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A Decade of UK Pensions Risk

Dan Mikulskis

11 May 2016

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But first, a quick story…

12 May 2016

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PENSIONS CRISIS TO LAST FOR 20 YEARS

By Helene Perkins

UP to 11 million Britons face reduced pension pay-outs because of a funding crisis that is set to last for 20 years.

Employers will struggle to have enough cash to meet their liabilities, with funding levels for defined benefit plans, like final salary schemes, worse now than 10 years ago, according to City pension consultants Redington.

Industry giants including BT, energy businesses Royal Dutch Shell and BP are among those to have pension deficits that run into billions of pounds.

In fact, given the funding pressures, defined benefit schemes could become a thing of the past, said pensions consultant Malcolm McLean, of Barnett Waddingham.

He said: "There is a real problem – they may be less generous in the future.

"They are unaffordable for many employers. Primarily we are living longer and they are increasingly

TURN TO PAGE 5

Dapper Duke: Why Prince Philip is our most stylish Royal

SEE PAGE 5

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Pensions in the News

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Daily Mail, Friday, April 1, 2016

Pension black holes engulfing our top firms

by Alex Brummer

AT FIRST blush there may appear to be little in common between Tata Steel in Britain, Mr Kipling owner Premier Foods and the department store chain BHS.

But as old, established UK-based enterprises they have all at times operated 'gold standard' final salary pension schemes.

When the companies change or seek to change ownership, there is an obligation for the existing owners and the buyers to take into account the company's covenant – their obligations – to the pension scheme.

One of the features of these older companies is that often the numbers of existing pensioners and the company's obligations to them exceed that of the existing workforce. In many cases current staff will have been weaned off defined benefit, or final salary, plans to defined contributions where the risk lies more directly with the workforce.

But it has not been enough to stop a huge black hole opening up in nearly 6,000 defined benefit pension schemes across the country, meaning there is not enough money in the pot to meet future obligations.

Recent numbers show that in February this year there was a shortfall of 80pc – or a thumping £322.8bn.

This would be the potential liability of the Pension Protection Fund (PPF), set up to protect pensioners if their pension fund becomes insolvent, if all the defined benefit plans were to go belly up at the same time. Among those companies with large deficits is Tata Steel, mainly formed from the old British Steel, once one of Britain's largest employers.

At BHS, negotiations about the pension deficit are ongoing with the former owner, Sir Philip Green of Arcadia.

Any new owner of Premier Foods, the subject of an American bid, will need to take on the pensions covenant to past and current staff.

Here we look at the three pension schemes.

BRITISH STEEL
Deficit: £966m
Members: 134,000

The £13.9bn British Steel pension fund is one of the biggest in the UK.

It has 134,000 members but just 16,075 current staff contribute to the fund.

A full valuation is carried out every three years and the last full update, back in March 2014, shows a relatively modest deficit of £90m.

However, this assumes regular contributions from Tata Steel, which took on what was left of British Steel when it bought Corus for £6.7bn in 2007 but has put its UK operations up for sale.

The pension trustees said Tata was expected to contribute £35m this year, £60m in 2017 and £65m in 2018.

However, if Tata sells the business or shuts it down these payment are at risk.

In an update issued this month the trustees estimate that without these contributions the deficit stands at a much higher figure – £966m.

But it is feared that the actual amount could be even more still as record low gilt yields hit returns on investments.

This has left the Government and any potential buyer with plenty to worry about.

Allan Johnston, chairman of the pension trustees said in the update 'if the scheme was wound up Tata Steel would be required to pay contributions' to cover the shortfall.

In the event that this did not happen the PPF would be required to pay limited compensation to members.

BHS
Deficit: £571m
Members: 20,000

Retailer BHS is struggling amid weak sales, rising costs and heightened competition on the High Street.

It was sold for £1 last year by billionaire former owner Sir Philip Green to a group of little-known private investors led by Dominic Chappell, a twice-discharged bankrupt former racing driver.

The group is now battling for survival and a major issue is the large hole in its pension fund.

The pension scheme, which closed 11 years ago, is expected to end up in the hands of the PPF, the state-backed 'lifeboat'.

Some 13,000 people in the scheme have not yet retired and could lose at least 10pc of their retirement income if the PPF takes over. Thousands more who are already retired will see annual pension rises capped at 2.5pc – meaning they would lose out if inflation rises above that figure.

About £300m is estimated to be needed to prop up the scheme, but the total shortfall is £571m.

Although Green no longer owns the company, the pension regulator has the power to force a former owner of a business to make payments to a pension fund if it can be proved there has been an attempt to avoid or not support statutory liabilities. The regulator is in talks with the PPF, the pension trustees and Green.

PREMIER FOODS
Deficit: £390m
Members: 50,000

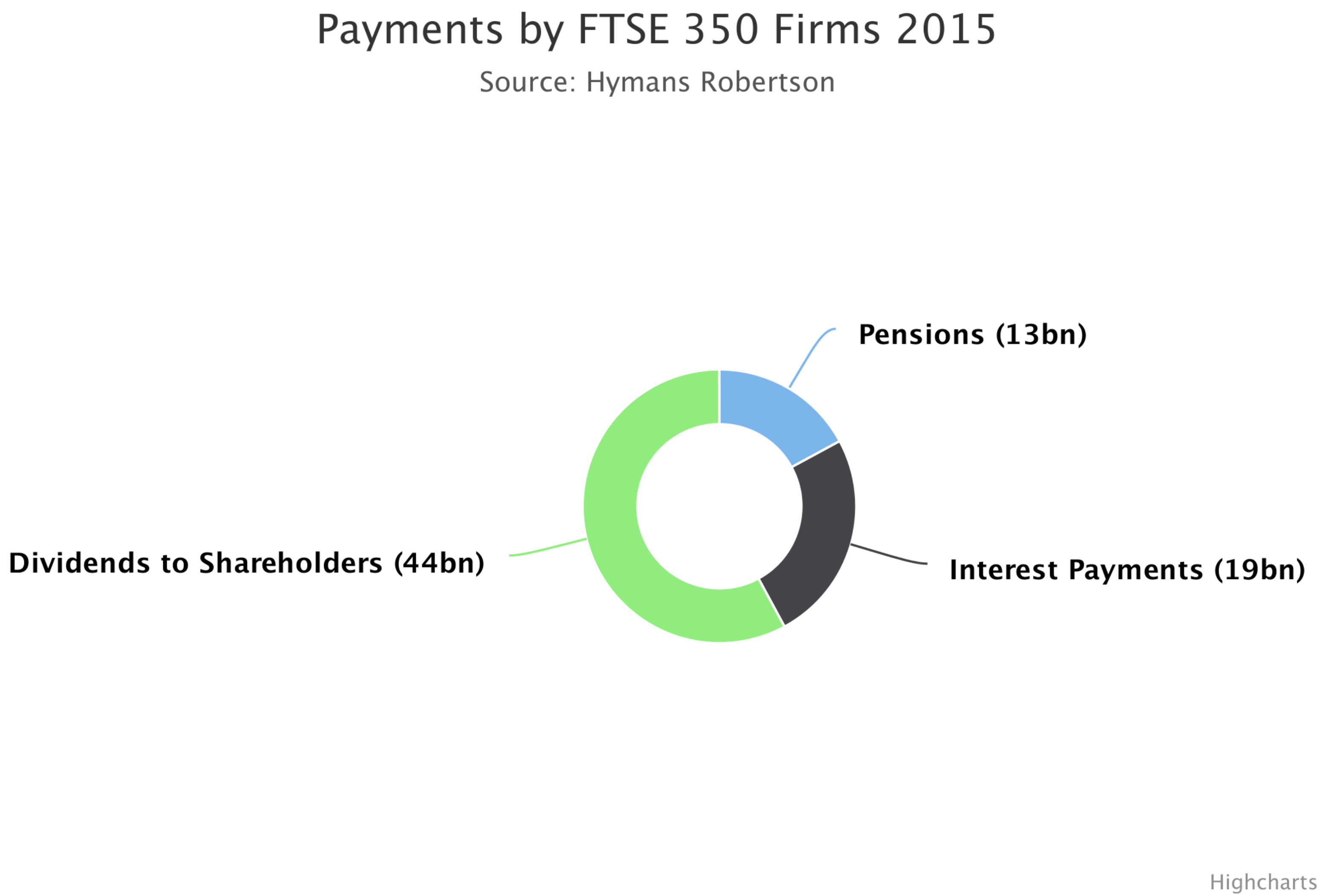
Mr Kipling cake maker Premier Foods is in takeover talks with US food giant McCormick.

