

Newsletter

# Investment Insights

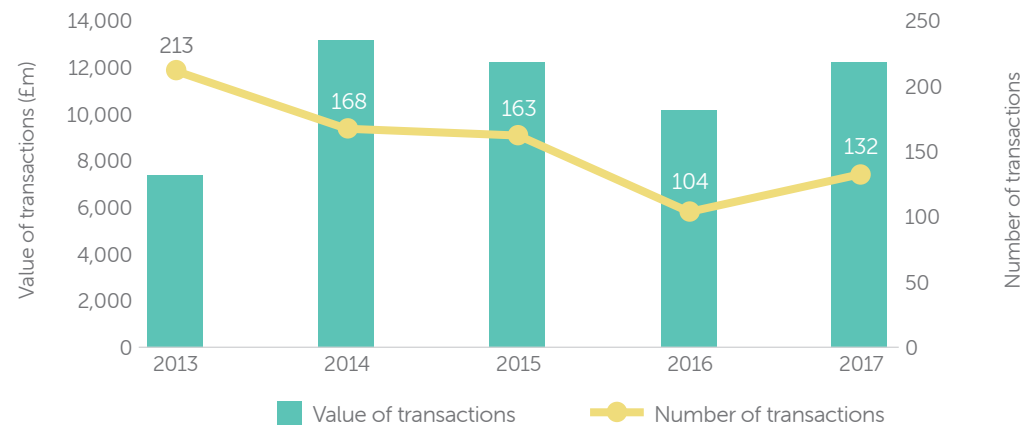
## Expanding the toolkit: Buy-ins



Over the last five years a combination of better funding positions, more attractive insurer pricing and more risk aware investment strategies mean that bulk annuity purchases have become an investment option much more worthy of consideration. In fact, with bulk annuity transactions exceeding £20bn in value, 2018 is set to be a record-breaking year in terms of demand for buy-ins and buyouts.

In this note, we consider if bulk annuity purchases should be of interest to a wider group of schemes. Whilst there were 132 transactions in 2017, this is still small compared to the 5,700 UK DB pension schemes, and so are these other 5,500 schemes missing a trick, or does bulk annuity purchase still only make sense in a small minority of cases?

PENSION SCHEME TRANSACTIONS BY UK INSURERS

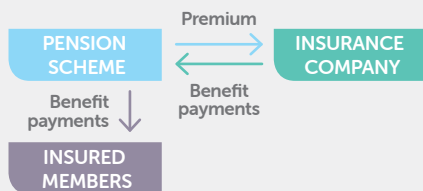


We start to answer that question by first looking at those schemes that may feel buyout is many, many years away and so may be questioning the importance of this note for them. We encourage these trustees to focus on the first half of this note where we put forward the argument that, despite quoted deficit numbers, buyout is more achievable than many think and so is a valid medium-term target. However, in this section we also caution trustees not to start the process of buy-ins too early in the journey towards buyout (and define what constitutes "too early").

The second half of this note is then more focussed towards those schemes that are further down this journey. How should these schemes manage the investment risks when undertaking buy-in exercises? How has annuity pricing evolved and how might it evolve in future?

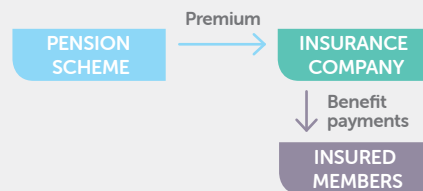
## Buy-in versus buyout

Throughout this note we will be quite deliberate in how we use the terms "buy-in" and "buyout". When talking about a "buyout" we are referring to a full discharge of scheme liabilities to an insurance company and the wind up of the scheme. A buy-in refers to the purchase of annuities for a proportion of a scheme's liabilities and the annuity becomes an asset of the scheme.



A buy-in policy is an asset for the pension scheme. The pension scheme remains responsible for paying the benefits to members.

In an extreme scenario where the insurance company goes bust, the scheme would still be liable for paying benefits.



A buyout involves issuance of individual member policies. The insurer is then responsible for making the benefit payments.

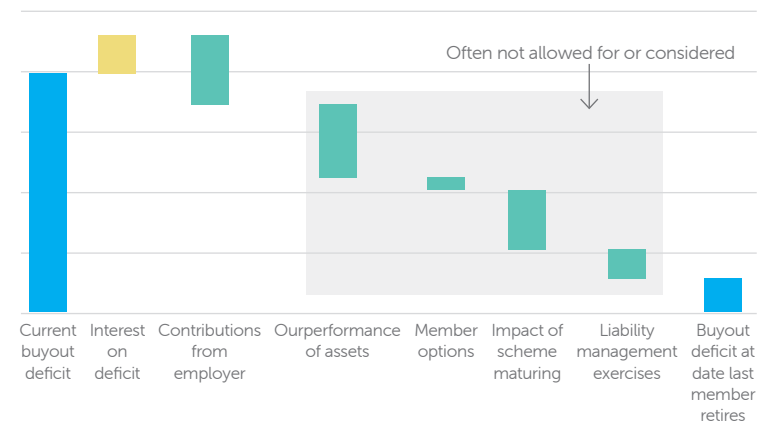
In an extreme scenario where the insurance company goes bust, the pension scheme would no longer be liable.

