

Background

Against the backdrop of the economic turmoil of the last few years, many pension scheme trustees and sponsors are looking at ways to reduce the risk and liabilities in their pension schemes. One solution that is finding increasing popularity is that of giving members the option to exchange some of their pension increases for a higher non-increasing pension. This is particularly relevant now, as trustees and sponsors are investigating the effect on their schemes (if any) of the proposed change from RPI to CPI.

Scheme members are already offered options at retirement regarding the amount of tax-free lump sum they wish to take and the further option of a flatter, bigger pension is an extension of the same theme.

Details

Pension legislation sets out the minimum levels of pension increases that occupational defined benefit schemes have to provide on pensions in payment:

- Statutory increases on Guaranteed Minimum Pensions (GMPs) (if contracted-out).
- Inflation (CPI), capped at 5.0% pa, on benefits accrued between 6 April 1997 and 5 April 2005.
- Inflation (CPI), capped at 2.5% pa, on benefits accrued after 5 April 2005.

Many schemes provide increases above these minimum levels; for example, and most commonly, providing increases (either at a fixed rate or in line with inflation) on pensions accrued before 6 April 1997.

Under a PIE exercise:

- Non-pensioners are offered a further option on retirement in addition to the usual options of pension or pension plus tax-free lump sum.
 - › This further option would be a higher (usually) tax-free lump sum and higher (but flatter) pension.
- Pensioners are offered a one-off opportunity to exchange some of their increasing pension for a higher non-increasing pension.
 - › This exercise can be repeated at periodic intervals to give members opportunity to take advantage of this option as their circumstances change.

Appropriate communications are provided enabling members to make informed choices.

Why would sponsors and trustees provide this option?

The principal reasons for making this option available to members are:

- Increasing pensions are expensive to provide, especially when interest rates are low, inflation is rising and longevity increasing.
- The exchange is generally structured in a such a way that the cost of the alternative benefits leads to a reduction in deficit, partially as a result of the non-pensioners taking a higher tax-free cash sum and partially because there is some value to the member in exercising the option.
- Whilst there is an initial increase in pension payment (and therefore PPF levy) the overall liability reduces due to the increased cash payment and conversion terms offered to members.
- This option does not involve the sponsoring employer paying for an incentive.
- Savings in respect of current pensioners are crystallised immediately.
- Whilst the savings for non-pensioners will only emerge over time (as members retire) it might be possible to build an appropriate assumption into the technical provision calculations so as to reduce the funding liabilities.
- Mortality and potentially inflation risks are reduced in the scheme.
- Ultimate buyout costs are relatively cheaper (since insurers tend not to like increasing pensions as much as flat ones).

Why would members exchange pension increases?

Defined benefit pension schemes provide members with limited choice at retirement which has no reflection of their personal circumstances. There are a number of reasons why a member would exchange increases even if they are informed that the value of the alternative benefit is lower, namely:

- Research shows that members already in the position of having a choice (i.e. those who have to purchase an annuity at retirement from a defined contribution scheme) predominantly select a level pension to maximise the initial income.
- For many pension scheme members an increasing pension in retirement is franked against state benefits, thus they may be no worse off without the increases.
- A higher initial pension can generally lead to a higher tax-free cash sum payable on retirement.
- Many members see the offer as good value (even where they are informed that the value is lower than the original benefits), as their expectations on life expectancy are shorter than assumed in valuing the liabilities.
- The cost of living in retirement does not necessarily increase with inflation as the level of activity reduces with age. Members want the highest income when they are most active, not when they die.

What does the Pensions Regulator think of these exercises?

The Pensions Regulator issued guidance on these sorts of exercises in 2010. The main thrusts were:

- Exercises should be clear, fair and not misleading.
- Exercises should be open and transparent.
- Conflicts of interest should be managed.
- Trustees should be consulted and engaged from the start of the process.
- Independent advice should be provided.

If these principles are adhered to (in addition to any wider legal obligations), then the Regulator expects that members will have all the information they need to make an informed decision for their own specific circumstances.

We have experience of robust processes and procedures and will work with the appointed provider with a view to meeting the regulators requirements.

Next steps

The first stage in developing a PIE exercise is to carry out a feasibility study to identify which members are in scope, the potential terms of the offer, documentation and legal issues, and the resulting expected financial and risk-related benefits. The cost of this study would be expected to be between £5,000 and £10,000 (plus VAT) depending on the complexity of the scheme.

For a firm quotation please consult your existing PCS actuary or your usual JLT contact.

For further information on how we might help, please contact Rob Dales on 0113 203 5883, Charles Cowling on 0161 242 5388 or Simon Taylor on 020 7895 7809. Alternatively e-mail us at solutions@pensionstrategies.co.uk or visit our website at www.pensionstrategies.co.uk to register your interest.

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