The DB funding regime in the current environment

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The Pensions Regulator

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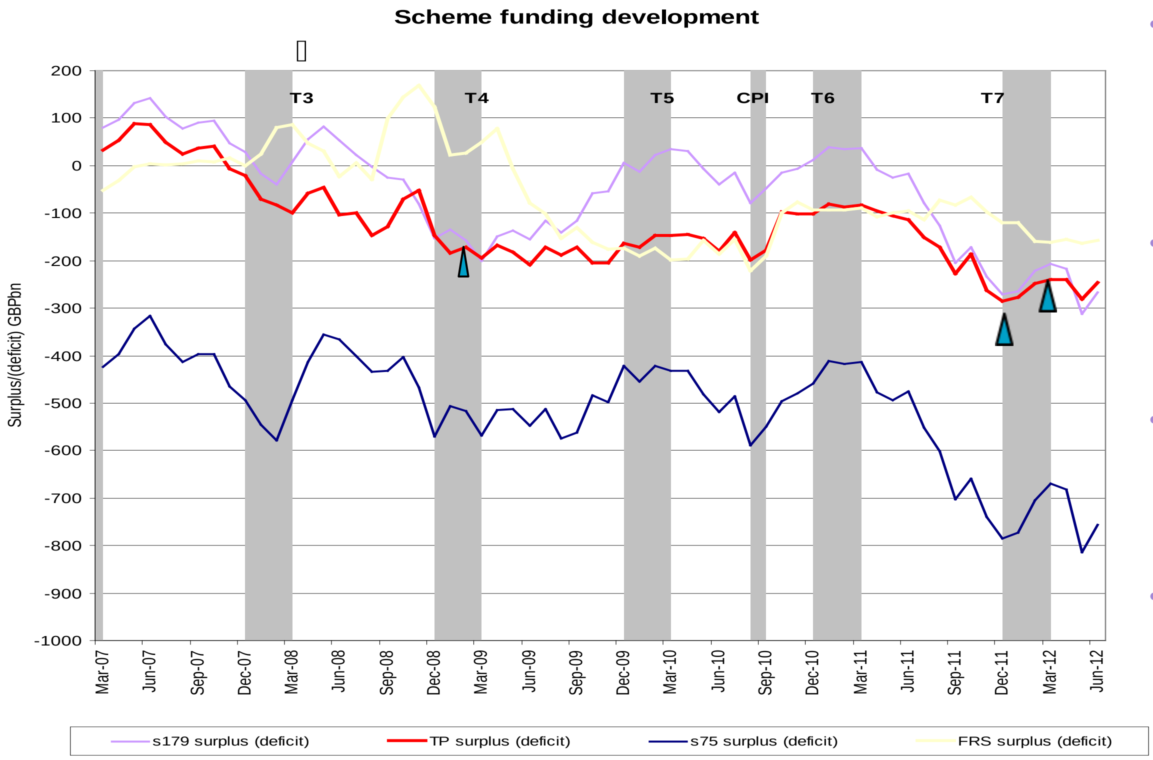
Agenda

DB Funding issues - Tranche 7 valuations - 22/9/11-21/9/12

- Funding past trends and future possibilities
- How flexibilities cope with the challenges
- The Pensions Regulator evidence + analysis
- Pro-active process
- What next – for The Pensions Regulator and you?

The problem in aggregate: ASTPI



- *__Technical Provisions__: measures the cost of members benefits under Part 3 of the PA04. This is the principal target of scheme funding plans and deficit repair contributions.*
- *__S179__: this provides a broad measure of the cost of providing a pension equivalent to the PPF level of compensation.*
- *__S75__: measures liabilities at or close to insurance buy-out prices – determines exit price for voluntary walk-away by solvent employers.*
- *__FRS__: a corporate accounting standard which measures pension liabilities for reporting in the sponsoring company's accounts. It is based on the prevailing yield on AA corporate bonds.*

- Bigger deficits overall
- More volatile
- Number of contributory factors, QE being one

