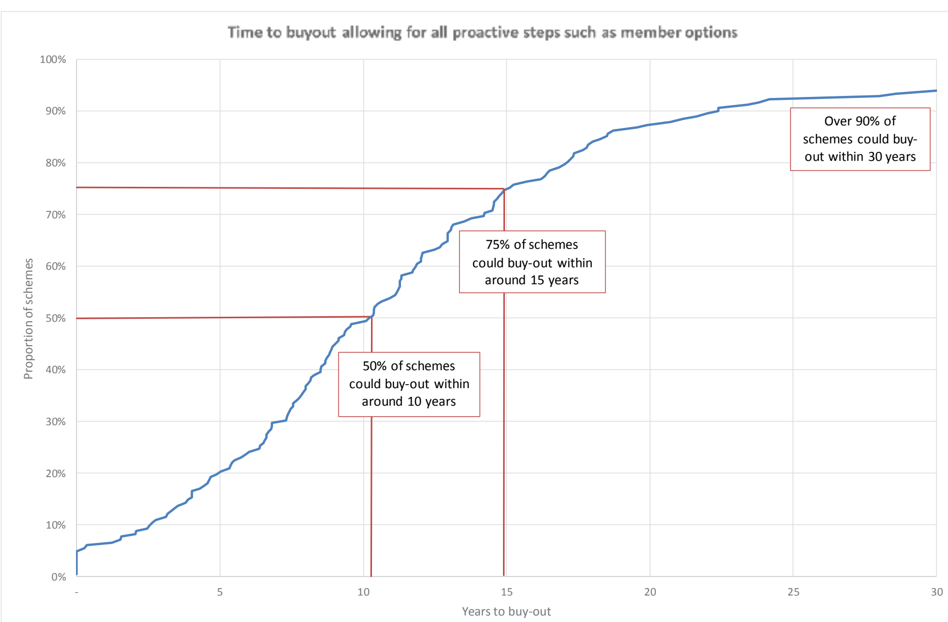
How far to go?

Tom Clarke asks how far away your scheme really is from being able to buy out members' benefits?

Despite current market volatility, record low yields and other pressing issues such as GMP equalisation, trustees and sponsors are talking more than ever about the endgame. Many schemes have a plan or a target date to get to buyout, but do schemes know how far away from buyout they really are? For most schemes, this will be a good news story as there are a number of reasons why buyout might be much closer than you think. Member options exercises and preparatory work taken ahead of approaching the insurance market can significantly shorten the timescales.

Aon has carried out research for all pension schemes with a FTSE 350 sponsor – schemes with liabilities in excess of £1 trillion – to understand what realistic timescales are.



What happens if I take no action?

The good news is that you can expect – on average – to make significant progress towards buyout without taking additional proactive steps. We have estimated the average time to buyout in this way to be around 20 years.

Aon research of schemes with FTSE350 sponsors
Taking proactive steps to reach buyout can halve the typical time taken from 20 years to 10 years.

One in five schemes could achieve buyout within five years following this more proactive approach.

For half of schemes, buyout in five to 15 years is realistic.

Deficit contributions are still being paid into most schemes and these will bridge much of the gap to being able to buyout. But they only go so far, and most schemes are not expecting contributions to continue beyond being fully funded at the three-yearly valuation. Most sponsors are likely to be unwilling to commit additional contributions beyond this point.

Investment returns are also expected to make a significant contribution. But can these be relied on? What is the impact of current record low yields? What happens if a recession hits? What happens if schemes de-risk their investment strategies further? The impact will vary significantly between schemes.

One other positive driver is that as schemes mature, buyout pricing becomes more attractive. This is primarily due to current pensioner members being much cheaper to insure than members who have not yet started to draw their benefits, especially where members exchange part of their pension for a tax-free lump sum upon retirement.

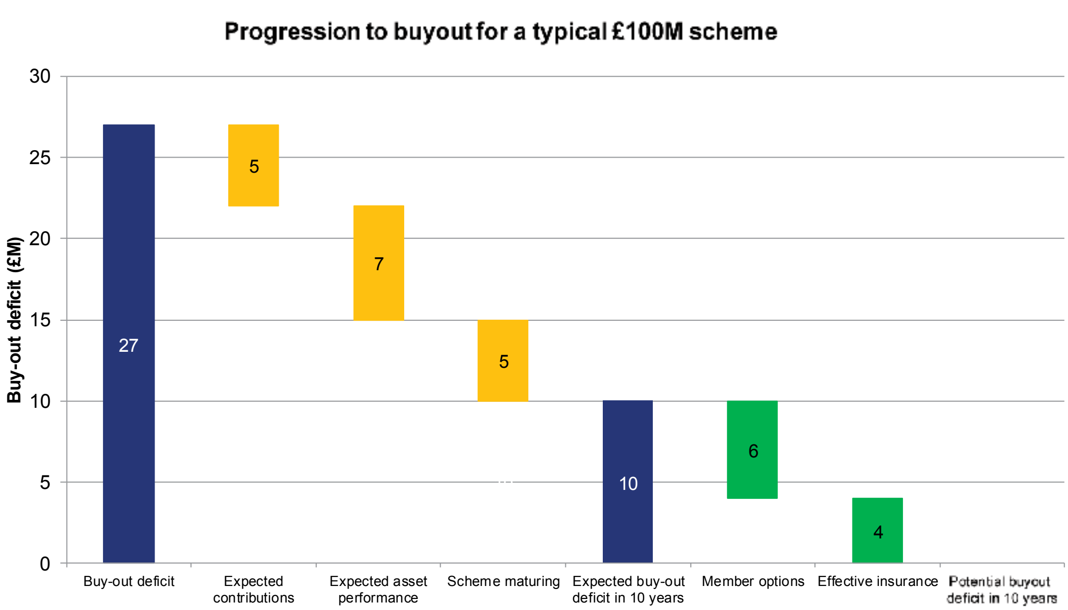
What action can my scheme take?
Our research shows that the typical scheme can expect to reduce its timescale to buyout from 20 years to 10 years through taking a number of proactive steps. One in five schemes could even achieve buyout within five years and a further 50 per cent in five to 15 years. These actions fall into two categories: member options and optimising the insurance transaction.

