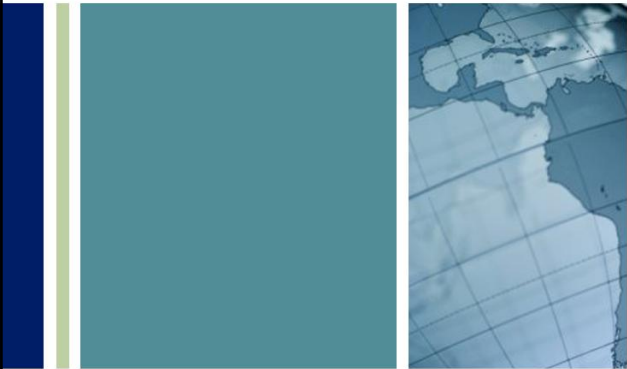


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Corporate Pensions Briefing

12 June 2007



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Corporate covenant and the pension scheme valuation - The corporate perspective

Adrian Bourne and Sean Weaver
12 June 2007



Scheme Specific Funding ("SSF") – an overview

- SSF regime effective from 22 September 2005.
- Defined benefit schemes must have assets sufficient to meet the scheme's "technical provisions", the actuarial value of the scheme liabilities.
- Employer and trustees must agree the contributions (where they were previously set by the employer).
- Where there is a deficit, a recovery plan must be agreed to provide for the elimination of the deficit.
- The Pensions Regulator (TPR) is responsible for overseeing the SSF regime.
- In the absence of agreement, or where TPR is not satisfied, TPR is empowered to set the technical provisions and recovery plan.

What to expect of TPR under SSF - the Code of Practice

Para 57 – It is essential for the Trustees to form an objective assessment of the employer's financial position and prospects as well as its willingness to continue to fund the pension plan's benefits (the employer's covenant).

Para 59 – The employer is obliged ... to provide the trustees with such information as they ... reasonably require ... This includes information reasonably required to assess the employer's covenant.

Para 92 – ... trustees should consider ... the ability of the employer to cope with the financial consequences of assumptions not being borne out by experience.

Para 101 – Trustees should aim for any shortfall to be eliminated as quickly as the employer can reasonably afford. What is possible and reasonable, however, will depend on the trustees' assessment of the employer's covenant.

Focus on the employer covenant through-out the valuation process

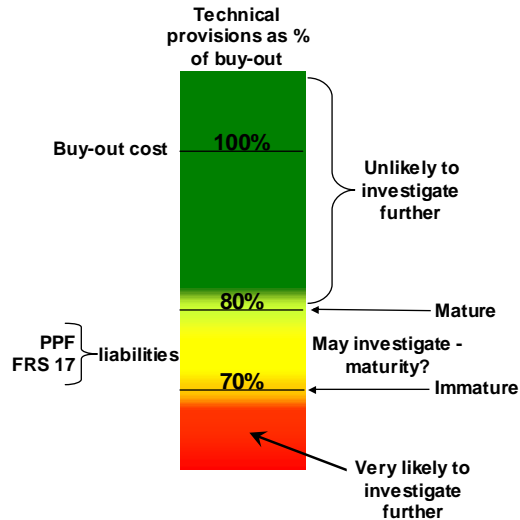
Do you believe that the trustees of your pension arrangements...

...will, collectively, be able to make a realistic assessment of the company's covenant?

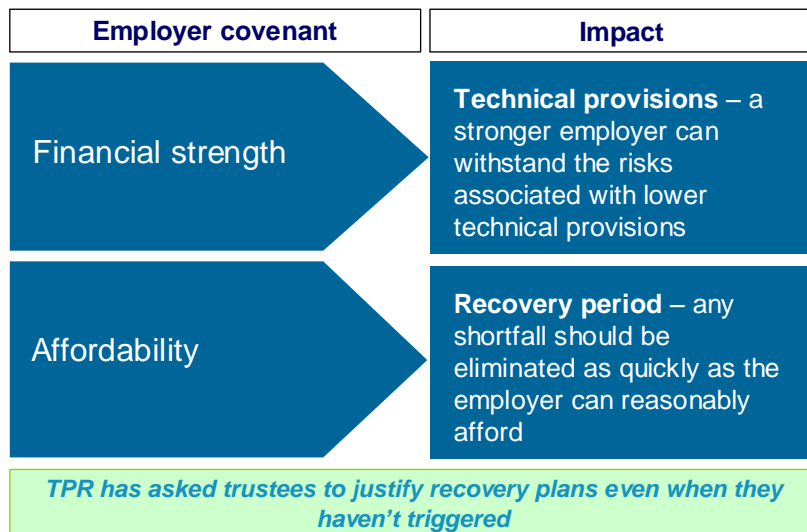
1. Our trustees understand our covenant better than I do
2. Given the right information, our trustees should get a good understanding of our covenant
3. If we gave the trustees lots of information, they might be able to get a basic understanding of our covenant
4. Even if we gave the trustees all the information in the world, they still wouldn't have the first idea about our covenant

