Insurance enters a new phase: a skyrocketing market

LCP report on future demand and supply in the buy-in and buy-out market

October 2022

Welcome to LCP's report on how market dynamics will evolve in 2023 and beyond

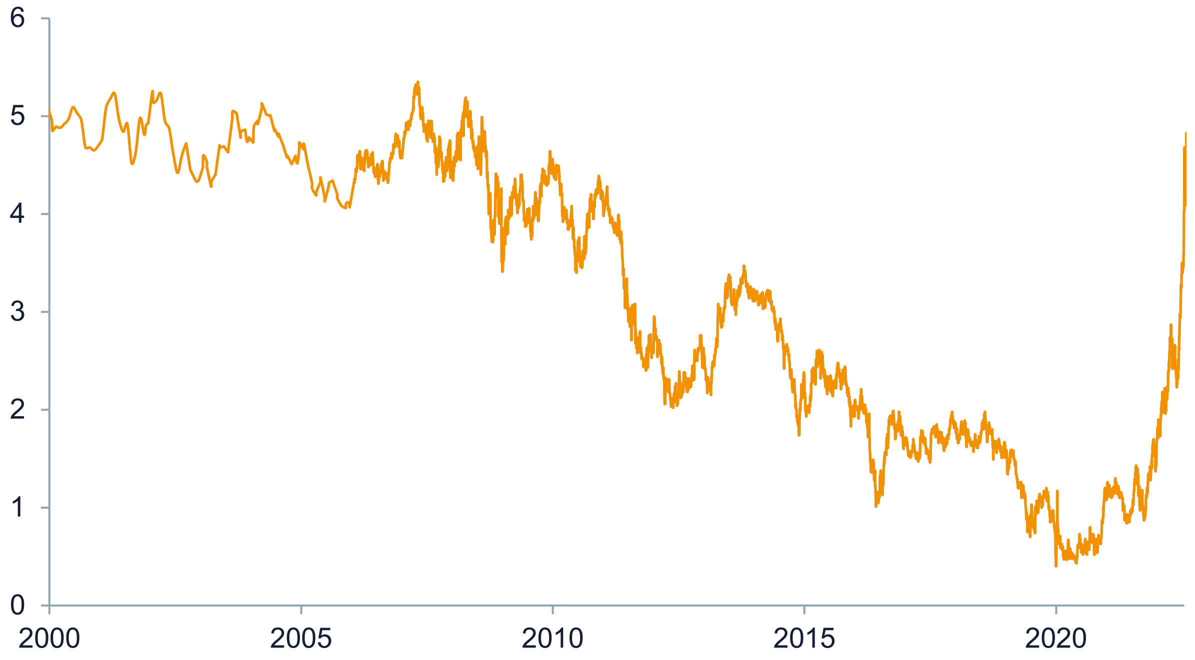
Introduction

2022 has been a year of enormous financial change for DB pension schemes. The steady fall in gilt yields over the last decade has been reversed in less than a year, with huge changes to the size of pension scheme liabilities and funding levels. Annual CPI inflation has exceeded 10% for the first time in over 40 years and annual pension increase caps are biting for many schemes.

In this report we ask what these changes mean for schemes considering insuring their liabilities through a buy-in or buy-out. We assess the level of improvement in buy-out funding levels over the last year and we project what this means for demand for insurance. We also look at how insurers are responding and whether there will be sufficient capacity and operational bandwidth to keep up.

We hope you enjoy reading our analysis and would be delighted to discuss the implications for you.

Chart 1: A decade of falling gilt yields unwinds in less than a year



Source: FTSE Actuaries' Government 15 year Fixed Interest Index

Key conclusions

Our headline conclusion is that the changed dynamics in 2022 have led to a huge rise in buy-out funding levels – a c15% improvement over the past year. Nearly 50% of schemes are now funded at 90% or over compared to the estimated buy-out cost.

