GUIDE TO

MEMBER OPTIONS

2019

Empower Results®

HELLO

Following the introduction of 'Freedom and Choice' for defined contribution (DC) pensions in April 2015, we have seen increasing numbers of members transfer out of defined benefit (DB) schemes to access these new freedoms.

While these options could be attractive for some members, they represent important considerations for both trustees and companies alike:

- For trustees, considerations include how to support members to fully understand the options available, whether to increase the range of options available in the DB scheme itself and implications for a scheme's investment strategy; and
- For corporate sponsors, a consideration may be using the new flexibilities as a way to manage risks in a scheme, reduce costs and bridge the gap to a possible future buyout.

Whether you are a trustee or a corporate sponsor, there is a range of issues to consider in relation to the new pensions freedoms.

In our 2019 review, we take a look at:

- How trustees are supporting members in their decision making at retirement
- The latest on bulk member options exercises and the IFA market
- Examples of schemes which have used member options exercises to bridge the gap to buyout
- Trends in relation to partial transfer options
- Investment considerations of carrying out member options exercises

Our insights are underpinned by the results of Aon's 2019 Member Options Survey covering 320 defined benefit schemes, as well as our experience advising on more member options exercises than any other consultancy in recent years. In this chapter we focus on the key investment considerations when carrying out member options exercises, or where schemes see large volumes of transfer values: cashflow management, LDI design and impact on future required investment return.

BEN ROE
SENIOR PARTNER AND HEAD OF AON'S MEMBER OPTIONS TEAM

MEMBER OPTIONS – WHAT ARE THE INVESTMENT CONSIDERATIONS?

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CHAPTER

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MEMBER OPTIONS – WHAT ARE THE INVESTMENT CONSIDERATIONS?

Trustees should be mindful of the impact on a scheme's investment strategy before, during and after member options exercises. Investment considerations include:

CASHFLOW MANAGEMENT

INTEREST RATE AND INFLATION HEDGING

IMPACT ON REQUIRED RETURN

IMPACT ON PRICING OF BULK ANNUITY INVESTMENTS

In this chapter, we focus on the interaction between member options and these considerations, identifying practical steps trustees can take to plan for and manage the investment impact.

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PRINCIPAL CONSULTANT

CASHFLOW MANAGEMENT

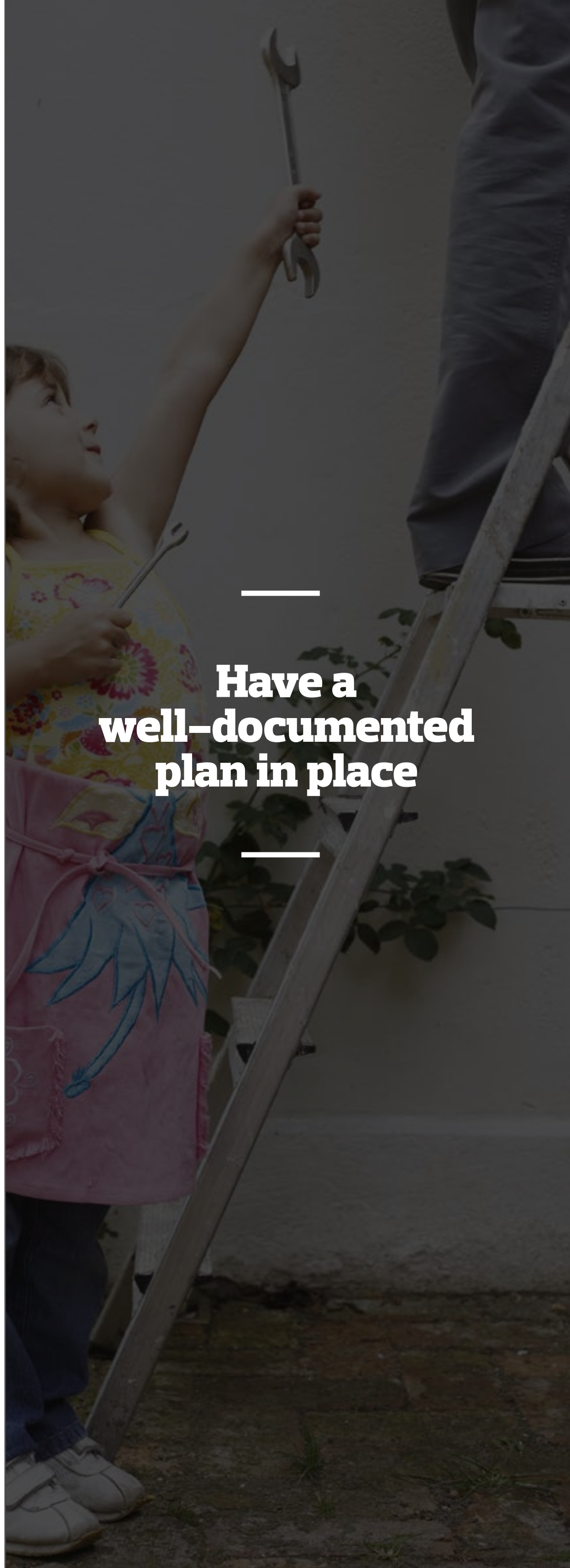
There has been a growing interest in recent years in cashflow driven investment strategies which aim to match some or all of a scheme's regular cash outgoings.

