



## Model Solutions for Pension Liability Management

Planning the reduction or elimination of pension deficits

**Defined benefit pension liabilities represent one of the most frustrating and intractable problems facing many Finance Directors in the UK today. Whilst the rise in AA corporate bond yields since mid-2007 due to the 'credit crunch' will have resulted in many final-salary schemes now having an accounting pension surplus, this may well prove illusory if yields return to pre-crunch levels and rising life expectancy is increasingly taken into account. Also of concern will be the inherent volatility of the pension numbers and the ability to recognise any pension surplus on company balance sheets.**

**The challenge is to plan the most effective, affordable and secure way to tackle the problem, involving all the stakeholders.**

**Xafinity Consulting can help, by enabling companies to plan the reduction or elimination of their defined benefit pension liabilities, as well as reducing balance sheet volatility, using our unique automated scenario planning environment – Model Solutions for Pension Liability Management.**



### **A major challenge to businesses**

After many years of pension deficits, companies are beginning to report pension scheme surpluses. For FTSE 100 companies, a combined deficit of around £30 billion at the start of 2007 had become an estimated surplus of £40 billion by March 2008, primarily as a result of the significant increase in corporate bond yields used to discount pension liabilities.

Whilst at first sight this seems good news, this can create problems, as both UK GAAP and International Accounting Standards place limitations on the recognition of surpluses. With schemes increasingly closing to new entrants and future benefit accrual, this can lead to a one-way bet against companies - deficits to be recognised, but not surpluses.

Such surpluses may, in any event, prove illusory if bond yields revert to previous levels: at the end of March 2008, over 15-year AA corporates yielded 1.75% in excess of long-term gilts, compared to a pre-credit crunch differential of typically 0.5%. Mortality assumptions are also likely to be strengthened going forward, reflecting continuing improvements in life expectancy, leading to higher pension scheme liability values.

The existence of a final-salary scheme can make it harder for companies to buy, sell or merge with another company, or refinance. In addition, an accounting deficit can impact on the ability to pay dividends or return funds to shareholders.

Trustees have also been given increased powers to negotiate higher contributions, and the Pensions Regulator is expected to put greater pressure on trustees and employers to accelerate scheme funding. There have also been significant increases in the levies payable by defined benefit schemes to the Pension Protection Fund.

Defined benefit liabilities can handicap Financial Directors in a wide range of ways, such as:

- balance sheet volatility
- surplus recognition
- cash flow and profit effects
- depressed share prices and dividends
- higher risk profiles, including potential insolvency
- restrictions on corporate restructuring
- employee/pensioner relations problems

The recent shift in financial markets also poses opportunities as well as problems. The increase in corporate bond yields, coupled with greater competition in the bulk annuity market, has made the cost of buying out all or part of a scheme's liabilities more attractive relative to historic levels. It remains to be seen whether this is just a short window of opportunity. A wide range of financial management techniques has also been developed in recent years to help companies manage pension scheme risk.

### **Finding the optimum solution**

This requires a broad strategy of managing assets up, and liabilities down.

To be successful in practice, this requires the judicious adjustment of various factors within or affecting the scheme, including:

- contribution levels
- scheme terms and benefits
- investment strategy
- valuation assumptions
- employment terms
- scheme membership

This adjustment needs to be balanced, realistic and aligned with the company's objectives. Finance Directors need to be able to model how changes in each or all of these variables will affect their pension accounting and funding positions.

### **Model Solutions for Pension Liability Management**

Model Solutions for Pension Liability Management is a unique tool developed by Xafinity Consulting, which enables companies to identify their optimum strategy.

Key Decision Makers can precisely model all of the key factors of their schemes, to explore alternative remedial strategies and arrive at the combination of measures that most closely suits their objectives.

They can balance the risks and benefits of specific future funding levels against the costs of various options for change, to create a pension strategy that supports their corporate priorities.

Crucially, with Model Solutions they can also get all the key players round the table and develop a solution which satisfies or balances all of their needs, in real time. Options for change could include:

- scheme closure or sale
- change of retirement age, removal of 'extras'
- restriction of benefits, eg move to career average/salary sacrifice
- buy-out or transfer-out of deferred rights
- buy-out all or part of pensioner liabilities
- increase company or member contributions
- reallocate assets against a new risk strategy

#### **The deficit valuation 'ladder'**

An ongoing deficit of £6m

= an FRS17 deficit of £11m

= a buy-out deficit of £26m



## THE BENEFITS

- Ability to model all possible combinations of action to create ideal scenario.
- Facilitates round-table, real-time stakeholder discussions and negotiations.
- Frees up company to pursue corporate goals without hindrance.
- Enables clear negotiation with, and demonstration of compliance to, regulators.
- Delivers real control over a long-term, business-distracting issue.

## HOW IT WORKS

### 1. Assess the problem

- Capture the design of the scheme and input to the Model Solutions environment, to create an accurate working model based around a dozen key variables.
- Test against last valuation and quantify the funding position accurately.
- Define corporate strategies, priorities, requirements and timelines.

