The right time

What is the optimal time to buy-in or buyout? **Myles Pink** discusses

Trustees and corporate sponsors often ask this question so they can plan when to devote resources to insurance de-risking. The cost of insuring defined benefit obligations is driven, in large part, by insurers' pricing discount rates which are in turn driven by the so-called risk free rate and a liquidity premium (being the extra yield that a long term buy-and-hold investor can earn after a deduction has been made for credit risk). Intuitively, one might think that annuities are cheaper for all pension schemes when interest rates are high and liquidity is scarce.

This is true in absolute terms; annuity premiums will be lower in high interest rate, low liquidity environments. However, the question of affordability for any pension scheme is relative: picking the "optimal time" becomes an asset allocation decision based on a comparison of the implied risk-adjusted yield of the assets owned by the pension scheme with the insurer's pricing discount rate.

No one set of market conditions provides the best time for all pension schemes to purchase annuities. One example of this is a phenomenon that may have peaked in the summer of 2012. The fall in real yields over the previous 9 months had led to an increase in the absolute cost of insurance. For many schemes, the value of their assets either fell in absolute terms or rose but not by as much as their liabilities – so the cost of insurance rose relative to asset values. However, for pension schemes that held any UK gilts during this period, the gap between gilt values and insurance cost closed, in some cases nearly to zero. For those pension schemes, the best time to insure for many years had arrived even though for others, the cost of insurance appeared prohibitively high.

Since last summer, insurers have had a number of enquiries from pension schemes that have low deficits in low interest rate environments. These pension schemes are looking to use their low yielding gilts to purchase insurance which, by comparison, offers an attractive implied yield (including the cost of longevity, inflation and other protections). However, if interest rates rise – as we have seen over recent weeks – it may not be these pension schemes for which annuities are most attractive, but instead it will be other pension schemes operating different asset strategies.

Trustees should understand how the relationship between their investment strategy and their scheme's benefit structure is influenced by the macroeconomic environment. They can prepare for buy-in or buyout by cleansing their data and working through key contractual terms. They should do this irrespective of current absolute premium levels and be ready to purchase annuities if the level of insurers' pricing discount rates relative to their asset yields looks attractive. Most insurers can provide frequent asset and premium valuations to help trustees pick their "optimal time" to secure members' benefits. ■

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