A NEW WAY OF LOOKING AT EMPLOYER COVENANT

It is not the longevity of the members that is important....
...it is the longevity of the Employer

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PRINCIPAL: Formerly Head of Pensions at Swiss Re from 2007 to 2009, Richard was responsible for creating a new team of broadly based pension specialists to help Swiss Re assess risk transfer opportunities and is FSA CF30 approved.

ADVISER: Led the Pension Corporate Adviser initiative at PwC from 2005 to 2007.

REGULATOR: Advised the Pension Protection Fund on its initial risk-based levy and the Pensions Regulator on its original Clearance Guidance rules. This included ground-breaking work on the development of the Employer Covenant, the use of Contingent Assets, the price for obtaining Clearance, and the PPF's innovative 33 per cent stake in restructurings.

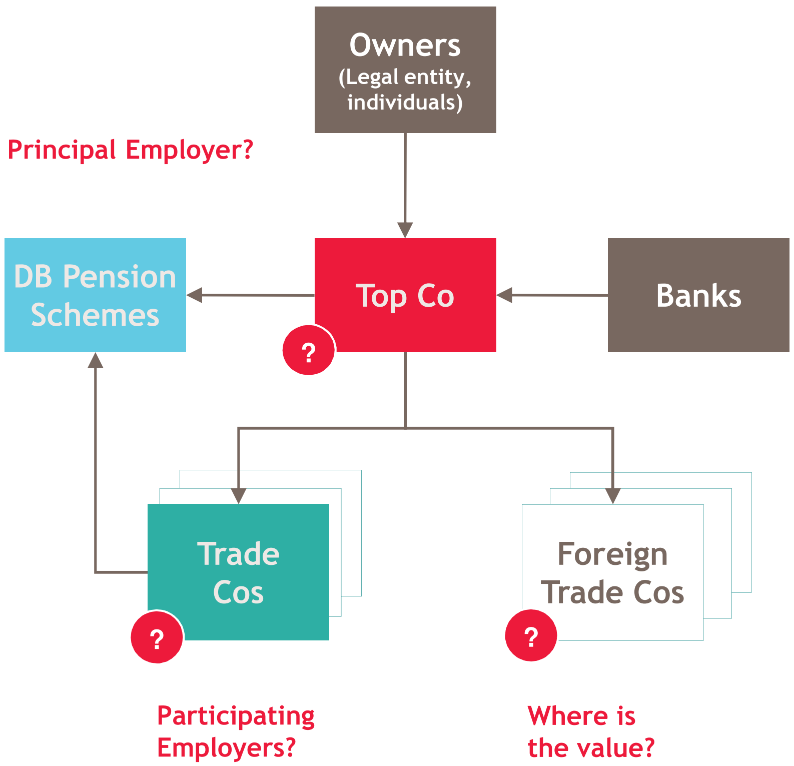
CEO/CFO: Co-founded two high-profile public to private turnarounds, including the first ever pre-pack, as well three highly successful IPOs.

TURNAROUND SPECIALIST: Member of the Institute for Turnaround.

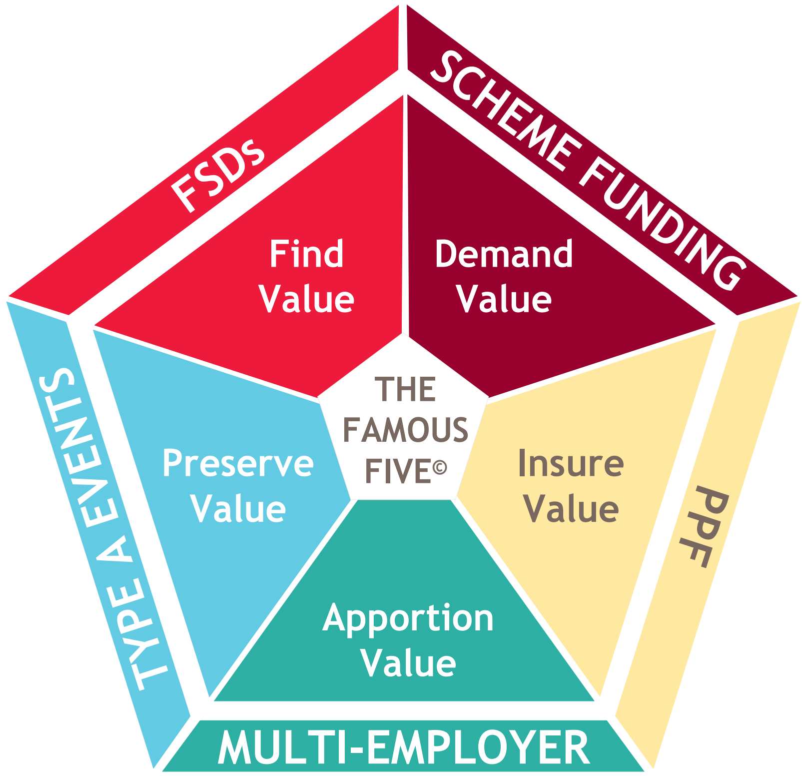
ACCOUNTANT: Richard is a Fellow of the Institute of Chartered Accountants in England and Wales.

