

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 actuarial 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 these back if you pay too much and it does nothing to reduce your exposure to the liabilities.

Companies generally have some control over factors that impact the business, but this is not the case with pension liabilities. The only real solution is to remove the liabilities. This can be achieved by buying out the 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 option is to offer members an opportunity to transfer their benefits out to another pension arrangement, usually a personal pension plan. This is effectively a transfer of risk from the company to the member.

The current transfer values offered by most trustees are not sufficient for the majority of members to accept this transfer of the investment risk. So that the option to transfer might be considered suitable by the member, the trustees could offer an enhanced transfer value.

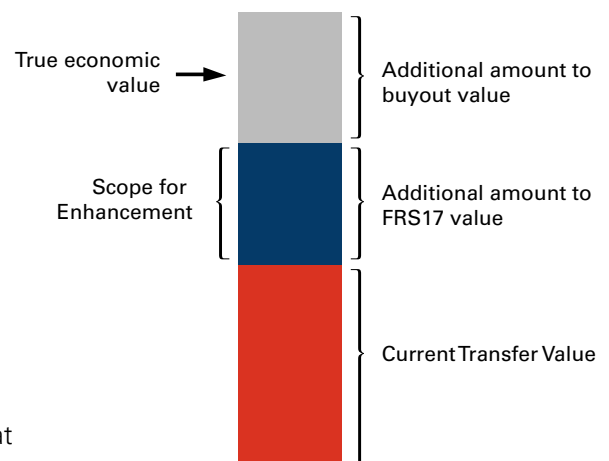
An extension of this option is for the enhancement, or part thereof, to be paid by the company direct to the member as cash (after tax and NI are deducted). Our experience is that providing this option for members improves take up rates.

At what level will it be suitable for members to take on the risk?

There will be a point at which transfer values will meet the critical yield needed by the member to match the benefits from the ceding scheme, but this may come at substantial cost to the employer. Before committing to the costs of an exercise, there are many question that companies need answers to:

- 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 for us?

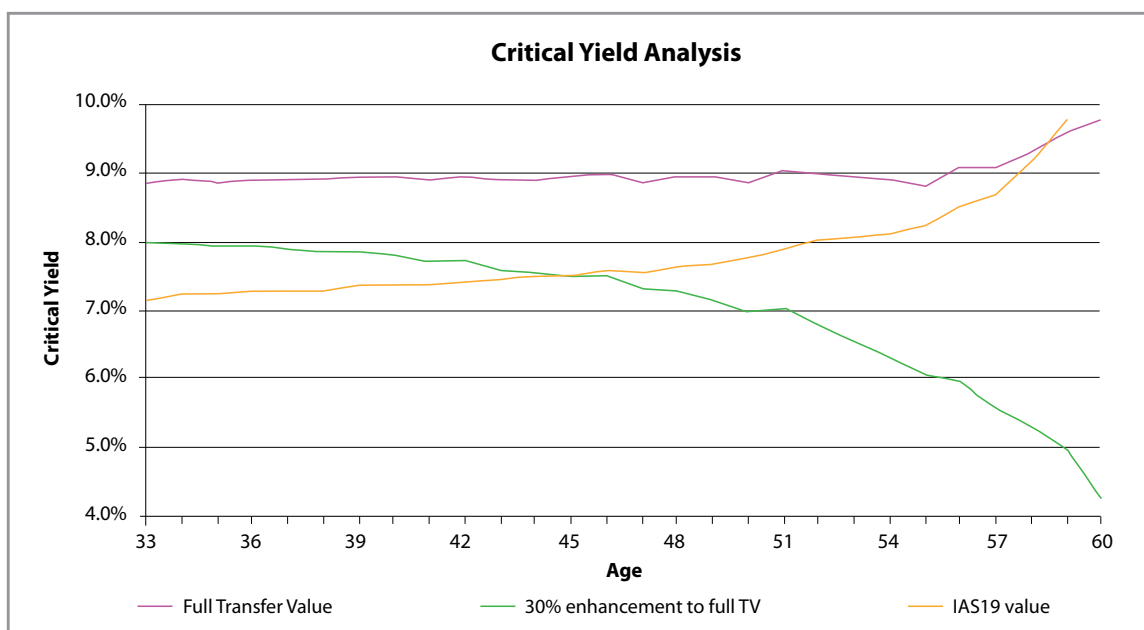
PCS have developed a financial modeller that will help companies answer these questions.



PCS Transfer Value Analysis Modeller

The PCS financial modeller analyses current membership details and provides a scenario analysis of the potential enhancements that could be offered to members. There are many different approaches to enhancing transfer values and the correct approach depends on the funds available from the company, the extent to which members are likely to understand the offer and, in some cases, the interaction with HMRC limits.

The PCS modeller is used in discussions with the company to determine the best approach for achieving the objectives. The key to any transfer value exercise is the Critical Yield, i.e. the investment return the member will need to earn on investing the transfer value to generate the same pension as provided by the scheme. A financial adviser has to calculate the critical yield using a Transfer Value Analysis System on a basis specified by the Financial Services Authority (FSA).



