Mid-Market Pension Survey
2012

So many ideas, such little time
*The pension challenges facing the mid-market*
<table>
<thead>
<tr>
<th>Contents</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Key findings</td>
<td>1</td>
</tr>
<tr>
<td>Introduction</td>
<td>2</td>
</tr>
<tr>
<td>Survey demographics</td>
<td>4</td>
</tr>
<tr>
<td>Part 1: Pension scheme strategy</td>
<td>6</td>
</tr>
<tr>
<td>Part 2: Dealing with assets</td>
<td>10</td>
</tr>
<tr>
<td>Part 3: Dealing with liabilities</td>
<td>15</td>
</tr>
<tr>
<td>Part 4: Operational challenges</td>
<td>19</td>
</tr>
<tr>
<td>Part 5: Keeping you awake at night</td>
<td>23</td>
</tr>
</tbody>
</table>
Key findings

- The single factor that concerns mid-market schemes more than any other is the external costs of running the scheme. Getting adequate resource to deal with pension issues is also a major challenge. The strongest theme emerging from the survey results is the contrast between the huge number of options that mid-market schemes now have at their disposal and the relative lack of resources (time, money, expertise) to explore these options.

- Two out of five mid-market schemes are now frozen – ie closed to future accrual for existing members, as well as to new entrants – and this is expected to continue to increase.

- Most schemes now have a long-term target, with just under half describing this as ‘self-sufficiency’. Timescales to reach long-term targets are typically in the range of 5-15 years, but with a quarter having longer-term timeframes. Only around a quarter of schemes said they had a robust strategy to reach their target – around one-third admitted their plan was ‘aspirational only’.

- Investment continues to be dominated by the 3Ds – Diversification (eg through diversified growth funds and the like), De-Risking and Dynamism (dealing with fast moving markets). Delegation of investment may have a strong role to play here. The trend away from equities – and UK equities in particular – towards alternative and matching assets is expected to continue.

- Nearly two out of five mid-market schemes have some sort of investment trigger in place, either based on investment conditions (eg equity market levels or interest rates) or more likely the scheme funding level. In a minority of cases these triggers are automatic – executed as soon as the trigger is reached – but most prefer some form of manual intervention or ‘last look’.

- Delegation is becoming more mainstream for a growing minority of mid-market schemes, although often on a partial rather than full basis. Around 14% of schemes have already delegated one component of their investment process, with another 27% saying that they are likely to do so soon.

- Liability management in the form of Enhanced Transfer Values and Pension Increase Exercises remain relatively uncommon, but with many more schemes expecting to implement these exercises in future, despite the threat of a new voluntary code. Trivial commutation exercises remain by far the most popular exercise in the mid-market, although one in five schemes say they have imposed a cap on the increases in pensionable salary.

- Buyout and Buy-in continue to be of interest, although with lower levels of activity at present due to low gilt yields. Most transactions in the near term are likely to be pensioner buy-ins from schemes with substantial gilt holdings.

- Despite the current focus of the longevity market on large deals, over 20% of mid-market schemes expect to have some longevity hedging in place over the next one to three years, suggesting that the demand exists in anticipation of the supply emerging.

- Nearly nine out of ten schemes believe that their data is either clean or that they have cleaning it in hand. However many of the other activities that are required to facilitate de-risking and settlement have not yet been tackled.

- Monitoring of all aspects of a pension scheme continues to increase in frequency, with funding levels for over half of mid-market schemes now being monitored quarterly or more often. One third of schemes monitor the employer’s covenant on a quarterly basis.

- The majority of schemes would be prepared to invest now (either time or money) to reduce the risks and costs associated with administration. Just under three-quarters said they would be prepared to encourage members to use self service (eg via the internet) to contain costs.
Introduction

Welcome to the Aon Hewitt Mid-Market Pension Survey 2012 – the definitive guide to what is happening in the mid-market of defined benefit (DB) pension schemes.

Mid-market is one of those terms that is difficult to define. Many in the industry have a different view of what the mid-market is, but at the same time everyone agrees what it is not. It does not mean the 3% of schemes by number that between them own about 60% of pension scheme assets in the UK. Nor does it mean the thousands of schemes at the other extreme with just handfuls of members. When we talk about the mid-market we mean the schemes between those extremes – the schemes with substantial assets, hundreds or thousands of members, and between them thousands of sponsors and tens of thousands of trustees, who are facing major pension challenges on a day-to-day basis.

Chart 1. Distribution of schemes by assets and number

- The smallest 2,300 schemes (35% of the market) control just 1.2% of the assets between them.
- The largest 220 schemes (3% of the market) control 64.3% of the assets.
- The remaining 34.4% of the assets, some £320 billion, is controlled by some 4,000 schemes that can loosely be said to represent the “mid-market”.

These schemes are the core of the pensions consulting industry. While Aon Hewitt advises many of the largest schemes in the country, around 50% of our clients have less than £50m in assets, and 75% have assets of less than £250m. As a business therefore, we really care about the mid-market and all its needs.

For this survey we particularly looked at responses from those involved with schemes with assets of between £20m and £500m. The survey was not limited to that range, and we received responses from schemes either side. In this analysis we have included schemes right down to the smallest that responded, which were under £10m in assets. However, to ensure that the survey remains representative of the mid-market, we have limited the core results to schemes with assets of less than £500m. We have commented where the results for larger schemes show material differences from their smaller counterparts. We thank all of the participants for their contribution.

