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IAPF TRUSTEE NETWORK EVENT

DB Pensions: De-risking for the Future

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Tony Fleming
IAPF Council

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DB De-risking for the future

Thursday 8 November 2018

Aon Empower Results®

Pension de-risking: what is it?

Financial risk reduction

More sustainable pension

Termination/wind up

What are the risks looking to remove?

Some of the key risks identified

Risks:

- Will change over time
- Differ depending on basis

20%

Irish Schemes completed buy-out or likely to in the short term*

Liability

Asset

Covenant

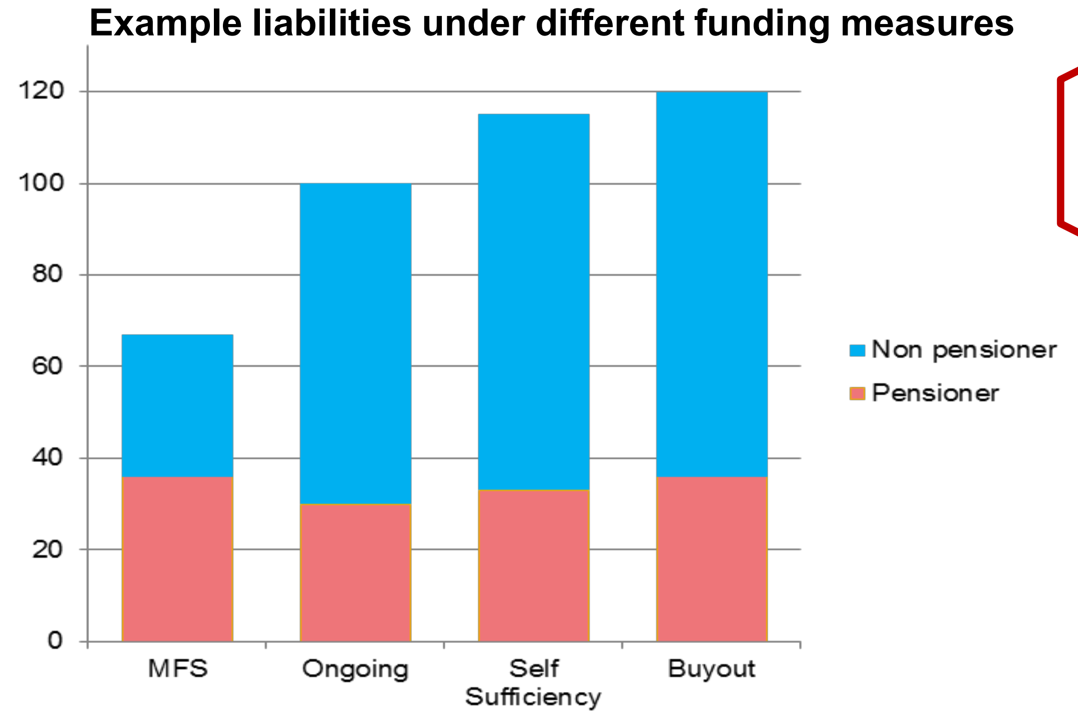
Legislation

Funding Volatility

*Aon Global Pension Risk Survey 2018

How do different targets compare?

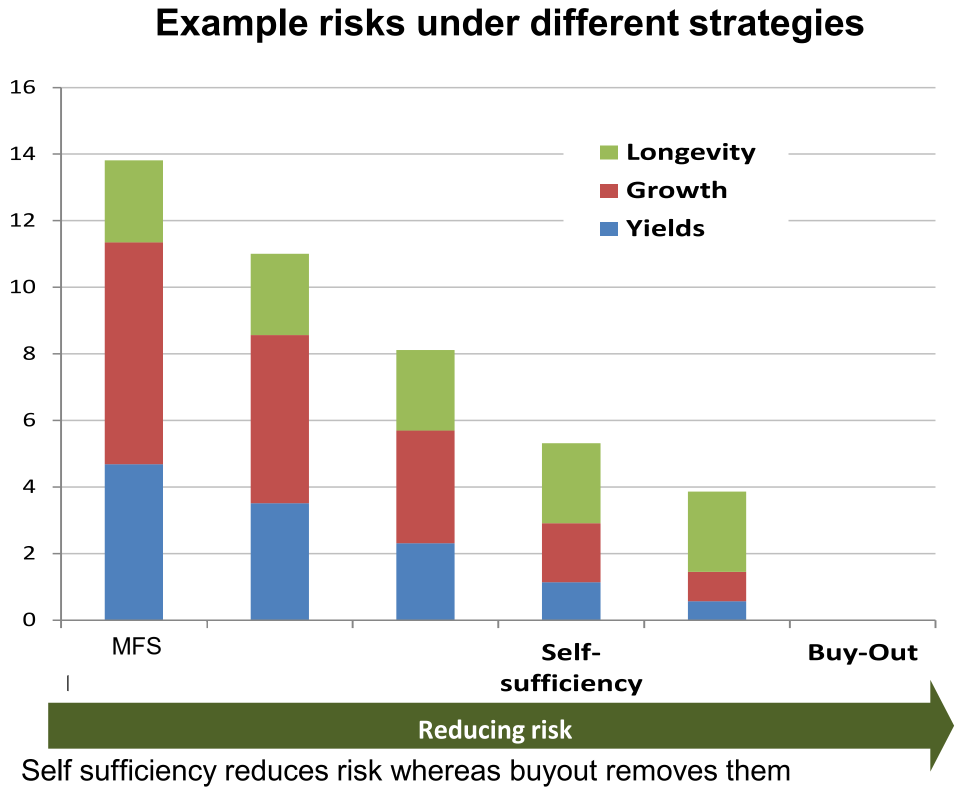
Cost



- Long term target typically much higher than MFS, particularly for immature plans
- Typically similar for pensioners with bigger gap for non pensioner
- As schemes mature targets typically converge

