Trustee Briefing

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Summer Budget: Changes to the taxation of pensions

Big news for the taxation of pensions

The benefits of data digitisation

Improving data quality using a novel approach

Exploring recent trends in mortality assumptions

Recent trends in longevity assumptions and what this could mean for the future

Building momentum in the longevity hedging market

AXA longevity hedge transaction highlights and more deals to come

TOWERS WATSON

Editorial

Welcome to the July/August 2015 edition of *Trustee Briefing*.

I recently had a conversation with a taxi driver. When he asked about my job I simply replied: "I work in pensions." ('I'm an actuary' is rarely met with any recognition.) He then proceeded to tell me that his wife had been offered membership of her employer's pension plan but that they did not see the point of pensions.

A depressingly familiar story for many in the pensions industry, and one the Chancellor decided to tackle on 8 July when he announced the publication of the Government's Green Paper *Strengthening the incentive to save: a consultation on pensions tax relief*. The consultation is being undertaken because, like my taxi driver and his wife, "Britain is not saving enough".

The paper highlights the need for pensions to be as simple as possible to understand – something few would argue with. What is my view? Well, when I explained that by not joining the pension plan, my taxi driver's wife would effectively be turning down both free money from her employer and any tax relief, his response was: "Oh, maybe she should join after all." Pensions are confusing to most but I think this particular problem is more likely to be solved through member education than through changing the system yet again.

As well as this potential change to pensions, the Chancellor announced changes to the annual allowance for pensions saving. David Robbins examines what is definitely happening and what is possibly happening on page 4.

In other news, many schemes are looking to remove or reduce longevity risks. On page 9 Mark Alexander examines trends in the mortality assumptions used for valuations – knowing where you are now is the first step in hedging – and on page 12 Shelly Beard examines the AXA Group Scheme's recent longevity hedge to see whether other schemes will follow suit.

De-risking is not just for the larger schemes, though, and on page 18 Ian Aley and Gemma Millington look at buy-ins for smaller schemes. And, as usual, Settlement Watch sums up the latest deals in the bulk annuity and longevity hedging markets as well as current pricing in the bulk annuity market on page 20.

For schemes that are looking to de-risk, having accurate, complete data can help achieve the best possible pricing. On page 7 Adrian Holmes, the Pension Manager at Philips, outlines the novel approach that the Trustee of the Philips Pension Fund took to improve its electronic data and the positive impact this had on the Fund's buy-in deal and ongoing administration.

And finally, we have Headlines on page 15, looking at the main developments in UK pensions over the summer.

As always, we look forward to hearing your thoughts and comments on *Trustee Briefing*.

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Trustee Briefing

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Summer Budget

Changes to the taxation of pensions

The Conservative Government's first Budget contained big news for the taxation of pensions. David Robbins examines a confirmed change and a potential revolution.

David Robbins
Senior Consultant

Definitely happening: less tax relief for high earners

From April 2016, 50p of the £40,000 annual allowance (AA) will be withdrawn for each £1 of income above £150,000, until it reaches £10,000 at incomes of £210,000 and above. Pension contributions, including employer contributions, count towards income for this purpose; people with taxable incomes of £110,000 or more are potentially affected.

Take an example. The AA will be £30,000 for someone with an 'adjusted income' (including pension contributions) of £170,000. A £1,000 pay rise would reduce the AA to £29,500. This could trigger a 45% AA charge on £500 of pension contributions (£225). Added to 45% income tax (£450), the total tax bill would be £675.

Should the individual choose to save this £1,000 in a pension, the tax becomes more punitive still. If three quarters of withdrawals are taxed at 40%, £975 of the £1,000 will ultimately go to the taxman!

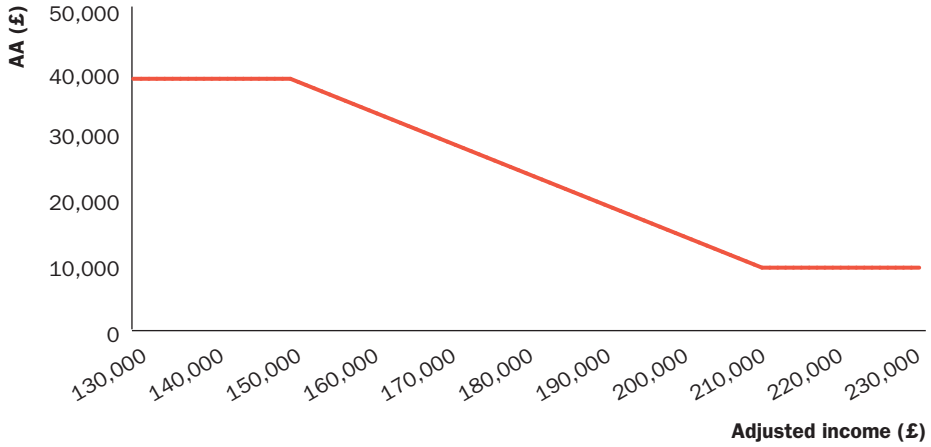
To facilitate this reform, pension schemes will have to spend an estimated £170m on aligning Pension Input Periods (PIPs) with tax years. (As Denis Healey might have said, this way of squeezing the rich will make the PIPs squeak…) Even then, high earners will have to anticipate their incomes and guess how much they can save tax efficiently; those with March bonuses may find this a challenge.

Substantial pension contributions will be less attractive for the well paid, so they may want cash alternatives. Meanwhile, more junior high-flyers may have a 'now or never' chance to pour money into their pension pots.

At a glance

- The AA will be reduced for individuals with income above £150,000. This creates a penal tax rate for some high-earning savers.
- The Government will consider whether to tax pension contributions instead of pension income.
- If this happens, new incentives for retirement saving could be easier to understand but less valuable.

Figure 01. Annual allowance reduction for high earners



Possibly happening: pensions tax turned on its head

The AA taper only affects high earners. But the Chancellor says he is also "open to…radical change", which would affect everyone. The Government will consider a range of ideas, but George Osborne highlighted how "pensions could be treated like ISAs: people pay in from taxed income, it is tax free when they take it out, and in between it receives a top-up from the Government".

The consultation is being undertaken because "Britain is not saving enough," Mr Osborne says. He thinks it is "important that the support on offer from the Government is simple and transparent, and that complexity does not undermine the incentive for individuals to save. It is also vital that the system is sustainable".

In HM Treasury, 'sustainable' is a synonym for 'cheaper'. So this boils down to a statement that the Government may try to increase retirement saving by taxing it more heavily! Its argument is that more comprehensible incentives could be less valuable but more effective.

Treating pensions like ISAs is equivalent to abolishing the tax-free lump sum for new pension savings: 25% would no longer be tax free at both ends. People would also lose the opportunity to turn 40% tax into 20% tax, or 20% tax into 0% tax, by deferring income until retirement.

Instead, there would be a Government top-up. How big this would need to be to compensate for the loss of tax-free cash and tax deferral depends on someone's tax circumstances in work and in retirement – and on the future levels of the State Pension and personal tax allowance. It is possible to come up with examples where the answer is as low as 6% or where it is well over 40%. If the Government top-up were flat-rate, people who pay 40% tax in work and 20% tax in retirement would lose out.

Retirement planning may be easier if the taxman had no further claim on any money inside a pension pot. But could the Government be trusted to run a surplus now because it is collecting tomorrow's taxes today? If not, would savers fear that their pensions will end up being taxed twice? Similarly, if the Government contribution were not added until retirement, how confident could anyone be that it would ever be paid?

"Substantial pension contributions will be less attractive for the well paid, so they may want cash alternatives."

