

Pension scheme funding in the current environment

UKAP Pensions Conference 2012

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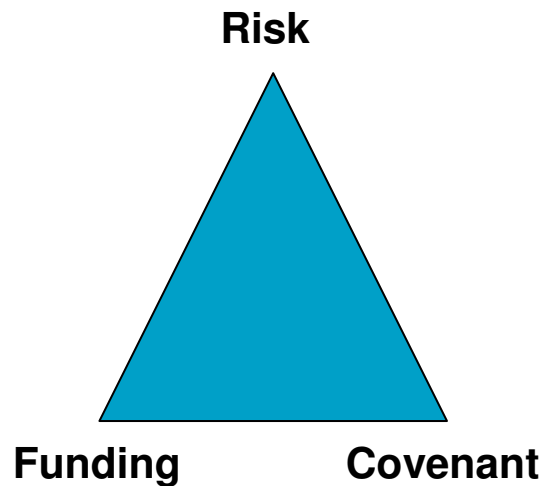
Objectives

- Provide more insight into our thinking behind the Annual Funding statement
- Explain how the statement should help trustee and employers facing the challenge of current difficult conditions
- Clarify our expectations from trustees
- Clarify what trustees can expect from us
- Q & A

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Our regulatory model

- Balancing strategies for funding, risk and member security in a risk-focussed and proportionate manner



- How much risk in funding and investment strategies?
- How is it financed?
- How is it supported?

Our expectation from trustees, based on the practical experience of the SSF regime over two full cycles is for a business plan which brings together these 3 strands in a coherent manner.

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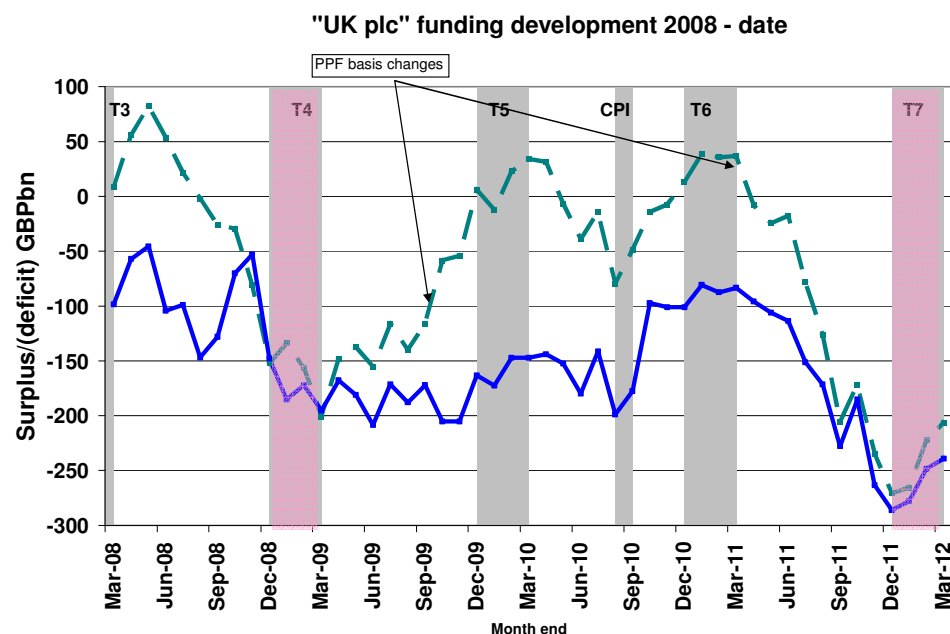
A re-statement of our earlier guidance

- Technical provisions
 - Primary measure of liability
 - Not to be compromised to make recovery plan affordable
 - Embedded risk should depend on available sponsor support
- Recovery plans
 - Determined by reasonable affordability to sponsor
 - Flexible in design and (within reason) length, to deal with individual circumstances.
 - Can be supported by non-cash elements
- Investment risk when used as a financing tool
 - Must take account of available sponsor support (which may be volatile over time)
 - Trustees should have realistic plans of how the sponsor will provide additional support if expected returns are not realised whilst there is still time.
- Sponsor support
 - Numerous forms, some more accessible than others
 - Can be volatile and may erode quickly
 - Needs regular monitoring and clarity about actions that would be taken and in what circumstances

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Current context: difficult financial conditions

- Aggregate position of all schemes covered by April statement estimated to be as follows (blue) and compared with PPF7800 index for same schemes (green).