USING A DASHBOARD TO ASSESS THE THREATS

CORPORATE STRUCTURE

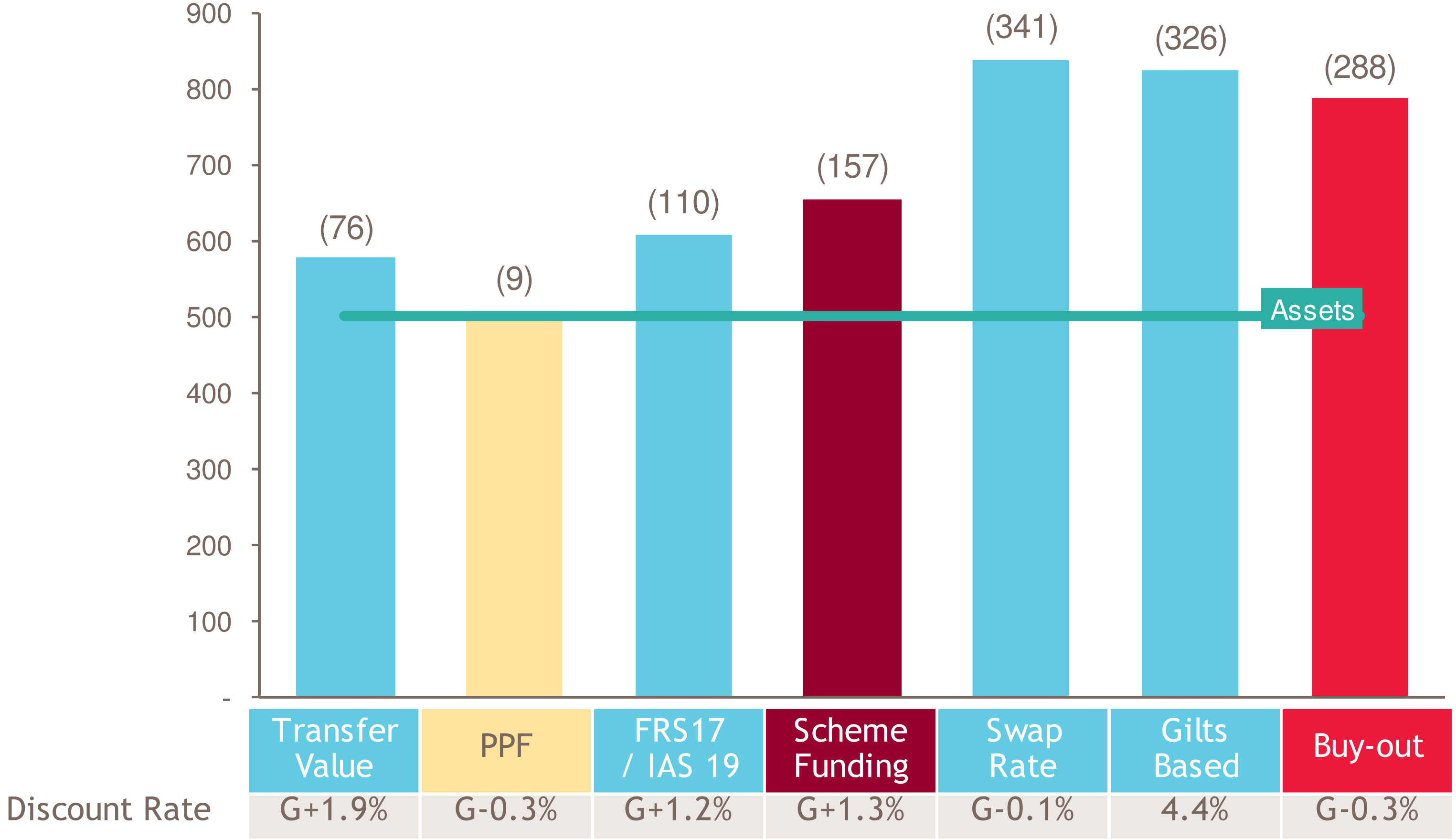


THE FAMOUS FIVE©

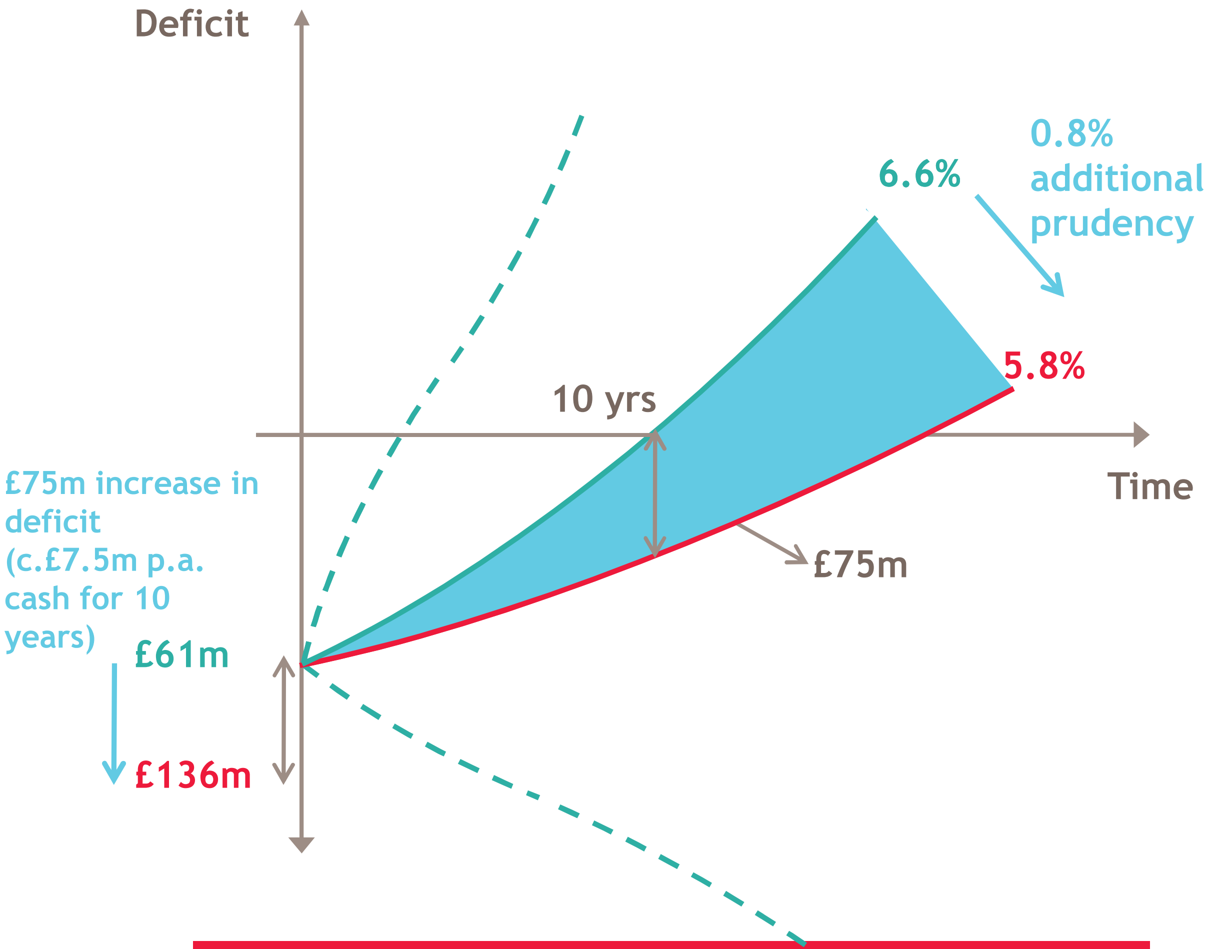


USING A DASHBOARD TO ASSESS THE THREATS

THE SEVEN DWARFS©



THE IMPACT OF DEAR OLD PRUDENCE

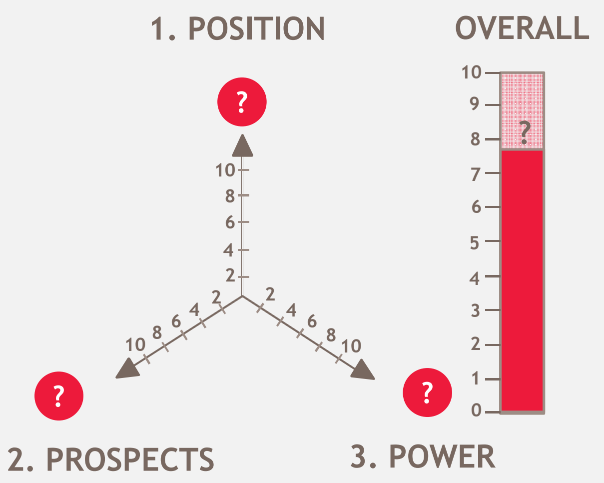


1. Based on the expected asset return of 6.6%, the deficit is £61m and will be repaid in full in 10 years
2. But there is uncertainty… …a funnel of doubt shows the potential range of outcomes
3. For Scheme Funding, the actuary allows additional prudency by reducing the discount rate
4. Based on the new "prudent" discount rate, a shortfall of £75m is expected after 10 years
5. Adding the shortfall to the existing Recovery Plan covers the deficit under the prudent assumptions
6. The additional cash contributions required represent the lack of credit given for Employer Covenant - for a company with a strong Employer Covenant, the blue shaded area should be nil

EMPLOYER COVENANT HAS A DIRECT IMPACT ON COMPANY CASH FLOW

