

Buyout hedging - cutting through the noise

In this briefing note, Sian Pringle explores how to protect your scheme's buyout position if you have already decided that buyout is the right destination for you.

Key takeaways for trustees:

- ▶ The right approach depends on where you are in the process. You have greater visibility as you get closer to a transaction, creating scope to meaningfully refine your strategy as you progress.
- ▶ Some market environments will punish hedge imprecision, others will be more tranquil but your strategy needs to withstand all weathers.
- ▶ Pragmatism at all stages is essential, and finding the right balance between cost and precision can be achieved through careful, detailed analysis.
- ▶ Monitoring is key - checking in on your hedge regularly can ensure you aren't blown too far off course.

Background

The past decade has seen funding levels of pension schemes improve significantly due to rising gilt yields and strong growth markets. As of 30 September 2025, the aggregate funding level on the estimated cost of a buy-out has now reached 112%, based on XPS's UKDB tracker.

This improvement in funding levels has accelerated many schemes' journey plans, and many have already decided to seek to undertake an insurance transaction. Whether you are a few years away from that transaction or about to enter into exclusivity with an insurer, there are lots of things to think about from an investment perspective to help you along the way. These include all aspects of your strategy including liquidity and ability to sell assets as required to fund the insurance premium. This note focuses on the choices around your hedging strategy, predominantly in to managing interest rates and inflation.

Three stages to LDI hedging in the run up to buyout

As your scheme progresses towards a transaction, your asset and hedging strategy will evolve. For schemes that are already very well-funded, we can broadly think of this final journey in three stages:

1	More than 12 months away and you have not approached the insurance market yet	2	Less than 12 months away and you are actively engaging with the market	3	In the process of going exclusive with an insurer and you expect to transact within a few months
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For each stage, we'll consider ways to align your hedging strategy to better match insurer pricing.

Phase 1: More than 12 months away

Key issues:

- ▶ You don't yet have any visibility of the price you will be transacting at
- ▶ Market conditions will likely change materially in the run up to any transaction
- ▶ There is sufficient timeframe for investment returns to come through and for some transactions costs to be recouped

Approach

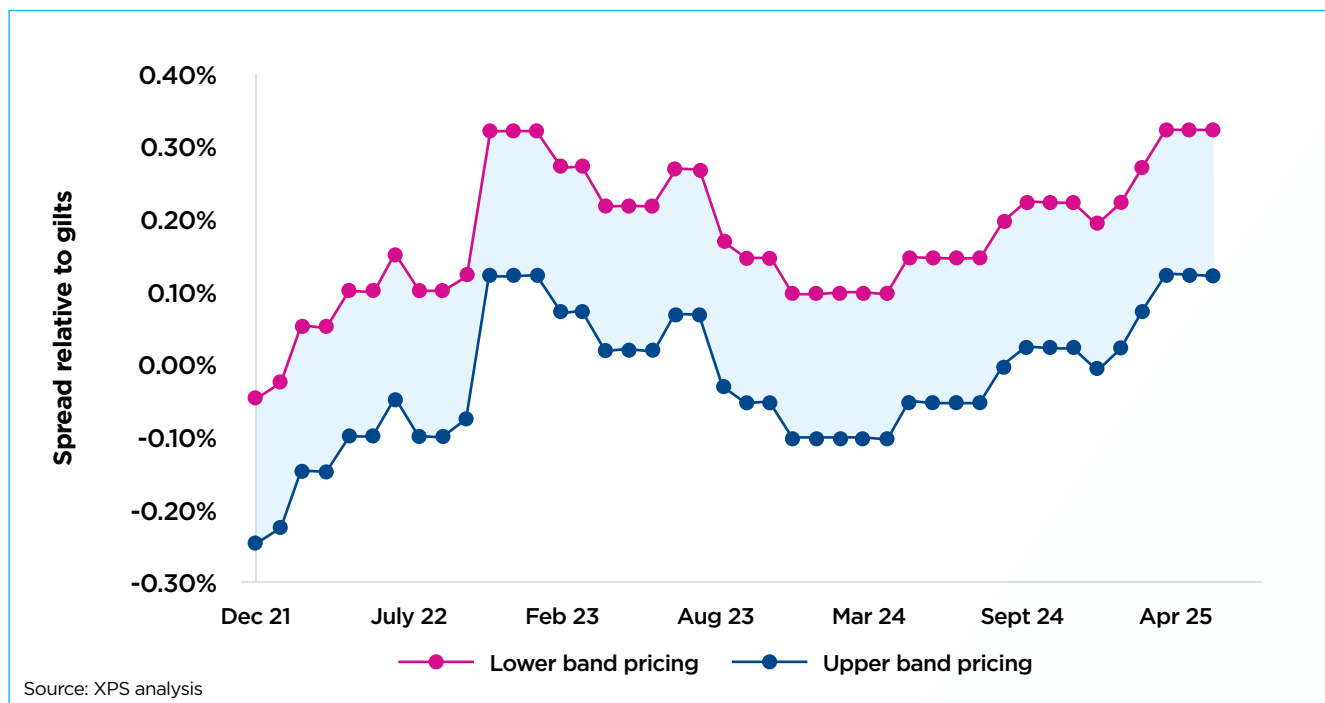
During this phase seek a pragmatic approach to broadly hedge the estimated interest rate and inflation exposure to a high degree on a low risk basis, whilst not slavishly aiming to hedge the estimated buyout price (which is constantly changing).

