RISK TRANSFER JOURNEY PLANNER

Q3 | 2024

Buy-out and other endgame options

Welcome to Quantum Advisory's Q3 2024 Journey Plan newsletter. Each quarter, our risk transfer team will bring you details of market pricing as well as sharing useful tips and experience to ensure that your risk transfer journey is as smooth as possible. This could be as a buy-in (where the members remain in the scheme) or a buy-out (where the members leave the scheme and are paid directly by the insurer).

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Pensioner buy-out & buy-in pricing

This note gives an update on pricing for pension schemes looking to buy bulk annuities for pensioners.

Overview of insurer pricing

Insurers price business based on gilt and corporate bond yields, plus the cost of setting aside regulatory capital, their desire for new business and how well any particular scheme would fit with their existing portfolio. This means there is no one figure for the buy-out cost for a pension scheme. However, we receive monthly data from a number of insurers which allows us to monitor how pricing moves over time.

Market background – financial drivers

Markets in Q2 2024 were fairly stable, but gilt yields rose by about 0.5% during the quarter while market implied inflation fell by about 0.1%. The net impact was lower insurer pricing for most benefits.

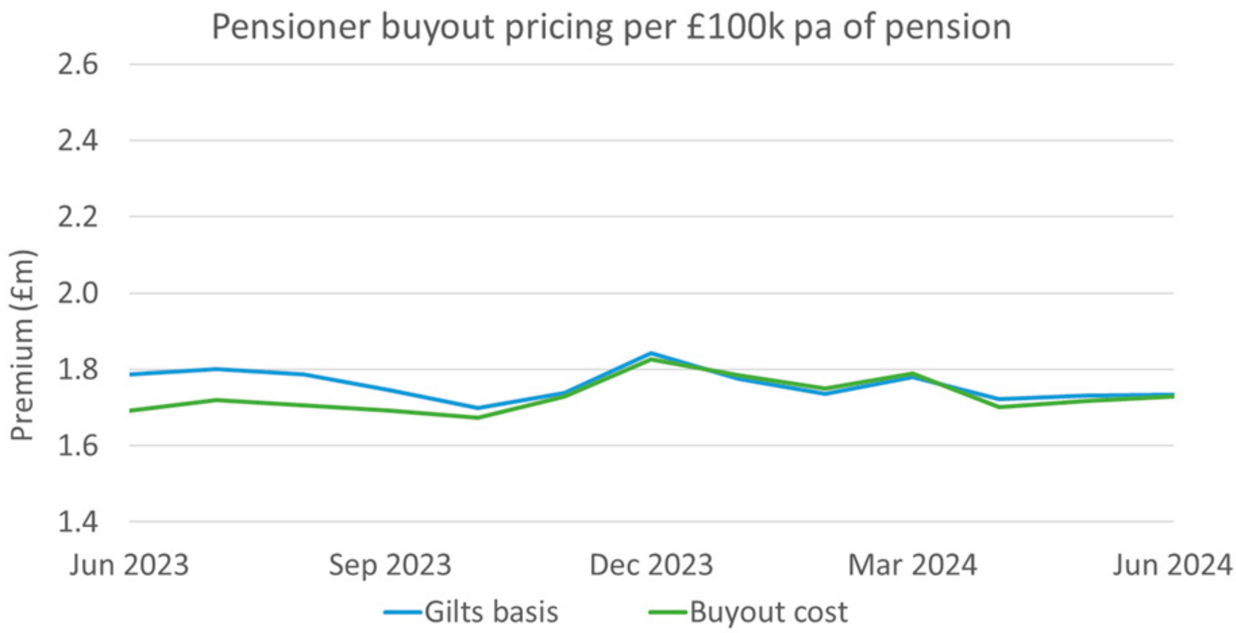
On the asset side, equities generally ended the quarter at a higher level to where they started, with equity prices up 10% and bond prices down 5%. The impact on individual schemes will depend on their asset allocation.

Pricing update and de-risking opportunities

The chart below shows that buy-ins for pensioners are becoming more expensive and are now roughly equal to the cost of funding the same benefits with a portfolio of gilts (shown by the green line being at the same level as the blue line).

A pension scheme looking to buy bulk annuities as a cash buyer will see pricing similar to a year ago, with little movement in absolute terms. However, pricing relative to gilts has increased to the point where a buyout might have a similar cost to holding a portfolio of gilts. Pricing will vary by scheme though and there will sometimes be opportunities to transact at more attractive prices.

Pricing for deferred members remains higher than for pensioners because of the additional risks they represent for an insurer. A scheme looking to sell gilts to fund a deferred member buy-in would still need to find an additional c10% on top of the value of the gilts.



