HYMANS ROBERTSON

November 2020

Pension Risk Transfer Insights

Achieving buy-out: One or more buy-ins?

So, you've decided to target buy-out. But do you know how you're going to get there? Here, we explore how pension schemes can set their buy-out strategy by weighing the pros and cons of a series of buy-ins.

Setting the scene

Buy-out has become the most popular endgame for UK defined benefit pension schemes, with our survey of 100 DB Trustees showing that 47% of schemes are targeting buy-out. This trend looks set to continue, for example, with Fast Track funding requirements under The Pensions Regulator's DB Funding Code potentially positioning schemes within touching distance of buy-out as they mature.

Once you know where you're going, the natural next question is how you're going to get there. All liabilities need to be insured, but should you do this all in one go once affordable, or enter into a series of smaller buy-ins over time?

The answer, as is often the case, is 'it depends' …

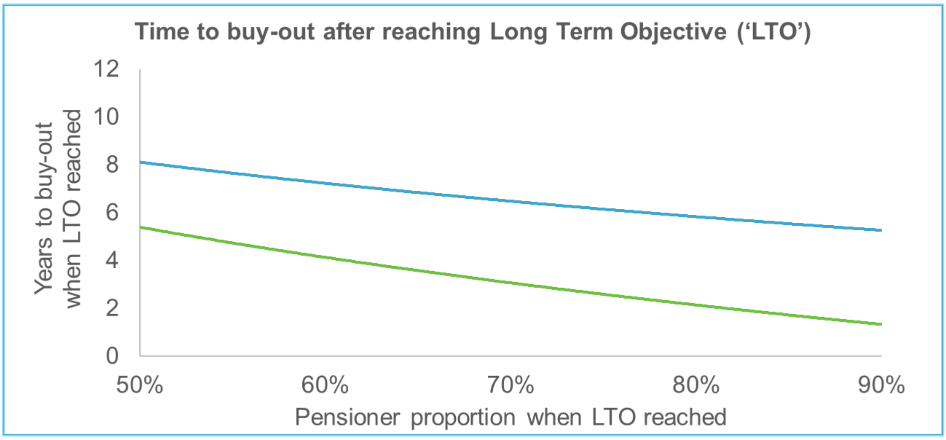
The tools for setting your buy-out strategy

Below, we explore the key 'inputs' you need when setting your buy-out strategy.

Timescales to buy-out

How far are you from buy-out? Projecting a scheme's buy-out deficit is often eye-opening, as buy-out is reached quicker than expected, driven by returns, contributions, and importantly maturity. Pensioners are cheaper to insure than deferreds, and options like cash at retirement generate savings against buy-out. Where buy-out is concerned, time is your friend.

We've demonstrated this with this chart, which estimates timescales to buy-out for a typical scheme once a given long term objective is met, depending on pensioner proportion at that time. There are no contributions coming in at this point; reaching buy-out is driven primarily by maturity, with a little asset outperformance.

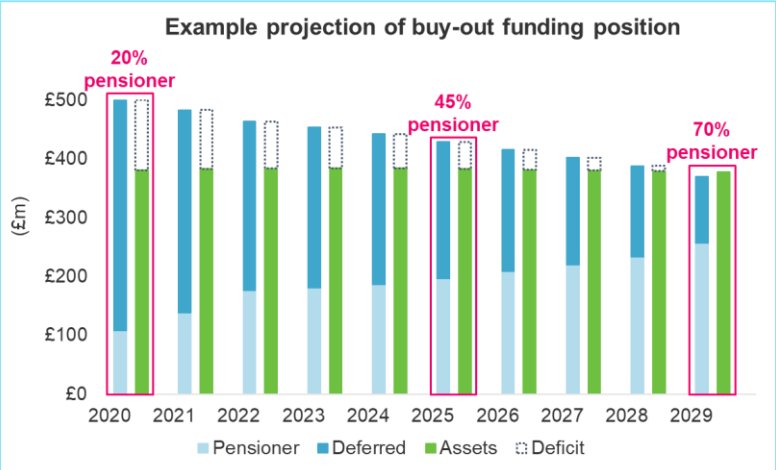


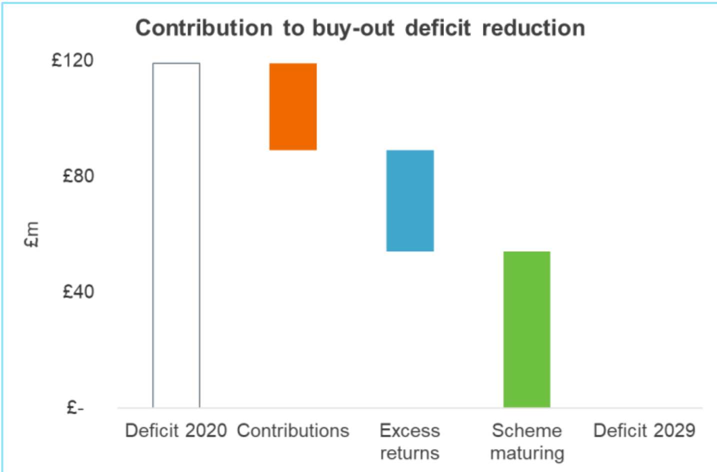
Liability evolution

Insuring deferred members is more expensive relative to insuring pensioner members. If you wait for deferred members to retire, chances are you'll pay less. Therefore, schemes typically wait to insure deferreds in a final buy-in.

