

In Sight

Quarterly Pension Publication
February 2009 / Issue 5

Welcome to In Sight

As the economic world changes, we highlight the issues for work-based pension schemes.

This quarter's round-up

We begin with a look at economic and financial conditions.

- [Investment insight](#)
A look at the debate surrounding corporate bond yields and their effect on the valuation basis.
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The regulator expects you to stay alert.
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New powers for the Pensions Regulator will impact on corporate re-organisation.

Death and taxes – their existence may be certain but the details continue to stimulate debate.

- [Live long and prosper](#)
We introduce some new approaches to setting mortality assumptions for your scheme.

PPF Levies

The PPF has now confirmed the details of its 2009/10 levies and published its proposals for future changes.

Risk sharing

The Government aims to strike a balance.

From the richest to the poorest

The Pre-Budget Report proposes to freeze the lifetime allowance, affecting both ends of the spectrum.

We consider a tricky issue which was the subject of a recent judgment.

Closing the Barber window

A recent High Court ruling has implications for some pension schemes.

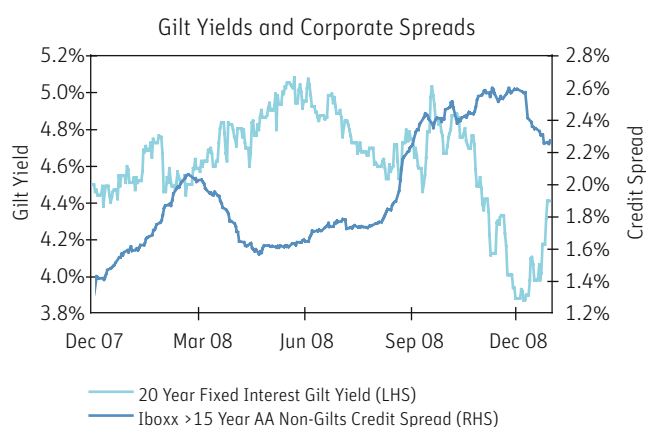
Regular features

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Developments drawing nearer in 2009.
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Investment insight

The missing link?

In this article, Hewitt's Asset Allocation Team consider the recent press debate that using current corporate bond yields without any adjustment gives too generous a valuation basis. Those who suggest adjusting the yields downwards correctly point to record high corporate 'spreads' – the difference between the corporate bond yield and the equivalent gilt yield. However, the fact that gilt yields have been at record lows never seems to come up. The chart below shows you how spreads and gilt yields moved in opposite directions last year. Many of the factors driving spreads up are the very same factors which are driving gilt yields down, so it seems important to consider how excessively low gilt yields might be.



Deflation or high inflation?

Investors' views on the outlook for inflation over the long term are a principal determinant of fixed-income gilt yields. Currently there are two opposing camps: those who fear deflation, and those who believe that the aggressively stimulative actions from governments and central banks will lead to high inflation down the road. We acknowledge that either of these polarised outcomes is much more likely than usual, but we are willing to believe that the fall in prices in 2009 will be a temporary feature and that after this, policymakers will manage to curb rising inflation. Another reason to make a 'middle of the road' assumption is that it is very difficult at this time to have real conviction to plump for one of the two polarised outcomes.

And what about real yields?

Another critical element of fixed-income gilt yields is the 'real' yield, that is, the yield once inflation has been stripped out. On our analysis, 'real' short-term interest rates have averaged around 2% over the long run, so long as inflation has been moderate. Happily this appears to coincide with the short-term interest rate central bankers believe is consistent with their inflation targets. However this analysis is based on the consumer prices index (CPI) and pension scheme liabilities are typically linked to the retail prices index (RPI). Colin Robertson, of Hewitt's Asset Allocation Team, suggests a 'real' short-term interest rate of 1.5% as fair value with reference to RPI. Allowing for a slightly upward-sloping yield curve, he assesses fair value for real gilt yields to be 1.5% or slightly higher.

Fixed-income gilt yields – 1% too low?

One element is still missing before we can pull this together to come up with a fair value estimate for fixed-income gilt yields. This is the 'inflation risk premium', which is the extra yield investors usually require to compensate for the uncertainties of inflation when investing in fixed income, rather than 'real' index-linked gilts. Typically, this is a positive number, but in these exceptional times it turned negative as investors have fled into fixed income as a more liquid safe haven. Taking all this together, Colin Robertson estimates a fair value yield for fixed-income gilts of around 4.5%. With 10 year gilts yielding close to 3% at year end and 20 year gilts around 3.8%, it looks like gilt yields were about 1% too low at year end.

