Unlikely to quote	More selective	More selective / More likely to quote	More likely to quote	More selective
PIC	✓ Able to write	More selective	More likely to quote	More likely to quote	More likely to quote	More likely to quote
Rothesay Life	✓ Able to write	Unlikely to quote	Unlikely to quote	More selective / More likely to quote	More likely to quote	More likely to quote
Scottish Widows	✓ Able to write	Unlikely to quote	More selective	More likely to quote	More likely to quote	Unlikely to quote

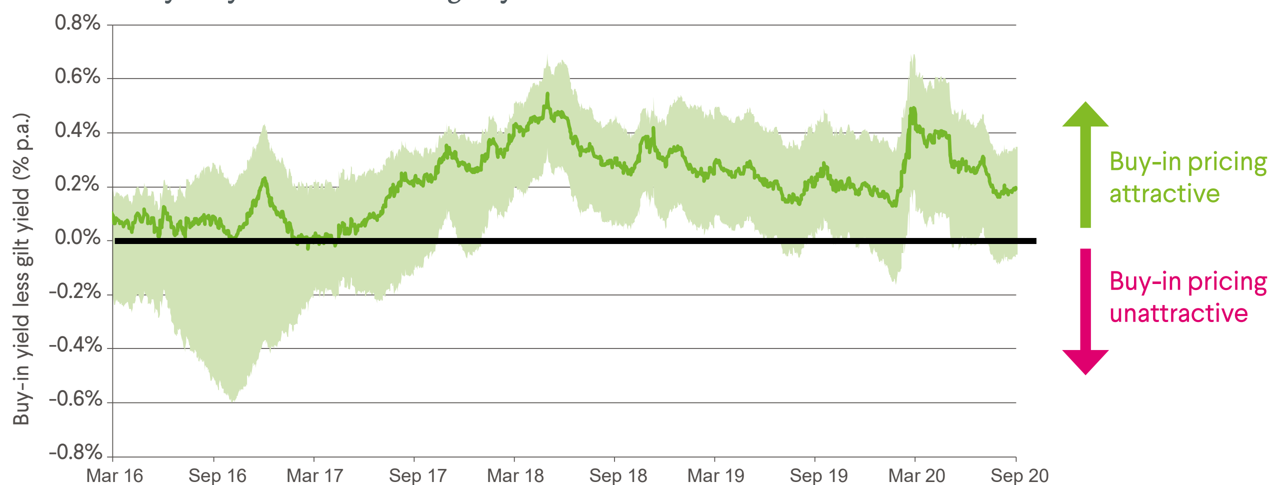
✗ Unable to write ● Unlikely to quote
? More selective ● More selective
✓ Able to write ● More likely to quote

Expectations of pricing

Although we expect the market to start off busy in 2021, the economic outlook remains uncertain. The effectiveness of the COVID-19 vaccine could cause further volatility in financial markets. As we saw in March and April 2020, such volatility can provide well-positioned schemes with short-term opportunities to take advantage of attractive pricing.

To capture these opportunities, schemes will have to be ready to act quickly. Data will need to be insurer-ready, the benefit specification will need to be signed off, and there will need to be a clear strategy, with objectives agreed between trustees and company. Early market engagement is crucial as well. Those schemes that already have an ongoing dialogue with insurers, with a pricing target in place, have the best chance of securing the most attractive terms. A well-informed price target gives insurers the confidence they need that you are serious about transacting, and that they have a realistic chance of achieving the desired pricing. This increases engagement, and gets you higher up the priority list.

Chart 2: Buy-in yield relative to gilt yields



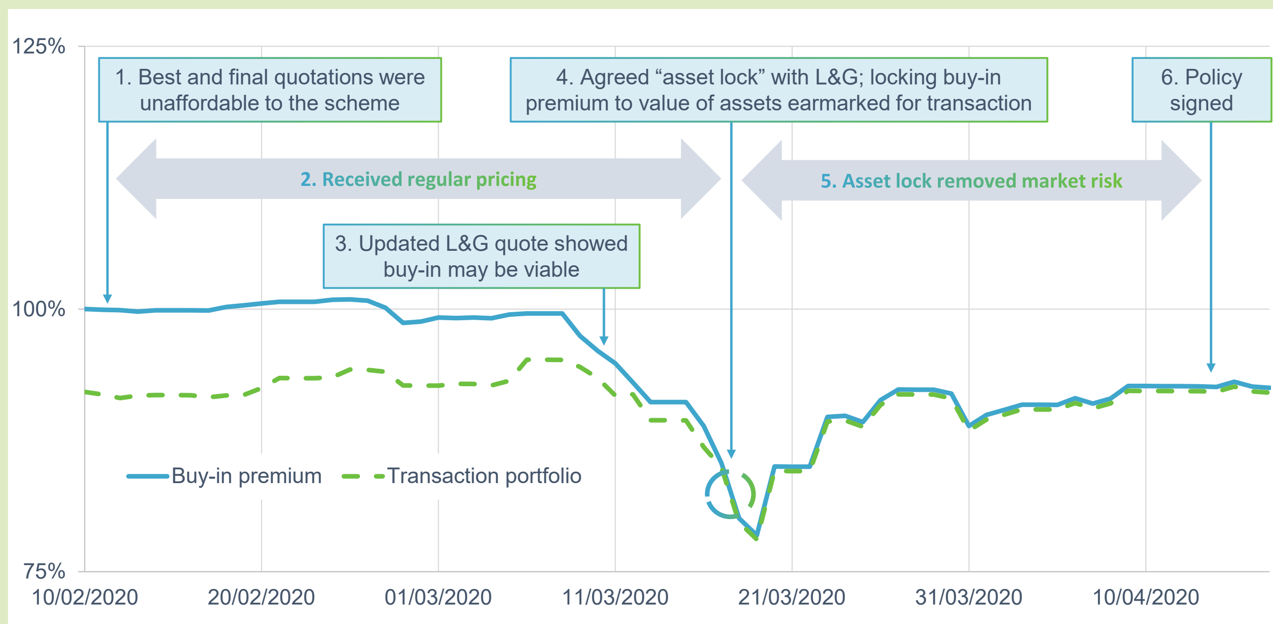
Case study

As the effects of COVID-19 really took hold in March 2020, credit spreads widened materially. Some insurers were able to translate this into extremely attractive pricing for those schemes who were already engaged in the market.

In March 2020, we led on a buy-in that combined the use of a pricing feed and 'asset lock' to take advantage of this improved pricing and secure an excellent outcome for both the trustees and the company.

In this case, the trustees had sought earlier buy-in quotations from the market. Although these quotations had shown that a shortfall existed, and an additional cash contribution would have been needed from the employer to secure the buy-in, the preparatory work carried out and dialogue established with insurers put the scheme in a strong position to take advantage of any subsequent market movements.

By setting up a pricing feed with insurers, the trustees were able to monitor the market, and have a clear understanding of whether the buy-in target could be hit with its existing assets. When market conditions allowed this target to be hit by L&G towards the end of March 2020, an exclusivity agreement was entered into, and an asset lock was agreed with L&G. As a result, the buy-in premium was no longer a £ amount that could change day-by-day, but instead it was a portfolio of the scheme's assets. This minimised market risk until the policy was signed the following month, which was particularly crucial at a time when there was much uncertainty about future market movements.



Lessons learned

Careful preparation
- Need to demonstrate attractiveness to insurers
- Data and benefit specification are insurer-ready
- Clear investment transition plan in place

Governance
- Feasibility exercise done
- Company and trustees on board
- Joint working party enables flexibility

Provide a target price
- Pricing an asset lock takes effort by insurers
- Target price gives confidence you are serious and that there is a good chance of transacting

Important to get price locks right
- Increased volatility increases risk of mismatch and pricing moving away from you

2 The trustee perspective

Setting the right course

By Kieran Mistry, Actuary and Head of Non-Traditional Risk Transfer

New destinations, and new tools to get there

As mentioned, 2020 was another strong year for conventional buy-in and buy-out. But it's likely to be looked back on as a landmark year for alternative endgame options and risk transfer tools.

Superfunds get the green light

The superfund landscape took a leap forward, with TPR releasing detailed guidance for trustees, sponsors and the superfunds themselves. This guidance provides the framework for the first transfers to happen ahead of a new long-term superfund regime.

For a summary of this guidance and its implications, see our Insight publications on the superfund and trustee and sponsor guidance.

Is TPR's guidance and specific longer-term legislation overkill with just two players in the market (Clara and The Pension SuperFund) and no transactions to date? Well, behind the scenes there are several other budding superfunds hoping to enter the market that are already in discussion with TPR. There is a growing sentiment that superfunds will have a role in the future DB pensions landscape. TPR is proactively engaging with this future, which is what you want to see from a forward-looking regulator.

Work is currently underway to assess the existing superfunds against the requirements in TPR's guidance. This is expected to be completed soon, following which individual transfers waiting in the wings can apply for clearance.

Innovative capital-backed solutions

Just as investor capital has been drawn to bulk annuity insurers to tap into the risk transfer market, there are a few direct-to-scheme capital-backed solutions being developed. These provide capital to well-funded pension schemes as a buffer against risk, while hoping prudent funding approaches and alternative investment strategies will provide profit back to investors over time.

The Aspinall Capital Partners (ACP) capital-backed journey plan completed its first pension scheme transaction in April 2020. The capital is designed to back the investment return required to bridge the gap to buy-out. The pension schemes that are most likely to follow suit are those where the trustee and sponsor are looking for more certainty over the timescale to buy-out.

Non-traditional insurance

Insurers are also playing their part in expanding the suite of risk management tools. Legal & General got their Assured Payment Plan (APP) over the line this year, announcing its first transaction in February 2020 – a £250m deal covering deferred liabilities of the AIB Group UK Pension Scheme. They followed that up with a £400m deal in December 2020 with one of their own pension schemes covering pensioner and deferred liabilities. APP is much like a buy-in, providing income to match payments to members in exchange for an up-front premium. However, unlike a buy-in, APP income is based on fixed longevity and demographic assumptions, and therefore does not provide protection against these risks.

Legal & General have one other non-traditional insurance solution, namely Insured Self Sufficiency, although no transactions have been announced that use this solution as yet. This aims to provide schemes with protection against 'non-extreme' risks, which improves affordability as insurer capital requirements are much larger when capturing extreme risk.

You can see our full summary on pages 5-6.

Choosing your endgame

As TPR finalises its new DB Funding Code, it's clear that long-term objectives will be a key feature. With schemes moving close to, and beyond, full funding on Technical Provisions, trustees and sponsors will be asking the question – what is our endgame?

Superfunds – a viable endgame?

It's trustees, and trustees alone, that choose whether to transfer members' benefits into a superfund. In doing so, they will ask themselves one simple question – **"are members better off?".**

To help trustees answer that question, TPR have outlined the "gateway test"; three principles which should be used by trustees to determine whether a transfer to a superfund is in members' best interests.