"The consultation is being undertaken because "Britain is not saving enough," Mr Osborne says."

Before pensions tax could be turned upside down, several details would need to be thrashed out:

- How would 'new pensions' be segregated from 'old pensions', so that only savings that enjoyed tax relief on the way in are taxed on the way out? Would savers be invited (or forced) to pay a one-off levy so that existing savings can be withdrawn tax free?
- Employees would incur a tax charge when an employer contributes to their pension. Would this tax be siphoned off the contribution or come out of pay packets? Would only income tax be applied, or National Insurance contributions (NICs), too?
- The consultation paper asks whether there should be separate tax regimes for defined benefit (DB) and defined contribution (DC) pensions. Would it be fair to maintain a more favourable regime for DB? Or to permit higher aggregate savings where individuals have access to both?

For now, the Chancellor is treading carefully: a Treasury source insisted to the *Daily Mail* that he is 'agnostic' about the idea. But he believes in simplification and may find accelerated tax revenues tempting. State Pension cuts for younger workers became politically painless when wrapped in structural change, and the Government may now take the same approach to trimming tax relief.

Ultimately, could turning tax relief into a Government contribution see it go the same way as Child Benefit? Once a partial tax rebate is rebadged as a 'handout', it may be easier to take away from people who do not 'need' it.

"Treating pensions like ISAs is equivalent to abolishing the tax-free lump sum for new pension savings."

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The benefits of data digitisation

A case study of the Philips Pension Fund

Adrian Holmes is the Pension Manager at Philips. In this article, he outlines the novel approach that the Trustee of the Philips Pension Fund took to improve its electronic data and the impact this had on the Fund.

Adrian Holmes
Pension Manager,
Philips

How the issue arose

The Philips Pension Fund is a large, long-standing defined benefit plan. It has a level of historical complexity that is typical for many such plans, with several distinct sections and non-standard benefits for some members transferred in following business acquisitions as Philips' UK business evolved over time. The Trustee had carried out a programme to improve and maintain electronic data quality spanning several years. However, when the opportunity arose to secure benefits with an insurer (a 'buy-in'), the Trustee realised it needed to review the electronic data in more detail so that it could benefit from the most attractive market pricing.

While preparing data for the Fund's first buy-in exercise, we identified a member with a special pension guarantee recorded in the supporting files but not on their electronic record. The insurer therefore asked the Trustee to ensure the electronic data fully reflected any members entitled to this pension guarantee. This represented a challenge, as we would have needed to review all of the supporting files for the entire pensioner membership – some 15,000 members!

We also identified that this was one of several historical details not held on electronic records. This is a common situation for many schemes and may not be a concern for ongoing administration, as long as there is a process in place to pick up the detail, for example when benefits come into payment. However, the insurer required all data to be provided in an accessible electronic form. If this had not been possible, the insurer would have increased its cost quoted for the buy-in to reflect this data uncertainty.

The 'traditional' manual approach

Traditionally, the only solution would have been a manual file review of the supporting scanned images, which we estimated would have taken at least 1,000 man-hours and possibly up to 1,500 hours. Hence we would have either had to delay the buy-in for several months, or pay a higher insurance premium.

Faced with this choice, we were keen to investigate a quicker and more cost-effective solution. I discussed the issue with the Towers Watson specialist data team leading our data improvement programme.

The solution: data digitisation

We worked with Towers Watson to develop a solution which involved making the data fields on the scanned images digitally readable so that they would become searchable in bulk (see **Figure 01**). Data digitisation techniques have rarely been used in the past, but recent improvements in technology now provide trustees and sponsoring employers with new options.

There were several areas where we thought this solution would be beneficial. Initially, as a trial of this approach, we focused on the pension guarantee that had highlighted the problem in the first place. We were able to analyse some 1.5 million documents swiftly and accurately. Where the document search indicated the possibility of a special guarantee, a focused file review was completed by the team and we identified a further 10 members with the special guarantee. Once the detailed set-up work had been completed, the actual data extraction took only 20 hours, compared with at least 1,000 hours for a manual review, as illustrated by **Figure 01**.

The insurer was satisfied that the process used was robust and removed uncertainty about the guarantee from the data. Any upward adjustment to the insurance premium was avoided.

The data digitisation process

1. **Assess and identify** – Review the original records (such as paper files or scanned images); identify target data fields.
2. **Configure and extract** – Scan (for paper records) and process the documents. Configure the software to identify data items of interest. Extract the target data into usable formats.
3. **Review and load** – Manually review any ambiguous or unreadable data. Verify results by applying risk-based checks and controls.

The end result is an ordered set of data in an electronic, searchable format, and extracted data which can then be loaded directly into the administration system.

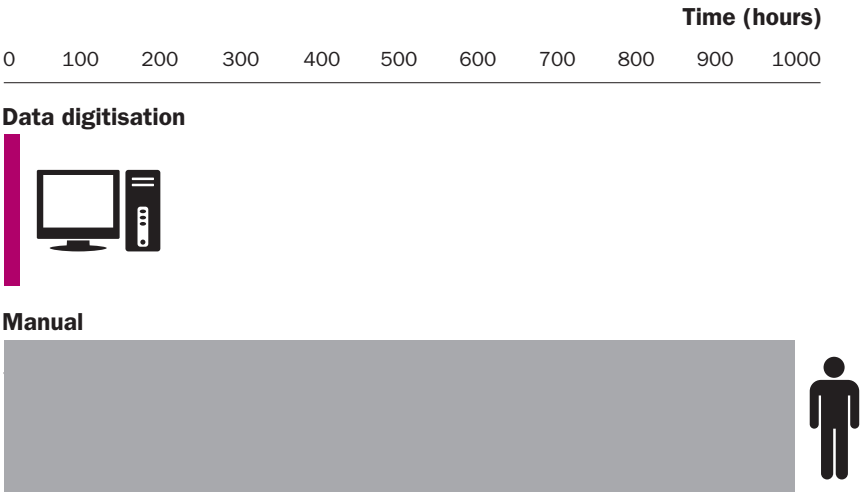
Follow-up work

Having successfully addressed the pension guarantee, we then used data digitisation to improve the data available in electronic form. Two examples include:

- **Funeral benefit** – Some of our members are entitled to a funeral benefit, which is documented on a form held as a scanned image. Using data digitisation, we were able to construct an electronic list of the relevant members. Without data, the insurer had originally priced this benefit assuming that all members were entitled to it.
- **Contingent spouses' pensions** – Spouses' pensions had always been calculated when they came into payment. Using a digitised approach, we were able to extract the data required to calculate contingent spouses' pensions in advance for 3,000 pensioners.

The total saving in the buy-in premium from these exercises has been estimated at £8m.

Figure 01. Comparison of time taken to extract the required data



Benefits of this work to the Trustee

- **Significant savings in the buy-in premium** – As described above. Providing more detailed data gave the insurer more certainty. These savings covered the cost of these exercises many times over.
- **Quicker results** – Although time and effort was initially required to set up the process, this was more than outweighed by the huge reduction in data processing time compared with a manual approach.
- **More efficient ongoing administration** – The improved data quality will enable the administrator to respond more quickly to member enquiries.
- **Reduced risk** – As a trustee board, we had confidence that a robust, automated process had been followed, reducing the risk of human error involved in a manual process. Computers do not get bored, even with millions of images to work through and we had reassurance in the results produced.

Could this work for others?

We are pleased that what began as a project to address a specific issue led to further financial savings in related areas, not only for the buy-in but for the ongoing administration of the Fund. For any pension scheme that holds data in paper formats or scanned images, I would recommend considering whether this approach could yield similar benefits.

