Risk settlement - it's not just about benefits and data – assets matter!

Aon's Lucy Barron discusses questions to ask when planning buy-ins and buyouts

2019 was a remarkable year for the UK pension scheme risk settlement market. Headlines were made by the amount and value of deals (doubling to £40bn compared to 2018) and the sheer size of the largest individual transactions (telent £4.7bn, Rolls Royce £4.6bn). Both were unthinkable even one or two years ago.

Last year was also remarkable because asset side considerations played such a vital role in the successful completion of many of the deals - and, because many of the 2019 deals were so large, this inevitably meant that there were more complex assets involved. So, 2019 became a year of innovation, working closely with insurers' asset teams to look at structuring solutions for transferring more illiquid assets and very careful asset transition preparation to ensure efficiency from a cost perspective and to minimise deal execution risk.

The key lesson from 2019 was that an increasing focus on asset preparation does not just apply to larger schemes – getting the asset strategy right ahead of buy-in or buyout can be the difference between a deal being affordable (and significantly reducing pension scheme risk) or not, for any-sized scheme. At the time of writing, COVID-19 continues to cause significant market volatility, worsening liquidity and cheapening credit assets (used by insurers to back deals). All of this means that careful planning of investment strategies is vital for both risk management and for being able to capture the best pricing opportunities in the risk settlement market.

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> *Lucy Barron, Aon*

Given this focus on assets and our recent experiences, we have set out the five key questions we think all trustees of schemes planning for future buy-ins and buyouts should be asking. These are relevant for all schemes with a target of buyout or phased buy-ins, even where insuring benefits is expected to be five or more years away.

1. Are we managing volatility with the goal of settlement in mind? Managing risk against funding and long-term targets remain key investment priorities. However, better matching insurer pricing by having high levels of interest rate and inflation protection, having an allocation to credit, and minimising growth assets that do not form part of insurer pricing portfolios, are all ways to reduce investment risk and increase certainty of securing member benefits through insurance.

2. Do our assets have sufficient flexibility? If you could afford buyout sooner than currently expected, are there any assets that would prevent you from achieving this due to loss of value when selling? Looking at investment decisions with risk settlement timeframes, risk and liquidity requirements in mind will avoid building up future problems – preventing phased buy-ins or extending the time to buyout.

3. Are there steps we could take today to make our scheme's assets more appealing to insurers or reduce exit costs? While buy-in and buyout premiums are frequently funded using cash and gilts, it is increasingly common for insurers in medium- and large-sized deals to accept appropriate low-risk assets such as specific corporate bonds and derivatives including swaps. Taking steps early to simplify and improve the quality of these assets can reduce the overall premium paid to insurers and reduce the risks associated with selling or transitioning assets as part of any deal.

4. Do we have sufficient time and governance budgets to focus on the key strategic risk settlement decisions? Risk settlement is an area where preparation and strategic planning is critical. Having the most efficient investment strategy can significantly reduce the time and risk in closing the gap to buyout. Allowing sufficient time for strategic planning can be the difference between securing members' benefits with an insurer or not. We are increasingly seeing schemes considering delegating day-to-day investment decisions to allow them to maximise efficiency and to focus their resources on strategic decisions that matter most.

5. Are our investment and funding strategies working together to maximise the chance of success? Well-timed actions across investments and liabilities could significantly reduce the time to reach buyout. Similarly, having an investment strategy with the liquidity and flexibility to support buy-ins along the journey can help schemes to de-risk sooner. A joined-up approach will help you to monitor and assess opportunities on the road to buyout as well as ensuring you present the scheme in the best possible way to insurers when you get there.

In short: planning is essential when considering pension risk settlement, and this is equally true for schemes of all sizes. The way you manage your investments is crucial to being well-prepared to transact when the time is right. Hopefully, these five questions are a start point, enabling you to assess your own preparedness and to put in place actions for addressing any areas for improvement.

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