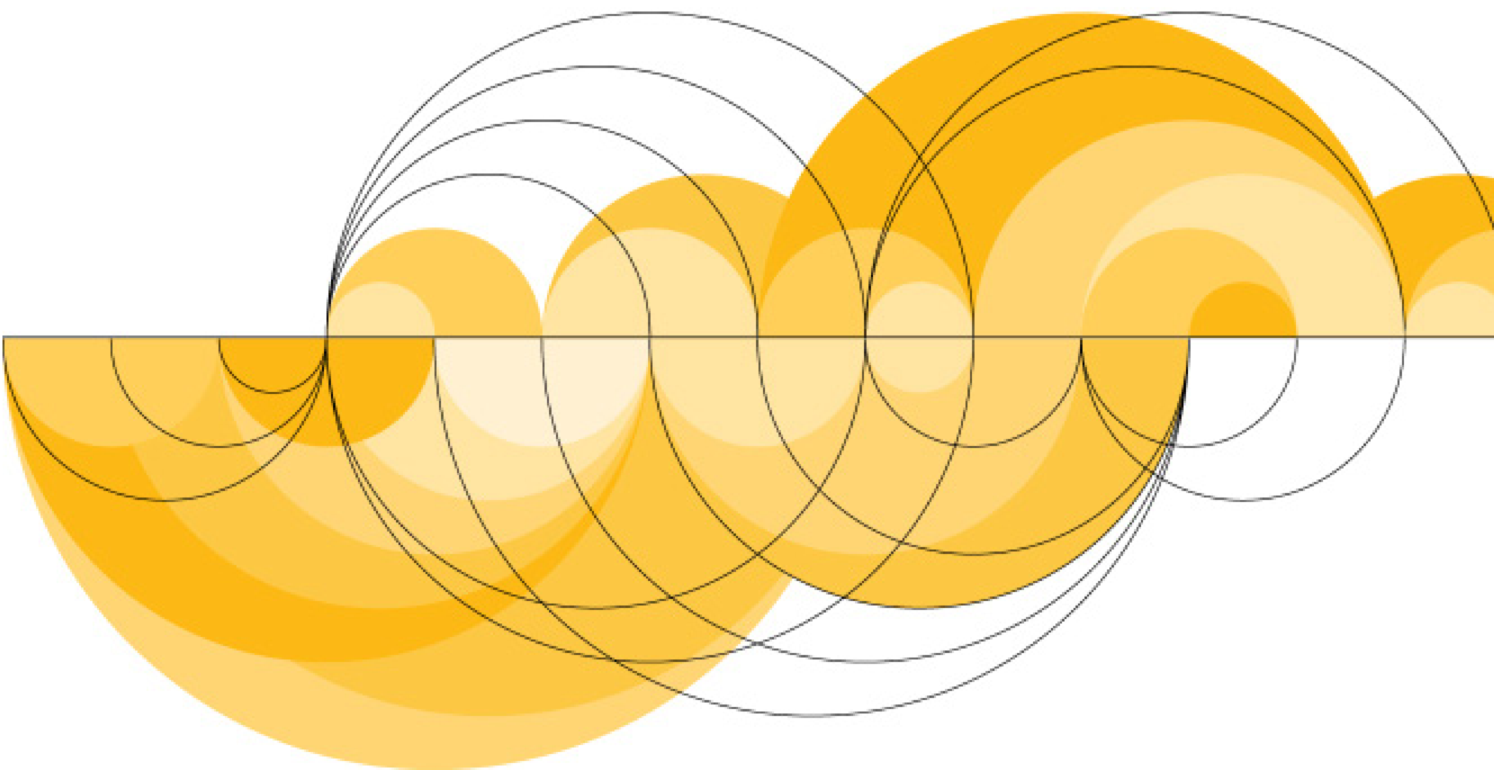
Synthetic credit when approaching buyout



