Expert investor series

How could pension scheme buyouts influence the gilt market?

Pension funds invest in gilts (UK government bonds) due to their ability to match liabilities, through their interest rate and inflation linkage. However, insurance companies, which take over the management and payment of members' pensions during a buyout, traditionally prefer higher-yielding assets. This shift in investment strategy as schemes go through buyout could affect the demand for future gilt issuance, gilt prices and swap spreads (the difference between the yield on an interest rate swap and a government bond of the same maturity).

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Differing investment strategies

A typical UK pension scheme holds more gilts than any other asset type and we estimate that, in aggregate, 40-50% of pension fund assets are held in gilts as they are a good match for inflation linked pensions. However, when pension funds are bought out by insurance companies, the asset mix can change.

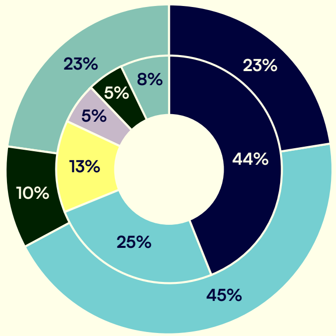
Insurance companies have not typically maintained the same allocation to gilts that pension funds do. While pension funds hold gilts to closely match their long-term, inflation-linked liabilities, insurance companies often seek higher-yielding assets to improve their risk-adjusted returns.

For example, Phoenix, a leading buyout provider, notes: "Here we can reinvest these individual portfolios, which are typically cash and gilts, into higher yielding liquid credit, and deliver enhanced risk adjusted returns."

So, when insurance companies take on liabilities from pension schemes, they often sell gilts to reinvest in other assets such as corporate bonds, infrastructure, or other illiquid assets.

Investment strategies of insurance companies vary widely but we estimate that, in aggregate, only around 20-25% of assets are held in gilts, implying a c50% reduction from the average position before buyout.

Estimated asset allocation of insurers (outer) and DB Pension Schemes (inner)



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What is the impact of this?

In 2023, around £50bn in buyouts occurred. The overall funding position of the DB pension system is very healthy, with the Pension Protection Fund's Purple Book showing the net funding position moved from a deficit of £438bn in 2022 to a surplus of £150bn in 2023. Improving solvency means schemes can potentially target buyout sooner than previously and LCP forecast that £360bn could be written over the following five years.

If gilt holdings drop from 45% pre-buyout to 22.5% post-buyout, gilt sales could total around £80bn over five years.

For comparison, the government issued £240bn of gilts last year and is forecast to issue at least £200bn annually in the coming years. The Bank of England also supplies gilts to the market as they reduce the size of its balance sheet by selling gilts they acquired following the 2008 financial crisis and the COVID pandemic.

While gilt sales from the buyout market are much less than government issuance, it can be material in driving cheapening of gilts (i.e. higher yields and higher borrowing costs for the Government) and, in particular, swap spreads.

The role of credit spreads

Over the last 18 months, gilts have become more attractive relative to credit as gilt yields increased and credit spreads reduced. One consequence has been that insurers are more heavily invested in gilts than in the past, and that new buyouts result in less selling of gilts than historically. We estimate that, a few years ago, insurers typically held less than 20% of assets in gilts.

PIC, another major buyout provider, explained in their annual report that: "For a specialist insurer like PIC, the higher yield on offer made gilts a relatively more attractive risk-weighted investment opportunity. The other significant factor which influenced our investment decisions was a general reduction in credit spreads. As a consequence, we sold down some of our overseas corporate bonds and redeployed the capital into UK gilts for a similar capital adjusted investment return but with lower overall risk."

Looking ahead, two scenarios could unfold. Gilts continue to remain relatively high-yielding assets, buyouts result in limited gilt selling and the impact of buyouts on the gilt market is muted.

Alternatively, credit spreads become more attractive again, asset allocations revert to historic norms and the impact on the gilt market is more material. In this case, we could see additional selling of gilts as tactical gilt holdings that have recently accumulated are reversed. The implications for the government in this scenario would be potentially higher borrowing costs and an increased dependence on overseas investors.

It should be a priority for the government to fully explore and appreciate the dynamics and implications of the anticipated increase in buyouts for the UK as a whole when looking at pensions policy.

Investment Grade GBP and USD Credit Spreads

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