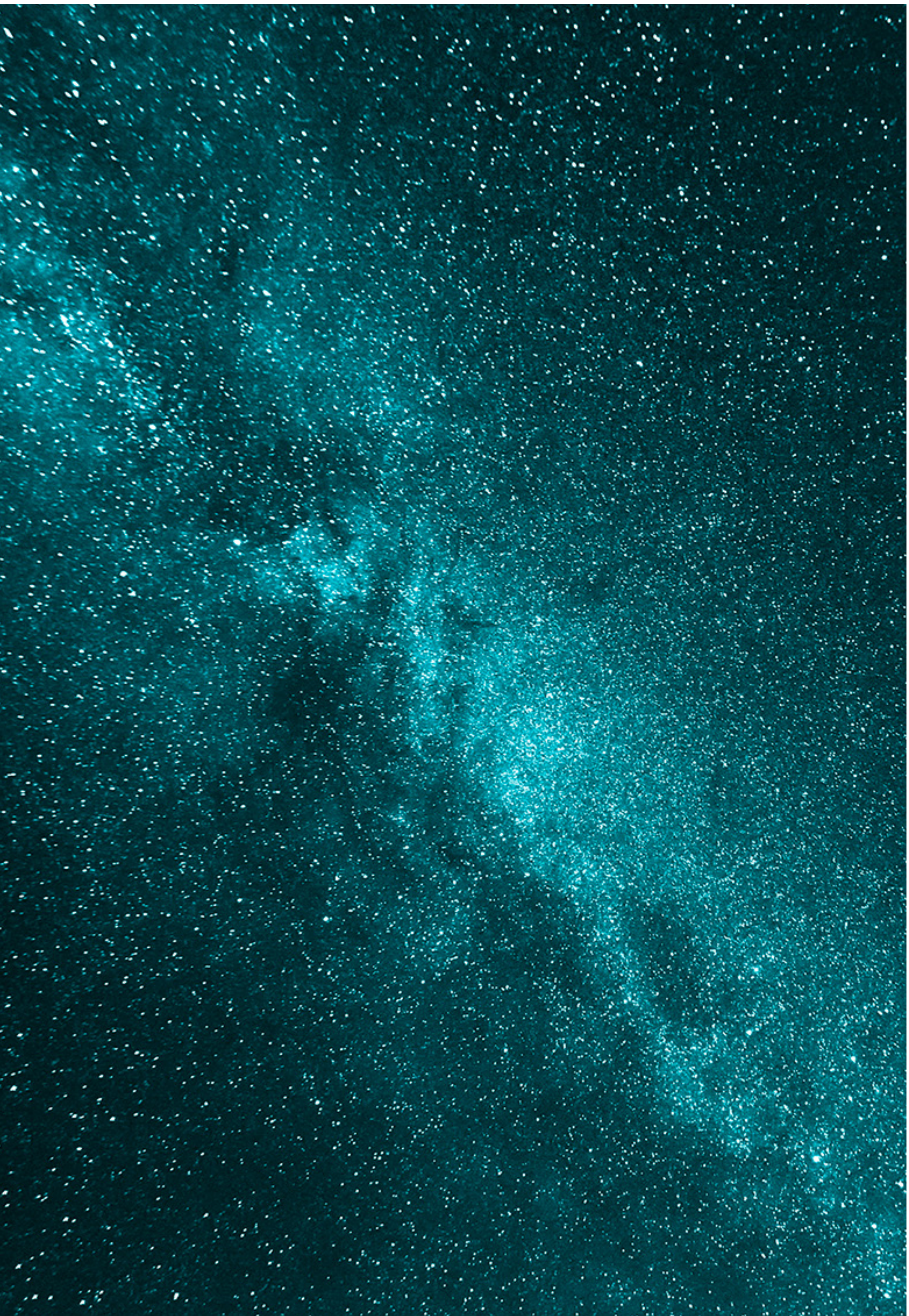
For Investment Professionals only

M&G Investments

A lesson from life

Is buy-out the only option for DB Pension schemes?



