Navigating you through your de-risking journey

Risk settlement market 2018

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Part of the Risk Settlement Market Review 2018

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Navigating phased buy-ins

Navigating the best insurance outcomes

The journey to buyout

The hidden value of annuities

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Navigating phased buy-ins: the big benefits and a step-by-step approach

In recent years, the bulk annuity market has been dominated by schemes insuring just part of their liabilities through a pensioner buy-in. Recent examples include Smiths Group, Kingfisher, Pilkington, and even Aon's own pension scheme. Our survey suggests that this trend will continue, with over two-thirds of schemes seeking buyout planning to adopt such a strategy.*

*Source: Aon's Risk Settlement Survey 2017

Over

66%

of schemes looking to buyout plan to **secure liabilities when pricing opportunities arise**

Key points

- Repeat buyers of annuities often get some of the best deals
- Phased buy-ins can target the scheme's largest risks, or the population that is cheapest to insure (and sometimes both at the same time!)
- Our Compass platform has been developed to obtain the best possible deal

The benefits of this approach are compelling:

For corporates, a buy-in is a clear way of demonstrating that all financial and demographic risks have been tackled for the relevant population. Indeed, around one-third of FTSE100 companies have now implemented a transaction to tackle longevity risk.

The desire to maintain a governance structure to manage the risks over the next 50 years is not appealing to many. Our survey suggests that buyout will be the endgame for over 80% of schemes. Once schemes have taken the decision to work towards the ultimate buyout, the challenge to construct an effective investment hedging portfolio is a fiendish one. Ultimately, the only way to hedge all three of insurer asset strategies, longevity risk, and market supply and demand simply is to invest in a buy-in itself.

In an increasingly busy market, schemes that have already transacted are more likely to get the best deals. Insurers have greater certainty that they will transact, and scheme stakeholders will be sufficiently experienced and nimble to seek and react to opportunities as soon as they arise.

With all of these benefits in mind, the key question is, why are more schemes not doing this already?

In our experience, the answer is twofold.

Governance and resources

The burden of running a pension scheme in current regulatory and financial conditions is challenging enough in itself, without carving out time to carry out a major transaction. A buy-in transaction may be equivalent to the sponsor selling a significant proportion of its business, and require a commensurate level of resource and focus.

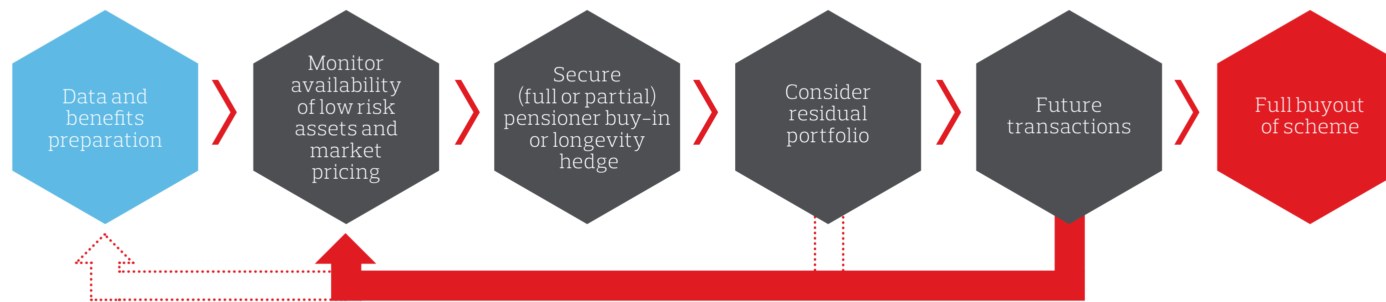
Investment priorities

Existing investment strategies can sometimes conflict with implementing a buy-in, for either of the following reasons:

- For schemes reliant on growth assets to meet their benefit obligations, there are simply not sufficient assets to fund the buy-in premium and keep the funding plan on course
- For schemes that have already materially de-risked, existing low risk assets may be tied up as collateral to hedge interest rate and inflation risks. In fact, over 80% of respondents in our survey cited hedging interest and inflation risk as a key priority.

