The Society of Actuaries in Ireland

Association of Pension Lawyers in Ireland

# Approaching Benefit Reduction Proposals

Joint Evening Meeting – 5 May 2010

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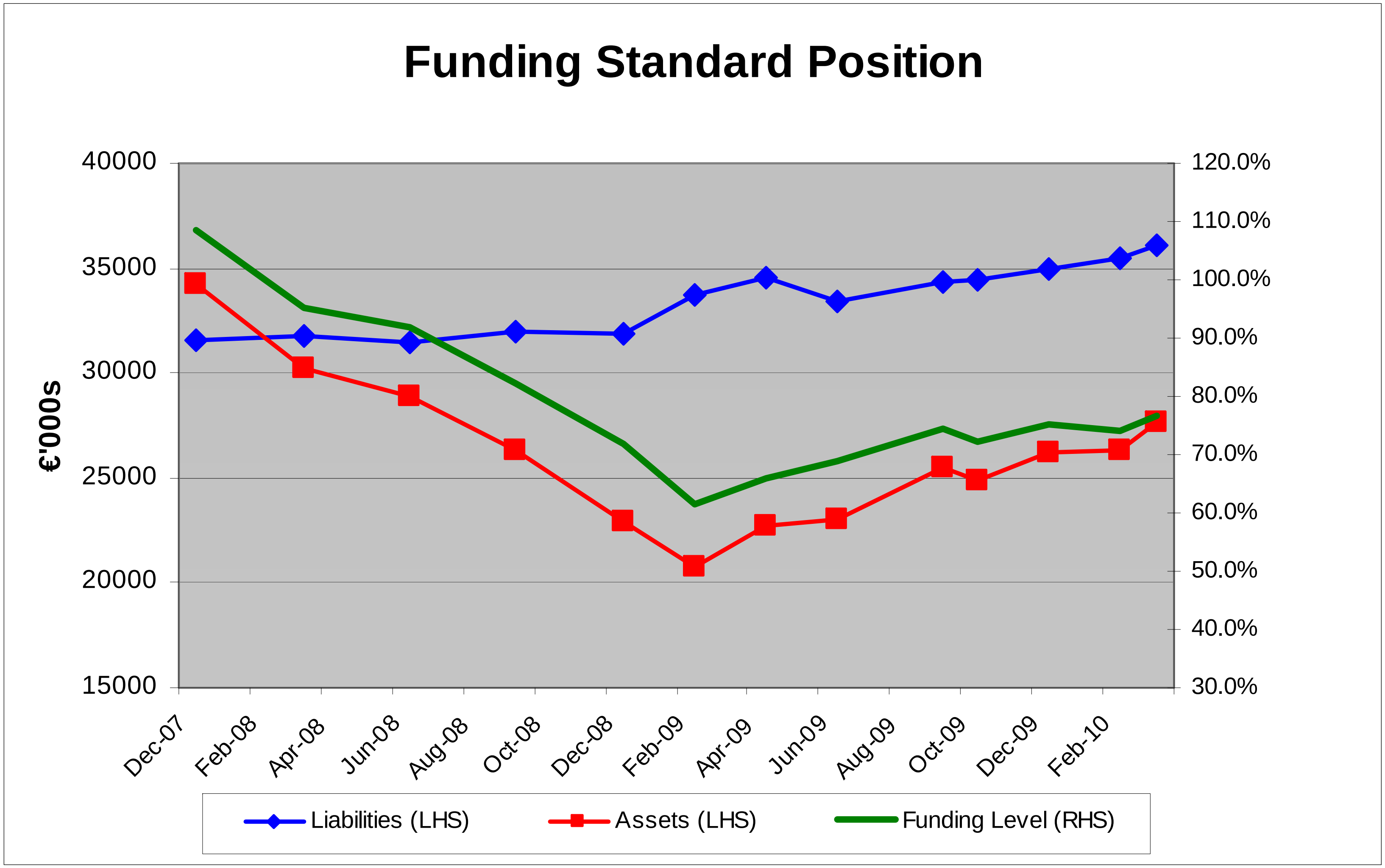
# Agenda