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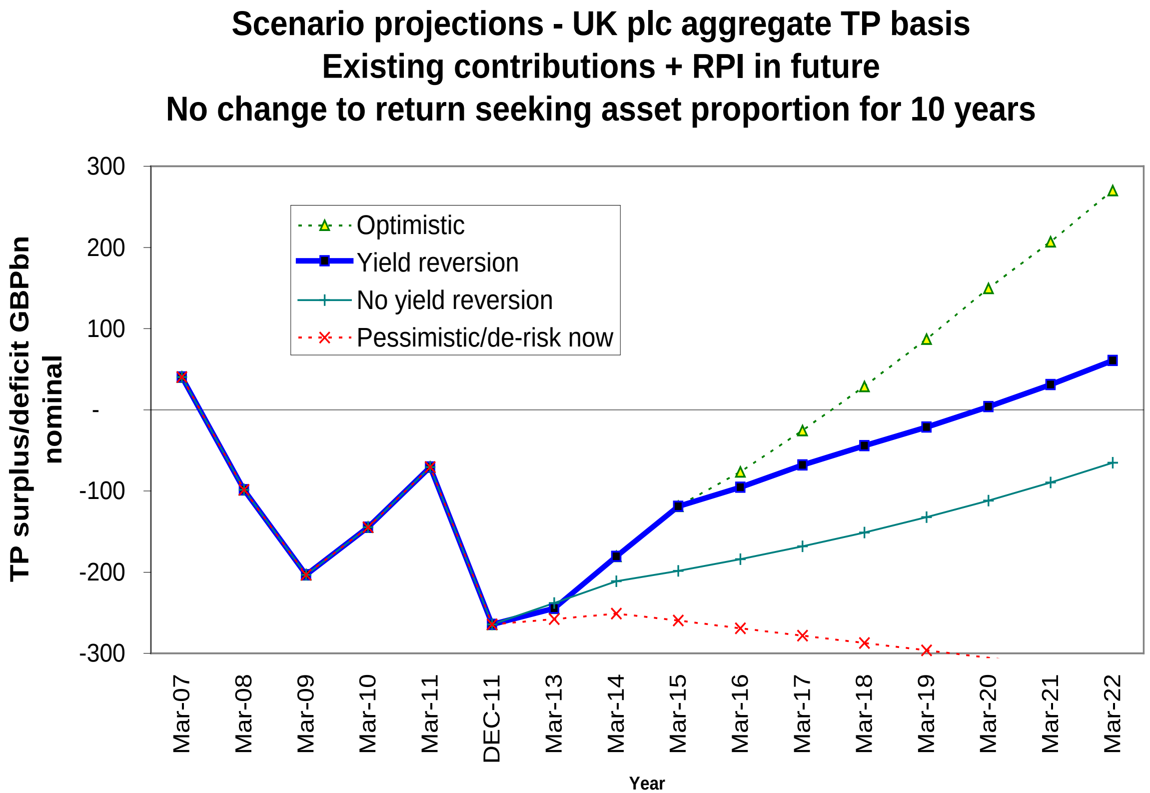
The uncertain future: normal service soon?



- Different views and different outcomes
- Long way to recovery
- Reliance on future investment markets alone not a prudent strategy
- Need to focus on recovery plan

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Aggregate analysis masks a lot of key underlying information

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At scheme level: difficulty for many but not all

- Granular differences matter – principle behind the Pensions Act 2004
- Outcome differs from scheme to scheme:
  - Previous funding history
  - A-L mismatch and risk management strategy
  - Other post valuation experience
  - CPI credit
  - Use of other flexibilities
  - Affordability of new deficit
  - Numerous other scheme/company specific features

- Across the board solution not necessarily the right answer

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Is the situation manageable?

Flexibilities

The Pensions Act 2004 regime has a number of flexibilities in the system which schemes can utilise as appropriate.

- Deficits do not have to be paid off immediately
- RP lengths are variable – 10 year trigger discontinued
- Schemes can take account of post valuation experience
- Back end loading if short term cash constraints
- Contingent assets as alternatives to cash
- Discount rates are set by trustees

April statement key issues:
Flexibility where needed – robustness where feasible

- Contributions where affordable - but trustees should not be ‘recklessly prudent’
- Trustees can welcome investment in growth of the sponsor where it improves ability to fund the scheme over time
- Legislation does not require trustees to only invest in gilts. Schemes with a strong employer may be able to afford to take more risk
- Where extra breathing space required – fully expect recovery plans to lengthen and schemes to utilise other flexibilities
- The Pension Regulator’s approach does not hinge on a 10-year trigger
- Trustees should assess risks in the round

