Pension scheme derisking: what the experts say you need to know

Derisking is a hot topic for defined benefit (DB) pension schemes as trustees increasingly find themselves in a position to realistically target buyout or achieve other derisking objectives.

For most schemes, buyout was a theoretical goal during more than a decade of ultralow interest rates after the financial crisis. But higher rates and asset growth have created surpluses for many schemes, opening up derisking opportunities.

The result was a record £50 billion of bulk purchase annuity transactions in 2023. This level stayed broadly the same in 2024, and a similar result is expected this year as trustees aim to remove risks and secure member benefits.

I joined a group of industry experts to discuss the opportunities to derisk – and how to avoid potential pitfalls – at our first Aptia UK conference in November. Chris Hogg, the former trustee CEO to the National Grid and Royal Mail schemes, chaired the panel which featured:

Emma Watkins, Managing Director, Retirement, Scottish Widows

Rob Mechem, Director of Commercial, Just Group

Tim Coulson, Managing Director of Bulk Purchase Annuities, Canada Life

Simon Bramwell, Business Development, Rothesay

Derisking can be a complex business. The practicalities, journey and aims will differ for each pension fund but there are common considerations that will help make the process efficient, orderly and ultimately successful.

This article looks at the top themes that emerged from our discussion – with our panellists providing insights from their experience working on derisking transactions.

Chris Hogg: "It was unusual and illuminating to get a group representing leading insurers together to discuss the derisking market from an administration and data point of view. These insights are important guidance for pension schemes considering derisking in today's market."

- **Form a strategy and build governance**

Pension scheme derisking involves multiple workstreams and stakeholders. It's vital that trustees set out objectives and structure at the start:

- What are you aiming for – is it risk transfer through buy-in or buyout or is it, for example, a particular level of funding or risk? Alternatively, some schemes are considering a period of run-on, though this involves many of the same considerations and activities, plus an appreciation and assessment of what the particular scheme's options are for risk transfer
- Are you and other stakeholders ready to act quickly and decisively as you reach milestones or when you have an offer from an insurer? Trustees often work to a quarterly timetable, but derisking may require you to meet more often and more flexibly to review plans, sign documents and make decisions. Certain steps and activities are likely to be time sensitive, such as insurer pricing where the insurer wants to lock into

current or favourable market conditions
- How will you measure progress and success – for example, what are your key metrics and how will you record task completion?
- Where are you starting from? The gap between here and the goal will define the required activities. This could include funding gaps, uncertainties in scheme rules or key parties agreeing to plans

For an orderly project, you will need the right people working together. Your administrators, the sponsoring employer, lawyers, investment advisers and the scheme actuary should coordinate to advance underlying workstreams. These are likely to include:

- Engagement with insurers
- Member data cleansing and tracing
- GMP equalisation and Lloyds 3
- Member communications
- Legal review and advice, including scheme benefits
- Transition plans, including assets, administration and cash flows
- Plans for wind-up

Rob Mechem: "One of the challenges is ensuring that all the advisers are talking to each other to understand the full picture. If a fully reviewed benefit specification is produced, that's great, but if in practice the administrator is doing something different then there will be challenges later down the line."

Emma Watkins: "Collaboration is vital – particularly between the trustees and the administrator as you prepare your data and benefits before a derisking exercise. The level and type of preparation will depend on whether you are looking to undertake a buy-in or whether the short to medium term goal is buyout. For instance, capturing marital status and spouses' dates of birth – particularly for larger pension amounts – is important to achieve an accurate and competitive price in a buy-in or buyout, but codifying your discretions is particularly important in the run-up to a buyout and will require work with the administrator to understand if any precedents have been set."

