

A SOLUTION TO THE INCREASING DEFINED BENEFIT BURDEN ON YOUR BALANCE SHEET

Pension liabilities are a material factor in the success of a business. The triennial valuation now leads to Trustees seeking significant increases to contributions and the volatility of the financial markets leads to uncontrollable changes in accounting deficits. Whilst a bond based investment strategy can reduce the volatility, it does come at a cost and is no defence for increasing longevity. Increased contributions do reduce the deficit but there is no way of getting them back if you pay too much and it does nothing to reduce your exposure to the liabilities.

Companies generally have some level of control over factors that impact the business but this is not the case with pension liabilities. The only solution is to remove the liabilities. This can be achieved by buying out the members benefits with an insurance company but, even with the recent changes in this market, the costs are still significantly higher than most companies are prepared to pay.

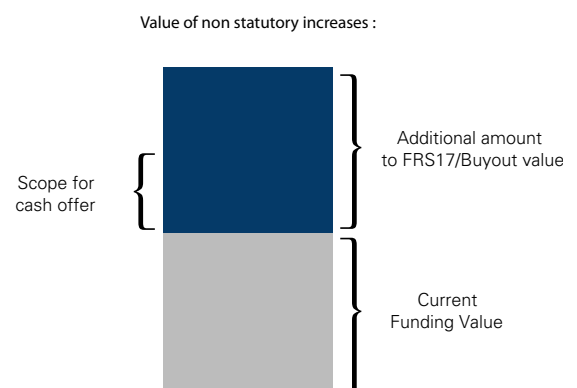
One solution is to offer pensioner members a cash lump sum in exchange for future non-statutory increases that they are entitled to receive from the Scheme, or alternatively give a one-off increase to their pension in lieu of future non-statutory increases. This enables the Company to reduce some of the longevity and inflation risk associated with the payment of pensions. An offer can only be made in relation to non-statutory increases (providing the Scheme rules allow this) thus Guaranteed Minimum Pension earned between 6th April 1988 and 5th April 1997; and any pension earned after 5th April 1997 cannot be included unless the scheme provides increases in excess of the statutory amount.

Pensioners are only likely to accept the offer if the cash lump sum is seen as being "good value for money" and from the Company's perspective the amount of the payments and the costs associated with making the offer need to be of a level to have a positive effect on the balance sheet liabilities.

At what level will members take on the risk?

There will be a level at which a cash offer is too good to turn down but this would be at a substantial cost to the Company. Before committing to the costs of an exercise, companies have many questions that need answering:

- How much should we offer?
- What is this likely to cost us?
- What benefit will we get from this expenditure?
- What will the impact be on our financial statements?
- How do we maximise take up?
- What are the risks to the Company and Trustees?
- What are the tax implications?



Why would a pensioner give up some of their future increases?

Each pensioner's reason(s) for accepting or rejecting an offer are likely to be different but these could include:

