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Pensions and Corporate Finance Seminar – 17 February 2010

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The regulator's view – responding to pension risk in the UK economy

Agenda

- Landscape
- An observation on risk
- Corporate dimension to Scheme Specific Funding
  - Economic background
  - Employer covenant
- The trend to de-risking
- We are not alone

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The landscape – PPF Universe

Table 2.1 | Distribution of schemes by scheme size (number of members)

Number of members	Less than 100	100-999	1,000-4,999	5,000-9,999	More than 10,000	Total schemes*
Estimated 2006 DB PPF-eligible universe	5,900	3,500	950	200	250	10,800 (7,800)
Purple 2006 dataset	1,812	2,799	756	175	230	5,772
Estimated 2007 DB PPF-eligible universe	2,840	3,570	930	210	250	7800 (7,500)
Purple 2007 dataset	1,858	2,877	802	160	195	5,892
Estimated 2008 DB PPF-eligible universe	2,724	3,341	919	192	224	7400 (7,300)
Purple 2008 dataset	2,468	3,132	884	191	223	6,898
Estimated 2009 DB PPF-eligible universe	2,566	3,226	893	188	227	7,100
Purple 2009 dataset	2,439	3,162	877	180	227	6,885
Purple 2009 dataset as a percentage of 2009 PPF-eligible universe	95.1%	98.0%	98.2%	95.7%	100.0%	97.0%

Source: PPF/The Pensions Regulator
* Final estimates in brackets.

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The landscape – PPF Universe

Table 3.1 | Distribution of schemes by status (including hybrid schemes)*

Percentage of schemes	Purple 2006	Purple 2007	Purple 2008	Purple 2009
Open (plus part open in 2006)	41%	36%	31%	27%
Closed to new members	44%	45%	49%	52%
Closed to future accruals	14%	16%	18%	19%
Winding up	1%	2%	2%	2%

Source: PPF/The Pensions Regulator

*Some columns in this and other tables in this Chapter do not sum to 100 per cent due to rounding.

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The landscape and funding

Table 4.1 | Key funding statistics as at 31 March 2009

	s179	FRS17	Full buy out	Technical provisions
Total number of schemes	6,885	6,885	6,885	6,885
Total assets (£ billions)	780.4	780.4	780.4	780.4
Total liabilities (£ billions)	981.0	834.2	1,351.6	1,109.5
Aggregate funding position (£ billions)	-200.6	-53.8	-571.2	-329.1
Total balance for schemes in deficit (£ billions)	-216.7	-93.2	-572.3	-
Total balance for schemes in surplus (£ billions)	16.0	39.1	1.1	-
Funding level	79.5%	93.5%	57.7%	70.3%

Source: PPF/The Pensions Regulator

Table 4.2 | Key funding statistics as at 31 March 2008

	s179	FRS17	Full buy out	Technical provisions
Total number of schemes	6,885	6,885	6,885	6,885
Total assets (£ billions)	857.0	857.0	857.0	857.0
Total liabilities (£ billions)	844.7	848.9	1,362.7	955.4
Aggregate funding position (£ billions)	12.3	8.1	-505.8	-98.4
Total balance for schemes in deficit (£ billions)	-57.6	-53.4	-507.3	-
Total balance for schemes in surplus (£ billions)	69.9	61.4	1.6	-
Funding level	101.5%	100.9%	62.9%	89.7%

Source: PPF/The Pensions Regulator

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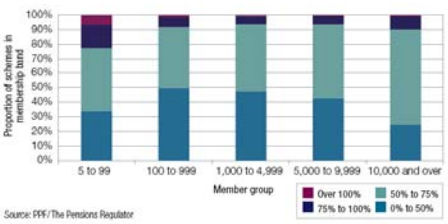
The landscape – does size matter?