A phased approach

Increasingly, we see schemes putting in place a de-risking framework such as the one below to integrate (a phased approach to) insurance within their existing investment strategy:



Schemes seeking to transact a partial transaction have a wide range of options to explore when seeking the best pricing. From time to time, different insurers will favour different populations to give the best price. Kingfisher's medically underwritten buy-in, covering the largest liabilities, is the most high profile case – but transactions covering oldest, youngest or benefit-related structures have all been shown to yield the best results at the right time.

Getting the best possible deal

For schemes exploring a buy-in, our Compass platform was developed to obtain the best possible deal. It draws upon two significant benefits to differentiate schemes from many cases in the market:

1. First and foremost, schemes go through a rigorous preparation phase, giving all parties greater confidence before significant resource is committed
2. Secondly, where pricing is not quite at the expected level, the innovative trigger mechanism ensures you will be at the front of the queue when conditions change.

Get in touch to find out more here

John Baines
john.baines@aon.com

Navigating the best insurance outcomes

2018 is set to be a huge year for pension de-risking, with improved pension scheme funding levels and better insurer pricing set to make settlement more affordable than ever.

How to ensure the best insurance outcome

There are four crucial areas to focus on when it comes to obtaining the best outcomes:

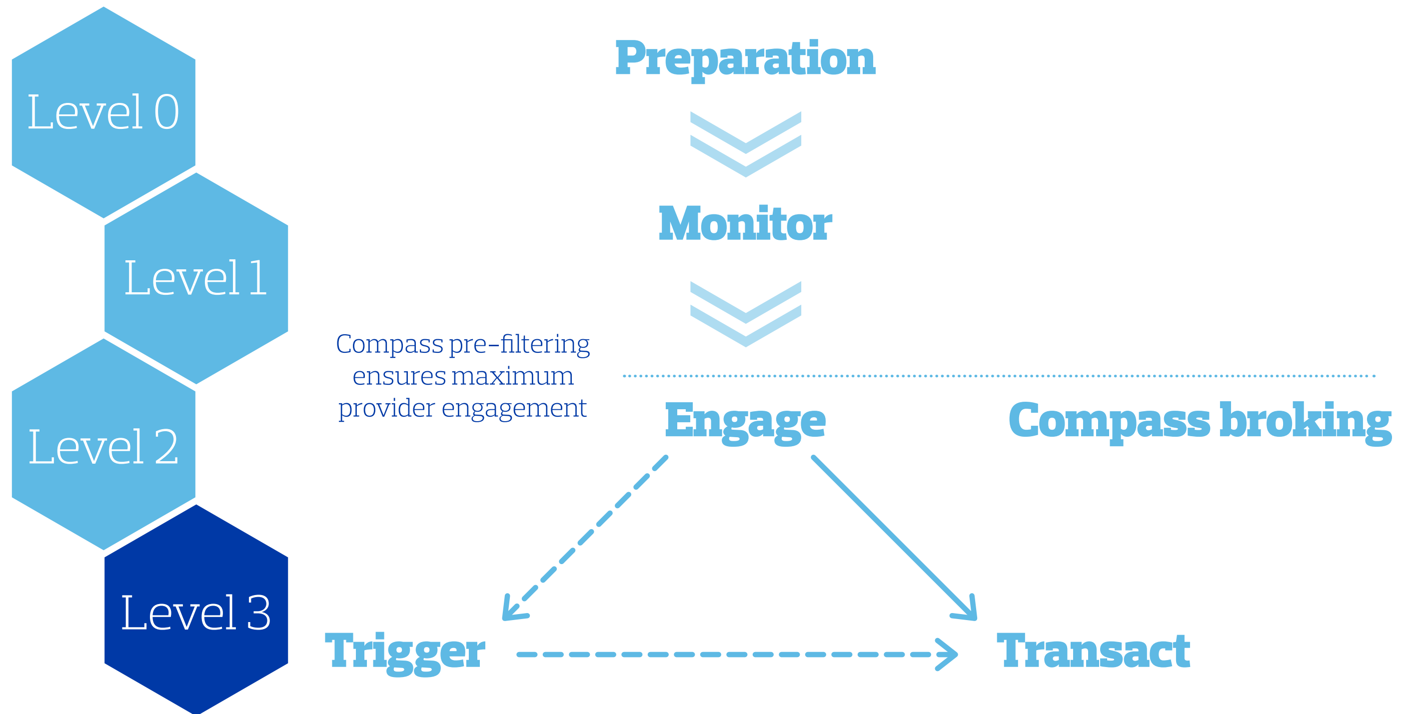
Key points

- Aon's Compass is designed to generate the most competitive annuity pricing
- Good preparation is crucial to getting the best deal on an annuity
- Monitoring the market maximises the chance of capturing pricing opportunities

How to make it happen with Compass

The first two levels of our Compass platform enable our clients to demonstrate their commitment to the transaction. This results in greater traction with insurers who, in turn, offer more competitive and committed pricing.

