Behavioural insights to help you navigate through pension scheme risk settlement

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In this step-by-step guide you can learn about risk settlement

Click on a section >>

Deciding your strategy

Engaging with the market

Selecting a provider

Completing your transaction

- Learn what it means to take longevity and demographic risks out of a defined benefit pension scheme.
- See what the process looks like.
- Understand where your scheme might get stuck.
- Find behavioural insights in this guide to help you navigate the process of thinking through the best route for your scheme.

Your risk settlement adviser can guide you through the complexities of determining the right strategy for dealing with longevity risk and then, only if it is right for you, help you to navigate the solutions on offer which work for your scheme.

Appendix: Types of risk settlement

Behavioural science glossary

Chapter 1 – Deciding your strategy

Step 1 Understand longevity risk and the options available to you

Step 2 Assess feasibility of options

Step 3 Decide strategy

Step 1 Understand longevity risk and the options available to you

How long people live is their 'longevity'. In pension schemes, longevity risk is the risk that members live for longer than expected. That means pensions are paid for longer than expected, which costs more money.

Demographic risk is the risk arising from other non-economic factors within your scheme membership. In pension schemes, demographic risk includes the risk that:

- More members are married than expected.
- Members' spouses are younger than expected.

Either of these would mean that pensions are paid more often, or for longer than expected, which costs more money.

For many schemes, longevity risk is likely to be one of your most significant risks

This is particularly the case if your scheme has a low-risk investment strategy.

Is taking longevity and demographic risks out of your scheme worth exploring?

To find out, you can arrange training with a risk settlement adviser.

Training will help you:

- Learn about all the options available to you.
- Build your knowledge about the process to give you a solid foundation.
- Get scheme-specific insights which consider the position of your scheme and your sponsoring employer.
- Know if further investigation is needed to understand the viewpoints of others, or what preparation you need.

Summary of the options available to you

The **Appendix: Types of risk settlement** sets out a high-level summary of the options available to reduce or remove longevity risk – bulk annuities longevity swaps. If you are not familiar with their features, we suggest you take some time to read the appendix before making your way through the rest of this guide.

Getting fully trained on the risk settlement process

It pays to speak to someone who has considerable experience with bulk annuity and longevity swap transactions, or of assessing consolidation options. If you would like to arrange a training session, please email talktous@aon.com and we will help you get started. If you decide to go ahead and 'approach the market', training will be ongoing throughout the process, so that you make all your decisions fully informed, with no surprises.

Step 2 Assess feasibility of options

Completed your training? Interested in exploring whether you can take longevity and demographic risks out of your scheme? The next stage is to have your risk settlement adviser prepare a feasibility study.

What does a feasibility analysis cover for you?

- Funding position — how will a bulk annuity or longevity swap impact it? Is a transfer to a Superfund viable?
- Investment strategy — how will a bulk annuity or longevity swap impact the expected return on assets or your hedging programme?
- Insuring your scheme benefits — are there likely to be any benefits that are difficult or expensive to insure?
- Member data — are there any concerns with the quality or completeness of your data?
- Member options exercises — Should they be carried out?

Member options exercises include offering members Pension Increase Exchange, Enhanced Transfer Values or other flexibilities which are potentially valuable to members, and also reduce risk within the scheme.

Bias blindspot

We all tend to have a 'bias blindspot'. It is easier for us to recognise how biases might impact on the judgment of others, while failing to recognise how bias might impact one's own judgment.

Having a risk settlement adviser conduct a feasibility study means you can benefit from their expertise and is a good way to step around any biases that could prevent you from fairly assessing both the upsides and the risks involved.

Understanding the views of others

Trustees should...

Talk to their sponsoring employer about the possibility of risk settlement options, such as a bulk annuity, longevity swap or a transfer to a Superfund. It is an essential part of the process when looking to reduce risk, as the sponsor is ultimately responsible for making up shortfalls that arise.

A sponsor might anticipate there being costs as a result of removing risks. Even though that may not actually be true in all cases, no one likes to think about large costs and the 'pain of paying' now, even when there are significant benefits to doing so.

Talk to your sponsoring employer about the upsides of removing longevity risk...

- Removes risk
- Reduces reliance on the sponsor covenant
- Has potential cash benefits, through lower contributions being required in the future, or lower costs of running the scheme.

...and also ensure your sponsoring employer knows any potential downsides

Your sponsoring employer is likely to be concerned about the impact a transaction could have on its accounting disclosures. Make sure you are clear with them and that they are supportive of a potential transaction before approaching the market.

Sponsoring employers should...

Be talking to the trustees about the possibility of a bulk annuity, a longevity swap or a transfer to a Superfund. Trustees may assume that sponsoring employers would not be supportive and are therefore discounting the possibility of reducing longevity risk.

Talk to your trustees about the upsides of removing longevity risk...

Removing risk and reducing the reliance on the sponsor covenant are likely to be of interest to trustees too.

...and also ensure your trustees know any potential constraints

Your trustees may not be aware of any timing or financial constraints which may affect the viability of a transaction. Make sure you are clear with them so that the right solution can be considered at the right time.

