Aon Hewitt
Retirement & Investment

Global Pension Risk Survey 2017

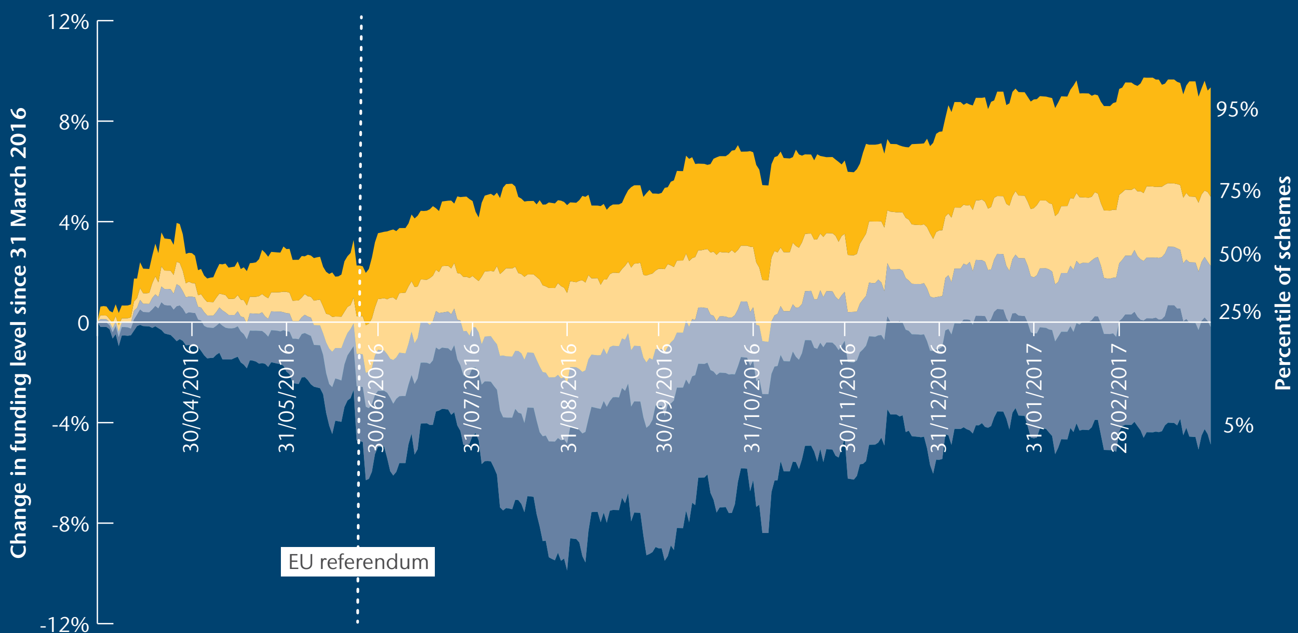
UK Survey Findings

Contents

Executive summary

Page 1 of 1

The two years since our last Global Pension Risk Survey have been challenging for UK defined benefit (DB) schemes. This period has been characterised by sustained low gilt yields and political volatility (such as the EU referendum) which has spilled over into investment markets. This is demonstrated in the chart below, which shows the development of funding levels over the year since 31 March 2016 for clients on our Risk Analyzer funding monitoring tool. The median scheme has seen around a 2% increase in funding level over the year, but the chart highlights the divergence of schemes' funding levels — the top 5% of schemes have seen increases in funding level of more than 9%, whereas the bottom 5% of schemes have seen their funding levels fall by more than 5%.



Against this backdrop, we were keen to understand how schemes had reacted to change and what plans they have for the future. 185 schemes responded to our survey questionnaire and we present the results of the survey here.

Our key finding is of action past and future; the variety of available actions for schemes has never been bigger and we found that schemes have taken significant action in all these areas, ranging from hedging instruments through alternative financing options and into additional pension options for members. What is more, it is clear that schemes also plan to do significantly more in the near future to continue to succeed in the challenging environment in which DB schemes operate.

'Action' is consequently the theme of this survey.

Click here for more depth

Demographics of survey participants

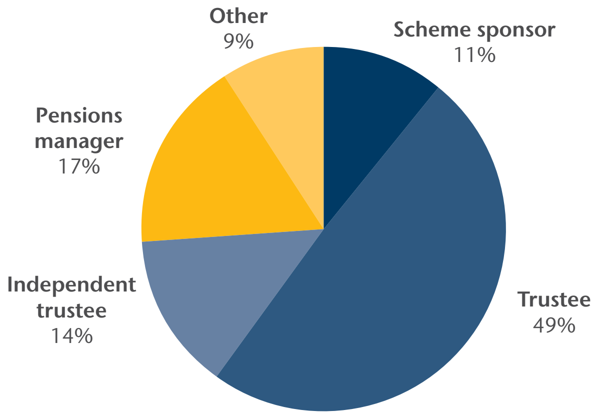
Page 1 of 2

Type of respondent

We had a total of 185 UK responses to the 2017 survey, covering schemes with nearly 4.5 million members and £500 billion of assets.

More than half the survey responses came from trustees, including independent trustees. The majority of the remaining responses came from pensions managers (17%) and scheme sponsors (11%). The 'Other' category covered a range of roles, with secretary to the trustees the most common.

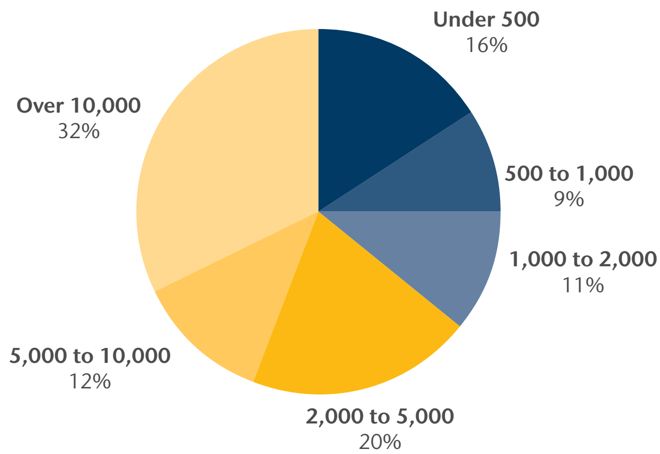
Here, and throughout the report, charts may not total 100% for reasons of rounding.



Size distribution of respondents

Estimated number of participants in defined benefit schemes

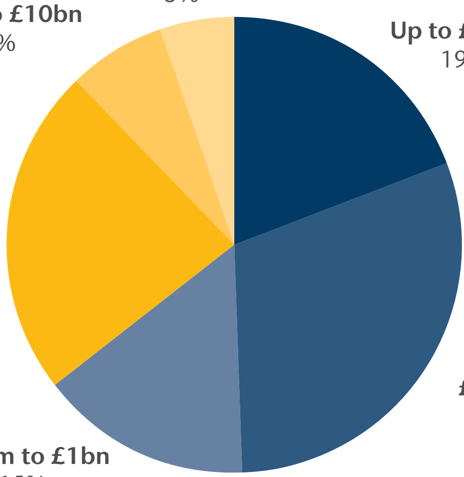
The survey responses covered schemes of all different sizes, from the very small with only a handful of members (16% of respondents' schemes had fewer than 500 participants) to the very large with hundreds of thousands of members (32% of respondents' schemes had over 10,000 participants).



Demographics of survey participants

Size distribution of respondents

Estimated assets in defined benefit schemes



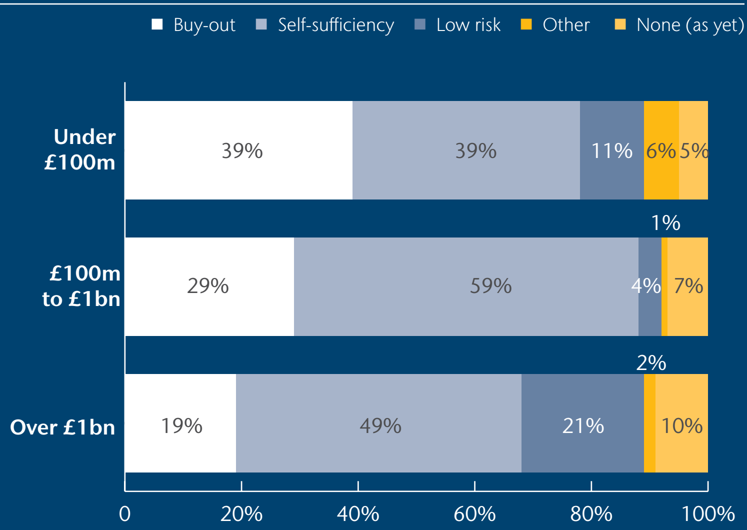
The survey responses also covered a wide variety of schemes by asset size. Nearly 20% of the responses were for sub £100m schemes, which we have defined in these results as 'small' schemes, while more than a third related to schemes with over £1bn of assets, which we have defined as 'large' schemes, with the remainder 'medium' sized. At various places in the survey report we have split the results by scheme size to see how industry trends are affecting schemes of different sizes.

We also asked respondents to share their schemes' funding levels on an accounting basis. We split the responses into broadly even thirds by their funding level, representing those who have funding levels below 84% (which we have defined in these results as 'low' funding levels), those between 84% and 97% ('medium' funding levels) and those over 97% ('high' funding levels). Again, at various places in the survey we have split the results by funding level where there was a clear trend in the data.

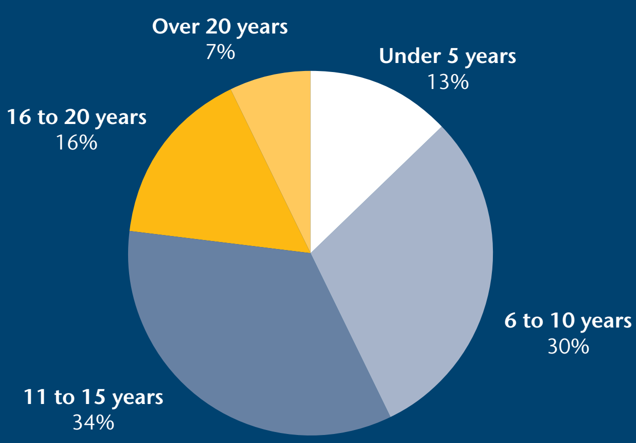
Long-term objectives

Long-term objectives are an increasingly large focal point for schemes, with the vast majority of schemes targeting either buy-out, self-sufficiency or other low risk positions. The chart to the right separates the responses on long-term funding objectives by schemes of different sizes. Buy-out is most popular amongst smaller schemes (39%), but developments in the insurance markets mean that buy-out is more realistic for larger schemes than previously. This is being reflected in schemes' long-term objectives: in 2015, only 8% of over £1bn schemes were targeting buy-out but this has increased to 19% in the 2017 survey. However, overall, a target of self-sufficiency or another low risk option remains the most popular approach (selected by 62% of respondents).

Long-term objective by size



Expected timescales to long-term objective



We also asked respondents about the expected timescales for achieving their long-term objective. The overall position is slightly rosier than two years ago with the average time to reaching the long-term objective falling from 12.0 years to 11.1 years. This is an area where the divergence of funding levels following the EU referendum result has had a significant impact. Schemes that saw a boost to their funding level will have seen their long-term objective get closer and may have been more able to take de-risking actions. For others the prospect of reaching their long-term objective may seem further away than ever.