When you've made buyout your goal and you are at or close to fully funded, it can be tempting to put a full solvency hedging target in place immediately and leave it be. But hedging 100% of the Scheme Actuary's estimated buyout basis is likely to miss the mark. This is because there is more to an insurer's price than just the discount rate assumption.

There are several underlying assumptions at work here:

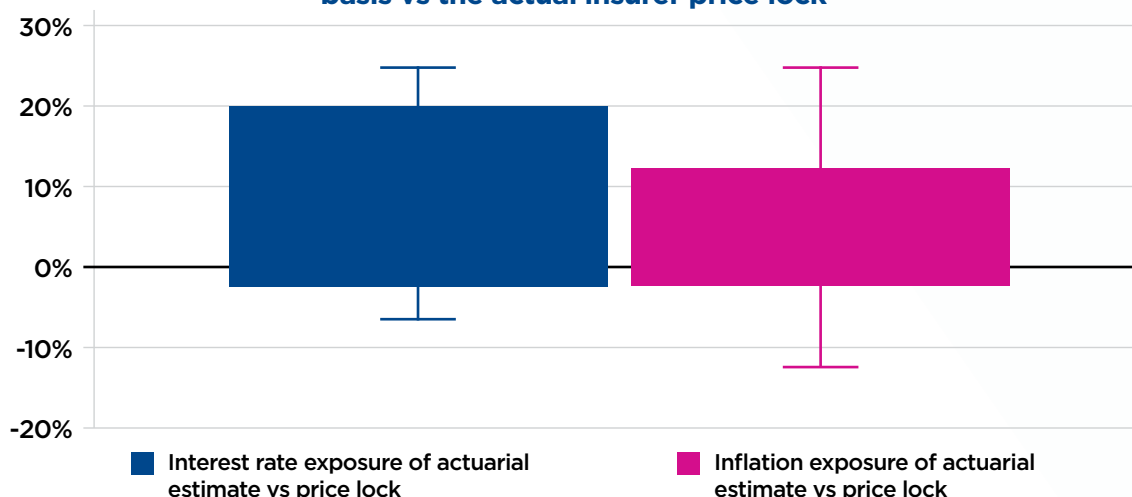
- ▶ Firstly, the insurer's best estimate of the cashflows is likely to meaningfully differ to the scheme actuary's prudent estimate and the exact discount rate used by an insurer is not visible to the scheme.
- ▶ Secondly, the buyout price also factors in expenses, the insurer's profit margin and return on capital which tends not to be particularly sensitive to interest rates and inflation.

These assumptions lead to high levels of volatility in the actuary's estimated buyout discount rate assumption. The chart below illustrates the wide and moving range of the equivalent spread above gilts for insurer pricing between 2022 and now, based on deals seen at XPS.



Although we do not have sight of exactly how insurers price their deals, we do eventually have sight of the price locks they put in place once a scheme goes exclusive with them. We have analysed a sample of past transactions looking at the actual interest rate and inflation sensitivity in the price lock formula during the exclusivity phase versus the level of sensitivity implied by the estimated buyout price and prudent cashflow information. The figures shown overleaf are represented as a % of notional value of all liabilities.

Implied sensitivities of an actuary's estimated buyout basis vs the actual insurer price lock



Source: XPS calculations, calculated retrospectively based on estimated sensitivity before the transaction versus the sensitivity witnessed in the price lock formula.

Based on this, we can see that during the exclusivity phase, the price lock quoted by the insurer is generally less sensitive to interest rates and inflation than a buyout basis, but we saw a wide range of implied hedge levels from 90% to 125% of the actual buyout liabilities.

