

Pensions Regulator Update

Inducement Exercises, Employer
Covenant, and other topical issues

Agenda

- A quick survey
- “Inducement” exercises
- Employer covenant
- An update from the regulator
- BW response
- Other topical issues
- Questions

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- **A quick survey**
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Have the scheme(s) you are involved with considered an inducement exercise?

1. Already run one
2. Will run in the next 12 months
3. Considering but no timetable set
4. Considered but decided against
5. Not considered
6. Not sure what they are

What was/will be the main reason for running the exercise?

1. Cost Reduction
2. Risk Reduction
3. Part of wider 'de-risking' strategy
4. Other

Are these exercises in the members' interests?

1. Never
2. Only for a few individuals
3. For certain groups
4. Not necessarily for all, but a helpful option
5. Always

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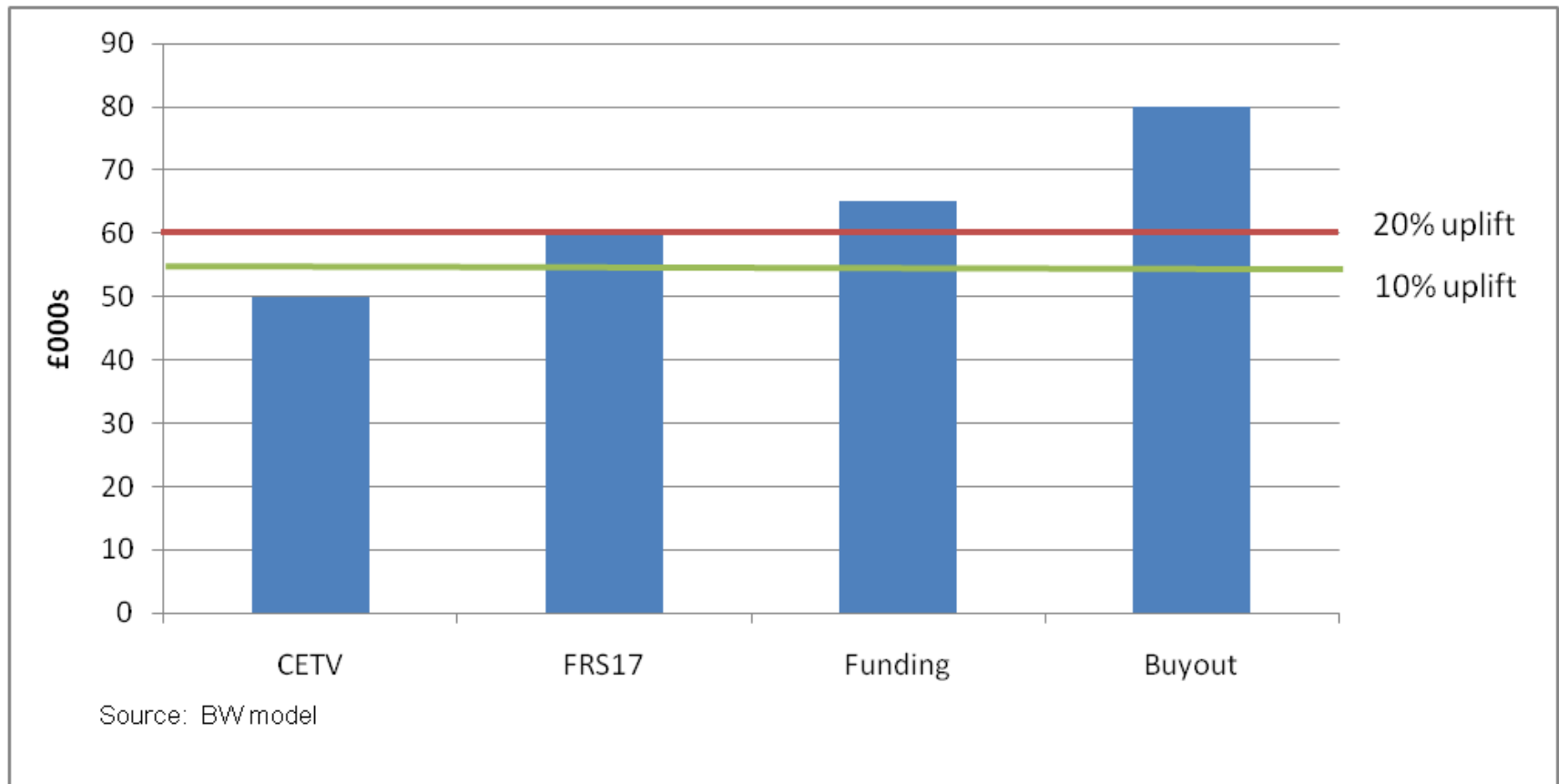
Enhanced transfer values