We estimate the total buy-out cost across the c5,000 of UK private sector defined benefit pension schemes has fallen by nearly £1,000 billion to c£1,400 billion in September 2022. That is nearly half of the UK's annual GDP knocked off corporate pension obligations in a year.

We project that this surge in funding levels will translate into rising market volumes in 2023 and beyond, with the potential for over £200bn of demand for buy-ins and buy-outs over the next three years.

From our work with insurers, we estimate that current insurer capacity stands at £45bn pa – comfortably above projected volumes for 2022 but less than possible demand of up to £60bn in 2023. Whether there is a "capacity gap" will depend on how quickly schemes come to market and whether insurers can flex up their capacity.

Our research reveals the biggest concern of insurers is the operational resource to cater for an increase in activity, which is likely to lead to ever tougher decisions on which deals to participate in.

Our job is to make sure our clients are well prepared and well advised, so they develop the right strategy for insurance and that they stand out to insurers against this backdrop.

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We have been publishing reports, analysis and research on the buy-in, buy-out and longevity swap market since 2007.

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Surging funding levels over 2022 have kickstarted a new growth phase for insurance.

How busy is the market going to get?

Affordability of full buy-ins / buy-outs is improving

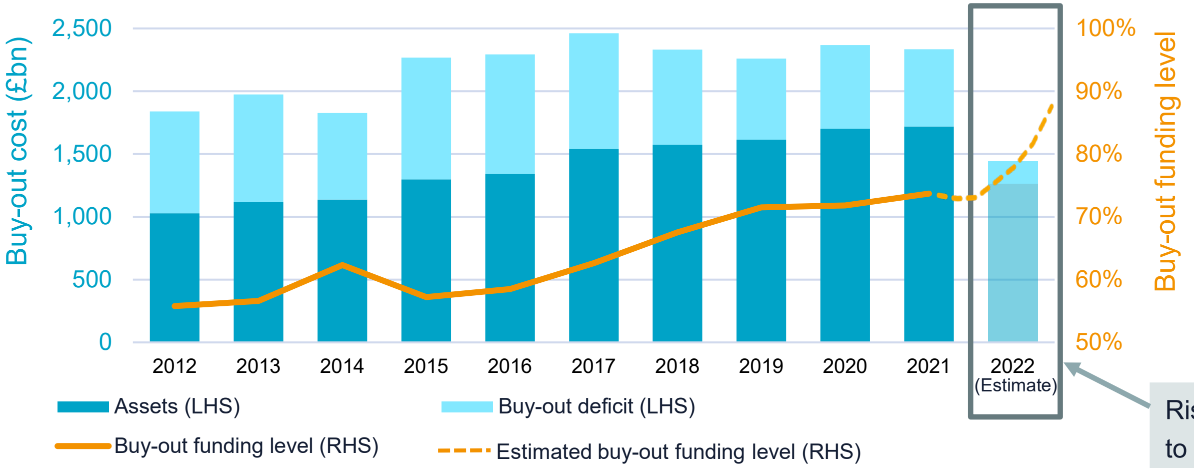
To answer the question of how busy the market is going to get, we need to consider how affordability has changed leading up to and during 2022 – covered on this page – and then on the next page how it is likely to change in 2023 and beyond.

Funding levels determine the capacity a scheme has to reduce risk through a buy-in or longevity swap and the size of any gap to move to full buy-in / out. Affordability fundamentally changed in 2022, with the gap to full buy-in / out smaller than ever before for most schemes.

Affordability improved steadily for ten years…

As shown in Chart 2, until this year pension schemes had seen a largely steady upward trajectory in full buy-out funding. The bars and solid line reflects the industry-wide data published in The Purple Book up to March 2021. Buy-out funding rose from 63% to 74% over the 5 years to March 2021, with the main contributors to the improvement being strong asset performance, stalling life expectancy growth and competitive insurer pricing.