Click here for more depth

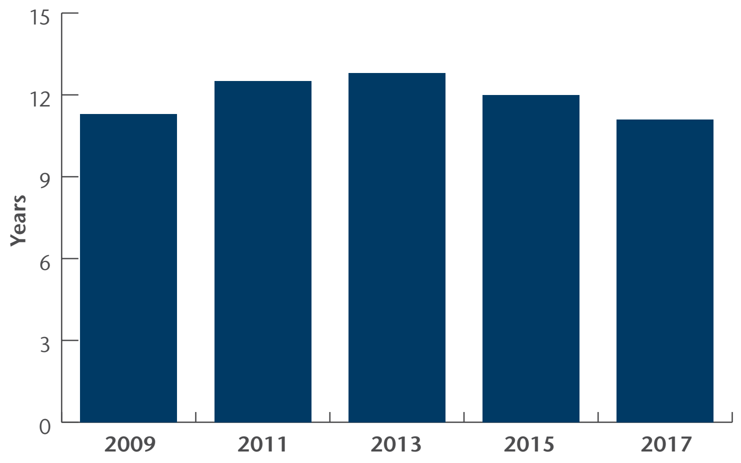
Long-term objectives – in more depth

Page 1 of 2

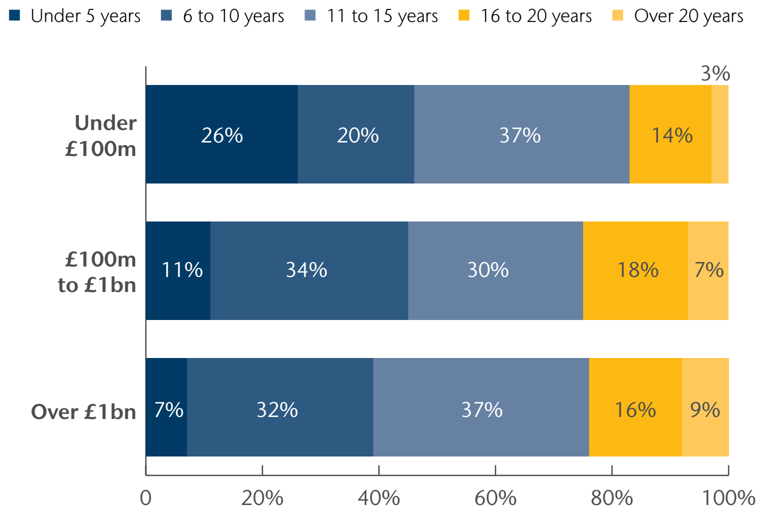
Timescales to long-term objective

We noted in the high level survey findings that the timescale to reaching the long-term target has reduced since our 2015 survey. The full trend since 2009 is shown in the chart to the right.

This demonstrates quite a profound trend. Despite the challenging economic circumstances over the past several years, among our respondents, the timescale to full funding on the target measure has actually reduced successively over the last four years. This stands as testament to the actions taken to manage pension schemes and the very considerable contributions that employers have made to them.



Timescales to long-term objectives by scheme size



The chart to the left splits the expected timescale to long-term objective by scheme size. The smallest schemes generally expect to reach this long-term objective the quickest, with a quarter of them expecting to do so within the next five years. However, the impact of diverging funding levels is apparent here — in 2015 61% of small schemes expected to reach their long-term objective within 10 years, but now only 46% do and there has been a significant increase from 17% to 37% in the number of schemes expecting to take between 11 and 15 years to reach their long-term objective.

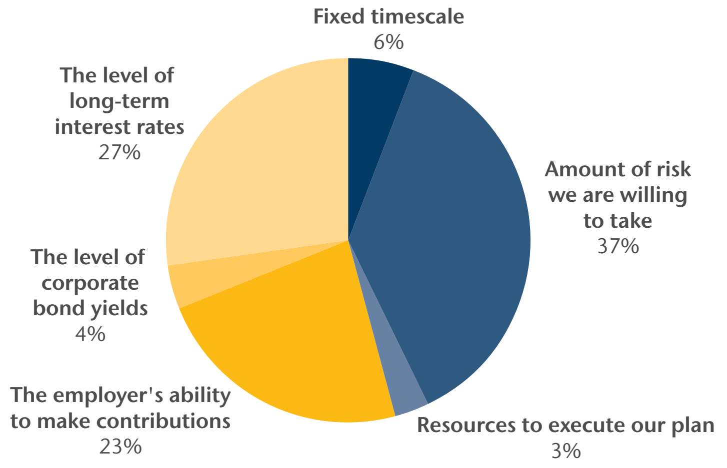
For the largest schemes the position has been more stable, perhaps because these are the schemes that were more likely to have hedged — a finding we discuss in more detail in the investment strategy section.

Long-term objectives – in more depth

Page 2 of 2

Factors determining the time to long-term objective

We asked respondents what key factors will influence when they will reach their long-term objective. Three key themes stood out — the amount of risk they are willing to take (37%), the level of long-term interest rates (27%) and the employer's ability to make contributions (23%). One noticeable change since 2015 is the fall in the proportion of respondents for whom the level of corporate bond yields is the most important factor. 21% of respondents in 2015 cited this as the most important factor but this has now fallen to just 4%, highlighting the ever-increasing disconnect between funding and accounting liability measures.

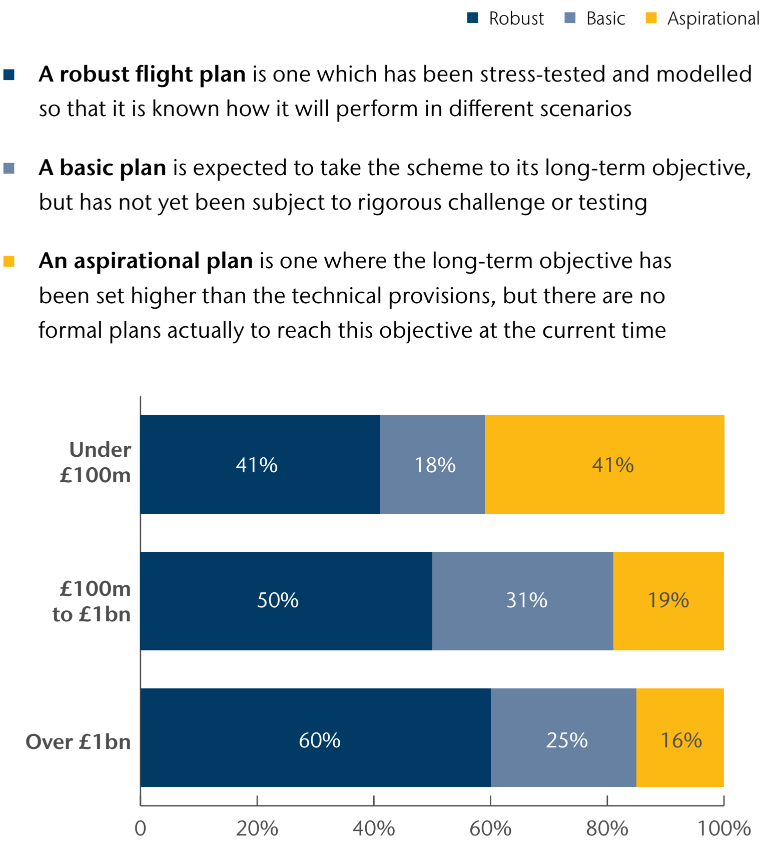


Robust flight plan by scheme size

Given the competing factors, it is important for schemes to have a flight plan to help reach their long-term objective by identifying and taking opportunities to move closer to the endgame. As part of the Global Pension Risk Survey we asked respondents to describe their flight plans as robust, basic or aspirational.

Perhaps unsurprisingly it is the largest schemes that are most likely to have a robust flight plan, with 60% of over £1bn schemes having a robust plan compared to just 41% of under £100m schemes. However, despite a large increase in the proportion of robust flight plans between 2013 and 2015, there has not been a further significant uptick since 2015. We do think that the Pensions Regulator's increased focus on Integrated Risk Management (IRM) will encourage more schemes down this route and we turn to the extent of schemes' implementation of IRM in the section on risk monitoring and mitigation.

- **A robust flight plan** is one which has been stress-tested and modelled so that it is known how it will perform in different scenarios
- **A basic plan** is expected to take the scheme to its long-term objective, but has not yet been subject to rigorous challenge or testing
- **An aspirational plan** is one where the long-term objective has been set higher than the technical provisions, but there are no formal plans actually to reach this objective at the current time



Managing benefits and liabilities

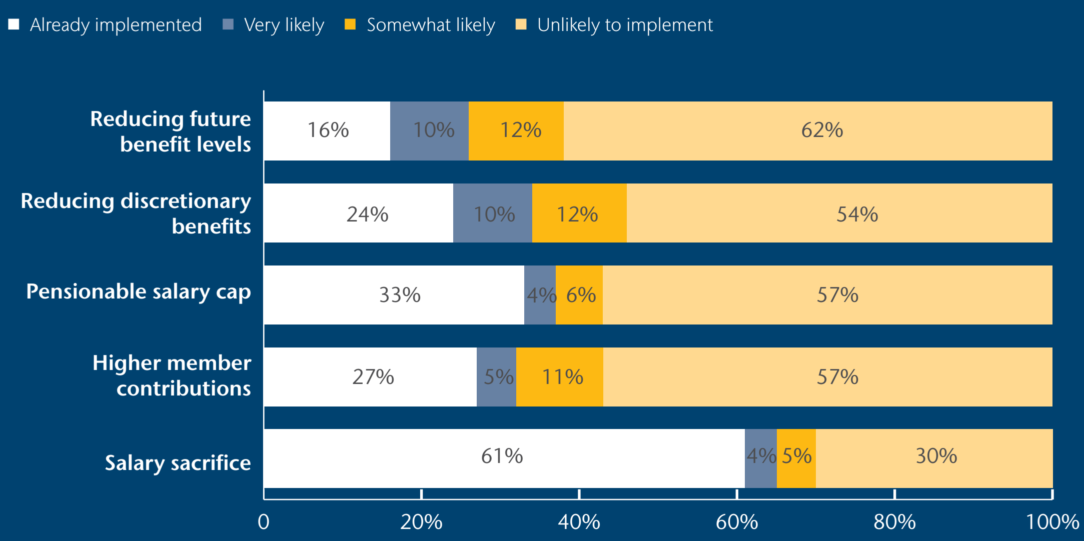
In the 2015 survey report, we noted that the percentage of schemes closed to future accrual had appeared to plateau at around 45%. However, the pressures on DB schemes have continued to grow and, coupled with many employers reviewing DB pension provision following the end of contracting-out in April 2016, the proportion of schemes closed to future accrual has now topped 50% for the first time, reaching 53% in the 2017 survey.

The chart below shows some other actions that schemes and sponsors can take to reduce the cost of defined benefit pension provision. For each action, we asked whether it has already been implemented, whether it was considered very likely or somewhat likely that the scheme would implement it in the next 12–24 months, or whether it was an action that was unlikely to be implemented.

The abolition of DB contracting-out was clearly a catalyst for changes to benefit design. The proportion of schemes that have now implemented each action has increased since 2015, typically by 6% or more. However the proportion of schemes saying they are unlikely to implement one of these actions has remained relatively constant. This suggests that the days of tinkering with benefit design might be coming towards a close and only the ultimate option of closing to future accrual remains.

Benefit actions

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



Click here for more depth

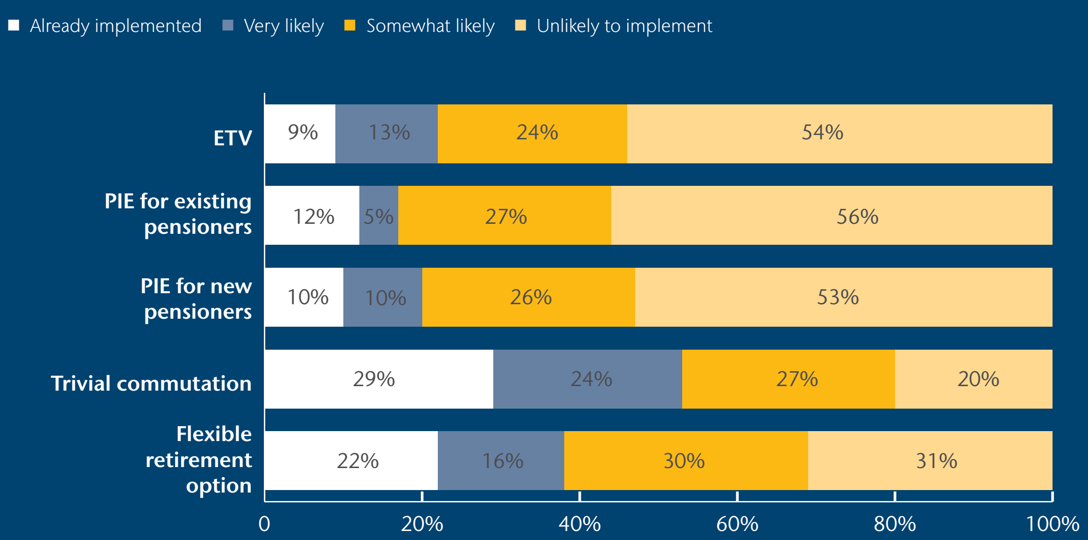
Managing benefits and liabilities

The other approach to managing benefits and liabilities is to offer members options to take their benefits in forms that either offer an immediate funding gain to the scheme due to the conversion terms; reduce the overall risk being run by the scheme; or simply reduce the overall size of the scheme because members transfer their benefits out. The chart below shows the five most common liability management exercises. We asked respondents whether they had already carried them out for their scheme, whether they were very or somewhat likely to implement them in the next 12–24 months, or unlikely to implement them.

