October 2018

SELF-MANAGED BUY-IN
AN EFFICIENT ALTERNATIVE TO A CONVENTIONAL INSURANCE BUY-IN

EXECUTIVE SUMMARY

Some defined benefit pension schemes are contemplating a conventional pensioner buy-in as an interim step towards a full buy-out of their liabilities. We believe that in some cases, schemes could be better served by a 'self-managed buy-in' solution, which combines a standalone longevity hedge covering pensioners together with a liability driven investment and credit investment solution. However, no single option is appropriate for all schemes and stakeholders should consider a wide range of factors – such as value for money, impact on overall scheme risk and governance – before making any decision. We look forward to working with you and your consultants to help you compare the different potential paths that can get you to your preferred endgame.

THE DE-RISKING DILEMMA

Given the closure of most private defined benefit (DB) schemes to new members and accruals, schemes are turning their attention to the endgame. With corporate sponsors increasingly considering DB schemes as a legacy issue, rather than an attractive employee benefit, many schemes are targeting a full buy-out of their liabilities as their ultimate objective. By transferring all scheme assets and liabilities to an insurance company a full buy-out provides security for scheme members, removes the risk to the company balance sheet, and avoids the ongoing cost of governing a legacy benefit.

Unfortunately, most schemes currently have insufficient assets to conduct a full buy-out of their liabilities. Furthermore, schemes will not typically buy out a portion of their liabilities as this could both disadvantage the security of the remaining members' benefits and challenge the trustees' fiduciary obligation to treat all members fairly.

Therefore, most schemes are left with two options in the short term:

- **Conventional insurance buy-in**[1]**:** Buy in all or part of the pensioner liabilities, planning for future tranches of pensioner buy-in as more members retire. This approach is understandable given that often a pensioner buy-in can be cost neutral on a Technical Provisions basis. Also, it secures payment for a significant proportion of the liabilities and seems to be a good first step towards a full buy-out.
- **Self-managed buy-in:** The scheme uses a combination of credit assets, liability driven investment (LDI) strategies and a series of longevity hedges to manage its major liability risks (see below). Longevity hedges cover pensioners, with further hedges purchased as additional tranches of members retire. The liabilities can be run off until the incremental cost of a full buy-out is acceptable relative to the costs and risks associated with governing the scheme on an ongoing basis.

[1] In a buy-in, the scheme is still responsible for paying pension benefits to its members, but it receives matching payments from an insurance company. In a full buy-out, pension benefits are paid directly by the insurance company and the pension scheme is wound up.

COMPONENTS OF A SELF-MANAGED PENSIONER BUY-IN

Under a self-managed buy-in, a scheme would hold a diverse range of assets that aim to generate cash flows in line with pension outflows and a return above the risk-free rate. Demographic risks would be hedged using a longevity hedge, with interest rate and inflation swaps being used to fine-tune the asset profile and better match liabilities.

Chart 1: Cash flows from physical assets

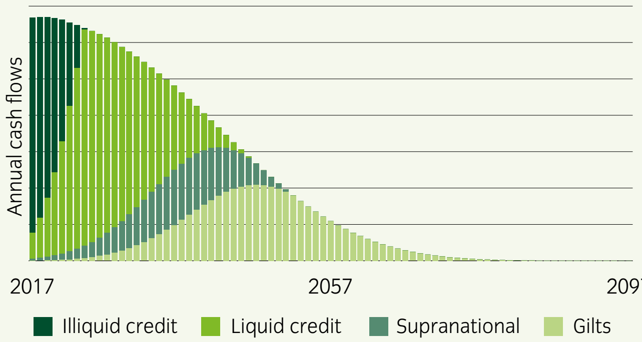
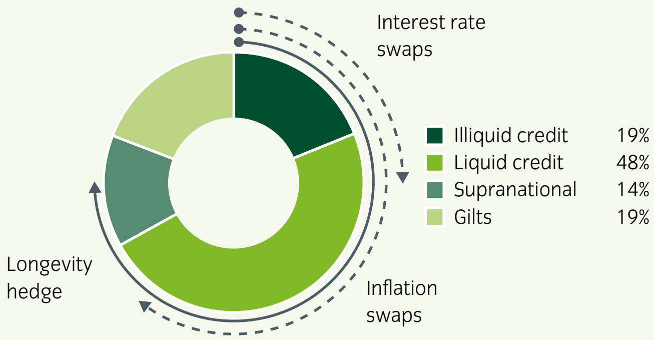


Chart 2: Asset allocation and overlays



For illustrative purposes only.

