UK Member Options Update - Impact of COVID-19

Executive Summary

- IFAs have largely been able to maintain a normal service and continue to advise members.
- It is too early to say whether the crisis will impact member engagement – there are arguments both ways and, anecdotally, we have seen high engagement in a recently launched bulk transfer value exercise.
- Member options remain attractive to many members, if not more so in a time of great uncertainty. The value of options is also at a high level compared to past benchmarks, particularly transfer values.
- Overall, there is no reason to advise that exercises cannot continue. However, there are significant uncertainties which need to be acknowledged and understood before proceeding, particularly with bulk exercises.

Impact of COVID-19

This paper gives our initial views on the impact of Coronavirus COVID-19 on Member Options in UK Defined Benefit pension schemes. At the time of writing (23 March 2020) it is still too early to say definitively what the short and longer-term impact may be, and the situation is changing daily. However, in this note we set out our current thinking including suggestions on what scheme sponsors and trustees can do next.

Impact on IFA's

Independent Financial Advisers (IFAs) are key participants in the Member Options market, particularly for transfer values where regulated advice is required for most transfers. Their ability to continue advising members is important as without this the market would grind to a halt.

In the short term, they have been affected in the same way as most businesses – that is they have had to rapidly change working practices as the Coronavirus crisis has unfolded. However, by and large, we understand that most firms have been able to do this and have been able to continue operating a normal service. Many advisers already worked from home for some or all of their time, and for those who were office based it has been reasonably easy to change to home working given the nature of the job.

The key change is that IFAs are unlikely to be able to facilitate face to face advice in the current circumstances, but this is relatively uncommon in any case and most advice is provided over the telephone already.

Member perspective

How will members react?

We expect many members will fall into one of the following two camps:

- ***Less likely to engage with pension options.*** These members have 'bigger fish to fry' and pensions falls down their list of priorities given everything else going on. Now is not the right time for them to focus on retirement decisions.
- ***More likely to engage.*** Conversely, either as a result of spending more time at home allowing them to focus on their finances or as a result of a greater awareness of their own mortality bringing this into sharper focus, we think some members will be more likely to spend time thinking about their pension options. For members affected by economic uncertainty, opportunities for flexible income may be very attractive.

It is too early to say with confidence which group will win out and the overall impact on engagement may therefore not be large. Anecdotal feedback from one IFA is that a bulk transfer value exercise launched in the last few weeks has seen higher than expected engagement.

How attractive are the options to members in current circumstances?

Most member options involve bringing forward the timing of income for the member and accessing the pension pot sooner. In a time of financial market volatility and economic uncertainty, this is sure to be attractive to some members. Clearly, sponsors and trustees will wish to ensure that members are making decisions to exercise options for the right reasons.

The communication programme and the provision of high quality advice will therefore be more important than ever.

With gilt yields at historic lows, transfer values will tend to be higher than in the past which could make the flexible retirement options available after a transfer look more attractive. Uncertainty over future inflation and over structural changes such as RPI reform may also point towards exercising transfer and PIE options if the member wants to 'lock in' the value of their pension before it changes.

Trustee and Sponsor perspective

How attractive are Member Options exercises to sponsors and trustees?

Recent financial market volatility has provided a perfect illustration of the risks inherent in DB pension schemes. Member Options are a great way to reduce risk and so the strategic rationale to carry out exercises to de-risk schemes remains strong.

However, the financial market volatility we are experiencing may mean that tactically it is not the right time for some to launch a new offer:

- There is greater uncertainty over engagement, as described above, and it is important to consider a range of possible take-up rates to stress test the business case.
- Whilst we expect the IFA market, scheme actuaries and administrators to be able to be able to cope with demand, there may be greater pressure on resource at the current time.
- The market volatility means that an offer calculated on a particular date could quickly age as market conditions change – resulting in the option being offered either at very generous levels (so the scheme loses) or very poor levels (so the member loses) when compared to the new market conditions.
- In addition to that, scheme funding levels may have been hit over recent weeks and months meaning that the impact of paying out large amounts in transfer values may need to be reassessed.

Trustee and Sponsor perspective (continued)

Overall, there is no reason to advise that exercises cannot continue. However, there are significant uncertainties which need to be acknowledged and understood before proceeding, particularly with bulk exercises.

Common exercises

We consider some of the most common exercises below.

Selecting a preferred IFA

Perhaps the most common activity we are currently seeing in the market is for schemes to select a preferred IFA to support their members. This typically involves running an RFP process and then a period of 'onboarding' the IFA before they are ready to begin advising members.

We see no reason to suspend this activity if you are currently in the middle of this process or to wait if you are planning to start shortly. If your IFA selection process would have involved a 'beauty parade' of short listed firms then this may need to be held via video conference, but we think this is an acceptable compromise in the circumstances. Other activities relating to contracting with and onboarding your preferred IFA can be carried out remotely.

You may wish to consider the launch date for the IFA support service in light of the current Coronavirus crisis. Having said that, now may prove to be a good time to launch if members are isolating and more likely to pay attention to communications. We recommend discussing this with your chosen IFA.

Bulk transfer value exercise

There are several variants of such an exercise but all involve calculating transfer values for some or all members in bulk and communicating these to members, along with an offer of IFA support and in some cases a one-off enhancement to the transfer value.

The timing of a bulk exercise may need more careful consideration. The biggest issue may be the impact that markets have had on the scheme's financial position leading to nervousness about commencing a major exercise and paying out large sums in transfers at this time.

You should consult with the IFA (to ensure their have capacity to resource the exercises given the current situation) and scheme advisers (to ensure they can calculate and process transfer values as required). As discussed above, there is greater uncertainty about how many members will engage with the offer and ultimately accept it so this needs to be considered given the significant costs of making a bulk offer. However, if all parties are comfortable with this risk, there is no reason not to proceed. In many cases, it is possible to show that a relatively low level of take-up is enough to justify the costs of the exercise.

If proceeding, it will be important to review the financial implications before offers are calculated to ensure that the offer design still makes sense given the most recent market data and changes in funding positions. You should also consider how the investment strategy will be adapted to protect against future market movements once the offer is calculated.

We recommend that particular attention is given to ensuring that the contract with the IFA is suitable. For example, what happens and the requirements for both the IFA and the client if there is further disruption due to COVID-19 or other unforeseen events.

Bulk PIE

Pension Increase Exchange (PIE) involves reshaping the member's income stream (typically swapping inflation linked increases for a higher starting pension that doesn't increase). There is no immediate cash outgo, albeit the monthly pension paid out would be expected to increase, and the key determinant of value is often linked to the rate of price inflation assumed in the calculation of the offer. The impact of market volatility and future RPI reform depends on the scheme's strategy for hedging inflation. A well hedged scheme may be less concerned about this provided that it can adjust the hedge at a suitable point in time to reflect the point the risk is crystallised in the offers. There are similar considerations about availability and capacity of the IFA and other advisers, and ensuring that all parties understand the greater uncertainty, but subject to these we see no reason not to proceed.

Contact us

David Bunkle – Partner
david.bunkle.2@aon.com
m: +44 (0) 7917 071382