COMPARING BUY-OUTS AND BUY-INS
WHY DIFFERENT ANALYSIS IS REQUIRED

BUY-OUTS AND BUY-INS ARE TYPICALLY UNDERTAKEN BY TRUSTEES OF DEFINED BENEFIT SCHEMES TO HELP MANAGE OR REDUCE RISK. WHILE BOTH SEEK TO REDUCE RISK AND SECURE MEMBER BENEFITS, THEY DIFFER FUNDAMENTALLY IN THREE WAYS: THEIR PURPOSE, PRACTICALITIES AND POTENTIAL INVESTMENT IMPACT. CONSEQUENTLY, THE ANALYSIS YOU SHOULD CONDUCT WHEN YOU CONSIDER THEM NEEDS TO BE DIFFERENT.

PURPOSE

An insurance buy-out is the destination point at which trustees and sponsors can be confident of securing all the members’ benefits, i.e. an endgame solution.

An insurance buy-in is a potential investment option to help trustees move towards their endgame, which is usually a buy-out.

PRACTICALITIES

Under an insurance buy-out, trustees typically transfer all their assets and liabilities to an insurance company. The insurer takes on legal responsibility for fulfilling pension obligations to scheme members. The corporate sponsor divests all responsibility for the scheme, and scheme members become policyholders with the insurer. This allows the trustees to wind up the scheme, extinguishing all governance responsibilities.

Under an insurance buy-in, trustees typically transfer some of their assets to an insurance company in return for a cashflow stream that reflects the actual pension payments for a portion of the scheme membership (the members insured). The insurance company makes payments to the scheme, which in turn makes payments to the pensioners. The trustees retain the governance responsibility for managing the whole scheme, effectively making the buy-in an asset of the scheme.

Figure 1: How buy-outs and buy-ins support payments to pensioners

1 Partial buy-outs are possible, but in the UK they are rare because this could leave trustees open to breach of their fiduciary duty to treat all members fairly in the subsequent event that there are insufficient assets to pay the remaining members’ benefits. 2 There have been some cases where trustees have conducted a buy-in for all of their liabilities, but this is usually a short-term, pragmatic step to extinguish the mis-match risk while preparing the details for a buy-out, and subsequent wind-up of the scheme. 3 For illustrative purposes only.
POTENTIAL INVESTMENT IMPACT

Once a buy-out is complete, the pension scheme has wound up, and scheme members are individual policyholders with the insurer.

Following a buy-in, when looking at the notional portion of the members that have been insured, it can appear that there are no investment implications as their pension payments are matched exactly by the insurance contract (ignoring any governance costs incurred by the scheme for managing these member benefits). However, when looking at the scheme as a whole, there can be significant investment implications.

Buy-in transactions typically do not cover non-pensioners, and therefore the longer-dated and most risky liabilities typically remain uninsured. So, schemes may transfer disproportionately more assets than risks to the insurer. In addition, an insurance buy-in ties up a significant proportion of the scheme assets and cannot be reversed – this can reduce the ability to deal with unpredictable events.

The investment implications may be four-fold:

1. Impact on the return required from remaining assets
   The level of funding may change following the buy-in, depending on the valuation basis of the liabilities involved relative to the cost of the buy-in. The disclosed level of funding may even appear to improve. Crucially, however, a buy-in leaves fewer assets under trustee control. Depending on the longer-term funding aspirations of the trustees, this could increase the return needed from the remaining assets, everything else being equal – meaning there may be a need to take on more investment risk. Additionally, in order to maintain a given liability hedge ratio, a portion of the remaining assets might have to be allocated to collateral. This could also push up the required return on the ‘free’ assets.

2. Impact on the scheme’s ability to hedge its liabilities
   In order to maintain a given hedge ratio, a portion of the remaining assets might have to be allocated to collateral, further pushing up the required return on the ‘free’ assets. Alternatively, schemes could decide to accept a lower hedge ratio (thereby increasing risk) or higher leverage.

3. Impact on the time to achieve a full buy-out
   The pursuit of higher returns following a buy-in increases the chance of negative returns, especially during times of market stress. The alternative – maintaining a lower return target – could lead to an increase in the time necessary to achieve a full buy-out.

4. Flexibility to deal with the unpredictable
   Up to the point of a full buy-out, 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. The illiquid buy-in asset gives trustees less flexibility to deal with any setbacks.

The analysis when considering buy-outs and buy-ins needs to be different

An insurance buy-out is widely deemed the least-risk way to secure payments for all members’ benefits, provided the insurer remains solvent. However, insurers need to comply with stringent regulatory restrictions on investments and will also be seeking to generate a profit. This means buy-outs are typically relatively expensive compared to other options.

The usual reason trustees would not pursue a buy-out is a scheme’s inability to afford it. Another reason would be if the trustees believe an equivalent outcome could be achieved more cost-effectively by adopting an investment strategy that incorporates techniques used by insurers, but without the regulatory and capital constraints insurance companies face.

When comparing an insurance buy-in to other options, trustees need to consider the impact on their certainty of achieving their target endgame. This involves considering the impact on a wider set of measures, such as the return required from remaining assets, the scheme’s ability to hedge its liabilities, time to achieve the endgame target, and flexibility to deal with the unpredictable.

Table 1: A summary of the differences between a buy-out and a buy-in

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<th>Buy-out</th>
<th>Buy-in</th>
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<td>Purpose</td>
<td>Endgame solution</td>
<td>Cost versus residual risk of managing liabilities</td>
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<td>Practicalities</td>
<td>Transfer all assets and liabilities</td>
<td>Transfer some assets in return for a cashflow stream that reflects some liabilities</td>
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<td></td>
<td>No further governance obligations</td>
<td>Retain all liability and governance obligations</td>
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<td>Potential investment impact</td>
<td>No further investment mis-match risk</td>
<td>Asset that reduces the mis-match risk for a notional portion of the liabilities, but could increase the time to, and cost of reaching, the target endgame overall</td>
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4 Source: Insight. For illustrative purposes only.
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