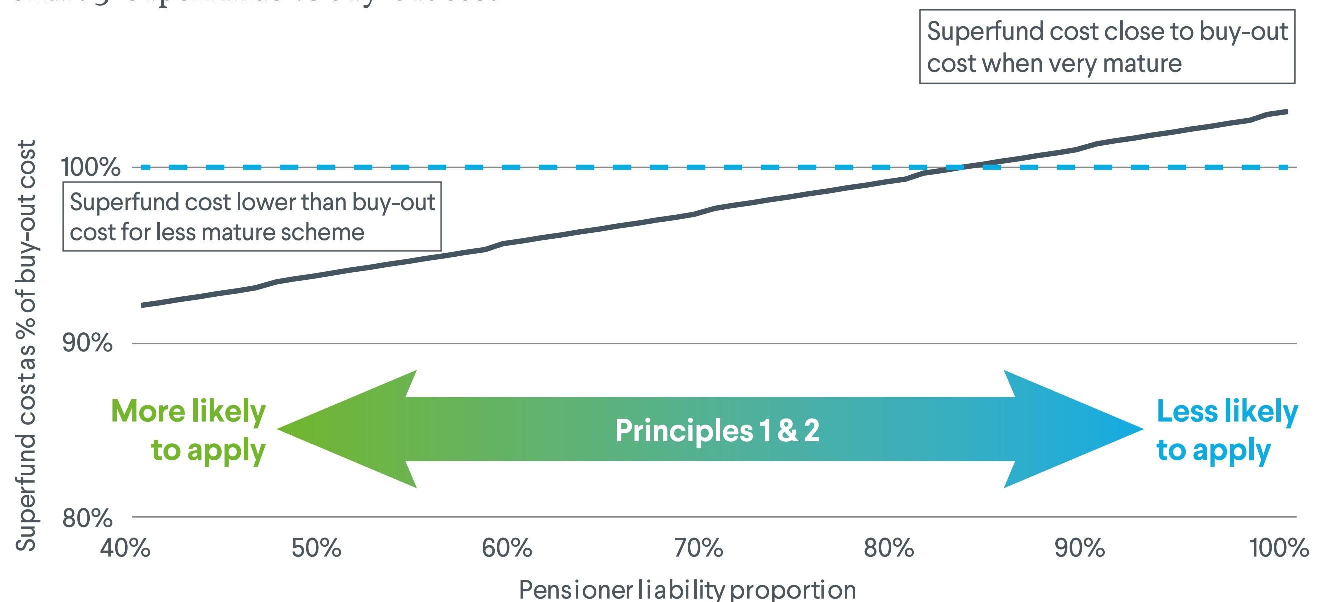
The gateway test

Principle 1:	Principle 2:	Principle 3:
The Scheme cannot afford to buy-out now	The scheme has no reasonable prospect of buying out in the foreseeable future (up to 5 years)	The transfer improves the likelihood of members receiving full benefits

Principles 1 & 2

For pensioner benefits, buy-out pricing is similar to (and in some cases less than) superfund pricing. For non-pensioner benefits, the superfund cost is likely to be lower. As a result, the costs of buy-out and consolidation converge over time as a scheme matures. Once a scheme reaches the point where transferring into a superfund is affordable, it may make it to buy-out by just hanging on a bit longer.

Chart 3: Superfunds vs buy-out cost



Given this convergence over time, in the absence of material near-term sponsor covenant concerns and while superfunds remain novel and untested, most trustees will continue to focus on buy-out with transferring to a superfund being a valuable contingency plan, should sponsor covenant deteriorate *(see our action plan for trustees navigating sponsor distress)*.

Principle 3

This principle is the most nuanced and challenging to address. Trustees and sponsors need to compare:

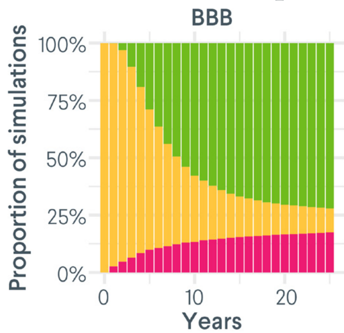
The status quo. How likely is sponsor insolvency and what level of benefits would members receive if the worst happens?	vs	Outcome in superfund. How robust is the capital backing the superfund and what level of benefits would members receive if the worst happens?

The answer will depend on the specific scheme's situation. However, with the right modelling tools, trustees can have the necessary insights to address even this challenging question.

Comparing outcomes in a status quo and in a superfund

We have developed tools and modelling to answer this very question.

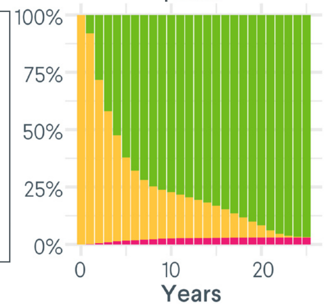
Chart 4: Outside superfund (BBB Sponsor)



State
- Buy-out
- Running
- Windup

Charts showing (broadly) the probability at any point in time that:
- members' benefits insured;
- members receiving 100% benefits from fund / superfund; or
- members receive less than 100% benefits.

Chart 5: Inside superfund



Buy-out or run-off?

Choosing between buy-out and run-off involves bringing together many different considerations. We've set out some of these below. Trustees and sponsors will place different weight on each of the criteria depending on their objectives, the powers within the scheme rules and the specifics of their situation.

Example considerations when setting an endgame

Risk
Including investment, longevity, liquidity, default, counterparty, and operational risk.

Member experience
Degree of trustee control, importance of maintaining link to sponsor.

Member security
Covenant and different regulatory regimes.

Flexibility
Extent to which certain strategies reduce or increase flexibility in the future.

There's lots to consider, all of which should be explored collaboratively with trustees and sponsors. However, ultimately it really all comes down to one question – **if you could afford to buy-out, would you?** For some, the answer is no.

PPF+ transactions – the expert view

By Jonathan Hazlett, Managing Director at Open Trustees Limited - a member of the PPF panel of trustees with extensive experience of dealing with PPF+ cases.

DB superfunds and PPF+ cases

A growing number of pension schemes are entering Pension Protection Fund (PPF) assessment that are over-funded relative to PPF compensation. Whilst the PPF won't assume responsibility for these schemes, they still need to go through a PPF assessment period.

Trustees must ultimately wind up these schemes and discharge members' benefits. This is normally achieved by securing a bulk annuity contract with an insurer. However, that's not the only method permitted by law. It's also possible to transfer benefits to another occupational pension scheme.

TPR has recently issued some guidance for trustees of PPF+ schemes which suggests that they should be considering DB superfunds in this context alongside more traditional buy-out routes.

TPR's guidance on DB superfunds

DB superfunds are occupational pension schemes set up on a commercial basis to consolidate other DB schemes by accepting transfers-in from them.

With a solvent employer, the employer's covenant is replaced by a financial buffer made up of DB superfund investor capital and a premium paid by the employer. For a PPF+ scheme, there's no employer premium or covenant exchange as the employer is insolvent, although the financial buffer made up of investor capital will still be available.

DB superfunds can potentially offer better pricing than bulk annuity providers (this means higher benefits in a PPF+ scheme scenario). This is because they're occupational pension schemes and so not subject to the capital requirements which apply to insurers. However, TPR's guidance does contain strict requirements for how DB superfunds must be run and funded, along with how they will be supervised by TPR.

Assess DB superfund feasibility

Trustees should seek advice early in a PPF assessment period to ascertain the scheme's funding position.

If a buy-out of full scheme benefits can be achieved, no further consideration of DB superfunds is needed unless the position changes. However, if this isn't possible, the level of benefits that could be provided by both insurers and DB superfunds should be kept under review. The decision for trustees in this scenario will be to either:

- secure a buy-out with an insurer at the PPF+ level that can be afforded (with insurers providing the highest level of benefit security); or
- transfer to a DB superfund that will give full scheme benefits, or at least materially higher PPF+ benefits (with DB superfunds providing a lower level of benefit security).

In many cases, we expect that a DB superfund will only be appropriate if it can provide full scheme benefits, as that will allow the transfer to proceed without member agreement. However, a transfer at less than full scheme benefits might be appropriate in certain cases where materially higher PPF+ benefits can be provided. However, transfers of this type will be particularly complex given the need for member agreement.

Agree mechanism for exit from PPF assessment

Trustees will need to agree with the DB superfund the mechanism by which the scheme will exit from PPF assessment and seek professional advice on the proposed structure.

Broadly speaking, there will be two ways of exiting PPF assessment:

- a scheme rescue, whereby a newly established employer sponsored by the DB superfund agrees to assume responsibility for the scheme; or
- a bulk transfer of assets and liabilities from the scheme to the DB superfund at the end of PPF assessment.

The most likely method will be a bulk transfer. However, to complete this without member agreement will require some form of financial transaction between the insolvent employer and the DB superfund sponsor. The way in which this is achieved requires careful consideration.

Depending on the nature of the insolvent employer, it may be possible for the DB superfund sponsor to acquire the insolvent employer and thus assume responsibility for the scheme. However, this would mean that the DB superfund sponsor also inherits all non-pension liabilities and the employer would still remain in an insolvency process.

Keep the PPF and TPR informed

When considering a transfer to a DB superfund on exiting PPF assessment, it's important that trustees notify the PPF and TPR at the earliest opportunity.

The PPF should be consulted about all issues including the investment strategy to adopt, the adjustment of PPF assessment tasks to suit a DB superfund transfer, any decision to enter into a DB superfund transaction and the costs associated with this.

A clearance application might not be appropriate or possible in a PPF+ situation. However, TPR still expects trustees to demonstrate their rationale for transferring to a DB superfund rather than securing members' benefits with an insurer and to keep them fully updated throughout the process.

Costs and expenses

TPR's guidance makes it clear that PPF+ scheme assets can be used for the standard advisory costs associated with assessing and implementing a DB superfund transaction. However, the assets cannot be used to pay for the development of new and innovative ways of transferring to a DB superfund; these costs must be funded by the DB superfund in the first few transactions as practice develops.

Review investment strategy

Trustees will need to take advice on the investment strategy to adopt during PPF assessment.

If the scheme is sufficiently likely to transfer to a DB superfund, trustees might wish to adopt an investment strategy that aligns with that outcome (for example, hedging against full scheme benefits rather than PPF compensation).

On entering into exclusive negotiations with one of the DB superfunds, the scheme's assets might need to be invested in a specific way to comply with any agreed price-lock mechanism.

Adapt PPF assessment period tasks

The PPF would expect all assessment period tasks to be completed before a transfer to a DB superfund takes place, unless a scheme rescue is possible early in the assessment period.

Much of the work required during PPF assessment would be done for any wind-up, for example, data verification and cleansing, and benefit audit and rectification. These tasks can lead to the identification of errors that increase the scheme's liabilities when corrected. This is one of the reasons why insurer and DB superfund pricing need to be kept under review throughout the PPF assessment process.

Undertake due diligence

Trustees will need to ensure that the risks of the proposed transfer to the DB superfund are understood and are appropriate relative to the improvement in benefits.

This assessment needs to be proportionate to the size of the scheme and the resources available. However, it will include things such as:

- reviewing TPR's initial assessment of the DB superfund and any updates needed;
- asking covenant and actuarial advisers to review and model the likely outcomes for members in the DB superfund, relative to an insurance solution; and
- reviewing what the DB superfund is offering in terms of their fees, their funding and investment objectives, their methods for implementing and achieving those objectives, and how conflicts of interest are managed.

Consider member options

Trustees should consider whether to offer options to members that would otherwise be available in a solvent wind-up situation, either during or after the end of PPF assessment.

For example, this might include the ability to transfer-out or to commute benefits using a winding-up lump sum. By default, these options are not permitted during PPF assessment. However, they may be offered during PPF assessment and then validated by the PPF in limited circumstances.

Take-up for these options could improve the level of PPF+ benefits received by remaining members who transfer to the DB superfund.

When to buy-in, and when not

By Richard Wellard, Partner and Risk Transfer Specialists

Key inputs when setting your buy-in strategy

There are four primary inputs which should be used by trustees and sponsors to assess whether it is more appropriate to carry out a series of buy-ins or wait for a final buy-out.

1. Timeframe to buy-out
Buy-out is often closer than you expect, driven by investment returns, contributions, and members ageing and retiring. A buy-in strategy typically adds most value if there is a reasonable period to buy-out. If you are very close, the best option may be to wait and carry out a single transaction.

