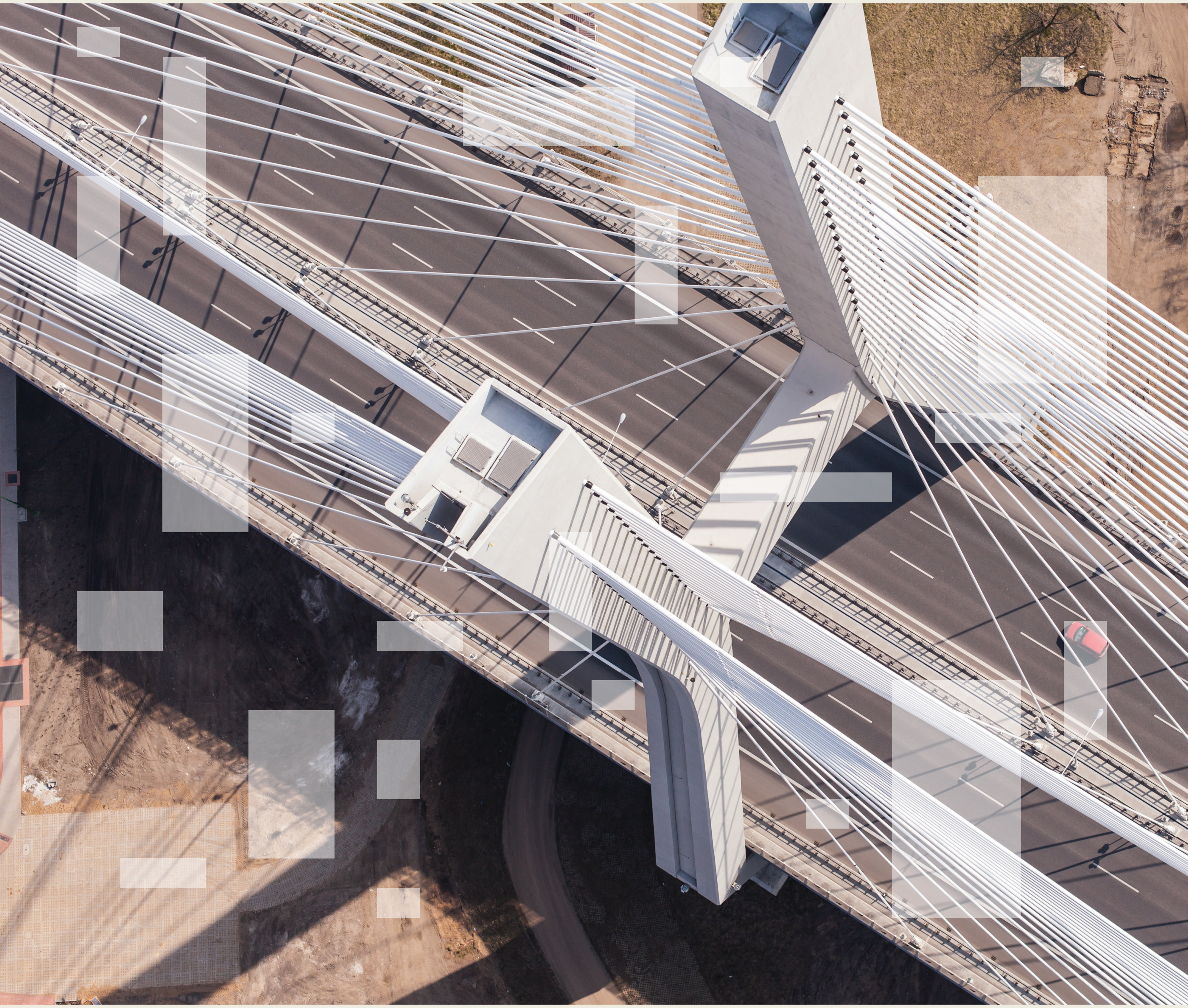