HOW SHOULD YOU MEASURE EMPLOYER COVENANT?

The BDO Employer Covenant Vector



We assess Employer Covenant on a ten point scale (one weakest to ten strongest), based on the three vectors set out above.

THE EMPLOYER COVENANT VECTOR

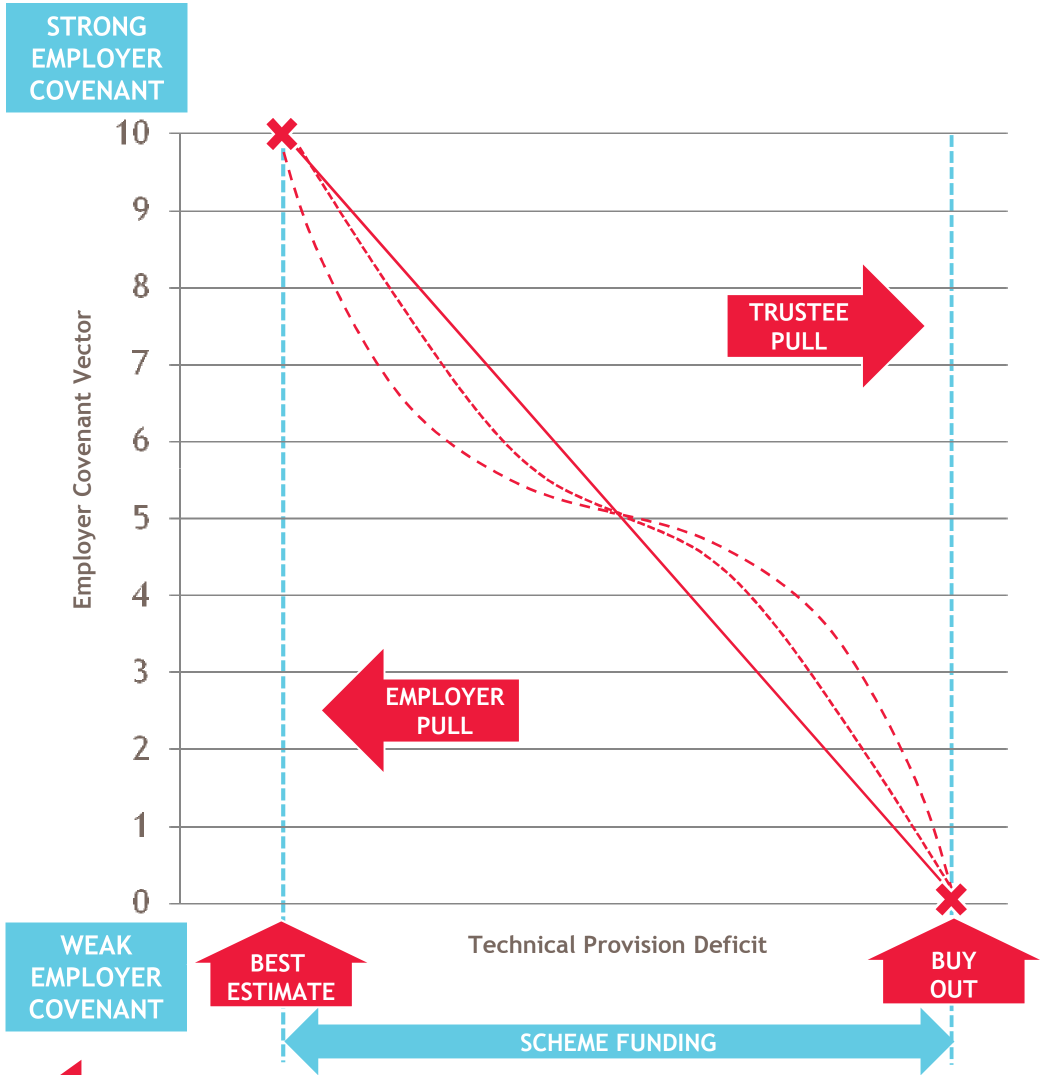
Our assessment process focuses on the Pensions Regulator's guidance and aims to assist the Trustees in forming an objective assessment of:

1. **POSITION:** It is important to consider both the Employer's **legal obligations** to the Scheme and its **financial position**. The primary diagnostic tool used for this purpose is an **estimated insolvency outcome analysis** which estimates the potential recovery by the Scheme following an immediate insolvency of the Employer. For complex group structures comprising Employer intercompany balances, an **entity priority model** may be required to demonstrate the effect of the Group structure on an insolvency of the Employer.

2. **PROSPECTS:** Assessed via a review of Employer forecasts, and business plans.

