February 2019

AN OBJECTIVE ASSESSMENT OF THE IMPACT OF A BUY-IN

AT FIRST GLANCE, A PENSIONER BUY-IN MAY BE PERCEIVED TO BE A GOOD STEP TOWARDS A BUY-OUT. HOWEVER, WHEN CONSIDERING THE WHOLE SCHEME, A BUY-IN MAY ACTUALLY MAKE IT MORE DIFFICULT TO ACHIEVE THIS GOAL. WE EXPLAIN WHY BY LOOKING BEYOND BUY-IN PRICES ALONE AND COMPARING DIFFERENT DE-RISKING OPTIONS USING A WIDER RANGE OF CONSIDERATIONS. WE ALSO PRESENT AN INTERVIEW WITH HAMISH WATSON, UK HR DIRECTOR AT SCOTTISHPOWER, WHO EXPLAINS THEIR DE-RISKING JOURNEY AND WHY THEY CHOSE NOT TO CONDUCT A BUY-IN.

A BROADER DE-RISKING ASSESSMENT

Today most private defined benefit (DB) pension schemes are closed to new members and scheme trustees are therefore focusing on their endgame as it draws nearer.

For many schemes the preferred endgame is a buy-out executed by an insurance company as this secures the liability payments for members, extinguishes the associated risks and costs of the scheme to the sponsoring company, and thus allows the scheme to be wound up.

Unfortunately, most pension schemes cannot afford the cost of undertaking a full buy-out in the near term and consequently require an interim solution. They therefore may ask themselves whether they should conduct a partial buy-in for a portion of their liabilities or simply evolve their current de-risking strategies, taking a 'self-managed buy-in' (SMBI) approach.

To help schemes make a more informed decision, we examine some of the wider factors they should be considering when evaluating different de-risking options:

1. Value for money
2. Impact on the overall portfolio
3. Flexibility to deal with the unpredictable

VALUE FOR MONEY

A major driver of the increasing demand for buy-ins is the seemingly competitive pricing from insurers. Typically, buy-in contracts are priced on a 'gilts plus' basis, making them look attractive when compared to the cost of matching pension liabilities with government bonds. However, investors should not focus on price alone, but focus on what they receive for this price.

An SMBI approach is able to replicate many of the characteristics of an insurance buy-in (see Figure 1), including longevity hedging,

Figure 1: An insurance buy-in and a self-managed buy-in – similarities and differences

Conventional insurance buy-in: A scheme transfers some of its assets to an insurance company, which in return covers the cost of the pension payments for some of the scheme membership, **usually the pensioners**.

Self-managed buy-in: A scheme aims to replicate the key characteristics of an insurance approach – such as hedging longevity risks and generating cashflows to match outgoing payments – **directly and more broadly across the whole portfolio**.

	Characteristics	Insurance buy-in	Self-managed buy-in
1.	Credit quality	High	High
2.	Credit risk	Concentrated	Broadly diversified
3.	Cashflow match	Yes	Yes (cashflow matched to payments)
4.	Inflation protection	Yes	Yes (inflation hedge overlay)
5.	Longevity protection	Yes	Yes (longevity hedge overlay)
6.	Liquidity	None	Predominantly liquid assets
7.	Used as basis for discounting liabilities	Yes	Yes
8.	Regulatory protection	FSCS and PPF*	PPF*

An SMBI is able to replicate the characteristics of an insurance buy-in but at a lower cost

* Financial Services Compensation Scheme (FSCS) and Pension Protection Fund (PPF).

but at a lower cost due to the allowance in insurers' pricing for capital and profit margin considerations, and more stringent investment restrictions.

Historically, we estimate that the difference has been up to 15% when considering the whole scheme membership. In the case of a typical pensioner-only transaction, the difference has been 5-10%, equating to a saving of £25-50m assuming a buy-in of £500m.[1]

In addition, a buy-in is unlikely to cover non-pensioners, whose liabilities are longer-dated and more difficult to assess, making them much more expensive to insure. Therefore, while the value of retained liabilities may fall after a buy-in, the risks (for example, the sensitivity to interest rates and inflation) will fall by less. This may result in schemes transferring disproportionally more assets than risks to the insurer.

