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# Is selling gilts for a buy-in the best way to secure pension promises?

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# Agenda

- The defined benefit pension de-risking journey
- Impact of insurance regulation
- What is the potential knock-on impact of all this?
- What might the synthetic model look like?

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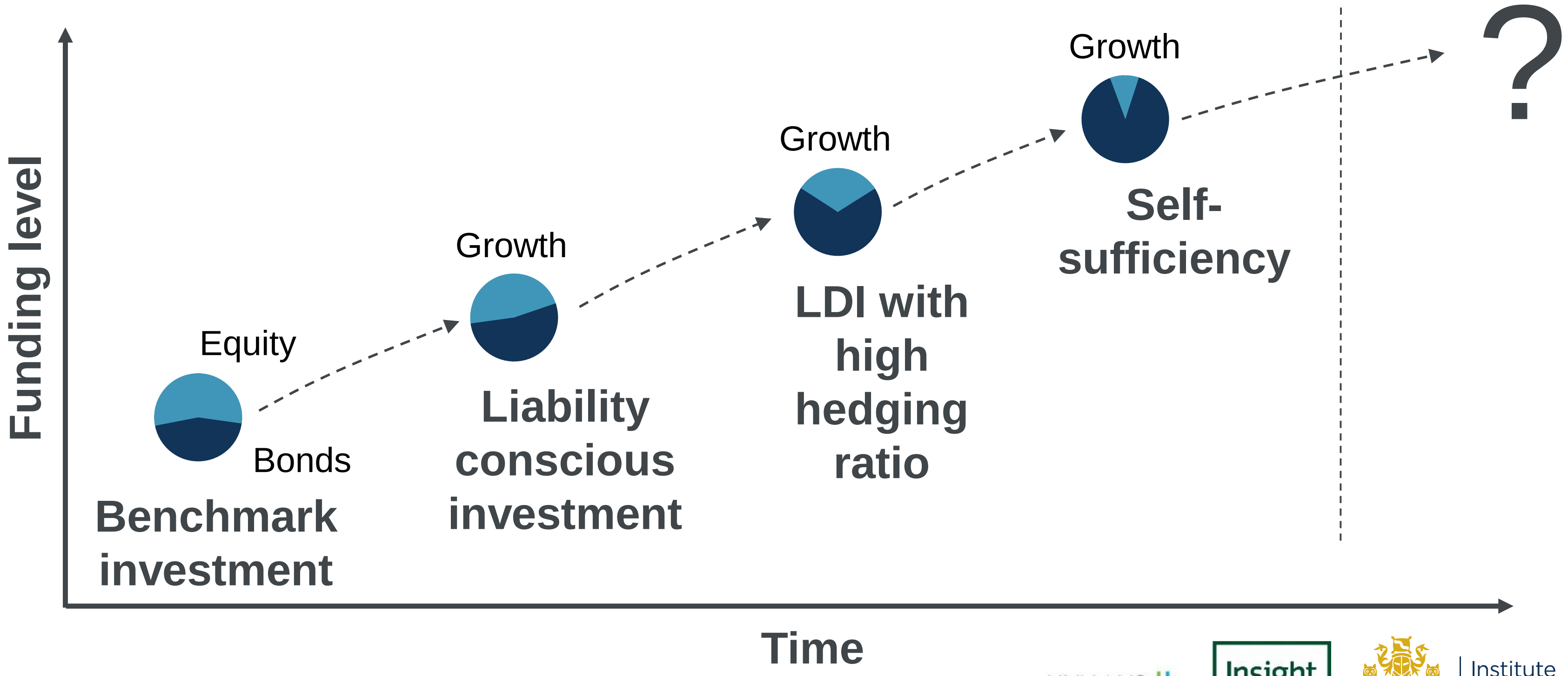
# The defined benefit pension de-risking journey

# The de-risking journey

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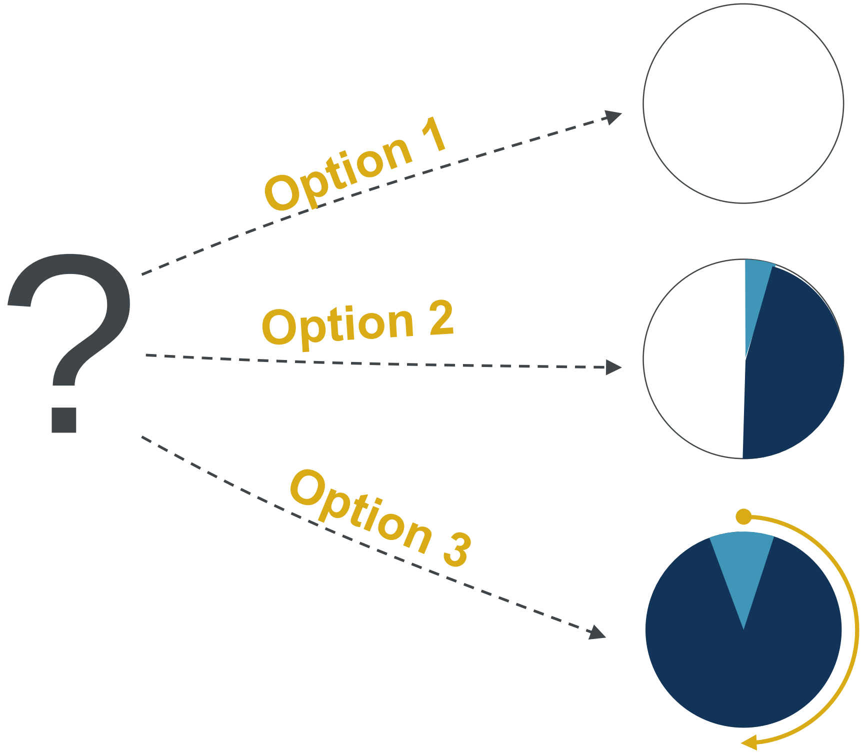
# Three options to meet pensions obligations