3. **POWER:** Willingness and ability are assessed subjectively based on an understanding of the past and proposed dealings between the parties.

SCHEME FUNDING: THE TENSION EXPLAINED



1. A framework for defining the impact of Employer Covenant strength on measurement of Technical Provisions
2. Infinitely high Employer Covenant strength -> Technical Provision = Best Estimate
3. Zero Employer Covenant strength -> Technical Provision = Buy Out
4. Does a straight line join the above points?
5. Employer position tends towards lower Technical Provision
6. Trustee position tends towards higher Technical Provision
7. Employer power is greatest if Employer Covenant is strong
8. Trustee power is greatest if Employer Covenant is weak
9. Where does the power switch from Employer to Trustee?
10. Scheme Funding is a negotiation with a range of outcomes based on Balance of Powers between Employer and Trustee

...but does reality reflect the theory?

SO WHAT ABOUT POSITION?

Using Pre & Post Insolvency Assessment

Gross asset value
£49m

Gross asset value

£49m

Pension Scheme full buy out deficit
£49m

Secured claims
£7m

Scheme FRS17
£7m

Trade and other creditors

£10m

Book value

£42m net assets post secured claims

£17m unsecured creditors including scheme

FRS17 deficit Scheme fully covered

Liquidation value

£19m available for unsecured creditors

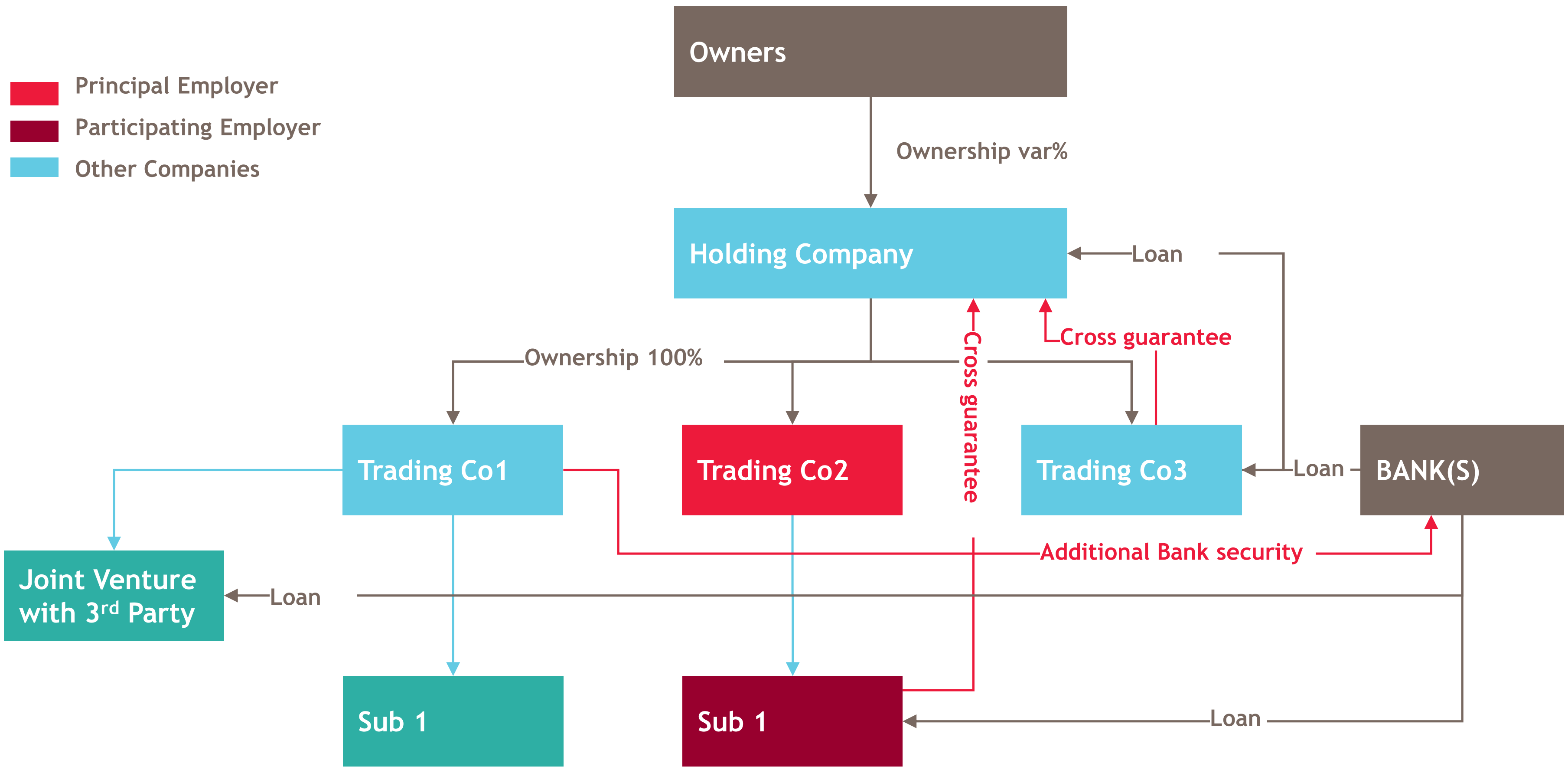
£62m unsecured claims

Dividend 30.6p in the £

Return to Scheme £15m

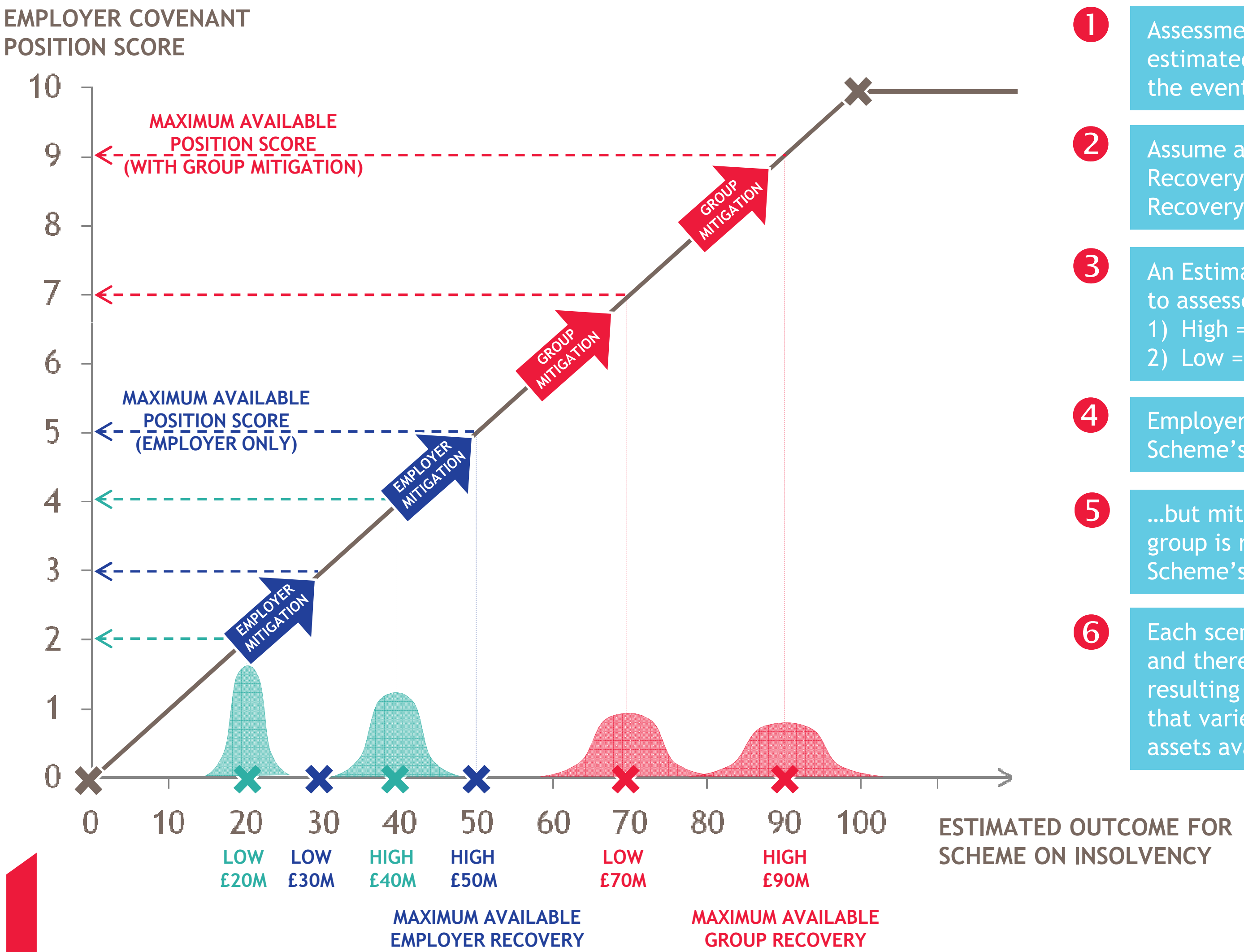
(Shortfall £34m)

SO WHAT ABOUT POSITION?
Importance of the Wider Group Structure



POSITION – OK, I GET IT

Based on Estimated Outcome on Insolvency



1. Assessment of Position is based on the estimated outcome for the Scheme in the event of a hypothetical insolvency

2. Assume a buyout deficit of £100m
Recovery of £Nil = 0/10 Position score
Recovery of £100m = 10/10 Position score

3. An Estimated outcome statement is used to assesses two scenarios:
   1) High = best case (going concern sale)
   2) Low = worst case (break-up sale)

4. Employer mitigation can improve the Scheme's position to a certain extent…

5. …but mitigation provided by the wider group is required to maximise the Scheme's position

6. Each scenario is based on assumptions and therefore subject to uncertainty, resulting in a range of potential outcomes that varies depending on the underlying assets available to the Scheme

