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SOLVENT WIND-UPS

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Solvent wind-ups—will they increase?

Drivers for increased solvent wind-ups

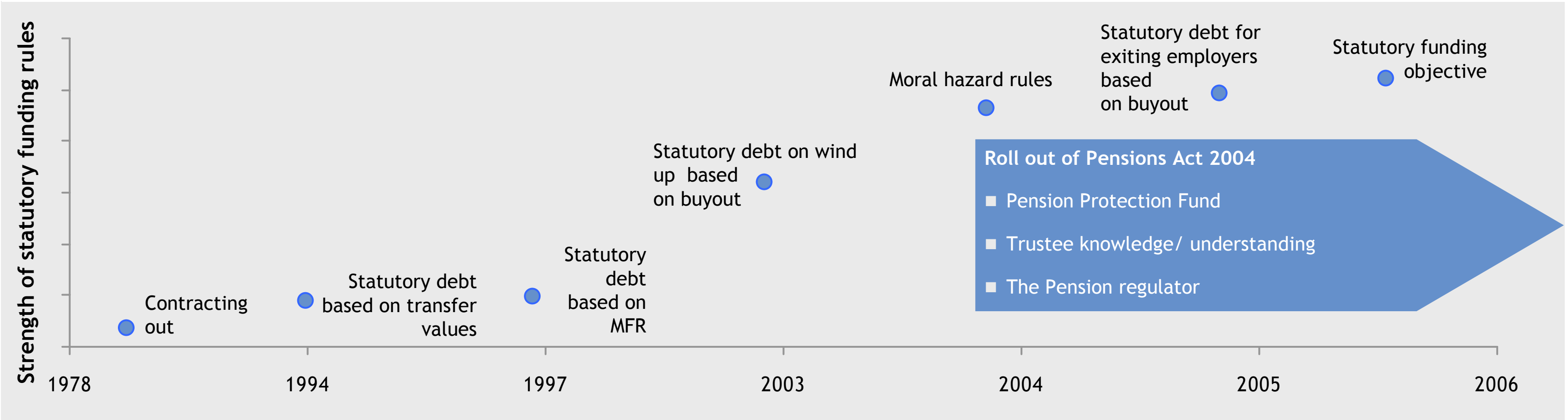
Buyout gap
- Increased funding overtime closes the gap to buyout (eg effect of Pensions Act 2004)
- Maturity of liabilities (deferreds becoming pensioners) further closes buyout gap

Economics/accounting/ June 11, 2003
- Greater understanding of the real nature of pension liabilities and associated risks makes wind-up more palatable

Fatigue
- Year after year of worsening funding positions
- More activist trustees (e.g. clearance, “behave like banker”)
- Employers have “had enough”

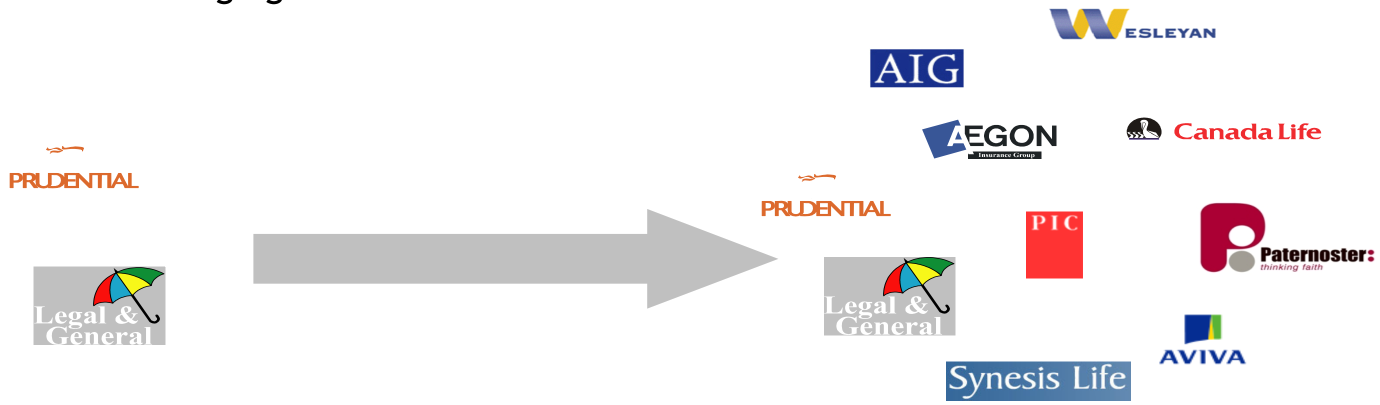
Surplus to requirements
- Plan closures mean many plans are now legacy - the MFR in 1997 was the start of the end

Strength of statutory funding standards/legal framework - summary



Still need convincing?