- Incentive for deferred members to transfer out
- Uplift to transfer value or cash payment
- Member has the **option** to choose whether to accept
- Reduces cost and/or risk for the scheme
- Gives member more control over their benefits
- Why popular now?
 - Corporate bond yields lower so more attractive relative to accounting liabilities
 - Employers looking to reduce risk and costs



Enhanced transfer values

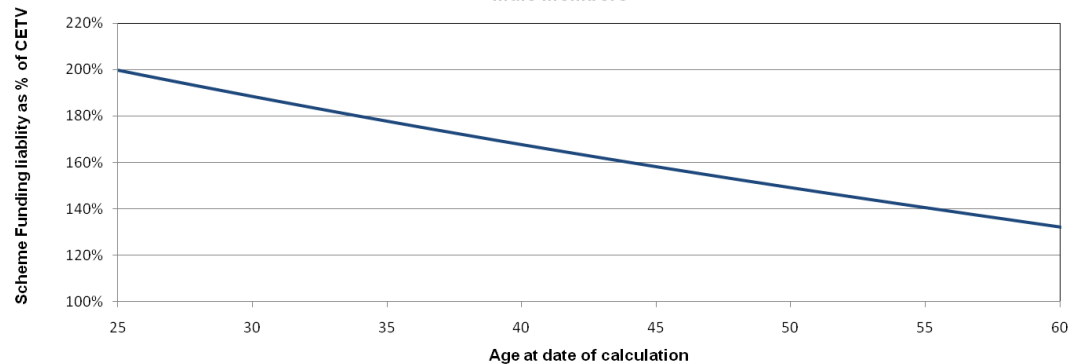
Liabilities on different funding measures for a typical 55 year old



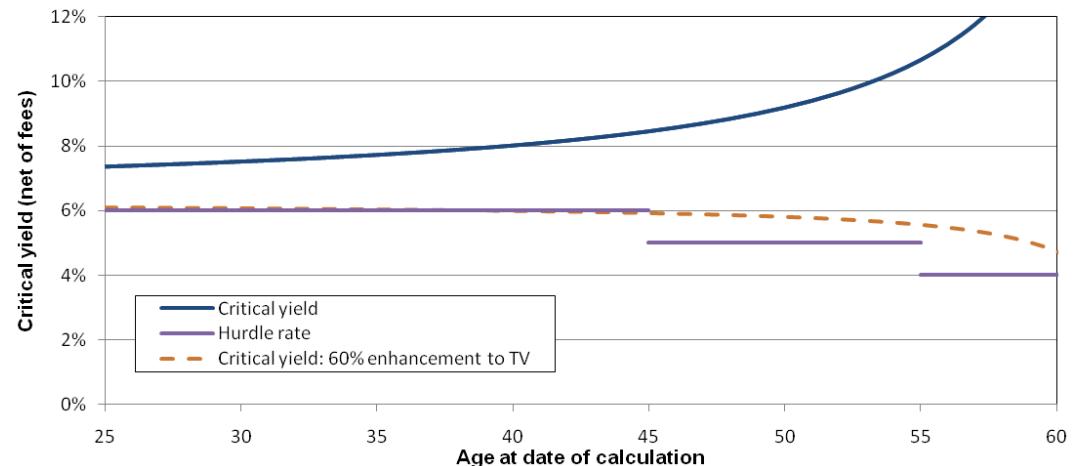
Transfer value offers – how to do it

- Set the enhancement at an appropriate level
 - Compare to funding reserve
 - Critical yield analysis

