GUIDE TO

MEMBER OPTIONS

2020

Empower Results®

WELCOME

Following the introduction of 'Freedom and Choice' for defined contribution (DC) pensions in April 2015, we have seen increasing numbers of members transfer out of defined benefit (DB) schemes to access these new freedoms.

While these options could be attractive for some members, they represent important considerations for both trustees and companies alike:

- For trustees, considerations include how to support members to fully understand the options available, whether to increase the range of options available in the DB scheme itself and implications for a scheme's investment strategy.
- For corporate sponsors, a consideration may be to use these new flexibilities as a way to manage risks in a scheme, reduce costs and bridge the gap to a possible future buyout.

Whether you are a trustee or a corporate sponsor, there is a range of issues to consider in relation to the pensions freedoms.

In our 2020 review, we take a look at:

- How trustees are supporting members in their decision making at retirement
- The latest on bulk member options exercises and the IFA market
- Examples of schemes which have used member options exercises to bridge the gap to buyout
- Trends in schemes offering members more flexibility at retirement
- Investment considerations when carrying out member options exercises.

Our insights are underpinned by the results of Aon's 2020 Member Options Survey covering 310 defined benefit schemes, as well as our experience advising on more member options exercises than any other consultancy in recent years.

KELLY HURREN
PRINCIPAL CONSULTANT
HEAD OF MEMBER OPTIONS

DRIVING BETTER MEMBER OUTCOMES

1 CHAPTER

1 DRIVING BETTER MEMBER OUTCOMES

CHAPTER

In this fast-changing world, we are using new channels to get the information and support that we need in life. We use technology to turn the lights on, do the shopping, have a virtual GP appointment, manage our personal finances and even to buy or sell houses. Why should pensions be any different?

> Members may not be aware of their options if they are not communicated effectively

KELLY HURREN
PRINCIPAL CONSULTANT
HEAD OF MEMBER OPTIONS

ONE OF THE BIGGEST FINANCIAL DECISIONS

For most people, a pension ranks alongside a house as their most valuable financial lifetime asset. Any future decisions on both require great care and expertise.

Poor retirement decisions or inept financial planning can have disastrous consequences. But how can members be expected to make the *right* decisions if they are not aware of, or fully-understand, their retirement options?

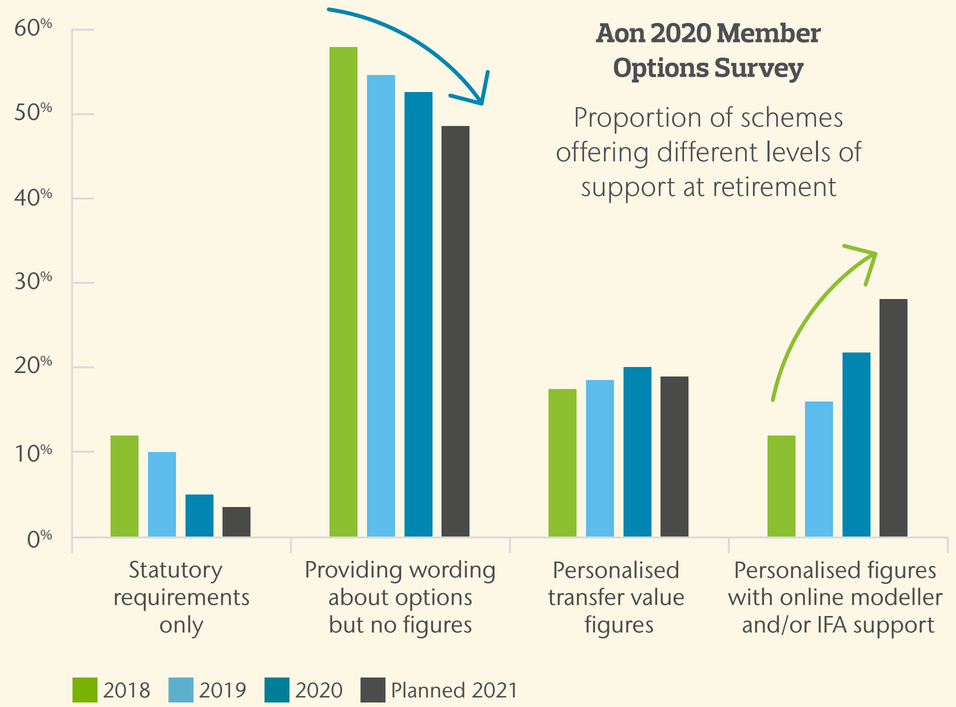
The guaranteed income from a pension scheme is likely to be the right option for the majority of members. Some members however, could benefit from the flexibility offered by pensions freedom options (for example, those in poor health, the unmarried, or those with a desire to pass on their pension as an inheritance), and these members may not be aware of their options if they are not communicated effectively. Perhaps that is why trends over recent years are showing a change in this area.

Pension scams remain a worrying predatory presence in the pensions universe – we encourage members and trustees to be vigilant in the face of this danger.

BUT WHAT DOES SUPPORT LOOK LIKE?