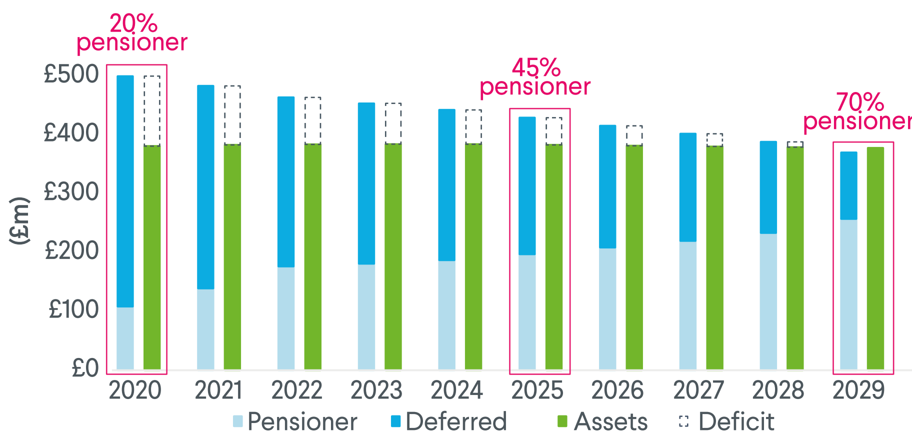
2. Liability evolution
Typically, non-pensioner (deferred) benefits are only insured in the final buy-out, with any buy-ins along the way covering only pensioner benefits. However, many insurers can offer better pricing for insuring deferreds at the end if pensioner benefits are insured at the same time. Therefore, understanding the evolution of the mix of deferred and pensioner liabilities is key to determining whether and when to buy-in over time.

3. Wider investment strategy
To understand the impact each buy-in would have on the wider investment strategy, trustees need to consider three key questions:

1. Is there enough capital to support interest rate and inflation hedging plans?
2. Will the investment returns needed to achieve a buy-out objective be maintained?
3. Is there enough liquidity to fund the buy-in premium and meet other cashflow needs?

4. The market
Market dynamics and insurer preferences drive the pricing and terms you can achieve. Different insurers prefer different transaction sizes and their pricing varies between different membership profiles.
You can't predict the distant future market landscape, but current market dynamics and general trends over time should inform your buy-in strategy.

Chart 6: Example projection of buy-out funding position



Projecting a scheme's buy-out position allows trustees and sponsors to see how far they are from buy-out and how liabilities mature over time.

Schemes can then map out buy-ins over time, ensuring each buy-in will attract sufficient competition and fit with their wider investment portfolio.

Pros and cons of a series of buy-ins

A set of considerations wouldn't be complete without an exhaustive list of other considerations that may steer you towards preferring one buy-out or a series of buy-in transactions. Below, we set out just a few of these. Schemes will place more emphasis on different areas and so the balance will differ depending on the context.

Pros of a series of buy-ins	Cons of a series of buy-ins
Smooth pricing exposure, capture opportunities Buy-ins along the way lock in insurer pricing, reducing uncertainty over future pricing. A measured and timely approach to market can help schemes capture pricing opportunities over time.	**Reduced flexibility in investment strategy** Using assets to fund a buy-in reduces your ability to make other changes to your investment portfolio in the future, such as increasing interest rate and inflation hedging, switching to a larger pool of income generating credit, or re-risking to accelerate the journey.
Reduce longevity risk exposure over time As schemes mature and de-risk their investment strategy, longevity risk becomes a more material component of overall risk. Buy-ins are one way to manage down longevity risk.	**Expenses and resources** Buy-ins cost money and take up governance bandwidth to implement. However, it is important to consider the net impact on costs as there are offsetting factors such as savings on investment management charges on the assets used to fund the premium.
Reduced P&L impact of final buy-out Buy-ins result in a balance sheet strain in company accounts. For a final buy-out, that strain may or may not flow through P&L depending on the auditor's approach. P&L is a key focus for a lot of companies. Balance sheet strains for buy-ins along the way do not go through P&L directly and help reduce the scale of any P&L charge on final buy-out.	**Insurers' perceptions of relationships** If a pension scheme has already carried out one or more buy-ins with a particular insurer, other insurers might be put off competing for future transactions if they think that previous insurer has established a preferred provider relationship with the trustee or sponsor. Conversely, the previous insurer may work harder, or use knowledge they have gained about the scheme, to offer a lower price to win the business and grow the relationship.

Monitoring buy-in readiness

Each of these considerations can be brought together to determine whether a scheme should undertake a series of buy-ins along the way to buy-out. If a series of buy-ins is most appropriate, the same analysis can be used to create a framework of metrics to monitor that will allow trustees and sponsors to pin-point times in their journey when buy-ins will add value, focus their engagement with the insurance market around these times, and have clear pricing targets and liability tranches for each buy-in.

If you want to find out more about setting your buy-in strategy, please see our recent webinar on a series of buy-ins vs full buy-out, and in our related Insights article.

3. External influences

Impact of RPI reform

By Nell McRae, Senior Investment Consultant and Risk Transfer Specialist

The results of the consultation on the reform of the Retail Price Index (RPI) were announced on 25 November 2020. These confirmed that RPI will be aligned with CPIH (the Consumer Price Index (CPI) adjusted for owner occupier housing costs), but not before 2030 and no compensation will be offered to index-linked gilt holders. The outcome of the consultation has concluded many months of speculation about the future of RPI, initially triggered by the House of Lords Economic Affairs Committee's January 2019 report, which recommended addressing statistical deficiencies in RPI.

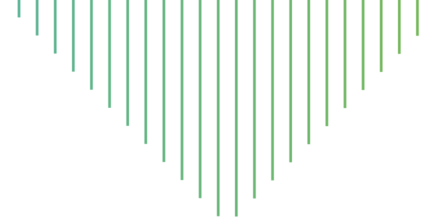
Issues with RPI have been known for many years and some may recall a previous consultation launched in 2012 on a similar topic, which also created a great deal of uncertainty in RPI, but eventually concluded with no changes.

Reform – the key points

- The reform will effectively replace RPI with CPIH, due to concerns over the validity of RPI as a suitable measure of inflation.
- The change is expected to occur in 2030. This does reduce the impact, as there was a possibility that the implementation date could have been set as early as 2025.
- Investors who hold index-linked gilts will receive lower coupon payments from 2030, but no compensation will be provided. This will result in a material transfer of wealth from index-linked gilt holders to the UK Treasury.

Replacing RPI with CPIH is expected to materially reduce the rate of inflation measured by RPI going forwards. The difference between RPI and CPIH has averaged 1% per annum since 2010. For example, an index-linked gilt today with 20 years' duration would be worth 10% less if RPI inflation was reduced by 1% per annum from 2030 onwards.

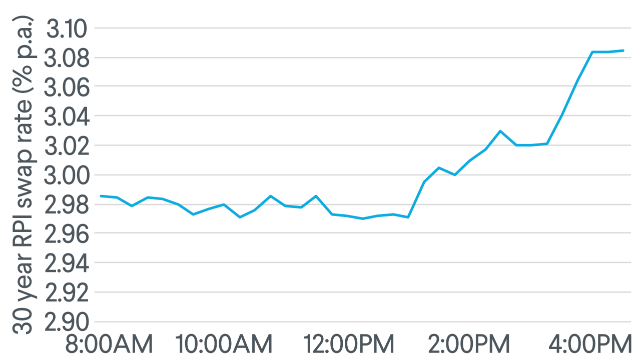
RPI Timeline



Market pricing

In anticipation of the outcome of the consultation, assets linked to RPI had already been re-pricing downwards. The market terms for long-dated RPI swaps would have been expected to fall following the announcement, however, the market reaction went in the opposite direction (see chart below). This suggests the market had already largely anticipated the outcome and broader concerns around the lack of supply of long-dated inflation protection dominated the impact on pricing on the day. In a year with record issuance of UK gilts (£346bn to end November), index-linked gilts made up only 4% of bonds auctioned.

Chart 7: 30-year swap rate on 25 November 2020



Source: Bloomberg

Impact on buy-in/out pricing and reserving

For insuring RPI-linked benefits, there is not expected to be a material change in buy-in/out pricing. The RPI market has reflected the impact of the consultation and insurers' pricing for RPI-linked benefits will continue to reflect the market price for hedging future RPI.

The greater potential impact is around the cost for insuring CPI-linked benefits. Which could be counter-intuitive, as CPI didn't change. The issues stem from the fact that, in general, insurers are not able to hedge all the CPI liabilities they take on using CPI-linked assets, as the supply of CPI-linked assets is not sufficient. Therefore, to varying degrees, insurers will reserve and price for CPI-linked benefits based on RPI market terms less an assumption for the difference between RPI and CPI (the assumed "RPI/CPI wedge").

With the expectation that RPI will move to CPIH from 2030, the logic would follow that RPI will be much closer to CPI from 2030. This would act to increase the cost of insuring CPI-linked benefits relative to the cost of insuring RPI-linked benefits. However, a step-change in pricing is unlikely to play out in practice, as:

1. insurers (like the rest of the market) will have anticipated the outcome of the consultation to some degree, allowing for the potential impact on their pricing of CPI benefits in the months running up to 25 November;

2. on average, CPIH is expected to be higher than CPI and so there will remain an expected "RPI/CPI wedge" even after 2030 (although this might be more of the order of 10bps, rather than 1%); and

3. the lower the difference between RPI and CPI, the less insurers need to hold as reserves to cover the mismatch risk, which reduces their reserving costs and helps lower their pricing.

The consultation outcome also has implications for the reserves that insurers hold to meet CPI benefits they have previously insured (their "backbook" of business). The same factors serving to increase CPI pricing for future business would reduce solvency levels for backbooks of CPI-linked benefits. However, we would not expect to see material shifts in insurers' solvency levels as a result of the consultation. In addition to the above factors that reduce the impact on future pricing of CPI-linked benefits, the impact on backbook solvency levels will also be muted due to:

- CPI-linked benefits only represent a minority of insurers' backbooks;

- insurers will hold some CPI-linked assets in their backbook reserves, which will not have been impacted by the consultation; and

- insurers will hold some network rail bonds which, although RPI linked, are expected to provide their holders with some financial compensation for the expected changes to RPI.

Responsible Investment considerations in insurer selection

By Simon Jones, Head of Responsible Investment and **Paul Hewitson**, Actuary and Risk Transfer Specialist

2020 has been a year in which the consideration of Responsible Investment (RI) issues has really hit home. The global pandemic highlighted that financial risks can arise from a variety of sources.

The World Economic Forum published its Global Risk Report in January and noted the challenges of making progress in Environmental, Social and Governance (ESG) issues. The actions of corporates in response have varied, but the financial performance from those who score strongly on their ESG credentials has been noticeably better over the year.

Trustees have seen a growing regulatory burden – changes to SIPs, the reporting on stewardship activity and embedding climate risk processes into their governance. Such changes may be driven by legislation, but they have forced many to confront issues that present clear financial risk. As trustees now bring this focus to their decisions around buy-in and buy-out, how should insurers' approach to RI be scrutinised? Is it relevant to the selection of an insurer?

A trustee's chosen insurer will ultimately take on responsibility for the payment of members' benefits many decades into the future. Obtaining assurance on their financial strength is seen as critical. However, it's not typical to consider whether the insurer has policies and processes in place to identify and address emerging risks, such as climate change, that could affect their future financial strength.

Insurance policies can be transferred between insurers and the trustee's chosen insurer may not be the one that needs to pay their members forever. Therefore, the role of the Prudential Regulatory Authority (PRA) is key in creating a benchmark of responsible investment across the industry. Recognising this, there is some evidence of growing regulatory oversight from the PRA on climate change issues.

Bulk annuity providers

We consider Responsible Investment as reflecting two key dimensions:

1. Sustainable investment: Investors should recognise the potential financial impact of ESG factors in investment decision making.

2. Effective stewardship: Investors should act as responsible and active owners, through engagement with company management when required.

There is a definite direction of travel amongst insurers, acknowledging the benefits of focussing on RI factors in what they do. Most follow the latest disclosure recommendations and through this we can identify differences in the way they:

- invest in socially beneficial projects and low carbon initiatives;
- reject investments involved in controversial activities;
- actively engage with companies they invest in to drive positive changes to their ESG performance; and
- expect third party asset managers to become signatories to the UN Principles of Sustainable Insurance.