Coming up with a single conclusion from this survey was always going to be a challenge. Within the mass of schemes that is the mid-market, we encounter every issue imaginable, and to claim that all mid-market schemes face the same issues would be to do an injustice to the diversity of circumstances and challenges that sponsors and trustees face. However, if there is one theme arising from the results, it would be the contrast between the huge number of options that mid-market schemes now have at their disposal and the relative lack of resources (time, money and expertise) to explore these options.
In this report, we look at a wide range of areas from funding to investment and longer-term plans, to administration and general trusteeship. In all of these areas, there are challenges to be faced, an ever-increasing number of options to deal with those challenges, and continual pressure to find the resources to address the challenges and implement the solutions. While the survey shows that many mid-market schemes have tackled most of the areas above with some vigour and determination, it also highlights a proportion which has not yet applied the latest thinking and tools to tackle their pension scheme issues.

So why is that? We are not, of course, so naïve as to think that every idea is right for everyone. Indeed a large part of our role as trusted advisers to many mid-market schemes is to help them separate the wheat from the chaff. But we do believe that there are more opportunities available for schemes and sponsors in the mid-market than have been implemented to date. In part this is due to some of the ideas being new and not yet fully tried and tested across the market. But in many cases we believe the underlying cause is related to the resources available to mid-market schemes:

- **Financial**: Lack of cash or a viable business plan to tackle the issues effectively.
- **People**: Time constraints on those who might have the ability and skills to work on the project.
- **Expertise**: Knowing what to tackle first and how to make it work, and how to get the right balance between in-house resources and those from external parties.

This was particularly clear when we asked schemes which issues were their greatest concern. The top six issues are illustrated below.

**Chart 2. Key concerns of mid-market schemes**

Of course, resource constraints are not limited to the mid-market but we believe they are often more intense in these schemes. As more and more solutions become available to the mid-market, the range of options which need to be considered continues to increase. The challenges to the mid-market are therefore set to stay for some time to come.

**Aon Hewitt**  
**February 2012**
Survey demographics

The Aon Hewitt Mid-Market Pension Survey 2012 received a total of well over 200 responses from across the UK. The schemes in the core sample, with assets of up to £500m, represent total assets of around £30bn and over half a million members.

Chart 3. Responses by size of assets

<table>
<thead>
<tr>
<th>Size of Assets</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>£0 - 20m</td>
<td>26%</td>
</tr>
<tr>
<td>£20 - 50m</td>
<td>20%</td>
</tr>
<tr>
<td>£50 - 100m</td>
<td>25%</td>
</tr>
<tr>
<td>£100 - 200m</td>
<td>20%</td>
</tr>
<tr>
<td>£200 - 500m</td>
<td>9%</td>
</tr>
</tbody>
</table>

Trustees dominate the responses, representing almost two-thirds of those responding (including 9% of responses from independent trustees). Pension managers make up another 21% of responses (a substantial proportion given that the existence of a dedicated pension manager is something of a luxury for many mid-market schemes) while 4% indicated that they held other company roles. 10% of respondents selected the ‘other’ category, and this covered a range of roles, with the most common single role (around 3% of responses) being the secretary to the trustees.

Chart 4. Role of the respondents

<table>
<thead>
<tr>
<th>Role</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sponsor</td>
<td>10%</td>
</tr>
<tr>
<td>Trustee</td>
<td>56%</td>
</tr>
<tr>
<td>Independent Trustee</td>
<td>9%</td>
</tr>
<tr>
<td>Pensions Manager</td>
<td>21%</td>
</tr>
<tr>
<td>Other</td>
<td>4%</td>
</tr>
</tbody>
</table>
With the continued trend towards closing schemes, not only to new entrants but also to existing members, we asked about the closure status of schemes. The vast majority of respondents were closed to new entrants. In our core sample, 39% of schemes are now frozen – that is, closed to future accrual for existing members as well. This is a substantial increase compared with perhaps two to three years ago, and something which Aon Hewitt had predicted.

However, compared to figures published in other surveys, this is a high closure rate – for example, the most recent NAPF survey, issued in December 2011, quoted a figure of 23%, while the Pensions Regulator’s most recent Purple Book, based on data at 31 March 2011, quoted a figure of 24%.

There are two main reasons for the differences.

First, the information in this survey is more up to date than the Regulator’s data. Given the pace of closures, that makes a substantial difference, and we would expect the next publication from the Regulator to see a substantial increase in closures.

The NAPF figure of 23% is quite recent, and is a significant increase on the previous figure of 17% of schemes they surveyed, which confirmed the trend. However, we believe that a strong factor in that survey compared to this one is the size of the schemes. Closure rates are closely related to scheme size, with smaller schemes typically taking the final step of closing to existing members much faster than larger schemes. While the percentage of schemes closed to accrual was 39% in our core sample, for schemes over £500m the percentage was 20% (i.e. close to the NAPF result), and that rate reduces further as schemes get larger. At the other extreme, the closure rate for schemes under £20m in this survey was 61%. These findings are consistent with the conclusions of our Global Pension Risk Survey 2011, which also noted that smaller schemes were much more willing (or perhaps compelled) to take measures such as closure to existing members, which help to control the risks and costs associated with their pension arrangements.

The Pensions Regulator also shows this feature strongly – over 50% of the smallest schemes (under 100 members) are frozen, whereas among the largest schemes (over 10,000 members) this figure drops to under 5%.

Chart 5. Scheme status

- Open to new members and accrual
- Closed to new members, open to accrual
- Closed to new members and accrual
Part 1: Pension scheme strategy

There is an old saying, attributed to a famous mathematician, which goes “If you don’t know where you are going, any road will take you there”. Although the mathematician in question is better known for his nonsense story about a young girl, a talking rabbit and a mad hatter, the inoffensive statement above is clearly not fiction.

