Scheme buyout and wind-up – demand set to rise

Dominic Grimley of Aon looks ahead to a return to pre-COVID-19 levels of bulk annuity transactions as the world begins to return to normality

THE TREND TO BUYOUT

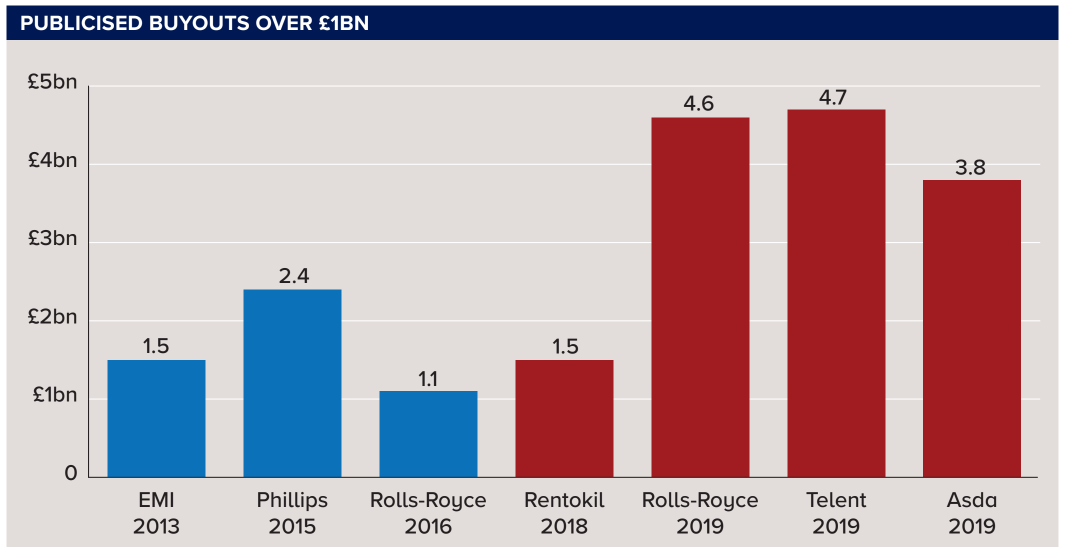
Before COVID-19 disrupted all our lives, a trend had started to emerge in the bulk annuity market.

This was an increased focus on full scheme buyouts, with a series of transactions of record-breaking size in 2019, including buyouts for Asda, Telent and Rolls Royce, with each one over £3bn. It created by far the largest year so far for this market.

To make this possible, the market raised significant capital to increase the volumes of annuities that could be written. Annuity providers increased their investment in longer-term assets, such as mortgages, that helped deliver an acceptable price for even a relatively immature scheme membership.

This growth was also supported by developments in the global reinsurance market, which took on a greater proportion of the risk from annuity providers. This allows an annuity provider to write more business with a given risk and capital budget, and particularly to write more buyouts.

In 2020, and as a result of the global pandemic, the focus changed to pensioner-only transactions. These are easier to initiate in a market where significant cash funding from sponsors may be in limited supply while businesses adjusted to difficult trading conditions.



Note: the deals shown in red were brokered by Aon

BACK TO TREND?

In our experience most schemes have maintained a healthy funding position through the market volatility of 2020-2021. Some locked in recent asset gains, by moving to a lower-risk strategy as their funding improved.

While many companies will understandably have more pressing priorities than buyout when we return to a more normal world, there is growing demand to remove pension risk. Given the c£2trn of liabilities left in UK defined benefit schemes, only a few percent of scheme sponsors need to act in order for buyouts to be driven to record volumes.

Some sponsors have made significant cash contributions to enable buyout, for which Asda is a well published example. Other employers would have taken note, which may in turn prompt more transactions of this nature.

NEW CHALLENGES AND SOLUTIONS

However, recent legislative developments have added challenges to those schemes looking to buyout. For example, new issues arising from legacy inequalities, tax uncertainties and impacts from Brexit. The market has created solutions as new challenges have arisen and it is still possible to plot the route through to wind-up.

A key area of focus must not be lost – the experience of the members themselves.

COMMUNICATION STRATEGY

Usually a scheme member will only become aware that their benefits are backed by an annuity after the transaction is concluded. This is because bulk annuity transactions themselves are carried out under strict confidentiality and trustees are keen not to set expectations with members until the transactions are completed.

There are however several stages of communication in taking members from understanding the transaction, to a smooth handover to the insurer's own administration teams.

Some schemes have developed quite advanced support to members – such as web-based self-service, extra illustrations of benefits to support at-retirement planning, access to independent financial advice, and options to change benefit packages. Members need time to understand how this support will be replaced by the differing governance arrangements under an annuity. Many may decide to investigate their benefits further with the familiar scheme contact points before the hand-over to the insurer.

Equally, annuity providers realise that the handover of scheme operation needs meticulous planning. They have developed substantial teams to manage administration transfers and to monitor the member experience afterwards.

The service needed by members in this handover period is a key resourcing challenge. The scheme administrators must simultaneously resource administration transfer planning, a communication programme and a likely sharp increase in member enquiries. Alongside this, a critical operational task runs – mining the history of the scheme database to finalise each member's entitlement.

To get this right, the communication strategy must consider the scope for using different media for delivering messages (including websites and meetings), the varying needs of different membership groups, and the optimal scheduling of each key communication.

RISKS SETTLED

After annuity purchase, a focus on more residual risk exposures may develop, and reaching a satisfactory conclusion to this is key to wind-up.

Insurers give a permanent commitment to members, to fund their benefits for as long as they are due. However, this is subject to the scheme being able to define each member's entitlement precisely. The long history and complexity of UK pensions means this is not as easy as it sounds, particularly for 'contingent' benefits that only become payable on some future event, such as benefit provision passing to the spouse on the member's death.

Cover for the risks associated with data and benefit uncertainties may be accessible too – although some cover exclusions will apply.

Post wind-up, there is still scope for claims to arise. These may seek recompense for a past action of the scheme trustees. While such claims are rare and may be defensible, this relies on there being somebody left around to provide that defence. The wider insurance market does offer solutions for such risk cover gaps.

The scope for legacy issues to resurface has come into the spotlight again recently, with the 2020 *Lloyds* judgment potentially mandating pay-outs to members who transferred their benefits out of the scheme as long as 30 years ago.

Several layers of protection can be built for the trustees: provisions in the scheme documents and legislation, any lasting protection from the scheme sponsor, and insurance – potentially from several different insurers. Each protection acts differently so understanding the best set of solutions is another key task.

Aon's Buyout and Wind-up Services team have had their busiest period in a decade, particularly from managing the many actions for smoothly decommissioning the schemes involved in this recent wave of large buyouts. This demands a clear plan, a strong focus, committed resource and a close-knit team of trustees and advisers to maintain strong momentum until the scheme is wound up.

THE WAY FORWARD

Front-runners like Asda and Telent created a bigger buyout market pre-lockdown, but most larger schemes have still to reach that goal.

Helpfully, these front-runners have advanced the industry's thinking on how best to plan full scheme decommissioning to a smooth conclusion. We expect many schemes to take advantage of this, as the maturing of the defined benefit market takes substantial steps forward in the coming years.

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