However, insurers differ considerably in the range of business they provide, the services they employ and the investment strategies they follow. Measuring the "outputs" doesn't provide a clear or comparable picture of the different insurers' approaches to Responsible Investment.

To get to the heart of the issue, trustees will need to gain insight into how insurers have integrated the consideration of ESG factors in their business processes, business oversight and resource allocation. It's the evaluation of these "inputs" that will better identify differences between how insurers are currently geared up to addressing the risk and ethical issues RI focusses on. Although this will be harder.

Our approach to evaluating insurers

We focus on the harder question of assessing these "inputs". The approach is consistent for investment managers and insurers, focusing on four key dimensions of Responsible Investment:

Culture:
To what extent is there an organisational commitment to ESG issues from the top down, such that it is embedded in the culture of the firm.

Transparency:
To what extent are ESG risk exposures measured and reported on within the firm.

Integration:
To what extent are ESG issues integrated into standard processes and business as usual decision making.

Stewardship:
To what extent does the firm proactively engage with the companies it invests in to promote ESG issues[3].

We research these areas so that trustees are equipped with the information to extend their approach to Responsible Investment through to their choice of insurer in a meaningful way.

[3] It should be recognised that insurers' investment strategies limit the extent to which they are able to focus on Stewardship issues (they will not hold equity investments to back buy-in/out business).

Regulatory update

By Michael Abramson, Partner and Risk Transfer Specialist

In December 2020, the European Insurance and Occupational Pensions Authority (EIOPA) published its recommendations following the 2020 review of Solvency II. Solvency II is the regulatory framework that applies to insurers across Europe. It is not automatic that any changes to Solvency II would apply in the UK, but the EIOPA recommendations are likely to be relevant for UK insurers for the reasons we discuss below.

What are EIOPA's recommendations?

For a full understanding of the various recommendations, see our Solvency II newsflash. The key recommendation relevant to bulk annuity insurers is in respect of the "Risk Margin". The Risk Margin is a concept that was first introduced in the UK by the Solvency II regime, and is essentially a component of capital. It's particularly onerous for insurers who hold longevity risk, especially for the longer duration longevity risk associated with deferred pensioners. Its introduction incentivised most bulk annuity insurers to pass off the longevity risk associated with buy-ins and buy-outs to reinsurers, as the cost charged by reinsurers for this generally looks attractive compared to the cost of capital associated with retaining the risk.

The EIOPA recommendation, if adopted, would reduce the Risk Margin by **around 15-20%** for current pensioners, with a greater reduction still for deferred pensioners.

Would the recommendations impact risk transfer pricing?

If the EIOPA recommendations are adopted in the UK, the reduction in the Risk Margin is unlikely to be great enough to change insurance behaviour – they would likely continue to reinsure longevity risk. Despite this, there could still be an impact on pricing for two main reasons. Firstly, insurers will often retain some of the longevity risk, in particular in respect of deferred members, so the capital required for these liabilities would reduce.

Secondly, any EU-based reinsurers would benefit from these recommendations as well, so there could be some reduction to reinsurance pricing that would flow through to the pricing of buy-ins or buy-outs for pension schemes – this would apply equally to longevity reinsurance pricing for pension schemes. However, these two factors are likely to have second order impact, the sort of changes to price that could easily be overshadowed by differences in pricing between insurers in a competitive process.

What impact if any will Brexit have on the regulatory environment?

Solvency II has been enshrined in UK legislation, so while currently UK insurers are now regulated at a UK level, the regulatory framework remains the same. However, the UK Government and the Prudential Regulation Authority are currently actively looking at how they might change the regulation of insurers in light of Brexit. This has the potential to make more significant changes to Solvency II than those recommended by EIOPA, and so could have more of an impact on risk transfer pricing. However, they may not deviate too far from Solvency II as they will no doubt wish to retain the benefits of "equivalence" – essentially, any regulatory regime deemed by Europe to be sufficiently similar to Solvency II enjoys various benefits that makes doing business in Europe much easier for insurers in an equivalent regime.

We do expect to see various changes in time to the UK regime that are likely have an impact on the pension de-risking market. To make sure that you keep up-to-date, visit our Risk Transfer insights page.

4. Longevity risk update

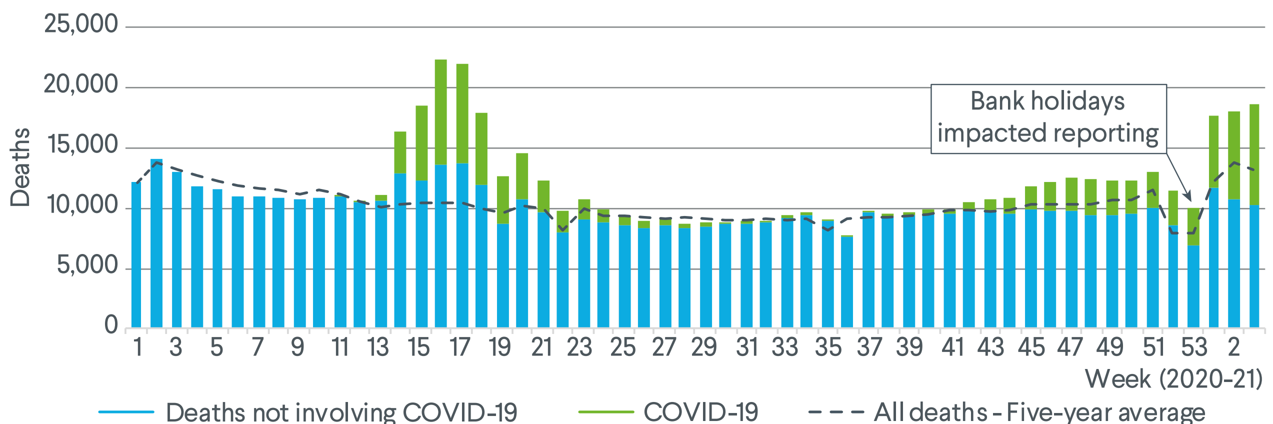
Lasting impact of COVID-19 on pension schemes

By Iain Pearce, Actuary and Risk Transfer Specialist

At the time of writing, nearly a year after the first confirmed case of COVID-19, the UK has entered a third national lockdown. While the approval of three different vaccines so far provides much-needed longer-term optimism, the short to medium-term outlook appears to be bleak, with rapidly rising levels of hospital admissions and deaths.

It's clear that the pandemic has impacted just about every part of society across the globe, and UK DB pensions looking to de-risk are no exception.

Chart 8: Weekly deaths since January 2020



Source ONS data: 6 January weekly coronavirus bulletin.

Immediate impact on liabilities and de-risking decisions

There have been c80,000 deaths in 2020 in excess of the 5-year reported average, equivalent to around 0.13% of the population of the United Kingdom. This is roughly 15% more deaths than in prior years and so will likely reduce obligations for pension schemes at a faster rate than previously anticipated.

Whilst COVID-19 has led to premature deaths for individuals of all ages, most related deaths have tended to be concentrated among older members of society and those with underlying health issues. These individuals have a shorter life expectancy than an average pension scheme member, and so the impact on pension scheme liabilities from excess deaths associated with COVID-19 has been significantly less than the per-capita mortality statistics might suggest.

The relatively minor impact on liabilities may provide many trustees with the confidence to continue to de-risk their schemes' longevity exposure. The potential "regret risk" from paying a premium for members who may sadly pass away shortly afterwards may equate to around 0.01-0.03% p.a. in yield terms when spread over the life of the policy. This may well be viewed as a price worth bearing in a time of uncertainty, and may be cancelled out in part or in full by pricing at opportune times.

Longer-term impact on liabilities

It'll take some time for the longer-term impact of the pandemic on future mortality to become clear, and whether this will accelerate or slow down the steady improvements in life expectancies that are expected to resume following the pandemic. Whilst the long-term impact is unclear, it's possible that the impact on improvement trends is more significant than the direct impact of the pandemic. As set out below, there are reasons to be both optimistic and cautious about the longer-term outlook.

Lower longevity improvements

Short-term risk of COVID-19
There is a risk that we see further waves of infection as social distancing measures are relaxed.

Long-term risk of COVID-19
Disease could continue to be a risk (e.g. uncertainty around effectiveness of vaccines and new variants emerging).

Impaired long-term health
The long-term health of those who were infected with COVID-19 but survived the virus might be damaged.

Disruption to non-COVID care
Deterioration of patients with non-coronavirus conditions due to delays in treatment (e.g. cancer).

Global recession
A global recession may impact future public sector spending on health care.

Higher longevity improvements

Survivorship bias
The average health of the surviving population could be higher in the years following the outbreak.

Reduced circulation of flu
Change in social behaviour (e.g. increased handwashing) may reduce prevalence of flu and other infectious diseases in future.

Reduction in air pollution
Change in social behaviour may result in the reductions to air pollution persisting.

Reduction in smoking
Disease may have encouraged existing smokers to stop.

Health/social care funding increase
Issues with funding unearthed during the pandemic may be more likely to be addressed.

While COVID-19 has caused a tragic rise in deaths over the past year, the rollout of a number of successful vaccines will gradually improve the situation. However, in terms of the pandemic's impact on life expectancy, the outlook remains far from clear and it will likely take years before this is fully appreciated.

Longevity risk in the context of your journey

By Baljit Khatra, Actuary and Risk Transfer Specialist

Longevity is a key risk for pension schemes, becoming more prominent as other risks are reduced over time. There are a number of approaches to managing longevity risk, but ultimately the purpose of each is to improve a scheme's journey towards its own objective. This could be meeting members' benefits over the long-term through buy-out or run-off.

To understand the cost vs value equation of hedging longevity risk, it is important to consider the impact it has on the 'journey risk' by looking at the overall profile of investment, financial and longevity risk for a scheme over its journey towards its objective.

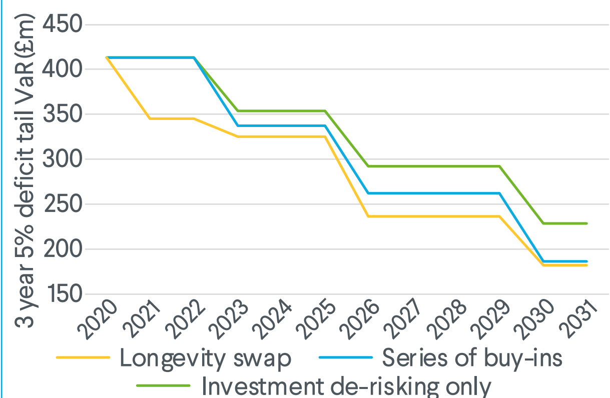
Buy-ins and longevity swaps are common insurance-based risk transfer tools to help manage longevity risk for a pension scheme, and these can both improve journey risk.

Which tool has the most impact depends on a scheme's specific circumstances, and the answer isn't simply the one that reduces the most longevity risk. In the context of journey risk, the timing, cost and tools used to manage longevity risk can all have an impact on achieving the best outcome.

Being able to map out and test the impact of different longevity risk hedging options all the way through the journey, as well as understanding the practical implications, helps to ensure longevity risk management decisions are undertaken in the wider context of journey risk.

Example: The chart below compares journey risk for a scheme looking to ultimately buy-out, either utilising a series of buy-ins once the investment strategy is able to support them (blue line), or by using a longevity swap to accelerate longevity de-risking (yellow line). Both approaches improve the journey risk (green line). Strategic preferences for each approach can then be weighed up in the context of risk as well as other factors.