At Aon we do not think that 'one size fits all' and we see our clients taking a range of approaches to support members whilst complying with statutory requirements, some of which include:

- Communications to members at 'key ages' to warm them up to their different options well ahead of retirement
- More engaging communications – both written and digital, with artistic flair being used to highlight key information, incorporating engaging covers for retirement packs and company-specific branding
- Online modellers for members to explore and contrast scheme retirement options with pension freedom options
- Provision of paid-for, independent financial advice from a qualified, reputable and vetted IFA
- Tailored videos explaining member options in a simple and engaging way
- Apps which enable trustees to send push notifications to members at key decision points
- Online-only communication exercises for international companies
- Annual benefit statements being provided to members of DB schemes



The chart above illustrates the results from Aon's 2020 Member Options Survey, which shows us that:

- Half of schemes quote (or shortly plan to quote) transfer values in retirement packs
- Fewer schemes are providing wording without also providing transfer value figures
- Schemes that only follow statutory requirements are very much in the minority, and should make a conscious decision about whether they remain comfortable with this approach
- Separately, in addition to retirement support, we are seeing more and more DB pension schemes providing annual benefit statements to members, with some also including transfer value quotes in these statements

AROM

21,500

MEMBERS GRANTED ACCESS

£7.5bn

OF CASH EQUIVALENT TRANSFER VALUES

60

LIVE SCHEMES

The Aon Retirement Options Model (AROM) was the first online educational tool to hit the market in 2016.

This tool can be used to help members explore and compare the immediate income they can receive in retirement, based on taking their scheme pension or by exploring pensions freedoms. Importantly, this tool is pre-populated with personalised member data – improving engagement and maximising member understanding.

Being the first of its kind to launch in the market means we have been able to continually adapt the tool to the evolving priorities of pension scheme members.

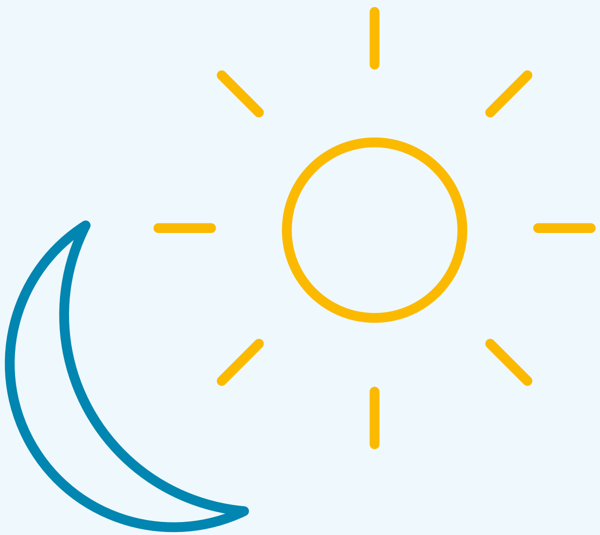
We must not forget that members are people – and people are individual.

Interestingly, when AROM was first designed, it was anticipated that members would use it 'out of hours' for support at times when IFAs were unavailable.

In fact, our data suggests that members use it most during working hours – perhaps when a quick check online is acceptable at the office but a lengthy call to an IFA is not. The heatmap to the right shows when AROM is being used the most – with 11am to 1pm the most popular time of day.

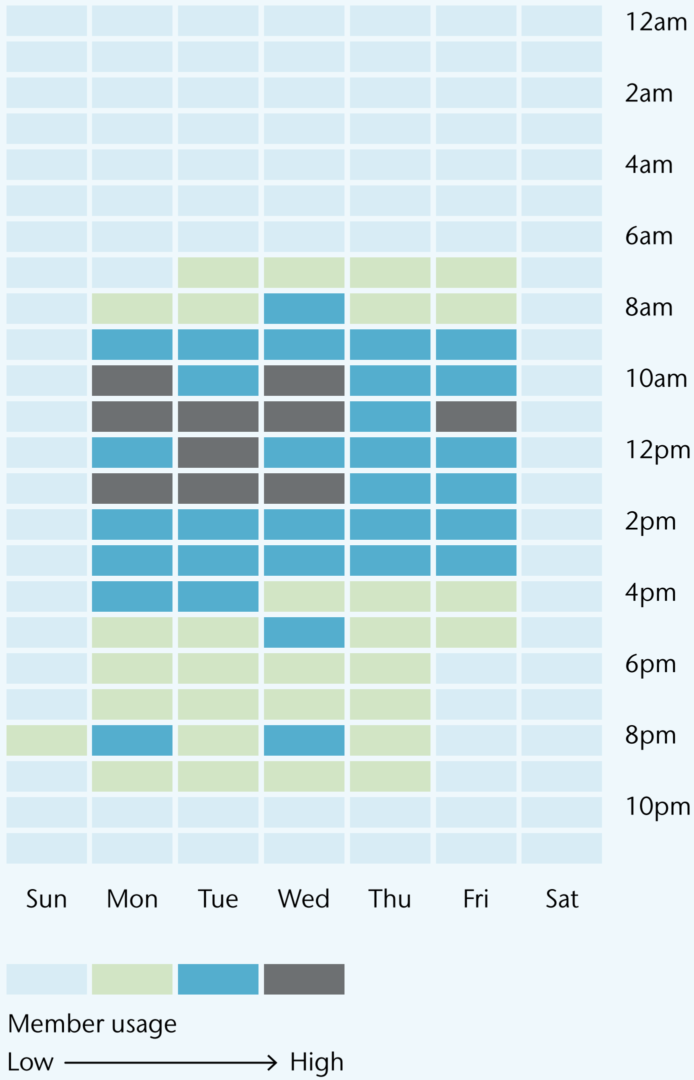
But members use the modeller at times that suit them. Some members have logged in on a Friday night, some at anti-social times in the morning, and some even on Christmas Day! Further evidence that one size doesn't necessarily fit all.

Fortunately, technology can help trustees to be flexible and is usually a cost-effective way to meet the needs of many different members.