The buy-in process

Transacting a buy-in will usually take a few months, but there are steps you can take to plan ahead and speed this up. These include:

- Ensuring that all Scheme documentation is in good shape, including common sticking points such as Barber benefit equalisation.
- Ensuring that your membership data is complete and accurate.
- Reconciling GMPs with HMRC, such that Trustee decisions are made, legal review completed and any benefit changes implemented or a timetable is agreed.
- Equalising GMPs for differences between male and female benefits, both for current members and historic transfers out.

Any schemes considering buying bulk annuities should be aware that insurer capacity will ultimately be limited by availability of assets and re-insurance. The steps above will help in showing insurers that you are serious when seeking quotes.

We can assist with planning for a buy-in if you are considering this route.

Next steps

Prices vary both between insurers and over time, so a full quote is the only way to obtain accurate pricing. If you would like more information, please speak to your usual Quantum contact.

Disclaimer

Quantum sources information from the insurance market monthly and is reliant on this information to produce pricing updates. This information is high-level and not specific to any individual pension scheme. Pricing for an actual scheme will therefore differ.

Administration during the buy-in process

When it comes to a buy-in, an area that is often considered after transaction pricing and member data quality is the change to administration services, both immediately post transaction and in the long term. Once a buy-in is complete, not only does the administrator need to continue carrying out the usual day-to-day duties of running a pension scheme, they must also incorporate a number of new tasks, which give rise to different challenges.

Administrator projects

Accurate and up to date member data, always important, becomes even more so once you enter into a buy-in contract. The data sent to the insurer at quotation stage directly affects the cost of securing the buy-in, so is naturally of vital significance. However, there are numerous data cleansing activities that are carried out after the buy-in is complete and a lot of emphasis is placed on the administrator to assist with these. Administrator resource is a key issue for many transactions and should be considered as early in the process as possible to ensure that the Trustee's contractual obligations can be met prior to committing to a transaction.

Administrators will be asked to carry out benefit audits to check that the data held is complete and accurate insofar as possible. They will also need to perform member write outs, seeking personal data directly from members, issuing communications to the different sections of the scheme membership, receive and record responses and to make any updates to member records as necessary. If benefit correction exercises are required, and often they are, then this will place further strain on an already busy administrator. They will often need to calculate the benefit changes required, communicate these with members and update systems accordingly. Data is usually lacking for these historic correction exercises and improvement work is then needed with any gaps needing suitable assumptions to address.

Trustees should ensure that administrators have generous resources and robust processes in place to carry out these tasks.

Benefit calculations

As part of a buy-in, Trustees will need to decide whether to continue calculating member benefits using their current administration systems, factors and calculation routines or to adopt the benefits calculated by the provider as part of the insurance contract payout.

The latter will mean a change in working practices. A working relationship will need to be established between the administrator and the provider and communication channels will need to be set up. Often, the administrator will also need to send the insurer requests for benefit calculations and transfers of funds, these will then be carried out by the insurer, the results sent back to the administrator and certain checks carried out, all before there has been any communication with the member. Ordinarily, the administrator must also regularly send the insurer details of member movements and any updates to member records. The administrator's workload will inevitably increase for member transactions so the cost of servicing these requests may also increase for Trustees.

The choice to continue with current administration systems or simply quote insured benefits will be driven by a myriad of factors. Trustees should consider whether the benefits insured are members' full and final benefit entitlements – this sounds simple but often differences between insured benefits and true entitlements arise when there are any known issues with the transaction data and/or benefit structure at the point of transaction. If the Trustees' tolerance for deviations in the final premium versus what is expected is low and there is a relatively short time to buy-out then quoting insured benefits is likely to be favoured. The number of transactions being undertaken during the buy-in period should also be considered, as should the time taken to service member requests under each of the approaches.

New administration practices

If the insurer is responsible for calculating benefits, it is usual for these to only be guaranteed for a limited time. While this is standard practice for cash equivalent transfer values, it may be new when it comes to retirement payments, which are usually based on relatively static scheme factors decided by the Trustees (and other relevant parties).

The administrator must ensure that members know that their benefits may change if claimed outside any guarantee period and also to have processes in place to request the transfer of funds from the provider if claimed inside any guarantee period, as failure to do so could lead to member dissatisfaction.

Member data changes during the buy-in are communicated to the insurer by the administrator too. Address changes, membership movements and more can often be sent to the insurer on a monthly basis to help with their data checks and balances at the point of buy-out.