Chart 4.4 | Distribution of estimated buy-out levels by scheme size by members as at 31 March 2009



Source: PPF/The Pensions Regulator

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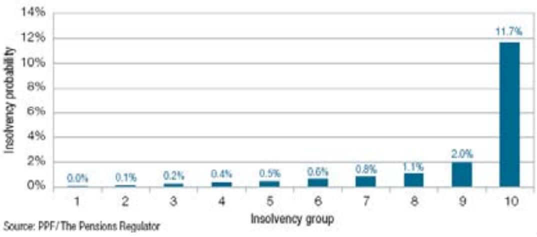
Employer solvency

Chart B1 | Average unweighted insolvency probability by insolvency group



Source: PPF/The Pensions Regulator

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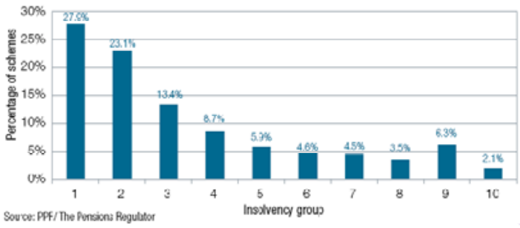
Employer solvency II

Chart B2 | Percentage of schemes by insolvency group



Source: PPF/The Pensions Regulator

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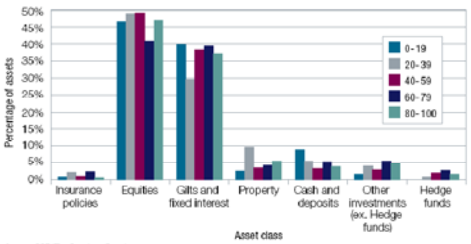
Employer solvency and asset allocation

Chart 7.5 | Weighted average asset allocation of schemes by insolvency score



Source: PPF/The Pensions Regulator

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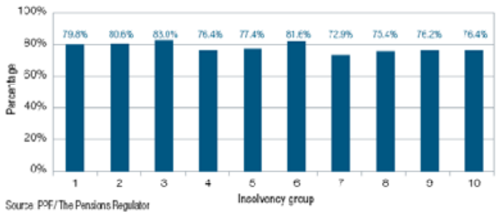
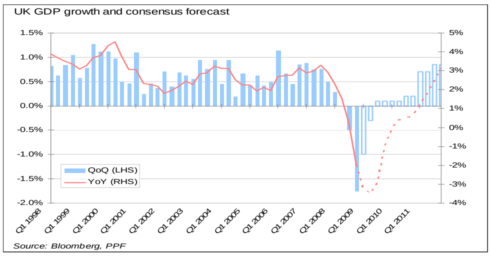
Employer solvency and funding levels

Chart B4 | Funding position on a s179 basis by insolvency group



Source: PPF/The Pensions Regulator

Context for recovery plans



Context for recovery plans

Table 1.1 | Economic and financial environment

	End of March 2006	End of March 2007	End of March 2008	End of March 2009	End of October 2009
GDP growth year-on-year	3.2%	2.4%	2.2%	-5.0%	-5.1%*
Insolvency rate – in 12 months to	0.70%	0.60%	0.60%	0.80%	0.9%*
FTSE All-share	3,487	3,848	3,550	2,509	3,342
10 year gilt yield	4.4%	5.0%	4.4%	3.2%	3.7%
10 year AA corporate bond yield	4.9%	5.5%	5.6%	4.8%	4.7%
Bank of England policy rate	4.5%	5.25%	5.25%	0.5%	0.5%

Source: Office for National Statistics, the Insolvency Service, Bloomberg

*Figures are for Q3 2009

The regulator's dilemma

Risk-based which means …

- Focus where we can have most impact
- Support the smooth and effective running of the markets
- Support helpful innovation
- Encourage knowledge within trustee board to be able to take appropriate decisions and actions
- Be alive to – and act to stop – inappropriate behaviours

Risks?

