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Current Issues in Pension's Seminar
Spring 2007, London

Scheme Funding

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Agenda

- Role of the Actuary in the new regime
- Conflicts of Interest and the new regime
- Employer Covenant
- Updates from the pensions world
- Examples of real funding negotiations
- Discussion questions

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Theoretical Role of the Actuary in Scheme Funding

CoP No 3 Funding Defined Benefits Para 72 – 105

Provide advice and calculations on
- Funding Method
- Assumptions
- Solvency

Certify
- Calculation of technical provisions
- Recovery Plan
- Schedule of Contributions

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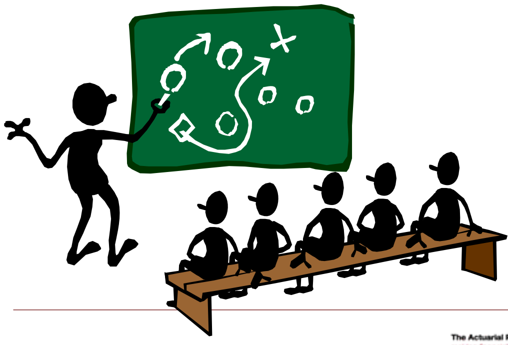
Coach not player



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The Role of the Actuary in practice
Who is advising?

Single person is Scheme Actuary and employer adviser

Separate actuaries from same firm

Separate actuaries from different firms

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The Role of the Actuary in practice

The Regulator recognises the range of roles so requires

- Discussion with the trustees on conflicts
- Disclosure of peer review approach

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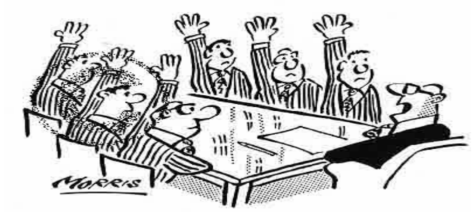
Q: The Role of the Actuary in practice

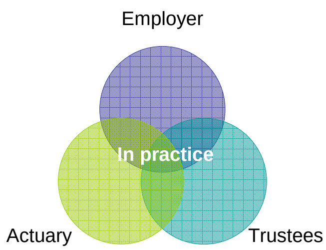
- Do some clients want to be told what to do?
- What detail do some clients want to go into?



"That's unanimous then - we don't know what to do."

Scheme Actuary historically setting the contribution rate? What now?

In Theory – Messy !



Conflicts of Interest
Basic Principle

- One individual or firm cannot act for more than one party where their interest conflict

BUT

- That basic principle can be subject to rare exceptions

Actual Conflict

- Acting for two clients with opposing interests in the same matter.
- Where you cannot fulfil the obligations to one client without failing your obligations to the other client

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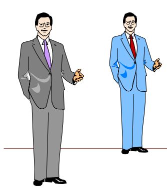
Potential Conflict

- Acting for two clients with different interests in the same matter



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Actuarial Professional Conduct Standard - Conflicts

5.1 Clients are entitled to assume that **advice given by a member is unaffected** by interests other than those of the client …

5.3 In the event of any such conflict…the clients involved must be **notified at the earliest opportunity**… if any advice … is influenced by interests other than those of that client …must be **disclosed** in the advice.

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Regulator's view on Actuary's conflict

CoP para 47 - Discuss with Trustees

- How you would recognise a conflict
- What steps would be taken if actual conflict arises
- 'It is reasonable for the trustees to insist that if the actuary could no longer act for both parties, then the actuary would cease to act for the employer.'

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What do Schemes do in practice?

- Keep and maintain a register of interests 24%
- Specific policy to manage conflicts 29%
- Has means to identify and record conflicts 60%
- None of the above 33%

Source: 'Occupational pension scheme governance – A report on the 2006 scheme governance survey' by the Pensions Regulator

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Q: How are conflicts managed in practice?

- By separation of advisors
- By Trustees absenting themselves
- By Trustees not also being Company Directors
- By having an Independent Trustee to see 'fair play'

- Has the composition of Trustee Boards changed?
- Do appointed Trustees now behave differently?

