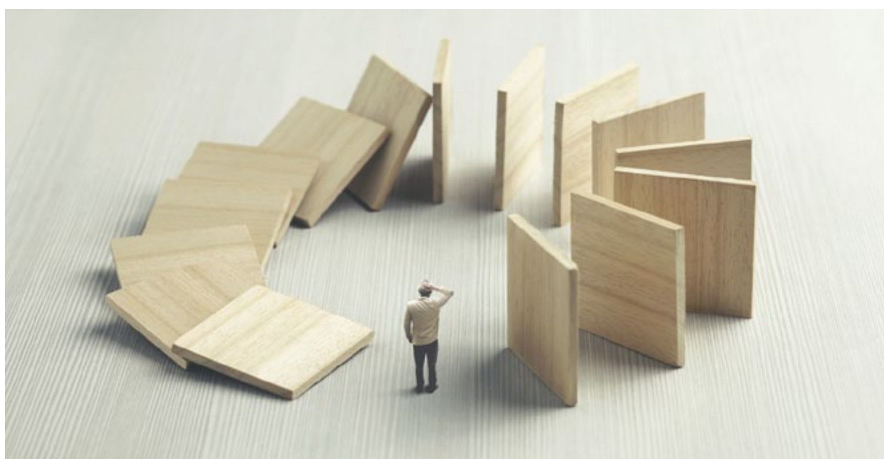
Summary
- Bulk annuity de-risking transactions have reached record levels in 2019, including very large buy-in deals, alongside buyouts.
- A buy-in requires very careful planning, particularly in relation to the impact it may have on the scheme's overall investment portfolio and strategy.
- A buy-in should be planned in relation to the scheme's longer-term funding plan, including future de-risking exercises.

Considering the consequences

The past year has seen record-breaking activity in the bulk annuity market, including a number of huge buy-in deals. David Adams looks at the reasons why pension scheme trustees might consider using a buy-in and the consequences that decision might have on scheme investment portfolios and funding plans



Bulk annuities are very much in fashion: buyout and buy-in transactions worth more than £30 billion in total were announced during the first nine months of 2019, well ahead of the £24.2 billion seen during the whole of 2018 and dwarfing the £12 billion total for 2017, according to LCP.

As well as eye-catching buyouts, 2019 has seen some very large buy-ins, including a £3.8 billion deal between the Asda Group Pension Scheme and Rothesay Life; and a £3.8 billion buy-in the same insurer is delivering for the Allied Domecq scheme. The latter deal was announced the same week that Rothesay unveiled the largest-ever UK buyout, a £4.7 billion transaction with telecommunications company Telent, which will eventually be completed as a buyout in 2022 but begins with a buy-in.

Other buy-ins announced during the year included the British American Tobacco UK Pension Fund insuring £3.4 billion of liabilities with Pension Insurance Corporation (PIC); and a Rothesay Life £520 million buy-in for the Cadbury Mondelez Pension Fund. Meanwhile, LCP has reported strong demand for its streamlined buy-in/buyout services for smaller pension schemes.

The logic behind a buyout is pretty straightforward, but the case for a buy-in is not always so clear cut. It may form a stepping stone to a buyout, but for some schemes, says PIC chief origination officer, Jay Shah, a buy-in is the next logical step in a de-risking journey that begins as a scheme moves towards holding more long-term, fixed income assets, rather than risk-seeking, high return assets. "The more de-risked a scheme already is, the greater proportion of its assets that are already held in fixed income, the more likely it is to move to buy-in," he says.

As an investment, the buy-in policy can offer greater security than fixed income assets because it provides cashflow – often better cashflow than provided by the gilts being used to purchase the buy-in – while protecting the scheme against longevity and negative inflation risks.

"For most of my clients, the decision starts with longevity risk," says PwC head of pension risk transfer, Ben Stone. "They've got interest rate and inflation hedging, but longevity risk can blow them off course."

"By using a buy-in you generate investment headroom; and it leads to greater security and less volatility," says Aon senior partner and head of the risk settlement group, Martin Bird.

But although a buy-in is notionally an investment, it is also a permanent arrangement. "Gilts you can sell, but a buy-in is for life," says Shah.