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Exploring recent trends in mortality assumptions

What assumptions are trustees making?

As many trustees await the initial results of their March/April 2015 triennial valuations, Mark Alexander looks back at recent trends in longevity assumptions and what this could mean for the future.

Mark Alexander
Senior Consultant

The length of time members will spend drawing a pension in retirement is one of the most important, and uncertain, drivers of the cost of running a pension scheme. As schemes move to de-risk their assets, longevity takes up a larger proportion of the risk budget, leading to an increased focus by trustees on longevity risks.

Recent increases in life expectancy

The last few decades have seen extraordinary increases in longevity, with figures from the Office for National Statistics (ONS) showing that the average lifetime in retirement increased by over 40% between 1982 and 2012.

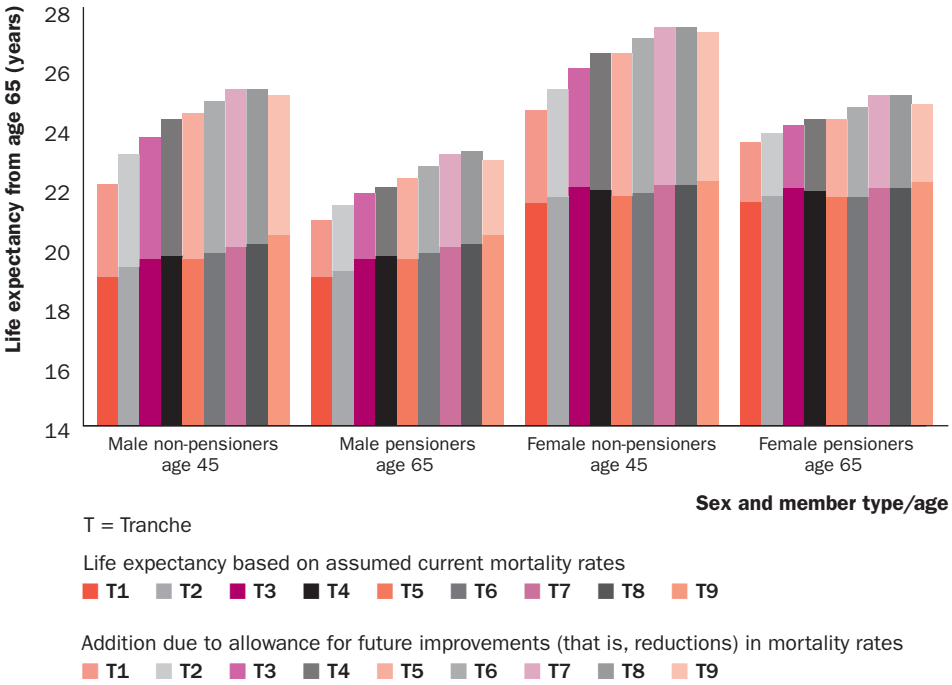
Pension schemes have rapidly increased their mortality reserves to reflect this, particularly during the 1990s and early 2000s when new mortality tables led to substantial funding shocks.

Towers Watson data reflects these trends. **Figure 01** summarises data compiled from a survey of assumptions adopted for some 850 pension scheme valuations over the last nine years. The data is split by valuation tranche in line with the Pensions Regulator's approach (so tranche 9 represents valuation dates between September 2013 and 2014).

At a glance

- The most recent tranche of actuarial valuations has seen a small reduction in the allowance trustees are making for members' life expectancies in retirement, bucking recent trends.
- Recently published tables from the actuarial profession suggest that 2014 valuations might see a further reduction in life expectancies.
- Uncertainty still abounds in this area, and many schemes are considering actions to reduce or remove longevity risks as part of their de-risking plans.

Figure 01. Mortality assumptions – implied life expectancies: Trend over time of average



"A typical male pensioner is now surviving for over 20 years in retirement."

The darker bars show that a typical male pensioner is now surviving for over 20 years in retirement (22 years for females) – an increase in lifetime of nearly 1.5 years over this period. The paler bars show the impact of expected future mortality improvements, with a man retiring today expected to draw a pension for 23 years.

By comparison, today's 45-year-olds are expected to spend more than 25 years in retirement. So, future mortality improvements are assumed to add around five years to the length of retirement predicted by today's death rates.

A stall in the improvement trend?

The other feature which jumps out from **Figure 01** is the drop in life expectancy for the most recent tranche. This reflects a fall in the level of future mortality improvements predicted by the CMI (Continuous Mortality Investigation) model, in reaction to observed improvement rates over 2012 and 2013 being much lower than was previously anticipated. The CMI model is updated annually, and is currently used by over 95% of pension schemes to set their assumptions of how mortality rates will improve over time.

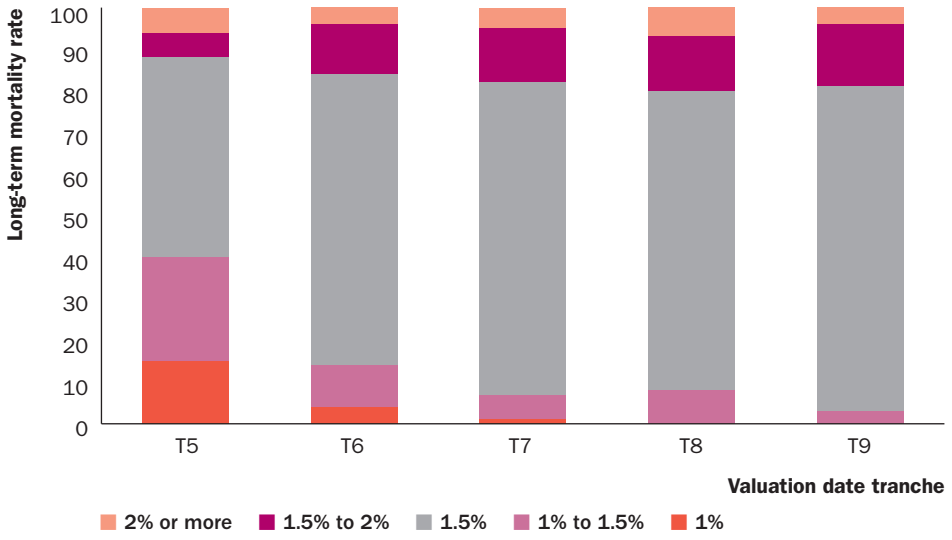
This fall is expected to continue as schemes move to adopt the latest versions of the CMI model (which is anticipated to be the standard table for valuation dates falling in tranche 10 – between 22 September 2014 and 21 September 2015). This model was published in November 2014, and predicts a reduction in life expectancies, leading to perhaps a 1-1.5% reduction in liabilities compared to the 2011 version of the CMI model, which many schemes will have used for their previous valuation.

"Today's 45-year-olds are expected to spend more than 25 years in retirement."

Early indications suggest that the 2015 refresh of the CMI model – which will be published in September, when most tranche 10 valuations are part way through their valuation negotiations – may well also put downward pressure on mortality assumptions following a recent spike in death rates.

However, the CMI model is also looking to refresh some of its underlying methodology – while this is likely to impact in 2016 rather than 2015, it may be that consultation on the proposed changes (set to begin in September), or a desire by trustees to set a prudent assumption to reflect uncertainty, puts some upward pressure on mortality assumptions.