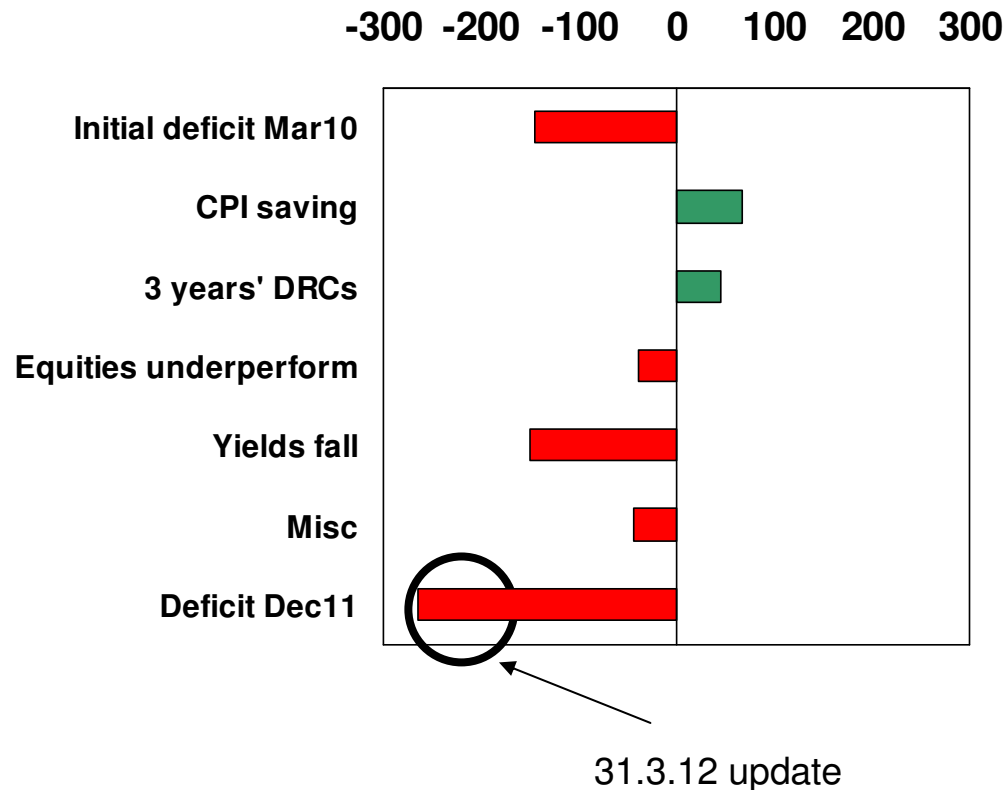
- Expect most deficits to be worse than 3 years ago
- Volatile markets = Volatile deficits
- Scheme specific variations - depending on many individual factors

TPs (in blue line) defined as gilts plus same outperformance as at previous valuation

Limitations to our data makes this suitable for big picture analyses only.

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Sources of deficit



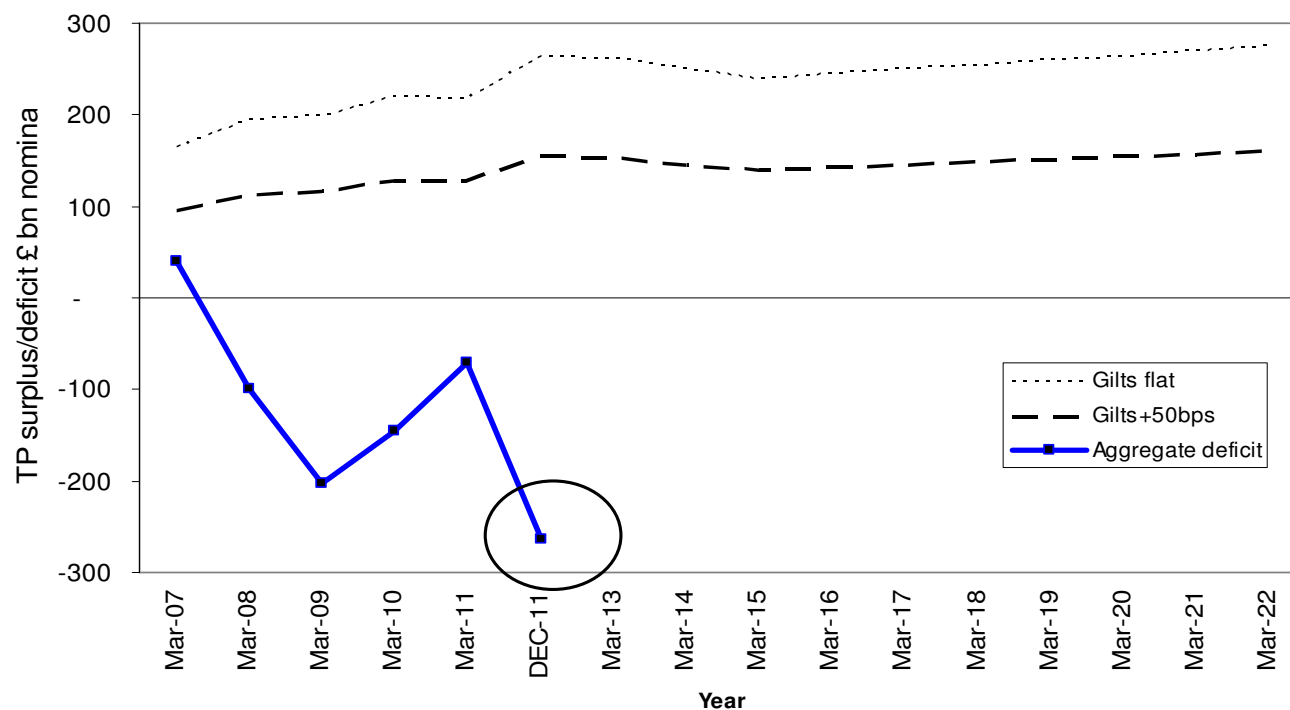
- Some respite from CPI saving
- Contributions, despite being at record levels, neutralised by net investment and other misc losses
- But significant loss from having to mark to current market
- March 2012 deficits smaller than Dec 2011 (and attribution to individual factors may be different)