The latest offer for Premier – there have now been three from McCormick – values the company at £1.5bn in total.

But the Americans want to pore over the detail of Premier's debt and pension scheme and have urged its would-be prey to 'engage fully' and open its books.

What it really wants to know are the details of the Premier pension scheme. Premier is an amalgamation of a series of takeovers and mergers, leaving it with seven pension schemes and more than 50,000 members who are past and present employees.

The schemes include the Chivers 1987 pension scheme and the RHM pension scheme, which comes from its ownership of the Hovis bread group. Three years ago, when Premier was desperately restructuring and performed a rights issue, the deficit was as much as £800m.


Payments by FTSE 350 Firms 2015
Source: Hymans Robertson
Pensions (13bn)
Interest Payments (19bn)
Dividends to Shareholders (44bn)
Highcharts

Not All Schemes are Equal, Why?

TP Funding ratio (Gilts +1% on average)

95th percentile	107%
75th percentile	93%
Median	83%
25th Percentile	73%
5th Percentile	56%

ICI
smiths
PHILIPS

BHS
BRITISH HOME STORES
TATA

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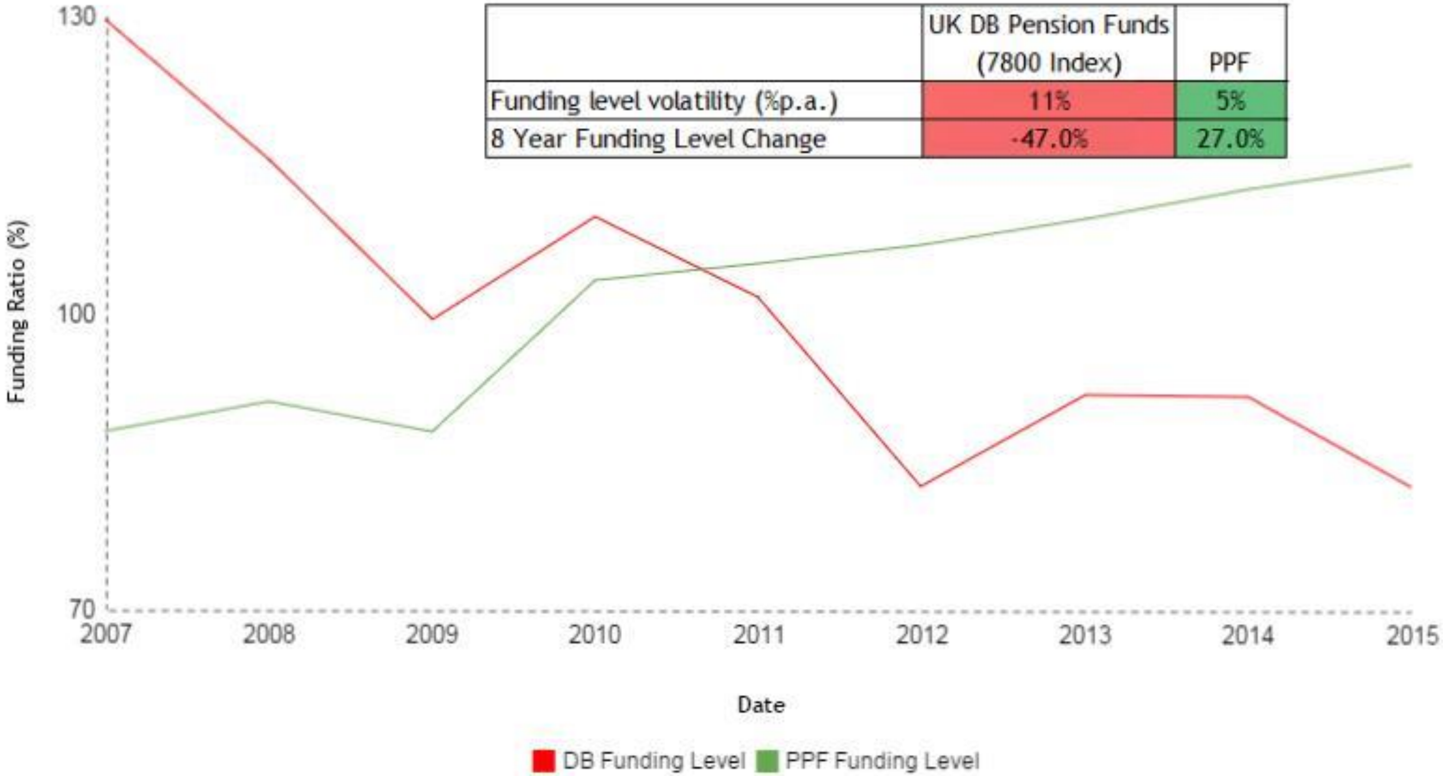
The PPF vs Everyone Else

	UK DB Pension Funds (7800 Index)	PPF
Funding level volatility (%p.a.)	11%	5%
8 Year Funding Level Change	-47.0%	27.0%



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Looking Back on a Decade of Risk

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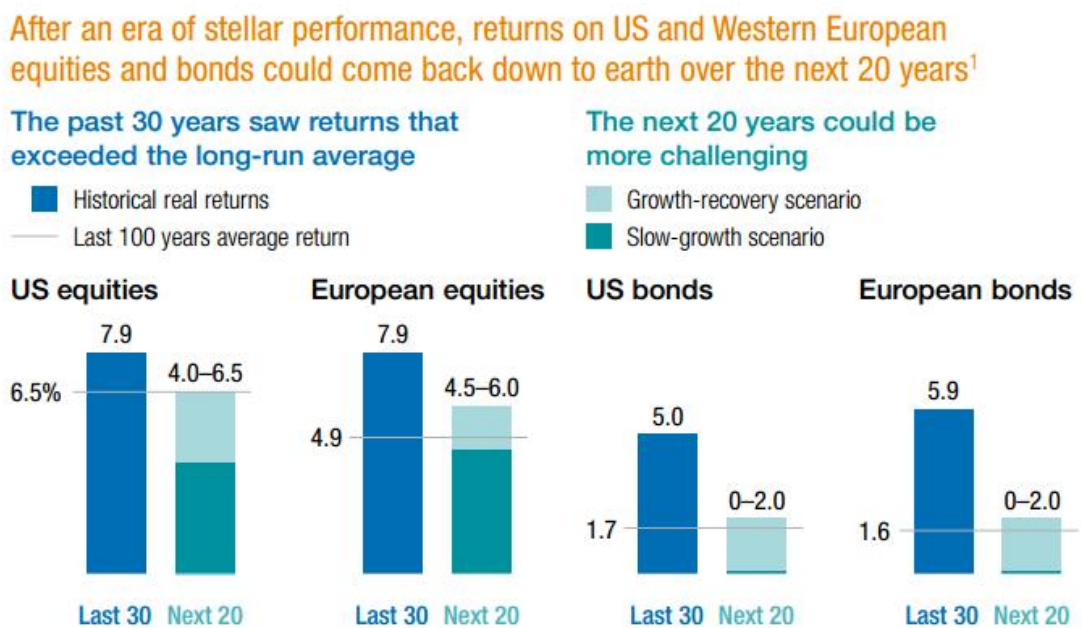
A Golden Age?