Chart 9: Value-at-Risk over the journey to buy-out

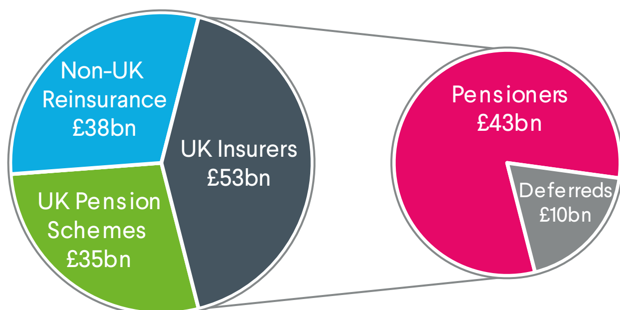


Longevity risk market

2020 has been a challenging year in many ways, but the longevity swap market has been resilient, busy and growing with more reinsurers competing in the UK than ever before.

Reinsurers are the ultimate holders of longevity risk in pension scheme longevity swaps and a significant proportion of buy-in/buy-out transactions. We estimate that reinsurers that are active in the UK longevity market have collectively written over £125bn of longevity reinsurance over the past two years. Chart 10 shows how the volume of this business has been split between longevity swaps with UK pension schemes, reinsurance for UK insurers (almost all of which sits behind buy-in/buy-out transactions), and longevity reinsurance outside of the UK. In terms of the number of transactions, this will have been dominated by longevity reinsurance for insurers writing buy-in/buy-out business – most insurers have easily repeatable “flow-treaties” to very efficiently undertake lots of medium sized longevity reinsurance transactions.

Chart 10: Longevity reinsurance activity over previous 24 months (c£126bn)



Hymans Robertson estimate based on our survey of the reinsurance market. Activity covers reinsurers offering longevity-only reinsurance in the UK including directly to pension schemes.

Interestingly, over the last year or so, demand for longevity reinsurance from the Netherlands spiked considerably, as low interest rates led to Dutch insurers reassessing their capital management approach and using longevity reinsurance to improve solvency. This sizeable demand impacted resource this year in the UK market, not least because of the nascent Dutch market not having the same transaction efficiency typically achieved in the UK. However, this feature of the market is expected to be short-term, as Dutch demand is limited to existing annuity portfolios which are not growing in the way they are in the UK.

Demand from the UK bulk annuity market has driven innovation in longevity reinsurance for deferred members (members yet to retire). As schemes mature and buy-outs become more prevalent, the demand for reinsuring deferred members has been increasing. As shown in Chart 10, over the last two years around one-fifth of the longevity reinsurance supporting buy-in/buy-out business has been in respect of deferred members.

As it stands, around half of reinsurers are willing to cover longevity risk for deferred members and many others are actively looking at providing this cover. This ‘coming of age’ has led to lower deferred reinsurance costs, which in turn reduces buy-out pricing. Lower deferred reinsurance costs has also prompted pension schemes to consider including deferred members as part of longevity swaps, to increase the level of longevity risk reduction.

We expect strong demand for longevity reinsurance to continue, primarily driven by maturing UK pension schemes seeking buy-in/buy-out or longevity swap transactions. However, reinsurers’ resource to price and implement new business is likely to continue to be a key influence in the supply, mitigated to some degree with new reinsurers now joining the market.

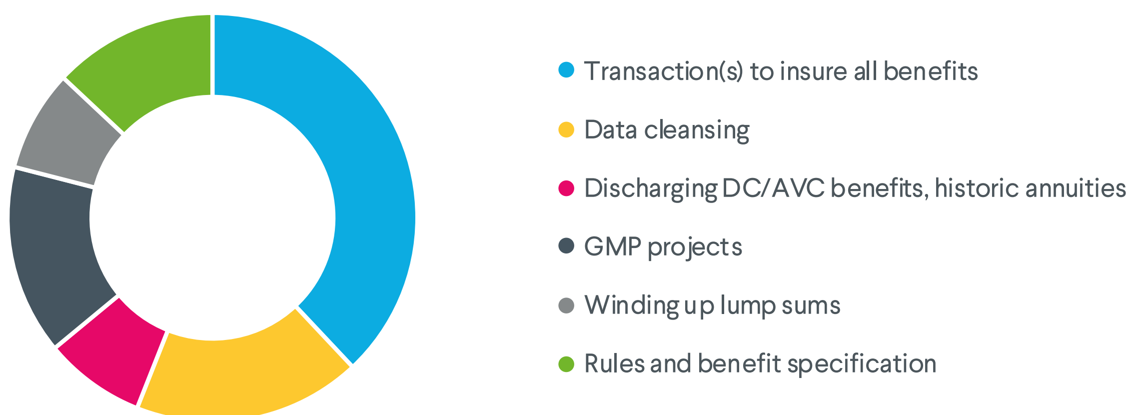
5. Getting buy-out ready

Buy-in is only the beginning

By Christine Cumming, Head of Wind Up and **Eloise Richer**, Actuary and Wind Up Specialist

Buying-out all scheme liabilities and winding up the scheme is often the most complex task a board of trustees will ever face. Even after trustees have done all the work to complete a buy-in transaction (or a number of buy-ins) covering all of their liabilities, there can still be a number of sizeable projects needed before the scheme is ready to ultimately wind up. The chart below gives a high level illustration of the split of the necessary time, effort and costs associated with the key steps along the journey to ultimate wind up.

Chart 11: Time, effort and cost split associated with winding up



Here we consider what the key steps are post buy-in. In our experience understanding these steps helps trustees plan and work towards a more timely and cost effective buy-out and wind up.

Data cleansing

Scheduling data cleansing work can be broken down into three key stages; pre buy-in, post buy-in and buy-out readiness as set out below.

Data issue	Pre buy-in	Post buy-in data cleanse	Buy-out readiness
High level reasonableness checks	✔ (green)		
Marital status / spouse date of birth	✔ (dark grey)	✔ (green)	
Member tracing: existence checks and find missing postcodes	✔ (dark grey)	✔ (green)	
Correct 'known' discrepancies identified as part of the pre buy-in and insurer checks		✔ (green)	
Identify 'unknown' discrepancies by carrying out sample checks, and obtaining reviews from advisors / trustees			✔ (green)
GMP Projects		✔ (green)	✔ (dark grey)

Green ticks represent the recommended stage to complete the data work, however the work could equally be carried out in the stage indicated by the dark grey tick.

Before going to market (pre buy-in), most schemes will have already carried out some high level checks on the completeness and reasonableness of their data. Following the signing of a buy-in contract, the scheme will typically have a period of 12-18 months to cleanse the data (post buy-in data cleanse), with an associated adjustment made to the insurance premium. At this stage, we would expect schemes to correct any data issues found and to carry out any GMP projects required.

After completing those checks which can be time consuming and sometimes costly, it's easy to think the data must be completely cleansed. When preparing for buy-out and wind up, it's the scheme's last chance to ensure that the insurer has all the required data schedule and benefit specification in order to pay the right people the right benefits at the right time[1]. Therefore, trustees need to decide what cleansing is appropriate in order to remove the risk that benefits are later found to be incorrect. Any unknown data issues that arise at this final stage have the potential to increase the insurance premium, as well as incurring additional time and cost.

Discharging AVC / DC benefits and historic annuities

When a scheme puts in place a buy-in, the scheme largely continues to run as normal. However, if a scheme has any DC or AVC benefits or historic annuities, these must be discharged before the scheme can wind up. Investigating the scheme's options early, including whether your chosen insurer can take these on as part of your final buy-in transaction, is key to avoid missing out on a cost-effective solution. When it comes to historic annuities, often schemes lack documentation which can add to the complexity and time required to deal with them. Trustees will also need legal help to discharge policies.

GMP Projects

As you move towards buy-out and wind up, GMP equalisation has the potential to stall progress. Many schemes will already have buy-ins in place which do not allow for equalised GMPs as, until recently, there has been a lack of clarity around how to equalise benefits – these will need to be updated. In addition, joining up data cleansing work with any work needed to ensure you have the necessary data for GMP equalisation calculations can save both time and money by avoiding repeated investigations.

Winding up lump sums

Members with relatively small benefits may be eligible to take a winding up lump sum; a one-off cash lump sum may have more value to some members than a small monthly pension. While it's not mandatory for trustees to offer this, the merits and drawbacks should be carefully considered. For some schemes, the added flexibility for members may outweigh the costs and added timescales.

Rules and benefit specification

On buy-out the insurer only takes on the schedule of data and the benefit specification signed off by the trustees; therefore, it's vitally important that this includes everything that is necessary to pay the right members the right benefits at the right time. It goes without saying that this document must undergo thorough scrutiny; by the legal advisor, by the administration team to check against current practices and by the trustees to ensure it hard-codes any discretions they want to apply post wind up.

Taking out a buy-in policy (or policies) and insuring all of the scheme's liabilities is a great position for trustees to be in. However, there's still more work, time and costs required to ultimately wind up the scheme. Understanding the remaining key projects is crucial to developing a cohesive project plan to take you from buy-in to buy-out and, ultimately, wind up as cost-efficiently as possible. Tackling work early on in the process that later projects rely on, will stand you in good stead for winding up within a reasonable timescale after reaching buy-out.

[1] As per TPR's Guide to Good Record Keeping - https://www.thepensionsregulator.gov.uk/en/trustees/managing-db-benefits/governance-and-administration/record-keeping

Residual risk cover

By Iain Chuch, Actuary and Risk Transfer Specialist and **Emma Horsfield,** Risk Transfer Specialist

Residual risk
Definition: Risks not covered by a traditional buy-out policy, such as data errors and missing beneficiaries.

It almost goes without saying, but buying-out and winding up a pension scheme is perhaps the most significant step that trustees can take, signalling the end of the life of the pension scheme in its current form. Importantly, trustees will need to be satisfied that they have secured the correct entitlements for their members.

A buy-out starts as a buy-in, providing an income to the scheme intended to match the scheme's benefit outgo before the policy is converted to individual annuities at the point of buy-out.

In the case of a standard buy-out, the actual benefits insured are only based on the data and benefit specification sent to the insurer, so if there is an error in either of these, the insurer is not on the hook.

The trustees then have a number of months to address any errors before individual policies are issued. If any errors are found, there will be an adjustment to the initial buy-out premium to reflect these.

What happens if errors are found following full wind up of the scheme? In practice, following a robust data cleanse, this is something that should rarely occur, but is not unheard of. For example, a deferred member who has been excluded from the buy-out in error, or a spouse pension incorrectly recorded in the data. We use the term "residual risk" to cover the risk of any such error transpiring following buy-out.

Trustees and sponsors have a number of options for dealing with such risks, which we summarise in the following table.

Options for residual risks

	Run-off cover	Sponsor indemnity	Residual risk cover
What is it?	Cover for defined risks in exchange for a premium. Typically, time and claim amount limited. Many policies will only cover the legal costs associated with dealing with claims, with only some policies also covering some element of data and benefit risk.	An indemnity provided by the sponsor to the trustees in respect of any liabilities that may arise which are not covered by the buy-out policy. Likely to be combined with some element of run-off cover.	Cover provided by the buy-out insurer for residual risks. Level of cover varies, but may include: • Data and benefit errors. • GMP equalisation methodology. • Missing beneficiaries.
Availability	Readily available from specialist insurers.	Available to all schemes where sponsor is a going concern.	Provided by buy-out insurer. Availability will vary based on insurer capacity and appetite, but typically only available for £200m+ buy-outs.

The first port of call for most schemes will be sponsor indemnity post wind up, as this is indeed the status quo prior to wind up, with the sponsor being responsible for the liabilities within the scheme. As noted in the table, this would typically be supplemented with some sort of run-off cover.

If the sponsor is unwilling to give an indemnity, or the terms are not satisfactory to the trustees, they can consider residual risk cover for larger buy-outs (c.£200m+) from a buy-out provider in the case of a successful claim post wind up. This is broader in scope than run-off cover, usually with no time or monetary limit on claims. It also provides members with a single port of call for any issues that arise. Of course, it does come at a cost.

