Feature

Smoothing risk transfer transactions

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Most UK defined-benefit pension schemes have found themselves in a situation where their "endgame" is now far closer than previously anticipated. Due to improving funding levels – principally driven by higher gilt yields and lower longevity assumptions – the pace at which schemes are seeking access to the insurance market (or other forms of risk transfer) has increased.

A vital component to success of any transaction will be having the right structure in place for the scheme's investment portfolio. A forward-thinking approach can help improve cost-efficiency, reduce execution risk and make the scheme more responsive to changing market conditions. A significant part of this transformation can be done through the scheme's LDI portfolio.

What are the issues in preparing an investment portfolio for the endgame?

1. The allocation between growth assets and matching assets.

Growth assets and matching assets play different roles as the scheme's journey plan progresses:

- Growth assets generate excess returns to help close a funding gap alongside deficit repair contributions made by the scheme's sponsor
- Matching assets stabilise the scheme's funding ratio by mimicking the performance of the scheme's liability benchmark

Ahead of settlement, the proportion of the overall portfolio that is dedicated to growth assets can be wound down. As the funding gap is extinguished, and settlement becomes feasible, the growth assets have done their job.

Winding down the scheme's growth assets (or 'de-risking') shouldn't be thought of as a one-off exercise. A gradual approach is often useful. Investment risk should reduce in step with the scheme's improved funding position. This is particularly true when illiquid investments have been used.

A pre-planned approach to de-risking can make the latter stages of the journey plan more predictable as the overall investment portfolio collapses into a composition entirely made up of matching assets.

2. The purpose of the matching assets

As settlement nears, the role of the scheme's matching assets subtly changes.

Throughout most of the scheme's journey plan matching assets have been mimicking the performance of an actuarially calculated liability benchmark.

When close to settlement, the matching portfolio needs to closely replicate the agreed portfolio of assets that dictate how the insurer's premium will move in the weeks before the transaction (the 'price-lock' portfolio).

This change needs to be reflected by a rebalancing of the portfolio of matching assets. How accurate this rebalancing can be depends upon the structure of the scheme's portfolio (and how the chosen insurer(s) and the scheme's investment manager(s) work together).

3. The structure of the portfolio of matching assets

There are two general approaches to how matching portfolios are structured – segregated and pooled.

Pooled funds are often thought to be cheaper and operationally simpler than the segregated approach. But, this is not always the case. Whilst the drawbacks of pooled funds came into focus during the gilts market crisis of 2022, there are also reasons why the segregated approach has benefits during risk transfer transactions:

- The precise rebalancing that is required is more easily achieved with a segregated approach – particularly when the matching portfolio comprises both government and credit securities
- Insurer's price-lock portfolios are typically a specific basket of gilts and corporate bonds or interest rate swaps. The use of pooled funds can therefore introduce greater risk of divergence between the premium payable and the value of the scheme's assets over the price lock period.
- An in-specie transfer of scheme assets to an insurer is a more practical option when they are held in a segregated portfolio

Please get in touch if you have any questions or would like to discuss how Cardano can help you.