Research Insights: The UK Risk Settlement Market

Endgame Is Near — Are You Ready?

For Professional Clients Only

Contents

Foreword

With the well-documented improvements in funding levels, an increasing number of pension schemes are closer to achieving their endgame and for many schemes that means securing members' benefits with an insurer via bulk annuities. However, being close to buyout — or buy-in — and achieving such a transaction are two very different things. To find out more about the preparation for this journey, Aon recently surveyed over 200 pension professionals to help gain insights on these plans and gauge levels of optimism from UK defined benefit (DB) pension schemes.

We found that while many trustees are actively targeting buyout, a significant proportion are still in the process of identifying the right route to take to achieve it. Different priorities are also appearing as to where schemes focus their preparation and what the key asks are for insurers when approaching the market. It is of utmost importance therefore to ensure a collaborative approach between all of the scheme's stakeholders when agreeing objectives for any transaction.

A key message to readers of this report is that trustees and scheme sponsors should seek to agree their strategy as quickly as possible. This will ensure they have clarity on the route they wish to take, and also help to put their best foot forward when approaching insurers to gain maximum traction and ultimately secure the best deal for their members. Choosing the right risk settlement partner will bring focus to reducing key risks and allow for the most efficient execution of your plan.

We would like to thank all our survey participants for taking the time to complete the survey and sharing your insights with us. We hope the findings offer you practical insights to help you make suitable choices that create more certainty within your own scheme.

Martin Bird

Senior Partner and Head of Risk Settlement

Executive Summary

- Buy-ins are rapidly increasing in popularity with many DB schemes.
- Over half of schemes (54 percent) have aligned their investment strategy with their endgame plans.
- When selecting an insurer, financial strength, price and price certainty pre-execution were most important to schemes, with cyber risk being an increasing consideration.
- Almost half (49 percent) of schemes who offer additional options to their members believe it to be important to retain these options after buy-in.
- The majority (77 percent) of respondents said they have concerns about residual risks, post buy-in. The most critical of these risks were data error.
- Despite surpluses at wind-up being increasingly common, use of surplus remains undecided for most schemes, with only 19 percent having agreed how their surplus will be allocated.

About The Research

This research is based on quantitative survey results from over 200 UK DB pension schemes who identified an insurance transaction as their endgame choice. Respondents represented schemes ranging in size from less than £20 million to over £1 billion assets under management.

Respondents included professional trustees, member-nominated and company nominated trustees, as well as company finance directors and pension scheme managers.

All references to small schemes mean those with assets of less than £150 million; mid-sized schemes have assets between £150 million and £1 billion; large schemes mean those with assets of £1 billion and more.

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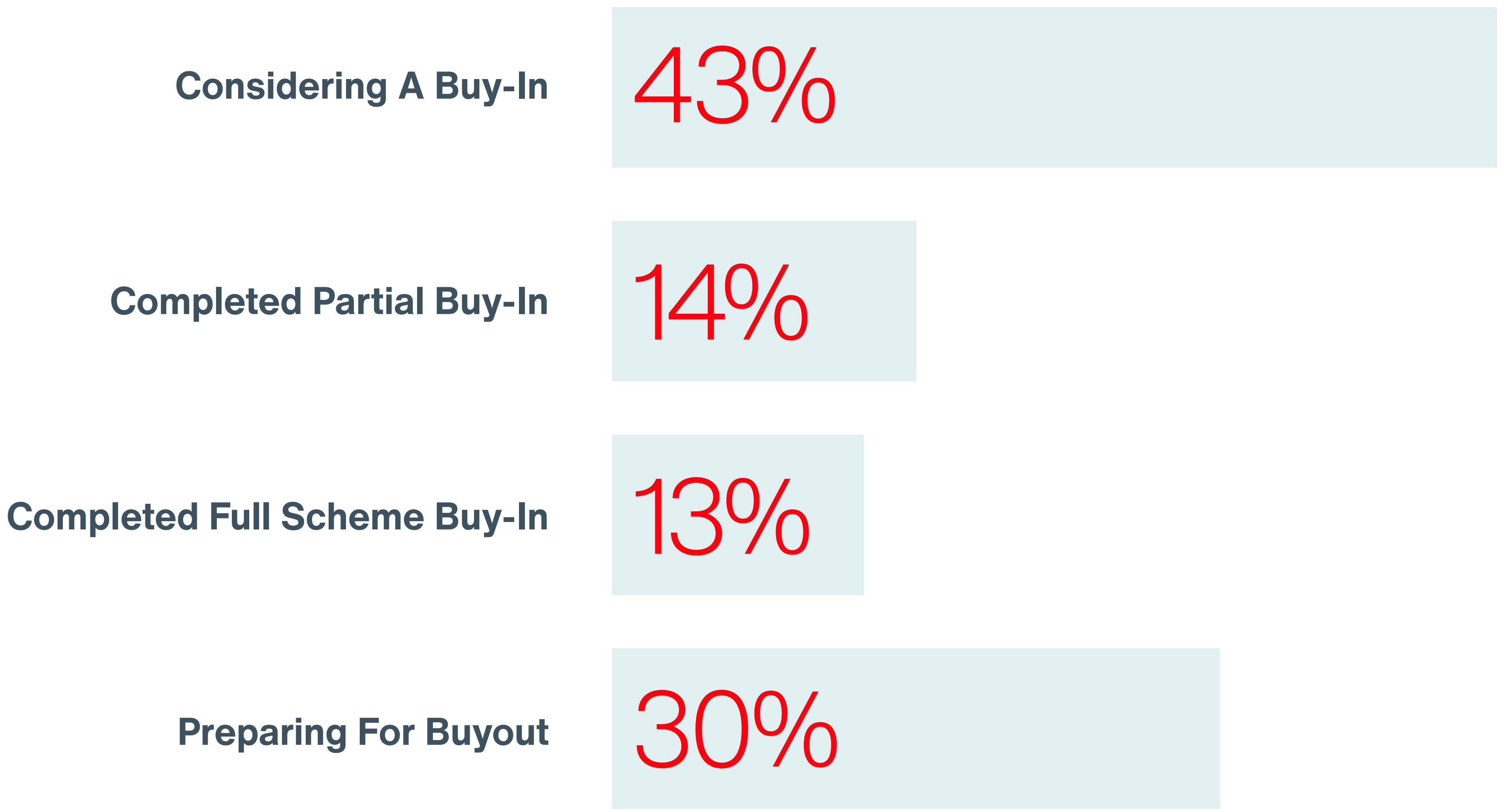
Preparing For Your Settlement Endgame

1

Preparing For Your Settlement Endgame

Buy-ins are rapidly emerging as the route of choice for many DB schemes to achieve their settlement endgame, with our survey indicating that 43 percent of schemes are currently considering buy-in. Some are already partway through this journey with 14 percent having completed a partial buy-in at the time of the survey, and another 13 percent having already completed a full scheme buy-in. The remaining 30 percent of respondents were even further in their endgame planning, and already preparing for buyout.