A pension increase exchange (PIE) exercise involves members exchanging a lower level of pension — but which has inflation-linked increases — for a higher level of pension that will not increase in the future. An enhanced transfer value (ETV) exercise involves sponsors offering enhancements to a member's standard cash equivalent transfer value to encourage them to transfer their benefits out of the scheme (usually to a defined contribution arrangement). A flexible retirement option is where a member transfers out of the scheme on retirement and then has the option to apply the transfer value to secure an annuity, or to take income drawdown or cash, or to keep the defined contribution pot untouched for inheritance tax purposes.

Liability management

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



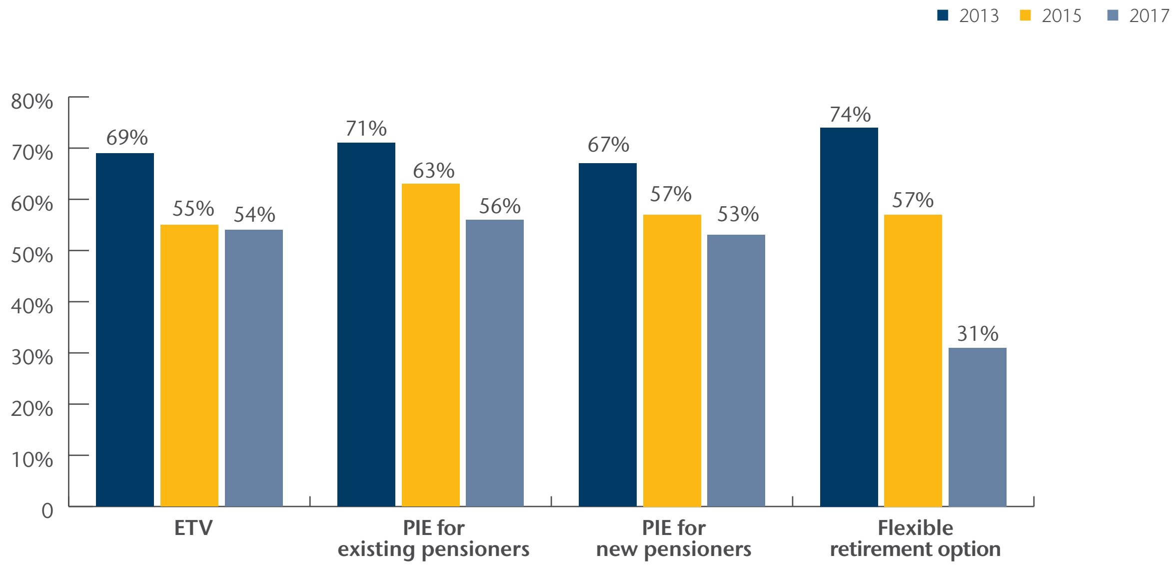
Following the changes introduced in the 2014 Budget, all of these options have increased in popularity. While some trustees were originally reluctant to implement options that were proposed by the company, these concerns are being overcome following a successful track record of implementation and the benefits that it can provide to members who have the opportunity to be properly advised on their many retirement options.

Click here for more depth

Managing benefits and liabilities – in more depth

Changing attitudes to liability management

Percentage of respondents saying unlikely to implement



The increasing acceptance of liability management exercises over time has been dramatic, particularly for the flexible retirement option where now only 31% of schemes say that they are unlikely to implement such an option in the next 12–24 months. Indeed, many trustees regard a flexible retirement option as good governance, making sure members are aware of the full range of options available to them, with any funding improvement or risk reduction an added benefit for the scheme. Steady, although smaller, reductions are also seen for the other liability management options.

Members with benefits worth over £30,000 are only able to take a transfer value if they have received independent financial advice about the transfer. This can typically cost £2,000–£3,000 on an individual basis, but schemes that appoint an IFA can obtain significantly better value by 'bulk buying'. Making access to an IFA more readily available also helps members make better decisions and it is schemes that have done this that have seen the greatest increases in take up of transfer values at retirement. We look in more detail at the help and guidance schemes are providing to members nearing retirement in the Hot topics section.

Investment strategy considerations

Page 1 of 2

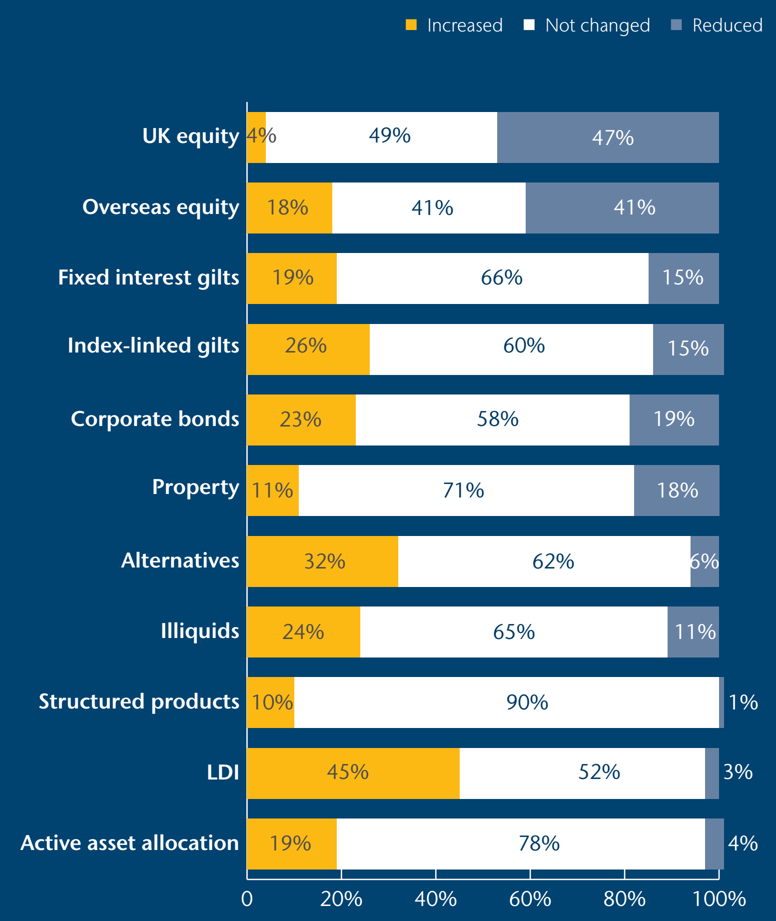
With the maturity of DB schemes ever increasing, the focus on investment strategy intensifies. Against this backdrop, the '4Ds' of De-risking, Diversification, Dynamism and Delegation take centre stage. In this section of the survey, we investigate the extent to which schemes have acted in these areas in the recent past, and also ask what their future plans are.

Our opening questions were aimed at understanding the changes schemes had made to their asset allocations over the past year.

Continuing the trend we have seen in previous surveys, respondents have generally been reducing their exposure to equity markets and moving towards strategies consisting of a diverse portfolio of return-seeking assets combined with a liability matching portfolio. This can be seen by the net increase in LDI investments of 42% (percentage increased less percentage reduced) along with a net increase in alternatives (26%) and illiquids (13%). Reductions in equity allocations and increasing allocations to bonds and LDI investments are also an indication that respondents have been continuing to de-risk over the period.

Investment changes

What changes have you made in the last 12 months to your target investment strategy?



Click here for more depth

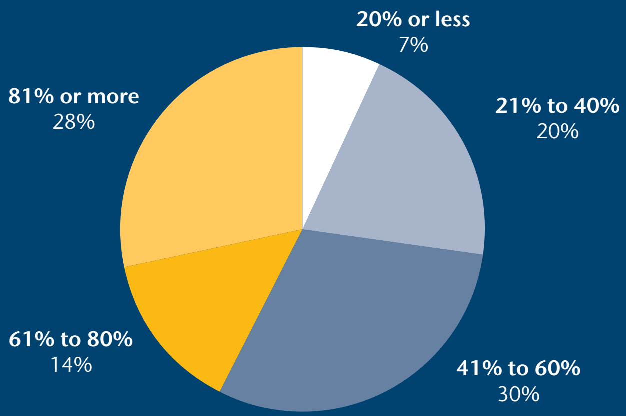
Investment strategy considerations

As we have noted in the Hot topics section, a crucial factor in how pension schemes' funding levels progressed in the last two years has been the degree of hedging (particularly of interest rates) that they had. We were therefore keen to understand the range of hedge ratios (as a percentage of the value of the liabilities) among our respondents. What the chart shows is a relatively even split, with the two largest groups, each representing almost one-third of respondents, being the 41% to 60% group and the 81% or more group.

We have long favoured relatively high hedge ratios, so of more concern are the groups representing over a quarter of respondents who have hedge ratios of 40% or less — in other words, a risk exposure of 60% or more of the value of the liabilities. Our concern here is that if yields do not rise from current levels as far or as fast as the market predicts, scheme funding could be impaired. We look in more detail at the impact that low yields have had on schemes in the Hot topics section.

Interest rate hedging ratios

What is your ratio as a percentage of the value of the liabilities?

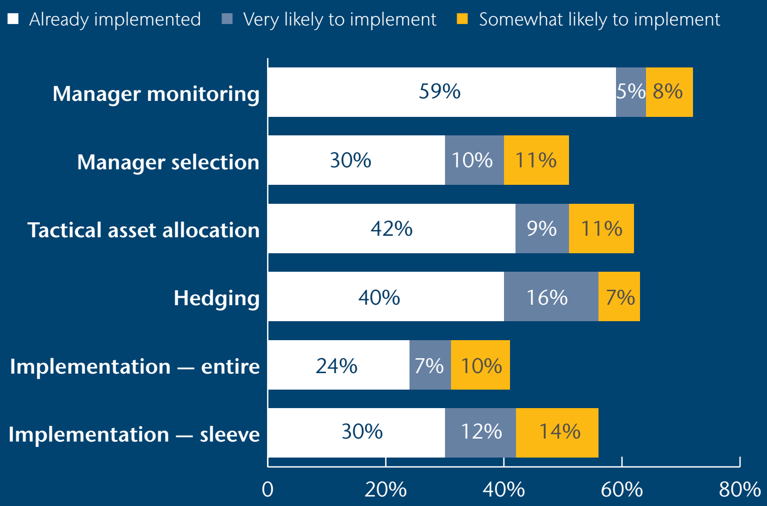


Once the investment strategy has been set, there is the question of how it is implemented. We asked respondents about their attitude to delegating implementation to a third party across a wide spectrum of investment activities. Not surprisingly, the monitoring of managers is already quite heavily delegated (59%) and remains the most popular area of delegation.

However, even the least popular area — delegation of the entire investment strategy — has already been carried out by almost a quarter of respondents, with a further 17% very likely or somewhat likely to follow suit. In the detailed survey results section we look at the change in responses across all these areas since 2013, but the percentage delegating the entire investment strategy has seen perhaps the most remarkable step up over the last two years, from 14% to 24%. Delegation is firmly a part of the pensions lexicon.

Delegation

What is your attitude to having your professional advisers implement aspects of your investment strategy?

