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Pension and benefits newsletter

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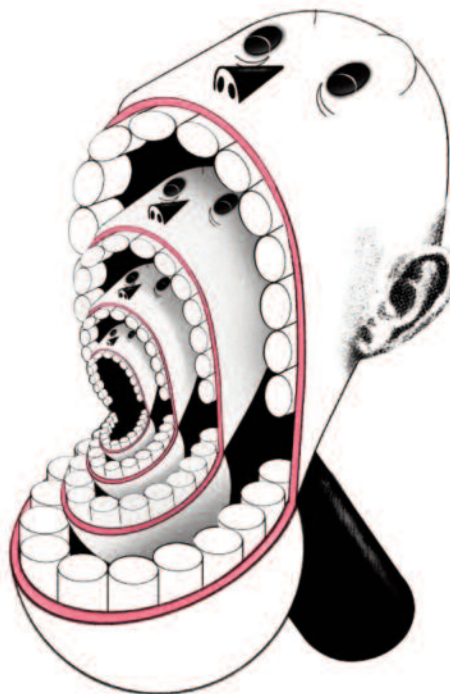
BDO Stoy Hayward
Investment Management

The funding nadir

Trustees of final salary pension schemes with funding valuations as of 31 March 2009 are in line for a shock. Financial markets have conspired to make the funding position of most schemes, measured at this date, pretty grim indeed.



Whilst equities and corporate bonds were pretty much at their lowest point in recent years, quantitative easing served to reduce gilt yields, on which actuaries like to base their discount rate. So the combination of low asset values and higher liabilities will be a cruel double whammy. Trustees will hold out the begging bowl again - but may find that sponsors have very little spare cash to offer by way of additional contributions.

Of course, given the ponderous pace at which most scheme actuaries work, it will be at least six months before the results of these valuations are actually being seriously discussed between trustees and sponsors. By then, anything could (and probably will) have happened in financial markets. If things have improved, we will see scheme sponsors keen to suggest to trustees that the monstrous deficits as measured at 31 March should be put to one side, on the basis that 'things are not really that bad'. Invariably current circumstances merely serve to highlight the disadvantages of a mark-to-market approach to funding - even though nobody has really come–up with a coherent and less volatile alternative.

Even allowing for a bit of jiggery pokery with measurement dates, deficits are still likely to be a big issue this year. Trustees demanding more cash are hardly going to be welcomed with open arms, especially given that, with scheme closures continuing unrelented, for most sponsors the old final salary scheme is of little relevance to ongoing remuneration policy.

If increased contribution rates are a no-go (although be careful - the Regulator has already said that pension schemes should not play second fiddle to shareholders and their dividend expectations), what else can trustees do? Security is likely to become increasingly important, with trustees scouring balance sheets for suitable assets that they might be able to ring fence. Undoubtedly recovery periods will be extended and schemes still open to accrual of benefit may well find their status under review. Investment strategy will also be placed squarely under the limelight - with increasing focus from sponsors, who may conclude that the only solution to a scheme's cavernous deficit is increased focus on investment returns.

When trustees and sponsors eventually sit down to discuss funding, it may be that the scheme actuary has little to say, having established that the deficit is 'big'. Actually quantifying the deficit may be somewhat pointless. Funding rates - for the shorter-term at least - may ultimately have to be driven by affordability.

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Market review:

Buy-out market picks up again

One of the significant developments for defined benefit pension schemes last year was the increase in both interest and activity in the buy-out market place.

After a lull in buy-outs in the last quarter of 2008, following fears on the part of schemes and providers, business picked–up again in the first quarter of 2009 with £900m worth of deals completed and around £8bn predicted for 2009 as a whole.

This is the same volume as 2008, but still less than one per cent of the potential market with many schemes that had been eyeing buy-outs now postponing plans in the wake of the equity market collapse.

First longevity swap deal completed

More attention has focussed recently on the longevity swap market where Credit Suisse has finally completed the first deal with Babcock International to cap the mortality exposure on its £800m pensioner liabilities.
Under a longevity swap, the scheme pays pensions for as long as its pensioners and their dependants are expected to live according to a pre-agreed mortality table, while Credit Suisse pays up or pockets the difference between the expected and actual payments. Other cases are now expected to follow but these are likely to be amongst larger schemes.

New kid on the buyout block

Met Life is aiming to join the eight other UK buy-out providers* by teaming up with Barnett Waddingham who will act as a clearing house and provider of indicative quotations for potential buy-outs. The catch is that scheme must appoint BW as adviser and pay £1,000 for the quotation.

*Legal & General, Prudential, Pensions Insurance Corporation, Paternoster, Aegon, Norwich Union, Rothesay Life, Lucida.

Compensation clarified

In a new guide published in April 2009, the ABI has cleared up confusion over compensation available under the Financial Services Compensation Scheme (FSCS) for insured buy-outs. It confirms that all forms of long-term insurance contract are protected in the event of an insurer failing. This includes buy-in and buy-out contracts, even if the contract is held in a scheme trustee's name. Longevity contracts held by the trustees are also protected. The protection provides at least 90 per cent of the benefits under the contract, with no upper cap – so better than the Pension Protection Fund for larger pensions.