- 2006 will go down in pensions history as the year the death bell for many DB plans started ringing



Increased number of insurers:

- Cheaper prices (sometimes)
- More flexible payment methods eg:
  - Partial buyout
  - Regular premium
- Greater credibility of price, even if not cheaper

- The new entrants are there in anticipation of increased bulk annuity premium deal flow. This means either:
  - An expectation of a massive collapse in the economy with lots of insolvent companies with enforced plan wind-ups at above PPF funding level ✘
  - An expectation of increased demand from pension plans for bulk annuities to de-risk (but not wind-up) or to wind-up (on a solvent basis) ✓
- Time will tell!
- The phrase "bulk annuity" is intended in its widest sense – some of the products available do not look like a traditional bulk annuity

Wind-ups triggers

- Trustees have the power and decide to exercise it
  - Plan well funded so trustees are locking that in
  - To enforce buyout debt on employer
- Employer has the power and decides to exercise it
  - As a result of a derisking/exit strategy
  - As part of a corporate transaction
- Automatic
  - Company ceases to participate and partial wind-up triggered
- Timing
  - Wind-up may be planned and therefore expected
  - Often it occurs very quickly in response to events e.g. a company is wound up (solvent basis) as part of corporate restructuring

Solvent wind-ups vs insolvency cases

Solvent wind ups can be more complex	■ Managing how the employer makes up the shortfall ■ Conflicts for the trustees between excessive accuracy and additional cost of delays ■ May be combined with the roll out of a new pension arrangement ■ Employer pressure to finish the job
Actuarially more testing	■ Co-ordinating the debt calculation with the actual shortfall ■ Employers requiring an early debt certificate for a clean break ■ Producing reliable estimates of the shortfall
Bulk annuities	■ Unlike insolvent cases, not necessarily driven by price ■ New flexible products—starting from a blank sheet ■ Amounts involved can be much larger
Some aspects are avoided	■ Pension Protection Fund assessment ■ Deemed buyback ■ Difficult member communication regarding benefit cut backs

Employer objectives- effect on process

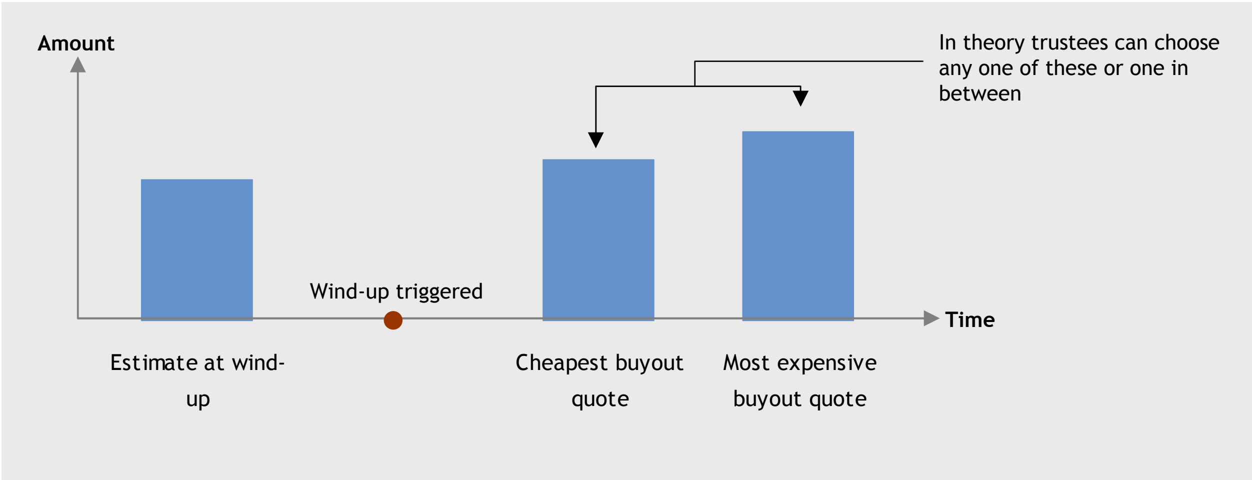
	Employer	Trustees
Timing	Requires quick completion of winding up eg to prepare a company for sale	Need to undertake a thorough process Some aspects outside of trustee control
Certainty of shortfall	Quick certification of debt so that employer can get a clean break eg to distribute monies to shareholders	Need to ensure unknown and uncertain liabilities are identified
Amount of shortfall	Managing the liability down using transfer values is attractive	May not be in member best interests
Buyout	Cheapest – forget benefit matching etc	Have a whole range of selection criteria
Trustee indemnity insurance	Unnecessary cost	Necessary to ensure trustee and member protection post wind up

