



**Corporate Pensions Briefing**  
**22 February 2006**

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**Agenda**



- Update on scheme-specific funding and PPF levies
- Impact of pension liabilities going on the balance sheet
- Emerging trends in plan design
- Strategies for financing pension schemes and managing the PPF levy
- Discussion groups

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## Key messages



- Increased focus on pensions governance and financial risk management from sponsors
- Pensions Regulator/trustees, falling bond yields and increasing life expectancy are increasing cash costs and decreasing flexibility
- Legislation and practice gives protection of benefits at all costs
- Increased interest in reducing or removing defined benefit accrual

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## Corporate Pensions Briefing

Update on scheme-specific funding and PPF levies

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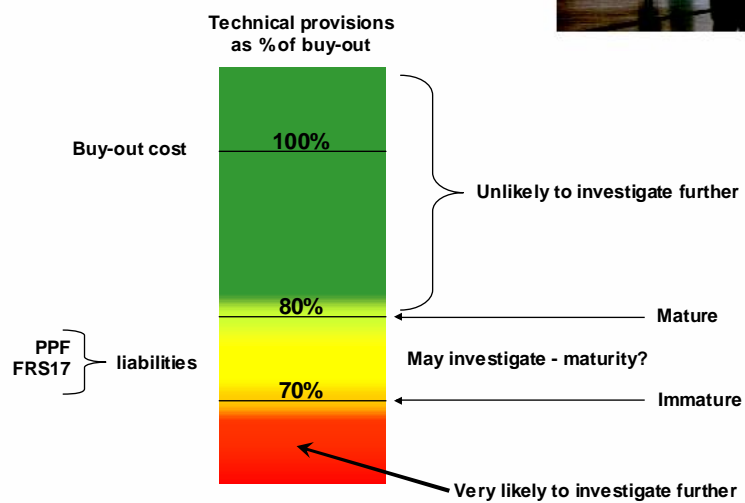
## Scheme-specific funding – update



- Power shift to trustees
- December's code of practice softened in tone:
  - “agreement may be reached without the need for negotiation”; “trustees should work with the employer to achieve common agreement”
  - “trustees should aim for any shortfall to be eliminated as quickly as the employer can reasonably afford”
- Emphasis on strength of employer covenant
- Allowance may be made for equity out-performance

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## Trigger points – funding targets



## The Pension Regulator's monitoring



- Consultation document on how Regulator will consider using powers to investigate funding of DB schemes
- Dual approach based on "trigger points" for:
  - funding target ("technical provisions") – previous slide
  - speed of correction ("recovery period") – Regulator will consider investigation where greater than 10 years
- Employer issues:
  - is focusing on a proportion of buy-out right?
  - is PPF or IAS19/FRS17 an appropriate funding target?
  - rough, with large caveats, Watson Wyatt mini-survey: 50-75% of schemes would need to increase funding target
  - Regulator research: 35% of employers need to pay more than 25% of free cashflow to remove deficit on this measure

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## PPF Levy – December announcement



- "Scheme-based" levy of 0.014% of PPF liabilities; plus
- "Risk-based levy" of  $U \times P \times 0.8 \times c$ 
  - U = Underfunding risk (normally  $1.05 \times \text{liabs} - \text{assets}$ )
  - P = assumed probability of insolvency
  - 0.8 = proportion of total that is risk-based
  - c = Levy scaling factor for 2006/07
  - = 0.53
- Risk-based levy capped at 0.5% of PPF liabilities
- Very tightly specified contingent assets (group guarantees, security over assets, bank guarantees/letters of credit) may reduce levy
- All participating employers may be taken into account

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## PPF levy – comment on December announcement



- How can employers minimise PPF levy?
  - additional contributions
  - contingent assets
  - 2 methods of calculation – check your method does not give the higher levy
  - manage the “D&B failure score” – the assumed probability of insolvency
  - inform Regulator of all employers participating in scheme
  - be quick – action needed by end of March
- Is total levy of £575m enough – how much is to make good initial PPF “shortfall”?
- What will happen if £575m insufficient?