When it comes to pension schemes, one of the trends in recent years has been for trustees and sponsors to think more rigorously about the endgame for their pension scheme, and consequently about the road that they need to take to get there. This in part has been due to the increased pace of scheme closures, meaning that many schemes now have a finite (albeit still quite long) lifetime. However, recent turbulent economic conditions (and how long has it been since we have had benign market conditions?) have led both sponsors and trustees to conclude that they have no desire to run a scheme which has such a high level of risk. A long-term lower risk destination must be considered.

Therefore, in our survey, we asked what sort of long-term targets now exist for pension schemes. We also asked about the strategy and timescales to get there.

Long-term targets

We asked about the long-term funding target that pension schemes had in mind. Although all schemes are required to report their statutory ‘Technical Provisions’, it is increasingly common for schemes to have in mind an additional, longer-term target. Our survey results suggest that most schemes do indeed now have such a long-term target in mind – even if they have not yet developed a full plan to reach it.

We found that the most common long-term target, chosen by 48% of respondents, was what we described as ‘self-sufficiency’. We described this in the survey as “a long-term target to be funded in a way that the scheme becomes self-sufficient (independent from the sponsor but without buyout)”.

Buyout remains a target for a substantial minority (24%) of mid-market schemes, while 19% of schemes identified their long-term target as something that is low risk but not self-sufficient. These results are consistent with what we have seen in previous years, although the proportion of schemes that say they have no long-term target is steadily reducing (from 17% in the 2011 Global Pension Risk Survey, to just 7% in this survey).

Chart 6. Long-term target
Although the term ‘self-sufficiency’ is cited regularly as a target, there is no doubt that it means very different things to different people. At one extreme, it may be very similar to ‘low risk’, while at the other extreme, it can be comparable to full buyout funding. While purists may argue that there should be a clear definition of self-sufficiency, in practice it is for each scheme to determine what is appropriate in their own circumstances. However, that does imply that each scheme needs to understand what their particular definition means. This includes what investment strategy would be required to support that long-term target once it is reached, what risks they would still face, and any reliance they would still have on the sponsor – for example in relation to expenses or PPF levies. There may well be time to refine what is meant by self-sufficiency, as we shall see later.

Comparing the results across schemes of different types, a number of differences emerge:

- Large schemes are less likely to have a buyout target than mid-market schemes. The proportion of schemes with assets over £500m targeting buyout is just 9%. This feature was also witnessed in Aon Hewitt’s Global Pension Risk Survey 2011. There is perhaps still a perception that buyout is not an option available to the largest schemes – or maybe that it is more economical to target a fully de-risked investment policy and longevity swaps to create a synthetic ‘do-it-yourself buyout’.

- Closure tends to increase the focus on buyout, particularly closure to future accrual. The percentage of schemes targeting buyout increases from 13% for open schemes, to 32% for schemes which are closed to future accrual.

**Timescales**

In relation to timescales, we found that the most common targets were 5 to 10 years and 10 to 15 years, with nearly two-thirds of respondents fitting into these two bands. These timescales are not too dissimilar to those reported to the Pensions Regulator under Recovery Plans for correcting Technical Provisions.

**Chart 7. Target timeframe for long-term strategy**
There are, however, some target timescales in this survey that are substantially longer than those typically reported to the Pensions Regulator – reflecting the fact that long-term targets are often substantially tougher than Technical Provisions. Many schemes clearly have long-term targets in place (or at least in mind) that are above and beyond the level of the statutory provisions.

We looked at these two factors – long-term target and timescales – and how they related to each other. We found that all types of target have a fairly similar range of timescales associated with them – ie the tougher buyout targets are no further away than the easier low risk targets. This suggests that there is some self-selection happening, with schemes that can feasibly achieve buyout aiming to do so, while those that are simply too far away from buyout targeting something more achievable. The art of the possible rather than the theoretical is clearly alive and well.

**Flight Plan – or aspiration?**

Finally, we asked a question about the plans that schemes have to reach their targets. This was a specific addition to this year’s survey: in the Aon Hewitt Global Pension Risk surveys we have asked about funding targets and timescales but not about the detailed plans that have been made to achieve them.

The results showed that around a quarter of schemes describe themselves as having a robust plan in place to reach their long-term target. Around two out of five schemes said they had only a basic plan, and almost a third of schemes said they had no plan at all for how to reach their long-term target – it is purely an aspiration at this stage.

**Chart 8. Plan to reach long-term target**
The fact that a third of schemes have no plan to reach their target is, at first sight, a concern. However, in practice we do not believe that things are quite as bad as they look. A number of schemes are in a position where the most important issue is the general direction of travel – for funding to improve through contributions and investment return, regardless of what the end destination is or how long it will take. For those schemes it is clearly not unreasonable to embark upon a journey that is simply to be ‘better funded’, but over time that does need to evolve into a specific target and strategy to succeed. Both the destination, and the method of reaching it, can be refined and modified over time, as the potential to reach the eventual destination becomes more credible.

Perhaps surprisingly, the closure position of the scheme is not a key driver of behaviour in this area – schemes that are closed to accrual are only modestly more likely to have a plan in place. However size does seem to be a significant factor. For schemes with assets above £500m, the survey indicates that 47% have a robust plan in place (almost twice as many as the mid-market) and only 21% say that their long-term target is just an aspiration.