Dealing with shortfalls—debt

- Trends
- **Detail**
- Wider issues
- Summary

- Statutory debt (Section 75) – relevant guidance note GN19
  - Buyout cost of benefits (actuary estimates)
  - Estimate of wind-up expenses
- Estimating the buyout cost

What number does the actuary use?



- The trustees select the effective date of calculation—can be anytime from wind-up starting until wind-up ends
- Expenses:
  - Estimated by the trustees, but the debt is "determined, calculated and verified by the actuary"
  - What is the actuary's role here?

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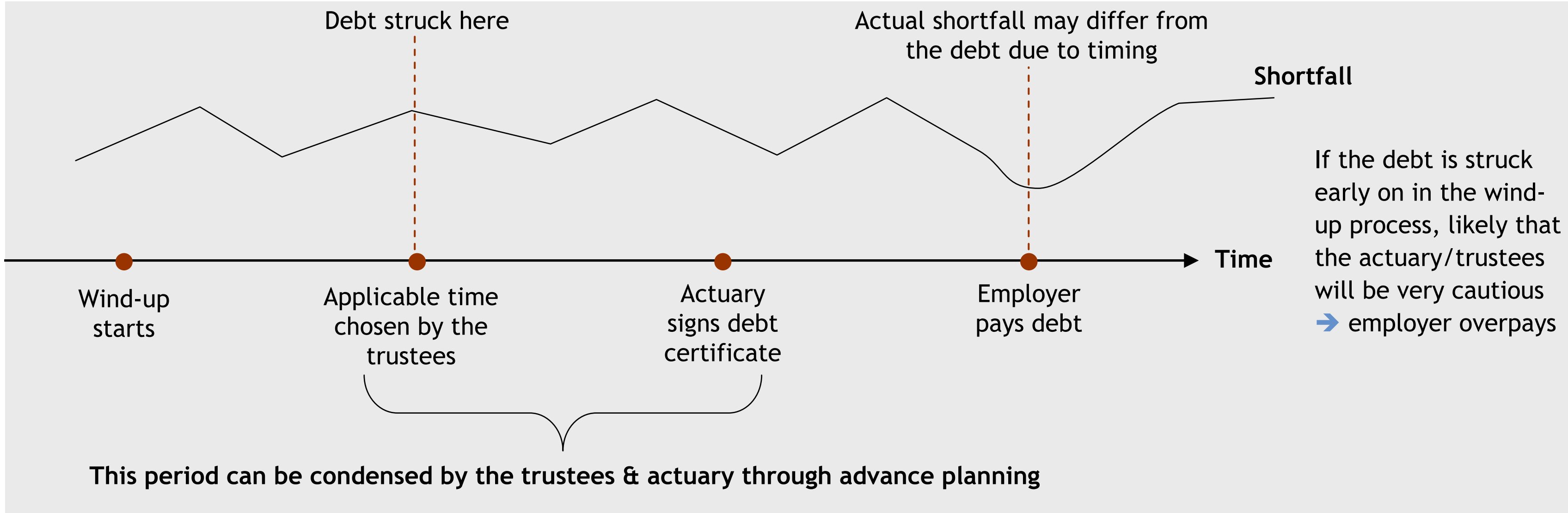
The debt is a clumsy way of recovering the shortfall



- Options
  - Employer makes up the shortfall on an adhoc basis outside of the debt rules—no debt struck by the trustees (or struck at the end of wind-up when minimal/no debt)
  - Employer can use an escrow or other security to give comfort to the trustees so that they are not in a rush to obtain the shortfall
  - Hedge out the timing risk

Debt-some detail

- As actuary do get legal advice if necessary
  - Who ultimately sets the expense reserve – see previous slides
  - How is the debt apportioned in multi employer plans
- Do you issue a report to accompany the certification?
- Don’t forget that an audited asset statement is required
- Ensure all relevant liabilities are included– eg
  - PPF levies
  - Investment costs
  - Insurer charges
  - VAT

Don't fall into the trap of thinking the debt is the total liability

"Rule 3.2 The trustees on the advice of the actuary will determine the employer contributions required to maintain the benefits of the members ……."