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#### Pension liabilities and accounting issues

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## Background



- FRS17
  - full implementation from 1 Jan 2005
  - immediate recognition through StRGL
- IAS19
  - all EU listed companies from 1 Jan 2005
  - immediate recognition at transition? (IFRS1)
  - various options for amortisation of gains/losses
- FAS87
  - no immediate recognition requirement
  - except if uncovered ABO

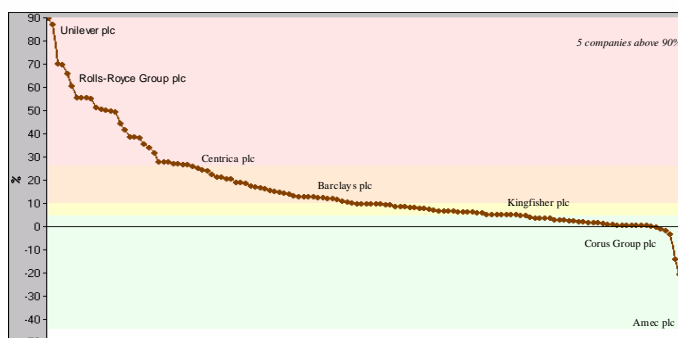
**Common market-related valuation approach**

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## Impact on UK companies



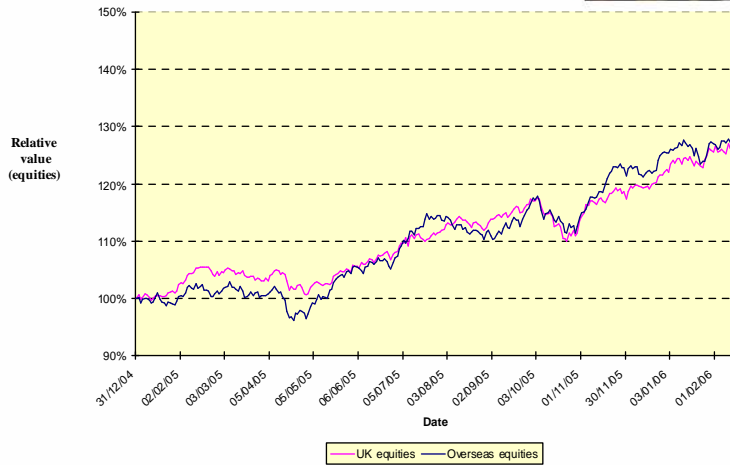
Ratio of year-end FRS17 deficit (surplus) to net assets (FTSE 350)



- Based on published accounts as at December 2004/January 2005
- Excludes companies with negative net assets

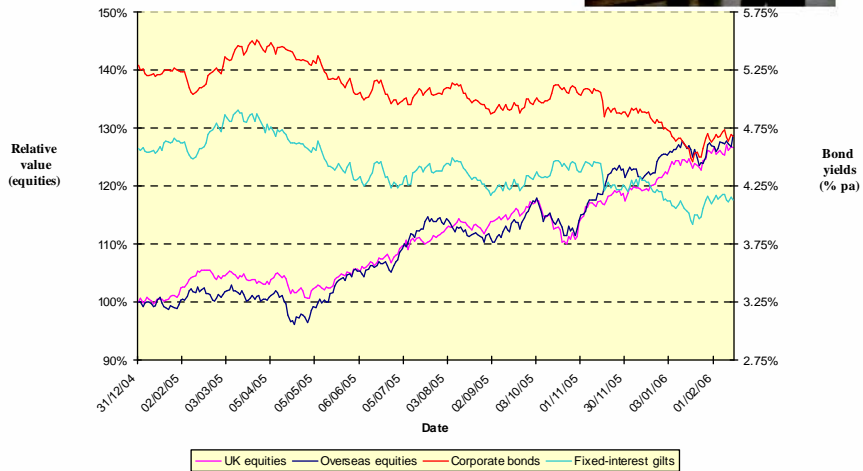
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But changing investment markets over 2005...