Warning: This is aggregate analyses based on highly summarised data and may not be representative of individual schemes whose results will depend on many scheme specific factors.

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Current financial conditions: the scale of the problem

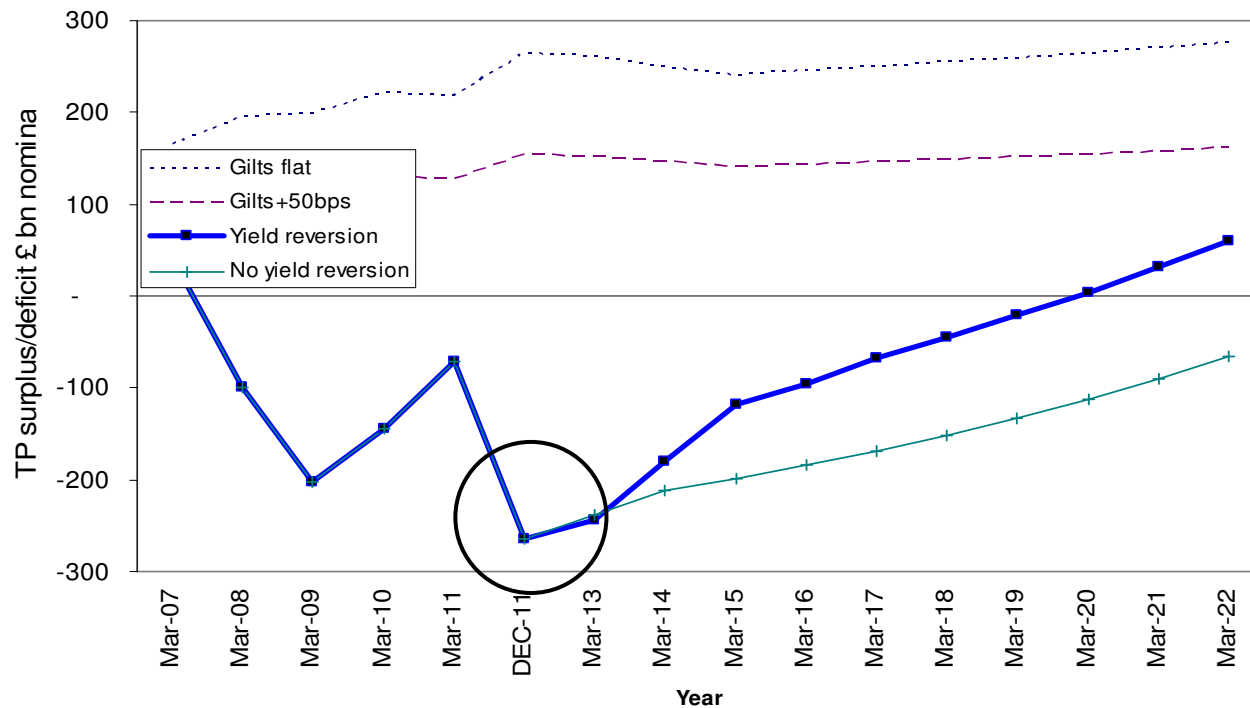
Scenario projections - UK plc aggregate TP basis



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Current financial conditions: a new norm or a temporary aberration?