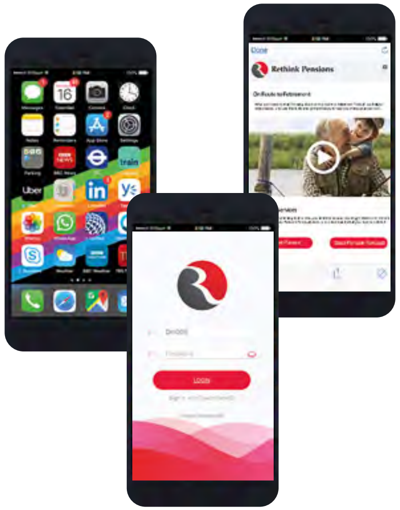
Usage of Aon's Retirement Options Model (AROM)

Showing users by time of day



INCREASING USE OF TECHNOLOGY

Technology is now more accessible to individuals than ever before. Trustees and employers are increasingly using app-based functionality to communicate with members, improve education and increase member engagement.



Aon's Retirement App is able to store key documents and send push notifications when new materials are released. This improves the speed and accessibility of communications.

Our Well One App (a global first health and wealth app) combined with our Wellbeing scorecard can help you and your employees further identify and understand individual health and financial needs, including areas of stress.

"

Members have more options than ever before as to how they draw their pension, so at Steve Southern Trustees Limited, we strongly believe they need more support to ensure the best possible member outcomes. Aon and I have been working on a mutual client to help improve the member retirement experience. As a trustee, it's about helping members to be able to make an informed decision, and achieve the right outcome for them.

The process starts with educational communications, long before members are even eligible to take their pension. We then seek to engage with them using a number of different communication channels, paper communications, an online retirement modeller (AROM), and paid-for IFA support.
We hope this leads to something for everyone and enables our members to make informed decisions.

"

REBECCA WOOD
STEVE SOUTHERN TRUSTEES LIMITED

AN UPDATE ON BULK EXERCISES

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2 AN UPDATE ON BULK EXERCISES

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Aon advised on bulk exercises involving:

In 2018

25,000 members

In 2019

50,000 members

Over the last two years, Aon advised on a new bulk transfer value exercise or Pension Increase Exchange (PIE) exercise roughly every other week, covering a wide range of schemes from £100m to over £7bn in size. So, what kinds of offers are we seeing?

ANDREW GASKELL
SENIOR CONSULTANT

"Offer terms, the IFA market and GMP equalisation should be considered when running a bulk exercise"

TYPICAL OFFER TERMS

Based on recent experience, most bulk transfer exercises offered an enhancement to the scheme's standard transfer value – on average around 20% – and we see a correlation between the size of the enhancement and the level of take up of the transfer value option.

PIE exercises also remained very popular in 2019. Typical offer terms provided members with between 70-80% of the value of their pension increases, with the remaining 20-30% improving the funding position of the scheme.

However, unlike transfer value exercises, take-up of the PIE offer is not generally correlated to the terms on the offer.

Members often already have their own view on how much they value inflation protection, which is independent of the terms of the offer.

IFA MARKET

The Financial Conduct Authority (FCA) has been consulting on a ban on contingent charging for DB transfer advice. Whilst the IFA firms which we consider for IFA selection with our clients do not work in this way, contingent charging continues to be used by many high-street IFAs and we expect that this was a key driver behind recent headlines and criticism of rates of transfer.

We expect the FCA to provide an update on this in the second half of 2020.

We have also become aware of the FCA applying greater scrutiny to IFA firms in relation to DB transfer advice, and a number of firms have voluntarily surrendered their permissions to give such advice.

The above factors, compounded by a significant rise in the cost of professional indemnity insurance, lead us to expect a contraction in the wider IFA market over 2020.

BULK TRANSFER EXERCISES

Whilst member engagement has remained relatively steady, 2019 saw a decline in take-up of transfer options for members under the age of 55.

For an IFA to advise an individual transfer, members must now be able to articulate a retirement plan. IFAs have told us that it is now more difficult to give a positive recommendation to transfer for younger members – unless there are specific, compelling circumstances for each individual case.

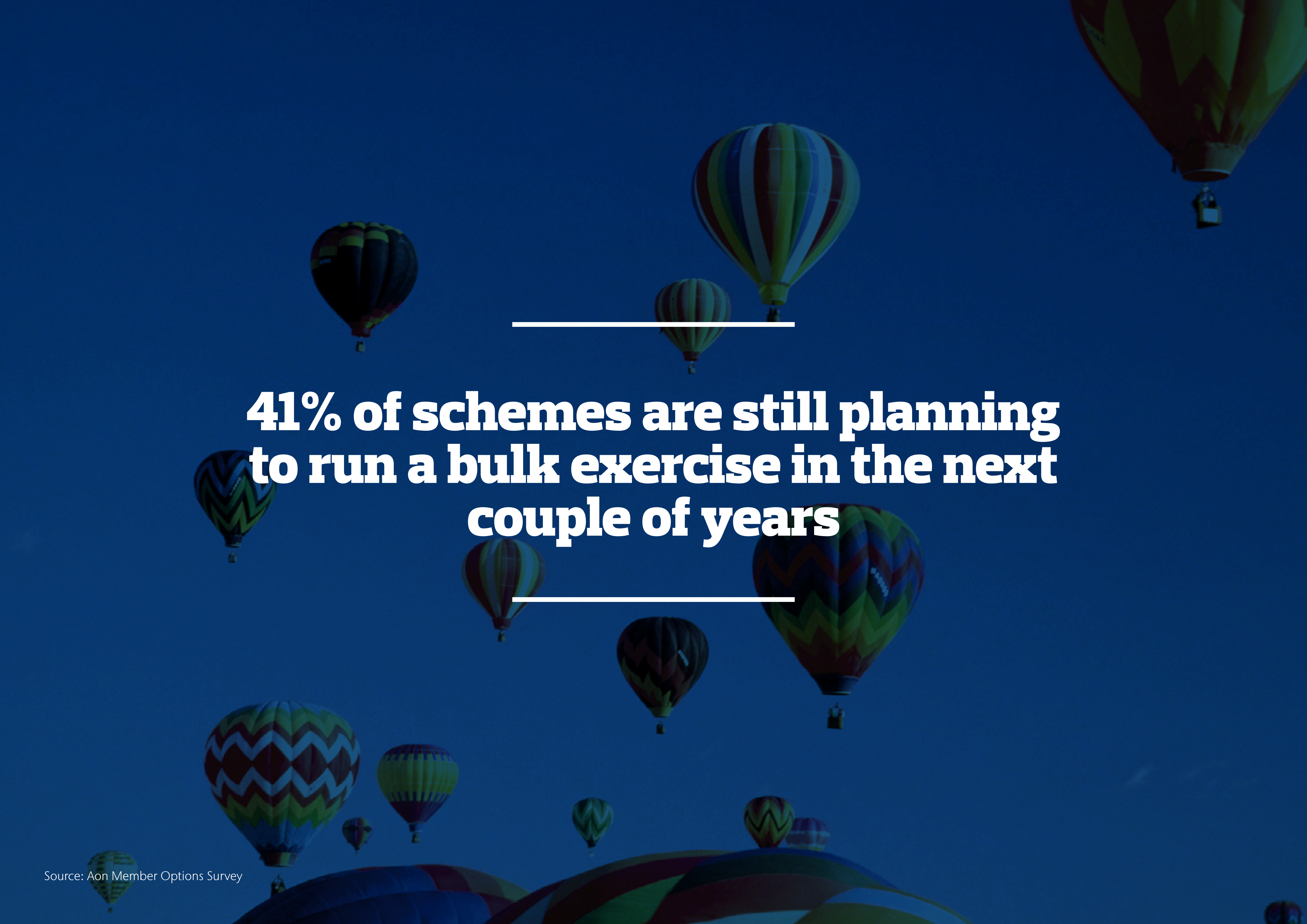
Take-up rates amongst members closer to retirement for 2019 were broadly in line with data from recent years.

