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FINANCE, INVESTMENT & RISK MANAGEMENT CONFERENCE

15-17 JUNE 2008
HILTON DEANSGATE, MANCHESTER

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Modern Approaches to Financing Pension Commitments

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Current Approach to Pension Scheme Funding

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Pension Scheme Funding – Overview

- **Pension scheme still not high up the corporate agenda**
- **Trustees usually in driving seat – backed by legislation, Pension Regulator and consultants**
- **Funding is volatile due to**
  - **Increasing longevity – assumptions reviewed infrequently and usually step changes upwards**
  - **Changing legislation and funding requirements**
  - **Overexposure to equities**
  - **Limited hedging of inflation and duration risks**

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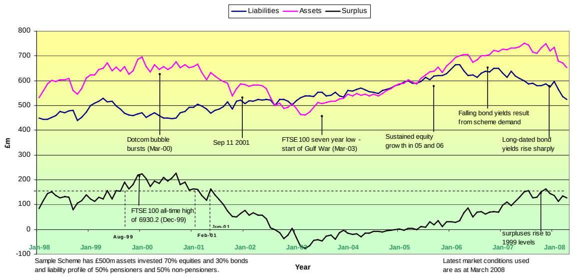
An illustration of the effect of market conditions on pension scheme deficits since 1998



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Why Look at Funding Approach Now?

- **Changing legislative landscape and increasing burden**
- **Regulator proposals to require significantly stronger longevity assumptions**
- **Increased volatility in deficits, increased opportunities to de-risk**
- **Level of competition means attractive pricing in the short term**
- **Frees up time, effort and cost of management involvement**

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Modern Funding Approaches:
Insurance & Corporate Transfer Models

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Insurance Transfer Model

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Insurance Transfer Model – Overview

- **On transfer of assets and liabilities can be removed from the scheme**
- **Either full or partial risk transfer**
- **Capacity increased 20x with new techniques - and competition lowering prices**
- **But still - 'Rolls-Royce' solution – insurers hold capital to secure member's full benefits to at least the 99.5% confidence level**

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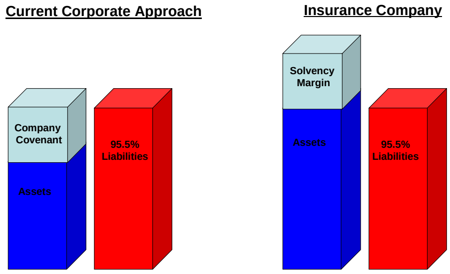
Applying Insurance Thinking to Scheme Funding



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Corporate Transfer Model - Perception

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Corporate Transfer Model - Reality

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Corporate Pensions Model
- Similarities with Insurance

- Target long term return based on small incremental improvements in scheme funding
- Returns to investors only possible when liabilities are considered more than secure
- Hedge risks - market volatility, interest rate risk, inflation, longevity risk
- Provide covenant to back pension liabilities
- Executed in partnership with trustees and sponsors

Corporate Pensions Model
- Differences to Insurance

- "Solvency Capital" provided by the sponsor covenant in the form of operating assets and/or financial capital
- No return to Pension Corporation in early years
- Returns to Pension Corporation only when additional assets are no longer needed to support the scheme

Corporate Pensions Model - Overview

Pension Corporation sponsored schemes are encouraged to:

- Apply investment governance models that allow the most efficient portfolios to be put in place
- Apply insurance company levels of risk management and financial reporting
- Enable more efficient investment approach than in an insurance environment

Asset and Liability Management (ALM)

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ALM – Strategy

- **Swap out inflation and interest rate risk**
- **Hold 20% of the portfolio as collateral – in cash or physical bonds**
- **Rest is invested in a wide variety of return seeking assets**
- **Limits risk exposure to any one manager or asset class**

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Joining Corporate and ALM Solutions: Case Study - Acquisition of Threshers

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Threshers Scheme Funding Position at 1st June 2007

- Deficit on FRS 17 basis of £33m (vs £62m of assets)
- Classic example of a traditional pension fund approach
- Invested 60% in Japanese, Euro, UK, and US equities and 40% bonds in BGI passive insurance linked funds
  - No use of alpha
  - Very short duration overall versus liabilities
  - No inflation protection
  - Bond portfolio duration much shorter than liabilities
  - Unhedged currency risk
- "Typical" governance structure
  - Asset allocation reviewed triennially
  - No investment committee or investment expertise

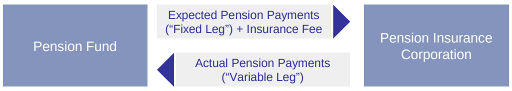
Risks Reduced

- The equities were sold as quickly as possible – T + 10 days
- Dealing with existing Investment Manager

Longevity Risk Management

Longevity Risk Market

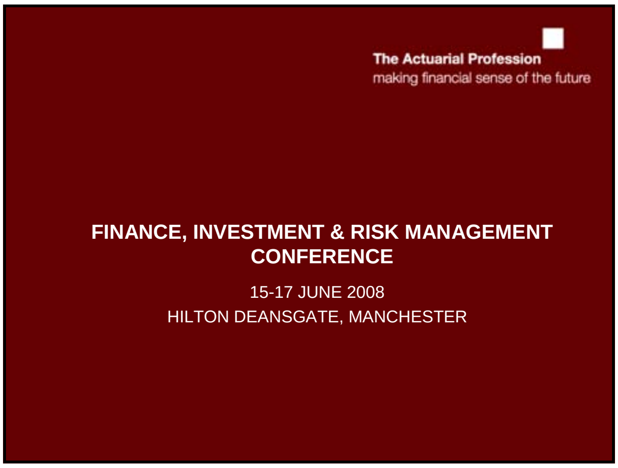
- Longevity risk market is immature but demand is high
- Variety of solutions being offered by different providers
- Pension Insurance Corporation offers comprehensive, “whole of life” longevity insurance
- Insurance on a swap basis



Benefits of Longevity Swap

- Fixes pension scheme payments in respect of pensioners and their dependants regardless of future longevity experience
- Eliminates single most significant risk to the scheme after ALM solution on place
- Comprehensive de-risking with cover matching scheme’s exposure
  - No residual basis risk from longevity
  - Does not affect assets and allows trustees to concentrate on investment strategy
- Maximises achievable investment returns by relocating “risk capital” from longevity to asset management

Questions?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