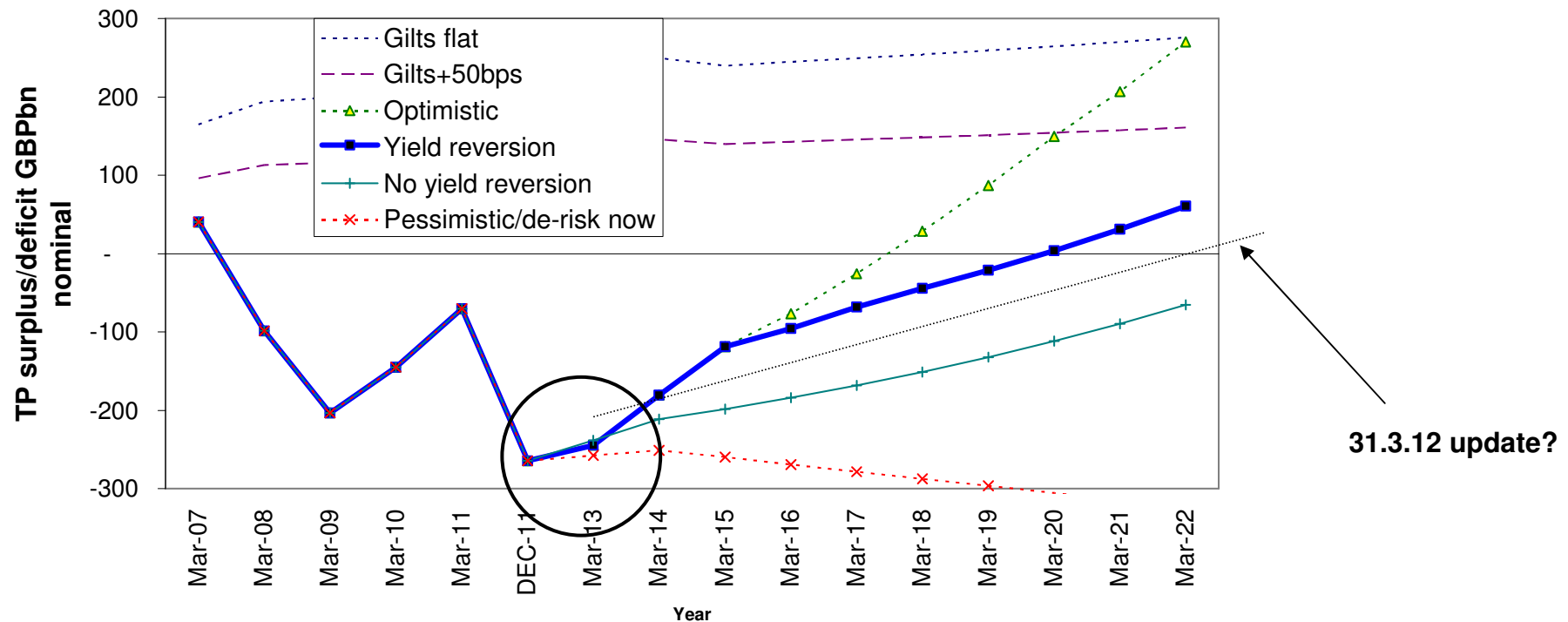
Scenario projections - UK plc aggregate TP basis
Existing contributions + RPI in future -
No change to return seeking asset proportion for 10 years



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Current financial conditions: other ways of getting there

Scenario projections - UK plc aggregate TP basis
Existing contributions + RPI in future -
No change to return seeking asset proportion for 10 years



Which one will it be?

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Coping with current conditions: TPs

- Prudent approach towards setting TPs, regardless of market conditions - legislative requirement
- We expect trustees to
 - Keep TPs transparent
 - Hold their strength: embedded risk consistent with what sponsor can support, now and in future
 - smoothing TPs not consistent with asset valuations; volatility needs to be managed not hidden
- Recovery plans have flexibility to cope with volatility and other aspects of the current financial landscape
 - If trustees have a strong view about what may be 'normal', and they factor it explicitly in their funding plan, then our preference is for this to be done in the recovery plan assumptions, together with a documented contingency plan