**Action points**

Actions that Aon Hewitt recommends in this area are:

- To put in place a long-term target and a flightplan to get you there.
- To understand what it will feel like to reach that destination (including the implied investment strategy and any residual risks).
- To test the flightplan to ensure it is robust.
Part 2: Dealing with assets

Investment strategy is one of the most important decisions facing pension scheme trustees. In most cases it has the potential to impact on the scheme to a far greater extent than contributions, and possibly only the covenant has a bigger influence on the security of members’ benefits.

In this survey we have deliberately not asked about how schemes are invested today. That information is widely available in a number of other places, and in many schemes is driven largely by their own scheme maturity, funding position and sponsor covenant. For most schemes, knowing what assets are held by the ‘average scheme’ is interesting but of minimal relevance.

Instead we have looked at trends in investment strategy – what do pension schemes expect to buy more of, sell more of, and whether those decisions are likely to be based on hard coded pre-determined views – i.e. triggers.

We have also looked at the role that delegation plays in today’s investment landscape, and the views that exist among trustees and sponsors. As with the rest of this survey, the focus remains on the mid-market and the investment decisions being taken by those schemes.

Investment trends

The survey asked respondents what they expected to happen to their target investment strategy over the next one to three years. For the most part, the results show a continuation of the trends that we have witnessed through our regular Global Pension Risk surveys. We can summarise the changes under our 3D headings – Diversification, De-Risking and Dynamism.

- **Diversification** leading to a reduction in equities (particularly UK equities but also global equities) in favour of alternative growth asset classes.

- **De-risking** leading to reduction in growth assets in favour of increased liability matching/defensive assets.

- **Dynamism** reflecting the size and speed of strategic change and continued interest in active asset allocation overlays.

Chart 9. Expected change in growth asset holdings over the next 1-3 years
We found that open schemes are moving away from equities more slowly than closed schemes – which is perhaps not that surprising given their longer time frames. We did not find material differences across different-sized schemes.

Looking wider than the core data and comparing to schemes over £500m, the main differences relate to the growth in alternative assets and active asset allocation, where larger schemes are more interested in extending allocations but make less use of diversified growth funds or similar. This division was evident in the latest Global Pension Risk Survey. However this survey shows that the mid-market is also exploring ways to tap into these themes – to move away from the reliance solely on equities as the driver of performance, and instead looking at ways to cope with the rapid movements that seem to be a permanent feature of modern capital markets.

While capturing the advantages of these themes clearly presents new challenges for smaller schemes, the benefits for mid-market schemes remain compelling. We expect to see continued interest as products are developed which offer access to these strategies in a way that fits with the governance and financial budgets of the schemes. Diversified Growth Funds, for example, cover a wide range of asset classes, including not just equities, but property, commodities, corporate bonds and even hedge funds – all within a contained, accessible, competitively priced unit. In some of these vehicles the manager also has discretionary authority to make tactical moves between asset classes in response to changing market conditions. Delegation of investment provides the ability to take this one step further.

Interestingly, the survey showed only minor differences in expectations in relation to longevity hedging, where smaller schemes – even those under £100m – are expecting to do almost as much as their larger cousins over the next one to three years. The pace of change in this market is clearly rapid, and over that timescale we do expect the longevity hedging market to become more commoditised, to the point that mid-market schemes have an easy way to access these products. In early 2012 that may still be ambitious, but we believe that by the end of the year the market will be more accessible than ever – and we will be working with providers to support that aim. After the Pilkington transaction at the end of 2011, which took the total longevity deals to around £11bn (of which Aon Hewitt has been involved in close to £8 bn) Legal and General stated “… now we’re in the market we’ll be looking at transactions involving liabilities of £50m and upwards”.

**Chart 10. Expected change in matching asset holdings over the next 1-3 years**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Percentage of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed interest government bonds</td>
<td>Reducing: 20%</td>
</tr>
<tr>
<td>Index linked government bonds</td>
<td>No Change: 50%</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>Increasing: 30%</td>
</tr>
<tr>
<td>LDI funds</td>
<td>Reducing: 15%</td>
</tr>
<tr>
<td>Longevity hedging instruments</td>
<td>No Change: 65%</td>
</tr>
</tbody>
</table>
**Investment triggers**

As well as general trends, we asked whether schemes had triggers in place to determine when they make changes to investment strategy. Triggers are often a way of dealing with very fast moving markets, where delays in decision making can lead to missed chances and the failure to capture valuable opportunities. We have commented on the growth of trigger mechanisms in previous Global Risk Surveys. In this mid-market survey, we asked specifically about three types of trigger:

- **Funding level triggers**, which result in a switch from growth assets into matching assets in response to improved funding position. For example, if the funding level hits 90%, then we will sell 5% of our equities, and re-invest the proceeds in government bonds.

- **Growth only triggers**, which result in the sale of growth assets in response to improved market levels/prices. For example, we may sell equities when the FTSE100 index reaches 6,000.

- **Matching only triggers**, which result in an increase in the level of matching in response to rising yields or falling inflation expectations. Many schemes would like, for example, to put interest rate swaps in place – but not at current yield levels. So a matching trigger may be to put on an interest rate hedge if 20 year yields hit 4%.

The results confirm the continued growth in popularity of triggers. Nearly one in three mid-market schemes report that they already have some form of funding level trigger in place, while around one in five state they have growth asset triggers, and another one in five have matching asset triggers.

After allowing for duplicates, nearly two out of five schemes stated that they operated at least one or other of these types of trigger.

We further looked to see how the triggers operated. Within the overall results there was a mix of trigger types, including:

- Fully automatic triggers (ie executed as soon as the trigger is hit).
- Semi-automatic (ie some manual intervention when the trigger is hit, but at a modest level), and
- Manual (ie the trigger prompts a meeting or discussion to agree an action).

