Scheme-specific funding - nice idea but...

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Financial Markets Advisory, 30th November 2004

ABN·AMRO

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Agenda

- **Statutory funding objective (SFO)**
- **Statement of funding principles (SFP)**
- **Valuation reporting**
- **Failure to reach agreement**
- **Future funding discussions**
- **Issues for trustees and employers**

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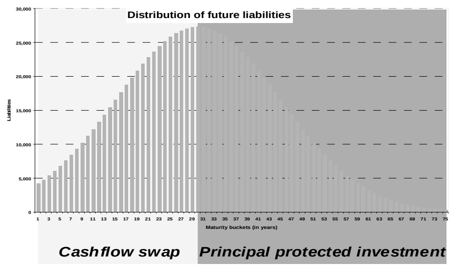
EU Directive - scheme liabilities



Statutory funding objective (SFO)

- **Shortfall = assets - technical provisions**
- **Assets are sufficient and *appropriate***
- **Technical provisions (TP) calculated in accordance with any "prescribed methods and assumptions"**
- **Actuarial certification within reasonable period**
- **Methods & assumptions for TP require agreement of employer**

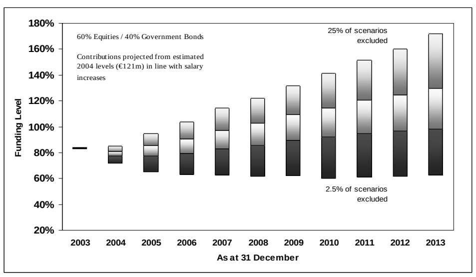
Statement of funding principles (SFP)

- **Trustees' written policy for ensuring SFO is met**
- **Agreement of employer and advice of actuary**
- **SFP includes methods & assumptions for technical provisions and correction period**
- **Recovery plan - action to meet SFO in the event of shortfall and period for correction**
- **Schedules of contribution consistent with SFP - certified by actuary**

Valuation reporting

- Actuarial valuations – at least every 3 years provided there are annual “actuarial reports”
- Actuarial reports - developments in technical provisions since last valuation
- Valuations against PPF as well…will impact risk-based levies
- More focus on solvency

More focus on solvency



Failure to reach agreement

- Basis for PPF – buy-out
- Regulator: minimise calls on PPF
- Regulator power to set SFO and conts
- Consider new scheme…then extend
- Regulator sees recovery plans
- How tough will new regulator be?

An Illustration of the hit

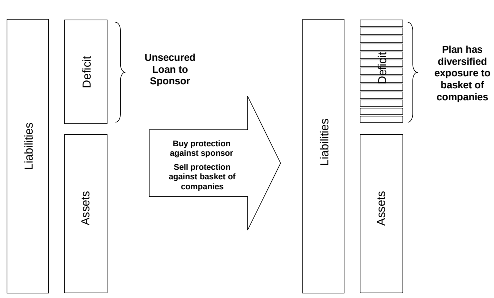
Assets £1.7bn and payroll £500m

	Typical Funding basis	Buyout Basis
Technical Provisions	**£1.9bn**	**£3.1bn**
Future service rate	**10%**	**25%**
Deficit funding (pa)	**£14m**	**£100m**
Contribution rate (pa)	**£64m**	**£225m**

Possible view of new regulator

- Initially, pension schemes likely to be in deficit against SFO
- Trustees making large unsecured loans back to the sponsor
- While contributions by the sponsor may have increased, it is unlikely that the deficit will be removed in the **near** future
- So new regulator's powers could include forcing protection against some of the deficit as well as increased contributions
- Trustees can buy protection using credit default swaps (CDS)
  - Can be linked to the deficit at the time of insolvency or stress-test
- Might have some appeal for the sponsor
  - Potential reduction in the risk-based levy to the PPF
  - more flexibility over future funding

Buying protection against solvency deficits



Letter of credit

- Alternative approach is arranging a Letter of Credit facility
- Sponsor gets bank(s) to underwrite deficit in the event of employer insolvency
  - Actuary calculates the deficit on the solvency basis
  - Sponsor pays bank(s) to meet this deficit on certain "trigger" events
  - Position could be reviewed following each formal actuarial valuation
- Enables sponsor to continue to fund with flexibility on an "ongoing basis"
- Depends on size of deficit - but could weigh up contributions vs extent of protection
- Not a perfect match - but easier for trustees to understand than CDS
- Reduced risk-levy to PPF?

Issues for trustees and employers

- **Need detail urgently**
- **More focus on solvency**
- **How tough will regulator be?**
- **Future discussions on funding…new ideas?**
- **More bad news for DB schemes…have you warned clients?**

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