Step 3

Decide strategy

During the feasibility process, your risk settlement adviser will have introduced you to all the options on offer and will help you to decide what is right for your scheme based on robust analysis.

For some schemes, doing nothing may be the right answer. As you make choices, it is important to be aware of the behavioural biases that might affect your decision making. Your risk settlement adviser can help you mitigate some of the common behavioural biases, by providing relevant analysis and nudges to help you navigate to the best answer for your scheme. Here are a few that you are likely to encounter.

The pain of paying

People do not like to spend money. We experience the pain of paying. Trustees and sponsoring employers may view insurance prices as expensive, as the solvency estimate is always likely to have been the biggest liability value shown in the valuation report.

You might find that you would not want to take the pain of paying now, even though reducing risk is likely to save you money over the long term. This is because people tend to care more about the present than the future.

By choosing a risk settlement adviser who understands how pension schemes, insurers and reinsurers all operate, you can draw on their extensive market experience and constructive working relationships with all market participants to answer the question of whether the price for insuring your longevity risk is fair or expensive.

Pain of paying

We experience mental discomfort when we pay. Research suggests high prices do seem to cause pain. Performing brain scans on people who were making purchasing decisions, Professor Brian Knutson and colleagues* looked at high-priced objects and noted that brain activity was activated in the insula region of the brain, which is associated with disgust or pain. Higher activation in this area was seen for products that were not ultimately purchased.

*(Neural predictors of purchases 2007).

Making decisions and regret aversion

People suffer from regret aversion, in that they do not want to make a decision which may prove to be a mistake — and one they regret.

Trustees and sponsoring employers may have reservations about taking action to reduce risk in case the risk never materialises, or in case they could have gained from running the risk.

In the same way that we tend to buy house insurance in order to reduce the impact of potential loss, rather than hoping to be burgled or suffer from a burst pipe, protecting a pension scheme against longevity and demographic risks is a prudent move.

Life expectancy has increased by more than two years per decade since 1840 in the countries with the highest life expectancies. Predicting future improvements is subject to much debate.

Your risk settlement adviser will help you understand the level of longevity risk within your scheme, and the potential impact on your funding position of running that risk.

Regret aversion

Humans dislike feeling regret, and may act to avoid feeling regret, even if that means they are avoiding an important decision. Any time we are doing something other than maintaining the status quo, we open ourselves up to 'regret'. Trustees have a tendency to be more cautious than the average person, and as a result, can be more swayed by wanting to avoid regret.

Getting stuck in the status quo

People have a strong tendency to want to stick with the status quo, the current way of doing things. Anything which involves change or disruption is uncomfortable for our brains. In order to fight this tendency towards sticking with the status quo, we need to break our mental deadlock. One way around it is to think about the actions we are going to take as already being reality. We can then argue for what we have now, to see if that still stands up to scrutiny.

For example – imagine that you already have no longevity risk in your scheme. Now make the argument for ADDING longevity risk into your scheme. Can you justify it?

When we look at our options and imagine that the action we want to undertake is already reality, it makes it easier for us to break out of our comfort zone and avoid getting trapped in the status quo.

Status quo bias

Status quo bias is one of the most powerful behavioural economic phenomena. Humans have a preference for choice options that are the most obvious or usual. Preference for the status quo is frequently irrational (from a conventional economics perspective) because it depends on which option constitutes the status quo. Therefore, changing the status quo may cause your preferences to reverse.

Checklist – deciding your strategy

	Yes	No	Maybe
We believe taking longevity and demographic risks out of our scheme is a good idea We have removed any ambiguity, by receiving training on longevity risk and the options available to reduce or remove the risk. We have removed the status quo bias by considering what actions we would take if we had already taken longevity and demographic risks out of our scheme.	⬡	⬡	⬡
A transaction is feasible for our scheme We have removed our 'bias blindspot'by having a risk settlement adviser conduct a feasibility study so that we can fairly assess both the upsides and the risks involved.	⬡	⬡	⬡
We know the view of the sponsoring employer/trustees We have painted a picture for the sponsoring employer/trustees which is vivid and clear: 'if longevity leaped two years for a 75 year old, our scheme would be £Xmillion underfunded. Reducing longevity risk would ensure, transfer to a Superfund that we were not responsible for dealing with this shortfall', and we understand their views.	⬡	⬡	⬡
We know what option we want to take – bulk annuity, longevity swap, transfer to a Superfund or no action We fully understand the options. We are not discounting any options due to either favouring those that are more familiar to us, or by anchoring our ideas against what other similar schemes are doing.	⬡	⬡	⬡

Unsure on any of these?

To discuss your particular circumstances with Aon's Risk Settlement Group, please email talktous@aon.com

Keen to learn more about the next steps? Go to the next chapter.

Chapter 2 – Engaging with the market to obtain pricing

Step 1 Preparing your data and benefit specification

Step 2 Transaction design

Step 3 Agreeing how to approach the market

Step 1 Preparing your data and benefit specification

How to ensure your scheme is at the top of the providers' priority list.