### 2. Manipulate the model

- Change combinations of variables to create alternative scenarios for reducing liabilities and/or increasing assets.
- Evaluate the impact of alternative scenarios against corporate strategy.
- Select the preferred strategy and fine tune changes to variables.

### 3. Create the roadmap

- Develop detailed implementation plan, including legal, actuarial, documentation and other considerations.

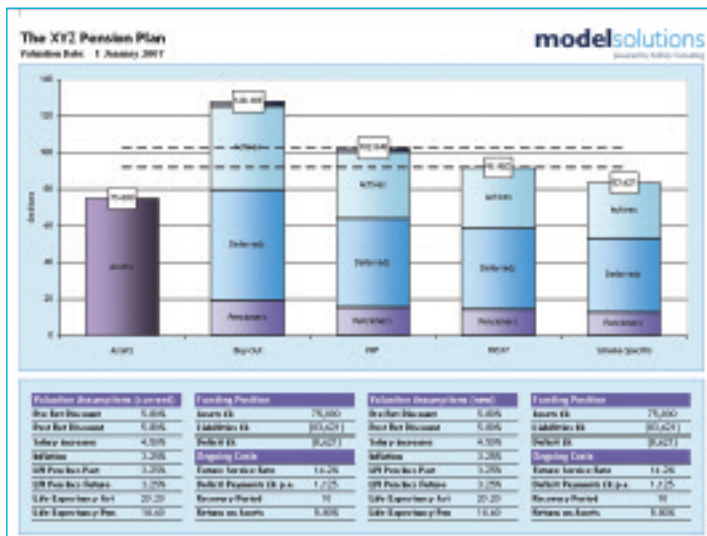
## The fastest, most effective route to success

With Model Solutions for Pension Liability Management, pension funders, trustees and analysts can see immediately the effects of alternative complex change programmes on their scheme values and choose the ideal strategy to adopt.

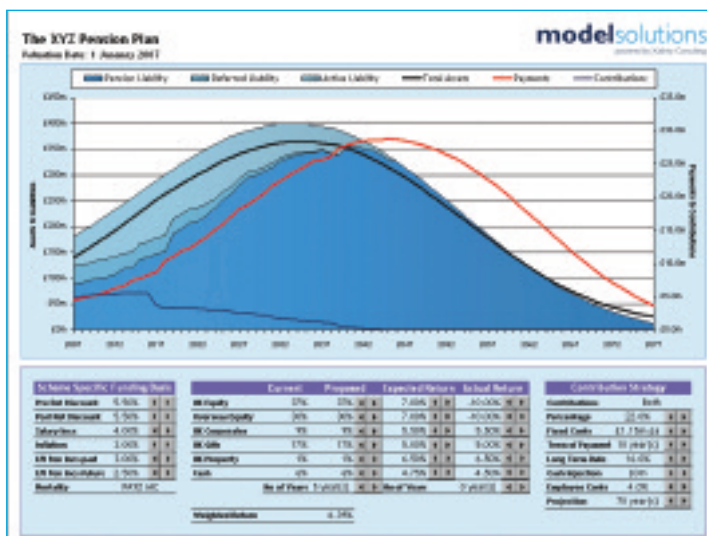
In many cases, the current accounting position can be significantly improved using a combination of tactics.

This leaves the company freer to pursue corporate strategies without hindrance; increases cashflow, credit rating and share price; and prevents the problem from escalating over time.

Model Solutions for Pension Liability Management can be installed quickly and simply. Working with Xafinity consultants, Finance Directors can be confident that they have modelled all available scenarios and explored all practical options, before choosing the strategy that suits them best.



**Scheme Specific Funding Model** – allows instantaneous comparison of liabilities under the proposed assumptions with the Buy-Out cost, Pension Protection Fund Liabilities and the relevant accounting measure under different scenarios.



**Projection Model** – projects liabilities over a period of 70 years under different assessment methods and varying assumptions.



Xafinity is one of the UK's leading specialist providers of pension, employee benefits and payments expertise, with 170 years' experience and handling £2 trillion annually.

The group provides consulting, software, resourcing, training and business process outsourcing services that enable public and private sector organisations to deliver employee benefits more efficiently.

In 2008, we were voted Pensions Administration System Provider of the Year and won the Pensions Administration Software Award, as well as winning Best Pensions Software provider in 2007. We are the accredited software supplier to the UK Principal Civil Service Pension Scheme.

With 1,500 people nationwide, we have operational and relationship management centres across the UK, in Bath, Cardiff, Crawley, Fleetwood, Leeds, London, Reading, Stafford, Stirling and Waterlooville.



Xafinity Consulting is one of the UK's leading specialists in employee benefit innovation and optimisation. Our expertise covers pensions and actuarial services, flexible benefits, healthcare, trusteeship and training. We are committed to working in partnership with our clients, providing a service to maximise the returns of their benefit strategies.

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