

# corporate briefing



## Liability management: reducing your pension scheme liabilities

### Summary

**Well-managed liability management programmes can reduce financial risks within defined benefit (DB) pension plans. In considering such a programme organisations should:**

- **commission a feasibility study to determine the costs and benefits of such action**
- **monitor the market to determine an appropriate time to implement an exercise**
- **involve trustees to gain their support and negotiate to include the costs of the exercise within an overall funding plan**
- **be prepared to react quickly to the right market conditions with cleansed data and an agreed strategy.**

With valuations showing larger deficits, and trustees pressing for more support for their DB pension schemes, many employers are looking at ways in which to reduce their pension scheme liabilities and the associated risks. A well-managed enhanced transfer value (ETV) programme can be a worthwhile exercise with potential benefits for all parties involved – members, company, trustees and shareholders.

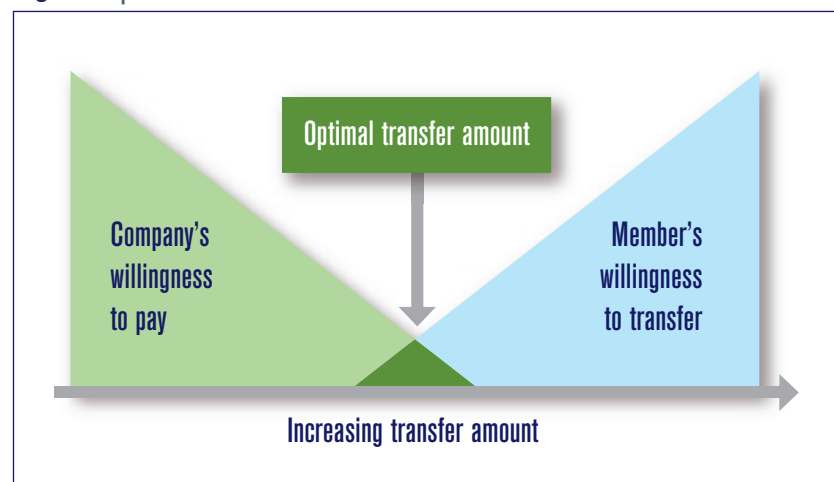
This briefing covers some of the issues involved in undertaking a liability management exercise and ways in which to make the exercise successful.

### What is an ETV exercise?

ETV exercises involve incentivising deferred pensioners to transfer their benefits to another pension arrangement. The level of encouragement may range from simply reminding them that they have a statutory right to transfer, to offering them a higher than normal transfer value and/or a cash incentive paid directly to the member.

Various types of enhancement are possible, such as a percentage of accounting or funding reserve, or targeting the minimum amount necessary to satisfy a financial adviser's requirement to recommend transfer. A feasibility study can help identify a suitable enhancement to encourage members to transfer, taking account of the costs of implementation and funds available.

**Figure 1 | Level of enhancement**





## Why carry out an ETV exercise?

Many employers now operate defined contribution (DC) plans for their new recruits, resulting in the member taking on the investment and longevity risks, rather than the employer. An ETV exercise offers the employer the opportunity to transfer the risks associated with providing DB pension benefits to deferred pensioners, whilst also removing the associated liabilities from the scheme at a lower cost than securing the benefits with a third party. It can provide many members with more flexibility over their retirement income.

A successful ETV exercise can:

- reduce the risks in the scheme (by transferring longevity and investment risks to the member)
- reduce headcount in the scheme (amongst those who are no longer associated with the company)
- improve the funding positions (and improve security for those members who remain in the scheme)
- reduce the deficit on a buy-out basis (the cost of securing benefits with a third party)
- reduce investment fees, Pension Protection Fund (PPF) levies and other administration costs.

An ETV exercise can also form part of a journey plan towards settlement. After taking on new business, many insurance providers will undertake an ETV exercise. Some, but not all, of the savings generated by the exercise will be reflected in the price they charge. Carrying out the exercise before settling the liabilities means that you can benefit from the full savings generated from an ETV exercise.

**“ Where the enhancement is to the transfer value (rather than a cash payment), it may be possible to use deficit contributions to fund the enhancement. ”**

## Is now the right time for an ETV exercise?

Whether now is the right time to undertake an ETV exercise will depend on your own circumstances. There is likely to be a cash requirement and you may need to consider whether an ETV exercise is the best use of available capital. Where the enhancement is to the transfer value (rather than a cash payment), it may be possible to use deficit contributions to fund the enhancement.

An ETV exercise will reduce the level of risk inherent in the scheme and will provide savings compared to the cost of insuring the benefits. However, in current market conditions, there may be a P&L charge (depending on the enhancement offered) which you may prefer to avoid. Another consideration will be the reaction of members to such an offer in the present climate. It is important, therefore, to monitor the market for the right conditions to enhance the success of your exercise.

