

corporate briefing



Tackling pensions in turbulent times

Summary

Companies looking to reduce pension risk and/or costs should actively consider:

- shrinking the size of the problem through incentivised transfer and early retirement exercises
- risk transfer through buy-out or buy-in
- trimming costs by cutting benefits
- tough negotiations with trustees on funding
- actively engaging on investment matters
- taking actions to reduce PPF levies
- pension implications of redundancies or business disposals.

Many companies are tightening their belts in the face of unprecedented turmoil in financial markets and an uncertain economic outlook. In business conditions that appear to be getting tougher by the week, tackling pension costs may pay rich dividends for some and prove to be a necessity for others. This bulletin highlights the main options available to companies.

How can companies contain pension costs?

The main options available to companies to take greater control of and/or reduce pension costs are:

- running effective liability management exercises
- buy-out or buy-in of all or part of the liabilities
- plan design
- tough negotiations with trustees
- investment strategy
- PPF levy management.

Some actions that companies might be considering could lead to unexpected pension consequences. For instance, redundancy exercises and business disposals or acquisitions can trigger large pension debts. Avoiding such “accidents” should be high on the agenda of management.

Liability management exercises

One very effective option is to shrink the overall size of the problem. This can be achieved through liability management exercises, which can reduce the total liability by 10% or more, at the same time as reducing the buy-out deficit and, frequently, the funding deficit.

There are several types of liability management exercises that companies might consider. Usually, the two that make the biggest financial impact are:

- Transfer value exercises – these involve encouraging deferred pensioners to take the value of their benefit to another scheme (for example, a personal pension or their current employer’s scheme). Encouragement may range from simply reminding them that they have a statutory right to transfer, through offering them a higher than normal transfer value, to providing a cash incentive direct to the individual if they transfer.
- Early retirement exercises – these involve encouraging deferred pensioners who are over age 50 to draw their pension before normal retirement age. Risk and deficit reduction arise principally because most members tend to take up the option to exchange around a quarter of their pension for a tax-free lump sum, on conversion terms that are typically cheaper than the cost of providing the pension.



↘ The financial impact of an enhanced transfer value exercise is illustrated below. In this case the company spends £10m in cash to enhance transfer values paid from the scheme to 80% of funding reserves, with the result that the scheme's funding deficit reduces by £20m and the buyout deficit by £35m.

Table 1 | XYZ Pension Fund

	Before		After	
	Funding basis (£m)	Buyout (£m)	Funding basis (£m)	Buyout (£m)
Liabilities	300	400	250	335
Assets	250	250	220	220
Deficit	50	150	30	115

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Many large companies have been somewhat hesitant in undertaking enhanced transfer value exercises, because of worries that they may be accused of trying to “bribe” members into taking decisions that are not in their interests. Whilst such concerns persist, increasing numbers of companies are taking the view that the Pensions Regulator’s guidance on the subject has effectively legitimised such exercises, provided they are done in the right way. The result is that a few large cases have now happened, and several others are at an early stage.

Buy-outs / buy-ins

Over the last 18 months, a number of pension funds have secured bulk annuity contracts with insurers, typically in relation to their pensioner liabilities. Bigger transactions have become common and September 2008 saw the first £1billion deal, between the Cable & Wireless Superannuation Fund and Prudential.

Many of the pensioner-only transactions have been priced at or around the level implied by the assumptions agreed between trustees and companies for funding. Transactions at this price make it possible for the Company to remove risk without being asked to pay significant, if any, additional contributions.

Insurance companies are probably still evaluating the direct and indirect consequences for them of the turbulence in financial markets. They can expect that companies will look for protection against the failure of bulk annuity providers. A number of insurers have resisted providing security to date, citing legal obstacles. However, we believe these can be overcome and we have already successfully negotiated security for at least one large pension fund.

In our view, the bulk annuity market has built enough momentum and there is sufficient demand from pension funds for it to overcome current market turbulence. It is a rapidly changing market, so we would suggest companies aim to be in a position to act quickly to take advantage of opportunities if and when they arise.

Plan design

Making changes to employees’ pensions has always been difficult. The vast majority of UK companies have made major changes since the turn of the century, typically moving to defined contribution plans for new employees and increasing member contributions for existing defined benefit members.



...employees and unions may prefer tough pension decisions to alternatives such as job cuts.



↘ Companies will not underestimate the potential industrial relations repercussions of cutting back pension benefits. But faced with difficult choices in the current economic climate, they might find that employees and unions prefer tough pension decisions to alternatives such as job cuts.

