

Buy-ins and buy-outs: de-risking or re-risking?

A recent [opinion piece](#) in the FT argued that buy-ins and buy-outs carry needless credit risks and likened them to “ultra-cheap, unsecured, long-term loans”. Should pension schemes and their sponsors be concerned about the trend towards using insurance as a risk management tool?

Loan or insurance policy

The article starts by comparing an insurance policy with a home mortgage. In the case of a bank lending to a mortgage holder the bank takes security over the property, whereas when a pension scheme pays a premium to an insurer, the pension scheme has no security over the “loan”. While this argument is made for a bulk annuity (“buy-ins” and “buy-outs”), it could apply equally to a retail annuity policy held by an individual.

When a bank provides a mortgage it is lending to an individual homeowner. At outset, the bank will look at the individual’s finances to get comfortable they are likely to pay the mortgage back, but the individual is not subject to any sort of legislation or regulation that requires them to be financially secure over the lifetime of the mortgage. The bank needs to take extra steps to ensure that in a default scenario, it has first call on the property for which the loan has been taken out. However, a bulk annuity is an insurance policy not a loan, so the policyholder is more than a creditor – in a default scenario the policyholder would be paid out (along with other policyholders) before any loan creditors see any of their debt repaid. In addition, the insurer remains subject to the rigours of the EU-wide Solvency II capital regime, which requires it to hold capital to cover unexpected outcomes – more on this to come.

Matching Adjustment: fact or fiction

The article also talks about the “manufacture of equity” via the Matching Adjustment. The Matching Adjustment is an established part of the Solvency II regime, and a similar concept has existed for many years in previous regulatory regimes. It applies for business where insurers can demonstrate to the Prudential Regulatory Authority (PRA) that asset cashflows match their liabilities to policyholders very closely and that they are able to hold those assets to maturity.

Insurers who use the Matching Adjustment value their assets at market value and measure their best estimate liabilities using a discount rate linked to the yield on these assets, less an allowance for credit risk. For a buy to hold investor, so long as the income stream on your portfolio continues to match the liabilities (and many insurers use longevity hedging to ensure that this is the case) and you continue to make an appropriate allowance for the risk of default on your assets, movements in market prices make you no more or no less solvent.

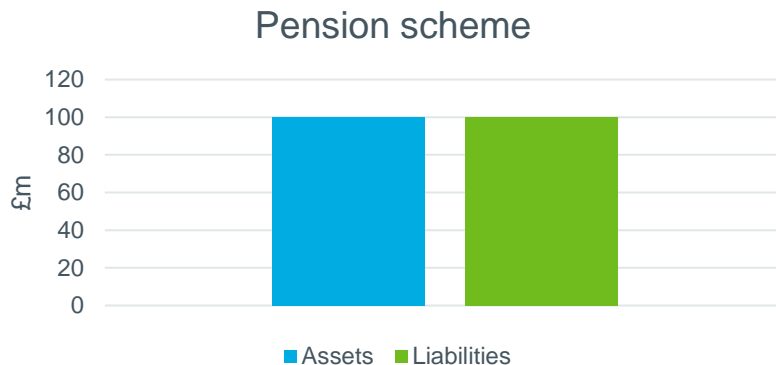
Regulatory arbitrage?

The Pensions Regulator has launched a consultation on its revised code of practice for defined benefit funding. Many readers will be familiar with the “fast track” long term objective set out in the consultation, which is for pension schemes to target full funding on a prudent basis (expected to be based on discount rate of either gilts plus 0.25% p.a. or gilts plus 0.5% p.a.) by the time most of their members have retired. Indeed, some pension schemes will already use more prudent funding measures than this.

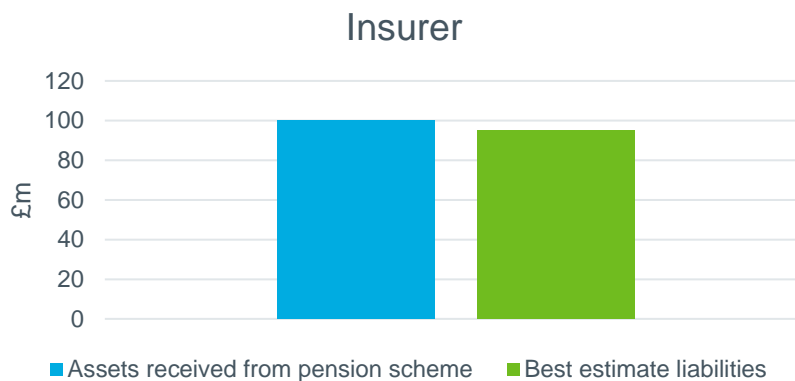
Bearing in mind that the Matching Adjustment allows insurers to use a discount rate that could be as high as 1.5% p.a. above risk free rates¹, you may wonder how it is that insurers are permitted to use much higher discount rate assumptions and still be considered more secure.