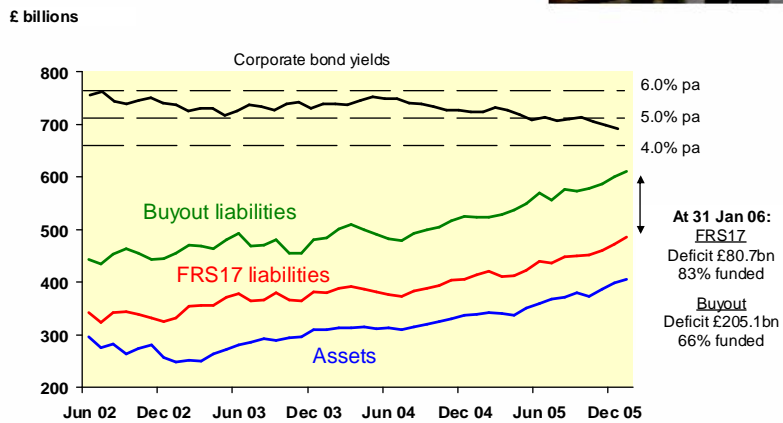
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But changing investment markets over 2005...



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Means that deficits have not disappeared...



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## Recent observations



- The numbers remain significant and...
- Increased scrutiny from auditors
  - assumptions and other aspects
- Mortality assumptions in the spotlight
  - media coverage
  - global research
- Internal survey of year-end assumptions
  - initial results focused on FTSE100
  - majority of clients to follow SoRIE approach

**Many clients are also focused on pensions**

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## Future developments



- Preliminary changes to FAS87/FAS106 announced
  - expected to apply from 15 December 2006
- Part of wider review by IASB and FASB
  - seeking “common conceptual framework”
- ASB also announced research project into pensions
  - serve as input to international project
  - allow for recent legislation changes

*Further changes/impact expected*

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Emerging trends in plan design

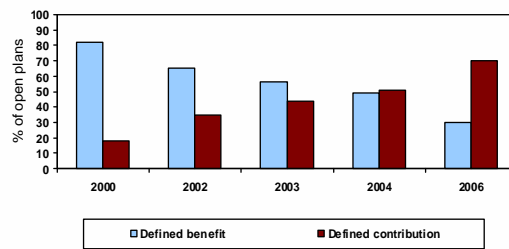
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## Trends in pension benefits for new employees



Schemes open to new entrants  
(Private sector)



**Very few companies have made fundamental change for existing members**

## However, pressures are beginning to build



	Final Salary	Middle ground	Defined contribution
Higher funding standard	✓✓	✓✓	—
PPF levies/cost of compliance	✓✓	✓✓	✓
Compulsion	✓✓	✓✓	✓✓
Corporate transactions	✓✓	✓	—
Transfer values	✓✓	✓	—
Attraction/retention	?	?	?
Moral/PR risk	—	—	✓
Accounting standards	✓✓	✓	—
Falling bond yields	✓✓	✓✓	—

**Companies are revisiting pension provision for existing members**

## Recent market announcements



Company	Proposed changes to final salary scheme	Reactions
Arcadia (Jan 06)	Increase member contributions from 4% to 6%. Raise retirement age from 60 to 65	Unions expressed anger. Retention of final salary benefits emphasised.
Co-op (Jan 06)	Change to career average earnings for future service	Potential strike of transport workers threatened
Provident Financial (Dec 05)	Increase contributions 7% to 14% or can join new cash balance for same contributions. DC for new hires	TUC comment: "tantamount to closing the final salary scheme by the back door"
Rentokil (Dec 05)	Change to DC for future accrual for closed group of DB employees	First FTSE100 company. Not currently unionised. NAPF: "inevitable that private sector employers will question whether they can afford to keep DB schemes open to existing members"
Scottish Power (Jan 06)	Close to new members. Increase contributions by 2% for existing staff.	Industrial action threatened.
British Airways	Unknown (announcement due in March)	Industrial action planned