"The Past 30 Years Have Been a Golden Age For Investment Returns "

- McKinsey April 2016



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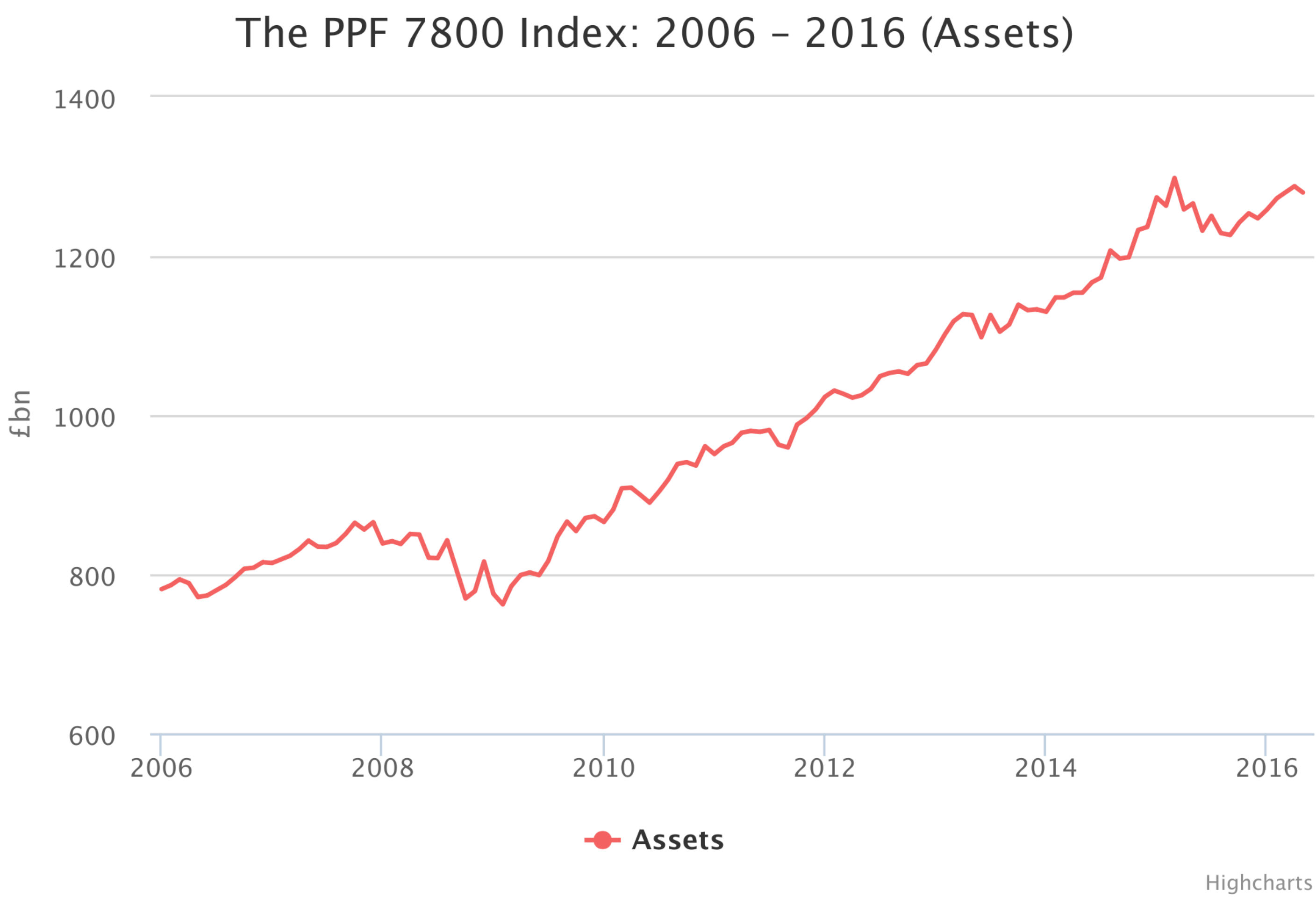
A Golden Age for Pension Funds?



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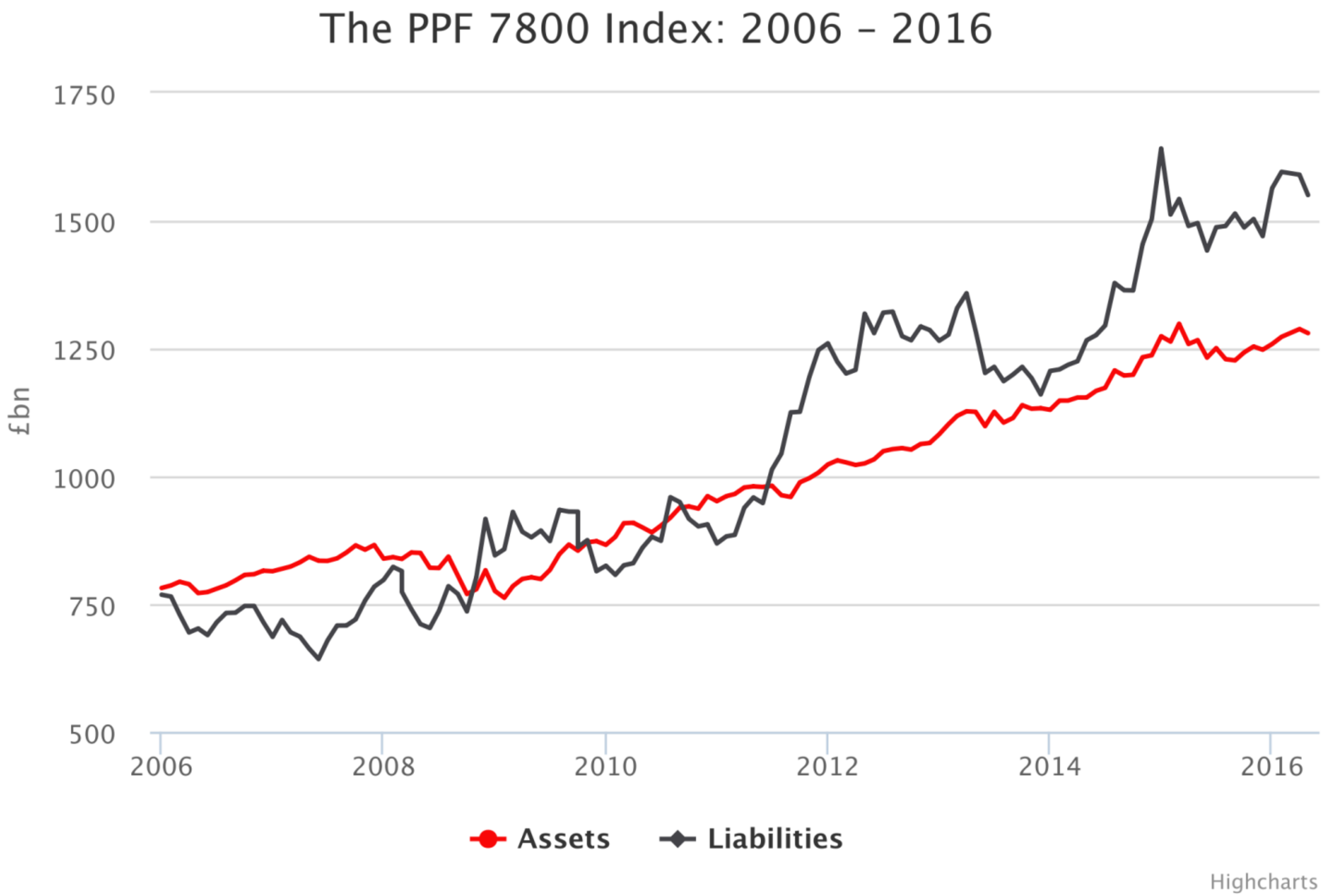
A Golden Age for Pension Funds?