These strategies have merits and drawbacks, depending on scheme circumstances. Nevertheless, we welcome the increased focus on managing cashflow risks, which is a key consideration for all schemes. It is important that trustees have a robust plan in place for managing both expected and unpredictable cash outflows.

POOR CASHFLOW MANAGEMENT CAN LEAD TO:

- A need to sell assets at short notice, when prices may be temporarily depressed
- Higher transaction costs from asset redemptions
- A greater governance burden for trustees

Because member options exercises can lead to increased (and less predictable) cash outflows from schemes in the short term, cashflow management can become of even greater importance. The key is to have a well-documented plan in place, a robust process to reduce operational risks and sufficiently liquid assets that can be sold at short notice and at limited transaction cost. The nature of the asset to be sold can also be important, because a more stable asset is less likely to be sold at a temporarily depressed price.



LDI DESIGN

Member options have an impact on the liabilities, which in turn affects liability hedging design. For example:

A PIE exercise will reduce the inflation sensitivity of some of the scheme's liabilities. If this is not reflected in the LDI solution, and all else being equal, the scheme will become over-hedged to inflation relative to the trustees' target

Transfers reduce the value of the remaining liabilities in the scheme, which can result in the scheme becoming over-hedged relative to the target hedge ratio if the LDI solution is not adjusted

Three ways of updating a liability cashflow benchmark:

1 RE-DOING

a liability benchmark is the most costly approach and requires new cashflow data from the scheme actuary.

2 RE-CASTING

a liability benchmark involves taking the existing benchmark, rolling this forwards to a current date and then approximately allowing for changes to the liability profile that have occurred due to the member options exercise.

3 RE-SCALING

a liability benchmark requires scaling the existing liability cashflow benchmark to an updated liability value which takes account of the member options exercise.

The most appropriate approach will depend on the size of the scheme, the level of hedging in place and the popularity of any member options exercise. For example:

Update to liability cashflow benchmark	RE-DO	RE-CAST	RE-SCALE
Impact of member options exercise	>10% of total liabilities transferred out; or >10% change in proportion of inflation linkage	5-10% of total liabilities transferred out; or 5-10% change in proportion of inflation linkage	<5% of total liabilities transferred out; or <5% change in proportion of inflation linkage
Size of task	Most involved	Medium	Simplest

Note: example only for a large scheme with a high hedge ratio. Clients should seek specific advice in relation to their schemes.

WHY DOES THIS MATTER?

If the inflation sensitivity of the liability benchmark differs from the underlying liability by 10%, then for a scheme with assets of £100m, a 0.5% shift in inflation could result in a £1m difference between where the asset value is expected to be and its actual position.

If there is a mismatch in the present value of a liability benchmark versus the target liabilities of a similar magnitude, then there will be a similar financial impact from interest rate yield movements.

In our 2019 Member Options Survey, 8% of schemes had seen their liabilities reduced by more than 5% as a result of transfer values being paid out. This was broadly matched by around 10% of schemes updating their liability hedge by a 're-scale' or 're-cast' approach.

