The Actuarial Profession
making financial sense of the future

Current Issues in Pensions 2012

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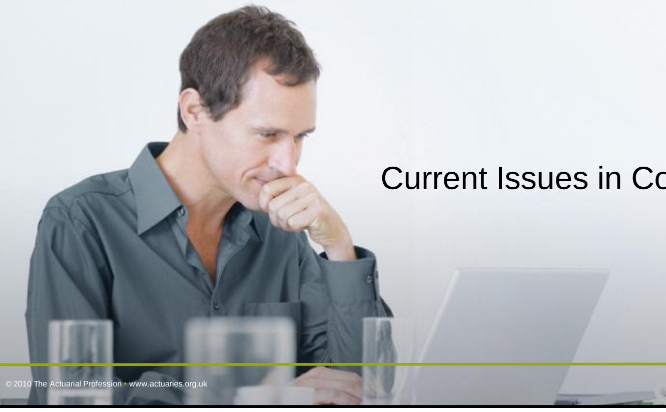

Current Issues in Covenant Assessment

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- What is the covenant?
- Integrating covenant within financial strategy
- Short and long term risks
- Issues for schemes supported by multi-nationals
- Contingent assets
- Real life examples
- The Holistic Balance Sheet and IORP II

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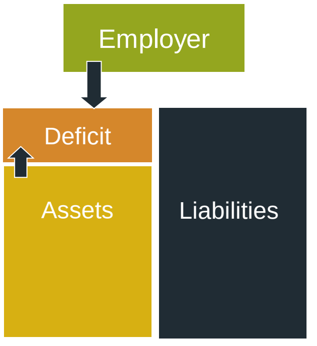
What is the covenant?

- Funding levels of DB schemes vary over time as assets and liabilities do not always move together!
- Schemes depend on future sponsor contributions and investment returns to address any deficit
- Covenant is the ability of the sponsor to remedy any deficit and should be reflected in Technical Provisions/Recovery Plan assumptions and investment strategy



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Covenant assessment

November 2010 TPR Guidance

- Already best practice for larger well run schemes?
- No longer "willingness and ability"; the focus is now more on legal obligation and financial position
- Focus on process as well as outcome; KPI's, metrics, triggers and actions arising
- Annual monitoring/ standing item – how frequent?
- Using in-house and external skills

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Covenant assessment

The legal structure of covenant support

- TPR focus on the participating employer group alone
- The particular structure may be historical accident – is it fit for purpose?
- Informal reliance on parental group –
  - Affordability, yes?
  - Insolvency, no? – but how can judgements about insolvency/default be made without reference to the wider group?
- *Is a change in the support structure the easiest way to resolve covenant deficiencies?*

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Covenant assessment

Affordability of pension contributions

- Apparently straightforward to measure coverage of pension costs by free cash flow
- … but requires detailed cash flow projections to analyse and stress test
- … and subjective assessment of the validity of competing claims on cash flow from shareholders, bankers and capital investment
- Long term liabilities vs. long term sponsor growth prospects and investment needs
- *Reasonable affordability is a matter of professional judgment*

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Integrating covenant within financial strategy

- Nature and strength of the covenant
  - *Not just a question of affordability – also availability of other security; timescale*
- Investment strategy and de-risking/flight-path to self-sufficiency
  - *Is it consistent with covenant strength / sponsor's ability to tolerate risk?*
- Actuarial assumptions for Technical Provisions
  - *Appropriate level of prudence but are they really the driver for funding payments?*
- Actuarial assumptions for Recovery Plan
  - *Stress testing "affordability"; VaR, ALM, Scenario testing*
- Sponsor's use of capital
  - *De-risking versus capital investment*
- Sponsor's share price and credit rating
  - *Impact of pension risk*

It is not all actuarial!