> If schemes are willing to pay a premium for an insurance approach, they should ask themselves what tangible benefits they are getting in exchange for this premium.

IMPACT ON TOTAL PORTFOLIO

An insurance buy-in offers security and cashflow matching in respect of a portion of the liabilities, but schemes should consider the broader impact on the overall portfolio. In particular, how does a buy-in impact the expected return needed on the remaining assets and/or the scheme's ability to hedge its liabilities, and the expected time to reach the targeted buy-out?

1. Impact on the target return required from remaining assets

If a scheme is underfunded, the nominal level of deficit will vary following the buy-in depending on the valuation basis relative to the buy-in basis. The disclosed deficit may even fall. Crucially, however, a buy-in leaves fewer 'free' assets to make up any funding level deficit. This increases the target return needed from the remaining assets, all else being equal . We illustrate this impact in Figure 2.

2. Impact on the scheme's ability to hedge its liabilities

The challenge may be made more acute following a buy-in due to the disproportionate transfer of more assets than risks to the insurer (see earlier). This means that in order to maintain a given hedge ratio, a proportion of the remaining assets must be allocated to collateral, further pushing up the required target return on the 'free' assets. This would incur additional costs and could result in potentially selling assets at an inopportune time. Alternatively, schemes could decide to accept a lower hedge ratio.

3. Impact on the time to achieve a full buy-out

The pursuit of higher target returns following a buy-in results in the need to increase the allocation to riskier assets assuming the same target date to buy-out. This increases the chance of defaults, negative returns and forced-selling risk, especially during times of market stress. Ultimately, it potentially reduces the chance of the scheme being able to afford a buy-out at the target date. Alternatively, maintaining a lower hedge ratio to keep asset return targets at an acceptably low level could lead to an increase in liability-mismatch risk.

A counter to these drawbacks is to extend the target buy-out date. This can help to keep risks within acceptable levels, but prolongs the time that the pension scheme needs to manage these risks.

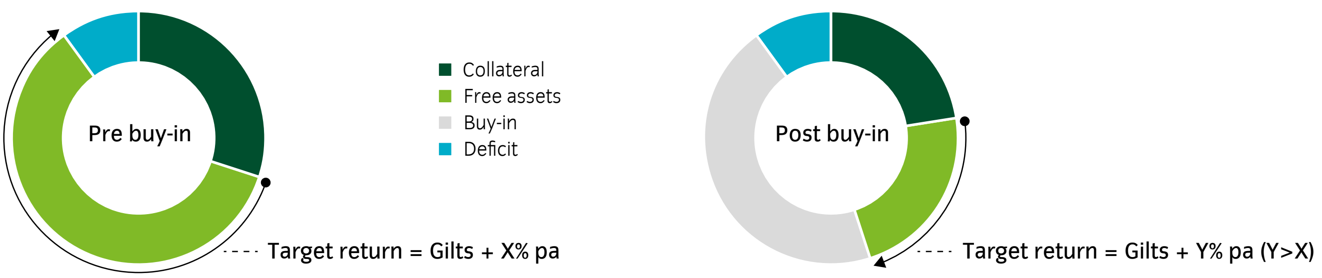
> In summary, a buy-in could increase the target returns required from the remaining 'free' assets, make liability hedging more challenging and/or extend the time to achieve a full buy-out. In short, it could reduce the certainty of achieving a buy-out at the desired target date.

FLEXIBILITY TO DEAL WITH THE UNPREDICTABLE

Up to the point of a full buy-out, regardless of the adopted de-risking method, 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, such as the recent UK High Court ruling that Guaranteed Minimum Pension (GMP) payments accrued between 1990 and 1997 must be equalised between men and women.

> An insurance buy-in ties up a significant proportion of the scheme assets and cannot be reversed, giving schemes less flexibility to deal with any setbacks.

