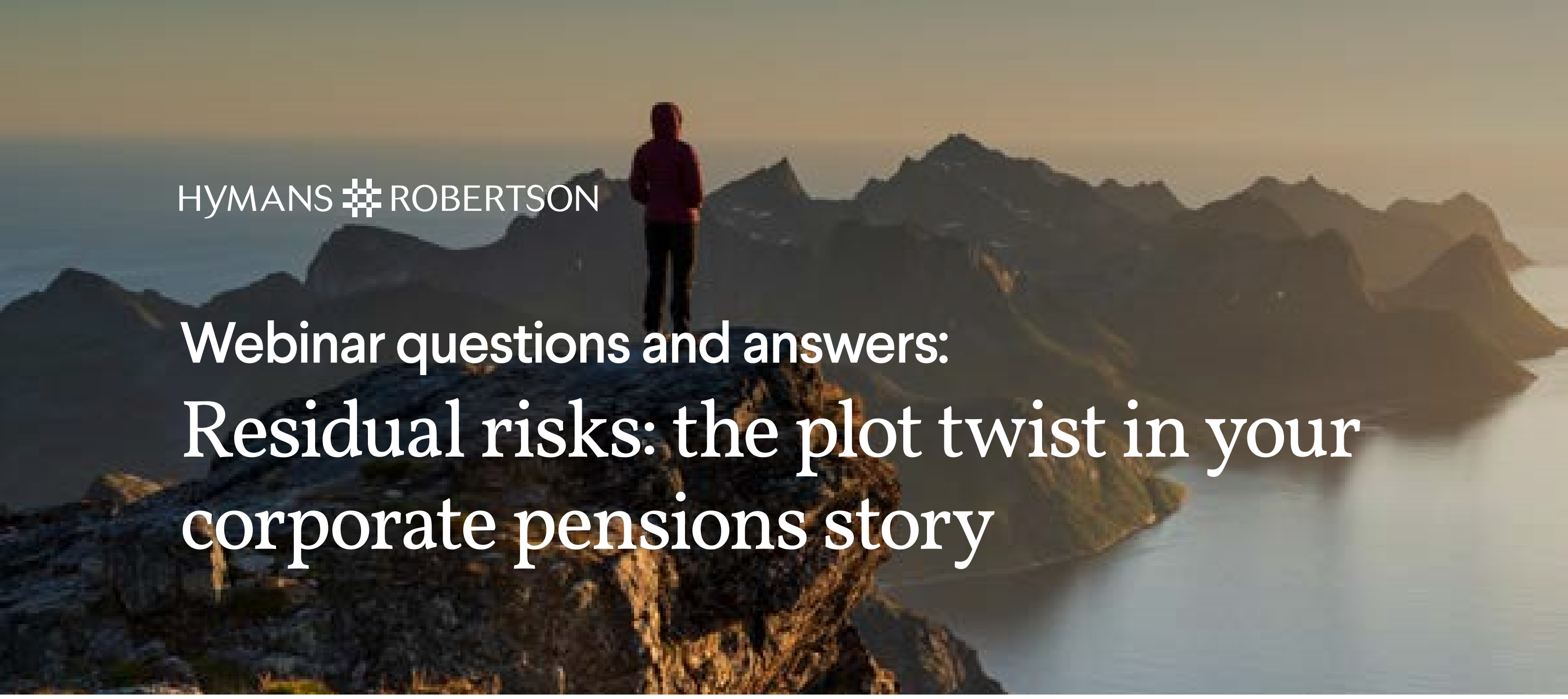

HYMANS ROBERTSON

Webinar questions and answers:

Residual risks: the plot twist in your corporate pensions story

1. Is there any value to residual risk insurance in the context of running on?

Whether a scheme is running on rather than buying-out, the employer remains responsible for funding any future liabilities. Protections against residual risks are typically available for schemes at the point of buy-out and wind-up whether through insurance or by way of statutory discharges afforded to Trustees (and therefore indirectly to Sponsors). While these are not available for ongoing schemes, considering residual risks and what mitigations can be put in place through a proactive approach to reviewing data and benefits should still be considered as part of a scheme's overall risk transfer strategy and is generally good governance. In effect, it brings forward work to be satisfied the Trustee and Sponsor are administrating the benefits correctly and liabilities are understood.

Particularly for schemes that are considering run-on, they may wish to pivot to a buy-out in a short timeframe if circumstances change. Therefore, being buy-out ready is essential and putting the scheme in the position to be able to benefit from any residual risk protections will be valuable.

2. Is there not a statutory discharge where winding up has been undertaken properly?

Yes, trustees can obtain a statutory discharge as a part of the wind-up if they settle or buy-out the scheme's liabilities after triggering wind-up. However this only covers the benefits insured under the individual policies that are issued to the insured members at buy-out and does not necessarily mean there is no future risk. Residual risk insurance and indemnities exist because certain liabilities - such missing beneficiaries or benefit miscalculations - could emerge later, even after winding up.

3. Given the carve outs and limitations in residual risk cover and the likely need for an ongoing indemnity from sponsors, how comfortable can sponsors be that there has been effective "risk transfer"?