**Transfer of all risks:**
**- Insurance buy-out solution**

**Transfer of key risks only:**
**- Insurance buy-in solution**

**Self-managed run-off with longevity hedge**

# Why consider a third way?

| | Buy-out | Buy-in | DIY approach |
|---|---|---|---|
| Deals with deferred members? | Y | N | N |
| Deals with longevity risk for Pensioners? | Y | Y | Y |
| Ongoing requirements for Investment management? | N | Y | Utilises a specialist investment manager |
| Reduces governance requirements? | Y | Partly | N |
| Provides future flexibility? | N | Limited | Y |
| Insurance regulation impact? | Y | Y | N |

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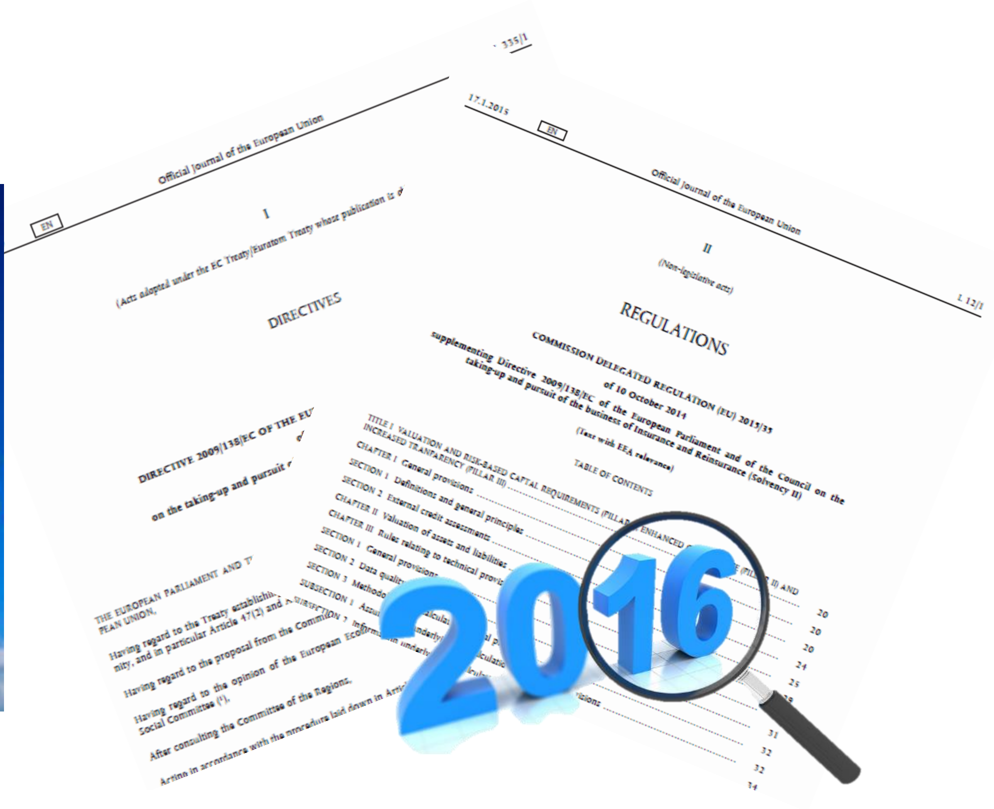
# Impact of insurance regulation