The way you engage with the market is vital. A provider calculating your pension scheme's insurance premium or transfer price undertakes a large amount of work. They want to know that:

- You have decided on a bulk annuity, a longevity swap or a transfer to a Superfund.
- You have a price range in mind, know at what price you would be happy to go ahead, and that the price is realistic in the current market.
- There is good quality data available, including on how long previous generations of pensioners have lived (for larger schemes).
- You have done the upfront work on getting your legal adviser to review the benefit specification against your Trust Deed & Rules.
- You understand the implications for your investment strategy.
- Key decision makers are fully engaged in the process and supportive of a transaction.

Sharing information on your data and benefits with providers

To obtain pricing, your risk settlement adviser will need to share member data and details of your scheme benefits with the market.

It is important for:

- Your data to be clean and complete, or for you to be able to articulate any known issues.
- Your benefits to have been set out clearly in a benefit specification.

Your risk settlement adviser can help you with these actions.

Sometimes it is not possible to have completely clean data, or not practical to refer to all historic documents governing your scheme. Your risk settlement adviser will advise you pragmatically on what work must be completed before approaching the market to obtain pricing, and what work can wait until you know whether the transaction will go ahead.

Planning fallacy

The tendency to think that our own projects will proceed as planned (even if similar tasks have run late) is called planning fallacy. Preparing a benefit specification is a key step that can delay many schemes if not done in advance, as the benefit specification would ideally be based on a full review of your scheme's Trust Deed & Rules (including historic copies) and signed off by your legal adviser.

Assessing your member data

Your administrator should know the current condition of your data, but you are likely to want your risk settlement adviser to take a view from an insurance perspective. Many data items used in the day-to-day running of the scheme will be kept up to date as a matter of course. However, some data items that are required by providers are rarely recorded, or updated.

When speaking with your administrator, you should check that the following data items are complete:

1. Current addresses for deferred members (with postcodes).
2. Spouse or dependant information for your pensioners.
3. Dates of birth for those spouses or dependants.
4. Complete GMP details following the reconciliation of scheme records with HMRC, or a GMP equalisation exercise.

While this is not a comprehensive list, these data items are often incomplete and require consideration before engaging with the market to obtain pricing.

You also need to check:

- Whether any members in the scheme are already covered by existing insurance policies. Is there any mismatch between the insured benefits and what the scheme pays the members?
- Whether your scheme carries out regular checks that the members you are paying are still alive (known as 'existence checks').
- Whether your scheme records experience data (how long your members have lived for, over the past 10 years say) that the market could use to feed into their pricing assumptions.

Data cleaning

Data cleaning means making your member data as complete and accurate as possible. Your administrator and risk settlement adviser will propose the actions needed to clean your data. It may be necessary to complete some data cleaning before you engage with the market, but some may be able to wait until after your transaction. It is common to have a data verification period following a transaction so that any adjustments required to the data can be agreed and factored into an updated price.

Your risk settlement adviser can help you prepare your data by conducting a gap analysis to see what is missing.

This is particularly important so that you can approach providers with confidence, understanding the potential financial impact of any further cleansing. Your risk settlement adviser can:

- Help you to complete any data cleaning through bulk calculation exercises or electronic tracing.
- Pre-empt queries from insurers and ensure your data is ready to be shared with the market.

Of course, the scheme remains responsible for ensuring compliance with any internal guidelines or external regulations around data sharing, if you choose to work with an external adviser on this.

Benefit specification

A benefit specification is a document that the providers will use to determine the benefits payable under the policy and the premium they will charge to insure those.

Your benefit specification needs to:

- Set out all relevant benefits in sufficient detail so that an insurer will know exactly what benefits they would need to provide.
- Identify benefits where the trustees or company have discretion over whether or how much should be paid, and then choose what the rules will be once this 'discretion' has been passed to the insurer. This is 'codifying' the discretions.

Ideally, the benefit specification would be reviewed by your legal adviser and administrators before it is shared with potential providers to avoid any inconsistencies being discovered later in the process.

Your risk settlement adviser can help you prepare your benefit specification

Your risk settlement adviser can also**:**

- Pre-empt queries from insurers or Superfunds by ensuring it is set out in an insurer-friendly manner that can be easily interpreted by pricing teams.
- Advise you on the most appropriate way of codifying your discretions.

Ambiguity

When we are one step removed from a process (such as when member data sits with an administrator), simple tasks are often overlooked. Cleaning up our member data in order to get accurate pricing is key, and good data can secure a better price, because it removes ambiguity for the insurer or Superfund.

Step 2 Transaction design

Your risk settlement adviser will help you decide the key features of your transaction, such as the overall target size and price threshold.

Keeping your options open, within reason

When first engaging with the market to obtain pricing, your risk settlement adviser will help you decide on a pragmatic set of questions and quotations to request from the providers. The complexity of your request will depend upon the size and sophistication of your planned transaction.

Deciding which members to insure

You can reduce the longevity risk in your scheme by insuring some, but not all, members. This decision will be based on advice from your risk settlement adviser.

They will help you decide which members to insure by considering:

- The relative pricing of different membership segments, and assessing which segments meet your price threshold.
- The longevity and investment risk being removed within each segment, and whether the premium being charged by the provider is good or poor value for that level of risk.
- Feedback from insurers around their preferences, and potential for price movements in later pricing rounds.

Anchoring

Are you anchored to the transaction structure first suggested during your initial training, or to what similar schemes are doing?

