Barnett Waddingham
Corporate Consulting

Pensions news for employers

July 2012

Welcome to the July 2012 edition of pensions news for employers. The newsletter covers a number of topical issues which companies should be aware of. For further information, please contact your usual Barnett Waddingham consultant or email **corporateconsulting@barnett-waddingham.co.uk**.

Incentive Exercises – Industry Code of Good Practice

Prompted by the Pensions Minister's concerns about poor practices being adopted when undertaking a pension Incentive Exercise an industry Working Group has issued a Code of Good Practice for employers, trustees and consultants. The Code is intended to improve the standard of Incentive Exercises whilst acknowledging that they remain a legitimate tool for sponsors looking to manage their defined benefit (DB) scheme liabilities.

An Incentive Exercise is an offer to a pension scheme member to change the form of their accrued DB rights where the offer is made with the intention of reducing risk or cost for the pension scheme sponsor and where the offer is not ordinarily open to members. Common examples include Enhanced Transfer Value (ETV) exercises and Pension Increase Exchange (PIE) offers.

Although it is voluntary, the Working Group anticipates all future Incentive Exercises will follow the spirit and principles of the Code. The Pensions Ombudsman and Financial Ombudsman Service will also use the Code when arbitrating on disputes involving Incentive Exercises.

The Principles

The Code introduces seven principles which parties undertaking Incentive Exercises should follow.

1. No Cash Incentives should be offered that are contingent on the member's decision to accept the offer.
2. For Transfer Exercises, advice should be provided to the member. For Modification Exercises, either advice is provided to the member, or a Value Requirement is complied with and then only guidance needs to be provided.
3. Communications with members should be fair, clear, unbiased and straightforward.
4. Records should be retained to provide evidence of what was intended and what actually transpired. The member advisor should also provide details of Insistent Customers to the other parties.
5. Exercises should allow sufficient time for members to make a decision with no undue pressure applied.
6. Incentive Exercises should only be offered to members who are over age 80 on an "opt-in" basis and the Vulnerable Clients policy should be followed.
7. All parties should ensure they are aware of their roles and responsibilities and should act in good faith.

Definitions:

A **Transfer Exercise** is an Incentive Exercise where members accepting the offer must transfer their benefits out of the pension scheme.

A **Modification Exercise** involves a change to members' benefits but with the benefits retained within the same pension scheme or trust.

The **Value Requirement** is specified within the Code but amounts to a requirement for the overall change to benefits to be at least cost-neutral from the members' perspective.

Insistent Customer refers to a member who has received advice and chooses to act contrary to the recommendation in relation to acceptance of the offer.

Vulnerable Clients refers to clients who may be particularly vulnerable by virtue of age, health, understanding etc, and who may therefore require special treatment.

How will this affect schemes where Incentive Exercises are planned?

Many of the principles outlined in the Code were already standard practice in well run Incentive Exercises. However, some aspects will have a noticeable impact on the administration and compliance costs associated with running an Incentive Exercise and the number of scheme members accepting the offer.

The following issues raised by the Code will have the biggest impact on future Incentive Exercises:

- Historically the majority of Incentive Exercises have included some kind of Cash Incentive and this has been a popular option with scheme members. The ban on Cash Incentives is likely to reduce the number of members accepting the offer which may ultimately put some sponsors off running these exercises.

  Small cash payments designed to encourage members to engage with the process, but payable regardless of whether they accept or decline the offer, will still be permissible. However, PIEs where the increase in pension is back-dated over a significant period to allow a lump sum to be paid will not be acceptable, although a small amount of backdating for administrative simplicity will be allowed.

- Where sponsors are making a PIE offer which will reduce the value of members' benefits they will have to demonstrate members have been provided with independent advice. Whilst sponsors have generally offered independent advice to members as part of an ETV exercise, this has been less common when offering a PIE. Sponsors will need to factor in the additional costs associated with this when considering whether to run such an exercise.

- The Code sets out strict guidelines for the content and structure of communications to members as part of an Incentive Exercise. Sponsors, trustees and consultants will need to carefully scrutinise literature and presentations given to members to ensure compliance.

- Sponsors and trustees should also ensure they receive a report on any Insistent Customers (i.e. members accepting the offer against the advice which they have been given) from the parties involved in providing independent advice to members.

- Vulnerable Clients, for example by virtue of their age, health or understanding, should be considered carefully when drafting communications and structuring advice to members. In particular, where an Incentive Exercise includes pensioners over age 80, these members should only be notified of the Exercise and should not be made an offer unless they request it. This requirement is likely to reduce take up rates for the offer and increase the complexity of running a PIE exercise. However, as the average liability for these members is likely to be smaller, the overall financial impact of a lower take up rate for this group is not expected to be significant.