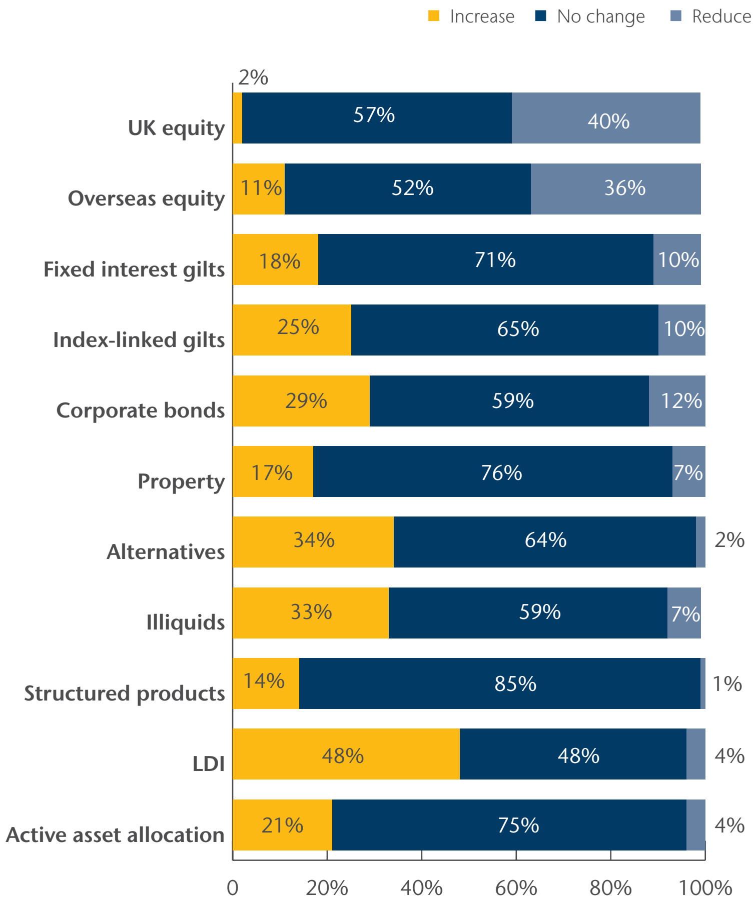


Click here for more depth

Investment strategy considerations – in more depth

Further changes to investment strategy

What changes do you expect to make in the next 12 months to your target investment strategy?



We saw in the high level results that the main trend over the previous year has been for schemes to diversify their portfolios away from equities and to increase allocations to LDI. We asked the same question, but this time in relation to expected change in asset allocation over the next 12 months. The results are shown in the chart and at first glance are almost a carbon copy of the backward-looking results, showing a strong continuation of the diversifying and de-risking trends.

One notable difference is an apparent switch in the attitude to property investment. The figures for the last year saw a net reduction in holding property of 7%, but looking to the next 12 months, this switches to a net increase of 10%. Property is generally considered to have a place in a diversified return-seeking portfolio, so the intention to increase allocations in the future is in line with the diversification trend. In addition, in the aftermath of the Brexit decision, the short-term outlook for UK property worsened and so new investments may have been delayed.

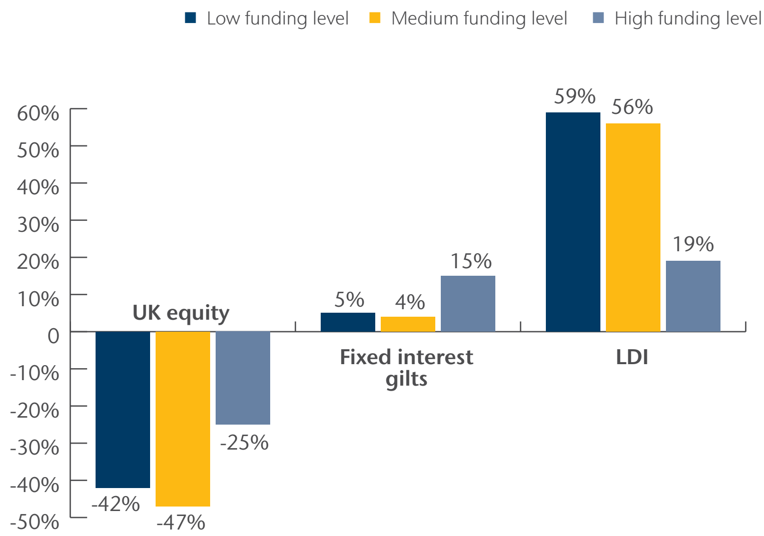
The results also show a continuing appetite to increase the use of active asset allocations and structured products in portfolios. This implies that trustees are continuing to look for return in risk-controlled ways, and are not shying away from the increased complexity and governance burden.

Investment strategy considerations – in more depth

Net expected investment by funding level

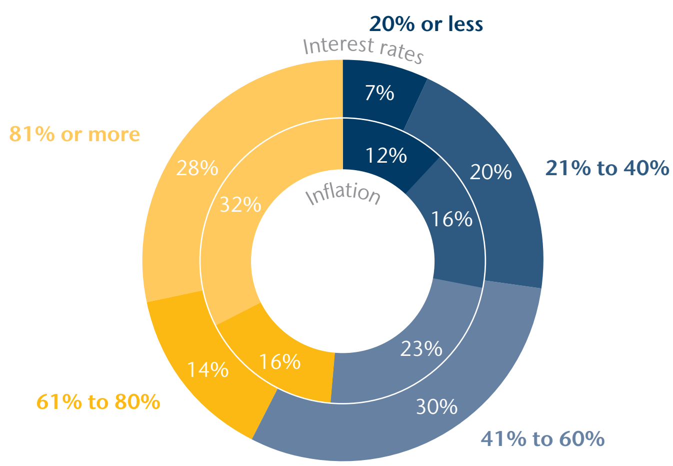
Those expected to increase their investment less those expecting to reduce investment

We analyse the results for future changes according to the funding level of the respondents in the chart to the right. This shows a very clear trend of schemes with lower funding levels being more likely to de-risk out of UK equities and into LDI than their better-funded peers. This is likely, in part, to be due to better-funded schemes already having lower-risk strategies in place, and those with lower funding levels anticipating de-risking as the funding level improves. It may also be a reaction to the experience of the last few years, where having a low hedging level has tended to be detrimental to the funding level; schemes have no wish to repeat that experience.



Hedging risks

Interest rate and inflation hedging ratios

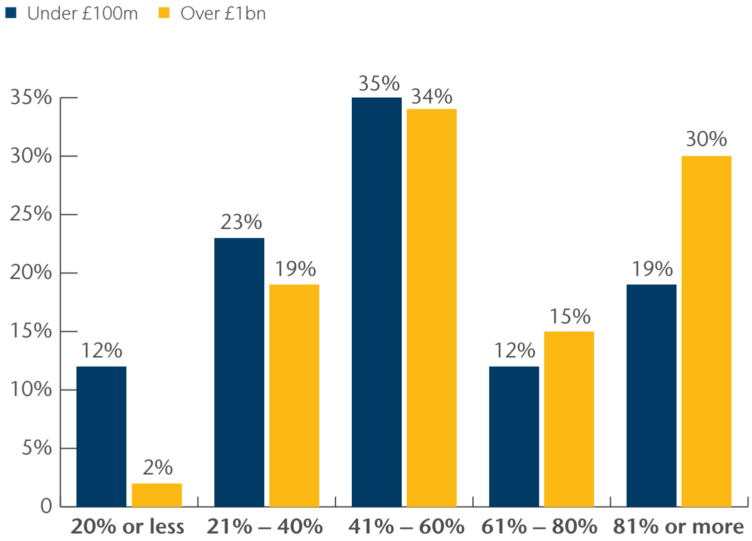


Two of the most significant investment risks are the exposures to interest rate movements and to price inflation. This chart shows that, in general terms, schemes are hedging these risks in similar ratios, and relatively evenly spread between the 20% bands.

Return to summary

Investment strategy considerations – in more depth

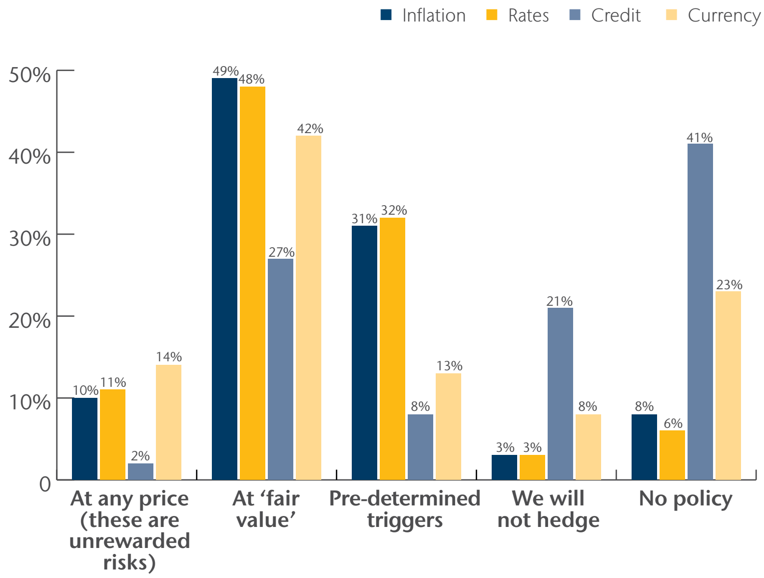
Interest rate hedging by size



We found in the survey results that there is a clear size bias in the degree of interest rate hedging. This is shown in the chart to the left, with the larger schemes verging on being 50% more likely to have a hedging ratio in excess of 80% than their smaller peers. This is a concerning trend because the risk of adverse interest rate movements affects all schemes, independent of their size. The growth in recent years of pooled LDI funds (in particular, those which do not require the creation of a bespoke liability benchmark) means that LDI is now available to schemes of all sizes. There is no longer a barrier to smaller schemes wishing to increase their hedging ratio.

Hedging policy

We asked in the survey about the general policy on hedging four different types of investment risk. What is interesting is the different approaches taken between the various risks. Generally, interest rate risk and inflation risk were viewed similarly and the most common approaches were to hedge these risks either at ‘fair value’ (49%) or when pre-determined triggers were hit (32%). In contrast, the most common response to credit risk was that there is no hedging policy (37%). A policy of deliberately not hedging this risk was also prevalent (19%). This difference in philosophy may arise because credit risk is generally judged to be a risk that is rewarded and is therefore worth retaining.

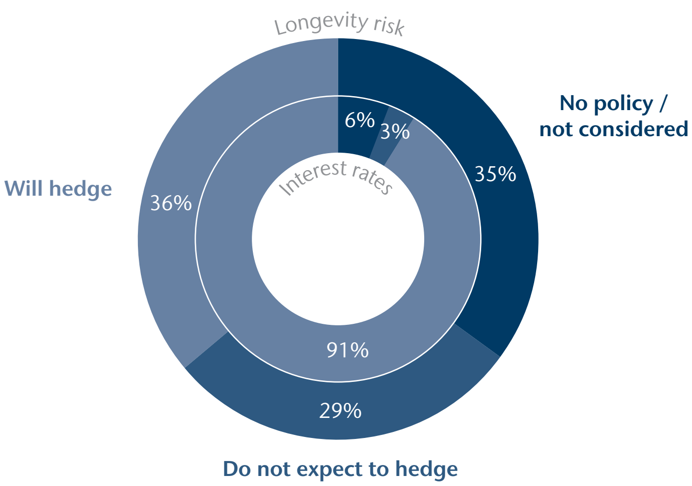


Investment strategy considerations — in more depth

Finally, there is currency exposure. The potential impact of currency movements on asset values was highlighted in June last year with the EU referendum result triggering a rapid decline in the value of sterling. Schemes that had not hedged their currency risk saw the sterling value of their overseas assets perform much better than those that had. What is interesting is the swing in the results from our 2015 survey; we have seen a reduction of 12% in the number reporting no policy on currency hedging and an increase of 18% in the number reporting hedging at fair value. We interpret this as a sign that many schemes have actively reviewed their policy following their experiences last summer and in light of recent weakness of sterling.

