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## Corporate Pensions Briefing

December 2006



## Agenda

- Scheme specific funding – our experience so far
- Experiences with the Pensions Regulator
- Lessons when closing to future accrual
- Changes to the buy-out market
- Discussion groups

## Key messages

- Scheme specific funding survey shows increasing liabilities and reducing recovery periods which will lead to increased cash costs – companies need to engage early on this
- When entering into corporate transactions Clearance and employer debt issues should be considered early
- A number of issues need to be considered before deciding to close to DB accrual
- New entrants to the buy-out market are increasing the opportunities for companies to transfer pension risk

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**Scheme Specific Funding**

Steven Dicker  
12 December 2006

## Scheme specific funding

- Introduced for all valuations after 23 September 2005
- For many schemes, an increase in trustee powers
  - Where company previously set the contribution rate, now a requirement for the company and trustees to agree
- The Pensions Regulator will oversee the new regime
  - Intervene “where the funding objective is imprudent or the recovery plan inappropriate”
  - Triggers to allow focus of resources at highest risk cases

## Impact on valuations

### Recent trends

- Increasing life expectancy
- Move to dual discount rates

### Scheme specific funding

- Greater trustee influence
- Employer covenant

### Regulator triggers

- Focus on accounting position?
- 10 year recovery plans?

*These factors are likely to lead to increased contributions to pension schemes unless increased security provided*

## Watson Wyatt survey

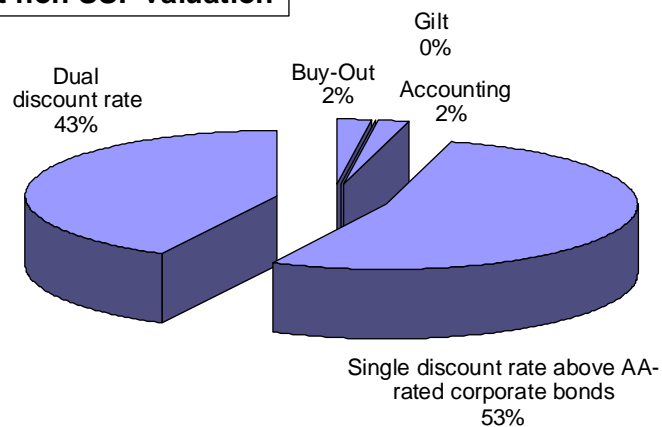
- Watson Wyatt survey investigating scheme specific funding
- Schemes with combined assets of just under £40bn
- Scheme specific issues remain key but survey gives an indication of changing practice

