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Aon's Investment Research and Insights

To buy-in or not to buy-in?

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Aon

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About Aon's Investment Research and Insights

Aon's robust portfolio of ideas, tools and researched solutions supports trustees and sponsors to anticipate their future investment requirements.

By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

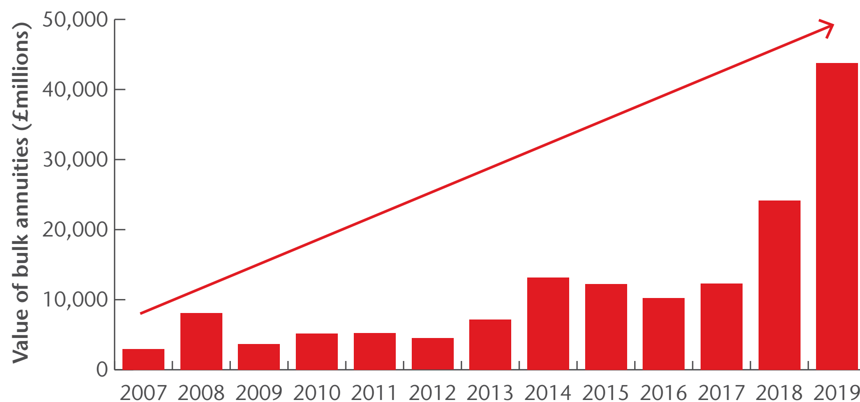
To learn more and to access other research and insights from Aon's investment experts, visit **aon.com/investmentuk**

Executive summary

- Buy-ins offer the opportunity for pension schemes to transfer a portion of their liability risk to an insurance company for a fixed cost.
- In addition to the interest rate and inflation hedging, which are also offered by LDI solutions, a buy-in also hedges against longevity risk.
- Buy-ins are illiquid and capital intensive and are often most effective for schemes that only need a low investment portfolio return.
- Portfolios that benefit the most from buy-ins typically have large holdings of gilts, index-linked gilts, investment grade credit or follow an LDI strategy with low levels of leverage.
- A key consideration is funding. Buy-ins are capital intensive and the scheme requires sufficient funds to pay the premium without undermining its capability to generate return.

Attractive pricing, and larger size deals, have led to increasing levels of activity in the market. At Aon, we are seeing an growing number of clients setting a long-term target of buyout (35% in 2019 vs. 27% in 2017).

Bulk annuity business written with UK pension schemes



Source: Aon Survey of Providers

What is a buy-in?

Buy-ins are increasingly being used as a way for schemes to reduce risk and secure member benefits through insurance.

They offer the opportunity for pension schemes to transfer a portion of their liability risk to an insurance company for a fixed amount. The insurer will then pay a regular income to the scheme matching the benefit outgoings to those members included in the buy-in. Compared with a buyout (full transfer of liabilities to the insurer), when a scheme goes to buy-in, they hold an annuity as a scheme asset. Most importantly, with a buy-in the scheme will still be responsible for ensuring members are paid.

When to buy-in

- **Where there is a low required investment return**
- **When a phased approach towards long-term buyout is being taken**
- **When there is a focus on income generation**

Required investment return

Buy-ins are often most effective for schemes that only require their investment strategy to deliver a low return (e.g. Gilts +2.5% p.a. or less). These schemes will typically be well funded with any deficits being closed through contributions or relatively low risk investments. Their investment portfolios are likely to have large holdings of gilts, index-linked gilts, investment grade credit or LDI strategies with low leverage.

In these circumstances, the scheme's existing matching assets can be exchanged for a buy-in without materially reducing the expected return on the portfolio. The buy-in will provide an exact match for a portion of the interest rate and inflation risk and in addition will also hedge against longevity risk.

Furthermore, buy-ins are not likely to suffer as much as traditional credit instruments in a credit market downturn (as we saw in March 2020), as they are typically longer-dated and invested in high quality credit markets.

At the time the buy-in takes place, any residual matching portfolio will need to be re-organised to hedge the fund's residual interest rate and inflation risk.

A phased approach to buyout

An increasing number of pension schemes have buyout as their long-term objective. From Aon's *2019 Global Pension Risk Survey*, 35% of respondents identified buyout as their ultimate objective. In determining whether to adopt a 'big-bang' approach to buyout or a more gradual approach, a few issues must be considered.

