

corporate briefing



Closure of final salary schemes

Summary

A significant number of organisations are expected to close their final salary schemes to future accrual over the next few years.

In implementing such a change organisations should consider:

- having a clear and simple business rationale that ideally should be championed by a key business figure
- ensuring thorough planning and due diligence is carried out at an early stage
- what alternative arrangements should be offered – existing defined contribution (DC) arrangements may not always be appropriate
- how best to communicate with employees through a robust and effective consultation process.

Headlines

The financial crisis that has engulfed the UK economy has had a major impact on most UK occupational pension schemes. Sponsors of final salary schemes are not only facing operational challenges, but are being pressed by trustees to continue or increase support for their final salary plans. For many employers the current climate represents a burning platform that will surely lead many to change their existing pension arrangements. Only the most committed (and financially secure) are likely to continue with final salary provision; for others, closure will become a business imperative.

This briefing covers the challenges employers face in closing their final salary plans to future accrual and describes elements of the solutions we have been developing with clients as they take steps to meet these challenges.

Is closure to future accrual really going to happen?

When we carried out our plan design survey in 2008 we asked respondents whether they anticipated closure to future accrual in the next 5 to 10 years. 40 per cent of those who have persevered with some final salary accrual to date indicated that they expected to cease this within the next 10 years – and that was before the economic downturn. Since then we have seen the National Association of Pension Funds survey which indicated that some 25 per cent of major UK employers similarly expected to do so over the next five years.

There are many factors driving this change: increasing longevity and lower investment returns are making pensions more costly to provide. But, on top of this, sponsors now face an increasing burden, with greater compliance and PPF costs. Perhaps worst of all, economic turbulence creates substantially higher financial risks (which are often out of the sponsor's control, in trustee hands). All of this makes final salary pension provision unattractive to UK employers.

Planning the change

A pension change exercise is a major undertaking for any employer and requires detailed preparation. A clear and simple business rationale for the change is paramount. Without this there will be little, if any, motivation for the change. Ideally, this should be championed by a key business figure – explaining the business context and positioning the pension change as a key component of corporate planning can help to reassure employees.

A pension change project will inevitably be complex. It is unfortunately all too easy to derail an otherwise well-considered change program, for example:

- if there is a challenge brought from an employment law perspective (for example, because a group of employees have contractual entitlements due to the age and the origin of their contracts of employment), or

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- if a group of people are inadvertently disadvantaged (for example, because a minority of the workforce have, for historic reasons, a lower retirement age or lower contribution rate).

Some organisations also have contractual commitments to their clients (particularly in the outsourcing industry) that could be threatened directly or indirectly through these changes.

Assessing the impact of the change on individual employees and considering whether to provide any compensation (financial or otherwise) can be a major element of the project. Similarly, specific thought needs to be given to ill-health and death benefits which often differ substantially between DC and final salary plans. Short-term measures may be required to ensure that all employees and their families are appropriately protected.

Many other issues need to be addressed as part of due diligence. A thorough review of the existing trust deed and rules is required to ensure that the closure process does not inadvertently trigger a debt on the sponsor(s). Even if it does not, trustees may take the opportunity to revisit the funding plan, so solutions in this area can often be developed, negotiated and agreed as part of the funding valuation.

Designing the new scheme

Many organisations already operate DC plans for their new recruits. It would seem natural for final salary employees to move to this arrangement, not least on grounds of consistency of treatment. However, this ‘obvious’ solution should at least be challenged. The critical question is whether the DC plan is fit for purpose: many of these plans have been in force for a number of years without substantive review. In that time, investment choices and options have been evolving and the general level of employer contributions has been increasing. Both these factors mean that the DC plan may be overdue for review. A further question is whether it is fit to meet the needs of the former final salary members.

Remember a DC scheme need not be worse than a final salary scheme for members, it could be equally valuable but it is radically different!

Managing change: the communication and consultation

The most significant challenge in any pension change program is the communication and consultation phase. All too often an effective pension solution can be scuppered by poor communication and consultation. In order for this process to be successful it must be open and constructive.

First, the legal requirements: consultation is governed by both pension and employment law. Where there is no need to vary the employment contract, the pension law applies. This requires a 60-day consultation process setting out the details and implications of the proposed change for the employees. Where employment contractual change is required, the process can be more complex, either requiring voluntary change or a fire and re-hire approach. In this case the consultation process must follow employment law requirements which are more substantive. Due diligence at an early stage is essential to understand the approach to be taken.

Regardless of these minimum requirements, our experience is that companies that underestimate the consultation process are most likely to run into difficulties.

Adequate time must be allowed for preparation of materials, establishment of consultation groups and due diligence of employee and union views.