Each of these areas present challenges and in many cases involve some degree of delegation by the scheme.

This is a pattern of triggers that is very similar across all schemes – regardless of size or closure status.

**Chart 11. Use of triggers**

![Chart 11. Use of triggers](image)
Interest in triggers in the mid-market has clearly developed rapidly in recent years. Had we asked these questions just five years ago, then the level of trigger activity in the mid-market would have been close to zero, and even as recently as 2010 we estimate that take-up would have been under 10%. We expect that when we ask the same question again in a year or two we shall see a further noticeable increase. Rapidly moving markets present both opportunities and threats to improving funding levels. Trigger mechanisms are not the only, or the perfect way, to deal with these conditions, but they can help on the path to a longer-term lower risk future.

**Delegation**

Finally in this section, we asked about attitudes to delegation as it applies to investment. In its widest sense, delegation by trustees covers a wide range of areas, including administration, communication, preparation of financial statements and day-to-day investment and disinvestments. A few years ago when it came to the core investment strategy, delegation was a contentious issue with trustees. The signs are that it is becoming more mainstream for a growing minority of mid-market schemes, although there remains a meaningful group in the ‘will not delegate’ camp.

One of the challenges in this area is getting a clear understanding of what delegation means. In this survey and in an attempt to ensure that the results are meaningful, we therefore gave extensive descriptions of what we meant by each type of delegation. In the box below we have repeated those definitions.

<table>
<thead>
<tr>
<th><strong>Manager monitoring:</strong></th>
<th>adviser monitors day to day performance and reports periodically to the trustees</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Manager selection:</strong></td>
<td>adviser selects managers without trustee ‘beauty parade’</td>
</tr>
<tr>
<td><strong>Asset allocation:</strong></td>
<td>adviser adjusts asset allocation or introduces new asset classes on behalf of trustees</td>
</tr>
<tr>
<td><strong>Hedging decisions:</strong></td>
<td>adviser changes degree of protection/leverage based on behalf of trustees</td>
</tr>
<tr>
<td><strong>Entire investment policy:</strong></td>
<td>all of the above, subject to overall objectives and strategy having been decided by the trustees</td>
</tr>
</tbody>
</table>
The results show that the vast majority of schemes are already comfortable with delegating responsibility for monitoring managers – the quarterly performance reports, together with regular supplements on manager activity and structure, make this an easy area to outsource. Delegation of other aspects of the investment process is illustrated in Chart 12.

**Chart 12. Attitudes to delegation**

<table>
<thead>
<tr>
<th></th>
<th>Already delegated</th>
<th>Very likely to delegate</th>
<th>Somewhat likely to delegate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manager selection</td>
<td>10%</td>
<td>5%</td>
<td>8%</td>
</tr>
<tr>
<td>Asset allocation</td>
<td>8%</td>
<td>5%</td>
<td>13%</td>
</tr>
<tr>
<td>Hedging</td>
<td>5%</td>
<td>4%</td>
<td>16%</td>
</tr>
<tr>
<td>Entire Strategy</td>
<td>5%</td>
<td>3%</td>
<td>9%</td>
</tr>
</tbody>
</table>

Investment strategy is one of the most important decisions that a trustee board has to make and it is understandable why trustees can feel that they should not delegate responsibility for these decisions. On the other hand, it is difficult for trustee boards, particularly in the mid-market, to maintain deep investment expertise. It is also challenging to put in place a governance structure to make investment decisions rapidly where required. Perhaps one way of reconciling these points of view is the fact that trustees typically only delegate the implementation of their investment strategy, not the formulation of that strategy?

While the results indicate that many UK schemes are yet to be convinced of the benefits of a fully delegated solution, there are clearly many schemes for which that model is favoured. 5% of schemes in the survey indicated that they had already delegated their entire investment strategy, and another 12% said that they were likely to do so. That in itself shows that delegation is certainly not a fringe activity. Further, if we exclude manager monitoring (on the basis that most schemes already delegate this), around 14% of schemes have already delegated at least one of the decisions outlined above, with another 27% saying that they are likely to delegate at least one of those decisions.

These results are consistent with our view that these approaches will find favour with some 20-25% of schemes in the medium to longer-term. However, at least for the present time, it appears that partial delegation seems to have more attraction for the mid-market.

**Action points**

Actions that Aon Hewitt recommends in this area are:

- To continue to monitor asset classes and strategies which become more accessible to mid-market schemes, to consider ways to diversify your growth assets, and to watch for the arrival of longevity hedging for schemes of your size.
- To consider the role that triggers could play in supporting the scheme’s strategy, what type might be appropriate, and how you could effectively run them.
- To consider the role that delegation plays in relation to investment and to decide which aspects of strategy are best delegated and which are best retained by the trustee board.
Part 3: Dealing with liabilities

While dealing with assets is one of the most important issues that a scheme faces, that does not mean the liabilities can be ignored. And in recent years we have seen both trustees and sponsors recognise that fact and start to consider options that previously were not even on the radar.

By the middle of the last decade, the pensions provided by UK defined benefit (DB) schemes were effectively guarantees backed by the sponsor, with no way out. Other countries such as Ireland and the Netherlands had taken different ways to resolve the dilemma between benefit levels and affordability. But the change to the debt on the employer regulations in 2003 meant that in the UK schemes had no escape route. Buying out the scheme was not an affordable option – and even selling the business did not provide a way out as buyers were so reluctant to take on DB pension commitments.

