HYMANS ROBERTSON

Buy-in monitoring service

Comprehensive analysis of the buy-in market - January 2017

Headlines

Pensioner buy-in pricing gets better and better at end of 2016

The final quarter of 2016 saw a rise in the attractiveness of pensioner buy-in pricing offered by insurers. Some schemes that were in a position to take advantage of the opportunity will have been able to transact at a price much lower than the value of gilts required to meet the same liabilities.

These opportunities will have been driven by a number of factors including commercial decisions by insurers to offer more competitive pricing so as to get transactions completed before their financial year ends. The introduction of Solvency II also suppressed the volume of business written at the start of the year, resulting in a desire for some insures to catch-up at the end of the year. **See our "Buy-in pricing" section for more details.**

Buy-in volumes set to surge in 2017

Highly attractive pricing being offered by insurers at a time when some schemes are seeing improvements in funding levels could create the backdrop for 2017 to be a very busy year and we might see buy-in and buy-out volumes of £12bn-£15bn.

Wide range of buy-in pricing between insurers

We have continued to see a wider range of buy-in pricing offered by different insurers than we typically saw before the introduction of Solvency II. In some cases, the range of prices between the cheapest and most expensive insurer has been double that seen in 2015.

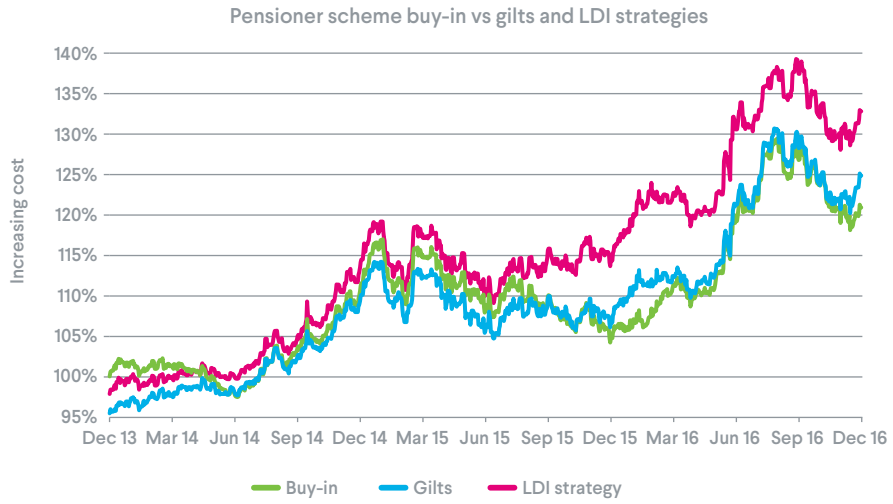
We are also seeing varying pricing for similar transactions. It is no longer the case that certain insurers are consistently stronger for certain types of transaction. This is not surprising given differences in approach to implementing the new Solvency II regime and the increased focus on sourcing particular assets for each transaction. **See our "Buy-in insights" section for more details on the link between insurers' investment strategies and the prices they are able to offer pension schemes.**

Buy-in pricing

A buy-in policy insures against all risks associated with a subset of pensioner liabilities. When considering whether to undertake a buy-in policy, pricing is best assessed against returns on other very low risk assets.

Pensioner buy-in pricing

The chart below plots the relative cost of hedging pensioner liabilities with a buy-in policy, a portfolio of gilts, or a swaps and cash based LDI strategy.