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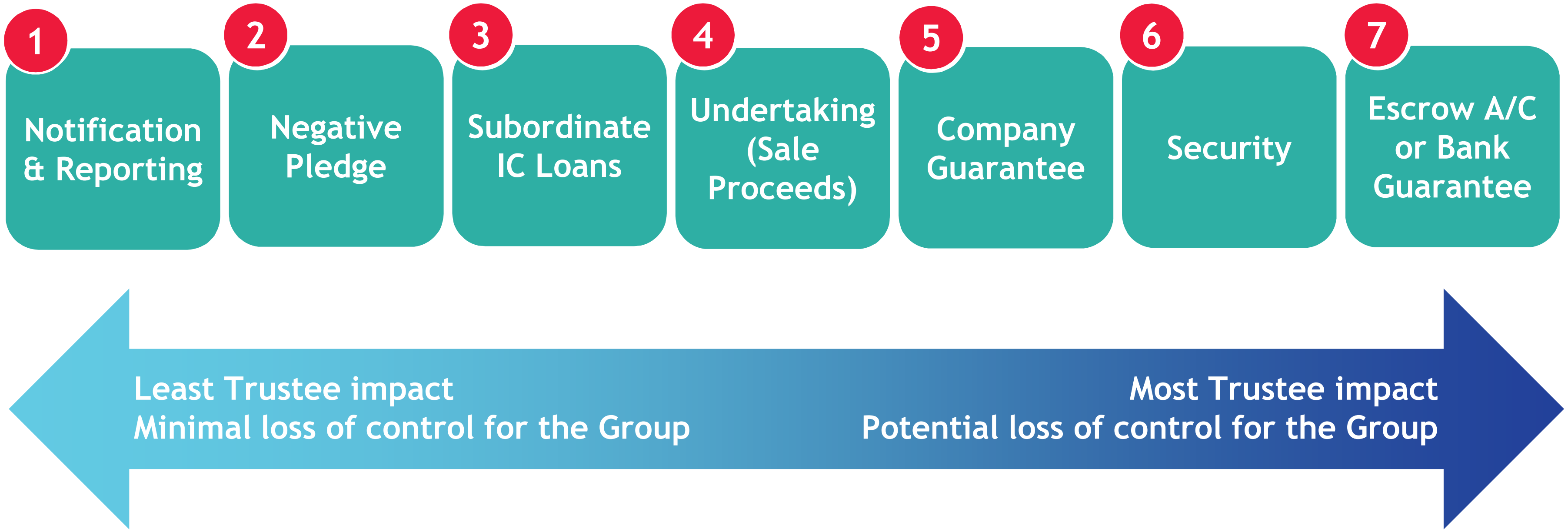
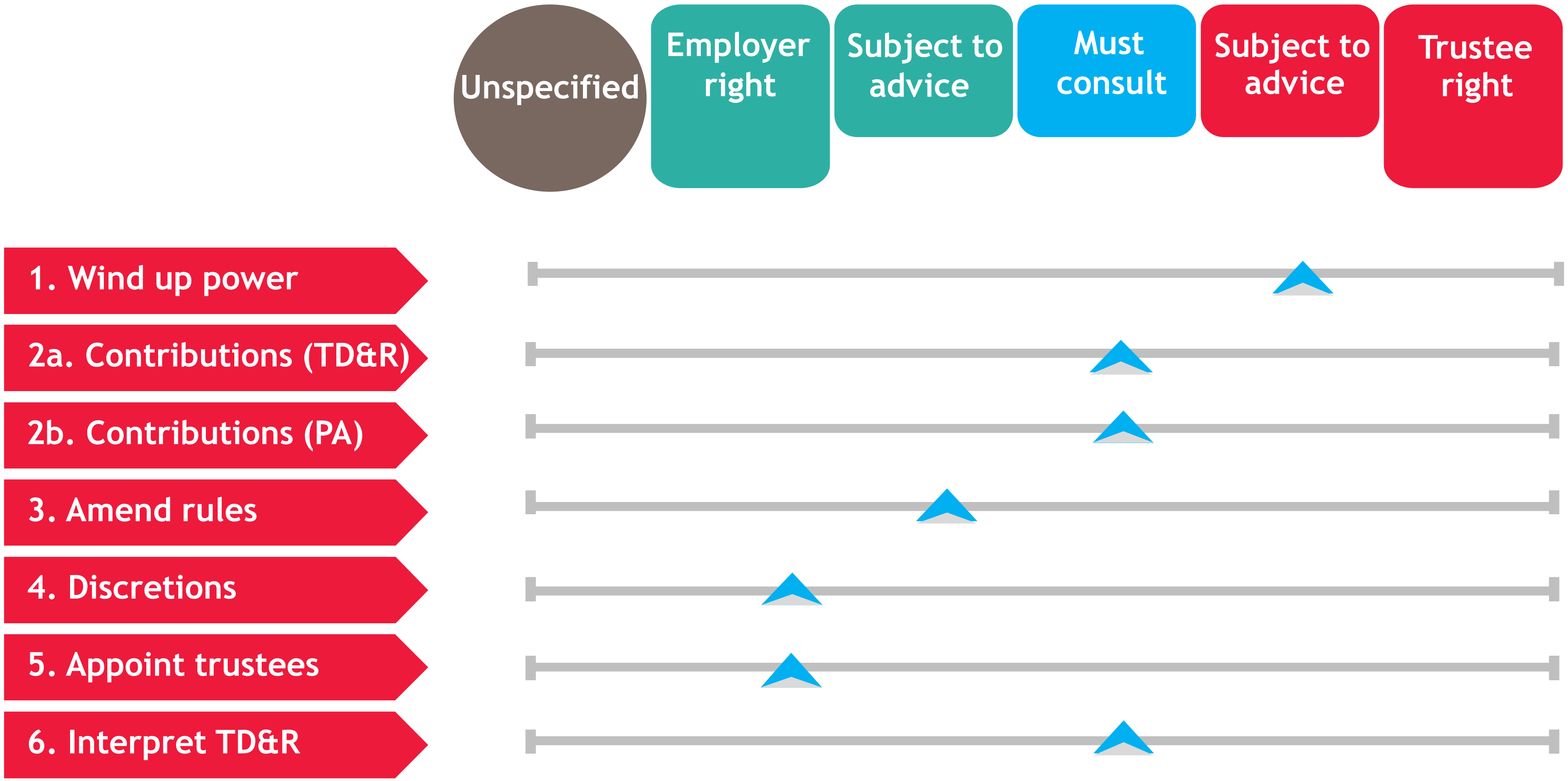