- Introduction/context
- Typical approach
- Overview of ways to reduce benefits/risk
- Legal methods of changing benefits
  - (i) Within terms of trust deed and rules
  - (ii) Contractual
  - (iii) Section 50
  - (iv) Windup and bulk transfer
- Legal protections
- Preservation and worked examples
- Accounting impact
- Practicalities
- Miscellaneous issues

# Context



Funding Standard Position
40000
35000
30000
25000
20000
15000
€'000s
120.0%
110.0%
100.0%
90.0%
80.0%
70.0%
60.0%
50.0%
40.0%
30.0%
Dec-07
Feb-08
Apr-08
Jun-08
Aug-08
Oct-08
Dec-08
Feb-09
Apr-09
Jun-09
Aug-09
Oct-09
Dec-09
Feb-10
Liabilities (LHS)
Assets (LHS)
Funding Level (RHS)

# Typical Approach

1. Outline strategy phase
   - Review current position
   - Understand sponsor objectives (cost saving, risk reduction, harmonisation of benefits, etc)
2. Detailed considerations
   - consider detail of possible benefit changes and associated costings (impact on funding / accounting)
   - legal advice to company
   - refine to final proposal
3. Trustee negotiations
   - Prepare business case for trustees
   - Present to trustees and seek agreement
4. Prepare communication and consultation strategy
   - draft communication materials (announcements, Q&As, presentations, etc)
   - obtain reviews from trustee board
5. Consultation process
   - launch member communication sessions
   - consider views from employee representation groups/unions
6. Implementation
   - execute deeds of amendment, issue new explanatory booklets, disclosure requirements, etc
   - review administration processes/system changes, etc

# Options

- **No change**
- **Alternative Funding Options (contingent assets)**
- **De-Risking – No change to benefits**
  - Buying out Pensions
  - Enhanced Transfer Values
  - Investment Strategy
  - Transfers without consent (<€10k)
  - Trivial commutation
- **De-Risking – Amend / eliminate benefits**
  - **Close to new entrants**
  - **Reduce discretionary benefits**
  - **Increase member contributions**
  - **Future service benefit entitlements**
    - ***Amend:***
      - Cap/freeze pensionable salary increases
      - Accrual rate
      - Pension increases
      - Definition of 'pay'
      - Final Averaging period
      - Career average
      - Normal Pension Date
      - Spouses benefit
    - ***Eliminate:***
      - Cease future accrual ("freeze scheme")
        - *Maintain salary link*
        - *Break salary link*
  - **Past service benefit entitlements**
    - ***Amend (Section 50 of Pensions Act)***
      - Pension increases*
      - Accrual rate
      - Normal Pension Date
      - Spouses benefits
      - Definition of 'pay'

      ** For pensioners, only permitted to change pension increases*
- **Wind up**

# Ways to change benefits

- Within the terms of the scheme
- Contractual change outside terms of the scheme
- Section 50 order
- Wind-up and replacement scheme

# Changes within the terms of the scheme

- **Key issues**
  - ➢ Is the amendment power valid?
  - ➢ Restrictions in the amendment power
  - ➢ Implied restriction on amending accrued benefits?
  - ➢ Getting trustees to agree to the amendment
  - ➢ Interaction with employment contract

- Suitable for changes to active members' benefits

# Contractual change outside terms of the scheme

- **Principle**
- **How the process works**
- **Role of the trustees**
  - Do they accept the principle works in Ireland?
  - Concerns over communications
  - Amend trust deed and rules following contractual changes?
- **Unilateral power to amend contracts ?**
- **Suitable for changes to active members' benefits**

# Section 50 order

- **Principle**
- **Role of trustees**
- **Pensions Board guidance / requirements**
- **Effect of a section 50 order**
- **Suitable to change benefits of actives and deferreds and remove pension increases for pensioners**

# Wind-up and replacement of scheme

- **Principle**
- **Workability**
  - Needs buy in of two sets of trustees
  - Security of funding in receiving scheme
  - Wind-up provisions of transferring scheme
- **Suitable for altering benefits of pensioners, deferreds and future service benefits of actives**