Aon's Bulk Annuity Compass



Level 0 – Prepare

As always, preparation is crucial. The most successful risk settlement transactions typically begin with a feasibility study, to establish the trustee and sponsor's de-risking aims and objectives. These studies consider the options available to your scheme – eg, bulk annuities, longevity insurance and member options – and evaluate the pros and cons of each, to work out an agreed approach.

By going through a feasibility study, we ensure that all pension scheme stakeholders understand the impact of a potential de-risking transaction. The considered factors include:

- Funding position
- Investment strategy – transferred assets and residual portfolio
- Corporate accounting position
- Administration

By considering these factors, we can remove perceived barriers and successfully obtain the support of all stakeholders for a chosen strategy.

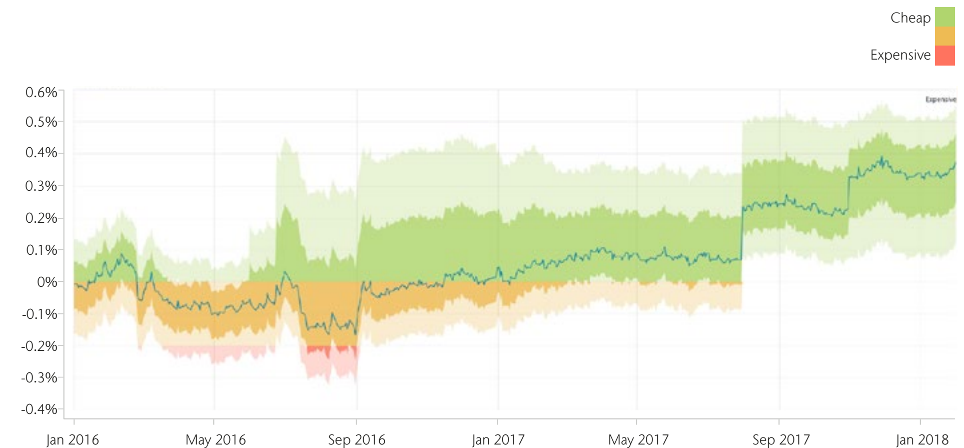
Early cleansing of data and drafting of a comprehensive benefit specification also demonstrate that both trustee and company have invested in the transaction, and are committed to de-risking their scheme. This matters because insurers spend significant sums on pricing opportunities they receive and understanding which schemes have spent time and money preparing – knowledge which helps them to prioritise the best opportunities.

Level 1 – Monitor

Pension schemes also need to understand when to insure their liabilities. Increasingly, trustees and companies are putting in place insurance triggers that focus on a combination of:

- Competitiveness of insurance pricing
- Funding position
- Available assets

Our Bulk Annuity Market Monitor (BAMM) provides a daily comparison of the competitiveness of insurer pricing relative to other low risk asset strategies. As well as using this, we can monitor your scheme's funding position with our Risk Analyzer software, and work with your investment adviser to keep a close eye on the asset position, so we can quickly inform you when the time is right to transact.



Source: Aon's Bulk Annuity Market Monitor on Risk Analyzer

Start early, be ready

The best insurance outcomes for pension schemes are obtained through early preparation. All of the above steps can be completed well ahead of a transaction to ensure that, when conditions are right, your scheme is ready to move quickly and to capitalise on the most favourable pricing opportunities.

Is your scheme ready?