IMPROVING YOUR POSITION

The Mitigation Map



BUT WHAT ABOUT POWER?

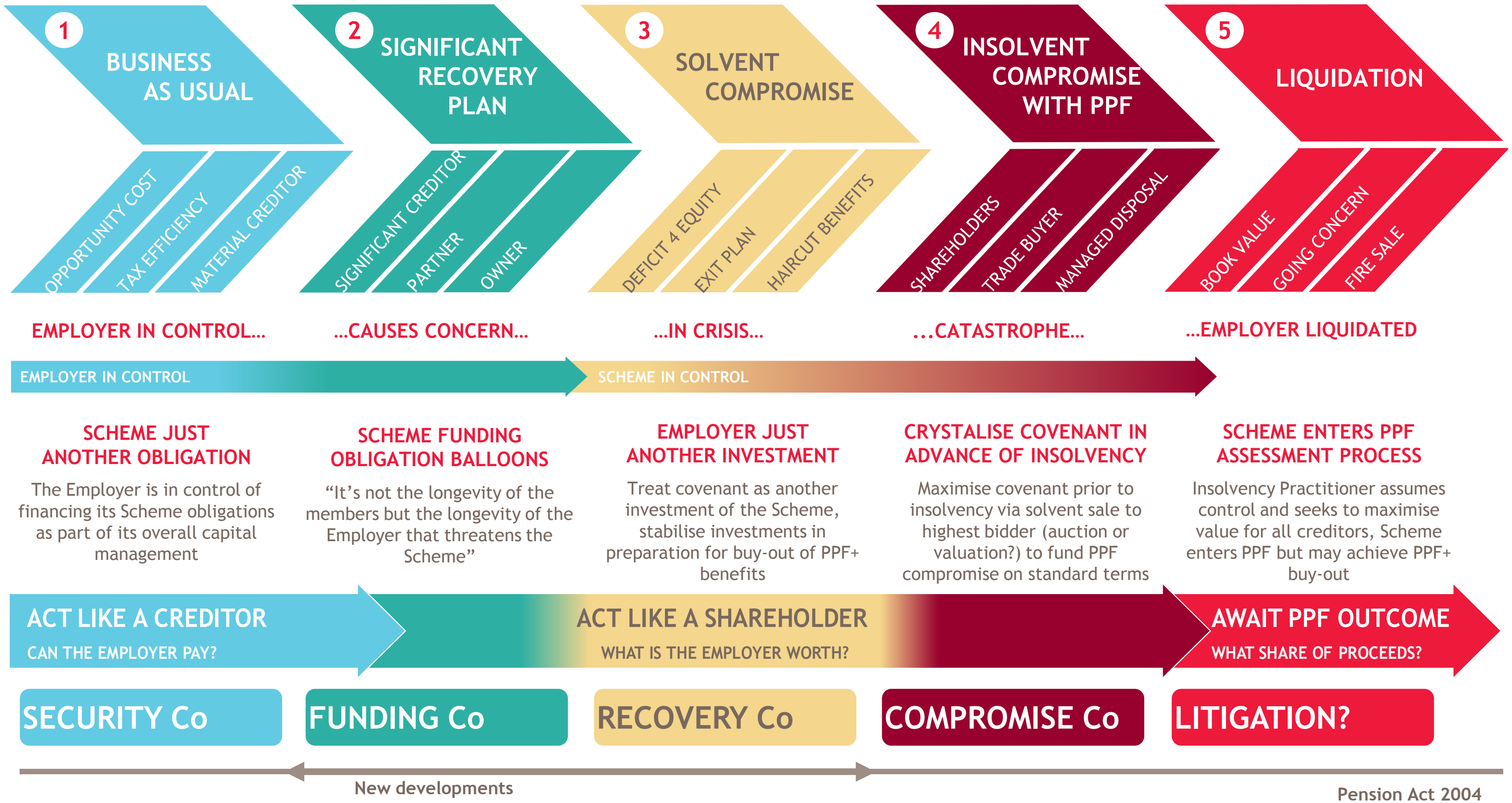
What is the Balance of Powers?