CETV uplifts equal to Scheme Funding liability male members



Critical yield analysis male members



Source: BW model

Transfer value offers – how to do it

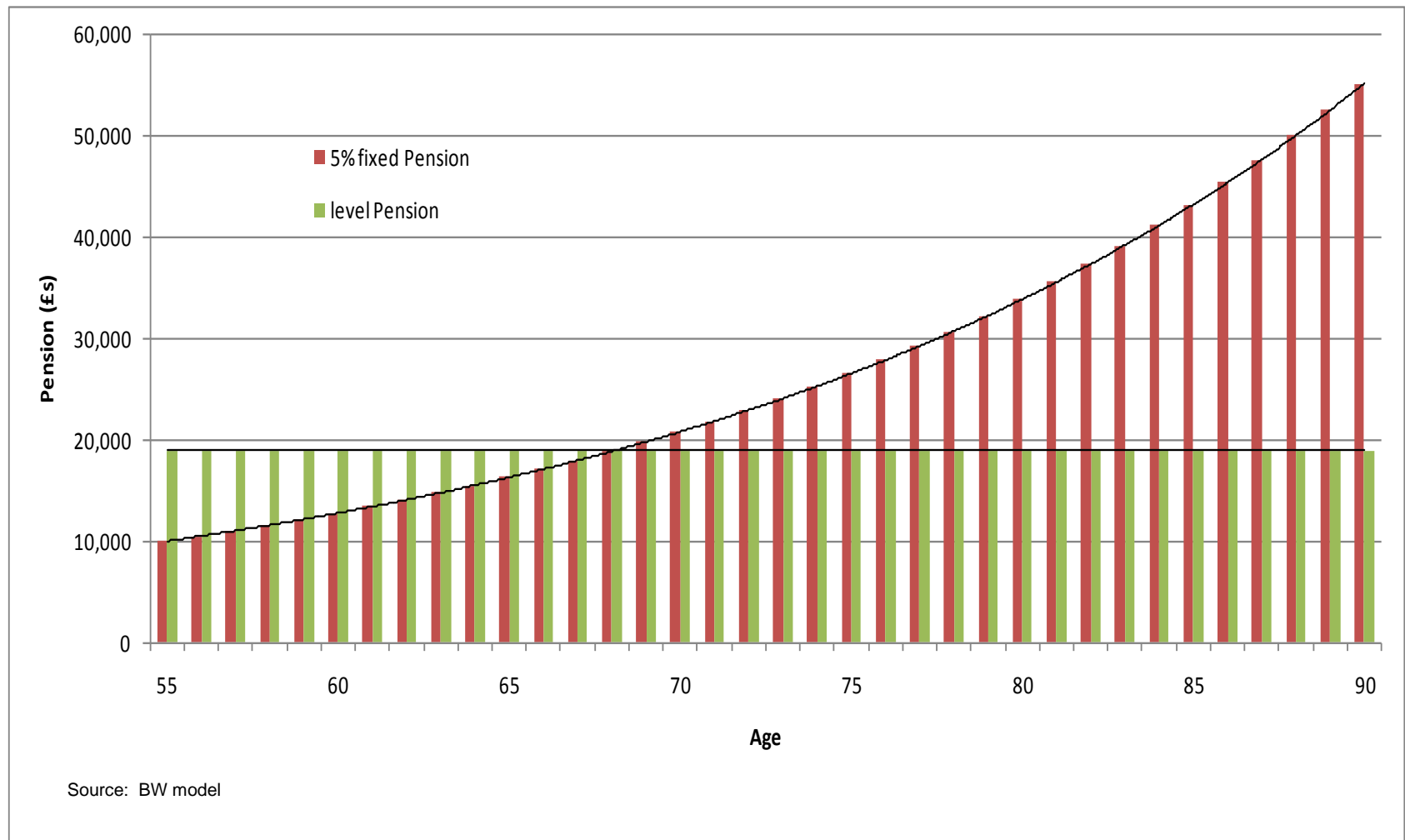
- Beware of discrimination if targeting members
- Engage with Trustees
- Communicate effectively and clearly
- Offer presentations and/or one-to-one meetings
- Provide **independent** financial advice
- Analyse the outcome and consider if/when another exercise may be productive
- Have regard to tPR guidance