Are you anchored to the price estimates shown on your risk settlement adviser's pricing monitor?

It is important to update your thinking for relevant facts that may have emerged through the review of your data or preparation of your benefit specification.

Step 3 Agreeing how to approach the market

Agreeing your governance structure

Your risk settlement adviser will make the transaction process as simple as possible for you, but there are several detailed decisions that need to be made along the way.

Consider appointing a joint working group of trustee and company representatives

It can be useful to have a dedicated group, to delve into the detail as required and to work within any delegated authority that your full trustee or company board is willing to give.

It is useful to have representatives from both the sponsoring employer and the trustees in your sub-group, as it helps to show insurers that all parties are working together towards a transaction.

It is common for the full trustee and company board to want to make the key go/no-go decisions through the process, such as:

- Choice of provider.
- Approval of final pricing and contractual terms.

Knowing who can make which decisions — and being able to make those decisions at short notice — is vital. By setting this out clearly, you will be able to take advantage of favourable pricing opportunities as and when they arise.

Deciding which insurers to approach for quotations

Each provider in the market has an appetite for different sizes of, and types of, transactions. Your risk settlement adviser will be able to provide information on which providers would be interested in your transaction in order to maximise competitive tension.

Groupthink

Creating a joint working group to make sure the project is delivered is a good idea. Make sure that the team has capacity to take on tasks and that they have delegated authority to make decisions. Most importantly of all, you want to avoid groupthink – which is where members try to minimise conflict to reach a decision without critical evaluation.

You want multiple perspectives for the project. Diversity of thoughts can be valuable, and your advisers can help you to critically evaluate those diverse views to reach a decision while avoiding groupthink.

The way you engage with the market is vital to ensuring your scheme is at the top of the providers' priority list.

Initial engagement

Your risk settlement adviser will discuss your potential transaction with the market as early as they can (on a no names basis) to get feedback on when would be a good time to approach the market to fit with the market's resource and asset availability.

Request for quotation

Your scheme formally approaches the market when your risk settlement adviser issues the Request for Quotation (RFQ) to the longlisted providers.

The RFQ gives the providers background information on your scheme, the sponsoring employer and the membership. It details what pricing is requested, timescales for responses, and any other requests (such as specific commercial terms that are important for your scheme) you may have. Alongside the RFQ, your risk settlement adviser will send the provider:

- Member data – setting out the data for the members to be insured.
- Benefit specification – setting out the benefits that should be insured.

Feedback

After initial pricing has been received, your risk settlement adviser will provide feedback to the providers. This will include how competitive each provider's pricing was compared to the other quotations received, along with points of note from the review of initial responses.

Your role in meeting potential providers

If you are keen to meet with potential providers during the process, you should let your risk settlement adviser know so that they can arrange meetings or calls.

Checklist: engaging with the market to obtain pricing

Yes No Maybe

Our member data is transaction-ready

We have cleaned up our member data in order to get accurate pricing and removed ambiguity for the scheme and the provider.

We have a benefit specification that is transaction-ready

We have prepared a benefit specification, and this has been through a legal and administrative review in order to get accurate pricing, and removed ambiguity for the scheme and the provider.

We have decided whether to set up a sub-group with delegated authority to delve into the detail

If you have decided to set up a sub-group:

- the terms of reference and delegated authorities for the group should be clear, and representatives from the sponsoring employer should be included if possible.
- groupthink can be avoided by ensuring advisers are present in meetings, and critically evaluating the advice provided.

We know the key features of our transaction

We have agreed the target size and price threshold for our transaction to be feasible, and have agreed a pragmatic set of questions and quotations to request from the providers.

We know which providers we will approach for initial quotations

Your risk settlement adviser has provided you with information on which providers would be suitable for your transaction, and you have considered this objectively and have not favoured providers who are more familiar to you.

Unsure on any of these?

To discuss your particular circumstances with Aon's Risk Settlement Group, please email talktous@aon.com

Keen to learn more about the next steps? Go to the next chapter.

Chapter 3 –Selecting a provider

Step 1 Assessing the pricing offered

Step 2 Proceed or pause?

Step 3 Selecting a provider

Step 1 Assessing the pricing offered

Once you have approached the market, you will receive pricing from a number of providers. They will also provide responses to any other requirements or questions you set out in your Request for Quotation.

Funding and investment perspectives

It is likely that an acceptable level of pricing, your 'price threshold', will be driven by analysis from both funding and investment perspectives. Working with your risk settlement adviser:

- Your scheme actuary can provide advice on the level of pricing required to be acceptable from a funding perspective.
- Your investment consultant can provide advice on the level of pricing required to not adversely impact your future expected return.
- For a longevity swap or a bulk annuity, comparing pricing against your best estimate life expectancies, reflecting the latest information, is key.

Does the pricing suggest your price threshold could be met?

This decision will be based on advice from your risk settlement adviser, who will compare the pricing received from the market against your price threshold.

You should also expect your risk settlement adviser to provide insights into their experience of negotiating price movements when the providers are asked to supply their 'best and final' pricing, and whether the pricing received is consistent with, or better than, that being seen on other live transactions.