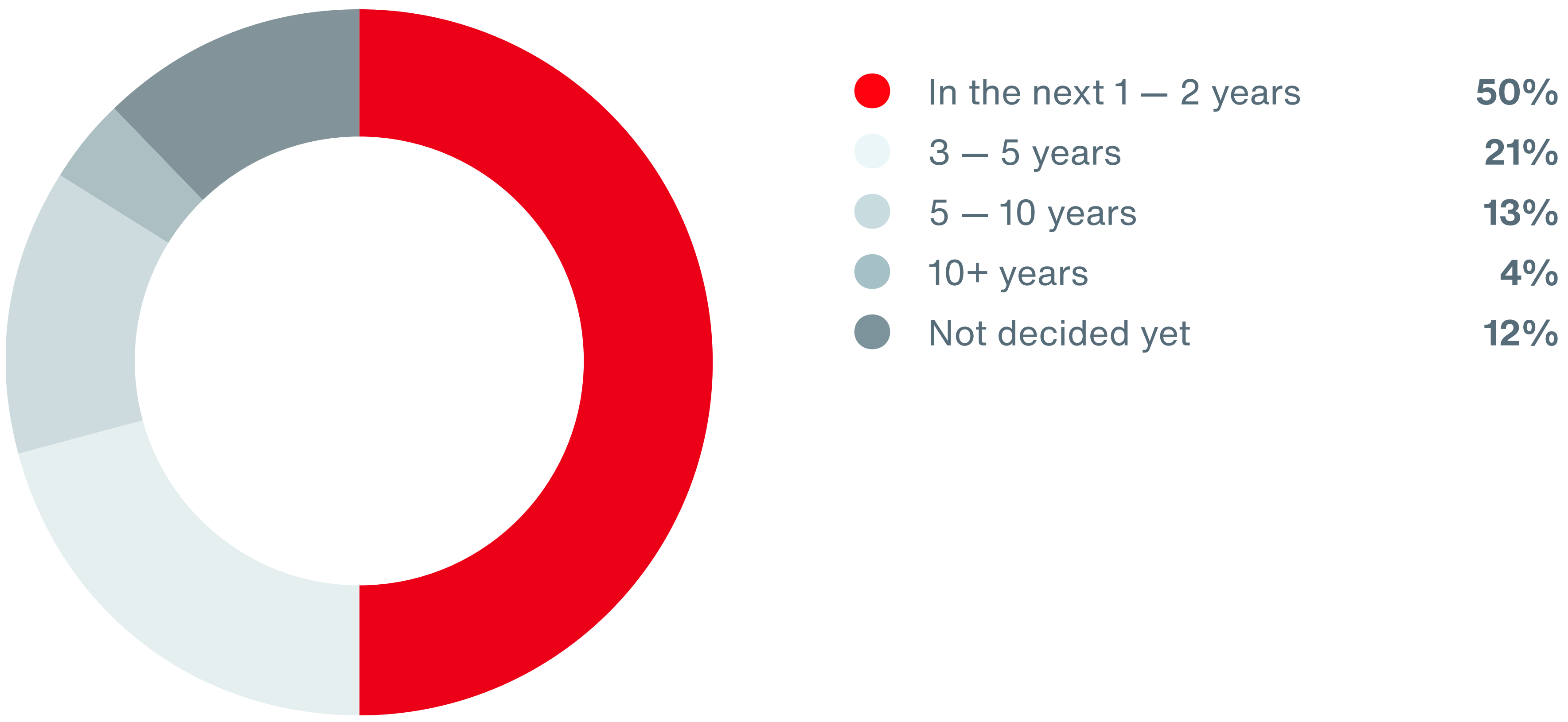
Where Are You On Your Settlement Endgame Journey?



Regardless of transaction type, i.e. partial buy-in or full scheme transaction, 50 percent of respondents were hoping to purchase a bulk annuity for their scheme in the next two years, with a further 21 percent expecting to do so in the next three-to-five years.

In such a competitive environment, it will be more critical than ever to take an attractive proposition to insurers. For many, this will boil down to how ready the data is and simplicity in how the benefits are conveyed to insurers. Administrative teams are stretched and therefore schemes need to prioritise readiness if buyout is the endgame and this work is not already underway.

When Are You Hoping To Purchase A Bulk Annuity For Your Scheme?



Managing Risks Prior To Buyout

Getting ready to go to market extends beyond ensuring a scheme is ready from an administrative perspective. When asked about managing risk in the run up to a transaction, the most common response was ensuring that no additional contributions would be required from their sponsor, with over half (56 percent) of respondents suggesting this topped their list. The second and third most popular responses both related to stability in the level of solvency funding, with the funding level percentage taking slightly higher priority than the GBP surplus or deficit amount in most cases.

Interestingly, although perhaps unsurprisingly, smaller schemes were noted to prioritise the absolute value of their surplus or deficit stability over funding level stability. This is largely in an effort to reduce the requirement to fund any additional unforeseen funding gaps via additional contributions from sponsors, which may be unavailable.

What Are Your Priorities In Managing Risk When Approaching A Transaction?

56%
No additional contributions required from sponsor

54%
Stability in the (solvency) funding level (i.e. the %)

48%
Stability in the (solvency) surplus/deficit (i.e. the £ amount)

22%
Reducing transaction costs

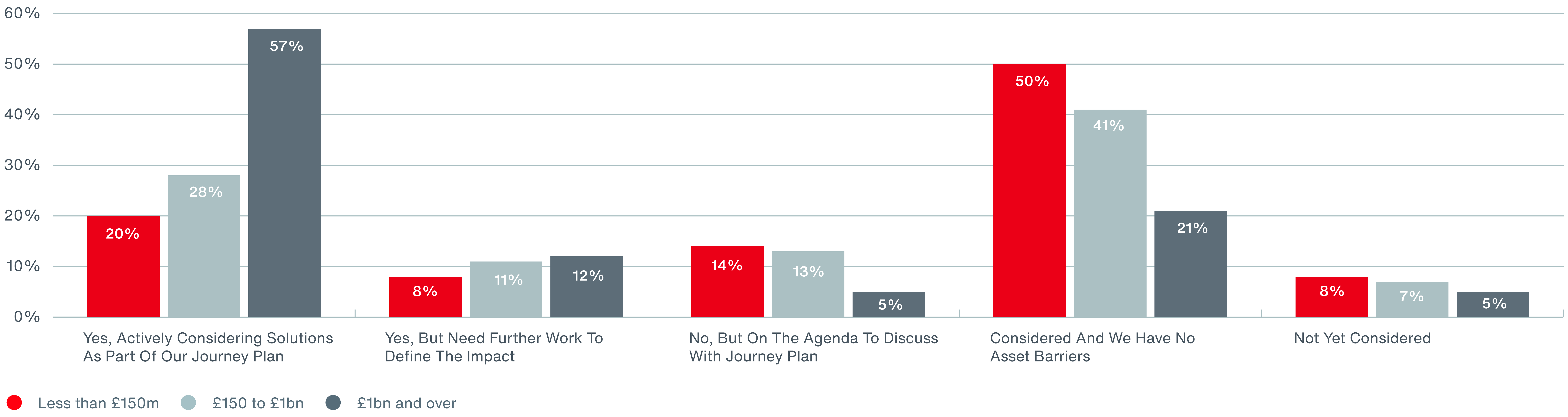
3%
Other

Asset Readiness For Transaction

One area of preparation which can often be overlooked is in the investment strategy. With rapid acceleration in funding levels over the last few years, schemes have found themselves with asset allocations which don't always align with their journey to settlement strategy, and may create barriers to transaction if not remedied. We asked respondents if they were aware of any such barriers to overcome prior to transaction (for example illiquid assets).

Considering scheme size, smaller schemes are more confident about going to market with their current assets, with half of smaller schemes already having reviewed their position and confirmed they have no asset barriers. In contrast, this compares to only 21 percent of larger schemes having resolved any of the hurdles they need to navigate. This is perhaps reflective of the increased level of complexity in investment strategies in larger schemes, and the flexibility available to them via their larger pool of free assets to meet ongoing cashflow requirements.

Are You Aware Of Any Of Your Assets That Could Create A Barrier To You Purchasing A Bulk Annuity (e.g. Illiquid Assets)?