- **Employees**
  - Have to change retirement plans
  - Unrealistic expectations of income
  - Lack of financial understanding
- **Employer**
  - Increasing costs
  - Employees don't value the pension scheme
  - The scheme is an excessive burden
- **Trustee**
  - Potential sponsor failure/insolvency event
  - Paying the wrong benefits
  - Low levels of TKU
  - Low levels of liquidity
- **Actuary/Consultant/Investment Manager**
  - Considered as unprofessional
  - Losing business

Scheme Specific Funding – corporate dimension

- Economic background
  - Affordability
  - Flexibility
- Covenant

How to cope as a regulator with these difficult conditions

Will required contributions exceed 100% corporate cash flow?

Analysis in 2008 showed

- Wide variability by sector
- Within each sector wide variability by company
- Need to retain flexibility to cater for difficult cases
- Across the board solutions sub-optimal
    - Need to segment

Funding now

Fundamental position for scheme funding remains the same:

- Technical provisions continue to have primacy and must be set at a prudent level
- Recovery plan must be appropriately realistic
- Where there is material detriment to the employer covenant it should be mitigated

Robustness versus flexibility

Technical provisions:

- must be robust;
- need to reflect the situation as it really is, not as we may like it to be.

Recovery plans can be flexible if needed:

- does not mean other stakeholders should get ahead
- pension scheme should share in recovery

Flexibility in recovery plans

Recovery plans should reflect what is possible and reasonably affordable…..

- but members should not be disadvantaged

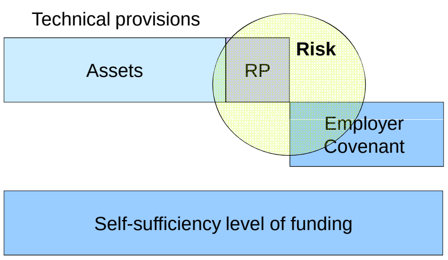
Considerations for flexibility

- Additional security to support longer plans
  - Contingent assets
  - Parental guarantees
- Back-end loading
- Step up payments once cash constraints cease
- Agree profit share over and above flat rate payments

Employer covenant – what is it really?

- Employers legal ***obligation*** and ***willingness*** to support the scheme
- Employer stands behind payments to cover ongoing payments; deficit repair; appropriate scheme expenses and underperformance
- For ongoing funding employer covenant provides security and if actual experience is worse than assumed

Employer covenant – where does it belong?



Self sufficiency features

- Risk minimised investments
- Cautious approach to longevity
- Actives valued no weaker than early leavers
- Expenses
- Member options?

Assessing covenant

- Trustees and employers need to work together
- Objective independent review is often helpful.

- Covenant assessment should answer the questions:
  - effect of corporate structure and legal obligations to the scheme
  - employers ability to meet ongoing demands as they fall due
  - the employers ability to stand behind any adverse experience in an ongoing situation, including the investment risk taken by the scheme
  - scheme's position on insolvency
  - options for alternative security, shape of payments

Employer covenant – the story so far

- Covenant affects the acceptable discount rate

- Employers assessed based on range of external rating experts with sense check (for triggering)
  - In more detailed analysis the assessment is company specific considering all relevant factors

- Covenant has been implicit and not necessarily accessible by the scheme

Employer covenant – what are the issues?

- Dynamic and can deteriorate quickly
- Art as much as a science
- Many trustee boards do not consider systematically, regularly and as part of Business As Usual

- By the time you spot it has gone wrong it may be too late to remedy
- Not strong correlation to SSF assumptions
  - Lack of process to make the linkage

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Employer covenant – where next?