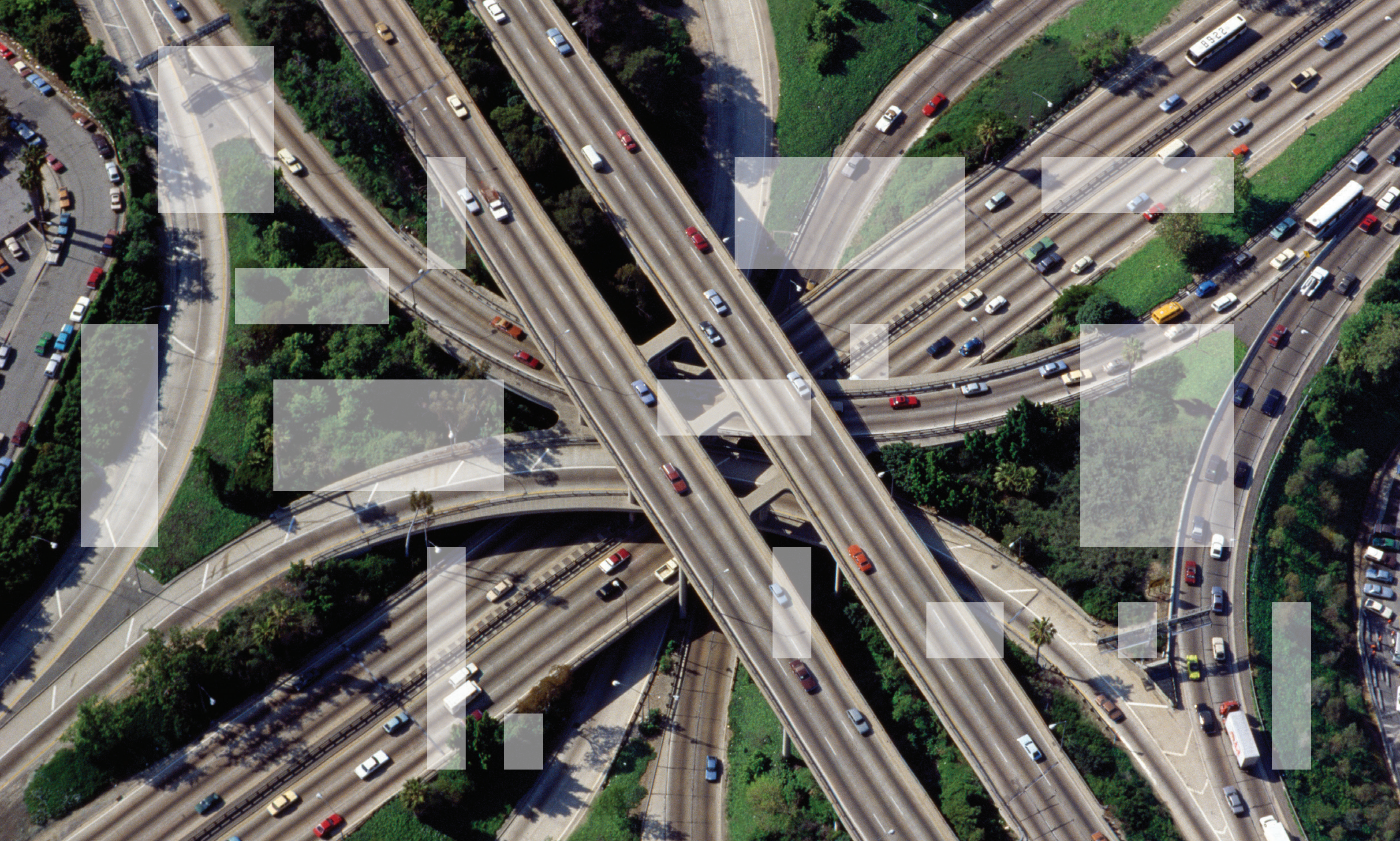