- **Involve your administrators early and fully**

Don't take our word for this point. All our panellists stressed the need for trustees to work closely with the scheme's administrator. This is because administrators have the clearest view of:

- Member data such as addresses, birth dates and spouse's benefits
- Scheme benefits currently being paid to members
- The calendar of scheme activities such as annual pension increases, payroll dates and valuation dates
- Other scheme data including factors used in pension calculations, treasury information, and contacts with trustees, advisers and HR
- Member communications and the overall member experience

Tim Coulson: "Involvement of existing administrators is key in a buy-in/buyout process, and what you need from them differs from ongoing administration. It's also critical to understand the role of the administrator post-transaction, as well as what is required to get to finalised data and individual policies."

Simon Bramwell: "Be prepared to spend good money on good administration – it's one of those areas that will pay for itself when you're considering the large premium amounts involved. I've worked on a case where the trustee didn't want to spend £10,000 on a data readiness exercise for a £100 million transaction. However, if the insurer loads their premium by just 1% because of concerns about data quality – which could be on the lower

end – that's £1 million extra. Put into those terms, there's a clear rationale for investing time and care in your data."

- **Make sure you have clean data**

Many pension schemes will have completed ad-hoc data cleansing exercises and have plans so that their data is good enough to support business as usual member transactions and communications.

However, even if your data is deemed good for day-to-day member services and actuarial valuations every three years, derisking will place higher requirements on that data. For example, actuaries can make assumptions about spouses' benefit details and benefit tranches for valuing ongoing schemes. But derisking forces you to address the underlying data and maintain it at the right standard for your derisking objective.

If you've completed ad-hoc data exercises, remember that data deteriorates with time and even if those exercises were completed in the last few years, further work may be required. This is because data quality slips as members move address, change contact details, retire, die and make new benefit decisions.

The lesson is: discuss and agree at the outset with your administrator what data activities you'll need.

Simon Bramwell: "I'm still amazed, despite industry-wide initiatives and constant messaging about the importance of clean data, that schemes still approach us with significant problems in their data. There have been instances recently where after a few weeks of insurers combing through the data there are maybe 300 or 400 queries. At that point, query logs become very hard to manage for everyone and there can be consequential impacts on insurer appetite, pricing, and the overall timetable.

"It's difficult to pinpoint why this happens, but it's certainly more likely when you have an administrator, scheme actuary, broker and other advisers acting in silos and not looking at the data and benefits holistically. It makes the transaction harder and pricing less certain."

- **Remember the capacity crunch**

The derisking market is set to stay busy in 2025 and beyond. That means continued competition for business with insurers, but also a contest to secure administrator capacity and slots for support with derisking projects.

Many tasks associated with derisking will be carried out by or involve your administrator. Involve them early to secure the capacity to support your timetable – and agree this with other important advisers such as your lawyers and scheme actuary.

Tim Coulson: "Demand for buyout remains high because, due to the progress of recovery plans, maturing of schemes and other factors, many schemes are now sufficiently well-funded to move to buyout.

"On most measures – such as capital and reinsurance – there is enough capacity in the insurance market to accommodate this demand. The main limitation is human capacity – enough skilled people to complete the transactions – and asset origination – enough suitable Solvency II-compliant assets to match the biggest-volume transactions."

Rob Mechem: "While the total value of transactions in 2024 may well be down, the number of transactions will be higher. Moving to 2025, we expect the demand to be there. New entrants will help the market to cope with this demand, but there will be massive capacity pressure in the next two years in data projects."

- **Consider residual risk**

Derisking transfers the risk of some or all of a scheme's liabilities to an insurer. But Trustees and sponsoring employers can remain responsible for residual risks if problems turn up later – such as errors in the data given to the insurer or changes to the law that affect benefits due.

You should think about residual risk early in any derisking exercise. If you understand and minimise these risks, you will reduce the overall cost of the transaction, ward off nasty surprises and avoid issues that can prevent or delay a scheme from being wound up.

The most basic protection is to make sure you receive good legal advice, understand the trust deed and rules, and follow due process – for example, by issuing statutory notices that you are about to wind up the trust.

