To buy-in or not to buy-in?

Jos Vermeulen compares a partial buy-in with an insurer to a self-managed de-risking approach

A broader de-risking assessment

Today, many private defined benefit (DB) pension schemes are targeting a buyout as their endgame. However, most schemes cannot afford the cost of undertaking a full buyout in the near term. Therefore, they may ask themselves whether they should conduct a partial buy-in for a portion of their liabilities or simply evolve their current de-risking strategies, taking a self-managed de-risking approach.

To help schemes make an objective comparison of different de-risking options, we examine:

1. Value for money
2. Impact on the overall portfolio
3. Flexibility to deal with the unpredictable

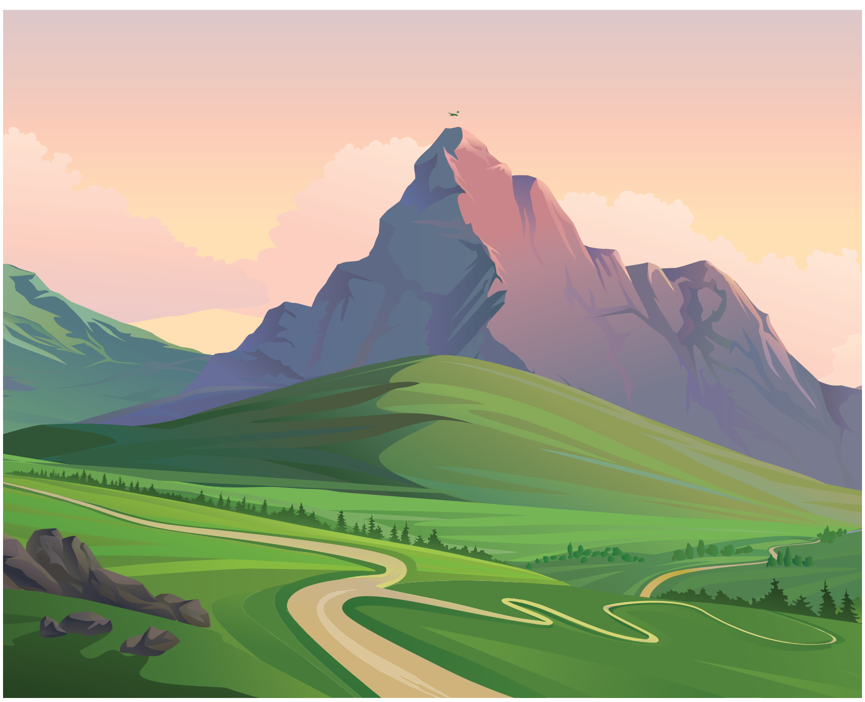
Value for money

A major driver of the increasing demand for buy-ins is the seemingly competitive pricing from insurers. Typically, buy-in contracts are priced on a 'gilts plus' basis, making them look attractive when compared to the cost of matching pension liabilities with government bonds. However, investors should not focus on price alone, but focus on what they receive for this price.

A self-managed de-risking approach is able to replicate many of the characteristics of an insurance buy-in, including longevity hedging, but at a lower cost due to the allowance in insurers' pricing for capital and profit margin considerations, and more stringent investment restrictions.

Historically, we estimate that the difference has been up to 15 per cent when considering the whole scheme membership. In the case of a typical pensioner-only transaction, the difference has been 5-10 per cent, equating to a saving of £25-50 million, assuming a buy-in of £500 million.[1]

Also, because a buy-in is unlikely to cover non-pensioners, while the value of retained liabilities may fall, the risks (for example, the sensitivity to interest rates and inflation) will fall by less. Therefore, under an insurance buy-in, schemes may transfer disproportionally more assets than risks to the insurer.