Much changed from 2005 onwards. In particular, sponsors started to work on reducing their pension scheme liabilities. Having taken the step of closing to new entrants and then to future accrual, the next step was to dismantle the remaining liabilities of the pension scheme – systematically and one piece at a time. Buy-ins, transfer incentives, pension increase conversions, trivial commutations and other exercises became the focus. The era of liability management had begun.

**Liability management**

We asked schemes about a range of liability management actions that they might be undertaking, from buyout and buy-in to the type of enhancement and incentive options that have recently been the subject of so much attention from the Pensions Regulator and the Minister for Pensions.

The results indicate that in the areas of enhancements and incentives there is a substantial minority that is actively pursuing each idea. Almost a third of schemes have or are likely to run an enhanced transfer value exercise, while 18% have or are likely to run a pension increase exchange exercise. Almost four in ten schemes have or are likely to run at least one or other of these exercises.

The results also show that there are far more schemes likely to implement either an enhanced transfer value exercise or a pension increase exercise in the future compared with those that have already completed such an exercise. It is possibly for this reason that the government is paying more attention to such exercises. In October 2011, the Minister for Pensions, Steve Webb, announced that he was establishing an industry working group to produce a voluntary code on how these exercises should be undertaken. The first draft of this code is due to be published in May 2012.

The most popular exercises to be undertaken relate to trivial commutation and restricting increases to pensionable pay. While trivial commutation is an easier exercise, it often does not have the same financial impact as the other exercises. Restricting pensionable pay, however, can get most of the financial benefits of freezing the scheme without the same emotional response.

Buyout and buy-in are on the radar for 36% of schemes. While buyout is likely to be out of reach in the short-term for most schemes, interest remains for pensioner buy-ins. This is particularly the case for schemes with significant gilt holdings which have seen their assets keep pace with, or surpass, the increase in the cost of annuity policies.
But while the results show a substantial level of interest in the various types of liability management, with the exception of trivial commutation exercises, the percentage of schemes pursuing them is still well under 50%. As we indicated in the introduction to the report, it is clearly not the case that every idea is right for every scheme. But we do believe that there are more opportunities available for schemes and sponsors in the mid-market than the figures above suggest.

One of the challenges facing mid-market schemes is how to tackle these exercises in a cost-effective way. The nature of some of the exercises is that there is an up-front cost with a lot of uncertainty around potential take-up. For larger schemes, the up-front cost is lower relative to the size of the scheme and the size of the membership means that take-up rates are likely to be more stable. Nevertheless, we believe that exercises such as these are becoming more standard, and schemes that have previously considered and rejected these ideas may find that over time they become more feasible.

Finally, when we cut the data by type of respondent, we found modest differences by size, but we did find one interesting difference – that pension managers have much lower expectations around enhanced transfer value exercises than all other groups, with 76% stating that they are ‘unlikely’ to run such an exercise, compared to around 50% in all other groups. This may be because many pension managers remember the impact of pensions mis-selling in the late 1980s and early 1990s and they have concerns that enhanced transfer value exercises could be subject to similar scrutiny, with the benefit of hindsight, in the years to come. It is therefore welcome that the Minister for Pensions is seeking to establish a voluntary code to set high standards for such exercises.
Clean Scheme

As well as liability management we asked in the survey about progress towards a ‘clean scheme’. By this, we mean a scheme that has taken the necessary actions to prepare for future de-risking activities, whether they are closer matching of the liabilities, transfer exercises, buy-in, or even other options that do not yet exist. As well as the obvious activities such as data cleansing, we asked about a range of other measures where we see schemes taking action to ensure that they have a complete and accurate assessment of the liabilities in their scheme.

The results show that the most common activities at the present time are around cleaning data and tracing members, while areas such as confirming that the benefits are understood and that the deeds are up to date are also relatively common. However, even in these areas, schemes need to be cautious about having misplaced confidence. Many schemes on reaching buyout or PPF entry realise that benefits and data that they had previously assumed were ‘clean’ still fall short of the requirements, resulting in additional time and cost.

Chart 14. Progress towards a clean scheme
At the other extreme, relatively few schemes have started to think about whether the assets are ready for possible settlement or have considered whether benefits need to be simplified (eg restructuring pension increases which are inefficient to place in the market) in order to facilitate a smoother settlement.

For some schemes, closer liability matching, de-risking and settlement may seem some time away, so it is understandable that some of these areas are not yet being actively pursued. However, opportunities will undoubtedly occur on the journey towards final settlement, and schemes that are well prepared will be the ones that are able to grasp them. Those that are not will miss them again.

Even though markets might make final settlement seem unlikely for many in the short term, a change of owner or of corporate strategy towards the pension scheme, could move the goalposts overnight. Nobody wants to have to explain to a new CEO that their newly decided pension strategy cannot be executed because the scheme is not ready.

**Action points**

Actions that Aon Hewitt recommends in this area are:

- To consider the role of buyout and buy-in, whether in the short, medium or long-term, as well as the potential benefits of enhanced transfer value, pension increase exchange and other liability management exercises.

- To review each of the clean scheme items to ensure that the scheme has a plan which addresses all of these areas, which will support de-risking and settlement, and also ensure that the scheme is able to deal with opportunities that may arise along the way.
Part 4: Operational challenges

Introduction

Despite the headwinds facing organisations of all types, there is more to life in a pension scheme than just managing the financials. It can sometimes feel that funding and investment are the only issues that need addressing, but day to day administration and general scheme governance remain crucial. For this survey we focused on three such areas.