Discover all you need to make the most of the fruitful market ahead

Discover

Seize your best opportunity this year

Get in touch and see which of our solutions will help boost your success

Michael Walker
michael.walker.3@aon.com

Liability settlement:

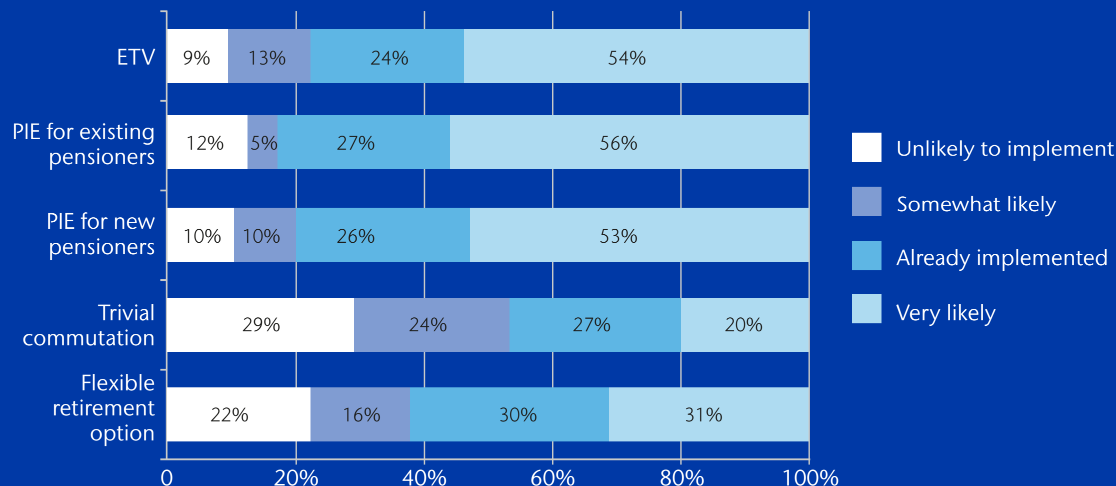
The journey to buyout

In with the new

Offering more choice and extra flexibility with the introduction of new member options is becoming increasingly common. In fact, our UK Global Pension Risk Survey 2017 showed that around half of all schemes had already implemented key member options or were likely to do so in the near future.

Liability management

What is your attitude to the following strategies over the next 12-24 months?



Source: Aon's Risk Settlement Survey 2017

Key points

- Many schemes can more than halve their path to buyout and reduce risk along the way
- An effective strategy for an accelerated buyout plan can start with a simple framework
- Options such as Pension Increase Exchange (PIE) can result in greater flexibility for members and reduced business cost

Better choices, reduced cost

So what is driving the introduction of these new options? In many cases, it is fuelled by a desire to give members greater choices and benefits that better suit their needs. However, increasingly we are seeing schemes focusing on the 'win:win' that arises when these options also reduce the cost of a bulk annuity policy – now or in the future.

50%

of schemes responding to our survey **have introduced new options** or will in the future

Perspective

Let us take a closer look at a case study to see how the new options have played out in practice.

The situation

A manufacturing company with a mature c£200m scheme, and aspirations to buyout, decided to offer a Pension Increase Exchange (PIE) to their pensioner members.

The outcome

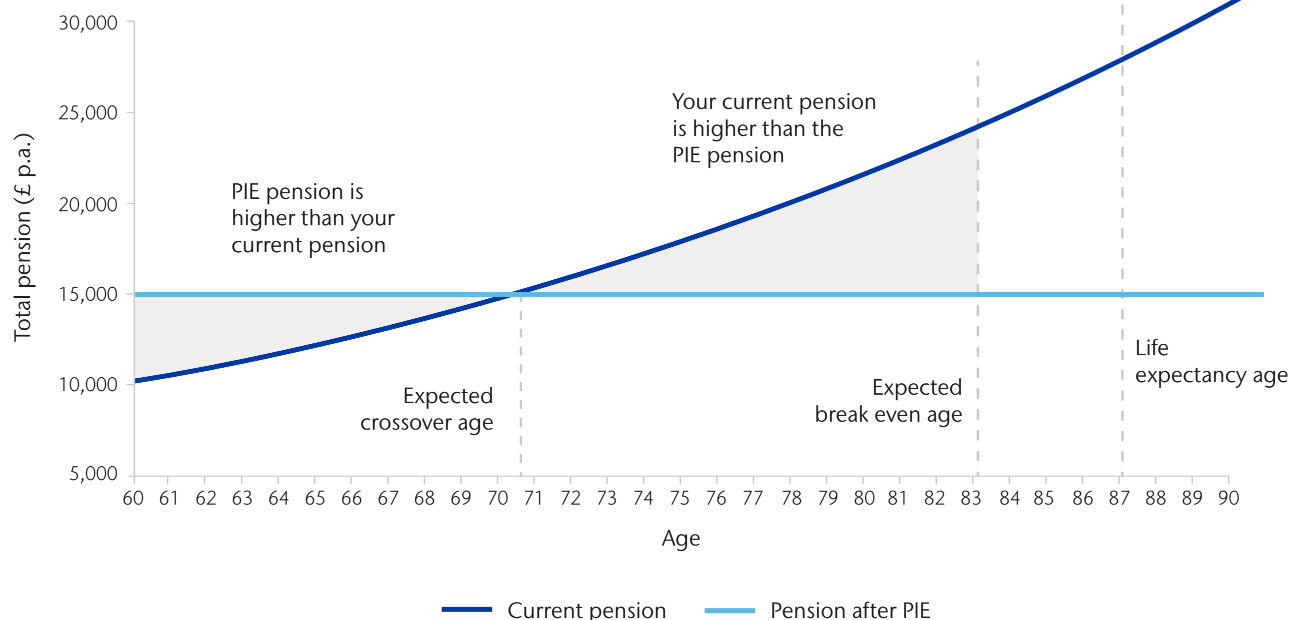
By swapping caps and floors (which were expensive to insure) for inflation-linked pension increases, the scheme reduced the premium for a pensioner buy-in at the same time as making an attractive offer to members.