Trustee Indemnity Insurance ("TII")

There is no shortage of issues for trustees to consider at the moment and the issue of protecting trustees from liability has become progressively more topical since the Pensions Act 1995 came in to force.

Trustees' duties are derived from the deed or document governing the trust, from statute and from common law. Inadvertent neglect or ignorance of these duties can lead to breach of trust, or duty and the potential of unlimited personal liability for the trustees involved.

The subject hit the headlines last year with a case concerning trustees of Greenup and Thompson Limited Pension Scheme. It has been reported in the press that the trustees have been ordered to personally repay £130,000 after being found by the Deputy Pensions Ombudsman (DPO) to have been in breach of the trust after approving an unsecured loan to the sponsoring employer.

The DPO also rules that the trustees couldn't reply on an exoneration clause within the scheme rules. In addition, the Pension Regulator found that the trustees were in breach of s.40 of the Pension Act 1995 and had committed a criminal offence in agreeing the unsecured loan to the sponsoring employer. The trustees were ordered to jointly repay the outstanding loan amount together with interest.

Such cases only highlight the growing need for insurance in protecting pension funds, and the fact that trustees can no longer rely on exoneration and indemnity clauses to protect them against personal liability.

Recently we have seen that more and more trustees and sponsoring employers are enjoying the financial security that an appropriately structured insurance policy affords to the pension fund and company, in addition to protecting individual trustees.

For the insurance coverage to be most effective, and of most value, it is important to ensure that the policy is specifically tailored to the pension scheme, with appropriate cover secured at a corporate and personal level for all parties involved in the management of the pension scheme.

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The insurance policy can offer cover across a number of areas including, but not limited to the following:

- Loss
- Legal liability
- Errors and omissions
- Exoneration losses
- Documents
- Retirement cover up to 12 years
- Internal administrators and adviser cover
- Employer indemnity

The trustee indemnity market is rapidly growing with a number of leading insurers now offering competitive terms and premiums. The interest for this type of insurance has increased in that pension schemes and their trustees, and sponsoring employers etcetera, are recognising that a tailored and comprehensive trustee indemnity insurance policy can be a cost effective means of protection against losses resulting from claims.

In the increasingly litigious and 'penny pinching' environment that we presently find ourselves in, the value of this insurance cannot be underestimated.

BDO Stoy Hayward Investment Management's specialist risk benefits team, with support from our actuarial team, can assist in this area. We can ensure that currently insured levels of TII insurance remain appropriate to your needs, analyse the market to see whether more competitive terms and premiums are available, or help with the implementation of cover.

Reducing benefit spend

As we are only too aware, times of recession and economic downturn force employers to look for 'belt tightening' scope in all areas of their businesses.

The myth

Surveys have shown that employees of all industries believe that their benefits will likely be reduced as one of their employer's cost cutting measures.

The facts

A study recently completed by Hymans Robertson LLP found that 95 per cent of employers have no plans to cut or remove employee benefits this year. Most employers understand the importance of benefits and the role they play in staff retention, staying in–line with the competition and upholding staff morale in difficult times.

With many employers still not undertaking regular comprehensive reviews of their benefits, plenty of cost savings can now be made without cutting or removing valued benefits. Some possible areas for consideration are outlined below, but for further details please ask your BDO contact.

Six ways to reduce benefit spend

1) Market Reviews

The current economic strain on all companies, including insurers, means that now is an opportune time to conduct a market review. Most large insurers are quoting competitive premiums when invited to tender for new business, as they vie to grow their books of business and strengthen themselves in these difficult times.

2) Reviewing accuracy of cover

The terms of insurance policies can be complex and require frequent review to ensure they match the employer's liabilities and needs. An analysis of the terms of cover against the contractual promises made in employee handbooks and contracts of employment, can help identify adjustments that should be made to ensure full cover is in place and the employer is not faced with an uninsured liability.

3) Eliminating benefit overlaps

A common occurrence are benefit overlaps or duplications. Duplications (such as a standalone Employee Assistance Programme (EAP) co-existing with an EAP provided free by a group income protection provider, for example) often go undiscovered, resulting in a continued unnecessary benefit spend.

4) Consolidating insurances

Many insurers now offer multiple cover discounts of around five per cent when companies place two or more insurances with them. However, the competitiveness of an insurer must of course be considered before any such switch is made.

5) 'Tweaking' legacy benefits

Employment lawyers may determine that a benefit redesign may be possible. Deferred periods for group income protection cover can be increased, payment periods can be shortened, excesses can be introduced on private medical insurance schemes.

These cut backs can be concentrated on the benefits that are the least utilised, so that the impact felt by employees as a result of the cost savings will be limited, quite possibly going unnoticed altogether.

6) Reviewing associated employment costs such as the management of employee absence

Particularly in large organisations, very few employers know the true cost of absence. Undertaking a thorough analysis of the actual cost of absence and reviewing or creating absence data to identify areas that would benefit from improved absence management methods (be it using internal HR or line manager resources, or with the ongoing support and intervention of an external specialist) can lead to improvements in absence records and a reduction in the cost of absence.