The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. The views expressed in this article should not be taken as a recommendation, advice or forecast. Past performance is not a guide to future performance.

Beneficiaries of defined benefit pension schemes have seen a rapid turnaround in their fortunes, as they have moved into surplus amid rising interest rates. This has prompted sponsors to pursue buy-outs with life insurers. But this report argues that, by being more patient, and taking time to optimise the scheme's portfolio and clean up member data, sponsors could gain more value for stakeholders later down the road.

"Don't panic. Don't do anything that you might regret later on in terms of selling assets. But do put in interest hedges so you lock in your funding position – and do it now. Then, you buy yourself some time to reposition your investment portfolio to appeal to an insurer."

Russell Lee, Head of Insurance Solutions at M&G Investments

The growing queue of corporate sponsors eager to offload risk in their defined benefit (DB) pension schemes onto life insurers is causing bottlenecks. However, there could be a better alternative, which could offer greater stakeholder benefits in the long run.

The challenge for sponsors in a hurry to transfer risk in their DB pension schemes to a life insurer is the number of like-minded others already in front of them in the queue. Simply put, the surge in demand is creating capacity constraints for life insurers while tilting in their favour the pricing dynamics of buy-outs and buy-ins.

Life insurers face capacity constraints around the actuarial and administrative staff required to process all the enquiries they are receiving. Such is the demand for their services, some could even run into capital limitations. Both issues have caught the attention of regulators.

Buy-ins occur when a life insurer provides cover for part of the scheme's liabilities, while a buy-out involves taking over all the liabilities.

Changes in interest rates and bond yields have placed most DB pension schemes in a much stronger funding position than they were just three to four years ago. The Pension Protection Fund (PPF) reported that the more than 5,000 schemes covered in its PPF 7800 index saw an estimated surplus of £446.1 billion in August 2023, with just 458 schemes in deficit versus 4,673 schemes in surplus. This compares with a surplus of £313.8 billion at the end of August 2022, with 1,134 schemes in deficit versus 4,081 schemes in surplus.

Deficit of	Surplus of	Surplus of
£91bn	£314bn	£446bn
2019	2022	2023

But, winding the clock back to August 2019, the schemes in the PPF 7800 registered an aggregate deficit of £90.7 billion with 3,396 schemes in deficit compared with only 2,054 schemes in surplus. Going back a few more years, these deficits routinely stood at over £200 billion.

With surpluses comes choice

This vastly improved funding position has given trustees the luxury of choice. This is worth pondering. Delays in processing transactions means that, other than those schemes that life insurers find most attractive, many will have to wait four to five years before they see the opportunity for a buy-out. For trustees, who now have no need to rush into a transaction with a life insurer, this should not be cause for concern.

An alternative approach could be to run the DB pension scheme the same way as a life insurer would: that is, with a focus on generating income. A side benefit of that approach is that it can lead to a reduced reliance on Liability Driven Investment strategies, which have come under greater regulatory scrutiny following disruptions in the Gilts market a year ago. LDI strategies are designed to reduce volatility in scheme funding levels by investing in assets whose value moves in tandem with the cash requirements of the scheme's liabilities.

Mimicking the approach of a life insurer would involve using the same Cashflow Driven Investment (CDI) strategies employed that they use, combined with hedging the interest-rate exposure. This could produce a better outcome for the scheme's stakeholders over the medium term.

The core objective of CDI is to match the expected future cash-flow requirements of the pension scheme with the income from the underlying assets.

Going down the CDI route has a number of advantages for a DB pension scheme. These include avoiding the need to pay premiums to an insurer; greater control over the scheme's underlying assets; more time to resolve critical administrative issues; and the possibility of generating better long-term outcomes for stakeholders.

Another important benefit of implementing a CDI strategy is that it will make the scheme more attractive to a life insurer – a factor that could become significant a number of years down the road, when the rush to do buy-outs should have subsided. That should also translate into more favourable pricing for sponsors.

