HYMANS ROBERTSON

Buy-in monitoring service

Comprehensive analysis of the buy-in market - May 2020

Headlines

Current market volatility creates pricing opportunities for well-prepared schemes
In amongst all of the uncertainty created due to COVID-19, widening credit spreads have created pockets of attractive buy-in pricing. The situation will vary between insurers, depending on their views on the risks presented by different investment opportunities and market volatility. This means some of these opportunities may be fairly short term. For schemes to take advantage of dips in pricing they will need to have spent the time preparing, have engaged with insurers and be in a position to make decisions quickly. See our **"Buy-in insights"** section for more details on the implications of COVID-19 on buy-in/out pricing and insurer capacity.

Too soon to estimate the longevity impact of COVID-19 on pension schemes
There is considerable uncertainty over the extent to which COVID-19 will impact (both directly and indirectly) mortality rates and there is the potential for the impact to vary significantly between pension scheme populations. This creates a risk that pension schemes could "over-pay" for insurance at this point in time, compared to holding off until the passing of the initial wave of COVID-19. However, the price reductions created by widening credit spreads (discussed above) is offsetting and in may cases outweighing the regret risk of transacting in the midst of a mortality spike. This balance requires careful assessment.

Impact on size and shape of market
2019 was a record year for bulk annuity transactions and early estimates were that 2020 would also be busy, perhaps with more numbers of transactions but lower overall volumes. The COVID-19 crisis will slow down activity. Even with attractive buy-in pricing available in the near term, pension schemes will need to assess their priorities and decide where to focus their activity and efforts. Once pension schemes have had time to address urgent issues, we could see a new surge in demand. In addition, if the middle of the year is quieter than predicted, insurers could become keen to write more business before year end, reducing prices and accepting lower margins to increase volume. 2020 could see a return to the very busy Q4 pattern of the buy-in/out market that used to be a common feature a few years ago.

Buy-in pricing

A buy-in policy insures against all risks associated with a subset of pensioner liabilities. When considering whether to undertake a buy-in, pricing is best assessed against returns on other very low risk assets.

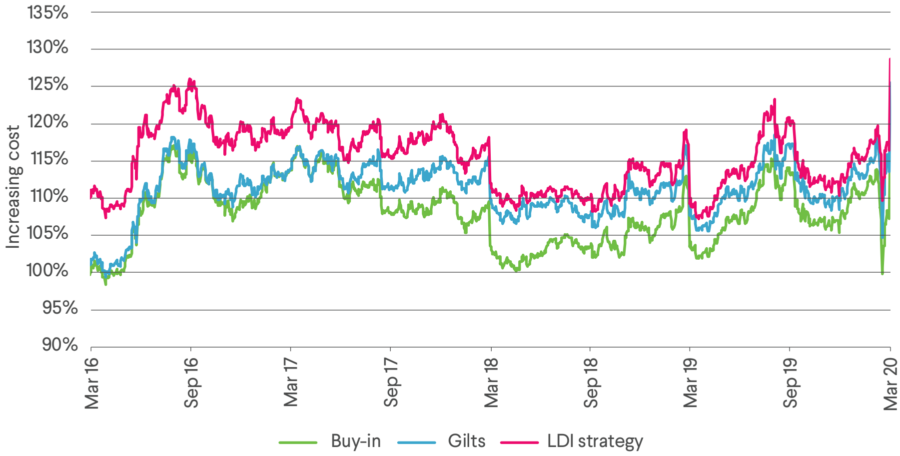
Pensioner buy-in pricing

The chart below plots the relative cost of hedging pensioner liabilities with a buy-in policy, a portfolio of gilts, or a swaps and cash based LDI strategy.

Pricing analysis

For those schemes able to secure attractive terms, average pricing has improved and remains cheaper than the value of gilts needed to match the same liabilities (the green line is below the blue line in the above chart). This means that schemes can exchange gilts for a buy-in policy, maintaining or improving the return on the overall asset portfolio, obtaining a better cashflow matching asset and addressing demographic risks.

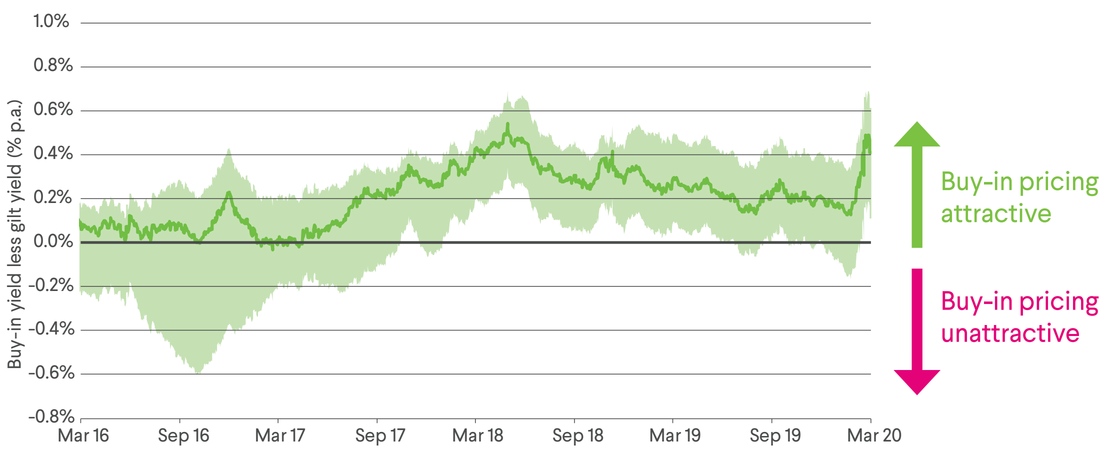
Pensioner scheme buy-in vs gilts and LDI strategies