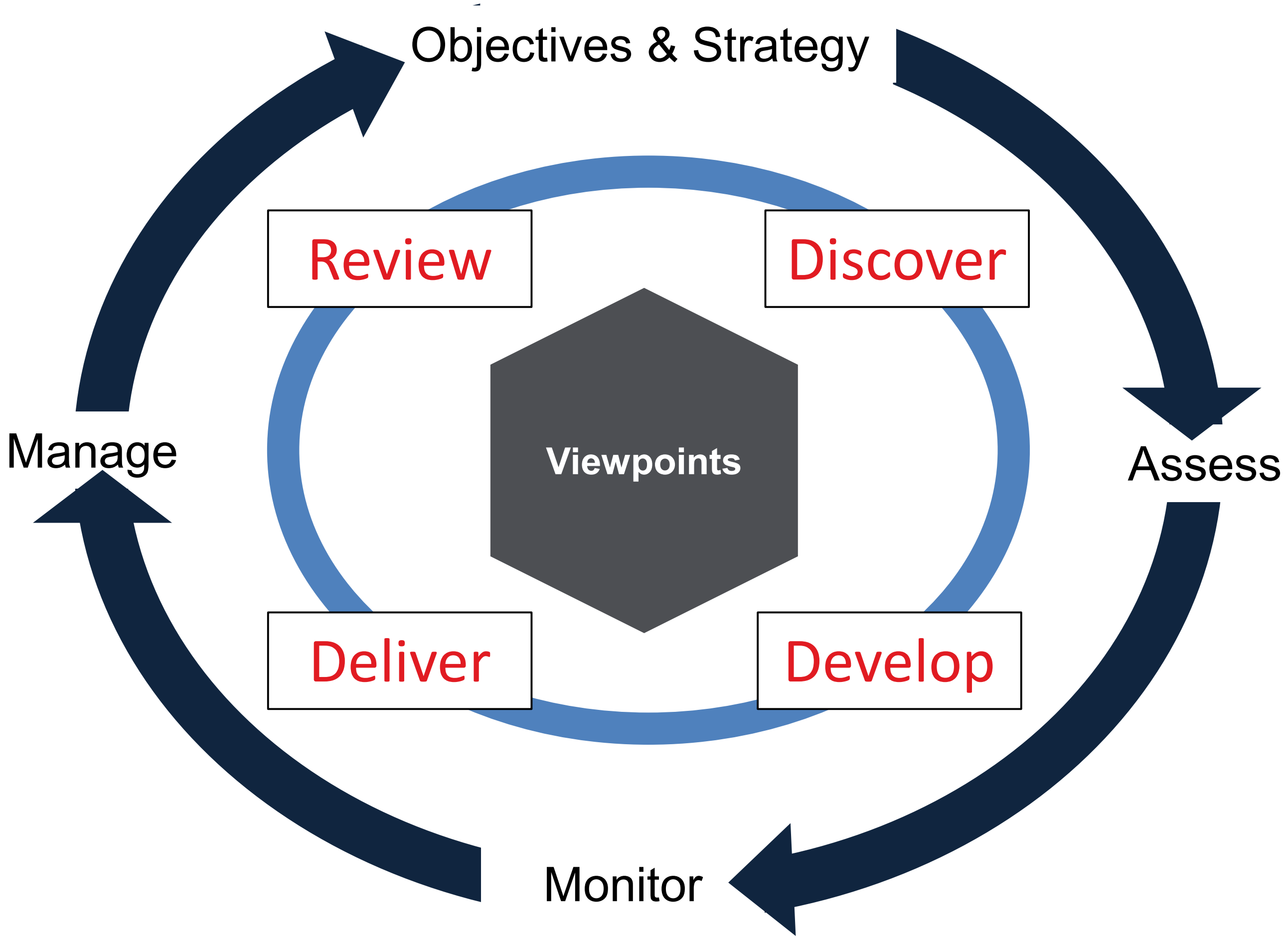
Vs

Risk



- Self sufficiency reduces risk whereas buyout removes them
- Exogenous risks in addition – buyout removes these
- Longevity risk becomes more significant as investments de-risked

Process to consider risks in more detail



What a de-risking plan might look like

Why a long term plan?

- Improve security for members
- Reduce the risk of future cash calls
- Comply with increasing regulatory pressure

What is your end-state?

- Buy-out?
- Long-term self-sufficiency?

What does the end-state look like?

- Liabilities/Assumptions/measurement
- Residual risks/ Buffer/ Treatment of future expenses
- Investment strategy

What does the journey look like?

- How quickly is it achievable?
- What balance between cash/investment returns
- What risks do you run – and how can you reduce these?
- Can you take actions to accelerate time/mitigate risk?

Covenant Assessments

What is employer covenant?

Pension schemes are creditors, usually unsecured creditors ranking behind secured bank loans

A covenant assessment is like a credit rating designed for pension scheme trustees

Employer Covenant is defined* as the Employer's (i) Legal obligation **and** (ii) financial ability to support the pension scheme now and in the future.

As there is no debt on employer in Ireland, (ii) may be replaced by the "willingness" or the "commitment" of the employer. Will the employer always be willing to meet contribution demands in future?

