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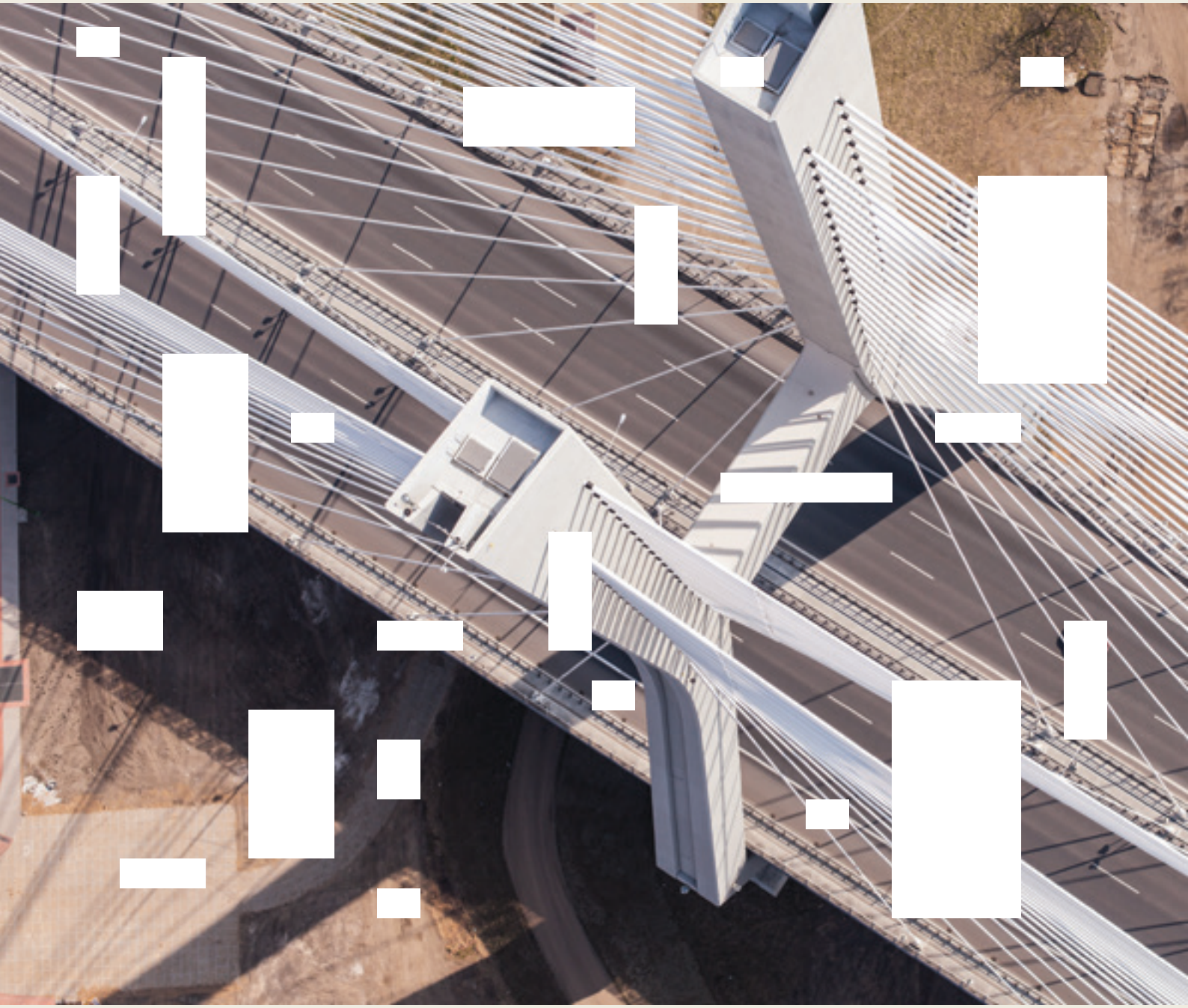
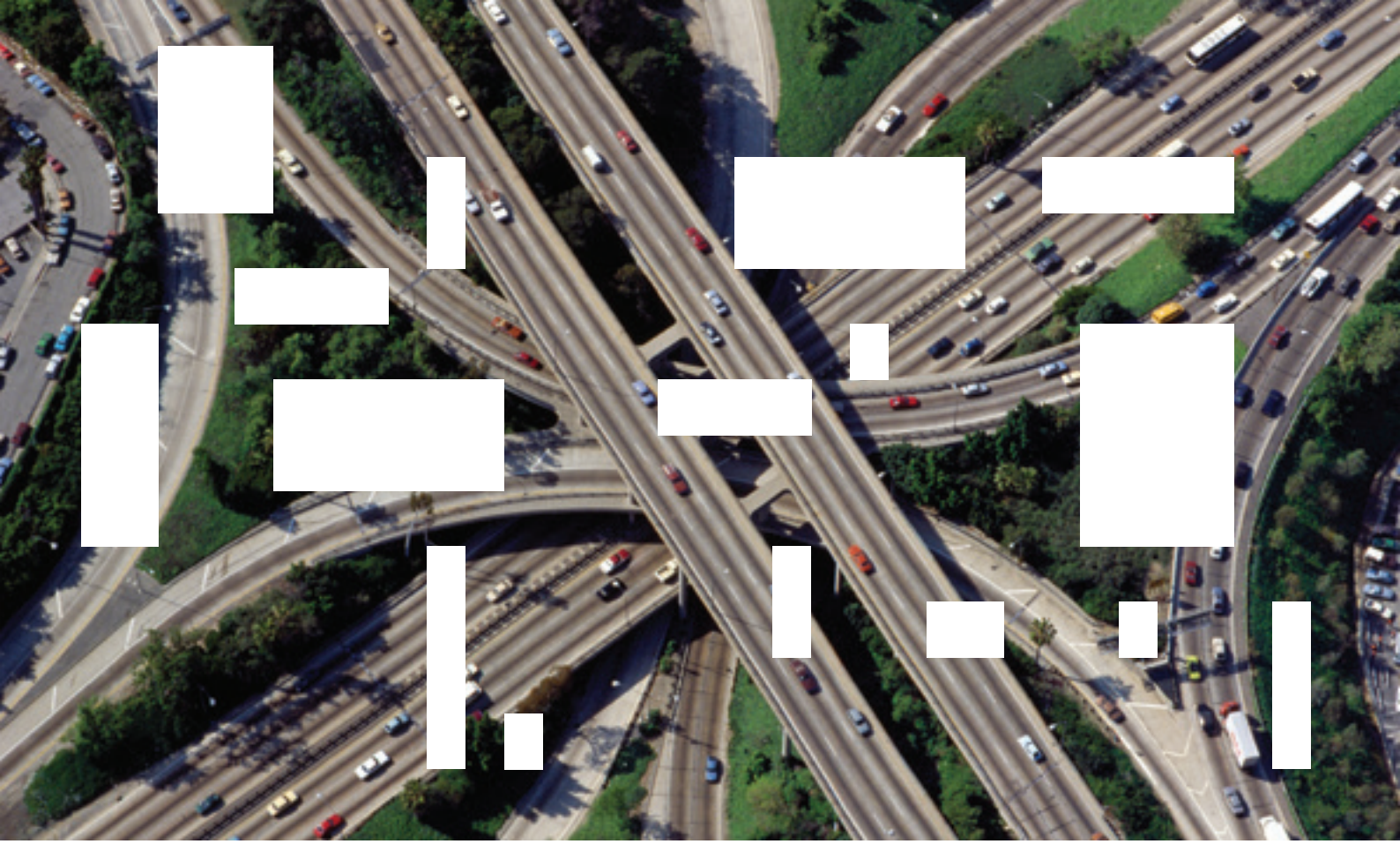