BULK PIE EXERCISES

Between 2018 and 2019, PIE exercise engagement and take-up has remained relatively static – and we would expect this trend to remain the case for 2020.

COVID-19

Regardless of the pandemic, IFA firms are all generally operating as normal with many having the infrastructure to work from home seamlessly. As a result, engagement rates on bulk exercises have remained largely unaffected.



41% of schemes are still planning to run a bulk exercise in the next couple of years

Source: Aon Member Options Survey

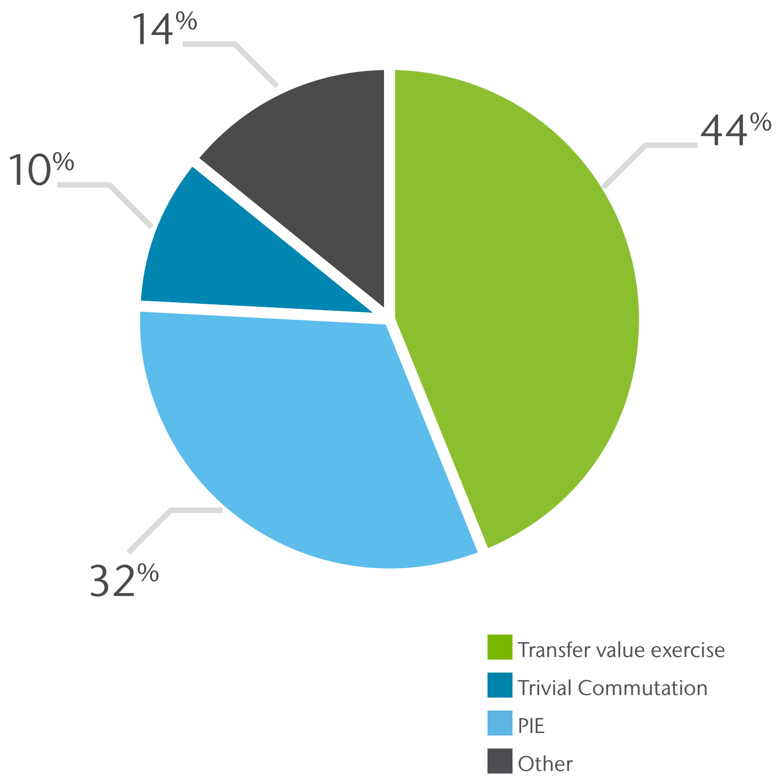
GMP EQUALISATION: A POTENTIAL BANANA SKIN?

On 26 October 2018, the High Court published its judgment on Lloyds Banking Group Pension Trustees Limited vs Lloyds Bank plc (and others). The pensions industry finally had some guidance on this long-standing issue. Many had expected that the requirement to equalise GMPs between the sexes would throw a spanner into the works of bulk member options exercises.

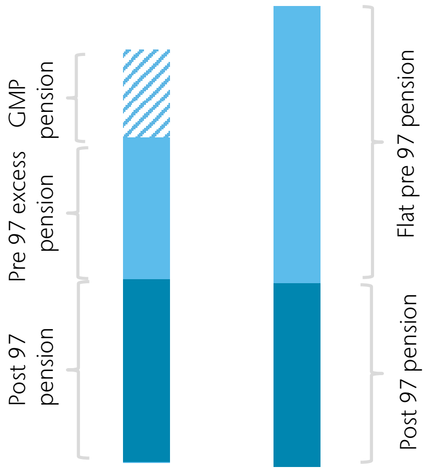
While GMP equalisation brings its own challenges, evidence to date suggests the impact on transfer value and PIE exercises has been more limited in practice. Since the judgment date, most schemes proceeded with their bulk exercises in 2019, often using various mechanisms to ensure that once GMP equalisation had been completed, members would receive any additional benefits due. Furthermore, based on the results of Aon's recent Member Options Survey, 41% of schemes are still planning to run a bulk exercise in the next couple of years.

