HYMANS ROBERTSON

The Evolution of Member Options

Part 3 – the valuable role of insurers

As schemes mature and get closer to their long-term objective, insurers have an increasingly valuable role to play in the future of DB. To meet both the rising demand for insurance, and responding to increased use of member options, insurers are becoming increasingly innovative in the solutions they can offer to schemes.

Part one of our "Evolution of member options" series explored how member options could be used as a powerful lever to help settle liabilities sooner and more cost effectively, whilst improving member outcomes. This in turn will accelerate schemes' journeys to their long-term objective, with almost half (47%) of schemes aiming to secure members' benefits within the insurance regime.[1]

In the final part in our series, we look at recent innovations in the insurance market to help schemes benefit from member options. We also give views on how we expect the insurance market to continue to develop to best serve the demand for member options from members and trustees. Finally, we provide some actions for trustees who are considering insurance to ensure they are well placed to benefit from member options.

[1] Hymans Robertson's Trustee Barometer research, 2020 – survey of 100 Trustees of UK DB schemes

We'll help you understand:

1. The importance of a joined up insurance and member options strategy
2. Innovations in the insurance market and finding the 'right' approach
3. What the future holds
4. Top tips for Trustees

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If you would like to discuss anything in more detail, please don't hesitate to get in touch.

Market context

When done in the right way, member options provide valuable choice and support around how members can take their scheme benefits to best meet their personal circumstances. **Proactively offering members a full suite of options could save schemes up to £120bn on their long term objective.**[2] That's because member options involve paying benefits from the scheme rather than paying to insure them, which is typically much more expensive.

The insurance market has never been busier – a record breaking £40bn+ of liabilities were transferred to the insurance market during 2019.[3] Although the market is busy, and despite market volatility we've seen in recent months, we continue to see attractive pricing opportunities present themselves for those schemes that are best placed to transact.

Part of this growth has been supported by insurers expanding their offerings. This has included a growing appetite among insurers for non-pensioner insurance. Insurers have also continued to look for opportunities to work closely with pension schemes to add value along the journey to full insurance. Insurers are being increasingly open to explore innovative solutions in their approach to allow for schemes running member option exercises.

In most cases, schemes may still significantly reduce the cost of settling benefits in full whilst offering terms that are no less generous than those currently available from the scheme, and that would be offered by an insurer after buy-out.

Insurers typically focus on meeting the benefits due to members and so typically don't make the full range of options available to policyholders. Some options could therefore only be made available prior to buy-out. For example, this could include a bridging pension, pension increase exchange and partial transfer options. Therefore, trustees wishing to provide this valuable choice need to do so before insurance is transacted.

The importance of a joined up strategy

We remain strong advocates that a member options strategy should be set in the context of the overall strategy for the scheme – only then can the value of member options be understood and success ultimately measured. This is especially relevant for schemes who are starting to look ahead to their end game strategy and where the timescales for achieving this end point have moved from being many years away, to now being within striking distance.

Moving into a new decade really brings this home – many schemes have journey plans ending in the 2020s so this is no longer aspirational, even after reflecting recent volatility.

Whilst member options can be a powerful tool to give members greater choice over how they take their benefits and accelerate buy-out, if not structured in the right way, it could potentially work against a scheme by making a transaction more complex or potentially giving rise to selection risk. This could result in disengagement from insurers in this busy market and ultimately less favourable insurance pricing.

A joined-up insurance and member options strategy will therefore be vital to ensure schemes achieve the best outcome, whilst providing options that will be very attractive for some members.

[2] Evolution of member options part 1 – supply & demand
[3] Hymans Robertson's 2020 Risk Transfer report

Insurer innovation and finding the 'right' approach

Where insurance is not yet a realistic possibility for schemes, embedding a supported approach to member options into business as usual processes will deliver benefits over the long term. We provided some valuable pointers on how best to do this in part one of our series.

For those schemes who are currently in the favourable position of considering whether to insure some or all of members' benefits, the optimal approach will depend on timescales and funding levels.

The table below gives an overview of the different approaches available in the market today, and in what circumstances they could be appropriate:

Approach	What is it?	When is it appropriate?
① **Member options undertaken prior to buy-in**	Offering member options prior to transacting. The member options impact will be known at the point of transacting.	This will be most suitable for the majority of schemes that could implement their member options exercises before they are able to approach insurers. It will allow schemes to reflect the actual member options experience/ take up in the future insurance transaction. Ongoing engagement with the insurance market prior to the exercise will be key to address any concerns that may impact the cost of insuring the remaining benefits.
② **Member options undertaken after buy-in, with scheme exposed to take up rates**	Member options offered post transaction, usually during the data cleansing window. Buy-in data typically reflects the position before member options, or with a cautious allowance for expected take up rates. Scheme receives a refund of premium to reflect actual member options take up.	As the expected savings of member options is typically smaller than the potential risk of worsening insurance pricing associated with delaying a transaction, this approach will be most suitable for schemes that are able to transact in the short term. Allows schemes to capture an immediate insurance pricing opportunity, and still benefit in full from member options savings. Not all insurers able to offer due to reinsurance and "matching adjustment" restrictions for some.
③ **Member options undertaken after buy-in, with insurer underwriting take up rates**	Provides certainty on transaction cost by locking into a certain member options take up, with the insurer taking on the upside and downside take up risk. In most cases, we would expect the trustees to still be responsible for the member option exercises to fulfil their responsibilities to members.	Suitable for schemes that are able to enter buy-in in the short term, but only if member options deliver a minimum level of savings. Insurers will typically transact based on a cautious take up rate, so the impact of member options on price is likely to be lower than if a scheme retains member option take up rate risk. Solution allows schemes to lock into attractive insurer pricing, which may be more valuable than maximising savings from member options alone.

