**Responding to Proposals for Scheme Changes: Tools for Trustees**

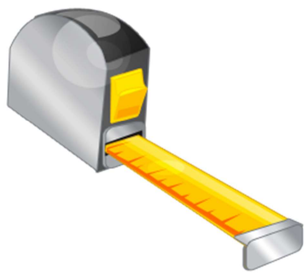
## Are schemes still closing?

| Percentage of schemes | Extended Purple 2007 | Purple 2008 | Purple 2009 | Purple 2010 | Purple 2011 | Purple 2012 |
|---|---|---|---|---|---|---|
| Open | 36% | 31% | 27% | 18% | 16% | 14% |
| Closed to new members | 45% | 50% | 52% | 58% | 58% | 57% |
| Closed to future accruals | 16% | 17% | 19% | 21% | 24% | 26% |
| Winding up | 2% | 2% | 2% | 2% | 2% | 2% |
| **Total** | **100%** | **100%** | **100%** | **100%** | **100%** | **100%** |

Source: PPF / The Pensions Regulator

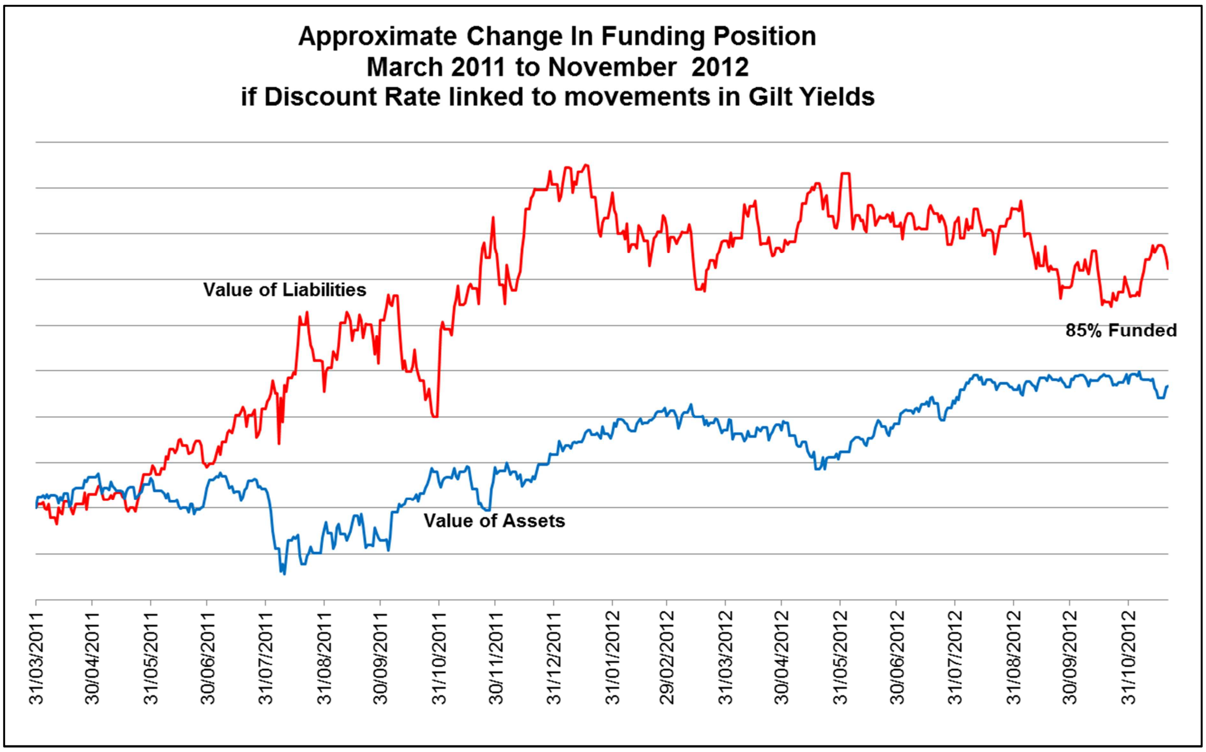
There is certainly room for debate on whether trustees should object to scheme closures. Some might argue that as the trustees are primarily responsible for accrued benefits, they should have no interest in future service benefits. To go further, they might prefer a scheme to be closed as this could mean more of the employer's resources are available to meet past service benefits and the employer is not taking on any additional risk. But it is equally sensible to point out that trustees are appointed to run the scheme as it stands and have a legitimate interest in understanding reasons for any proposed amendments and protecting members in these situations.