# What is Solvency II?

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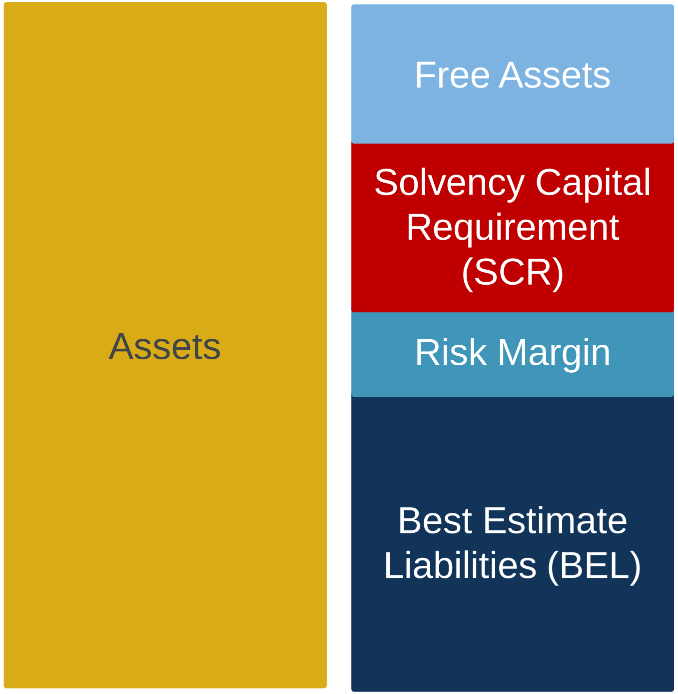
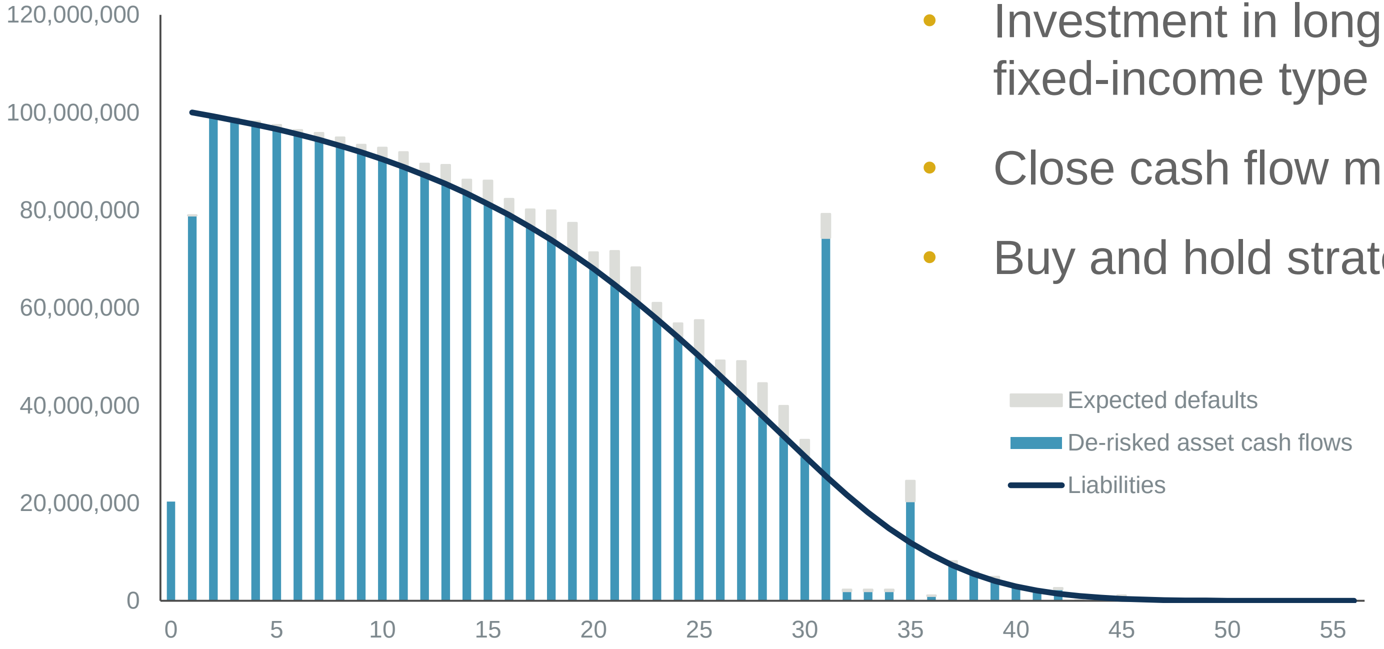
# Solvency II 101




- SCR to cover the risks faced by insurer at a 99.5% 1-year VaR level
- Risk Margin to take liabilities up to theoretical transfer value
- BEL based on projection of best estimate cash flows

# Annuities in an insurance world




- Investment in long-dated, fixed-income type assets
- Close cash flow matching
- Buy and hold strategy