Exchanging Pension Increases

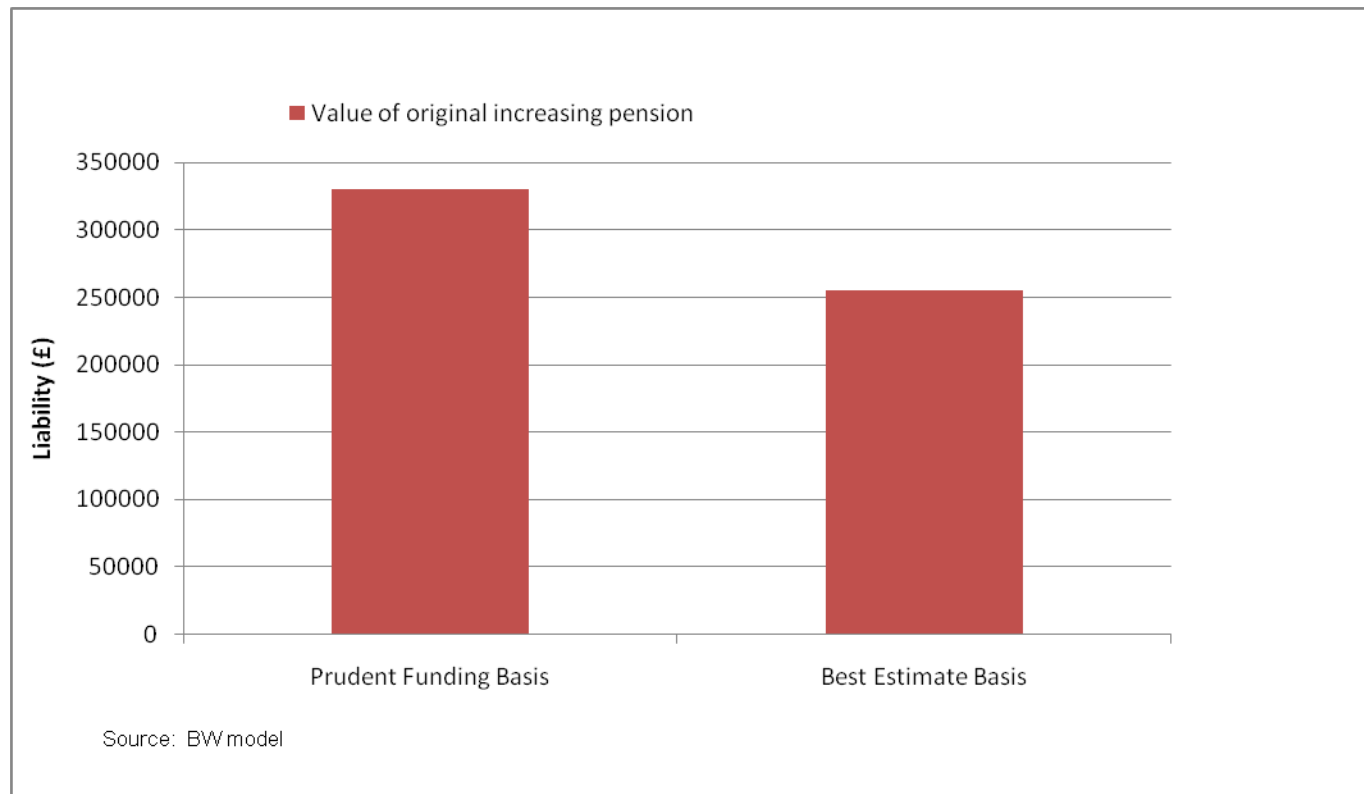
- Swap pension increases for a higher annual pension
 - Inflation-linked increases or fixed increases
 - Non-statutory increases only
- Why?
 - Removes future inflation risk
 - Removes longevity risk
 - Can reduce funding reserve
 - Members prefer higher pension in short term



Pension increase offer – an example



Change in pension value



Scheme: 10% saving on funding reserve

Member: 2% loss of value on “best estimate” basis (but higher pension in short-term)

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Employer Covenant

- What is it?

Code of Practice – Funding Defined Benefits:

“It is essential for the trustees to form an objective assessment of the employer's financial position and prospects as well as his willingness to continue to fund the scheme's benefits (the employer's covenant)”

- When is it relevant?
 - Valuations
 - Ongoing monitoring

What do the schemes you are involved with generally use to assess sponsor covenant?

1. Discussion among Trustees
2. Presentations from company at valuation time
3. Regular presentations/ information from company
4. External review at valuation time
5. Regular external monitoring

How has this changed since the first scheme specific funding valuation?

1. Less as trustees more comfortable now
2. About the same
3. More as trustees feel the need
4. More to satisfy the regulator

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The Relationship of the Employer to the DB Scheme

Enhanced Transfer Value, Pension Increase
Exchange exercises and Employer Covenant

Simon Wasserman, Strategic Actuary
The Pensions Regulator

The Pensions
Regulator

Agenda

- ETVs and PIEs
- Employer Covenant



ETVs and the reshaping of the PIE

- What are they?
- Why are they important?
- Why have we issued guidance now?
- What do we expect of
 - Trustees
 - Advisers
 - Sponsors



What are they?

- A step in the de-risking journey
- Enhanced Transfer Value Exercises
 - Proactive offer led by sponsoring employer
 - Offers deferred pensioners higher TVs than 'normal'
 - Offer may also include 'cash on the side'
 - TVs designed to pass critical yield tests and achieve levels of take-up
- Pension Increase Exchange Exercises
 - Proactive offer led by sponsoring employer
 - Offers pensioners, actives or deferred higher starting/current pension to give up some future increases
 - Advice is unregulated

What is the problem??