What to expect of TPR under SSF - the triggers

- TPR will use a number of “triggers” to decide which schemes to investigate further:
 - technical provisions below PPF benefit level / FRS 17
 - Recovery period greater than 10 years, significant back-end loading or inappropriate assumptions
- TPR will expect trustees and employers to demonstrate they have followed issued guidance
- The employer covenant is integral to the process



What to expect of TPR under SSF - the practice so far...



At the first scheme specific funding valuation...

...what level of covenant assessment did/do you expect your trustees to carry out?

1. None
2. Review of financial information in the public domain
3. Request additional information and form own conclusions
4. Basic external advice
5. Detailed external advice

Negotiating scheme funding with trustees – the considerations

- The level of company contributions is driven by the technical provisions and the length of the recovery plan.
- Companies need to demonstrate financial strength but...
- ... may wish to emphasise the need to balance competing demands for resources, including:
 - investment in the business (which ultimately strengthens the covenant)
 - the interests of shareholders.
- Contingent funding can be used in negotiations, for example:
 - escrow accounts
 - allowing the scheme to take security over company assets.
- However, diverting free cashflow into escrow accounts or granting security may impact credit ratings and bank covenants and be costly to implement.

Negotiating scheme funding with trustees – the process

1. Presentation to trustees demonstrating employer strength/showing need to balance competing demands for cash.
2. Follow up document for the trustees, implement regular information flow.
3. Provide information to trustee advisers (if necessary).
4. Review trustee adviser's report to ensure it is factually correct and comment on findings.
5. Negotiation over impact of covenant on assumptions and recovery plan.
6. Consideration of contingent funding (if necessary).

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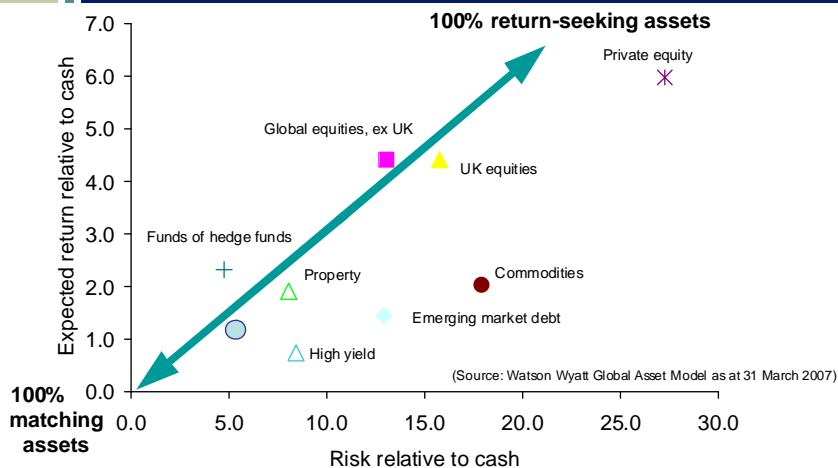
**Latest developments in pension
scheme investment – how to get
more (return) for less (risk)**

Craig Gillespie
12 June 2007

More return for less risk

- Sounds too good to be true but...
- We consider three ways of achieving this ideal:
 - More efficient asset allocation within the Scheme.
 - Reducing risk from the liabilities.
 - Transferring risk within the Sponsor.
- Disclaimer:
 - These approaches will not work for everyone!

The traditional big lever – how much investment risk?



Life insurers typically live bottom left, while pension schemes will be closer to the middle

What is your company's ideal allocation...

...to return-seeking assets for the pension scheme given its current funding position?