Pension "Debt"
(unsecured creditor)

Other Debt
(secured and unsecured)

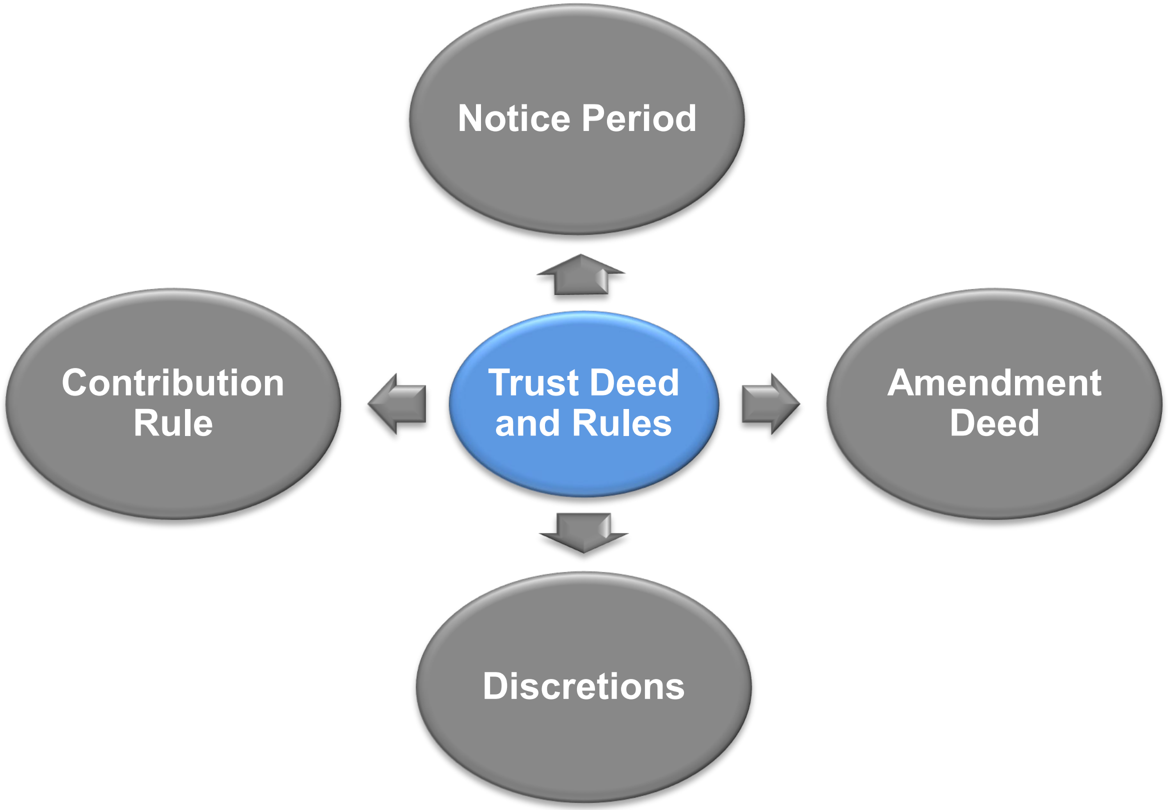
* Source – the (UK) Pensions Regulator

Employer’s commitment

If an employer meets financial difficulties or has other circumstantial changes, will the pension scheme be supported as well in future?

Scheme trustees should assess:

- Any legal commitment with the company or the parent company
- Balance of powers in the trust deed and rules



Why is covenant important?

Covenant influences the size of ongoing liabilities and deficit contributions

1

Assess the covenant (strong or weak)

Weak | Tending to Weak | Tending to Strong | Strong

2

Based on the strength of covenant, choose an appropriate **asset mix** and then set a prudent discount rate for ongoing valuations

Conservative investments & actuarial assumptions

Prudence

Optimistic investments & actuarial assumptions

Best estimate

3

Quantify the MFS deficit and funding proposal contributions *(what's affordable €€€ ?)*

€€€€€
Shorter FP period
Higher Contributions
Lower EROA

€€€€€
Longer FP period
Lower Contributions
Higher EROA

Member Option Exercises

What are member option exercises?

Member options exercises involve:

1. Making new options available
2. Amending existing options
3. Raising awareness on options available

Which allow members to choose a different form of benefit to those provided as a default by the scheme.

Focus today on:

- Transfer Exercises
- Pension Increase Exchanges

Why implement member options exercises?

Benefits from the trustee /sponsor perspective	Benefits from the member perspective
▪ Better service to members as gives them more options ▪ May reduce the cost of funding the scheme ▪ May reduce ongoing risks (e.g. mortality) ▪ May make liabilities easier to match ▪ May reduce ongoing administration costs ▪ May make buyout more affordable	▪ It is a new option ▪ Provides additional flexibility – may give members the option to choose when to retire and the level and shape of retirement income to better suit needs and circumstances ▪ May give a higher tax free lump sum (retirement option) and/or pension ▪ Tax efficient death benefits ▪ May offer additional security to members

These exercises do not need to be sponsor led - trustees may want to offer additional options to members. As long as they are communicated clearly and in a balanced way, it is in members' best interests to highlight the options and to facilitate members investigating and taking them.