Changes that companies consider might include those that affect accrued benefits (therefore reducing funding and accounting deficits) and future benefits (therefore reducing the regular cost of accruing benefits). Either type of change would normally reduce both profit and loss (P&L) costs and cash contributions required to finance pensions.

The most radical change that companies can make is to cease further accrual of defined benefits altogether for all employees, and to remove any linkage to salary at retirement for accrued benefits. Less radical changes may include:

- introducing caps on salary that is pensionable
- reducing the pension accrual rate (for example, from 60ths to 80ths)
- trimming back ancillary benefits such as those provided on death
- increasing member contributions
- capping pension increases to the statutory minimum (2.5% per annum, or RPI if lower).

Whether companies choose to trim back benefits or take a more radical approach, we expect that a serious economic downturn will force a number of companies into another round of pension reviews.

Funding negotiations with trustees

Many companies will find it much more difficult to be cash generative as a combination of the credit crunch, falling sales and rising costs put pressure on liquidity and cashflows. They will therefore resist higher pension contributions and may have to take a much tougher stance in negotiations with trustees. Some will even have to reopen discussions on previously agreed contribution schedules.

Trustees, on the other hand, will also be under pressure to be more cautious and seek improved funding, because they will be worried that:

- plan sponsors are less secure – the perceived risk of company insolvencies is without doubt higher now than only a few weeks ago
- the worsening economic outlook will cause longer-term damage to the funding position.

Whilst the Pensions Regulator is likely to be wary of taking a stance that bankrupts companies, the diverging pressures on trustees and companies may lead to more difficult negotiations than previously experienced. Both sides will need to be well advised, and be prepared to consider alternative approaches in order to reach agreement.

Investment strategy

Making investment strategy decisions in the present climate must be one of the most difficult tasks facing trustees. On the one hand, moving into safe havens such as Government bonds may lock into losses, as a flight to quality has already pushed up prices of such investments. On the other, the extreme volatility in markets will be making companies and trustees nervous about investment in equities, corporate debt, property and just about any other alternative asset class.

Those pension funds that have used derivatives and swaps to reduce risk will be looking to understand the lessons to be learnt from the failure of Lehman Brothers, who were employed by some pension funds as counterparties. They will wish to ensure that both their documentation and collateral are robust, as primary security



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Further information

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↘ comes from these, and that in the event of default they can replace positions quickly to minimise possible market loss.

Those pension funds that don't presently use derivatives and swaps may be coming to the conclusion that they should now do so, because of a broad realisation that such strategies have proved their worth in the very challenging investment environment. However, in current market conditions, it could be very difficult to implement derivative strategies.

Whilst trustees are empowered by legislation to make investment strategy decisions, they have to consult the sponsoring companies, who more so than ever should take a very active interest. Not doing so runs the risk of crystallising losses or running unacceptable risks. Given that investment performance drives the amount that companies have to pay in contributions, trustee decisions could have a very material long term impact for the companies.

PPF levy management

Many companies made efforts earlier in the year to reduce their PPF levy for 2008/09 and 2009/10 by one or other of the following means:

- improving D&B scores of employers that participate in their pension scheme(s)
- improving the PPF funding of those schemes, perhaps by paying contributions that they were contracted to make earlier than they would have done
- providing inter-group guarantees or other contingent assets in a form acceptable to the PPF.

Companies will wish to continue to look at ways in which they can reduce their PPF levies, particularly if the PPF concludes that it needs to raise more in levies than it presently intends to. This could well be the case if it concludes that many more companies are likely to become insolvent in current economic conditions than it had previously anticipated. Of the options identified above, only the second and third can still be used in relation to the levy for 2009/10.

The PPF stated in November 2007 that without a significant change in long-term risk, the levy it seeks to raise would be increased from its current level of £675 million in line with average earnings growth in each of the next two years. Earlier this year, its chairman highlighted that if unusual events occurred, then it has the right to change its mind. However, the PPF announced last month that it intends to keep the levy at the same level for 2009/10.

Avoiding pension debts

Section 75 of the Pensions Act 2005 gives rise to a debt if an employer "ceases to participate" in a multi-employer pension scheme. Actions that companies may be contemplating, such as the sale of a subsidiary or redundancy exercises, could trigger section 75 debts, if they result in an employer no longer having any active members of the pension scheme.

The consequences can be very material and altogether overshadow the intended benefits of the actions. For instance, a small redundancy exercise involving only a handful of people could result in a debt of tens or even hundreds of millions of pounds, because of the way pension debts are calculated.

Care is therefore needed when considering such actions – with appropriate planning, unintended pension consequences can be avoided.

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