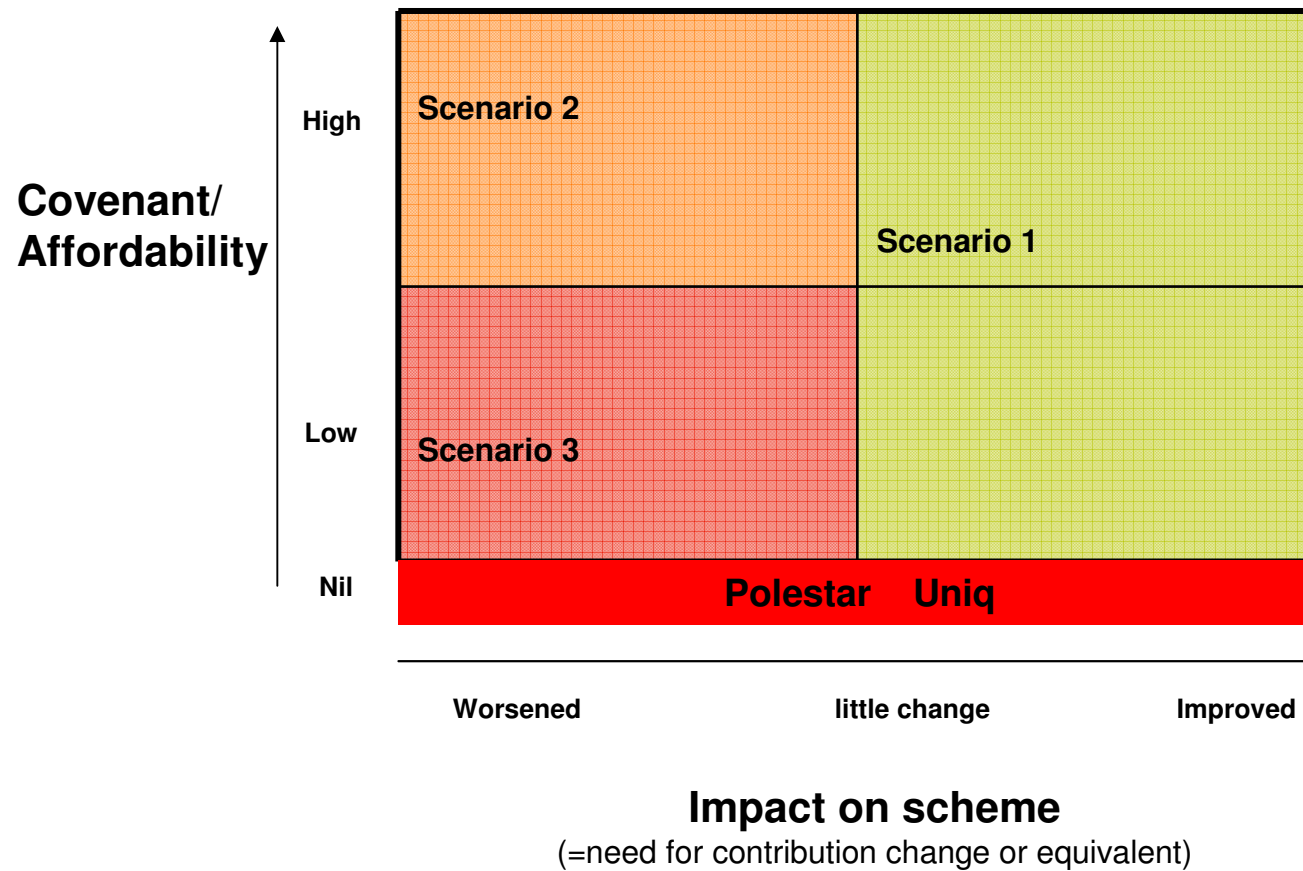
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Future recovery plans: our expectations

- Guiding principle: reasonable affordability without compromising sponsor's viability
- In general we expect contributions to be maintained in real terms or increased in line with business performance
- Higher increases if previous level of contributions was low relative to what the sponsor could have afforded
- Servicing debt and capex are essential elements of strong businesses – should be seen to be improving sponsor covenant
- When cash leaves the company the pension creditor should receive an equitable share
- Reassess dividend payments where there is a substantial risk of pension obligations not being met
- If affordability is reduced longer recovery plans may be acceptable but justification needed for material extension
- Trustees should document the justification for any reductions – good governance

