The compelling ESG case for bulk annuities

As the global economy pivots to net zero, long-term investing has become yet more challenging. Scale matters – and Aviva, a whole of market de-risking provider – can help schemes of all sizes achieve long-term sustainable outcomes

The traditional arguments for pooling the resources of defined benefit (DB) pension schemes through bulk annuity deals have been economic – lower costs and reduced risk. But the rapid acceleration of ESG investing is bringing a whole new set of reasons.

The old economic arguments are not undermined — indeed, they are more vital than ever. But they are now reinforced with additional reasons that go to the heart of a pension scheme's purpose.

Aviva's annuity asset origination director, Marcus Mollan, says that only the largest and most sophisticated institutional investors can most efficiently finance the innovative transactions that deliver long-term attractive cash flows while helping to decarbonise the economy.

He says the large number of small DB schemes "face challenges in terms of efficient investment, and in terms of the value that can be created from investing those assets from the viewpoint of society".

These goals, he says, are complementary. With time horizons that may extend decades, he says it is vital that investments must take into consideration the changes in both climate and regulation that may happen a long way into the future.

Aggregation of smaller DB scheme assets into the bulk annuity portfolio of a large insurer such as Aviva means "those assets can be invested more efficiently. We can bring much greater firepower to bear when making investment decisions".

Innovation in action

As an example of the complexities of these new investments, Mollan points to the recent innovative deal made by the Aviva annuity business and Aviva Investors with the UK's largest port operator, Associated British Ports, and BNP Paribas. This swap transaction sees the port operator get a discount to its borrowing rate provided it meets certain ESG performance measures, including significantly cutting carbon emissions (both its own and those of direct suppliers) by 2030.

ABP is already one of the UK's largest corporate solar energy producers; the deal gives it a clear financial incentive to continue its aggressive carbon reduction campaign. For Aviva Investors, Aviva's asset management arm, the transaction delivers what head of structured and private debt, Munawer Shafi, described as "tailored sustainability considerations, without compromising on outcomes for borrowers or risk-adjusted returns for our clients".

Mollan comments: "Not even all insurance companies have the ability to do that sort of transaction, and most pension schemes find it even harder."

Mollan gives insights into the complexity of Aviva's investment process in the ESG era. For annuities, the insurance firm invests almost exclusively in investment-grade assets with contractual cash flows. Conventional investment thinking would label these as "very safe" — but with investment horizons in decades it is vital to assess the risk that climate change poses. This can be a physical risk, such as a property investment at risk from extreme weather, or regulatory risk as governments apply sticks and carrots to drive down carbon emissions.

Decarbonisation targets

Aviva has set itself challenging targets for decarbonising its portfolio: not only net zero by 2040 but intermediate targets that are tougher than that required by the Paris Agreement, such as a 60 per cent cut by 2030. These may seem distant, but many of the investments Aviva makes today will still be in the portfolio at that date. Action is needed today.

With investment at scale, it is possible to create frameworks that deliver across multiple investments. For example, Aviva Investors has committed to achieving net zero across its entire Real Assets platform by 2040, which represents approximately £50 billion of assets. This includes developing a proprietary framework for sustainability-linked real estate loans that encourages borrowers to achieve key sustainability targets such as gains in energy efficiency and installation of on-site renewables. The programme, which aims to originate at least £1 billion of loans by 2025, most recently provided £200 million of refinancing to Primary Health Properties plc on behalf of Aviva's annuity business.

Large organisations also have the resources to participate in global initiatives. Aviva, for instance, is a signatory to the United Nations-backed Principles for Responsible Investment, the Finance for Biodiversity Pledge, the Powering Past Coal Alliance, and many other organisations. Such initiatives bring transparency and reassure those who have a pension pot invested with the firm that it is being managed responsibly.

Nuanced decisions are often needed. For example, natural gas is a cleaner fuel than coal, meaning that some gas investments are allowed in the portfolio, but Aviva still needs to undertake a careful evaluation to balance the merits of any such transaction. Aviva has rejected some transactions due to concerns about the risk of methane leakage, since methane is a potent greenhouse gas.

Clearly, energy investing in the current environment requires deep expertise. Mollan says that with long investment horizons, all investments need scrutiny. Climate change will affect whole economies; even government bonds need to be considered through an ESG lens. "Pretty much every long-term investment that we make now, which is pretty much every investment that we make, needs an ESG assessment," he says.

Meaningful engagement

Stewardship is another task that is more effectively done at scale. Engagement not only helps manage risk, but it can also drive investment performance. Aviva can point to many success stories of engaging through its in-house asset manager, Aviva Investors, using its voice to deliver positive change at the companies it invests in. As an active investor, having scale improves the level of influence in being able to build a better and more sustainable future. The alternative is divestment, but doing this means they lose their voice as an investor. Staying invested in a company and speaking up on key issues and resolutions as a shareholder arguably makes more of a difference than walking away, although it is also important to be prepared to divest when an engagement programme has not delivered the results that were hoped for.

The Pension Protection Fund's (PPF) *Purple Book 2021*, the most recent version of the industry's authoritative factbook, estimates the number of DB schemes eligible for PPF protection at 5,220 as of 31 March 2021.

"Some may have in-house investment professionals or large, efficient mandates with external managers," says Mollan. "So they could, in principle, do some of this activity. But the vast majority of those 5,000-plus pension schemes couldn't do it themselves —and there would be significant overheads to them paying an investment manager to do it."

Drill down into the *Purple Book* data, and the lack of scale becomes clearer still. Although giant schemes such as the BT Pension Scheme with its 280,000-plus members get the most attention, they are atypical. 80 per cent of schemes have less than 1,000 members. And 36 per cent of schemes are tiny, with less than 100 members.

Mollan says: "Each of those has their own management structure, their own set of trustees, and in many cases, they're investing, usually with advice from professionals, on their own account. I think that's an inherent inefficiency in the way that pension assets of working people are invested in smaller schemes."

Even before interest in ESG accelerated, smaller schemes were feeling the strain. Managing funding constraints is only one of their many challenges – the constant shift in regulation, keeping down costs, trustee recruitment and training – the overall picture is daunting!

But the real problem, is that small schemes may find it increasingly challenging to access investments that potentially offer higher returns and the new era of ESG and sustainable investing could exacerbate the matter.

There is also the bigger picture to consider. Although mindful of returns, there is a belief that scheme members want their pension savings to work building a better, greener world for future generations.

Mollan says that funds locked up in smaller schemes may struggle to do that: "Those assets can be invested in a more efficient way." If moved under the control of an insurer via bulk annuity transactions, "we can bring significant scale and expertise to the investment decisions we make and the industries we are able to finance from those assets".

Aviva director, annuity asset origination, Marcus Mollan