Given current capacity constraints, some life insurers will take data from a DB pension scheme, monitoring pricing so they are ready to strike a deal if the stars align for the sponsor and trustees. That approach is sometimes used for smaller schemes and can speed up a transaction once everything is in place.

"Securing a deal in the insurance market is nowhere near as easy as many people think it might be. There is a huge capacity constraint relative to the potential demand in the market. If you don't have a desperate need to enter this stampede to buy policies, then why would you?"

Mike Smaje, Trustee Executive,
BESTrustees Limited

Vastly improved environment

DB pension schemes are now in much healthier funding positions to transact with life insurers, due to the dramatic turnaround in interest rates and bond yields.

Illustrating the change in fixed-income markets, the 10-year Gilt yield stood at around 4.4% in mid-September 2023, compared with just under 1% in December 2021. This reflects one of the fastest-ever increases in the Bank of England's base rate, as it rose from 0.1% on 2 December 2021 to 5.25% on 3 August 2023 as a measure to dampen rampant inflation.

Inflation started picking up from around March 2021, topping out at 11.1% in October 2022, as pent-up demand was unleashed by the ending of Covid-19 lockdowns, together with disrupted supply chains and the playing out of the Ukraine-Russia war.

Owing to the improved position of DB pension schemes, industry sources estimate there could be as much as £180 billion worth of buy-outs and buy-ins taking place over the next 12–18 months, with over half the industry currently being 'buy-out funded' – typically, that means 5% overfunded. JPMorgan estimates that up to £600 billion of pension liabilities could be transferred to life insurers over the next decade.

Consultant Hymans Robertson estimates that £25 billion worth of business was transacted with life insurers in the first half of this year and volumes are expected to remain buoyant into the second half. This year could even surpass the £43 billion in transactions recorded in 2019, leading to concerns that life insurers are becoming over-stretched. There are currently eight life insurers, also known as bulk annuity providers, in the UK market.

Regulators are concerned

The pace and volume of deals being struck by life insurers is clearly a cause for concern at the Prudential Regulation Authority (PRA). In a speech published on 27 April 2023, Charlotte Gerken, the PRA's Executive Director of Insurance Supervision, told life insurers to "exercise moderation" in the face of "considerable temptation." In this context, the regulator is concerned about financial stability risks resulting from life insurers' absorbing too many assets too quickly.

On the same day The Pensions Regulator (TPR) published its annual funding statement calling for trustees to question whether a buy-out is viable, and to examine their end-game options. This is a reminder that regulators could step in to moderate the pace of activity if they deem that it poses a threat to financial stability.

Nonetheless, sponsor enthusiasm to conduct a buy-out or buy-in is understandable. Most DB pension schemes have languished in deficit for over a decade due to very low interest rates and bond yields. This left corporate sponsors often making only painfully slow progress in their attempts to close funding gaps. Many sponsors see the current higher yield environment as an unexpected, but welcome opportunity to offload the risk in their DB pension schemes.

However, rushing to complete a transaction could leave value on the table, which could be used in the medium term either to enhance member benefits or be returned to the corporate sponsor to be invested in the UK economy.

For DB pension schemes already in surplus, there are a number of options in terms of how those extra funds can be deployed. However, this can only happen within the confines of current legislation and the scheme's deeds and rules. For instance, there are considerable restrictions on returning any surpluses to sponsors.

Otherwise, those surpluses can be used to post extra benefits to retired members to help them manage the cost-of-living crisis, particularly if payments are restricted by an inflation cap. In instances where the DB and a defined contribution pension scheme sit in a joint trust, some of the surplus in the former may be able to be transferred to the latter.

The options available to DB pension schemes will be explored in greater depth later in this report.

LDI strategies come under scrutiny

A key reason why portfolio management strategies such as CDI are back in the spotlight is due to an event that rocked DB pension schemes and made many stakeholders question earlier approaches to generating returns.

Prior to the dramatic change in the interest-rate regime, a 'go-to' investment strategy for many DB pension schemes had been based on Liability Driven Investments (LDI). A report published by Parliament on 23 June 2023 included a TPR estimate that, by the end of 2021, 3,000 (60%) private-sector DB pension schemes had used LDI.