As noted above, the Matching Adjustment is only permitted where insurers hold assets that closely match their liabilities and are not exposed to the risks of temporary fluctuations in market prices. In addition, Solvency II requires the insurer to hold sufficient capital (in excess of the assets required to cover its liabilities) to withstand a 1-in-200 stress. For annuity business, this capital will mostly be in respect of credit risk (i.e. the risk of default and downgrades within their asset portfolio) and longevity risk, to the extent that this has not been hedged by the insurer. The result of this additional capital is that the total assets held in respect of the liabilities by an insurer are much greater than they would be by a typical pension scheme.

It may be helpful to think about this in terms of some figures, albeit in a simplified example. Consider a pension scheme that consists only of pensioners, with £100m of liabilities on a gilts +0.5% basis and £100m of assets to back the liabilities.



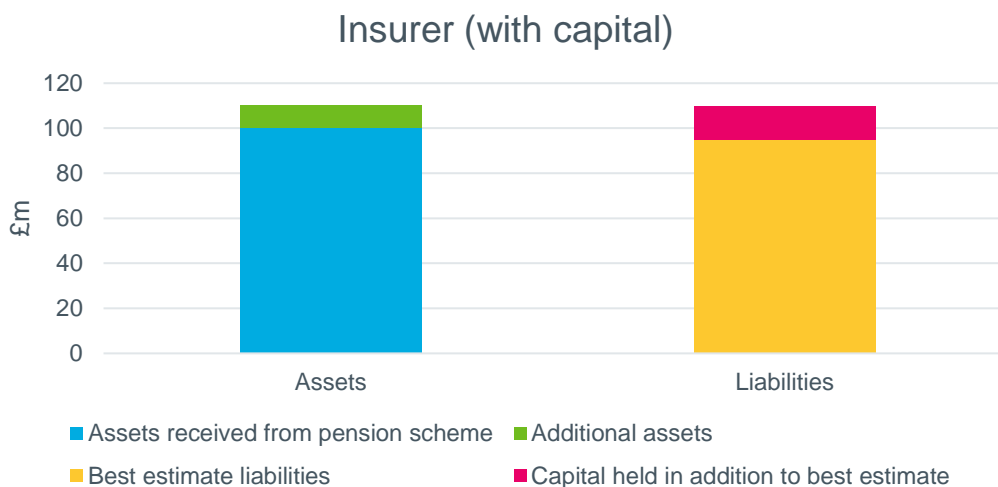
If this pension scheme purchases a buy-in policy for £100m, the insurer receives the assets as payment of the premium and then re-invests a portion of them into higher yielding assets that match the liabilities of the scheme (e.g. corporate bonds, infrastructure debt, etc.). By applying the Matching Adjustment, the insurer’s best estimate liability is not £100m, rather it is now £95m.



¹ Note that the matching adjustment is added to a swap yield curve to determine the discount rate used by insurers



This insurer now holds £5m of capital, as the £100m of premium exceeds the £95m of best estimate liabilities. However, in order to have a sufficient level of assets to cover its risk exposure (the key risks being credit and longevity), it actually needs to hold £15m of capital², so must fund a further £10m itself.



The closest parallel for capital in the pension scheme regime is the covenant of a pension scheme’s sponsor, as this provides a buffer should an unexpected event occur and the assets of the scheme not be sufficient to cover its liabilities.

Member security

In summary, how do we think about member security in the context of buy-in and buy-out? It is important that we distinguish firmly between the two:

- in the context of buy-in the pension scheme retains protection not just from the buy-in itself but also from the scheme sponsor and the PPF; whereas
- in the context of buy-out, these latter two are replaced by the insurer and insurance regime.

With a bulk annuity, pension schemes (for buy-in) or members (for buy-out) do retain a direct counterparty exposure to the insurer, but it is not akin to an unsecured loan. This is because of the capital requirements imposed on the insurer, the legal protections placing policyholders ahead of creditors, and the active and effective regulation from the PRA.

In addition to these protections, policyholders of insurers authorised by the PRA are protected by the Financial Services Compensation Scheme (FSCS) should an insurer suffer an insolvency event. All long term insurance business, including individual annuitants and pension scheme trustees with buy-in contracts, currently have 100% of their benefit covered. It should be noted that the FSCS is funded by levies paid by financial services firms. There is no precedent of the FSCS being called on to assist a large life insurer – if required to do so it would either look to industry to assist in the short term, or rely on an agreement it has with government to borrow from the National Loans Fund and then seek to recoup this through future levies.

While pension schemes can effectively manage risk themselves, for many schemes the substitution of an uncertain (in the long term) sponsor covenant with that of an insurer is a clear improvement. For very well funded pension schemes with very strong employer covenants, of which there are not many, the case for buy-out or for moving from buy-in to buy-out may not be so clear.

² For the purposes of this article, we consider risk margin to be capital and have not distinguished between the Solvency Capital Requirement (SCR) and the Risk Margin. We have also assumed in this example that the insurer holds a small buffer above the SCR.

Get in touch

If you have any questions about anything covered, please don't hesitate to get in touch.



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