The offer was so attractive that it generated a take-up of more than 50%. This has meant that the scheme can afford to insure all of its pensioners now rather than waiting and risking markets moving against them.

What is a Pension Increase Exchange?

- The Pension Increase Exchange (PIE) gives members the option to swap the increases on their pension, when it comes into payment, in exchange for a higher, non-increasing pension
- Many schemes can more than halve their path to buyout and reduce risk along the way
- Options such as Pension Increase Exchanges can result in greater flexibility for members and reduced business cost.

Example PIE offer for a male member aged 65



Accelerating the path to buyout

A number of steps can be taken to achieve an accelerated path to buyout. Often, one alone will not be enough but putting several steps together, with marginal gains from each, can dramatically reduce the time taken to reach the goal.

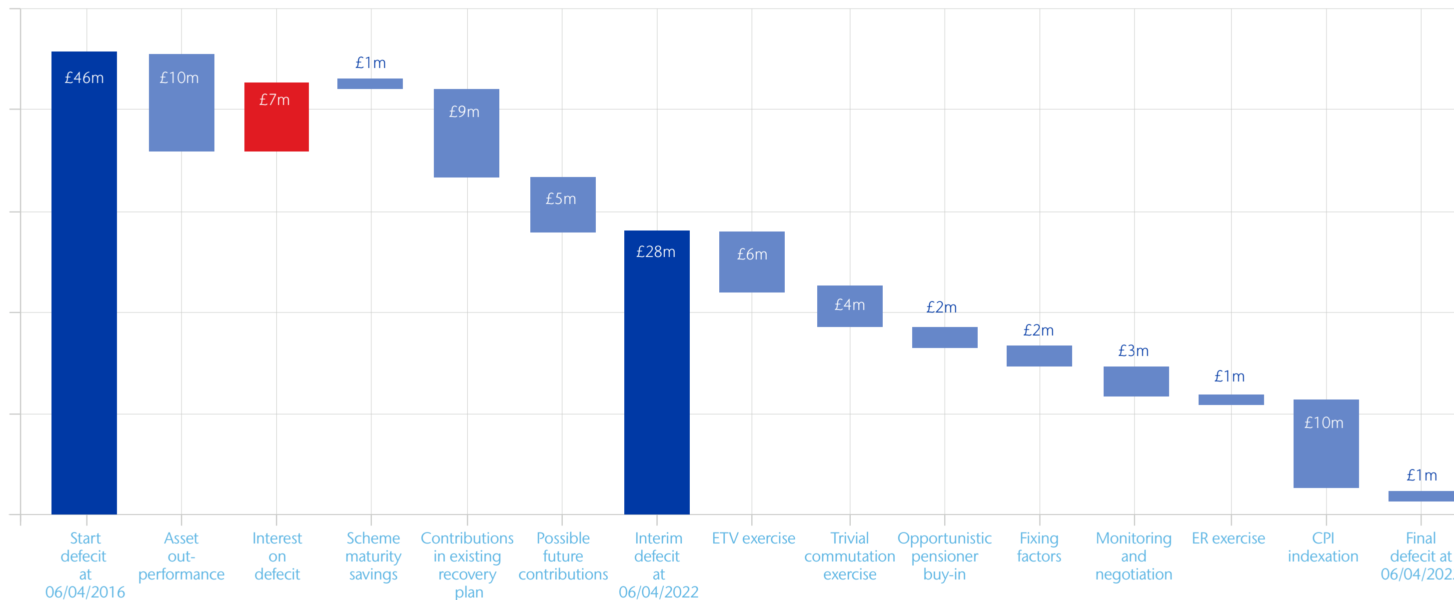
Our research suggests that many schemes can more than halve the time to buyout and significantly reduce risk along the way.

