What are you thinking?

In a series of podcasts, Aon explored the underlying thought processes when deciding whether to implement a de-risking solution

Aon recently produced four podcasts explaining the consultancy's research into behavioural insights and risk settlement decisions, conducted in partnership with Behave London.

Aon and Behave London carried out research in early 2019 to explore trustees' understanding and views on longevity risk and the options available to reduce that risk and identify behavioural biases that could impact these decisions. Here are some of the highlights of those findings as presented in the podcast series.

Behavioural finance

In the first podcast, Hannah Lewis, founder of Behave London, explains her firm's approach to the project and some of the key biases that affect trustees and sponsors when considering big projects such as de-risking transactions.

Why is behavioural science relevant to trustees?

Hannah Lewis: "We need our emotions to help us make decisions, but that means that quite a lot of our decisions are emotion-led. When we're trying to make good, clear decisions, we're trying to take emotion out of the picture, look at what those behavioural biases are, and remove them from our decision making.

"That doesn't mean that we're perfect once we've done that. It's one thing knowing that we do have behavioural biases, but it's a very different thing to mitigate those to make good decisions."

Aon commissioned research in early 2019, with Behave London, to find out trustees' understanding and views on longevity risk. What did you find out?

Lewis: "We went out and looked at all the information that already existed on de-risking to see if a trustee could easily find all the information that they needed to understand the process.

"The short answer to that is no – that information didn't exist. Nobody had written an end-to-end guide to help trustees navigate the process. On top of that, we spoke to trustees, both independent and lay, legal advisers and administrators, everyone involved in the process, to understand what de-risking looks like and what their perspectives are.

"When we don't understand a process, it's really hard for us to engage with it. You're not going to buy something that you don't fully understand, and de-risking is the same. You need to understand what it is you're getting."

How can that ambiguity or lack of clarity affect trustees' decision making?

Lewis: "There's a huge difference in the range of understanding of trustees. A lay trustee told me that they hadn't heard the word 'buy-in' until they'd actually done one. A key output of the research was that we knew that we had to make the process transparent for people and easy to understand. We know from behavioural science that, when you give people this mental model, it's much easier for them to then delve into and understand the detail. It's starting with the big picture, fleshing out the steps, and giving a rounded understanding – that's definitely one of the key outputs that we knew we needed to pull together."

How important is training for trustee boards?

Lewis: "Training is a very important part of what an adviser like Aon does: taking people through the process, allowing them to ask questions, clearing up any ambiguity that comes up during the process. It's very much that kind of learning loop of talking to people, understanding where they get stuck, and then clearing the way for them to understand it better.

"There's very much a case for explaining the process as it happens… When we don't understand something, it's big and amorphous. We need to wrap our heads around it and it's very hard to start with the detail unless we've got the big picture."

Understanding what you're buying

For episode two, Lewis was joined by Martin Bird, head of the risk settlement team at Aon, to begin talking through how behavioural biases affect the process of pension risk transfer.

Let's say we have received initial pricing from the market, whether that's for a longevity swap or a bulk annuity. What biases could affect decision making at this stage?

Lewis: "The bias that comes up the most is the pain of paying. Because you're taking the transaction cost now and the benefit is ongoing, you're reducing your longevity risk, but you're also reducing your risk over a period of time. It's not like paying fees on a regular basis. You're taking the upfront cost, and what we know from brain research is that we experience physical pain in our brains when we pay a lot of money for something."

Martin Bird: "We talk about analysis paralysis quite a lot. I think that comes down to the fact that normally there are a lot of numbers in the system.

"Doing the groundwork upfront to define what pricing you'd be willing to transact at is critically important. We often see trustees and sponsors looking at pricing, and by then it's too late because they haven't actually done the groundwork to understand what metrics are important, and then they're trying to retrofit that framework into live pricing, and that makes life hard."

What happens when pricing doesn't quite work? What biases come into play there?

Lewis: "The bias that comes into play when we're looking at making a decision is sunk cost. This is when we have expended something already, whether that is time, money, or resources, and we're reluctant to back out of a decision because we've already put so much in."

Bird: "We're always very concerned that people on settlement projects don't get carried away with deal fever. There's a sense of excitement about completing a transaction. If the pricing is mediocre, sometimes there's a momentum around the project – you need to make sure you don't just plough on just because you feel like you've already sunk a lot of cost, and effort, and emotional energy into the project."