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Preparing for buyout

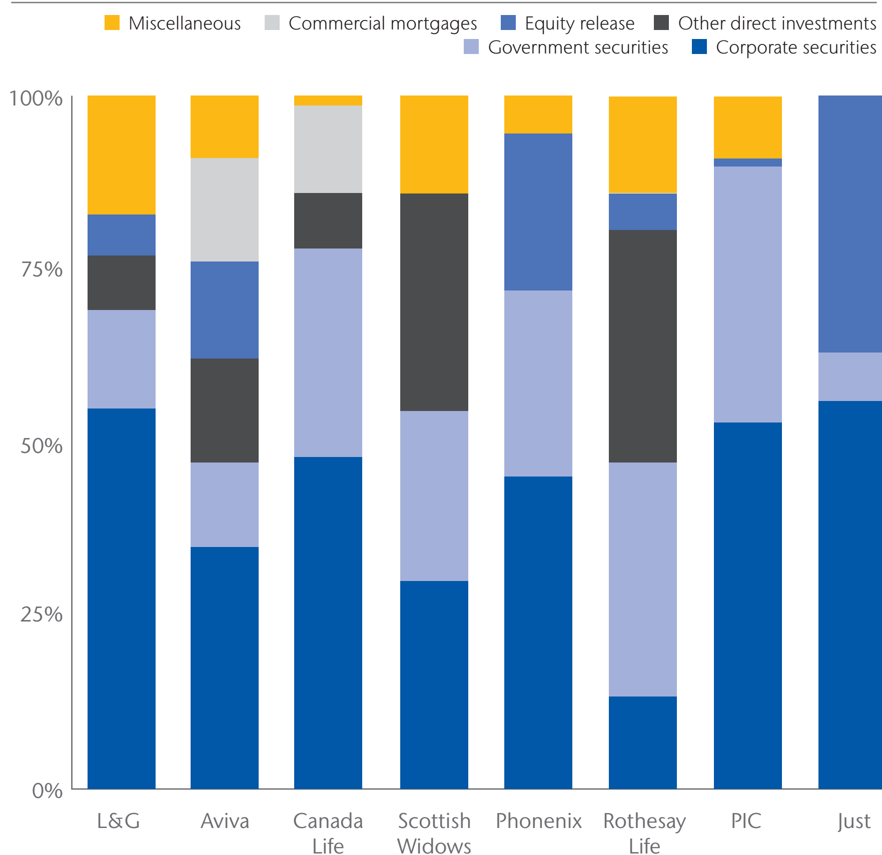
Aon's 2019 Global Pension Risk Survey showed that many pension schemes are now less than 10 years away from buyout and securing their members' benefits with an insurer.

As Trustees prepare their scheme for buyout, they will need to evolve their investment strategy. The focus shifts from being growth-orientated to ensuring the scheme's assets move more closely in line with insurer pricing. The requirement to have assets that are sufficiently liquid, flexible and straightforward to sell or transfer to an insurer becomes increasingly important.

The role of credit to match insurer pricing

Insurers will typically include an allocation to credit in the investments that they use to price their buyout contracts. The chart below shows the assets held by the eight main UK insurers to back previous insurance transactions.

Asset summary breakdown by insurer



Source: Aon surveys/Insurers as at 31 December 2019.

At a glance...

- Many pension schemes are approaching their endgame and for many this means securing their members' benefits with an insurance company.
- Having exposure to credit helps to ensure a scheme's assets move in line with insurer pricing.
- Pension schemes can benefit from synthetic credit exposures provided by diversified exposure to investment grade credit default swaps.
- Synthetic credit can be used in the overall journey to buyout and carries many benefits versus physical credit.

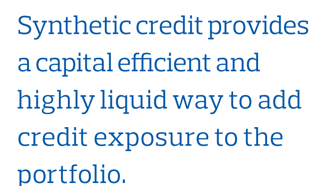
When selecting an insurer to complete a buyout transaction, the premium the insurance company asks for will reflect the assets that the insurer is intending to invest in to back those liabilities. As seen in the chart on the previous page, most insurers use corporate securities such as Investment Grade (IG) corporate bonds in their investment strategies alongside government bonds and illiquid private credit assets. The range of exposure varies from insurer to insurer; some have allocations starting from 14% while others hold more than 50% in credit.

This means that the price of a buyout transaction is frequently linked to movements in corporate bond yields. We believe increasing or introducing a 20%-40% allocation to investment grade credit will provide some protection against insurer pricing moves as schemes approach buyout.

As schemes get closer to the point of transacting, having a flexible credit portfolio which can be adjusted quickly and cheaply is crucial. Depending on the insurer, the credit sensitivity may need to be increased, for example to 50% or reduced to 0%. Using synthetic credit can provide this flexibility rapidly, at a low cost and allows better matching of buyout liabilities. We explore synthetic credit in more detail below.