Chart 2: Buy-out funding positions for UK DB pension schemes



Source: Data up to 2021: Purple Book 2021 data covering UK private sector DB pension schemes at March each year. Data after 2021: Estimated by LCP, reflecting the movement in estimated buy-out funding observed across LCP clients up to 30 September 2022.

…followed by a huge acceleration in affordability in 2022

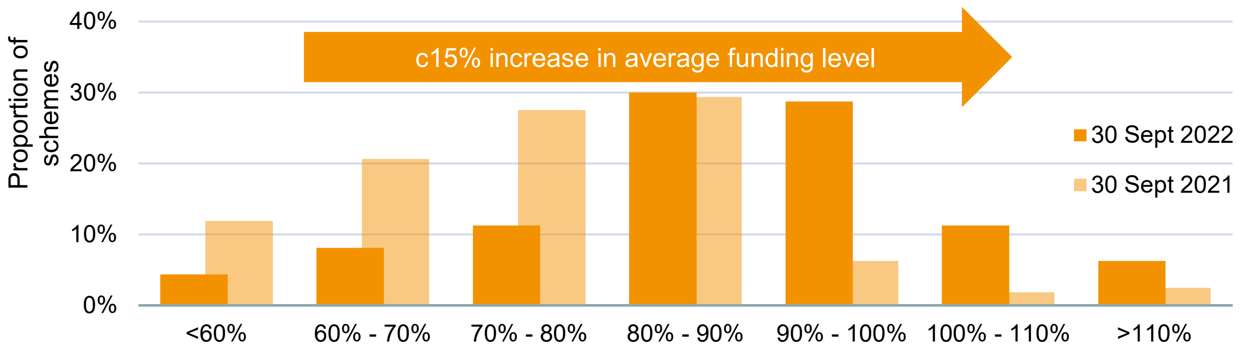
Since late 2021, full buy-in / out funding has accelerated in a way unlike we have seen before – with a c15% increase in the average scheme's buy-out funding level over the year to September 2022. This dramatic increase can be seen in the orange buy-out funding level line on the right hand side of Chart 2 and in the distribution of buy-out funding levels in Chart 3.

The main drivers of this rapid acceleration in buy-out funding levels over 2022 have been:

- Rapid increases in long-term yields and widening credit spreads, reducing the full buy-in / out price
- Further improvements in longevity pricing, particularly for deferreds, from both reinsurers and insurers
- Strong competition amongst the insurers and reinsurers, as overall capacity in 2022 has exceeded demand

This improvement in buy-out funding over 2022 has brought full buy-in / buy-out within reach for a significant proportion of schemes. Whilst many schemes, particularly those with data challenges and less liquid assets, will have work remaining before they approach insurers, the overall improvement in affordability will accelerate de-risking volumes forward over the next few years.

Chart 3: Distribution of est. buy-out funding levels: 30 September 2021 vs 30 September 2022



Source: LCP analysis based on estimated buy-out funding across LCP clients calibrated to the wider DB universe.

Rising yields have reduced the total buy-out cost across the c5,000 DB pension schemes from c£2,300bn in March 2021 to an estimated £1,400bn at 30 September 2022. This nearly £1,000bn fall is almost half the UK's annual GDP.

At the same time, the average scheme is now estimated to be c88% funded against their buy-out measure at 30 September 2022, up by c15% from a year earlier. The top 18% of schemes are estimated to be fully funded on buy-out and 45% of schemes are estimated to be at least 90% funded on buy-out.