Corporate spreads and gilt yields inextricably linked

A key factor driving gilt yields down has been fear over how deep the economic recession will be and how long it will last. This has had exactly the opposite effect on corporate bond spreads. Also gilts have benefited from their 'safe haven' status while corporate bonds sit clearly in the 'risk assets' category and so have suffered from adverse investor sentiment. Therefore, it is not surprising that gilts have become distinctly expensive at the very time that corporate bonds have become distinctly cheap. As a result, when deciding on an appropriate return assumption for corporate bonds, it would be wrong to revise corporate spread assumptions down without increasing the gilt yield assumptions on which these spreads are based.

“Trustees should not over-react in the face of the downturn, but should ensure they are active and alert to potential changes in the health of the sponsor, and to the funding level of the scheme.”

David Norgrove, The Pensions Regulator Chair

Vigilance around scheme funding Caught in the Act?

In its October 2008 statement, the Pensions Regulator specifically addressed those trustees who have seen falls in the values of their schemes' assets and whose concerns about their employers' covenants have increased. The watchword is 'vigilance', as trustees keep the position of their schemes under review. The regulator believes that its codes and guidance are robust and flexible enough to allow trustees to react appropriately.

In particular, the regulator points out that trustees should consider reviewing and, if necessary, revising recovery plans where the employer's covenant has changed significantly. If the employer believes that the existing plan may jeopardise the company's future, the trustees should take this into account. The trustees may reconsider the pattern of contributions and the length of the recovery period. Although a recovery period over 10 years will attract the regulator's notice, the regulator will consider it in the light of the economic conditions.

The Pensions Regulator published its annual review of recovery plans in December 2008 and restated the possible need to revise plans, to avoid endangering the development or solvency of companies.

Companies prompted by the economic downturn to consider changes which could have a materially detrimental impact on benefits need to consider the Pensions Regulator's new powers to issue Contribution Notices and Financial Support Directions. The powers are intended to target new models of securing pension provision including certain non-insured buy-outs. However, the Government has accepted that it is not possible to clearly define the new models it intends to target. This may leave some normal business activities open to the threat of future regulatory action unless companies obtain clearance from the Regulator.

Safeguards added to the Pensions Act 2008 towards the end of the parliamentary debates included:

- A requirement for a regulatory Code of Practice, setting out how the Pensions Regulator expects to use its powers under the new material detriment test; and
- A statutory defence.

The Code of Practice consultation closes on 6 February and this material detriment element of the new powers will not come into force until the final Code is in place.

Deflation – the implications

The UK's financial markets are anticipating a period of deflation this year, something we have not experienced for almost 50 years. You will need to consider the impact this has on your current pensioners. If you are starting the valuation process for your scheme, you will also need to consider whether to make any adjustments to your financial assumptions to reflect the current conditions.

November's pre-Budget statement noted that the Retail Prices Index (RPI) is likely to fall in the year to September 2009. This is the month most commonly used to calculate pension increases. We have outlined the consequences for pension schemes below.

- **Schemes that increase pensions in payment in line with a statutory minimum** (for example **Limited Price Indexation** on post 5 April 1997 benefits and increases on post-88 GMPs). Deflation would mean no increase to pensions in payment in the relevant year. When inflation

returns in a future year, the inflationary increase will need to be paid in full – there will be no offsetting against the deflation.

- **Schemes that increase pensions in payment using other forms of indexation.** The position will depend on the scheme rules. It is unlikely that the rules will allow pensions in payment to go down, but it is possible a lower level of increase can be paid in future to offset the period of deflation.
- **Schemes that provide statutory revaluation in deferment.** These calculate the pension at retirement using the increase in the RPI over the whole period of deferment. (The cumulative maximum is 5% a year over the period, and the cumulative minimum is 0%.) This means that falls in prices will reduce the overall revaluation increase and so deflation will reduce future benefit levels.



Live long and prosper

Trustees and employers should consider some recent developments when they set the mortality assumption for valuations of pension schemes providing defined benefits.

There are generally two parts to a mortality assumption:

- Current observed mortality rates, and
- Expected improvements to those rates in the future.

Current mortality rates

New tables

To date, many pension schemes have used standard mortality assumptions, based on an analysis of data from insurance companies, as this was the most appropriate information available. The tables commonly used today are called the '92 series' or the '00 series'.