Impact on the overall portfolio

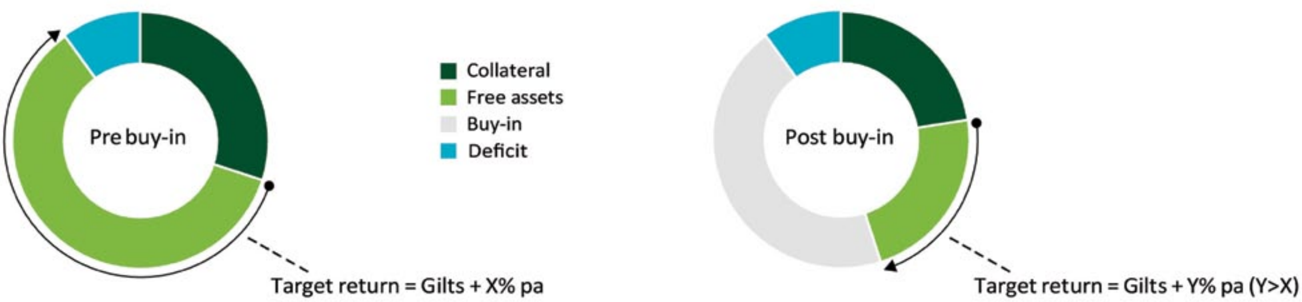
An insurance buy-in offers security and cashflow matching in respect of a portion of the liabilities, but schemes should consider the broader impact on the overall portfolio. In particular, how does a buy-in impact the expected return needed on the remaining assets and/or the scheme's ability to hedge its liabilities, and the expected time to reach the targeted buyout?

1. Impact on the target return required from remaining assets

If a scheme is underfunded, the nominal level of deficit will vary following the buy-in, depending on the valuation basis relative to the buy-in basis. The disclosed deficit may even fall. Crucially, however, a buy-in leaves fewer 'free' assets to

[1] Insight calculations, 2019. Given current Solvency II regulation, we estimate that a pension scheme could achieve a net asset yield of circa 100 basis points more than an equivalent insurer. Around two-thirds of this difference is due to the pension scheme's greater investment freedom, with the remainder reflecting the insurer's cost of capital. We assume that, on average, pensioner liabilities have a duration of 10-15 years.

Figure 1: An insurance pensioner buy-in can increase the target return needed from your assets



For illustrative purposes only

make up any funding level deficit. This increases the target return needed from the remaining assets, everything else being equal.

2. Impact on the scheme's ability to hedge its liabilities

In order to maintain a given hedge ratio, a proportion of the remaining assets must be allocated to collateral, further pushing up the required target return on the 'free' assets. This would incur additional costs and could result in potentially selling assets at an inopportune time. Alternatively, schemes could decide to accept a lower hedge ratio.

3. Impact on the time to achieve a full buyout

The pursuit of higher target returns following a buy-in increases the chance of defaults, negative returns and forced-selling risk, especially during times of market stress. Ultimately, it potentially reduces the chance of the scheme being able to afford a buyout at the target date. The alternative, maintaining a lower hedge ratio, could lead to an increase in liability-mismatch risk.

Flexibility to deal with the unpredictable

Up to the point of a full buyout, regardless of the adopted de-risking method, there will always be risks affecting the assets or the liabilities that cannot be predicted or hedged. Examples could be poor short-term returns, transfer values forcing payments earlier than expected, or changes in legislation causing changes to benefits.

Conclusion

We suggest that schemes look beyond buy-in prices alone and assess the impact at the total-scheme level, considering a wider range of factors, such as value for money, impact on the total portfolio and flexibility to deal with unpredictable events. We believe that this will help them reach their endgame with more certainty. When considering these wider criteria, we believe a self-managed de-risking approach offers a more efficient route to a buyout for many schemes than an insurance buy-in.

Conventional insurance buy-in: A scheme transfers some of its assets to an insurance company, which in return covers the cost of the pension payments for some of the scheme membership, usually the pensioners.
Self-managed de-risking approach: A scheme aims to replicate the key characteristics of an insurance approach – such as hedging longevity risks and generating cashflows to match outgoing payments – directly and more broadly across the whole portfolio.

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