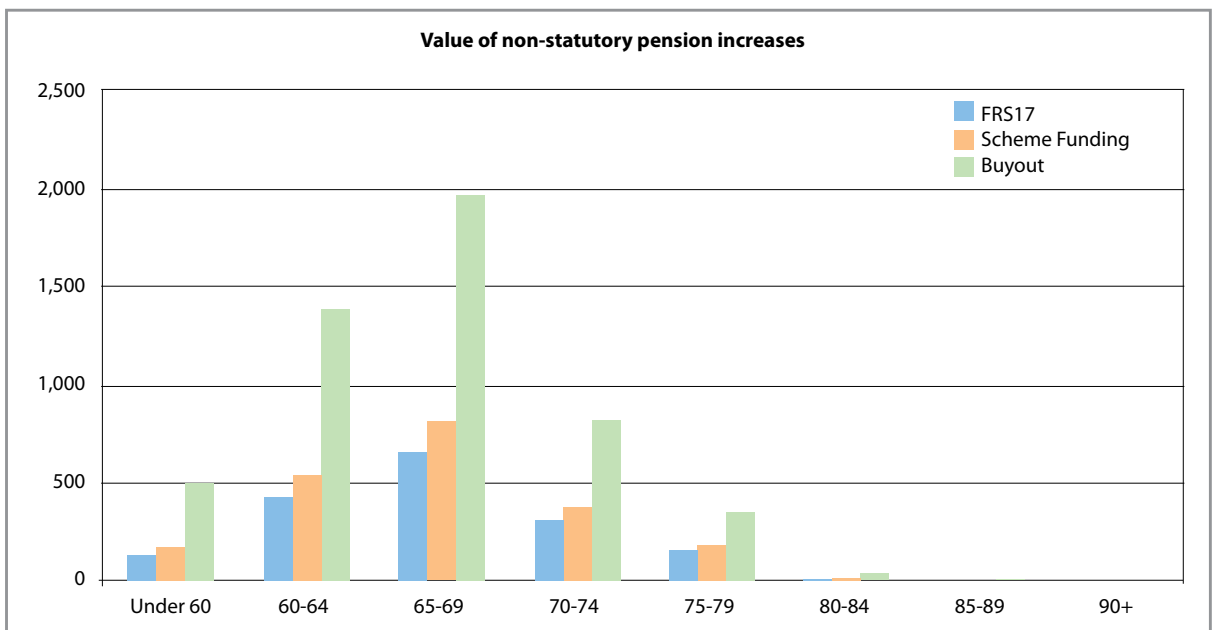
- Other sources of retirement income
- Deteriorating health
- Care fees
- Need for cash now - e.g. debt repayment, car, holiday
- Reducing level of expenditure
- Widowed
- Gifts to children/grand-children

In many cases pensioners will be able to reach their own decision (maybe with the help of family or other advisers) about whether to accept the offer or not. Where this is not the case, JLT's Private Clients consultants will be able to help them come to a decision having reviewed their personal circumstances.

PCS Modeller

PCS have developed a financial modeller which analyses current pensioner details and provides a scenario analysis of the potential cash payments that could be offered to members.

The PCS modeller is used in discussions with the Company to determine the best approach for achieving the Company's objectives. The key to any offer is the link between the value the Company places on the increases and the cash payment offered. The value placed on the increases will vary depending on the assumptions used, in particular the discount rate, inflation and longevity.



In making an offer to a member it needs to be sufficiently attractive for the member to be interested in taking it but at a level that reduces the Company's overall liability and risk. It also needs to be acceptable to the Trustees.

A key aspect will be how many years' increases is the cash payment equivalent to in the eyes of the pensioner. Pensioners may be willing to accept a relatively low number of years as they place great value on having the money now.

The PCS modeller assists the Company in choosing the appropriate enhancement basis by modelling various enhancements and projecting the take up rates based on the number of pension payments the cash payment is equivalent to. The Company needs to balance the initial cost with the anticipated benefits on a realistic take-up rate.

The Offer Process

Having agreed a basis for the offer, the next stage is to implement a communication process with pensioners. PCS, in conjunction with JLT Private Clients, have developed a process to effectively communicate and advise on these offers to pensioners. This process maximises the take up rates whilst abiding by the regulatory requirements of the FSA and Pension Regulator.