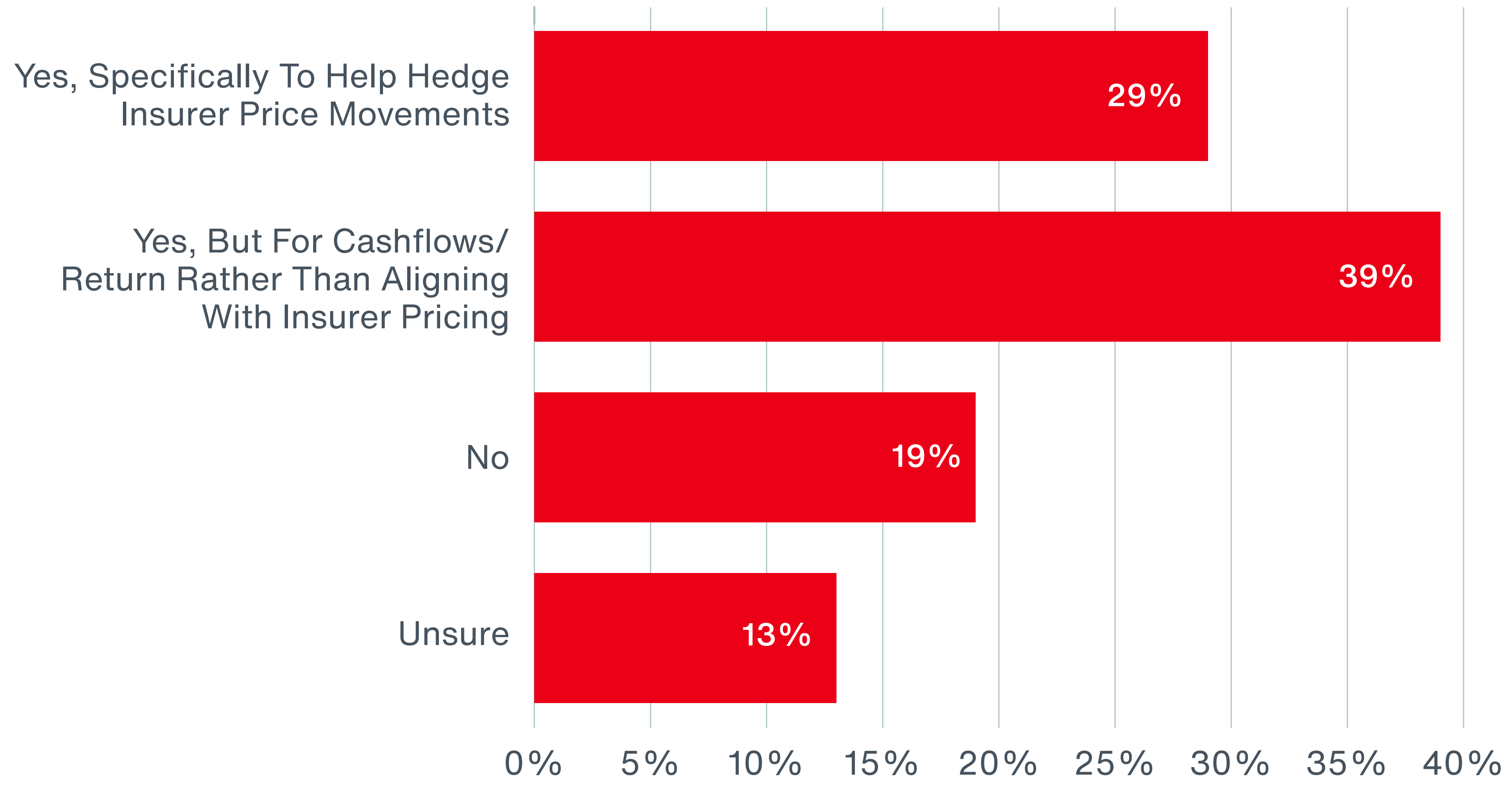


To minimise these barriers, schemes need to be planning early for their journey to settlement and ensuring that their investment strategy aligns with the timescales involved. When asked, most schemes (55 percent) said their investment strategy is fully aligned with their endgame plans and that their journey plan is formally agreed by the trustees and the sponsor. While this is encouraging, it is clear that a significant proportion of schemes still have some work to do to get to this point.

It is very difficult to fully align with insurer pricing ahead of approaching the market, in large part because the investment strategy adopted by each insurer varies according to their own internal requirements, and often changes over time. As a result, it is common to target a proxy for insurer pricing. This portfolio usually consists of gilts, cash and credit assets, with the proportion of each considered on a spectrum to represent the range of approaches observed across insurers. Where schemes are looking to hedge insurer pricing movements, it is important to monitor any changes in insurer approaches over time, this requires specialist knowledge and advice.

We asked respondents whether their current investment strategy contains investment grade credit. Over two thirds (68 percent) of schemes confirmed they do indeed have this within their portfolio, although in most cases, this was noted to be for the returns and cashflows it offers, rather than seeking to align with insurer pricing. Whatever the reason, having this as part of their portfolio will help to hedge insurer pricing as they grow closer to a transaction.

Does Your Scheme Have Investment Grade Credit Exposure?



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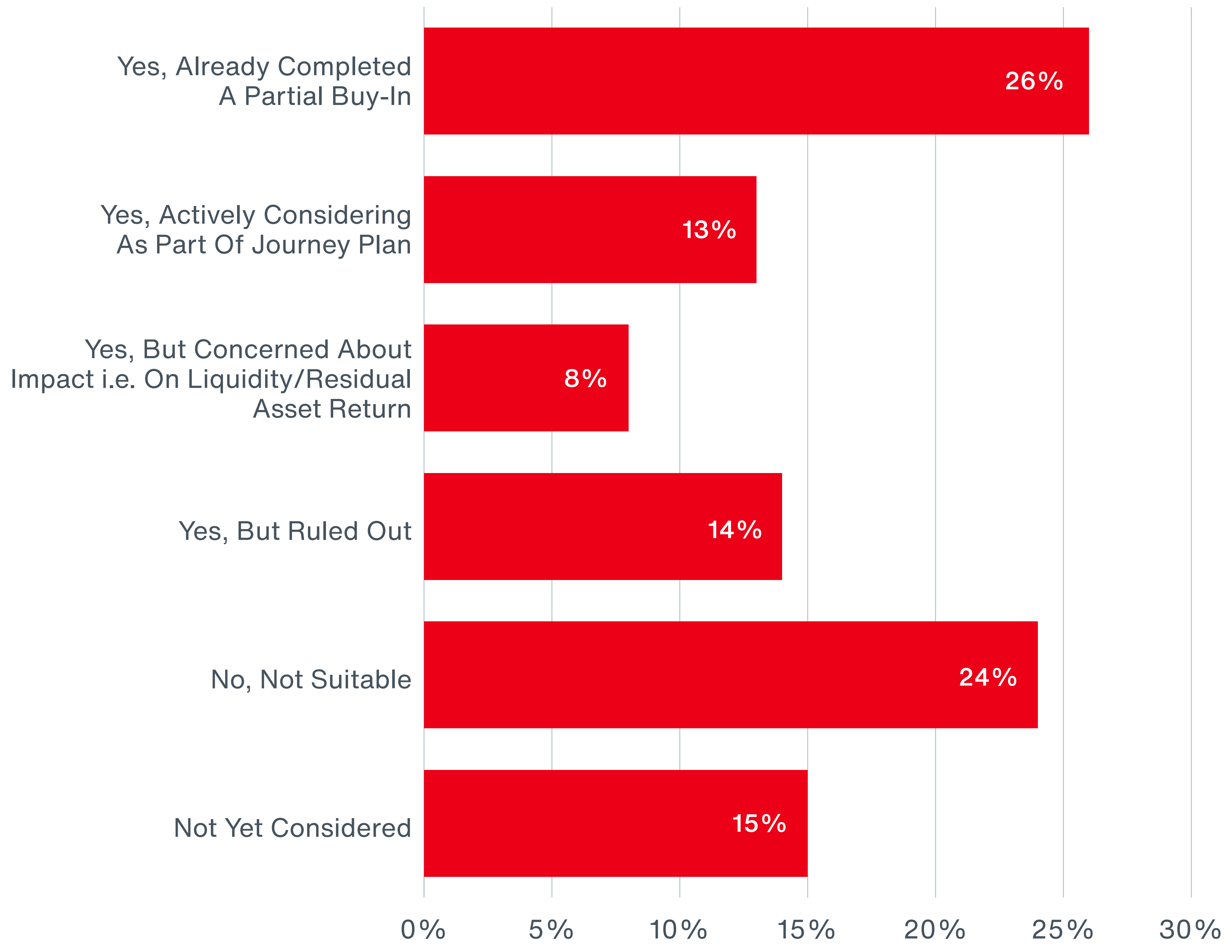
Following the rapid increases in funding levels, and some schemes finding themselves fully funded sooner than expected, we have seen a correspondingly large increase in the number of full-scheme transactions in the market. However, there is still very much a place for partial buy-ins in your long-term journey, depending on your scheme's circumstances.