We are seeing a lot of clients who view joint PIE & GMP conversion exercises as a neat way to provide additional pension flexibilities to members, as well as leading to better outcomes for the scheme. In one of our 2020 surveys, 55% of clients reported that they were either progressing such an exercise already or intending to do so in future.

What bulk exercises are schemes planning?



Source: Aon 2020 member options survey



GMP CONVERSION: A POTENTIAL WAY FORWARD?

Many schemes are now exploring whether GMP conversion could be the most advantageous way of delivering GMP equalisation, as required by the High Court judgment. This has the potential to make a PIE exercise more attractive, as the converted GMP pension could be included in the PIE offer.

PRIOR TO CONVERSION AND PIE:

Scheme pension is a rainbow of multiple tranches of benefit. Only non-GMP pre 97 tranches are eligible for PIE.

POST GMP CONVERSION AND PIE:

GMP can be converted into a regular scheme pension which is then in scope for PIE. A range of different increases can be exchanged for a higher flat pre 97 pension. Bringing the GMP part of the pension into scope for a PIE exercise typically increases potential savings by around 20%, but this is very scheme-specific.

WHAT IS GMP CONVERSION?

One of the administrative challenges of dealing with GMP is that it usually increases in a different way to other scheme benefits, both in deferment and payment.

GMP conversion permits schemes to transform an existing GMP benefit into a different form of pension with the same actuarial value. In doing so, a potentially complex series of pension tranches can be exchanged for a single benefit. Not only is this significantly easier to administer, it should be easier and cheaper to secure with an insurer when the time comes to buyout.

In summary, these type of exercises continue to feature prominently on corporate and trustee agendas, with many exercises either being planned or already underway in 2020. IFAs in this space continue to be busy, but there is capacity in the market, supported by new entrants and increased capacity in existing firms. While most schemes have yet to address the issue of GMP equalisation, we do not expect this to be a significant barrier in the near term.

CHAPTER 3

A NATURAL STEP AHEAD OF THE ENDGAME?

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2019 saw over £10bn in full scheme buyouts, continuing the rising trend to move directly to full buyout rather than opting for a series of buy-ins first. For many schemes, the path to full buyout can seem a long way off. But what if there was a faster way to get there?

In recent years, we have seen member options exercises being successfully carried out in advance of approaching the insurance market to bring down the cost of the buyout premium. What if we were able to integrate these exercises and carry them out at the same time, rather than treating them as separate projects?

JAMIL MERALI
PRINCIPAL CONSULTANT

IN 2019 OVER

£10bn

TRANSACTED IN FULL PENSION SCHEME BUYOUTS

CASE STUDIES

Schemes integrating member options with full buyout

During 2018, Aon advised two of the largest fully-funded buyouts; Rentokill and PA Consulting – both of which integrated member options in the buyout process.

In 2019, Aon advised on the largest buyout of a leading technology company (£4.7 billion), which was preceded by member options exercises.

Although the parent companies of the schemes were very different, they all shared a common goal – to secure member benefits and free their businesses from large pension scheme obligations. They were all keen on reducing risk, but their buyout targets were a long way off without a large cash injection.

When insurance pricing improved a buyout started to look more affordable, so the schemes began to consider the possibility of carrying out member options exercises to help bridge the gap.

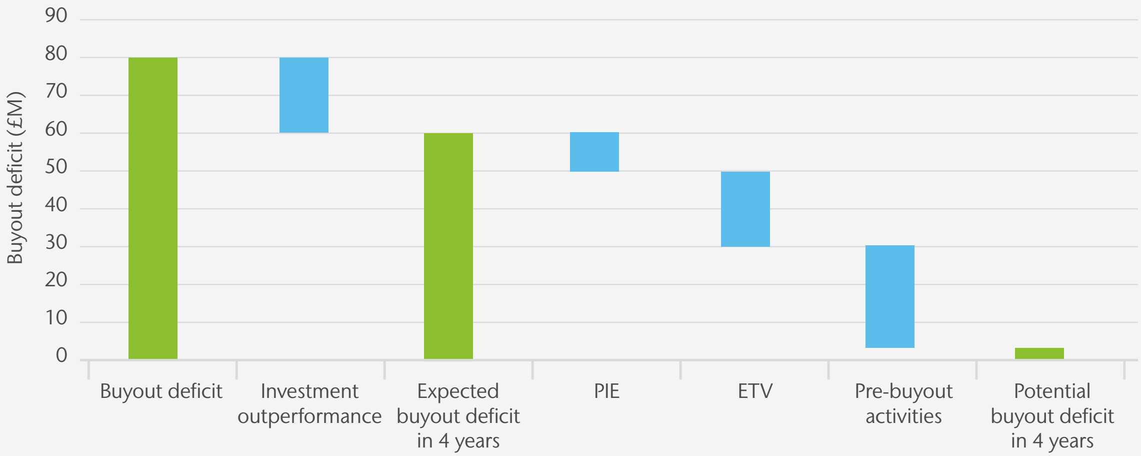
Both Rentokill and PA Consulting actually ended up with a surplus – a better outcome than envisaged at the start of the project. Members were given the option to reshape or transfer their benefits out of the schemes – and these exercises were carried out alongside the insurance broking process. Running the processes alongside each other in this way was a first in the market in 2018.

Member options continue to be integral to planning for full buyouts.

"This project has achieved the outcome we really wanted. By a collaborative approach from all parties, we have been able to secure a deal which no-one imagined possible at the outset."