Comment

The Industry Code of Good Practice formalises many of the practices already included in well run Incentive Exercises and will hopefully ensure members are fully aware of the value of benefits they are giving up. The onus will fall on scheme sponsors to ensure they are operating with the spirit of the Code when making offers to members. Some of the requirements of the Code may well affect the cost of running Incentive Exercises and also the take up rate from members.

A full copy of the Code of Good Practice can be found at www.incentiveexercises.org.uk.

High Court rules on RPI to CPI discretion - QinetiQ Case

The High Court has ruled that where trustees have a discretion in the rules to choose the index used to increase pension benefits, a switch from Retail Price Index (RPI) to Consumer Price Index (CPI) would not breach Section 67 of the Pensions Act 1995 which protects members' accrued rights.

In Danks and others v QinetiQ Holdings Limited and another, the High Court considered whether the trustees of the QinetiQ Pension Scheme could use a discretion in the rules of that scheme to switch to CPI for increasing all preserved and pension benefits. The High Court decided that the trustees could make such changes for future increases to all types of benefit and more significantly for all pensionable service.

Comment

Although the High Court's decision is based on the precise wording of the QinetiQ scheme rules, many schemes will have similar definitions for the index to be used to increase pension benefits. Based on the ruling, companies may want to request scheme trustees to look at their rules once again and exercise any discretionary powers the trustees have to change the index.

Stronger funding targets? -Solvency II and UK pension schemes

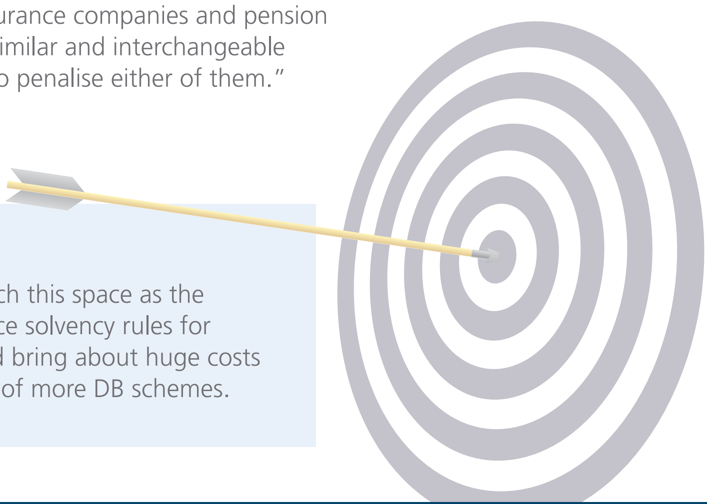
Commissioner Michael Barnier has announced a delay to the timetable to apply Solvency II rules to UK occupational pension schemes, but insists that they will still be included.

Barnier reported that revisions to the Institutions of Retirement Provision Directive will now be postponed from the end of 2012 until summer 2013.

Barnier reasoned that the delays are necessary in order to allow for the disparities between pension schemes across Europe. He believes that schemes should face the same regulation as insurance companies.

He said: "If we do not start the necessary reforms today, there will be no guarantee that the occupational pensions paid out in 10 or 20 or 30 years will be adequate."

Barnier continued: "I believe it is important in regulatory terms to maintain a level playing field between insurance companies and pension funds when they supply similar and interchangeable products. I do not wish to penalise either of them."



Comment

Companies should watch this space as the introduction of insurance solvency rules for pension schemes would bring about huge costs and lead to the closure of more DB schemes.

New IAS19 standard

The EU has endorsed a revised IAS19 standard which will impact on the disclosed profits of companies with DB plans.

The new standard is effective for accounting periods beginning on or after 1 January 2013, although early adoption is encouraged.

The agreed changes will affect the calculation of the finance cost, the recognition of actuarial gains and losses and the treatment of expenses. The International Accounting Standards Board (IASB) who published the revised standard, has also confirmed that only those events which result in a significant reduction in the number of employees shall be classified as a curtailment going forward.

Companies currently reporting under FRS17 are also likely to see future increases in the reported pension costs, as the UK Accounting Standards Board (ASB) has published proposals which aim to align the calculation of interest expense under FRS17 with that of IAS19. This change is expected to come into force for accounting periods beginning on or after 1 January 2015.

Comment

Companies will need to fully understand the implications the changes will have on their financial statements. They will also need to consider the merits of early adoption as well as the likely implications of implementing the changes. This is most pressing for entities reporting under IAS19, but will also affect those reporting under FRS17 from 2015.