There are several layers of protection or insurance that trustees can rely on or buy to support wind-up of a scheme. These include:

- Any indemnities and protections contained in the deed of the trust – for example explicit references to trustee duties and indemnities
- Indemnities provided by the sponsoring employer, with the strength of the employer covenant being a key consideration if this is pursued
- Run off insurance which can be bought from a general or specialist insurer to cover defined risks withing the scheme up to a fixed monetary amount and for a set period – perhaps three years
- Residual risk insurance bought from the bulk purchase insurer to cover the whole scheme indefinitely

Unfortunately, schemes whose trustees are most likely to require insurance policies will also have to pay the most for those policies. This can sometimes put transactions or wind-ups at risk. The most common areas of concern are data quality and questions about benefits or rules.

There are drawbacks to all these options, so the best insurance is to start work early on data cleansing and benefit specifications so that everyone feels confident about the risks involved.

Tim Coulson: "We offer residual risk insurance and have written options into existing buy-in contracts. However, this requires lots of detailed work that can be very expensive. The cost will be loaded into what we charge, and it's therefore unlikely to be cost effective for small schemes.

"Residual risk cover insures against the unknown risks that remain after the due diligence has checked the data. If the data is in a condition where the insurer can't get comfortable that the risk is low, then the price charged will be higher, or no price will be offered at all. Trustees need to think carefully before going down the route of residual risk cover."

Rob Mechem: "Insurers will be trying to find everything that is lurking in the scheme – and that could involve looking through every box and filing cabinet for the one document that says a member may be entitled to an uplift to their pension. Trustees need to consider other options – for example, sponsor indemnity alongside trustee run off cover. It's also important to use an adviser that has seen these before and can give the pros and cons of residual risk for the scheme."

Emma Watkins: "It's important to understand how each of the protections available work. Getting advice on their respective limitations and how they might interact with each other is important. A sponsor indemnity, for example, is usually very comprehensive but the trustees need to be confident that the employer will still be in existence some 10 years later."

- **Think about your members**

Price is still the biggest factor when choosing an insurer. But with more schemes in a position to derisk and new entrants coming to the market, trustees have more choice and are considering broader factors – particularly the service their members will get after the transaction. These include:

• Member experience – how does the insurer's administration service to members compare with the wider market and are the trustees satisfied that members will be looked after once the deal is complete and key stakeholders have walked away? This includes service level agreements, the quality of communications, and process standards

- Automation and digital – this overlaps with member experience but is worth calling out separately. Is the administrator investing in technology to support services and delivery into the future? And is the administrator streamlining frontline contact experiences for members, including the elderly, who are increasingly used to apps and digital (instant) correspondence?
- Customer service and scores – how are queries and complaints handled, how do service level agreements perform, and what are the net promoter scores?
- Environmental, social and governance issues – what is the insurer doing, what is it committed to, what is it investing in and what are its values? Trustees and members are increasingly interested in these questions
- Multiple insurers – if you've already done a buy-in and are targeting further buy-ins or buyout, you will need to balance benefits of price competition against having different administrators and brands for your members (plus whether having different insurers will be a practical barrier to ultimate buyout).

Emma Watkins: "Given that the benefits that are insured are not necessarily the same as the scheme benefits, it's important that trustees communicate with their members to tell them about any differences before they move to buyout, thus avoiding surprises for policyholders further down the line. I dealt with a case where the young spouse's reduction moved from fixed in the scheme rules to financially neutral under the bulk annuity. This can make a big difference for someone, and often they won't be aware until it is too late."

I hope you've found this article illuminating, and particularly the views of our experts from the frontline of the derisking market. By discussing how to overcome the potential obstacles, our aim has been to show the route to a smooth and successful transaction.

With another busy year predicted and with healthy competition between numerous old and new providers, there has arguably never been a better time to make progress towards securing the benefits of your members, which is ultimately the mission of any pension scheme. I'll leave it to our panel chair to sum up.

Chris Hogg: "Our overriding message is to bring your administration function into derisking projects early and draw up a clear plan. In my experience it is well worth investing time in this. If you work closely with your administrator, you'll have a smoother transaction and avoid many potential pitfalls."

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