Insights
Retirement

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Readying for Buyout

Market Dynamics for Pension Scheme Trustees

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Schemes seeking a buyout must consider how the relative valuations of Gilts, corporate bonds and interest rate swaps can affect the cost of this transaction, and whether they should alter their investment strategies to prepare.

As UK defined benefit (DB) schemes become increasingly well-funded, many are considering buying out with an insurer to secure their members' pensions and discharge their responsibilities.

However, different insurers find different portfolio compositions appealing; therefore, aligning your books to the insurer's preferences is no easy sell.

Buyout *The transfer of a scheme's assets and liabilities to an insurer.*

Moreover, with growing competition among schemes looking for a buyout, as well as the rise of alternative endgame options, the buyout market has become increasingly complex. This means that even if a scheme is technically well-positioned for buyout, the present timing may be inopportune. It is crucial then for schemes to assess whether a buyout offers good value, and how to position themselves advantageously in the buyout queue.

Below, we explore these factors against the backdrop of the current market environment, considering which investment strategies may be employed on the road to buyout, as well as when alternative endgame options may come into play.

Current Market Dynamics

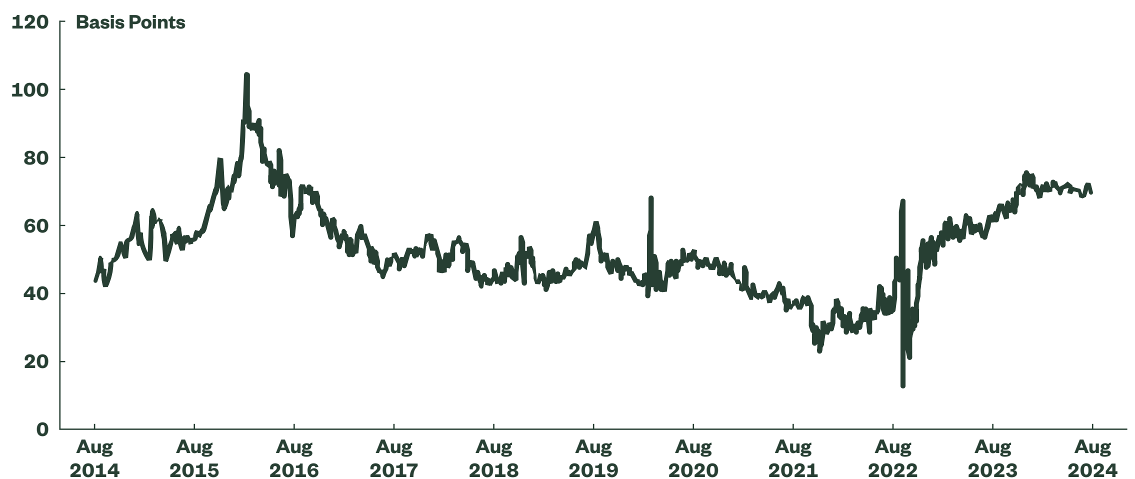
Gilts Hit Record Lows Against Swaps

Over the past two years, Gilts have cheapened significantly compared to swaps, reaching levels not seen since 2016.

This trend began with the government's fiscal response to the pandemic and the Russia–Ukraine war, which led to a surge in Gilt issuance. Initially, this surge was partially offset by the Bank of England's (BoE's) quantitative easing programme, but the more recent shift towards tighter monetary policy has seen the BoE sell Gilts back to the market, thereby increasing supply to the private sector.

The March budget highlighted that Gilt issuance will remain elevated, with gross issuance expected to surpass £1.2 trillion over the next five years. Strong demand from the UK private sector and foreign buyers will be needed to absorb this supply, making attractive valuations essential for Gilts compared to other asset classes, especially given the reduced demand from pension schemes that are now well hedged.

Figure 1
Spread Over 30 Year Swaps of 30 Year Gilts



Source: Barclays Trading, IHS Markit, as of September 2024.

Why Buyouts Make Gilts Cheaper

The typical asset allocation of pension schemes differs significantly from that of insurers.

Pension schemes typically have a greater weighting in government bonds, while insurers tend to prefer higher-yielding assets with predictable cash flows, such as corporate bonds, due to the requirements of the Solvency II / UK regulatory framework. Additionally, pension schemes tend to discount their liabilities on a Gilts curve, while insurers do so on a swaps curve.

Solvency II / UK *Sets out regulatory requirements for insurance firms and groups, covering financial resources, governance and accountability, risk assessment and management, supervision, reporting and public disclosure.*

Thus, when a pension scheme goes to buyout, the process often involves selling Gilts in favour of higher-yielding assets and interest rate and inflation swaps. This can further cheapen Gilts relative to swaps, particularly if many pension schemes are opting to buy out at the same time.

Insurers' Fixed Income Strategies

While insurers typically favour corporate bonds, since the start of the year some have preferred to hold Gilts as the valuations of this asset class became more attractive.