LDI strategies are thought to have been employed for over 30 years, with LDI funds having existed for around 20 years, and the use of leverage has been available for around 15 years, according to a discussion paper published in April 2023 by the Bayes Business School and The Pensions Institute called 'Liability Driven Investment - A Victimless Disaster'.

Many added leverage to free up funds to invest for higher returns. Prior to the rapid rise in interest rates, this was a popular strategy, particularly for underfunded schemes.

The downside of using leverage is that schemes are subject to collateral calls when the Gilts they've invested in fall in value. The use of leveraged LDI was put to the test when the government of former Prime Minister, Liz Truss, published a controversial budget on 23 September 2022. This featured significant unfunded spending commitments, which spooked the Gilts market. This event triggered the largest single-day spike in long Gilt yields in two decades, with the value of these bonds, which were being used as collateral in LDI strategies, falling dramatically.

It was a risk some trustees hadn't accounted for.

Nonetheless, LDI, now with much lower leverage, remains an important tool in the kit for DB pension funds looking to hedge their risks relating, for example, to interest rate movements. Indeed, pension schemes would be remiss not to 'lock in' the funding improvements arising from higher interest rates.

Leverage comes under regulatory scrutiny

Meanwhile, the Financial Conduct Authority (FCA) and TPR are now carefully monitoring the use of leverage by DB pension schemes and requiring the latter to follow a much more conservative approach. For example, on 12 October 2022 the TPR recommended that trustees should discuss their LDI strategies with their investment advisers. The regulator advised trustees to take practical measures, such as reviewing their operational processes and checking their liquidity positions in case of another eruption of volatility in the Gilts market.

The UK Parliament also took considerable interest in the September Gilts incident and the problems with certain LDI schemes, and subsequently set up at least three committees to investigate the impact of these events on the pensions industry.

Scrutiny by regulators and legislators has prompted some trustees to rethink substantially the investment strategies of the schemes that they oversee, largely with a view to reducing risk. Regulatory interventions and general caution on the part of counterparty banks have greatly reduced the capital efficiency of leveraged LDI strategies.

Pension schemes are now required to put up considerably more collateral against their derivatives and any leveraged exposures.

Fortunately, the rise in Gilt yields and the fundamental repricing of capital have led to many schemes no longer needing to use significant leverage to gain adequate returns. Furthermore, for the first time in more than a decade, their stronger funding positions have given them real choice in terms of their long-term ambitions.

"LDI requires higher levels of collateral, more liquidity across the asset base, more diversification in the collateral pools as well as being able to manage and maintain LDI portfolios but LDI also offers real benefits in helping schemes progress toward their end game with greater certainty."

David Walker, CIO, Hymans Robertson

Defining CDI

A strategy that is being increasingly introduced to DB pension schemes is cashflow driven investing (CDI). Along with Gilts, it makes use of other assets, such as investment-grade corporate bonds and private debt. This is how insurers invest in order to back these liabilities post buy-in. Hence, many market participants describe CDI as "investing like an insurer".

The reality is that most asset managers define CDI according to their capabilities, meaning that many CDI solutions bear little resemblance to what insurers do.

Some of these 'solutions' combine LDI with short-dated floating-rate debt instruments, which will not move in line with the pension scheme's liabilities. Other CDI offerings include sub-investment-grade debt or high-yield bonds, which are not appropriate for matching with pension liabilities as they introduce undue credit risks into the portfolio.

Then, there are providers that do have life insurance capabilities, but keep their best assets to service their in-house schemes, rather than allowing outside schemes to invest in them.

The key differences between CDI and LDI is that the former matches the timing of cash flows and liabilities, while the latter manages sensitivity to interest rates. CDI is about cash-flow predictability while, with LDI, it is more about risk management and reducing funding volatility.