Deferreds are more expensive to insure for a reason. The longevity risk is higher and the reinsurance market is less developed. Their cashflows are more uncertain because of member options. Their benefits are more complex to administer. As a result, many insurers can offer better pricing for deferreds if a material proportion of pensioner liabilities are included too.

All of this means it's important to have a clear view of your liability evolution over time to forecast when you'll have sufficient pensioners for a decent interim buy-in, and how new pensioner liabilities will emerge over time for another interim buy-in or to improve attractiveness of the final transaction.





Wider investment strategy

A buy-in is a one-way transaction, becoming an asset of the scheme. It's important that any buy-in fits the scheme's wider strategy and your overall portfolio continues to provide the risk/reward profile you need to achieve your objectives. Three key questions to ask are:

Maintain returns needed to achieve buy-out?

Interest rate and inflation **hedging maintained** with acceptable leverage within Liability Driven Investments?

Sufficient liquidity to fund premium and manage cashflow and hedging requirements going forward?

As funding levels improve, schemes typically de-risk their investment portfolio. If you're aiming to buy-out, you should look at how buy-ins could be incorporated into your investment de-risking plans.

The market

Market dynamics and insurer preferences drive the pricing and terms you can achieve. You can't predict the future, but current market dynamics and general trends over time should inform your buy-in strategy.

The insurance market landscape is nuanced and complex. Each insurer has its own preferences, business objectives and capabilities, and even broad rules of thumb don't always work. A good example of this is the 'bigger is better' argument. Yes, having a larger transaction should drive economies of scale within insurer pricing (e.g. expense loadings won't be as material), and we have seen some of the most attractive pricing for 'mega' sized deals (>£2bn), but factors like streamlined processes and pre-negotiated reinsurance terms for smaller transactions means that excellent terms can be achieved for smaller transactions too.

One trend we've seen over time is increasing demand from pension schemes for buy-ins and buy-outs. With many schemes targeting 2030 as their end game and around £2trn of uninsured defined benefit liabilities, there is a material risk that increasing demand pushing up insurer pricing in future. For schemes that are far from buy-out, a series of buy-ins along the way mitigates this risk.

It is important to understand these dynamics when deciding how and whether to divvy up liabilities into smaller buy-ins to generate sufficient competition from the market and allow schemes to achieve their price targets.

Table: Insurer appetite by transaction size and profile

	Deferreds?	<£50m	£50m - £100m	£100m - £0.5bn	£0.5bn - £2bn	>£2bn
Aviva	✓	🟢	🟢	🟢	🟢	🔴
Canada Life	✗	🟢	🟢	🟢	🔴	🔴
Just	?	🟢	🟢	🟢 🟡	🔴	🔴
Legal & General	✓	🟡	🟡	🟢	🟢	🟢
Phoenix	✗	🔴	🟡	🟡 🟢	🟢	🔴
PIC	✓	🟡	🟢	🟢	🟢	🟢
Rothesay Life	✓	🔴	🔴	🟡 🟢	🟢	🟢
Scottish Widows	✓	🔴	🟡	🟢	🟢	🔴

Key

✓	Able to write	🟢	More likely to quote
?	More selective	🟡	More selective
✗	Unable to write	🔴	Unlikely to quote

Other considerations

A set of considerations wouldn't be complete without a bunch of 'other stuff' (!) that may tip you towards preferring one or a series of transactions.

Below we set out these other considerations through the lens of pros and cons for a series of buy-ins. Schemes will place more emphasis on different areas and so the balance will differ for each scheme.

Pros of a series of buy-ins	Cons of a series of buy-ins
Smooth pricing exposure, capture opportunities Steps can be taken to invest more 'like an insurer' to better match insurer pricing, but the complex factors that drive pricing cannot be perfectly matched. Interim buy-ins lock in insurer pricing, reducing mismatch risk. Also, a measured and timely approach to market can help schemes capture pricing opportunities over time.	**Reduced flexibility in investment strategy** Locking up assets in a buy-in reduces your ability to make other changes, such as dialling up hedging of interest rate and inflation risk or re-risking.
Reduce longevity risk exposure over time As schemes mature and de-risk their investment strategy, longevity risk becomes a more material relative to total risk. Buy-ins are one of the few ways to manage longevity risk.	**Expenses and resources** Buy-ins cost money to implement, both through advisory fees and disinvestment costs. These costs should be balanced against the benefits of a buy-in, which include savings on investment management charges on the assets used to fund the premium.
Potential P&L charge on final buy-in reduced Buy-ins result in a balance sheet strain. For a final buy-in, that strain may flow through P&L depending on the auditor's approach, which is a key concern for a lot of employers. Balance sheet strains for buy-ins along the way do not hit P&L directly, reducing the potential final P&L charge.	**Tempered market due to existing relationship** Any existing relationship may put off other insurers if they think you prefer a certain insurer or, conversely, your previous insurer may work harder and price keener to win your business.