Liability management

Reducing pension scheme risk through increased member options



Liability management – reducing pension scheme risk through increased member options

There are several options available to help manage risk in defined benefit (DB) pension schemes. At one end of the spectrum there is the purchase of annuities from insurance companies to hedge all risks associated with the members covered by the contract. Yet for many schemes the cost of this is currently beyond their means.

There are, however, other less costly options that can help companies that wish to reduce the magnitude and volatility of their DB scheme costs and that help move the scheme nearer to the trustees' and company's goal of self-sufficiency or buyout. These options also give members greater choice and flexibility over their benefits.

Provided such options are communicated clearly and fairly, and members are supported so they can make informed decisions which suit their particular circumstances, then the result can be a 'win' for all concerned.

Here we mainly focus on three methods of reducing pension risk:

- **Pension increase exchange (PIE)**
- **Retirement transfer option (RTO)**
- **Enhanced transfer value (ETV)**

We also mention some of the other possible liability management options available. Trustees and companies may wish to consider just one of these options or a combination and also incorporate them into a wider de-risking programme.

Pension increase exchange

A PIE exercise offers members the choice of exchanging future increases on their pensions for a one-off uplift within the DB scheme. The uplifted pension does not then attract any further increases. Legislation prevents certain pension increases being exchanged within a DB arrangement, so a PIE exercise is likely to be attractive where schemes offer increases over and above the statutory level of increases – particularly in relation to pensions accrued prior to 6 April 1997.

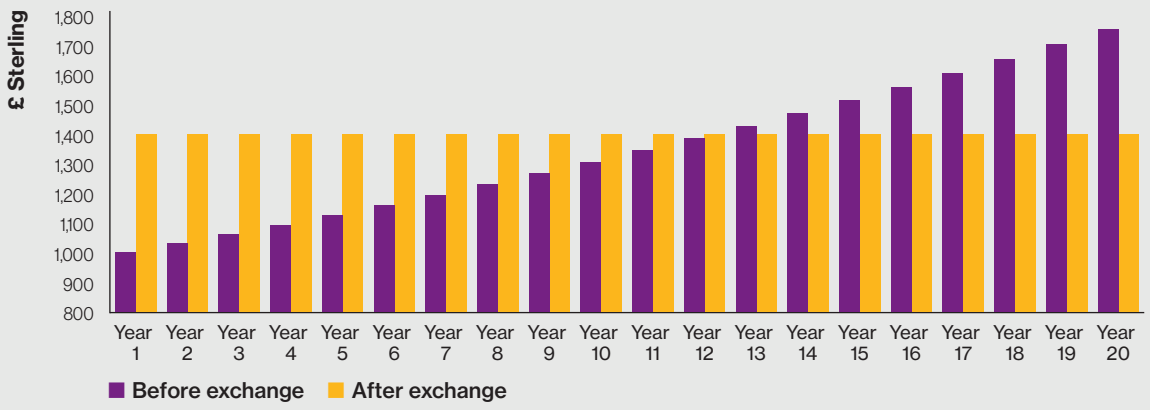
This option can be offered to current pensioners as a bulk exercise, to future retirees at the point of retirement or as part of an exercise to communicate the scheme's early retirement options to deferred members.

PIE options are popular with members who appreciate a higher pension in the short term. In particular, if offered at the point of retirement, they allow members to receive more pension in the first years of their retirement when they are likely to be more active. The popularity of level annuities amongst people with defined contribution (DC) pension savings indicates that flexibility over pension increases might also prove appealing to some DB scheme members. If offered at retirement, a PIE may also mean that a member can take a higher tax-free cash sum.

At a glance

1. **Useful for schemes that provide increases on pre-97 pension**
2. **A way to reduce the costs of subsequent buyout**
3. **Can produce an immediate positive balance sheet and P&L impact**
4. **An additional option for members that can also be made available to pensioners**
5. **Can help as part of a wider de-risking strategy**

Figure 1. **Example of how a PIE affects a member's pension**



Retirement transfer option

Traditionally, DB schemes have not permitted transfers immediately prior to retirement. Since April 2015, individuals with DC savings have had flexibility over how they access their funds in retirement. Some members of DB schemes will want to investigate accessing this flexibility by transferring to a DC arrangement.