The PCS modeller assists the company in choosing the appropriate enhancement basis. The company needs to balance the initial cost (the lower the yield, the higher the cost of enhancing the transfer values) with the anticipated benefits on a realistic take-up rate (the higher the yield, the lower the likely take up). There will be a point, referred to as the Target Critical Yield, where an independent financial adviser (IFA) will be most likely able to recommend a transfer to a member with a balanced investment perspective.

By grouping members' likelihood of transferring, using a red/amber/green system we can identify the potential costs and benefits of the exercise.

Enhanced Transfer Values £000's											
Age	Under £5,000	£5,000 - £9,999	£10,000 - £16,000	£16,001 - £24,999	£25,000 - £49,999	£50,000 - £74,999	£75,000 - £99,999	£100,000 - £150,000	£150,000 - £250,000	Over £250,000	Total
Under 20	9	30	47	27	0	0	0	0	0	0	113
20-24	10	40	31	164	0	0	0	0	0	0	244
25-29	13	119	140	437	1,030	72	0	0	0	0	1,810
30-34	7	40	140	328	1,404	215	107	0	0	0	2,239
35-39	1	79	125	1,229	2,106	1,573	213	131	0	0	5,457
40-44	0	30	203	846	5,616	286	533	0	251	0	7,765
45-49	0	18	47	956	6,788	14,372	2,239	980	433	0	25,830
50-54	0	20	0	901	7,207	11,440	3,411	160	199	475	23,812
55-59	0	0	0	218	4,072	1,144	1,279	300	231	326	7,571
60-64	0	0	0	137	702	1,001	640	190	494	520	3,683
Total	40	374	733	5,242	28,922	30,102	8,421	1,762	1,608	1,321	78,524

The PCS Transfer Value Implementation Process

Having agreed a basis for enhancement, the next stage is to implement a communication process with members. In this respect we will work with our colleagues in JLT Benefit Solutions Ltd (JLT) who have extensive experience in the project management of these exercises. Clients have the option to instruct us on specific aspects of the project or alternatively we can undertake the full exercise from beginning to end, including the IFA appointment.

Stage 1 Project planning and trustee agreement	The key matters to address before any communication is issued are: <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• Check that the Scheme administrators have accurate and complete records for all members to be included and if not obtain missing addresses/benefit details• Negotiate terms and application processes with insurance companies• Prepare a project plan and seek agreement from all parties• Book seminar dates and venues• Set up call centre services• Set up a telephone helpline
Stage 2 Initial Letter To members	To maximise interest, an initial letter is sent to members with details of the offer. Members are asked to express an interest in receiving full details and advice from the appointed IFA. PCS and JLT will: <ul style="list-style-type: none">• In conjunction with the Scheme Actuary and appointed IFA, estimate transfer values and enhancements• Prepare and issue letters to all members• Monitor replies from members• Run a call centre to follow up the letters issued to members and invite members to return the forms and attend the seminars.• Manage the project plan and keep the employer updated with responses• Run the telephone help line and information seminars either on site or at suitable locations• Issue members who respond with a personal fact find questionnaire on behalf of the appointed IFA if not JLT
Stage 3 Formal Offer and advice to members	In respect of all members expressing an interest, PCS and JLT will - in conjunction with the appointed IFA if not JLT: <ul style="list-style-type: none">• Arrange for the trustees to prepare formal transfer value quotations• Prepare and issue formal offers to members along with the Transfer value quotation• Obtain a Transfer Value Analysis Report (*)• Provide a personalised advice report on whether the member should transfer or not (*)• Continue to run the telephone helpline and call members (*) <p>(*) - These aspects of the exercise that involve the appointment of an IFA for member advice might be undertaken by JLT Benefit Solutions Ltd or an external third party IFA</p>
Stage 4 Process transfer payments	For all members who have agreed to transfer, PCS and JLT will: <ul style="list-style-type: none">• Check the trustees have complete records to make a transfer payment• Prepare a schedule of payments due and arrange payment by the Company and trustees• Assist in communications, and negotiations if required, with the scheme trustees• Set up call centre services to chase any outstanding forms from members
Stage 5 Review	At the end of the project, it is important to review the outcome and consider: <ul style="list-style-type: none">• Were the objectives met? If not why not?• 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?• What is the impact on the PPF levy?• Should the scheme's investment strategy be revised?

Consultants at PCS have been advising employers on transfer value exercises for over 5 years and have built up a wealth of practical experience, which is now being applied to current projects. We have set out below the financial outcome for a company, where we recently completed an exercise.

Our client offered a 30% enhancement to transfer values as a direct cash payment. 10% of active members and 50% of deferred members took up the offer. The company paid out £2.5m in cash payments and NI resulting in a reduction of £1.2m in the scheme funding deficit and an improvement of £400k in net assets. The pension liabilities on the balance sheet have reduced by £10m.

Pension Scheme Financial Position

	BEFORE		AFTER
	Trustee Valuation	Transfer Value Valuation	Trustee Valuation
Active	10.0	8.0	9.0
Deferred	15.0	13.0	7.5
Pensioners	8.0	8.0	8.0
Total	33.0	29.0	24.5
Assets	25.0	25.0	17.7
Deficit	8.0	4.0	6.8

Company Financial Position

	BEFORE	AFTER
Cash at bank	4.0	1.5
Other Assets	25.0	25.0
FRS17 assets	25.0	17.7
FRS17 liabilities	-38.4	-28.2
Net assets	15.6	16.0

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