- Consider a pension plan
  - With a history of discretionary annual pensions increases
  - The trustees may be able to justify funding to buyout cost **plus** buyout cost of discretionary increases
- Real example
  - Assets £47mm
  - Buyout cost contractual liabilities £38mm
  - Buyout cost indexation and early retirement £12mm
  - Total £50mm
  - Do the trustees spend £50mm and recover £3mm from the employer, or £47mm and only secure part of the discretionary benefits?
- Message
  - If advising an employer on triggering wind-up do your homework!

Trustees may take two looks at the employer's wallet

- In many circumstances trustees have the power to request payment of contributions under the contribution rule during an employer's notice period before wind-up is triggered
- It they have this power they will probably use it, leaving the Section 75 debt as the back up
  - This may result (with hindsight) in excessive amounts being paid to the plan as any preliminary estimate will be approximate
- Consider how to manage this
  - Agree an escrow agreement that the Trustees can draw against
  - Other "clever" solutions

What benefits should be secured on wind-up?

"Rule 17.3 The trustees will purchase annuities to secure as near as practicable the benefit entitlements of…"

- Does "near as practicable" mean at any cost?
- Real example
  - Insurer A: Buyout cost £20mm
  - Insurer B: Buyout cost £26mm
  - Insurer B will cover unreduced ill health retirement (a plan provision)
  - Insurer B says it can exclude that if requested (which then mirrors Insurer A) in which case buyout cost is £25.6mm
- Questions:
  - Which insurer did the trustees choose?
  - And did you base your debt estimate on a provisional quote from Insurer A?

Actuarial factors

"Rule 5.3 A member retiring at NPA can exchange pension for lump sum at a rate determined by the trustees having consulted the actuary"

	Pre wind-up	Insurer cost neutral default	What the trustees secure
Commutation factor (per £1pa for pension)	12	17	?
Transfer value factor (per £1pa per pension)	8	13	?
Early retirement reduction 5 years early	20%	22%	?

- Consider how to manage the transition
- Consider what to buyout

Pragmatism

Who holds the risk?	■ The buck stops with the trustees ■ Very difficult decisions for trustees

Example: GMP equalisation	■ Do the trustees take a pragmatic approach to GMP equalisation?
	  ■ Lower professional fees
	  ■ But a risk some members get less than their true (unknown) entitlement
	■ Do the trustees follow a "text book" approach?
	  ■ Higher professional fees
	  ■ Benefits probably levelled up
	  ■ But employer picks up the cost (if no surplus), so why not!

Other difficulties	■ Data inaccuracies ■ Benefit uncertainties (eg booklet not aligned with the trust deed and rules) ■ Money purchase underpins
Options	■ If there is a surplus- level up above the problem point ■ Trustee indemnities (from insurance or the employer) ■ Use a professional trustee