1. More than 90%
2. Between 60% and 90%
3. Between 40% and 60%
4. Between 10% and 40%
5. Less than 10 % (i.e. closely matched to liabilities)

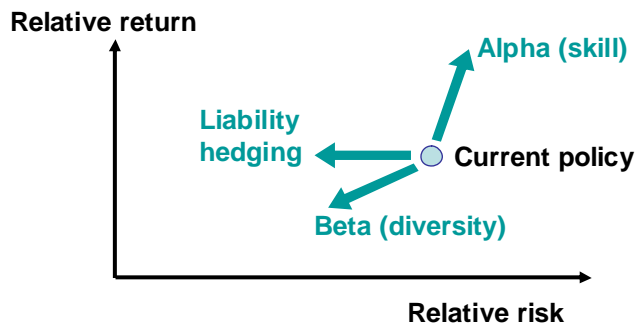
If your scheme's financial position improves...

...will this change your views on the asset allocation?

1. No, our views wouldn't change
2. Yes, we should increase the allocation to liability-matching assets as we can afford to reduce risk
3. Yes, we should increase the allocation to return-seeking assets as we are able to take more risk

Three important smaller levers

The building blocks of investment efficiency are effective liability hedging, cheap beta, reliable alpha



Best investment practice is driven by governance

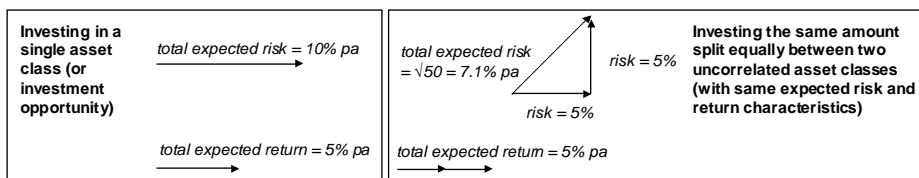
Diversification – Return drivers

Beta (diversity)

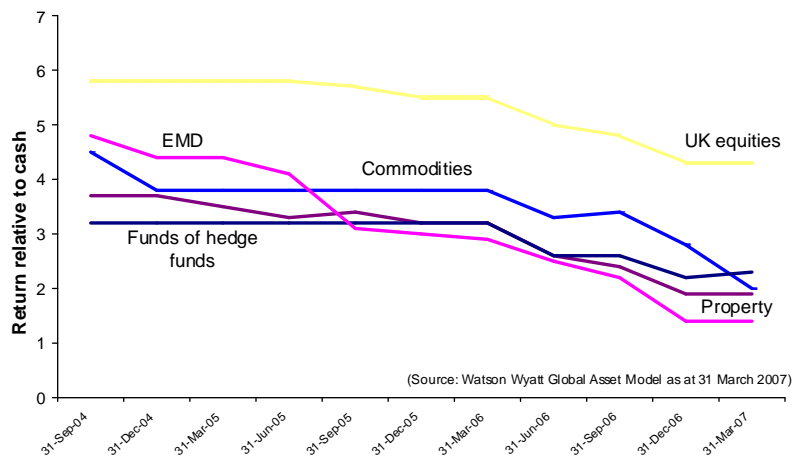
- We believe there are five fundamental reasons for return-seeking assets to outperform matching assets:

Equity Risk Premium	This has been institutional funds' main return driver
Skill risk premium	Pockets of inefficiency in markets can be exploited by skilful managers
Liquidity risk premium	Most institutional funds do not need much liquidity and are natural buyers
Credit risk premium	Higher yields available to compensate for default risk
Insurance risk premium	A premium can be received in return for accepting certain risks

- We believe that investors should seek exposure to multiple sources of outperformance. This should lead to a more efficient investment policy (as shown below)



But... the diversity stampede



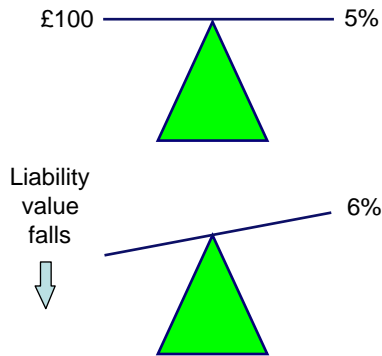
Nowhere left to hide?

What risk most concerns you looking forward?

