

Scheme Benefit Changes & Closure to Future Accrual

The expense of providing defined benefit (DB) pensions is proving onerous for UK businesses. Employers have found the associated costs to be higher than anticipated due to increasing life expectancies, low investment yields, and increasingly complex legislation. For those DB schemes that remain open to future accrual, changes to future service benefits may be necessary to keep costs at a sustainable level.

There are several key reasons why companies will currently be considering their options with regard to future service benefits for DB schemes.

- Amendments to legislation over time have had the effect of increasing the level of guaranteed benefits whilst correspondingly adding layers of complexity and cost to DB arrangements.
- DB pensions have become less tax efficient for higher earners and for scheme members with longer service due to changes in the annual allowance and lifetime allowance regimes.
- With the introduction of the single-tier State Pension, the abolition of contracting-out for DB schemes (effective from April 2016) is expected to give rise to widespread benefit reviews - approximately 83% of schemes open to future accrual are contracted-out (source: NAPF 2012 annual survey); for those schemes, both sponsoring employers and active members will no longer be eligible for a National Insurance (NI) rebate. This is expected to increase employers' NI costs by around 2.5% of active member salary roll. The action taken will vary depending on the circumstances of specific employers and their schemes, but all those affected should consider their options as soon as possible.
- With the advent of auto-enrolment, some employers may see a substantial increase in pension scheme membership and the corresponding contribution requirements. Companies with fixed or tightly restricted budgets may need to consider a lower cost scheme than they offer currently.

DB or not DB?

A large DB scheme can add significant volatility to the balance sheet. For example, in 2012 there were 33 companies in the FTSE350 with pension deficits exceeding 20% of shareholders' funds. This has an inevitable impact upon corporate decision-making by putting a strain on cashflow and potentially hindering transactions and restructuring.

Trends in employment culture have also resulted in a move away from the paternalistic model which DB schemes envisaged by rewarding employees for 'life-long' service. As individuals move jobs with increasing frequency, the traditional final salary pension can seem inefficient to employers and employees alike.



Changes to future benefit accrual

The potential savings from making changes to future service benefits will depend on the exact makeup of the scheme's active membership. The main determinants will be the length of past service, term to Normal Retirement Age (NRA), and expected salary progressions (both inflationary and promotional).

We would typically run calculations of potential cost savings at the level of individual members, then amalgamate these to give an overall result. However, reasonable estimates can also be derived from summary scheme information if necessary.

We would expect that in the run up to April 2016, many employers will wish to consider the impact of the end of contracting-out upon the future service costs of their DB schemes. The remedial changes to offset the increase in NI costs can be very simple, e.g. increase employee contributions or reduce the accrual rate. However, many employers will wish to undertake a more fundamental review of future service, including the possibility of closing to future accrual.

In considering the available options, employers will need to balance future sustainability (i.e. affordability) against the ability of members to retire on the benefits provided.

To assist employers in this regard, we can estimate the change in future service costs and member benefits for all potential benefit changes. Some examples with illustrative cost savings are set below:

- Increasing NRA from 65 to 68 is likely to reduce future service costs by around 15%
- Reducing accrual from 60ths to 80ths is likely to reduce future service costs by around 15%
- switching to a Career Average Revalued Earnings (CARE) scheme is likely to reduce future service costs by around 10%

Further examples of common future service benefit changes include the following:

- linking NRA to State Pension Age (SPA)
- capping pensionable salary increases
- reducing pension increases or spouses' benefits
- cash balance scheme

In addition, employers may wish to explore the introduction of cost saving at-retirement options such as a pension increase exchange (PIE), or transfers out of the scheme to a personal annuity at the point of retirement. The latter involves the use of Independent Financial Advisors (IFAs) to assist members in reviewing annuity options which might better suit their requirements than the scheme pension.

The option is most popular with those members who prefer a non-increasing or single life pension, or those who can obtain an enhanced annuity based on lifestyle factors. The option not only provides a saving for the employer against the expected cost of providing benefits through the scheme, but also helps to reduce the size and risk level of the scheme.

Further possibilities for delivering future service benefits may present themselves through the Department for Work and Pensions' (DWP) review of workplace pensions. This might allow for the removal of spouse benefits, discretionary indexation or other "DB lite" structures. However, this will require primary legislation to be enacted and would likely only be a consideration in the medium term.



Closure to future accrual

Though a significant undertaking, many schemes have taken the decision to close their DB schemes to future accrual over the past decade. The gains from doing so are self-evident: closure to accrual will reduce future service costs for employers and furthermore may produce a one-off reduction in liabilities if the link to future salary increases already allowed for within scheme funding calculations is broken.

The ability to break salary links for past service benefits will depend on the wording of the scheme rules and contracts of employment. If contracts of employment need to be changed, this can sometimes be achieved amicably, but it may require tough negotiations especially if there are trade unions involved. Some employers may choose to retain the salary link for past service benefits, so that any changes to the definition of pensionable salary affects only future service.

Alternatives to breaking the salary link include:

- a cap on annual increases in pensionable salary
- freezing pensionable salaries
- a CARE structure, so that benefits earned each year are based on that year's salary plus inflation indexing up to retirement

When a DB scheme is closed to future accrual, a new scheme will be required to provide future service benefits and this would typically be a defined contribution (DC) arrangement.

DC schemes are far simpler to design and operate than DB schemes, but there are still many important decisions to be made and ongoing governance requirements.