- Asymmetry of ...
 - Knowledge
 - Resources
 - Sophistication and understanding... between sponsor and member
- Conflict of interest
- Distortions due to cash vs future promise



*The number of these exercises appears to be increasing.
The regulator wants to minimise poor behaviour and maximise
positive outcomes for members*

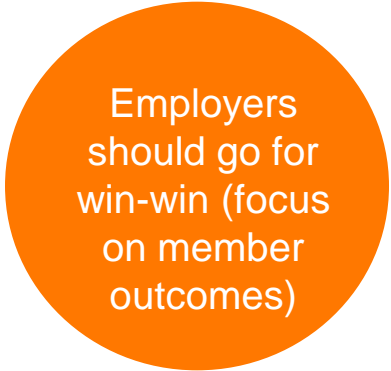
The Pensions
Regulator

The Risks

	ETV	PIE
Detrimental impact on members' benefits	Medium to high	High
Member understanding and ability to make rational retirement decisions	Medium to high	High
Negative impact on the scheme	Medium	Low
'Miss-selling'; profit accrues elsewhere as member loses	Medium to High	High
Poor or uninformed behaviours	Medium to high	High
Lack of trustee engagement	Medium	Medium to high

What do we expect of ... sponsoring employers


- Member communications should be clear, fair and honest – give scheme members time and space
- Exercises should be conducted in an open and transparent manner
- Conflicts of interests should be identified and managed
- Trustees should be brought in early to any intended exercise, ensuring members best interests are represented
- Independent advice should be made accessible to all members



Employers
should go for
win-win (focus
on member
outcomes)

What do we expect of ... trustees

- Start with assumption that you may need to protect members
- Ensure members have sufficient information and advice in a form that enables them to take a well informed and rational decision
- Conflicts of interests should be identified and managed (eg adviser remuneration, interests of those who transfer vs those who do not)
- Be critical and actively engage in any intended exercise, ensuring members best interests are represented
- Ensure advice made available to members is not misleading



Trustees should
be cautious and
critical

What do FSA expect of financial advisers

- Ensure that the basis of remuneration does not conflict with advice to the members
- Remember that the member is the client even though the employer or trustees may be paying
- Advise the client in a professional manner as specified by FSA or other requirements
- Have sufficient contact with the client to ensure that the message/advice has been understood
- Pension Increase Exchange exercises should be conducted to the standards that would apply to regulated business.



Our stance

- Revised 'inducement' guidance consultation issued in July. Still in consultation period. Intended to apply to both ETV and PIE
- A joined-up government approach to member protection
- A risk-based and proportionate response to poor behaviours
- Reactive to whistle-blowing reports and proactively using information gathering and shared intelligence to identify risks
- Where necessary the regulator will take action to ensure member's benefits and PPF are protected

Agenda

- ETVs and PIEs
- Employer Covenant



Employer Covenant


- What is employer covenant?
- Why is it important?
- Why have we issued guidance now?
- How to measure covenant
 - Process
 - Internal/external
- Making it tangible
- What to do with the answers



As important as
monitoring
investment
performance

What is the employer covenant?

- From ...
 - PA2004
 - Pensions Regulator approach to Scheme Specific Funding
- Legal obligation & financial ability
 - Now and in the future
 - Willingness is important but not part of covenant
- So ...
 - Scheme size relative to employer
 - Deficit vs. employer cash flows
 - Depends on corporate structure
 - Can be complex if parent overseas
 - Can be problematic if parent just gives letter of recognition (not guarantee)



Can the employer support the scheme?


Why have we issued guidance now?

- Time to take stock
- Recent economic downturn
- Part of a journey
- Our research showed perceptions as follows:
 - Trustees: “everything is fine”
 - Advisers: “mixed picture”
 - The regulator: “some concerns”

We encourage schemes to migrate to – or maintain – standards that protect member benefits in the event of employer weakening.

Why is it important?

- Employer stands behind pension obligation
 - Strength can deteriorate quickly
 - Waiting until covenant changes may be too late to obtain greater security
 - Members expectations assume the continuation of the employer (s.75 only protects where the employer still exists)
- Covenant affects what a scheme can/should do and the risk it can bear
- Decline in scheme funding may well occur at the worst time

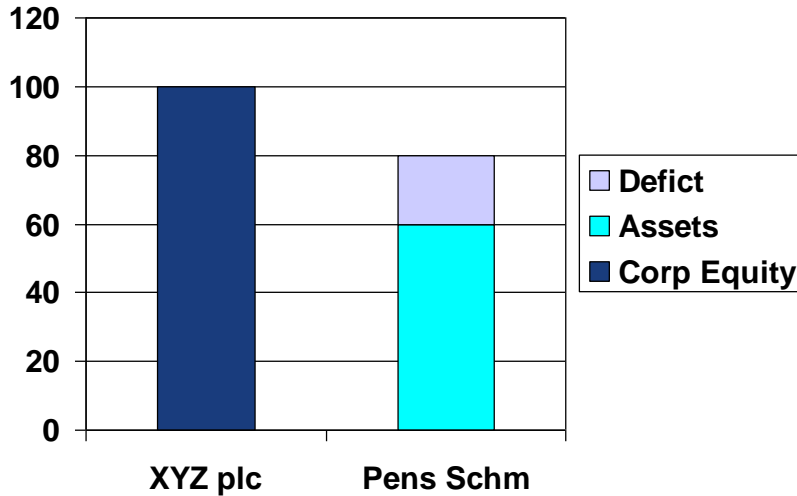


Covenant limits
the range of
possibilities

How quickly can covenant disappear?