Introducing synthetic credit

Pension schemes can benefit from synthetic credit exposures provided by using index credit default swaps (CDS) to provide diversified credit exposure. CDS are standalone contracts that provide investors with liquid, standardised, synthetic exposure to the corporate bonds of a defined set of companies.



Synthetic credit offers a number of benefits. These include:

Better diversification – It can provide a broad and diversified credit exposure. For example, it can achieve exposure equally weighted across 250 US and European IG credit issuers (so each issuer represents limited credit risk making up just 0.4% of the portfolio).

Capital efficient – As an extension to the LDI toolkit, it uses leverage, meaning schemes can gain credit exposure whilst having the assets to improve the liquidity elsewhere or invest in other assets alongside the credit allocation.

Low cost – It offers lower costs versus physical credit (such as Buy & Maintain or passive) in terms of both ongoing management and transactions costs. Transaction costs are always low, regardless of the trade size.

Highly Liquid – Not only does it provide credit exposure, but synthetic credit can allow for the easy adjustment of the exposure to match a specific insurer's pricing basis. It is also very liquid, which means it can replace a portion of a scheme's cash allocation to improve investment returns.

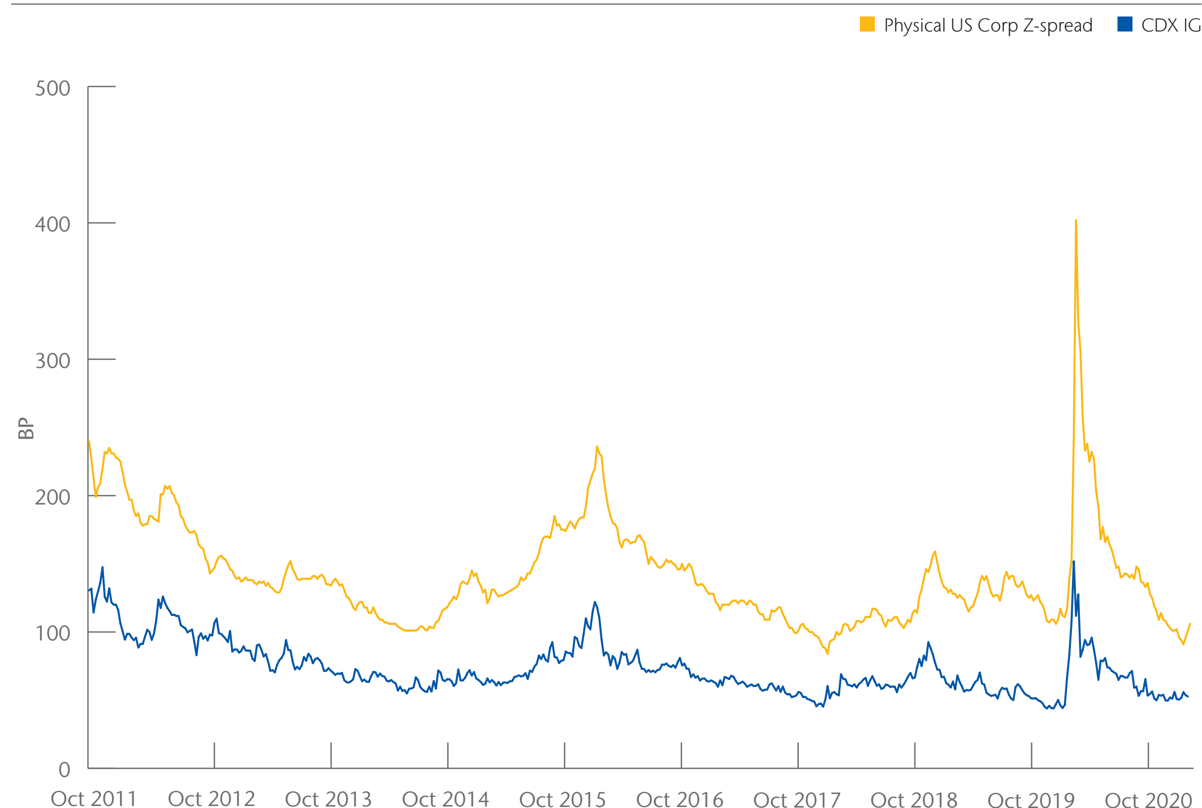
Good fit with Liability Driven Investment (LDI) – Using synthetic credit allows schemes to adjust the credit sensitivity of the portfolio without affecting the interest rate or inflation hedging positions. It can also help to enhance returns in a hedging portfolio when used with leverage.

