Key Points

- Options range from amending benefits to sophisticated investments
- The employer needs to consider its duty of good faith
- RPI/CPI

Main Sources

- The Pensions Regulator's statement on Incentive Exercises (2012): link
- The Pensions Regulator's Guidance on Asset–backed Contributions (November 2013): link
- Pensions Act 1995
- Pensions Act 2014
- IBM United Kingdom Holdings Limited v Dalgleish: link
- Barnado's & Ors v Buckinghamshire & Ors: link
- Incentive Exercises For Pensions A Code of Good Practice (version two, January 2016): link

Liability Management

Liability management describes a wide range of actions that trustees and sponsors can take that are intended to reduce the financial risks which a defined benefit occupational pension scheme faces. Below are some of the most common actions.

Benefit Redesign

Over the last few years one of the most popular ways of reducing the financial risk associated with defined benefit occupational pension schemes has been to close such schemes to new joiners and/or future accrual. The ability to do this depends on the provisions in the scheme's documentation, including, in particular, the amendment power. It will also usually be necessary to consult with scheme members.

A less drastic alternative to closing the scheme is changing the benefit structure for future benefit accrual, for example:

- by moving to career average or a cash balance type arrangement;
- by asking members to pay higher contributions; or
- by putting a cap on the salary which counts towards pension benefits.

Following the decision in IBM v Dalgleish, employers should be conscious of their duty of good faith when redesigning benefits. Whilst the case is very fact specific, it highlights the importance of adopting a proper process.

Enhanced Transfer Value (ETV) exercises

This is where employers offer deferred members an inducement to transfer their benefits out of the scheme (usually to a defined contribution scheme). In the past, the inducement was sometimes a cash payment made directly to the transferring member. However, in the light of the Pensions Regulator's guidance, the inducement now more commonly takes the form of an increased transfer payment paid through the scheme.

Guidance from the Pensions Regulator sets out the issues which trustees should consider if asked by the company to offer ETVs. It is important to take care over these exercises and it would be usual to follow the Guidance closely.

The Government has the power (due to expire in 2020) to make regulations to prohibit incentive exercises, but it has not yet done so. It continues to monitor compliance against the Guidance.

The Industry Code of Good Practice for Incentive Exercises (revised January 2016) should be followed where an ETV exercise is undertaken.

Pension Increase Exchange (PIE)

A PIE is usually designed as an option under scheme rules providing members with an opportunity to give up non-statutory pension increases (for example, increases on pension accrued in excess of Guaranteed Minimum Pension prior to 6 April 1997). In return, the member may receive a cash lump sum or (more commonly now) a different kind of benefit such as a higher initial pension.

Following the introduction of new pension flexibilities, PIE is likely to become a common option available to members reaching retirement, alongside commutation and transfers out.

If the PIE exchange is not an option under the scheme rules that is ordinarily available to members, the Industry Code of Good Practice for Incentive Exercises (revised January 2016) should be followed where a PIE exercise is undertaken.

Asset Backed Contributions (ABC)

Under an ABC, the employer pays a significant additional contribution to a pension scheme on condition that it is used to buy an interest in a special purpose vehicle ("SPV"). The SPV is typically a Scottish Limited Partnership for specific and important technical reasons, although alternative structures such as Jersey Limited Partnerships can be used instead. It is important that ABCs are structured in such a way so that they comply with the restrictions on employer related investments.

The SPV typically uses the money to acquire an asset (or assets) from the employer which is capable of producing income (such as property or intellectual property rights) and it then leases that asset back to the employer to generate a regular income which the SPV in turn pays to the pension scheme. The "asset" which the pension scheme acquires is the partnership interest, which is valued as the net present value of the future anticipated cash flows that it delivers.

Such arrangements can have an immediate positive impact on a scheme's funding level and can have a cost saving on the Pension Protection Fund levy if certain requirements are met.