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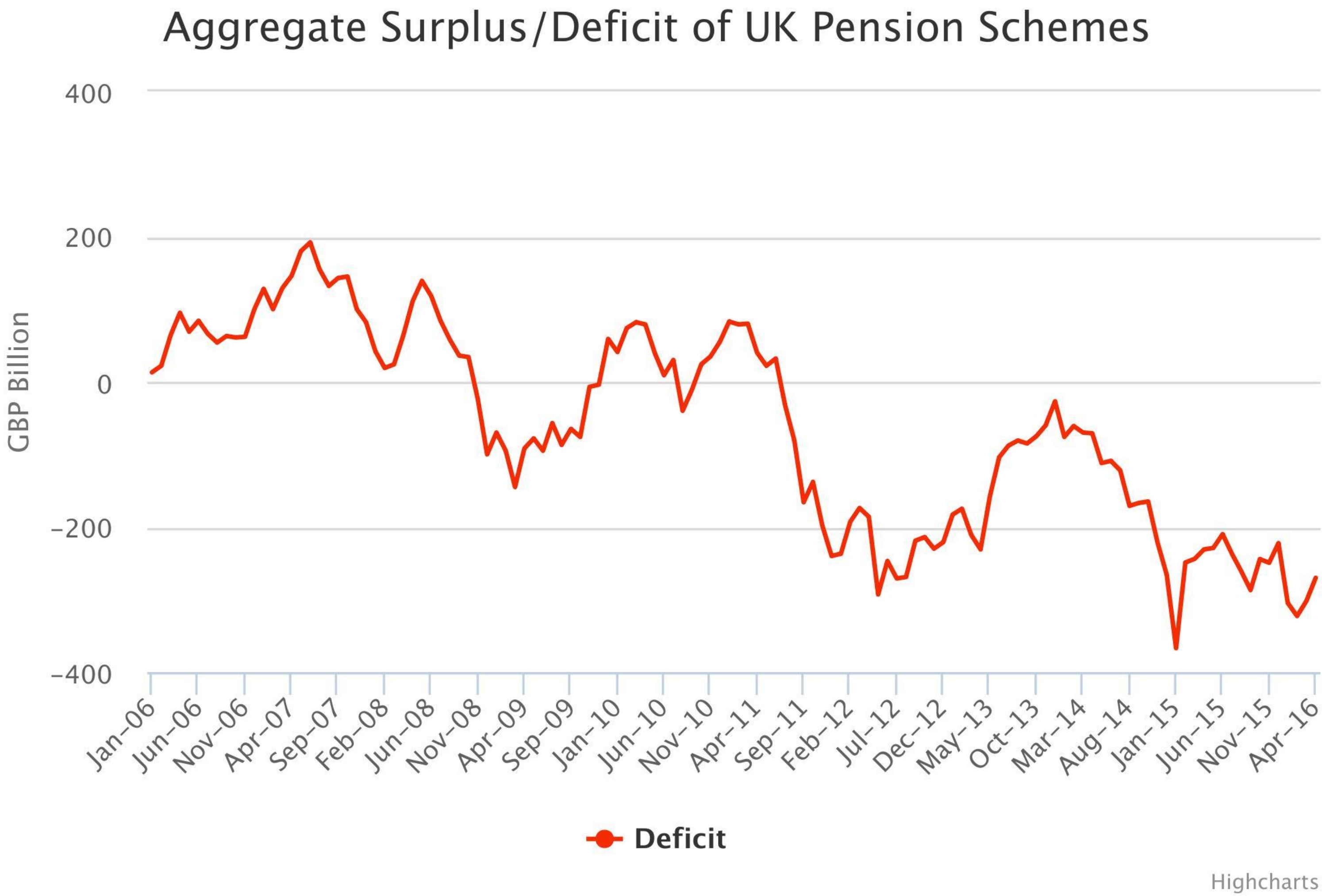

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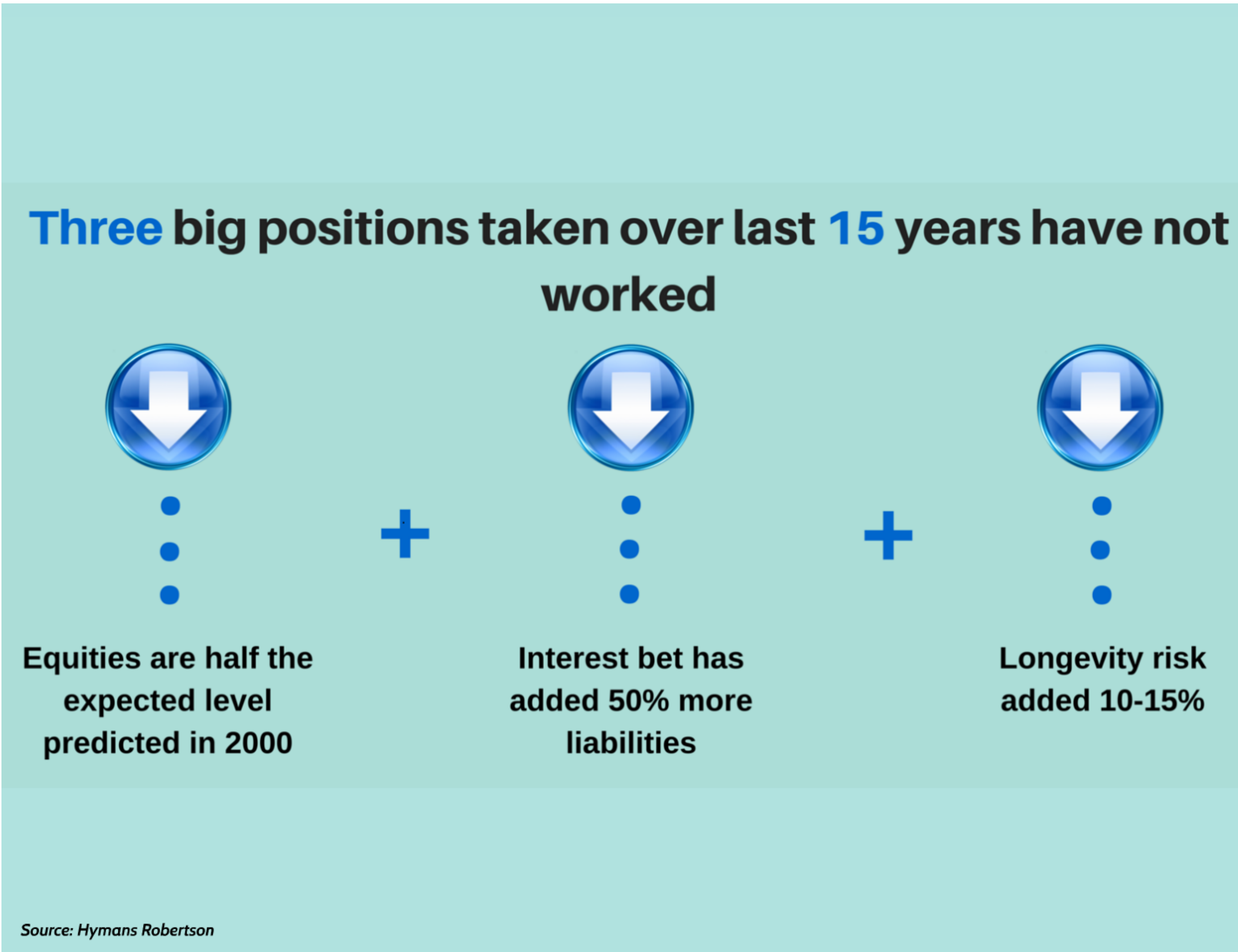
Why?