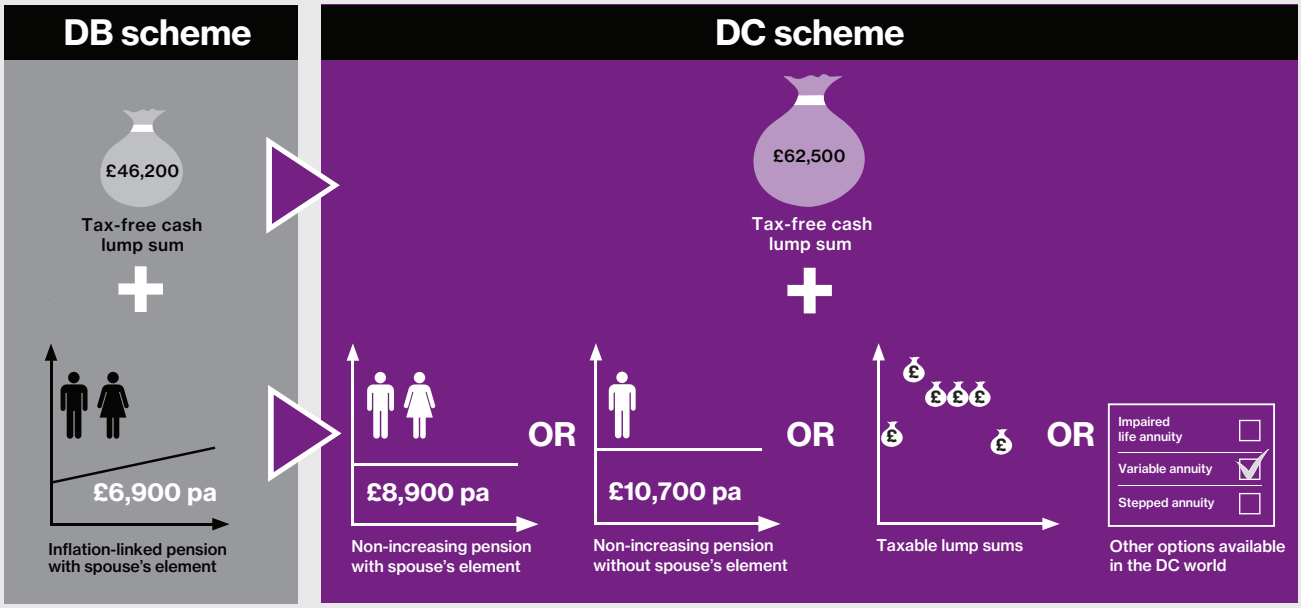
An RTO improves the retirement process for DB schemes by providing support in considering the wide range of options now available. In particular, this option allows members to select benefits that suit their own circumstances, for example their preferred levels of pension increases and spouse's benefits. Since April 2015, members have been able to take their fund as taxable lump sums in whatever pattern they choose. In addition, members may be able to take a higher tax-free cash lump sum. Whilst not suitable for everyone, this flexibility is likely to be of interest to a significant number of DB scheme members. Trustees of DB schemes should, at the very least, make sure that their members are aware of these potential options.

An RTO involves actively engaging with members to help them understand all the options available to them – both within the DB scheme and outside of it – and then facilitating a transfer for those members who select this option. Typically members would simply be offered their normal cash equivalent transfer value and the RTO would be introduced as part of the 'business as usual' retirement process for active and deferred members approaching retirement. However, an RTO can also be part of a bulk early retirement offer to all deferred members over age 55, many of whom may not realise that they have the option to take their pension at this time.