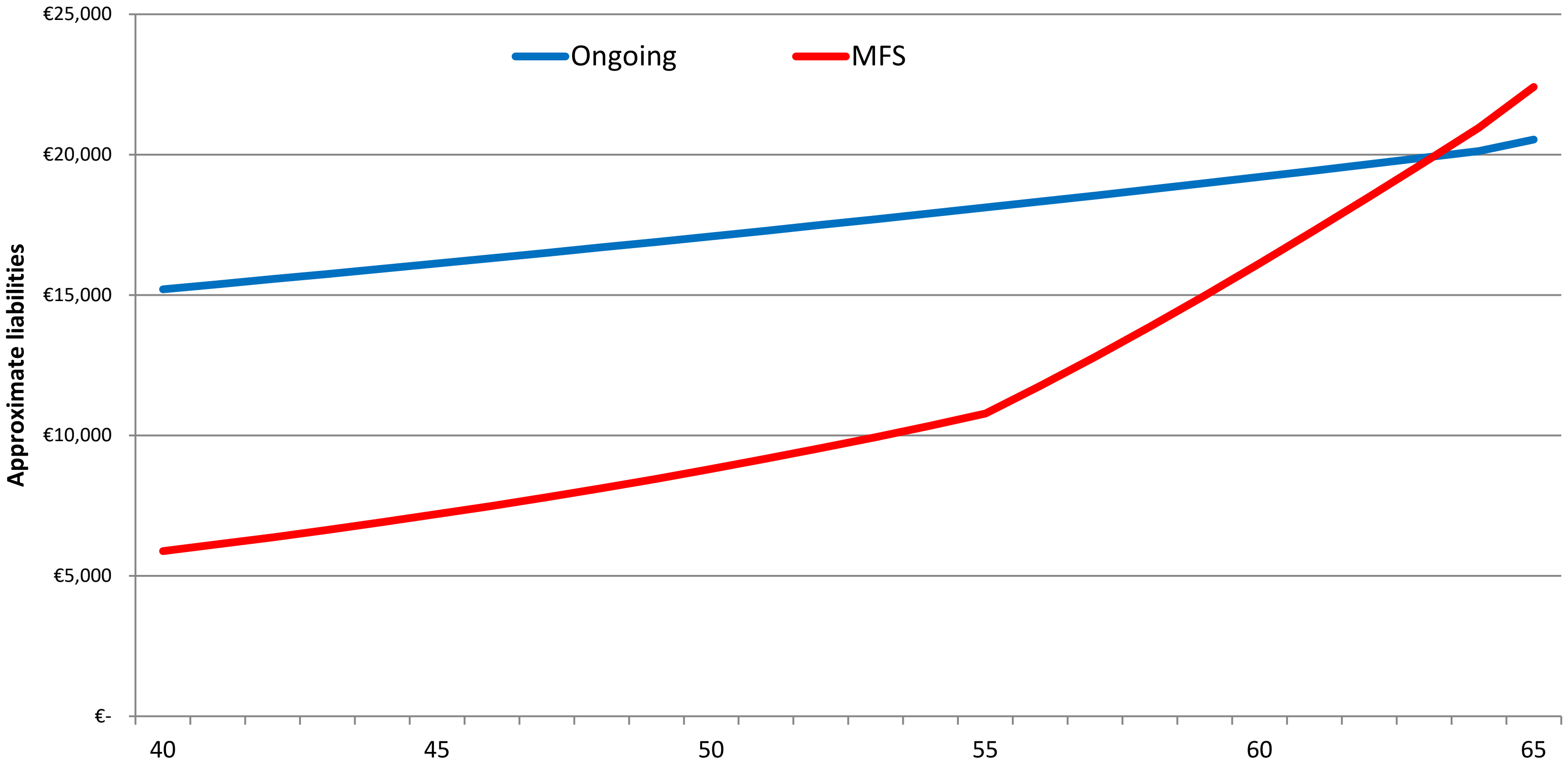
Transfer Value Exercises

Enhanced transfer exercises

	Transfer exercises	
What is it?	Members offered (enhanced) transfer value to transfer their benefits to an alternative pension arrangement.	
Who is it aimed at	Could provide offer in a bulk exercise to deferred members or all non-pensioners or just those over age 50 or could provide just when members come to retire.	
	Other DB scheme	**Drawdown**
	Members transfer out of scheme to consolidate benefits	Members transfer out of scheme to enter into long term drawdown, possibly including a cash free lump sum, from an Approved Retirement Fund. N.B. To access this option a member must have: ▪ Guaranteed Pension Income of at least €12,700 pa ▪ €63,500 invested in an Approved Minimum Retirement Fund (AMRF) ▪ Used €63,500 to purchase an annuity or combination of annuity and AMRF
Liability impact	Liabilities (and assets) removed from the scheme will alter priority order on Minimum Funding Standard (MFS) as pension increases last on MFS	
Risk impact	Removes all risks	
Deficit impact	Depends on term. **See next slide**	
Advice requirement	Not required but recommended that member takes or is provided with independent financial advice.	
Why would members transfer?	▪ It's unusual for DB members to be able to retire early as it creates an immediate strain on the MFS. Therefore transferring to DC provides additional flexibility ▪ Gives members the option to choose level and shape of retirement income to better suit needs and circumstances ▪ May give a higher tax free lump sum than offered in the scheme ▪ May offer additional security to member ▪ Members with small benefits may want to consolidate with other benefits ▪ Inheritance tax benefits	

Bulk transfer exercises

Illustrative value of €1,000 p.a. Pension with level pension by age:



Design decisions:

- Level of enhancement – is it required and who will pay?
- Member support – will advice be provided and if so which?

Example offer – member viewpoint

- The main motivation of improving the retirement process is to help members make better decisions – this is clearly a good thing for them. In addition to this, a more engaging and interactive experience will enhance their appreciation of the benefits they receive and the value they get from the scheme.
- Where changes lead to more transfer values being taken, is this still a good thing? Experience shows that many members would prefer the flexibility available to them following a transfer. From a **trustee** perspective, our view is that, provided the options are communicated clearly and in a balanced way, making the choice available (or facilitating that choice) is in members' best interests.
- The tables below show how a 10% uplifted transfer option on a standard TV of €440,000 might look for a member aged 65 with a retirement age of 65.