Capacity in the insurance market is a key determinant of whether a transaction is feasible. Whilst there were c.£40bn of transactions in 2019 with a few individual deals approaching £5bn, the bulk annuity market has generally been worth around £10–£20bn in recent years. Therefore, for many schemes it will be appropriate to approach the market in a phased manner over a number of years rather than risk there being insufficient capacity from insurers.

Pricing is another important consideration. Annuity pricing is cheaper for pensioner members than for deferred members, meaning that as the scheme approaches maturity (all else being equal) the cost of insuring benefits will decrease. Consequently, multiple buy-ins over a number of years may be advantageous from a cost perspective.

Spreading buy-ins over a number of years also offers liquidity benefits when compared to a buyout. The premium for each individual buy-in will be smaller than that for a buyout. This may allow for the scheme to hold a lower portion of liquid assets at any given time and benefit from the often-higher returns offered by illiquid assets.

Income generation

As pension funds mature, they become cashflow negative, especially if deficit contributions have ceased or reduced. A buy-in is the ultimate cashflow matching asset. It is the only asset that will exactly match cashflows from a timing, pension increase and longevity perspective. It also reduces the need to generate income to pay members benefits from the rest of the portfolio. However, ensuring sufficient liquidity to support LDI portfolios and drawdown from illiquid assets remains important.

Timing

Given the fall in yields over the first half of 2020, many schemes will have seen the leverage within their LDI portfolios fall over this period. Schemes therefore may be able to make better use of their gilt holdings by re-leveraging their LDI portfolios and using the proceeds to help fund a buy-in.

When not to buy-in

- **Where required returns are high**
- **Where schemes are close to full buyout**
- **Where the long-term target is low dependency**

High required returns

A characteristic of a buy-in policy is that it is capital intensive. In other words, assets need to be transferred in to pay the premium. Once these have been transferred there are no return generation possibilities from this portion of the total portfolio. Therefore, poorly funded schemes which require a high rate of investment return in order to close their funding deficits are not best suited to a buy-in.

Schemes close to full buyout

We would typically not recommend a buy-in transaction for schemes that are targeting a buyout within three years. In these circumstances a buy-in is likely to divert governance time and cost that could be better deployed elsewhere. It is our experience that focusing time on reducing risks within the portfolio, planning strategy and selling any illiquid assets can reduce the time to buyout by up to 18 months.

For schemes where the long-term target is low dependency

For pension schemes that have articulated self-sufficiency as their long-term target, a buy-in policy would need to be evaluated alongside other assets available to the fund. Trustees would need to consider if the longevity protection and other risk reduction, return and liquidity characteristics of the of a buy-in policy are a better fit for their investment strategy than the other options available.

In the cases where trustees have not yet set long-term goals, we would encourage that the setting of such goals be made a priority and take place before consideration of a buy-in.

Getting to the optimal size of buy-in

Given the capital required and the illiquid nature of a buy-in policy, it is important to assess the impact on the residual investment strategy. There are two key questions to consider here:

- **Is there enough capital to retain flexibility in the investment strategy (is the scheme able to retain enough liquidity to meet unforeseen cashflow requirements and/or capitalise on new investment opportunities)?**
- **Can the scheme generate sufficient return in the residual portfolio to meet the funding objectives?**

To answer these questions, we have developed a tool that considers the impact on your portfolio for different sizes of buy-in policies in both normal and stressed market conditions. Using this tool, we can help trustees to achieve the optimal size of buy-in.

Preparing assets

To prepare scheme assets for a buy-in, we recommend doing the following:

Minimise volatility

- Hedge interest rate and inflation risk
- Reduce growth assets
- Consider allocation to corporate bonds

Manage complex assets

- Plan for divesting illiquid assets
- Reduce complexity in LDI portfolios
- Improve credit quality

Minimise transaction risk

- Assess liquidity
- Maximise in-specie opportunity
- Engage early with Insurers and LDI managers

Trustees should seek advice from relevant parties at the earliest opportunity to maximise the benefits of a buy-in by ensuring that the scheme's assets are properly prepared.

Key considerations

Buy-ins will be most appropriate where the scheme has a low required rate of return on investment and is focused on generating income.

Schemes wanting to take advantage of opportunities in the illiquid asset space, such as infrastructure, should consider whether implementing a more illiquid solution is likely to limit their ability to meet cashflows.

Once the decision has been made to pursue a buy-in, the trustees should seek advice at the earliest opportunity to right-size the buy-in and properly prepare the scheme's assets.

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