Kully Janjuah, PA Consulting

Expected evolution of the buyout deficit at the start of the project



BUYOUT SPECIFIC CONSIDERATIONS

On the face of it, the structure of these exercises was similar to any other member options exercise; however, the key difference here is the proximity to buyout. If members took no action, they would end up with an insurance policy at the point of buyout. This means there are several special considerations for these projects compared to a regular member options exercise.

SCHEME TERMS VS INSURER TERMS

After buyout, members will still be able to take a transfer value from the insurer, but this means that the transfer terms available in the scheme will need to be compared with the transfer terms that the insurers would offer members following the transaction.

Trustees from two of the recent large buyout cases were able to offer members terms that were more generous than the insurer terms, yet still provided savings on the buyout premium.

INSURER LIAISON

If the timing of the exercises means they can be concluded before the final round of insurer pricing, the impact can be captured in this pricing.

For one scheme, the buyout happened on accelerated timescales and, in this case, the insurer agreed to underwrite the risks associated with the transfer exercise as part of the final round of pricing. This was a first in the market and allowed the trustees and company to lock intothe transaction more quickly than would otherwise have beenthe case.

COMMUNICATION WITH MEMBERS

Communication material will need to be carefully drafted to explain the offer being made, the potential buyout transaction and that IFA advice is being provided to help members decide whether or not to transfer ahead of buyout. High quality advice is crucial in these circumstances, so it will also be necessary to fully brief the IFA so that they understand the process.

In one of our case studies, 85% of the members contacted the IFA for advice, which shows the importance of providing access to good quality advice in such projects.

IN THE FUTURE

As more schemes look to the insurance market as a way of reducing risk, we see it becoming increasingly common for member options exercises to be carried out alongside the insurance broking process. For those schemes that are moving towards full funding, there is now a lot of merit in giving serious consideration to whether that buyout target is closer than previously thought.

ALTERNATIVES TO BUYOUT

Throughout this chapter we have focused on buyout as the ultimate long-term destination, but it would be wrong not to comment on the alternatives to buyout at this stage.

In particular, in Q1 2020 the Pensions Regulator published its Funding Code consultation. This consultation focused on defined benefit pension schemes with the aim of improving security and governance over the short and long term. The consultation proposed to introduce a series of principles by which pension schemes will be expected to comply. The second principle from the consultation requires trustees and companies to set long term objectives for their schemes. Whilst this objective could indeed be to target buyout, pension schemes have the opportunity to investigate other long term destinations such as self sufficiency which, depending on each scheme's specific circumstances, may or may not be more attractive.

Additionally commercial consolidators continue to be an attractive option for some schemes. There are an increasing number of third parties willing to take risk away from pension schemes, with new regulation expected in 2020 to support these models. Although this will not be right for everyone, a lower cost option is likely to be an attractive endgame for some. Watch this space!

OTHER OPTIONS

CHAPTER 4

4 OTHER OPTIONS

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310

SCHEMES SURVEYED

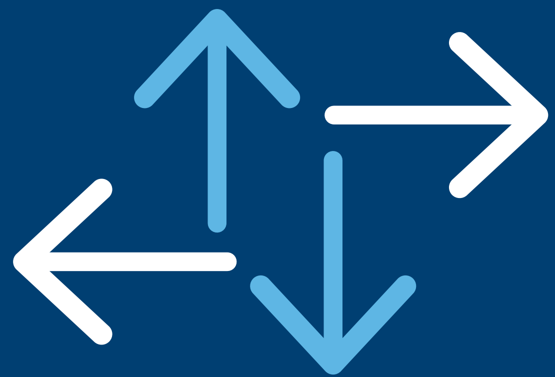
60%

OFFER FLEXIBILITY AT RETIREMENT

MORE AND MORE FLEXIBILITY

A ‘one size fits all’ approach is becoming increasingly rare in pension schemes. As members approach retirement, trustees and companies are recognising that members are placing increased value on options and flexibility. Historically, members were usually faced with a binary choice at retirement – taking a transfer out of the scheme, or taking the scheme pension. However, in this ever-changing pensions environment several new, innovative mechanisms have been developed and introduced over the last few years.

Flexibility has become increasingly popular in the current environment, with members less likely to withdraw money from DC funds – instead looking to options from their DB schemes.



OPTIONS PROVIDED TO MEMBERS AT RETIREMENT

These additional options are popular with members, with almost 40% of schemes that offer a PIE option at retirement seeing take-up rates of more than 25%.

Transferring out of a DB scheme can be seen as an 'all or nothing' decision – whereas the alternative options shown allow members to benefit from both the security of a DB pension and the flexibility of transferring to the DC market.

We are seeing many clients take increasing interest in bridging pension options, an emerging trend in the member options space.

32%
Extra spouse's pension

12%
Bridging pension

24%
Partial transfer option

32%
Pension Increase Exchange (PIE)

53%
Transfer out

Long-term security coupled with greater flexibility

PARTIAL TRANSFERS

Following the introduction of pensions freedoms, most schemes have experienced an increase in members transferring out to take advantage of pensions flexibilities. However, for members, the transfer decision leads to a 'binary' choice between long-term security from the regular income of a defined benefit pension, versus greater flexibility from transferring to the defined contribution world.

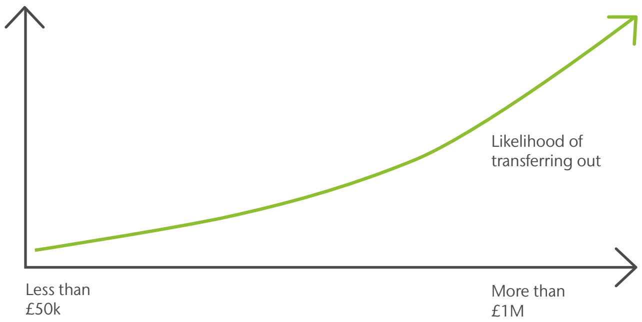
A partial transfer gives members the option of transferring just a proportion of their defined benefit pension and leaving the rest in the scheme. So, what is not to like about an option that provides members with both security and flexibility?