Hedging policies on interest rates versus longevity

The final risk we surveyed for views on hedging was longevity risk. This chart shows the results compared to the equivalent results for interest rate hedging and demonstrates very clearly how differently schemes think about these two risks. Whereas over 90% of schemes plan to hedge interest rate risk at some point, only just over a third currently plan to hedge longevity risk — and a further third either have no policy or have not considered their policy to longevity risk. We find this surprising because — until recently — the experience for two decades or more has been of the actual trend in longevity outstripping typical assumptions.



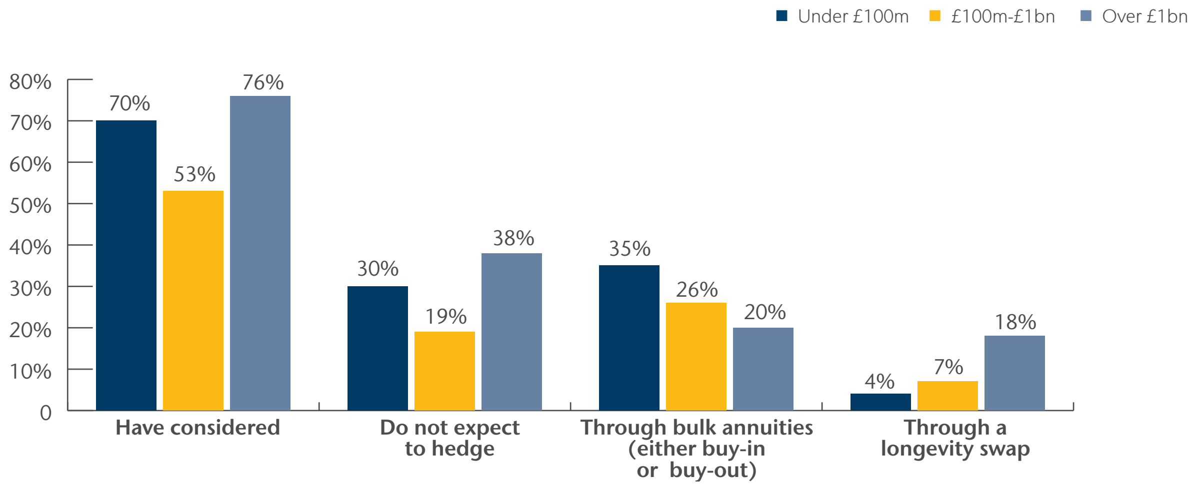
We interpret this as a sign that schemes recognise that longevity risk tends to be of a longer-term nature than typical investment risks and so consider there is less immediate need to hedge the risk. In contrast, fingers have been more seriously burnt in recent years with the dramatic fall in interest rates, causing many to take more immediate action in hedging that financial risk. This interpretation is backed up by the fact that poorer-funded schemes are more likely (44% compared to 32% for better-funded schemes) not to have considered longevity risk. This is understandable if those schemes have been focusing more on controlling shorter-term risks and finding better or additional sources of return.

Overall, although an increasing proportion of schemes are taking action now by purchasing bulk annuities or combining LDI and longevity swaps to hedge both financial and demographic risk, we remain concerned that some schemes will ultimately be blind-sided by longevity risk.

Investment strategy considerations – in more depth

Longevity hedging

How do you plan to manage your scheme's longevity risk in the future?



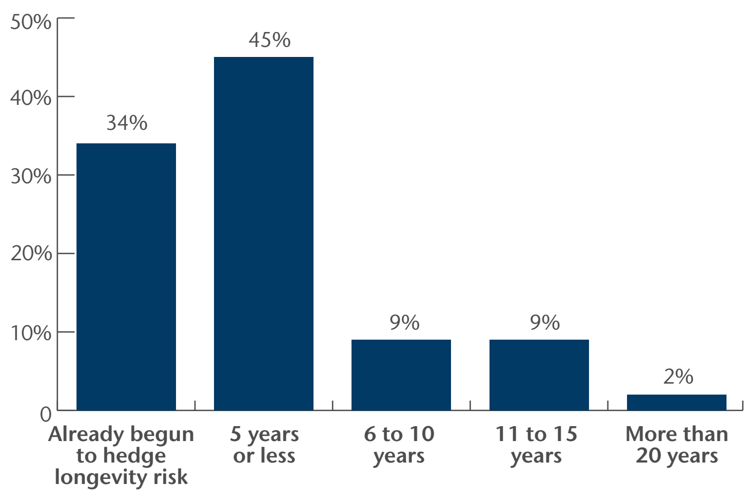
The attitude to longevity risk has an interesting connection to scheme size, as shown in the above chart. Interestingly, on the left side of the chart, we see that smaller and larger schemes are both more likely to have considered hedging longevity risk and reached a definite conclusion on it than their mid-sized counterparts. This suggests that mid-sized schemes most need to consider this risk. Having said this, a significant proportion of all schemes are yet to consider longevity risk. We expect these schemes may also not be clear on the overall 'endgame' strategy they wish to target over the long-term.

Turning to the right side of the chart, we see that where schemes have decided to act on longevity risk, there is a clear polarisation of actions. Smaller schemes are the most likely to buy annuities and larger schemes are the most likely to enter into longevity swaps. This is understandable given past constraints on bulk annuity capacity and on minimum longevity swap sizes, but this is rapidly changing, with both options now available to schemes of essentially any size. It will be interesting to see whether this trend declines in our next survey.

Longevity hedging timescales

For those expecting to hedge, what is the timescale for doing so?

We asked schemes planning to hedge longevity risk to indicate their timescale for action. The results are very clear; when hedging longevity risk is on the agenda, schemes intend to act swiftly, with almost 80% of respondents planning action within five years and 34% of these having already acted. This reflects the continued trend for partial buy-ins and longevity hedging.

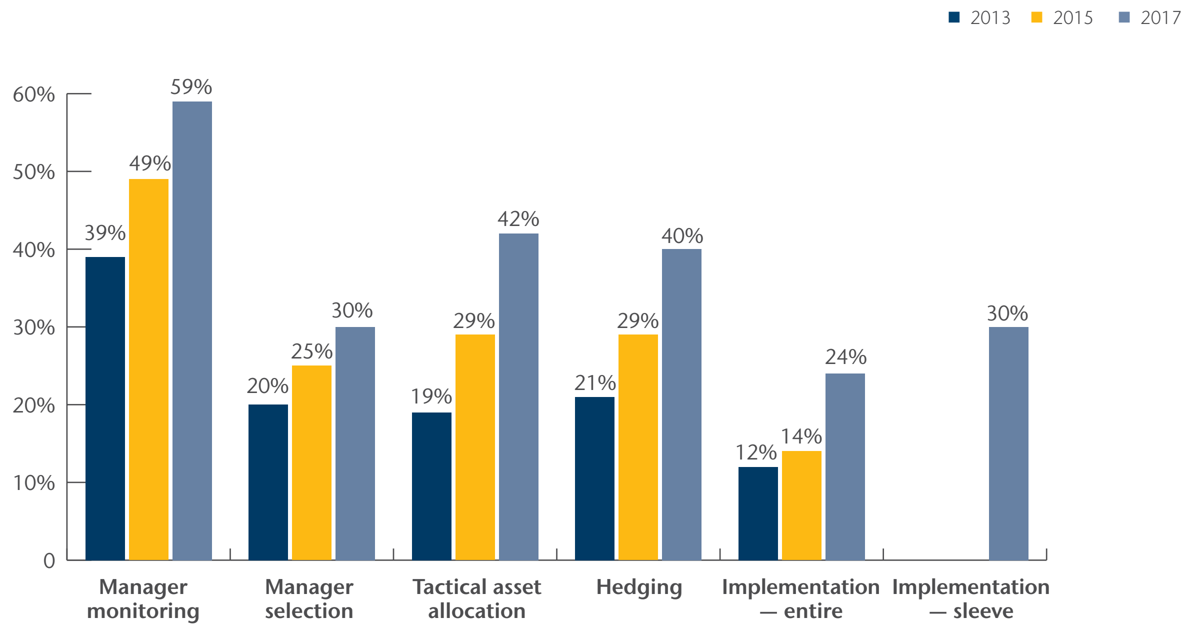


Investment strategy considerations – in more depth

Delegation

Change in attitude to delegation

Percentage of schemes reporting they had already delegated certain investment functions



Note: the extent of delegating an investment sleeve was not assessed in the 2013 and 2015 surveys

We saw in the main survey results that many schemes are delegating each aspect of the investment strategy to third parties, but the full scale of the trend to increasing delegation is only apparent when we compare the 2017 results with our two previous surveys. The chart above shows that every aspect of the investment strategy has shown consistent growth in delegation over the last four years and, if anything, the trend has accelerated in the last two years. Particularly notable is the increase in the delegation of the entire investment strategy (+10%).

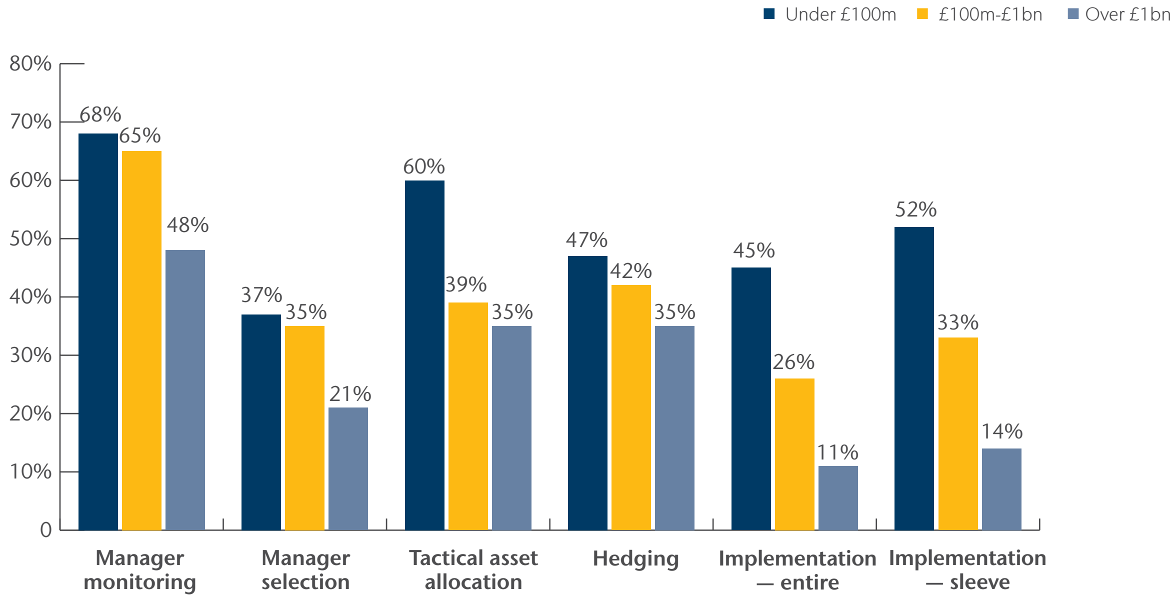
We believe this rise is likely to be due to providers becoming increasingly established in the marketplace and being able to provide track records over relatively long periods.

This year, for the first time, we asked respondents whether they delegated the investment of a sleeve (eg, a single asset class) as opposed to the entire strategy. Nearly a third of respondents indicated that they did so, demonstrating that this approach to implementation is most definitely a mainstream activity.

Return to summary

Investment strategy considerations – in more depth

Delegation by size



Does the size of scheme link to the degree of delegation? Most definitely, as shown in this chart: smaller schemes are more likely to delegate investment implementation across every single activity area. This is not particularly surprising because investment delegation is one way in which smaller schemes can take advantage of things such as access to the best managers and lower fees, things that their larger counterparts can achieve directly. Perhaps more surprising is the result for delegation of an investment sleeve. Anecdotally, we have evidence that larger schemes prefer to delegate implementation using this approach; for example, by delegating the investment in hedge funds but retaining the implementation in-house for other asset classes. However, this survey shows that for large schemes, even though delegation via a sleeve is more popular than delegation of the entire strategy, smaller schemes are still using this option more extensively.