Buy-ins and buy-outs still remove the majority of funding and investment risks associated with DB pensions. Residual risk cover, run-off insurance and statutory protections provide an extra degree of protection but often includes exclusions (e.g., benefit errors known before buyout or errors resulting from ineffective execution of historical scheme documentation) – therefore 100% risk transfer is rarely achieved. Sponsors should assess what risks remain post-buyout which could be captured under a Sponsor indemnity offered to the Trustee or simply as a result of reputational risk, and consider what level of due diligence they may wish to do.

4. Given the limited cases that may result in residual risk claims, and the level of due-diligence that's carried out in the market. Does residual risk cover offer effective value for schemes?

It depends. Some schemes may determine that the low likelihood of claims does not justify the cost, particularly if they have undertaken robust due diligence themselves. However, for schemes with complex benefit structures, historical uncertainties or where there has been an active corporate acquisition strategy, residual risk cover can provide trustees and sponsors with greater confidence in completing a buy-out, particularly against systemic risks.

The value of the cover should also be relative to the risk appetite of the trustees and sponsors.

5. What is the most commonly seen range of residual risk charge in the market at the moment? What are the key drivers that will increase this charge?

Pricing varies widely depending on scheme demographics, complexity, and insurer appetite, but we estimate that charges typically range from 0.5% to 1.5% of liabilities. However this is the cost for the providing protection against unknown risks emerging in the future. Insurers will undertake a detailed due-diligence process as part of their underwriting process to identify as many 'known' issues as possible; any issues will either need to be paid for, corrected or excluded from the cover.

Key factors affecting pricing include:

- The quality of data and due diligence completed pre-buyout.
- The extent of exclusions in the policy.
- The nature of the benefits being insured (eg complex benefit structures increase risk).
- Terms on any existing partial buy-ins and the need for 'wrap-around' cover.
- Market conditions and insurer capacity for residual risk cover.

6. Is there a popular method of calculating residual risks seen in the market at the moment?

There is no single standardised approach. However, insurers often use:

- Scheme-specific risk assessments based on detailed due diligence.
- Actuarial modelling to estimate potential liabilities.
- Scenario testing to determine the likelihood of claims emerging post-buyout.

Schemes are increasingly undertaking pre-buyout due diligence to reduce insurer uncertainty and improve pricing.

7. Is no digging/encouragement consistent with Consumer Duty?

The Consumer Duty principle emphasises acting in members' best interests and providing good outcomes. If a trustee deliberately avoids investigating known risks to secure a smoother buyout or to avoid breaching the contractual provisions of a residual risk policy, this could conflict with those principles. However, proportionate investigations, rather than exhaustive analysis, would generally be acceptable.

8. Is it worth insuring such risks, that typically have a lot of exclusions when insured, and for a high cost?

In some cases, no. If key risks are excluded from coverage, the policy's value is reduced. Sponsors and trustees should evaluate whether residual risk insurance meaningfully reduces liability or simply shifts risk elsewhere.

The cost-benefit trade-off must be carefully considered.

It's also worth noting that an insurer being asked to actively take on a new risk is likely to have a different view to a Sponsor who has been inherently carrying the same risk while the Scheme has been ongoing. The due-diligence process that insurers go through also means that once issues has been identified, it is likely to be challenging for trustees to ignore even if they are excluded from the residual risk policy. While it's highly likely new issues will emerge during due-diligence, for risks which insurers are known to exclude, trustees and sponsors should think carefully before lifting the bonnet.

9. If a company indemnity in scheme rules says expressly that it survives wind-up would you be comfortable advising trustees that they can rely on that post-wind-up?

Generally, yes - but it depends on the specific drafting of the indemnity. Legal review is essential to ensure the indemnity provides the intended protection without unintended loopholes. The operational aspects should also be considered to ensure there is an established protocol for dealing with claims once the Scheme has wound-up. This may involve identifying the key individuals/team at the Sponsor and ensuring appropriate consideration has been given to where and how data will be stored to allow claims to be managed in the future.

10. Is responsibility for residual risks visible enough in the current discussions around return of scheme surplus?

No, not always. While allocating surplus is a growing topic of discussion as some schemes have seen their funding position dramatically improve over recent years, who ultimately bears residual risk following termination of the scheme is often overlooked. Surplus distributions should factor in potential future liabilities that could arise post-buyout; this may influence how surplus is ultimately shared, what level of data and benefit verification is undertaken and what additional protections should be secured.

11. Do the speakers think residual risk insurance is seen as an alternative to "doing the work" on the benefit structure and member facts? Trustees get a lot of protection if they have done their best, and RR cover is only a partial solution because many or even most known risks will be carved out.

It shouldn't be. Appropriate due diligence should always come first. While residual risk cover provides an extra layer of protection, it is not a substitute for proper data and benefit validation and good governance processes.

But ultimately it depends on the trustee and sponsor's risk appetite and if the trustee's 'doing their best' and the associated protections afforded to them are sufficient in the context of their own scheme's circumstances.

Schemes that rely solely on insurance without doing the work also risk higher premiums and weaker protection due to exclusions from the policy Insurers are incentivised to find the issues as part of their due-diligence but once discovered, given their fiduciary duties, trustees are likely to find it challenging to ignore problems even if they are carved-out. If trustees and sponsors want to pursue residual risk insurance, schemes should think about getting their ducks-in-a-row ahead of engaging with insurers to ensure they go into the process with their eyes open.