Mental accounting

Human beings find it hard to think about prices in absolute terms. We tend to think about everything 'relative' to something else. Do the most competitive prices seem 'relatively' good compared to other prices that are on offer, or are they good in their own terms?

Step 2 Proceed or pause?

How do you decide when it is the right time to go ahead?

Your risk settlement adviser will analyse the quotations received against a set of criteria so that you can see whether the quotations provide compelling offers, and if so, which insurers' offers are most favourable. Your criteria will be unique to your scheme and will be discussed with you.

Taking into account the quotations received, and the benefits that can be insured, you should make an active decision on whether to accept a quotation, proceed to a further pricing round, or whether to pause. You should never get 'deal fever' and proceed at all costs.

'Sunk cost' fallacy

Humans tend to count previously-invested resources such as time, money or effort as 'sunk costs', which makes us more likely to continue an endeavour when perhaps we should pause. (Arkes & Blumer, 1985). This fallacy, which is related to loss aversion and status quo bias, can also be viewed as bias resulting from an ongoing commitment. So, in short – be wary of continuing just because you feel that you have invested resources in the process.

Step 3 Selecting a provider

Following analysis of providers' responses to your request for quotation, it is common to shortlist providers, or to potentially select your preferred provider.

- Shortlisting means that only the providers with the best chance of winning your business are asked to provide further pricing or information that you could accept and lock in to.
- Selecting your preferred provider means that you are confident you have negotiated the best deal possible, and that you are ready to accept a quotation that has been offered, and to work exclusively with the provider towards an agreed transaction.

Price tends to be a major driver in the decision to select or shortlist a provider, but other factors (as set out below left) should be considered and discussed with your risk settlement adviser. The 'familiarity heuristic' can be seen in practice when brand awareness and existing relationships are being considered.

Familiarity heuristic

Humans tend to rely on using a familiarity heuristic (a rule of thumb) when they are feeling under pressure and can be swayed by a familiar name when it has little to do with the underlying criteria we should be judging against. An 'heuristic' is otherwise known as a 'rule of thumb'. For example, what people think is a high level of tax will be referenced against their own culture. Whether you are American, or English, or Swedish, your 'rule of thumb' will be different.

Checklist: Selecting a provider

Yes No Maybe

We have assessed the pricing and insurance offered

We have considered both the pricing and the insurance cover available in absolute terms, rather than relative terms, and are satisfied it meets our needs.

We have taken an active decision on whether to proceed or pause

If we are going ahead, we are going ahead because it is right for the scheme, and not because of 'sunk costs' we feel we have spent such as time, money and effort.

We know which providers to shortlist/choose as our preferred provider

We have assessed the quotations received objectively, and if we have allowed for the familiarity heuristic to influence our assessment, we have done so knowingly.

Unsure on any of these?

To discuss your particular circumstances with Aon's Risk Settlement Group, please email talktous@aon.com

Keen to learn more about the next steps? Go to the next chapter.

Chapter 4 – Completing your transaction

Step 1 Exclusivity period

Step 2 Signing the contract

Step 1 Exclusivity period

Exclusivity is the period between choosing your preferred provider and signing the contract with them. During this period, the provider and your advisers work together on an exclusive basis to agree a transaction that is acceptable to both sides, but either side can pull out pre-signing. In practice, this is highly unlikely and would only occur in extreme circumstances.

There are two key areas for consideration during the exclusivity period:

- Checking the final level of pricing, if this is subject to change during the exclusivity period.
- Agreeing your policy terms.

Checking the final level of pricing

Having chosen your preferred provider, and entered exclusivity, there is a risk that the price moves against you, to the point where you would no longer want to go ahead.

To guard against this, it is possible to negotiate a ‘price-lock’ mechanism which provides visibility on how the price will change between choosing your preferred provider and signing the contract with them. For buy-ins, buyouts and Superfund transfers this can be structured to move perfectly in line with the assets you already hold, or in line with your funding valuation, in some scenarios.

Pricing of longevity swaps is less sensitive to market conditions than the pricing of buy-ins and buyouts. When checking the final level of pricing for a longevity swap, it is important to consider the coverage that your hedged cashflows give to your scheme liabilities, and check this is acceptable to you.

Agreeing your policy terms

Your legal adviser will work with your risk settlement adviser to provide advice on the legal and commercial terms that have been negotiated and agreed with the provider.

They will also highlight the key clauses from your point of view, which might include:

- How the assets will be transitioned to the provider.
- How future changes to data will be accommodated.
- The warranties you are required to give to the insurer, ie, statements around the status of the scheme and the data.
- Indemnities in favour of the trustees.
- Clauses covering the potential to adjust benefits in the future, and future proofing.
- Termination rights, or the ability to transfer or amend the policy in future in certain situations.

Lawyers, pessimism and planning fallacy

In many respects, a lawyer is a professional pessimist. A good lawyer takes the view that troubles are a pervasive fact of life, and that it is prudent to check for cons and conceive of catastrophes. A lawyer's role is to anticipate problems and expect failures, and that is why their early participation in the process can only be of benefit to trustees. Humans tend to suffer from a cognitive bias called planning fallacy, where we do not think about all the sub-steps that make up a task, or how long it will take.