Liability management

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 full funding or to other long-term goals such as 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 two methods of reducing pension risk:

- **Retirement transfer option (RTO)**
- **Enhanced transfer value (ETV)**

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

Retirement transfer option (RTO)

Traditionally, DB schemes have not offered transfers to members at the point of retirement and a member's statutory right to a transfer ceases at normal pension age. Enabling transfers in the period just before retirement may give DB members access to a wider range of retirement options available in DC schemes.

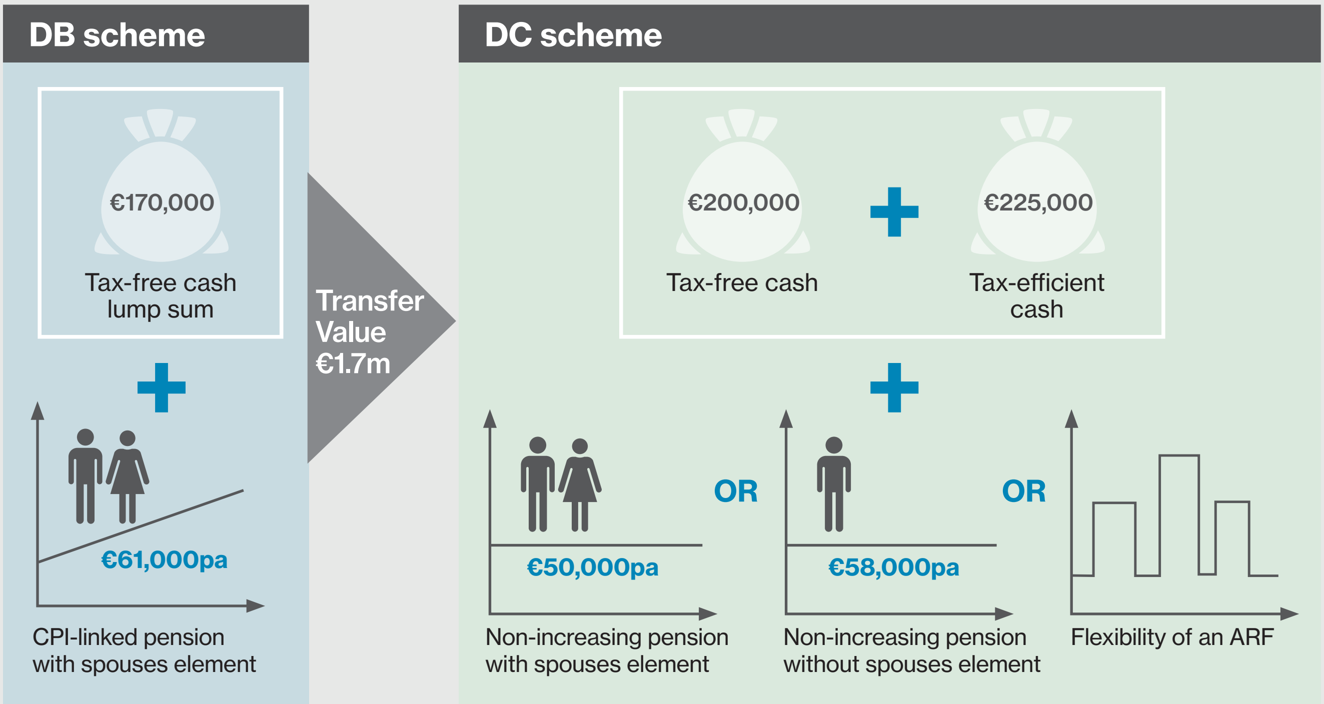
In particular, this option allows members to select benefits that suit their own circumstances, for example their preferred levels of pension increases and spouse's benefits. In addition, members may be able to take a higher tax-free cash lump sum. Whilst not suitable for everyone, this flexibility is 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.

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. **More flexibility for DB members, particularly high earners**

Figure 1. **Example of the options a member could choose through an RTO**



Enhanced transfer value (ETV)

Deferred members often make up a significant part of a DB schemes liabilities. Whilst these members can transfer their benefits to another arrangement, few give this detailed consideration and even fewer actually transfer.

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.

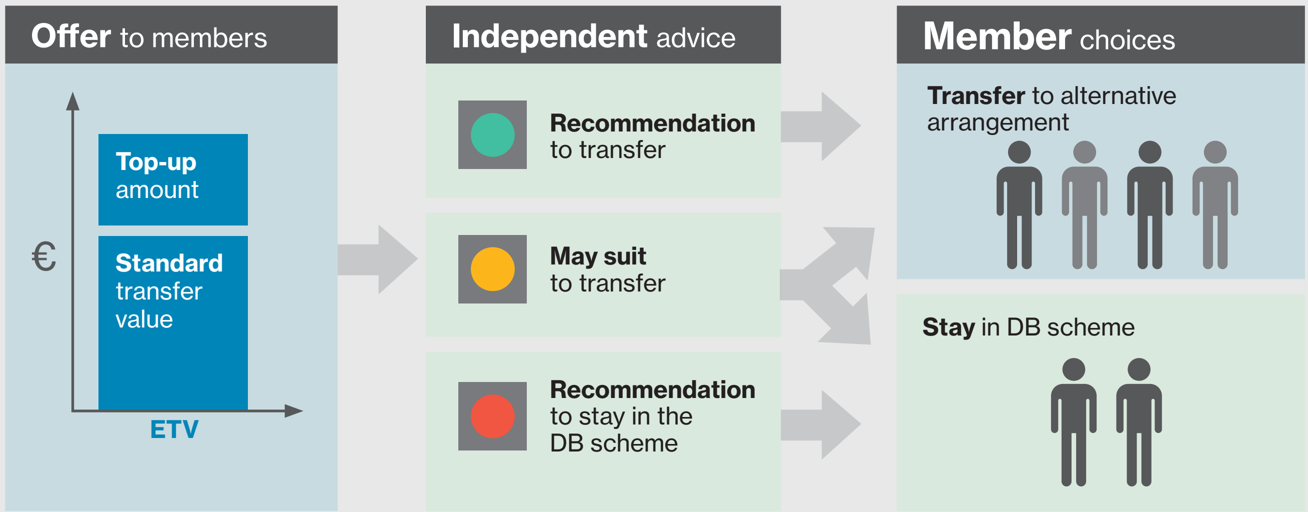
Through enhancing the terms usually offered, and arranging suitable financial advice, more members are likely to consider a transfer. There are many ways that the enhancement could be calculated, from a flat enhancement for all, to one varying with the individual age of the member, or to one that targets replication of benefits on a suitable 'defined contribution (DC) projection'.