# Legal protection of members' benefits

- **Trust deed and rules**
- **Employment contracts**
- **Legislation**
  - Payment of Wages Act 1991 – member contributions
  - Section 59B Pensions Act – no reductions in pensions in payment
  - Sections 59D and E Pensions Act and bulk transfer regulations – bulk transfers without consent
  - Part 3 and Second Schedule Pensions Act, preservation regulations, special calculations regulations - preservation

# Preservation

Preservation applies on termination of relevant employment prior to normal pensionable age (excluding termination caused by death in service) where the member has at least two years' qualifying service

In effect, grants deferreds statutory entitlements on top of entitlements in trust deed and rules

## Preserved = Basic Preserved + Additional Preserved

J = Basic Preserved = A x $B_1$ / C

A = original Long Service benefit (LSB)

$B_1$ = completed reckonable service after 01/01/1991
$B_2$ = completed reckonable service prior to 01/01/1991

C = prospective reckonable service to NRD

G = scheme leaving service benefit

H = value for money benefit such that actuarial value of H is equal to member contributions

Additional Preserved = greater of: (i) G-J (ii) H-J (iii) A x $B_2$ / C

# Preservation (contd.)

## Changes to benefits

Where there is an alteration in the **basis** of calculating **long service benefits**, the basic rule is that the effect of alteration is accrued over reckonable service arising after the alteration

Basic Preserved = A x $B_1$/C + D x E/F

D = change in LSB at date of alteration

E = completed reckonable service after date of alteration

F = prospective reckonable service to NRD after date of alteration

Additional Preserved as shown on previous slide

Full financial saving of benefit reduction may not be achieved unless and until employee reaches normal retirement age

# Worked examples of typical benefit changes

- Changing accrual rate
- Capping Pensionable Salary Increases
- Change in Normal Retirement Age
- Removing pension increases under section 50 order

# Example #1 – change in accrual rate

Change from 1/60th of Salary to 1/80th of Salary

1. No change
2. For future service only
3. For all service (assuming permitted by amendment clause)
4. For all service (Section 50)

