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Closed DB Schemes

"Managing Your Escape Route"

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Pensions Austerity 2013

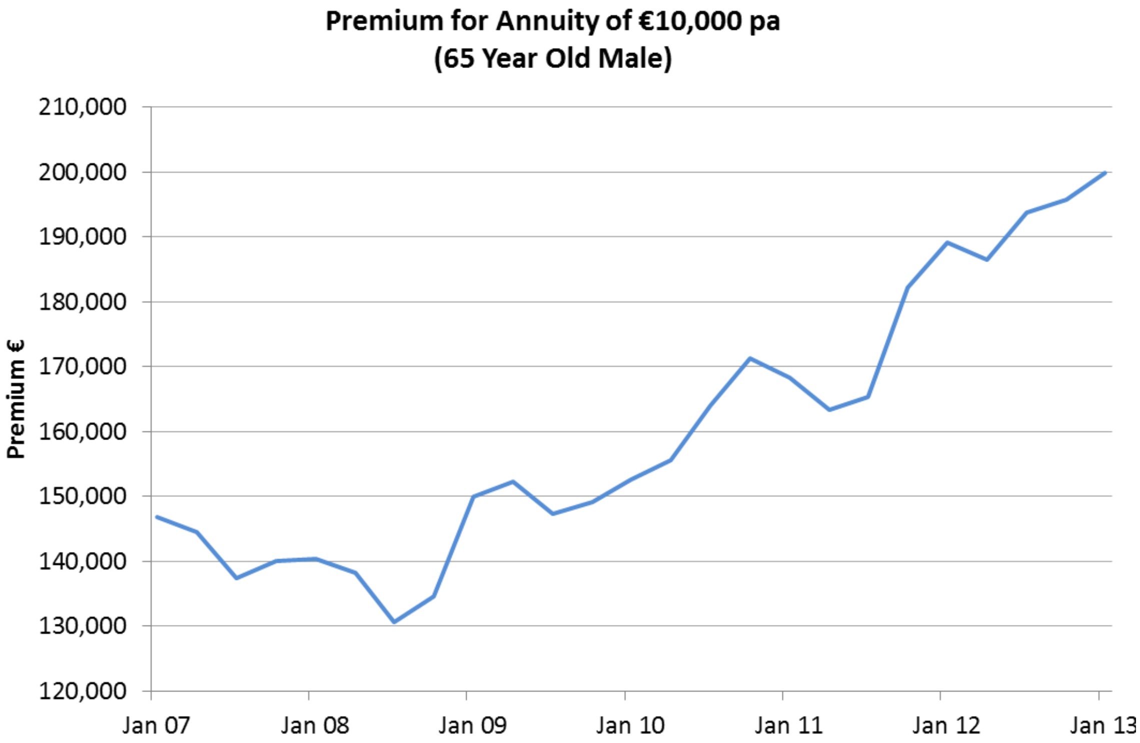
- Next 6 months could see a seismic shift in the pensions landscape
- 80% of DB funds are in deficit
- 30th June 2013 deadline for funding proposals
- Potential change in priority order
- Sovereign annuities
- Stakeholders in conflict

Outlook for DB schemes

Harsh medicine to be administered:

- Benefit reductions
- Increased member contributions
- Increased sponsor contributions
- De-risking from current investment policy
- Cost of operating schemes increases
- Annuity costs at all time high
- Stakeholders in conflict

Background



- Annuity rates have increased by more than 50% since 2008.
- Typical bond portfolios did not perform in the same way.
- Falling bond yields also impacting expected returns.

Conflicts of Interest

Stakeholders to be considered:

- Plan Sponsor
- Trustees
- Active Members
- Deferred Members
- Pensioners
- Senior Executives who act as Trustees
- Advisers

Managing Conflicts of Interest

When starting out on a restructuring path:

- Review the Management Roles
- Review the Trustee Roles
- Ensure the Plan Sponsor and the Trustees have their own professional advisers in place.

Difficult decisions will be made and some will be legally challenged:

- Process followed will be as important as whether the correct decision is reached.
- Separate, independent legal and actuarial advisers for the trustees and the employer are therefore essential.