Source: Hymans Robertson and Insight, for illustration purposes

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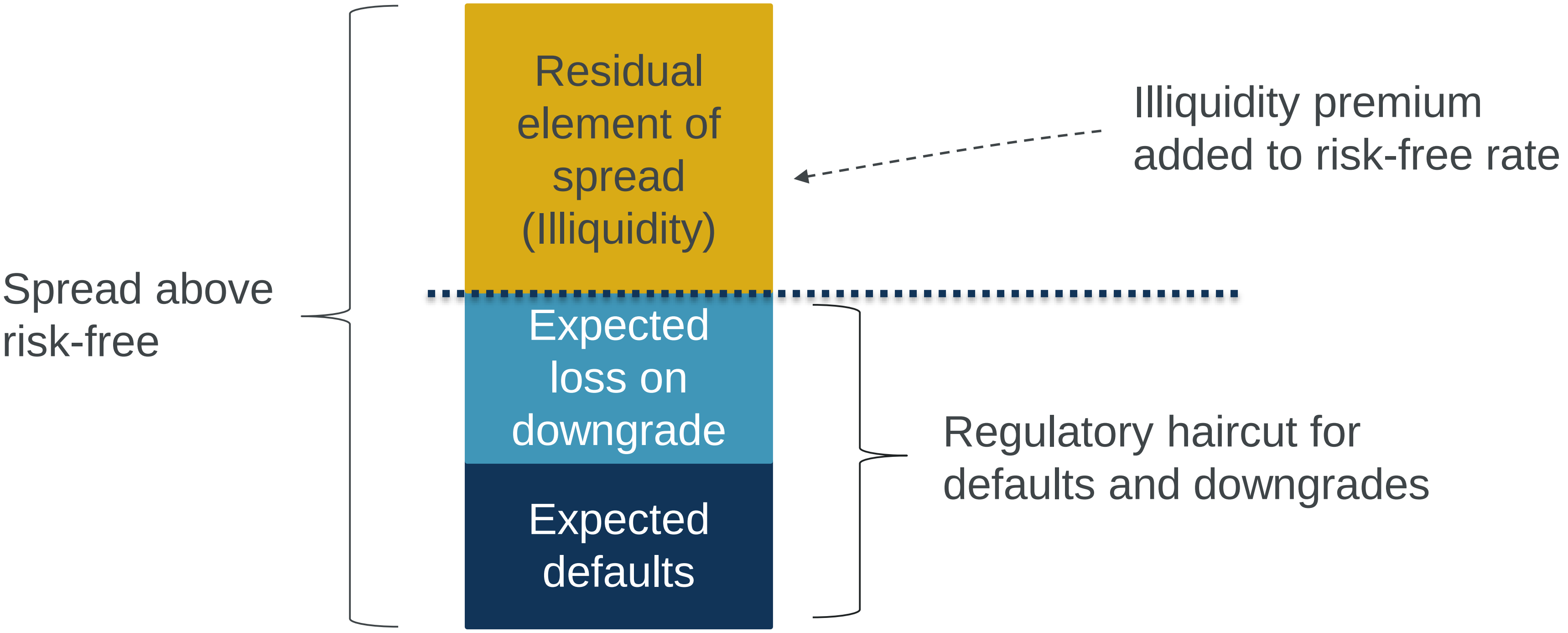
# Capturing the Illiquidity Premium



# Capturing the Illiquidity Premium

Spread above risk-free

Residual element of spread (Illiquidity)

Illiquidity premium added to risk-free rate

Expected loss on downgrade

Expected defaults

Regulatory haircut for defaults and downgrades

£59bn

Source: Sam Woods, PRA

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# Pre-approval required from the regulator

- Eligible assets
- Eligible liabilities
- Asset liability matching
- Portfolio governance

# Asset eligibility

*"… bonds and other assets with similar cash-flow characteristics…*

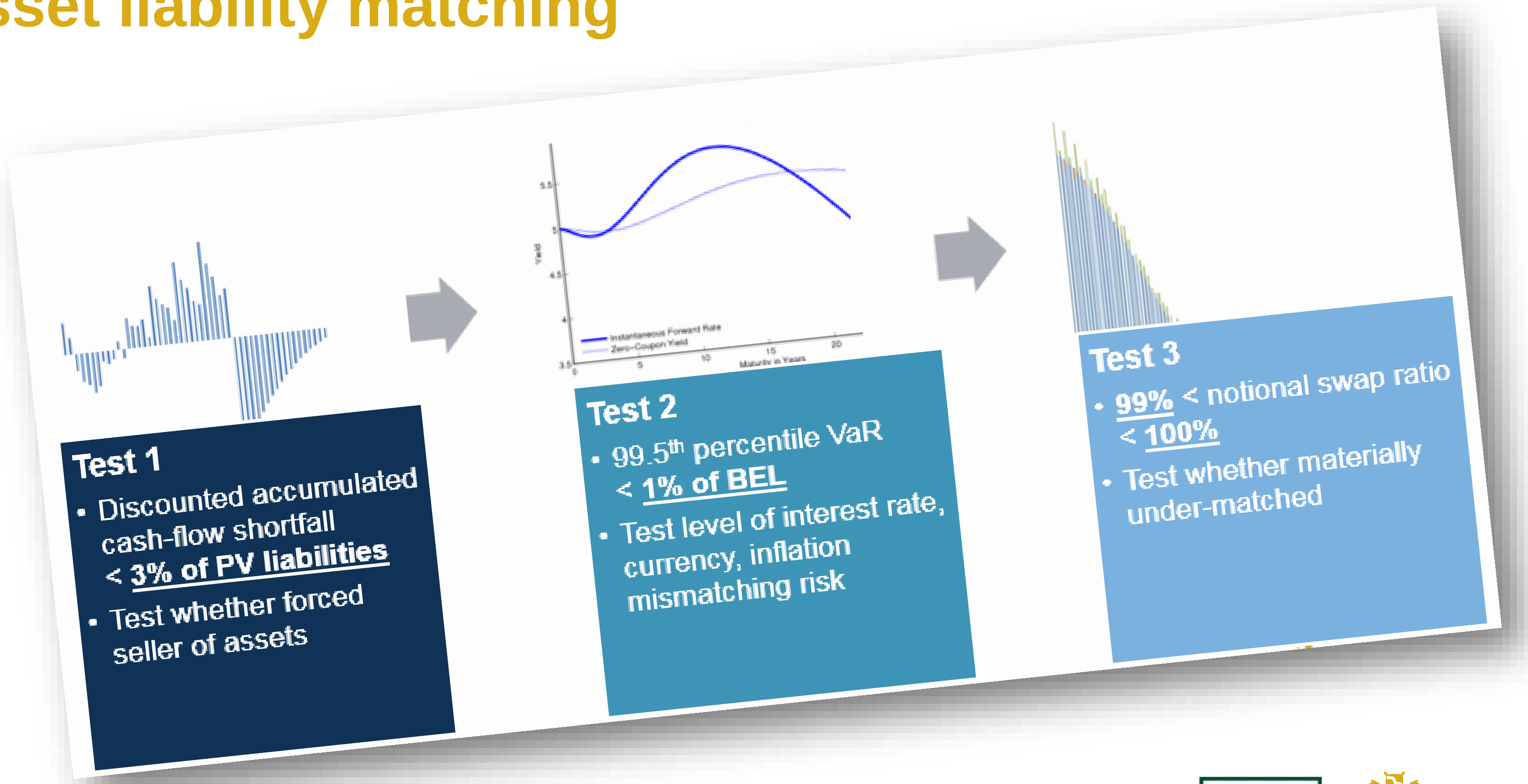
*… the cash flows of the assigned portfolio of assets are fixed and cannot be changed by the issuers of the assets or any third parties;"*