£100m Capital value corporate

£80m pension scheme with £20m deficit

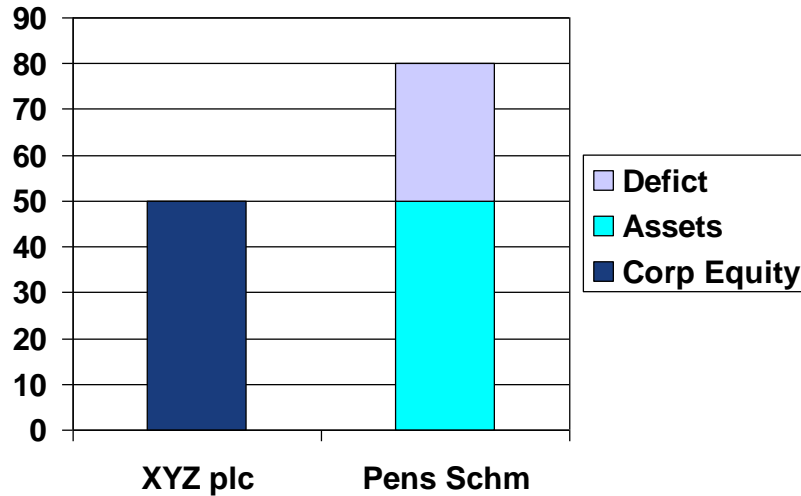


- Equity value £100m
- Pension assets £60m
- Pension deficit £20m
- Deficit covered five times
- Liabilities 80% of corporate value

How quickly can covenant disappear?

Equity value of company halves


£80m pension scheme and assets fall by 15%



- Equity value £50m
- Pension assets £50m
- Pension deficit £30m
- Pension liabilities 160% of corporate value
- Deficit uncomfortably close to company value

How to measure it

- Define the objectives/budget
- Measure only what is relevant
- Base on the past – focus on the future
- Reasonable affordability
- Place pension scheme in context of other creditors
- Make sure the answers/reports are understandable to trustees



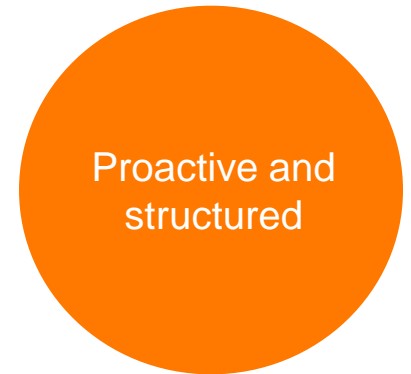
Look realistically
at what is
relevant

How to measure it – internal/external?

- Do the trustees understand the key factors that affect employer performance?
- Is there sufficient financial expertise on the trustee board to analyse and predict future changes to group performance?
- Do trustees understand the corporate group structure and which employers have legal obligations?
- Can trustees provide independent assessment not relying solely on company opinion?
- Is there sufficient expertise on the trustee board to enable trustees to challenge the assessments?

How to measure it – process?

- Agree outputs/timescales at the outset
- Before triennial actuarial valuation
- Annual financial update
- Standing item at each meeting - as appropriate
- The information protocol should reflect trustees' needs
- Trustees should be prepared to sign confidentiality agreements
- Anticipate/reflect significant corporate activity




Making it tangible

- Negative pledges
- Priority changes
- Scheme rules balance of power
- Contingent assets
 - “Group” or cross-company guarantees
 - Security over specific assets
 - Third party guarantees
 - Escrow
 - SPV
 - *Watch for*
 - *Cash flow requirements/liquidity*
 - *Post contingent value*
 - *Reasons*



What to do with the answers

- Have a monitoring plan with triggers to action/review
- Set triggers to allow remedy before it is too late
- First duty of trustees is to scheme members
- Actions may include:
 - Realign investment policy
 - Strengthen actuarial valuation assumptions
 - Bring forward next valuation
 - Shorten recovery plan
 - Call in contingent assets
 - Involve The Pensions Regulator
 - May depend on powers in Trust Deed
- An open and cooperative relationship may remove the need for any/all of the above




Be prepared
(and brave enough) to act
appropriately

And a final word for our sponsors ...

- Employer stands behind scheme
 - Vital to measure and monitor extent of support
 - Open and cooperative approaches are best for all
- In de-risking
 - Deal fairly with all members
 - Be seen to do so

And be sure that the de-risking delivers what it says on the tin.