<u>Details</u>

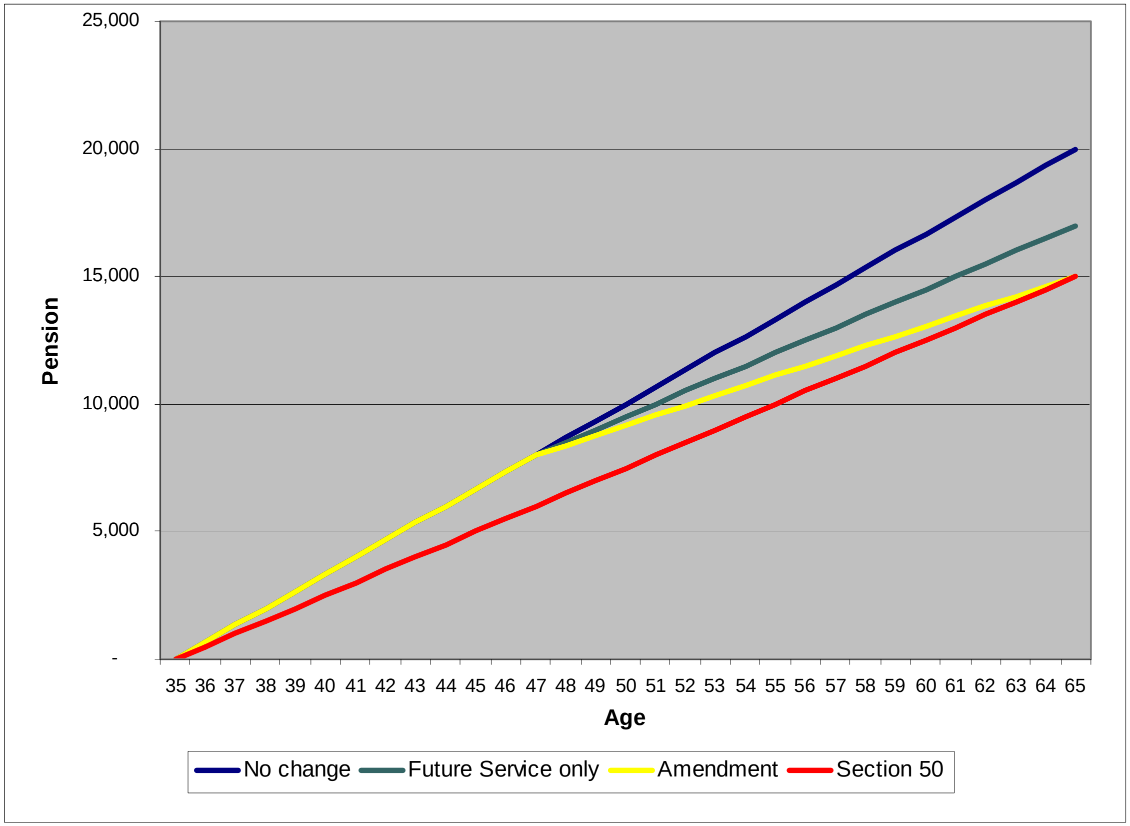
Salary €40,000

Joined age 35, NRD 65, Benefit scale changed age 47

1. LSB = 30/60 x €40,000 = €20,000

2. LSB = 12/60 x €40,000 + 18/80 x €40,000 = €17,000

3&4. LSB = 30/80 x €40,000 = €15,000



# Example #2 – capping pensionable salary increases

**General comments**

- Popular measure
  - allows actuary to credibly reduce salary growth assumption
  - overnight reduction in disclosed deficit under ongoing and accounting valuations but not Funding Standard
- Most suitable for mature DB schemes, closed to new entrants?
- Any special arrangements for promotions?
- Supplementary DC provision on non pensionable DB earnings? Same trust?
- Can be implemented outside the scheme by a contractual variation to remuneration (basic/non pensionable allowance) or by rule amendment
- Varying views on preservation issues
  - Change in rule/definition equals a change in long service benefit?
  - …but no change in long service benefit immediately before and after alteration
  - If one accepts it is a change in LSB then it triggers D x E/F calculation and phasing in

# Example #2 – capping pensionable salary increases

Pensionable salary cap introduced of lesser of: (i) actual increase (ii) price inflation and (iii) 4%

<u>Details</u>

Joined age 40, NRD 65,

Starting salary €40,000

Pensionable Salary growth 5% p.a.

Cap introduced at age 50, pensionable salary €65,156

Inflation assumption 2% p.a.