Actuarial advice may be required in quantifying many of these areas

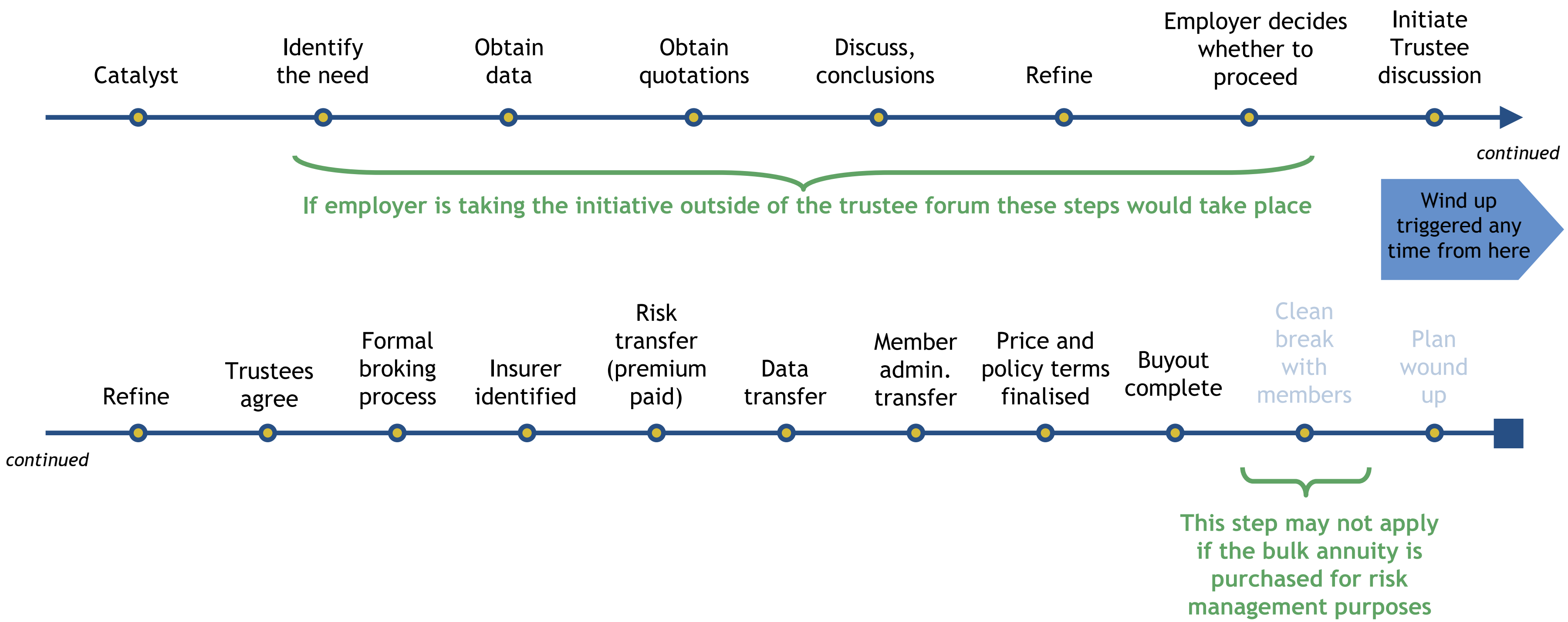
Buying out the benefits

- Timing
  - End of winding up
  - As soon as possible after wind up starts
  - Before wind up starts
    - 1 week
    - 1 year
    - 10 years
- Winding up is the period starting from the date of formal wind up trigger
  - In reality many plans are already in wind up mode in all but name, but the Trustees do not realise it
- Buying out early gives certainty of funding
- Insurer credit risk remains with the trustees and employer until bulk annuity assigned to members
  - But employer gets a clean break if the debt is certified and paid before then

Buyout process - more detail

Solvent wind up catalysts:

- M&A—buyout might be part of the deal or pre-sale
- M&A/Corporate restructuring—buyout might be triggered automatically
- Funding/risk management—buyout might be part of the solution



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Transfer values

Transfer value exercises

- In effect offer members a transfer value that is lower than buyout cost – a "win win" if the member finds the transfer value attractive
- Professional issues- "*we believe there is a high risk of conflict for an actuary who has to advise both trustees and the employer in such circumstances*" Pensions Board
- Link in with what the eventual bulk annuity insurer will offer to avoid misrepresentation
- If exercise will be run after the bulk annuity is purchased agree with the insurer who retains the actuarial release for transferees
- Similar issues for early retirement exercises

GN11 certificate

- Will transfer values be based on the insurer transfer value basis?
- Pre wind up the trustees/actuary are responsible for the basis/calculation
- GN11 certificate needs alteration (and whilst on the subject don't forget to alter the Regulation 30 certificate once wind up starts)

Accounting—IAS19/FRS17

- Curtailment rules may apply (e.g. if wind-up releases active member salary increase reserve)—affects P&L
- Settlement rules may apply (e.g. to the extent that buyout cost exceeds accounting reserve)—affects P&L
- Some of the cost may by-pass the P&L and go through the SORIE/STRGL as actuarial gains and losses
- Depends substantially on specifics of the case eg
  - Buyout policy purchased pre wind up
  - Buyout policy purchased post wind up
  - When the bulk annuity policies are assigned
- Check with the company auditor