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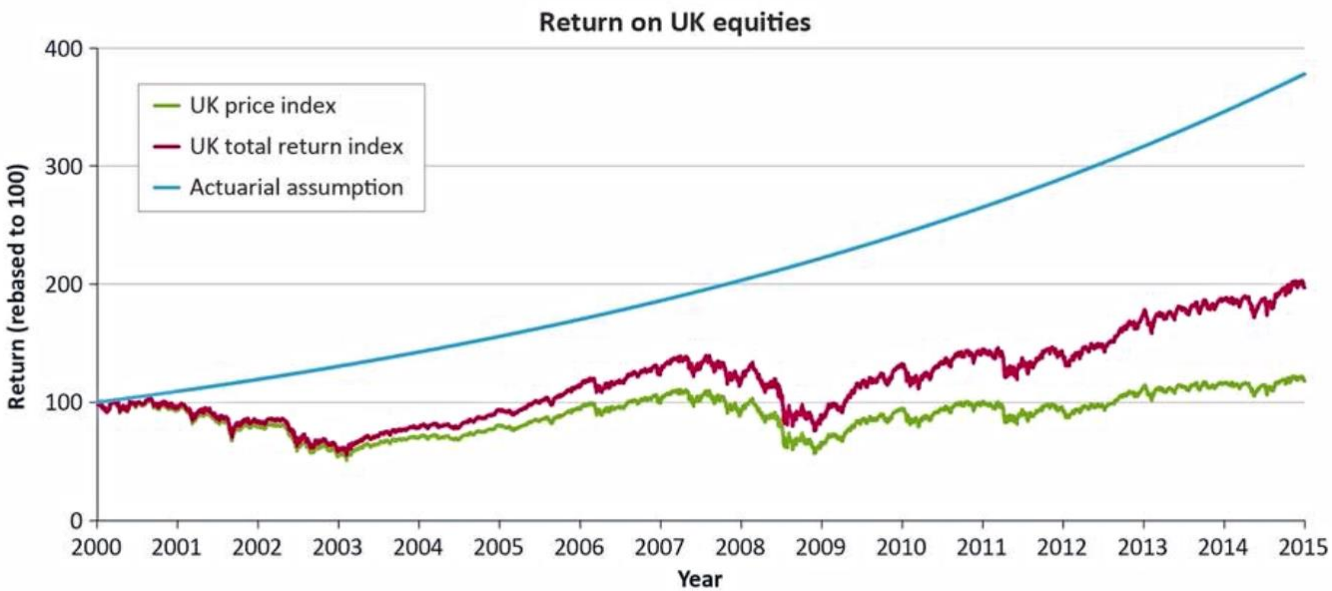
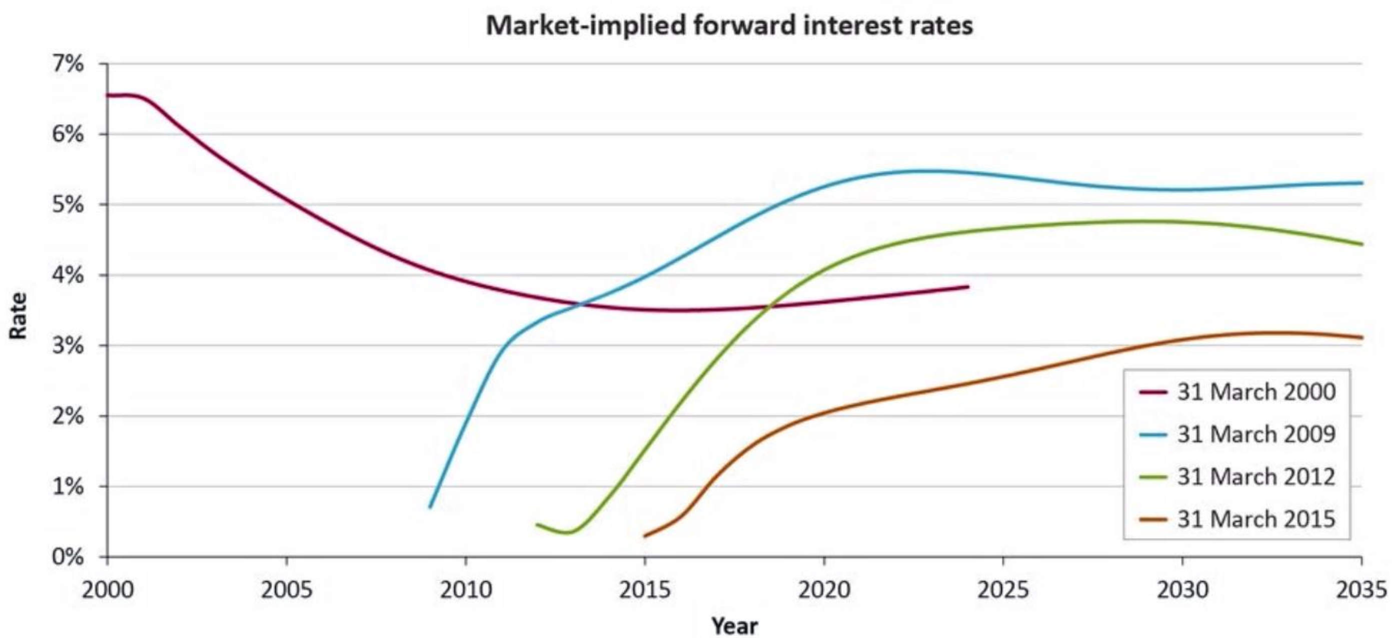


Source: Hymans Robertson



Source: Hymans Robertson

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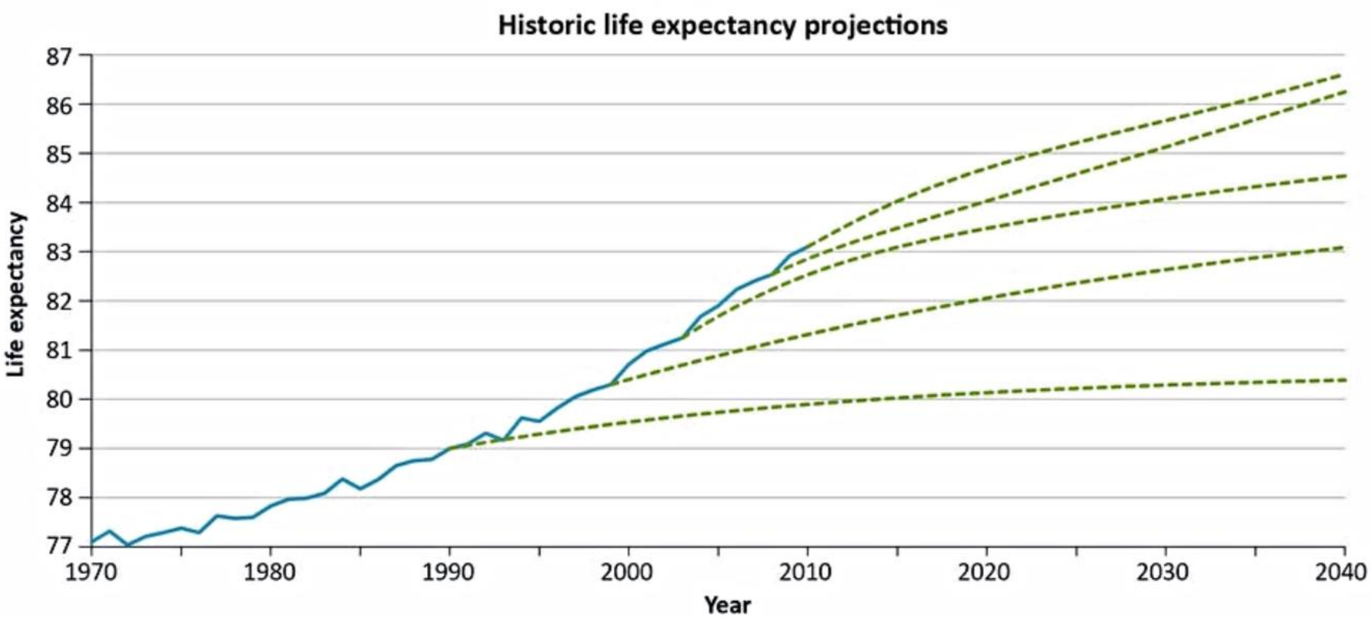
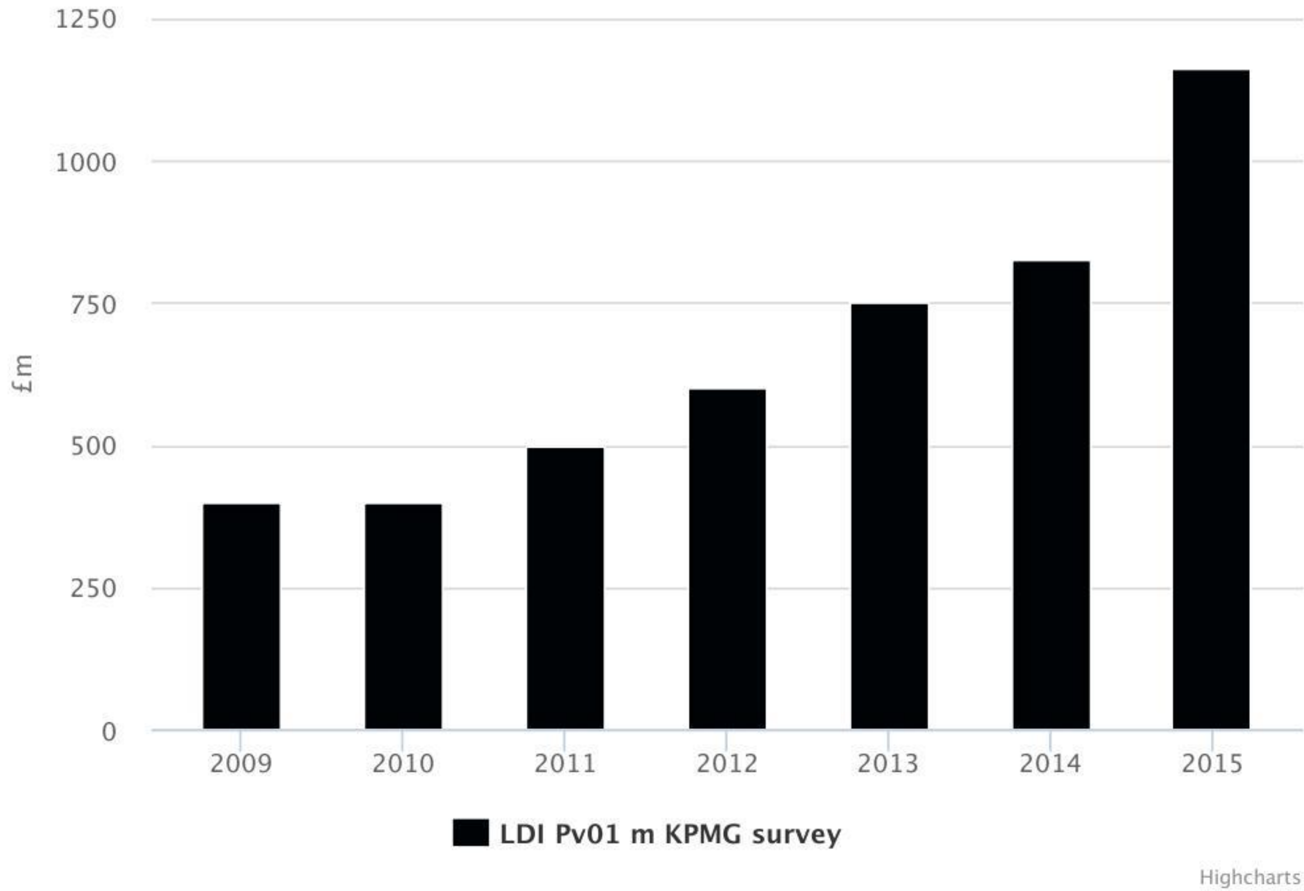