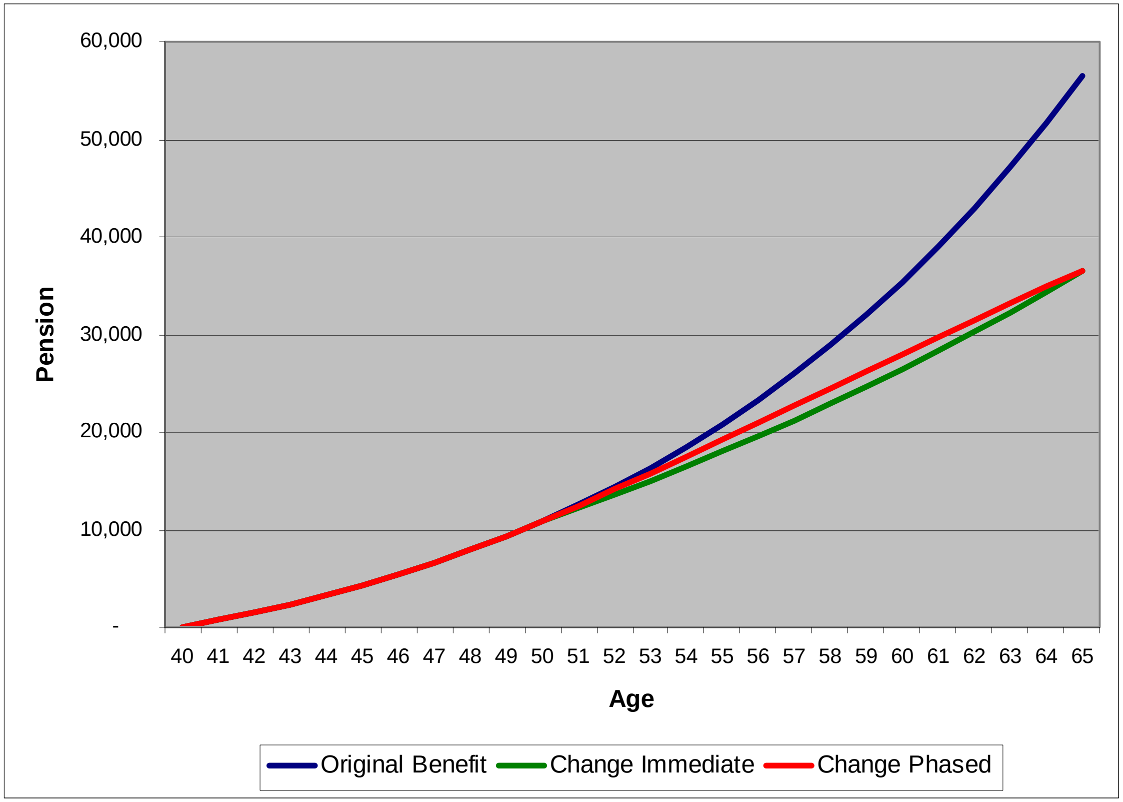
Projected "Old" pensionable salary at age 65: €135,454

Projected "New" pensionable salary at age 65: €87,691

LSB at date of change = 25/60 x €65,156 = €27,148

"Change Immediate" based on 1/60 x New Pensionable Salary x Service

"Changed Phased" based on A (old PSal) x b/c +D (difference in LSB between old & new PSal) x e/f




Phased approach has implications for funding proposals and accounting (reductions recorded over vesting period) as well as more complicated administration.

# Example #3 – increasing Normal Retirement Age

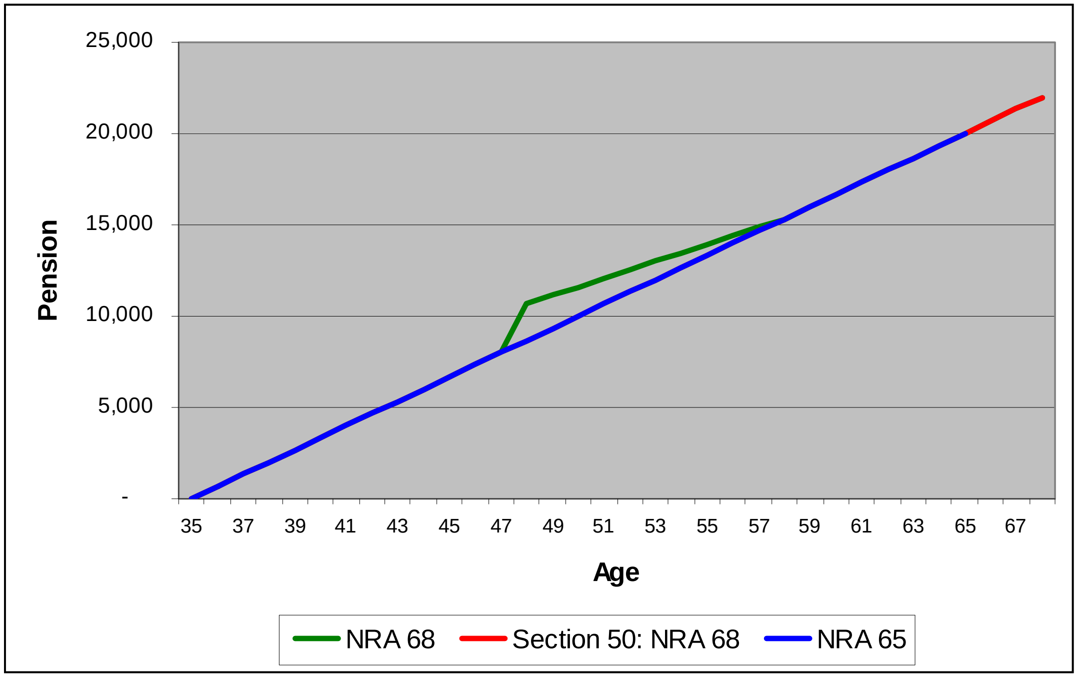
Current special calculation regulations: changing retirement age phased in over 10 years or period to new NRD, if less.