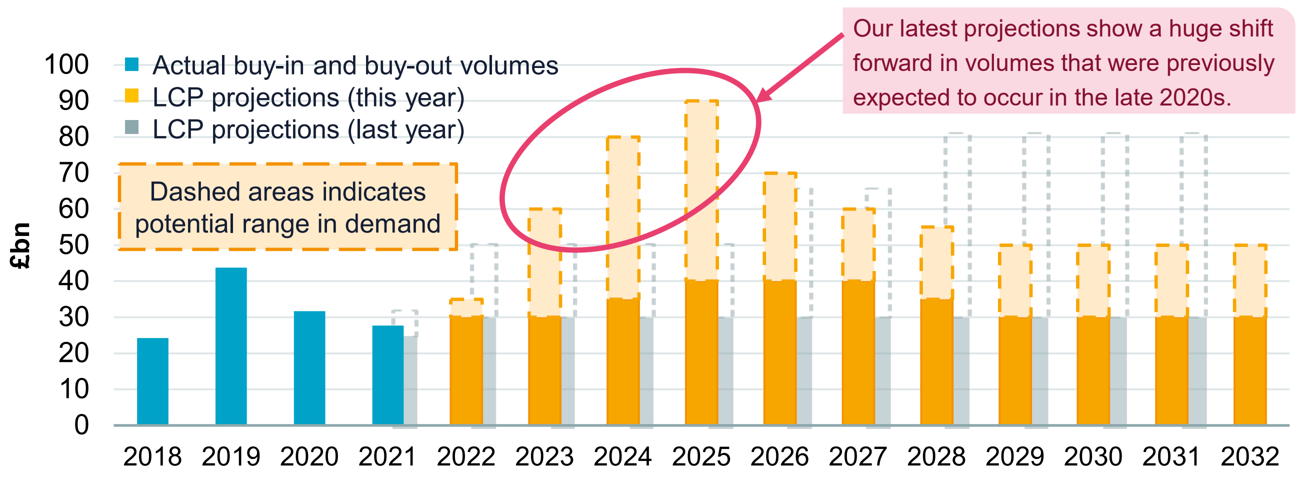
How busy is the market going to get? *Continued*

Projected demand for buy-ins and buy-outs

To understand how higher buy-out funding levels will translate into demand for buy-ins and buy-outs, we have conducted analysis to project the buy-out funding levels over the next decade. From this, by making assumptions about the proportion of schemes that will seek to buy-in or buy-out and when, we can estimate potential future demand.

Chart 4 shows our projections for future buy-in and buy-out volumes over the next decade. This analysis does not take account of capacity constraints – which we cover in the next section – but sets out a realistic demand range if capacity continues to be available.

Chart 4: Projected buy-in and buy-out volumes over the next decade



Source: LCP analysis

Over the past year, the average projected time to reach full buy-out has reduced by over 5 years.

What is driving the large increase in projected volumes?

Our analysis shows that the surge in funding positions could result in significantly larger volumes over the next three years as compared to our projections last year. Whereas last year our projections showed the potential for a surge in the late 2020s – as shown by the grey bars in Chart 4 – market conditions have brought that surge forward to occur over the next few years.

The total projected volumes over the next decade are broadly similar to last year at a little over £600bn. This should be seen in the context of a much smaller DB pensions universe of £1,400 billion in September 2022 compared to £2,300 billion a year ago, indicating a huge increase in the proportion of schemes using insurance over the next decade.

Some shorter term challenges ahead of insurance

Whether our £60bn upper estimate for 2023 will be reached depends in practice on the number of schemes choosing insurance and how quickly these schemes are ready to come to market.

For example, some schemes have significant data projects to complete, and many have illiquid asset holdings, particularly larger schemes. Illiquid assets can be a key obstacle to moving to full insurance, as current Solvency II rules restrict insurers from taking on the types of illiquid assets typically held by schemes without significant haircuts. For these reasons amongst others, there may be a lead-in time before higher funding levels translate into transaction volumes whilst schemes work through these projects.

In addition, schemes may now have less scope for partial buy-ins following recalibration of LDI strategies with higher collateral levels so as to provide improved resilience to further yield rises. We still expect partial buy-ins to occur but to be executed at higher funding levels when there is less need for assets to generate return or to provide collateral if yields rise further.

Will schemes target self-sufficiency?