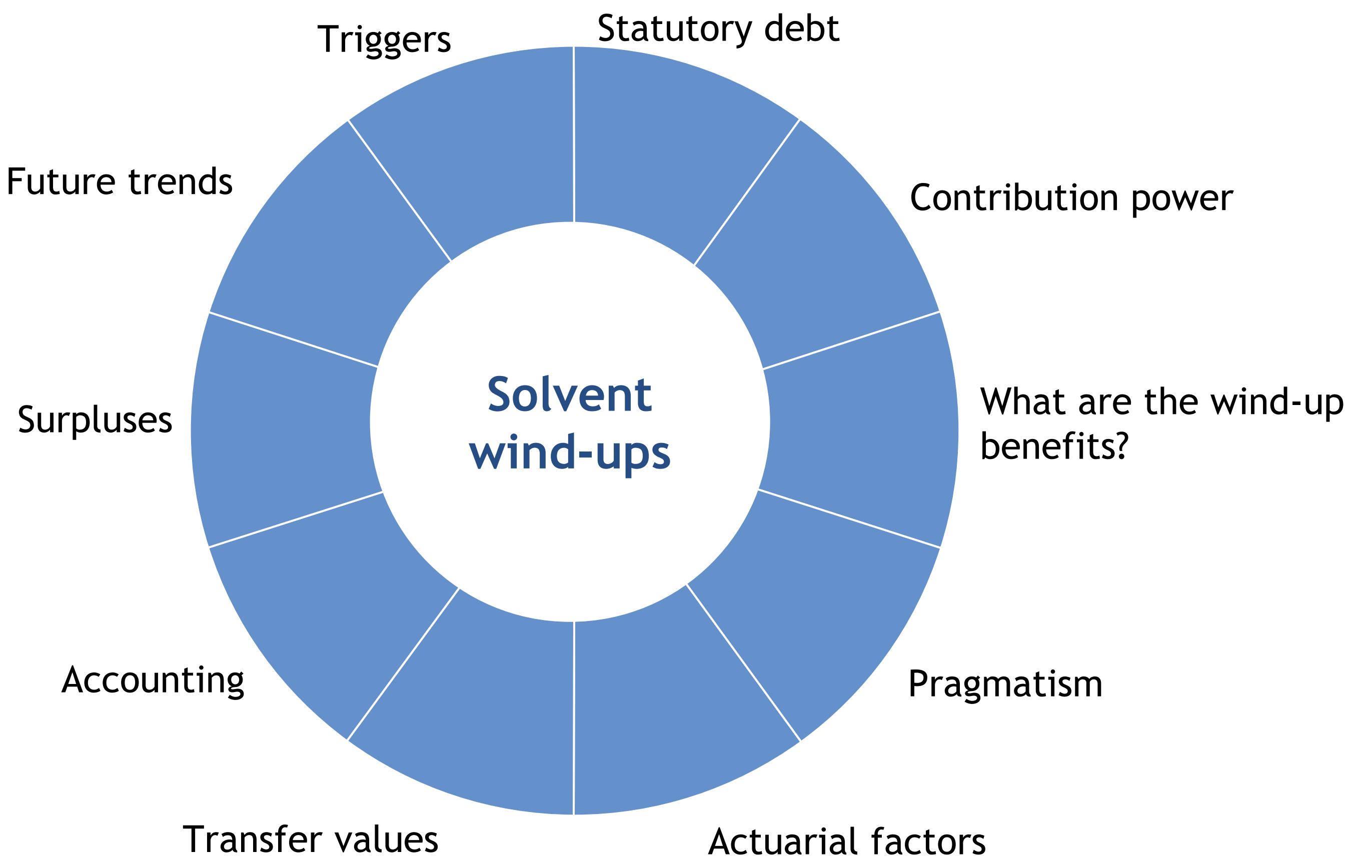
Dealing with surpluses

- In solvent wind-ups surplus will often occur, if only by "accident"
- Consult plan rules – actuarial advice may be required
- Dealing with shortfalls is normally straightforward– just follow the priority rules
- However, most surplus rules are very wide and so give extensive discretion
- Refund to employer may be possible
- Small surpluses can be relatively time consuming to deal with
  - If possible time shortfall payments so that surplus does not arise

Consulting process/business issues

- Increased number of buyout insurers/more flexible bulk buyout designs
  - How will you select insurers?
    - Approach them all, or
    - follow a shortlist approach
    - And what selection criteria will be used?
    - What type of process will be run – formal tender with rules, or informal?
  - Can you deal with questions about insurer security?
    - Risk of advice being challenged with hindsight
    - Identify partners competent in life company strength if trustees require more than the standard risk comment
  - Are staff skilled sufficiently to (a) consult, and (b) select
    - Is there a full understanding of "what is out there", and
    - in how the new bulk annuity options can be utilised.
- Increased solvent wind-ups
  - How will you consult with clients about exit plans/wind-up?
  - Will wind-up work be centralised?
  - Will bulk annuity broking be centralised?
  - Does the investment practice include bulk annuities as an investment option?

Summary


Triggers
Statutory debt
Future trends
Contribution power
Solvent wind-ups
Surpluses
What are the wind-up benefits?
Accounting
Pragmatism
Transfer values
Actuarial factors