Basic Preserved = A x E/C + A x S x T/C where T = U + (100-U) x V/W
where U = percentage certified by Actuary such that actuarial value of a preserved benefit after the change is equal to the actuarial value before.

Section 50 (SI 148/2010): U=100%, no phasing required and impact of higher NRD is immediate.

Section 50 change

| Age in 2010 | New SPA | TV impact |
|---|---|---|
| 65 | 65 | 0% |
| 60 | 66 | -6% |
| 55 | 66 | -7% |
| 50 | 67 | -13% |
| 45 | 68 | -19% |
| 40 | 68 | -19% |
| 35 | 68 | -19% |
| 30 | 68 | -19% |



# Section 50 example – removing pension increases

| | Current: w/ pincs | S50: Remove pincs | S50 Stress #1 (weaker) | S50 Stress #2 (stronger) |
|---|---|---|---|---|
| Expenses | 13 | 13 | 13 | 13 |
| Pensioners | 204 | 157 | 166 | 166 |
| Deferreds | 94 | 74 | 74 | 86 |
| Actives | 330 | 263 | 263 | 297 |
| Total | 641 | 507 | 516 | 562 |
| | | | | |
| Assets | 400 | 400 | 364 (91%) | 364 (91%) |
| Funding Level | 62% | 79% | 71% | 65% |
| | | | | |
| Contributions – 10 years | | | | |
| -Accrual | 28% x Salary (22 pa) | 28% x Salary | 28% x Salary | 28% x Salary |
| -Deficit – no change to investment strategy (70% eq/30% bond) | 20 p.a. | 0 p.a. | 13 p.a. | 20 p.a. |
| -Deficit – switch to 100% bonds over 3 years | 35 p.a. | 10 p.a. | 8 p.a. | 15 p.a. |

Stress test #1 (weaker): 0.5% fall in yields (impacts annuity costs and TV MVAs), 15% fall in equities, Projected investment return of 5% p.a.

Stress test #2 (stronger): 0.5% fall in yields (impacts annuity costs and TV discount rates), 15% fall in equities, Projected investment return of 4.5% p.a.

# Section 50 example (contd.) – key messages

| | Current: w/ pincs | S50: Remove pincs | S50 Stress #1 (weaker) | S50 Stress #2 (stronger) |
|---|---|---|---|---|
| Contributions – 10 years | | | | |
| -Accrual | 28% x Salary (22 pa) | 28% x Salary | 28% x Salary | 28% x Salary |
| -Deficit – no change to investment strategy (70% eq/30% bond) | 20 p.a. | 0 p.a. | 13 p.a. | 20 p.a. |
| -Deficit – switch to 100% bonds over 3 years | 35 p.a. | 10 p.a. | 8 p.a. | 15 p.a. |

1. There may be differences in how the mechanics of the stress test are interpreted
2. The cap on assumed future investment returns over the projection period reduces the incentive to hold "risky" assets
3. The stress test results, assuming a switch to bonds in the near term, produces a lower initial deficit funding requirement as a result of not having to hold investment mismatching reserves.

# Accounting implications

- Changes for future service only / increased member contributions
  - Reduced service cost

- Past service changes e.g. section 50
  - US GAAP: spread forward over average future working lifetime
  - FRS17/IAS19: negative past service cost, recognised over period in which reduction vests

- Pensionable Salary capping:
  - FRS17/IAS19 (OCI): curtailment gain recognised in P&L
  - IAS19 (corridor): curtailment gain + proportion of unrecognised actuarial gains/losses)

- Closure to future accrual:
  - Service cost (retirement benefits) goes to 0
  - FRS17/IAS19 (OCI): if Final Salary linkage removed, same as pensionable salary capping
  - IAS19 (corridor): curtailment gain if Final Salary linkage removed plus immediate recognition of unrecognised items? Also future gain/losses to be recognised immediately (due to no AFWL)?
  - US GAAP: complicated – may involve full recognition of unrecognised prior service costs. Future gains/losses may be amortised over average life expectancy of inactives.

