Five Pension Ailments and How To Treat Them

Defined Benefit Schemes Show Their Age

Defined Benefit (DB) pension schemes have entered middle age.

The features of youth — contribution holidays, equity-laden investment strategies, double-digit interest rates and discussions on allocation of surplus — are gone.

The majority of schemes have not yet arrived at old age, though. This is when risks should be expected to be manageably small (or transferred to the care of a third party), such that the sponsor could avoid a failure to recover from a major shock to the scheme's funding.

Individuals with corporate responsibility for DB schemes now find themselves managing the difficult transition between these two phases, often characterised by a desire to reduce risks without increasing costs. This challenge is sometimes the result of a legacy arrangement and is frequently added to other, ongoing duties.

Based on Aon's experience guiding companies through this transition, we have compiled a list of five challenges that repeatedly stand out in our discussions with finance professionals.

Explore our five common pension ailments and review their symptoms. If any of these resonate with you, see our suggestions for possible treatments or book a **free health check** for your scheme.

Five Pension Ailments and How To Treat Them

1 Increasing Cash Contributions

2 Operational Inefficiency

3 Risk Exposure

4 Accounting Problems

5 Suboptimal Investment Strategy

1

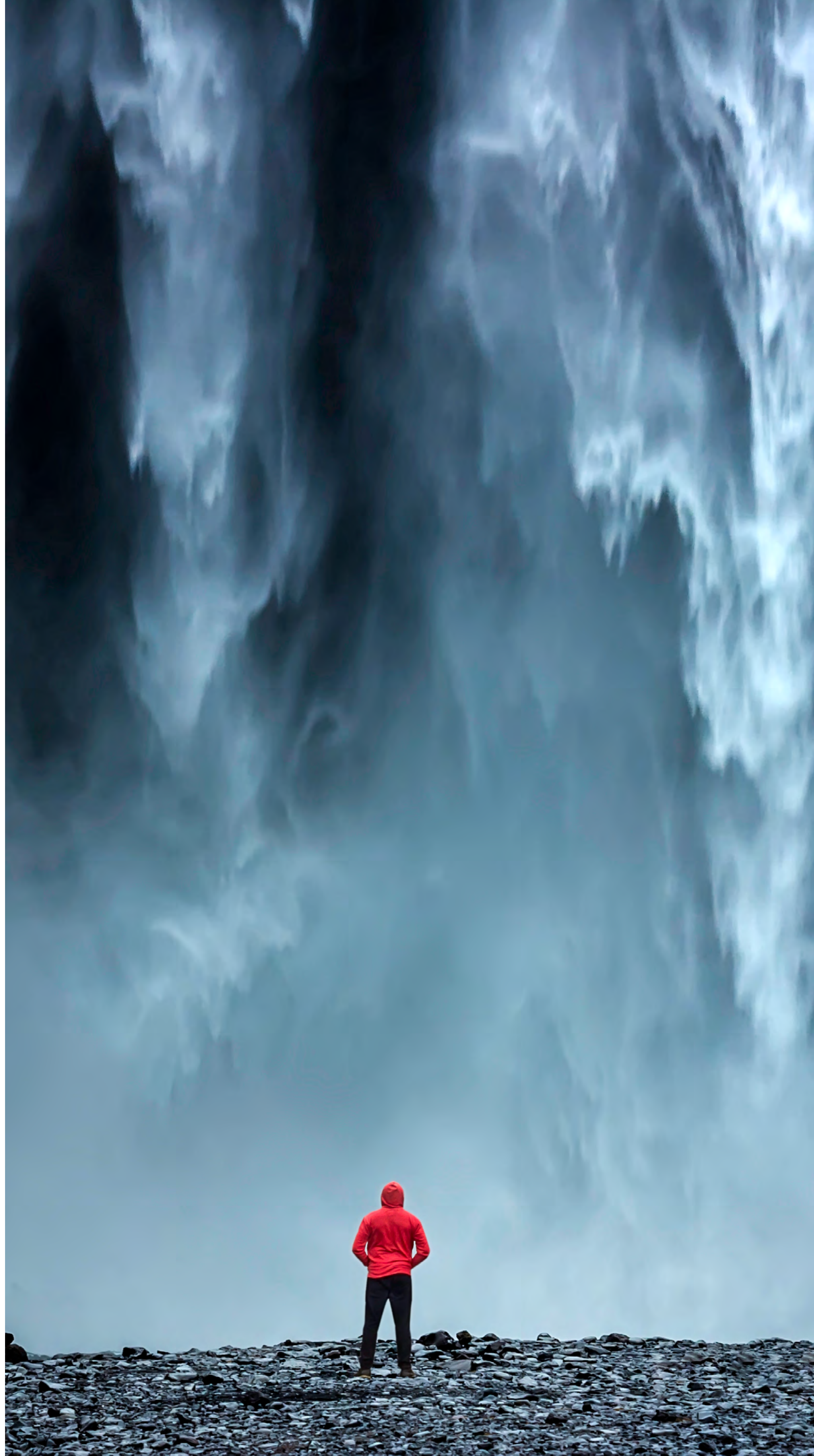
Ailment One: Increasing Cash Contributions