Arguably the biggest uncertainty in projecting demand is the proportion of schemes that will opt for self-sufficiency rather than insurance, particularly for larger schemes who are able to run on more efficiently at scale. Reasons to run on might include retaining investment return to pay for discretionary increases or managing the corporate accounting impact.

Times are however changing with a number of £10bn+ schemes now on the path to insurance, as they become more comfortable that buy-ins / outs are a secure long-term home for their members. We could see this effect snowball – as more large schemes realise they are at full funding on buy-out and follow their peers in opting for insurance. This would drive volumes to the upper ends of our projections.

Over the last 15 years, insurance capacity has always met or exceeded pension scheme demand.

This dynamic is likely to reverse over the next three years and the challenge for insurers is to scale up capacity.

A new phase for insurance is beginning.

Will insurer capacity be able to keep pace?

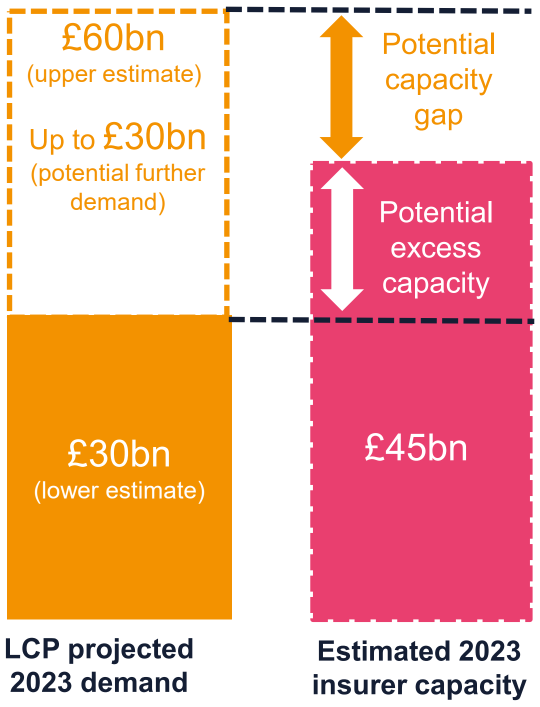
With the potential for over £200bn of demand for buy-ins and buy-outs over the next three years, will capacity from the insurers be able to keep up?

Over the next couple of pages we consider this question and the implications for the market. This is based on a combination of analysis, market insight, data from surveys and our regular interactions with the eight insurers in the market.

What are insurer target buy-in/out volumes for 2023?

Chart 5 shows that as soon as next year we could be in a situation where pension scheme demand has outstripped the available insurance capacity.

Chart 5: Projected demand versus capacity



Source: LCP analysis

Based on insurer business plans and other information, we estimate that there is capacity of up to £45bn across the eight insurers. In contrast we estimate that there could be up to £60bn of transaction opportunities next year.

In recent years we have seen some insurers temporarily pull back from the market as they have reached their business targets or reached the limit of their asset sourcing pipeline. It is one of the reasons why there has been such a wide spread of business between the insurers. As one insurer pulls back, another insurer starts winning more. This has kept the market extremely competitive.

If a large "capacity gap" were to open up then we may see periods where most, if not all, insurers pull back from the market or periods where insurers participate but do not offer competitive pricing.

In practice, the majority of the insurers do not have explicit business targets and often any target is expressed over a period of years. So flexibility exists to absorb larger volumes for a period. The largest transactions are increasingly being treated like one-off M&A opportunities rather than as part of an insurer's normal annual capacity.

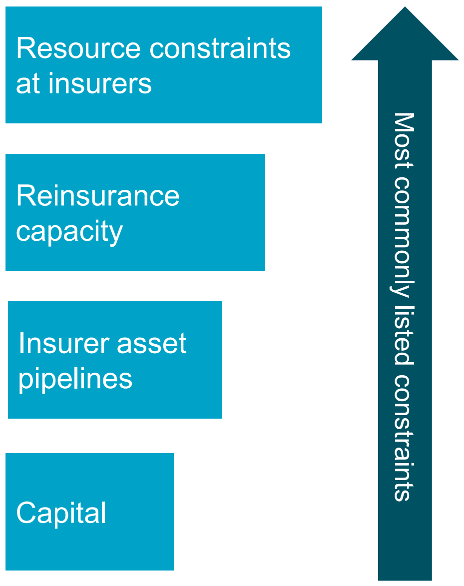
> *The insurers identified resourcing constraints as the key barrier to quoting on more transactions.*

What are the key constraints that limit insurer capacity?