We asked respondents to confirm whether they had considered a partial buy-in, and almost half (47 percent) are either actively considering one, or have already completed one. When using partial buy-ins as part of your long-term strategy, there are additional considerations required beyond those for a full-scheme buy-in. For example, the residual asset strategy and also the insurability of the residual member profile will be important to consider and plan for. Despite the need for this extra consideration, partial buy-ins can provide an optimal route for some schemes as part of a well-structured de-risking process.

47%

are either actively considering the impact of a partial buy-in on their scheme, or have already completed one

Have You Considered Partial Buy-Ins?



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Selecting An Insurer

2 Selecting An Insurer

Choosing an insurer is likely to be one of the most important decision in a scheme's lifetime. As such, it's unsurprising that 81 percent of respondents rated insurer due diligence ahead of a transaction as 'very important', with a further 15 percent saying it's 'somewhat important'. With insurers covering different target areas of the market, and having different operating structures and areas of focus, it can be difficult to know which one to choose.

We asked respondents to rank in order of priority which criteria were most important when selecting an insurer. With the security of their members' benefits at stake, the number one criteria was financial strength of the insurer. This was closely followed by price and price certainty during the price-lock period prior to transaction.

In fourth place was member experience. This is increasingly becoming a key focus for trustees and sponsors seeking to ensure their members receive an excellent level of service from the insurer, but also in seeking to retain valuable options available to members within their scheme post-wind-up. Member experience is discussed in detail later in this report.

One further notable item is cyber security. This has risen in focus in recent years for trustees and sponsors, in part due to some high-profile cyber attacks which impacted administration businesses. Clearly, this can have a direct impact on the security of members' benefits and their personal details if breached, and as such, we have developed our due diligence to include a cyber security review when assessing insurers. This provides peace of mind when choosing an insurer knowing if they have robust processes in place.

While all criteria on this list will be of value to schemes in selecting an insurer, they will have varying importance depending on the objectives set for your transaction.

When Selecting An Insurer, Which Criteria Are Most Important?

1. Financial Strength Of Insurer
2. Price
3. Price Certainty During Price-Lock
4. Member Experience
5. Track Record
6. In-Specie Transfer Of Assets
7. Cyber Security
8. Brand Name
9. ESG Credentials
10. Recent Deals By Insurer

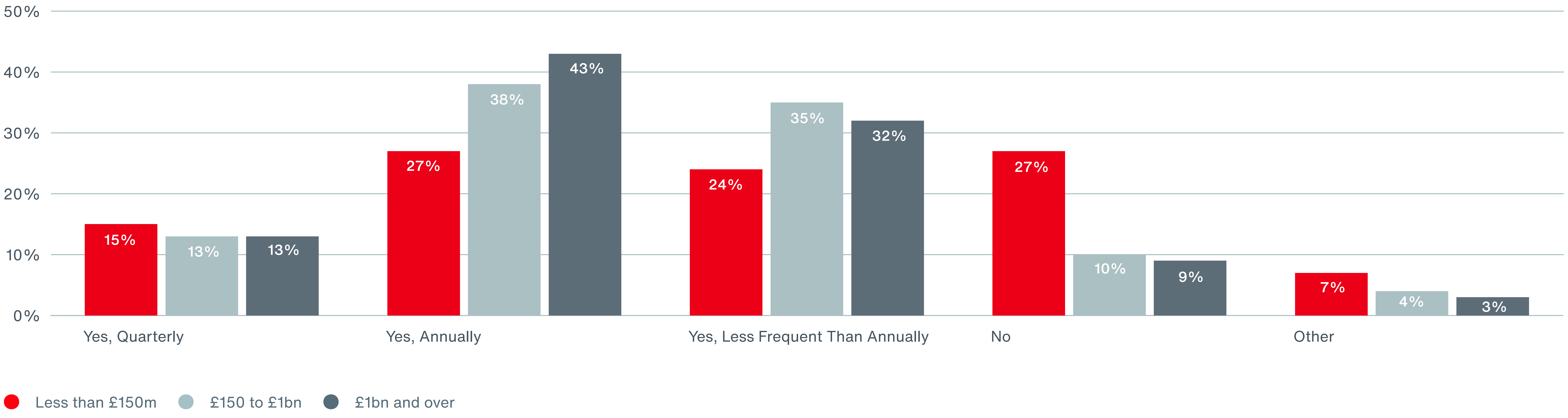
81%

of respondents rated insurer due diligence ahead of a transaction as "very important"

Due diligence is an extremely important tool to support with such a complex decision but need not be a one-time exercise. In the same way a trustee board or sponsor may review the covenant of their sponsor on a regular basis, re-assessing the strength of your chosen insurer over time will provide an additional layer of comfort as you approach buyout. We asked respondents about the frequency of their due diligence after a buy-in and nearly half (49 percent) would seek to refresh their due diligence at least annually, with another 30 percent suggesting they would refresh regularly but less frequently than annually.

Interestingly, this emphasis being placed on due diligence changes depending on the size of the scheme. When asked about how active this due diligence work was, 27 percent of smaller schemes indicated that they would not refresh this analysis post transaction. In contrast, only 10 percent of mid-sized schemes and 9 percent of large schemes suggested they would not renew their due diligence.

Following A Buy-In Transaction, Would You Refresh Your Due Diligence Analysis On The Insurer On An Ongoing Basis?



Exclusivity Or Competitive Tender?

In such a busy market, insurers are looking for ways in which to increase their chances of closing the deal to make the best use of their resource. One way in which some insurers now achieve this is by asking schemes to partner with them in exclusivity from the outset, rather than running a competitive tender process. Depending on your circumstances, this may or may not be optimal — but how do you decide? We asked respondents how important it is to have more than one insurer competing for their scheme. Almost half (49 percent) said it's very important to them, with a further 42 percent saying it was somewhat important.

When asked what reasons they may have for working exclusively with one insurer, 63 percent of respondents suggested the number one reason would be if the due diligence uncovers strong performance on the part of the insurer. This was followed by 53 percent saying a key driver may be a previous relationship with that insurer e.g. they may already have some members insured with that insurer. Interestingly, the least popular reason was choosing to work with the insurer was on brand name alone, with only 15 percent of respondents saying this would be a driving factor, suggesting schemes understand the importance of looking beyond brand name to understand better the insurer they will be partnering with.

49%

said it's very important to them to have more than one insurer competing for their scheme.