Figure 02. Long-term mortality rates assumed in projection model: Male non-pensioners



Indeed, as shown by **Figure 02**, trustees have gradually been adopting more prudent assumptions over time by increasing their assumed long-term rate of mortality improvements. Four years ago, around 40% of schemes assumed that long-term improvement rates would fall below the 1.5% pa now adopted by the vast majority of schemes, but these have now dwindled to a very small group at the same time that some 20% of schemes now assume higher (and more prudent) rates.

A good time to hedge?

In parallel with this increase in life expectancies, many schemes have been looking to remove or reduce longevity risks. Hedging need not prove expensive – often, switching an existing gilt portfolio into an insured bulk annuity policy can be done without reducing expected returns (therefore hedging longevity risks for little or no cost).

While the alternate route of using longevity swaps does typically come at a cost, many schemes have found that this option makes sense when considering the risk reduction achieved – with sophisticated modelling now allowing a Value-at-Risk figure to be placed on mortality risks, the same cost-benefit analysis can be performed when considering changes to investment strategy.

Of course, hedging might not be the right solution for all schemes, but we are seeing many trustees increase margins in their valuation assumptions to reflect the inherent risk in projecting future lifetimes, and removing this risk is becoming a more viable alternative.

No doubt the continued uncertainty over future mortality will give trustees some interesting points for discussion as part of their next valuation, potentially leading some to explore the transfer of this risk to third parties.

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Building momentum in the longevity hedging market

The AXA transaction – will other schemes follow suit?

Following a bumper year for longevity hedging in 2014, the AXA Group Pension Scheme recently announced that it has entered into a hedge covering its pensioner liabilities of £2.8bn – the first major longevity hedge of 2015. Shelly Beard, adviser on the AXA transaction, explains the background to the deal and explores why longevity hedging continues to be high on the agenda for pension schemes.

Shelly Beard
Senior Consultant

What is a longevity hedge?

Removal of longevity risk through the scheme paying an agreed schedule of payments to a counterparty based on an 'expected' mortality assumption in respect of a specified group of members. In return, the scheme receives actual payments, which are linked to whether the scheme members underlying the hedge are alive or not at each payment date. The longevity risk for this group of members passes from the scheme to the hedge counterparty.

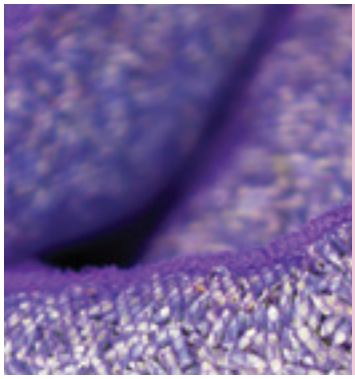
The AXA deal – highlights

The AXA Group Pension Scheme has entered into a transaction which protects the Scheme against the risk of approximately 11,000 pensioner members, representing half of its liabilities, living longer than expected.

Global reinsurers find longevity risk attractive as it diversifies against the large amount of mortality risk that they have on their books. However, UK pension schemes cannot transact directly with reinsurers – the scheme must transact with a company that holds a primary insurance license.

Similar to the transactions carried out by Aviva and Phoenix last year, the Scheme was able to reduce the cost and complexity of hedging by accessing the reinsurance market by transacting with an insurer owned by AXA.

"Global reinsurers find longevity risk attractive as it diversifies against the large amount of mortality risk that they have on their books."



At a glance

- The AXA Group Pension Scheme recently transacted a longevity hedge covering its pensioner liabilities of £2.8bn.
- This is the latest in a growing list of pension schemes that have entered into longevity transactions over the last 12 months.
- Managing longevity risk is increasingly a big item on trustees' and sponsors' agendas and activity is expected to increase over the rest of the year.

Different structures for different circumstances

Not all sponsors will be insurers, but trustee-owned insurance vehicles can deliver similar reductions in cost and complexity, making longevity hedging an option for more schemes. Looking back over the past year, five out of the last six longevity hedging transactions have used either a sponsor- or trustee-owned insurance entity to access the demand for longevity risk in the reinsurance market.

As well as the examples noted above of schemes using sponsor-owned insurers, the BT Pension Scheme set up its own captive insurance company in order to transact its record-breaking £16bn deal last year. Towers Watson has also developed Longevity Direct to allow our clients to efficiently access the reinsurance market through the purchase of a 'ready-made' insurance cell company, and at the end of 2014 the Merchant Navy Officers Pension Fund (MNOPF) became our first client to complete a deal through this innovative structure.

The increasing number of options means that schemes are more likely to find a route suitable for their circumstances, where the costs of hedging are affordable. We expect to see clients taking advantage of the variety of different routes to market over the coming months, and as more and more schemes transact this is becoming an increasingly well-trodden path.

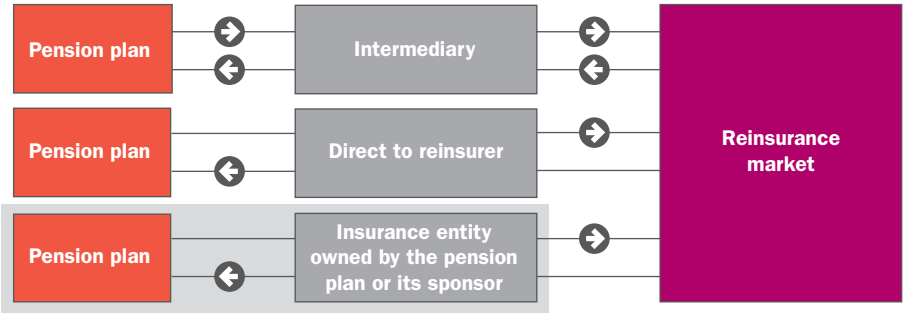
Company and Trustees working together to achieve the best deal

The Trustees of the AXA Group Pension Scheme worked closely with the Scheme's sponsor to take advantage of its in-house experience and make sure the final transaction fulfilled the objectives of both the Scheme and the employer.

AXA UK Director of Pensions, ALM and Capital Management Emma Ferris said: "We've leveraged our own internal expertise, and worked hard with the Trustees, the advisers and RGA (Reinsurance Group of America) to develop an innovative solution which provides Scheme members with additional security, as well as improving the risk management and capital position of AXA UK."

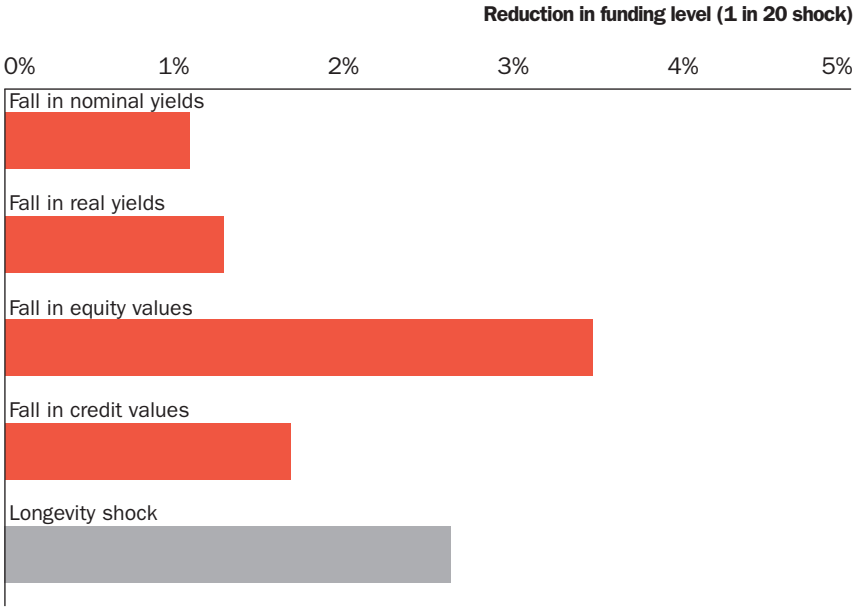
Sponsors, particularly those in the financial sector who are used to considering and managing risk budgets, are increasingly focusing on unhedged risks such as longevity and wish to avoid unexpected calls for contributions in future. Where attractive pricing for hedging is available, we are seeing that sponsors and trustees can effectively combine forces as their objectives for entering into these transactions are aligned and achieve good traction in the market.