Consideration will also need to be given to how employee and union feedback will

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“ It will be important for employees to see what the change means for them personally ”

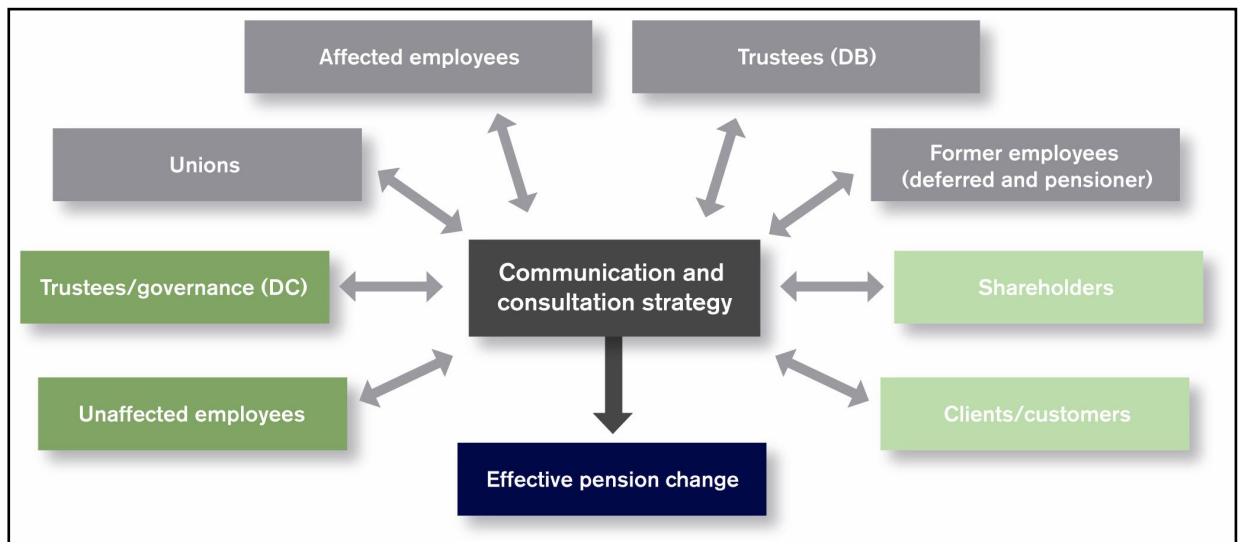
be responded to, possibly including the preparation of back-up announcements (for example, in case materials are unexpectedly made public). The commitment and availability of key individuals to consider responses to unexpected challenges and issues may also prove to be critical.

The consultation process will involve different groups: unions may represent certain sectors of the workforce or certain sites. Employee representatives will represent all employees but, depending on their background, may have significantly different perspectives. Their likely positions should be identified at an early stage and solutions developed to address these positions where required.

It will also be important for employees to be able to see what the change means for them personally: thought will be required as to the level of detail – from a handful of representative illustrations via ‘ready reckoners’, to specific individual modellers which are designed to allow individuals to model the personal impact of the change. Where consultation requires individual agreement, it is vital that this process is managed efficiently, particularly the administration of individual consent.

And do not forget public relations too: it is likely that customers and clients may be concerned about the effectiveness of your business through this change program, and it is essential that they are informed and reassured. If the importance of a rigorous and transparent communications process is underestimated, consultation can be a painful, drawn-out and potentially damaging process. Done correctly, it raises the levels of engagement and appreciation of occupational pensions, giving the sponsoring organisation a healthy foundation on which to build a more sustainable pension relationship as a cornerstone of total reward.

Figure 1 | Strategic stakeholder management



Implementation – going live

This may seem like the most straightforward part of the project but, again, can present significant challenges for any organisation. For example, it will be vital to ensure that all changes are fully documented, both with the employees concerned and for subsequent pension staff who may need to refer back to items of detail - the frustration of trying to reconstruct old individual agreements makes this case clear. This will include final salary benefit statements and possibly variations to contracts of employment.

DC schemes require individuals to make significant choices, primarily relating to their level of contribution and the investment of those contributions. This is, of course, in contrast to final salary where the investment choices are made by the trustees. This means that there is an education requirement for employees to ensure that they are able to make these choices and understand the implications.

There needs to be an efficient process in place to manage and record these choices.

Not least, there will be significant changes to payroll systems, both to accommodate the changes in individual contribution rates, and in many cases the likely change in the contracted-out status. This may cause further confusion with employees if not fully communicated.

Meeting the challenges

Managing pension change involves a number of key specialist areas within each organisation: pensions management, communication, employee and union relations, payroll, external communications, legal (employment and pensions), actuarial, and financial education. Equally important is the project management to ensure that internal and external resources are organised in the most efficient manner to bring a pension change program in on budget. A strong project team consisting of these skill sets will see the change program through to completion.

How Watson Wyatt can help you

Having guided and supported companies with a variety of size and pensions background, we are perfectly placed to bring this experience to bear in pensions change projects.

We appreciate that a change or closure program involves skills from a number of different disciplines and respond to this challenge by providing our clients with a multidisciplinary team of pension change specialists. Our approach is flexible to complement the skills and resources of our clients but, in general, our teams would comprise of specialists in each of the following areas:

- actuarial consulting
- member education and financial awareness
- payroll and pension plan operational changes
- communication and consultation management and production of materials
- project management and coordination.

Further information

For more information on how to manage your pension change program, please contact your Watson Wyatt consultant or:

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February 2009

Ref: 2009-COR-MKT08

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