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# CHANGES TO DEFINED BENEFIT PENSION PROVISION

The Government has approved a number of changes to Defined Benefit (DB) provision to help ensure its sustainability and increase equity between members of DB schemes, as follows:

- The existing funding standard (amended to give credit for sovereign annuities, where purchased) will be restored for a 3 year period. Details will be announced by the Pensions Board before year end;
- By 2022, schemes will need to meet the requirements of a revised, strengthened funding standard involving a risk reserve against future volatility in the financial markets;
- The way in which accrued benefits are revalued will be changed to ensure equity between those who have left the scheme and existing employees;
- The priority order in which funds are disbursed when a scheme winds up is to be changed;
- The Pensions Board will be given powers to wind up schemes in certain limited circumstances.

Legislation will be introduced to implement these changes in the coming months.

## Re-introduction of the funding standard by year end – first deadlines 1 July 2012

Full updated guidelines will be issued by the Pensions Board on Section 49(3) and Section 50/50(A) to take account of the above announced changes and provide all the technical detail for trustees and companies needed to prepare recovery plans.

Section 49(3) guidelines relate to the approach the Pensions Board adopts in deciding whether to grant applications for extended recovery plans. Section 50/ 50(A) guidelines relate to the approach the Board takes in deciding whether to grant consent to or direct a reduction in benefits.

Although deadlines are expected to be known by year end, the first deadlines will be no earlier than 1 July 2012 to allow trustees adequate time to prepare proposals for their schemes in light of the new requirements and options.

## Guidance on the operation of sovereign annuities

The guidance available on the Pensions Board website is intended to enable insurance companies to develop and issue sovereign annuity contracts. The availability of sovereign annuities will provide scheme trustees and companies with additional options when managing their schemes.

## Revised Funding Standard – further detail

The existing funding standard will be restored initially which will give underfunded schemes 3 years in which to restore their funding levels to the current standard.

After 3 years, the revised funding standard will apply to schemes, with an amendment to include a requirement to hold risk reserves as a buffer against future financial market volatility. Schemes will have an approximate maximum 10 year period (until 2022) to meet the new standard.

**The availability of sovereign annuities will provide scheme trustees with additional options when managing their schemes.**

It is expected that the risk reserves will take the form of the sustainability requirements currently applying to schemes restructuring under 'Section 50'. The application of the 'Section 50' sustainability tests requires the scheme to withstand an investment stress test comprising an immediate fall in equity values of 15% and a simultaneous decrease in interest rates of 0.5 per cent.

It is estimated that the effect of the requirement to hold risk reserves will be to add circa 10% to scheme funding requirements for the average scheme - this assumes that most of the schemes' assets remain in equities, thus attracting a risk reserve, but offset by a reduction in the funding standard for pensioners (through the purchase of sovereign annuities). However the effect on an individual scheme's statutory funding position will depend on

- the scheme's pensioner liabilities;
- the scheme's planned holdings of assets that require a risk reserve (thus the size of the risk reserve is determined by the trustees' investment policy) and;
- whether the scheme avails of sovereign annuities.

It is expected that risk reserves would apply except possibly where trustees have a legally enforceable guarantee from an employer to meet any deficit that arises.

A link to a previous KPMG article on the above topic can be found here: **http://www.kpmg.com/ie/en/issuesandinsights/articlespublications/pages/pensions-article2.aspx**

## Revaluation of scheme benefits

DB schemes apply a revaluation rate (annual increase) to deferred members at a rate which can give rise to the benefits of deferred members being revalued at a more favourable rate than that applied to active scheme members who are still contributing to the scheme. The Pensions Act will be amended to change the revaluation rate to ensure greater equity between members.

## Power to wind up a scheme

The Pensions Board will have the power to require the trustees to wind up a scheme where a scheme is underfunded and the trustees and employer are not in a position to adopt a funding proposal and it is clear the position will deteriorate.

## Change to wind up priority

The current balance is to be tilted such that in the event of a scheme winding up in deficit a greater proportion of actives and deferred members' benefits will be delivered while ensuring pensioners are still protected. While pensioners will continue to be prioritised this will only be up to a certain level of benefit, which is yet to be determined.

## Sovereign Annuities

The Pensions Board on 26 October 2011 set out its certification conditions to enable insurance companies issue sovereign annuity products. The certification process is to ensure that the sovereign annuity products are allowable under the Pensions Act.

A sovereign annuity is a type of annuity product where payments under the policy will be directly linked to the proceeds of Euro denominated bonds issued by any EU Member States and payments under the sovereign annuities can be reduced due to an event of non-performance in relation to the reference bonds ie default.

Because sovereign annuities are likely to be less expensive than conventional annuities, the purchase of these annuities would make additional assets available to secure the benefits of active and deferred scheme members.

Where sovereign annuities are purchased in the pensioner's name (rather than the scheme name), payments will be made directly to the pensioner but if there is any restructuring of the backing bond then the pensioner him/herself may suffer a direct reduction in their benefits.

A link to a previous KPMG article covering the topic of wind-up priorities and sovereign annuities can be found here **http://ipad.accountancyireland.ie/Archive/editions/201106/files/48.html**

## What should trustees and companies be doing now?

Given the variety of options from which trustees / companies need to choose and the financial significance of each, organisations with DB schemes need to ensure they are receiving the right advice and support at this time in order to take control of the management of their pension schemes.

Sovereign annuities widen the options available to the trustees of DB schemes. Trustees and company sponsors will need to make some tough decisions in the coming months and weigh up the following:

- Whether to pay pensioners their benefits from scheme resources or purchase annuity products for all or a portion of their benefits instead?
- If purchasing annuity products, whether to purchase conventional annuities (linked to French/German bond yields) or the new sovereign annuities, or a mixture?
- If purchasing annuity products whether to purchase these products in the name of the trustees or in individual pensioners' names?
- Which insurers to purchase any sovereign annuities from, given that individual insurers have discretion in a number of areas. For example insurers can determine the sovereign annuity rates, the bonds which the sovereign annuities are referenced to, the percentage of payments which can be reduced due to an event of non-performance, whether any reduction can be applied immediately or whether it can be spread forward, etc.

More generally, trustees and companies should examine the impact of the revised funding standard on their projected liabilities and contribution requirements. Companies should reflect on the appropriateness of the existing investment strategy and consider initiating liability management and benefit restructuring exercises in light of the more onerous funding standard to apply in 3 years' time.

Any benefit restructurings or reductions either within or outside the 'Section 50' process will require careful negotiation with all stakeholders. Companies looking to implement such changes need to factor this into their timelines and pre consultation actions should commence at the earliest opportunity.

It is expected that the re-emergence of funding proposal deadlines with revised legislative requirements and options, will allow companies take the necessary action to put their DB plans on a sustainable path for 2012 and beyond.

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