BUT IT IS NOT JUST ABOUT THE TD&R!

BUT WHERE IS YOUR EMPLOYER ON ITS LIFECYCLE?

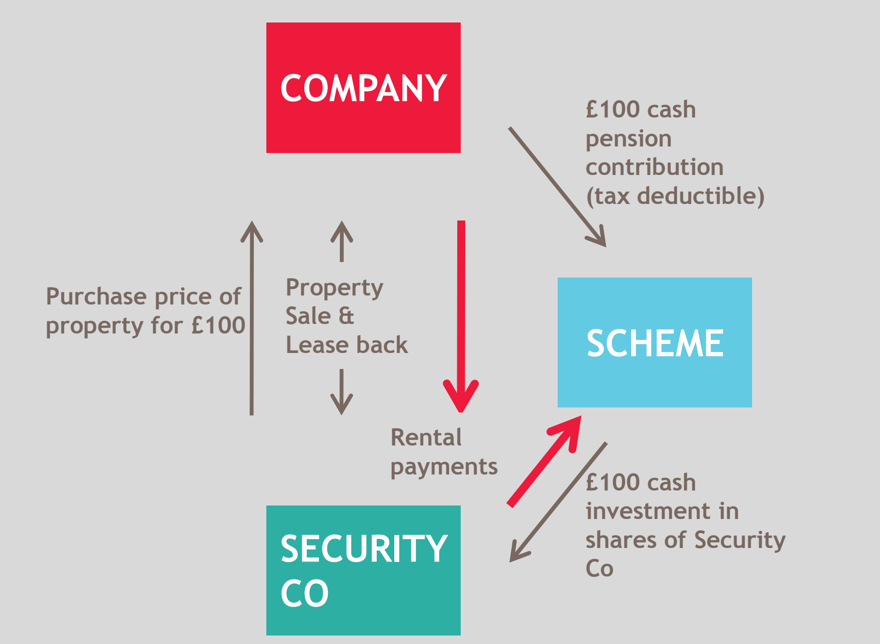
The Pension Control Chevron©



1. SECURITY CO

Asset Backed Security structures

Structure



1. X years of rental payments (i.e. Recovery Plan) discounted today is worth £100
2. Insolvency value of Security Co worth £100
3. At the end of x years, Property is returned without consideration to Company

Issues?

1. Property structures:

Compare to a Sale & Lease back of the property to a Bank, together with the payment of the sale price to the Scheme

Structure should offer better terms than the equivalent Bank solution (reduced costs or more flexible terms)

2. Other assets?

Potential to apply to assets that can't be financed (e.g. Intellectual Property)

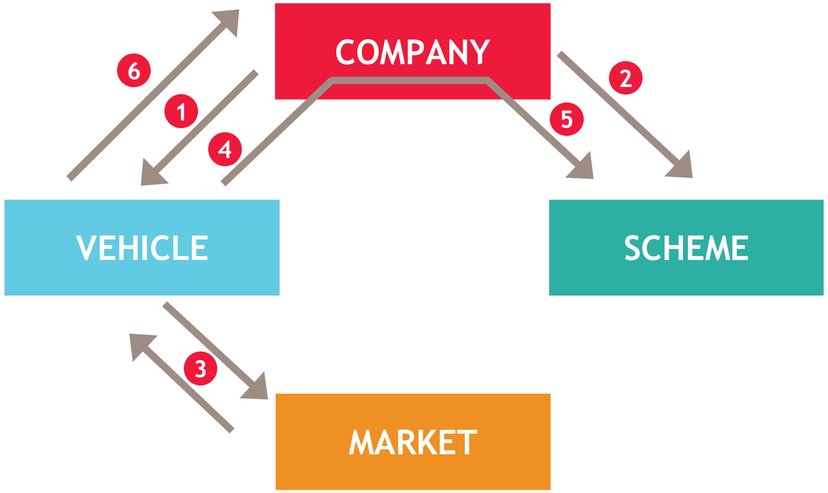
3. Self-investment rules

Scottish LP structure removes legal self-investment concerns, but what about economic risk?