3

Member Experience

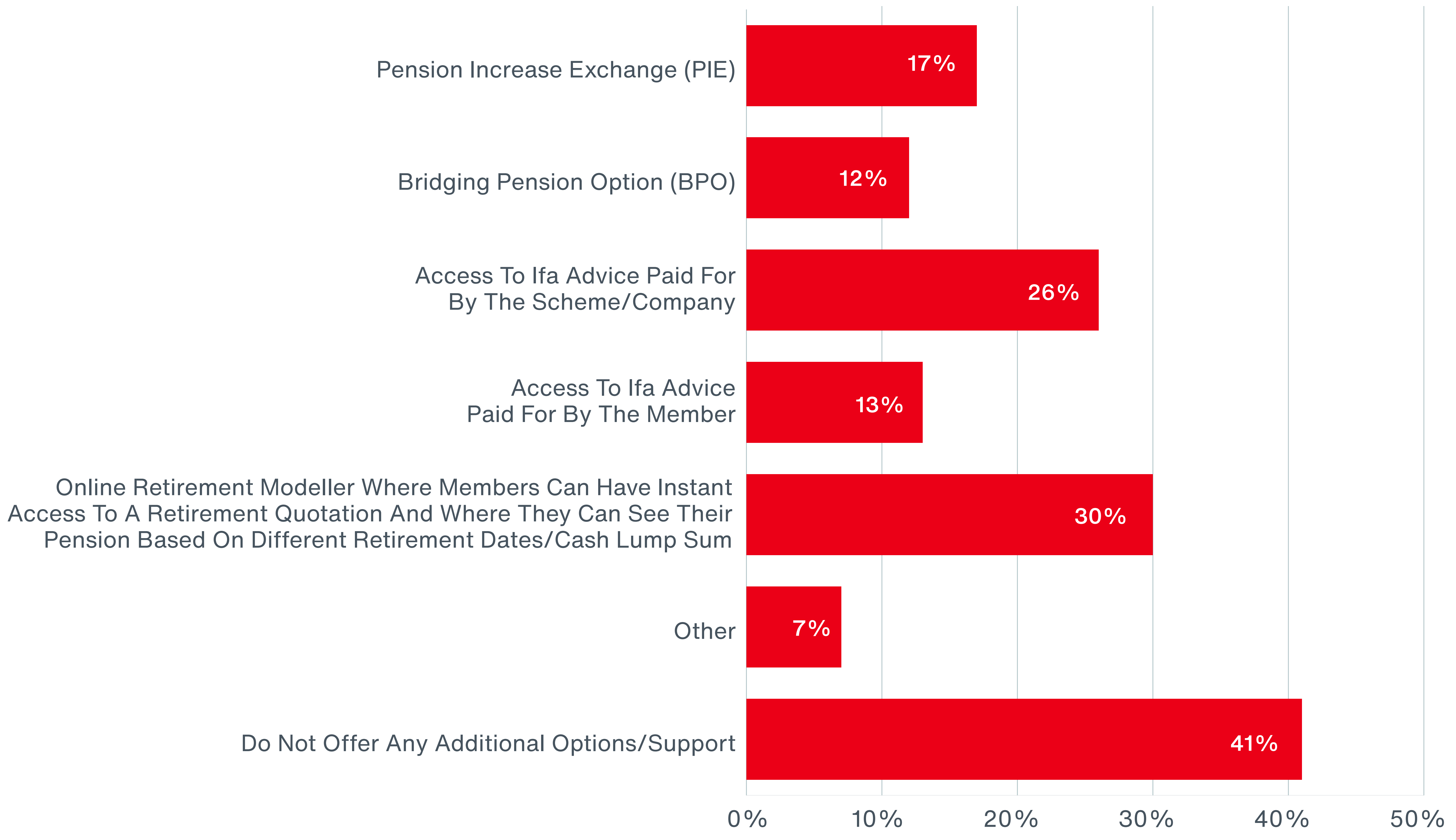
3 Member Experience

With members at the heart of every decision, the focus on the member experience both in the transitional period prior to buyout and beyond is increasing rapidly for both schemes and insurers alike. As such, we have been, and continue to, push insurers to improve the options and service they provide to members, and insurers are reacting, with some further ahead in their offerings than others.

We asked respondents about the importance of retaining member options already provided in their scheme *for example Pension Increase Exchange (PIE) or Bridging Pension Options (BPO).* A significant majority of 62 percent of respondents saw these as at least somewhat important to provide after buyout. With a similar level of importance placed on additional member support, in the form of IFA advice or retirement modellers, 66 percent of respondents said it was important to provide this kind of additional member support after buyout.

Interestingly, though most schemes identified these as important requirements for insurers to satisfy, these are currently far from standard offerings across the market. When asked about options, 41 percent of schemes suggested they don't offer any additional options or support to members at retirement. Of those that do, the most common support option is an online retirement modeller (30 percent), with only 17 percent of respondents confirming they offer PIE and 12 percent do so with BPO.

Do You Currently Offer Any Of The Following Options/Support To Members At Retirement?



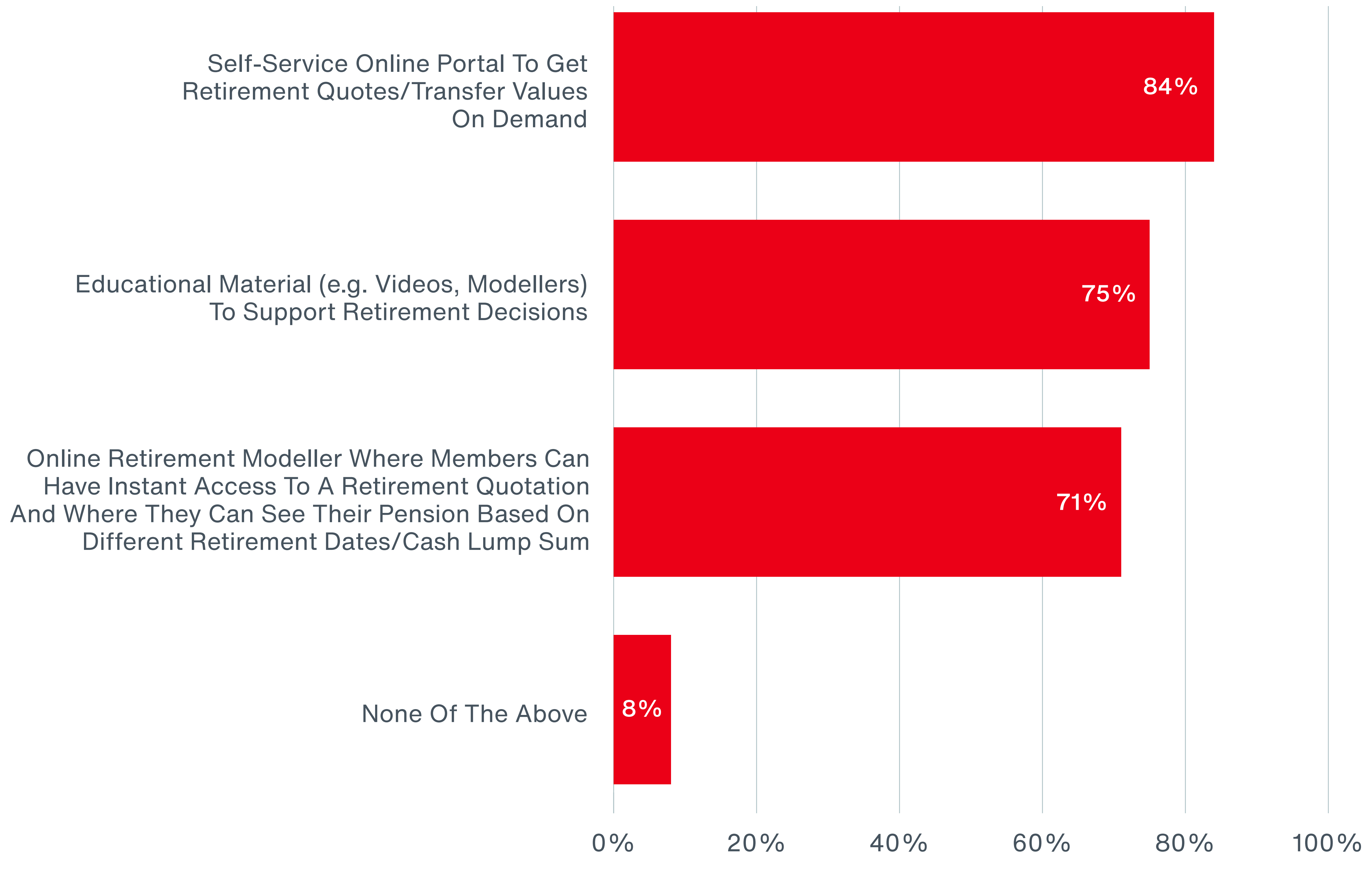
Building in options for members creates an additional layer of uncertainty for insurers, and can mean an increase to the premium payable due to a number of factors including the terms of the options and reinsurer views. However, schemes were less enthusiastic about paying for retaining member options. When asked if they would be willing to pay an additional premium to secure valuable member options or support, 63 percent said they would not, and instead expect to insurer to provide these as standard.

Beyond the options insurers can offer members, the vast majority of respondents (84 percent) said they would expect an insurer to provide a self-service online portal for members, with 75 percent expecting education material including videos to be available. Tellingly, only 8 percent of respondents would not expect an insurer to provide any of these.

As noted, insurers are generally investing to provide additional options and wider ranges of support, with some insurers further ahead than others.

With some elements of member experience already standard, such as requesting a transfer value or retirement quote, increasing the options to meet growing expectations will come at a cost, and a balance will need to be struck over the cost passed to the schemes to make this attractive. Over time, with ever-growing numbers of schemes coming to market, this is an issue which will need to be addressed sooner rather than later by insurers to ensure they remain competitive amongst their peers.