Many sponsors equate the burden of their scheme with the amount of money demanded by trustees to be tied up in the scheme, instead of being put to use elsewhere within the business.

Common Symptoms

- Increases or volatility in the contributions required for the scheme
- Increases or volatility in future service costs
- Difficulty explaining these cost increases to a parent company
- Concerns about the scheme limiting your dividend policy
- Concerns about the scheme limiting your ability to invest elsewhere within the business

Review treatment suggestions.



1

Ailment One: Increasing Cash Contributions

Treatments To Consider

- Take your own independent actuarial valuation advice, which can help benchmark assumptions and support robust negotiations with trustees. This can help avoid excessive or hidden prudence being included in technical provisions, while ensuring recovery plan flexibility is explored fully.
- Consider alternative financing arrangements such as surety bonds, parent company guarantees or charges over assets to support a funding agreement and to reduce the level of cash contributions otherwise demanded by trustees.
- For open schemes, consider whether the design of scheme benefits is appropriate considering it's likely there have been significant increases to future service costs since the last review.
- Consider the range of liability management exercises available to improve the funding position of your scheme and reduce cash contribution demands. This treatment could also reduce your **risk exposure**.

Concerns about increasing cash contributions are often linked with other ailments, such as **suboptimal investment strategy** and **operational inefficiency**. If you would like more information about these symptoms, including case studies describing suggested treatments, please register for a **free health check**.

2

Ailment Two: Operational Inefficiency

In addition to the costs of financing existing (or accruing) benefits, many sponsors are also concerned about the ongoing costs of running their scheme and its governance structure. This is often expressed in terms of time spent (management and trustee), administration expenses, opportunity costs or a combination of all three.

Common Symptoms

- Concerns about the ongoing cost and budgets required to run your scheme
- Uncertainty about the changes to VAT recoverability of such expenses
- Concerns over the speed or efficacy of the trustees' decision-making process
- Concerns about the size of your pension protection fund levies
- Running multiple schemes that haven't been consolidated
- Lack of appropriate resources to enable trustees to run and monitor the scheme with the same standards of governance, strategy and oversight as any other business unit
- Lack of a long-term strategic business plan for your scheme

Review treatment suggestions.

2

Ailment Two: Operational Inefficiency

Treatments To Consider

- Carry out a self-assessment of your operational effectiveness.
- Encourage trustees to review advisors and ensure that the scope and cost of the work being carried out is reasonable.
- Use alternative operating models to reduce running costs (such as increased delegation of more routine and compliance items).
- Consider merging multiple schemes to benefit from operational synergies.
- Take advice about possible PPF levy mitigation actions to minimise costs. This treatment could also mitigate **increasing cash contributions**.
- Provide training for trustees similar to training provided to senior company management. This can improve trustees' skills and elevate their role to non-executive director.
- Consider whether any internal resources (pensions manager, HR function, internal communications department) could be deployed. This can free up trustee time to focus on more strategic actions.
- Consider whether sub-committees could be created to ease the burden on the full trustee board and improve decision-making processes.

Concerns about operational inefficiency are often linked with other ailments, such as **accounting problems** and **risk exposure**. If you would like more information about these symptoms, including case studies describing suggested treatments, please register for a **free health check**.

3 Ailment Three: Risk Exposure

Many sponsors are concerned about monitoring the level of risk borne by their scheme, and how a risk budget can be optimised. Risks in this context are not limited to financial risks — sponsors may also have concerns about the scheme's resilience to changes in legislation, demographic or reputational risk.

Common Symptoms

- Inability to readily quantify and monitor risks (interest rate, inflation, longevity, investment) on an ongoing basis
- Concerns about whether the risk budget within the scheme or company has been allocated efficiently
- Inability to coherently combine pension risks with other risks being borne elsewhere in the organisation
- Desire to reduce risk
- Unexpected or volatile changes in deficits and costs
- Concerns around the implications of new powers introduced by the Pensions Scheme Act 2021

Review treatment suggestions.