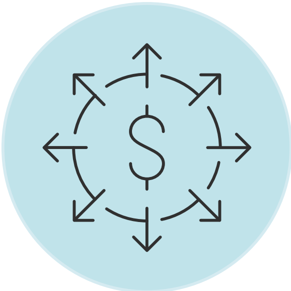
Along with deleveraging, CDI is seen by some trustees as part of the de-risking process – one that typically happens over several years. It is particularly suitable for schemes that are nearly or fully funded.

Replacing LDI with long-dated physical matching assets can improve yield and, therefore, boost the efficiency of the portfolio. Those higher returns can help schemes to close funding gaps more quickly or simply be used to benefit all stakeholders. This is particularly good news for sponsors plotting a self-sufficiency route or looking to achieve a buy-out in a number of years' time.

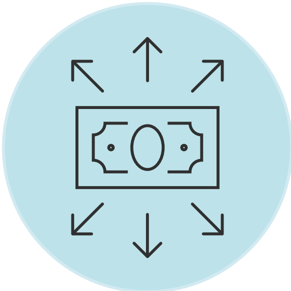
"CDI is also adaptable to self-sufficiency. It's really just to make sure that you have adequate amounts of assets in your portfolio to generate the cash to meet your pension payment requirements on time, without having to sell assets. It's another form of de-risking."

Grant Hadland, Head of UK Institutional Distribution, M&G Investments

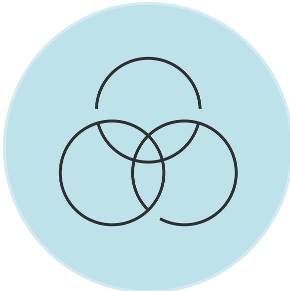
A true CDI strategy should meet the following criteria as used by life insurers



Are the assets in the portfolio generating cash flows that are fixed in nature?



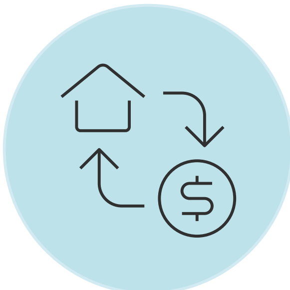
Are those assets of investment-grade quality, thereby providing a degree of certainty around cash flows?



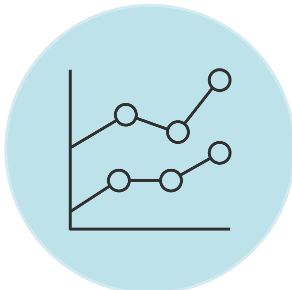
Does the portfolio provide sufficient diversification?

Do the cash flows from the CDI strategy match the pension fund's liabilities?

Are any of the holdings exposed to collateral calls? (If so, this is not a true CDI strategy)



Is there going to be a need to sell assets that are subject to market movements to recoup the principal, such as a piece of real estate? (If so, this is not a true CDI strategy)



Any hedging against value (as done by LDI) is not a cash-flow matching strategy

A dynamic approach to liability valuation

DB pension schemes contemplating using CDI can employ a 'dynamic discounting rate' approach to calculate the current cost of future pension obligations. The discount rate is determined by estimating expected rates of return from investments over the long term and includes a prudent haircut in case of asset underperformance.

The discount rate will move in line with the yields on the low-risk asset portfolios supporting the liabilities. Typically, the discount rate will reduce over time as schemes mature and as portfolios are de-risked.

Currently, most DB pension schemes use a discount rate derived from Gilt yields. The dynamic discount rate approach would, in theory, make it easier for DB pension schemes to invest in other safe assets beyond the Gilts market and also reduce the volatility of a scheme's funding level.

Though life insurers use dynamic discounting- it is subject to strict rules set out by the PRA. Crucially, it is only allowed if the investment portfolio meets the definitions of CDI as described in table above. In other words, assets and liabilities, along with cash flows and outflows, must be precisely matched, with interest rate risks removed. This approach is underpinned by the use of high-quality assets with little default risk.

"Rather than being led entirely by Gilts, you can basically use other high quality assets in your fund minus a haircut as your discount rate. So long as you are prudent about the haircut for the returns that you are using, it can actually reduce the volatility of your funding level going forward."

