Synthetic Buy-In: Just conceptual theory or a real option for trustees of larger schemes?

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What do you get if you cross a well established method of hedging pension liability inflation and interest rate risk with one of the most exciting current developments in the investment banking sector?

The answer, a synthetic buy-in, is becoming one of the most talked about solutions in the pension scheme world. But what is it, how does it work, and just exactly what sort of scheme could benefit from this new development?

The concept of synthetic buy-in

Let's first recap on the concepts of buy-in and buy-out.

A buy-out is the payment of a lump sum to an insurer, who then takes full responsibility for the payment, administration and funding of certain liabilities. These liabilities no longer remain associated to the pension scheme and the members' contract is purely with the insurer. A buy-out can be in respect of all, or part, of a pension scheme's liabilities.

A buy-in is an investment in an insurance contract made by a pension scheme in respect of all, or part, of a pension scheme's liabilities. The liabilities remain the responsibility of the trustees and the insurer makes regular payments to the scheme to match pension payments.

A synthetic buy-in is the removal of all, or part of, the inflation, interest rate and longevity risk inherent in a defined benefit pension scheme. We refer to it as a synthetic buy-in, rather than synthetic buy-out as, like a traditional buy-in, the assets of the scheme are retained under the control of the trustees and the trustees retain responsibility for governance of the scheme, including paying the liabilities covered by the solution.

How does it work in practice?

A synthetic buy-in combines interest rate, inflation and longevity hedges in order to fully, or partially, remove the associated risks in the scheme. The inflation and interest rate parts of a synthetic buy-in are implemented using gilts or swaps (this may be familiar to many trustees already under the guise of "Liability Driven Investing"). The longevity part of the hedge is implemented using a swap, and it is the development and increasing availability of the longevity swaps which has allowed synthetic buy-in to start to become possible.

But is it any better than a traditional buy-in or buy-out?

The main advantages of a synthetic buy-in over traditional buy-in or buy-out are capital efficiency and cost. Because insurers are subject to solvency requirements and charge profit margins on their businesses, the capital cost of implementing a synthetic buy-in should be much less than the cost of removing risk via an insurer i.e. trustees can achieve removal of risks with a lot less money. In addition, because swaps are capital efficient, if swaps rather than real matching assets are used for the inflation and interest rate hedge, the assets needed to support the synthetic buy-in may be much less than 100% of the pension scheme liabilities, leaving some monies available to invest in growth assets.

In addition to the capital efficiency benefits, synthetic buy-in may be attractive because:

1. As the inflation, interest rate and longevity swaps can be transacted as separate deals, the three elements of risk can be removed at different times, allowing trustees to take advantage of timing in the market, and to tailor the risk that they remove.
2. Trustees retain control of their investment strategy.
3. Synthetic buy-in can be structured so that it could be reversed if scheme or sponsor circumstances change and the solution no longer remains appropriate.
4. Many of the additional "hidden" costs of buy-in and buy-out (for example data cleansing) are avoided.
5. Third party and counterparty risk can be diversified. This is more difficult to achieve with traditional buy-in as typically only one insurer is involved, although the Financial Services Compensation Scheme provides some additional protection.
6. Depending on the structure of the solution, and allocation to growth assets, synthetic buy-in could have less detrimental impact on scheme funding, as compared to traditional buy-in. This is because with a traditional buy-in the scheme actuary is often forced to adopt a lower discount rate for valuations, reflecting the lower returns expected on the assets paid to the insurer. As fewer assets are used to support synthetic buy-in, then there is less reason to reduce the discount rate.

So why isn't everyone doing it?

Whilst there are many benefits to a synthetic buy-in, there are also a number of practical points which mean that synthetic buy-in may not work as a practical solution.

1. The level of complexity, governance and associated advice needed to set up a synthetic buy-in may mean that the cost is prohibitive.
2. The minimum size of segregated swaps (especially for longevity) means that synthetic buy-in may not be an option for smaller schemes.
3. It may not be possible to obtain an exact liability hedge with synthetic buy-in, whereas traditional buy-in normally covers liabilities fully.
4. The longevity swap market is still fairly new and will take some time to establish itself as a "run of the mill" solution for trustees.

Would my scheme be suitable?

Synthetic buy-in is a new concept and it will undoubtedly take some time for the trustee community to accept it as a genuine solution for removing risk. There are clearly some barriers to entry for small schemes however, as the market develops further, we may see pooled products become available which would allow these schemes to take advantage of synthetic buy-in as an affordable risk management solution. As for larger schemes, any set of trustees considering buy-in or buy-out should at least explore the possibilities of a synthetic buy-in before committing to the insurance route. It may be more accessible and affordable than you think.

If you want to learn more about Synthetic Buy-In please contact your Client Director.

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