Would You Expect An Insurer To Be Able To Provide The Following To Members?



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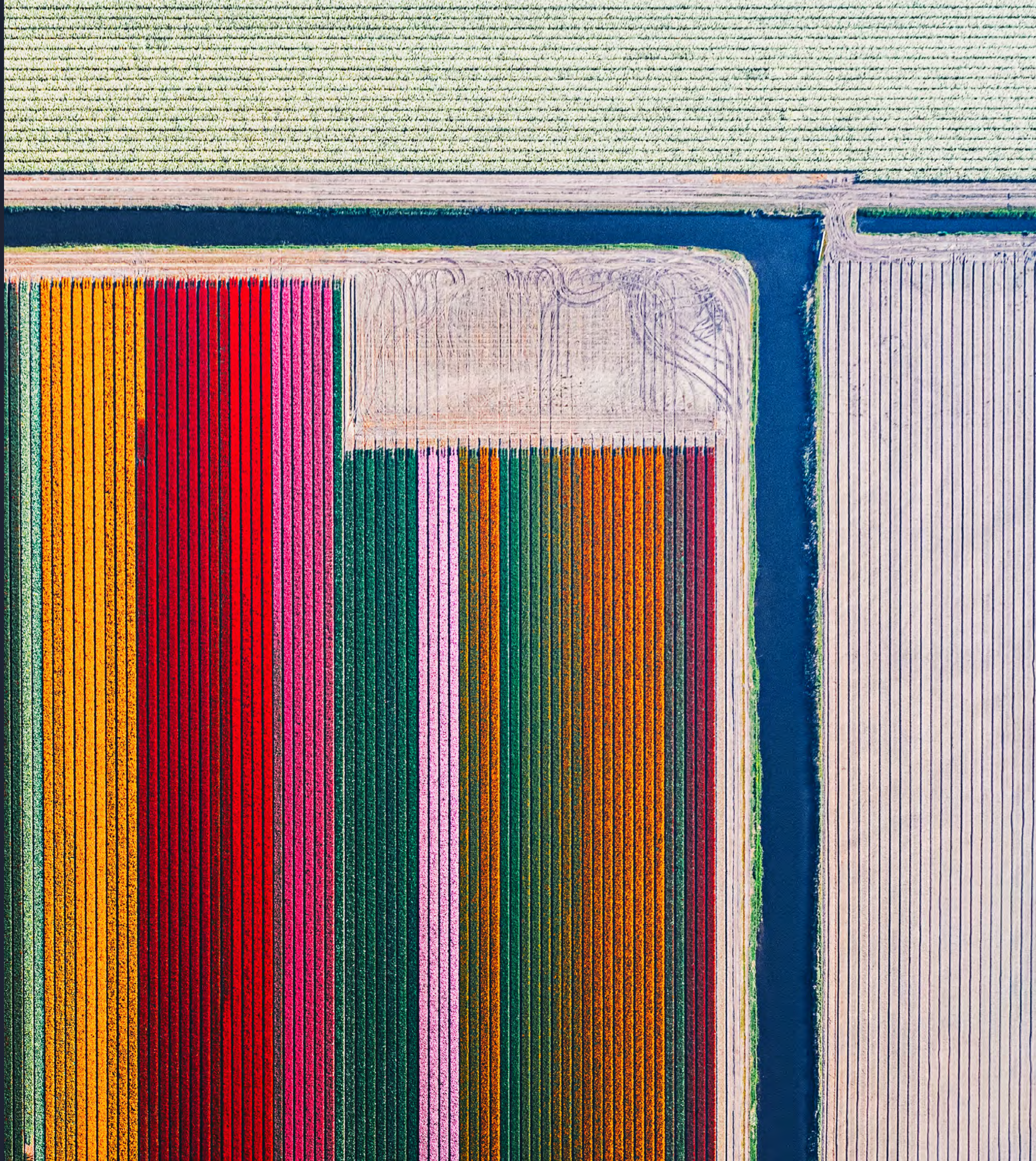
Beyond Buyout: Residual Risks And Use Of Surplus



4 Beyond Buyout: Residual Risks

While an insurer assumes responsibility for paying the benefits insured post-buyout, some risks remain which trustees and sponsors need to consider and agree a plan for. These include a potential scenario in which a missing beneficiary comes forward seeking payment of their entitlement from the scheme, errors relating to scheme data or errors made in calculating benefit entitlements.

We asked respondents how concerned they were with these residual risk issues and a large majority of over three quarters (77 percent) revealed they were somewhat or very concerned about residual risks post-buyout. Data errors were, predictably, the top ranked residual risks followed by benefit errors. The next risk causing most concern for respondents was missing or incomplete documentation. Following the Virgin Media ruling which centred on the available documentation evidencing relevant certification of changes to a scheme's rules, this is understandably an increasing area of focus for schemes in the preparation for buyout and wind-up.

In order to cover such risks, schemes will have different options available to them based on the size of the liabilities insured. Residual risks insurance is generally only offered by insurers for total liabilities of circa £300 million or more and will provide cover for the majority of these residual risks, usually subject to some agreed exclusions based on the findings from the due diligence process.

In light of this, almost half of respondents (48 percent) said they were willing to undertake due diligence on their own data and documentation — through incumbent advisers — ahead of an insurer initiating such an exercise to facilitate residual risks cover. Another 27 percent would be willing to do so but with independent advisers, presumably due to the potential benefit of a fresh pair of eyes. Whether through incumbent or newly appointed advisers for this process, this is a common approach adopted by schemes ahead of going to market to create efficiencies in the residual risks due diligence process by schemes presenting their findings to an insurer, rather than more than one insurer investing time during the exclusivity period to undertake this work.

Residual Risks Ranked In Order Of Most To Least Concerning By Respondents

1 Incorrect Data

2 Incorrect Benefits In Payment

3 Missing Or Incomplete Documentation

4 Missing Beneficiaries

5 Member Expectations

6 Legislation Changes

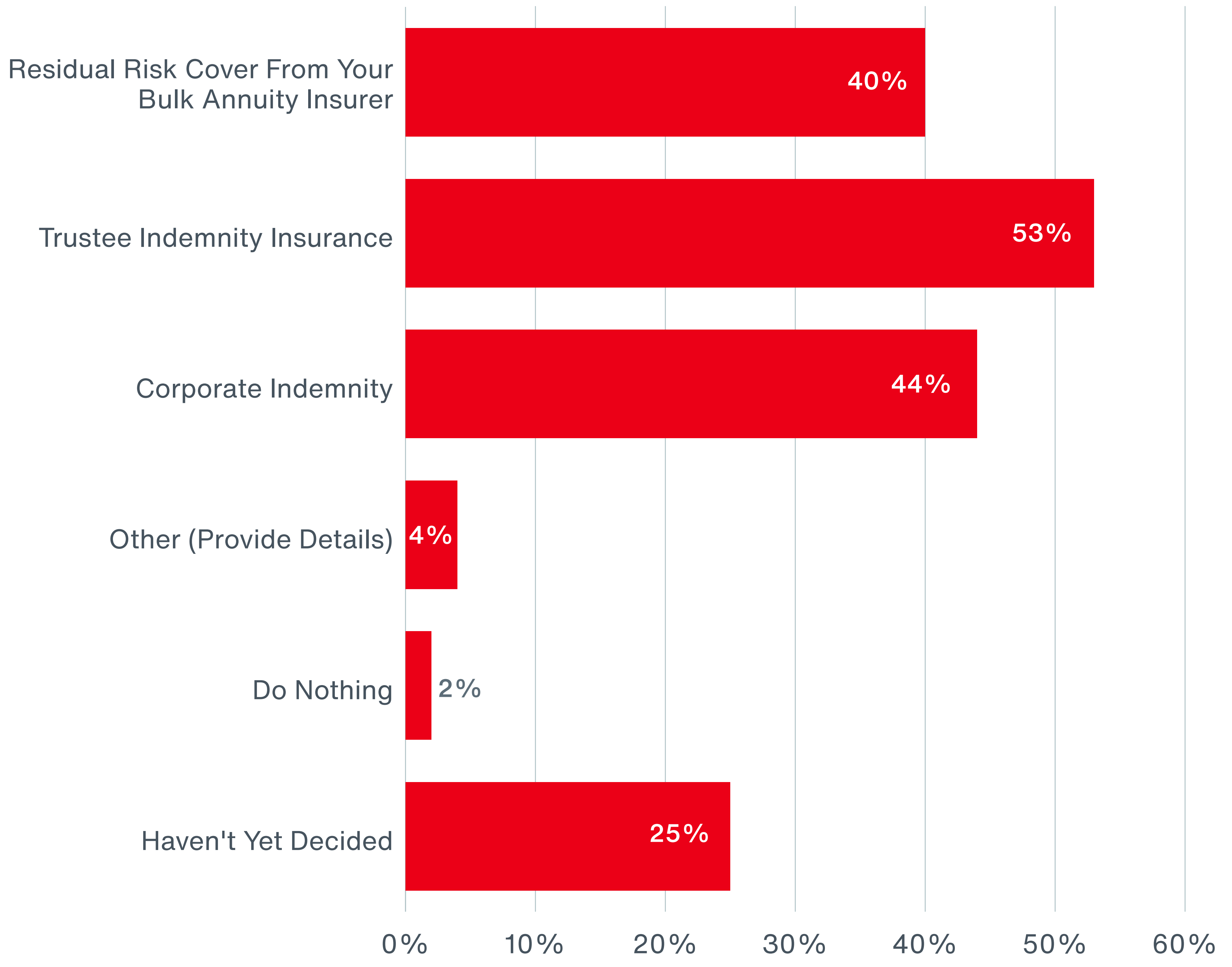
Since not even residual risks cover is sufficient to cover all possible future scenarios which may result in a claim from a member after wind-up, trustees and sponsors usually need to agree a wider package of protections in the event either residual risks cover is not available or will not pay out. To understand how schemes intend to address residual risks, we asked which options they are considering. Over half (53 percent) of respondents said they planned to address such residual risks through the purchase of trustee indemnity insurance, with 44 percent planning to rely on an indemnity from the sponsor (corporate indemnity) and a further 40 percent would do so by purchasing residual risks cover from a bulk annuity insurer.

