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Pension Scheme Valuations Challenges and Opportunities in 2015
Liability Management

The issue
The pensions "freedom and choice" rules introduced from April 2015 have made it almost essential for Defined Benefit ("DB") scheme sponsors to consider flexible retirement options for members – either as a standard option at the point of retirement, or as a bulk exercise open to all members over the age of 55. A formal valuation provides the perfect opportunity for accurate, up-to-date calculations to be performed to assess the potential impact of member options on scheme liabilities. But the valuation process can be challenging enough, without having to worry about assessing liability management options on the side. So, how can a scheme sponsor make the most of the opportunity without over-burdening its management team with pension issues?

Introduction

In our paper "Pension Scheme Valuations – Challenges and Opportunities in 2015" we highlighted the impact of falling long-term gilt yields on pension scheme valuations and five actions companies could consider for their defined benefit pension schemes. In this paper we consider the fifth possible action: liability management.

Background

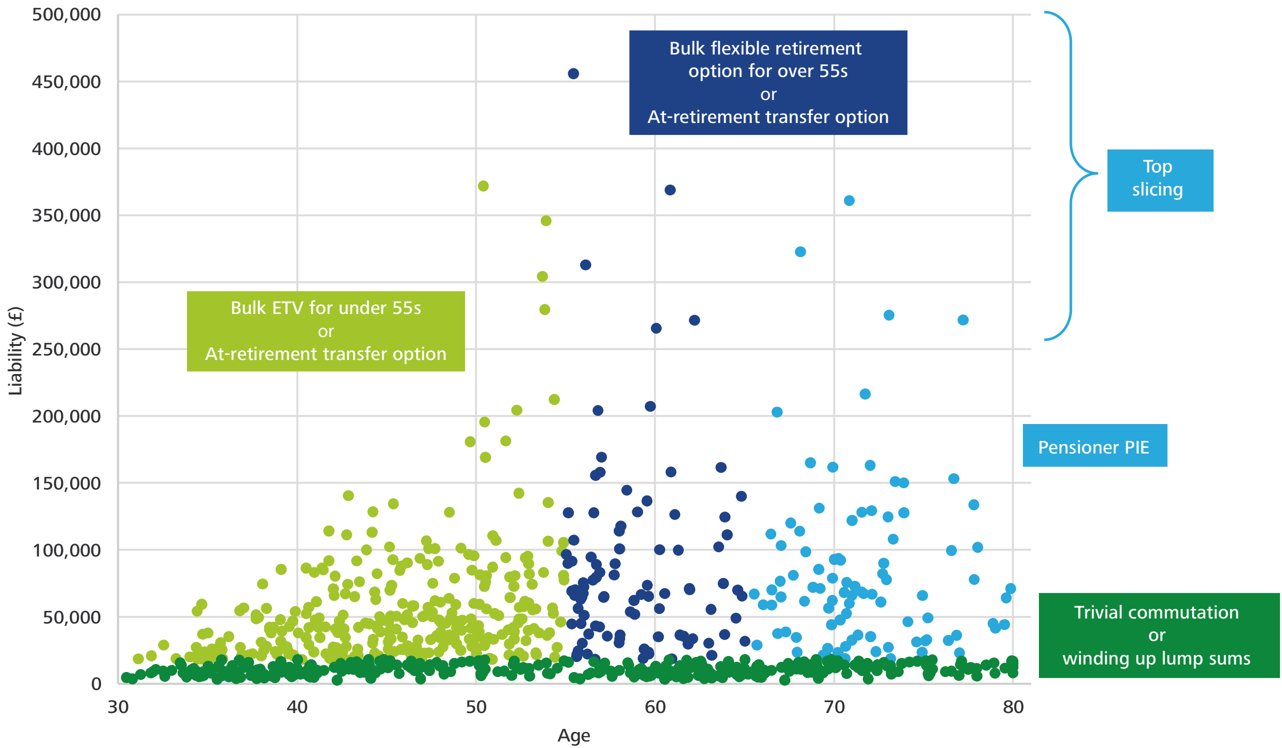
Liability management can reduce the overall quantum of DB liabilities and the level of risk carried by the sponsoring employer. This can be very attractive to employers both in meeting their own objectives for the scheme and, for quoted companies, in demonstrating to the market that they are managing pensions risk. However, great care is required to determine whether a particular exercise is right for all parties and to optimise the chances of it being successful.