At a glance

1. Can be a beneficial option for most schemes
2. Reduces future volatility of pension costs
3. Little or no financial impact on sponsor or scheme
4. Can become part of normal retirement process
5. Gives DB members the same flexibility as DC members

Figure 2. **Example of the options a member could choose through an RTO**



Enhanced transfer value

Deferred members often make up a significant part of a DB scheme's liabilities. Whilst these members can already transfer their benefits to another arrangement, few give this any detailed consideration and even fewer actually transfer. Typically this means that the vast majority of these liabilities stay in the scheme and eventually come into payment at retirement.

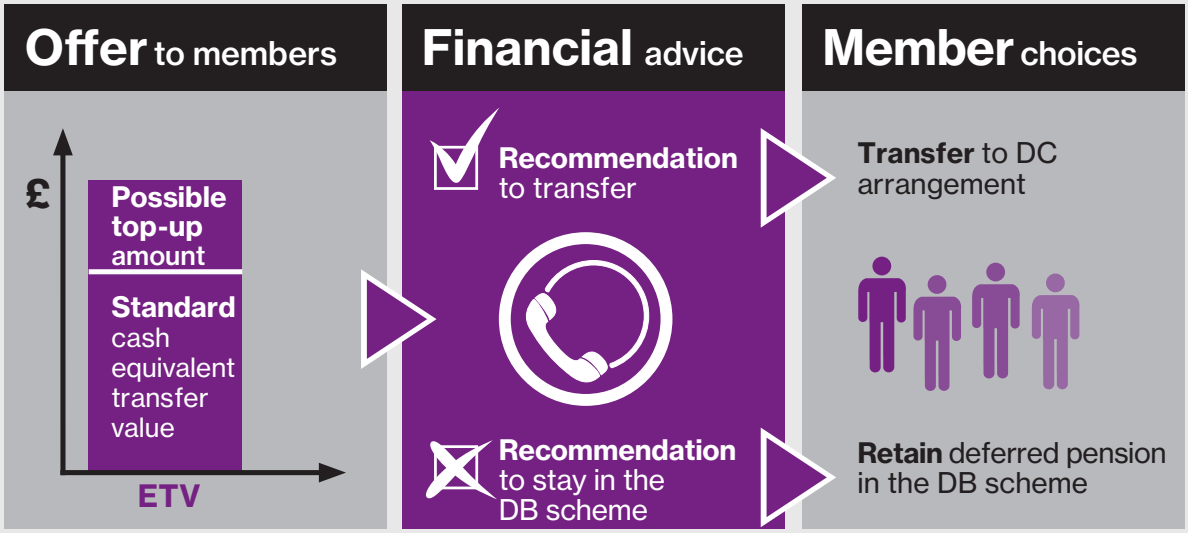
ETV exercises involve incentivising deferred members to transfer their benefits to another pension arrangement. The level of incentive may range from simply reminding them that they have a statutory right to a transfer, to offering them a higher than normal transfer value. An ETV offer places members under no obligation to accept and members who do not accept it will simply retain their deferred DB entitlements. However, some members may want to have more say over the form of their retirement income and will be comfortable taking personal responsibility for their pension.

Through enhancing the terms usually offered and paying for financial advice, more members are likely to consider a transfer. There are many ways that the enhancement could be calculated. It could be a flat enhancement, one varying with the individual age of the member or linked to the amount required to achieve a recommendation to the potential transfer from the appointed financial adviser. Another important consideration is which deferred members to make the offer to. In the past ETV exercises have focused on younger members, but older deferred members may have more idea of the type of pension they want in retirement and may be attracted by the flexibility a transfer offers.