### Today's focus

- Discount rate
- Mortality
- Mortality improvements
- Recovery plan

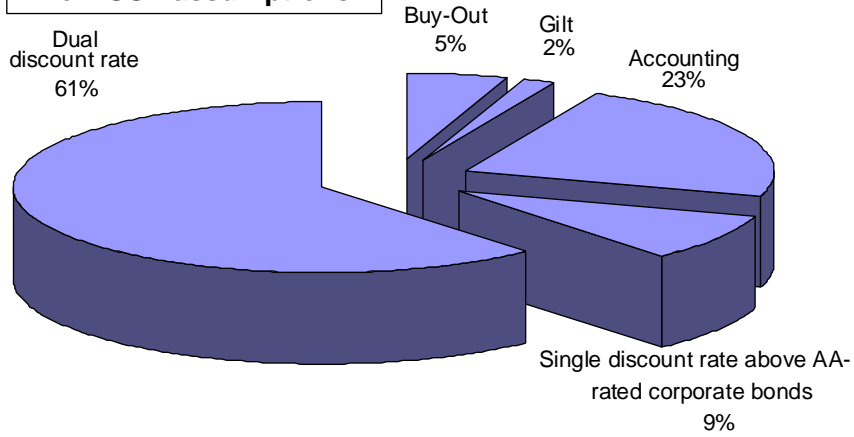
## Setting the technical provisions

### Last non-SSF valuation



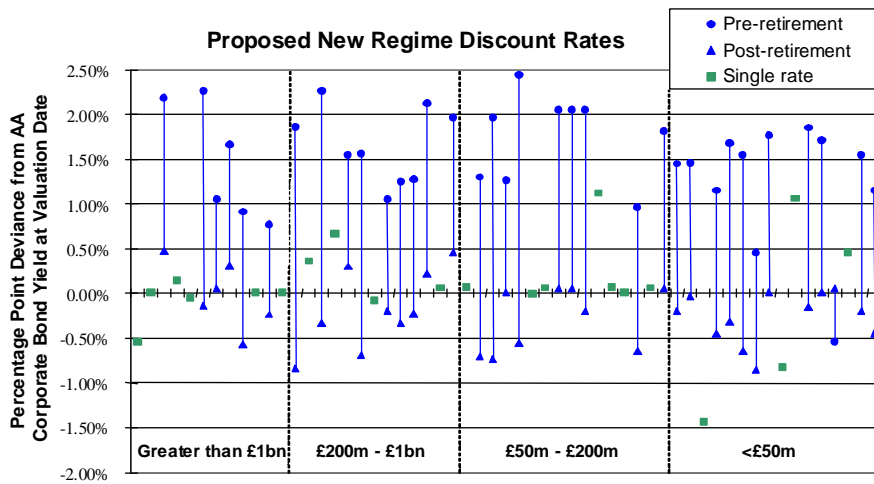
## Setting the technical provisions

### New SSF assumptions



Dual discount rates continue to be prevalent despite Regulator's trigger

## Discount rate



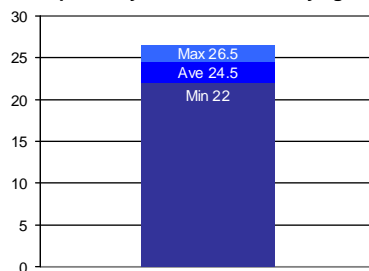
## Impact of company covenant

D&B failure score	Technical provisions above trigger	Technical provisions at trigger	Technical provisions below trigger
100 to 80	10%	35%	55%
1 to 79	14%	43%	43%

*Where the employer is stronger less prudence is being used in the assumptions*

## Mortality assumptions

Life expectancy for a male currently aged 60



- All schemes have adopted the PM/FA92 series of tables
- 88% have made some allowance for future improvements
- 30% have made some allowance for future improvements in line with medium cohort

*The majority of schemes make some allowance for mortality improvements*

## Increasing liabilities?

### Discount rate

- Real discount rates have reduced since the last valuation
  - Pre-retirement by c1% pa
  - Post-retirement by c½% pa
- Part of reduction a result of rising equity markets/falling bond yields?

### Mortality

- The average life expectancy for a male currently aged 60 has increased by nearly 2 years since the last valuation
- Allowance for future increases has risen from 58% of schemes to 88% of schemes

*Expect significant increases in schemes' liabilities*

## Recovery plans

- Average length 7½ years
- 7 years for schemes closed to future accrual compared to nearly 8 for schemes with benefits still accruing
- Where technical provisions are on an accounting basis all schemes surveyed allowed for investment outperformance
  - Typically 1.5% pa above the discount rate
- Increasing interest in contingent funding to improve security and limit cash contributions

*Increased liabilities and shorter recovery periods will lead to increased cash contributions*

## The Regulator's experience

- 48 recovery plans submitted
- 27 'triggered' on technical provisions or recovery period
- Recovery periods of 6 months to over 20 years
- 22 adopted higher pre-retirement investment return than post
- Majority adopted mortality in line with PM/FA92 but with a variety of approaches to future improvements
- 12 adopted different asset return assumptions for the recovery plan

## Our experience of the Regulator (1)

- Strong employer with medium size scheme (£300m assets)
- Technical provisions 95% of FRS17 & 90% of the PPF (S179) liabilities
  - Triggers on technical provisions
- Recovery plan of 7.5 years with equal monetary amounts paid each year
  - Passes on recovery plan
- Valuation report submitted with standard information
- Confirmation that Regulator review completed and no further action taken within 2 months

## Our experience of the Regulator (2)

- Very strong US employer with large scheme (assets of over £1bn)
- Post-retirement discount rate = yield on Gilts
- Pre-retirement discount rate = yield on Gilts with 1% allowance for out-performance of the scheme's actual investment portfolio
- Medium Cohort mortality
- Technical provisions were greater than the liability on a FAS87 basis
- Recovery plan of 5 years with no further allowance for outperformance
- Information submitted to the Regulator - no reply received