<p>Stage 1 Project Planning and Trustee Agreement</p>	<p>To ensure the success and smooth running of the exercise the key matters to address at outset are:</p> <ul style="list-style-type: none"> • Prepare a project plan and seek agreement from all parties • Establish a Project Management Liaison Group • Obtain the initial agreement of the Trustees • Obtain completed Scheme Questionnaire to determine all benefit structures • Check that Scheme administrators have accurate and complete records for all members to be included and if not, obtain and correct addresses and accurate benefit detail • Obtain sample anonymised data cut for each benefit structure and pensioner type • Establish process for receipt of response forms and payment of cash sums • Establish whether Scheme Rules need to be changed
<p>Stage 2 Pre-Communication Stage</p>	<p>Once the areas above have been addressed then more detailed planning can take place:</p> <ul style="list-style-type: none"> • Prepare communication material for approval by the Employer and Trustees • Assist in communications and negotiations if required, with the trustees and their advisers • Book seminar dates and venues • Set up telephone helpline
<p>Stage 3 Initial Letter to Pensioners</p>	<p>Because the data about the pensioners is controlled by the Trustees the pensioners must be notified by the Trustees that they intend to pass the data to third parties. Pensioners are asked to respond if they do not wish their data to be passed over or to receive an offer.</p> <ul style="list-style-type: none"> • Issue Data Protection Act letter and reply slip to all pensioners • Collate responses from pensioners who do not want their data passed to a third party and pass to Scheme Administrators • Run telephone helpline to assist pensioners
<p>Stage 4 Formal Offer to Pensioners</p>	<p>In respect of all members who have not responded during Stage 3 PCS and JLT will:</p> <ul style="list-style-type: none"> • Issue - formal offer letter from the employer <ul style="list-style-type: none"> - JLT letter - JLT explanatory booklet - Value of Offer Calculation - Seminar Invitation - Decision Form - Decision Tree - Freepost envelope • Collate responses for seminars by post and telephone • Continue to run the telephone helpline • Provide regular information to project stakeholders • Issue Fact Finds to those pensioners wanting individual financial advice
<p>Stage 5 Communication and Advice to Pensioners</p>	<p>The success of any exercise is dependent on ensuring that the pensioners fully understand the proposal that is being made to them therefore JLT will:</p> <ul style="list-style-type: none"> • Issue reminder letters regarding the seminars • Encourage callers to the Helpline to receive advice • Conduct seminars • Issue final reminder to non-respondents
<p>Stage 6 Process Payments and Project Closure</p>	<p>For all members who have accepted the offer PCS will:</p> <ul style="list-style-type: none"> • Prepare a schedule of payments for the Employer/Trustees • Advise the Scheme Administrators of those pensioners whose non-statutory increases are to be removed • Chase any outstanding forms from members • Produce final Management Information • Issue questionnaire to pensioners (both those accepting and rejecting the offer) to establish Treating Customers Fairly outcomes
<p>Stage 7 Project Review</p>	<p>At the end of the project it is important to review the outcome and consider:</p> <ul style="list-style-type: none"> • Were the objectives met and if not why? • What is the impact on the scheme funding valuation and schedule of contributions? • What is the impact on the Company balance sheet and P&L account? • Should the Scheme's investment strategy be revised? • Should a pensioner buy-in/buy-out be considered?

Case Study

A client had pensioners with about £4.1m of non statutory increases and offered a cash payment equal to 80% of the FRS17 value. The PCS modeller estimated the equivalent value of the offer to the members. The potential outcome is a cash payment by the company of just over £1m with a £272k improvement in the FRS17 position value and £1.5m reduction in scheme liabilities.

						Percentage of value to offer:			80%		
						The offer is equivalent to how many years' increases?			Potential outcome		
Age	No. of pensioners	FRS17 value of increases £'000	Funding value of increases £'000	Buyout value of increases £'000	Average life expectancy	Assuming member spends it	Assuming invested at 2%	Assuming invested at 4%	Cash cost to Company £'000	Saving against FRS liabs £'000	Reduction in scheme liabilities £'000
Under 60	15	132	176	508	30.1	15.7	17.4	19.7	106	26	176
60-64	36	427	543	1,387	24.1	14.0	15.4	17.1	342	85	543
65-69	86	662	817	1,964	20.4	12.6	13.7	15.1	530	132	817
70-74	50	311	375	823	16.6	11.0	11.9	12.9	249	62	375
75-79	16	155	180	348	13.1	9.5	10.1	10.8	124	31	180
80-84	4	11	15	38	9.0	7.4	7.8	8.2	9	2	15
85-89	3	2	2	5	5.5	5.1	5.3	5.4	2	0	2
90+	2	0	0	1	3.2	3.3	3.4	3.4	0	0	0
Total	212	1,701	2,107	5,074	20.6	12.6	13.7	15.1	1,361	340	2,107

For more information on how we might help please contact Rob Dales on 0113 203 5883 or Simon Briggs on 0113 2023 5820.



Rob Dales
Pension Capital Strategies
0113 203 5883
rob_dales@pensionstrategies.co.uk



Simon Briggs
JLT Private Clients
0113 2023 5820
simon_briggs@jltgroup.com

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