Bulk annuity briefing, Quarter 4 2022

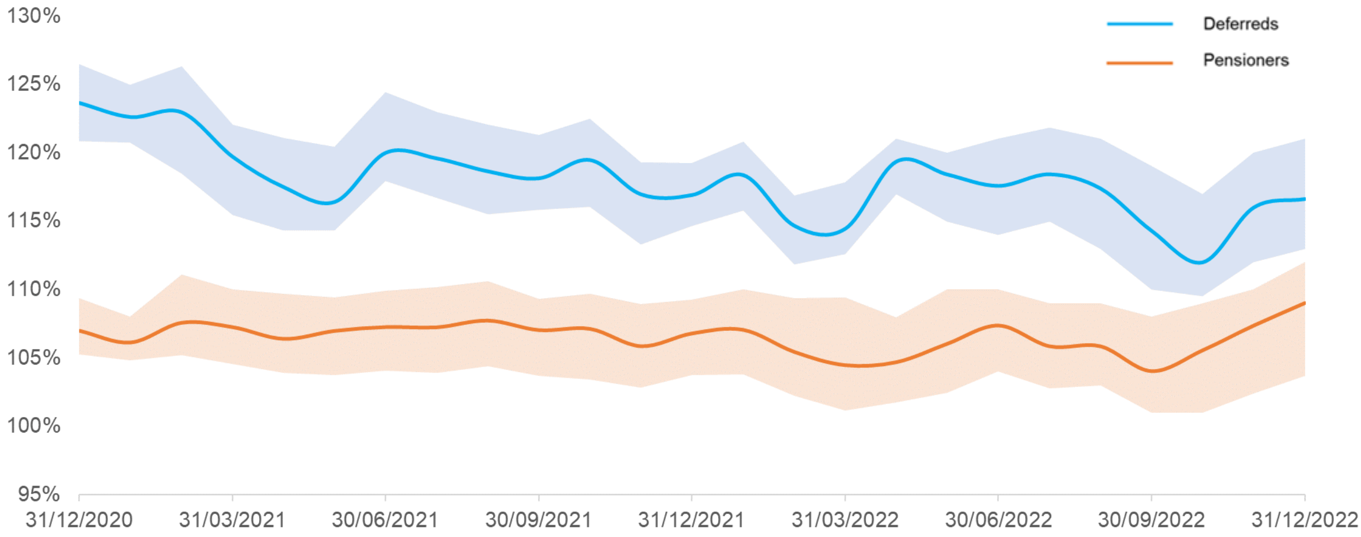
In this briefing, we look at the latest update to the First Actuarial Bulk Annuity Index, which monitors pricing trends in bulk annuity transactions relative to self-sufficiency liabilities.

We also explore the benefits of assured payment policies (APP). These allow pension schemes that cannot yet afford buy-out to begin their de-risking journey with an insurer. We discuss how they can provide greater certainty on the timeframe and cost of a future buy-out.

The chart below shows the average price of a £50 million bulk annuity transaction (with a mixture of fixed and inflation-linked liabilities) as a percentage of the liabilities measured on a self-sufficiency basis, using a discount rate of 0.5% pa above gilt yields.

The solid lines represent our estimate of the average price relative to self-sufficiency liabilities. The shaded area shows the range of sample pricing received from different insurers.

First Actuarial Bulk Annuity Index (£50 million transaction) – pricing relative to self-sufficiency liabilities



As at 31 December 2022, we estimate that the average price of a bulk annuity covering pensioners will be only 9% higher than the equivalent self-sufficiency liabilities. In other words, for a scheme that is 100% funded on a typical self-sufficiency basis, we estimate that for every £10 million of pensioner liabilities, an additional £0.9m of funding will be required. However, for every £10 million of deferred liabilities, we estimate an additional £1.7m of funding will be required.

Insurers charge a higher premium for deferred members than for pensioners of the same age. Deferred members are entitled to exercise options around when to retire and whether to take part of their benefits as a tax-free cash lump sum. This makes it harder to predict the benefit outlay.

For many schemes, the cost of a full buy-out can be prohibitive. But generally, as schemes mature and approach a self-sufficiency target, the extra funding required to reach buy-out decreases.

One option for schemes that cannot currently afford buy-out is to consider assured payment policies (APP). We discuss the benefits of APPs on the next page.

What is an APP?

An APP is insurance policy that protects schemes against investment-related risks. Legal & General is currently the only provider offering APPs.

Trustees pay an upfront premium, as they would with a bulk annuity. The insurer then provides a series of pre-agreed payments designed to match the pension scheme's liabilities, which may be fixed or inflation-linked.

APPs are similar in nature to buy-ins, but the crucial difference is that future payments don't vary with longevity and other demographic factors. This results in a saving – relative to securing a bulk annuity – of around 15–20% for deferred members.

APPs allow schemes to lock down investment and inflation risk on attractive terms relative to gilt yields. At a later stage, they may add longevity and wider demographic risk protection by converting to a bulk annuity.

APPs and smaller schemes

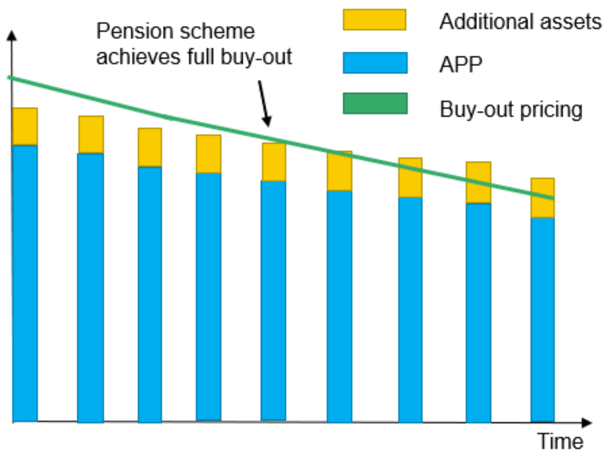
First Actuarial recently advised a client on an APP transaction with Legal & General, for around £10 million. This transaction – the first APP for a premium of less than £100 million – opens up the use of APPs for smaller schemes.

Benefits for smaller schemes

APPs give smaller schemes:

- Access to the insurer's annuity backing asset portfolio, and the access and scale it delivers
- Reduced running costs
- Inflation linkage for pension increases, with different caps and collars that may be otherwise hard to hedge
- The ability to restructure cashflows on a regular basis, taking actual experience into account
- The opportunity to convert the APP into a buy-in at a later date. This can be invaluable for smaller schemes in an increasingly busy market.

How does an APP support the path to buy-out?



As a scheme matures, deferred members get older and become pensioners. This brings down the cost of reinsuring longevity risks (all else being equal), making buy-out more affordable.

The expected gap to buy-out closes over time. The residual bulk annuity shortfall can be met from assets held in the scheme alongside the APP, or from ongoing sponsor contributions.

We can help you with bulk annuities

Over the last 12 months, First Actuarial has helped schemes secure bulk annuities with all the main insurers operating at the smaller end of the market. We are ideally placed to help smaller schemes navigate the bulk annuity market.

Find out more about First Actuarial's buy-in and buy-out services.

To discuss how we can help your scheme with a potential bulk annuity, please contact your usual consultant or email our buy-out team.