

PREMIER PENSIONS MANAGEMENT

LEGISLATION UPDATE : 1/05

Cost Containment Strategies

There are a number of new ideas which seek to control the inherent costs involved in operating Final Salary style occupational Plans. This note outlines these.

1. Direct Cost Reduction

Buying out non-statutory Guaranteed Pension Increases

This is a where liabilities are reduced with a pension scheme deficit being similarly reduced.

The method works on the premise that all classes of member (actives, deferreds and pensioners) give up their non-statutory guaranteed pension increases in return for a cash sum paid to him/her by the sponsoring Employer outside the Pension Scheme. This is typically the pension increases which are guaranteed for pre-1997 service. This approach is especially beneficial where there are fixed increases (usually 3% or 5% p.a. compound) rather than those limited to the Retail Prices Index (RPI).

It is a straightforward concept with the member agreeing, in writing, to accept the cash sum with a lower value than the value of the increase being given up. In effect, they receive their money today rather than possibly later if they remain alive and the Pension Scheme is able to meet its obligations as the non-statutory pension increases would fall outside the Pension Protection Fund.

There are variations on this theme and the company can set the terms to be offered. The concept is one which pension scheme lawyers have accepted and the Inland Revenue has raised no objections.

Applications have also been made to the Inland Revenue to see whether the cash sum can be paid tax free. This is an approach that has historically proved popular with members and the Pension Scheme deficit reduction can be significant (more than the actual cash paid in lieu of the increases given up).

Initially the proposal must come from the **Company** to the Trustees. It is therefore usual for a set of actuaries, not associated with the Pension Scheme, to work with the Company putting together the proposal.

Comment

If the Pension Scheme has any pension increases which are more than the statutory minimum, this approach is likely to be much more beneficial for the Company to consider as the cash payable will be exceeded significantly by the reduction in the liabilities. So, if the Company is either already putting additional contributions into the Pension Scheme (especially by payment of a

lump sum) or is shortly to do so to address an existing deficit, this could be a better way of utilizing the additional expenditure

2. Indirect Cost Control

(A) Liability Led Solutions

Several investment managers have now developed sophisticated modelling tools to enable Trustees (and the Company) to assess the risks inherent in various strategies. These build upon the expertise of the investment managers but encompass the specific liability profile of the Scheme in question. The key points about this trend is:

- As it is understood that all Schemes need this type of analysis, it is provided, currently free of charge, in the Investment Management fee.
- Whilst the quality of the analysis is excellent, typically, these use a very user friendly format which make a difficult subject easier to digest. This format is therefore probably likely to be much more helpful to most Trustee groups than the technically focused documents produced by most Investment Consultancies.
- Once prepared & implemented the manager can then report quarterly on the specific strategy so that where significant deviation from the expected position occurs, this can be seen as soon as it takes place & the Trustees can consider whether any revisions are needed or discuss the implications with the Company.
- Currently, the Investment Manager knows little of the risk parameters acceptable to the Trustees. They are set a benchmark to work within. They believe as experts in their field that they can use new investment vehicles to help the Trustees as long as they are aware of the liability profile. They do not want to be restrained by benchmarks.
- They also believe that with many Final Salary Schemes now in deficit innovative ideas are needed. They only feel able to introduce these if they know about the liability profile.

(B) Unconstrained benchmarks and Absolute Returns

- Several investment managers are looking to actively discuss with Trustees unrestrained benchmarks. Essentially, these are benchmarks which are framed around the specific objectives of the Trustees. Whilst the terminology seems to go against the grain of most Trustees who have to act “conservatively”, in reality, at the moment virtually all the current benchmarks are linked to a large extent to FTSE All Share Index – so it could be argued that this approach is not conservative. This index is driven by a small number of large companies – so the investment manager must

hold significant weightings to these companies even if they do not rate the prospects of the stock, otherwise they would be taking too much risk by departing too far from their benchmark.

Comment

1. Investment managers believe that they are being constrained by the benchmarks
2. If you have the right Investment Manager you can involve them in the full process and they can suggest innovative solutions to current problems which will undoubtedly influence current collective thinking within Trustee Boards in the future.

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