



## MANAGING DEFINED BENEFIT LIABILITIES AND INCREASING MEMBER CHOICE

Running a defined benefit pension scheme is not becoming any easier in the current economic and regulatory environment. Pension scheme sponsors have been paying increasing amounts into their schemes in order to get them to a satisfactory funding level. However this remains a moving target for most schemes, due for the most part to falling markets and increasing longevity.

Sponsors who can afford to secure their scheme's liabilities in the market, via a buyout or buy in policy, have increasingly followed this route in order to de-risk their schemes. But such sponsors are in a minority. For the remainder of schemes, the necessity to de-risk is just as important if not more. However solutions need to be pursued which will not require a significant upfront outlay of funds from the sponsor.

One de-risking strategy which can assist trustees and sponsors to manage their scheme's liabilities, while providing an increased amount of choice to scheme members, is the implementation of an early retirement exercise. The exercise would involve all members aged 50 or over (55 or over with effect from 6 April 2010), who are proactively offered the option to start drawing early retirement benefits from the scheme. The benefit payable on early retirement would be reduced, using the scheme's current early retirement factors, to allow for the longer period over which the benefit is expected to be paid. Members would also be invited to commute part of their pension for tax free cash, in accordance with scheme rules and pension legislation.

### **How does an early retirement help in managing liabilities?**

Schemes are generally funded on a conservative basis, so that there is a very high likelihood that there will be sufficient assets held to pay members' benefits in full. This is a specific requirement following the introduction of the Statutory Funding Regulations.

On the other hand, early retirement and commutation factors are generally calculated on a "best estimate", realistic basis. As a result, a profit will usually accrue to the scheme, on the funding basis, every time a member takes early retirement and/or commutes pension for cash.

The amount of funding profit to a scheme will depend on how the factors used compare to equivalent factors calculated using the funding basis. Our experience shows that this can be substantial for some schemes.

Some second order benefits arising from an early retirement exercise are as follows:

- the scheme liabilities are reduced on a one-off basis every time pension is commuted for cash - a smaller scheme is inherently less risky and less volatile in absolute terms
- pensioner liabilities are normally priced less conservatively than deferred liabilities, therefore the cost of buying out scheme benefits is likely to reduce following an exercise with a reasonable take-up rate.

An early retirement exercise does not benefit a pension scheme alone. Taking early retirement may well be advantageous to members, depending on their individual circumstances. It is often true that individuals prefer to start taking their benefits out of a scheme as early as possible, so that they are “getting something back” in respect of the contributions made to the scheme.

The following tables show the percentage reduction in an individual member’s liability (as measured on a prudent funding basis) as a result of scheme early retirement and commutation factors.

Percentage reduction in liability on immediate retirement as a result of scheme retirement factors					Percentage reduction in liability on immediate retirement as a result of scheme commutation factors				
Age at retirement	4% Compound	4% Simple	5% Compound	6% Compound	Age at retirement	Equivalent to 10 at 65	Equivalent to 12 at 65	Equivalent to 15 at 65	Equivalent to 16 at 65
50	2.9%	28.3%	17.0%	29.2%	50	17.6%	11.0%	3.7%	1.8%
51	2.1%	23.7%	15.4%	27.1%	51	17.5%	10.9%	3.7%	1.8%
52	1.3%	19.4%	13.9%	24.9%	52	17.3%	10.8%	3.6%	1.8%
53	0.6%	15.6%	12.3%	22.8%	53	17.1%	10.7%	3.6%	1.7%
54	0.0%	12.2%	10.8%	20.6%	54	16.9%	10.6%	3.6%	1.7%
55	-0.6%	9.2%	9.4%	18.5%	55	16.7%	10.4%	3.5%	1.7%
56	-1.0%	6.6%	8.0%	16.4%	56	16.6%	10.3%	3.5%	1.7%
57	-1.4%	4.4%	6.7%	14.3%	57	16.4%	10.2%	3.4%	1.7%
58	-1.7%	2.6%	5.5%	12.3%	58	16.2%	10.1%	3.4%	1.7%
59	-1.8%	1.1%	4.4%	10.3%	59	16.0%	10.0%	3.4%	1.6%
60	-1.8%	0.1%	3.4%	8.3%	60	15.8%	9.8%	3.3%	1.6%
61	-1.7%	-0.6%	2.4%	6.5%	61	15.5%	9.7%	3.3%	1.6%
62	-1.5%	-1.0%	1.6%	4.7%	62	15.3%	9.6%	3.2%	1.6%
63	-1.1%	-0.9%	1.0%	3.1%	63	15.1%	9.4%	3.2%	1.6%
64	-0.5%	-0.5%	0.5%	1.6%	64	14.9%	9.3%	3.2%	1.5%

The above is just a sample of potential factors a scheme could currently use. Where the Scheme’s factors currently produce a large profit, the company may wish to offer an enhancement (through the scheme) but still resulting in a profit. For example, at age 60 on a 12:1 factor, moving from 6% to 5% would increase a member’s pension by over 5% but still result in a reduction in liability of c12%. Our experience shows that the offer of an enhancement generally improves take-up.

### Trustee considerations

It is of course important that scheme trustees are involved in any discussions around this type of exercise. In particular, given that early retirement may require explicit trustee consent, they may want to have final approval of any communications issued to members.