At a glance

1. **Useful for schemes with large deferred populations**
2. **Removes deferred pensioners at costs below buy-out**
3. **Can have significant impact on risk within the scheme**
4. **Deficit contributions could be used to fund some of the costs**
5. **Gives members more control of their savings**

Figure 3. **Example of an ETV exercise from the member's perspective**



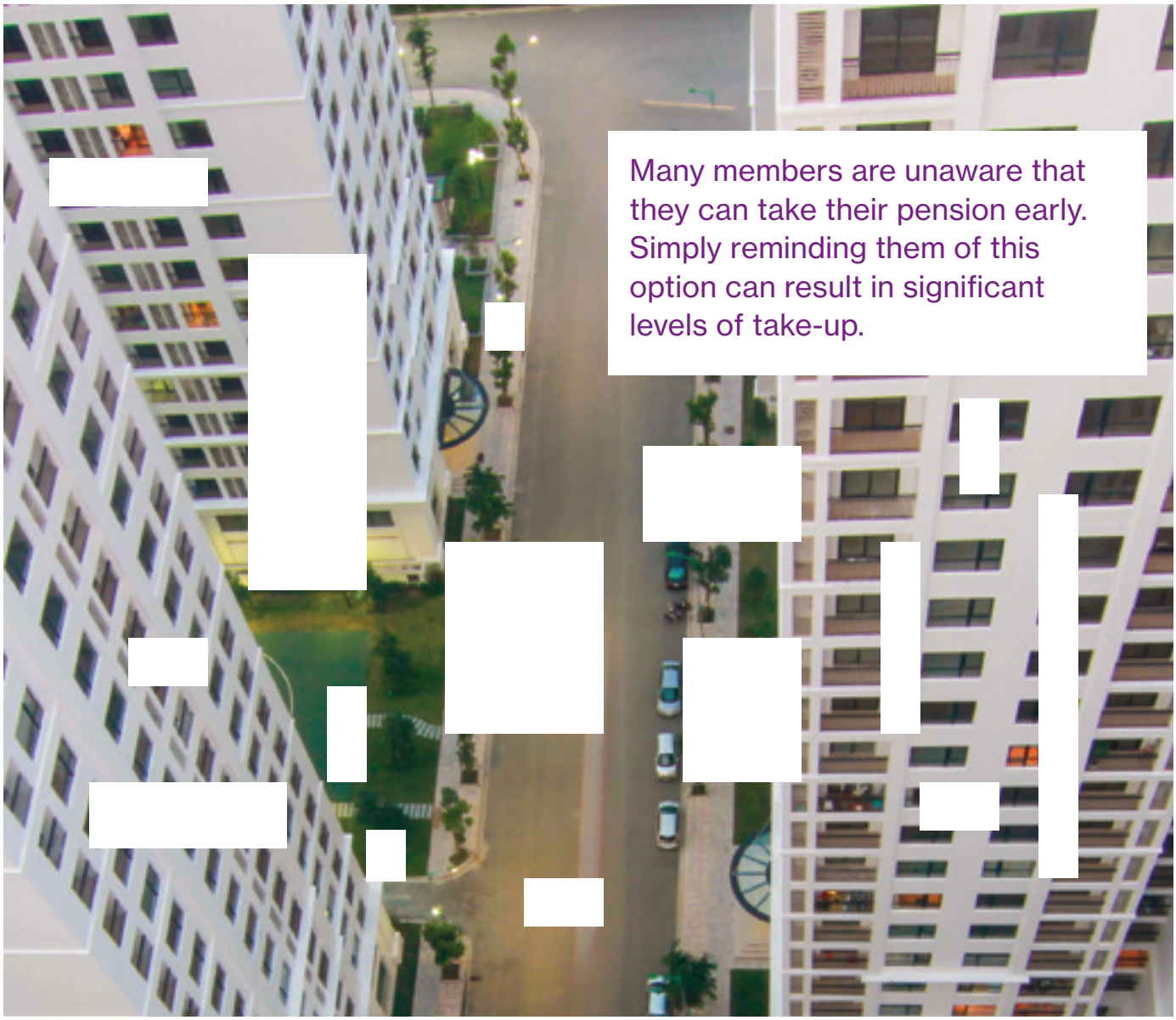
Other liability management options:

Early retirement

Many members are unaware that they can take their pension early. Simply reminding them of this option can result in significant levels of take-up. An early retirement exercise would usually involve writing to all deferred members over age 55, setting out their current early retirement pension. Typically the standard early retirement terms are offered and there is no formal offer window as these members can take their pension at any time. Exercises can be designed where enhanced terms are offered, which would then fall within the scope of the Code of Good Practice for Incentive Exercises.