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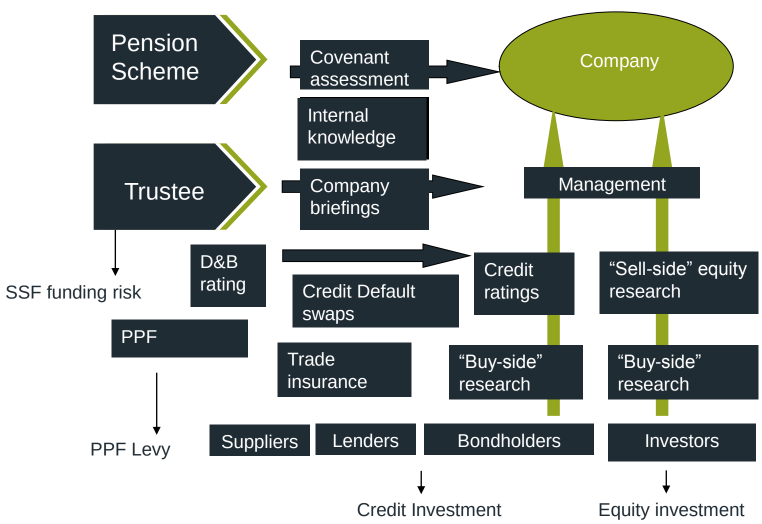
Different stakeholders monitor corporate strength from differing perspectives



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Shorter term risks

- Business / economic cycles
- Poor macro-economic prognosis
- Emerging vs. developed markets
- Funding and liquidity challenges
- *…but a number of corporates are still performing well*

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Longer term risks

- Risk factors
  – Cyclicality or exposure to business or macro economic cycles?
  – Discontinuance risks e.g. political or regulatory change, environmental, technological shifts
  – Risks inherent in the financing structure (e.g. public utility vs. industrial sponsor)
- Risk measures – CDS rates, Dun &Bradstreet scores

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Longer term risks

Changes in the **FTSE 100 from 1985-2011**

- Significant merger and demerger activity
- 26 companies acquired by overseas parents
- Not binary “default/ healthy” (only 7 defaulted) but a further 26 experienced a time of financial stress
- Only 11 companies remain intact
- **Only 10 companies had a benign experience**

Significant changes in corporate risk exposure can be expected over the life-time of a scheme

Insolvency risk

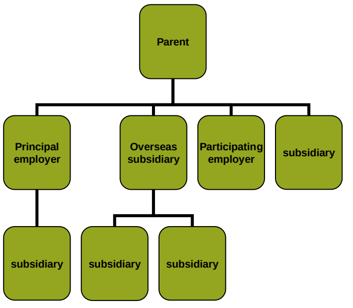
The position on insolvency/default

- Reflects value of the residual business / assets and scheme’s relative creditor ranking
- “Desk-top” insolvency analysis can give some indication based on available information and some approximate value “haircuts” against asset categories but estimates can vary widely
- *The path to insolvency: tortuous; changes in structure; finance providers competing for priority and imposing harsh terms to waive banking covenants*

Issues for schemes supported by multi-nationals

- Finances may not follow the legal structure
  - Centralised treasury and allocation of capital, cash pooling
  - Management and market reporting by product / activity not by statutory entity
  - Tax driven restructurings
- …pressure to distribute up to the parent

This does not sit easily with TPR position



Contingent assets

- Increasingly offered by sponsors to substitute for cash
  - *driven by economic pressures*
- Range of asset classes is growing (property, brands, treasury stock, whisky, receivables)
  - *Sorting the wheat from the chaff*
- Double jeopardy risk
- Governance
  - *Is it a reasonable asset for a pension scheme?*
  - *Constructive engagement in development*
  - *Due diligence and evaluation*

Evaluation of contingent assets

Attractions to the Company

- Tax and cashflow advantages (over the current FD's time horizon)
- Presentation to the market

Concerns / issues for the Company

- Long term asset structures / (quasi) securitisation
- Risk to e.g. banking facilities
- Potential constraint to future finance raising?
- Significant implementation costs

Attractions to the Scheme

- Contingent asset: quasi security

Concerns/ issues for the Trustee

- Real value compared with cash contributions?
- Risks associated with long-term inflexible arrangements
- Additional complexity – requires detailed "what if" scenario planning and ongoing monitoring

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Typical cases

- Strong covenants in certain industries
  - *Banks, oil companies, drinks companies, utilities*
  - *Trustees can push for shorter Recovery Plans*
- Weak covenants
  - *PPF is the backstop; what else can be done?*
  - *Trustees have to accept longer Recovery Plans*
- Weak covenant but in a strong group
  - *Contingent assets play a crucial part*
  - *Parental guarantees highly sought after*