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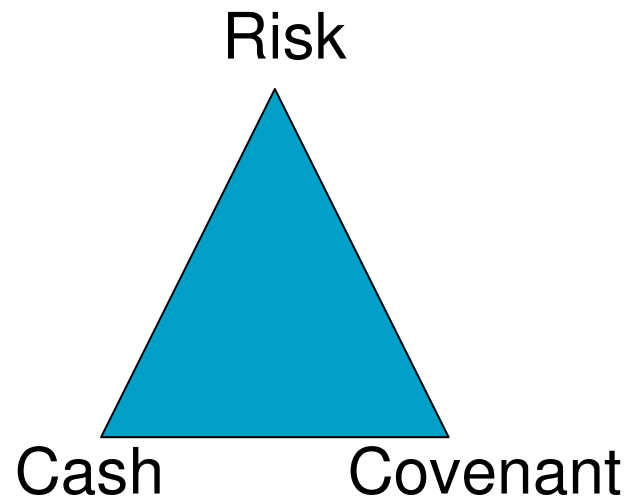
Impact vs affordability



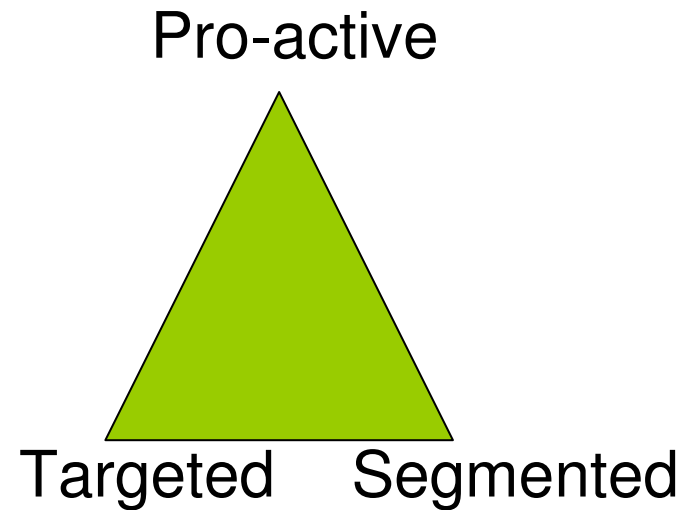
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Managing T7 valuations

Scheme issues

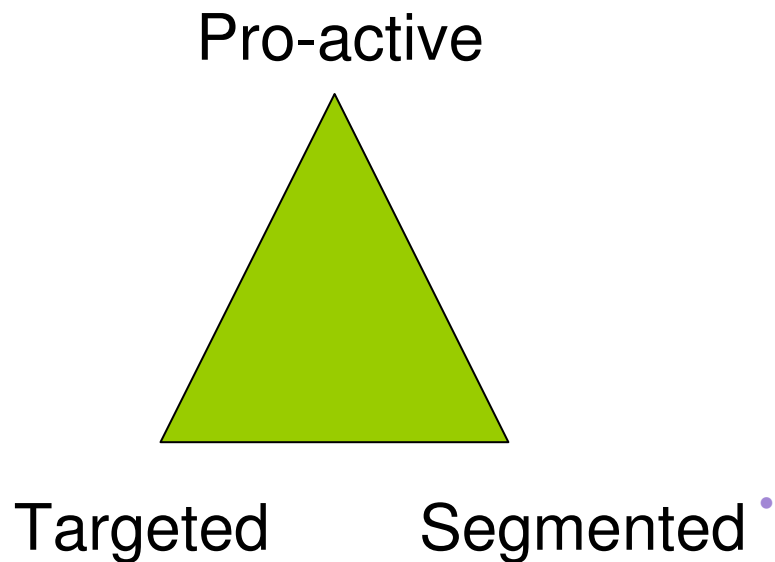


TPR process issues



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The Pensions Regulator: process