Andrew Swan, UK Institutional Distribution, M&G Investments and Non Exec Trustee Director, Prudential Staff Pension Scheme

The road to buy-out

Many DB pension scheme sponsors were surprised by the recent rapid and positive change in their funding positions. Many were originally anticipating a decades-long preparatory period to get their schemes sufficiently funded for a buy-out. The main focus, therefore, was on generating returns and administering the scheme, with little thought given to the possibility of conducting a transaction with a life insurer.

In practice, this means that a large number of these schemes – despite being fully funded – simply aren't ready for buy-out, for two key reasons. The first is that member data will usually require a lot of work to be sufficiently clean for insurers to use in pricing, and the second is that investment portfolios are not structured to appeal to a life insurer. Both are common issues across the industry that, in each case, could take several years to rectify.

To produce a clean, up-to-date list of all the scheme's members, the amount of data required is substantial. It should cover items such as each member's identity, including full name, date of birth, national insurance number, full contact details, marital status, retirement date, pension entitlements, plus details of any deferred memberships or pension transfers.

Incomplete or outdated information can lead to an insurer simply rejecting a scheme or making a more expensive quote that reflects their uncertainty over the liabilities they would be taking on. Given the current demand for buy-ins and buy-outs and their obligations around matching regulatory capital to potential liabilities, insurers are likely to take a conservative view on pricing to allow for potential discrepancies.

For example, data-validation exercises have, on occasion, uncovered members who weren't previously on the database, or have been proven to have underestimated the entitlements of other members, all of which are detrimental to a scheme's perceived fulfilment of its obligations.

"In the era of zero interest rates, money was cheap, and banks were retreating from long-term lending. There was an opportunity for the stable investor, therefore, to earn additional returns by lending for the long-term. With the recent increase in the cost of money, investors should re-evaluate their strategic asset allocations. Many are likely to conclude their priorities should change. Particularly with the opportunity to move to buy-out / buy-in on more favourable terms, pension funds should consider if they would prefer to have a more liquid asset portfolio."

Carl Hitchman, Chief Investment Officer
and Head of Investment Consulting at Buck,
a Gallagher Company

'Inadequate data equals higher transaction costs, delays and uncertainty,' The Pensions Administration Standards Association (PASA) warned in a document called 'Data readiness for buy-in and buyout Guidance' published in February 2023.

PASA, therefore, advises sponsors not to approach the insurance market until they are sure they are in possession of high-quality data, in order to avoid 'nasty surprises' related to premium adjustments, or even an enforced revision of their chosen pricing methodology.

Meanwhile, the rush by sponsors to conduct buy-outs has led to administrators being overwhelmed by requests to carry out data-cleansing exercises. This is further delaying the readiness of schemes for buy-out.

"Transferring the administration of a pension fund to an insurance firm is incredibly hard work and is very labour-intensive. For an insurer to divert a lot of its resources and people to work on your scheme and give you a quote, they have to know that you're serious about transacting and you've done your preparation."

Mike Smaje, Trustee Executive,
BESTrustees Limited

Building ‘life-insurer-friendly’ portfolios

The second area that requires attention before approaching a life insurer is the composition of the scheme’s investment portfolio, an aspect often deferred in anticipation of a long restructuring period.

The growth-driven priorities of yesteryear may have led to investments in illiquid assets such as infrastructure and real estate, and even, in some cases, equities. These are not investments favoured by most life insurance companies.

In its annual funding statement, published on 27 April 2023, TPR advises trustees where a buy-out is being contemplated that the scheme should hold assets that are preferred by life insurance companies and that are de-risked to minimise the potential negative outcomes for members and sponsors.

All life insurers will happily take on Gilts and investment-grade corporate bonds, and some will also take on board assets such as private credit and commercial ground rents. Those in the best position to perform a buy-out – i.e., those in a strong funding position, with clean data – should aim for the liquid end of the asset spectrum.

