RISK

A smart move

From buy-ins and buyouts to longevity swaps and cash flow-driven investments, European pension schemes are becoming more innovative – finds Graham Buck

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Sometimes bad news hides an element of good news. A sharp slowdown in life expectancy improvements in the UK and worsening mortality rates in some regions has halted the steady improvement in longevity expectations. It's lifted some funding pressures from UK pension schemes as reinsurers have trimmed their pricing, so that the cost of de-risking options such as buy-ins has become more cost-effective.

While other European countries have also seen a slowing rate of improvement in life expectancy (with Italy bucking the trend), the UK was bottom of the recently-issued league table of 20 leading world economies. By contrast, the Netherlands recently announced it will press ahead in 2021 with an increase to 67 in the age at which the AOW state pension becomes payable, despite actuaries stating that the government could afford to hold off for five years.

"An overarching theme globally has been the focus by multinationals on global oversight and innovative ways to de-risk both assets and liabilities," reports Aon global retirement strategy consultant Jim Tindale. "Each country has its own particular regulations though on how schemes may be funded and remediations available. This affects the types of de-risking that are prevalent."

For UK schemes, de-risking via buy-ins and buyouts has become more affordable than at any time since the global financial crisis. The first half of 2018 saw deals totalling around £8 billion completed, reports Lane Clark & Peacock. "The UK is currently on a cusp as activity has picked up strongly. H1 easily beat the previous record of £6.9 billion for H1 2014, when the figure was pushed up by two major de-risking deals, ICI and Total," says LCP partner Charlie Finch.

"These increased levels are likely to continue for the foreseeable future and several insurers have already announced they are closed to any further new quotes for the remainder of this year. It's very much a buyer's market," he says.

UK longevity risk transfers similarly broke the previous record of £11.9 billion set four years earlier, due largely to Prudential's sale in March of its £12 billion annuity portfolio to Rothesay Life and National Grid's £2 billion longevity swap with Zurich in May.

As for other de-risking options, he adds, liability-driven investment (LDI) strategies are something that the market has adjusted to generally; less so cash flow-driven investment, which isn't yet that big a segment but could be taken up by smaller schemes.

The UK's bumper year is thanks to a couple of main drivers, says XPS Pensions Group head of de-risking solutions Colette Christiansen. "Firstly, many schemes have now matured and become progressively cheaper to insure year by year. Secondly, pricing has materially improved in response to the latest longevity trends.

"Both insurers and reinsurers wanted to ensure the latest figures weren't simply a blip, but have now moved on to the latest actuarial tables. It has been further helped by the fact that 12 reinsurers are now in the market, enabling insurers to pass much of the risk on," she adds.

Post-Solvency II

Additionally, by contrast to the concerns that surrounded its introduction in 2016, the Solvency II directive has bedded down, removed regulatory uncertainty and had a positive impact on the asset side, reports Christiansen. "Post-Solvency II insurers have become more creative and have reduced their reliance on gilts and corporate bonds.

"They have investigated various investment options, such as housing projects, which return more than corporate bonds as long-term investments that attract a premium."

Christiansen adds that low interest rates have been a fact of life for so long across Europe that trustees have stopped waiting for them to rise. "There's a greater readiness to hedge and lock in at a relatively low rate as it's no longer seen as a temporary phenomenon. It has also made it easier to go for options such as cash flow-driven investment," she explains.

Pension Insurance Corporation head of business development Mitul Magudia reports the low interest rates of the past decade persuaded around half of UK schemes to hedge. The other half didn't and their assets have struggled to keep pace with liabilities. "Those that hedged are in far better financial shape and can now consider longevity risk", he

explains. "The buoyancy of the reinsurance market, including Pension Insurance Corporation and Legal & General, has encouraged greater competition for business," he adds. While Solvency II placed some restriction on the assets insurers can look for, continues Magudia, it extends to long-term illiquid assets that offer yield. "In addition, the size of the ticket has increased significantly, so there is direct investment in risks such as housing associations, university accommodation and others able to provide a regular income stream. Corporate bonds, by comparison, typically have duration of five years, or 10 at most."

Defensive de-risking

It's a different picture in Scandinavia where Norway's Kommunal Landspensjonkasse (KLP) director of finance, Oliver Siem, reports there has been no major change to the insurer's risk ability and appetite in recent years. "We clearly see de-risking as a theme for many life insurance companies across Europe though, as capital burdens become expensive in a low interest rate environment and very visible under Solvency II.

"Our own situation is slightly different as we are a mutual company competing with self-managed pension funds. The product, public sector pension scheme (DB), is pre-agreed among the employers and employees' organisations, thus outside of KLP's control.

"Risk adjustment is most relevant on the asset side – with the aim to keep risk ability in a low interest rate environment. De-risking policies are in place to cope with market shocks on our equity portfolio, where any large fall in equity prices will lead to a gradual sell-off."

At Finnish insurer Varma, chief investment officer Reima Rytsölä says the country's strong compulsory occupational schemes means voluntary occupational pension schemes are less common than in the rest of Europe – although multinationals such as Nokia, which has its own scheme, is free to review its own parameters in deciding how to de-risk.

"Finnish pension schemes are more asset-based rather than liability matched, so solvency ratios are important, says Rytsölä. "While we haven't see a great deal of de-risking, bear in mind that as recently as early 2017 our solvency calculation changed – one feature of this was greater freedom for individual insurers to take on a little more risk, should they choose.

"It's a two-step model – the second half was introduced earlier this year – and means a pension insurer can carry 8 per cent more equity risk than previously.

The majority of insurers have de-risked to an extent, reflecting the low interest rate/low returns universe we operate in. Low net yields mean returns on fixed income are meagre. As an asset-based investor Varma has to question many of the laws and the fact the more risk you assume, the better the returns usually are.

"De-risking methods are generally fairly defensive though and over the long term hedging the exposure can prove expensive."

Variety of approach

In continental Europe the key longevity markets are in the Netherlands, which has seen significant transactions in recent years driven largely by the many consolidations among smaller schemes. "The UK has the broadest range of de-risking with strong focus on restructuring the benefit accrued, transferring to individuals or third-parties, hedging and asset diversification," says Tindale. "Clarity of communication to individuals is key when transferring or restructuring benefits."

"In Switzerland, passing the risk over to an insurer is often seen as an expensive option as the nature of the benefits means there aren't the same funding expectations as the UK. The Netherlands by contrast, has stronger funding requirements, which you might expect would drive schemes to insurance but this is countered by the subsequent need to guarantee pension escalation.

"German schemes have traditionally been unfunded, so any buy-in or buy-out involves finding the cash from within the business. Pensionsfonds are becoming more popular as a tax efficient way to build up assets to reduce balance sheet risks; also multi-employer Pensionsfonds to reduce the governance risk and enable broader asset diversification.

"Similarly, consolidation of plans is starting to appear in the UK, including the potential to remove the liability as an option for schemes that can't yet afford to insure because their funding isn't quite good enough."

It's the genesis for recently-formed DB consolidator Clara Pensions, whose founder and CEO, Adam Saron, says that while a fully insured buyout is the 'gold standard' that schemes should target for members, this goal remains out of reach for many of them and their sponsors.

"That's where our idea for Clara comes from – we will act as a bridge for the scheme between the corporate sponsor and a fully insured outcome," says Saron. "Because of the scale we will build by consolidating pension schemes and the injection of capital from our investors, we can both lower the risk and speed up the journey to buy-out for members and allow companies to transfer the burden of their pension liabilities from their balance sheets to ours." ■