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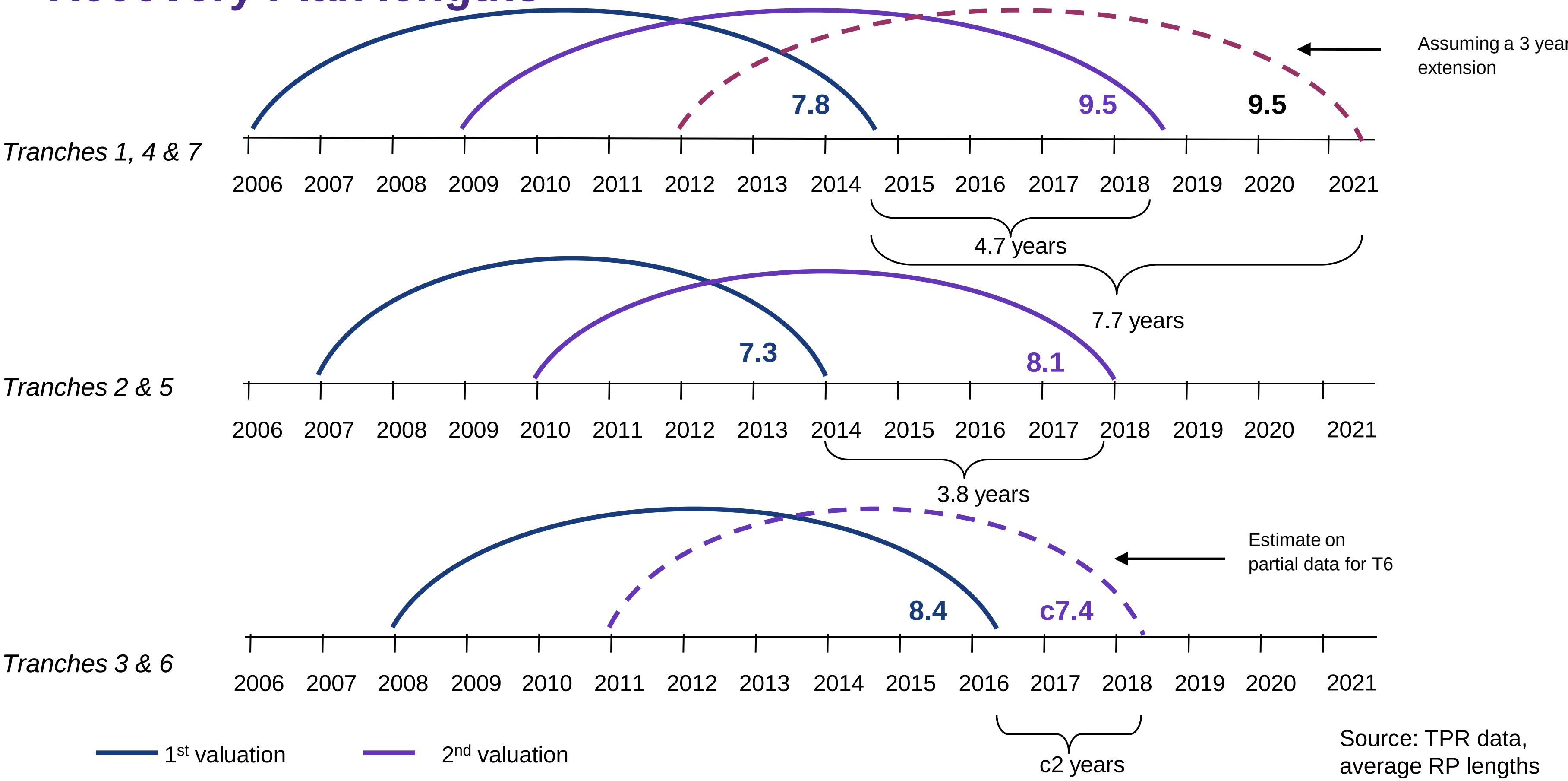
Do schemes use these flexibilities?

Many schemes have used the flexibility available in setting Recovery Plan lengths



- First two cycles (Tranches 1&4, Tranches 2&5), average extension approximately 4.2 years from their original end date
- Tranche 7 expectations :some trustees will need to use this flexibility further.

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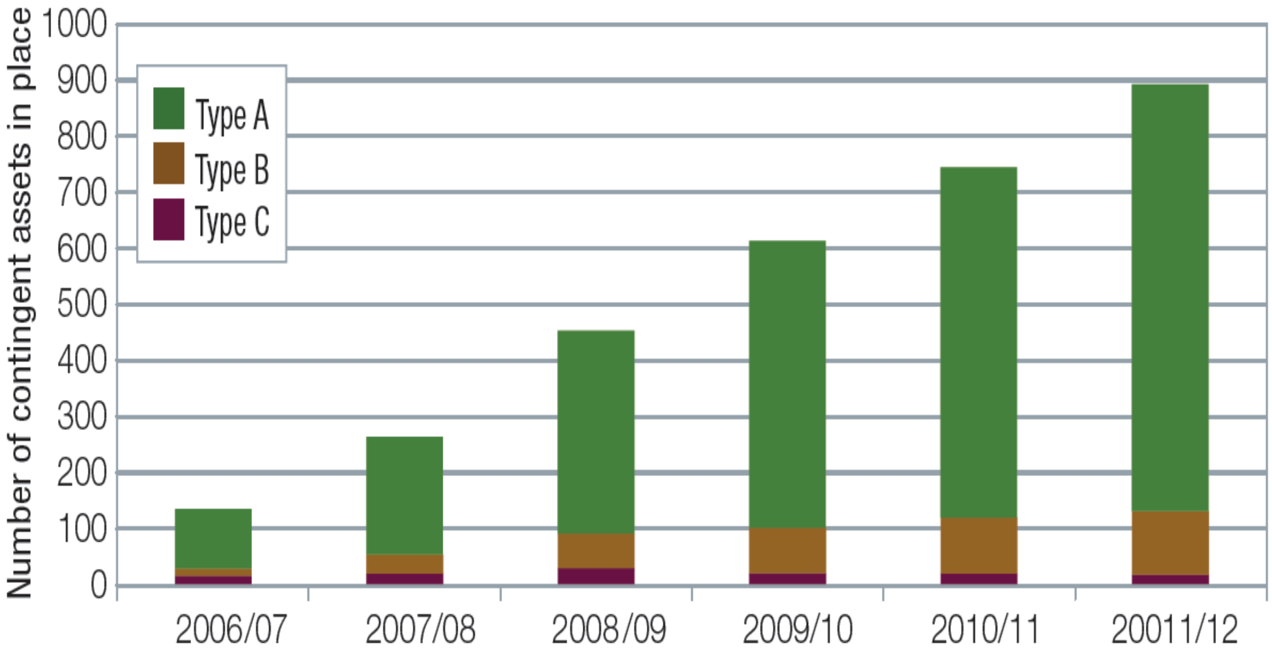
Schemes have used the option of using contingent assets as well as making cash contributions to schemes