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**

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.

Figure 2. **Example of an ETV exercise from the member's perspective**



Other liability management options

There are a few other exercises that schemes could run to help manage their DB pension liabilities as follows:

Trivial commutation

Members with small benefits can take a lump sum instead of their pension, often referred to as 'trivial commutation'. Where a member's pension is less than €330 p.a., this can be fully commuted with any amount in excess of the normal tax-free lump sum being taxable at 10%.

A more wide-ranging option applies to members with total benefits across all pension arrangements with a value of less than €20,000. With member consent, these benefits can be paid as a one-off lump sum, subject to normal tax and PRSI.

In a trivial commutation exercise those members who are likely to qualify for lump sum benefits are identified and then informed of the options available. Members will often prefer to receive a lump sum than small monthly pension payments.

Compulsory transfer value exercise

Under section 35 of the Pensions Act (and associated regulations) the trustees of a scheme may effect a transfer payment from the scheme, without the member's consent, where:

- The transfer value is less than €10,000
- The transfer is not reduced due to the funding level on the Funding Standard
- The member left the scheme more than two years ago

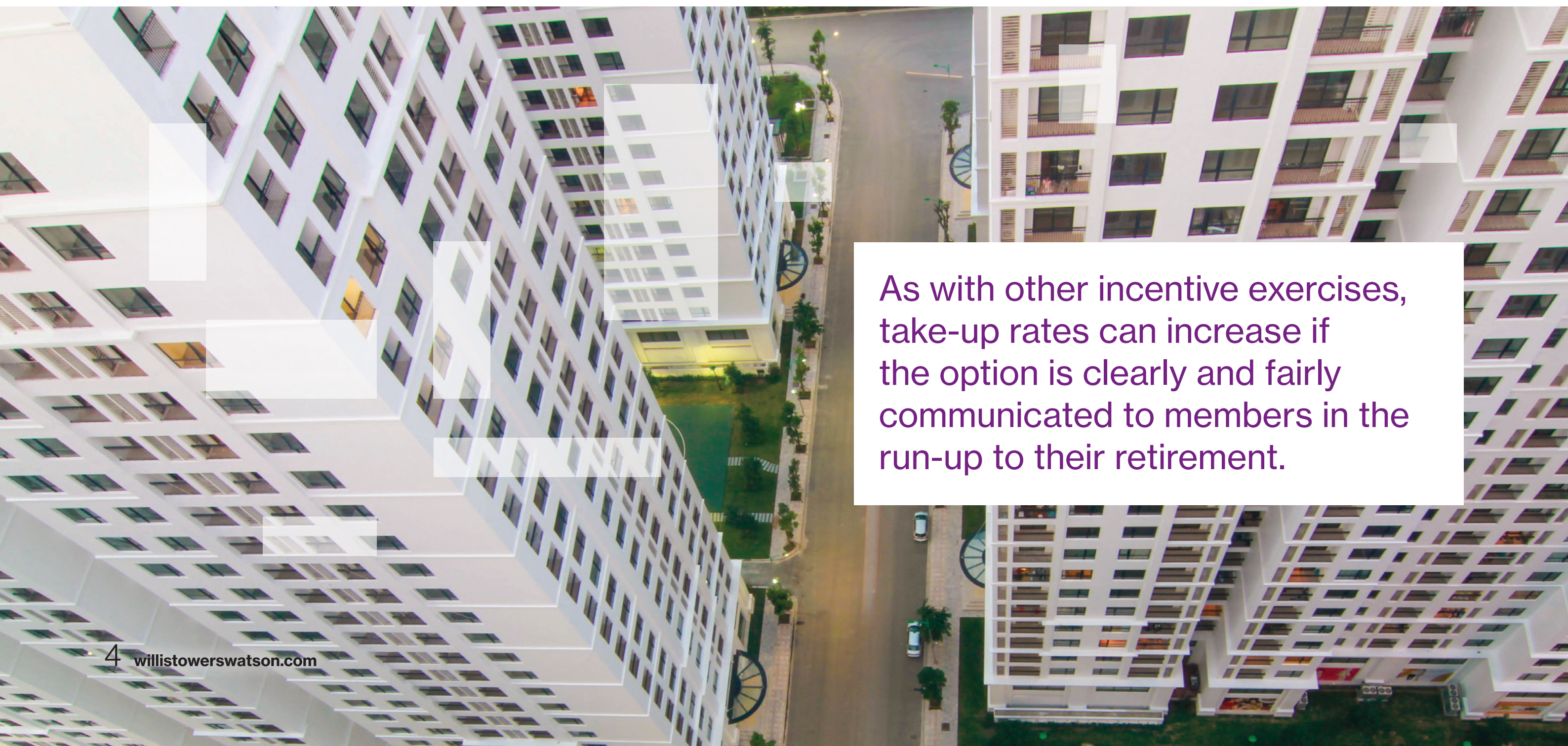
This option can be used to remove small and administratively expensive deferred pensions from the scheme, in circumstances where trustees can be persuaded to co-operate.