Framework, strategy, action!

With an accelerated path in mind, we see more and more schemes putting together strategic action plans to achieve this goal. It is possible to use a framework like the one below to develop a strategy and then monitor progress as you implement it.

We work with schemes of all sizes on this journey and many of the insurance transactions reported in the market, including the one for our own Aon schemes, have been possible because of succession action plans like this.

Possible actions to take to reach your long-term target on a buyout basis



Member option exercises will accelerate your path to buyout

Ben Roe
benjamin.roe@aon.com

The hidden value of annuities

Are they worth it?

Weighing up the options

Some schemes opt against insurance as an investment due to the headline cost, instead settling for self-insuring their risks by implementing an asset and contribution strategy that has a reasonable likelihood of seeing them through to the final benefit payment.

The downside risks of this can be substantial and the full implications of running a pension scheme to the very end – perhaps in 60 years' time – often make annuities look more attractive than at face value.

Key points

- The hidden value of an annuity is often overlooked
- The risks in long-term asset strategies need to be considered
- You can optimise your strategy with affordable buy-ins

The hidden value of annuities

The value of an annuity is easily underestimated. But let us take a closer look:

- **Asset optimisation** – Maturing schemes tend to adopt an increasingly narrow range of asset strategies to limit governance requirements. In contrast, insurers specialise in sourcing long-term income-bearing investments, often from within their own business or as a preferential investor. This allows the insurer to optimise returns within the constraint of matching asset and liability cashflows
- **Sustainable arrangements for members** – Annuity funds consolidate defined benefit commitments, and will pay pensions to hundreds of thousands of members. This is likely to be a more viable administration and governance model than a closed and matured pension scheme, which has little to no link to the current HR function of the sponsor
- **Concentration risk** – For most schemes, larger value members will influence a scheme's risk profile considerably more than in an annuity fund (the funds are typically £15bn-£50bn in value)
- **Yield improvement** – At recent prices, pensioner buy-ins offer an investment yield materially in excess of that from gilts and LDI, and the comparison looks starker when the risk protection gained is considered.

85% of schemes surveyed **expect to use annuities** to reach their end goal

The potential risk of self–insuring

Before selecting either option, it is important to gain a full understanding of the potential value and any risks. For self-insuring, some of the considerations to be aware of include:

- **Long-term asset risk** – A long-term target of 'self-sufficiency' – which our 2017 Global Pension Risk Survey showed was the objective of many schemes – often involves asset strategies carrying some risk over the very long term, leaving cost uncertainty for the company
- **Long-term covenant risk** – The strategy may also effectively assume that the sponsor remains around for the very long term (eg, 60 years), in case unanticipated problems emerge later on, and will be both able and willing to fund the scheme
- **Longevity risk** – Schemes that do not address longevity risk under annuities (or longevity swaps) carry a risk to funding that is not expected to be rewarded
- **Exposure to future changes** – Schemes are subject to potential future legislation that could alter liabilities or tighten current funding and investment freedoms, adding to cost volatility. Sponsors also carry the risk of legacy data issues eventually coming to light.

We believe that these factors mean that the optimum strategy for most schemes will become buyout after a certain level of maturity, typically best achieved by a series of affordable buy-ins over time.

More than 60% of schemes **intend to introduce buy–ins** to their investment strategy

Get in touch to find out more here

Phil Curtis
phil.curtis@aon.com

About Aon

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For further information on our capabilities and to learn how we empower results for clients, please visit

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