First, we asked about frequency of monitoring. In an era of fast-moving events, how often do different aspects of the scheme get looked at?

Second, we asked about administration service. In an environment where schemes are increasingly legacy arrangements, there is significant interest in looking at ways to reduce ongoing risks and costs, not least in the administration of schemes.

Finally, we asked about relationships with advisers, and in particular the mid-market issue of ‘bundling’ of services. In particular, we asked what were perceived to be the most important benefits of having a single provider rather than multiple providers.

Monitoring

It is a fact that the most common timing for trustee meetings is quarterly, although clearly there is some variation between pension schemes. In truth, there is no requirement for this timing and it appears as though the quarterly trend is as much an inherited cycle as it is as a result of the current governance requirements for each pension scheme.

To get a picture of the monitoring landscape, we therefore asked how often the mid-market looks at different aspects of its schemes.

Chart 15. How frequently does the scheme receive information on the following issues

Given the comments above, it is perhaps not surprising that the most common frequency of monitoring across all areas of scheme activity is quarterly. Around 50% of all monitoring takes place quarterly, and is presumably timed to match quarterly meeting schedules. Of course, as outlined above, we need to be careful of cause and effect here.
Of the areas covered in the question, the one that is monitored most frequently is investment performance. While the majority of schemes (60%) monitor their investments quarterly, almost nobody looks less frequently, and almost a third of schemes (31%) looks at assets monthly. One in twenty mid-market schemes said they monitor their assets weekly or more frequently.

Second and third in the rankings of frequency of reviews were administration issues and risk registers, with quarterly again being by far the most common frequency. Surprisingly perhaps, funding levels were at fourth place in the monitoring stakes. Nearly two-thirds of mid-market schemes monitor their funding level on a quarterly basis or more often – a large increase compared with just a few years ago. Just under one-third of schemes monitor their funding level annually, which is the minimum frequency required by legislation.

Finally, the areas monitored least frequently are covenant and buyout. Even there, however, the trend towards more frequent monitoring is visible.

Covenant monitoring did not even exist for most schemes as recently as 2005, since when it has emerged as something to be done at triennial actuarial valuations, then annually, and now more frequently. 37% of schemes now monitor covenant at least quarterly. As well as monitoring covenant generally, our experience is that schemes are increasingly considering affordability on a more regular basis, particularly where there have been issues in relation to available cash for recovery plan contributions. At the other extreme, 3% of schemes claim not to monitor covenant at all – despite the Pensions Regulator’s emphasis in recent years on the importance of covenant and covenant monitoring.

In relation to buyout, we are now seeing more interest in tracking bulk annuity prices more frequently, with a view to identifying market opportunities for buy-in or buyout transactions. Aon Hewitt’s Bulk Annuity Market Modeller is available to assist clients with market timing – this has been developed from our knowledge of insurers’ pricing bases and benchmarked against the pricing we see on live cases.

Whatever the area, we also found that larger schemes monitor almost everything more frequently than smaller schemes. At the largest end, schemes over £500m monitor things more often than the mid-market schemes of this survey, perhaps facilitated by the sub-committee structures that larger schemes tend to have. At the smaller end, however, we see the same pattern, as schemes with under £100m monitor things less frequently than larger mid-market schemes. The only exception to this was covenant monitoring, where the frequency was largely independent of scheme size – the importance of a strong employer backing the scheme is crucial, regardless of the size of the scheme and the employer.

As we have seen, the frequency of monitoring of the various aspects of the pension scheme generally seems to be driven by the quarterly cycle of trustee meetings. However, in this information age, is it really necessary to have a meeting in order to assess and react to the pension scheme’s position? We would argue that to fulfil a de-risking agenda, trustees need to monitor and react to changes more frequently. There is evidence for this trend already and it is likely to continue in future.

**Administration**

Regardless of what is happening with financial markets, member records need to be maintained and the administration team needs to ensure that the right benefits get paid to the right member at the right time. That, after all, is the ultimate purpose of the scheme.

In order to do this, the administrator needs to hold accurate records, no small feat considering that most current pension schemes have been in place for several decades and have seen several rounds of changes to benefits, if not scheme mergers or bulk transfers-in. Having accurate member, benefit and employer records also pays significant dividends when undertaking other exercises, such as liability settlement or employer exits.
Separate to this, many schemes now contain few – if any – active members, so that pension schemes can no longer rely on employers to front the communications to members. This is encouraging schemes to find new ways to communicate directly with members, such as ‘self-service’ via the web, which also has the attraction of reducing manual intervention, an area of risk as well as cost.

In the survey we asked whether schemes would be prepared to invest now (either time or money) to reduce these risks and costs. Overall, the answer was a resounding ‘yes’, with twice as many respondents saying that they would be prepared to invest to reduce cost and risk as saying they would not.

**Chart 16. Administration**

The areas that we focused on in this survey are not an exhaustive list of possible strategies to contain cost, but they cover three common areas.

First, we asked about standardising the service. Two-thirds of those expressing an opinion agreed that they would accept standardisation of the service to maintain costs at a lower level. This, however, is a view that seems to be limited to the mid-market. For schemes that are larger than £500m that drops to 41%, and continues to fall as schemes get larger.

Second, we asked about encouraging self-service through the internet. These facilities have been developing for many years and are common in defined contribution (DC) schemes, but the online functionality of DB schemes is clearly not as advanced. The question in the survey around member self-service saw the greatest interest, with just under three-quarters of schemes saying that they would be prepared to encourage members to use such facilities to maintain costs. That figure increased to 80-90% for the largest schemes.