Service Level Agreements

If the benefits quoted to the member are being calculated by the insurer there may be initial delays in processing member requests shortly after the buy-in, as the insurer will need time to set up new calculation models and processes. The administrator will need to adapt their communications to reflect the new procedures. Both will add to the time taken to get ready for business-as-usual post transaction.

These initial delays and any changes to turnaround times should be managed carefully with the membership and communicated clearly so expectations are set early on in the process. It is likely that Service Level Agreements will need to be changed (lengthened) from what Trustees and members have previously expected, to allow for the additional steps that are now required for quotations and payments.

Summary

When a pension scheme purchases a bulk annuity contract, it will encounter various challenges. Member data, benefit calculations, new administration practices and the time taken to perform previously routine scheme administration services need to be considered at an early stage.

Before any transaction takes place, Trustees should carefully consider how the member experience will change, making arrangements to smooth the transition as much as possible, and whether their current administrator will be well placed to deal with these challenges adequately when the time comes.

Development of the buy-out market

Whilst the infamous September 2022 mini budget may seem like a distant memory, the boom in the UK pension risk transfer market shows no sign of slowing down. Many trustees are looking to secure pension benefits where their scheme has seen a significantly improved funding position. While there are several options for trustees to consider, insuring benefits through a full scheme buy-out continues to be the most popular.

Insurers have been working hard to adapt quickly to the surge in demand, but capacity constraints within the insurance industry were inevitable. In addition to the shrinking availability of reinsurance, the sector has a limited number of specialists, and increasing the workforce is a long-term problem for the industry as a whole. As they fight it out for the same staff, insurers become more selective on the schemes they quote on and have heavily invested in streamlining processes and offering simplified solutions (in particular for smaller schemes).

Over recent years there have been eight insurers in the market. However, this is set to change with several key developments over the past year.

September 2023
M&G re-enter the market after two deals worth £617m. A further £309m deal completed in 2024.

March 2024
Royal London announces entrance to the market after deals with two internal schemes worth c£650m. External deals expected before the end of 2024.

March 2024
Rothesay acquire Scottish Widows bulk annuity portfolio for c£6bn.

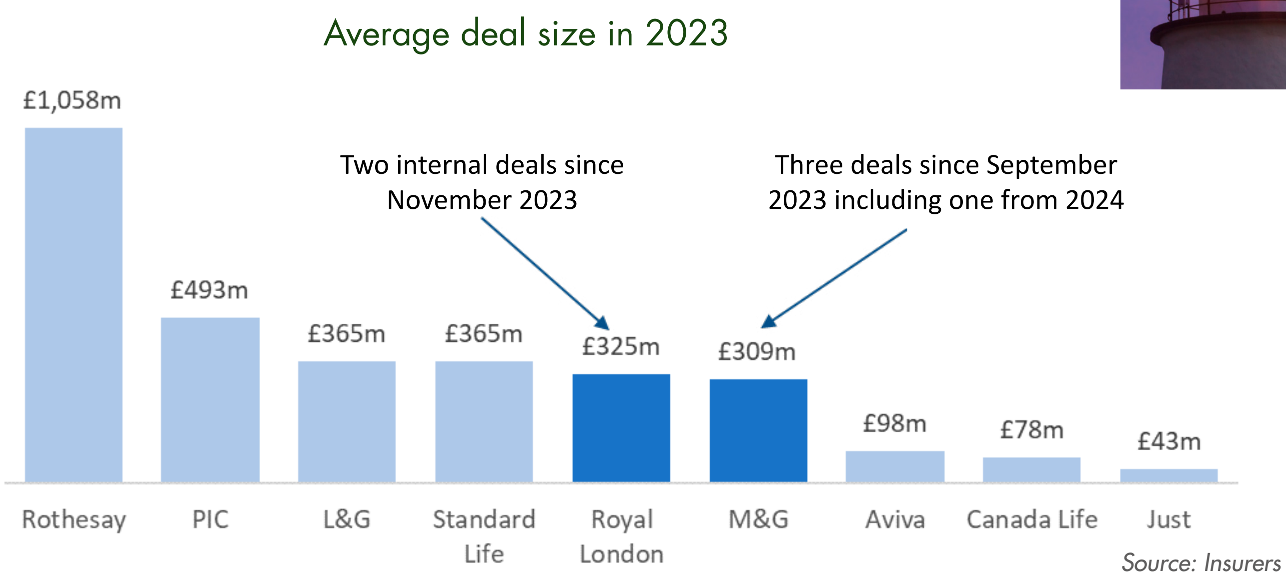
July 2024
Utmost reported to be entering the market, first transaction is expected to be completed next year.

July 2024
Brookfield, who have completed c$3bn of deals in the US, are reportedly looking to enter the UK market.