UK Pensions Regulator

- The UK Pensions Regulator guidance to trustees on managing adviser conflicts advises that

> ***"There are two main types of adviser conflicts that may arise:***
>
> ***1. an adviser may have a conflict of interest if he or she (or the same firm) is also advising the employer or, in certain circumstances, acting for another scheme or employer with whom the trustees are engaged e.g. an actuary, auditor or lawyer; and/or***
>
> ***2. advice provided by the adviser is biased due to financial or non-financial benefits derived by the adviser, or the adviser's firm."***

- Institute and Faculty of Actuaries (UK) is introducing new regulations in 2013 which will effectively ban actuaries from advising both the employer and the trustees of a pension scheme where the advice relates to the funding of the scheme or has a direct bearing on the benefits payable under the scheme.
- It is unclear whether this ban will extend to Irish members of the Institute and Faculty of Actuaries but, in any event, it is best practice for separate advisers to be appointed.

Closing your DB scheme or wind up?

- What do Trustees need to consider ?
- Review the Trust Deed and Rules to consider the available options
- What triggers a wind-up?
- Is there a deferral option and should it be exercised?
- Should the scheme be maintained?
- Should / can the Trustees demand contributions?
- Should the Trustees negotiate or just demand?
- Run the DB scheme as closed fund?

Why defer a wind up?

- Priority order expected to change leading to a different / more equitable carve up of the assets
- Funds may end up being diverted away from pensioners to active and deferred members
- Long-term interest rates at historical lows / annuity prices at all time highs
- Capacity / competition in the bulk annuity market is limited
- Pensions may be secured using sovereign annuities if market develops
- Avoid fire sale of the assets
- Illiquid assets
- Outlook for current investments?
- Manageable hurdle rate?
- Section 50
- Could the Sponsor contribute in the future if trading conditions improve?

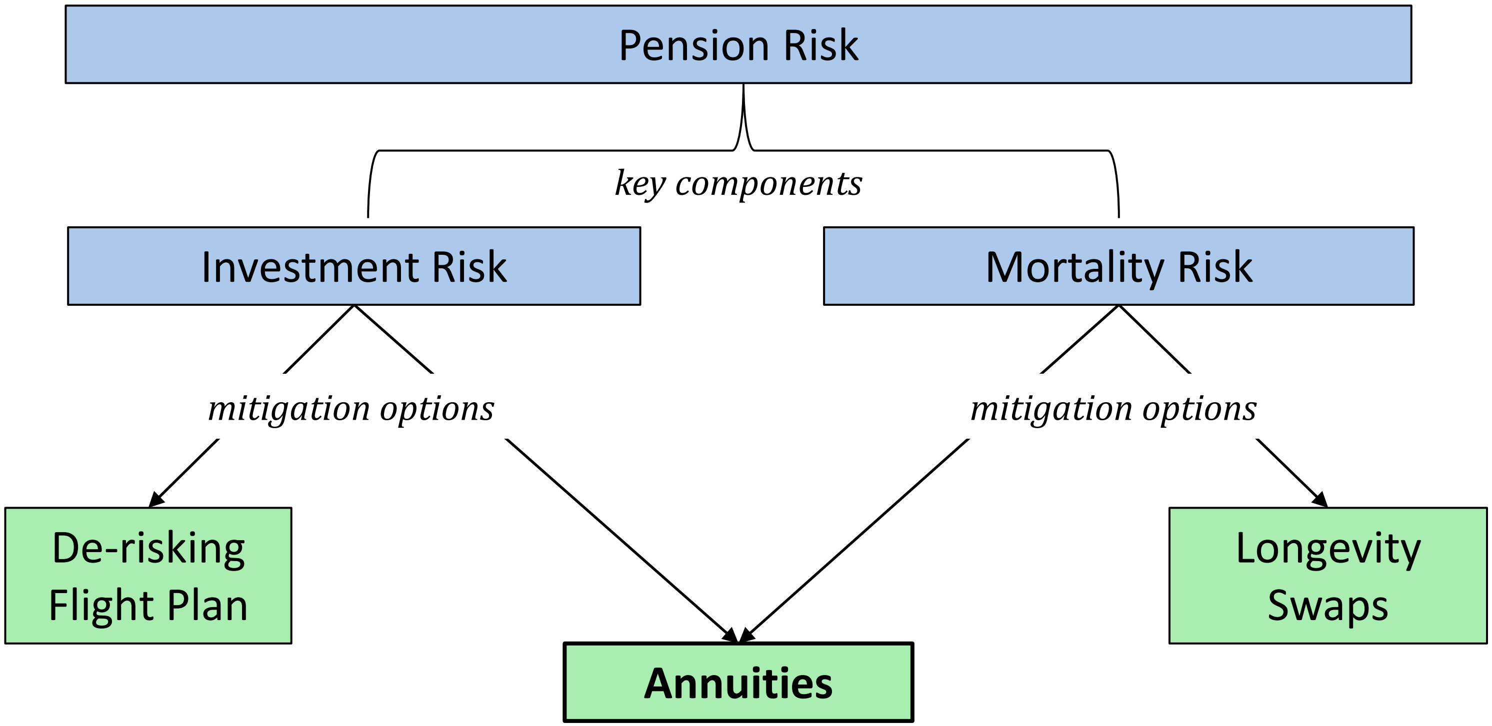
Why defer a wind up?