Figure 01. Options for accessing the longevity hedging market



"Not all sponsors will be insurers, but trustee-owned insurance vehicles can deliver similar reductions in cost and complexity, making longevity hedging an option for more schemes."

Figure 02. Ranking your key risks

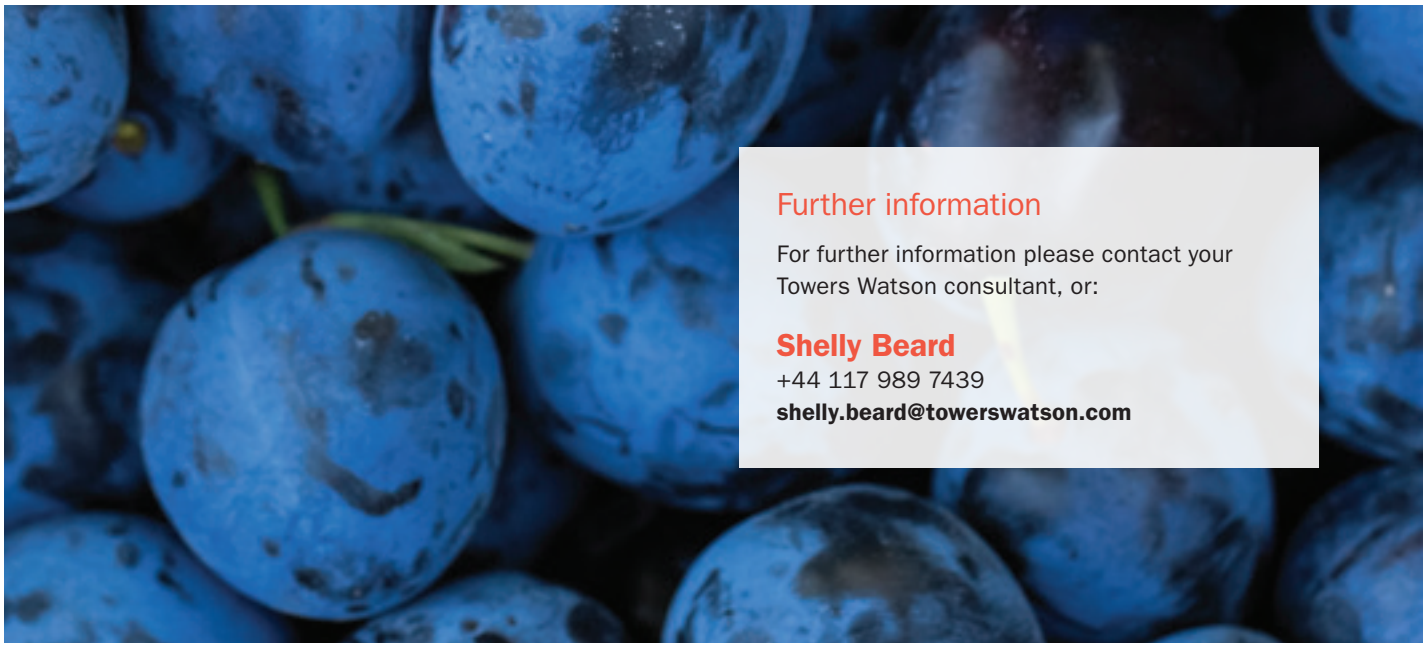


The grey bar shows the impact of a longevity 'shock' on a typical scheme's funding level – in other words, the impact of an event occurring that has a 1 in 20 chance of happening.

Longevity – the next risk on the list?

As more and more schemes act to manage their investment risks and reduce the volatility of their funding position, longevity is increasingly becoming a more dominant unhedged risk. Schemes which are progressing with their journey plans to long-term sustainability are finding that longevity risk is starting to stand out on their risk governance plans and are looking to the markets to find a solution.

Currently, the reinsurers still have considerably more mortality risk than the £100bn or so of UK longevity risk that has been transferred – and they are keen to take on longevity risk, which is reflected in their pricing. However, over the medium to long term, and with £2 trillion of UK defined benefit (DB) pension liabilities, this position may change. At a conservative estimate, longevity demand might average £50-100bn of liabilities a year, which based on our estimates of supply, is likely to cause upward pressure on prices over the medium to long term. For schemes looking to manage their longevity risk, the opportunities in the market now may lead to advantageous pricing for those who act quickly.



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Headlines

August 2015

Our regular round-up of the latest pensions news. This month we look at changes to the AA announced in July's Budget, DC quality standards, the FCA's new pension transfer rules, figures from the PPF's latest annual report, the end of contracting out, the Regulator's latest on DB funding and pension scams.

Janine Bennett
Consultant

Mark Dowsey
Senior Consultant

Summer Budget: Aligning PIPs with the tax year

The Government intends to introduce a tapered annual allowance (AA) for anyone with income above £150,000, and to facilitate this all Pension Input Periods (PIPs) will be aligned with the tax year. Transitional arrangements will apply for 2015/16. Broadly, all PIPs which would have ended in 2015/16 will end on 5 April 2016. For example, a PIP currently running from 1 July 2014 to 1 July 2015 will end instead on 5 April 2016. The 'combined PIP' will be split into a 'pre-alignment period', which will cover a period from the start of the combined PIP to 8 July 2015 (the date of the Budget), and a post-alignment period from 9 July 2015 to 5 April 2016.

The AA for the pre-alignment period will be £80,000. Any amount unused in that period will be available for use in the post-alignment period, subject to a maximum of £40,000. However, defined benefit (DB) and cash balance arrangements will only need to calculate the value of members' benefits at the start and end of the combined PIP, not as at 8 July 2015. The pension savings in the combined PIP will be proportioned between the pre- and post-alignment periods.

Scheme return 2015

The Pensions Regulator (tPR) has published a guide to changes in the 2015 defined contribution (DC) scheme return, which will enable the Regulator to identify:

- The chair of the trustee board (unless the scheme is exempt).
- Compliance with the charge cap.

The scheme return for 2016 is expected to require confirmation that a governance statement has been produced by the chair. Trustees who fail to produce a chair's statement will automatically be fined between £500 and £2,000.

FCA publishes revised pension transfer rules

The Financial Conduct Authority (FCA) has issued a policy statement on changes to its pension transfer rules. These changes (effective from 8 June 2015) cover the new regulated activity introduced by the Government in relation to transfers and the conversion of 'safeguarded benefits' to 'flexible benefits' – broadly, transfers or conversions of DB rights into DC rights.

The changes are in line with those originally proposed in March 2015, with the following exceptions:

- A transfer value analysis (TVA) will be required unless a member has reached the DB scheme's normal retirement age (NRA) and wishes to access their benefits immediately. Later this year, as part of a broader review of the FCA's pension rules, the FCA will consider whether there is a need for a full review of its TVA requirements.
- Members will not have to use a pension transfer specialist where advice is taken on transfers from occupational DC schemes 'without safeguarded benefits'.

