

De-risking: Alternatives to Buyout

There has been a lot of discussion in the press recently about the buoyancy of the buyout market. Whilst buyout might be a good idea in principle for some schemes, the costs can sometimes be prohibitive. In this paper, we discuss alternative options for “de-risking” a pension scheme.

Introduction

Bulk buyouts of pension scheme liabilities are becoming increasingly popular as the cost of buying out has reduced. This follows increased competition in the insurance market for this business, and the rise in corporate bond and swap spreads. However, despite this, the up front cost of a buyout may still be prohibitive. Even a scheme that is fully funded on a scheme funding basis is likely to show a deficit on the more cautious buyout basis. The sponsor will be required to make up this deficit in order to buyout all of the liabilities.

For example, a £100m scheme which is 80% funded on a buyout basis would require a capital injection of £20m to buyout the liabilities. The question should be addressed as to whether this capital could be put to better use in the company rather than using this capital to buyout the liabilities. After all, the net balance sheet position is the same.

Buyout or Buy-in?

One option is to only buyout the pensioner members of the scheme. This is often an attractive solution as it allows active members to continue to accrue benefits if required and the scheme assets should be sufficient to cover the costs. However, if an under-funded scheme takes this option, the security of other members' benefits is jeopardised by effectively fully funding the pensioners members and leaving other members in a worse funding position than before. Instead, the trustees could buy-in the pensioner liabilities. This means, the annuities from the insurance company become an asset of the scheme and hence provide a perfect matching asset for the pensioner liabilities whilst still preserving the overall funding level.

With a buy-in, the trustees still retain administrative and legal responsibility for paying the pensions and with this comes expenses. Therefore, the choice to buy in annuities is an investment decision, and should be compared against other ways of removing risk.

In assessing buyout or buy-in, the sponsor and /or trustees need to consider the cost versus the benefit. A large amount of risk reduction can be achieved using other, cheaper methods that this paper goes on to discuss. These options can be interim strategies until buyout becomes more affordable, or risk reduction strategies in their own right.

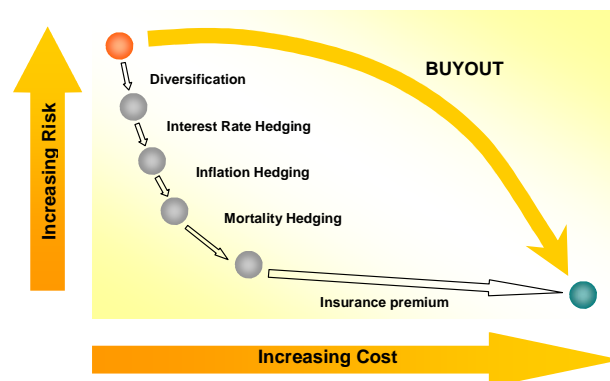
Key Risks for a Pension Scheme

The key risk for a pension scheme is having insufficient assets to pay liabilities as they fall due. To estimate the assets required the scheme will value its future liabilities using a number of assumptions. The risk is therefore that experience differs from these assumptions, or that assumptions vary over time, causing volatility in the funding position and/or contribution rate. This volatility can be mainly attributed to the four risks described below:

- **Interest Rate Risk** – long term interest rates determine the value of the current liabilities and there is the risk that if interest rates fall, the value of the liabilities rises, causing funding and contribution volatility.
- **Inflation Risk** – many pension payments are inflation linked, as are increases in deferment and salary increases. As a result there is the risk that inflation rises and these pension payments are higher than expected
- **Longevity Risk** – this is the risk that people live longer than expected and the pension has to be paid for longer. In addition there is also the risk of mortality assumptions changing to reflect expected future improvements which puts a higher value on the liabilities.
- **Asset Risk** – the risk that assets do not perform as assumed in the funding plan, thus introducing funding and contribution volatility

Buyout removes all of these risks in one step, but there are ways to manage each risk separately. The remainder of this paper discusses these methods and how they can be used to tailor the Scheme's risk profile.