## Buyout may be closer than you think...

If we consider the "average" pension scheme then buyout may seem a forlorn hope. The "average" scheme is only around two-thirds funded on a buyout basis and sponsors take one look at the deficit figure and state they cannot afford that. Discussion over.

However, we feel that is often misguided as that deficit figure can be reduced in many different ways and, for example, an often underappreciated route is "time". The quoted buyout deficit naturally reduces over time as members retire and take benefits. Allowing for that and the investment returns schemes are aiming to achieve, buyout could be more achievable than it first appears.

### EVOLUTION OF BUYOUT DEFICIT OVER TIME



Source: Barnett Waddingham, illustrative only

## Does the solvency estimate represent the real cost of a buyout?

**According to the Purple Book, on average schemes are 68% funded on a full buyout basis (March 2017).**

It is a statutory requirement to include a solvency estimate at triennial valuation reports and many trustees might be tempted to use this as an anchor when assessing the viability of a buy-in. However, the trustees should not be discouraged by this figure as there are a number of reasons why this number may not fully reflect the real cost:

### Member options

A solvency estimate assumes members do not take tax-free cash at retirement however, in reality, many members take this option.

### Liability management exercises

Similar to members taking tax-free cash, bulk (or individual) liability management exercises can significantly reduce that buyout deficit. These should be considered as one of the options for reducing that buyout cost.

### Deferred members

The solvency estimate will include the value of deferred annuities, which are expensive. As members retire and the scheme matures the buyout cost will naturally fall. Hence, time helps to significantly reduce the deficit.

Despite us suggesting that buyout is more attainable than may be first imagined, it doesn't automatically follow that all schemes will, or should, set this as their target. Self-sufficiency, whereby schemes look to run a low-risk investment strategy and meet benefit payments from traditional invested assets, remains a suitable approach for many, at least for a period of time. This is particularly true for those with a very strong employer and relatively immature liability structure.

## When, in that journey, do you look at buy-ins?

If you have set your long-term target to buyout (as around one-third of our clients have) and have a plan in place for how to reach that, then when should you start purchasing annuities for parts of the liability profile?

The short answer is "not too early". The timing comes down to two things: risk and returns.

### 1. When you have removed the vast majority of interest rate and inflation risk, meaning longevity is now one of the more significant risks

It is crucial that the impact of the partial buy-in on the overall risk for the scheme is considered. In particular, for many pension schemes, the amount of risk arising from interest rate and inflation exposure – and even the risk arising from growth-style investments – exceeds that arising from longevity and other demographics. What's more, interest rate and inflation risks can be hedged through investments other than annuities in a much more capital efficient way. Therefore, we believe buy-ins should only be considered for schemes that have already made significant progress on removing these two key risks; otherwise a buy-in can actually lead to an increase, not a decrease, in overall risk.

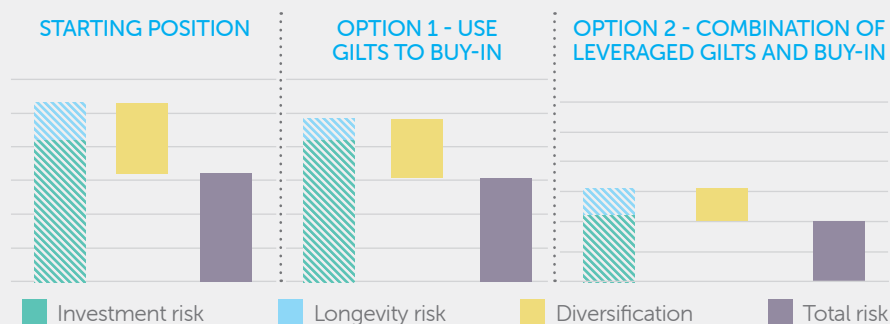
## Options for reducing risk

Scheme A invests 50% of its assets in gilts. Given the attractive price of annuities at the moment, the Trustees are considering whether to use these gilts to purchase annuities for some of its pensioners through a bulk buy-in. The advisor puts forward two possible options available to the Scheme:

Option 1 is for the Scheme to secure annuities for some of its pensioners. This would remove the interest rate, inflation and longevity risk for those pensioners. However, the interest rate, inflation and longevity risk arising from pensioners is small in comparison to the Scheme's total interest rate, inflation and longevity exposure, as pensioners are older. Therefore, the reduction to the overall level of risk is minimal.