Pension levelling option

Changes in the State Pension age mean that members of most DB pension schemes will start to receive their scheme pension before their State Pension. For many members, particularly those with lower pension expectations, those years without any State Pension income may be difficult.

Companies can seek to introduce rules that allow members to surrender a small part of their long-term pension in favour of a larger temporary supplement that is payable until the State pension kicks in. In that way a member's income stays reasonably level over their entire retirement, perhaps enabling them to use their cash sum for the purposes they had previously anticipated.

From the sponsor's point of view there is a benefit that arises from shortening the duration of their liability (which reduces risk) and reducing the longer term benefit (which may lead to a decrease in eventual settlement costs). These effects are more pronounced if the pension levelling option is offered in conjunction with early retirement. As with other incentive exercises, take-up rates can increase if the option is clearly and fairly communicated to members in the run-up to their retirement.



As with other incentive exercises, take-up rates can increase if the option is clearly and fairly communicated to members in the run-up to their retirement.

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.

2 Avoidance of annuity strain

Liability management exercises are especially useful in avoiding the strain of annuity pricing, be it implicit in the Funding Standard measurement or explicit if an annuity is ultimately purchased. In ETV and RTO exercises, liabilities are typically settled on cheaper terms than the cost of purchasing an annuity. Under the Funding Standard this means avoiding the financial strain caused by retirement thus improving future funding levels and, for schemes in a funding proposal, the chances of ultimately meeting the stated objective.

3 Improvement in funding and accounting 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 potentially lower governance costs as well. 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

Willis Towers Watson best practice

ETV exercises carry an exposure to criticism if the design and communication of the offers to members lead to a risk of some members making poor and uninformed choices. Willis Towers Watson in Ireland has developed a set of guiding principles, based on the UK Code of Good Practice, which are intended to assist clients in minimising any such exposures.

By following our guiding principles, companies and trustees can operate liability management exercises with greater confidence and reduced reputational risk, enabling use of liability management as a legitimate de-risking tool.

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.

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.

In these complex exercises, which have many moving parts, excellent project management is required to ensure that the whole project stays on track and within budget.

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 requirements of our guiding principles 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. Trustees should ideally also have significant involvement 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.

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

Our Settlement Solutions team, in conjunction with local market practitioners, 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

Recognising lessons learned and best practice from other jurisdictions, we have developed a set of guiding principles for Irish exercises. In the UK, Willis Towers Watson provided direct input into the development of the industry Code of Good Practice and fully supports the principles it sets out. Our UK colleagues also have direct input into the Incentive Exercise Forum, the UK industry working group established to monitor these exercises and promote best practice.

Project management

Our approach focuses on effective project management to provide a framework for efficiently run exercises and on-time delivery.

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 on time and within 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 40,000 employees serving more than 140 countries. We design and deliver solutions that manage risk, optimize 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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