Clarification of:

- How covenant comes into the scheme funding process
- Need for ongoing monitoring by the trustees
- Need for agreed plans

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Employer covenant, recovery plan and investment policy

- Must make sense together
- Investments don't grow on trees
  - They are set in a context
- Who will pick up the pieces?
- Flexibility
  - Good to stop the pension scheme pulling the company down
  - But not to allow the employer to avoid responsibilities

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Low security segment

Table 8.5 | Average weighted deficit per scheme (schemes in deficit)

Insolvency group	Average insolvency probability	Average funding position	Weighted deficit (£millions)	Number of schemes	Average weighted deficit per scheme (£millions)
1	0.0%	79.81%	35.9	1,601	0.02
2	0.1%	80.60%	67.4	1,313	0.05
3	0.2%	82.97%	56.5	795	0.07
4	0.4%	76.43%	38.1	502	0.08
5	0.5%	77.39%	26.8	337	0.08
6	0.6%	81.64%	27.0	254	0.11
7	0.8%	72.92%	32.5	271	0.12
8	1.1%	75.42%	29.4	202	0.15
9	2.1%	76.18%	73.0	370	0.20
10	11.8%	76.45%	94.9	113	0.84
Total			481.5	5758	0.08

Source: PPF/The Pensions Regulator

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Typical de-risking proposals

- Buy-out of pensioner members' liabilities with an insurer
- Buy-in of pensioner members' liabilities
- Closure of the scheme to future accrual or limiting future accrual
- Transfer incentive exercise aimed at deferred members
- Pension scheme transferred to a pension specialist sponsoring employer (uninsured buy-out)
- DIY approaches

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Issues around de-risking

- Risk reduction or risk transfer to members
- Balancing risk and reward for different groups
- Dealing with uncertainty around outcomes
- Ensuring members are properly informed/advised
- Mitigation

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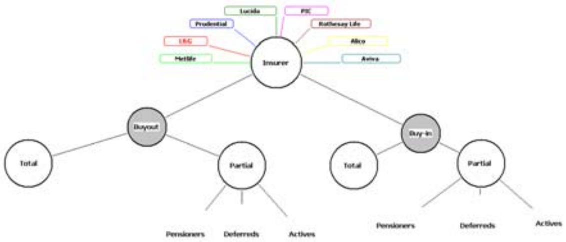
2009
Market for Insured Buyouts & Buy-ins



Total value £2.5 bn YTD
Number of deals : 127 YTD

larger deals include :
Lucida : Merchant Navy Officers Pension Fund (£500m)
L&G: Dairycrest Pensioners (£170m)

Risk factors within the buy-out market

- Asymmetry of risk – scheme operates or is designed to operate for profit where proper account is not taken of members interests
- Misalignment of interests
- Non-insured buyouts
- Circumstances where we expect to use the material detriment test
- Transfer incentives – or other "window dressing" pre-insured buy outs
- Risk to the PPF

Transfer value incentives

What we want to see
- Full disclosure to members of their options
- Clear understandable language
- Presented to enable the member to make "the right" decision
- Independent advice to members not linked to the exercise
- No coercion

An open and transparent exercise where relationships are clearly understood and conflicts are managed appropriately

Current intentions?

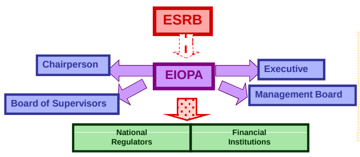
- 31% of schemes considering buy-out
- 37% considering buy-in
- 32% considering transfer incentives
- 25% considering longevity transfer

(source: Lucida PensionsPulse Survey Oct 2009)

Longevity transfer – the next big thing?

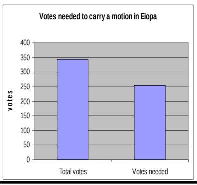
- Small number of LARGE high profile deals to date
- Large number more in the wings
- 2 routes
  - Derivative
  - Insurance wrapper
- Often led by corporate
- Important to understand the small print and the residual risks
- Are they a step on the road to buy out??

We are not alone – the changing structure of European pensions regulation



The new structure and objectives will lead to new (binding) regulations through EIOPA and may drive convergence towards a more supervisory style of regulation.