The S1 tables, based on the experience of a large number of occupational pension schemes, have just been published. These are likely to become the starting point for occupational pension schemes, not least because they are based on more than double the data of the insurance company tables. However, there are twenty different tables available, so trustees and employers will need detailed advice in order to choose the most appropriate table. They may also need to make adjustments to reflect the particular circumstances of their scheme. As well as separate tables for men and women, the tables are further split where other factors have been identified, including:

- Size of pension; and
- Ill-health retirements.

New approaches

In the past, larger pension schemes have used an analysis of their own pensioner population in order to calculate an assumption for current mortality rates that reflects their scheme's experience. However, for smaller schemes this would not be statistically reliable. The assumption has generally been set by making a broad-brush adjustment to a standard table to reflect the average membership profile of the scheme.

New approaches are being developed to take account of a range of factors that affect life expectancy. These approaches can derive current mortality rates for different groups of members within a scheme, or even each individual member. Hewitt is developing an approach that combines:

- Pooled data across many schemes; and
- Health, wealth and lifestyle characteristics (compiled by consumer credit agencies) for a member's address.

This approach will provide a greater understanding of the factors that affect different members of the scheme, and can be used for any size of scheme. It can help trustees and sponsors understand their scheme's exposure to longevity risk in much more detail than has been possible in the past.

Future improvements

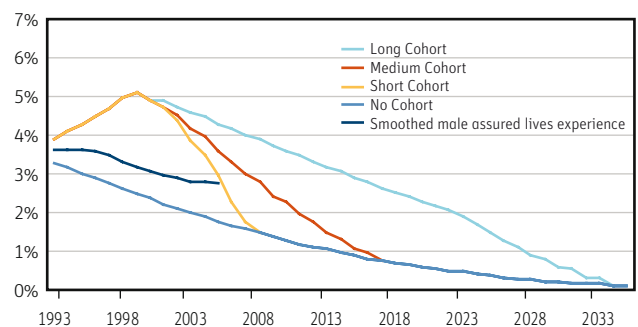
Deciding on an assumption for current mortality rates is reasonably objective and evidence-based (to some degree, at least). In contrast, deciding on an assumption for how life expectancy will improve in the future is far more subjective. It is the subject of much research and lively debate, and experts (not just actuaries!) have a wide range of views. What is clear is that previous estimates of future improvements have often understated what has happened in practice in recent years.

Those born after the first world war are living much longer than those before. The difficulty lies in deciding whether this is a one-off acceleration in the trend or not. If you assume this rate of improvement continues for a short, medium or long time you get very different answers.

Over the last few years, pension schemes have generally used one of the three 'cohort projections' (either short, medium or long cohort) as part of their mortality assumption. Recently most schemes appear to have used the medium cohort, sometimes with an underpin.

The aim is to avoid underestimating future rates of improvement. However, experience to date (as shown in the graph) has suggested that actual improvement rates have neither 'spiked' in the way suggested by the short or medium cohort projections, nor tailed off as quickly as projected. Research is ongoing into new projection methods. In the longer term, these will be incorporated into a scheme's mortality assumption.

Assumed annual rates of future mortality improvements for someone born in 1932



“We think the proposals in this paper offer a way to improve fairness.”

Lawrence Churchill, Chairman, PPF

PPF Levies

No change for now...

The PPF has now confirmed the details of its 2009/10 levies. The PPF aims to collect a total of £700 million, with a scaling factor of 2.22 (compared to 3.77 in 2008/9) for the risk-based levy. The levies follow a similar structure to 2008/09. The levies for 2010/11 are also likely to follow a similar structure and we would expect the final scaling factor to be published in November 2009. It is not too late to take action to reduce your scheme’s levy.

...but what about the future?

The PPF has published its proposals for introducing significant changes to the way it calculates a scheme’s levy from 2011/12. The intention is to reflect more accurately the long-term risk that the PPF believes the scheme poses. It intends to introduce another element to the risk-based levy to take account of the impact that a scheme is expected to have on the PPF in ‘adverse conditions’ over the longer term. This will be done by modelling expected scheme funding levels and employer insolvency rates over a five-year period assuming that negative economic conditions occur. The PPF’s aim is to build up funds over a number of years to be able to meet claims under these conditions – presumably so that it does not have to place an undue burden on remaining levy payers at that time.