# Asset eligibility

- Problem children:
  - Callable bonds
  - Bonds/loans with "make whole" or "spens" clauses
  - Non £-denominated bonds
  - Prepayment options

- Possible solutions:
  - Outright sales
  - Hedging
  - Modifying cash flows
  - Repackaging

# Asset liability matching




Source: IFoA Matching Adjustment working party – for illustration

# Portfolio governance

| | |
|---|---|
| **Approved asset list** | • Full review of bond documentation required, requires expert judgement |
| **Management actions** | • Client approval may be required by the asset manager before trading can take place |
| **New issues** | • Potential inability to access new issues due to delay in obtaining full documentation |
| **Ongoing analysis** | • Requirement for regular review of matching tests |

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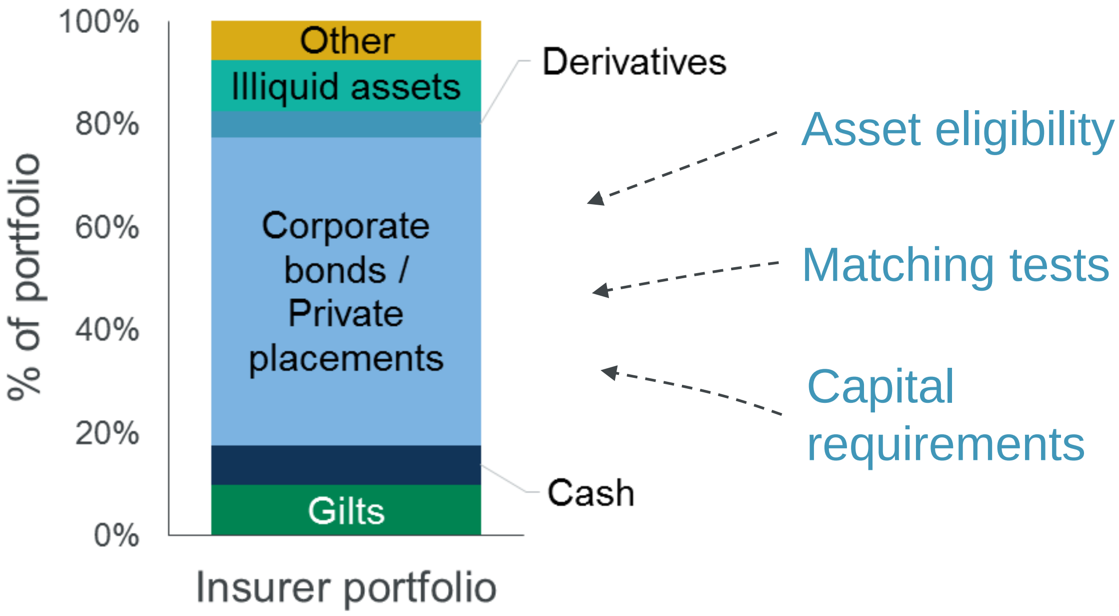
# What is the potential knock-on impact of all this?

# Consider an insurance company…

- Asset portfolio backing block of immediate annuities
- Spread, net of haircut for expected defaults and downgrades, of 110 bps