With the emergence of M&G and Royal London, soon to be followed by Brookfield and Utmost, and Rothesay's deal to purchase Scottish Widows' annuity book being agreed, this means there could potentially be eleven active insurers in the market that trustees could turn to for buy-out quotes.

Whilst a small number of insurers are whole-of-market, certain areas of the market tend to be served by specific insurers, with appetites driven by their wider business objectives. It is very unlikely that all insurers will quote on any one scheme. For example, currently a <£50m scheme is likely to receive quotations from Aviva, L&G, Just and possibly Canada Life, whilst the largest of deals are reserved for the likes of Rothesay, PIC and L&G. Many of the providers serve the market in between but current business volumes and scheme desirability will tend to drive the number of interested parties for these. Schemes with assets of £10m or less may struggle to find more than one insurer to quote and even if they do most quotations at the very small end are provided on an exclusive basis so a commitment to a provider must be made at the outset and a competitive process can’t always be followed.

Where do the new entrants fit into this? To date, M&G and Royal London have written three and two deals respectively, valued at a total of around £900m and £650m. They have not confirmed the range of scheme sizes they are targeting at this stage, and it is difficult to deduce given one of M&G’s deals and both of Royal London’s were their own “internal” schemes. Utmost and Brookfield aren’t yet quoting on deals. It is expected that at least Royal London and Utmost will provide greater competition at the smaller end of the market. Brookfield are expected to be targeting larger deals given their private equity backing however all providers are likely to be interested in schemes in the hundreds of millions, a space in which competition is already fierce.



Source: Insurers

More competition in the market should be beneficial to pension schemes. As the number of options for trustees increase, technically insurers need to work harder to attract their favoured deals from being serviced elsewhere. We can see benefits for trustees emerging in the following areas:

- **Reduced premiums** – More competition should lead to lower premiums as insurers fight to gain market share. We expect Royal London to focus at least some attention on the smaller end of the market and their mutual business model make-up may lead to more competitive pricing for small schemes which is very much welcomed.
- **Increased streamline offerings** – Just, Aviva, L&G and PIC offer streamlined services with standardised terms, data templates and transaction processes, making it easier to complete deals, particularly at the smaller end.
- **Fewer exclusive deals** – Commonly insurers provide quotations to pension schemes on an exclusive basis to reduce the amount of wasted resource in quoting for schemes where transactions don't materialise. We see the increase in insurers servicing the smaller end of the market and more common and efficient streamlining meaning that such resource wastage is reduced which may lead to competitive tendering being offered more often at the smaller end of the market in the medium term.
- **Fewer rejections of unfavourable scheme profiles** – More insurers servicing the market should mean that more deals are completed during a calendar year. Less favourable scheme profiles, such as those with small asset values, a high proportion of deferred members or those with difficult to model underpins, may find it easier to get quotes as insurers battle for business.

However, more participants will bring significant challenges for the providers themselves such as the capacity constraints discussed above. There is also a systematic risk. As the number of participants increases, the pool of human resource is spread too thin and relatively more resource is being used to set up and run the fundamentals of bulk annuity businesses rather than working on and completing the deals that will ultimately drive increased capacity of the market. With eleven insurers you will need eleven modelling development teams, eleven sets of client relationship managers, eleven compliance functions, eleven executive teams reporting to board on performance and growth and so on.

Other investors are actively considering entering the market, either by purchasing one of the existing bulk annuity providers or starting a new provider from scratch. However, regulatory requirements and staff shortages are significant challenges to overcome so the flow of new faces is expected to be steady at best. We may even see consolidation of the market over time as insurers are unable or unwilling to react to the evolving demands of the market and choose to concentrate on other areas of the business.

This quarter's edition was prepared by Adam Cottrell, Senior Consultant and Actuary at Quantum Advisory.

Adam is a Scheme Actuary and a key member of the Risk Transfer team at Quantum Advisory, leading our research and engagement with the major consolidators and master trust vehicles as well as project managing, delivering advice and preparing schemes for traditional insurer buy-out exercises.

He is also a member of Quantum's Multi-Employer and Public Service Pensions team, focusing on helping employers manage the ongoing risks and costs associated with their multi-employer schemes, including LGPS, SHPS and Teachers Pension Schemes, advising on and implementing admission agreements and cost effective exit strategies.

Adam has more than ten years of experience providing actuarial, strategic pension consulting and other specialist pension advice to trustees and sponsoring employers of UK pension schemes. He enjoys all things football, has a particular passion for food and drink and is glad to see an increasing focus on the social impact side of ESG within corporate decision making.

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