PPF eligible contingent assets as reported in Purple Book for PPF levy years

Type A – Parent or group guarantees

Type B – Security over cash, UK real estate and securities

Type C – Letters of credit and bank guarantees

– Increasing trend for use of non-cash security.
  - 7 fold increase in 6 years
  - More than 20% T5 schemes used at least one contingent asset.

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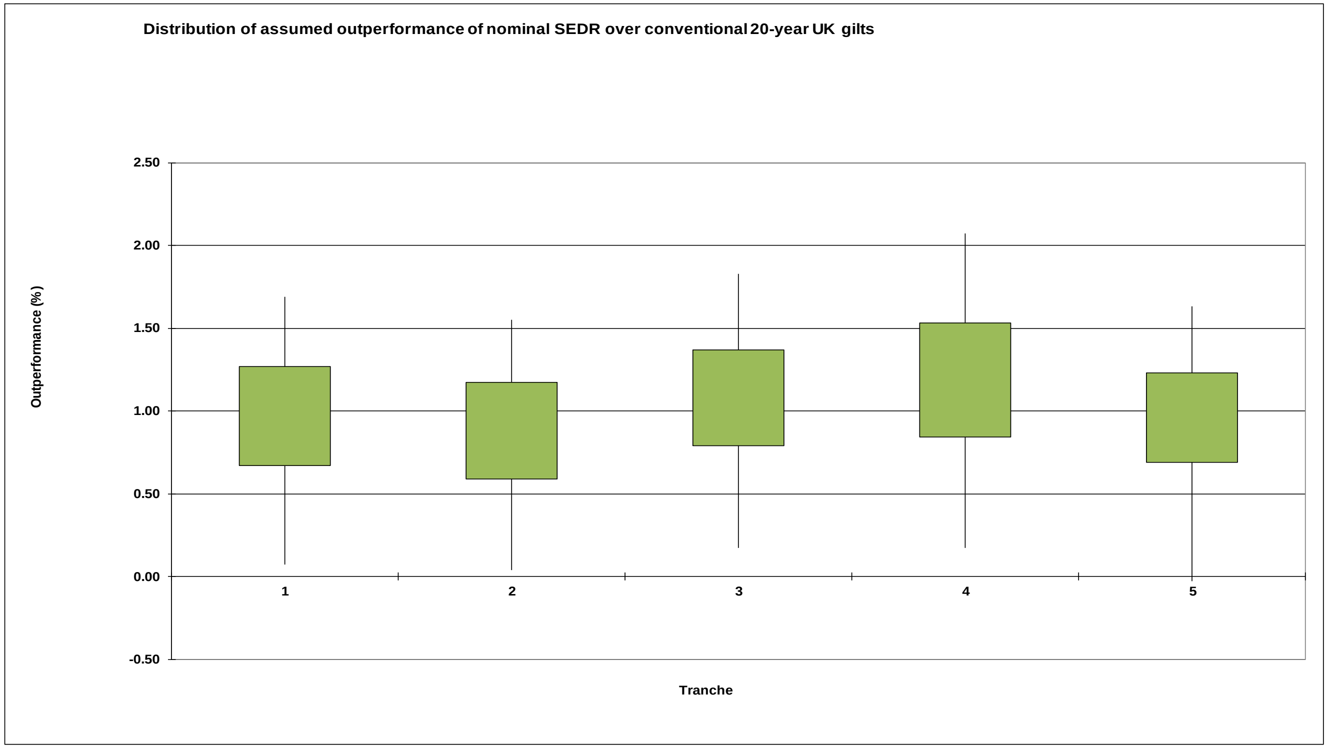
Discount rates are set on a scheme specific basis



