The Actuarial Profession
making financial sense of the future

Breakout session C3:
Winding up and the Impact of New Legislation

Isabel Coles
Barnett Waddingham LLP

6 June 2005

Agenda

- Review of recent legislative changes:
  - Pension Protection Fund
  - Debt on the employer
  - Priority order on wind up
  - Contribution notices & clearance statements
- Some considerations when wind-up becomes likely

The Actuarial Profession
making financial sense of the future

Pension Protection Fund

- Since April 2005
- Takes over assets & liabilities of failed eligible schemes
- Pays compensation to scheme members
- Funded by annual levy
- Run by independent Board
- No guarantor of last resort

The Actuarial Profession
making financial sense of the future

Compensation benefits

- 100% pension
  - Aged over Scheme Normal Pension Age
  - Ill health retirements
  - Existing widows/widowers
- 90% pension
  - Everyone else (including early retirements)
- Increases to pension
  - Post 1997 pension: 2.5% LPI
  - Pre 1997 pension: nil
  - Deferred revaluation: 5% LPI
- Pensions capped at £25,000 pa

The Actuarial Profession
making financial sense of the future

Who can claim?

- Defined benefit/hybrid scheme
- Scheme not in wind-up before April 2005
- Employer insolvency event
- Insufficient scheme assets to buy out the PPF level of benefits
- Scheme rescue not possible
  - Insolvency practitioner to advise
  - Possibility of business rescue without scheme attached

The Actuarial Profession
making financial sense of the future

Assessment period

- Lasts approximately 1 year
- Actuarial valuation
- Various PPF powers
- No new members
- No further benefit accrual
- No contributions (other than those already due)
- No transfers
- Benefits paid at PPF level
- Winding up cannot start

The Actuarial Profession
making financial sense of the future

Transfer of liabilities to PPF

- Transfer notice issued to trustees
- PPF takes on assets of scheme
- Scheme wound-up
- PPF pays “compensation”
- Trustees discharged
- *…but only if PPF decides to accept the scheme!*

The Actuarial Profession
making financial sense of the future

“Closed scheme amendment”

- Sufficient assets to buy PPF level benefits, but unable to buy out
- Apply to run as closed scheme
- Regular actuarial valuations
- If at later date assets insufficient to secure PPF level benefits then apply to PPF

The Actuarial Profession
making financial sense of the future

How is the PPF financed?

- Assets from “failed” schemes
- Investment returns of fund
- Pension Protection Fund levy
  - Set by PPF Board
  - Flat rate and risk-based components
  - Aim for consistent costs over time regardless of economic cycle
  - Total annual levy estimated at £300m

The Actuarial Profession
making financial sense of the future

Who pays the levy?

- Schemes eligible to claim on the PPF
- Trustees must pay levy from scheme assets
  - Expect trustees to recoup it from employers
  - Members *may* pay flat-rate levy
- **Initial levy**: April 2005 to April 2006
  - Based on number and class of member
    - £15 per active member
    - £15 per pensioner
    - £5 per deferred member

The Actuarial Profession
making financial sense of the future

Calculating the levy

- Flat rate - scheme-based:
  - Number of members
  - Sum of pensionable earnings
  - Sum of liabilities
- Risk-based (80% of levy):
  - Funding level
  - Likelihood of insolvency
  - Mismatch of assets and liabilities
- Levy ceiling:
  - Increased annually in line with earnings
  - Max 25% higher than previous year

The Actuarial Profession
making financial sense of the future

Assessing underfunding for PPF levy

- First PPF valuation for scheme:
  - Effective date between 1 November 2004 and 5 April 2008
  - Can prepare at same time as next triennial valuation
  - Send to Pensions Regulator within a year of the effective date
  - Submit relevant form with summary details to PPF
- PPF valuations must be carried out at least once every 3 years
- PPF valuations submitted by 31 December each year will be taken into account for following year's levy
  - For 2006/07 levy submit first form by 31 December 2005

The Actuarial Profession
making financial sense of the future

Assessing underfunding for PPF levy

Assumptions:

- Net investment return: IL gilt yield – 0.5%
- Investment return non-increasing pensions: FI gilt yield
- Mortality tables: PMA92 mc & PFA92 mc for member's year of birth
- Winding-up expenses:
  - 3% of any liability value up to £50 million, plus
  - 2% of any liability value between £50 million and £100 million, plus
  - 1% of any liability value in excess of £100 million
- Benefit installation/payment expenses:
  - Pensioners: age-related scale (£250 to £450 per member)
  - Deferreds: £500 per member

Assessing underfunding for PPF entry

- Similar assumptions to levy calculation, except:
  - Compensation cap increases: 1.5% pa over LPI
  - Mortality tables: additional age rating applied

Pension size	Age rating
< 25% of compensation cap	+ 2
25%-50% of compensation cap	0
> 50% of compensation cap	- 2