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Employer Covenant

Essential to assess covenant

To do this, need info on employer

Employer required to share info

- **"It is essential for trustees to form an objective assessment of the employer's financial position and prospects as well as his willingness to continue to fund the scheme's benefits (the employer's covenant).** This will inform decisions on both the technical provisions and any recovery plan needed"
- "…to undertake such an assessment, the trustees will need to obtain information about the employer. Some of this information is likely to come from the employer"
- "The employer is obliged, on request, to provide the trustees with such information as they or their professional advisers reasonably require … to assess the employer's covenant"

Source: CoP No 3 Funding Defined Benefits Para 57 - 61

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Employer Covenant

What's in public domain?

Third party assessment?

Expected to revisit decisions, if view of covenant changes

- "Trustees should be alert to information about the employer which is in the public domain"
- The trustees should also consider using commercially available services"
- "[Events that can justify changing TP in future]…For example a change in the Trustee's assessment of the strength of the employer's covenant could justify a change in the relevant assumptions"
- "Trustees should consider reviewing and if necessary revising [the SFP, RP, SOC] where there is a significant improvement or decline in the employer's covenant"

Source: CoP No 3 Funding Defined Benefits Para 93 & 138

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Relevance of covenant to members

- Failure of sponsor covenant is
  - a binary event
  - a potentially catastrophic event
- Care over not being seduced by buy-out—Trustees are not required to eliminate all risk, and reducing risk for one party increases it for another

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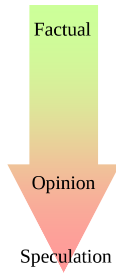
Sample Trustee questions

- **Recovery in distress:** What cash could be recovered if sponsor were to fail immediately
- **Competing creditors:** Who are other stakeholders, and what is their impact on scheme's position as an unsecured creditor
- **Available security:** Are there any sponsor assets (or assets of related parties) that can be used as security
- **Maximum affordable contributions:** What is maximum cash available to pay ongoing pension costs while maintaining a viable business (and how does this stack up against what is employer willing to pay)
- **Future prospects:** Review management business plan and forecasts



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Types of players in employer covenant market

- Credit Rating agencies
- Accountants
- Actuaries with in-house capabilities
- Independent banks, boutiques and other niche players

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Credit Rating agencies
- Standard & Poor's, …

- Unique selling feature: state a view of the probability of insolvency occurring
- Don't give advice—legally structured as a journalist
- Quantitative assessment for £6K to £10K can inform whether further analysis would be helpful

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Accounting firms
– KPMG, PwC, Grant Thornton, Baker Tilley, …

- Main product is an independent business review, of the sort a lender might require
- Generally involves review of financial structure, past performance, and management plans for future
- Terms of references vary as do the fees. Fees can mount up quickly if the adviser is given a wide or overly detailed brief
- Big 4 firms often find themselves conflicted out
- May have insolvency mind-set

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Actuaries with in-house capability

- Provides one-stop shop
- Can be integrated with actuarial advice
- Often single person or very small team
- Style depends on background of key person

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Independent banks, boutiques and other niche players
- Close Brothers, Kroll, Penfida, Gazelle, …

- Make a play about being able to give non conflicted advice
- Do not sit on fence (though may seek indemnities)
- Fees quoted are substantial

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What do people say in practice?

Secured parental guarantee

Trustees happy to assess covenant themselves

Seemed to simply play back what I (FD) told them about business

Got legal confirmation overseas parent must support scheme

Showed company could afford more than it said, and contributions boosted as a result

Credit rating report seen as journalism with no risk on part of adviser

Led to better disclosure of information by employer

Cost well over £100K but clearly do not understand our business, and parachuted in team of graduates

End product was a huge report, packed with caveats

Helped understand structure and where assets really lie in group

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Update – DB scheme characteristics

- 58% are closed to new members
- 36% of scheme sponsors are in manufacturing, more than double the share of manufacturing in the economy

Source: The Purple Book

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Update – DB scheme funding

- 31 March 2006 total PPF deficit of £33.8bn

But

- 83% in deficit aggregate £76.7bn
- 17% in surplus aggregate £42.6bn

- 31 March 2006 total buy-out deficit £440.4bn

(only £0.3bn in aggregate surplus)

Source: The Purple Book

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Update – DB scheme funding sensitivity

- 0.1% increase in gilt yield reduced aggregate deficit by £13bn
- 2.5% increase in equity prices reduces aggregate deficit by £11bn
- Another year add to life expectancy would add 3-4% to liabilities raising the aggregate deficit about £20bn.