RICHARD COOK
SENIOR CONSULTANT

THE BEST OF BOTH WORLDS?

There are clear advantages for some members who could benefit from defined benefit security and defined contribution flexibility at the same time. Aon's analysis below shows that when only provided with the option of a full transfer, the members most likely to transfer are those with the largest pots.

Member decision by size of transfer



Members with modest-sized pension pots may not be able to afford the risk of transferring all their defined benefit pension, but if a partial transfer was available, they may benefit from transferring a portion. Additionally, members who have multiple defined benefit pensions may be comfortable transferring one of their pots in its entirety and leaving the others unchanged. However, long-serving members do not have this flexibility unless they are provided a partial transfer option.

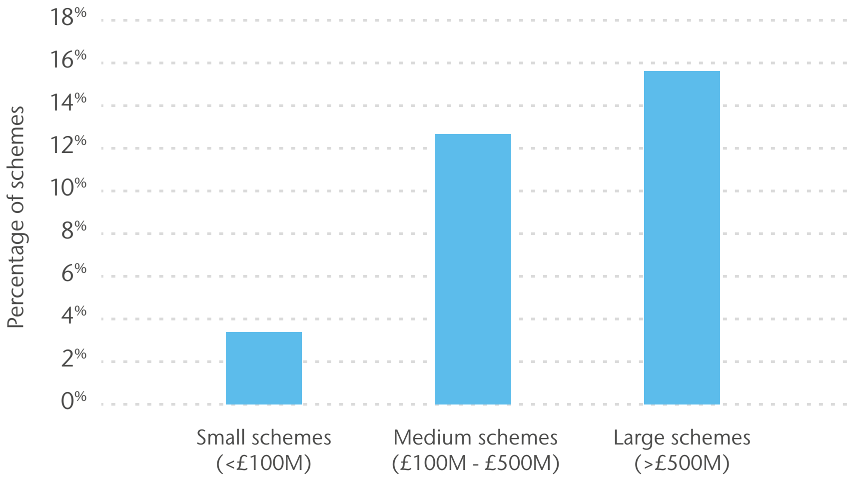
So, plenty of potential advantages for members – but what about trustees and sponsors?

A partial transfer may give some comfort to trustees and sponsors who are concerned that a binary option may not lead to best outcomes for members. Where there are concerns from trustees and sponsors regarding the risk of members/employees running out of funds in retirement, a partial transfer option can address those concerns. It also opens up opportunities for a much wider spectrum of members, leading to greater risk reduction overall.

SO, HOW POPULAR IS THIS OPTION?

Aon's recent Member Options Survey has shown that around 10% of pension schemes that offer a transfer option at retirement also offer a partial transfer option – with larger schemes tending to offer greater flexibility for members.

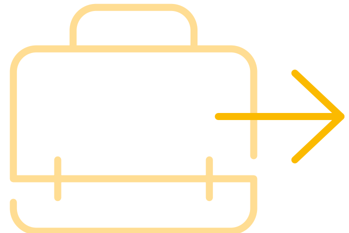
Schemes offering a partial transfer option alongside a transfer value at retirement



Given the advantages, why are more schemes not doing this?

The most likely reason is that schemes have only recently started considering the support they provide around full transfers – such as communications, online tools and IFA support. Offering partial transfers is seen as an extension to the full transfer process and this is only just starting to make it onto the agenda for most schemes.

Offering partial transfers is seen as an extension to the full transfer process



1 in 10

Schemes offer a partial transfer option alongside full transfer values – it's likely more schemes will be considering this option going forwards.

IT SOUNDS LIKE A WIN–WIN, SO ARE THERE ANY PITFALLS?

We have talked about the potential advantages of offering members a partial transfer option, but there are some potential pitfalls to consider when setting up such an option.

COMPLEXITY

First off, although it may be a valuable option for a wide range of members, it has the danger of leading to member disengagement if not communicated properly. Clear and engaging communications that do not overwhelm members are therefore vital to realise the benefits.

ADMINISTRATION

Secondly, there will be administration considerations when the option is first set up to ensure the administrators can calculate the correct portion of benefits to transfer and the correct portion to put into payment at retirement. Administrative challenges can be reduced if the option is well designed – administrators are used to processing a cash lump sum option on behalf of most members at retirement; a partial transfer option would work in a similar way. Options to reduce the administration burden include limiting the availability of the option to ‘at retirement’ only and to limit the offer to fixed proportions, such as 25%, 50% or 75% of pension.

In addition to administration and communication, there are a range of structural considerations, including:

- Which tranches of pension should be transferred first – eg will the ‘more expensive’ or complicated slices of pension be transferred first (maximising any funding savings and risk reduction)?
- How do schemes deal with smaller benefits? Does the scheme impose a minimum size of partial transfer or residual benefit left in the scheme?
- Will the option be included as part of any bulk exercise, or just as a ‘business as usual’ option?
- Will the option be available at any point before retirement, only at retirement as a one-off, or unlimited?

Partial transfers will not be right for all schemes and they need to be carefully structured to reduce complexity. Given the benefits, we think more schemes will be considering this option going forwards.

MEMBER OPTIONS – WHAT ARE THE INVESTMENT CONSIDERATIONS?

5

CHAPTER

5 CHAPTER

MEMBER OPTIONS – WHAT ARE THE INVESTMENT CONSIDERATIONS?