However, provided the trustees are satisfied that the early retirement and commutation factors being used to calculate scheme benefits are reasonable, trustees should be neutral in relation to the exercise as far as each individual member is concerned. What is offered to members in this type of exercise is an additional option - members do not have to take it up if they do not think it suits their particular circumstances, and they will be no worse off than before if they do that.

To the extent that an early retirement exercise improves a scheme funding level while providing more valuable benefits to the members who opt to retire early, the exercise is a win-win situation for members, trustees and scheme sponsors.

### Feasibility Study

PCS has developed a model that analyses liabilities for deferred members over age 50 and identifies the savings available on early retirement. The model also shows potential outcomes (or the current and enhanced basis) on a funding and accounting valuation.

## The process

An early retirement exercise will include a significant amount of communication to members. It is therefore very important to have clarity in respect of what should be communicated at each stage. A clear, detailed project plan will ensure that all aspects are covered and that each party's responsibilities are allocated as appropriate. The main steps of the process are summarised below.

<p><b>Stage 1</b> Obtain trustee approval</p>	<p>The key steps for this stage are:</p> <ul style="list-style-type: none"> <li>• draft a detailed project plan, taking into account the objectives of the various parties</li> <li>• issue the plan to the trustees, together with a letter detailing the proposal and expected outcomes for the exercise</li> <li>• obtain trustee approval for the exercise</li> <li>• identify, and find appropriate solutions to, practical issues associated with the early retirement calculations (e.g. consent issues, treatment of GMPs and AVC funds).</li> </ul>
<p><b>Stage 2a</b> Initial calculations</p>	<p>After the basics of the exercise have been laid out in stage 1, initial calculations need to be carried out. The main steps are:</p> <ul style="list-style-type: none"> <li>• identify the members to be involved in the exercise</li> <li>• collate the relevant data, including data on DC funds if relevant</li> <li>• develop and set up a model to carry out the calculations on the most efficient basis possible.</li> </ul>
<p><b>Stage 2b</b> Member tracing exercise</p>	<p>It is unlikely that a pension scheme will hold current address details for all deferred members. As part of the early retirement exercise the address database should be updated - this is also good governance for the scheme. The main steps are:</p> <ul style="list-style-type: none"> <li>• review data held on administrator's file</li> <li>• implement a separate exercise to verify existence and trace missing addresses</li> <li>• amend the member database in respect of deaths and current addresses.</li> </ul>
<p><b>Stage 3</b> Initial letter to members</p>	<p>This stage is fundamentally important as the correct amount and level of information may have a significant impact on the overall success of the exercise. The main steps are:</p> <ul style="list-style-type: none"> <li>• agree format and content of initial correspondence (e.g. accurate/approximate calculations, timescale for replies, include/exclude estimate of benefits at retirement)</li> <li>• draft and issue member letters; monitor responses</li> <li>• (if required) set up telephone helpline to assist members with factual information.</li> </ul>
<p><b>Stage 4</b> Issue formal quotations &amp; set up benefits</p>	<p>This stage would follow once the deadline for responses has expired. The main steps for this stage are:</p> <ul style="list-style-type: none"> <li>• Issue formal, guaranteed quotations, together with the supporting documentation to enable payment to commence</li> <li>• monitor responses; provide additional information on an ad hoc basis</li> <li>• process formal requests for early retirement, make cash payments and set up regular pension payments</li> <li>• amend member files as required.</li> </ul>
<p><b>Stage 5</b> Review</p>	<p>An early retirement exercise should be followed by a review of the outcome in order to establish:</p> <ul style="list-style-type: none"> <li>• whether the objectives were met</li> <li>• whether the exercise should be re-run at some point</li> <li>• the impact on the scheme funding level and contribution strategy</li> <li>• the impact on the company accounts as far as the pension figures are concerned</li> <li>• the impact on the Pension Protection Fund levy</li> <li>• whether the investment strategy needs revising as the liability profile has changed.</li> </ul>

## Trivial Commutation

Current regulations allow an individual to commute their scheme benefits in full, provided the overall value of their benefits is under £2,000. No reference needs to be made to benefits held in other arrangements (different rules apply if a scheme is winding up or if benefits from other pension schemes are taken into account). We suggest that eligible members are also offered the trivial commutation option at the same time as they are offered the early retirement option. This should help maximise the take up rate for the exercise.

## Case study

The previous tables show that it is possible for factors to be enhanced with a profit still accruing to a pension scheme. Enhancing the factors on a temporary basis, to coincide with an early retirement exercise, will help maximise the take-up rate, benefiting the scheme and the members at the same time.

A retail client had 300 deferred members over age 50. The PCS feasibility study identified £1.0m liability could be removed with £300k improvement in funding by improving early retirement terms and reminding members of their options.

By the end of the exercise 45 members had taken early retirement with cash payments of £1.5m and the scheme funding level improved by £0.5m, as a cost to the Company (advisory costs) of £40k.

## Next steps

Estimating the potential profit to a scheme of an early retirement exercise is relatively straightforward and can be done on an approximate basis based on a limited amount of data.

If you are interested in this type of exercise please contact Rob Dales on 0113 203 5883 or Charles Cowling on 0161 242 5388.



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