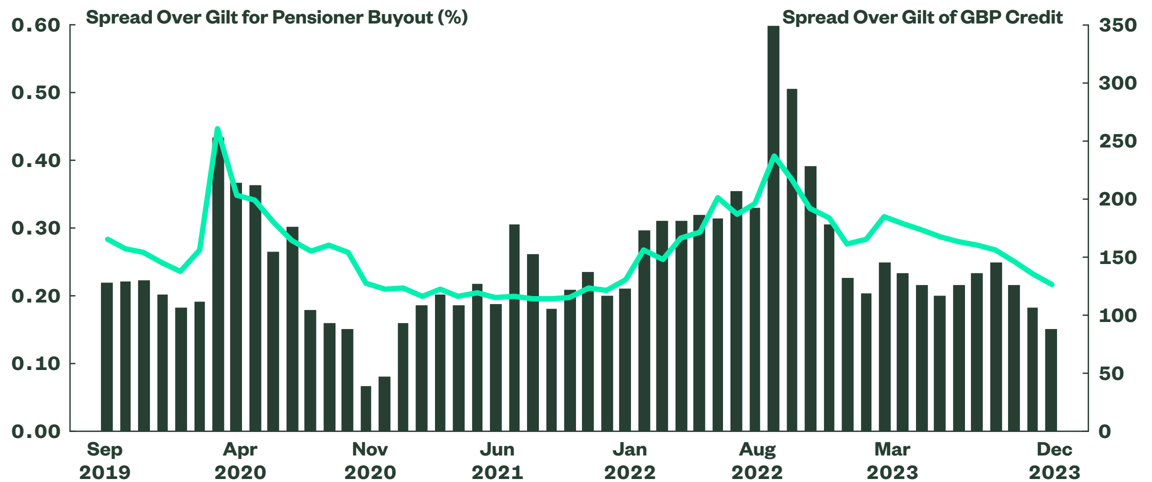
Given the small size and relative illiquidity of the sterling corporate bond market, insurers have also increasingly looked to overseas corporate bond markets to bolster their credit exposures. Each alternative asset class must be carefully evaluated according to the Solvency II framework, ensuring that overseas assets are protected against currency risk and offer an illiquidity premium that goes beyond the simple risk of default. However, the recent tightening in credit spreads and the cost of currency hedging mean some insurers currently view corporate bond market valuations, particularly in USD credit markets, as unattractive. These insurers have by and large chosen to retain their Gilt holdings, thus limiting the potential for further cheapening of Gilts versus swaps.

What All This Means for Buyout Pricing

The continued strong demand from pension schemes for buyouts, coupled with a lack of attractive assets for insurers, has led to tighter buyout pricing. As shown in the graph below, the correlation between spread pricing and buyout pricing suggests that as spreads tighten globally, buyout pricing is likely to tighten as well.

Figure 2
Spread Over Gilts for Pensioner Buyouts and UK Credit Spreads

Spread Over Gilts Pensioners (LHS)
UK Credit Spreads (RHS)



Source: Barclays Trading, IHS Markit, as of June 2024.

Given pension schemes' improved funding levels, as well as the large number of schemes looking to insure their liabilities, any increase in the cost of buyout is likely to be frustrating for trustees who have been targeting buyout as their goal.

Schemes must re-evaluate their asset allocations and credit exposure. While investing in credit might cause some deviations from a Gilt-based benchmark, it can help protect against rising buyout premiums as spreads narrow. The appropriate credit exposure for a scheme depends on various factors, including the mix of pensioners and deferred members within its member base.

Most schemes that are close to buyout will have already de-risked considerably and increased their exposure to investment grade credit, but it is essential to consider holding periods, as insurers historically prefer to receive liabilities in the form of cash and Gilts. With Gilts currently cheaper than swaps for most maturities that are relevant to DB schemes, we expect most schemes to have limited swap exposure. For those with Gilt-based benchmarks, the safest and highest-return portfolio likely mainly consists of Gilts at this time. However, some schemes might still have legacy swap positions or might want to use a mix of leverage sources, including repo, total return swaps (TRS) and swaps.

Importantly, schemes should also be flexible when considering their endgame options, with a number of alternative endgames having been endorsed by the UK regulators. Run-on and surplus extraction, for instance, have become far more viable for well-funded schemes.

Timing Is Everything

Schemes that are further from buyout must aim to match the average insurer price while generating sufficient returns to close any funding gap. It is crucial for them to avoid moves that may later prove costly, while still thinking about making their portfolios insurer-friendly.