Option 2 is to use leverage in their gilt portfolio in order to reduce the overall amount of interest rate and inflation risk across both deferreds and pensioners. The Scheme is able to hedge all of its interest rate and inflation exposure using 30% of the assets. The Scheme could then use the remaining 20% investment in gilts to purchase annuities for some of the pensioners, thus removing some of the longevity risk for the Scheme as well.

**Overall, Option 2 produces a far lower level of risk for the Scheme.**



For most of our schemes, this will mean that they have already hedged their interest rate and inflation risks and have "spare" assets before they look to start purchasing annuities (by "spare" assets, we mean that the scheme could complete the buy-in and still have enough assets remaining to maintain the interest rate and inflation hedging and generate the required returns).

## 2. When you are sufficiently well funded

The second aspect, closely linked to having "spare" assets, is being sufficiently well funded.

For any scheme in deficit, there are three levers that can be used to recover the deficit: the first is contributions from the scheme's sponsor, the second is additional returns from the scheme's assets and the third is more time (assuming there is already some outperformance from assets above the risk-free rate).

In most cases, it is desirable that a buy-in could be completed without requiring additional contributions or extending the Recovery Plan. Therefore, it will typically be the case that, following a buy-in, the remaining, smaller pool of assets will have to work harder to remove the same size (or possibly a slightly higher) deficit.

The amount of additional returns required depends on a wide range of things, including the proportion of liabilities that annuities are being purchased for, the cost of the annuities and the time horizon over which you are looking to reach full funding.

The table on the next page sets out the additional investment returns that would be required each year on a scheme's assets, if it were to purchase annuities to cover 25% of its liabilities and still wish to reach full funding over a 10 year period. We consider different initial funding positions and different levels of contributions from the sponsor.

		EMPLOYER CONTRIBUTIONS (AS % OF DEFICIT*)				
		0%	25%	50%	75%	100%
FUNDING LEVEL*	50%	4.7%	3.3%	2.0%	0.9%	0.0%
	60%	2.8%	2.0%	1.3%	0.6%	0.0%
	70%	1.6%	1.2%	0.8%	0.4%	0.0%
	80%	0.9%	0.6%	0.4%	0.2%	0.0%
	90%	0.4%	0.3%	0.2%	0.1%	0.0%
	100%	0.0%	0.0%	0.0%	0.0%	0.0%

\* Funding level on a basis that discounts liabilities in line with gilt yields ("gilt-only basis")

For example, consider a scheme that is 70% funded on a low-risk, gilt-only basis and, under the existing recovery plan, contributions from the scheme sponsor will remove 25% of that deficit, with the rest of the deficit being removed through the outperformance of the scheme's assets. If this scheme was to purchase annuities to cover 25% of its liabilities, then the assets remaining following the buy-in would need to generate an additional 1.2% p.a. in order to maintain the existing recovery plan.

This shows that the greater the level of contributions the scheme sponsor has already agreed to pay, the earlier partial buy-ins can commence. For the majority of schemes, recovery plan contributions cover 30-50% of the scheme's deficit on a gilts-only basis.

Whilst there is no "right" answer to the question of when to start buying annuities, as a general rule of thumb once the funding level is over 85% on a gilts-only funding basis, the impact on the required returns from even a large buy-in exercise is relatively modest. It is perhaps as schemes approach that level of funding that buy-in becomes a key consideration.

We now turn our attention to those schemes that have established a long term buyout objective and are sufficiently well-hedged and well-funded that starting to buy annuities makes strategic sense. What are current market conditions and do these represent an opportune time to purchase annuities? If so, how should that be factored into the wider investment strategy?

## Taking opportunities on the way

A number of changes to the insurance market have meant that the price of annuities has been coming down – in particular when compared to the yields available on traditionally held pension scheme assets.