Capturing attractive buy-in pricing along the way

For a buy-out, price assessment is generally based on affordability – can you afford the premium based on available assets and any contribution the sponsor is willing to make, while holding back a reserve for contingencies and expenses to finalise wind-up?

For interim buy-ins, assessing price is not so simple. While traditionally buy-in has been assessed based on return requirements, as schemes view buy-ins through the lens of a wider buy-out strategy, buy-ins can instead be assessed based on the impact on the scheme's journey to buy-out and how pricing compares to general market levels. This leads to two considerations:

The price you need:

Any buy-in which maintains or accelerates a journey to buy-out is a positive outcome. Better still if the buy-in reduces risk around that central expectation. Indeed, the risk reduction might even justify a slight lengthening in timescales to buy-out if it materially narrows your range of potential outcomes and gives you a better chance of getting there.

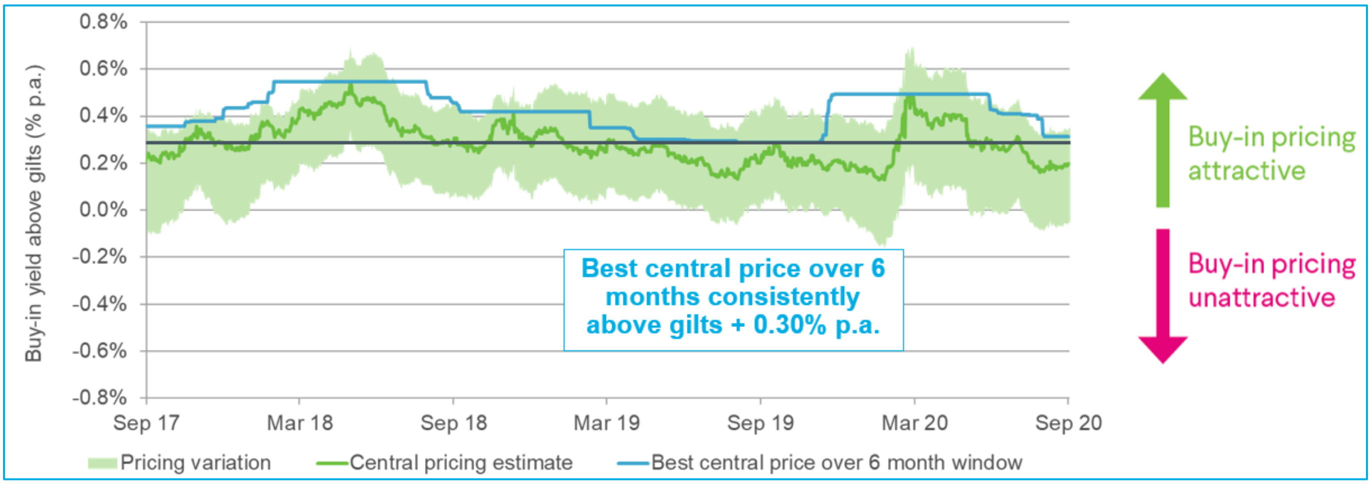
The price you deserve:

Schemes will want to ensure they are getting a competitive price from the market. Market pricing is volatile over time, and there are peaks and troughs to that volatility. A good risk transfer adviser will be clued into market pricing and able to give a view regarding whether a scheme is getting a good price.

Schemes can balance these two considerations to form a view on their price hurdle – the level that the insurers must get below in order to have a chance of winning your business. This hurdle can then be used when approaching the market. If it's not achieved, time to wait out the market, perhaps working exclusively with one or two insurers until pricing volatility works in your favour.

Below we've illustrated how patience can work in a scheme's favour. The chart shows general insurer pricing over time, and the best price achievable in any 6 months period.

Chart: Typical pensioner buy-in pricing over time



Closing thoughts

The right buy-out strategy for a scheme will depend on their unique situation. Trustees and sponsors should work with their advisers to map out their journey, balancing competing risks and priorities against the backdrop of an increasingly busy market to find the solution that works for all and gives the scheme the best chance of ultimately reaching buy-out.

We explored this topic in a webinar earlier this year, a recording of which can be found on our website. On the webinar, we also looked at case studies putting this all into practice.

If you would like to discuss the right approach for your scheme, please don't hesitate to get in touch.

Dr Richard Wellard

Partner and Head of Buy-out Solutions

0121 210 4355
richard.wellard@hymans.co.uk

Kieran Mistry

Risk Transfer Specialist

0121 210 4338
kieran.mistry@hymans.co.uk