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**Experiences with the Pensions  
Regulator**

James Riley  
12 December 2006

## Clearance/employer debt – a recap

### Clearance

- Pensions Act 2004 introduced Contribution Notices and Financial Support Directions
- CNs or FSDs may be imposed some time after a corporate event
- Clearance option available to protect against CNs and FSDs

### Employer debt

- Triggered when an employer ceases to have active members in a scheme
- Based on share of buy-out deficit
- Not payable if withdrawal arrangement is agreed

## Clearance... what we've learnt

- Typically the “price” of Clearance is 50% of FRS17 deficit upfront and the remainder over 3 – 5 years
- Price could be higher
  - Can it be lower?
- Trustee consent needed?
- Favourable deviation from the application could technically invalidate Clearance
- If FRS17 bulk transfer provided, not strictly necessary

## Withdrawal arrangements

- Available if debt is “more likely to be paid”
- Test is whether net assets of exiting employer exceed debt
  - Whether or not these assets could be realised
- Not based on available cash held by the exiting employer
- If net assets exceed debt then debt is payable

*A withdrawal arrangement may not be an option*

## Managing employer debt

- **Pay it** – can a reduction in ongoing contributions be agreed?
- **Deal structure** – amend so no employers exit (care over “avoidance”)
- **Rule amendment**
  - Specify how the debt is calculated; and/or
  - Allocate debts to a single employer
- **Sectionalisation** – no debt payable (administratively complex)

*When entering into corporate transactions these issues need to be considered early*

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## Corporate Pensions Briefing

### Lessons when closing to DB accrual

Kate Walker  
12 December 2006



## Why close to DB accrual?

### Financial drivers

- Reduce cost?
  - Future service
  - Salary link on past service
- Reduce risk?
- More rapid deficit funding?
- Message to market?

### Future HR drivers?

- Harmonise benefits?
- Improve DC or CARE Plan?
- Align benefits to corporate needs/objectives?

## Initial exploration

There are 4 primary areas of focus:

- Trust Deed - power of amendment?
- Winding-up 'trigger' and Section 75 debt implications?
- Business disruption?
- Contractual constraints?

*Issues need to be considered in the context of business case for the change*

## Consultation

- Pensions Act requires 60 days
  - But 90 days under employment law?
- Must be 'fair'
  - When proposals are still formative plus adequate time/ information
- There must be a conscientious employer consideration of the responses
- Significant time requirement

*Implementation cannot begin until consultation complete*

## Concessions

### To the Trustees

- Deficit funding?
- Investment strategy?
- Salary link?

### To the Unions

- Involvement in consultation?
- Input in to design?

### To the members

- Roadshows?
- Helplines?
- Benefit improvements?

*Be clear on what you are prepared to 'concede'*

## Success factors

- Resolve – don't backtrack
- Plan the 'campaign'
  - Build a clear business case
  - Allow realistic timeframes (and costs)
- Commit and support internal resource
- A proactive PR programme is critical

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## Corporate Pensions Briefing

### Changes to the buy-out market

Andrew Reid  
12 December 2006



## Managing the DB pensions legacy... the history

- Defined benefit pension schemes increasingly viewed as a legacy issue
- Present companies with a major corporate finance headache due to impact on cash, P&L and balance sheet
- Buy-out market has been capacity constrained
- Buy-out cost often viewed as prohibitively expensive

*Historically there has been limited opportunity to transfer pension risk to a third party*

## What's changed?

- **New players** – new organisations are entering the bulk annuity market creating additional competition
- **Partial buy-outs** – 'halfway house', DB provision rests with the company but elements of risk are transferred
- **Non-insured buy-outs** – similar to an M&A transaction as the pension scheme is transferred to another employer who is not an authorised life assurer. Will Regulator clamp down on these?

*Increasing opportunities for companies to transfer some or all pension risk*

## Key messages

- Scheme specific funding survey shows increasing liabilities and reducing recovery periods which will lead to increased cash costs – companies need to engage early on this
- When entering into corporate transactions Clearance and employer debt issues should be considered early
- A number of issues need to be considered before deciding to close to DB accrual
- New entrants to the buy-out market are increasing the opportunities for companies to transfer pension risk