Step 2 Signing the contract

Once you are comfortable with the terms that have been agreed, it is time to sign the contract. A date for signing will have been agreed between your advisers and the provider. The signing date is likely to coincide with trading dates for your investments where possible.

It is a big step; you are potentially handing over significant sums of money. However, in return you are reducing or removing several risks and increasing the chance that your members will receive the scheme benefits they expect and are entitled to.

There will be several documents to sign:

- You will need to sign the policy that has been agreed with the provider.
- You will also need to sign any disinvestment and transfer instructions to facilitate payment of the relevant premium or fee collateral.

Pain of paying

In signing the contract, you are potentially handing over significant sums of money and may experince the pain of paying.

Remind yourself of the decisions made to get to the point of signing, your overall objectives and how the contract will help meet those objectives.

Make sure you are clear on what will need to be signed, by whom and when, so that the physical signing of the documents can be as stress-free as possible.

Checklist – completing your transaction

	Yes	No	Maybe
We accept the negotiated policy terms We are confident that our legal adviser has negotiated terms which work for us, and these have been reviewed by our risk settlement adviser.			
The final level of pricing achieved is acceptable We are happy that the price achieved is acceptable and the provider offers everything we wanted.			
We accept the arrangements for the payment of the premium or fee collateral Our risk settlement adviser has created a checklist of all the steps that will need to happen for the payment to be made smoothly.			
We have arrangements in place to sign the required documentation We have agreed delegations for executing the documentation or have a planned trustee meeting where they will be signed.			

Unsure on any of these?

To discuss your particular circumstances with Aon's Risk Settlement Group, please email talktous@aon.com

Appendix – types of risk settlement

The options available to you to reduce or remove the risk

There are three core ways to reduce the longevity and demographic risk associated with paying pension benefits — a **bulk annuity, commercial consolidator** and a **longevity swap**.

Bulk Annuity

There are two types of bulk annuity – a buy-in and a buyout.

Buy-in

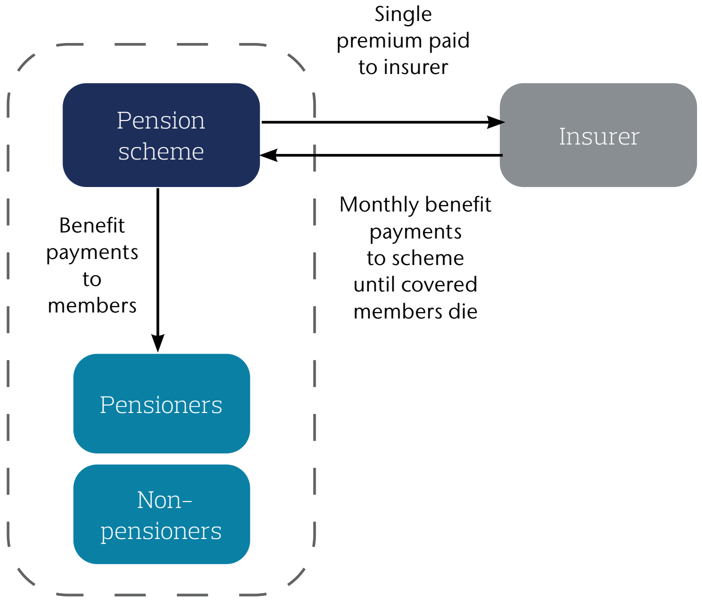
Under a buy-in, the pension scheme buys an insurance policy to secure all or part of all future pensions and benefits due to be paid to members.

The scheme pays a fixed amount up front to an insurer, and in return the insurer takes on responsibility for meeting the insured benefits, along with the interest rate, inflation, longevity and demographic risks associated with those benefits.

The insurer would generally make the payments to the scheme which, in turn, pays the members. End result: the pension scheme holds the bulk annuity policy as an asset and retains the ultimate responsibility for interacting with members and making sure their pensions can be paid (as shown in the diagram on the right), while the insurer takes on the financial and demographic risks.

Where the bulk annuity policy does not cover all members' benefits, it would be referred to as a 'partial' buy-in.

Where the bulk annuity policy covers **all** future pensions and benefits due to be paid to **all** members, it would be referred to as a 'full scheme buy-in'.



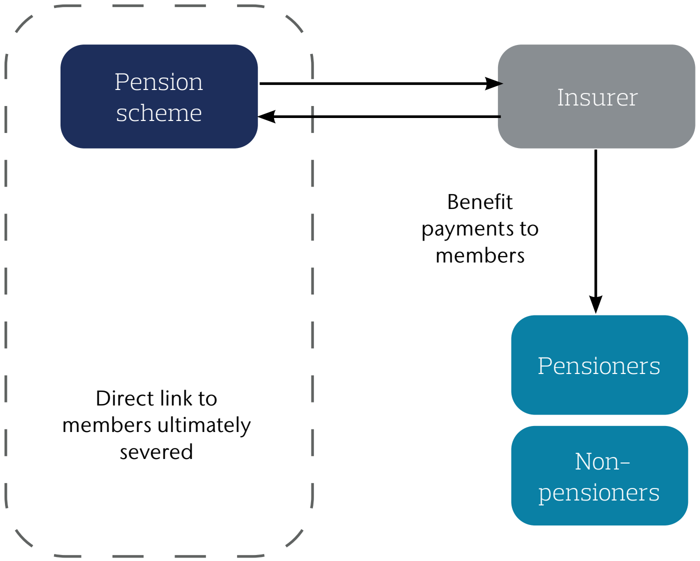
Bulk annuity (continued)