In response to concerns expressed during the initial consultation, the Department for Work and Pensions (DWP) and FCA will consider making changes to ensure the advice requirement operates as intended for non-UK residents. Currently, non-UK residents who wish to transfer their benefits overseas will need advice from an FCA-authorised adviser and (in all likelihood) a local overseas adviser, increasing costs and complexity.

Pension Protection Fund – 10 years on

In its 2014/15 Annual Report and Accounts, the Pension Protection Fund (PPF) trumpets an increase in surplus to £3.6bn and a funding ratio of 115.1% (up from 112.5% the previous year). However, this is tempered by a reduction in its 'probability of success' from 90% to 88%. This is the probability of the PPF being financially self-sufficient by 2030, as calculated by the PPF using its stochastic 'Long Term Risk Model' (LTRM). The Chief Risk Officer attributes this to an increase in scheme liabilities resulting from continuing falls in interest rates coupled with 'some deterioration in the credit quality of certain employers'. Following various adjustments to the LTRM, the PPF believes its funding strategy 'remains fit for purpose'.

Other figures in the Annual Report and Accounts include:

More consultation to follow as DWP exercises caution on post-2016 world

The DWP has published regulations relating to the treatment of contracted-out rights that have already built up when the single-tier pension changes take effect in April 2016, along with its response to a consultation on the draft regulations. The measures are intended to make sure that the protections afforded to contracted-out rights while they were being built up are not eroded in the future. There are a few points of interest:

- There will not be an override facilitating modification of schemes to reflect the reforms being made to the State Pension. Although this may have been useful to schemes that contained some degree of integration, the Government does not believe that an override is necessary because the basic State Pension will continue to exist and be paid to pre-April 2016 retirees.
- The DWP will consider further how to preserve reference scheme test (RST) underpins in schemes where the underpin is defined by reference to the legislation.
- Further consultations are planned on:
  - The restrictions on amending accrued contracted-out rights.
  - Transfers of contracted-out rights between schemes.
  - Trivial commutation of Guaranteed Minimum Pensions (GMPs).
  - Whether employers will need to notify and consult members in advance of the end of contracting out – to be carried out as part of a consultation on changes to the disclosure regulations.

The DWP also states that GMP conversion and equalisation issues are being considered separately, but it gives no indication of when developments can be expected.

"Trustees who fail to produce a chair's statement will automatically be fined."

"The FCA will consider whether there is a need for a full review of its TVA requirements."

PPF compensation paid to date: **£1.8bn**. An **increase of 50%** over the year.

Value of new claims from schemes entering PPF assessment: **£322m**. A **decrease of 48%** over the year.

Single-tier still not clear

In addition, the Pensions Minister has been bringing her consumer focus to bear by driving the delivery of a DWP fact sheet on how people's 2016 starting pension will be worked out. It is a valiant effort, but ultimately the deductions that will be made to show how periods of contracted-out service are to be reflected in pre-2016 single-tier accrual still need a magic wand to be made intelligible.

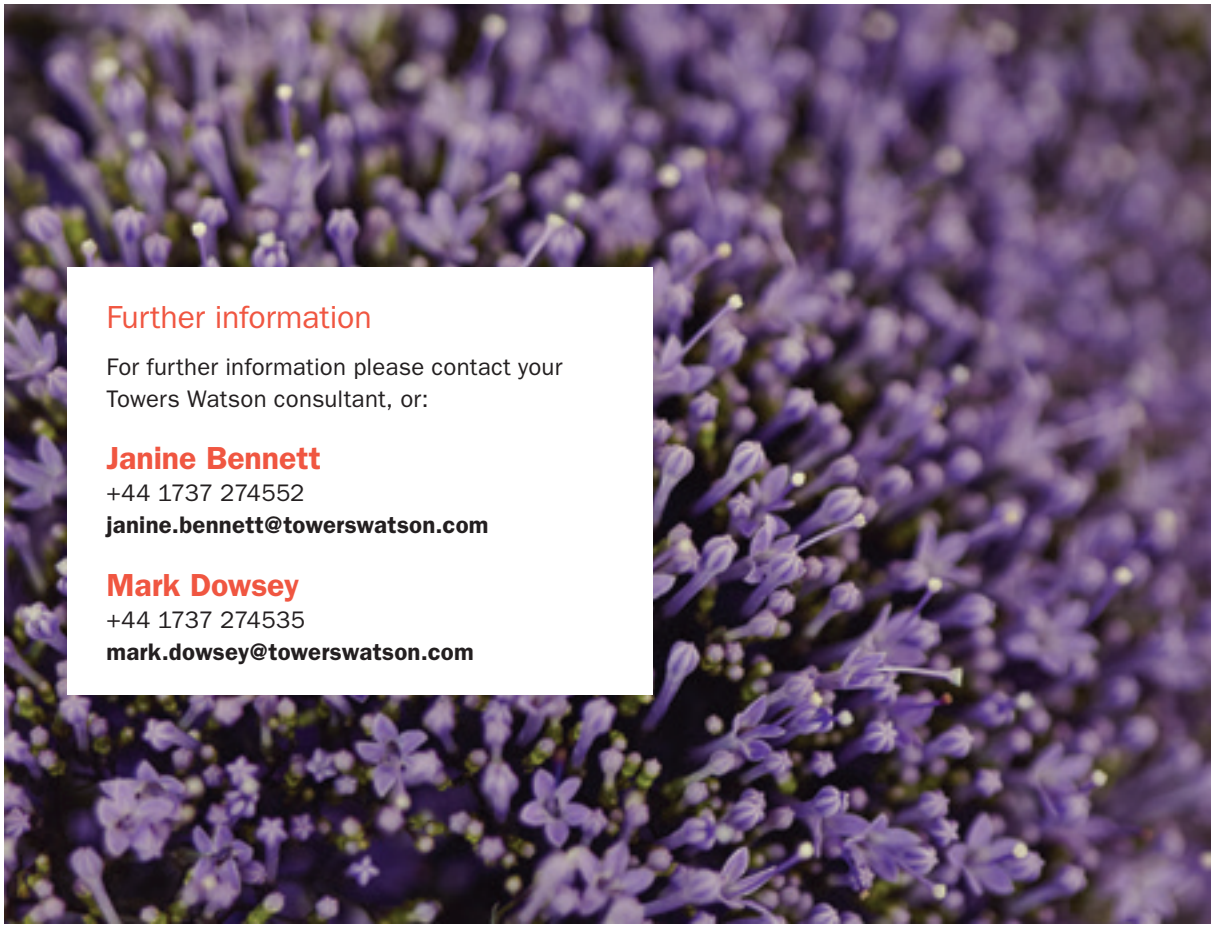
Funding DB schemes – a brief update

TPR has issued a short guide and video aimed at employers whom it expects to be in discussion with trustees regarding valuations drawn up under the revised Code of Practice published a year ago. The information emphasises the need for employers and trustees to work together in assessing and monitoring the employer covenant.

There is nothing new in the material, but at three pages and three minutes respectively, the guide and video are a helpful, high-level introduction for anyone who has not been following the Regulator's publications – including the annual funding statement and analysis published in May.

More on pension scams

- The new Pensions Ombudsman has supported providers' due diligence processes in the latest pensions liberation cases. He dismissed claims against Prudential on the grounds that, at the time of the transfer (prior to the publication of tPR's guidance), the transfer appeared to comply with the requirements to be statutory. He also dismissed a claim against Royal London which, having decided that a transfer request did not meet statutory requirements, exercised its discretion under the scheme rules to refuse a transfer to a small, self-administered scheme. However, the Ombudsman did criticise Royal London for failing to explain fully to the member the reason for its decision.
- TPR has added new material to its website as part of 'Scams Awareness Month', including new 'at a glance' examples of pension scams and a short video to warn savers about the risks and explain what action is being taken to combat fraud.