Trivial commutation and small lump sums

Members with small benefits can take a lump sum instead of their pension, often referred to as 'trivial commutation'. Broadly speaking, this applies to members with total benefits across all pension arrangements with a value of less than £30,000 or with benefits in one scheme with a value of less than £10,000. In a trivial commutation exercise those members who are likely to qualify for lump sum benefits are identified and then informed or reminded of the options available. Members will often prefer to receive a lump sum to small monthly pension payments.



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Why carry out these exercises?

1 Risk reduction

Successful ETV and RTO exercises reduce the size of DB obligations. For each member who transfers out, longevity, inflation and investment risks are removed from the scheme. An ETV exercise can remove the longer-term and higher risk liabilities associated with deferred members, in return for offering members higher than normal transfer values. This is particularly relevant for financial services companies that need to hold substantial capital for younger deferred members. With an RTO exercise the DB scheme could benefit from risk reduction without incurring the cost associated with offering enhancements. A successful PIE exercise reduces inflation risk and (to a lesser degree) longevity risk within the scheme.

2 Reduction to buyout cost

Liability management exercises are especially useful where the ultimate objective is to buy out the scheme's benefits. In ETV and RTO exercises, liabilities are typically settled on cheaper terms than if bought out with an insurer. PIE exercises may also have a positive impact on buyout or buy-in costs as insurers will typically quote better terms for pensions that are not dependent upon future levels of inflation. Running an early retirement exercise before purchasing bulk annuities also acts to increase the number of members who can be included within the transaction, helping to accelerate the de-risking journey. Buying annuities for very small pensions can be very expensive and an initial trivial commutation exercise can help to avoid this scenario.

3 Improvement in funding positions

Liability management exercises can reduce the volatility of the future cost of the pension scheme on funding and accounting measures. Depending on the terms offered and market conditions at the time of the exercise, funding deficits may reduce. Both ETVs and RTOs reduce the size of the pension scheme, both in terms of assets and liabilities. As the size of the scheme decreases the monetary impact of any volatility is reduced, making market movements in the funding position less material to the employer.

4 Reduced operational costs

Successful ETV and RTO exercises will reduce the headcount of the scheme, leading to lower administration fees and PPF levies. A trivial commutation exercise can also help to reduce the headcount, focusing on those members where the administration costs are disproportionately high compared with the size of the liabilities.

Key considerations for running a successful liability management exercise

The Code of Good Practice

In June 2012 an industry working group published the Code of Good Practice for Incentive Exercises, which aimed 'to improve the standard of Incentive Exercises for pensions carried out in the UK, while preserving such exercises as a legitimate tool for sponsors to help manage the liabilities in their defined benefit pension schemes'. The Code sets the standard for well-designed and well-run exercises.

A second iteration of the Code was published in February 2016. Minor updates were made to reflect the changing pensions landscape and the fact that increasingly trustees are leading these exercises, but the key principles remain largely unchanged.

By following the Code companies and trustees can be reassured that their exercise is following best practice.

Which exercise is best for your scheme/company?

Liability management options can be introduced as one-off exercises to achieve a significant change in a relatively short time or as at-retirement offers, which reduce risk more gradually as members retire. Which approach and which exercise is right depends on the objectives of the company and trustees – such as the relative importance of risk reduction, improvements in funding positions and the company's constraints both in terms of the need for upfront cash and the impact on accounting disclosures. The interests of the scheme members will also play a part in this: for example, many members may wish to access the flexibility available to DC members.