## Tool 1: The Tape Measure



It is important that decisions about the long term future of pension schemes are made on sensible bases. This is a particular issue at the moment because of the impact of Quantitative Easing on gilt yields.

Over the recent past, it has been common to set the expected rate of return on growth assets as the rate of return on gilts plus an expected level of outperformance. This "gilts plus" approach may not be sensible when the rate of return on gilts is depressed by Government buying gilts and pushing up prices so reducing yields. The graph below shows the effect Qualitative Easing has had on funding levels if liabilities are measured using a gilts plus approach.




There is a strong argument that the effect of QE has been to break the tape measure. So the first considerations must be whether decisions about the long term future of a scheme are being taken on an ill informed basis where the actual long term position of the scheme is distorted by current markets.

As well as affecting past service valuations, the effect of QE on the cost of accruing benefits can be significant. For a valuation at the end of 2011, the same benefits might cost 30% compared to 20% at the end of 2008. This result is in part because the assumption in most valuation approaches is that future contributions will be invested at the rates currently available in the market. This is a questionable assumption and it is certainly possible to argue that different approaches should be taken in considering the long term costs of a scheme.

The first step for trustees and negotiators has to be to consider whether the valuation result is reliable or whether further consideration needs to be given to setting the valuation assumptions given the effects of QE.

## Tool 2: The Plane

In cases, where it is clear that the combined effect of the deficit contributions and the cost of ongoing benefits is beyond the scope of affordability for an employer, there are alternatives to the knee jerk reaction of replacing reasonable db with inadequate dc.

A sensible first approach is to consider "shaving" the levels of db benefits being provided. We have seen a number of approaches taken over the recent past including:

a) Increasing member contributions
b) Increasing retirement ages
c) Changing from final salary to CARE arrangements
d) Reducing accruals
e) Introducing risk sharing mechanisms (eg longevity adjustment factor)
f) Reducing pension increases (and revaluation)

All of these are sensible reactions to the increasing cost of schemes which change the level of befits accruing in the future but which don't affect the benefits already accrued.

There have been some rather more aggressive approaches to reducing benefits including transfer value exercises, pension increase exercises, introducing caps on future increases in pensionable pay and switching pension increases from being linked to RPI to CPI. These changes, which affect benefits members have already built up, are perhaps more questionable.

The table below shows indicative costs for schemes with different benefit designs:

| **NRA** | **60** | **65** | **65** | **66** |
|---|---|---|---|---|
| **Final salary / CARE** | FS | FS | CARE | CARE |
| **Accrual** | 1/60 | 1/60 | 1/80 | 1/80 |
| **Pension Increases** | RPI max 5% pa | CPI max 5% pa | CPI max 2.5% pa | CPI max 2.5% pa |
| **Cost** | 37% | 26% | 15% | 14% |
| **Member Contribution** | 6% | 10% | 7% | 6% |
| **Employer Cost** | 31% | 16% | 8% | 8% |

**Tool 3: The Saw**

In cases where limited reductions in db benefits are not sufficient to make the scheme affordable, more major changes may be required. In these circumstances, the changes could include:

a) Contracting back in to the State Second Pension
b) Reducing the accrual rate significantly to 1/100th or below
c) Changing from a pension accrual to a cash balance arrangement
d) Perhaps introducing dc provision alongside this low level dc arrangement to provide additional benefits without exposing the employer to additional risks.