1. A fall in equity prices
2. A fall in bond yields
3. Manager underperformance
4. Mortality improvements
5. Why worry, it's not like I can control any of this stuff

A pension liability's response to an interest rate rise

Liability hedging ←



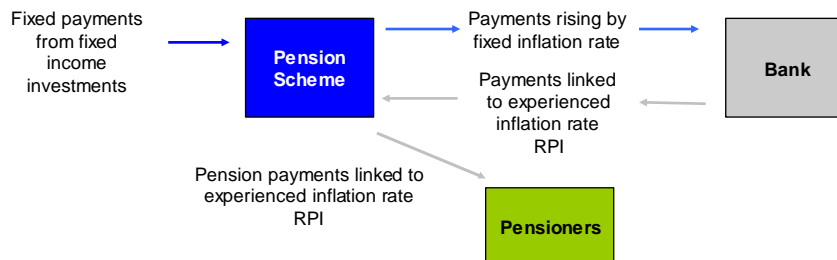
- £100 Liability in one years time
- Market interest rate 5%
 - need to invest £95 today to meet liability in one year

- Market interest rate rises to 6%
 - still need to meet £100 liability in one year
 - now only need to invest £94 today to meet liability
 - present value of liability falls

Fixed pension liabilities and fixed coupon bonds respond to changes in interest rates in the same way

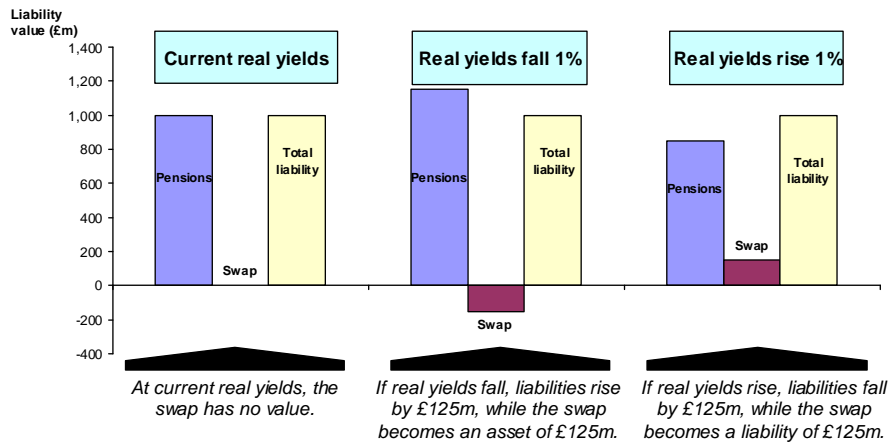
What is an inflation swap?

- Pension scheme and bank agree to exchange cashflows
- Pension scheme pays bank periodic payments that increase according to a fixed inflation rate
- In return bank pays pension scheme periodic payments that are linked to the experienced inflation rate
- Pension scheme receives an inflation linked payment stream it can use to meet inflation sensitive liabilities, which it is funding with fixed payments



Overall aim

- The strategic goal of a swap programme is to create an equal and opposite change in liability value when real (or nominal) yields move.



What do you think of LDI?

1. Just another fad
2. Interesting but too expensive
3. Interesting and we are considering using it
4. Done it

Taking more Company risk?

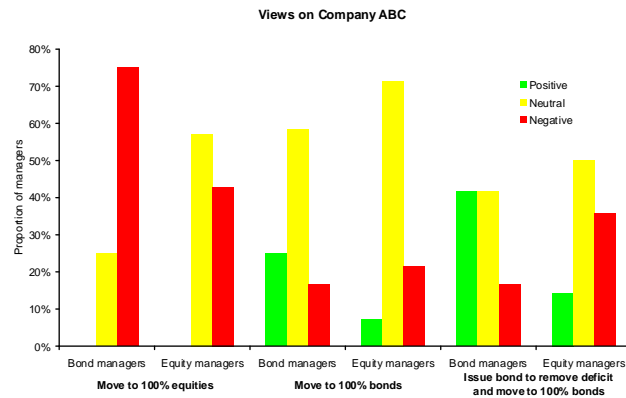
- Equities in the pension scheme can be considered additional gearing.
- Switching equities to bonds combined with an increase in corporate gearing could be considered neutral in leverage terms.
- IF the Company's "return on capital" is higher than its marginal cost of borrowing by a greater amount than the equity risk premium (equity return minus corporate bond yield) allowed for in the Scheme's IAS 19 charge.
- THEN switching out of equities and doing an equivalent monetary share buy-back would leave the Company with a greater earnings per share.