Feasibility studies can help decide which liability management exercise or combination of exercises is suitable. They will show how the terms of the offer will impact the scheme and the sensitivity of the outcome to different rates of take-up. These initial cost-benefit analyses can also help decide who to make offers to and whether the offers should be made in phases.

Terms of the offer – a balancing act

There is no single set of correct offer terms for liability management exercises. Offer too generous terms and the company's targeted savings will fail to materialise. Yet ungenerous offers may mean members will not accept the offer.

Willis Towers Watson has developed a number of tools to assist employers and trustees in understanding the impact of proposed liability management exercises.

For PIE offers to pensioners, a key consideration will be whether the offer should meet the 'Value Requirement' set out in the Code of Good Practice. Under the Code independent, impartial advice (leading to a formal recommendation) must be provided to members where the value of the uplift is less than 100% of the value of the benefit being exchanged (measured on the scheme's cash equivalent transfer value basis). Where the value of the uplift is greater than or equal to 100% of the value of the benefit being exchanged, only 'guidance' needs to be provided: here members can discuss the offer with an adviser but there is no recommendation of what they should do. The feasibility study will look at whether it might be better to offer a lower uplift (with potentially lower take-up) with full advice, or a bigger uplift and less expensive guidance.

Do not underestimate the importance of data

Liability management exercises rely on good quality data and more information than may be needed for day-to-day administration. Ensuring that contact details are up to date will increase the population that can be included in the offer. It is also important that everything needed for benefit calculations is all present and correct on members' electronic records to ensure offers can be calculated accurately and efficiently. The time and effort required for this stage of an exercise should not be underestimated.

Communications

One of the key principles of the Code of Good Practice is that member communications are clear, fair, unbiased and straightforward, setting out clearly the company's reason for making the offer and the risks to the member of accepting it. Making sure that members understand the choices they have will also help to minimise any reputational risk for the company.

Engagement with all parties

A number of parties will be involved in the running of a liability management exercise: the company, financial advisers, lawyers, actuaries and administrators. The Pensions Regulator has left no doubt that it would also like trustees to be heavily involved throughout these exercises.

In these complex exercises, which have many moving parts, excellent project management is required to ensure that the whole project stays on track and to budget. These projects require project management skills on two fronts – someone who has the technical expertise to understand exactly what is required and when for the project to succeed, and who can also have responsibility for the wider project aspects to keep everything on track.

Successful ETV and RTO exercises reduce the size of DB obligations. For each member who transfers out, longevity, inflation and investment risks are removed from the scheme.

How can Willis Towers Watson help?

Willis Towers Watson has considerable experience in providing complete solutions covering all aspects of liability management exercises. We believe Willis Towers Watson is uniquely placed to work with you in achieving your objectives for the scheme.

Unrivalled expertise

We can offer unrivalled expertise in designing and implementing liability management exercises across a range of schemes, from the biggest to the smallest.

Market-leading approach

We have a market-leading approach to risk management and have been a pioneer of well-run, best practice exercises that mitigate reputational risks for our clients.

Best practice

We also have a thorough understanding of the implications of UK pensions law, the industry Code of Good Practice and the Pensions Regulator's statement on incentive exercises. Willis Towers Watson provided direct input into the development of the Code and fully supports the principles it sets out.

We also have direct input into the Incentive Exercise Forum, the industry working group established to monitor these exercises and promise best practice.

Relationships with financial advisers

We have an in-depth understanding of financial advisers and their advice models.

Project management

Our accredited PRINCE2 specialist project managers have extensive experience in delivering these complex projects. Many of them also hold pensions industry professional qualifications. By combining experienced pensions professionals with wider project management capability, we are able to communicate with clients using a common language and set of tools.

We have a track record of delivering to time and budget.

Tailored solutions

Most importantly, we are willing to work with you to design and implement the exercise that is right for the company, the trustees and the scheme's membership.

Further information

For further information, please contact your Willis Towers Watson consultant, or

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About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 39,000 employees in more than 120 countries. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

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