Being ready to react quickly once the conditions are right for you to proceed is key. Carrying out an exercise requires careful planning and preparation which can take several months. To maximise success, it may be necessary to verify addresses and trace missing ones. Determining which financial advisers to work with and gaining agreement from the trustees ahead of commencing implementation also support this objective.

## What are the risks involved?

The key risks are the potential for mis-selling claims and reputational risk via bad publicity. These risks can, however, be minimised through careful design and implementation of the offer. The Pensions Regulator and FSA have both provided guidance which indicate that they are not averse to such exercises and also provide a minimum framework within which to make offers to members.

Other risks that will need to be managed are listed below.

### Short-term cash injections

Cash will need to be made available once a member has decided to transfer. The amount needed will depend on the enhancement offered, the take-up rates and whether the enhancement is taken as cash or additional transfer value (and hence possibly paid through agreed deficit contributions).

# “ The key risks are the potential for mis-selling claims and reputational risk via bad publicity. ”

## Significant fixed costs of implementation

If take-up rates are low, then the costs of feasibility and implementation may be disproportionately high.

## Anti-selection risk

Single members benefit from the fact that the transfer value calculation builds in an allowance for spouses' pensions which might become payable on death, assuming on average a certain proportion of members are married. If mainly single members take a transfer value, the scheme will have paid out more than it should have.

## Age discrimination and legal risks

The offers made should comply with the scheme rules and legislation, such as age discrimination.

## Data analysis and cleansing

Clean data will ensure that members can be contacted and that the transfer values calculated are accurate.

## Trustee relations

The trustees hold the scheme data and therefore the trustees need to be happy to release it for use in an ETV exercise.

## What are the financial implications of an ETV exercise?

An ETV exercise can have a number of financial implications which should be considered prior to implementation. These include:

- cash payments to the member from the company
- balance sheet and P&L implications
- possible improvement to the funding position of the scheme (which could result in lower future deficit-reduction contributions)
- reduction in any buy-out deficit (making settlement of all liabilities more viable)
- reduction in PPF levies
- reduction in administration costs and investment fees.

## How can take-up be maximised?

The likely level of take-up can be influenced by a number of factors:

- size and form of the offer
  - the more generous the offer the more likely members are to transfer
  - offers which include a cash element are likely to be more attractive to members
- communication exercise and financial advice provided
  - well designed material including multi-media presentations and outbound calling to increase member engagement
  - readily accessible and high-quality financial advice increases members' understanding
- accuracy of member data
  - up-to-date contact details increase the size of population able to participate in the exercise
  - accurate personal information ensures that the correct benefits and enhancements are calculated
- investment conditions
  - members may take a more cautious attitude to investing their money when stock markets are volatile, preferring to wait for signs of market recovery
  - the adviser can help explain the risks and opportunities
- members' perception of employer covenant
  - if members are concerned about the security of benefits, they may be more inclined to transfer
  - as part of the advice process, the benefits they would receive from the PPF if the company becomes insolvent should be demonstrated.





## A feasibility exercise is the first step to help identify whether an ETV exercise is appropriate and to determine the optimal approach. ”

### Alternative liability management tools

Other liability management tools can be used in order to maximise liability and risk reduction. These can be run alongside an ETV exercise or as a standalone exercise and can include the following:

#### Trivial commutation exercise

A cash payment can be made directly to members to extinguish the liability in respect of small pensions. Direct savings will be small due to the small pensions involved, but reduction in headcount may be beneficial from an administrative perspective as well as helping reduce headcount based PPF levies.

#### Early retirement exercise for deferred members

Deferred pensioners over the age of 50 (55 from April 2010) are offered early retirement. The liabilities for those members who choose to retire early and take a tax-free cash lump sum may reduce and any savings from commutation terms will be brought forward (typically on all of buy-out, funding and accounting measures).

#### Re-shaping of non-statutory pension increases

Members are offered the opportunity to re-shape their pension benefits by converting non-statutory pension increases for additional non-increasing pension. This can make the pensions more attractive to an insurer for a potential buy-out and increase the potential tax-free cash at retirement, thereby reducing liabilities.

### How Watson Wyatt can help you

A feasibility exercise is the first step to help identify whether an ETV exercise is appropriate and to determine the optimal approach. It will help to ensure that the time and expense involved in the project is put to best use and the ETV exercise is executed at the right time. Watson Wyatt can carry out a feasibility study to identify potential savings for different levels of enhancement, assess the likely financial impact, set out key considerations and advise on how to implement a successful exercise.

In addition to carrying out a feasibility study, Watson Wyatt can help in many other areas of ETV exercises as follows:

- design of offer
- a professional programme management service
- data cleansing
- selection of default transfer vehicle
- appointment of panel of IFAs or tied agent
- advice to senior executives
- preparation of company and trustee information packs to members
- running generic workshops and help-lines
- operating inbound and outbound call centres.

### Further information

For more information on ETV exercises and other liability management techniques, please contact your Watson Wyatt consultant or

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