3

Ailment Three: Risk Exposure

Treatments To Consider

- Implement a risk monitoring tool such as Aon's **Risk Analyzer** for daily tracking of your scheme's funding position and a range of risk metrics.
- Undertake enterprise-wide scenario stress-testing to quantify your risk tolerance.
- Review investment strategy to ensure your scheme's portfolio is delivering the highest possible return for the level of risk you and your scheme are willing to take.
- Consider the range of liability management exercises available to reduce liabilities and remove risk. This treatment could also reduce **cash contributions**.
- Consider the range of pension risk transfer exercises available. For example, pension increase exchanges and transfer exercises such as longevity swaps or buy-ins.
- Review corporate policies and procedures in the context of the Pensions Scheme Act 2021

Concerns about risk exposure are often linked with other ailments, such as **increasing cash contributions** and **accounting problems**. If you would like more information about these symptoms, including case studies describing suggested treatments, please register for a **free health check**.

4

Ailment Four: Accounting Problems

For many sponsors, the statutory disclosure of the pension scheme in financial statements receives the most attention and carries the most importance.

Common Symptoms

- Volatility in your balance sheet or profit-and-loss (P&L) statement and visibility to investors
- Adverse impact on dividend or reward policy
- Concern over benchmarking of assumptions versus peers
- Concern over reducing expected return on assets under US generally accepted accounting principles (GAAP)
- Concern over impact of pensions exercises on balance sheet or P&L
- Risk of balance sheet asset restrictions
- Risk of having to recognise additional liabilities under international financial reporting standards (IFRS)

Review treatment suggestions.