ABCs can help the employer to negotiate lower annual pension contributions and give trustees additional assets over which they have access in the event of employer insolvency. Guidance from the Pensions Regulator sets out the issues which trustees should consider if asked by the company to enter into an ABC arrangement.

RPI/CPI

Cases such as those involving the schemes of Qinetiq and Arcadia have caused many companies to review the rules of their pension schemes to check the precise definition of inflation used for the purposes of calculating increases to pensions for retirees and those pending retirement.

In some instances, it will be possible to change the inflation index which applies from the retail prices index to another index, such as the consumer prices index, which tends to result in lower increases and therefore lower liabilities in the scheme.

However, it will not always be possible to change the index as can be seen by the recent decision in Barnardo's. Each case will turn on the precise wording of the scheme's rules. Even if the scheme rules are drafted in a way that such a change could legally be made, companies are likely to have to make a compelling case to trustees in order to get them to agree to make such a rule change.

Buy-In/Buy-Out

A buy-in is an insurance contract which trustees purchase as an asset of the scheme. The contract produces an income stream which is intended to cover the accrued scheme benefits payable to and in respect of certain scheme members. A buy-in will often cover just pensioners but it can cover both pensioners and deferred members.

A buy-in contract can be purchased and held as a long term investment of the scheme or it might be purchased with a view to moving straight to buy-out (see below).

As the buy-in contract is a trustee investment, the trustees need to make sure they have the power to enter into it. They must also obtain written investment advice to confirm that it is a suitable investment for the scheme.

While the buy-in contract is in place, the trustees remain responsible for paying the members' benefits although the intention is usually that the payments from the insurer to the trustees under the buy-in contract will match the payments due to the members covered by that contract under the scheme.

If there is a shortfall between the benefits payable under the buy-in contract and the benefits payable under the scheme, the trustees will be responsible for any such shortfall, unless the trustees purchase additional cover from the insurer (referred to as 'all-risks' cover).

A buy-out is much like a buy-in, except that a buy-out contract is an individual contract between the insurance company and a particular scheme member. The insurance company will be responsible for paying benefits to or in respect of the member and, provided that the buy-out contract meets certain requirements, the trustees will no longer be liable for paying such benefits.

Buy-out contracts are usually purchased as part of the process of winding-up a pension scheme. Trustees might purchase buy-out contracts in the members' names or they might assign the benefit of a buy-in contract to the member.

With a buy-in, the employer remains liable for funding the scheme and the Pension Protection Fund is usually available on the employer's insolvency. In addition, if the insurer who issued a buy-in policy became insolvent, the Financial Services Compensation Scheme (FSCS) would pay compensation to the trustees. Following a buy-out, compensation for any shortfall on the insolvency of the insurer would be under the FSCS only.

Medically underwritten policies are increasing in popularity. Risk profiles of scheme members can be taken into account and policies tailored either to reflect the membership as a whole or on an individual member basis.

Longevity Swap

These are relatively complex financial instruments and have been used by a few large schemes as means of countering the risk of members living longer than expected. Under a longevity swap, the trustees transfer to the contractual counterparty (some or all of) the risk of increased liabilities arising from increased life expectancy. Swaps operate using a fixed leg and a floating leg.

Trustees make payments to the provider for a specified period based on assumed mortality: this is the fixed leg. In return, the provider pays a cash flow in respect of members covered by the swap contract for the remainder of each such member's life, whether that period is longer or shorter than the specified period (this is the floating leg).

In practice, the parties' opposite payment obligations are "netted off", so only the balance is payable. Longevity swaps can be structured through insurance policies or as a derivative.

Longevity swaps operate over a potentially long time period and if a buy-in or buy-out is anticipated in the future, schemes should think carefully before entering into a longevity swap as to how the swap would interact with, or be replaced by, a subsequent buy-in.

Key issues for trustees to consider are the swap's termination provisions and the likely risk/reward profile of implementing a longevity swap and then a subsequent buy-in, as compared to the corresponding profile for avoiding the longevity swap and moving straight to a buy-in at some time in the future.