Member with €60,000 final earnings, €20,000 annual pension and nil pension increases

Details		Without tax-free cash	With maximum tax-free cash	
		Annual pension	Annual pension	Tax-free cash
Scheme	Flat, joint-life	€20,000	€10,000 (9:1 commutation)	€90,000 (1.5 times final earnings)
Insurance company (via transfer)	Flat, joint-life	€18,000	€13,000*	€121,000 (25% of fund €485k)
	Flat, single-life	€20,000	€15,000	€121,000
Drawdown (via transfer)		Drawdown fund €485,000	Drawdown fund €363,000	€121,000

Member receives higher tax-free cash and more income

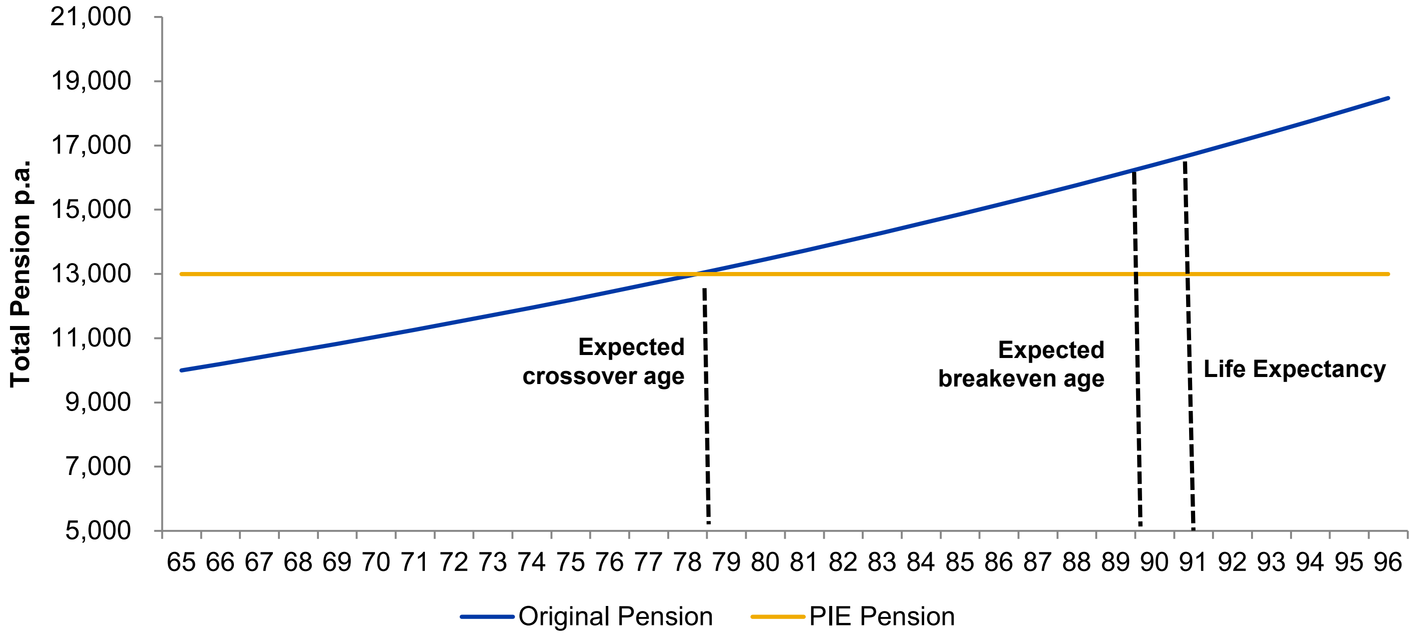
**SPDIR pension lower than under scheme*

Pension Increase Exchange

Pension Increase Exchange

	Pension Increase Exchange (PIE)
What is it?	Members are offered the option to exchange their guaranteed pension increases for a higher level of non-increasing pension
Who is it aimed at?	Can be provided as part of a bulk exercise for current pensioners or included as an option at retirement
Liability impact	Liabilities stay on balance sheet although may be reduced. Will alter priority order as pension increases lower priority on discontinuance
Risk impact	Reduces inflation and longevity risk and may lead to lower annuity pricing
Deficit impact	Can structure to reduce deficits
Advice requirement	Not required but recommended that member takes or is provided with independent financial advice.
Why would members exchange their pension increases?	Gives members the opportunity to reshape their total income in a way that better suits their personal circumstances