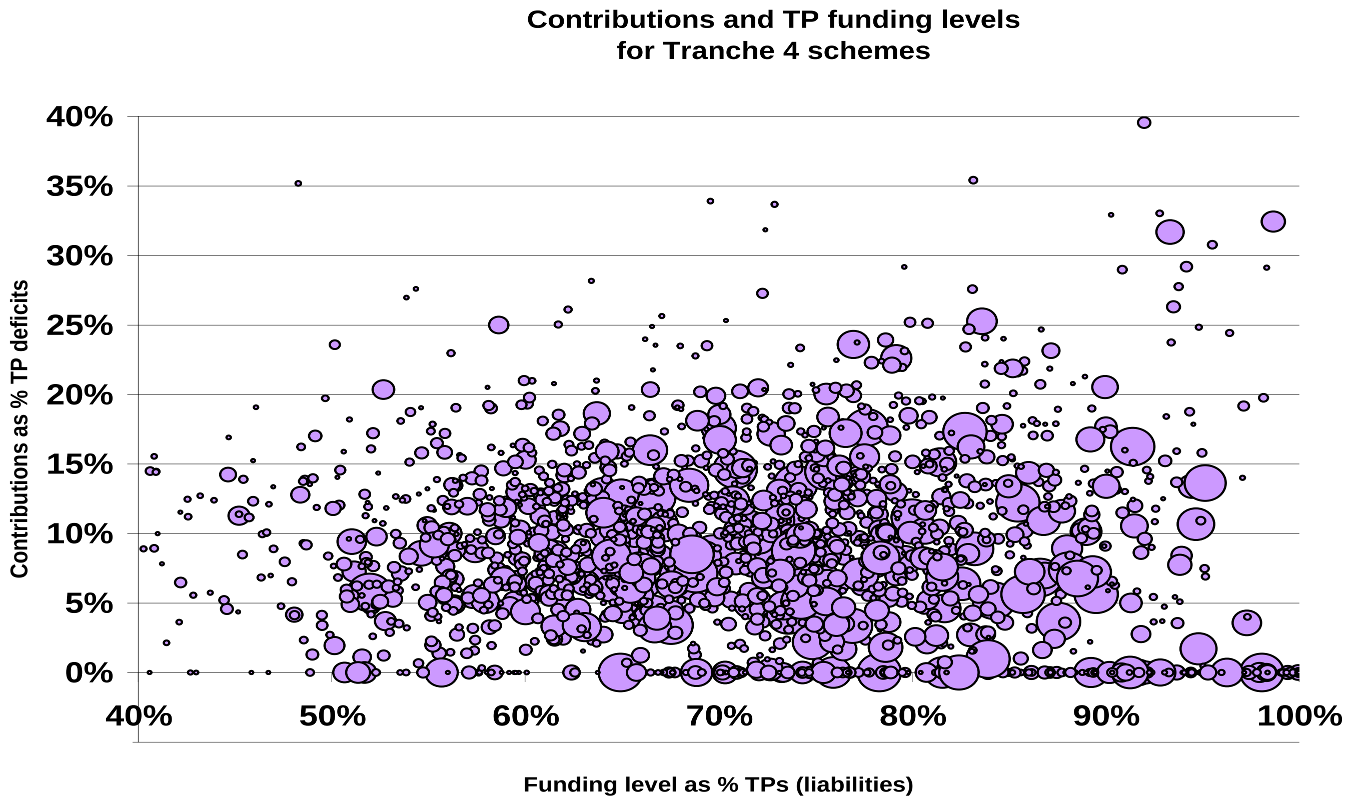
Box plots represent 5th, 25th, 75th and 95th percentiles

SEDR – Single Effective Discount Rate

Source: TPR data

- Discount rates vary substantially from scheme to scheme representing a scheme specific approach dependent on individual characteristics
- Outperformance over tranches 1 to 5 has ranged from below zero to over 200 bps.
- The regulator views any increase in the asset outperformance assumed in the discount rate to reflect perceived market conditions as an increase in the reliance on the employer's covenant.

Funding levels vary from scheme to scheme & contributions are scheme specific



Source: TPR

Bubble size indicates the size of scheme by technical provisions

- No significant correlation between funding levels and speed of recovery, because many other factors contribute to the speed at which deficits are paid
- Wide variety of scheme circumstances - regulatory framework must take account of a range of differing schemes and employers

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Foreign “solutions” – suitable for the UK?

- Smoothing approaches elsewhere have superficial appeal,

  ……….. but there is a sting in the tail at least when it is used elsewhere:
  - Risk free discount rate
  - More stringent deficit recovery periods
  - Tighter rules for funding
  - Benefit reductions

- Not all of these would be essential is smoothing were applied in the UK
- But what is smoothed and how exactly it might be done would be important
- The UK regime is balanced differently – tinkering with individual elements requires the balance to be re-thought
- How the other parts of the system might have to adapt would be critical.