An example design might be a 1/120$^{th}$ accrual final salary scheme with benefits payable at 65 with member contributions of 8%. The employer pays the balance of costs of the scheme (which might be 5%) but also pays a 5% contribution to a dc arrangement for each member. At retirement, the member can transfer the dc pot into the scheme, provided they then take it out as a tax free lump sum – so they reduce the need to commute their db benefits to provide cash.

A point to be made to employers considering closing db accrual is that once the db scheme is closed, there is no option of asking members to share in the pain of ongoing db – for example by asking them to pay more, give up past service benefits or sacrifice a limited period of accrual.

**Tool 4: The Sledgehammer**

Often trustees are given fairly sweeping powers in limited circumstances. As an example trustees may be given the power to wind up the scheme if the employer ceases contributions or ends accrual of benefits in the scheme. The difficulty is often that exercising these powers would have a dramatic effect on the sponsoring employer - triggering a wind up debt which in some cases would be sufficient to bankrupt the organisation.

It is rarely sensible for trustees to exercise these powers but in cases where they do have them, the trustees can use this as a lever to improve the offer from the employer – either in terms of the future benefits for employees or in the deficit contributions to be made by the employer to improve the security of accrued benefits.

**Tool 5: The Trowel**

In those worst case scenarios where the battle has been lost and the scheme is closing to accrual, there are a number of steps trustees can take to make sure no cracks appear in members benefits as a result of the closure.

The first is to get the best revaluation for member benefits in the period between scheme closure and retirement. When members chose to leave schemes, they often get the minimum level of statutory revaluation of CPI subject to a maximum of 2.5% per annum. As scheme closures are not a result of member choice, there is a strong argument that higher revaluation should apply. Indeed in some schemes, it is not possible to remove the link to final salary. Trustees should consider arguing for higher levels of revaluation than the statutory minimum – if not a salary link then a link to full cpi or rpi.

The second is to make sure that member options are not lost on the closure of the scheme. Many schemes pay a benefit on ill health retirement of the benefits accrued in the scheme (paid unreduced) plus all or part of the future benefits they could accrue. Whilst it is understandable that if future accrual is removed, ill health retirees should not have the benefit of future service, there is no reason why any member who remains in service with the employer should not continue to have access to their accrued pension on an unreduced basis in the event of ill health. Other options which should be retained in the event of scheme closure are options to draw down part or all of the benefits early.

Another option to consider is AVCs. It might seem counterintuitive to allow members to pay AVCs to a closed scheme but in some cases, stopping paying AVCs can mean the member experiences some financial loss such as the loss of guaranteed annuity rates or the imposition of a penalty. A slightly wider point is that continuing to pay AVCs to the closed schemes rather than redirect contributions to a new dc arrangement may be better for the member in arranging tax free cash at retirement.

On this last point, it is helpful to think carefully about the effect on members of having split pension provision. If new dc provision is within a contract based arrangement or a separate occupational scheme, the member will have the tax requirement applied separately to each scheme. So if they want to take cash, they would take one quarter of their dc arrangement as cash and use the rest to buy an annuity. At the same time, they will be commuting one quarter of their db benefits for cash and taking the rest as pension. So the member is hit by the double whammy of commuting db benefits at very low rates and having to buy annuity with a dc pot at very high rates. A simple solution is to allow members to transfer dc pots into the scheme at retirement, provided they immediately take them out as tax free cash. The transfer in means the tax requirements operate across all provision.

**Tool 6: The Hard Hat!**

The other thing trustees need when discussions on closing a scheme are taking place is a hard hat! It is very difficult to get caught in the middle being blamed by both the members and the employer for the demise of the scheme whilst at the same time being pressured by the Pensions Regulator to demand more money or security from the employer. It can also sometimes be difficult trying to balance the members' desire for security of benefits with their desire for ongoing accrual of benefit. Here the priorities of pensioners and active members can be quite different and fulfilling one's duty to all of them can be difficult. Two important things to do are to take advice and to make sure you communicate with members. Trustees almost never meet with members these days and planet pensions is perhaps the worse for it.