Takeover Panel Consultation – proposals for bidding companies to disclose pension plans

Responses to a previous Takeover Panel consultation last year criticised its failure to include pension scheme trustees as stakeholders in takeover bids. The Takeover Panel said that it would carry out a separate consultation in due course, and it has been true to its word.

The proposed changes focus on requirements to provide information to trustees and for their response to be disclosed to the bidder. There are no changes specifically designed to give additional protection to scheme members - although proposals set out by a bidder within an "offer document" must be adhered to for a period of 12 months if the takeover goes through. The consultation does not propose to extend this period, but suggests instead that trustees should record agreements in a separate document which could offer greater legal recourse if needed.

The consultation notes that trustees, upon receiving details of a bidder's intentions towards the pension arrangements, will wish to take advice which could be substantial in nature. The proposals do not require the company under offer to meet costs incurred by the trustees in taking advice, but notes that in many cases the company will be responsible for meeting all costs of running the scheme.

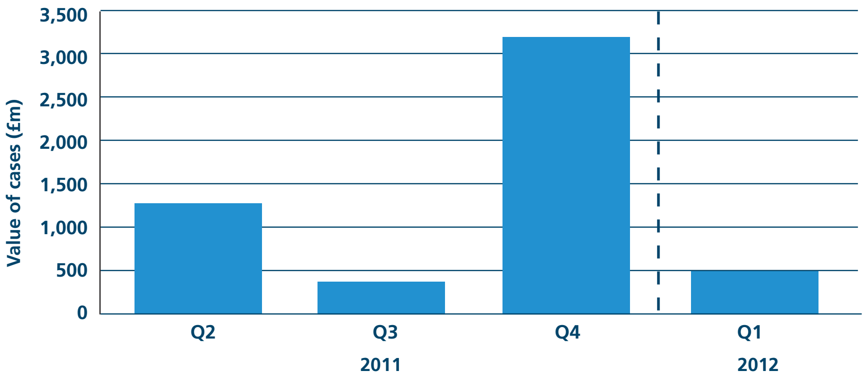
In our experience companies usually take appropriate advice and typically engage directly with trustees where the pension scheme is a significant component of a takeover. Therefore, the proposals should not have a significant impact given the way takeovers work in practice at the moment.

Comment

Pending the outcome of the consultation, though, companies should review any procedures they have in place for takeovers to ensure no new requirements are overlooked.

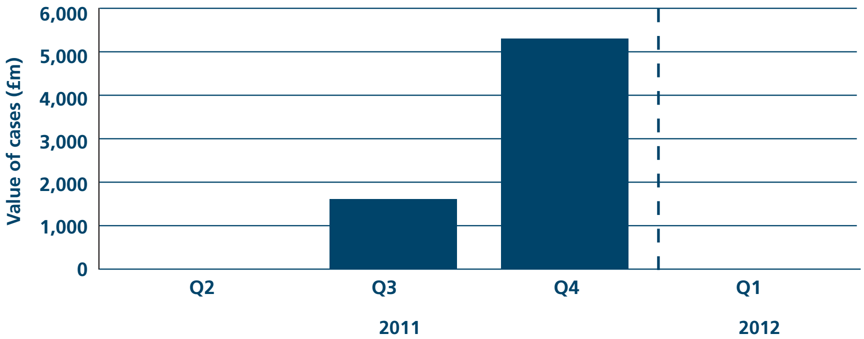
The consultation runs until 28 September 2012. Further details can be found at www.thetakeoverpanel.org.uk.

Buy-outs, buy-ins and longevity swaps



Bulk annuity market business

Quarter 1 of 2012 was much quieter than the previous quarter. Pension Insurance Corporation led the way during Q1, completing transactions worth £339m.



Longevity swaps market business

No longevity swap deals with UK pension schemes were completed in Quarter 1. In Quarter 2, Swiss Re completed a longevity swap protecting £1.4bn worth of liabilities with one of the Akzo Nobel schemes.

Source: Barnett Waddingham LLP

Regulator publishes report on BMI pension scheme

The Pensions Regulator (TPR) has published a report detailing its role in the regulatory action taken in connection with the deal which saw the British Midland Airways Limited (BMAL) Pension and Life Assurance Scheme fall into the Pension Protection Fund (PPF) and BMAL freed from its pension scheme liabilities.

