Longevity Trends 2020

How longevity is disrupting the world across health, science, business, technology and financial services

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3.3 How the pension de-risking market can overcome obstacles to further growth

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Many of the obstacles preventing the further growth of the pension de-risking market stem from trustees' desire to future-proof and ensure the flexibility of the terms of the arrangements that they enter into. Although most trustees are on a "de-risking journey", their individual circumstances may present difficult decisions over whether to take actions sooner that would help them, but which might hinder them down the line; or simply wait with certain of their risks unhedged. However, the industry has been evolving and seeking solutions for these challenges.

Conversions of Longevity Swaps to Buy-Ins/Outs

In relation to the longevity de-risking market, a key obstacle for some schemes has been the lack of straightforward mechanics for converting longevity swaps to buy-in/out transactions. While this challenge remains a topic of concern, given the difficulty of "hard-wiring" any legally binding conversion mechanics and an increasing desire to transact without undue complexity, trustees may gain confidence from the increasing number of schemes with swaps successfully achieving a conversion.

Several insurers active in the buy-in market have devoted considerable time and effort to agreeing a set of framework terms for hedging their longevity risk with a panel of preferred reinsurers. Framework terms allow for additional tranches of risk to be reinsured on a largely agreed set of terms, with the specifics being captured in a confirmation for that particular transaction. The approach emerged in the buy-in market in recent years and has since been adopted for broader use by the insurance industry. This development affords insurers greater flexibility to take on a pension scheme longevity swap when the scheme wishes to move to a buy-in/out, as they can potentially accept the economic position (and price that into the buy-in/out transaction) and more easily migrate the terms of the pension scheme swap onto their existing reinsurance framework arrangements.

Consequently, the legal barriers for entry into longevity swaps for a more limited period may to some extent break down for pension schemes for which a buy-in/out does not make sense but hedging longevity risk would deliver benefits. Inevitably, trustees and insurers will still need to agree to some bespoke provisions at the time of conversion; for example, in relation to collateral provisions and other commercial matters. However, the recent success of several schemes in navigating this route suggests that market participants widely acknowledge that they must develop pragmatic solutions to this issue. New longevity swaps may also be able to better anticipate some of these conversion issues as the body of experience develops.

Flexibility for Insurers

Trustees clearly have a legitimate concern regarding solutions that can adapt to their needs over time. However, insurers have also been adjusting to uncertain times and a high degree of regulatory change and focus that shows no signs of abating. The challenges of Brexit and its impact upon cross-border licensing has been an issue requiring consideration for most insurers active in the de-risking space.

In the buy-in/out market, contractual terms have undergone adjustment in recent years as the volume of de-risking transactions has grown and new entrants have joined the market. A high-water mark may have occurred in this respect in favour of pension schemes in late 2017 amid strong market competition. But during subsequent high-volume periods, the pendulum has clearly swung back to offer mild correction in favour of insurers in some areas where they have a legitimate need for future flexibility. For instance, insurers are solidifying their views around their own commercial needs to grow and develop their business models, including in the areas of index replacement and Part VII transfers. In addition, wider acknowledgement and understanding of the robustness of the UK insurance regulatory regime has assisted in bridging some of the historical expectation gaps between trustees and insurers regarding matters such as collateral and termination rights.

> *"Insurers have also been adjusting to uncertain times and a high degree of regulatory change and focus that shows no signs of abating"*

Will Private Equity Heighten Engagement in Pension Fund Consolidation?

Pension consolidation through "superfunds" has drawn widespread attention as a further strategy to help address the needs of corporates and pension schemes on their de-risking journey. However, several obstacles have loomed large over potential consolidators — including the fact that they have been stuck in a holding pattern until the conclusion of the UK government consultation process on superfunds, arguably another victim of the ongoing political turmoil in the UK. However, the announcement of the first deals has been long expected, which would clearly result in this part of the market turning the corner and becoming a more realistic option for pension schemes.

On the investment front, the private equity sector's involvement in this emerging segment of the de-risking market suggests that it may be poised to overcome the hurdles facing it. Private equity investment in leading UK bulk annuity providers, such as the Blackstone and GIC backing of Rothesay Life's successful and rapid development, has been a feature of the de-risking market for some years. These heavyweight investors, including TPG and Disruptive Capital Finance, have now become involved in backing the so-called "superfunds", and other strategic investments in this area seem likely to follow.

Notably, these early investments transpired despite the continued regulatory uncertainty (including around the potential future regime that may apply to superfunds, and their governance and control structures). Initial deal sizes may be relatively modest whilst proof of concept is firmly established; however, if we see deals starting to come through in early 2020, this limitation will only be temporary. In particular, those interested in the de-risking sector eagerly anticipate resolving the thorny issue of how to achieve the appropriate level of regulation to protect from regulatory arbitrage between insurance and pension consolidation models.

As a "bridge to buy-out", these structures may fill a perceived gap in the current market. They are also sometimes seen as a potential option for smaller schemes that perhaps lack the scale to feel successfully able to negotiate the buy-in market at an appropriate pricing point. However, the traditional insurance and investment management providers have created their own solutions for those schemes that are not yet at the stage of seeking a buy-in/buy-out, but which aim to access an investment strategy that helps them move closer to their goals. In a demonstrably innovative industry that has fuelled the rapid development of the buy-in/buy-out market, it may be a close race as to which of these alternative strategies gains real traction first.

Implications

The development of the pension consolidators may present some challenges to the insurance industry depending upon the final regulatory regime. Insurance regulators have emphasised the potential for arbitrage — a point well-observed by the industry itself as it grapples with its own exacting regulatory standards and the widespread use of longevity reinsurance to manage its bulk annuity business appropriately. However, at the level of activity seen in 2019, there clearly seems to be a gap for smaller schemes that may face difficulties gaining the attention of the insurers who are able to focus their efforts on larger deals as they build scale. Pension consolidators may offer an opportunity for these schemes to find a solution, as well as for those who have not yet reached funding levels that support an insurance solution.


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