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Enhanced transfer value exercises

- Not necessarily a bad deal for members
 - Enhanced Transfer value > “best estimate”?
 - Increased flexibility
 - *Investment strategy*
 - *Form of benefits (increases, dependants)*
 - *Timing of retirement*
 - *Ill-health*
 - Better than PPF benefits on employer insolvency?

Pension increase exchanges

- Benefits for employer
 - Could be structured so that reduces funding requirements
 - Even if no cost saving statutory increases likely to be less risky than say fixed 5% or LPI
- Benefits for members
 - Some may prefer higher level pension now
 - Gives them a choice – they can always say no

Inducement exercises

- Communication
 - Members understand what is being offered
 - Members understand what is being given up
- Advice
 - Members given opportunity to take independent advice

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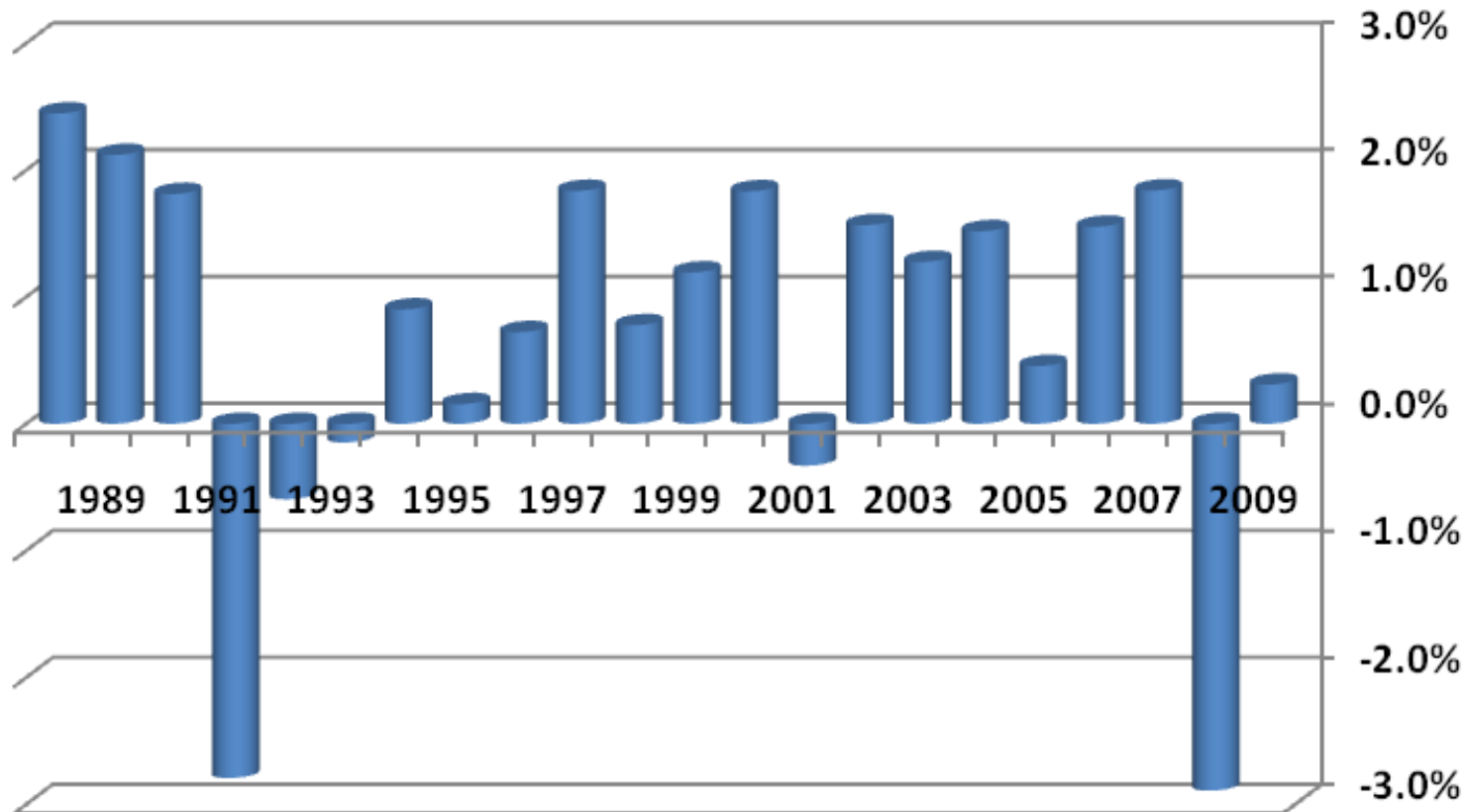
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RPI vs CPI