What role does an insurance company's brand play?

Lewis: "The bias here is called 'familiarity heuristic'. The more familiar we are with the brand name the more likely we are to engage with it and feel comfort around making a decision. The classic phrase is 'nobody gets fired for buying IBM'. That's when people are picking brands – they're doing it because they don't want to feel like they made a mistake."

Bird: "Trustees and sponsors are rightly concerned that, when they come to communicate these transactions to members, what will be the member perception, and how easy will the members find it to understand dealing with different types of insurers.

"Being alert to the influence of brand is an important part of the decision-making process. Having said that, these are complicated transactions. It's not just pricing. We need to put brand awareness in context, but there are a whole range of other factors."

Regret aversion

In the third episode, John Baines, partner and head of the bulk annuity team at Aon, and Lewis discussed 'regret aversion' and how consultants can steer trustees and employers through the risk transfer process.

What is regret aversion?

Lewis: "It's anticipated regret. It's about us wanting to avoid decisions that we might regret in hindsight. The higher the stakes, the more we anticipate regret and we don't want to make an erroneous decision on something that we might regret later."

Baines: "That's something we hear from a trustee and sponsor point of view. When they're thinking about entering a buy-in transaction, one of the

questions we often get asked is, what if life expectancies don't increase, then we will have overpaid for that transaction. Equally, they might just be thinking more fundamentally about the pricing – what if pricing is set to get better into the future? That leads them to the situation where they're slow to take action.

"Other trustee boards are on the opposite side of the fence from a regret aversion point of view. They're keen to make progress, keen to capitalise on pricing, and rush very quickly into transaction without thinking of all the issues."

How can we navigate through regret aversion?

Lewis: "The main way to counter regret aversion is to have an expert on hand. Particularly someone like Aon as a risk settlement adviser, but this is also about your lawyers, it's about people who have been through the process before and can help steer you through it. It's about minimising that anticipated regret by making sure that you've made the right decision in the first place.

"That's where experts can help you navigate that emotional territory of not wanting to do the wrong thing and, by not wanting to do the wrong thing, not doing anything at all, when what you really should be doing is de-risking."

Baines: "We make sure the trustees have all of the information to hand. It's about putting real-life scenarios of what would happen to the pension scheme if life expectancy increased, or didn't increase, whether or not you've considered a buy-in. It's a delicate balance because our job isn't to persuade you to take a certain course of action or not, it's to make sure that you're confident that you've taken the right course of action."

Lewis: "You don't say, 'what if we buy house insurance and the roof doesn't cave in?'. It's really important to think about these kinds of transactions as taking real, obvious risk off the table."

Challenging the status quo

In the final podcast, Mike Edwards, partner in the risk settlement team at Aon, and Lewis discuss how to break through the status quo and how to manage the changes that can occur through a scheme's de-risking journey.

How does status quo bias manifest in a de-risking context?

Lewis: "We have a tendency to stick with what we've already got, which is why people stick with their banks for a very long time. If we're trying to beat that, we have to use some tactics."

Mike Edwards: "For trustees, when we start introducing concepts like buy-ins, longevity swaps and buyouts, they'll be hearing about them for the first time. Most pension schemes have been through a journey of managing their interest rate risk and their inflation risk, so their natural approach is to try and improve their hedging further as a continuation of an existing risk management programme."

What can we do to overcome the status quo bias?

Lewis: "One of the things we want to do is think about the reality that we're heading towards. What is this thing that we want to do? We need to imagine it's reality, and then argue back for what we have today."

Edwards: "We talk about these, sometimes nebulous, concepts of longevity risk and we talk about the actions that trustees can take to remove that risk. That can feel like quite a big step. If you turn the whole situation on its head and imagine a situation with a pension scheme that has removed all of its longevity risk through a buy-in or through a longevity swap, and try and build a business case to bring that longevity risk back onto the pension scheme's balance sheet, that is incredibly hard to do."

Could there be a status quo bias even if you've completed a transaction previously?

Edwards: "It would be easy for schemes to fall into a trap of having done a buy-in, and deciding to do another buy-in. But there are some good case studies in the marketplace where schemes have changed direction over time and done the right thing at the right time for them.

"One of our clients, Pilkington, would be a good example of that. They implemented a longevity swap and the next insurance transaction they implemented was a pension buy-in, and that reflected the attractiveness of the pricing."

To listen to the four podcasts in full, visit aon.com/risksettlementuk

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