Figure 2: An insurance pensioner buy-in can increase the target return needed from your assets[2]



[1] Insight calculations, 2019. Given current Solvency II regulation, we estimate that a pension scheme could achieve a net asset yield of circa 100 basis points more than an equivalent insurer. Around two-thirds of this difference is due to the pension scheme's greater investment freedom, with the remainder reflecting the insurer's cost of capital. We assume that, on average, pensioner liabilities have a duration of 10-15 years. [2] For illustrative purposes only.

CONCLUSION

We believe a self-managed buy-in offers a more efficient route to a buy-out for many schemes than an insurance buy-in. In particular, it can offer greater value for money, offer similar characteristics at a lower cost, and it can provide greater flexibility to deal with unpredictable risks which cannot be hedged.

Whichever choice schemes make, we suggest that they look beyond buy-in prices alone and assesses the impact at the total-scheme level, considering a wider range of factors, such as **value for money**, **impact on the total portfolio** and **flexibility to deal with unpredictable events**. We believe that this will help them reach their endgame with more certainty.

An interview with Hamish Watson, UK HR Director, ScottishPower

What has been the de-risking journey for ScottishPower's pension schemes?

ScottishPower has two defined benefit schemes with total assets of c.£5bn. Today, we have 2,900 active members, 5,000 deferreds and 13,000 pensioners. We are absolutely committed to funding the schemes and we work very closely with our scheme trustees to achieve our shared objectives of de-risking and securing benefits for members.

We have had a fairly traditional journey to our endgame. We invest in growth assets in our search for strong returns but complement this allocation with bonds to help reduce risks, and a liability-driven investment (LDI) portfolio with the aim of stabilising and reducing volatility. In 2014 we undertook a £2bn longevity swap to cover the longevity risk for 9,000 of our pensioners, and then another swap in 2016 to cover the remaining 4,000.

Why didn't you choose to conduct a buy-in?

We value certainty, but don't want to overpay for it.

We believe that the cost of a buy-in today, or targeting a buy-out in the short to medium term, is too expensive for us as a trade-off against certainty. In their pricing, insurance companies include a margin for uncertainty, a margin due to regulatory capital requirements and a margin for profit.

We think that this is a poor use of our capital. When we assess various competing calls on corporate capital, we would not invest in a project which is expected to return gilts plus 0.3%.

What is your definition of a self-managed approach to de-risking?

Our definition of a self-managed buy-in is to:

- invest in assets which look to mirror the kind of assets that an insurer would put in place
- do so with more flexibility in the timing and price of acquiring those assets, to avoid paying a premium
- look to minimise any mismatch with scheme cashflows

In short, we want to find high quality assets at an appropriate price which can help us meet our cashflow requirements.

What lessons have you learnt from going through your de-risking journey?

Be ruthless on the asset selection:

- Buy good-quality assets at the right price
- Look for assets that can be transferred to a bulk annuity provider at low/nil cost in the future
- Focus on matching cashflows rather than on following trends

Continuously look to make the liabilities more certain:

- Implement longevity hedges to reduce the next biggest risk after interest rate and inflation mismatches
- Undertake a pension increase exchange exercise to change the shape of the cashflow profile, reducing the inflation risk from the liabilities

Take time to cleanse your data:

- Data drives longevity hedging and buy-out pricing
- Cleansing data allows a scheme to obtain good insurance pricing so that it will not unnecessarily overpay if it decides to conduct a bulk annuity purchase in the future
- It facilitates the production of more accurate cashflow projections today

Will you conduct a buy-out in the future?

We have not yet decided whether self-sufficiency or a buy-out is our endgame, but we have time to make this decision.

A buy-out may still be the endgame, but perhaps many years further in the future than expected. It would be once the schemes are more mature, cashflows are more certain and assets would have generated more returns. In the meantime, we would have taken the time to build the right asset portfolio at the right price.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

FIND OUT MORE

Institutional Business Development
businessdevelopment@insightinvestment.com
+44 20 7321 1552

European Business Development
europe@insightinvestment.com
+49 69 12014 2650
+44 20 7321 1928

Consultant Relationship Management
consultantrelations@insightinvestment.com
+44 20 7321 1023

@InsightInvestIM

company/insight-investment

www.insightinvestment.com

14384-02-19