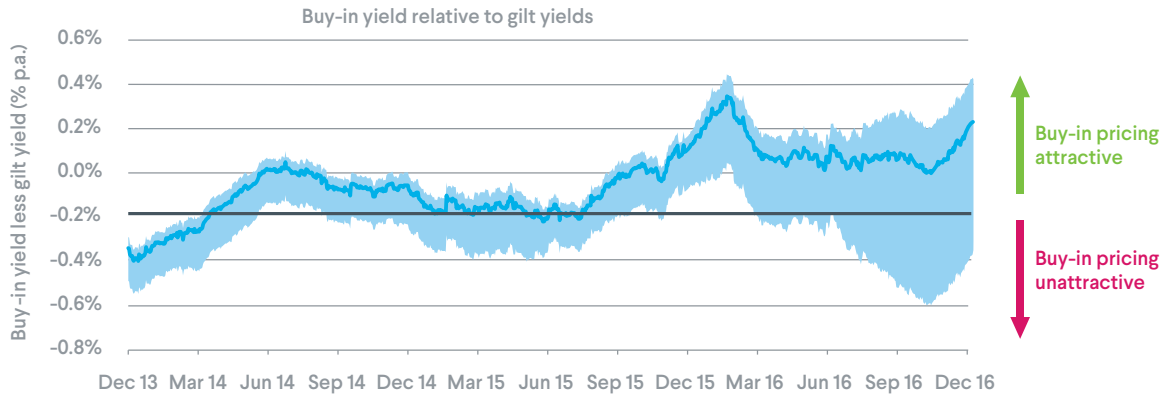


Pricing analysis

Yields bounced back during November 2016 which has helped to reduce the nominal price of buy-in. Average pricing is cheaper than the value of gilts needed to match the same liabilities and improved further towards the end of 2016 (the green line is below the blue line in the above chart). This means that schemes can exchange gilts for a buy-in policy, whilst increasing the return on the asset portfolio, obtaining a better cashflow matching asset and addressing demographic risks.

Buy-in yield analysis

Although tailored to meet the benefits of a subset of members, a buy-in contract remains an asset of the scheme. In assessing the attractiveness of a buy-in, it is useful to understand the investment return (yield) implied by the price.

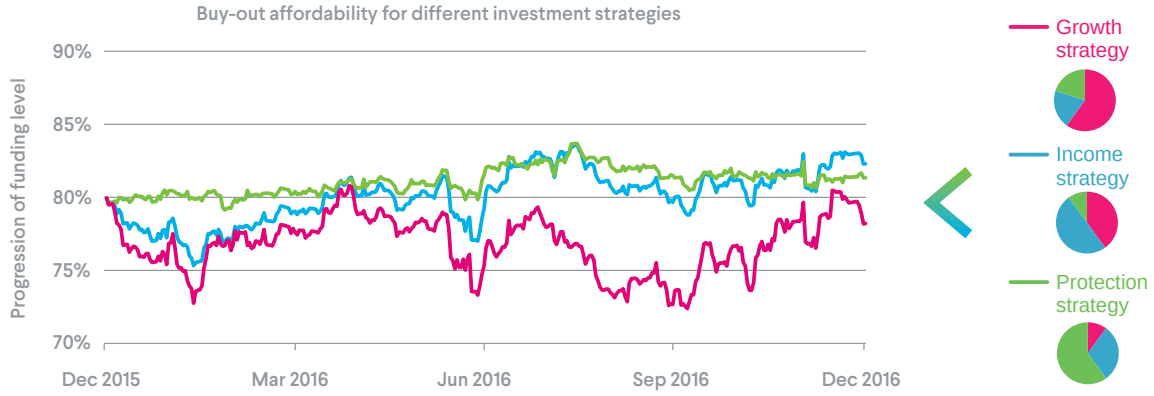


The chart above shows the yield locked into based on typical buy-in pricing. This analysis varies between schemes depending on particular views over members' life expectancies. A buy-in yield of 0.1% p.a. to 0.2% p.a. below gilt yields might be viewed as a "fair" price to pay, given the reduction in longevity risk, other demographic risks and level of cashflow matching achieved.

Hyman Robertson's online 3D Analytics tools allow trustees and sponsors to track buy-in pricing and yield analysis tailored specifically to their individual scheme population.

Buy-out affordability

The chart below shows progress towards full buy-out funding for pension schemes at different stages in their de-risking journey.



Affordability analysis

2016 has been a very volatile year for financial markets. The impact on buy-out affordability for pension schemes very much depended on the scheme's asset and hedging strategy. Those hedged to interest movements through an income or protection based strategy generally fared well post Brexit when interest rates fell significantly. However, strong equity returns will have helped improve the funding position of schemes with high growth asset exposures.

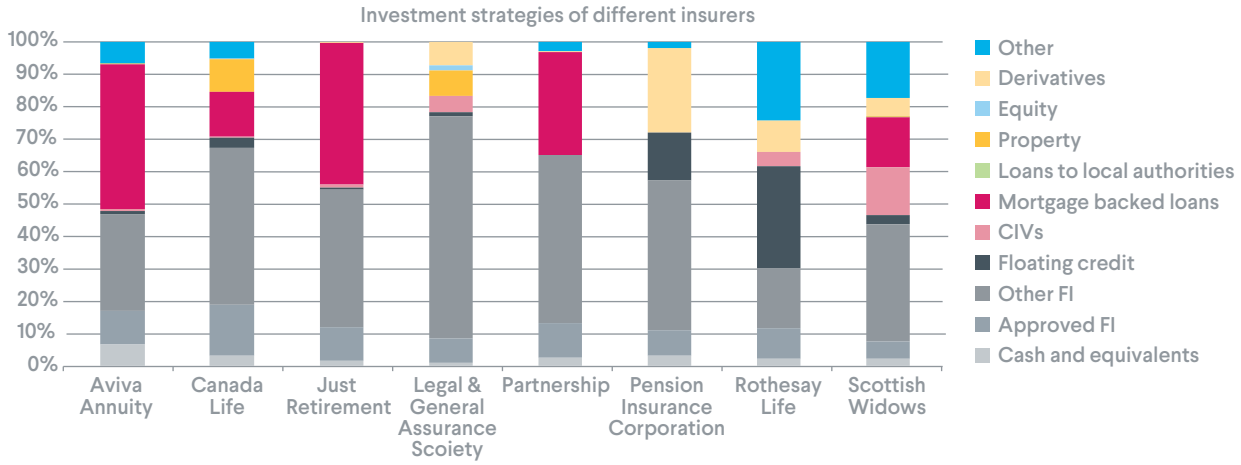
On average, schemes following an income or protection based strategy will be in a better position and closer to buy-out now than they were at the start of 2016, whilst those with lower hedging and more in growth assets are more likely to have maintained their position or lost ground.