**A wide range of strategies to manage pension risk**

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## Risks in different plan designs



Risk	Final salary	Career average	Cash balance	DC	Comments
Investment pre-retirement	Company	Company	Company	Employee	Typically aim to achieve added investment return over this period above bonds (eg equities)
Investment post-retirement	Company	Company	Annuity provider	Annuity provider	Not appropriate for individual to take substantial risks post retirement
Mortality (trends) up to retirement	Company	Company	Employee	Employee	Risk of changes in average life expectancy up to retirement
Mortality post-retirement	Company	Company	Annuity provider	Annuity provider	Risk of changes in average life expectancy and specific individual life expectancy
Salary progression	Company	Employee	Flexible	Employee	As it affects income replacement rates on retirement

**DC passes all financial risk to employee (then to annuity provider)**

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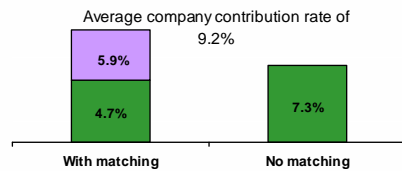
## DC is most popular for new entrants – what are the key issues?



### Joining process

- 45% of companies have take-up rates >90%
- Auto-enrolment is key factor leading to high take-up
- 56% of plans have a default investment option

### Contribution rates



How great is the company's responsibility?

Will members be able to afford to retire ?

*Need for communication and governance*

### Ensure members

- Understand options - and risks
- Take appropriate decision – and review regularly
- Accept their responsibility – it does not lie with the company by default

Source: VWF TSE100 DC Pension Scheme Survey 2005

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**"Pensions as debt" and how to manage it**

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## Background



- What does the landscape look like?
  - Greater scrutiny of accounting assumptions
  - PPF explicit charge for risk (more to come?)
  - Shorter repayment timescales for deficits
  - Loss of control over funding assumptions
  - Closure increases “legacy” perspective
  - Pensions a hindrance to M&A?
- A thought – if pensions has in the past been the easiest (implicit) way to obtain credit, is that still the case?

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## Options



- Invest your way out of trouble aggressively
  - Investor and PPF implication of perceived risk?
- Take risk out via LDI
  - Is the current price of this sensible?
  - Why lend at low rates when you can borrow?
- Fund the problem in the usual way
  - Most efficient use of capital/trapped resources?
- Look for alternative solutions
  - Increasingly attractive in the right circumstances

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## Forms of contingent funding



	Cash	Escrow	Security over assets	Parental guarantee	Letter of credit
Reduces cashflow requirements	x	x	✓	✓	✓
Reduces PPF levy	✓	✓*	✓*	✓**	✓*
Trustee has control of assets	✓	Likely to be more control for company		-	-
Reduces probability of irrecoverable surplus	x	✓	✓	✓	✓

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## Rating debt vs. funding



	Funding	Raise capital and repay deficit
Repayment period	10 years	More than 10 years and possibility of roll-over
Balance sheet impact	Uniform reduction over 10 years	No change
P&L impact	Interest on deficit at (variable) AA rate, plus high gearing from asset strategy	Interest on loan at agreed rate
Impact on PPF levy	Modest, incremental	Significant and rapid
Leverage on Trustees	As before	Enhanced
Cashflow	Interest and capital	Interest only until redemption, with possibility of roll-over
Tax	Generally tax relief on employer contributions	Further gain – interest on corporate debt within tax shelter

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## Where next?



- Now is a time of great change
- Uncertainty over TPR approach to funding, PPF levy structure, ongoing nature of scheme provision, investment landscape, relationship with Trustees
- Question for corporates is whether these changes alter perspective of maintaining pension debt versus other forms

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## Key messages



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