Therefore during this first stage, given the number of uncertainties, the primary focus should be to implement a high level of hedging with reference to your low risk funding basis. The actual target you may set for your scheme will depend on a number of factors, such as the funding level, any contributions due from the sponsor, value of any asset backed funding arrangements and any economic hedge that comes from assets in the portfolio. In addition, it will be important to consider the level of prudence within the scheme's other assumptions, such as demographic or mortality assumptions. By its nature the target hedge is less well defined, so seeking to immunise all risk is not warranted where it comes at a cost of excessive transaction fees or spurious accuracy.

Phase 2: Less than 12 months away

Key issues:

- ▶ You may start to have some indicative quotes along with a better feel for which insurer you might transact with and what sort of price you will transact at.
- ▶ Considerable variability still exists and the insurance pricing basis can move frequently (you are no longer hedging an actuarial basis that stays the same between actuarial valuations).
- ▶ Investment market conditions could also change materially in the run up to any transaction.

Approach

During this phase hedging can be more finely tuned based on your best estimate of insurer pricing sensitivity to interest rates and inflation and credit exposure.

For the first time you now have information on the pricing that you might transact at, but unlike your Technical Provisions basis, you are no longer hedging a basis that is fixed for three years between each valuation cycle. Insurer pricing is likely to change frequently, driven by a number of factors, some of which can be accounted for or mitigated, along with others that can't.

Each insurer will have different views on the pricing factors. We have simplified and summarised these factors into three key areas:

- ▶ **Cashflows**
- ▶ **The insurer's outlook for asset returns**
- ▶ **Demand in the insurance market**

Cashflows

Cashflows are the Scheme Actuary's projection of the expected payments for the scheme and heavily depend on the underlying data and the assumptions used by the actuary.

It's important to understand the mortality and demographic assumptions underlying your buyout liability basis. The assumptions are wide-ranging and cover aspects such as inflation expectations, the life expectancy or marital status of the membership.

Insurers and reinsurers will be working with the latest market assumptions, therefore if your scheme assumptions are out of date or overly prudent, then you risk seeing a divergence between the liabilities you're hedging and the actual premium. Your liability mortality and demographic assumptions are key and need to be reviewed to create accurate cashflows to use in your hedging strategy.

Therefore you should work closely with your investment advisor and scheme actuary to understand and target an appropriate hedge level for your scheme, taking into account a number of factors including the removal of any expense allowance in the cashflows, the level of prudence in your demographic assumptions, the funding level as well as the wider assumptions used in your basis.

The insurer's outlook for future asset returns

Insurers' views on returns they expect to achieve on their portfolio will feed through into how they price any policy. We see wide disparity between insurers asset allocations and their views are dynamic and change in line with market conditions. Credit spreads are particularly relevant for this, given that corporate bonds are popular assets for insurers, and the credit spread directly informs the level of return.

Credit exposure to match the exposures being priced in by the insurers can range from 20-60% depending on the insurer so narrowing down the likely insurers can be helpful. When trying to match the credit risk in an insurer's basis it's important to focus on running an appropriate level of risk in the strategy, whilst seeking to minimise round trip transactions costs.

While current credit spreads are tight compared to historical averages, they still offer additional yield and could tighten further from here, and so having some exposure is desirable. However, we recognise that credit risk is asymmetrical, and credit spreads could widen much further and faster than they could tighten, so you would not want to be overexposed to this risk. How much credit to hold would depend on what you currently hold (across liquid and illiquid mandates), the cost of buying/selling credit, and the time period this credit is expected to be held over.

Additional yield available on investment grade corporate bonds



Source: LSEG, ICE BofA E Non-Gilt Index - Option Adjusted Spread

Demand in the insurance market

The final piece of the puzzle of how insurers are likely to price your policy is based on the demand in the insurance market and each individual insurer's profit margin. Commercial decisions made by insurers based on their appetite and capacity can significantly impact pricing, and can also be highly unpredictable. We have seen insurers' prices reduce by a couple of percent simply due to their appetite to do the deal.

It remains important to recognise that buyout pricing still has many components that are "un-hedgeable", such as insurer views on expected returns and insurer supply/demand dynamics. Pursuit of precision in the hedging strategy should therefore not be a source of complacency.

At this stage it might be worth considering which insurers are likely to be a part of your process, and whether their allocations to credit are at the higher or lower end of the wider market.

On a more practical note, trustees should also look to ensure any signatory lists are up-to-date as you approach the exclusivity phase.