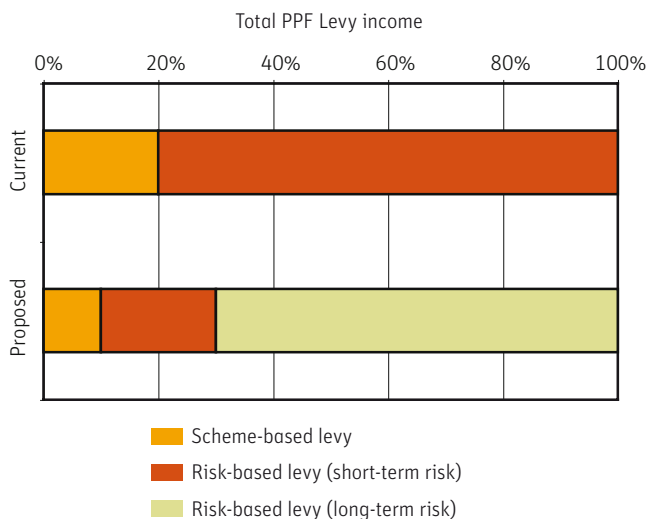
To allow for this, the PPF will scale back the current element of the levy which allows for the one-year risk to the PPF. The scheme-based levy may also be scaled back. The diagram shows how the PPF’s total levy income could change.

The proposals will not result in the PPF receiving any more income than it does currently, but it will change the way in which an individual scheme contributes to the PPF’s levy income. In some cases this could be significant. The PPF estimates that around 10% of schemes will see their levy more than double, although a similar number will see their levy more than halve.

The PPF also proposes to allow for a scheme’s investment risk in the levy calculation. Schemes with a higher proportion of assets invested in equities and property will pay a higher levy. The PPF suggests that this will not affect investment decisions.

In practice, the proposals will most adversely affect those schemes that are currently well funded or who have a strong sponsor, particularly if they have a significantly mismatched investment strategy. Such schemes are therefore likely to see the proposals as controversial. The PPF claims that these schemes have not been paying their fair share to date, as the current levy calculation does not allow for the true long-term risk. Even though two-thirds of schemes will pay a levy of less than 0.2% of their liabilities (small in relation to the size of the scheme), this is unlikely to be much comfort.

Though its latest proposals may be controversial for some, perhaps the more important question (not covered by this consultation) is whether the PPF needs to significantly increase its overall levy income, given the increased risk it faces in the current economic downturn. The problem for the PPF is that the downturn has arrived before it has been able to build up any reserves to protect itself. It reported a deficit of over £500 million in its latest accounts. The PPF therefore faces a tricky balancing act to ensure its long-term solvency. Should it increase levies in the short term across all schemes to build up its reserves more quickly, or should it run the risk that there may not be enough solvent schemes paying levies over the long term?



“The opposing views expressed by respondents to this consultation reinforce the need to be vigilant in striking the balance between member protection and encouraging employer provision of pensions.”

Government Response to the Risk Sharing Consultation

Risk sharing

In December, the Government published a response to its June 2008 consultation, on options for sharing pension scheme risk between employers and employees. It covered options available under the UK's current regulatory framework and outlined options that would need a change to the law.

The Government's response confirms opinions were divided. Stakeholders representing scheme members tended to take the view that far-reaching deregulation was not required. Industry and employer stakeholders thought that Government should take this opportunity to deregulate further.

The Government is concerned that allowing options which will need significantly more legislation would increase the complexity of the current pensions laws and make them more difficult for members to understand. It has confirmed that it will not be removing mandatory indexation nor introducing legislation to allow for 'conditional indexation' based on the financial health of the scheme.

However, it plans to:

- Develop proposals to allow flexibility in the way pensions build up for future service to reflect changing life expectancy;

- Carry out further research into whether it is appropriate for cash balance schemes to have to provide index-linked increases for pensions in payment;
- Undertake further work on how 'collective defined contribution' schemes might operate in the UK;
- Review the complex contracting out arrangements;
- Consider with the Pensions Regulator's help how to improve the transfer of knowledge across industry participants on current risk-sharing practices; and
- Take forward other wider initiatives to reduce regulations in areas such as employer debt, where the work has already started. (The DWP has carried out an informal consultation on possible changes. Currently, an employer debt can be triggered by corporate re-organisations, where one employer no longer employs any active members. The DWP is considering options for changing the debt obligations in these circumstances. The suggested changes would apply to "those employers where the re-organisation would not be detrimental". A formal consultation will follow and any changes to the law are expected from October 2009.)