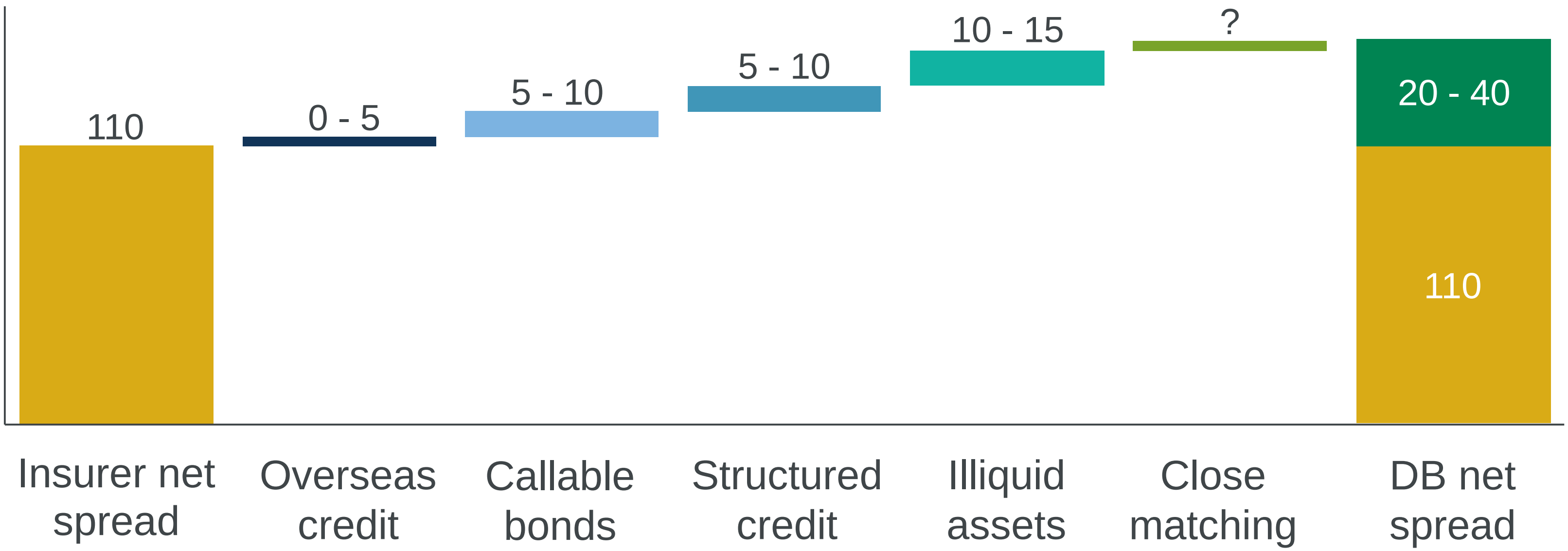



Source: Hymans Robertson and Insight, for illustration purposes

### Assumptions

- The buy-in insurer does not make any profit. All its investment return is used to pay claims, expenses and cost of capital
- The buy-in insurer operates at SCR level: no surplus above this level
- The insurer general expenses are equivalent to the operating expenses of the scheme (as percentage of liabilities)
- The buy-in insurer reinsures 100% of the longevity risk and has no competitive advantage on pricing for the protection
- The scheme puts in place a cash-flow matching investment strategy once the longevity hedge is in place
- Calculations are on a Standard Formula basis

# Impact of greater investment freedom




Source: Hymans Robertson and Insight, for illustration purposes

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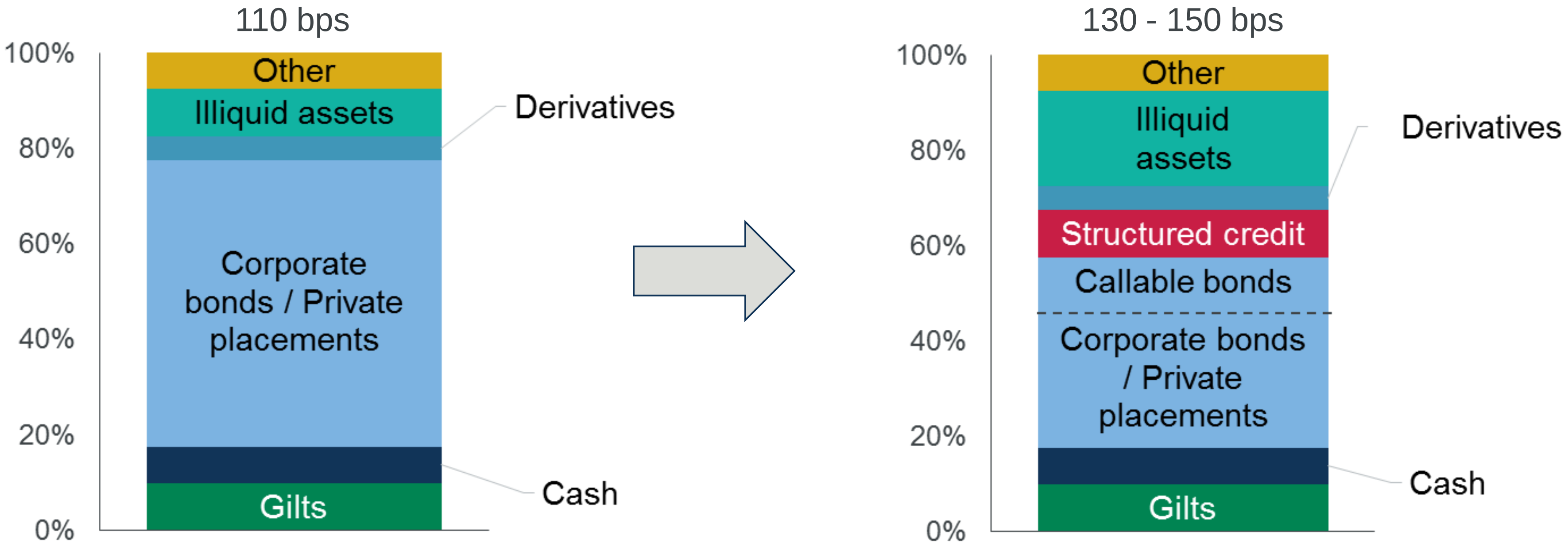
# The reshaped investment portfolio