Buy-in yield analysis

Although tailored to meet the benefits of a subset of members, a buy-in contract remains an asset of the scheme. In assessing the attractiveness of a buy-in, it is useful to understand the investment return (yield) implied by the price.

Buy-in yield relative to gilt yields



The chart above shows the yield locked into based on typical buy-in pricing. This analysis varies depending on the schemes' characteristics and views over members' life expectancies; this variation is reflected on the chart, with the solid green line the position for the "typical" scheme.

A buy-in yield of 0.1% p.a. to 0.2% p.a. below gilt yields might be viewed as a "fair" price to pay, given the reduction in longevity risk, other demographic risks and level of cashflow matching achieved.

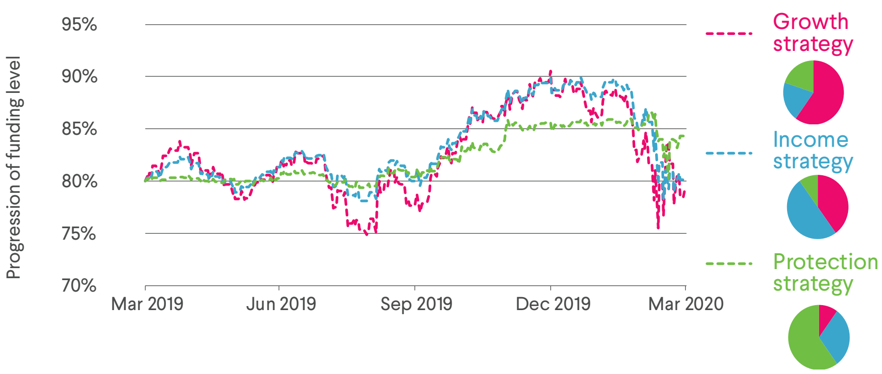
Hyman Robertson's online 3D Analytics tools allow trustees and sponsors to track buy-in pricing and yield analysis tailored specifically to their individual scheme population

Buy-out affordability

The chart below shows progress towards full buy-out funding for pension schemes at different stages in their de-risking journey.

Buy-out affordability for different investment strategies

Affordability analysis



Schemes will have seen significant volatility in their buy-out funding level so far in 2020. Whilst buy-out pricing has improved, lower values on credit assets and equities falling back to 2011 levels will have worsened the position for some.

The impact of COVID-19 will differ drastically between schemes. Schemes with high levels of hedging to interest rate movements and low exposure to growth assets will have fared much better and see the biggest benefit from improvements in buy-out pricing.

However, schemes with a high risk strategy will have seen a material drop in funding level. These schemes may need to reassess their strategy and likely timeframe to reach their objectives.

Buy-in insights

Impact of COVID-19 on pricing

Insurer pricing for buy-in and buy-out will generally be improved by widening credit spreads, as the credit assets that the insurer will use to back the liabilities will have lowered in price. However, credit spreads will have widened, in part, due to higher expectations of future defaults. Insurers' views on this and the extent to which it means they need to hold more capital will influence how much the wider credit spreads translate to lower prices.

Lower interest rates require insurers to hold more capital, which increases their prices. This will be more acute for longer duration business – e.g. buy-outs or buy-ins covering deferred pensioners.

For most insurers we would expect the combination of widening spreads and lower rates to lead to a net improvement in price when compared to a gilts benchmark. However, this will not be consistent across insurers as each insurer uses a different investment strategy, nor will it be consistent across different schemes as it will depend on the duration of the liabilities being insured.

Insurer capacity

A number of corporates are already being impacted by the far-reaching impacts of COVID-19 on the economy. Insurers will be considering how this impacts their ability to source the assets they would want to hold to back new buy-in/out business. Any challenges in asset sourcing will naturally be greater for larger transactions.

Insurers don't just rely on corporate bonds to deliver attractive pricing and use a number of other asset classes including infrastructure, equity release, and commercial real estate lending. Insurers will be looking in some detail at their existing holdings in these assets to understand how they could perform going forward. For new business, insurers will face new challenges in identifying or creating these investments.

People capacity at insurers is not proving too much of a challenge. The industry is generally well set up for remote and flexible working. There will be some practicalities to overcome (eg. signing documents remotely), but nothing that will impact the ability to complete transactions.

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