Determining the cost

Prior to providing residual risk cover, buy-out providers need to do their own due diligence on the scheme. This will include commissioning a legal firm to comb through the scheme's past – rules, member communications, minutes... in essence, everything! This exercise is time and cost intensive, and so insurers will typically only be willing to put in the work at, or close to, the point of exclusivity with a pension scheme.

The cost of providing residual risk cover typically ranges from around 0.5% to 1.5% of the buy-out premium, depending on the level of cover sought and the extent to which issues are identified by the insurer during their due diligence. However, it's important to understand that if the insurer identifies any particular issues during due diligence, it will factor these into the cost of the buy-out premium before adding the 0.5% to 1.5% loading, which deals with the *unknown unknowns*.

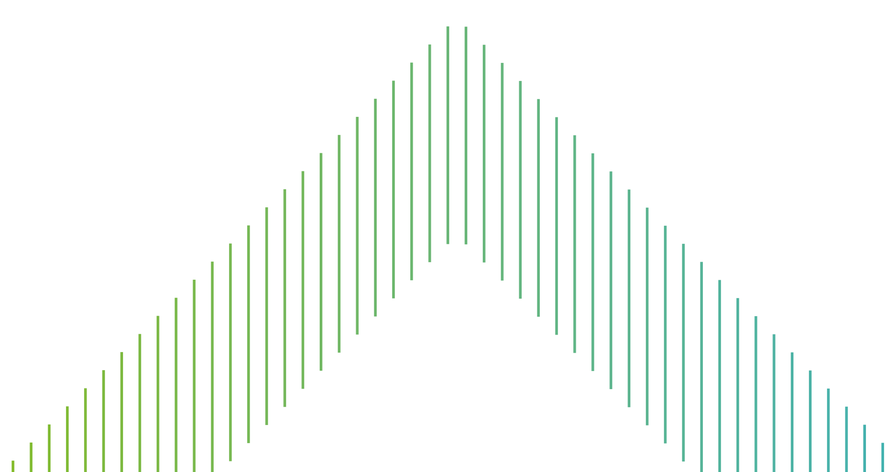
If the insurer and the trustees take a different view on the likelihood of an issue occurring in the future, this can cause some interesting negotiations and choices for both parties. If the insurer identifies an issue that it believes is material but the trustee does not, the trustee can choose between paying the premium for that issue or exclude it from the cover. And if they do consider paying, they may wish to also amend the benefits accordingly to pass any value straight through to members.

An alternative approach

One of the complicated aspects of investigating residual risk cover is the fact that it typically comes late in the insurer selection process, which means that schemes may risk losing leverage with the insurer who is conducting the due diligence if competitive tension is lost.

An alternative approach is for schemes to commission their own due diligence prior to engaging with insurers. This is similar to the concept of a "vendor due diligence" pack in merger and acquisition scenario. Done well, it allows trustees to go into such a process more aware of the issues that may exist within the scheme, and allows insurers to provide more informed pricing and terms earlier in the broking process.

There are several issues associated with seeking residual risk cover that require careful consideration and planning. For these reasons, trustees and sponsors should engage early on in any buy-out process to agree how to deal with residual risks.



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Appendix II

Risk Transfer Market Data

Buy-outs and buy-ins during twelve month period ending 30 June 2020

The total value of buy-outs and buy-ins struck in H1 2020 was around £12.6 billion (around £38.8 billion for the year to 30 June 2020).

Buy-outs and buy-ins	Number of transactions completed			Value of transactions completed		
	H2 2019	H1 2020	Total	H2 2019	H1 2020	Total
Aviva	35	26	61	£2,738m	£3,082m	£5,820m
Canada Life	3	1	4	£49m	£73m	£122m
Legal & General	16	25	41	£4,009m	£3,176m	£7,185m
Pension Insurance Corporation	9	6	15	£1,225m	£3,507m	£4,732m
Phoenix	3	3	6	£670m	£1,080m	£1,750m
Just	12	10	22	£720m	£462m	£1,182m
Rothesay Life	6	4	10	£15,585m	£765m	£16,350m
Scottish Widows	3	1	4	£1,260m	£410m	£1,670m
Total	**87**	**76**	**163**	**£26,256m**	**£12,555m**	**£38,811m**

Longevity swaps

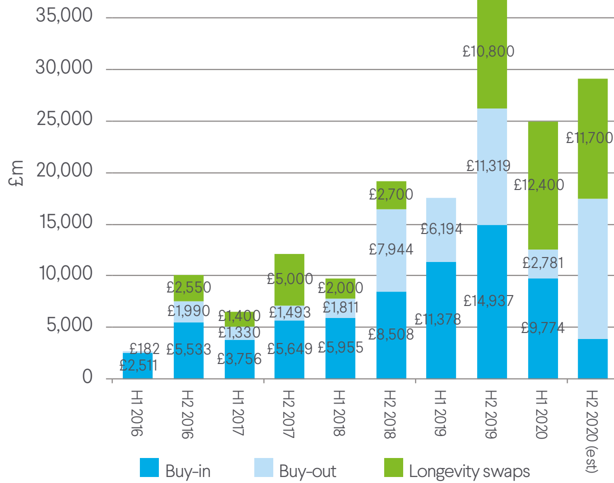
Forty eight longevity swaps covering liabilities worth £107 billion, have been completed since 30 June 2009.

Organisation	Date	No. of pension schemes	Provider	Approximate Value
Babcock	Q3 2009	3	Credit Suisse	£1.2 bn
RSA Insurance	Q3 2009	2	Rothesay Life	£1.9 bn
Berkshire	Q4 2009	1	Swiss Re	£1 bn
BMW	Q1 2010	1	Abbey Life	£3 bn
British Airways	Q3 2010	1	Rothesay Life	£1.3bn
Pall	Q1 2011	1	JP Morgan	£0.1 bn
ITV	Q3 2011	1	Credit Suisse	£1.7 bn
Rolls Royce*	Q4 2011	1	Deutsche Bank	£3 bn
Pilkington	Q4 2011	1	Legal & General	£1 bn
British Airways	Q4 2011	1	Rothesay Life	£1.3bn
Akzo Nobel	Q2 2012	1	Swiss Re	£1.4 bn
LV=*	Q4 2012	1	Swiss Re	£0.8 bn
BAE Systems	Q1 2013	1	Legal & General	£3.2 bn
Bentley	Q2 2013	1	Abbey Life	£0.4bn
Carillion	Q4 2013	5	Deutsche Bank	£1bn
AstraZeneca	Q4 2013	1	Deutsche Bank	£2.5bn
BAE Systems	Q4 2013	2	Legal & General	£1.7bn
Aviva	Q1 2014	1	Own insurer conduit- Munich Re, Scor Se and Swiss Re	£5bn
BT	Q2 2014	1	Own insurer conduit - PICA	£16bn
PGL*	Q3 2014	1	Own insurer conduit - Phoenix Life	£0.9bn
MNOPF *	Q4 2014	1	Own insurer conduit - Pac Life Re	£1.5bn
ScottishPower	Q4 2014	1	Abbey Life	£2bn
AXA UK	Q3 2015	1	Own insurer conduit - RGA	£2.8bn
Heineken	Q3 2015	1	Aviva	£2.4bn
RAC (2003) Pension Scheme	Q4 2015	1	Own insurer conduit - Scor Se	£0.6bn
Unnamed	Q4 2015	1	Zurich	£0.09bn
Serco*	Q4 2015	1	Undisclosed	£0.7bn
Pirelli Tyres Limited	Q3 2016	2	Zurich	£0.6bn
Manweb Group	Q3 2016	1	Abbey Life	£1bn
Unnamed	Q4 2016	1	Zurich	£0.05bn
Unnamed	Q4 2016	1	Legal & General	£0.9bn
Unnamed	Q1 2017	1	Zurich	£0.3bn
Skanska	Q2 2017	1	Zurich	£0.3bn
SSE*	Q2 2017	1	Legal & General	£0.8bn
Marsh & McLennan Companies	Q3 2017	1	Own insurer conduit - Canada Life Re and PICA	£3.4bn
British Airways*	Q3 2017	1	Own insurer conduit - Canada Life Re and Partner Re	£1.6bn
National Grid	Q2 2018	1	Zurich	£2.0bn
Lafarge	Q3 2018	2	Own insurer conduit - Munich Re	£2.4bn
Unnamed	Q3 2018	1	Legal & General	£0.3bn
HSBC	Q3 2019	1	Own insurer conduit - PICA	£7.0bn
HSBC	Q3 2019	1	Own insurer conduit - Swiss Re	£3.0bn
Unnamed	Q4 2019	1	Zurich	£0.8bn
Lloyds Banking Group	Q1 2020	3	Scottish Widows - Pacific Life Re	£10.0bn
Willis Towers Watson	Q1 2020	1	Own insurer conduit - Munich Re	£1.0bn
UBS	Q2 2020	1	Zurich - Canada Life Re	£1.4bn
Prudential	Q4 2020	1	Own insurer conduit - Pacific Life Re	£3.7bn
Barclays	Q4 2020	1	Own insurer conduit - RGA	£5.0bn
BBC	Q4 2020	1	Zurich - Canada Life Re	£3.0bn
Total to date		**48 (deals)**		**£107bn**

*Since the original swap transaction date these have been converted to buy-ins.

Risk transfer transactions (including longevity swaps)

Total pension scheme risk transfer transactions over the last year covered liabilities of around £59.0 billion.

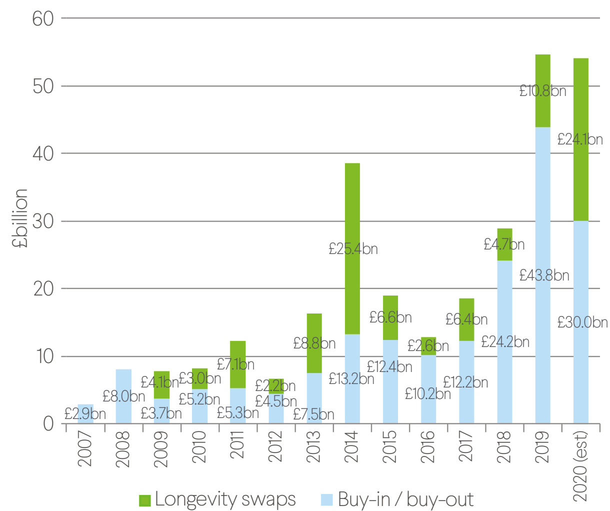


Average buy-in and buy-out transaction size

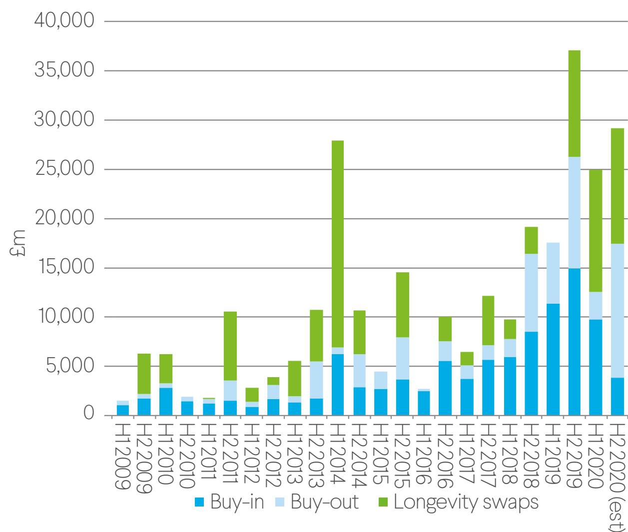
The overall average buy-in/buy-out deal size for the last year was £238 million, which is a small increase compared with the average of £211m over the year to 30 June 2019.