Average Insurance Price *The typical cost of transferring a scheme's assets and liabilities to an insurer, usually defined as a yield spread over Gilts.*

As discussed above, insurers traditionally prefer cash and Gilts, but many are becoming more willing to receive illiquid assets from pension schemes. Pricing depends on whether an insurer feels the need to take these assets in the context of the broader market and deal conditions, as well as whether the assets appear attractive on the insurer's balance sheet. Insurers may also simply reject the governance burden associated with illiquid assets. Pension schemes may consider approaching insurers only when they believe that their assets and liabilities align with those desired by their target buyout providers. Crucially, this is not a one-size-fits-all process: different insurers find different portfolio compositions appealing.

Even though both pension schemes and insurers typically own corporate bonds, there may be limited appetite in transferring a scheme's existing holdings. Insurers will have their preferred credit holdings, so may not want the same exposures that the pension scheme has. In addition, for transparency, insurers are likely to give a price for a buyout relative to pre-agreed gilt portfolio. Therefore pension schemes may need to invest in line with this gilts-only portfolio ahead of the buyout transaction, once the terms have been agreed.

Front Book ... Back Book *Front book refers to assets and liabilities of any new scheme that an insurer agrees to buy out. Back book refers to existing assets and liabilities of the insurer.*

Since de-risking within pension schemes often leads schemes to buy credit, doing so might not be beneficial for short periods due to transaction costs, if the scheme expects to go to buyout. Therefore, trying to match an insurer's typical credit exposure might not be worthwhile; instead, it is more helpful if the insurer is flexible about the assets it accepts and their pricing.

Considering all of the above, the road towards buyout is long, giving schemes some time to unwind their legacy positions, including any illiquid assets. However, if these assets have multi-year lockups, this extra time may still not be sufficient for a scheme to unwind entirely. Thus, trustees should also consider whether their scheme has the governance systems — and the desire — to liquidate its portfolio efficiently. An outsourced chief investment officer (OCIO)/ Fiduciary Manager may be a useful resource in this regard.

Alternative to Buyout: Clara-Ready Rather Than Insurer-Ready

Like insurers, the UK Defined Benefit superfund Clara Pensions offers a price-lock portfolio to provide transaction certainty for pension schemes.

Superfunds are consolidation vehicles for DB pension schemes that are designed to provide an endgame option for schemes, which are unable to afford an insurance buyout. A superfund broadly comprises (a) an occupational DB pension scheme and (b) capital provided by the superfund's investors held in a special purpose vehicle outside the pension scheme. This capital provides security for members' benefits and typically replaces the transferring scheme's existing sponsor covenant.

Ahead of the government introducing a legislative framework for superfunds, they currently operate under the Pensions Regulator's (TPR) superfund guidance. TPR's guidance has been designed to ensure that superfunds hold sufficient risk-based capital — and linked to a superfund's investment strategy — such that there is a very high probability members will receive their benefits in full. In addition, TPR requires superfunds to demonstrate they are well run, with specific expectations around governance, people and systems and process. Superfunds are required to complete TPR's assessment process before they complete transactions — Clara is currently the only superfund to have completed this process.

Clara operates a 'bridge to buy-out' superfund model. Its investment strategy is credit-based, not dissimilar to bulk annuity insurers. The additional capital provided by Clara's investors improves the likelihood of members receiving their benefits in full, providing a safer journey to ultimately securing members' benefits in the insurance market over a 5–10-year time horizon.

As a pension scheme, Clara has more flexibility than insurers to accept existing assets in-specie. This is particularly the case for less-liquid assets, which can often prove problematic for pension schemes. In its two transactions announced to date (total AuM ~£1.2bn), Clara, assisted by fiduciary manager Van Lanschot Kempen, provided a price-lock that included the schemes' legacy illiquid assets. This was key to providing the schemes with a transactable solution, price certainty, while also delivering better value than if the schemes had to sell these assets.

Naturally, Clara must understand, for any less-liquid legacy assets it takes on, that it must ensure that they meet the needs and liabilities of a particular scheme. Clara benefits from deep investment expertise through fiduciary manager Van Lanschot Kempen, investment adviser LCP and its capital providers. Pension schemes transferring to Clara are also able to benefit from increased investment scale and, in some situations, improved investment oversight and governance. Additionally, since Clara is a 'bridge to buyout', it benefits from a longer time horizon to manage and unwind legacy positions.

Conclusion

Pension scheme trustees are increasingly opting for buyouts by insurers, to be discharged of their liabilities, but that, compounded by changing market dynamics, coincides with increasing complexity in executing a buyout. Aligning the books with insurer preferences is a good start but that may not be enough to close out a buyout with good value for the trustees. In short, being insurer-ready is not the same as being buyout-ready. Along with excellent governance and the right investment strategy, a successful buyout depends on expert timing, where trustees may enlist the services of a specialist OCIO. Alternatively, as a bridge to a buyout, trustees may pivot their schemes to being Clara-ready.

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* Pensions & Investments Research Center, as of December 31, 2023.
† This figure is presented as of September 30, 2024 and includes ETF AUM of $1,515.67 billion USD of which approximately $82.59 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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