Knowing which option is right for you

The right approach to combining member options with insurance will depend on a range of factors. This includes scheme-related factors (funding levels, timescales and demographic profile) as well as factors impacting the pricing dynamics of the insurance market.

For schemes that are putting in place a strategy to meet their long term objective over a number of years, we expect them to offer member options prior to approaching the insurance market. Doing so minimises the cost of settling benefits, gives members flexibility over their benefits at the earliest opportunity and maximises insurer engagement.

The right approach for member options alongside or after insurance needs careful thought as part of discussions with insurers. Trustees need to ensure that member options is maximising value rather than introducing additional complexities that might reduce insurer engagement and competitive pricing tension.

How do insurers view selection risk arising from member options?

Insurers will carefully consider whether the member options exercise has introduced selection risk or not. For example, insurers may conclude members who take a transfer value are likely to be worse health than average, and that the remaining members may be expected to live for longer. If so they could increase their costs to insure benefits.

To help minimise any concerns around selection risk, trustees should typically seek to demonstrate that the member options have been designed to be reasonable and fair, and that specific subgroups have not been targeted solely to select against an insurer. Trustees should consider sharing member options communications with insurers to ensure they are broadly comfortable that they aren't introducing unnecessary selection risk.

It may not be possible to convince all insurers not to make an adjustment to their pricing for selection risk for all member options. Even so, we would still expect a well-run member options exercise to be a valuable tool to help secure members' benefits. This is still the case even if some pricing adjustments act to slightly moderate the savings generated by member options.

What does the future hold?

We've seen much of the innovation happening over the last couple of years as insurers have looked for areas to differentiate themselves in a highly competitive market. Insurers are increasingly willing to be more flexible if this helps schemes accelerate the pace at which assets are transferred to the insurance market.

Past innovations have included the growth in longevity only transactions and investment solutions that seek (at least in part) to lock into the assets that underpin buy-in pricing. These developments involve trustees choosing which financial and demographic risks to prioritise transferring to the insurance market, and are typically most suitable for schemes that are not in a position to enter into a full buy-in.

By extension, we may start to see some schemes exploring whether to retain member option risks whilst they wait to be able to fully insure benefits. For example, schemes could lock into insurance terms but retain the risk for member options including transfer values, early retirement and cash commutation take up rates.

These options typically reduce the cost of insurance and so can be viewed as a "rewarded risk" for a scheme to retain, especially if insurers only include a prudent allowance for these options in their pricing. Such solutions will allow schemes to lock into favourable insurance pricing without necessarily being in a position to fully insure all risks.

We'd expect this risk sharing on member options to apply for a limited time only until full insurance is affordable. If experience does not emerge as favourably as expected, full insurance may not be possible until later than thought. In more extreme cases schemes may need to find additional funds to fully insure all benefits.

This future innovation will allow schemes to enter into insurance on favourable pricing terms sooner, locking down material financial and demographic risks whilst potentially benefiting from the upside for member options. This can only be a good thing for the market generally.

Top tips for trustees

For trustees who are considering using both member options and insurance to reach their long term objectives, we've covered the importance and value that can be added by viewing these as complementary tools.

There are some additional areas that trustees should consider to ensure both they and their members are getting the most out of their strategy:

Engage with insurers early in the process

As schemes near the point when insurance may be possible, trustees will invariably be trying to manage and close the gap between the value of assets compared to cost of insurance. Member options can play an important role in bridging this gap between two large numbers, but trustees need to always be satisfied that these exercises are being conducted in a way that is ultimately expected to make insurance more affordable.

Early, transparent engagement with insurers will be key to ensuring member options adds the value you expect for you and your members.

Ensure fair option terms

A successful member options exercise relies heavily on engaging members with a fair financial offer. It must give members a realistic chance of achieving a better outcome outside of the scheme. Exercises run on poor terms can lead to low engagement and take up, in no way justifying the project costs incurred.

As buy-out approaches, it will become increasingly important to consider the option terms offered relative to those that would be offered by an insurer post transaction and costs relative to insurance pricing.

Offering members materially different terms in the run up creates a cliff edge, where member outcomes depend on whether they exercised an option before or after buy-out. This could leave schemes open to future challenge from members who exercise their options when the trustees knew buy-out was close.

Trustees need to think about how all members are treated fairly, regardless of the options they take and when they take them. Fairness needs to be considered primarily in the context of the scheme's current position but also with one eye on what the future could hold.

Adopt an effective engagement strategy

Where trustees are also looking to use member options to accelerate buy-out, this often involves communicating with deferred members who may have had little contact with the scheme over the years. All of a sudden they're being asked to make a decision over how to take benefits which will impact the rest of their lives.

It's essential that the trustee's engagement strategy is holistic, forward looking and empathetic to the emotional dimension of how the changes could impact members. These emotions might range from over-excitement at the size of a transfer value; to fear and incomprehension that an insurance company they have never heard of will soon be responsible for their retirement income.

To successfully achieve the scheme's objectives and ensure good outcomes for all members, trust, confidence, and understanding should be built with members early in the process. This is too important not to be at the heart of a scheme's long-term journey planning.

See our 'a smoother journey to DB nirvana' guide for top tips on member engagement.

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