	Total value of transactions	Total number of transactions	Average transaction value
Aviva	£5,820m	61	£95m
Canada Life	£122m	4	£31m
Legal & General	£7,185m	41	£175m
Pension Insurance Corporation	£4,732m	15	£315m
Phoenix	£1,750m	6	£292m
Just	£1,182m	22	£54m
Rothesay Life	£16,350m	10	£1,635m
Scottish Widows	£1,670m	4	£418m
Totals	**£38,811m**	**163**	**£238m**

Volume of risk transfer transactions since 2007 up to H1 2020



Half-yearly risk transfers since 2009



Insurer summary insights

Aviva

2009 to end of H1 2020

Transactions completed	Value of transactions	Average transaction size
540	**£16.9bn**	**£31m**

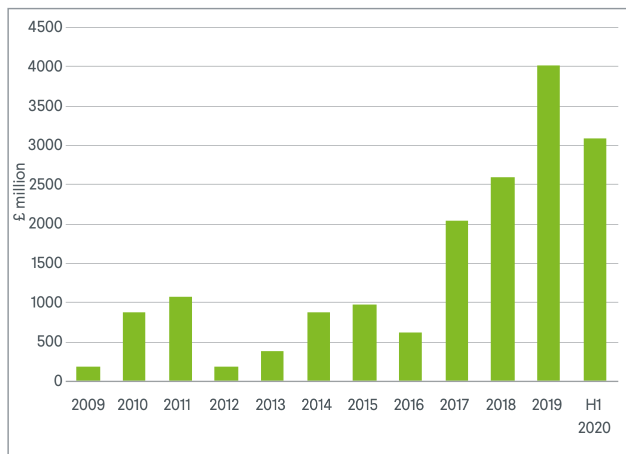
Twelve months ending 30 June 2020

Market share	Number of transactions	Average transaction size
13%	**61**	**£95m**

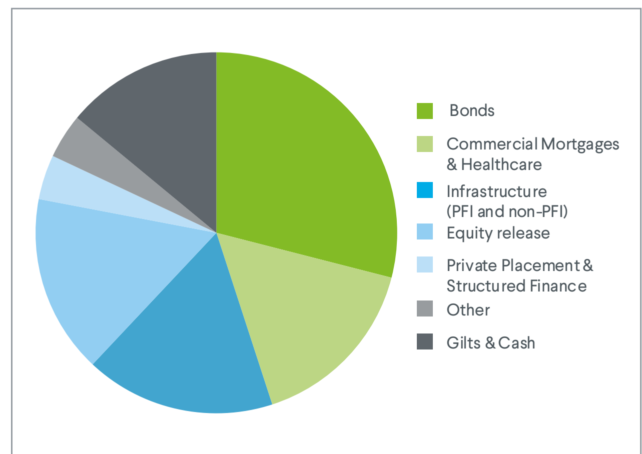
Noteworthy recent transactions

Aviva completed a £1bn buy-in with the Co-operative Pension Scheme in January 2020, as well as a £875m buy-in with the Aviva Staff Pension Scheme announced in November 2020.

Volume of DB annuity transactions



Annuity asset strategy



Financial strength – Aviva Life & Pensions UK Ltd

AKG	Fitch Rating	Moody's Insurance Financial Strength Rating	S&P Financial Strength Rating
"A" (superior) (March 2019)	**AA-** (stable) (October 2020)	**Aa3** (November 2019)	**AA-** (September 2020)

Team size

169

(including internal support and administration teams).

Insurer summary insights

Canada Life

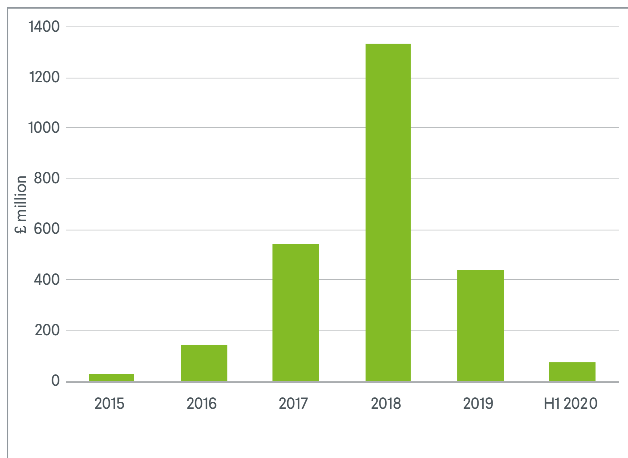
2009 to end of H1 2020

Transactions completed	Value of transactions	Average transaction size
25	**£2.5bn**	**£103m**

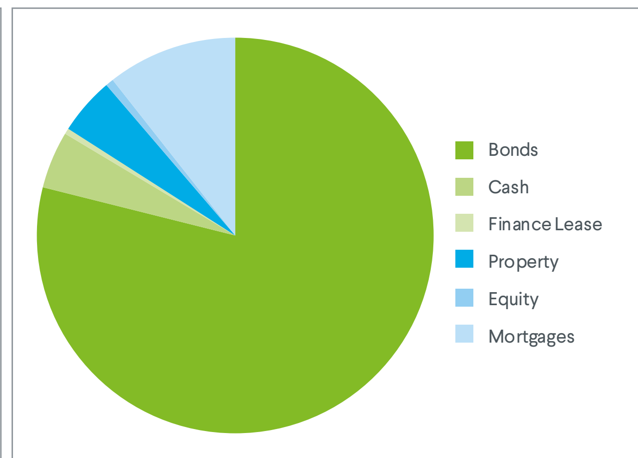
Twelve months ending 30 June 2020

Market share	Number of transactions	Average transaction size
‹1%	**4**	**£31m**

Volume of DB annuity transactions



Annuity asset strategy



Financial strength – Canada Life Ltd

AKG

"B+" **(very strong)**

(October 2020)

Team size

20

Insurer summary insights

Just

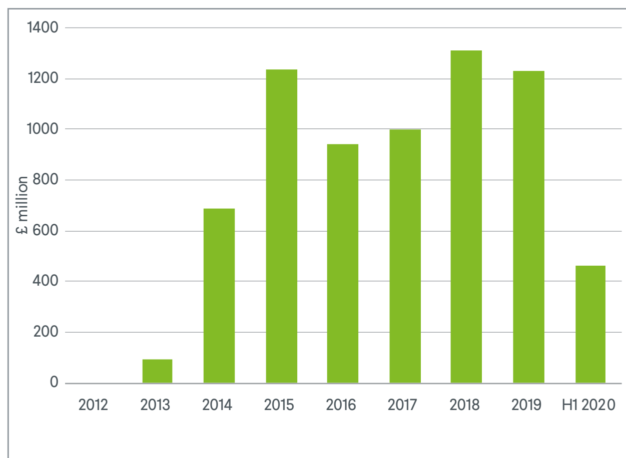
2009 to end of H1 2020

Transactions completed	Value of transactions	Average transaction size
192	**£6.9bn**	**£36m**

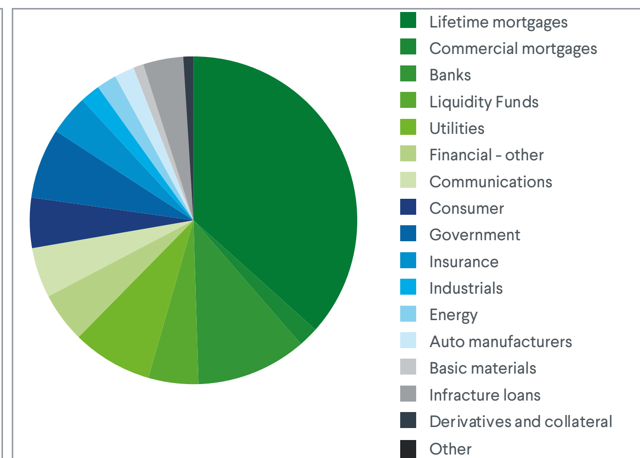
Twelve months ending 30 June 2020

Market share	Number of transactions	Average transaction size
3%	**22**	**£54m**

Volume of DB annuity transactions



Annuity asset strategy



Financial strength - Just Retirement Ltd

AKG

"B+" (very strong)
(July 2020)

Fitch Rating

A+
(October 2020)

Team size

87
(includes administration team and internal support functions).

Recent developments

Just has become the first UK insurer to launch a green bond which has raised £250m.

Legal & General

2009 to end of H1 2020

Transactions completed	Value of transactions	Average transaction size
700	›£42.0bn	£60m

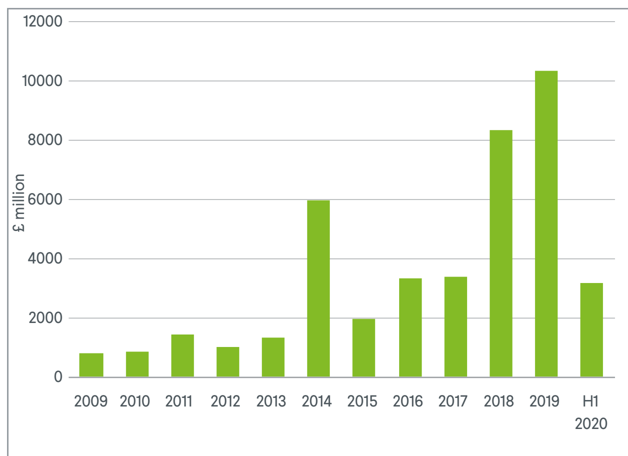
Twelve months ending 30 June 2020

Market share	Number of transactions	Average transaction size
16%	41	£175m

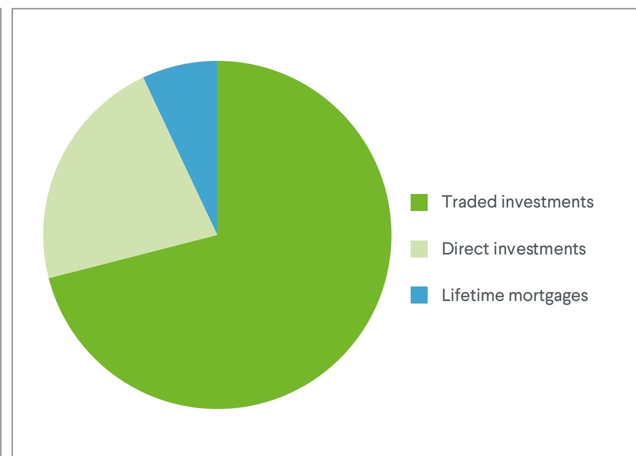
Noteworthy recent transactions

Legal & General completed a £1.1bn buy-in and assured payment policy deal with Allied Irish Bank in February 2020, a £650m buy-in with 3i Group in May 2020 and a £530m buy-in with Siemens in August 2020.

Volume of DB annuity transactions



Annuity asset strategy



Financial strength – Legal & General Assurance Society

AKG	Fitch Rating	Moody's Insurance Financial Strength Rating	S&P Financial Strength Rating
"B+" (very strong) (February 2020)	AA- (August 2020)	Aa3 (April 2020)	AA- (July 2020)

Team size

c250
(including in-house buy-out administration team).