Pension Increase Exchange – deep dive



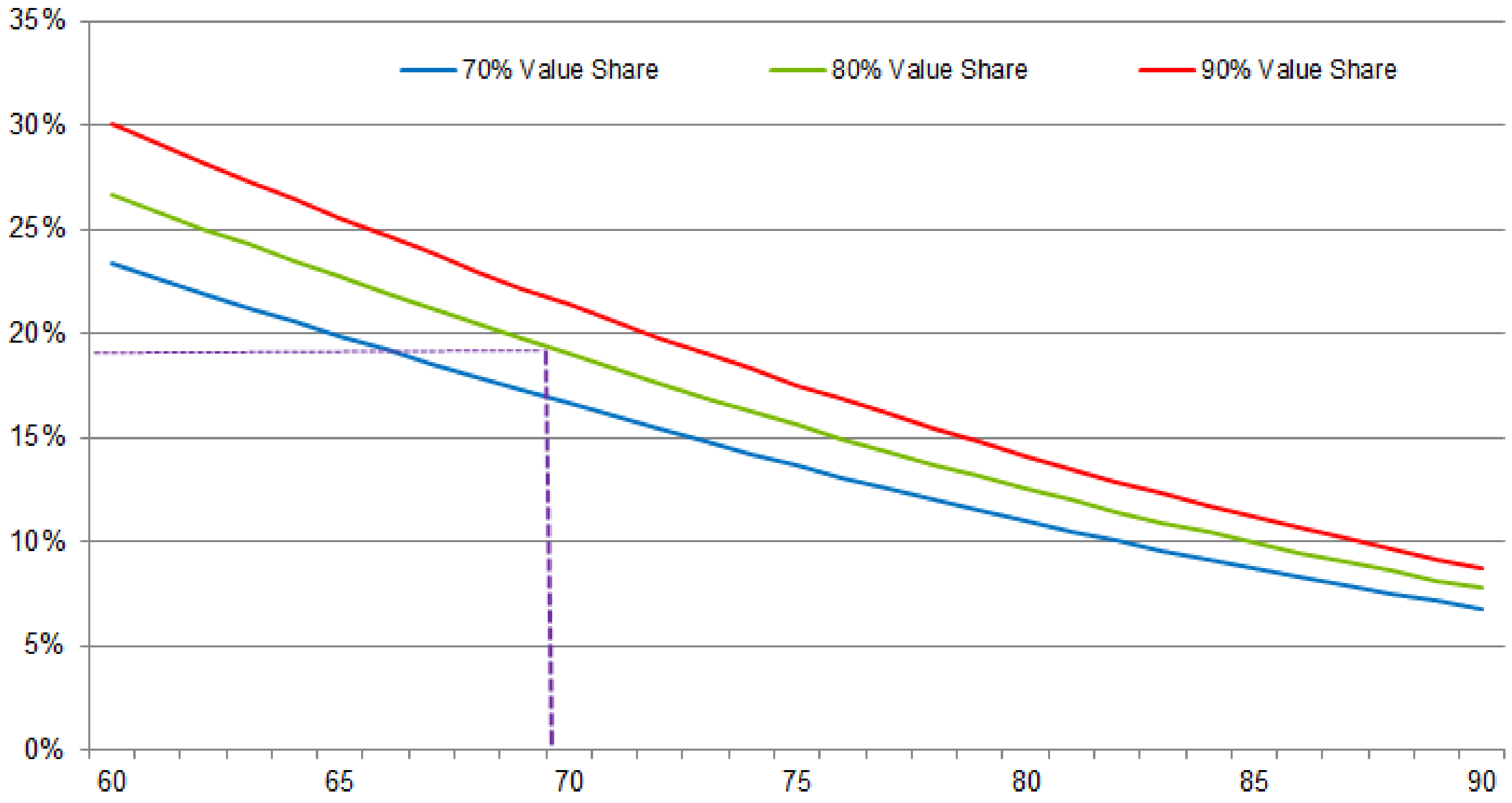
- **Take-up rates are high – typically, based on experience in the UK, between 30% and 40%.**

There are a number of reasons for this but ultimately many members prefer the higher starting level of income provided by the PIE option to the standard scheme benefit.

Design decisions:

- Level of offer – what ‘value share’? ‘balanced deal’?
- Contingent spouses pension – include or exclude?
- Member support – provide advice or guidance?
- Investment – Change from inflation hedged to fixed bonds?
- Opt-in basis – Members over 80 or with small pensions?

Example uplifts to pensions



Indicative uplifts for an example male member with inflation pension increases and 50% spouse's pension. Actual uplifts depend on the benefits exchanged and the assumptions used to calculate the value share

- For example, with an "80% value share" offer, a member aged 70 would see an uplift of around 19%
- This applies to the part of their pension eligible for exchange only

Member Support and Communications

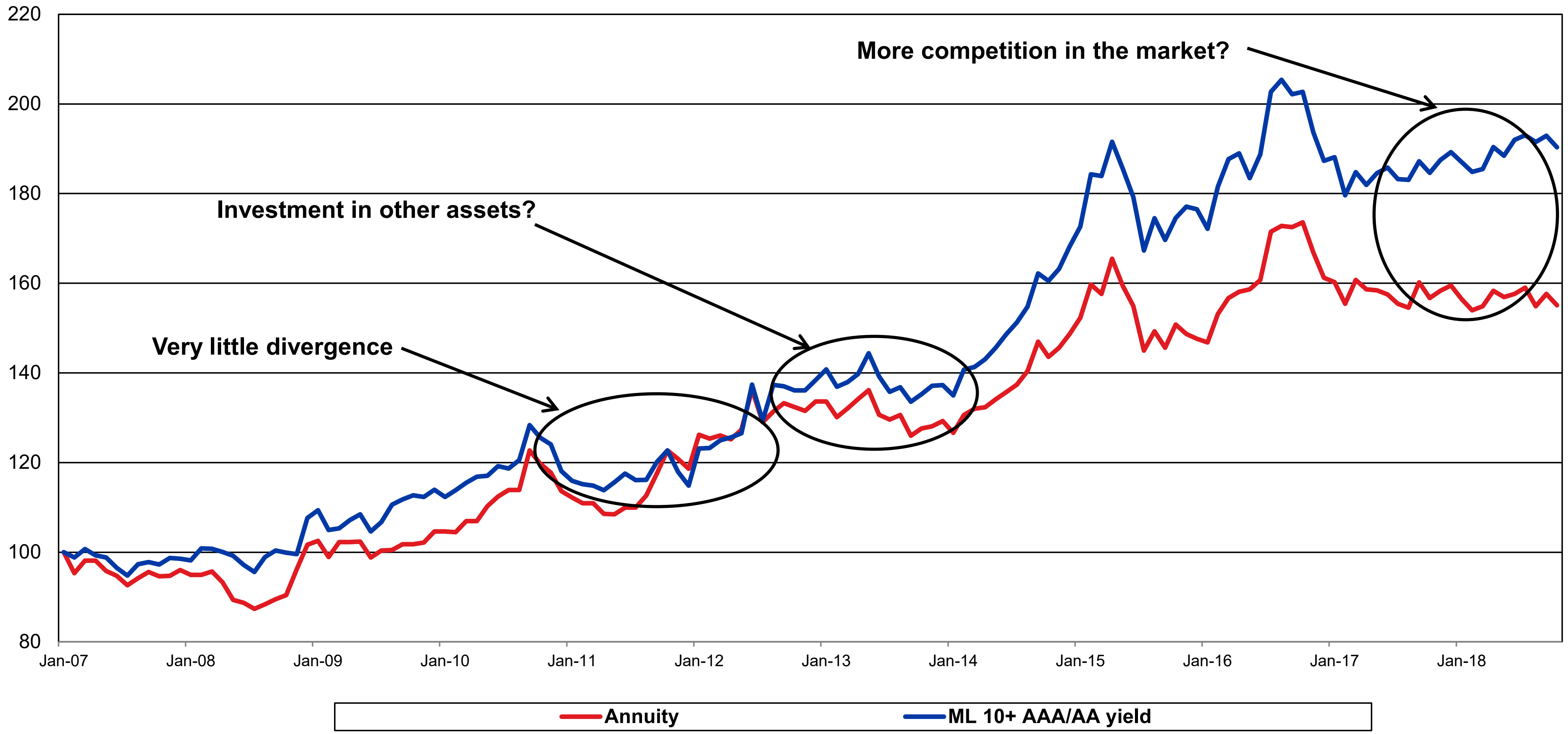
Process for typical member options exercises