Buyout

Under a buyout, the pension scheme pays a fixed amount up front in order to fully secure all future pensions and benefits due to be paid to members. In most scenarios, this will cover all members of a pension scheme. An insurer receives the payment and takes on responsibility for meeting those liabilities, along with the interest rate, inflation, longevity and demographic risks associated with the benefits. The insurer deals directly with the scheme members (who then become policyholders) as shown in the diagram on the right.

The end result: the link between the scheme and the members is ultimately severed.

Where a buyout covers all members of a scheme, the scheme can be wound up as it now has no assets, no liabilities, and has transferred responsibility to the insurer for paying the benefits.



Commercial consolidation solutions

There are two types of commercial consolidation solution:

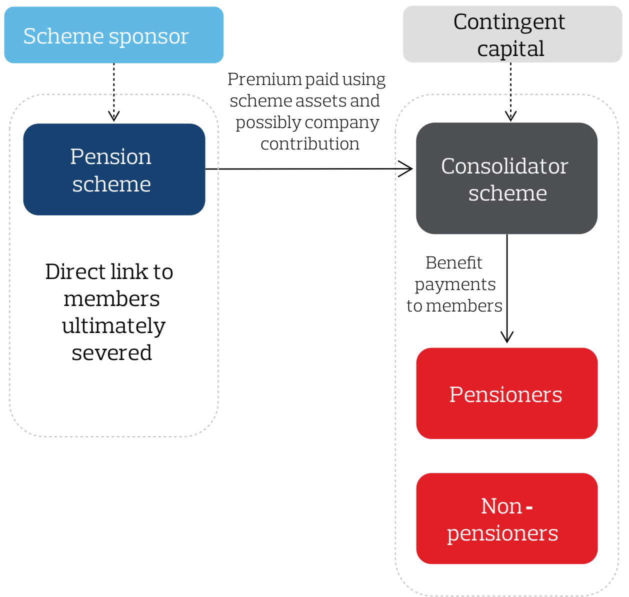
- Off balance sheet commercial consolidators, known as Superfunds (such as Clara or The Pension SuperFund)
- On balance sheet capital backed investment structures (such as Legal & General's Insured Self Sufficiency)

Off balance sheet commercial consolidator (Superfund)

A premium is paid to the consolidator using scheme assets, which may include an additional company contribution to support the transaction. The link between the scheme and the members is broken with members receiving their pensions from the Superfund once the premium has been paid.

The Superfund operates as a pension scheme (with its own trustees, administrators and advisers) and the Superfund sponsor is typically a shell company that holds capital. The Pensions Regulator must formally assess Superfunds before they accept any schemes. The original scheme sponsor must apply for clearance if a transfer of the scheme to a Superfund is being seriously considered.

As the Superfund operates as a pension scheme, member benefits are covered by the Pension Regulator's guidance and the Pension Protection Fund.



On balance sheet capital backed investment structures

Capital backed investment structures are investments, where the scheme delegates investment to a third party in return for them putting up some capital backing to protect against adverse experience from investment returns and/or longevity expectations, for example. There is no transfer of the scheme or the covenant away from the scheme sponsor.

Capital backed investment structures often seek to provide a smooth path to buyout in the medium term, with the provider's capital buffer being called on if actual experience is worse than assumed e.g. as a result of life expectancy increases, or lower than anticipated asset returns. In other words, the reliance on the current sponsor is reduced.

The provider typically receives regular administration and/or investment fees when performance is as anticipated or better.

Could Superfunds be right for your scheme?

Complete our short checklist to see if off balance sheet commercial consolidation might be a viable option for your scheme.

Longevity swap

A longevity swap is an alternative way to remove longevity risk

There is no upfront payment required, and so your scheme can retain more assets either to provide additional asset returns in the future or to support an interest rate and inflation hedging strategy. Longevity swaps currently tend to be focused on pensioner members, and while they are available to schemes of all sizes, their complexity tends to mean they are more popular with larger schemes.

A longevity swap generally works as follows:

- The swap provider and the scheme estimate the expected payments that will become due to the scheme's members, and how long these payments will be payable for.
- The scheme then makes fixed payments, which reflect these expected payments, to the swap provider for the duration of the agreement.

The provider of the longevity swap, in return, pays the trustees variable amounts which are payable for as long as each member survives. In practice, if a member lives only as long as expected, these two payments will cancel.

There are several options affecting the structuring of the swap, which trustees should consider carefully to determine which is the best fit for their scheme.