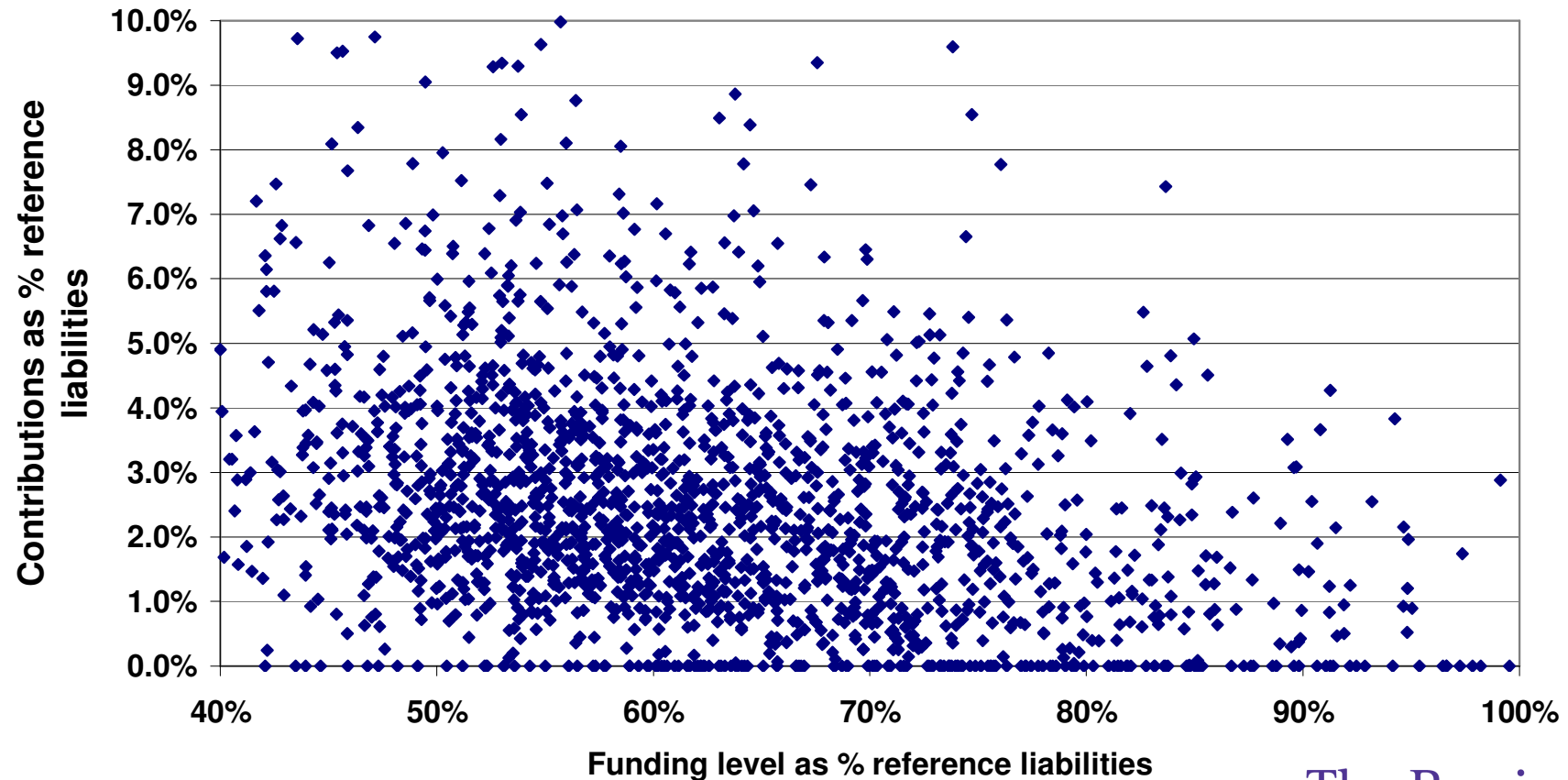


- Pro-active
 - More interested in early engagement
- Targeted on key risks
 - These are
 - Covenant
 - Investment
 - Inadequacy of contributions
 - TP/RP length is means to an end only
 - Evolve triggers to better address key risks
- Segmented
 - Increasingly discriminate between different situations in terms of our approach

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Current recovery plans (T4): bird's eye view