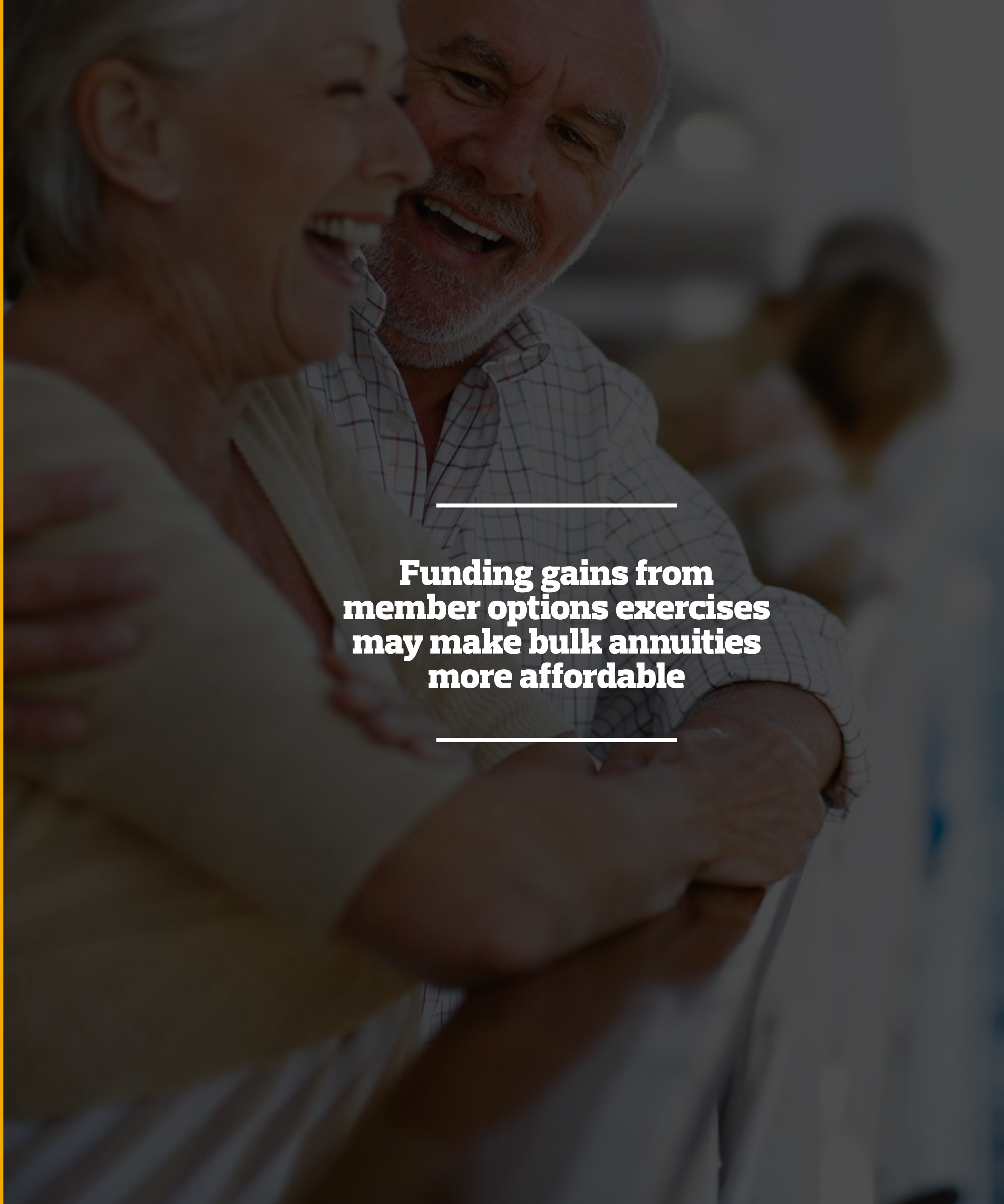
The importance of maintaining an accurate hedge will depend on the circumstances of the scheme. For example, better-funded schemes with high levels of hedging are more likely to place a greater emphasis on maintaining an accurate LDI hedge, because an inaccurate hedge may become one of the largest remaining risks in the scheme.