Source: Hymans Robertson

Prepared for the Road Ahead?



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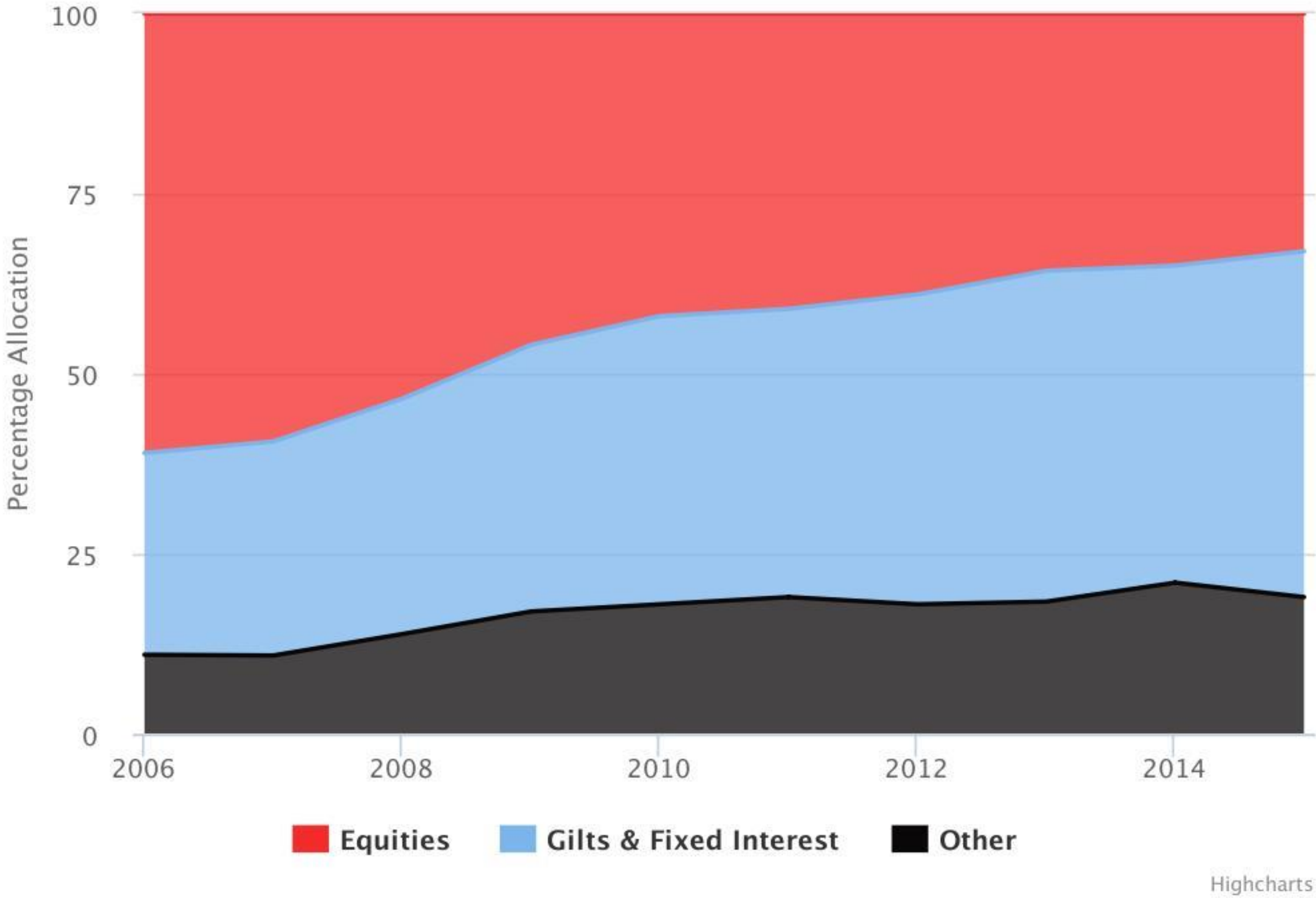
Prepared for the Road Ahead?



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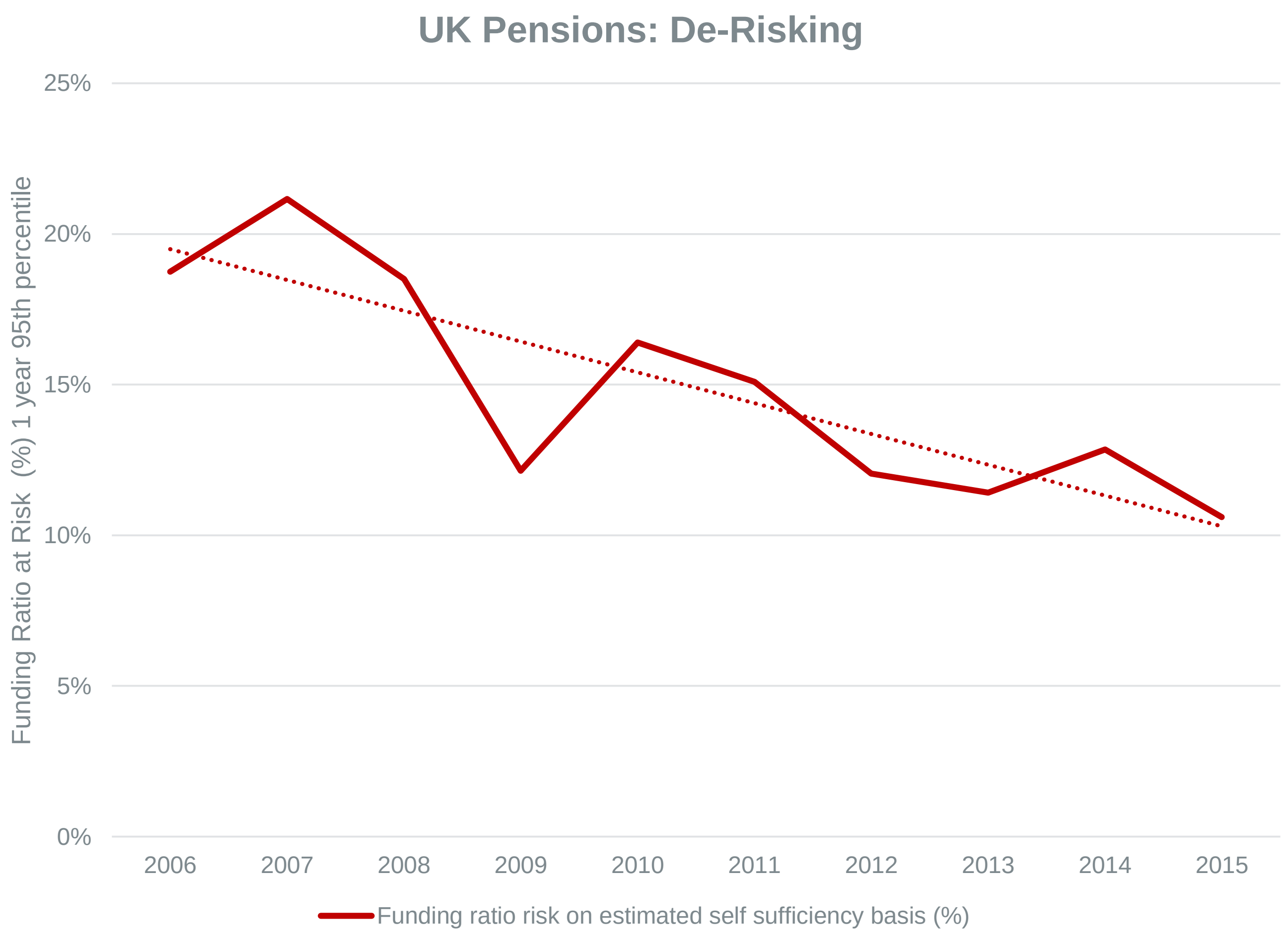
De-Risking