Pensions and Lifetime Savings

Association (PLSA) DB policy lead, Tiffany Tsang, stresses the importance of trustees considering the wider consequences of a buy-in. "What impact does it have on your remaining assets?" she asks.

LCP partner, Charlie Finch, says his team always asks trustees considering a de-risking transaction exactly which assets will be used to fund it. "You need to make sure you have enough collateral, liquid assets, to maintain the hedging you need," he says.

"To what extent is this going to limit flexibility?" asks Barnett Waddingham head of bulk annuity consulting, Gavin Markham. "Might it inhibit my ability to hedge? If I'm spending a good chunk of my assets, do I have sufficient liquidity to meet further needs going forward?"

Indeed, as Stone puts it: "If you give away your gilts to pay for the buy-in, you may find that the numbers don't add up and you have to exchange more of your return-seeking assets for more gilts you can use to hedge."

There is a risk that a buy-in may make a buyout more difficult, warns Insight Investments head of solutions design, Jos Vermeulen.

"When we've looked at the impact of a buy-in on portfolios we have found that, in a majority of cases, buy-ins make it more difficult to get to buyout," he says. "The reason is what it can do to the risk and return of the remaining portfolio. You're left with some risky liabilities and fewer assets to deal with that risky liability.

"A buy-in ties up a lot of capital in a very illiquid asset and if transfer values move, or equity markets fall, you have very little scope to change things. In many cases it will extend the time it takes you to get to buyout."

There is also a need to ensure that the mix of liabilities the scheme will be asking an insurer to take on in a future buyout will appeal to the insurer's risk appetite.

"Smaller schemes are more constrained in terms of how many times they can slice and dice liabilities," says Markham. "You don't want to be going to the market with slices of liabilities that are too small."

Bird stresses the need to balance numbers of pensioner members and deferred members within the group of members to which the buy-in applies. "If you leave yourself a block of risk that is very deferred-heavy that's going to be a lot less attractive to the market," he warns.

Each insurer will have a different appetite for different types of risk, so solution might be to work with a number of different insurers to de-risk different groups of liabilities. However, this could create additional complexity and communication challenges if the scheme then moves to a full buyout later on.

Some trustees may conclude, when considering the impact of a buy-in on investment and funding strategies, that there is a case for proceeding straight to a buyout.

"Insurers' prices are very competitive at the moment, so more schemes find themselves thinking about full scheme buyouts sooner than they had anticipated would be the case," says Bird. "Once you get within a few per cent of being able to afford it, maybe there are levers that can be pulled. Maybe the sponsor can draw on a war chest."

But, says Vermeulen, trustees also need to consider the impact of the buy-in on the scheme sponsor, in part because there is a risk the process will actually push the date of a buyout further into the future. "If you want to solve *[the de-risking problem]* in the same amount of time you need to take on more risk; if you're not taking on more risk you're pushing the buyout further into the future," he says. "You're relying on the sponsor covenant for longer, which means you're taking on more risk.

"If you're going to do a buyout in the next few years, then you can understand why a scheme would be doing buy-in: they're not taking much risk and they're well-funded," he continues. "But if you're looking to do buyout in five to 10 years' time, a buy-in is probably not the best use of your capital."

On the other hand, external events may change the situation, such as a sponsor preparing for a major acquisition, or itself being acquired by another company. Such changes may encourage the sponsor to increase available funding for the scheme with a view to moving to a buyout.

That means it may be sensible for a scheme to put in the groundwork needed for a buyout, suggests Rothesay Life co-head of business development, Sammy Cooper-Smith. "There's no harm in pension schemes starting that process now: cleaning data, checking records are correct and so on," he says. "We have seen examples where something has changed and a scheme is suddenly in a position where they can afford to do a buyout. If you find yourself in that position, you will be pleased you are ready."

Whether – or whenever – an individual scheme is ready to go through a buy-in or a buyout, the market for de-risking transactions has acquired a powerful momentum. But even when the price starts to look very appealing, the decision as to whether to buy-in or buyout must be based above all on a clear assessment what it will mean for the members' long-term interests.

"You need to look at the before and after positions of doing the transaction and ask what impacts it has on your future returns and on your risk profile, to establish whether doing this is taking the scheme towards your objectives," says Markham. "It's a decision that needs to be strategically correct."

Written by David Adams, a freelance journalist

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