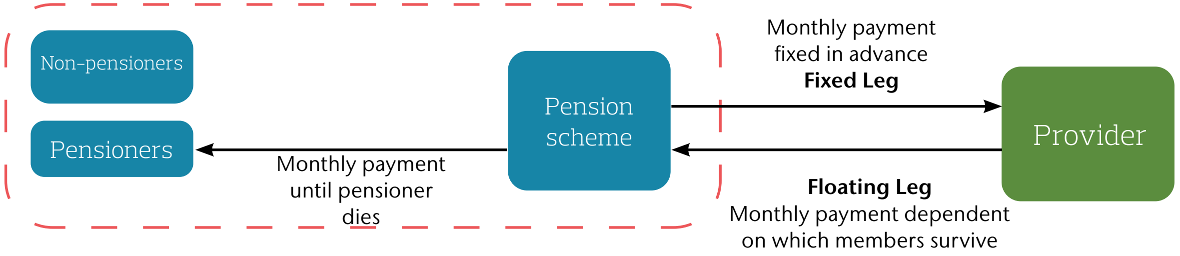
The main benefit for your scheme of a longevity swap, as with a buy-in, is certainty

If the actual payments due to the scheme members who are covered by the swap turn out to be higher than expected because those members live longer, the shortfall has to be met by the swap provider.

Initially, the floating payments and the fixed payments are equivalent (excluding fees), and therefore no money changes hands. In some arrangements, the payments to or from the scheme will be held as collateral.

Choosing the right option for your scheme

It is important that your risk settlement adviser starts with no pre-conceptions about what outcome or structure will work. They should work with you to identify your criteria for success and which, if any, solutions are appropriate. If it turns out that longevity hedging is not right for you at this time, they should tell you.



Behavioural science glossary

A recap of the behavioural biases mentioned in this document

Ambiguity

People do not like it when situations are ambiguous. Cleaning up our member data in order to get accurate pricing is key, and good data can secure a better price, because it removes ambiguity for the insurer.

Anchoring

Are you anchored to the transaction structure first suggested during your initial training, or to what similar schemes are doing? It is important to update your thinking for relevant facts that may have emerged through the review of your data or preparation of your benefit specification.

Bias blindspot

We all tend to have a 'bias blindspot'. It is easier for us to recognise how biases might impact on the judgment of others, while failing to recognise how bias might impact one's own judgment.

Familiarity heuristic

Humans tend to rely on using a familiarity heuristic (a rule of thumb) when they are feeling under pressure and can be swayed by a familiar name when it has little to do with the underlying criteria we should be judging against. An 'heuristic' is otherwise known as a 'rule of thumb'. For example, what people think is a high level of tax will be referenced against their own culture. Whether you are American, or English, or Swedish, your 'rule of thumb' will be different.

Groupthink

Creating a joint working group to make sure the project is delivered is a good idea. Make sure that the team has capacity to take on tasks and that they have delegated authority to make decisions. Most importantly of all, you want to avoid groupthink – which is where members try to minimise conflict to reach a decision without critical evaluation.

You want multiple perspectives for the project. Diversity of thoughts can be valuable, and your advisers can help you to critically evaluate those diverse views to reach a decision while avoiding groupthink.

Mental accounting

Human beings find it hard to think about prices in absolute terms. We tend to think about everything ‘relative’ to something else. Do the most competitive prices seem ‘relatively’ good compared to other prices that are on offer, or are they good in their own terms?

Pain of paying

We experience mental discomfort when we pay. Research suggests high prices do seem to cause pain. Performing brain scans on people who were making purchasing decisions, Professor Brian Knutson and colleagues (Neural predictors of purchases 2007) looked at high-priced objects and noted that brain activity was activated in the insula region of the brain, which is associated with disgust or pain. Higher activation in this area was seen for products that were not ultimately purchased.

Planning fallacy

The tendency to think that our own projects will proceed as planned (even if similar tasks have run late) is called planning fallacy. Preparing a benefit specification is a key step that can delay many schemes if not done in advance, as the benefit specification would ideally be based on a full review of your scheme’s Trust Deed & Rules (including historic copies) and signed off by your legal adviser.

Regret aversion

Humans dislike feeling regret, and may act to avoid feeling regret, even if that means they are avoiding an important decision. Any time we are doing something other than maintaining the status quo, we open ourselves up to regret. Trustees have a tendency to be more cautious than the average person, and as a result, can be more swayed by wanting to avoid regret.

Status quo

Status quo bias is one of the most powerful behavioural economic phenomena. Humans have a preference for choice options that are the most obvious or usual. Preference for the status quo is frequently irrational (from a conventional economics perspective) because it depends on which option constitutes the status quo. Therefore, changing the status quo may cause your preferences to reverse.

Sunk cost

Humans tend to count previously-invested resources such as time, money or effort as ‘sunk costs’, which makes us more likely to continue an endeavour when perhaps we should pause (Arkes & Blumer, 1985). This fallacy, which is related to loss aversion and status quo bias, can also be viewed as bias resulting from an ongoing commitment. So, in short – be wary of continuing just because you feel that you have invested resources in the process.

Contacts

John Baines
0121 262 6944
john.baines@aon.com

Martin Bird
020 7086 9027
martin.bird@aon.com

Mike Edwards
020 7086 0437
mike.edwards@aon.com

Karen Gainsford
020 7086 9071
karen.gainsford@aon.com

Stephen Purves
0113 394 3510
stephen.purves@aon.com

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