The report describes how clearance was sought from TPR to transfer responsibility for the scheme, and in particular its liabilities, from the BMI Group to Deutsche Lufthansa AG ('Lufthansa'). At the time the proposal was made, the scheme's sole statutory employer was BMAL, a part of the BMI Group. The BMI Group was a wholly owned subsidiary group of Lufthansa.

Lufthansa had provided significant financial support to the BMI Group since 2009 but had no statutory obligation to fund the scheme. It was, however, prepared to provide a conditional and capped level of support on a voluntary basis over a 25-year recovery plan.

The scheme's funding deficit at this time was estimated to be approximately £450m on a 'buy-out' basis, i.e. the amount it would cost to secure members' benefits by purchasing annuities, and approximately £230m on the PPF's section 179 basis.

With this in mind, Lufthansa's proposal would have relied upon significant investment out-performance in order to prevent a deterioration in the scheme's funding position.

TPR's view was that in the absence of a legal commitment, this proposal posed unacceptable risks to member's benefits and PPF levy payers. TPR therefore declined to provide clearance but agreed to work with the parties involved to explore alternatives.

This resulted in an agreement between the trustees and Lufthansa to submit a revised clearance application, under which the scheme's liabilities would fall to the PPF via a Regulated Apportionment Arrangement (RAA). Under this arrangement, which was accepted by the PPF, the scheme (and therefore the PPF) received £16m – significantly more than would have been received from the insolvency of BMAL. In addition, Lufthansa proposed to provide a further voluntary contribution of £84m in order to top up member's benefits outside the PPF.

Comment

TPR's report confirms that such arrangements are extremely uncommon and that TPR was only able to give approval in this case due to its 'moral hazard' powers being unavailable, i.e. not all of the relevant legal tests had been met. The proposed transaction was, in TPR's view, the best possible outcome in the circumstances.

Company news

UK Coal has asked TPR to approve a plan to reduce the £430m pension deficit by offloading the pension scheme liabilities to the PPF. In exchange, UK Coal will offer the PPF an equity stake in the mining business together with future income from the company's property portfolio.

Fujitsu's pension scheme saw a 22% take-up of its pension increase exchange (PIE) offer.

Swiss Re has completed a £1.5bn longevity swap with Akzo Nobel for 17,000 pensioner members.

Dairy Crest has reduced its pension scheme's liabilities by £15m through an enhanced transfer value (ETV) exercise. The firm has agreed to pay £20m per year in deficit reduction contributions.

Impact of pensions on UK business – BT case study

It is often suggested that investors do not understand DB pension schemes and therefore do not properly allow for them when assessing the value and risks associated with a particular company.

In conjunction with the Centre for Global Finance at the University of the West of England we have undertaken some research to consider the impact various pension related events have historically had on a company's share price.

With liabilities in excess of £40bn and a deficit of around £4bn British Telecom (BT) certainly has significant DB pension obligations. We have investigated a series of announcements and news stories relating to the BT pension scheme to look for any impact on share price.

Of the events we analysed, a number were found to have had a statistically significant impact on BT's share price, allowing for share price volatility around the time of the event.

Our research emphasised the important impact that certain pension-related news stories can have on the value of a company, particularly in recent times where we have seen pension deficits soar.

To view the full article visit the following link - http://bwllp.co.uk/nm

Forthcoming Barnett Waddingham Events

15 November 2012

Pension Conference

Taking place at the Cumberland Hotel, London

The annual Barnett Waddingham Pension Conference is to take place at the Cumberland Hotel located in the centre of London. Further information will appear on our website soon.

January (16 Birmingham and 23 London) 2013

Investment Conference

Being held at the National Motor Cycle Museum, Birmingham and the Cumberland Hotel, London

After the success of this year's Investment Conferences, we will again be holding our annual Investment Conference at Birmingham's Motorcycle Museum and the Cumberland Hotel in London. Further information will appear on our website soon.

For more information on our forthcoming events, please visit the events page on our website http://bwllp.co.uk/C or email seminars@barnett-waddingham.co.uk

Corporate Consulting Blog

Looking for concise up to date commentary on the key pensions issues you face as an employer with a defined benefit scheme?

Why not set up an RSS feed to our blog http://bwllp.co.uk/gU

Corporate Consulting on Twitter

Follow us on Twitter for interesting #actuarial, #pensions & team news at @BWLLP_Corporate

Online Pensions Guide for Finance Directors

Visit our online pensions guide for Finance Directors www.fdpensions.co.uk for a single source of clearly written, up to date information on defined benefit pension schemes.

For further information on any of the news raised here or for any other corporate matter please contact corporateconsulting@barnett-waddingham.co.uk

July 2012
BWNEWS1012