Bonds largely make up the CDI strategies pursued by life insurers. The more closely the scheme’s portfolio matches that of a life insurer, the easier and cheaper it will be to transfer it to a life insurance firm. Creating a portfolio that is attractive to a life insurer will require a review of the assets held in the scheme’s portfolio, particularly if it is geared towards a growth strategy.

Whereas liquidating a portfolio of publicly traded stocks is relatively easy, the same is not necessarily true for illiquid assets. Indeed, many DB schemes have been selling illiquid assets at deep discounts in a rush to rebalance their portfolios to appeal to life insurers.

Such actions may accelerate a transaction, which is clearly good for the scheme’s stakeholders. However, with a little bit of patience, either members’ benefits could be enhanced, or corporate sponsors could get back some of the funding that they have put into the scheme over many years, and which otherwise would have been invested in the UK economy.

“Give yourself time to sell your illiquid assets at decent prices and gradually move into CDI strategies - in the meantime, you can also hedge interest rate exposures.”

Russell Lee, Head of Insurance Solutions at M&G Investments

Leaving surpluses at risk

Other trustees, despite the now strong funding position of the schemes they manage, have been slow to de-risk the portfolio, leaving them vulnerable to any reversal in the current favourable interest rate environment.

Given the discouraging imbalance between upside and downside risks, fully funded DB pension schemes that are not yet ready to transact with life insurers should consider putting in place interest rate hedges to secure their gains. This will allow them time to rebalance their portfolios to be more appealing to life insurers.

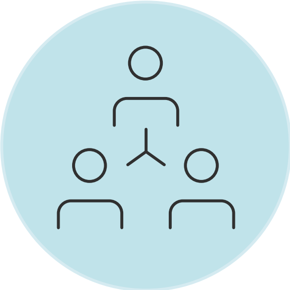
Ironically, when interest rates shot up recently, it was the schemes that did the least amount of interest rate hedging historically that reaped the biggest rewards. If, for some reason, rates were to fall rapidly, funds that are under-hedged will suffer most in terms of their long-term funding positions.

Sponsors committed to self-sufficiency, or who are still underfunded, have more flexibility in terms of asset mix. They can park funds into less liquid, but higher-yielding long-dated assets and run combinations of CDI and LDI strategies.

"Don't be incremental about this. Change your strategy quickly so your gains are locked in."

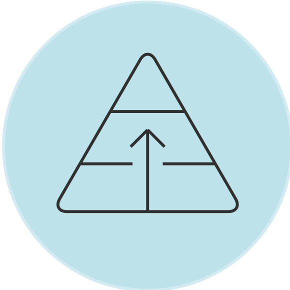
Russell Lee, Head of Insurance Solutions at M&G Investments

Considerations for trustees contemplating a buy-out



The members

Could delaying 'buy-out' produce a better outcome over the long term?



The sponsor

Is there confidence that the pension scheme can remain fully funded in the event of a substantial downturn in bond yields?

Trustees

Is the credit quality of the sponsor sound (and can it, therefore, afford to wait before transacting with a life insurer)?

Data

Do administrators have all the relevant data pertaining to the scheme's members, such as their addresses, marital status, commutation factors, transfer values, entitlements, etc ...? If not, how long would it realistically take to compile this information in a clean format acceptable to a life insurer?

Portfolio

Is it made up of investments that would be attractive to a life insurer, namely that they meet the criteria?

If the scheme meets the first three points, but not one or both of the last two, is there really a rush to do a buy-out? Could waiting afford an opportunity to either enhance member benefits or to provide some upside return to the sponsor?

Investing like an insurer

Most UK defined benefit pension schemes are suddenly in their strongest funding position in many years, which has opened-up greater choice.

Understandably, following over a decade of deficits many have opted to pursue buy-outs with life insurers. However, given the less favourable buy-out terms, those schemes not yet in the best position to negotiate may be better served by taking time to make the necessary preparations. 'Investing like an insurer' and employing similar strategies, combined with hedging the interest-rate exposure, could produce a better outcome over the longer term.

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