Throughout this stage, there's value to be found in continually monitoring the hedging position. By implementing LDI monitoring, you can see quickly how your actual position has changed when taking into account things like up-to-date member data and insurer pricing. You can then revise your hedge as necessary to protect your buyout funding position.

Phase 3: In the process of going exclusive with an insurer

Key issues:

- ▶ **Once exclusive, you may have scope to agree a price-lock formula with the insurer - this gives something firm to focus hedging on.**
- ▶ **The level of hedging precision should be high, reflecting scope for seeking to protect the scheme from potentially volatile market conditions if they arise.**
- ▶ **If the price lock can incorporate assets you already hold then this can become an asset-lock which reduces risk materially.**

Approach

During this phase, the approach to hedging should seek maximum precision to the extent feasible and in light of anticipated cost/benefit.

When going exclusive, as part of their quotes, insurers will typically provide a price-lock mechanism which will state how the price of the buy-in will move during the exclusivity period. This isn't contractually binding, but would be reputationally damaging for an insurer not to honour, and provides scope to meaningfully reduce risk in the run up to a transaction.

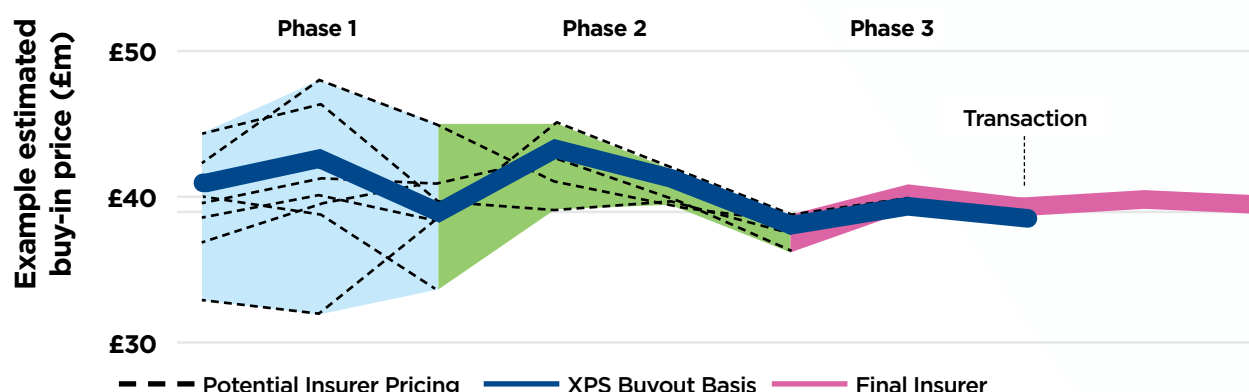
Schemes should use this opportunity to try and ensure that the price-lock of your chosen insurer contains assets you are able to access and hold - typically gilts and high-quality corporate bonds. In this way the price lock can become an asset-lock for some or all of your portfolio. By engaging early with your insurer, it means that your investment consultant will be able to design a matching portfolio that can reduce as much of this financial risk as possible.

If an asset lock cannot be achieved with your current assets, then moving your portfolio as quickly as possible into a close match to the price-lock will reduce the interest and inflation risk as well as any wider financial risks in the final few months as you approach a transaction.

In summary

As you approach your insurer transaction, there is greater scope to have more confidence in securing your buyout position. By taking action early in the process and implementing regular monitoring of your position, there is reduced scope for surprises to cause problems, leading to a greater chance of a successful transaction.

Example of how the estimated buyout price changes as you approach a transaction



Actions for trustees:

Trustees can follow these key actions to have the greater confidence of maintaining the funding position whilst securing their transaction:

Phase 1: More than 12 months away

- Seek a pragmatic approach to broadly hedge the estimated interest rate and inflation exposure to a high degree on a low risk basis
- Consider your scheme specifics to reduce the risk of being over or under hedged at this stage

Phase 2: Less than 12 months away

- Finely tune hedging based on your best estimate of insurer pricing sensitivity to interest rates and inflation and credit exposure
- Be mindful of what actions will deliver value for money when you are making changes to your strategy

Phase 3: In the process of going exclusive with an insurer

- Review hedge and seek to minimise risk against the price-lock
- Seek to incorporate assets you hold into the price lock formula

Find out more

To discuss any of the issues covered in this edition, please get in touch with Sian Pringle or Kirsteen Morrison. Alternatively, please speak to your usual XPS contact.



Sian Pringle
Partner

 sian.pringle@xpsgroup.com



Kirsteen Morrison
Consultant

 kirsteen.morrison@xpsgroup.com



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