The most common constraint highlighted by the insurers is **resource constraints** to process all of the business coming to market, from initial quotations through to structuring, execution and post-transaction support.

The insurers highlighted that they are recruiting to meet expected higher activity levels, but building team size has a lead-in time and there is a limited pool of people with the right skills and knowledge. Insurers have also been seeking to drive efficiencies in their pricing processes, particularly for smaller schemes, where "streamlined" processes are becoming the norm.

Chart 6: Capacity under strain



Following resourcing, the next most common constraint is **reinsurance capacity**. Most insurers rely on external longevity reinsurance, and even where it is implemented post transaction they often use reinsurer quotes to inform their pricing. Like the insurers, the reinsurance market is also under pressure due to rising demand – and whilst reinsurance capacity is growing (both traditional longevity reinsurance and funded reinsurance), the availability of quotes from reinsurers is becoming more squeezed (particularly as the reinsurers also quote on longevity swaps with pension schemes).

The other two areas the insurers view as key supply-side constraints are their **asset pipeline** and **capital availability**. These are currently less of a concern for the majority of insurers, although some insurers note that the availability of suitable high-yielding assets could tighten. The warning is that where asset pipelines are restricted, this will affect the pricing insurers can offer, and they will be increasingly selective about which deals they allocate their "best" assets (and hence best pricing) to.

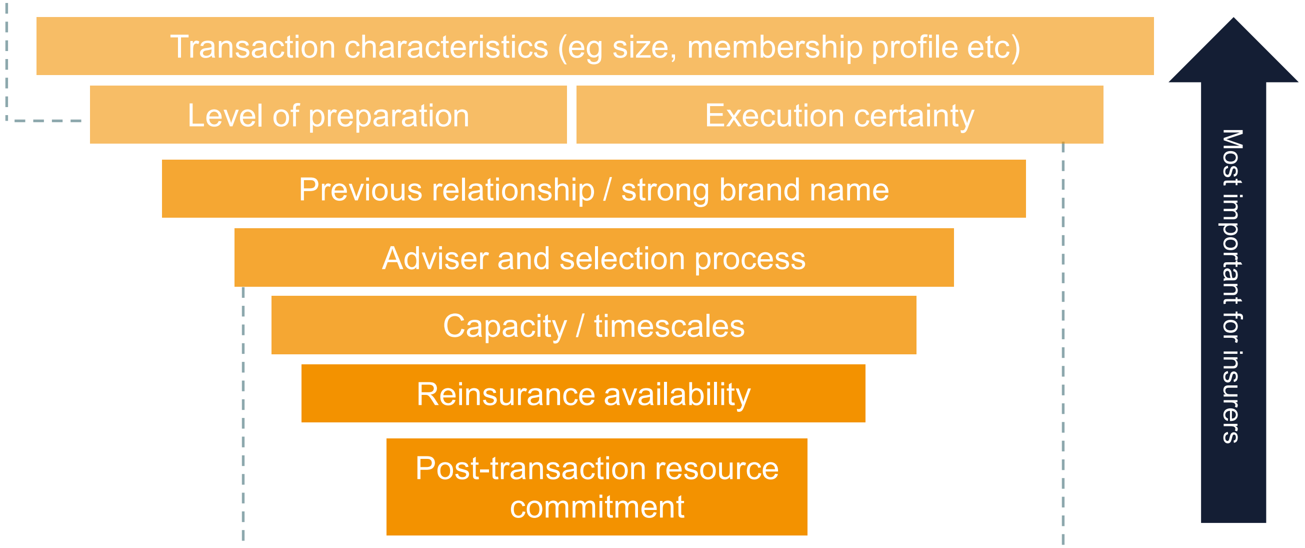
Capital is generally felt to be the least concern by insurers. The majority of insurers' business models provide flexibility in capital availability for the right opportunities.