Insurer summary insights

Pension Insurance Corporation (PIC)

2009 to end of H1 2020

Transactions completed	Value of transactions	Average transaction size
209	£38.2bn	£183m

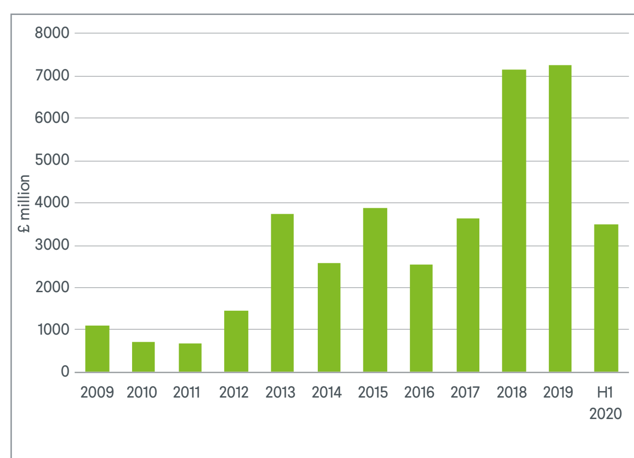
Twelve months ending 30 June 2020

Market share	Number of transactions	Average transaction size
11%	15	£315m

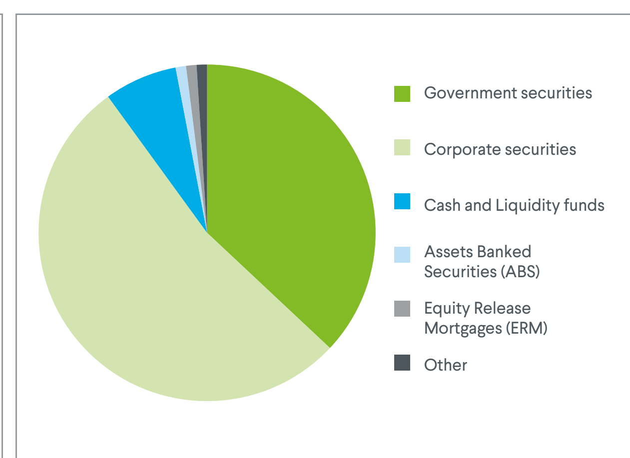
Noteworthy recent transactions

PIC completed a £1.6bn buy-in with the Merchant Navy Officers Pension Fund in February 2020, a £1bn buy-in with the Co-operative Pension scheme in February 2020 and a £2bn PPF+ buy-out with the Old British Steel Pension Scheme.

Volume of DB annuity transactions



Annuity asset strategy



Financial strength - Pension Insurance Corporation plc

AKG	Fitch Rating
"B" (strong) (August 2019)	**A+** (October 2020)

Team size

50

Recent developments

PIC raised £750m of new capital from its shareholders in February 2020 to fund a pipeline of new pension risk transfer deals expected to complete in 2020.

PIC provided £277m of debt funding for eight Spanish solar parks renewable energy investment vehicles.

Insurer summary insights

Phoenix

2009 to end of H1 2020

Transactions completed	Value of transactions	Average transaction size
12	**£5.2bn**	**£439m**

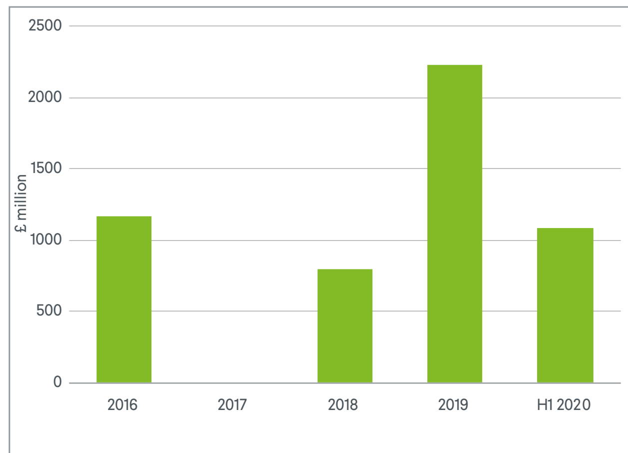
Twelve months ending 30 June 2020

Market share	Number of transactions	Average transaction size
4%	**6**	**£292m**

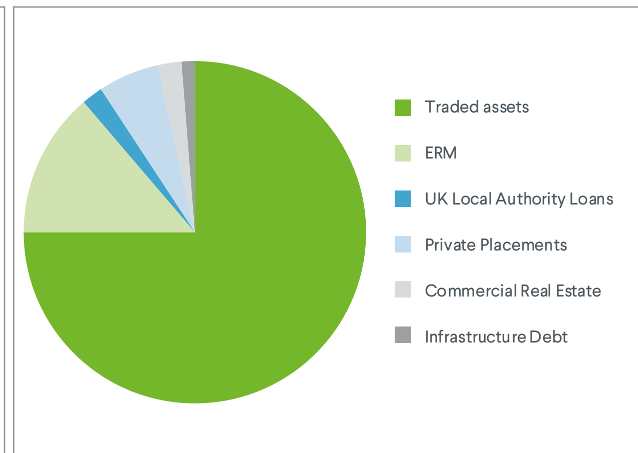
Noteworthy recent transactions

Phoenix completed a £800m longevity swap to buy-in conversion with LV= in July 2020.

Volume of DB annuity transactions



Annuity asset strategy



Financial strength - Phoenix Life Ltd

AKG	Fitch Rating
"B" (strong) (October 2018)	**A+** (August 2020)

Team size

25

Recent developments

Andy Briggs has joined Phoenix as chief executive from Aviva.

Tom Ground joined Phoenix from Aviva in January 2021 as Managing Director of its Retirement Services business unit.

Rhian Littlewood has joined Phoenix as head of life BPA and reinsurance from Aon.

Insurer summary insights

Rothesay

2009 to end of H1 2020

Transactions completed	Value of transactions	Average transaction size
›51	£28.1bn	£552m

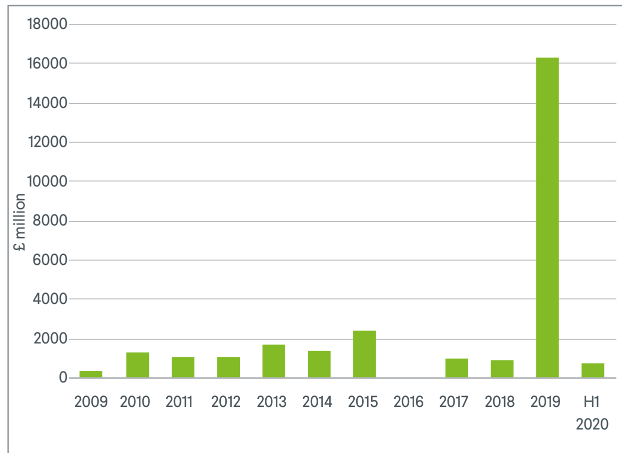
Twelve months ending 30 June 2020

Market share	Number of transactions	Average transaction size
37%	10	£1.63bn

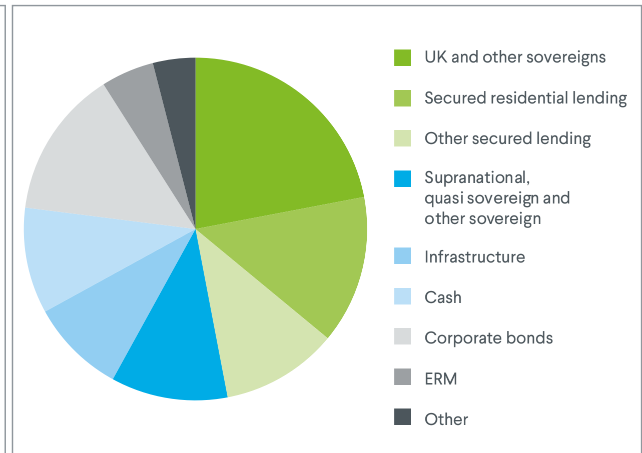
Noteworthy recent transactions

Rothesay completed a £930m buy-in with Littlewoods in July 2020 and a £610m full buy-in with Marathon Services (RockRose) in July 2020.

Volume of DB annuity transactions



Annuity asset strategy



Financial strength - Rothesay Life plc

AKG	Fitch Rating	Moody's Insurance Financial Strength Rating
"B+" (very strong) (February 2021)	**A+** (July 2020)	**A3** (July 2018)

Team size

89

Insurer summary insights

Scottish Widows

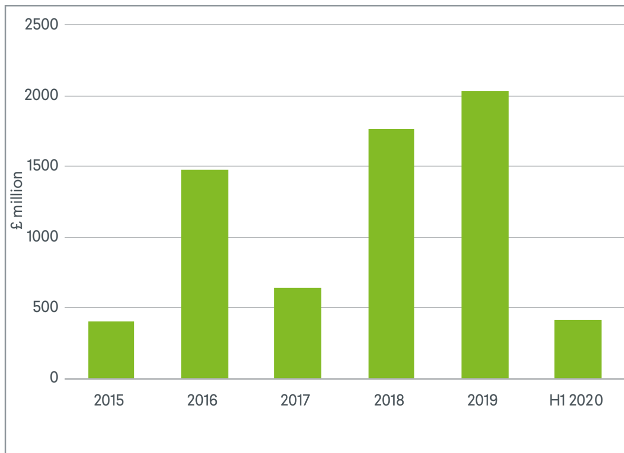
2009 to end of H1 2020

Transactions completed	Value of transactions	Average transaction size
29	£6.7bn	£232m

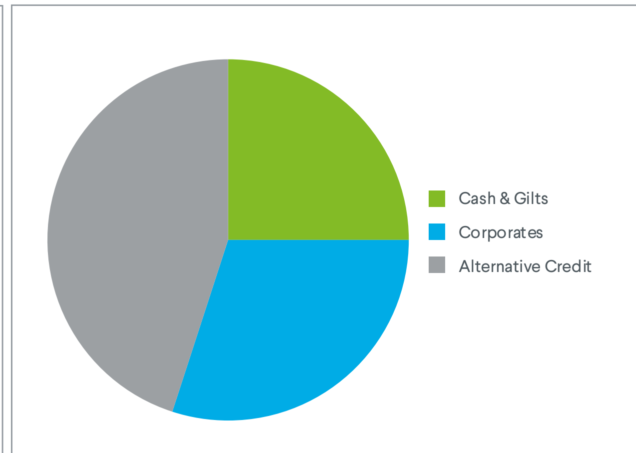
Twelve months ending 30 June 2020

Market share	Number of transactions	Average transaction size
4%	4	£418m

Volume of DB annuity transactions



Annuity asset strategy



Financial strength - Scottish Widows Ltd

AKG	Fitch Rating	Moody's Insurance Financial Strength Rating	S&P Financial Strength Rating
"B+" (very strong) (November 2020)	**AA-** (September 2020)	**A2** (November 2020)	**A** (November 2020)

Team size

c75
(includes internal support teams).

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Derivatives

All forms of derivatives can provide significant benefits, but may involve a variety of significant risks. Derivatives, both exchange-traded and OTC, include options, forwards, swaps, swaptions, contracts for difference, caps, floors, collars, combinations and variations of such transactions, and other contractual arrangements (including warrants) which may involve, or be based upon one or more of interest rates, currencies, securities, commodities, and other underlying interests. The specific risks presented by a particular derivative transaction depends upon the terms of that transaction and your circumstances. It is important you understand the nature of these risks before entering into a derivative contract.In general, however, all derivatives involve risk including (amongst others) the risk of adverse or unanticipated developments of a market, financial or political nature or risk of counter-party default. In addition, you may be subject to operational risks in the event that your manager(s) does not have in place appropriate legal documentation or internal systems and controls to monitor exposures of this nature.

In particular, we draw your attention to the following: -

• Small changes in the price of the underlying security can lead to a disproportionately large movement, unfavourable or favourable, in the price of the derivative.
• Losses could exceed the amount invested. There may be a total loss of money/premium. Further, an investor may be called on to make substantial additional payments at short notice. Failure to do so in the time required can result in additional loss.
• The right to subscribe is invariably time limited; if such a right is not exercised within the pre-determined timescale, the derivative may be rendered worthless.
• Not all derivatives are liquid (that is, they may be difficult or, at times, impossible to value or sell). You may incur substantial costs if you wish to close out your position. OTC derivatives in particular can introduce significant liquidity risk and other risk factors of a complex character.
• OTC derivatives may result in exposure to the creditworthiness of the derivative counter-party.
• Derivatives used as part of 'protection' strategies may still expose the investor to an unavoidable difference between the underlying asset (or other interest) and the protection offered by the derivative.

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