REQUIRED RETURN

It is possible that funding improvements resulting from member options exercises could reduce the required return on the scheme's investments. In other cases, significant cash outflows can exacerbate the consequences of under-funding, because a smaller asset base needs to 'work harder' to close the scheme's deficit.

FOR EXAMPLE

A scheme with £100m liabilities and £90m assets requires c.1% p.a. asset outperformance to become fully funded in 10 years (assuming no deficit contributions are made). To illustrate the principle with an extreme example, if £50m of benefits are transferred out, the scheme will have £50m liabilities and £40m assets, and will require c.2% p.a. outperformance from the residual assets to meet the same goal.



BULK ANNUITY INVESTMENTS

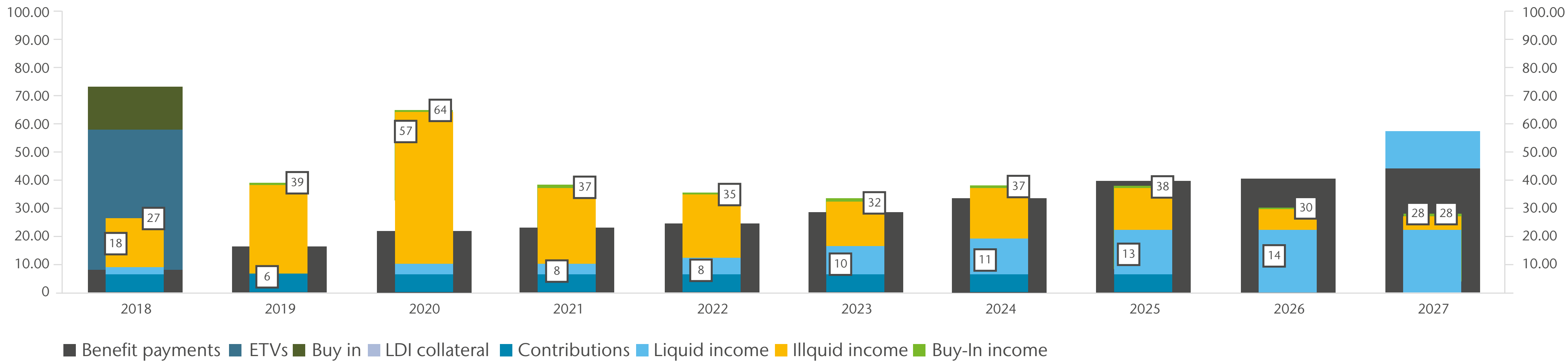
Funding gains from member options exercises may make bulk annuities more affordable. By reducing uncertainty (for example, a reduction in inflation risks following a Pension Increase Exchange exercise), insurance premiums may also fall.

PLANNING FOR MEMBER OPTIONS EXERCISES

In our view, the best way to plan for the investment impact of member options exercises is to analyse the expected cashflows from a scheme over time, with different member options outcomes.

Various stresses can then be applied to test the resilience of potential investment strategies. For example, we can address questions such as 'if there is a 20% take-up rate in an ETV exercise, and an LDI collateral call occurs around the same time, are the scheme's assets sufficiently liquid to meet these payments? And what will be the impact on remaining asset liquidity?'

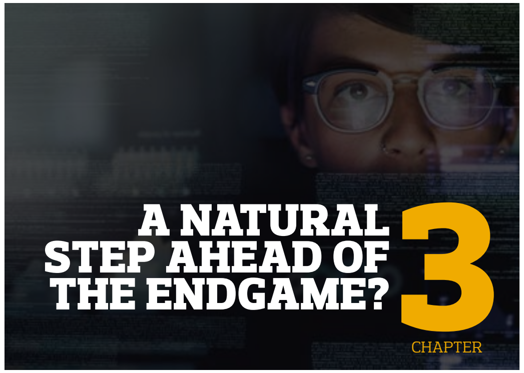
Example cashflow analysis



This type of analysis can help trustees move forwards with a member options exercise with greater knowledge of the possible investment impact and the steps required to mitigate cashflow risks.

If you would like to see Aon's Guide to Member Options in its entirety, please email the Member Options team and we will be in touch.

READ PREVIOUS CHAPTERS



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About Aon

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