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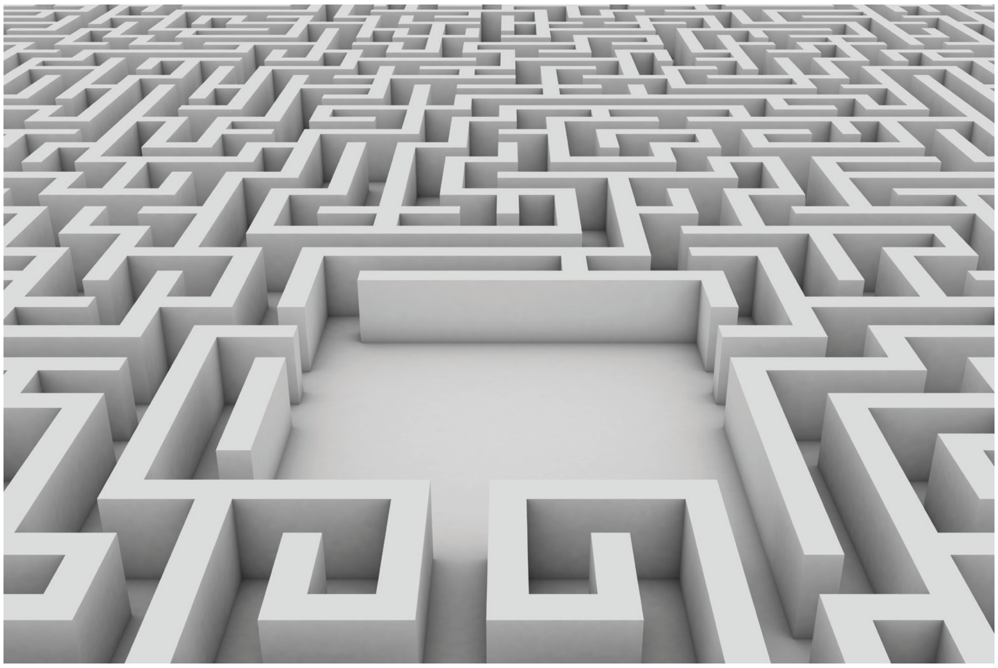
Flexible buy-ins — a new LDI asset class?

Guy Freeman of Rothesay Life asks if liability driven investment is set to take a new direction with flexible buy-ins



Annuity buy-ins are now sufficiently well understood by the pension advisory community that they are increasingly on the agenda when deciding how to invest a pension fund's assets. While bulk annuities have largely been ignored by investment consultants in the past, this is changing with improvements in asset-liability modelling. The development of standalone contracts that price and hedge longevity risks are enabling a more rigorous analysis of the difference between LDI with financial assets and the liabilities.

Naturally, annuities need to provide a risk/reward benefit in order to find their place in a fund's asset allocation.

Characteristics of the asset class

In addition to removing longevity risks, an annuity contract typically contains a number of key risk management features relevant to pension funds

Feature	
Investment risk	The risks associated with investing in assets are removed
Duration	Interest rate risk is fully hedged
Inflation	Inflation risk is fully hedged
Complex increases	Pension increase caps and floors are fully hedged
Spouses risk	The impact of uncertainties about the % of members that are married and the age of eligible spouses is removed
Cash flows	Cash flows are provided to matched benefit payments
Data risk	The risk that the members benefits have been incorrectly calculated can also be removed

An annuity also provides an implicit return guarantee from the issuing insurer by providing the benefits for an upfront premium payment. In assessing the decision to invest in an annuity, the implied return is often related to that available from gilts.

Given the risk reduction features of an annuity, a switch from gilts to annuities is an easy decision where the implied return is at or above gilt yields and this is the current focus for many funds that hold gilts and are looking to improve their risk/reward position. Annuities can be viewed as being somewhat like secured bonds but with a number of additional risk mitigation features that enable much better LDI matching.

So with annuities currently providing the potential for a pick-up in yield versus gilts and a reduction in asset-liability risks relative to virtually all forms of LDI, the possibility of exchanging gilts for annuities is becoming a common theme for the industry and the focus can shift to optimising this exchange.

Pick'n'mix annuities

For funds that intend to buy-out and assign their liabilities into individual insurance policies the focus for trustees will invariably be on buying an annuity that matches their benefits as closely as possible, for example with the relevant pension increases and inflation reference. A lot of work is put into designing them such that no changes are subsequently required and a policy can be assigned to the members to provide and settle their entitlements.

