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Pension risk transfer market: Entering unchartered territory

The UK pension risk transfer market is arriving at a unique juncture, driven by evolving supply and demand factors, regulatory change, and macroeconomic and capital market volatility. The impact on end game strategies could be far reaching.

Transferring benefits to a life insurer has long been seen as the 'gold standard' for delivering defined benefit (DB) member pensions. Between 2018 and 2021, over £125bn of buy-in and buy-out transactions were written, with demand expected to increase even further (current market consensus indicates that up to £50bn of transactions a year could be expected over the next decade). Whilst the insurers in this market have underlined their confidence in being able to meet this challenge, some market commentators have questioned whether insurer capacity/supply will be sufficient.

Against this backdrop, the UK life insurance regime is about to undergo potentially significant change. The UK Government's review of Solvency II remains ongoing and, whilst there is market consensus over many of the proposed changes, uncertainty remains over what is arguably the most important component – the Solvency II Matching Adjustment – which, in effect, allows insurers to provide cheaper insurance by taking advance credit for at-risk returns. This, and the resultant overall changes to UK insurance regulation that follow, could have significant ramifications for UK life insurers and DB scheme members.

On top of this, life insurers find themselves navigating a macroeconomic climate that has not been experienced in over 40 years – high inflation, coupled with the Bank of England's recent recession warning, means that the UK could be heading into 'stagflation'. As such, insurers could see the quality of their investments deteriorate through increased credit downgrades and defaults.

Furthermore, any insurers looking to raise hybrid debt capital in the near-future may experience higher borrowing costs than in recent years, whilst any increase in volatility in interest rates and credit markets could create pressure on liquidity management for insurers – we saw this dynamic during H1 2020, following the first COVID-19 lockdown, when insurers faced an increase in collateral calls on their derivative instruments.

As a result, trustees and sponsors will need to put more focus on understanding insurers' financial strength, risk management and capital resilience when undergoing an insurer-led risk transfer exercise, so that the most appropriate insurer is selected to deliver benefits to their scheme members. For schemes already holding buy-in policies, proportionate monitoring of their insurer counterparty should form an important part of the scheme's wider integrated risk management framework.

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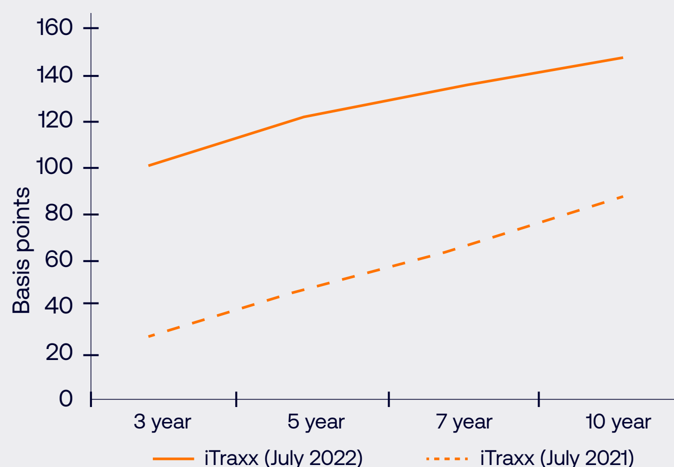
Datawatch: Credit default swap (CDS) spreads

A CDS spread is a useful gauge for assessing the perceived credit risk of a corporate (as effectively insurance for its debt holders) and is influenced both by macroeconomic and company specific factors. In this current period of macroeconomic uncertainty, evidenced by record levels of inflation, increasing interest rates and supply chain disruption, it is unsurprising that there has been a marked widening in CDS spreads, with the iTraxx[1] ten-year CDS spread increasing by c.60bps over the past 12 months.

An increased CDS spread for sponsors not only signals market concern about the strength of a company's creditworthiness, but will often coincide with falling share prices. Where CDS spreads increase for a sponsor, trustees should consider whether this indicates that their covenant has changed and, if so, how they can respond.

iTraxx 12-month CDS movement[1]



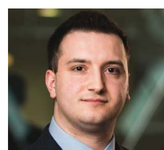
[1] The iTraxx index is a family of European, Asian and emerging market tradable credit default swap indices

Ask the Analyst: Why is it important to consider the impact of macroeconomic volatility on covenant strength?

Inflationary pressures may have the dual impact of both increasing a sponsor's cost base (e.g. through wage increases) and reducing consumer demand (for discretionary spending in particular).

Financial impacts are only part of the wider picture of macroeconomic uncertainty. The war in Ukraine has caused supply chain disruption across a range of industries and has compounded pre-existing logistical challenges associated with Brexit and the COVID-19 pandemic. The automotive industry, for example, has already been struggling with the impact of a global semiconductor shortage which has constrained the supply of new cars.

An effective assessment of the interaction between macroeconomic dynamics and sponsor financial performance remains key for trustees in fully understanding the outlook and strength of a scheme's covenant, and its ability to support investment volatility within the scheme.



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Regulatory developments: £1bn schemes within TCFD and climate change governance scope from October 2022

Schemes with assets of £1bn or more will be in scope of TCFD-aligned (Task Force on Climate-related Financial Disclosures) climate reporting requirements from 1 October 2022. Some of the key learnings from the £5bn+ schemes we have advised to date include:

1. Early engagement with all advisors is key to ensuring that advice can be integrated across common climate scenarios;

2. Co-operation between sponsors and schemes leads to better outcomes as analysis can be focused on common information – particularly, where schemes are required to report ahead of the company's own TCFD requirements;

3. Given the inherent uncertainty of climate change, conventional deterministic and stochastic models may be less informative than scenario analysis. Through encompassing a range of key variables, scenario analysis offers trustees the best opportunity to prepare for realistic downside outcomes; and

4. Undertaking the required steps to comply with climate change governance requirements can help demonstrate to trustee boards why sustainability should be a core consideration when undertaking long-term journey planning.

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