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Real life examples

- Restructuring
  – *Mitigation in the form of parental guarantee*
- De-merger case
  – *Equalising the covenant in the two parts using a Contingent Funding Agreement*
- Demerger/Takeover/Demerger case
  – *Ensuring the strength of covenant was maintained throughout*

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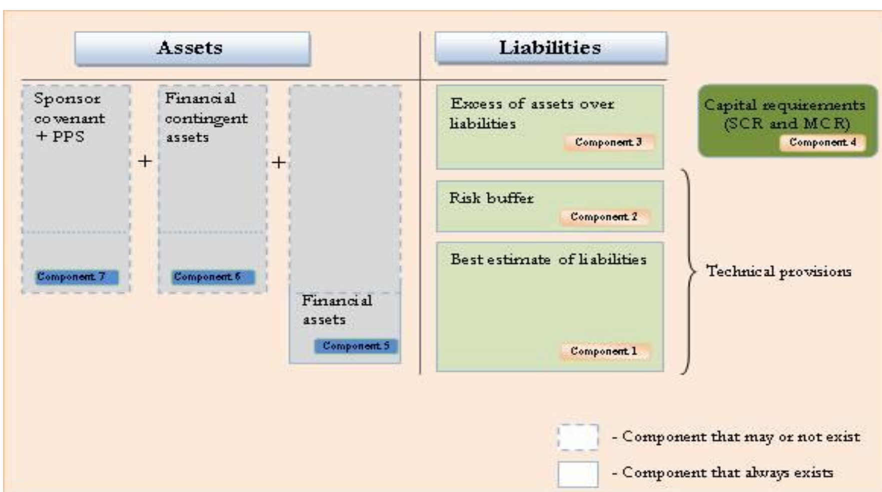
The Holistic Balance Sheet - EIOPA consultation



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The Holistic Balance Sheet

- Places sponsor covenant in its proper perspective - a vital element of pension security
- Numerous challenges to practical implementation – EIOPA conducting a Quantitative Impact Study
- Concerns about its use - what is the purpose of precise quantification?
- Some flaws - the Occupational Pensions Stakeholder Group prefers “Holistic Framework” – HBS not a proper balance sheet and should not be used for supervision purposes

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Implementation issues

- Huge range of sponsor circumstances
- Valuation of intangibles is difficult, such as brands
- Intercompany guarantees and cash sweeps are common
- What reliance should be put on the wider group?
- How to allow for insolvency risk
- Quantitative Impact Study
  - *“EIOPA recognises that there is much further development needed to implement the HBS concept and that cost/benefit analysis will be important.”*

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Quantification?

- Case 1 - Strong covenant:
  - Sufficient to certify deficit covered?
- Case 2 - Weak covenant:
  - No point in measuring with precision?
- Case 3 - Weak covenant of Statutory Employer but strong covenant of wider group:
  - Real issue is strengthening the legal position

The Big Question: What will the Regulator do with the information?

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Concepts in the IORP Directive challenged under HBS

- Exclusion of internally funded (book reserved) pensions!
- Self-investment constraints?

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Inclusion of Pension Protection Schemes?

Distinction between ongoing and insolvent sponsor

- Ongoing - PPS irrelevant other than cost of levy - ongoing prudent funding assumptions or flight plan
- Insolvent - PPS highly relevant - HBS irrelevant

Does the value of a Pension Protection Scheme belong on the Holistic Balance Sheet?

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Best estimate of liabilities – two approaches to funding

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Two levels of technical provisions

- Level A – Europe wide ‘risk free’ valuation basis
- Level B – expected investment return
- ‘Scheme owned’ assets to cover Level B only?
- Level A and B converge over time?

How would current TPR supervision change?

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The Holistic Balance Sheet

- A valuable concept if used to inform supervisory activity
- Dangerous if used to drive regulatory action?

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Closing comments

- Much focus now on legal/corporate structure in assessing covenant and contingent assets in remedying weaknesses
- Good covenants are at more risk than generally recognised
- Funding and investment strategy should be driven by covenant strength and covenant should be stress-tested for funding and investment assumptions
- Pension risk to the sponsor also needs to be integrated
- IORP II encourages a holistic view and a more integrated approach

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