Risk Reduction Components



De-risking does not have to mean buyout. There are many strategies that can be implemented that take steps on the way to buyout, as illustrated in the diagram above. The number of these steps and the order in which they are taken is a scheme strategy decision.

1. Asset risk management (minimal cost)
2. Interest rate hedging
3. Inflation hedging
4. Mortality hedging (significant cost)
5. Residual risks

Each of these steps has a different cost / risk reduction profile which is discussed in more detail below.

Managing Asset Risk

When taking on the liabilities of a pension scheme through a buyout arrangement, insurance companies rarely take much risk in their investment strategies. They generally invest the assets in the way that the pricing of the buyout was determined e.g. if the scheme was valued using a gilt yield, the assets would be invested in gilts.

A pension scheme managing its own assets can invest them as it chooses. The trustees could follow a similar strategy to the insurance company and invest in the same way as the discount rate e.g. cash or gilts (perhaps combined with a swap overlay so the assets move in a similar way to the liabilities).

Alternatively, the trustees may wish to take some risk in pursuit of higher returns, perhaps to help fund a deficit. This may include investing in equities, corporate bonds, property etc. Ways to manage risk in such a portfolio include:

- **Diversification** across asset classes and different regions will provide a more stable return. This is a cheap and effective way of managing asset risk.
- **Derivative strategies** such as equity hedging aim to manage the downside risk in the asset portfolio. The P-Solve Risk Management Solutions (RMS) team create bespoke solutions which can be structured to meet Scheme specific needs.

One of the key benefits of retaining asset risk is control. The asset allocation strategy can be structured to target the scheme's specific risk and return requirements.

Managing Interest Rate and Inflation Risk

Schemes have begun to implement liability hedges over the past few years as a way of mitigating interest rate and inflation risk using bonds and swaps.

For example, a scheme may enter into an interest rate swap with a counterparty where they receive a fixed amount at maturity and pay out an amount linked to cash (LIBOR) returns over the period.

The value of this contract is determined by long term interest rates which are the market's prediction of future cash returns. If those expectations fall then the agreement will go up in value and vice versa.

How does this help? It is the same market expectations of interest rates that drive the valuation of the liabilities and so when they fall the liabilities rise. Therefore when the liabilities are rising in value (because of interest rates) then the swaps will also rise in value, preserving the funding position. A similar strategy can be followed for inflation.

Implementing this kind of liability hedge is good value compared to the risk it removes.

Managing Longevity Risk

Longevity risk is a problem for pension schemes as changes to mortality assumptions can affect the value of pension scheme liabilities significantly. This is one of the main attractions to buying-out as this has historically been the only way to hedge this risk

However, now there may be alternative solutions. The Punter Southall Group has recently been liaising with a number of providers who wish to enter the market for mortality swaps in the UK.

The first trade of this kind has yet to be executed in the UK to the best of our knowledge, but similar trades have been executed in the US, mainly involving the risk associated with US Life Insurance products. However, as the first deal is yet to be finalised in the UK it is hard to ascertain the extent of the costs involved.

There is also another school of thought on mortality. Pension schemes may well have felt the largest impact already in terms of improvements expected as some argue that mortality rates cannot continue to improve as they have done in the past. Therefore it is worth carefully considering whether the pricing offered is worth the risk it is removing, both in terms of buy out and de-risking using mortality swaps.

Summary

Trustees need to consider all options available for de-risking and the cost benefit profile of each. Buyout and buy-in have many advantages but can be prohibitively expensive for any scheme that is not fully funded on the buyout basis. Other, much cheaper options are available for reducing risk for a pension scheme and can be designed to specifically meet the trustees' needs. These other options can be introduced into the investment strategy as an interim solution to buyout or as an absolute risk reduction strategy in their own right.

Where can I get further information?

For further information, or to discuss the possibility of a training session on any of the areas discussed, please contact the P-Solve RMS team at RMS@psolve.com or call 0207 533 6999.