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Pension Risk Transfer Insights

What does COVID-19 mean for bulk annuity insurers' portfolios?

With The Pensions Regulator's increased focus on long term objectives, more and more pension schemes are looking to the insurance regime to help them manage risk. Buy-in and buy-out pricing has improved hugely over the past few years, largely due to insurers changing their investment strategies and moving away from traditional publicly traded corporate bonds to more illiquid assets. In this publication, we focus on what COVID-19 means for these assets, the challenges posed to insurers and how insurers might respond.

A brief history of bulk annuity investments

Over the past few years we have seen bulk annuity insurers significantly increase their allocations to illiquid assets. As banks have reduced their appetite for longer-dated loans, partly as a result of higher capital requirements, annuity providers and some pension funds have increased their exposure. Putting member options for non-pensioners to one side, insurers are required to meet future pensions payments from these annuity policies, which cannot simply be cashed in and so are not exposed to "run on the bank" scenarios. Annuities present a fairly predictable stream of liability cashflows, so an asset that provides a steady stream of income but is difficult to sell is generally an appropriate backing for annuity or pension liabilities.

Solvency II, the current insurance regulatory regime, recognises this (as in fact did the prior regime) with the concept of the "matching adjustment", the notion that insurers can make allowance for the illiquidity premium associated with these assets when calculating their reserves. Solvency II also requires insurers to hold sufficient capital to cover a 1-in-200 stress event, and insurers typically hold an additional buffer of around 40-80% of the capital required.

While insurers are still significant investors in public corporate bonds as well as government bonds, the sorts of illiquid assets that they have diversified into include the likes of infrastructure (e.g. clean energy, transport), commercial real estate, social housing, student accommodation and equity release mortgages. Often these assets are restructured in some way, either to provide the insurer with greater security (so that they are amongst the last to suffer from any underlying defaults), or to ensure that the asset provides an income stream that is better suited to match their liabilities.

So, what will insurers be watching out for at the moment when it comes to their asset portfolios?

Key risks for insurers

Default risk

A loan, whether through the form of a public corporate bond or a private investment, typically provides a series of coupons and then a final redemption value where the principal is repaid. Insurers will be more concerned than usual about the default risk inherent in loans, given the far-reaching economic implications of Covid-19 and the associated lockdowns around the world. Clearly some sectors are more exposed than others, though insurers typically do not have significant exposure at a sector level to those that have been hardest hit. Insurers also hold significant capital buffers in respect of default risk, and will often cite their excellent management at a portfolio level and low historic default rates, even through the previous credit crisis.

However, insurers will still be geared up for more defaults than they have experienced in recent times and will be doing what they can to mitigate these. In some cases that will mean trading out of exposure to certain sectors or companies, but in other cases they will need to actively engage with the borrowers. To understand the sorts of issues at stake, consider the case of Delta Airlines – a name that has recently been downgraded from investment grade to junk bond status. It recently raised high-yielding debt secured against collateral that included landing slots at New York's JFK and London Heathrow airports. Until recently, such collateral would have been viewed as providing a high degree of security and helped to cheapen the cost of borrowing – today its value is much harder to appraise. There will be similar considerations with some other secured illiquid assets, for example commercial real estate – consider lending to fund a retail park secured on the site itself. While lenders may be able to take control of the underlying security, they would simply inherit the problem and so may be hesitant to do so. Lenders are far more likely to try and renegotiate and restructure the loans, seeking to enhance their security in some way.

Some asset classes have specific options tied to them that might increase the risk of default, for example the "no negative equity guarantees" associated with equity release mortgages – these guarantees protect the borrower and mean that the loan can never exceed the value of the underlying property. A fall in UK house prices would increase the risk of these guarantees biting and loans not being repaid in full. Equity release allocations vary quite widely between insurers, from around 1% of portfolios to over a third, though some of this exposure is protected through reinsurance.

Downgrade risk

For many insurers, downgrades will be a far greater short term concern than defaults. For any investor, a downgrade signals a warning and the investor may well review the holding – for insurers, it also has an immediate capital impact, as lower credit ratings attract higher associated capital. This could eat into insurers' surplus assets and therefore reduce solvency coverage. Some insurers disclose the sort of impact a mass downgrade could have on their solvency coverage. For example, at 31 December 2019 a downgrade by one whole letter (AAA to AA, AA to A and so on) of 20% of insurers' matching portfolios would have reduced the solvency coverage ratios of three bulk annuity insurers by between 6% and 13%[1].

Internal credit ratings

Over the last few years, as insurers have looked to originate their own private assets to back annuity liabilities, one challenge they have faced is that these private assets are not necessarily rated. Insurers have been permitted to rate these assets themselves in order to determine their credit quality, with close scrutiny from the Prudential Regulatory Authority (PRA). In the case of two of the main bulk annuity insurers who disclose the amount of internally rated assets, the proportion of these is around 15-20%, roughly double what it was at the start of 2016 when Solvency II was introduced. The PRA has recently communicated with both banks[2] and insurers[3] regarding

[1] Based on those bulk annuity insurers who have disclosed these sensitivities.

[2] Sam Woods' letter to UK Bank CEOs regarding capital requirements and loan covenants: https://www.bankofengland.co.uk/prudential-regulation/letter/2020/covid-19-ifrs-9-capital-requirements-and-loan-covenants

[3] Note to insurers following up on the letter to UK Bank CEOs: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/follow-up-to-letter-from-sam-woods-covid-19-ifrs-9-capital-requirements-loan-covenants

these types of internal ratings, and will be working closely with insurers to ensure that these ratings remain appropriate in the current climate.

Impact on new business

While it is these illiquid assets that have largely supported improvements in bulk annuity pricing over the last few years, the freezing of many parts of the economy has meant that such opportunities are more scarce. However, a widening of credit spreads on public corporate bonds has presented other (arguably more traditional) opportunities to insurers. While some of the spread widening can be attributed to increased risk of default, insurers will continue to be on the look-out for specific investments that they see as being attractively priced with an acceptable level of risk, which have helped to provide improved buy-in and buy-out pricing in recent weeks.

Policyholder view

Pension schemes with buy-ins in place

The fact that insurers and the PRA are actively monitoring and managing these risks should give comfort to pension schemes who hold buy-ins with bulk annuity insurers, though pension schemes may wish to monitor developments specific to their insurer. Some solvency positions will have worsened over recent weeks, though we expect that most insurers will still have ample capital to cover the 1-in-200 stress required. For example, Just Group plc announced on 14 May 2020 that their coverage ratio had fallen between 31 December 2019 and 30 April 2020, but only by 3%. If insurers do find that they have to hold more capital, for example if there are downgrades within their portfolio, they will generally seek to recapitalise in order to regenerate capital buffers and maintain healthy solvency coverage – all good news for the security of policyholders.

Pension schemes considering investing in a buy-in

While the insurance regime provides a far greater level of security than the covenant of many pension scheme sponsors, it has always been important to consider the particular level of security afforded by not only the insurance regime but also the chosen insurer. The current situation only serves to emphasise the importance of this step, so pension schemes who are thinking of entering into a buy-in or buy-out may wish to take a close look at how insurers have been impacted by Covid-19 and are managing these issues before they select any particular counterparty.

Get in touch

If you have any questions about anything covered, please don't hesitate to get in touch.

Michael Abramson

Partner

020 7082 6155

michael.abramson@hymans.co.uk

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