- Government announcements
 - Increases in Public Sector schemes to be CPI
 - Statutory minimum increases in occupational schemes to be CPI based
- Consulting on changing increases in FAS/PPF from RPI to CPI

RPI vs CPI

Difference between RPI and CPI

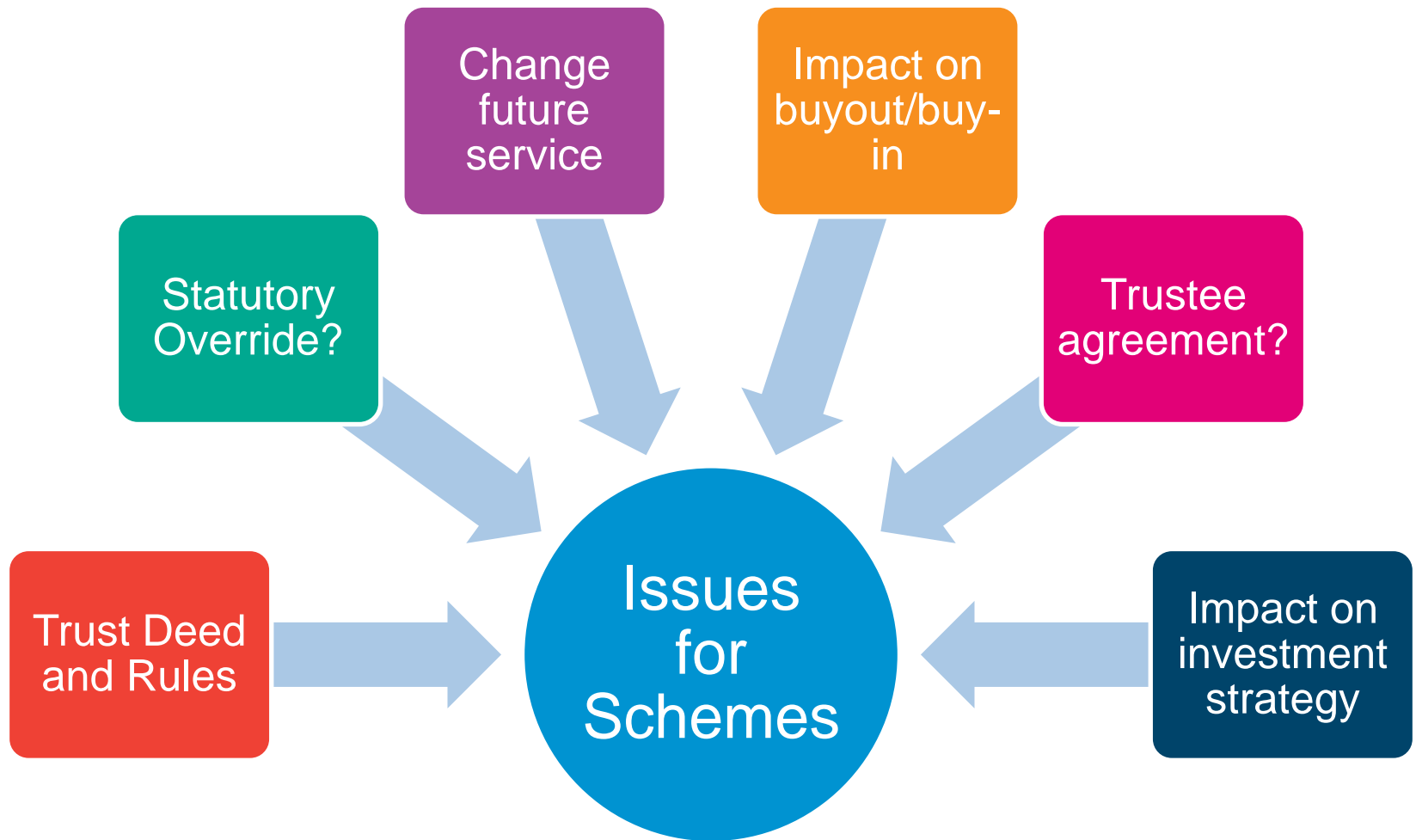


Source: ONS/Barnett Waddingham

RPI vs CPI

- Why is this important?
 - CPI increases < RPI increases historically
 - Would allow lower funding assumptions
 - Reduction in scheme liability of around 5%-10%
- What are the major differences?
 - Difference in calculation method (c. 0.5% pa)
 - RPI includes housing costs, which can be volatile

RPI vs CPI



Other Issues

- S251 of PA04 – surplus refunds
- Tax on high earners
- TPR cases
 - Contribution Notice – Bonas
 - Financial Support Direction – Nortel
 - Funding dispute – EMI

Questions



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