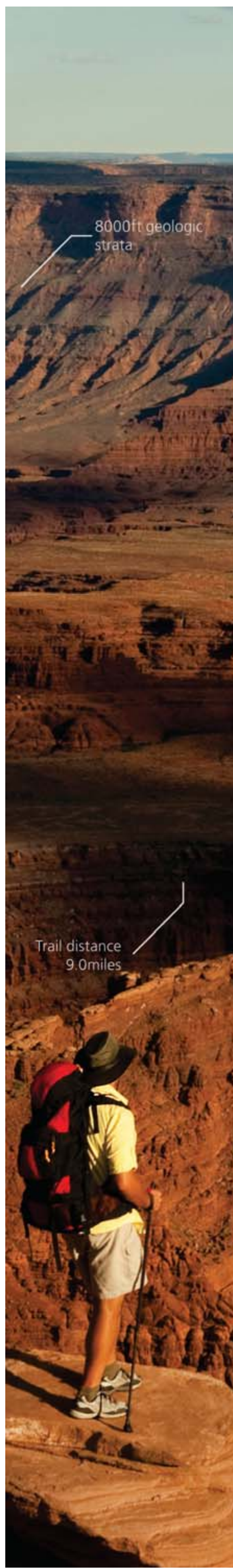
The PCS Alert

The latest in Defined Benefit Pensions

JLT PENSION CAPITAL STRATEGIES



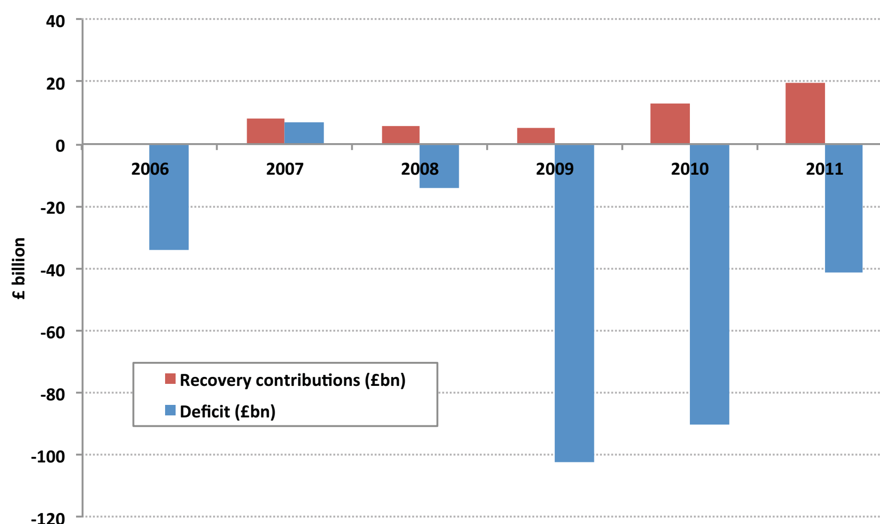
Shareholders – don't let your FDs invest in the pension black-hole!

Dear Sid,

Getting a return on the contributions paid into defined benefit schemes

With the year-end fast approaching, many companies and trustees will be embarking on funding valuations of their pension schemes. For those with January or tax year-ends, the valuation process is likely in full swing. With ever increasing life expectancies, depressed gilt yields and equity markets and the spectre of some chunky inflation on the horizon, it is likely that the contribution requirements on UK businesses will increase again.

This got us at JLT Pension Capital Strategies thinking. Over the five years to June 2011, FTSE 350 companies contributed around £51bn into their schemes, yet the aggregate balance sheet position has worsened by £7bn!



This begs the question: Just what are shareholders getting in return for the contributions that their FDs commit to their pension schemes?

Received wisdom, and practice since time immemorial, is for the contributions to be paid into the pension fund and invested in line with the long-term strategic asset allocation. In many cases this means a large proportion of equity exposure.

This seems strange to us - committing significant capital expenditure to an investment over which you have no influence or interaction. In effect, many FDs are paying contributions to the scheme and crossing their fingers and hoping that one day the assets meet the liabilities. Shareholders should demand more.

There is, however, another way. We believe that liability reduction and management exercises should be treated as a pension scheme investment. The funds committed to the scheme by the company should first be used to carry out some of these exercises. The advantages of this are:

- Successfully run liability management exercises should see the deficit in the scheme reduce; from the trustee's viewpoint, equivalent to a recovery plan contribution.
- The scheme's liabilities should also have reduced, meaning that the quantum of "the pension problem" is smaller.
- Depending on the liability management exercises carried out, the level of risk should have reduced.

- Members will have been given options so that they can get a benefit from the scheme that better suits them.
- The company has not locked away money in the scheme that it cannot get back if pension schemes ever return to surplus. (Another way of achieving this is to use the company's assets (physical or intangible) to provide a securitised income stream to the pension scheme using a SPV structure. Once the preserve only of the very large schemes, these alternative financing solutions can now be cost effective for much smaller schemes.)

We have worked with many of our corporate clients on designing a recovery plan that incorporates the above ideas and is acceptable to the trustees and Pensions Regulator. This involves agreeing a dedicated "pension spend" each year, the first use of which is to carry out annual liability management and reduction exercises. Any spend unused at the end of the year is then paid to the scheme. The exercises give rise to a further reduction in deficit.

JLT's Implemented De-risking Platform is an excellent way of carrying out liability and asset de-risking and management programs in a timely and cost effective way.

The principal liability management exercises that can be carried out are:

- Enhanced transfer value exercises - Members are offered an additional payment (either by way of extra transfer value or cash in hand) if they transfer the value of their benefits out of the scheme. The communication and process are vital to ensure a successful exercise, as is the provision of independent financial advice to the member. These exercises, if implemented properly, are excellent ways to reduce liability, deficit and risk in the scheme whilst giving the member a choice.
- Pension increase exchange exercises - Current and future pensioners are given the option to exchange their non-statutory pension increases for a higher flat pension. Again, this exercise removes risk, liability and deficit in the scheme.
- Early retirement exercises - Members aged 55 or over have the ability to draw a pension but many are not aware of this or that they can continue in employment as well. This exercise involves reminding members of this and is usually combined with the pension increase exchange offer.
- Transfer to immediate vesting personal pensions - Under this option, members over age 55 can transfer out and purchase an annuity immediately. The advantage to the member is that there is no requirement for the annuity to have increases in payment or attaching contingent dependant's benefits. Members can take advantage of drawdown options and the relaxation of annuitisation requirements means that some members can pass on their pensions savings in a tax efficient manner after their death. The member can structure their retirement entirely according to what they need.
- Buy-in – Insurance policies are purchased as trustee investments and match the benefits payable to certain groups of members. These can be bought progressively as funds allow and reduce investment and longevity risk associated with the members covered by the policy.

The return that these exercises can potentially provide makes them look very attractive when compared to the alternative of investing in the scheme and crossing your fingers. FDs don't usually commit to significant spend without there being some potential acceptable return. Why should pensions be any different?

So JLT Pension Capital Strategies is issuing a call to arms to shareholders and FDs: make sure you get something back for the money you spend on your pension schemes. Instead of aiming for the assets of your scheme to one day meet its liabilities, fund and finance your pension schemes effectively so that one day the liabilities will meet the assets!

Yours sincerely

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