MERCER
Human Resource Consulting

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Institute of Actuaries Seminar
Solvent wind-ups

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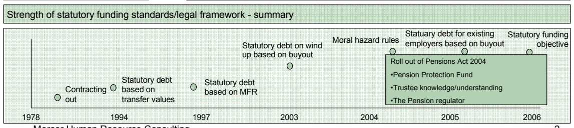
Solvent wind-ups – will they increase?

Drivers for increased solvent wind-ups

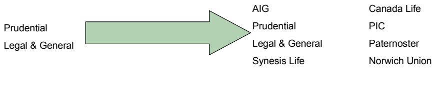
Buyout gap	•Increased funding overtime closes the gap to buyout (e.g. effect of Pensions Act 2004) •Maturity of liabilities (deferreds becoming pensioners) further closes buyout gap
Economics / accounting / June 2003	•Greater understanding of the real nature of pension liabilities and associated risks 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" •PPF Levy "the last employer out pays the levy for all failed schemes".
No longer required	•Plan closures mean many plans are no longer used to attract and retain staff – the MFR in 1997 was the start of the end

Strength of statutory funding standards/legal framework - summary



Does the market believe solvent wind ups / buyouts will increase?

- The buyout market has been possibly £0.5BN pa (with occasional "bumper years")



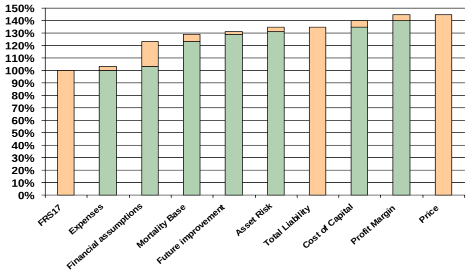
Increased number of insurers:
•Cheaper prices (sometimes)
•More flexible payment methods e.g.:
  •Partial buyout
  •Regular premium
•Greater credibility of price, even if not cheaper

- 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)
- Potential £1,300BN market (but how much if it will materialise?)
- The phrase "bulk annuity" is intended in its widest sense – some products available do not look like a traditional bulk annuity

On the other hand buyouts can look expensive

Moving from FRS17 liability to bulk annuity premium



Will wind up triggers occur?

- **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 de-risking/exit strategy
  - As part of a corporate transaction
  - Deficit improves so the employer wants "out" (employer must meet the shortfall but the trustees would spend most of any surplus)
- **Automatic**
  - Company ceases to participate and partial wind-up triggered / Covenant weakens
- **Timing**
  - Wind-up may be planned and therefore expected
  - Often it occurs very quickly in response to events e.g. 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 practical versus safest approach (e.g. GMP equalisation)
- May combined with the roll out of a new pension arrangement
- Employer pressure to finish the job

Trustees aim?
- To provide exactly 100% of benefits
- To get cash into the Scheme ASAP despite risks of ending (any +10% from fully funded

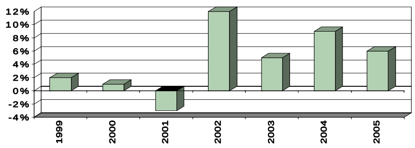
Employer aim?
- Quick completion for a sale
- Quick certification to get a clean break
- Cheapest method of exiting

Solvent wind-ups vs insolvency cases

Solvent wind ups are actuarially mores 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

Movement of buyout prices versus a least risk investment portfolio



Solvent wind-ups vs insolvency cases

Bulk annuities

- New flexible products – starting from a blank sheet
- Amounts involved can be much larger
- Innovative solutions to deficit:
  - Escrow account
  - Reinsurance back to the employer
  - "Return" of the mortality bond
  - Buyout part of the liability (but which part)
  - Attempt to capture transfer value and retirement cash commutation factor profit

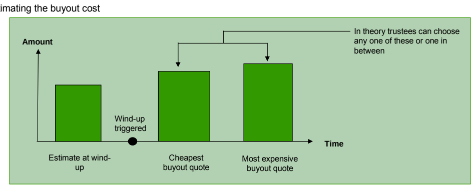
Some aspects are avoided

- Pension Protection Fund assessment
- Deemed buyback
- Difficult member communication regarding benefit cut backs

Dealing with shortfalls - debt

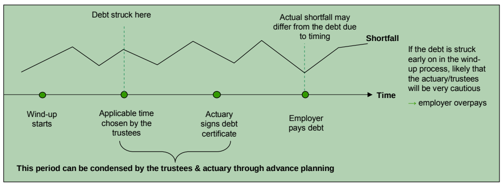
- Statutory debt (Section 75) – relevant guidance note GN19
  - Buyout cost of benefits (actuary estimates)
  - Estimate of wind-up expenses
- Estimating the buyout cost

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?

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

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, e.g.
  - PPF levies
  - Investment costs
  - Insurer costs
  - Insurer charges
  - VAT
  - Discretionary increases?

Debt - 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
- If they have this power they will probably use it, leaving the Section 75 debt as the back up
  - This may result (with hindsight) in exercise amounts being paid to the plan as any preliminary estimate will be approximate

Debt - 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?
- Example
  - Insurer A: Buyout cost £50 million
  - Insurer B: Buyout cost £60 million
- Questions:
  - Which insurer would the trustees choose?
  - Would the choice differ if the assets were £60 million and employer was entitled to surplus?
  - What should the debt estimate be?

Pragmatism

Who holds the risk?

- The trustees (out of their homes and personal savings Y/N?)

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 (e.g. 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 professional trustee

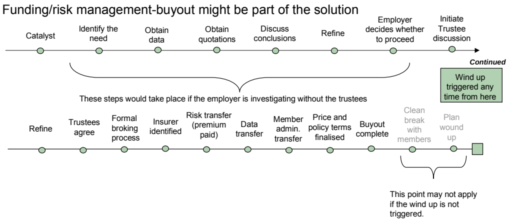
Buying out the benefits

- 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



Transfer values

- Move to buyout cost?
- Or look for profit?

Accounting – IAS19/FRS17

- Accounting liabilities do not equal buyout cost – something has to give eventually!
- Depends substantially on specifics of the case e.g.
  - 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 but would be taxed
- 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 just a shortlist?
    - What type of process will be run – formal tender with rules, or informal?
  - Can you deal with questions about insurer security?
  - Are sufficiently staff 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

Solvent wind-ups

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