Further information

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Settlement in Focus

Punching above your weight: buy-ins for smaller schemes

Size matters in the bulk annuity market, with larger deals attracting preferential terms relative to smaller transactions. This, combined with the cost of advice, has in the past put a buy-in out of reach for smaller schemes. Ian Aley and Gemma Millington explore how a streamlined approach can eliminate these barriers and provide an efficient, cost-effective buy-in process for transactions under £100m.

Ian Aley
Head of Transactions

Gemma Millington
Senior Consultant

Why does size matter?

The bulk annuity market was busier than ever in 2014, with a record volume of transactions. As schemes continue to mature and trustees and sponsors get closer to the endgame, we only expect the interest in these transactions to increase.

Whilst a buy-in or buy-out is an effective de-risking solution for schemes of all sizes, historically larger schemes have held sway in the bulk annuity market as factors such as a fixed element of insurer expenses and, often, lower appetite from insurers make pricing less attractive for smaller deal sizes. Furthermore, with less money at stake, the bargaining power of the scheme is vastly reduced, making negotiation with the insurer a challenge.

Put simply, it can be hard for smaller deal sizes to get the attention of the market. And without engagement from insurers, the outcome will always be sub-optimal, whether this means paying above the odds or a failure to transact at all.

Power in numbers

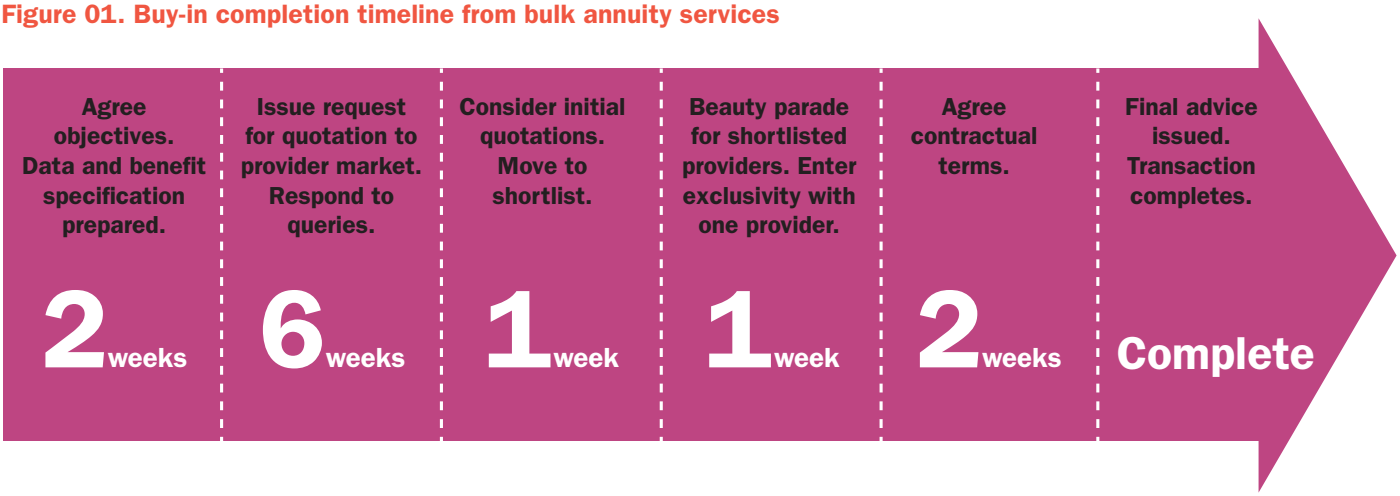
Towers Watson's new streamlined buy-in service eliminates the hurdles that previously faced smaller schemes looking to insure all or part of their liabilities. Targeted at transactions under £100m, this service provides access to improved insurer pricing and terms that would otherwise be unavailable for deals of this size, making a buy-in a more affordable solution.

Why is this? It all comes down to collective buying power or, in other words, power in numbers. From an insurer's perspective, 10 identical buy-ins of £100m are equally if not more attractive than a single £1bn transaction.

Therefore, by designing a process under which there is consistency of approach from one transaction to the next, and under which legal contracts have been pre-agreed, negotiating power can be dramatically increased to be similar to that of a much larger transaction. Towers Watson has been able to leverage the scale of our client base in agreeing the terms of the offering. Crucially, the allowance for expenses within the premium charged by the insurer is minimised as the insurer's costs, including those associated with legal advice and negotiating the commercial terms, are spread over a number of deals, not just one.

On top of this, competitive tension is maintained, with our streamlined service incorporating all market participants within a competitive pricing process to ensure that the best possible price is achieved.

Figure 01. Buy-in completion timeline from bulk annuity services



"The streamlined process is designed to guide trustees and sponsors efficiently through the otherwise complex and lengthy buy-in process."

Packaged advice

For the streamlined service, Towers Watson has partnered with leading UK law firm Burges Salmon LLP to pre-negotiate terms with the major insurers. This not only provides schemes with access to terms which have generally not been available to smaller transactions but also eliminates the need for schemes to incur what can often be substantial legal fees for relatively small transactions.

In the same way that insurer costs are spread between deals, so too are advice costs. Moreover, a standardised process means costs are better able to be predicted. The streamlined offering combines actuarial and legal services into a fixed fee, providing trustees and sponsors with cost certainty at the outset.

Streamlined = efficient, fast, simple

In the pensions world, we are used to thinking about things over a long time frame. After all, for some pension schemes the last payment to a member may not be made for over 100 years. In this context, most trustees and sponsors can afford to take their time over any decisions relating to the scheme.

However, this can be fatal for a bulk annuity transaction where quick decision making is critical. Long transaction times risk adverse market movements, and loss of insurer engagement, which can jeopardise the success of a transaction. Minimising the time between approaching the market and execution is therefore essential, particularly where market conditions are volatile or uncertain.

The streamlined process is designed to guide trustees and sponsors efficiently through the otherwise complex and lengthy buy-in process. **Figure 01** shows a typical timeline for a streamlined buy-in.

Recognising our differences

The streamlined approach includes everything that is critical to a transaction, and nothing that is not, to deliver a well-managed, quick and cost-effective route to buy-in. That said, one size does not necessarily fit all and we recognise that schemes are different. Larger schemes or schemes with specific non-standard objectives may require a more tailored process.

Once the sponsor or trustees have determined that a buy-in or a buy-out meets their strategic objectives, the best way to get there should be openly discussed. Whether the streamlined service or a more bespoke solution is adopted, a successful buy-in process is one which is well-managed from start to finish, minimises costs and timescales, and, ultimately, achieves the best possible price.

Further information

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Settlement Watch

The long road to buy-out?

August 2015

So you have secured a buy-in for your liabilities – what next? For many trustees and sponsors, the logical next step is to issue individual policies to members and wind up the schemes as quickly as possible. In our experience, the length and cost of the buy-out period can be significantly reduced through specialist project management and effective data cleansing.

Ian Aley
Head of Transactions

Shelly Beard
Senior Consultant

The Pensions Regulator recommends that trustees appoint a project manager to run the wind-up, recognising that there are a number of key stakeholders involved and all parties should remain focused and make timely decisions. The project manager will also be able to draw on prior experience to ensure that major exercises such as the Guaranteed Minimum Pension (GMP) reconciliation are completed as efficiently as possible – for example using data digitisation techniques.