As you will see from the chart of results to the right, it is common for residual risks to be mitigated through a combined package of available measures.

53%

of respondents said they planned to address residual risks through the purchase of trustee indemnity insurance.

How Do You Plan To Address Residual Risks?



Unsurprisingly, some schemes have not yet decided, with one quarter of schemes still to consider. Some schemes who are still a few years from transaction may be unaware of the risks which can remain, and thus presenting a training need to understand the options available for complete member and trustee protection post-wind-up. This is evidenced by almost one third (31 percent) of schemes suggesting they are unsure whether they were concerned about the availability of residual risks cover for their scheme. Almost half (46 percent) of respondents said they were not concerned and so may indeed be reassured they can access this cover or instead have other protections in mind. The remaining 23 percent confirmed they were concerned about whether this cover would be available, suggesting they may need to consider alternative options.

Bulk annuity deals of at least £1Bn in size can agree certain scenarios with the insurer in which the policy can be terminated and assets transferred back to the scheme.

Additional Security From Insurers

For the largest schemes, it can be possible to agree enhanced terms with insurers providing additional security in certain circumstances. The main area in which we see negotiation on this front is via termination rights. For the average bulk annuity deal, it is not possible for the policy to be terminated by either the trustee or the insurer. However, deals of around at least £1 billion in size can agree certain scenarios with the insurer in which the policy can be terminated and assets transferred back to the scheme. These are usually linked to financial or operational failure of the insurer. Half of respondents suggested it would be at least somewhat important to have the ability to terminate their bulk annuity, with 26 percent suggesting this would not be important and 23 percent were unsure.

In the event of termination, the refund provided by the insurer may not provide either the full value of the remaining contract payments or provide return of assets in the preferred form. We asked which would be most important – the level of refund provided or the type of assets refunded. A significant 73 percent of respondents suggested they had not yet considered, but with the level of refund ranked ahead of the type of assets, for those who have considered. This perhaps suggests that further thought or education might be needed for those schemes who have the option to agree additional termination rights with insurers when the time is right.

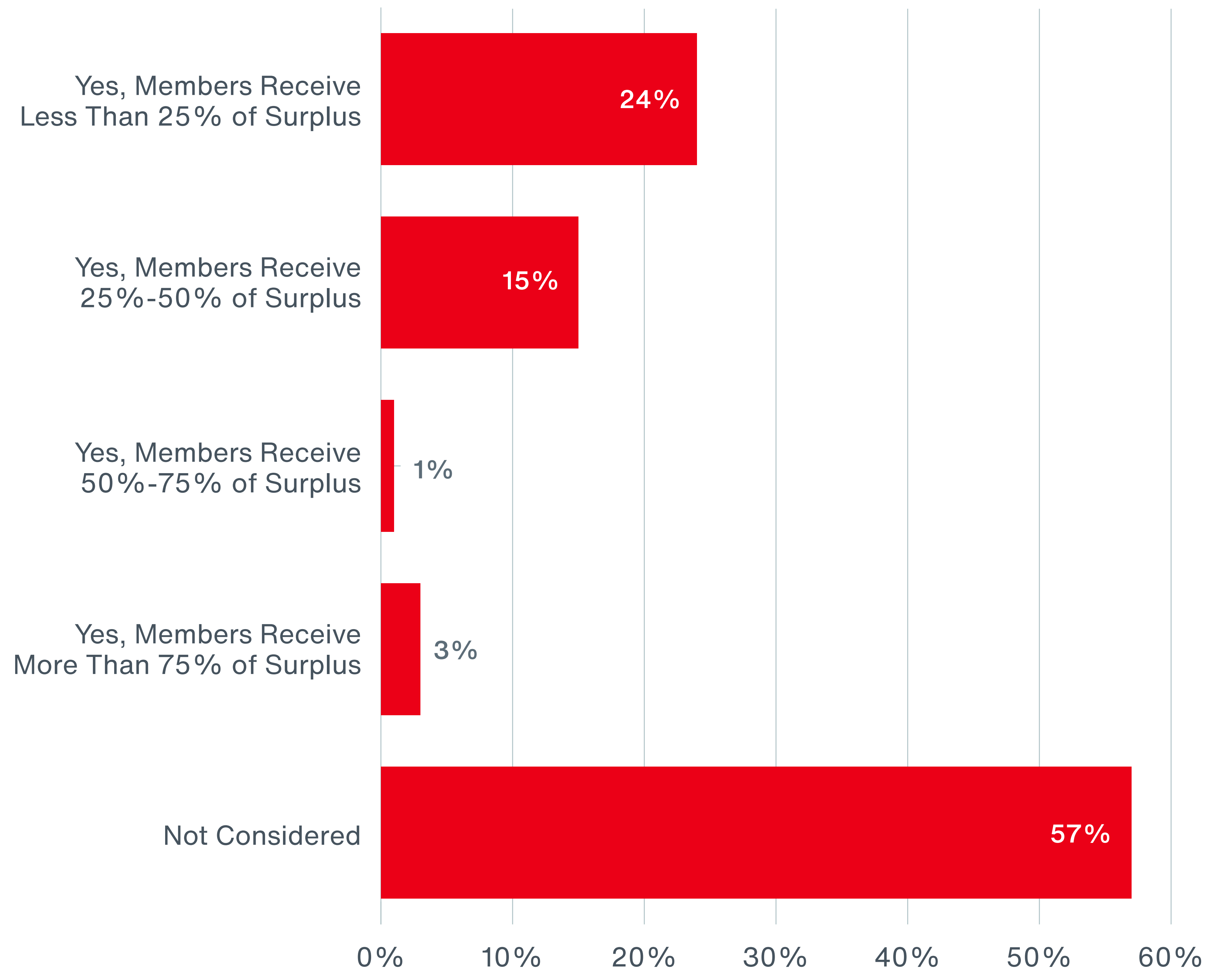
Beyond Buyout: Use Of Surplus

At the point of buyout, increasingly, some schemes find themselves in surplus, and have a decision to make on how this should be used. The scheme rules will usually indicate whether the surplus can be returned to the employer upon wind-up, but where the trustees have the option to decide how this surplus can be allocated, careful consideration needs to be given as to its best use.