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Some insights into the immediate concerns –

our analysis for Tranche 7 schemes

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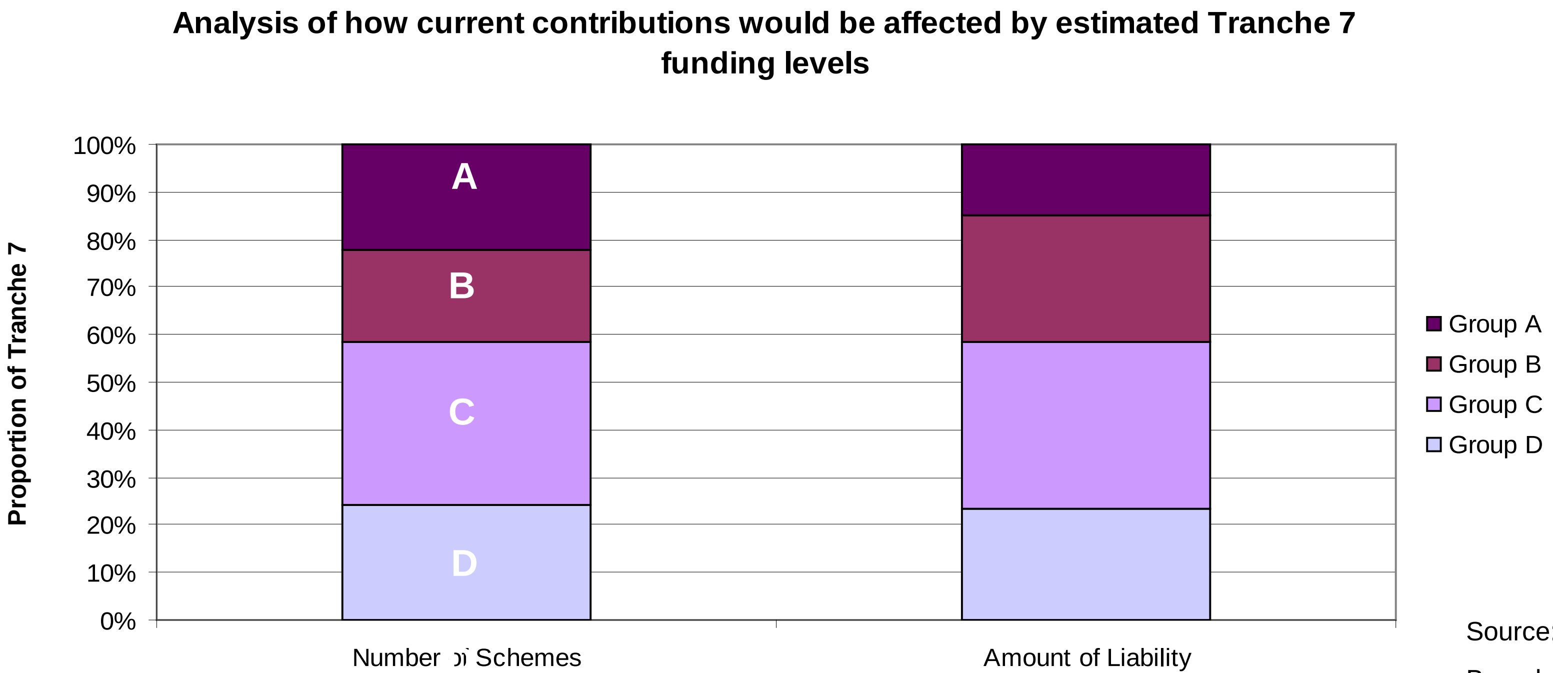
Tranche 7 DRC impact analysis



Source: TPR

Based on 2023 schemes with a valuation date due in T7 – assumed to be 31/3/2012

- Possible impacts for four groupings of T7 schemes based on maintaining DRCs in real terms:
  - Group A: DRC increase above 10% even with a 3 year extension and weakened recovery plan assumption **ABOUT 25%**
  - Group B: DRC increase contained to 10% if 3 year extension applied, but only through weakened recovery plan assumption **ABOUT 20%**
  - Group C: DRC increase contained to 10% if 3 year extension applied **OVER 30%**
  - Group D: No need to amend recovery plan **ABOUT 25%**
- By liabilities large schemes dominate - those in the highest impact category represent a smaller percentage of the total.
- Assumed the same outperformance in the discount rate as reported by schemes in their T4 valuations – results very sensitive to this