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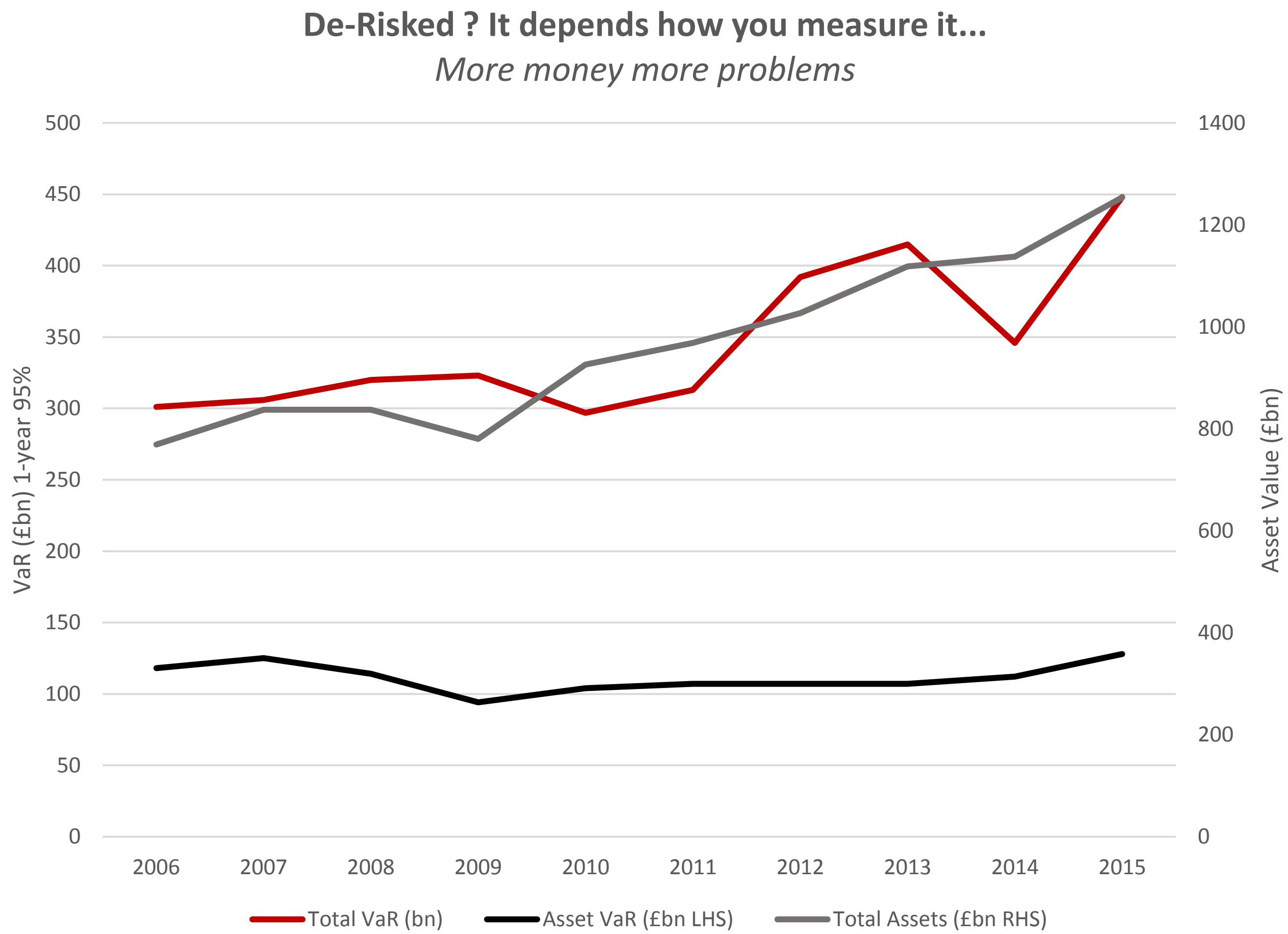
De-Risking?



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De-Risking


Low Risk / Low Return
Less asset-side risk means less return
VaR (%) 1 year 95th percentile
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
2006
2007
2008
2009
2010
2011
2012
2013
2014
Expected returns over cash (% RHS)

On Track?

TP Funding ratio (Gilts +1% on average)

95th percentile	107%	>> Required return Gilts +0%
75th percentile	93%	>> Required return Gilts +1.5%
Median	83%	>> Required return Gilts+2.4%
25th Percentile	73%	>> Required return > Gilts +3%
5th Percentile	56%	

Required returns estimated to 2030, on self-sufficiency basis of gilts+50bps assuming average industry-wide contributions 1% of liabilities per year

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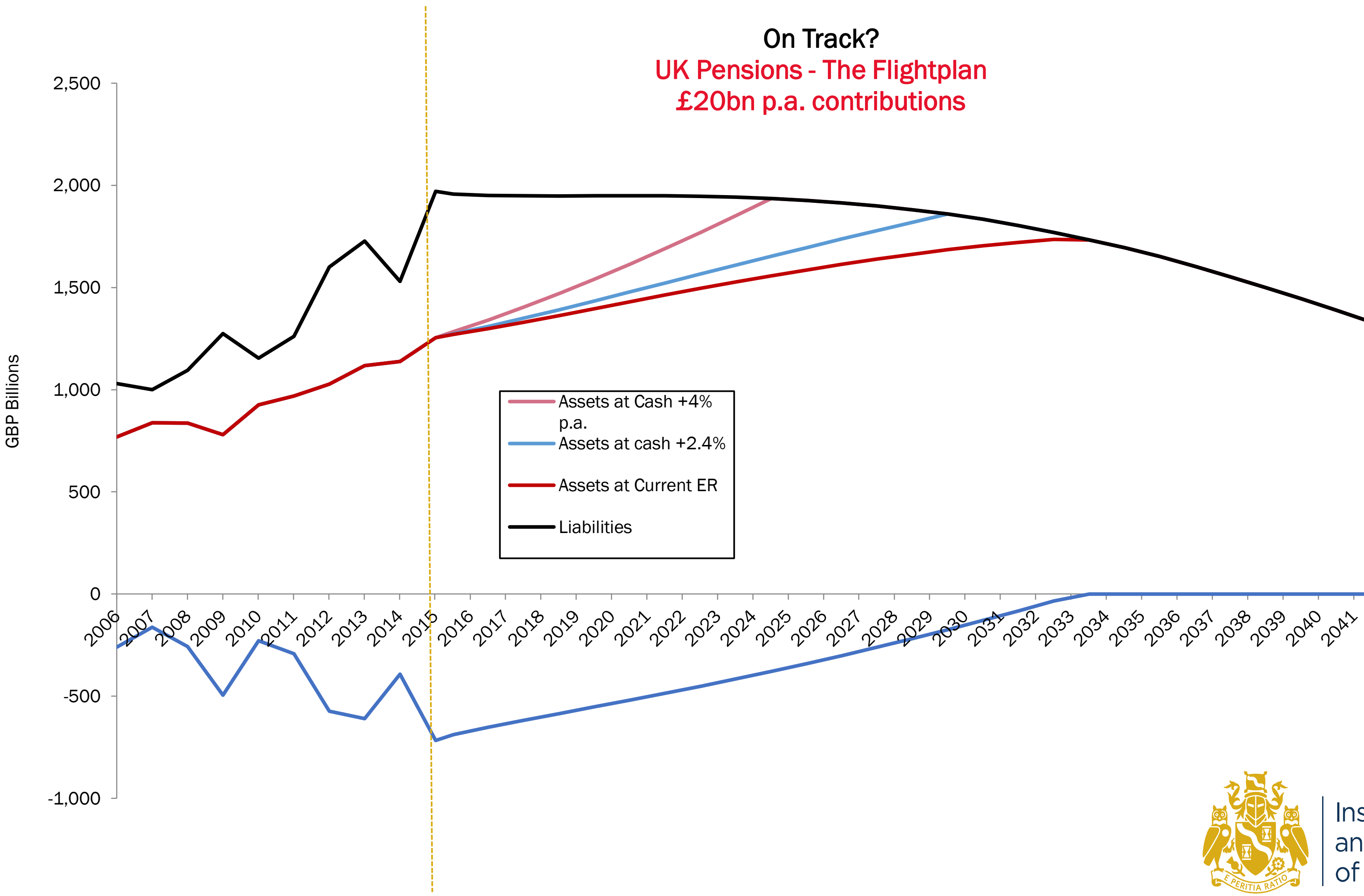
On Track?