There are a variety of liability management exercises relevant to different sections of a scheme's membership. Brief descriptions are set out below and the chart overleaf provides an illustration of which exercise can apply to each member.

Top-slicing, as illustrated on the chart overleaf, refers to the targeting of exercises towards the highest liability members in the scheme. This can sometimes deliver the majority of the desired de-risking in a more cost-effective way.

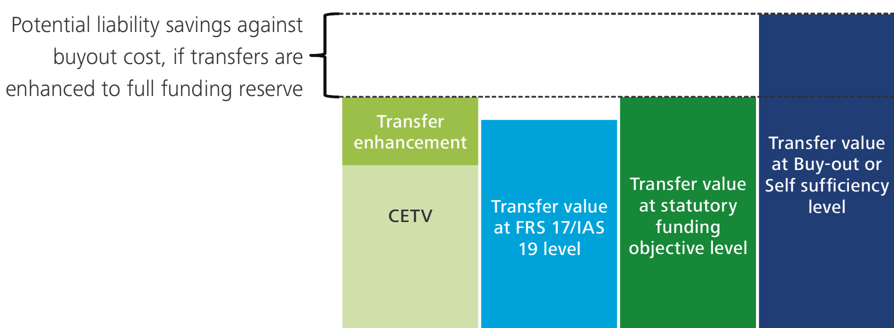
Flexible Retirement Option (FRO)	Enhanced Transfer Value (ETV)	Pension Increase Exchange (PIE)	Trivial Commutation	Winding Up Lump Sums (WULS)
Members over age 55 can take immediate retirement either with a scheme pension or by transferring out to an immediate annuity or drawdown arrangement. An enhancement to transfer values may be offered to incentivise members to transfer.	Non-pensioner members, typically targeting those under age 55, are offered an enhancement to their standard transfer value to incentivise them to transfer the value of their benefits out of the scheme.	Members are given the option to exchange some of their future pension increase entitlement for an immediate uplift in pension. This is typically offered to existing pensioners as a bulk exercise.	Members over age 60, who have benefit values of up to £10,000 can be fully converted into a cash lump sum. A higher limit of £30,000 is also available, but must take into account a member's entitlements across all UK registered pension schemes.	When winding up a scheme (for example if merging one scheme into another for operational reasons) individual benefit values of up to £18,000 can be paid as cash to members of any age.

Targeting different membership sections



Flexible Retirement Option (FRO)

- The UK Government's paper on "Freedom and Choice in Pensions", which came into force from 6 April 2015, allows individuals with Defined Contribution ("DC") pension savings full flexibility on how they access their savings when they reach retirement age. There is no longer a requirement to buy an annuity.
- Deferred members over the age of 55 could be offered a Flexible Retirement Option ("FRO"). A transfer value of a member's DB pension is paid to an immediately vesting personal pension, with a possible enhancement from the sponsoring employer. This enables DB members to access the Freedom and Choice options available for DC pension savings.
- Even if the member wishes to have the security of an annuity, then depending on the options selected, market pension rates, and the member's lifestyle, they may be able to achieve a higher initial pension and/or cash lump sum than with a scheme pension.
- Highlighting this option to members and potentially offering an incentive to transfer can eliminate some of the scheme's liabilities and reduce the risks associated with these. It can be offered as a one-off exercise to current eligible deferred members and can also be embedded as an option for members at the point of retirement in future.
- A cash injection is typically required from the company to fund any enhancement above the Cash Equivalent Transfer Value ("CETV").
- The trustees set a CETV basis for calculating the asset transfer to another scheme if a member transfers their pension benefits. The basis is set to reflect the cost of providing the benefits in the current scheme, based on the scheme's investment strategy.
- The level of potential savings from such an exercise will depend on the terms of the transfer value offered to members and the take-up rates. A higher transfer value offer can result in lower savings per member, but higher savings overall if the offer is thereby more attractive and take-up rates are higher. There is therefore a balance to be struck in setting the level of the enhancement.



- An illustrative example is shown below, where a cash enhancement is made to bring the total level of the transfer up to the value of the benefits on the trustees' scheme funding assumptions.

- Legislation requires members to receive Independent Financial Advice before their DB benefits can be transferred to a DC arrangement. For bulk exercises, an industry code of practice says that the advice should be paid for by the sponsoring employer.

Enhanced Transfer Value (ETV)

- The FRO exercise can be extended to members under age 55, through an Enhanced Transfer Value ("ETV") exercise. An ETV exercise is similar to a FRO, but there is no scheme pension option and members will not be able to draw any benefits immediately from the arrangement they transfer to (as 55 is the minimum age for accessing pension benefits).