However if a fund wants to de-risk and is likely to hold an annuity contract for say at least five years then does it need to focus on the close matching of the benefit promises? The trustees could instead choose the risk components that it would like to hedge from the above list in order to optimise the de-risking in a pick'n'mix approach to constructing an annuity.

A few examples

Pension increase floors

The simplest, most current example is in relation to floors on annual inflation-linked pension increases i.e. if inflation is negative the pensions are not decreased. Hedging prices for inflation floors are commonly perceived to be expensive by trustees at the moment and they may therefore see more value in de-risking using an RPI-linked annuity (i.e. one that might decrease when inflation is negative) which at current prices is more than 5% cheaper than an RPI-linked annuity with an annual floor.

As bulk annuity pricing is effectively driven by a building block approach, trustees need to determine what constitutes efficient pricing for the various features and at what level they would be comfortable retaining certain risk exposures. In particular many agree that supply-demand dynamics are leading to unattractive pricing of inflation floors and thus purchasing protection on this exposure does not necessarily represent the best use of funds for a scheme that does not need to buy the inflation floor immediately.

CPI v RPI

Many pension funds now have a liability for CPI pension increases. However the market for CPI linked investments is yet to develop to a similar extent as RPI. Given the lack of CPI-linked instruments the cost of hedging CPI is generally perceived to be poor value relative to hedging RPI. Similarly an RPI linked annuity will generally be perceived to be better value than a CPI-linked annuity and trustees with CPI-linked liabilities may choose to de-risk with RPI annuities.

RPI (0,2.5)

Prices for pensions increasing at 2.5% are only marginally more expensive than pensions with an increase capped at 2.5% and floored at zero. Trustees may therefore see better value in de-risking with a fixed pension increase of 2.5%.

The above are just three examples illustrating the point that there's a genuine choice to be made if you are not tied to replicating the liabilities. Perhaps it is simpler to ask which risk features a pension fund would choose if it were able to construct LDI bonds with any or all of the above risk features listed above? Clearly this will depend on the cost benefit analysis i.e. how does the implied return vary according to the risk components purchased and therefore removed.

Making it work

With the individual nuances of each scheme, it is important for trustees to consider a buy-in approach that meets their specific requirements and needs in a cost efficient manner, which does not necessarily always mean precise liability matching.

Of course annuities are not like the unsecured bonds that pension funds regularly invest in, but instead differ because they are generally not designed to be surrendered and changing them can also be subject to insurer consent.

So if an annuity is purchased by trustees as an efficient hedge against the liabilities there are some aspects on which they will need to take particular care when not matching the pension increases precisely.

1) Trustees should not rely on being able to surrender an annuity as insurers typically rely on the illiquidity of an annuity contract to generate an excess return and therefore will not guarantee surrender terms. To avoid ever having to surrender part of the annuity trustees will want to ensure that the annuity benefits do not exceed the actual benefits and the fund is always in a position of needing to buy more to achieve full de-risking rather than sell.

2) Even if wind-up is not planned in the foreseeable future, trustees will want to understand the path to completing wind-up and will want to be able to convert the pension increases in the policy to a form that matches the benefits in order to make assignment to individual policies and a discharge easy to effect.

Depending on the change in the pension increases the insurer will either charge an additional premium or increase the benefit amounts to change the contract depending on whether the overall increases are expected to be higher or lower. Trustees will want some transparency regarding the terms and some comfort that they can achieve fair pricing at the time.

For example a fund might choose to buy an annuity covering 50% of its pensioner liabilities with full RPI increases instead of LPI with an annual floor and cap on the pension increases.

Having initially purchased an RPI annuity covering 50% of the LPI benefits this coverage ratio will increase if inflation is above the 5% cap in any year and decrease when inflation is negative. However even with high inflation it seems very unlikely that the coverage ratio will unexpectedly exceed 100% without the trustees having an opportunity to act.

When the time comes to convert the policy to LPI then market pricing can be obtained for an exchange of RPI for LPI and this can be used as an input to the terms for converting the policy increases to LPI.

In addition an annuity that does not cover 100% of the benefits cannot be assigned into individual annuity contracts. So bulk annuities that pay 50% say of the benefits for a group of members will need to have a mechanism that enables the bulk annuity to be converted into one that pays 100% of the benefits for 50% of the members covered.

Flexible buy-ins

Bulk annuities are of course not a new asset class but instead one of the oldest – just hard for investment consultants to compare against other assets classes in asset-liability models that ignore longevity risks. This has changed with increased understanding of longevity and now the question is how to optimise the flexibility available in structuring annuities while enabling wind-up and assignment.

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