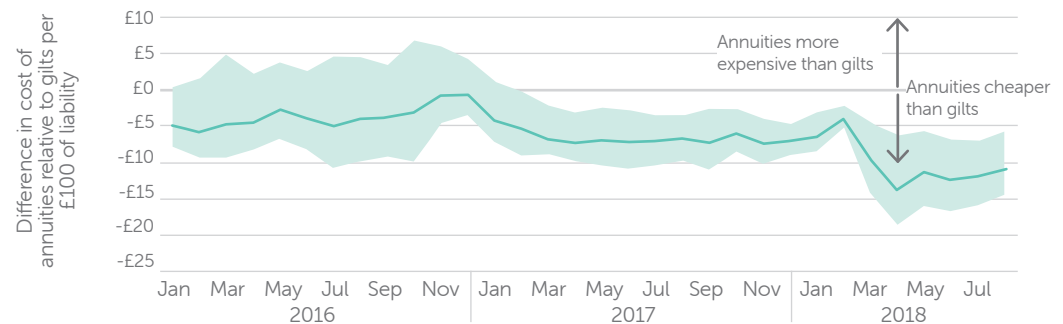
### Drivers of changes in annuity pricing

There are a number of drivers that have pushed down the price of annuities in recent years – one of the biggest factors has been the expansion in the range of investments insurers have been able to invest in; with a focus on illiquid, long term, income paying assets. Recently hitting the headlines been the role of equity-release mortgages (ERMs). Whilst the potential change in the regulatory approach to ERMs is likely to have an impact, the trend towards a wider investment toolkit by insurers looks set to continue and this should continue to provide some benefit to pricing. An increase in competition has also been quoted as a key factor in pushing down the price of annuities during 2018.

### What this means for schemes

The following chart – calculated using the Barnett Waddingham Bulk Annuity Pricing Model – shows the cost of purchasing annuities for a typical pensioner population compared to the value the scheme would need to hold to meet the same liabilities if it were invested in gilts.

### PRICE OF ANNUITIES RELATIVE TO GILTS



The chart shows that pensioner buy-in pricing has been at a very competitive level relative to gilts over the past three years, and particularly over the period from March 2018. At present, for very large schemes buy-ins for pensioner members are achievable at an implied investment return of the order of gilts plus 0.25%-0.35% p.a. This compares well even against a long-run self-sufficiency assumption.

Whilst pensioner buy-in pricing has been favourable in recent times this may not always be the case. Therefore, for those schemes for which partial buy-ins make strategic sense it is important to be "ready" from an investment sense and to be aware of the opportunities that may be available.

#### **Being ready means:**

1. Knowing what assets are available to fund a buy-in. This will be a function, as we spoke earlier, of the funding position, your liquidity needs and your hedging requirements.
2. Being in a position to hedge the risk of pricing moving against you whilst negotiating the transaction. Whilst insurers will hold a variety of illiquid assets, the key drivers of changes in the insurer's price are likely to be changes in interest rates, inflation expectations and the yield available on investment grade credit. The key is to ensure these risks are hedged.
3. Care needs to be taken around including illiquid assets in your portfolio; whilst the insurer may hold very similar assets in their annuity book, they will not accept pooled fund holdings and therefore it is key to be holding assets that can be readily transferred across to an insurer. In practice, for all but the largest of transactions this will be achieved in "cash". Therefore, having a source of liquid assets is important.

## Conclusion

2018 is set to be a record-breaking year in terms of demand from pension schemes for buy-ins, reflecting the attractive pricing of annuities. More crucially than this, we believe it is reflective of improvements in schemes' funding positions and the fact that many schemes are already hedging significant proportions of their interest rate and inflation risk.

This demand is not expected to wane and, whilst some recent regulatory changes may put upward pressure on the price of annuities, there is reason to believe that the high level of competition in the market will continue and will go some way to offset this.

With this in mind, buy-ins should firmly be on the list of investment options for pension scheme trustees. In particular, those looking toward buyout in the medium to longer term. In determining whether a buy-in may be the right next step for your scheme, it is important to consider:

### Risk

How does the overall risk for the scheme compare pre- and post- buy-in? Are there any other, more capital efficient approaches that would have a greater impact on the overall level of risk and the likelihood of you achieving your longer term goal?

### Funding

Is your funding level sufficiently high that the assets remaining after the buy-in will be able to meet the return requirements?

### Pricing

Is now the right time? This is the least important of the three criteria. It's nice to get a "good price" but this is only ever known in hindsight. More important is whether the transaction offers value and helps you reach your long-term aim.

Finally, be prepared. If buyout is your objective, have a strategy for how you wish to achieve that. Ensure you know how the various elements will help you get there. Schemes can undertake partial buy-ins too early in that process, but equally can miss opportunities if they wait too long. Once you are well-hedged and well-funded (around 70% on a self-sufficiency basis) then we believe it is time to start considering the use of buy-in policies within your investment strategy.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

✉ [matt.tickle@barnett-waddingham.co.uk](mailto:matt.tickle@barnett-waddingham.co.uk)

☎ 0333 11 11 222

[www.barnett-waddingham.co.uk/investment-strategy](http://www.barnett-waddingham.co.uk/investment-strategy)

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