The benefits of synthetic versus physical credit

Synthetic credit is a useful tool for schemes targeting buyout as it can better match movements in buyout pricing. We believe synthetic credit provides a range of benefits over physical credit:

Holds value and liquidity better in market-sell offs – CDS typically holds its value better than physical credit when there is a credit sell-off. During the credit sell-off in March 2020, CDS retained better liquidity than physical credit meaning that its spreads were less impacted by the sell-off.

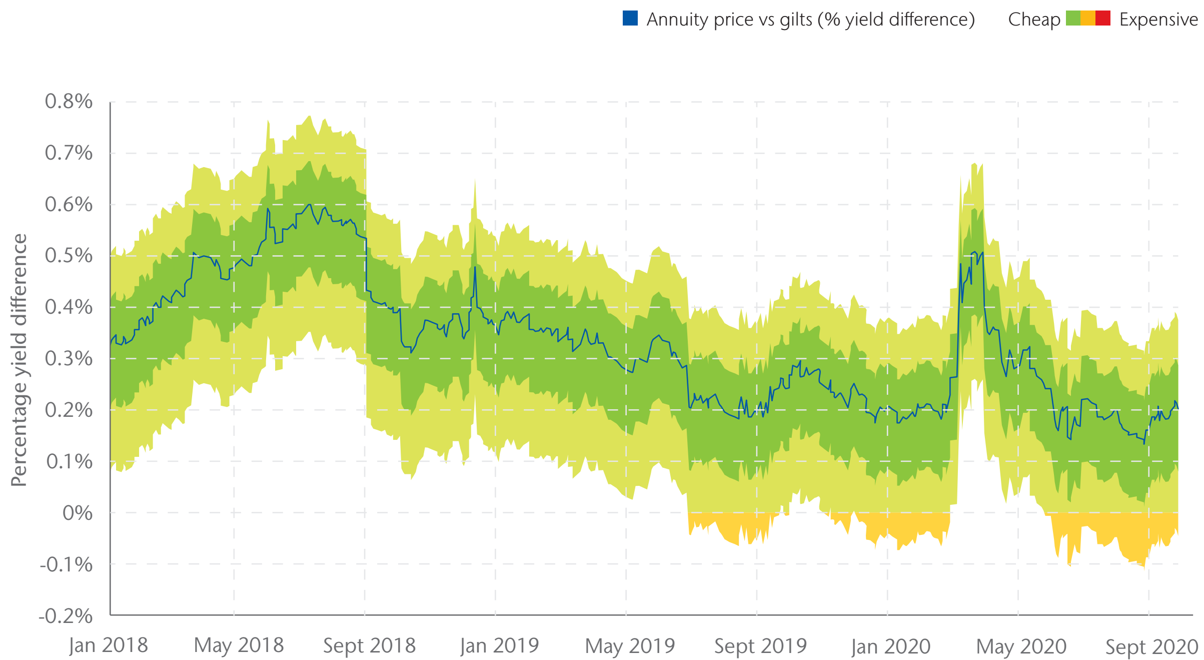
US CDX 5yr IG Spreads and US Intermediate IG Credit OAS histories



Source: Bloomberg

Better match to insurer pricing – CDS can track (provide a better match to) insurer pricing. In March 2020, we saw insurer pricing improve when credit spreads increased (as shown in the chart below). There was a slight drop in the value of synthetic credit, however this was relatively small when compared to the drop seen within physical credit.

Insurer bulk annuity cost for pensioners



Source: Aon Risk Analyzer

Quicker and cheaper to transact and transition to an insurer – Synthetic credit is cheaper and easier to trade than holding physical corporate bonds. This is important as schemes look to be flexible in the later stages of their buyout transaction.

Summary

- Many pension schemes are targeting securing their members' benefits with an insurer.
- Having the flexibility to adjust credit exposure quickly to match insurer pricing will be an important consideration as schemes get closer to transacting.
- Synthetic credit can help ensure a scheme's assets move in line with insurer pricing. It can also help maintain liquidity in the assets to ensure the eventual transition to an insurer is efficient and cost effective.

Contacts

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