The Actuarial Profession
making financial sense of the future

Moral hazard

- Employers dumping scheme liabilities on PPF
  - "At risk" companies waiting for PPF
  - Change scheme to become eligible
- Tactics to increase PPF claim
  - Augmentations
  - "Ill-health" retirements
  - Buy-out full annuities for pensioners
  - Adopt riskier investment strategy

The Actuarial Profession
making financial sense of the future

Protecting the PPF

- Risk-based levy
- Ignore recent rule changes and discretionary increases
- Review of ill-health awards
- Schemes must be eligible for PPF during three years before insolvency event
- Contribution Notices
- Financial Support Directions
- Early warning programme
- Power to reduce benefits

The Actuarial Profession
making financial sense of the future

Debt on employer

Crystallisation date
GN19
Effective date for debt calculation
Cash equivalent/GN11 basis
Winding-up date
Minimum Funding Requirement
Employer insolvency date
Annuity buy out cost
Insolvent employer
Solvent employer
Multi-employer schemes

The Actuarial Profession
making financial sense of the future

Insolvent employer

- Insolvency event triggers wind up
- *Wind-up starts before 15 February 2005*
  - MFR value of benefits for all members
- *Wind-up starts on/after 15 February 2005*
  - Buy-out cost for all members

The Actuarial Profession
making financial sense of the future

Solvent employer

- Trustees and/or employer decide start wind up
- *Wind-up starts before 11 June 2003*
  - Buy-out cost for pensioners
  - MFR transfer value for non-pensioners
- *Wind-up starts on/after 11 June 2003*
  - Buy-out cost for all members
- Timing of debt calculation is up to trustees

Implications for trustees

- If scheme rules permit, trustees can trigger wind-up and buy-out debt
- Trustees can agree lower debt
  - If in best interests of scheme and members
  - Notifiable event for the Pensions Regulator
  - Opra Update 7 provided guidance
  - Deficit of PPF valuation basis?
- Potentially difficult decisions for trustees

Impact on employers

- Incentive to avoid wind-up!
- Greater emphasis on company's ability to pay
  - Assessing ability to pay
  - Scheme specific funding
  - Regulator's influence?
- Impact on company deals and reorganisations?

Multi-employer schemes

Debt can be triggered by:

- Insolvency of one employer
  - Debt is buy-out cost since 15 February 2005
- Employer's last active member leaves service
  - Debt currently still calculated on MFR basis
  - … so last employer could pick up buy-out cost
  - Expected to change in summer 2005
    - Buy-out cost
    - MFR/scheme specific funding if financial support is put in place for the scheme

The Actuarial Profession
making financial sense of the future

Priority order on wind-up

- Once upon a time…
- … scheme rules and trustees' discretion
- Then came the Pensions Act 1995 …

The Actuarial Profession
making financial sense of the future

Original Pensions Act 1995 priority order

Transitional priority order:

1. AVCs
2. Non-surrendering pre 1997 insurance contracts
3. Pensions in payment (no increases)
4. Contracted-out liabilities (no increases)
5. Pension increases on 2 & 3
6. Pension increases on 4
7. Remaining deferred pensions (with increases)

Post April 2007 priority order:

1. AVCs
2. Non-surrendering pre 1997 insurance contracts
3. Pensions in payment (no increases)
4. Deferred pensions (no increases)
5. Pension increases

The Actuarial Profession
making financial sense of the future

Priority order from 10 May 2004

Winding Up Amendment Regulations 2004:

1. AVCs
2. Non-surrendering pre 1997 insurance contracts
3. Pensions in payment (no increases)
4. Deferred pensions (no increases)
5. Pension increases on 3
6. Pension increases on 4

were due to be merged in 2007

The Actuarial Profession
making financial sense of the future

Priority order from 6 April 2005

- s270 of PA2004 modifies s73 of PA1995
- New priority order:
  1. Non-surrendering pre 1997 insurance contracts
  2. Pension Protection Fund benefits
  3. AVCs
  4. All other benefits
- Money purchase benefits (including AVCs) are excluded and paid at 100%
- Added-years AVCs and AVC pensions in payment from scheme may be reduced

The Actuarial Profession
making financial sense of the future

Non PPF benefits include

- Deferred pensioners / pensioners under NRA (excl. ill-health, dependants)
  - 10% of pension (from 90% to 100%)
  - Pension in excess of £25,000 pa
- All members
  - Increases on pre 1997 pension
  - Increases > 2.5% LPI on post 1997 pension
  - Spouse’s pensions > 50%
  - Revaluation in deferment > 5% LPI
  - etc

The Actuarial Profession
making financial sense of the future

TVs / Early retirement

- Amend method of scaling-back transfer values to reflect new priority order
- Early retirement will no longer result in "priority-creep"
  - Members still getting some benefits out at 100% before wind-up (although TFCS taken can reduce PPF entitlement)
  - Effect on pensions of over £25,000 pa