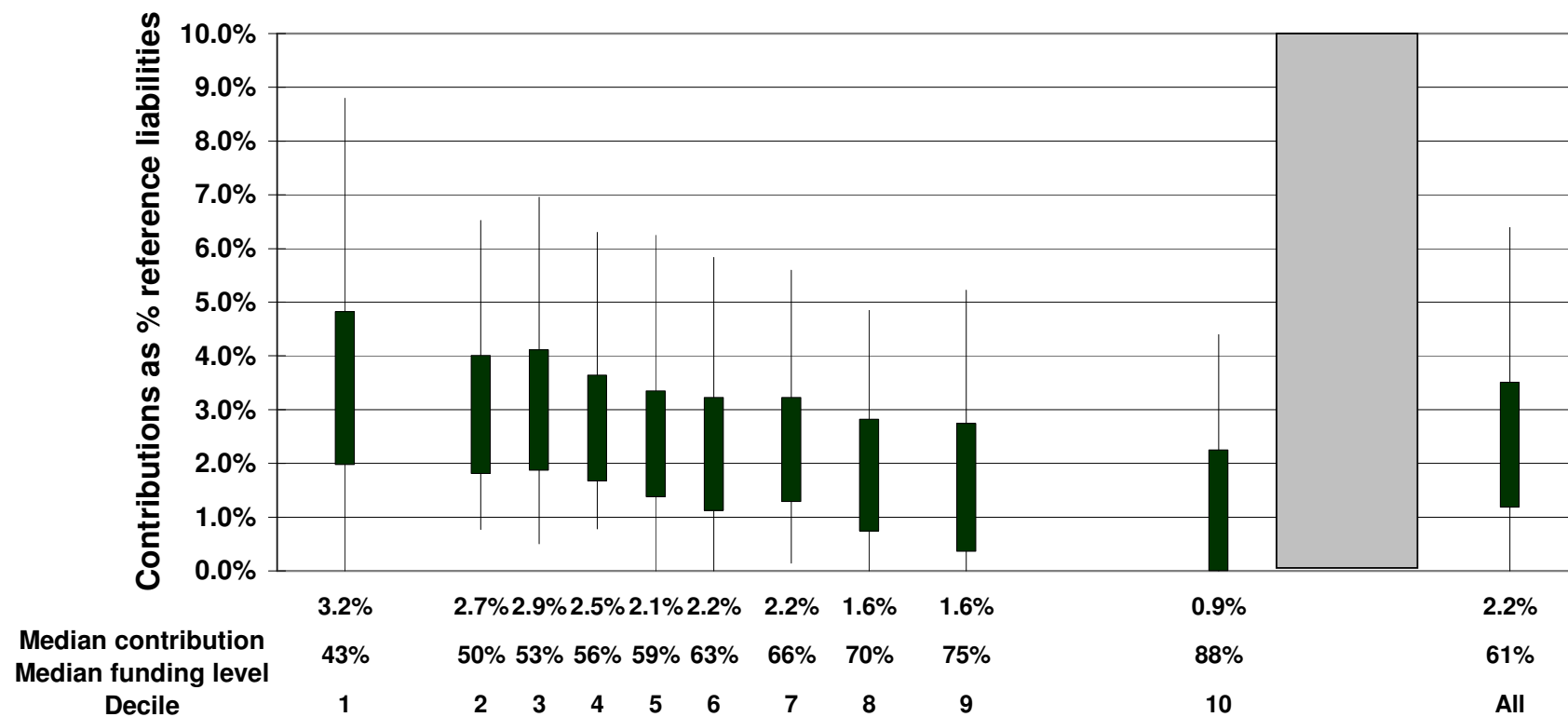
Range of contributions and funding level
Tranche 4 (excluding outliers)



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Current recovery plans (T4): a closer look

Range of contributions by funding level decile
Showing 5th/25th/75th/95th percentile for each decile

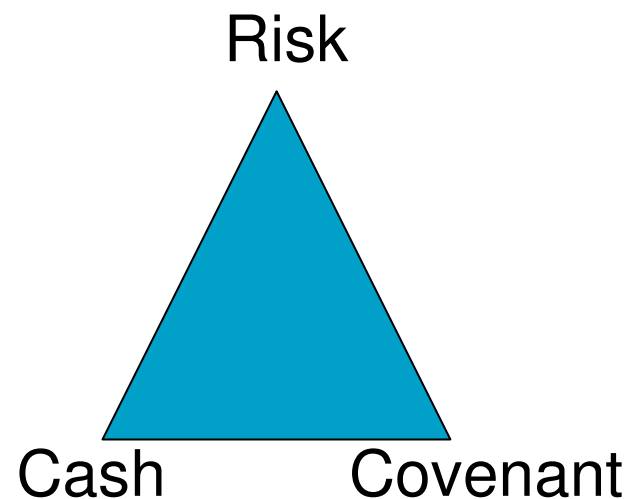


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Managing T7 valuations

Trigger developments we wish to explore

Scheme issues



*Note: These are exploratory ideas only.
The final approach may not adopt any
of these ideas, and others may emerge*

Funding

- Contributions vs TP/RP length
- Surplus declarations

Investment risk

- RBL
- VaR
- ABCs
- Flight paths

Covenant risk

- External advice
- Monitoring
- Directness of covenant

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Sum up – our overall expectation

- Increasingly joined up funding/investment/covenant
- Business plan, including clarity about strength of sponsor support, where it resides and how accessible it will be if and when needed.
- Parental support / wider group support increasingly formalised
- Monitoring covenant and suitable actions that may be taken and in what circumstances
- Trustees to be flexible where covenant is weaker and tolerance needed, but with corresponding shareholder restraint
- There are many well managed schemes doing the right things. We are happy to work with them to identify models of best practice.
- We want to get ahead of issues for schemes where this is not the case, in part by pro-active engagement

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Questions?



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