Will insurer capacity be able to keep pace? *Continued*

How are insurers deciding which transactions to prioritise?

The graphic below shows the factors that insurers use when triaging new transaction opportunities, with the factors that are most important to insurers nearest the top.

Preparation
This doesn't just cover clean membership and experience data – there's a range of other factors including an accurate benefit specification and asset de-risking. Insurers will view it positively if assets have been de-risked as an interim step to stabilise funding whilst other preparation work is completed.



Adviser and selection process
Having specialist advisers with a strong track-record provides insurers with confidence the selection process will be effective, efficient and fair. Insurers know the best advisers will execute efficiently when their client's objectives are met.

Execution certainty
Schemes can demonstrate execution certainty where there is clear alignment of the key stakeholders (particularly if a sponsor top-up contribution is required) and a clear process to transact when their objectives are met.

Given the potential constraints on insurer capacity, we have set out below our top tips (from over 250 LCP-led transactions in the last 15 years) for how to manage the final stage of the journey to insurance so as to maximise insurer engagement and optimise pricing.

LCP's top tips for a successful insurance process

1. Make sure your scheme has a **practical and action-based journey plan**, with a co-ordinated strategy across all preparatory workstreams. Focus on your investment strategy, with particular focus on managing illiquid asset holdings and interest rate / inflation hedging levels. This will help to minimise funding volatility whilst preparation work is completed. For broader journey planning see our GEARS framework.
2. Get your **data and benefits "transaction ready"** before approaching insurers, with a thorough benefit specification covering all historic rules and addressing gaps in key data (eg experience data, marital status data). See more detail here.
3. Consider ahead of time whether **residual risks insurance** might be required. If so, to maximise insurer engagement it will be important to complete detailed upfront legal and data due diligence, potentially from an independent specialist firm. This can be a 6-12 month project.
4. Ensure all **key stakeholders are aligned** on their objectives, and the governance framework is in place so decision making can happen efficiently.
5. Consider **powers in the rules** early in the process if the scheme is exploring a full buy-in, so all parties understand the balance of powers if there is a **surplus** – will it be returned to the employer or will extra benefits be insured for members (a higher cap on pension increases, for example, would protect members in times of future high inflation) or a combination of both.
6. Carefully consider the **insurer selection process**. We are running more processes that involve only a small number of insurers or a chosen strategic partner. Structured in the right way all these processes can deliver superb outcomes for schemes. Smaller schemes in particular should consider streamlined transaction processes (with pre-agreed contracts) to increase insurer engagement.