DB schemes have key advantages:

- Risk Pooling
- Risk Sharing
- Time Continuity
- Economies of Scale
- Economies of Scope

Transferring Risk with Annuities

Pension risk is transferred from the scheme to the insurer:



The key question is price: with interest rates low and markets volatile, it can cost a lot to offload long-duration pension liabilities.

How the Premium is Determined

- The premium for an annuity consists of:
  1. The expected cost of providing the future pension payments.
  2. Administration costs of paying pensions.
  3. Asset management costs.
  4. The cost of guaranteeing the pension payments (solvency margin).
  5. Profit for the insurer.

- The premium is greater than the current expected cost of meeting the benefits through the scheme, because the scheme does not have to guarantee the payments or make a profit.

Value for Money

- The decision for the trustees is whether the extra cost of insuring, above the expected cost of providing benefits through the scheme, is worthwhile.
- Underlying return on current annuity pricing <1% using Standard Transfer Value mortality assumptions
    - German Long Bonds – 2.4%
    - French Long Bonds – 3.2%
    - Irish Long Bonds – 4.6%
- Long term investment hurdle rate for the pensioners is not challenging!

Value for Money

- MFS liability increases by 8% to 9% p.a. over the term to retirement for a deferred member with 15 years to retirement and more for older deferred / active members.
- Very challenging investment hurdle rate!