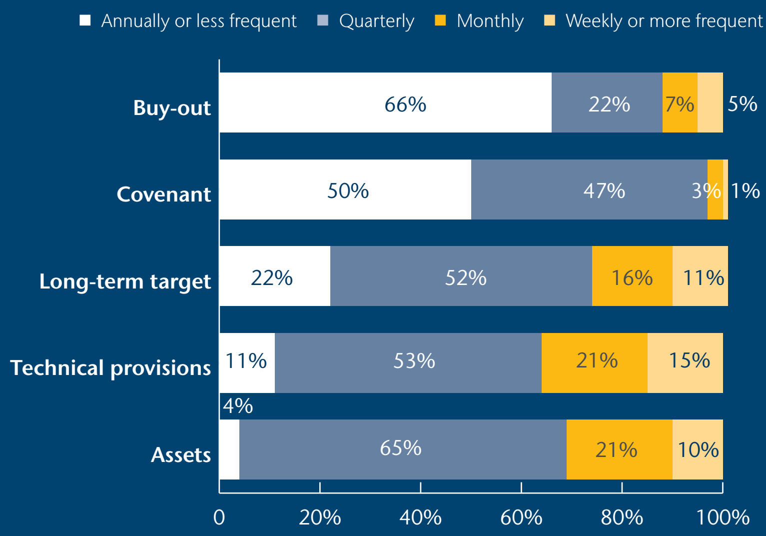
Monitoring and mitigating pension risk

As the value of DB schemes' assets and liabilities continues to grow, the monitoring and management of risks becomes increasingly important. This is reflected in the Pensions Regulator (tPR) placing greater emphasis on its Integrated Risk Management (IRM) concept. In the survey, we asked both about the frequency of monitoring pension risks and the degree of implementation of IRM plans.

The broad spread of responses on monitoring continues from the 2015 survey; asset and liability values continue to be monitored relatively frequently, with over a quarter of schemes assessing the position on a monthly or more frequent basis. However, the strength of the employer's covenant and of the buy-out position are generally assessed annually or less frequently.

Frequency of monitoring

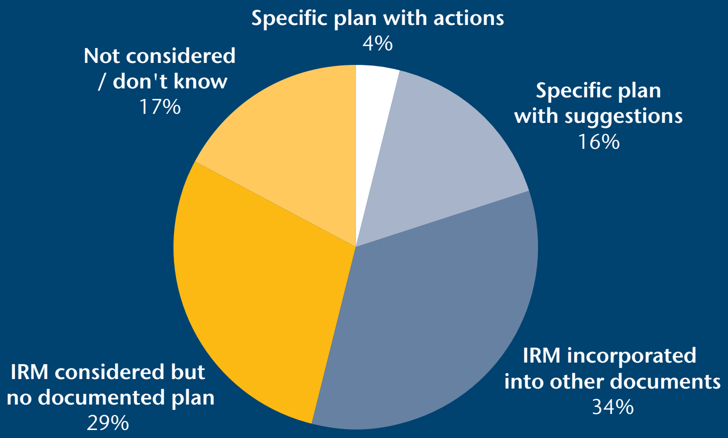
How often do you review the various components of your pension risk?



What is more surprising is that since 2015, the monitoring of the liabilities has tended to become more frequent (36% versus 29% monthly or more frequently) whereas the monitoring of the assets has tended to become less frequent (31% versus 42%). We would expect these two numbers to converge as trustees place emphasis on funding level progression above absolute asset performance. This is particularly important for the increasing number of schemes using LDI investments. Also, the increasing accessibility of 'live' liability value updates (contrasting with the range of diversifying growth assets which only offer monthly valuations) may explain why some schemes are monitoring liabilities more regularly than assets.

Approach to Integrated Risk Management

How would you describe your plans in relation to IRM?



IRM was launched by the Pensions Regulator in late 2015. We asked about the degree of schemes' implementation of the guidelines. As can be seen, there is a wide range of responses. However, only 4% of schemes have fully implemented tPR's vision of a plan with actions, with 79% of schemes either having suggested actions; covering IRM in other documentation; or having considered IRM but not documented it. Perhaps of most concern to tPR will be the 17% of schemes that either have not considered IRM or who did not know their state of implementation.

Click here for more depth

Monitoring and mitigating pension risk – in more depth

Page 1 of 2

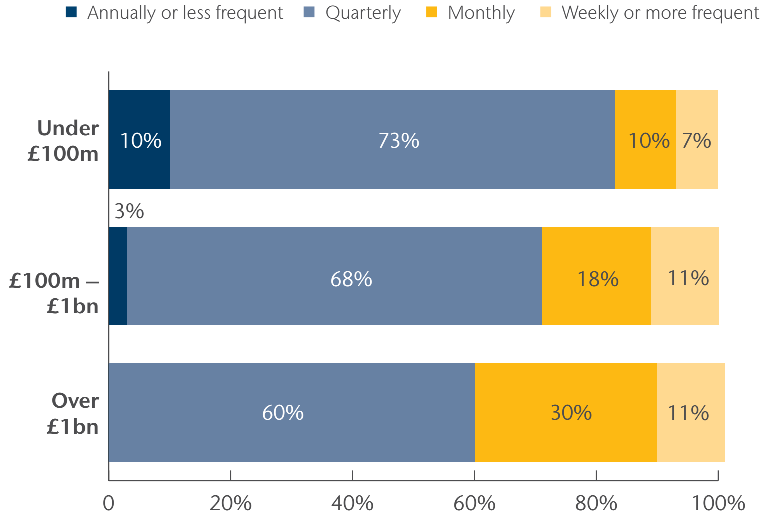
Frequency of monitoring

We analysed the monitoring of pension risks by scheme size and a clear trend is visible. The larger pension schemes tend to monitor asset values more frequently than their smaller counterparts. For example, 10% of smaller schemes monitored asset values annually or less frequently, whereas all respondents representing larger schemes monitored more frequently than this.

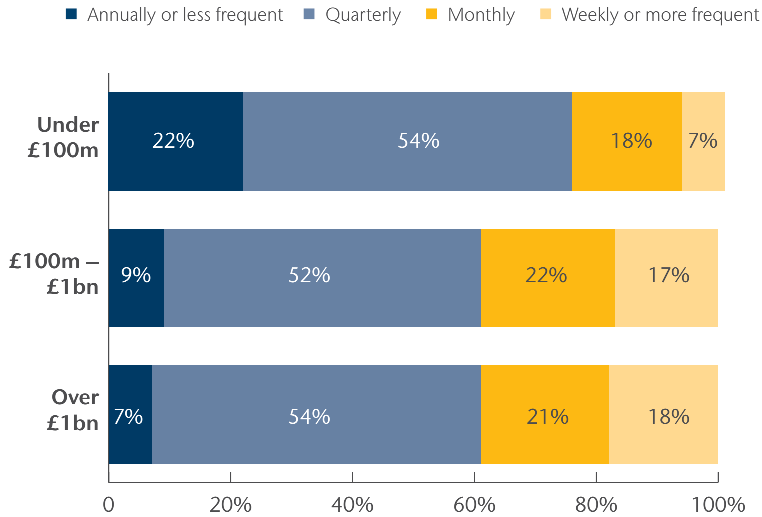
The picture is similar with the monitoring of liability values, with an even more distinct difference between large/medium schemes on the one hand and smaller schemes on the other.

Each of these three sizes of schemes follows the overall trend we detected for an increased frequency of monitoring liabilities and reduced frequency of monitoring assets over the last two years.

Frequency of monitoring assets by scheme size



Frequency of monitoring liabilities by scheme size

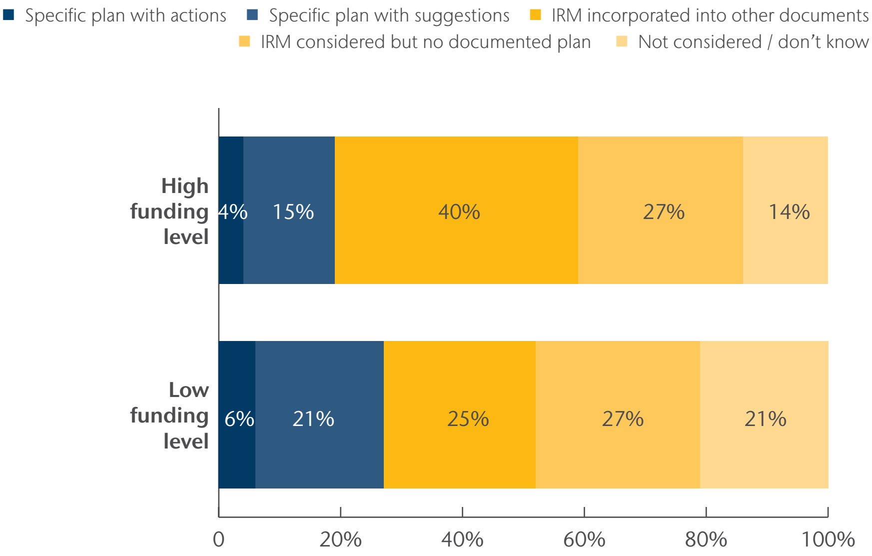


Return to summary

Monitoring and mitigating pension risk – in more depth

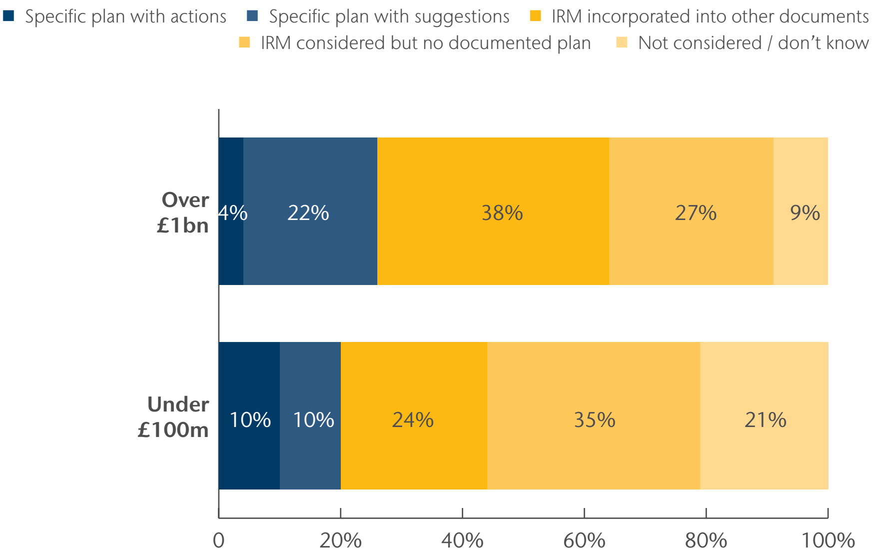
Integrated risk management

Approach to Integrated Risk Management Plans by funding level



In the headline results, we saw that there was quite a range of degrees of adoption of tPR's IRM guidelines. But we were interested to see whether there was any connection between degree of implementation and funding level. This chart shows that there may be a connection: less well-funded schemes are more likely not to have considered IRM (or do not know the current status) than their better-funded counterparts. Having said that, better-funded schemes are more likely to be relying on existing scheme documents rather than having a separate IRM plan.

Approach to Integrated Risk Management Plans by size



We also looked at the same question broken down by scheme size. The tempting headline is that there is quite a noticeable trend, with large schemes more likely to have gone further with IRM. But the real picture is more nuanced; smaller schemes are more likely to have implemented a specific IRM plan with actions (tPR's ambition) than their larger counterparts.

Hot topics

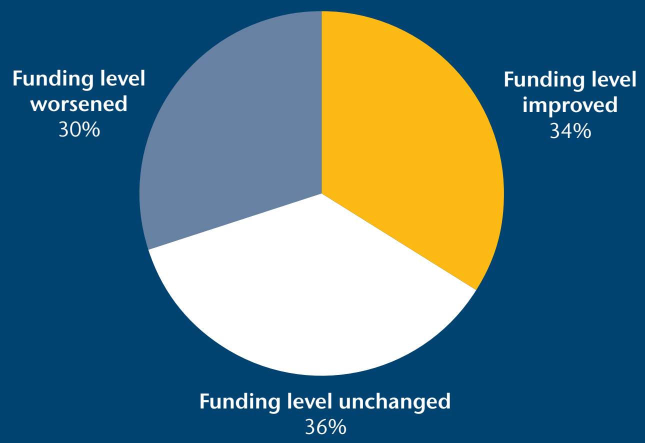
Page 1 of 3

The past few years for DB pension schemes have been dominated by the persistent low levels of gilt yields compared to the more distant past. This has had profound implications for funding levels. We asked respondents what the effect has been for them and what the likely response will be.