Votes	Countries
29	UK, Germany, France, Italy
27	Spain, Poland
14	Romania
13	Netherlands
12	Greece, Czech Republic, Belgium, Portugal, Hungary
10	Sweden, Austria, Bulgaria
7	Slovakia, Denmark, Finland, Ireland, Lithuania
4	Latvia, Slovenia, Estonia, Cyprus, Luxembourg
3	Malta
345	**27**



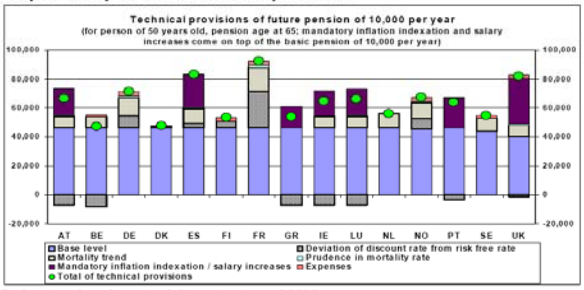
Europe – how different are reserves?

Table 1 Summary overview - Components of technical provisions

		AT	BE	DE (pk)	DE (pf)	DK	ES	FI	FR	GR	IE	IT	LI	LU	MT	NL	NO	PT	SE	UK	Total
Discount rate	Fixed max. discount rates	Y					Y	Y						Y CAA							4
	Current risk free market rates				Y	Y										Y		Y	Y		5
	Expected return on assets		Y							Y	Y	Y	Y	Y C&BF	Y					Y	8
	Based on life directive			Y					Y								Y				3
Mortality Tables	Current mort. rates		Y		Y	Y		Y		Y	Y					Y		Y	Y		9
	Trend included	Y	Y	Y	Y		Y		Y		Y		Y	Y		Y	Y		Y	Y	13
	Prudence added	Y		Y			Y		Y				Y	Y	Y		Y			Y	9
Reserving method	No infl./sal. indexation			Y	Y			Y	Y				Y		Y	Y	Y		Y		9
	Inflation protection										Y									Y	2
	Inf. protec. and sal. index.	Y					Y			Y				Y				Y			5
	Other		Y			Y						Y									3
Indexation to deferred benefits	Obligation of the IORP										Y									Y	2
	Common practice Yes	Y		Y		Y		Y				Y		Y		Y	Y		Y		9
	Common practice No				Y													Y			2
Indexation to pension in payment	Obligation of the IORP																	Y		Y	2
	Common practice Yes	Y		Y		Y	Y	Y			Y	Y		Y CAA		Y	Y		Y		11
	Common practice No				Y				Y												2
Expenses	Covered by TP	Y	Y	Y	Y	Y		Y	Y							Y	Y		Y	Y	11
	Not covered by TP						Y			Y	Y	Y		Y	Y			Y			7

Europe – how different are reserves?

Graph 7 Components of technical provisions*



Explanation: based on actual discount rates end 2006.
* On April 28, Graph 7 was updated to reflect the same data source for the risk free rate for the UK.

Europe – what about security?

Table 8 Summary overview of security mechanisms

Security mechanisms	AT	BE	DE	DK	ES	FI	FR	GR	IE	IT	LI	LU	MT	NL	NO	PT	SE	UK	Total
Regulatory Own Funds	Y	Y	Y	Y	Y		Y						Y	Y	Y		Y		10
Subordinated loans			Y	Y			Y							Y	Y		Y		6
Sponsor support – Unlimited	Y				Y	Y						Y CAA	Y					Y	6
Sponsor support – Limited		Y		Y							Y	Y CSSF				Y	Y		6
Sponsor support – Not automatic			Y				Y	Y	Y	Y				Y	Y				7
Guarantee fund			Y				Y											Y	3
Reduction of accrued rights	Y	Y	Y						Y	Y				Y		Y			7
Reduction in future conditional indexation				Y										Y			Y		3
Other security mechanism									Y									Y	2

Any questions?

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