FEASIBILITY	▪ Consider impact on liabilities and deficit, cashflows and risk profile ▪ Take legal advice on how the offer would be implemented under the scheme documentation
IMPLEMENTATION SET UP	▪ Formulate a comprehensive project plan ▪ Cleanse member data for the calculations ▪ Decide on the population for the offer
STRUCTURE OFFER	▪ Design the offer ▪ Select independent financial adviser ▪ Agree the role and responsibility of all parties (company, trustees, advisers, IFA) ▪ Plan the end-to-end communications strategy
IMPLEMENTATION CALCULATIONS	▪ Carry out individual member calculations ▪ Review output and obtain agreement of all parties to proceed
MEMBER SPECIFIC OFFER	▪ Warm up communication ▪ Offer pack communication ▪ Member presentations ▪ Members engage with the IFA ▪ Members return acceptance form if want to proceed ▪ Include cooling off period
IMPLEMENTATION PAYMENTS	▪ Implementation of new pensions, transfers, etc. ▪ Confirmation statements issued to members

ONGOING PROJECT MANAGEMENT

Annuity Market Ireland

Cost of annuity versus bond yields



Preparing for buy-out

Level 0

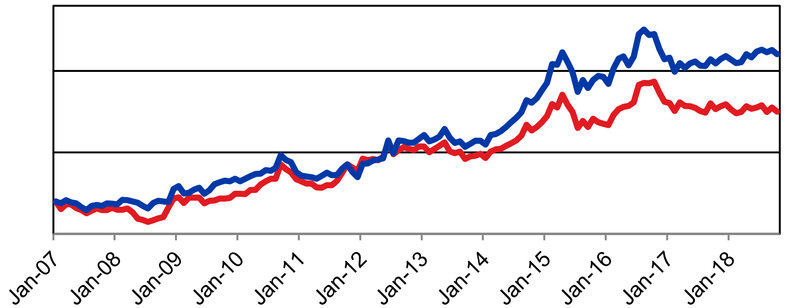
Level 1

Level 2

Level 3

Preparation

Monitor



Asset Strategy

Engage

Trigger

Transact

Asset De-risking

Asset De-risking

Liability Risk

- Interest rate
- Inflation

Asset Risk

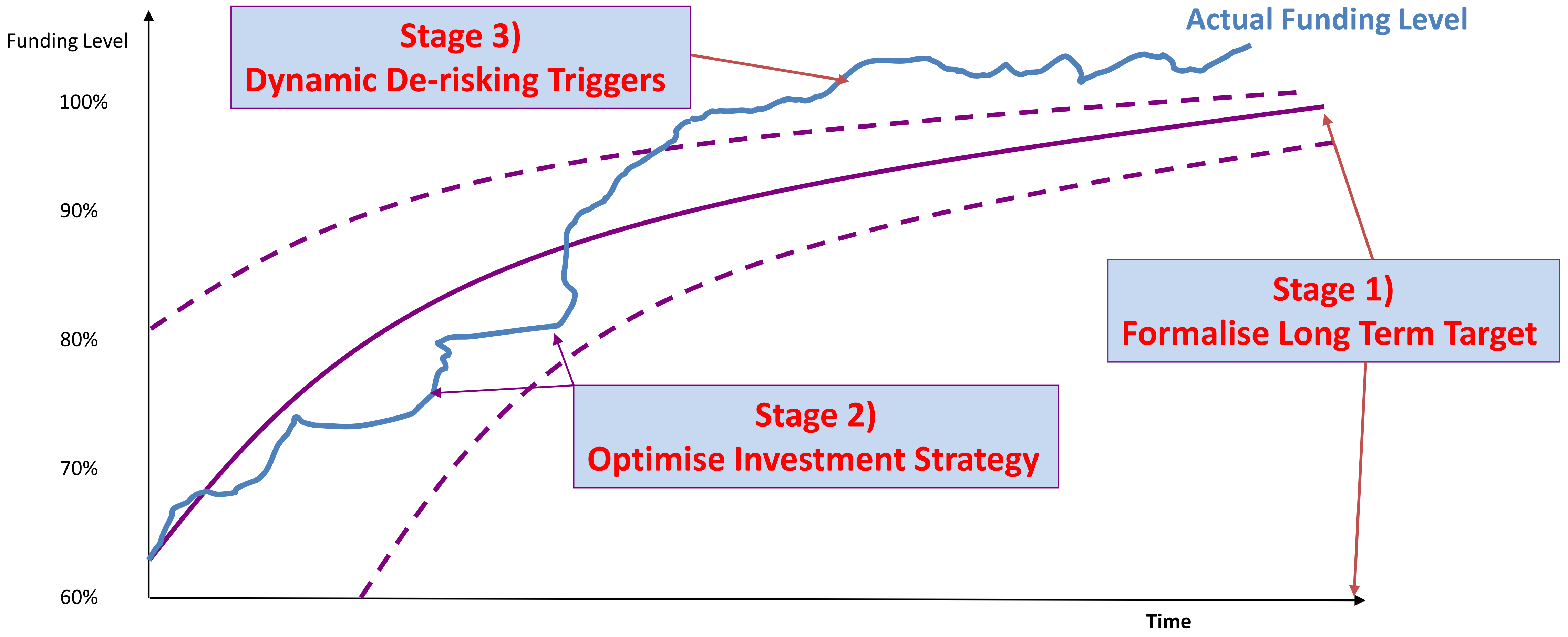
- Improving equity portfolio
- Credit opportunities
- Illiquid assets
- Liquid alternatives