The other zeitgeist is DB schemes' reaction to the 2014 pension freedoms. We were keen to understand how the flexibilities now available within defined contribution (DC) pension schemes had changed the approach to DB member options, particularly at retirement.

Response to low yields

What has happened to your funding level?



We asked whether the recent experience of falling gilt yields — most singularly observed at the time of the EU referendum result in June 2016 — had impacted on pension scheme funding levels. The answer was a definite 'maybe'! As the chart shows, responses were split almost exactly into thirds of those who saw their funding level improve, stay the same, or worsen. This matches our analysis soon after the referendum result.

Far from implying some kind of random outcome, what lies beneath these results is that the degree of hedging of investment risks was fundamental to determining how the funding level reacted to falling interest rates: those with high hedging levels saw a relatively benign reaction; those with low hedging levels the exact opposite.

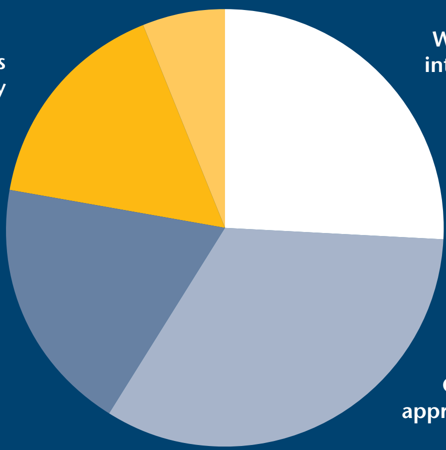
Click here for more depth

Hot topics

Page 2 of 3

Valuation methods

Are gilt yields still appropriate for discounting liability values?



The most common way of valuing pension scheme liabilities is via a discount rate based on the yield on gilt assets, on the basis that pension scheme liabilities are generally somewhat akin to a special kind of bond whose term depends on the lifespan of the individual. But with gilt yields moving to lower levels, does this approach remain valid?

Respondents were split on this. About a quarter were relatively unconcerned with the question because they had hedged out their sensitivity to gilt yields. A third were comfortable with the approach, despite the pain it is causing.

Although 6% of respondents already use an alternative methodology, of more concern is that 19% of respondents felt an alternative methodology had potential, but did not know what the alternatives were — thereby throwing down the gauntlet to scheme actuaries. And 16% were hopeful that gilt yields would revert to higher levels in the near future. This does put us in mind of J M Keynes: 'The market can remain irrational longer than you can remain solvent'.

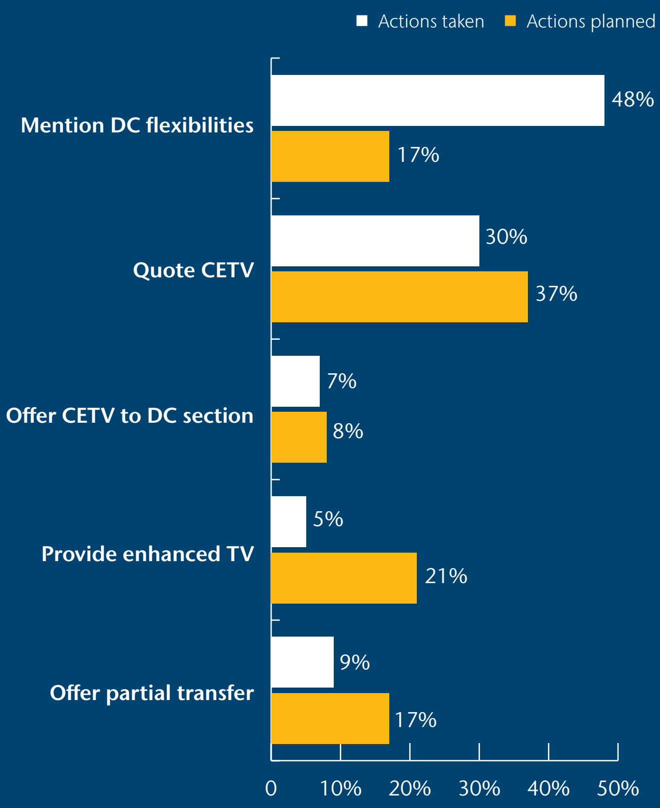
Click here for more depth

Hot topics

Page 3 of 3

Member support at retirement

In connection to a transfer to DC, what support do you offer?



Our other hot topic area for the UK related to DB schemes' reaction to the additional flexibilities on retirement from DC schemes. We were keen to understand whether and to what extent DB schemes were facilitating transfers at retirement, and the extent of guidance to members on their options.

This chart demonstrates that schemes have already made considerable changes in this area and expect more to come. Where schemes have acted on member support, nearly one half of the actions involved mentioning a transfer out option at retirement, and 30% involved quoting the transfer value The trend flips when we look at planned actions, however, meaning that schemes are moving from simply informing members of their options to including the member's own figures. Our anecdotal evidence is that the main factors now holding back schemes from quoting a figure are actually practical ones such as amending administration systems to accommodate it.

Some schemes are planning to go further with approximately one in five of the actions planned being either to offer enhanced transfer terms at retirement, or to offer a partial transfer option. This latter option might be particularly attractive to members, as they can retain a core DB benefit but supplement it with DC benefits that they can draw flexibly.

Click here for more depth

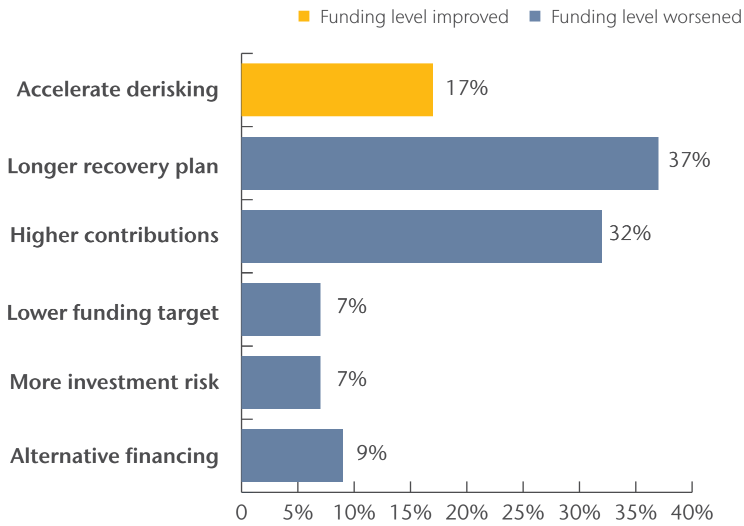
Hot topics – in more depth

Response to low yields

Response to low yields

If your funding level has changed, what action do you expect to take?

We saw in the main body of the results that the impact on funding levels across DB schemes had been very mixed, with broadly equal proportions seeing an improvement (34%), no change (36%), or a worsening of the funding level (30%) as a result of low gilt yields. Against this backdrop, we were keen to understand what actions were being taken by schemes that had experienced a funding level movement. This is summarised in the chart to the right.



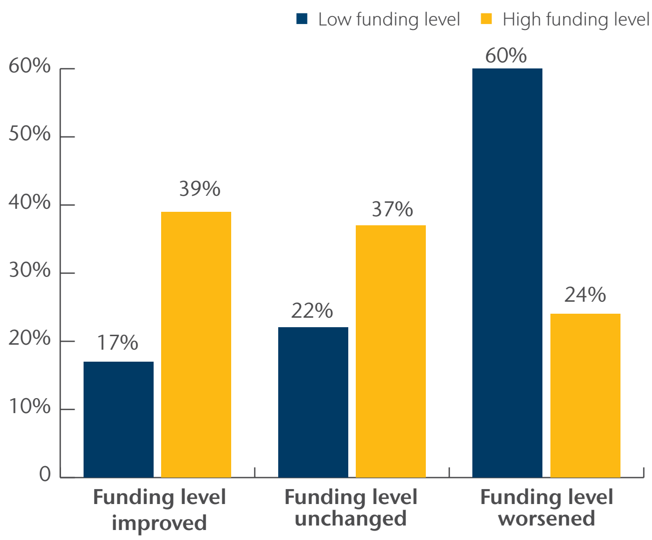
Note: More than one option could be selected so the rates will not total 100%

Approximately half of those schemes that had experienced an improvement in funding level were intending to 'spend' it by accelerating their de-risking plans. The remaining half expected to reach their target funding level sooner.

Among schemes that had seen a worsening of their funding level, by far the most common expected outcomes from the next actuarial valuation were higher contributions (32%), a longer recovery plan (37%) or potentially both. But broadly equal proportions (7% to 9%) were expecting alternative financing, adding investment risk (and so return) and/or a lower funding target as outcomes.

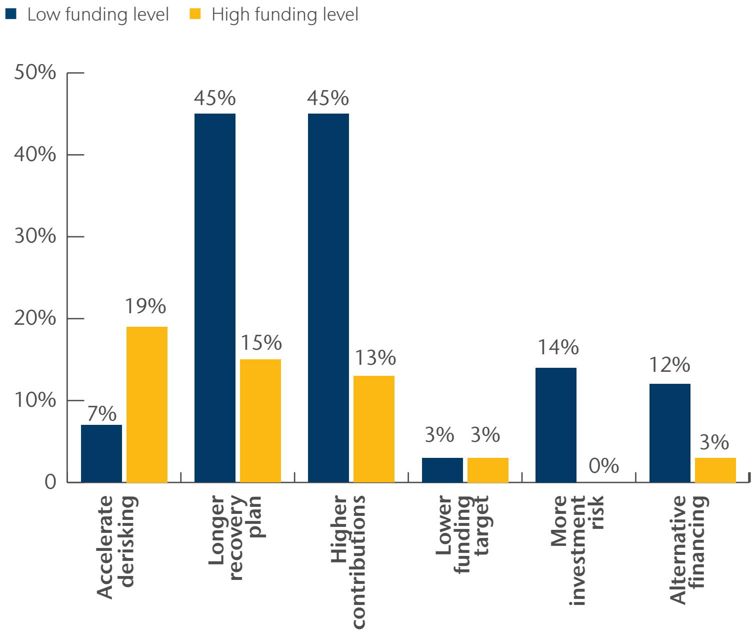
Response to low yields by funding level

There was a very interesting trend in the responses when we analysed the results by the funding level of each scheme. The chart to the right clearly shows that the well-funded schemes have tended to become even better-funded while the worse-funded have become even worse as a result of the fall in yields. This may be a sign that less well-funded schemes have been reluctant to invest in protection measures such as hedging in case it impairs their potential asset return. Having said this, as we show in the analysis of asset allocation changes in the investment strategy section, it would appear that worse-funded schemes are changing their opinions and are more likely to increase their hedging levels in future than better-funded schemes.