- Members would be offered a transfer of their liabilities from the scheme to another pension arrangement (e.g. a personal pension arrangement) with an enhancement funded by the sponsoring employer. As with the FRO, members gain access to greater benefit flexibility and may potentially receive a higher initial pension and/or cash lump sum than they would have received in the DB scheme.

- The level of expected take-up would depend on the level of enhancement that the company is willing to offer and which members are targeted by the exercise. The higher the level of enhancement offered, the greater the expected take-up rates (although not necessarily proportionate). Member take-up of the option can then eliminate the risks associated with transferring pension liabilities.

Pension Increase Exchange (PIE)

- Members can be offered the opportunity to give up future pension increases on a portion of their benefit (where increases are in excess of the statutory minimum required) in exchange for a higher initial pension that increases at a lower rate, or not at all. Below is a table which sets out the statutory minimum pension increases.

Pension accrued	Statutory minimum increases
Pre 6 April 1997 Pension	Nil increases
6 April 1997 to 5 April 2005	CPI subject to a maximum of 5% p.a.
Post 6 April 2005	CPI subject to a maximum of 2.5% p.a.

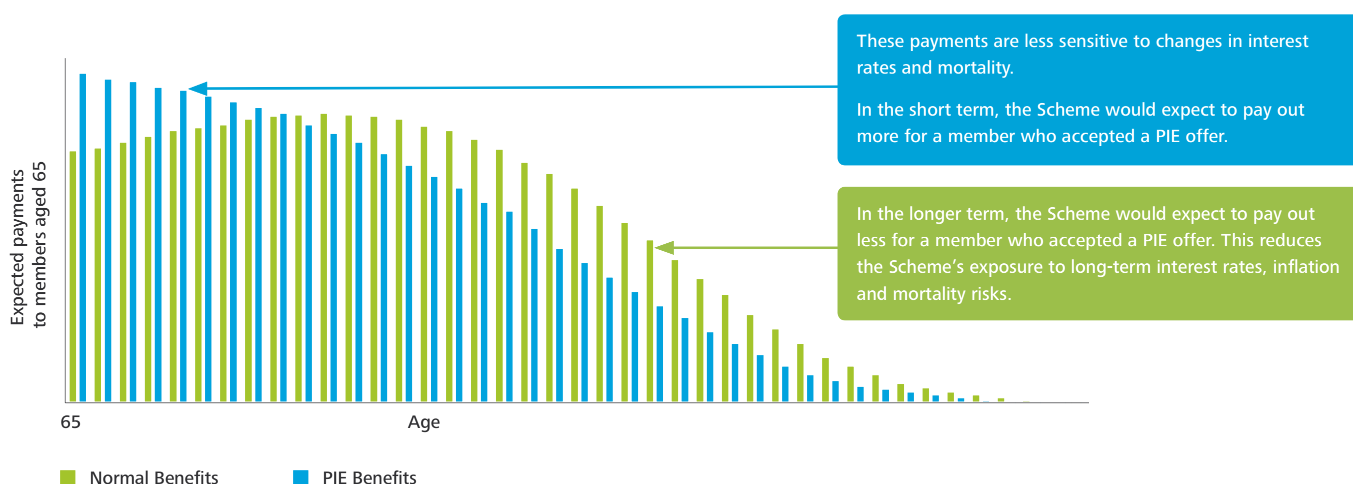
- Pre-1997 pensions will include an element of Guaranteed Minimum Pension ("GMP") for schemes that have been contracted out of the additional state pension. The GMP element cannot be included within the PIE offer, unless a separate exercise is first undertaken to convert the GMP to a scheme pension, which is not common market practice.

- A PIE exercise can reduce the scheme's liabilities and bring forward the timing of the cash flows, reducing exposure to long-term interest rates and inflation, as well as reducing the impact of improvements in longevity.

- The option is commonly offered to existing pensioners as a bulk exercise and/or to individuals at the point of their retirement.

- An industry code of practice applies to bulk exercises of this kind and, depending on the value of exchange for members, either guidance or advice should be provided to members, paid for by the sponsoring employer.

- A PIE exercise does not require any cash payment to the scheme and is likely to give rise to a P&L gain for the sponsoring employer in the year that the exercise is completed.