Funding deficits with borrowing

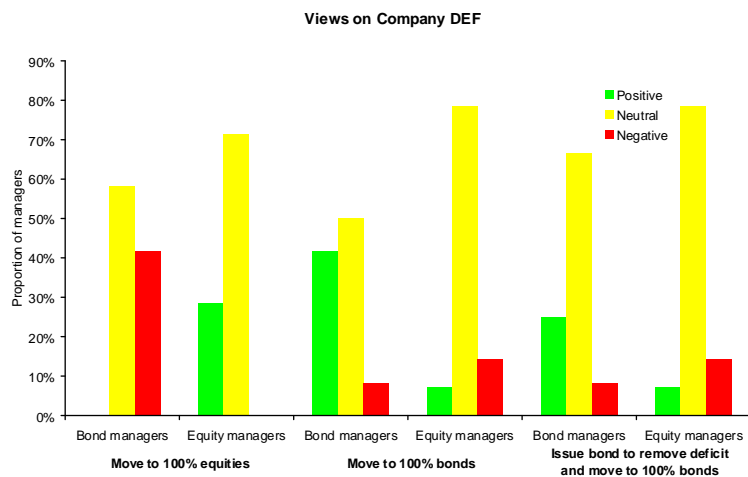
- Most rating agencies and analysts consider pension deficits to be equivalent to other corporate debt.
- So that Company's who have borrowed to fund pension deficits have not seen their ratings reduce.
- If you can earn more than the cost of borrowing through investments in the pension scheme, then the net impact of the borrowing will be positive.

What do analysts think of pension scheme equity investment?

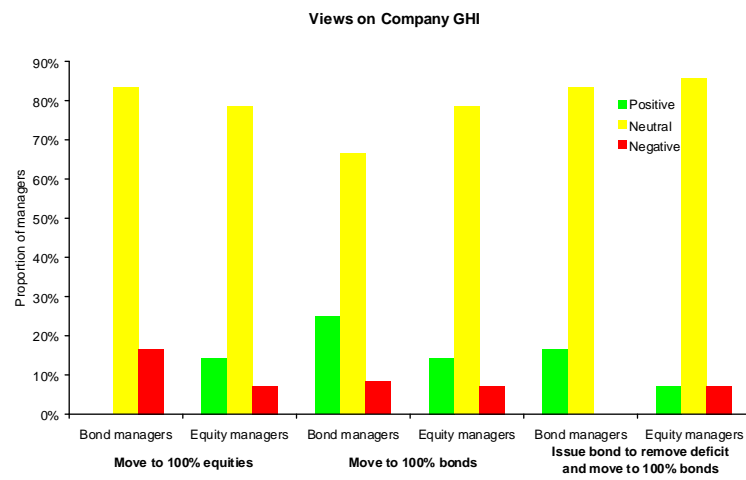
- These are the results of a survey we did of bond and equity analysts.
- We asked their views on equity investment and borrowing to pay off deficits for three fictional sponsors.



What do analysts think of pension scheme equity investment?



What do analysts think of pension scheme equity investment?



Conclusions

- Diversify – at the right price.
- Hedge – to improve bond matching (at the right price).
- Consider whether funding the deficit through external borrowing will be efficient.
- Consider where it is best to take the risk.



Corporate Pensions Briefing

Enhanced transfer value exercises

Steven Dicker
12 June 2007

Background

Transfer value – *n. a cash sum paid from one pension scheme to another where a member transfers their benefits*

Current position

- Transfer value = expected cost of providing benefits
- Can be reduced if scheme underfunded
- Most DB Schemes closed to transfers in

Impact

- Transfers to DC arrangements
- Low transfer values
- Members discouraged from transferring out

- Government consulting on new legislation but this is unlikely to change the position substantially

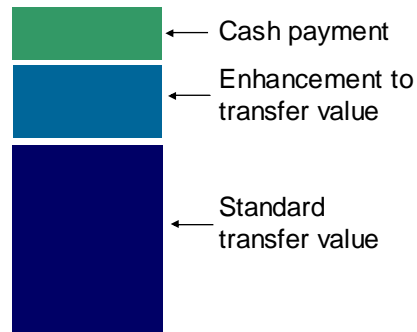
What is a transfer incentive?