Source: The Purple Book

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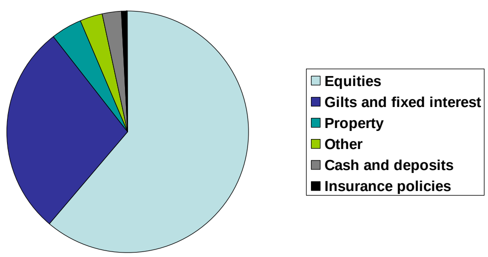
Update – DB scheme asset allocation



Source: The Purple Book

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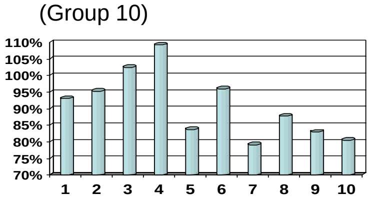
Update – DB scheme risk concentration

- 41% of risk for PPF comes from 2% of schemes (Group 10)



Correlation of Funding level and insolvency probability

Group	Average Insolvency Probability
1	0.1%
2	0.5%
3	1.2%
4	1.7%
5	2.4%
6	3.4%
7	4.8%
8	6.7%
9	9.3%
10	35.7%

Source: The Purple Book

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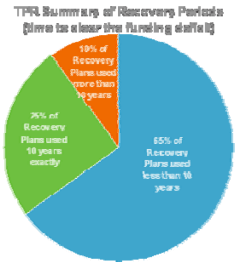
Update - Summary of Recovery Periods



Source: ACA Conference Presentation by June Mulroy 9 February 07

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Case Study 1 – Parent Company Guarantee

Background

- UK sponsoring employer is subsidiary of US parent
- In recent years the UK subsidiary's covenant has reduced
  - More tax-efficient for UK balance sheet to be weaken in favour of US
  - Manufacturing sites off-shored so UK workforce mainly now sales and marketing
- UK subsidiary still profitable
  - Cashflow expected to be enough to deal with deficit – but this is far from certain

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Case Study 1 – Parent Company Guarantee

Solution

- Trustees agreed a weaker approach to funding than originally considered based on UK Company's strength by lengthening the Recovery Plan
- Parent Company provided guarantee – legal advice needed to try to ensure enforceable in US Courts

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Case Study 2 – Clearance for survival

Background

- UK business dependent on parent company support for business and pensions contributions
- Multi-national business in slow recovery from serious problems
- Sale of part of UK business – negative net proceeds
- Section 75 debt would push entire UK business into insolvency

Case Study 2 – Clearance for survival

- Company says it can afford FRS17 in about 15 years, given equity returns
- Trustee alternative is PPF with reduced benefits
- Regulator encourages Trustees to challenge what is affordable and understand what would happen on insolvency

Result

- Company lives to fight another day
- Members better off with some funding - even if poor - than no further funding

Case Study 3 – Willingness to pay matters

Background

- A company was selling a division using the proceeds to repay unsecured loans from other non-UK companies in the same group, about two-thirds of the business of the division being sold was acquired using the original loan.
- The company had always taken a reasonable, measured approach to funding in the past and this was emphasised in the subsequent clearance application.

Case Study 3 – Willingness to pay matters

- Covenant adviser to Trustees argued that the proceeds should be split 'pari-passu' between meeting the FRS17 deficit and paying down the unsecured loan

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Case Study 3 – Willingness to pay matters

Result

- Meeting at the Regulator following conference calls
- Suggested broader solution considered combined with funding valuation underway
- 'another show of willingness might help do the deal'
- Company slightly raised its offer (but nowhere near 'pari-passu'), which the Trustees accepted and Clearance was granted.

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Questions

1. Has the behaviour or structure of Trustee Boards changed to recognise conflicts of interest?
2. What employer covenant advice are Trustees getting?
3. What is your experience of funding valuations under the new regime?

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