

Pensions

Unprecedented times, Exceptional actions

By Munro O'Dwyer



It is always debatable how best to deal with extreme events; however, for employers who provide defined benefit pension benefits for their employees, and for the trustees that oversee these schemes, it is impossible to downplay the magnitude of the financial storms of recent times.

Cashflow pressure

As we move through 2009 employers are seeing pressure on cashflow, exacerbated by the limited access to credit and difficult trading conditions. Underfunded defined benefit pension schemes will need higher levels of cash contributions just when employers are seeking to preserve cash by all means necessary. Trustees are under pressure to secure cash contributions from employers to repair the significant deficits that have emerged, while cash-strapped employers are finding the contribution levels being demanded difficult to afford.

When working through the challenges with employers there are key questions that arise in practically all circumstances:

- ▶ How much cash will the pension fund need?
- ▶ When will the cash be paid and how?
- ▶ What is the risk of bigger deficits, and thus cash and cost?
- ▶ How are risks being managed?
- ▶ How can rising costs be controlled?

Given the current point in the economic cycle, the potential for conflict is high as a result of the significant sums involved.

Trustees want higher cash contributions, allowing deficits to be funded over shorter periods. Employers are seeking to extend recovery plans as far into the future as possible, allowing contribution rates to be minimised. In this environment, and in view of the amounts involved, there is an increasing trend for employers to seek independent actuarial, financial and legal advice to allow them to ensure that their perspective is proactively considered rather than relying on Trustees and their advisors to set the agenda.

Employer control

The employer's approach to negotiating with Trustees is key. Employers are looking to reinvest cash into their business – whether to fund capital expenditure, workforce reduction, or other costs – with a view to ensuring their long-term viability. More employers are now realising the need to engage with Trustees and to highlight the benefit to Trustees of having a sponsor that is viable in the long term. Increasingly employers are engaging the services of independent advisers to develop a 'business plan' that delivers cash contributions that will be acceptable to the pension scheme Trustees, while also recognising the cashflow needs of their business. It is not surprising that

employers are uncertain about where the wider economy is going and how their businesses will be affected: this has a direct impact on the level of pension scheme funding that they are prepared to commit to.

Employers received a temporary reprieve from increases in pension contributions following the market turmoil of 2008 when the Pensions Board allowed an extension to the timeframe within which a plan needed to be submitted to fund deficits in schemes that had become insolvent as a result of asset falls. The extension periods will run out for many schemes at the end of this year, so for employers the second half of 2009 will be a period in which difficult decisions will need to be made as to the future direction of the defined benefit pension schemes that they sponsor.

Non-cash solutions

To avoid placing undue strain on company cashflow, broad business thinking will have to be brought to the table to solve the pension issues that are arising. Employers are considering contingent asset solutions which can enable a compromise to be reached between the security sought by Trustees and the level of cash contributions that is feasible for the business. The

contingent asset is not passed directly to the pension scheme, but instead provides security to the Trustees in the event of an insolvency event or where any step is taken to wind up the pension scheme. Such structures can provide security for pension schemes in the short term while securing extended periods to allow the pension scheme deficit to be repaired. The extended periods for deficit funding mean that short term cash contributions are minimised.

While the solution presents an opportunity for certain employers, there can be challenges in identifying appropriate, unencumbered assets. Equally the solution serves only to buy time. Of itself, a contingent asset solution does not solve anything – where such solutions prove most effective is where the additional time afforded is used to develop a long-term sustainable plan to restore the pension scheme to health.

From the regulatory perspective, where pension schemes are under-funded, the Pensions Board has said that it will allow recovery plans of more than ten years in appropriate circumstances.

The challenge for Trustees in accepting such long-term funding periods will be that schemes will remain under-funded for extended periods of time: how do Trustees reasonably evaluate the risk of insolvency of an employer over (potentially) a 10-year period of a recovery plan?

Trustees will want to safeguard the interests of scheme members but there is a pragmatism there too that will encourage Trustees not to demand contributions which will prove too much from an employer who is struggling.

In light of the foregoing, the need for the employer to come forward with a sensible plan and to drive the agenda is clear. The employer will know what will work best for the business, and a pension deficit funding plan needs to be developed which will accommodate the business needs. Employers want to understand the interaction of the pension funding challenges with their business challenges before a plan is presented back for the consideration of the Trustees.

Liability management opportunities

Many employers, recognising the significant long-term cost that defined benefit pensions create for their organisation, are looking to planning techniques to manage their pension liabilities. Some are seeking to offer 'swaps' to employees to encourage them to take the liabilities off their books.