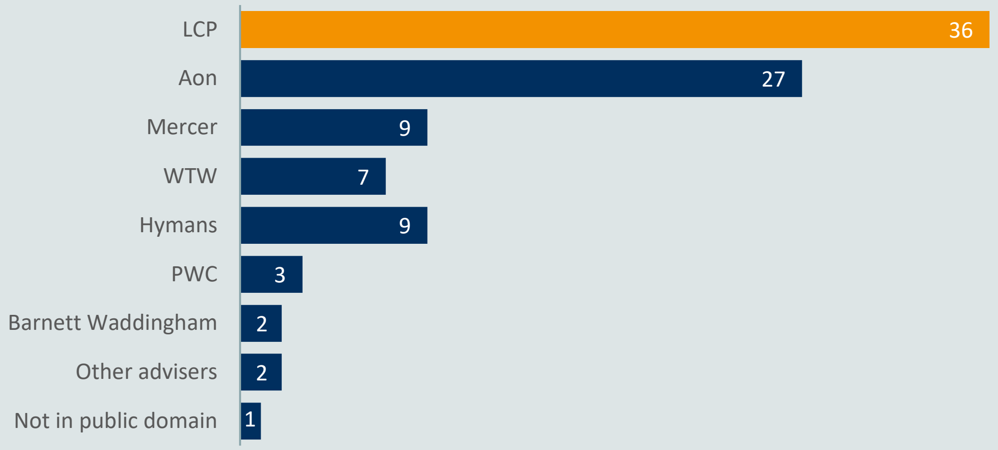
Conclusion

The analysis in this report shows that demand in the buy-in and buy-out market over 2023 and beyond may for the first time exceed insurer capacity, heralding a new phase of higher activity levels. For many schemes, the sheer rate of improvement in their buy-out funding level will be as unexpected as it is welcome, and schemes will want to consider taking steps to protect their funding level whilst preparatory work is carried out to ensure good insurer engagement and pricing.

We look forward to helping current and future clients consider whether insurance is right for them and, where it is, to help guide them through the process to engage effectively with insurers. The graphic below shows the advisers who have been most active in advising on buy-ins and buy-outs since 2014, reflecting lead adviser data provided by the eight insurers that participate in the market.

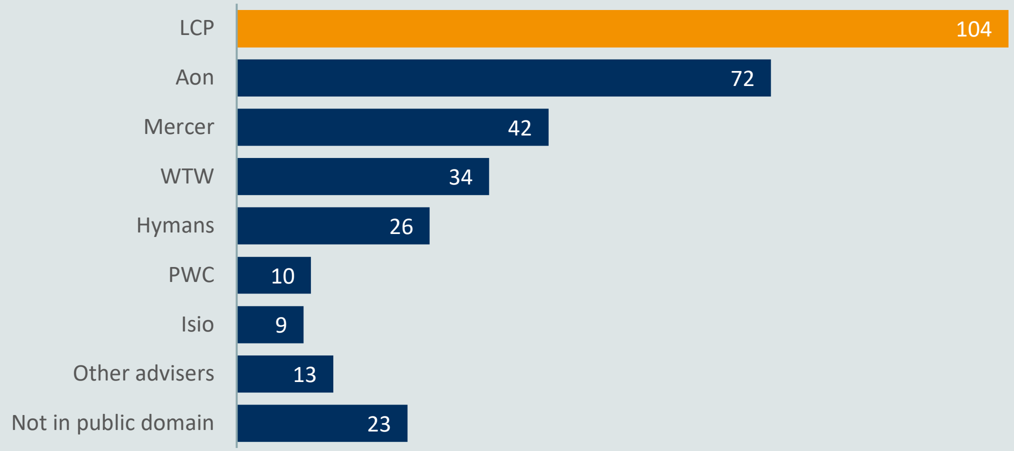
LCP is a market-leader in all segments of the buy-in and buy-out market

Over £500m: Lead adviser on buy-ins/outs over £500m since 2014



Source: Insurance company data up to 30 June 2022. Data excludes L&G Assured Payment Product (APP) transactions.

Over £100m: Lead adviser on buy-ins/outs over £100m since 2014



Source: Insurance company data up to 30 June 2022. Data excludes L&G Assured Payment Product (APP) transactions.

Under £100m: Lead adviser on buy-ins/outs under 100m since 2014

Insurance company data shows that LCP has been the lead adviser on **30% of all buy-ins and buy-outs under £100m** between 2014 to 2021. It's not possible to produce adviser comparisons like the above for smaller transactions as insurers do not publish granular data on lead adviser for transactions under £100m.

LCP has now completed 64 transactions through our streamlined buy-in and buy-out service for smaller schemes, bringing the total liabilities insured through this service to over £2.2bn.

LCP has been the lead adviser on 30% of all buy-ins and buy-outs under £100m

Contact us

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At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in pensions, investment, insurance, energy, financial wellbeing and business analytics.

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