Contribution notices

- Regulator's decision
- "reasonable to impose liability"
- Employers or any connected person or associate
  - Exemption for insolvency practitioners
- "act or deliberate failure to act"
  - On or after 27 April 2004
  - Prevents recovery of whole/part of s75 debt
  - Prevents debt becoming due or reduces amount of debt due
  - 6 year time limit
  - Regulator to consider purpose of act and whether act was to protect employment

The Actuarial Profession
making financial sense of the future

Clearance procedure

- Provide some certainty for business transactions
- Regulator provides clearance statement
- Regulator sets application and determination procedure
- "An event affecting an entity which is financially detrimental to the ability of a defined benefit scheme to meet its pension liabilities"
- Decision "as soon as reasonably practicable"
- Not binding if material change in circumstances

The Actuarial Profession
making financial sense of the future

Clearance considerations

- Deficit measure
  - Going concern
  - Discontinuance & buy-out deficit
- Regulator expects trustees to negotiate in same way as any material unsecured creditor of the company to achieve deal
- Regulator “referees” on whether deal is satisfactory for clearance purposes

The Actuarial Profession
making financial sense of the future

Events leading to clearance request

- **Priority**: change in level of security given to creditors that might lead to pension creditor receiving a reduced dividend in event of insolvency
- **Return of Capital**: reduction in overall assets of company which could be used to fund pension deficit
- **Control structure**: change in group structure including change in parent company
- Any other event potentially compromising amount due to pension scheme
- Notifiable Events list expected to be expanded

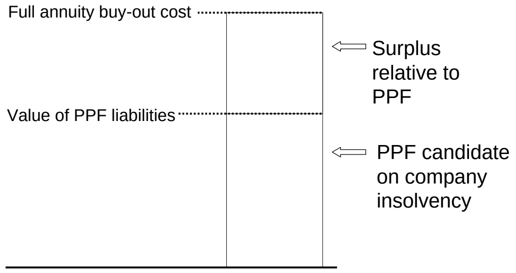
The Actuarial Profession
making financial sense of the future

Some other considerations

- Winding-up clause: who/what triggers wind-up?
  - Company insolvency
  - Company contributions ceasing
  - Notice from Principal Employer
  - Trustees (if doubt over future viability of the scheme)
  - Sale/purchase of employer
  - …

The Actuarial Profession
making financial sense of the future

Funding position?



Continuing contributions

- At a “reasonable” level
  - Input from company, trustees and possibly Regulator
- Cover future accrual and expenses?
- Remove past service deficit?
  - On funding basis?
  - Period to be agreed
  - Based on company’s ability to pay
  - Trustees as unsecured creditors of the company
- Trustees less likely to trigger wind-up while contributions continue

Impact of PPF levy?

- Extra cost of levy
- Trustees pass on cost to employer
- Steps employers can take to reduce their scheme levy?

Changing the scheme

- Alternative future service benefits
  - Retains active members & company interest
  - Wind-up less likely
- Terminating accrual
  - Look out for scheme oddities
  - Employment contracts
  - Comparison with replacement benefits
- Member agreement to benefit changes?
- Employee communication issues

The Actuarial Profession
making financial sense of the future

Running down (closed) schemes

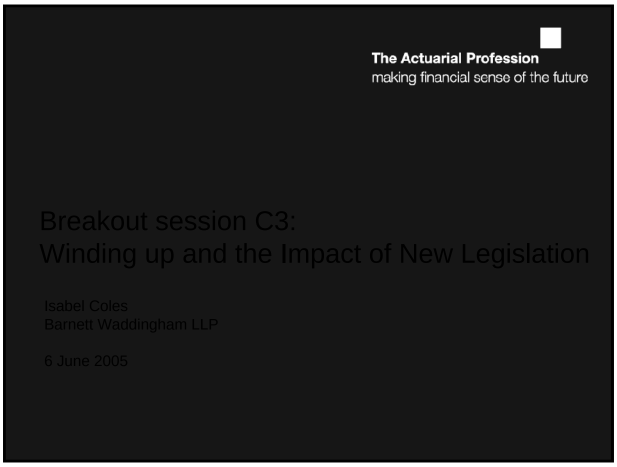
- Essential for large schemes
  - Buy-out market capacity?
- Preferable for many schemes with buy-out deficit
- Review funding & investment strategies
  - Term of liabilities to likely buy-out?
  - Funding to target eventual buy-out?
- Reducing scheme size
  - Partial buy-out?
  - Transfer value option

The Actuarial Profession
making financial sense of the future

Communication

- Maintain open lines of communication between trustees and company
- Discuss proposed funding and investment strategies between company and trustees
- Keep trustees informed of company's position and plans

The Actuarial Profession
making financial sense of the future


The Actuarial Profession
making financial sense of the future
Breakout session C3:
Winding up and the Impact of New Legislation
Isabel Coles
Barnett Waddingham LLP
6 June 2005