We asked respondents whether the trustees and sponsor of their scheme have agreed what would happen in the event of a surplus, and only 19 percent of respondents suggested this had already been agreed. Over one third (34 percent) confirmed this had been discussed but not yet agreed, with the remaining 47 percent having not yet discussed or instead not expecting a surplus to arise. Agreeing the split of surplus between member benefits and return to the sponsor can be a difficult and sometimes emotive debate, and so not uncommon that this is yet to be decided until the appropriate time.

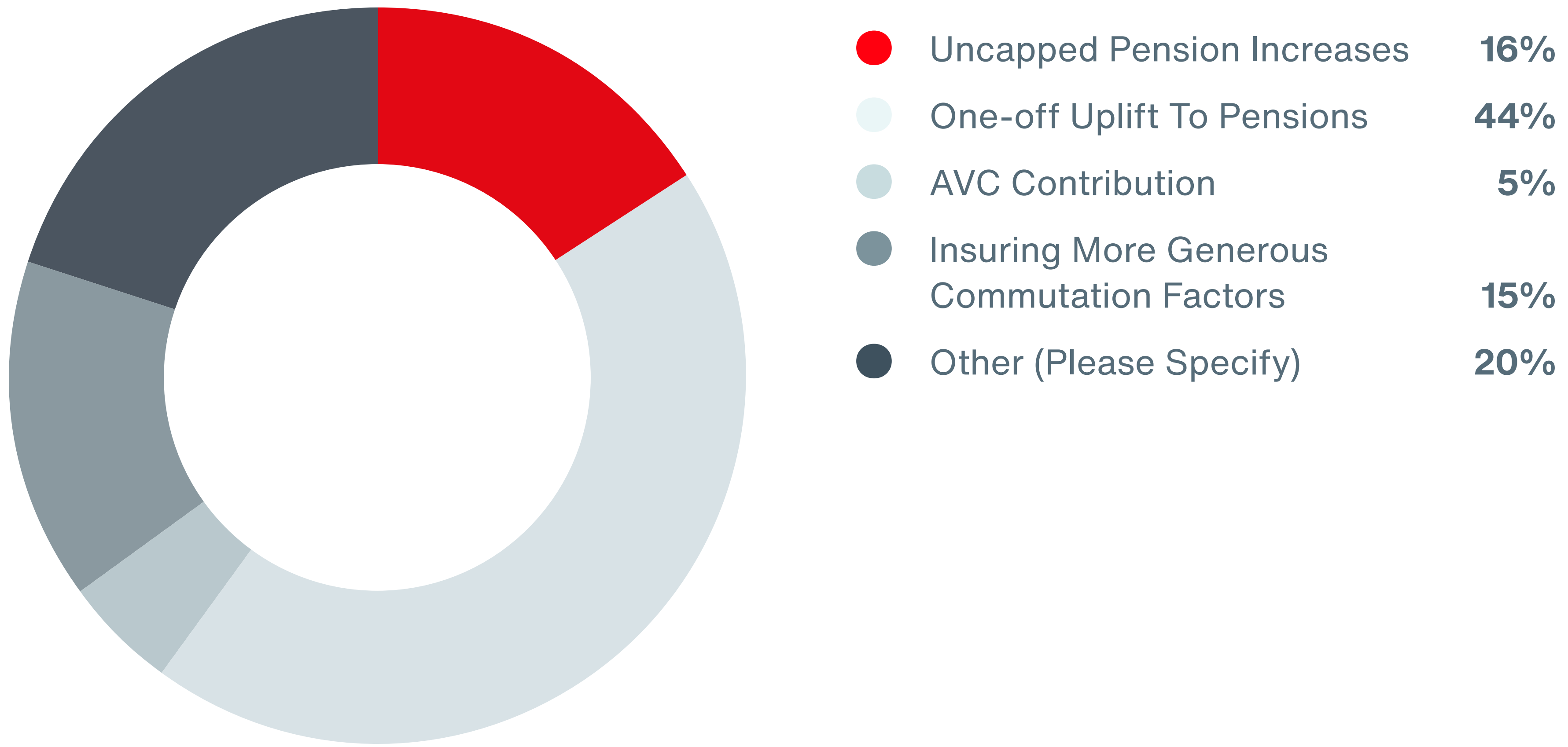
When delving deeper into the use of surplus and the split between members and sponsor, we asked what share of surplus members may be likely to get from their scheme. The majority (57 percent) had not yet decided but for those who had considered, the results were interesting, with the most popular option (24 percent of respondents) being that members would receive less than 25% of surplus, and a further 15 percent suggesting the maximum share of surplus would be 50%.

Have You Considered Sharing The Surplus Between Sponsors And Members? If So, What Share Of The Surplus Would Members Get?



In the event that at least some surplus is used to enhance members benefits, we asked which option schemes have considered and the overwhelming preference was to provide a one-off uplift to pensions. This is often deemed to be the simplest and fairest approach to split across the membership, with other options perhaps providing greater benefit to some members based on their split of pension or member status.

If You Were To Enhance Member Benefits, Have You Considered What This Would Most Likely Be?



For most schemes, this decision may be some years in the future, and preferences may change over time. That being said, the use of surplus is often the most challenging discussion point on the road to wind-up and so discussing this early, and being clear on the rights within the scheme rules will be key to making this process as smooth as possible.

5

Conclusions And What Next?

5 Conclusions And What Next?

From our research, it is clear that there remains a huge appetite from schemes to secure their liabilities via bulk annuities and based on the timescales indicated by respondents, we can expect a significant number of schemes coming to market in the next few years. The insurance market is gearing up to cope with this demand but with limited resource available from insurers, advisers and administration teams, trustees will need to focus and prioritise areas of preparation to present the best version of their scheme within achievable timescales.

Many schemes have indeed begun their journey to settlement and have begun formulating plans and taking action to streamline their process. In particular, the majority of schemes have already sought to align their investment strategy with their endgame plans – this is an area which can often be overlooked somewhat, but can indeed have a significant impact on the overall transaction timescales and affordability, particularly where illiquid assets potentially pose a barrier to transacting. Despite this early preparation by some schemes, there is likely to still be a great deal of work to refine this strategy, alongside preparing data and benefits as schemes move closer to a transaction.

Additionally, it appears there are a number of areas in which trustees and sponsors may still need a great deal of guidance and education for the many decisions still to be made on the journey, particularly in the later stages of choosing an insurer or agreeing steps to complete the buyout and wind-up of the scheme. In making these decisions, since the outcomes will directly impact members both in terms of the options available to them and the service provided by the chosen insurer, it will be critical to be fully informed and make the best decisions possible for members.

Member experience is an increasingly key area for trustees and sponsors when choosing an insurer, to ensure that members receive uninterrupted service, and this includes retaining options post-buy-in which are currently available from the scheme. With higher demand from schemes, we have already seen insurer offerings widen in this area, with a greater deal of focus being placed on the administration service offered, as well as some insurers now prepared to offer additional member options at retirement.

In 2025 and beyond, we expect to see an increase in the number of schemes coming to market. This will require insurers to evolve their offerings, including member experience, and solutions to complex assets, all helping to streamline the journey to transaction.

In such a buoyant and competitive market, there are ample opportunities for schemes to achieve great outcomes for their members. With two new insurers entering the market in the last 12 months, and the potential for further new entrants, competition has never been greater between insurers to offer attractive pricing and terms to schemes looking to transact. The best prepared schemes will be in prime position to make better decisions and achieve optimal outcomes.

We look forward to seeing how the market continues to evolve, and how trustee and sponsor preferences may be the catalyst for driving this change.

About Aon

Aon plc (NYSE: AON) exists to shape decisions for the better — to protect and enrich the lives of people around the world. Through actionable analytic insight, globally integrated Risk Capital and Human Capital expertise, and locally relevant solutions, our colleagues in over 120 countries provide our clients with the clarity and confidence to make better risk and people decisions that protect and grow their businesses.

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