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Making DB pension costs easier

May 2016

Introduction

Running a defined benefit pension scheme is expensive and costs have been increasing. Economic conditions have resulted in poor investment returns for many schemes and life expectancy has been rising fast. The Government has imposed significant statutory burdens on employers. Many companies are therefore looking at ways to reduce the financial risks. Critical to any proposed changes are the accounting implications and employers may want to structure projects to finish within their accounting year.

8 steps to managing pension costs

1. Companies, which have not done so already, are looking at closing schemes to existing members, as well as new joiners, so that no more benefits can be earned. The process can be difficult, but not impossible. Employers should be prepared to demonstrate the business need for the scheme closure. Trustees are obliged to examine the commercial and financial reasons for closure and may want to explore alternatives with the employer. They will need to be assured that the pension obligations will be met in the long term.
2. Employers or parent companies are often asked by the trustees to provide security over an asset in order to reduce pension scheme liabilities. Beware; this could make it more difficult for the company to borrow in the future. Companies should check borrowing facilities before entering into any guarantee. Parent company guarantees can also be useful to reduce the levy payable annually to the Pension Protection Fund as long as the guarantee is documented in a way acceptable to the PPF. Guarantees of this type would need to be included as a liability on the guarantor's balance sheet.
3. Investments can be used as part of a risk management strategy. Apart from the traditional investments of equities and bonds, there are an increasing number of new investment products to help manage liabilities and reduce volatility. These include, for example, swaps to help manage longevity risks. Products can cover other risks as well. Employers can't choose the investment strategy of the scheme as the investment decisions must be taken by the trustees. However, employers can lead discussions on these issues with the trustees and could ask to sit in on investment talks with the trustees or offer their own expertise in this area.
4. Buy-outs were popular a few years ago and their popularity is increasing again. Trustees buy out their obligation to pay pensions to some or all of the pensioners and deferred pensioners with an insurance company. The cost of buying out benefits is expensive so the employer will usually need to put some more money into the scheme. In some cases, trustees retain the obligation to pay the pensions, but have a policy with an insurer as an asset backing these pensions. This is known as a buy-in. Once the buy-out or buy-in has been completed, the liability for the pensions bought out is fixed.
5. Another way to remove liabilities from the scheme is to offer members who have left the company a financial incentive to transfer their pensions out of the scheme. The incentive could either be a cash payment to the member or an enhanced transfer amount. This would be funded by the employer. Any cash payment made to the member would be taxed. The Pensions Regulator has issued strict guidance which the trustees would need to consider carefully.
6. To tackle deficits and reduce their pension contributions, a number of employers have entered into asset-backed partnerships with their scheme trustees. Assets are transferred to a special purpose vehicle in which both the employer and the scheme have an interest. The scheme's interest is treated as an asset of the pension scheme resulting in a corresponding reduction in the scheme's deficit. The employer may want to take accountancy advice to ensure that the arrangement gets appropriate accounting treatment from the employer's perspective.
7. Remember that project management is key to many of these options, as there are likely to be a number of advisers involved as well as the trustees. Timescales can be severely challenged by negotiations with the trustees and their advisers. Allow enough time in the project plan for this.
8. In some cases it will be necessary for the employer to consult with the affected members before making the proposed changes. Consultation should usually last for at least 60 days. This is a statutory duty on the employer, so again factor in enough time for the consultation process and to consider any responses by members.

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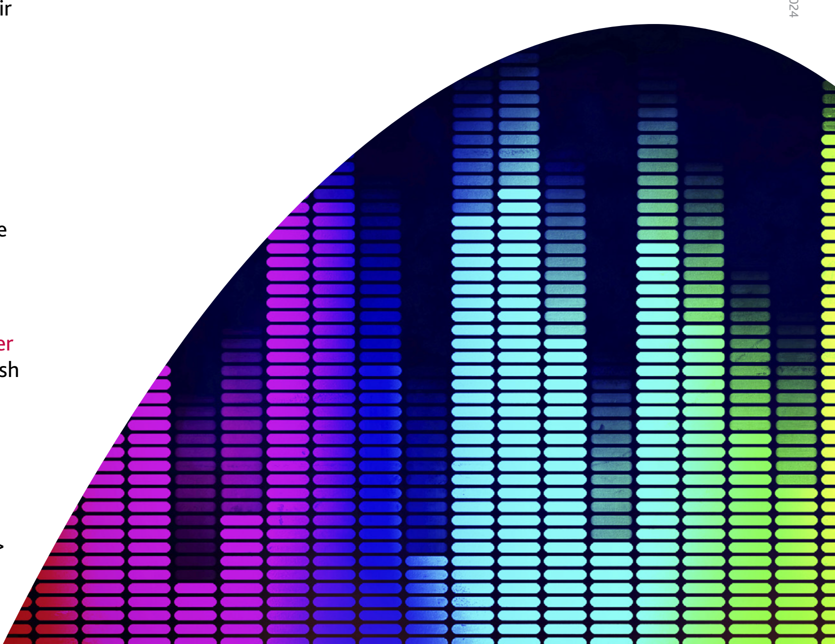

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Further reading

We have produced more detailed guides on transfer incentives, scheme closure, and the employer consultation process.

Pensions law can be tricky… but it doesn't have to be. These 'making it easier' guides explain key issues in simple terms, giving practical help to trustees and employers.

The series is growing; additional copies can be downloaded from www.pinsentmasons.com

Current topics include: Using advisers; Scheme changes and Becoming a trustee

Comments and ideas for further topics are welcome…

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