Trustees should be mindful of the impact on a scheme's investment strategy before, during and after member options exercises. Investment considerations include:

CASHFLOW MANAGEMENT	INTEREST RATE AND INFLATION HEDGING
IMPACT ON REQUIRED RETURN	IMPACT ON PRICING OF BULK ANNUITY INVESTMENTS

In this chapter, we focus on the interaction between member options and these considerations, identifying practical steps trustees can take to plan for and manage the investment impact.

CAROLINE ALLENSBY-GREEN
PRINCIPAL CONSULTANT

CASHFLOW MANAGEMENT

In current market conditions, liquidity is low and cashflow management is even more important – especially when it comes to large cashflows from a transfer exercise.

These strategies have merits and drawbacks, depending on scheme circumstances. Nevertheless, we welcome the increased focus on managing cashflow risks, which is a key consideration for all schemes. It is important that trustees have a robust plan in place for managing both expected and unpredictable cash outflows.

POOR CASHFLOW MANAGEMENT CAN LEAD TO:

- A need to sell assets at short notice, when prices may be temporarily depressed
- Higher transaction costs from asset redemptions
- A greater governance burden for trustees

Because member options exercises can lead to increased (and less predictable) cash outflows from schemes in the short term, cashflow management can become of even greater importance. The key is to have a well-documented plan in place, a robust process to reduce operational risks, and sufficiently liquid assets that can be sold at short notice and at limited transaction cost. The nature of the asset to be sold can also be important, because a more stable asset is less likely to be sold at a temporarily depressed price.

LDI DESIGN

Member options have an impact on the liabilities, which in turn affects liability hedging design. For example:

A PIE exercise will reduce the inflation sensitivity of some of the scheme's liabilities. If this is not reflected in the LDI solution, and all else being equal, the scheme will become over-hedged to inflation relative to the trustees' target.

Transfers reduce the value of the remaining liabilities in the scheme, which can result in the scheme becoming over-hedged relative to the target hedge ratio if the LDI solution is not adjusted.

Three ways of updating a liability cashflow benchmark:

1 RE-DOING

A liability benchmark is the most costly approach and requires new cashflow data from the scheme actuary.

2 RE-CASTING

A liability benchmark involves taking the existing benchmark, rolling this forwards to a current date, and approximately allowing for changes to the liability profile that have occurred due to the member options exercise.

3 RE-SCALING

A liability benchmark requires scaling the existing liability cashflow benchmark to an updated liability value which takes account of the member options exercise.

The most appropriate approach will depend on the size of the scheme, the level of hedging in place, and the popularity of any member options exercise. For example:

Update to liability cashflow benchmark	RE-DO	RE-CAST	RE-SCALE
Impact of member options exercise	>10% of total liabilities transferred out; or >10% change in proportion of inflation linkage	5-10% of total liabilities transferred out; or 5-10% change in proportion of inflation linkage	<5% of total liabilities transferred out; or <5% change in proportion of inflation linkage
Size of task	Most involved	Medium	Simplest

Note: example only for a large scheme with a high hedge ratio. Clients should seek specific advice in relation to their schemes.

WHY DOES THIS MATTER?

If the inflation sensitivity of the liability benchmark differs from the underlying liability by 10%, then for a scheme with assets of £100M, a 0.5% shift in inflation could result in a £1M difference between where the asset value is expected to be and its actual position.

If there is a mismatch in the present value of a liability benchmark versus the target liabilities of a similar magnitude, then there will be a similar financial impact from interest rate yield movements.

In our recent Member Options Survey, 8% of schemes had seen their liabilities reduced by more than 5% as a result of transfer values being paid out. This was broadly matched by around 10% of schemes updating their liability hedge by a 're-scale' or 're-cast' approach.

The importance of maintaining an accurate hedge will depend on the circumstances of the scheme. For example, better-funded schemes with high levels of hedging are more likely to place a greater emphasis on maintaining an accurate LDI hedge, because an inaccurate hedge may become one of the largest remaining risks in the scheme.

REQUIRED RETURN

It is possible that funding improvements resulting from member options exercises could reduce the required return on the scheme's investments. In other cases, significant cash outflows can exacerbate the consequences of under-funding, because a smaller asset base needs to 'work harder' to close the scheme's deficit.

FOR EXAMPLE

A scheme with £100M liabilities and £90M assets requires c.1% p.a. asset outperformance to become fully funded in 10 years (assuming no deficit contributions are made). To illustrate the principle with an extreme example, if £50M of benefits are transferred out, the scheme will have £50M liabilities and £40M assets, and will require c.2% p.a. outperformance from the residual assets to meet the same goal.

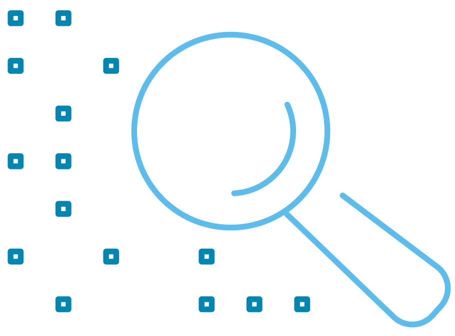
BULK ANNUITY INVESTMENTS

Funding gains from member options exercises may make bulk annuities more affordable. By reducing uncertainty (for example, a reduction in inflation risks following a Pension Increase Exchange exercise), insurance premiums may also fall.

PLANNING FOR MEMBER OPTIONS EXERCISES

In our view, the best way to plan for the investment impact of member options exercises is to analyse the expected cashflows from a scheme over time, with different member options outcomes.

Various stresses can then be applied to test the resilience of potential investment strategies. For example, we can address questions such as 'if there is a 20% take-up rate in an ETV exercise, and an LDI collateral call occurs around the same time, are the scheme's assets sufficiently liquid to meet these payments? And what will be the impact on remaining asset liquidity?'



Funding gains from member options exercises may make bulk annuities more affordable

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About Aon

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