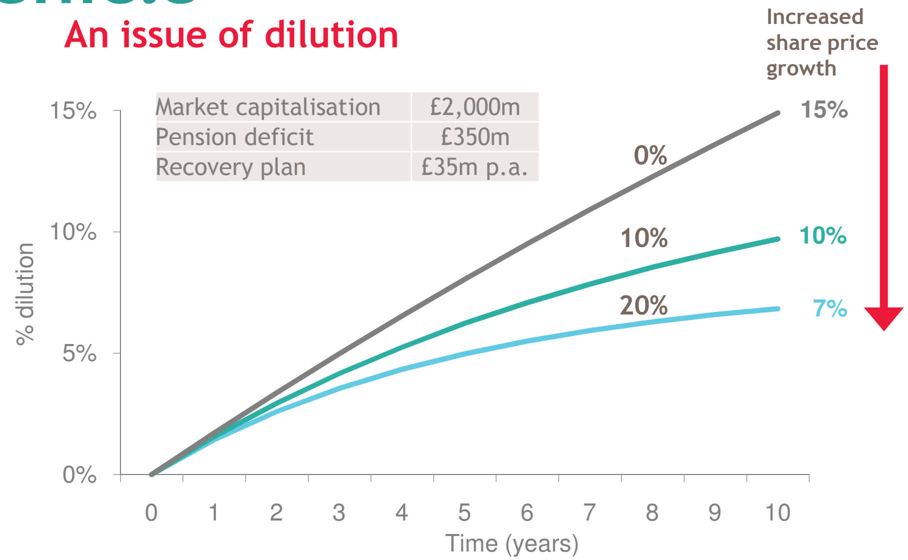
2. FUNDING CO

Deferred equity funding vehicle

How it works



An issue of dilution



1	Options granted to Vehicle for the full value of Recovery Plan
2	Each year, Company decides to pay cash or fund via equity
3	Vehicle exercises options places shares in market
4	Sale proceeds transferred to Company via protected channel
5	Company makes Recovery Plan payment
6	Excess options are cancelled each year (reducing dilution)

Options: exercise price = market value at date of exercise

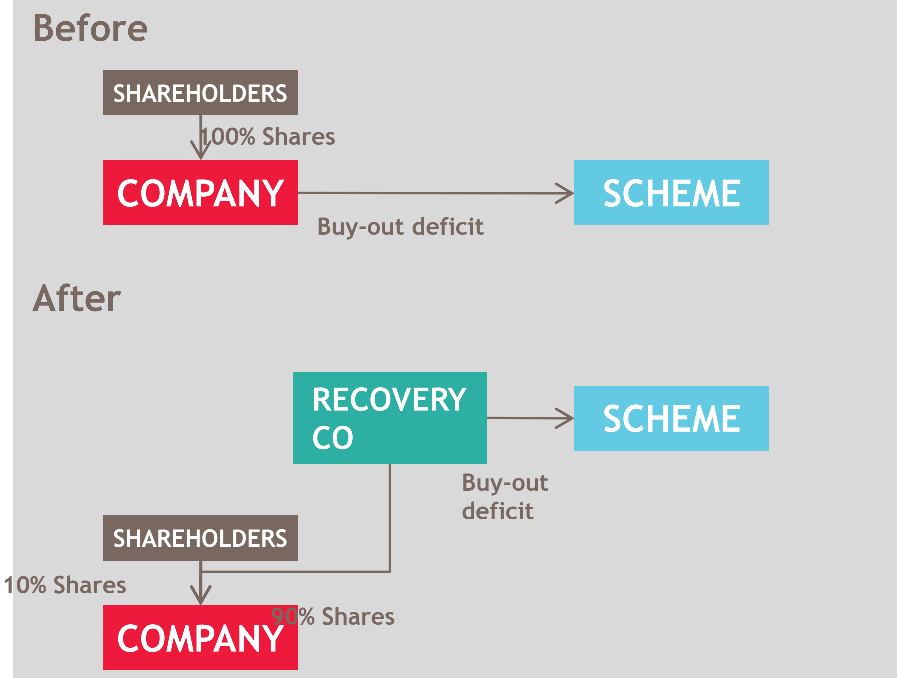
Vehicle only sells as many shares as required to fund Recovery Plan payment

Compared to a up-front rights issue that would cause a dilution of 15% today, Todd offers a gradually increasing dilution over time, with an aggregate dilution that halves if the Share Price grows at an average rate of 20% p.a.

3. RECOVERY CO

Solvent Compromise

Structure



1. Deficit 4 Equity swap via Recovery Co
2. Exit plan to realise Shares
3. Wind-up and buy-out with Haircut to benefits

Issues?

1. **Abandonment?**

TPR and PPF need to provide Clearance. Need to prove that structure is in the best interests of all stakeholders.

2. **Method**

Apportionment /Withdrawal - are funding tests met?

Regulated Apportionment Arrangement - intention to transfer to the PPF within 12 months?

Sectionalisation - no funding tests?

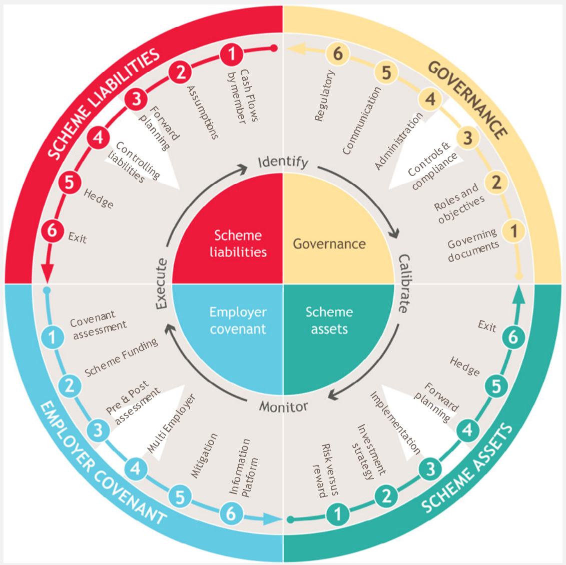
3. **PPF Eligibility**

Buy PPF Insurance underpin before the structure?

If RAA Route is used, 12 month period before CVA is required? CVA crystallises value / haircuts benefits

DON’T FORGET THE BIGGER PICTURE:

The Pension Risk Quadrants ©



COMPANY AGENDA		
1. Shareholder agenda	2. Strategic direction	3. Other stakeholders
4. Risk policy	5. Capital structure	6. Deadlines
7. HR policy	8. Financial accounting	9. Tax

TRUSTEE AGENDA		
1. Funding	2. Attitude to risk	3. Legal
4. Accountability	5. Member Issues	6. TKU
7. Data quality	8. Value for money	9. Fiduciary duties

THE PENSION RISK QUADRANTS©

Employer Covenant could be considered to be **similar** to any **other economic investment** by the Scheme, but with one important distinction – an **insolvency** of the Employer often **signals a wind-up** of the Scheme shortly thereafter.

The potential for the Employer to become insolvent must, therefore, be a **primary driver** for all aspects of Pension Risk.

Our Pension Risk Quadrants© framework comprises a six step diagnosis of each of the four key risks of **Scheme Liabilities**, **Employer Covenant**, **Scheme Assets** and **Governance** and their **inter-relation** in the context of both the **Employer** and **Trustee** agendas.

You and your Client are at the **centre** of this framework and need to think and act **strategically**, **tactically** and **operationally** within the pension environment.

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