

2020... A Roller Coaster Year for Credit Spreads

Awareness of credit spreads is very important for pension plan sponsors, especially this year. For instance, at the end of the first quarter, it was common for sponsors to see an improvement in their plans' accounting funded status while observing a deterioration in the solvency funded status. Such counterintuitive divergence was explained by an increase in credit spreads through the end of the first quarter while GoC interest rates decreased significantly.

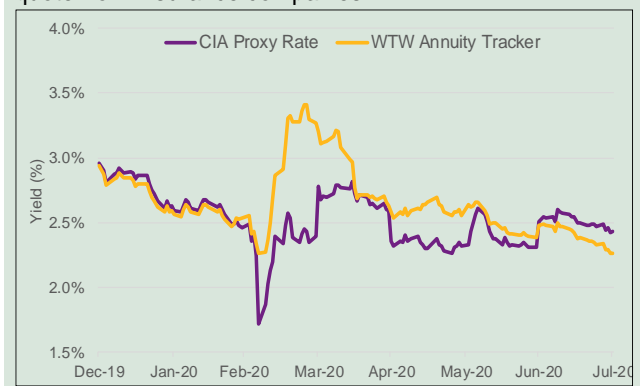
Credit spreads and insurers' ability to acquire illiquid assets at high spreads also have a significant effect on group annuity pricing. The widely accepted measure for estimating the cost of Canadian group annuities is based on the CIA guidance, which adds a fixed spread to an index of unadjusted GoC marketable bond yields over 10 years. This spread is typically updated on a quarterly basis and is heavily influenced by the movement in credit spreads for public and private fixed income assets available to insurers. A volatile environment, as we have experienced in 2020, makes it challenging to accurately estimate the cost of annuities for plan sponsors looking to transact simply by referring to the most recent CIA guidance.

The Willis Towers Watson Annuity Tracker was created to specifically address this issue as described in the box to the right. For example, the WTW Annuity Tracker indicates that at the end of July, actual annuity pricing that appeared expensive relative to the CIA guidance may still in reality have been competitive.

Willis Towers Watson Annuity Tracker

WTW Annuity Tracker assists sponsors in tracking the cost of annuities (shown as the yield in the chart below) and assessing the true competitiveness of quotes received from insurers by reflecting a marked-to-market evolution of credit spreads.

In addition, the WTW Annuity Tracker can be calibrated to reflect the underlying expected mortality experience of specific cohorts based on socio-economic factors obtained from an analysis of the members' data and postal codes using the WTW Postal Code Mortality Tool. When combined, the tools provide an even better estimate of what should be considered a competitive quote from insurance companies.



2020 Market Observations

Market volatility continues – After a steep decline during the first quarter of 2020, solvency funded positions slowly recovered as all major global equity markets partially or fully rebounded. Credit spreads also contributed to the market volatility after reaching a multi-year high in March. This was showcased by the increase in the spread published in the CIA guidance of 160 bps at the end of the first two quarters of 2020 – an all-time high! Since March, credit spreads for investment grade bonds dropped by up to 100 bps through the end of July, but the spread published in the CIA guidance remained at 160 bps at the end of June, highlighting the competitiveness of the group annuity pricing in the market during the second quarter of 2020.

So far, a buyer's market – Plan sponsors who were able to come to the group annuity market during the second quarter benefited from very favourable pricing due to the increase in insurers' appetite and competitiveness driven by the low volume of transactions during the first half of the year. To the extent that sales continue to lag 2019 volumes, we expect this appetite and competitiveness to continue during the second half of 2020.

Outlook for the second half of the year – We expect a volume of at least \$3 billion to \$4 billion in the coming months driven by some large transactions coming to market.



Want more information?

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