# Practical issues

- Conflicts of interest
  - Trustees
  - Advisers

- Role of employer
  - No engagement with employer but statutory deadline close
  - Unpersuasive justification for reducing benefits
  - Confusion over implementation method
  - Content of communications in contractual variation process

- Role of trustees
  - How far to push the employer for a better deal
  - How much financial information to seek
  - Security of ongoing funding arrangements
  - De-risking

# Practical issues

• Not thinking through all of the details of how reductions will sit with the existing benefit structure and who they affect

- How would you draft the deed of amendment?
- Death benefits, contributions, state scheme offsets etc
- Multi-sectional schemes

> Preservation

- Does revaluation or phasing in apply?
- Ask the Pensions Board?
- Funding and administration depend on the correct answer

# Practical issues

- Pensionable Salary capping
  - What to do with State offset?
  - Correspondence with contributory base for member contributions?
  - What inflation is referenced if pensionable pay is at a point in time?
  - Administration issues: storing and tracking different rates of pay

- Future service provision
  - Death benefits
  - Ill health benefits

- Administration issues
  - Revision to factors e.g. commutation / early retirement
  - Administration
    – split benefits, part timers, benefit statements, systems
  - Identifying who is affected by the reductions

# Miscellaneous issues: (1) career average

- Principle of uniform accrual doesn't work when calculating preserved benefit

Example: Member joins CARE (2% accrual) scheme at age 30 and leaves at age 33. NRA is 60.

Accrued pension calculated as follows:

| Year | Salary | Accrued Benefit in Year | Revaluation on Opening Figure | Closing Figure |
|---|---|---|---|---|
| 1 | €25,000 | €500 | 0 | €500 |
| 2 | €27,000 | €540 | 15 | €1,055 |
| 3 | €30,000 | €600 | 32 | €1,687 |

The rate of revaluation has been taken as 3% each year, although the example is not sensitive to this.

Long Service Benefit = €1,687 + 27 x 2% x €30,000 = €17,887

Preserved benefit calculated as LSB x 3/30 = €1,789

Preserved benefits that are greater than the intended leaving service benefit is not a desirable outcome.

Impact for revaluation recognised in para 6 of second schedule but no recognition given to calculation of preserved benefit.

# Miscellaneous issues: (2) pre scheme service

– Issue on windup

➢ Pre scheme service does not count as reckonable service

- Classified as additional preserved
- Para 3 of Third Schedule cover basic preserved benefits (plus future revaluation)
- Para 4 of Third Schedule covers pre 1991 benefits (excluding future revaluation)
- Para 5 of Third Schedule covers additional preserved (to extent not covered in previous paragraphs) plus future revaluation
- Para 5 of Third Schedule ranks last on wind up under S48(1A)(b), even after post retirement pension increases

**<u>Example</u>**

Member joined company at age 22 (01/01/1986) and scheme at age 25 (01/01/1989). Pensionable service is service with company [max 40 years]. Member leaves employment at age 46 (01/01/2010). Salary €50,000.

Scheme deferred pension = 24/60 x €50,000 = €20,000 pa

Basic Preserved = 40/60 x €50,000 x 19/40 = €15,833 pa

Additional Preserved = max[€20000-€15833=€4167 ; 40/60 x 50,000 x 2/40=€1667] = €4,167 pa

On windup:

(i) basic preserved (€15,833 pa) + future revaluation covered under para 3 of Third Schedule

(ii) Pre 1991 element of additional preserved (€1,667 pa) excluding future revaluation covered under para 4 of Third Schedule

(iii) Pre scheme service (€2,500) + future revaluation on additional preserved (€4,167) covered under para 5 of Third Schedule