From the richest ...

The Government announced in the Pre-Budget Report in November that it intends to keep the lifetime allowance at its 2010/11 level of £1.8 million for a further five years. The annual allowance will also remain constant at £255,000. It expects this freeze to produce a gain for the public finances of £725 million over the next four years. This will affect not only high earners, but individuals with pensions of less than one percent of the lifetime allowance.

The lifetime allowance was introduced under the 2006 'A-Day' changes as a major plank of the 'simplification' of the taxation of pensions. It places a limit on the total amount of pension benefits that can qualify for tax concessions. The increases for the first five years were fixed, as the allowance started at £1.5 million, increasing to £1.8 million by 2010/11. The freeze appears to go against the Government's original intention of up-rating the allowance in line with inflation.

The freezing of the lifetime allowance is likely to decrease its real value from 2011. The impact in the short term, especially if inflation continues to be low, may not be great. However, in the longer term, a freeze could result in many more people losing tax relief on part of their pension benefits. Individuals and companies may feel they need to review their pension arrangements as a result.

... to the poorest

The move also affects individuals with small pensions. These can be 'trivially commuted' if the value of an individual's total pension benefits is under 1% of the lifetime allowance. Some individuals may now have to take an income rather than a cash sum, which may affect any means-tested benefits. However, it is hoped that the effect of this will be mitigated by new regulations, due to be finalised later in the year, which extend the scope for commuting small pensions.



Closing the Barber window

Barber – a brief reminder

On 17 May 1990, the European Court of Justice ruled on the Barber case. For service from that date onwards, occupational pension schemes must provide equal benefits for men and women. In practice schemes with unequal normal retirement ages did not change their rules immediately and any increase in the normal retirement age for women usually applied only to benefits building up from the date of the change. As women continued to have the right to an unreduced pension at the lower age until the date of the change, this also gave men the right to claim an unreduced pension at that lower age between 17 May 1990 and the date of the rule change – the period known as the ‘Barber window’.

Following the Barber judgment Foster Wheeler took steps to equalise benefits between men and women. In November, the High Court ruled that Foster Wheeler members who built up any benefits with a normal retirement age of 60 are entitled to take all their benefits from 60. Foster Wheeler did not reduce benefits for early retirement from 60 (until 2003) but required that the Company must consent to the early retirement. For members with service in the ‘Barber window’ (1990 to 1993 for Foster Wheeler) different normal retirement ages applied to benefits for different periods of service (‘mixed NRD members’).

The High Court found that these ‘mixed NRD members’ should have been entitled to take all of their pension at age 60 without any reduction (except in respect of a subsequent rule change in 2003). It rejected a proposal that NRD 60 and NRD 65 service should be calculated separately, which would have allowed either consent to be withheld in respect of post 1993 service or early reduction factors applied to NRD 65 service. The conclusions apply to retirements from both active and deferred status.