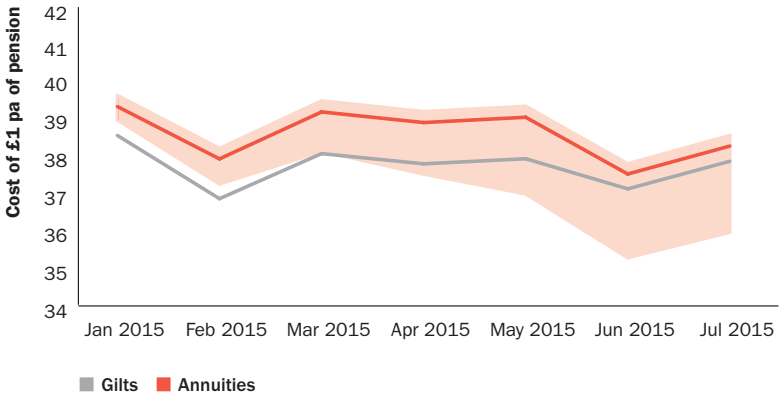
Figure 02 illustrates the key activities that need to be completed during the move from buy-in to buy-out.

Buy-in pricing versus gilt pricing

Figure 01 shows a comparison between the typical cost of insuring £1 pa of inflation-linked pension for a 60-year-old male pensioner via a bulk annuity, and the liability in respect of the same pension using a gilt-based discount rate.

If the gilts line is above the annuities line, this suggests a scheme may be able to swap a portfolio of gilt holdings covering a set of pensioner liabilities for matching annuities at no additional cost to the scheme or sponsor. The lighter red shading around the annuities line shows the range of pricing currently in the market.

Figure 01. Approximate buy-in pricing and gilt pricing for a sample member



Overview of deals

July 2015:	£70m buy-out for the MIRA Retirement Benefits Scheme.
July 2015:	£1.6bn buy-in for the Civil Aviation Authority Pension Scheme.
July 2015:	£2.8bn longevity swap for the AXA UK Group Pension Scheme.
June 2015:	£42m medically underwritten buy-out for the Kuwait Petroleum Services Company Pension Scheme.
May 2015:	£675m buy-out for the Lehman Brothers Pension Scheme.

Figure 02. Key activities on the move to buy-out

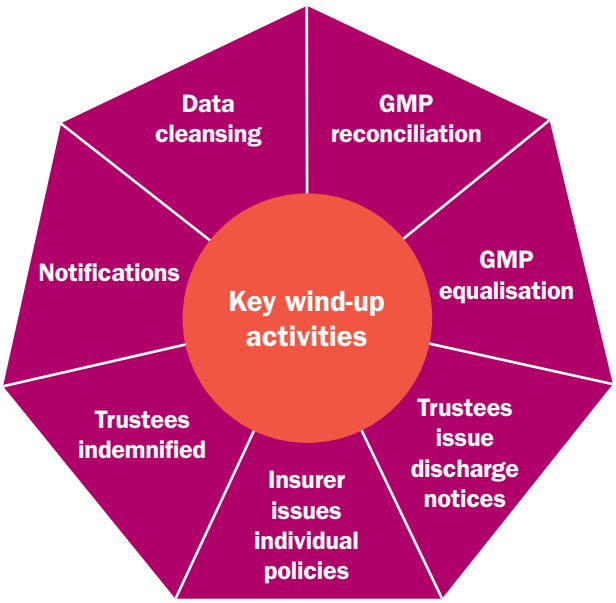
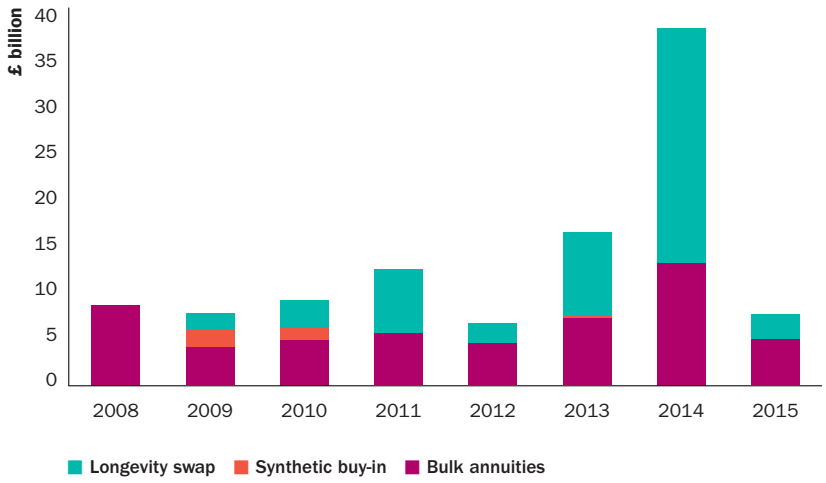


Figure 03. Volumes of business by year



Market terms are subject to considerable variability and at any one date a wide range of quotations could be obtained from different providers. Ultimately, the actual position can only be determined by obtaining actual quotations and completing a buy-out.

Settlement Watch uses pricing data from a range of insurance companies including Aviva, L&G, Pension Insurance Corporation and Rothesay Life.

"In our experience, the length and cost of the buy-out period can be significantly reduced through specialist project management."

Further information

For more information on Settlement Watch, or assistance in exploring the position of your scheme, please contact your Towers Watson consultant, or:

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Events

Towers Watson regularly runs webinars, forums and other events of interest to sponsors of pension and benefit arrangements. Please speak to your Towers Watson consultant or visit events.towerswatson.com to register.

Introductory trustee training

These sessions are designed for those new to trusteeship and provide a participative environment in which trustees are able to explore the challenges they face with their peers and leading members of the Towers Watson team.

Tuesday 22 September 2015
Wednesday 4 November 2015

Contract-based DC training

This one-day introductory course is designed to provide delegates with a practical guide to running an effective contract-based defined contribution (DC) pension arrangement.

Wednesday 7 October 2015

DC training

This one-day course is designed to give delegates a better understanding of the many issues they will face as a trustee or scheme manager of a DC scheme.

Thursday 19 November 2015

Investment management trustee training

This one-day course is designed to give delegates a deeper understanding of a range of investment issues that apply to both defined benefit (DB) and DC pension schemes.

Thursday 3 December 2015

Timeline

Key forthcoming legislative events and milestones are listed below:

Summer/ Autumn 2015
Details expected of protection for £1m lifetime allowance

30 September 2015
Closure of consultation on pensions tax relief

October 2015
New entrants to occupational DC schemes cannot get short service refunds after more than 30 days' service

2015 (tbc)
Announcement on equalising for the effects of unequal GMPs

April 2016
Tapered reduction in annual allowance for people with earnings over £150,000

April 2016
End of contracting out for DB schemes

April 2016
Scottish Parliament gets new income tax powers

April 2016
Ban on differential charging and DC commission

April 2016
Lifetime allowance will reduce to £1m

April 2016
Expected that law will allow consumers to sell annuities

Autumn 2016
'Pot follows member' begins on an 'opt in' basis

31 December 2016
Proposed implementation of revised EU Pensions Directive

2017
Review of DC charge cap

1 April 2017
NEST contribution limit and bulk transfer ban lifted

5 April 2017
Deadline for Individual Protection 2014 applications

October 2017 – October 2018
End of automatic enrolment transitional periods

About Towers Watson

Towers Watson is a leading global professional services company that helps organisations improve performance through effective people, risk and financial management. With 16,000 associates around the world, we offer consulting, technology and solutions in the areas of benefits, talent management, rewards, and risk and capital management. Learn more at towerswatson.com

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