Some phasing-in may be appropriate to ensure that the members closest to retirement are not left with extremely small DC pots which can offer poor value for money in the open annuity market.

This aside, moving from DB to DC will impact most heavily on those furthest from retirement and careful consideration is required to ensure that the new benefit structure is appropriate to their needs and that the benefit is valued by them.

DB to DC modeller

We can interactively model the employer costs and member benefits of different defined contribution (DC) structures using basic summary information about your scheme.

This will include consideration of National Insurance contributions, as well as the costs of any employee benefits required, such as life assurance and income protection.

Our model can work with fixed level contributions, age-related contributions, or matched contribution structures (i.e. where the employer matches employee contributions above a certain level, to encourage a higher level of self-provision).

We will also be able to confirm "qualifying scheme" status under auto-enrolment requirements.

THE XYZ PENSION SCHEME DB to DC Modeller

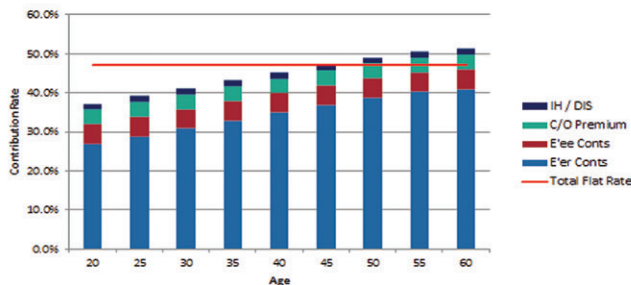
Results - DC rates required to match current benefits

Age dependent contribution rates (60ths accrual):

| Age | Required contribution rate |
|-----|----------------------------|
| 20 | 37.3% |
| 25 | 39.3% |
| 30 | 41.3% |
| 35 | 43.3% |
| 40 | 45.3% |
| 45 | 47.2% |
| 50 | 49.1% |
| 55 | 50.6% |
| 60 | 51.3% |

Flat rate contribution rate (60ths accrual):

| Flat Rate | Required contribution rate |
|-----------|----------------------------|
| | 47.2% |



Results - Comparison of current and proposed benefits

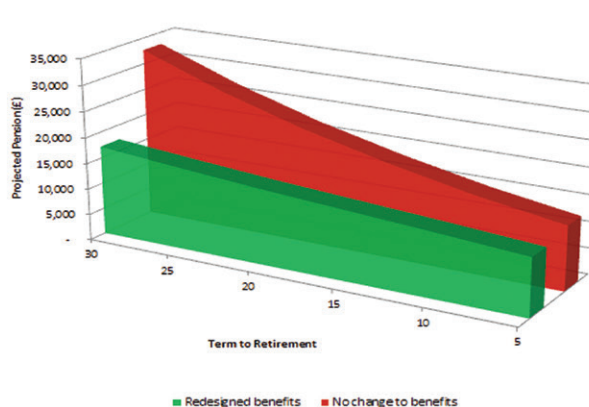
CURRENT - Projected DB at retirement age (60ths accrual):

| Age | Pension (£pa) |
|-----|---------------|
| 20 | 75,700 |
| 25 | 55,300 |
| 30 | 39,800 |
| 35 | 32,700 |
| 40 | 26,900 |
| 45 | 22,100 |
| 50 | 18,200 |
| 55 | 14,900 |
| 60 | 12,300 |

PROPOSED - Projected DB and DC benefits (Manual input contribution rate)

| Age | Pension (£pa) |
|-----|---------------|
| 20 | 40,900 |
| 25 | 27,900 |
| 30 | 18,900 |
| 35 | 17,200 |
| 40 | 15,800 |
| 45 | 14,500 |
| 50 | 13,400 |
| 55 | 12,300 |
| 60 | 11,100 |

Projection for 35-year old with 5 years' past service



Tax-free cash taken:

| Age | Lump sum (£) |
|-----|--------------|
| 20 | 504,700 |
| 25 | 368,700 |
| 30 | 265,200 |
| 35 | 217,900 |
| 40 | 179,100 |
| 45 | 147,200 |
| 50 | 121,000 |
| 55 | 99,500 |
| 60 | 81,800 |

Tax-free cash taken:

| Age | Lump sum (£) |
|-----|--------------|
| 20 | 404,300 |
| 25 | 272,900 |
| 30 | 180,200 |
| 35 | 148,300 |
| 40 | 125,500 |
| 45 | 108,500 |
| 50 | 95,300 |
| 55 | 84,400 |
| 60 | 75,400 |

Closed scheme services

For those schemes which do close to accrual there is a menu of further changes and exercises available to enhance the scheme's position.

We believe that it is important to devise an exit strategy, or end game plan (e.g. buy-out in 15 years) and start taking steps towards this.

Some potential considerations could include:

- Introducing at-retirement options such as PIE, or partial and full transfers out.
- Bulk liability management exercises (pensioner PIE, enhanced transfer values (ETV), flexible retirement) and trivial commutation exercises.
- Partial buy-in (i.e. purchasing bulk annuities in the trustee's name for a subset of members), or the use of other matching strategies for interest, inflation, and longevity.
- A general review of investment strategy as the Scheme matures more quickly.

Pitfalls of closure to accrual

Closure to accrual will move the scheme towards being cashflow-negative much more quickly, if not immediately. That is needing to disinvest funds to meet pension payments and other outgo, rather than investing funds every month. This is a significant change and the investment strategy will require careful consideration. This could also incorporate the possibility of allocating some funds to de-risking strategies.



Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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