Trivial Commutation

- Members whose pension liabilities are under £10,000 (or £18,000 if the scheme is winding up) are eligible to commute their pensions to cash.
- This can help to eliminate small liabilities. It reduces administration costs and costs associated with buying out these small pension pots.
- This can be a "business as usual" option for members at the point of retirement and/or run as a bulk exercise. The amounts involved are by definition relatively small, so it is unlikely that large liability savings can be made. However, there may also be savings on ongoing administration costs. If the exercise is run at the same time as, for example, a data cleansing exercise, the liability savings produced might cover the costs of both.

Winding Up Lump Sums (WULS)

- On wind-up of a pension plan, the Trustees can extinguish the liabilities in respect of small pension entitlements by paying members of any age the value of their entitlement as a 'winding-up lump sum', as long as the pension benefits have an actuarial value of less than £18,000.
- The valuation assumptions and methodology used to calculate the lump sums is set by the Trustees and their actuarial advisers.
- The costs of securing small pension entitlements with an insurer are disproportionately high as there will be a significant element of administration expenses included in the premium. To the extent that the lump sums paid to members are lower than the cost of buy-out, undertaking a WULS exercise would reduce the ultimate buy-out cost.
- Subject to Trustee agreement, a WULS exercise could be implemented on an "opt-out" basis, where members receive the WULS unless they specify that they do not wish to. Other approaches could be to give members an option to receive a WULS (lower take-up rates expected) or to unilaterally pay out the WULS without member consent (increased risk of member complaint). In our experience, trustees are likely to be more comfortable with an exercise where the member is also given the option of not commuting their benefits.
- It is not permitted to make use of the WULS provisions if doing so is the main purpose of winding up a scheme. HMRC can impose significant fines that are likely to exceed the liability savings made, as well as causing reputational damage.

Looking at liability management as part of the formal scheme valuation

Advantages

There are various advantages of performing calculations to assess the potential impact of member options on scheme liabilities within the funding valuation process, including:

- it allows accurate calculations to be performed for a liability management feasibility study;
- there is potential to include allowance in the recovery plan contributions for expected liability savings from a bulk exercise;
- there is potential to include allowance for some take-up of an at-retirement transfer option, if implemented during the valuation process, in the same way as commonly done for the tax free lump sum option currently.

What needs to be done within the formal scheme valuation?

We would typically propose a feasibility study is undertaken to assess the potential impact of the various member options to help in deciding which liability management exercises are most appropriate for a scheme and to assess the potential design and savings of the offer.

- This involves undertaking detailed calculations to value members benefits on a number of different bases, (typically funding, CETV, accounting, buy-out and an illustrative IFA basis). This can be done most efficiently and accurately as part of the formal funding valuation.
- The Company can request that the scheme actuary calculate the accounting, and CETV liabilities at the funding valuation date and either provide member by member results or provide a summary of the liabilities split by:
  - Category of members – actives, deferreds and pensioners,
  - Above age 55 and below age 55 for deferreds,
  - Different pension increase tranches,
  - Different normal retirement ages.

  This information can be provided within the funding valuation report prepared by the scheme actuary.

- When assisting clients in such cases, corporate pensions advisers will typically:
  - Project manage the calculations carried out by the scheme actuary
  - Undertake the follow-up analysis, calculate potential savings and, based on the company's objectives, help to determine which liability management exercise are most appropriate.
  - Advise on the design of each exercise, including the potential enhancements that could be offered
  - Advise on implementation considerations and approximate costs.

Considering the risks

As we have demonstrated in this paper, there are a variety of liability management opportunities available to defined benefit pension schemes. However, both the sponsoring employer and the trustees should remain vigilant to the potential pitfalls such as low take-up rates or poor member decisions. It is therefore important to consider all options available, appreciating the risks and potential downsides together with the advantages.

Liability management options have the potential to offer significant savings. Savings are usually based on assumptions which may not be borne out in practice. Sponsors should challenge how sensitive these savings are to changes in the assumptions.

By fully considering the risks and benefits of liability management exercises, employers can approach them with greater confidence.

Contact us

Deloitte has an extensive network of professionals working in an integrated way to bring cutting edge pensions advice and solutions to our clients. If you would like to speak to us about any of the opportunities raised in this series of papers or in dealing with a deficit please feel free to make contact with us using the details below or directly through your usual Deloitte contact.

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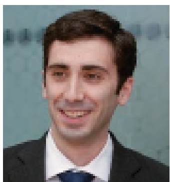

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