Finally, we asked about data, and whether schemes would be prepared to finance a data cleanse exercise to allow greater automation. Again the answer was positive, with 69% of respondents saying yes. This question did not show substantial differences in views by size, but did indicate that trustees are substantially more open to such an exercise than sponsors.

**Providers of multiple services**

One of the ways in which mid-market schemes differ from the largest schemes is the way that advisers are used. In particular, mid-market schemes are much more likely to use a smaller number of advisers, each of whom provides multiple services.

We therefore asked respondents to indicate what they felt were the most important reasons to take a bundled service. While most of respondents agreed with most of the reasons in the survey, there were still clear differences in the strength of support for each area.
The headline figures indicate that well in excess of 70% of respondents agreed with the reasons to use multiple services from a single provider. That does not, however, mean that 70% of schemes do this. Nor does it mean that 70% think they should. What it means is that most respondents agree that for a scheme considering using multiple services, all of these are factors that should influence that decision.

The factor with the highest ranking was related to accessing solutions which require combinations of skills. These could be asset and liability modelling (investment and actuarial advice), cashflow management (investment and administration), valuation advice (actuarial and covenant), life assurance (administration and broking) or one of many other areas. Virtually all responses (95%) agreed with this proposition, suggesting that it is one of the most important considerations when considering whether to use multiple services.

Some factors had lower levels of support. For example, 77% indicated that lower fees was a key reason to bundle services, and 76% indicating that quality of advice was a key advantage. The results suggest that while respondents consider these to be important, the primary attraction of obtaining multiple services is to reduce operational risks and make the governance of services easier.

### Action points

Actions that Aon Hewitt recommends in this area are:

- To review the frequency at which you monitor different aspects of the scheme, and whether the frequency of monitoring should be driven by meeting schedules.
- To consider actively whether long-term administration costs can be reduced by investment in various areas.
- To consider whether your operational and adviser structure is the best available to meet your current and potential future strategic plans.
Part 5: Keeping you awake at night

A survey such as this, despite being extensive, cannot possibly cover all aspects of pensions. So in our final question we asked about a wide range of areas, with the aim of determining the issues that are keeping trustees and employers awake at night.

Auto-enrolment

Auto-enrolment has already begun for the largest employers in the UK, but for mid-market schemes it remains something to deal with in the future. In our survey 60% of sponsors and 75% of trustees who expressed an opinion indicated that they were comfortable with the issues arising from auto-enrolment. Only 35% of sponsors and 25% of trustees indicated that they were concerned.

The announcement in late 2011 that staging dates for mid-size companies were to be put back further had not been announced when this survey was issued, and if anything that is likely to increase the level of apathy that exists in some sponsors and trustees. But despite the delays, it remains important that companies start to plan early. Even if schemes do not need to introduce auto-enrolment now, there are a number of areas where it may have a more immediate impact including:

- Benefit policy – any review of employee benefits (eg flexible benefit terms, life assurance, review of pension strategy or provider terms) should be carried out with the potential future impact of auto-enrolment in mind.
- Financial impact – longer-term business plans will need to include any change in employer pension costs, so we suggest employers develop a high level strategy at an early stage to ensure projections are sensible.
- Other internal projects – auto-enrolment will involve systems and process changes so the interaction with other planned projects should be considered, including timescales and resourcing constraints.
- Providers – your payroll, HR and pensions providers may be able to take on much of the administrative burden, so any review of providers should include an assessment of their auto-enrolment capability and importantly (given the vast number of employers affected) capacity.
**Scarcity of resources**

As well as auto-enrolment we asked about 18 other areas which may be of concern to mid-market schemes. The graph below shows those most commonly causing concern.

**Chart 18: What keeps you awake at night?**
When grouped into similar themes, the results show some interesting patterns:

- Cost of running the scheme is a clear first choice across all groups of respondents.
- Topics related to resources are grouped at the top of the table, including concentration of knowledge (2), availability of resources (3), ability to react quickly (4), availability of member nominated trustees (5) and time commitment to run the schemes (6).
- Topics related to administration tended to be grouped at the bottom of the table, including accuracy of benefits being paid (18), quality of data (14) and member experience (15).
- Funding and Investment topics were spread around the middle of the table, from covenant (7) to long-term strategy (8), investment strategy (13) and frequency of financial information (16).

The fact that administrative issues are not a major cause for concern will be encouraging for anyone involved in providing administration services, whether as a third party or in-house. Administration is an area where accuracy is essential and anything less than the correct benefit is a problem. So it is good to see that most respondents were comfortable with the accuracy of benefits, and only a handful were concerned.

Overall, however, it is the results in relation to resources that are most compelling, and they suggest that this is the biggest challenge facing mid-market schemes. There are many options now available to schemes to obtain resources from the pensions industry, whether it be on an ad-hoc basis or through greater levels of delegation to providers. While concerns over cost remain the number one priority, this is going to be a difficult issue to solve. But in the absence of a solution the scarcity of resource will remain and that will mean that schemes need to develop a way to assess the cost and benefit of the various options so that they can make effective decisions.

**Action points**

Actions that Aon Hewitt recommends in this area are:

- Ensure that you are familiar with any plans in place to deal with auto-enrolment issues, and that the proposed timescales leave sufficient time to deal properly with the implications.
- Consider the support that your scheme needs in relation to resources, and how that might be fulfilled from a variety of sources, whether internal or external.
- Develop a way to examine the cost and benefits of potential issues and solutions.
If you would like more information about the survey findings then please speak to your usual Aon Hewitt Consultant, or contact us on 0800 279 5588 or email enquiries@aonhewitt.com.

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