Transfer incentive – *n. a sum exceeding the normal transfer value with the aim of encouraging members to transfer out*

Options

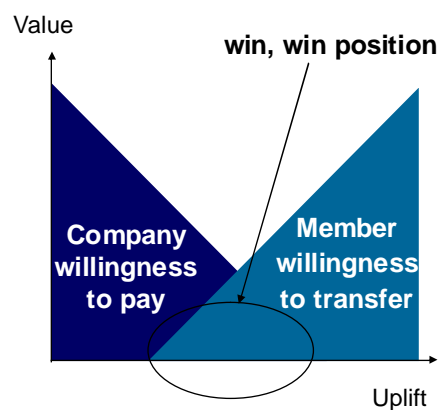
- Higher transfer value
 - more generous basis
 - one-size fits all uplift
- Cash payment
- Combination

Example payment



Why consider transfer incentives?

- Opportunity for Company to
 - de-risk scheme
 - reduce buy-out deficit
 - possibly reduce IAS 19 deficit
- ... and benefit both parties
 - company can reduce risk at a cost it is willing to pay
 - member gets “value” for money



*Potential for win, win ...
... but striking the right balance may be difficult*

Company considerations

Pros	Cons
<ul style="list-style-type: none">■ Reduce pension liability and associated volatility/risk■ Reduce running costs including PPF levies■ Gain on balance sheet if settled at below IAS 19 value■ Potential short-term cash savings if settled below funding reserve■ Reduce buy-out deficit	<ul style="list-style-type: none">■ Potential increase in long-term cost■ Potential mis-selling claims / regulatory involvement■ Short-term cash injections may be required■ Possible low take-up but high costs■ Anti selection risk■ Potential reputational risk

Also need to consider Pension Regulator guidance (12 key issues) and trustee views

Is your company considering an enhanced transfer value exercise or similar form of liability management?

1. Yes, we are considering one at the moment
2. No, we aren't considering one at the moment but might do in the future
3. No, we won't consider one due to the risk of bad publicity
4. We have already done one

If one of the new buyout providers was prepared to take over a scheme prior to buyout ...

...and conduct an incentive exercise under the supervision of an independent trustee, with 'profits' to be shared by the ceding company and the provider, would you be prepared to consider an enhanced transfer value exercise?

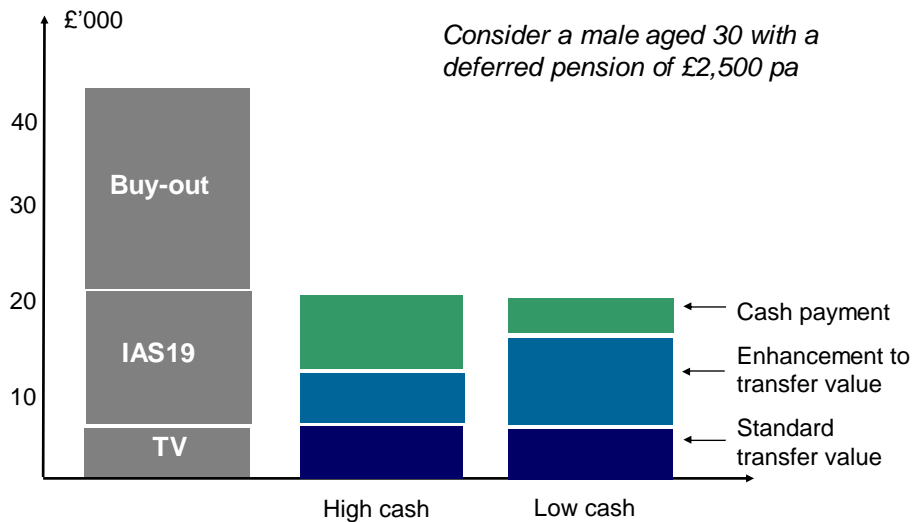
1. Yes, we would
2. No, we still wouldn't be comfortable

Determining the incentive – the considerations

- High enough that members accept and IFAs can recommend but...
- ... no higher than company is willing to pay to reduce risk.
- Which group of members you wish to transfer e.g.
 - older members (higher liabilities) or
 - younger members (potentially greater risks).
- Encourage take up – e.g. via a cash alternative.
- Avoid bad publicity.
- Avoid regulatory intervention.

At a recent Watson Wyatt seminar, 60% of the audience were willing to pay 110% of IAS 19 to remove pension liabilities

Determining the incentive – an example



Making the exercise successful

- Take legal advice.
- Get the “right” level of enhancement.
- Communication is key
 - cover the Regulators 12 key issues.
- Engage with an IFA.
- Engage with the Trustees.
- Default DC scheme.
- Ask members to register interest:
 - early indication of possible take-up.