There are two key opportunities for employers in this area:

- ▶ Increasing numbers of employers are looking to offer 'enhanced transfer values' to former employees to encourage them to transfer their benefits out. In essence, the employer offers a 'top-up' to what the pension scheme Trustees would pay where a former employee looks to transfer their benefits out of the pension scheme. Where the former employee opts for the enhanced transfer value, the investment and longevity risk is removed from the employer. As a risk reduction measure, such an offer is attractive to employers. Equally, in current market conditions, defined benefit schemes have lost their 'guaranteed' tag, so an offer of an enhanced transfer value can be attractive to former employees who may be concerned that the pension scheme will not be there in the future to pay their pension benefit.
- ▶ The second opportunity is more time critical and involves senior individuals within defined benefit pension schemes who are approaching retirement age. There can be possibilities for such employees to draw benefits immediately from the pension scheme – including significant tax free sums. From the employer's perspective, facilitating such a move is attractive as the benefits drawn from the pension scheme reduce the liabilities which the employer is carrying, but a word of warning: the window of opportunity to manage liabilities through this approach is rapidly closing.

In his Supplementary Budget in April 2009 the Minister for Finance



© Clicktrick | Dreamstime.com

signalled a change to pensions later this year:

The Commission on Taxation is examining various aspects of pension tax treatment including the treatment of lump sums and I expect to be dealing with their recommendations in the 2010 Budget next December.

There is a strong suggestion that Tax Free Lump Sum entitlement could be significantly restricted – closing off opportunities for employers and individual employees who are approaching retirement age.

More difficult choices

For a large number of employers, the combination of advice focused on their short-term cashflow needs, lateral thinking around the funding opportunities available and application of certain liability management techniques will sufficiently manage the challenges of funding their defined benefit pension schemes. Such measures will not be sufficient for all.

Against that, previous court judgements offer support for employers. A ruling in a key UK case notes, in terms of Trustee cash



demands, that ‘...they must be careful not to impose burdens which imperil the continuity and proper development of the employers’ business or the employment of the members who work in that business.’

So what will emerge in the pensions landscape post- 2009?

The *PricewaterhouseCoopers 2009 Pension Survey* identifies that, in almost all cases, employers are giving active thought to reducing the risk that their defined benefit schemes present. A range of options is being considered – most commonly:

- ▶ ceasing future accrual of benefits,
- ▶ freezing or capping pensionable salary,
- ▶ removing certain benefits such as pension increases, and
- ▶ winding up the arrangement.

Given the wider business challenges, there is a broad move across employers to remodel pension arrangements to target a more cost controlled arrangement being provided into the future, albeit this will mean that lower levels of pension promises are made to employees.

Defined benefit schemes, where appropriately designed, do provide a valuable insurance to employees as

the risks in terms of the level of pension income that is to be provided are pooled (unlike in a defined contribution scheme where each employee is impacted directly by the performance of their investments held). As the employer is meeting the cost of any under-performance or negative experience, and bearing the risk, the challenge is to develop an arrangement that is supportable and sustainable in the long term. In essence the choice is often to provide 100% of the benefit with 80% certainty, or to provide 80% of the benefit with 100% certainty.

Given the subject matter at hand – retirement, old age, financial security – and against the current backdrop of a more uncertain world, there is a move to increase certainty of delivery of the pension promises that are being made.

Implementing change

Rising unemployment, salary freezes and salary cuts, and generally lower job security are part of the current working environment. In many businesses, the choice to be made is between jobs and salary on the one hand, and pensions on the other, and

when this trade-off is effectively communicated, employee ‘buy-in’ is significantly easier to obtain, in relation to future benefits to be earned, and also to non-core benefits such as pension increases.

The key is the communication process. The business drivers for the changes should be made clear, and the outcome from the changes should be made clear also – a pension arrangement that is more appropriate and affordable for the business, and a business that has a more appropriate cost structure. Clarity needs to be provided to employees at every step, and properly managed, positive change can be delivered.

Regulatory changes

Pension legislation was historically designed to protect the interest of pension scheme members. Reacting to the investment market conditions of the past 24 months, the Government’s response has been to amend pension legislation to make it easier to reduce the benefits of current employees and those who have left employment but have yet to retire. The changed legislation also facilitates the removal of future pension increases to current pensions in payment.

Taking advantage of the legislation changes is not without challenge – the guidance provided by the Pensions Board notes that what is required is a fundamental review of the scheme, that all options have been considered. Trustees need to be of the view that an application to reduce benefits is in the best interests of the members.

In many respects all roads lead to the same place: for employers who sponsor defined benefit pension schemes, there is a need for an assessment of what is being provided in the context of where their business has moved to in 2009 – with a view to moving to a solution that is sustainable and affordable in the long term.

Munro O’Dwyer is a pension actuary and Director of the Pension Advisory & Solutions Group at PricewaterhouseCoopers.

Hear an interview with Munro O’Dwyer on the *Accountancy Ireland Podcast* www.accountancyireland.ie