Buy-in insights

Insurance company investment strategies

Insurers invest in a portfolio of bond-like assets which provide a good match for their cashflow requirements. They adopt a "buy-and-hold" approach and include illiquid bonds. The insurer is able to hold these bonds until maturity and is not expected to be a forced seller at any point. The insurer can then reflect the illiquidity premium in these investments in the discount rate used to value its annuity liabilities and offer a lower price to pension schemes.

Different insurers adopt different investment strategies (illustrated in the chart below) and their investment strategy affects their pricing basis. So how insurers invest will impact how competitive they are from time to time.



Source for chart data: PRA Insurance Returns and Hymans Robertson research.
Figures are as at 31 December 2015 for all firms except Just Retirement, which is as at 30 June 2015
For Canada Life, Legal & General Assurance Society and Scottish Widows, only the assets held in the non-profit fund have been included.
For all firms, total assets in both Form 48 (non-linked) and Form 56 (index-linked) have been included.
Please note for some companies (for the funds shown in the chart) there may be some assets backing non-annuity business.

Over the past few years there has been a trend for insurers to move away from vanilla corporate bond investment strategies towards alternative forms of long-dated lending, which are typically more illiquid and therefore provide a higher illiquidity premium. These assets include infrastructure debt, commercial real estate loans and social housing loans. As can be seen from the above chart, Just Retirement and Partnership (collectively now JRP Group plc) and Aviva have material proportions of their portfolios invested in equity release mortgage assets. We have also seen increased use of overseas corporate bonds (hedged back to Sterling).

The growing competition in the buy-in market is only likely to fuel this trend towards alternative forms of debt – insurers need to optimise their investment strategies in order to maximise their competitiveness if they are to capture a sufficient share of the market.

Solvency II has heightened the need to closely match assets and liabilities. Firms that adopt a buy-and-hold strategy and can evidence close cashflow matching can benefit from a "Matching Adjustment" which leads to more efficient use of capital and a lower price to pension schemes.

In a Solvency II environment, the different investment strategies adopted by each insurance company and market conditions at the time has a much greater impact on the relative competitiveness of the insurers. It is important for schemes to be aware of these dynamics and the potential short-term nature of pricing opportunities when planning a buy-in.

Buy-in contact

If you would like to discuss this quarterly update in more detail please contact your usual Hymans Robertson contact or:

James Mullins
Partner
Head of Risk Transfer Solutions
T 0121 210 4379
E james.mullins@hymans.co.uk

Richard Wellard
Partner
Risk Transfer Specialist
T 0121 210 4355
E richard.wellard@hymans.co.uk

Eddie McAuley
Partner
Risk Transfer Specialist
T 0141 566 7792
E eddie.mcauley@hymans.co.uk

Clive Fortes
Partner
Risk Transfer Specialist
T 020 7082 6235
E clive.fortes@hymans.co.uk

Michael Anderson
Risk Transfer Specialist
T 0121 210 4362
E michael.anderson@hymans.co.uk

Christine Cumming
Risk Transfer Specialist
T 0141 566 7943
E christine.cumming@hymans.co.uk

Iain Pearce
Risk Transfer Specialist
T 0121 210 4358
E iain.pearce@hymans.co.uk

Freya Williams
Risk Transfer Specialist
T 0121 210 4346
E freya.williams@hymans.co.uk

Harry Allen
Risk Transfer Specialist
T 0121 210 4365
E harry.allen@hymans.co.uk

Kieran Mistry
Risk Transfer Specialist
T 0121 210 4338
E kieran.mistry@hymans.co.uk