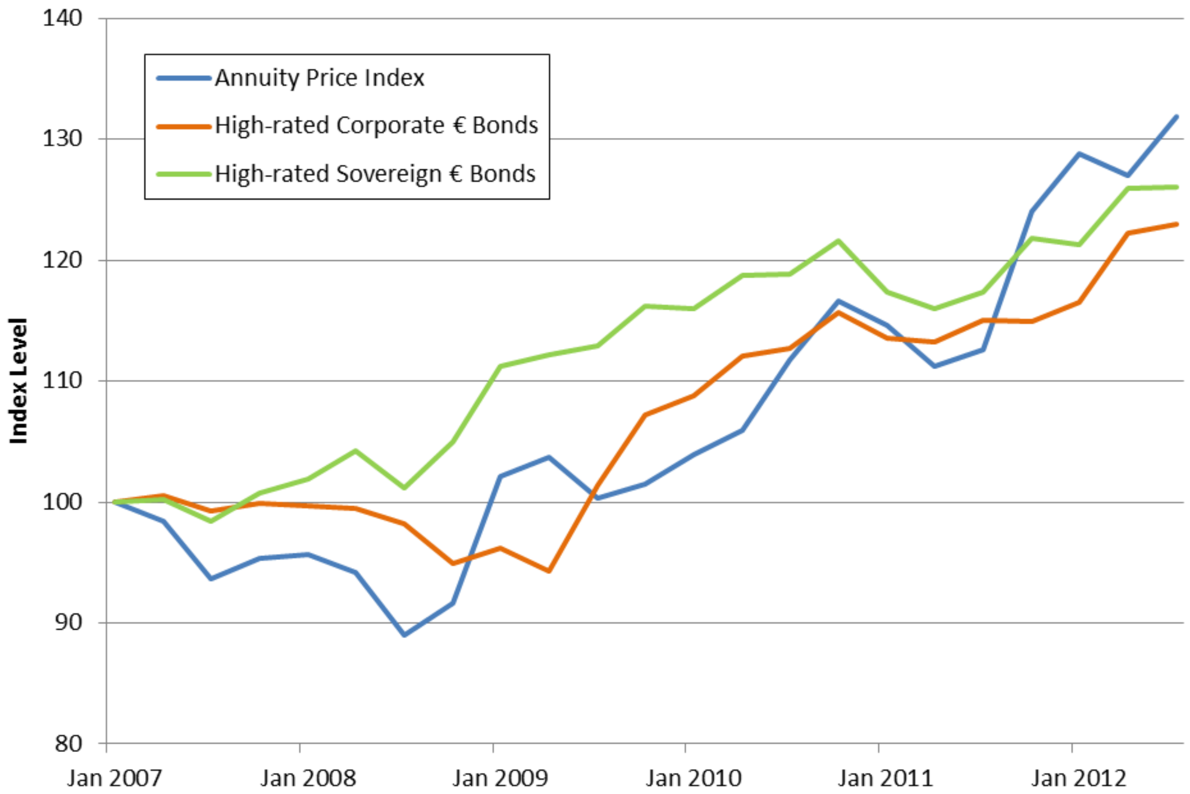
- Demographic profile of scheme and split between pre- and post-retirement liabilities will determine scheme specific hurdle rate.
- The hurdle rate can vary over time so projections can show periods in the scheme lifecycle where wind-up may be more opportune.

Timing of Decision

- The attractiveness of an annuity purchase will vary over time, as insurers' premiums and the cost to provide the benefits through the scheme vary.
- Make a plan and be ready to avail of market opportunities.
- Difficulties liquidating assets may delay purchase.
- Difficulties obtaining additional contributions due from sponsor may delay purchase.
- Set trigger points based on annuity premiums and compare to either:
  - The cost providing the benefits through the scheme, i.e. the current minimum funding liability.
  - The cost of constructing an asset portfolio which will very closely match the liabilities, with a large margin for error.

Timing of Decision

Monitor the affordability of annuities by comparing the cost of annuities versus the performance of the fund



Bulk v Individual Annuity Pricing

- Selection
- Health
- ‘Amounts’ mortality
- Underwriting
- Unisex rates
- Administration costs
- Profit margin / competitive pricing

Any strategy to use annuities for de-risking should aim to preserve the bulk annuity pricing advantage.

Alternative Approaches to De-risking

On the Assets side:

- Reduce investment risk
- Obtain contingent asset / employer undertaking
- Increase funding

Addressing both Assets and Liabilities:

- Offer enhanced transfer values (ETV’s)
- Wind-up scheme

On the Liabilities side:

- Reduce benefits
- Longevity swaps
- Captives

The approaches set out above do not exclude the possibility of purchasing annuities at a later stage, and may indeed provide good stepping stones towards a purchase.

Summary

- Buy-out of pensioner liabilities unaffordable at present.
- Limited offset from sovereign bonds / annuities in cases where funding proposals are required and subject to onerous administrative requirements.
- Combination of historically high annuity prices and unchanged priority order leaves actives and deferred pensioners exposed.
- Legislation might change in the future.
- With volatile conditions, windows of opportunity may emerge to secure annuities. Trustees should consider what they would do if such an opportunity arose.
- Trustees need a framework to exploit such opportunities.

Conclusion

- Consider all options.
- Carry out a data cleansing exercise.
- Take independent advice.
- Identify what capital could be burnt.
- Have an open mind to solutions.
- Communicate with all stakeholders.
- Devise a strategic plan and a framework with a road map to exit.

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