Total Portfolio

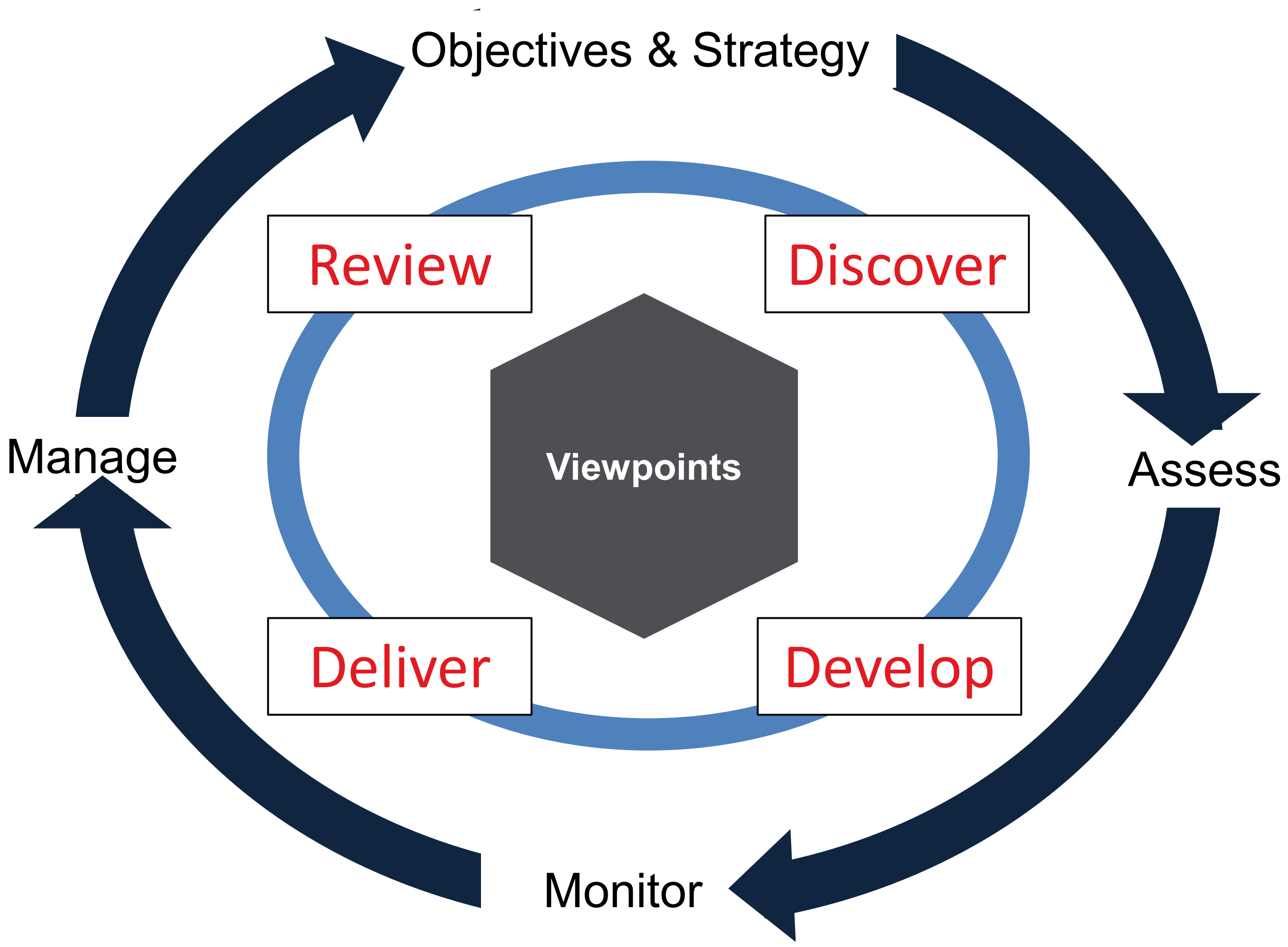
- Cashflow management
- Proactive Flightpath management
- Currency management
- ESG

Bringing it back together

Managing de-risking



Integrated Risk Management Framework



Summary

- Future Focus: Risk Management
- Plan
- Consider all options
- Prepare
- Manage
- Deliver

DB PENSIONS: DE-RISKING FOR THE FUTURE
Q&A

Tomás Griffin, Aon

Evelyn Ryder, Aon

Tony Fleming, IAPF Council

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UPCOMING EVENTS

14 November – Trustee Network Event "The Case for European Long Lease"

20 November – Trustee Training Essentials

29 November – IAPF Annual Governance Conference

4 December – Trustee Training Refresher

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