30 September 2009 United Kingdom

Issue 104: Synthetic Buy-in

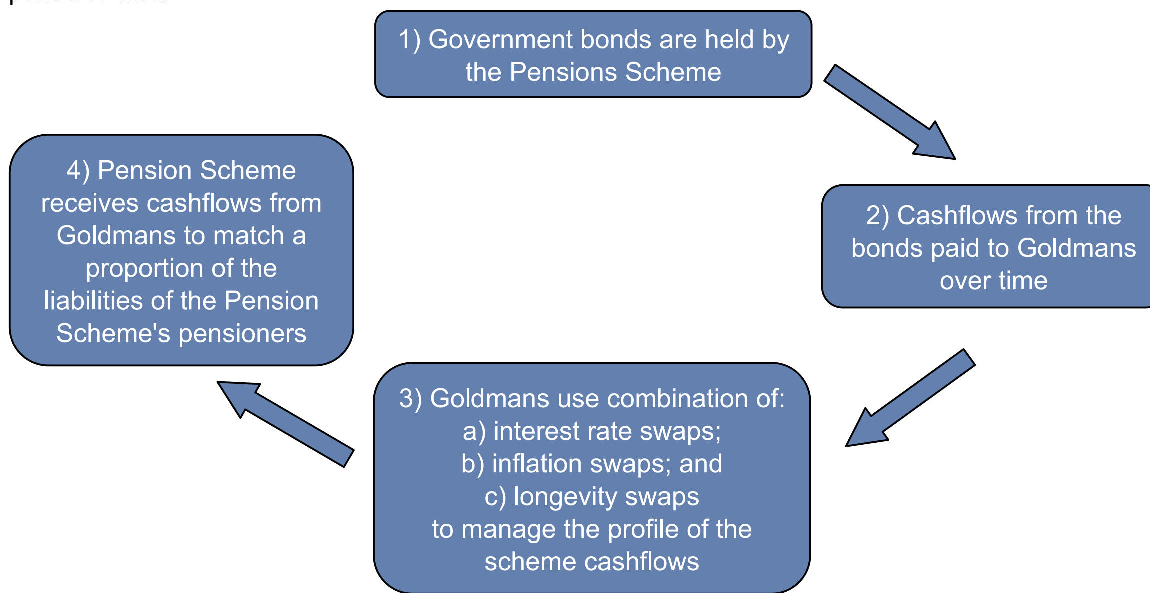
A buy-in is a method which can be used by pension schemes to get rid of key risks including interest rate risk, inflation risk and longevity risk in one package. It differs from buy-out as the members remain in the scheme and the ultimate responsibility to pay benefits remains with the scheme. The synthetic or DIY version means the scheme chooses to place a number of separate policies with the same or different companies to cover the risks.

A synthetic approach allows you to consider which risks to focus on first, and then gradually build up protection when the market conditions are right. You can choose to remove longevity risk first and then return to hedge inflation and interest rate risks when you feel the market offers better value. Or you can take your existing Liability Driven Investment (LDI) strategy and extend it so you also cover longevity risk. In addition you can choose whether or not to have credit risk or equity risk in the structure.

Currently synthetic buy-in is in its infancy with the first big deal being the recent RSA/Goldman Sachs transaction. However, LDI has successfully evolved from a tailored solution with individual contracts only suitable for large schemes, to become a standard tool for trustees of many schemes. Similarly synthetic buy-in may follow suit in the next few years. Arguably it is the next logical step for existing LDI structures.

The RSA/Goldman Sach's deal[1]

A potential problem with a standard buy-in is that the security of benefits depends on the strength of the counterparty. RSA and its trustees selected a synthetic solution because it enhanced the security for the scheme as the scheme continues to retain the underlying investments, of gilts and UK government backed bonds, and only pays the cashflows from these investments to Goldman Sachs. You could think of this transaction as a buy-in with a deferred premium – they only pay gradually over a long period of time.



[1] Hewitt were one of the many advisers in the multi-disciplinary team advising the Trustees of the RSA pension schemes on this transaction, however this article is written from publicly available information in order to abide by confidentiality agreements.

Copyright © 2009 Hewitt Associates Limited

This deal is specific to RSA's circumstances and was a bespoke transaction. In the short term only large schemes that already have a significant proportion of investments in low risks assets are likely to be able to follow suit in exactly the same way. However, other variations may be used and in the longer term this may be the start of an emerging trend of synthetic buy-ins.

To find out more about synthetic buy-ins please contact your usual Hewitt contact or Martin Bird (+44 (0) 121 2625059) or John Belgrove (+44 (0) 20 7939 4277).

If you would like to receive these bulletins by e-mail, please contact spotlight.enquiries@hewitt.com.

Copyright © 2009 Hewitt Associates Limited

Hewitt Associates Limited is registered in England & Wales. Registered No: 4396810.
Registered Office: 6 More London Place, London SE1 2DA

Nothing in this document should be treated as an authoritative statement of the law on any particular aspect or in any specific case. It should not be taken as financial advice and action should not be taken as a result of this document alone. Consultants will be pleased to answer questions on its contents, but cannot give individual financial advice. Individuals are recommended to seek independent financial advice in respect of their own circumstances.
.