Member options

Transfers: The popularity of member options has risen significantly in recent years, with record numbers of members transferring their defined benefit pensions to defined contribution schemes. More and more schemes are going a step further and taking steps to facilitate this. In some cases the focus is on regular transfers (often at point of retirement). This typically involves taking steps to help members navigate the complex decision such as by sourcing a reputable IFA and enhancing the member journey through improved communications and online support. Increased transfers could reduce time to buyout by two years.

Bulk transfers: Other schemes are taking similar steps but as a bulk, one-off project such as an enhanced transfer value exercise. One-off exercises are usually particularly attractive as schemes approach buyout. Transfer terms are often more generous to members than the transfer terms which would be available from the insurer following the buyout but still leading to an insurance premium saving. This takes a future profit from the insurer and giving it to members now instead. In this way we often see these exercises

Where does your scheme fit in?
If you would like to understand how distant your scheme may be from buyout, the possible actions to take and how it compares to the schemes in our research, get in touch with Aon at **memberoptions@aon.com** for a free buyout timescale consultation.



as a win-win for transferring members, remaining members and sponsors. This step can bring buyout two to three years closer.

Pension Increase Exchange: Other than transfer values, the other main types of options are those that allow members to reshape their pension. The most common of these is a Pension Increase Exchange exercise (PIE) where members choose to give up future annual pension increases in return for a one-off increase to their pension. With many people preferring to spend more money in the earlier, more active years of retirement, this tends to be a popular option. Such options can look particularly attractive when viewed through the lens of getting to buyout due to insurers pricing inflation-linked pension increases more expensively than would typically be considered fair value. Some schemes may offer other ways for members to reshape their pensions, for example with the option of a bridging pension. This aims to make a member's total income before and after state pension age broadly equal. Implementing these kinds of options, both for current pensioners and as an additional option upon retirement, can reduce buyout timescales by more than two years.

Optimising the insurance transaction

There is also a huge range of actions that schemes can take in the settlement space to attract good buyout pricing.

Member benefits: It is important for schemes to understand early on which benefits are being insured. For example, understanding current discretionary practices (and considering if these should be insured) can have a material impact.

But perhaps the most material variable when it comes to understanding members' benefits is the level of actuarial factors, in particular commutation factors (the factors used to convert annual pensions into tax-free lump sums upon retirement). Insurers have their own sets of factors and typically set these at a level that is far more generous to members than those currently used by most schemes. This could present a windfall benefit improvement to future retirees compared to previous generations of retirees. For some this may be acceptable, but other schemes may prefer the insurer to set factors at a lower level – both for equal treatment of members and for reduced cost. While there is a limited range within which insurers will typically be happy to set their factors, this action could still bring buyout more than a year closer for the typical scheme.

Negotiation: Negotiation plays a key part. Deciding on your strategy for approaching the market (how many rounds of pricing?), maintaining flexibility and partnering with an adviser with experience of similar transactions are all key. Exploiting these competitive tensions in the buyout market could easily reduce buyout timescales by one to two years. In some cases, we have seen insurers reduce pricing by as much as 5 per cent overnight.

Insurer pricing is constantly changing due to supply and demand characteristics, market yields and asset availability. Being ready to transact at the optimal time also helps, with some schemes putting in place triggers to kick off the transaction once the insurance pricing reaches an acceptable level. This can mean schemes for which buyout is just beyond their reach (without additional contributions) can find themselves buying-out following a favourable change in yields.

Data and preparation: In an increasingly competitive buyout market, carrying out preparatory steps such as data cleansing, marital surveys and benefit audits can help schemes to stand out and attract the best pricing. It also avoids nasty surprises further down the line when insurers look into schemes in more detail as part of their due diligence. This can also bring buyout closer, in particular by increasing the attractiveness of your scheme compared to the other schemes obtaining insurance quotes.

What is right for my scheme?

The preferred approach will differ between schemes and not all schemes will wish to carry out all of the activities discussed here. Some sponsors and trustees will prefer a multi-year plan to get to buyout while others will prefer to hold out and consider issues such as member options once buyout is within touching distance.

This kind of planning is also relevant for funding and investment discussions between sponsors and trustees, with some schemes risking being overfunded once the scheme is buyout ready. A nice problem to have for some, but surely something most sponsors would prefer to avoid.

In summary, understanding how far away your scheme really is from being able to buyout members' benefits is the key to making the right decision for your members on funding, investment and the day-to-day running of your scheme.

Success story – PA Consulting

PA Consulting expected that their scheme would run on a self-sufficient basis for 10+ years. This was challenged by the Aon team, who showed that buyout was achievable in much shorter timescales with no further cash contributions. By combining a successful series of member option exercises and bulk annuities, all liabilities were secured, leaving the scheme with a small surplus.

Written by Aon senior consultant, Tom Clarke

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