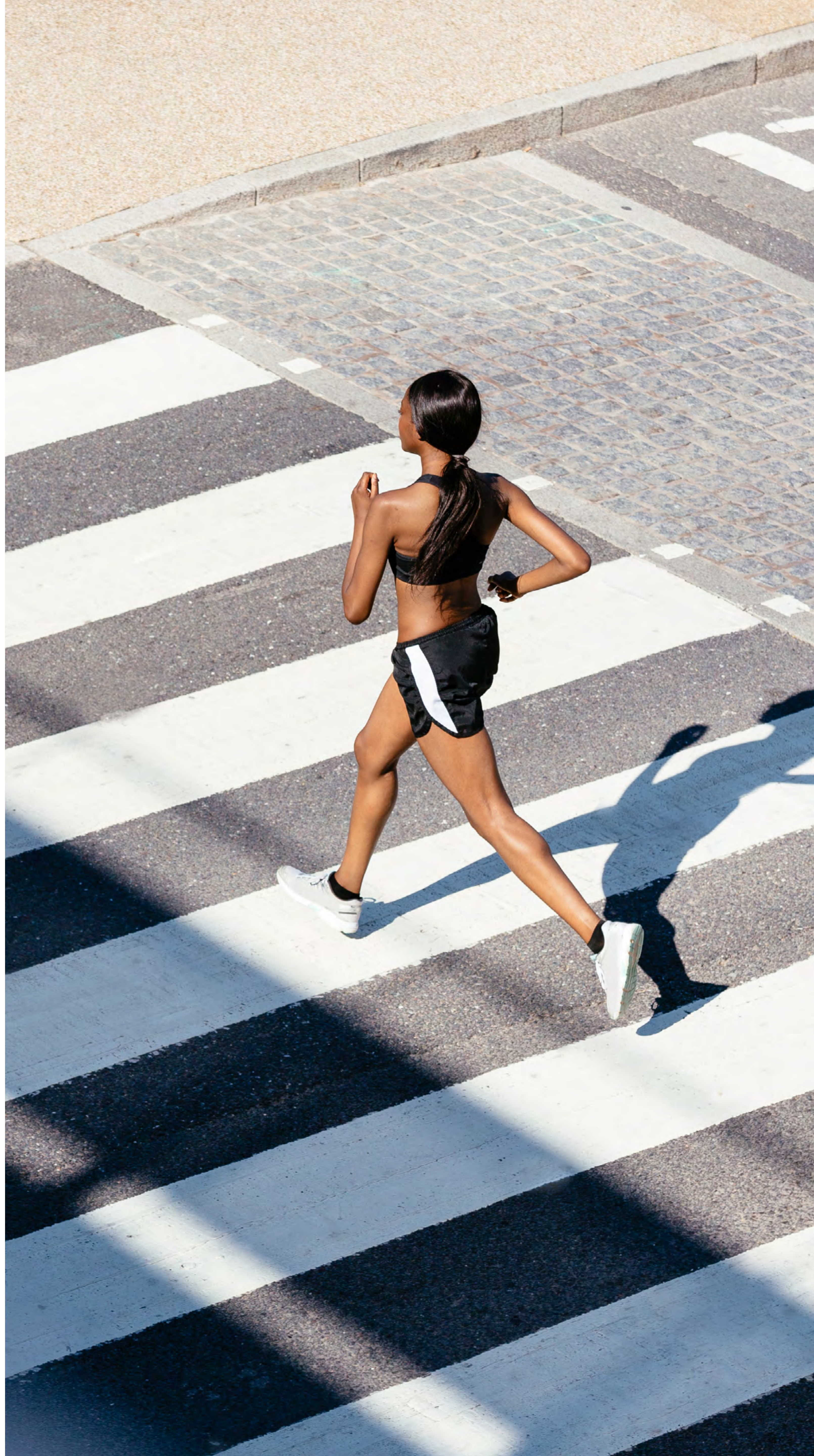
4

Ailment Four: Accounting Problems

Treatments To Consider

- Take accounting advice from a firm that is able to benchmark accounting assumptions with your peers and is in close dialogue with the main firms of auditors to understand current market practices.
- Use a daily tracking tool such as Aon's **Risk Analyzer** to forecast results, including real-time impact of changing assumptions and any liability management or risk settlement actions being considered.
- Review investment strategy to ensure your scheme's portfolio meets your objectives in relation to your accounting position.
- Use alternative financing arrangements such as a pensions stability buffer or escrow account to avoid the risk of trapped surplus.
- Review the accounting approach to ensure that flexibility in the standards is being optimised.

Concerns about accounting problems are often linked with other ailments, such as **operational inefficiency** and a **suboptimal investment strategy**. If you would like more information about these symptoms, including case studies describing suggested treatments, please register for a **free health check**.



5

Ailment Five: Suboptimal Investment Strategy

Although trustees are ultimately responsible for a scheme’s investment strategy, sponsors are consulted when a change is made. Many could be more proactively engaged with trustees in agreeing on an optimal strategy.

Common Symptoms

- Concerns over the range of investment classes utilised by your scheme
- Concerns about the use of active vs. passive management by your scheme
- Concerns about the lack of diversification used by your scheme
- Belief that your scheme’s assets could be invested more efficiently
- Concerns about the liquidity of your scheme’s assets to meet benefit outgo
- Belief that you could be engaging more with the trustees about investment strategy
- Doubt that trustees are sufficiently equipped to make optimal judgements on the scheme’s investment strategy (or that they are not making them)
- Lack of visibility or alignment of your scheme's investment strategy with your Environmental, Social & Governance principles

Review treatment suggestions.

5

Ailment Five: Suboptimal Investment Strategy

Treatments To Consider

- Appoint a corporate investment advisor to carry out an independent review of your scheme's investment strategy or to represent your position in investment strategy discussions.
- Use Aon's ViewPoints tool to ensure the investment beliefs of all stakeholders are well understood, and that your scheme's investment strategy reflects these beliefs.
- Consider whether full or partial delegation of investment implementation could accelerate decision making and action.
- Review your scheme's ESG approach and ensure alignment with your company policies.

Concerns about suboptimal investment strategy are often linked with other ailments, such as **operational inefficiency** and **risk exposure**. If you would like more information about these symptoms, including case studies describing suggested treatments, please register for a **free health check**.

Your Free Health Check

If your pension scheme is presenting any of the symptoms described in this document (or you want to prevent those symptoms), why not take advantage of Aon's no-obligation DB pensions health check service?

The **free health check**, performed by experienced Aon corporate pensions consultants, will be tailored to fit your schedule.

No two schemes are alike, so your consultation will be personalised to examine the health of your scheme. We will consider its potential to impact your wider corporate objectives and offer practical solutions about maintaining or improving its health.

We understand the complicated interactions between symptoms and will take the time to explore the underlying source. We'll treat your scheme holistically rather than suggesting quick fixes or solutions that only apply to individual problems.

Click here to register your pension scheme for a free health check or to get more information. An Aon team member will be in touch shortly to arrange a convenient time.

About Aon

Aon plc (NYSE: AON) exists to shape decisions for the better — to protect and enrich the lives of people around the world. Our colleagues provide our clients in over 120 countries with advice and solutions that give them the clarity and confidence to make better decisions to protect and grow their business.

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