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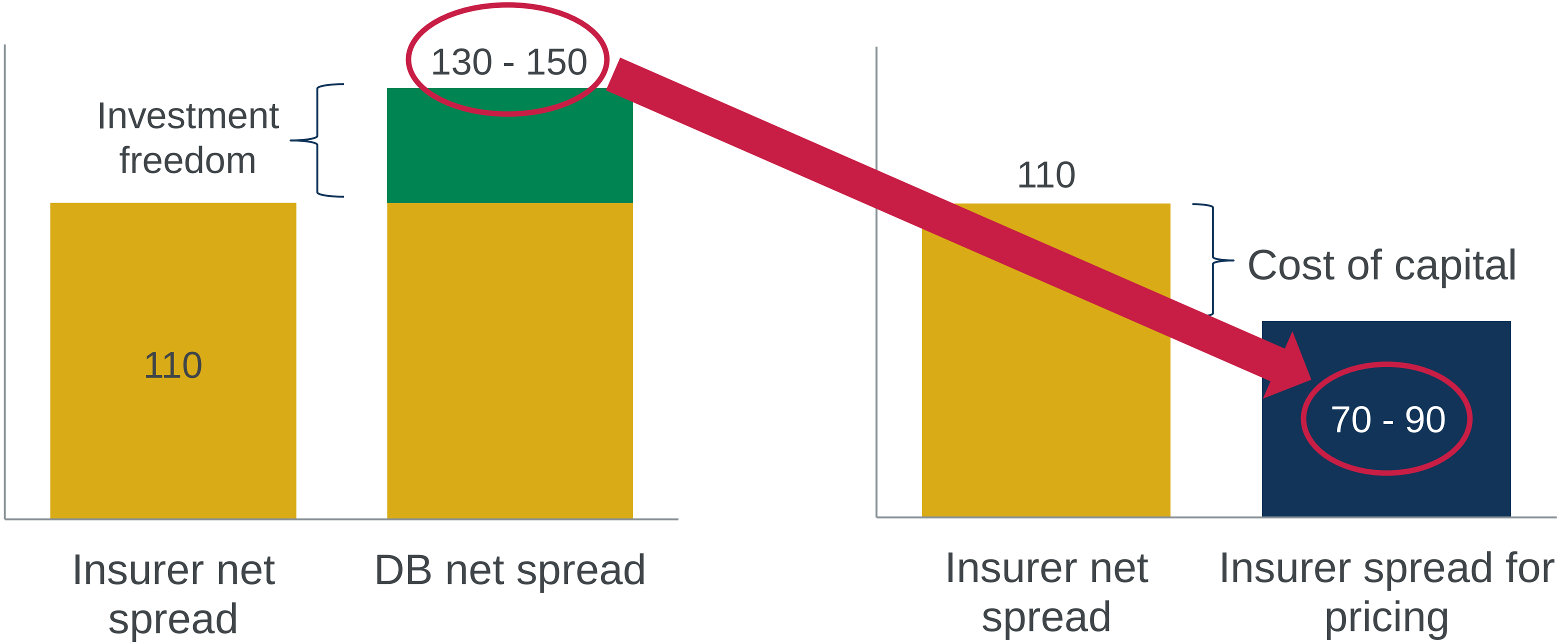
# Impact of removing the cost of capital




Source: Hymans Robertson and Insight, for illustration purposes

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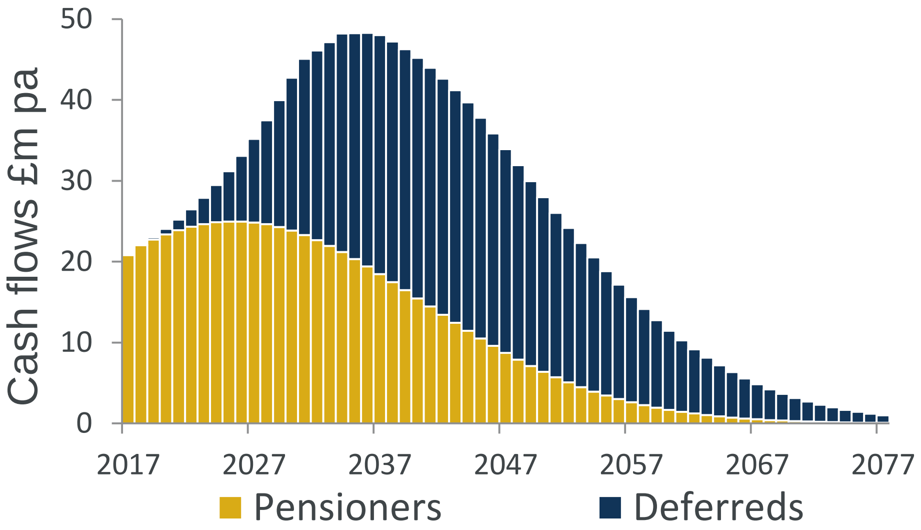
# What might the synthetic model look like?