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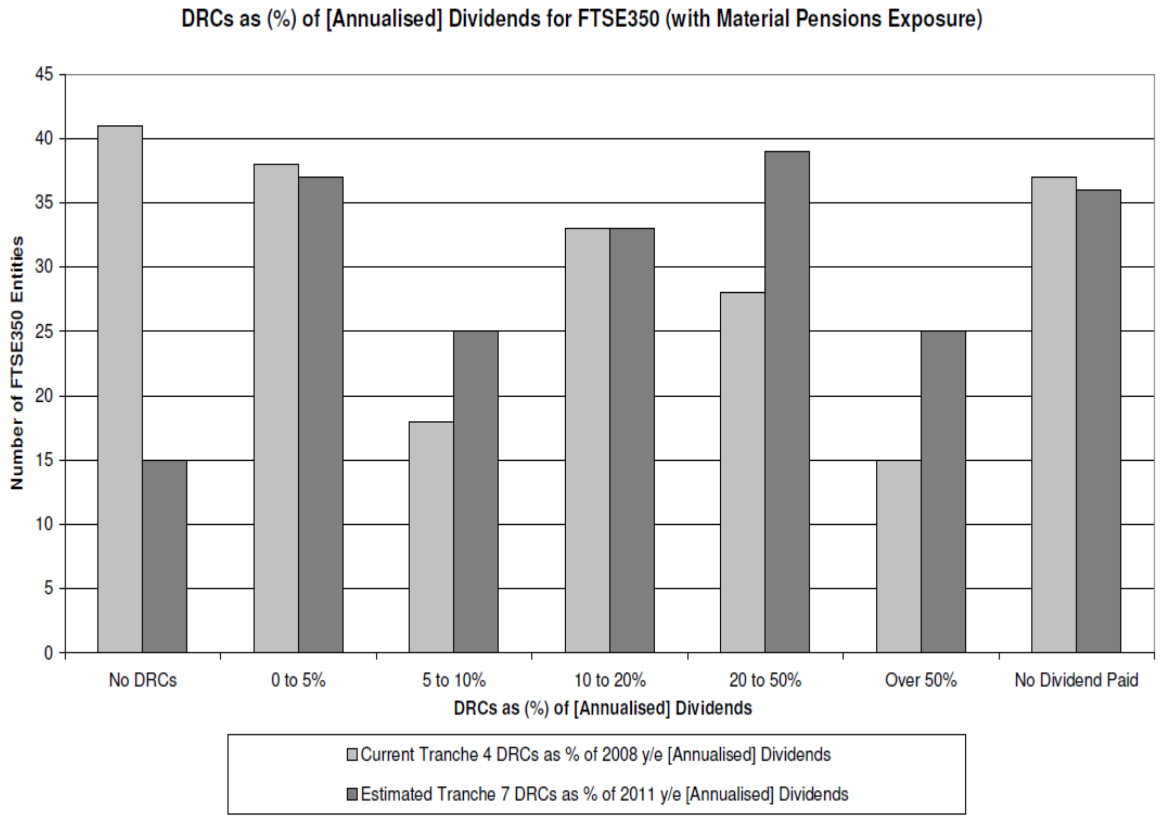
Yes, but what about affordability?

Deficit Repair Contributions (DRCs) as a % of dividends



For listed sponsors where recent dividend information was available, we investigated what the new DRC requirement might be as a proportion of dividends paid to shareholders

Source: Capita Registrars, TPR

- For more than half of FTSE350 sponsors in the sample, DRCs represent less than 20% of the value being paid in dividends
- For a limited number of schemes, DRCs are higher than current dividend payments; and for some, DRCs are being paid but dividends have been suspended
- The data is informative, but it says little for privately held companies, mainly SMEs

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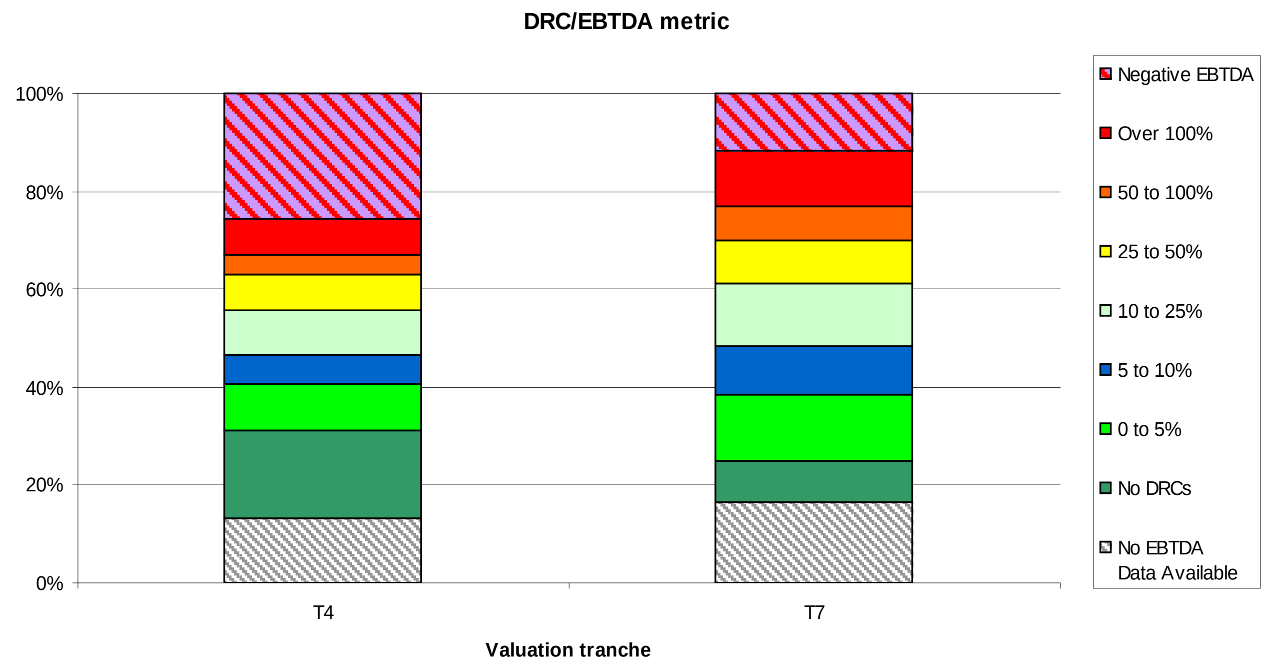
Estimated projected DRC's as a proportion of sponsor's EBTDA