Hot topics – in more depth

Response to low yields — action by funding level



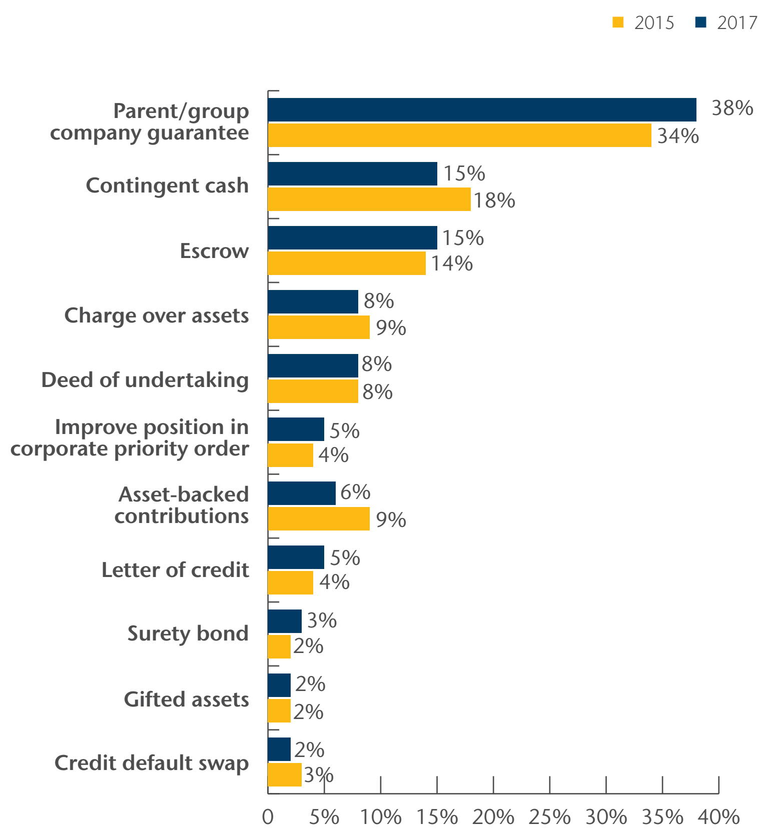
The results schemes expect from their actions also show a stark divide between better- and worse-funded schemes. Very clearly, less well-funded schemes are much more likely to be expecting contribution rises (45%) and/or longer recovery plans (45%). It is also clear that less well-funded schemes are more likely to make use of a wider range of solutions. No better-funded schemes were intending to take more investment risk, whereas less well-funded ones were (a result that might attract regulatory scrutiny). But another finding in the results is that better-funded schemes are proportionately more likely than less well-funded schemes to lower the funding target itself.

Alternative financing

Which of the following measures do you use or plan to use?

A growing reaction to the size of DB deficits is the use of so-called alternative financing; in other words, other forms of support for the pension scheme than cash contributions. We asked what types of alternative financing schemes planned to use and the chart compares the findings to our previous survey in 2015.

The results show steady growth in most alternative financing options as trustees and sponsors become increasing comfortable to use them to support scheme funding agreements



Return to summary

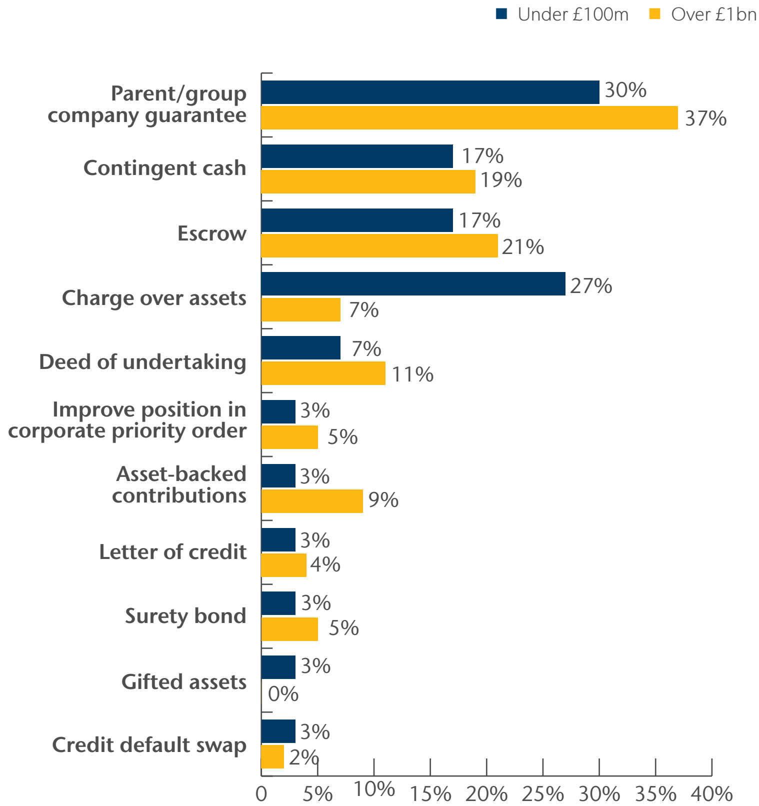
Hot topics – in more depth

Alternative financing by scheme size

We also analysed the responses by scheme size. Again, there are some clear trends. Smaller schemes are more likely to be using charges over assets (27%) or gifted assets (3%) compared to their larger counterparts (7% and 0% respectively). Conversely, larger schemes are more likely to have implemented or be planning to implement asset backed contributions, an escrow or a surety bond than their smaller counterparts.

At least some of these differences are down to accessibility. Some of these solutions have been the preserve of larger pension schemes, but even this has changed in recent times. For example, surety bonds can now be purchased to cover risks from £2m to £1bn in size. A second factor will be the cost of implementation — a charge over assets might have a lower relative implementation cost than an escrow-type arrangement and so be more appealing to smaller pension schemes. However, it is clear that the full range of alternative financing options is available to schemes of all sizes and, what is more, each option is now definitely a mainstream part of managing DB pension schemes.

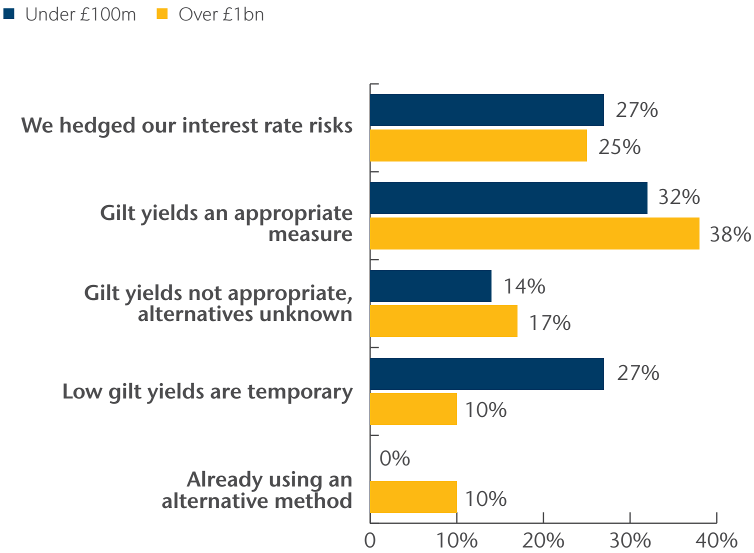
Which of the following measures do you use or plan to use?



Return to summary

Hot topics – in more depth

Valuation methods by scheme size



The responses to the question about valuation methods in a low-yield environment show several differences between schemes of different sizes. Smaller schemes are generally not using valuation methods that are unconnected to gilt yields, such as basing the discount rate on the best estimate return less a margin for prudence. In part, this will be because some of the alternative methods (such as stochastic valuations) are relatively more costly to carry out, but this is not universally true. Perhaps there is an opportunity here for smaller schemes to consider alternative methods that might better fit their circumstances.

Conversely, smaller schemes were much more likely to be expecting gilt yields to rise in the relatively near future which, presumably, would serve to improve the funding level. The risk here is that the scheme actuary will already have anticipated the rise in gilt yields represented by the market's yield curve and so the expectation is that yields will rise further and/or faster than the market predicts. If this does not manifest, these schemes could be exposed.

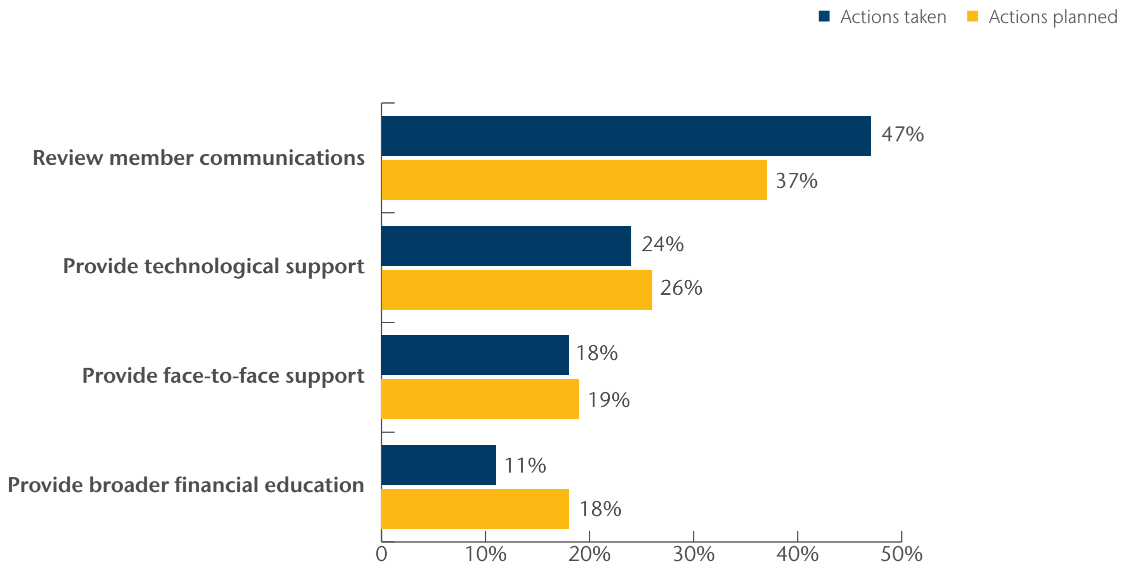
Hot topics – in more depth

Page 5 of 6

Member support at retirement

Member support at retirement

In connection to the retirement process, what support do you offer?



We saw in the main results that DB schemes are increasingly providing their members with details of their transfer options at retirement. We went on to ask what member support schemes were already providing and were intending to provide. Again, the results show a lot of action has already taken place and more is yet to come.

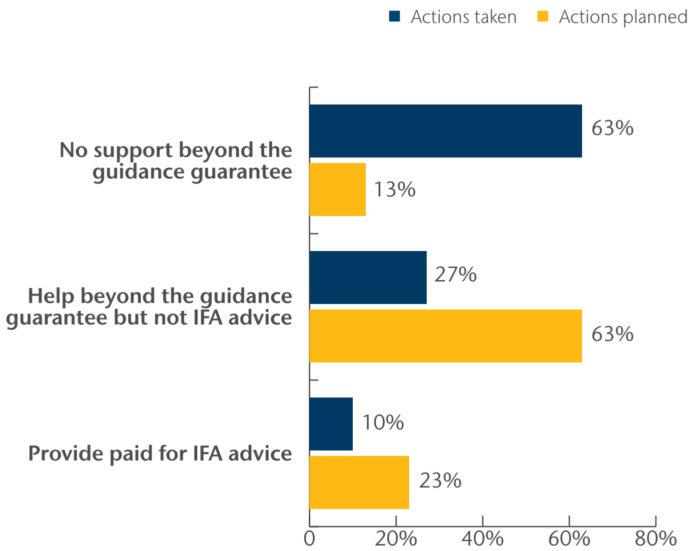
Not surprisingly, communication has been the main focus so far and it also remains the most popular area for future action. But the action goes beyond this. When action has been taken, almost one in four actions have been to provide a technology solution (‘robo advice’); one in six to provide face-to-face support and one in nine broader financial education. DB schemes are clearly working hard to ensure their members are ready not only for pensions decisions but broader savings decisions too.

Hot topics – in more depth

Member support at retirement

Member support at retirement

What guidance / advice do you offer at retirement?



That leads us into our final question, which was about guidance and advice to members at retirement. In the chart to the right, we see that where schemes have taken action almost two-thirds of the activity was to provide support within the guidance guarantee, but nothing further. However, a similar two-thirds of planned actions are to go beyond this in the near future. When it comes to advice from an Independent Financial Adviser, we see that a quarter of the planned actions are to offer this on a paid for or subsidised basis.

Putting our findings together, we find that this is a very active area for DB schemes. Considerable action has already been carried out to make members aware of their transfer options, to communicate with members more effectively, and to provide guidance and advice. But schemes are not stopping there – the expected 'standard' retirement service to members continues to move forward and our respondents have shown that they have significant plans to do just that. The likely outcome will be better informed and supported members, better able to select the most appropriate retirement option, and this in turn will help schemes better manage their pension liabilities.

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