# Example pension scheme




| Gilts-flat basis | Value (£m) | Duration (yrs) | PV01 (£m) |
|---|---|---|---|
| Non-pensioners | 500 | 25.0 | 1.25 |
| Pensioners | 500 | 14.0 | 0.70 |
| **Total liabilities** | **1,000** | **19.5** | **1.95** |
| Assets | 800 | | |
| **Funding ratio** | **80%** | | |

## Assumptions

- For simplicity we assume that the buy-in premium is equal to the gilts-flat valuation of the corresponding liabilities
- We examine the impact of an immediate pensioner buy-in versus the alternative of a DIY approach
- We assume a discount rate of gilts + 75bps for the DIY buy-in and a longevity hedging fee of 3% pa
- The DIY liability value is £880m

Source: Hymans Robertson and Insight, for illustration purposes

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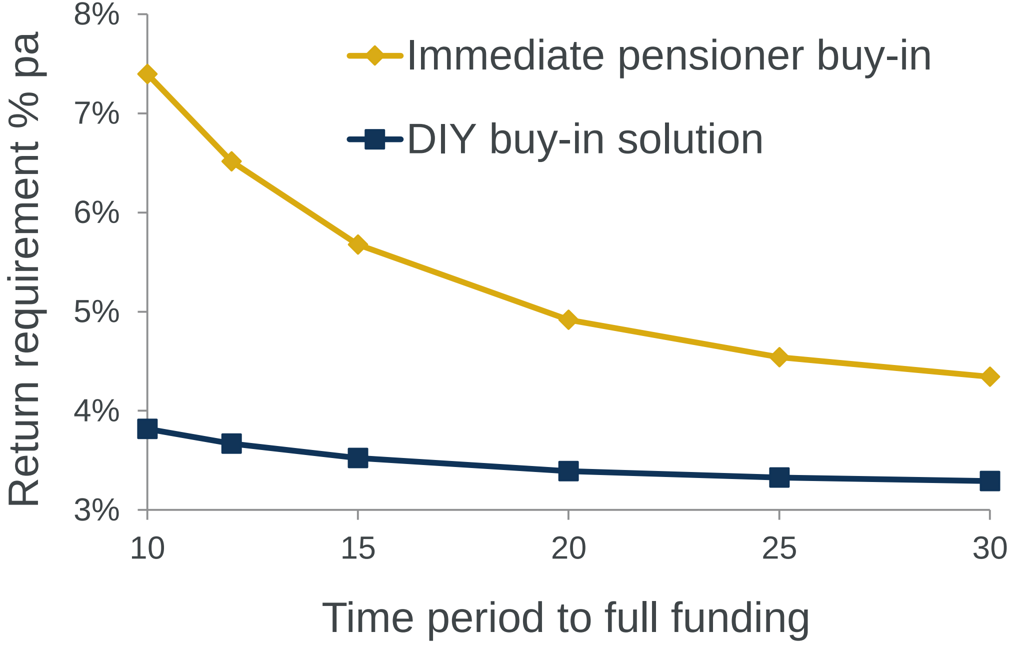
# Return requirements for full funding




- **In each case we consider only the assets that the trustees can invest**
- At all tenors the trustee return target is far higher under the pensioner buy-in approach
- Taking account of the returns on the pensioner buy-in gives an overall 10 year return target of 4.6% pa (rather than 7.4% pa)
- The longevity swap adds c.10bps to the DIY buy-in return requirement

Source: Hymans Robertson and Insight, for illustration purposes

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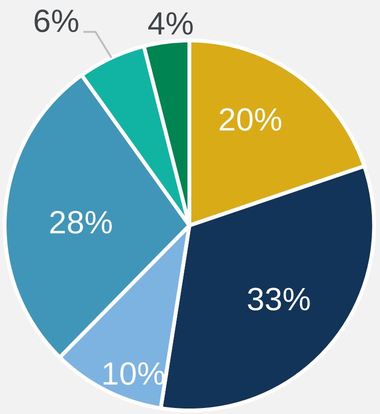
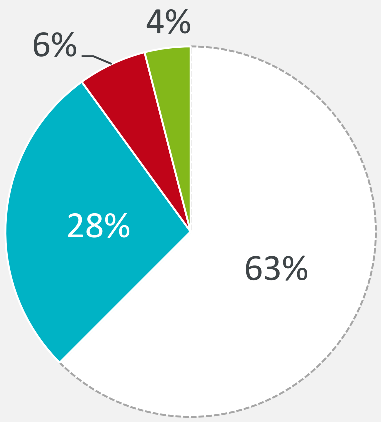
# Impact on investment objectives




## DIY buy-in

- LDI assets
- Corporate bonds
- Alternatiive bonds
- Global equity
- Property
- Private equity

- **Trustees have investment control over all assets**
- They invest in a diversified range of asset classes in order to meet their investment objectives




## Immediate pensioner buy-in

- Buy-in
- Global equity
- Property
- Private equity

- £500m is invested in a pensioner buy-in
- **Trustees have control over just 38% of the assets**
- They must invest primarily for growth

Source: Hymans Robertson and Insight, for illustration purposes

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Questions

Comments



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