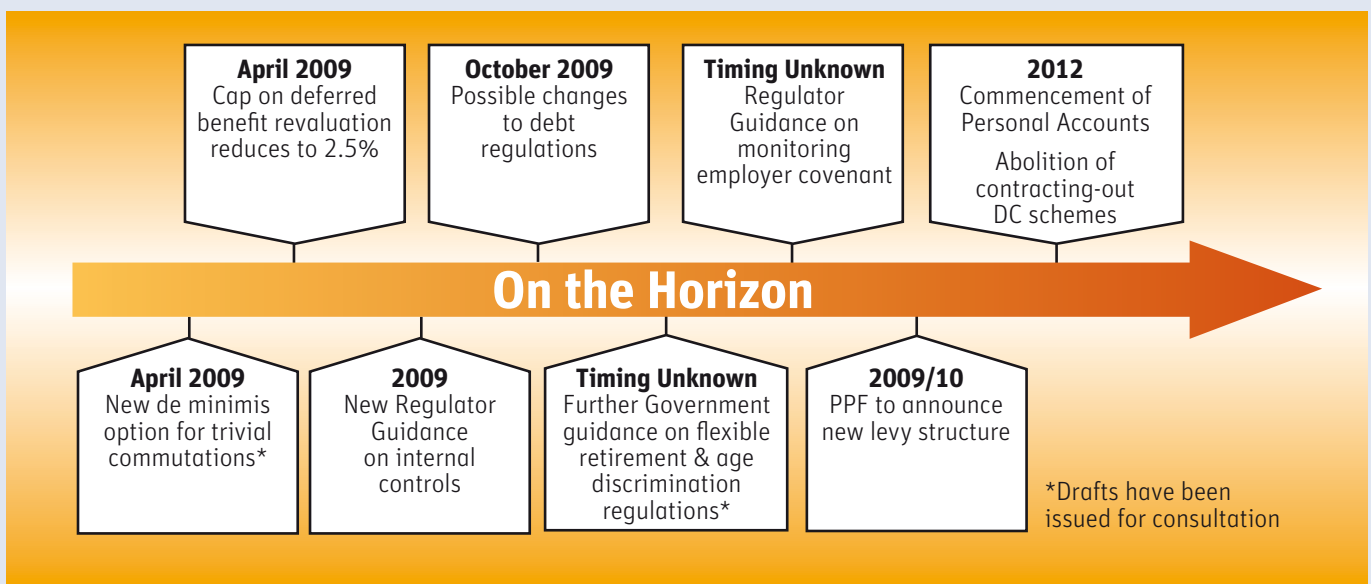
Potential implications

Although the ruling is subject to appeal, there are potential implications for some schemes which equalised benefits in the same way as Foster Wheeler:

- Company consent to retirement at age 60 cannot be withheld for members with any NRD 60 benefits;
- All benefits should come into payment at the same time, and NRD 65 benefits can only be reduced for early payment if the scheme rules explicitly allow this;
- Company consent cannot be withheld, therefore scheme rules should also allow deferred pensions to be paid from age 60, rather than 65, unless part of the benefit is actuarially reduced between 60 and 65.

On the horizon

Key dates for expected legislative developments impacting occupational pension schemes are highlighted in the chart below.



Governance diary

When the original code of practice for Trustee Knowledge and Understanding (TKU) was released in 2006, the Pensions Regulator planned to review the framework every two years to ensure it continues to be relevant. The regulator has now issued a draft of a revised framework for consultation.

Proposed additions to the previous guidance include:

- The importance of good administration, reflecting the regulator's increased interest in administration;
- A reference to the approaching Personal Accounts regime, an introduction to the subject would be helpful for trustees ahead of more detailed guidance;
- Recent developments in investment;
- The importance of the employer covenant and trustees' understanding of their powers;
- Buyout issues, including abandonment and inducements; and
- Pension scheme wind-up and appropriate steps to prepare for this.

The regulator believes that creating separate guidance documents for defined benefit (including hybrid) schemes, defined contribution schemes and small fully-insured defined contribution schemes cuts down on unnecessary confusion. It proposes that the original scope guidance be split into three to ensure trustees are aware of the TKU requirements for their particular scheme.

Trustees may therefore need further training and the regulator is creating further modules on its toolkit to include additional material on the above topics. Trustees will also need to consider what further training they need to meet the revised scope.

Nothing in this document should be treated as an authoritative statement of the law on any particular aspect or in any specific case. It should not be taken as financial advice and action should not be taken as a result of this document alone. Consultants will be pleased to answer questions on its contents but cannot give individual financial advice. Individuals are recommended to seek independent financial advice in respect of their own personal circumstances.

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Seminar Dates

Full Day Course	2009 Dates
Introduction to Trustees' Responsibilities	4 Mar, 16 Apr, 18 May (Birmingham), 4 June, 15 July
Essentials for DB Trustees	9 Mar (Birmingham), 25 Mar, 24 June
Essentials for DC Trustees	12 Feb, 13 May, 7 Sept (Birmingham), 16 Sept
Investment Essentials for DB Trustees (half day)	26 Mar, 25 June
PMI Award in Pension Trusteeship (2 days)	25/26 Feb, 6/7 May, 21/22 Oct This course is held in Woking
Where we have not given the location in the table, the courses are held in central London.	

Teleconferences

Keep up with current issues from the comfort of your own desk through our regular series of one hour teleconferences. Aimed at trustees, these will help you to keep abreast of current pension matters and developments in the industry and discuss the practical issues you should be considering.

The teleconferences are free of charge – to register to attend, email: ukevents@hewitt.com.

2009 Teleconferences 5 Feb, 14 May, 10 Sept, 26 Nov

Following the turbulence of 2008 trustees are asking what they can expect for 2009 and what plans they need to be making now. The February teleconference will consider the actions trustees should be taking in 2009 to manage risks and take advantage of opportunities, how companies' behaviour toward their pension scheme might be different in 2009, and whether funding valuations will be different second time around?