We looked at the likely changes in required DRCs as a proportion of Earnings Before Tax, Depreciation and Amortisation (EBTDA)

Source: BvD FAME; TPR & PPF Data

Comparing revised DRCs against cash flows (stacks) and T4 outcome v T7

- Compared with current situation under already agreed RPs, for majority of schemes new DRCs as a proportion of cash flow do not change significantly.
- A number of companies not currently paying DRCs, but will likely have to do so in future.
- Position is obscured by the number of companies with negative EBTDA but are paying DRCs. This reflects the limitations of this metric in looking at impacts on sponsors' cash flow.

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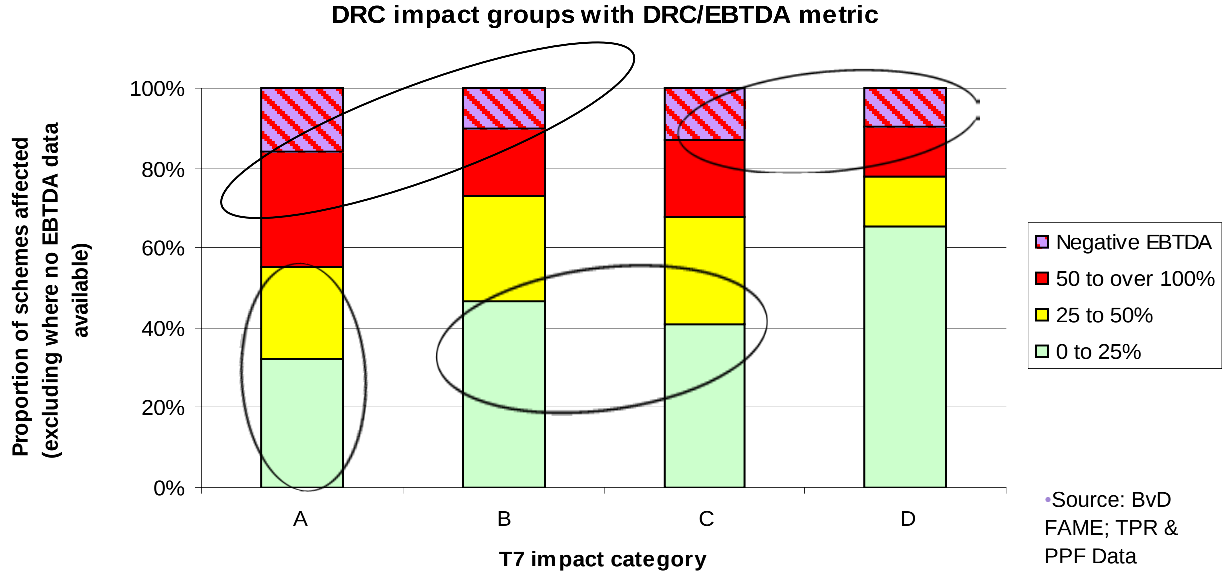
Pulling together the actuarial and affordability analyses

Are the schemes facing increased contributions likely to be subject to affordability constraints?

Increasing impact on cash flow



•Source: BvD FAME; TPR & PPF Data

Excludes circa 20% of schemes where no earnings data available – probably SMEs

Increased DRC 'ask'

Substantial change, good affordability for many, but also significant challenge for many

Significant change but many have good affordability

Limited change but some flexibility needed

No change but some need more flexibility

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And what about the "pro-active" approach?

Pro-active process
“Match guidance from the referee”

Typical engagement process

- Familiarisation meeting
- Share initial factual results
  - TPR discusses/raises issues as needed
- Share proposed recovery plan
  - TPR discusses/raises issues as needed
- TPR indicates likely support
- Sign off by trustees/employer
- TPR no action letter without further work

Analysis encouraged

- Long term asset/liability modelling
  - 10 years+
  - Include 95th percentile
  - “minimum risk” assumptions
- Reconciliation to covenant
  - Current risk capacity
  - Long term uncertainty
- Monitoring framework
  - Balanced scorecard
  - Feasible Plan B

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What next?

- For The Pensions Regulator
- Pro-actives play out
  - Feedback for other schemes
  - Trickle down to small/medium schemes
- Trigger design
  - Adapting the current triggers
- TPR long term strategy
  - Code of practice for the 2010’s
- Tranche 8 statement in 2013
  - How different?

Questions and Discussion

What is next for you?

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