THE MORE ATTRACTIVE PATH TO THE ENDGAME?

Many factors, such as the size and funding position of the scheme and the strength of the sponsor covenant, will influence the option a scheme chooses. We believe that in many cases, when total-scheme costs and risks are considered, schemes would ultimately be better served by implementing a self-managed buy-in. There are two main reasons for this:

- **Value for money:** Based on data available to Insight, we estimate that a self-managed buy-in could be up to 10-15% cheaper than a conventional buy-in[2]. This view reflects the fact that insurance companies must hold regulatory capital and operate under stringent investment constraints. These constraints increase the cost of providing the pensions and result in a significant drag on investment performance, disadvantages which are ultimately borne by insurance clients. As a self-managed buy-in is executed mainly under pension regulation it does not suffer from these disadvantages, and can therefore offer significantly greater value for money.
- **Investment efficiency:** As pensioners are the lowest risk category of scheme liabilities, due to their shorter duration, a conventional buy-in often results in the transfer of proportionately more assets than risks to the insurer. This puts additional pressure on the residual assets as they must generate the returns needed to bridge any deficit and also hedge the remaining liabilities. Specifically, a conventional buy-in typically converts high-quality assets, which could otherwise be used as collateral to support a risk-reducing LDI strategy, into an illiquid insurance contract. This means that schemes implementing a conventional buy-in have to either:
  a. Reallocate some of their growth assets for liability-hedging purposes, resulting in lower expected returns, or
  b. Accept a lower overall liability hedge and increased risk

  The illiquid nature of a conventional buy-in also means that schemes are unable to participate in future investment opportunities. A self-managed buy-in does not create these inefficiencies.

The lower cost and increased investment efficiency of a self-managed buy-in compared to a conventional buy-in means that schemes can reach the point of self-sufficiency (i.e. fully de-risk) earlier. Alternatively, schemes may choose to relax the quicker time target and pursue a lower-risk investment strategy.

THERE IS NO FREE LUNCH

The implementation of a self-managed buy-in results in the scheme maintaining a long-term exposure to credit risk. Schemes can largely address this risk by investing in a diversified portfolio of credit assets, adopting prudent default assumptions and maintaining the credit quality of the portfolio over time. We believe that in most situations the cost savings and efficiency associated with self-managed buy-in will more than offset the residual risks.

There may be a higher governance burden in relation to pensioners with a self-managed buy-in. However, when looking across the whole scheme, neither a self-managed nor a conventional buy-in significantly reduces scheme governance costs. Under both options the scheme still needs to manage assets and non-pensioner liabilities, as well as continuing to provide administration services for all members.

CONCLUSION

With the majority of pension schemes unable to secure an immediate full buy-out of their liabilities, many schemes are intending to de-risk via a series of conventional buy-ins. We believe that, in many cases, the scheme would benefit from opting instead for a self-managed buy-in. The associated cost savings and investment efficiencies are likely to bring these schemes to their endgame much faster. The scheme would only adopt a full insurance solution when its membership has matured significantly and a buy-out becomes economically viable.

When judging the merits of these two potential solutions we believe that schemes should consider a wide range of factors, such as:

1. Value for money
2. Expected time to self-sufficiency
3. Required rate of return on residual assets
4. Impact on overall scheme risk profile
5. Future investment flexibility
6. Governance requirements and costs
7. Capacity of insurers

[2] Given current Solvency II regulation, we estimate that a pension scheme could achieve a net asset yield of circa 100 bp 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.

IMPORTANT INFORMATION

RISK DISCLOSURES

Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

ASSOCIATED INVESTMENT RISKS

Liability-driven investment

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.

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 bonds are affected by interest rates and inflation trends which may 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

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14187-01-18