On Track?
UK Pensions - The Flightplan
£20bn p.a. contributions
GBP Billions
2,500
2,000
1,500
1,000
500
0
-500
-1,000
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
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2036
2037
2038
2039
2040
2041
Assets at Cash +4% p.a.
Assets at cash +2.4%
Assets at Current ER
Liabilities

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Looking forward

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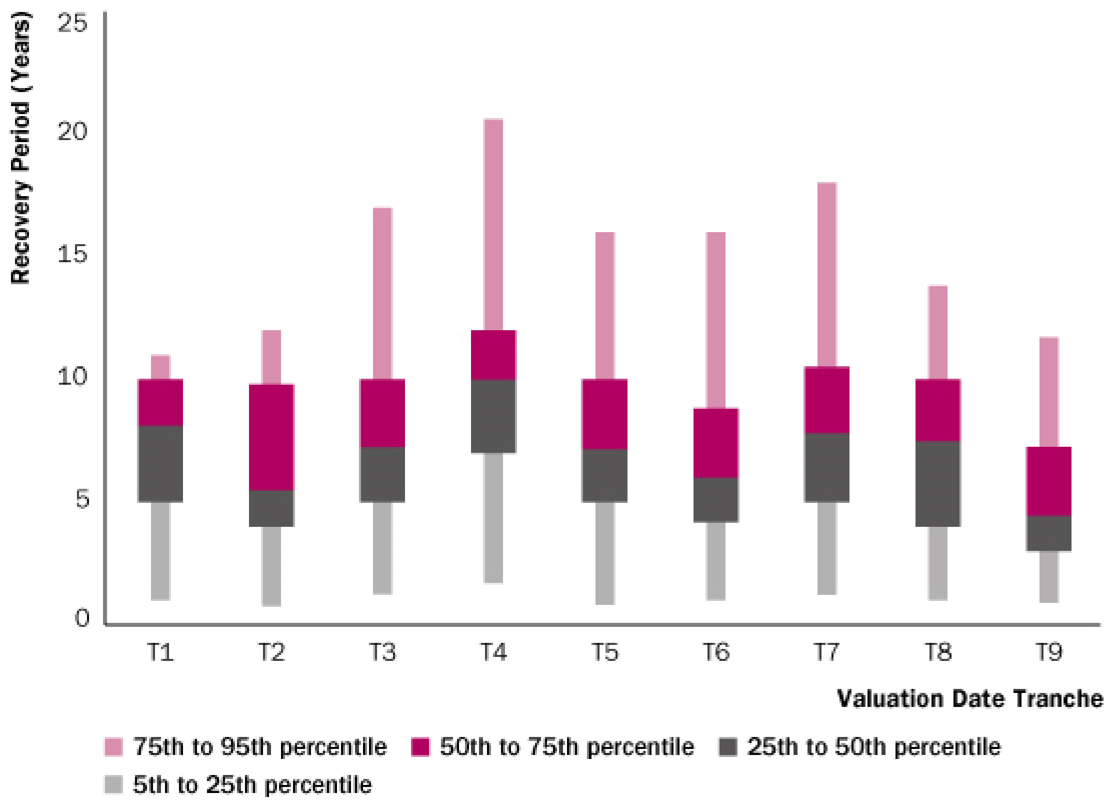
Other Developments

Figure 01 - Trends in the length of the recovery period over time



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A Vital Difference

- Pension schemes are fundamentally in a very different position to a decade or more ago
- Half of Schemes in Negative Cashflow
- This necessitates a very different approach. ***Aiming for asset growth by itself may not work***

> “FTSE350 schemes are already paying out £13bn a year more in pension payments than they receive in contributions, and we expect this to rise to £50bn a year over the next 15 years as schemes mature and deficit contributions turn off.”

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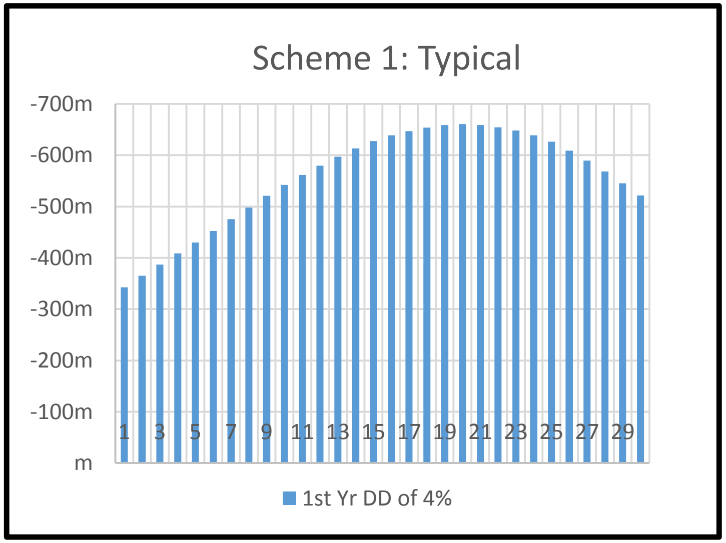
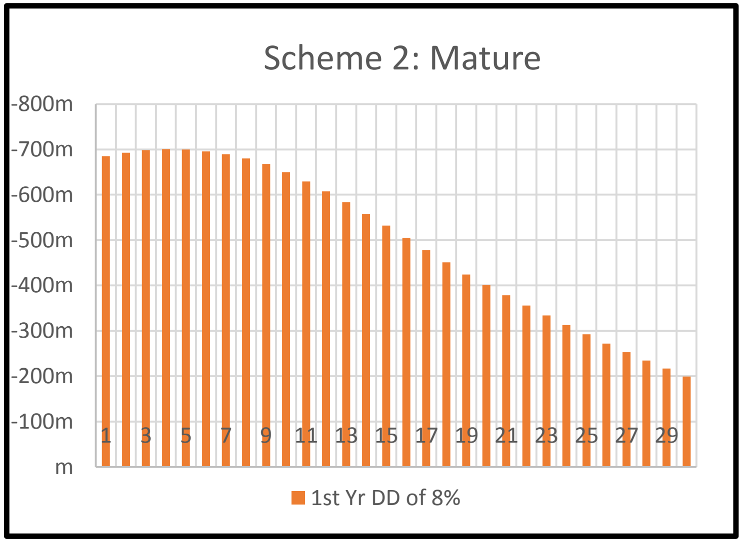
A Vital Difference

- Two very different beasts
- Even with the same asset portfolio





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Windchill – The Impact of Maturity

- Pension schemes with large negative cashflows face extra challenges
- In order to help trustees understand and assess the potential impact of these challenges, we can quantify some of these using ALM tools.
- There are two main impacts of shorter, more drawdown-heavy cashflow profiles:
  - It generally leads to a higher ***Required return***
  - It generally leads to a higher chance that the Required return in the future may increase substantially (i.e. greater ***Required-Return-At-Risk*** "RRaR"),

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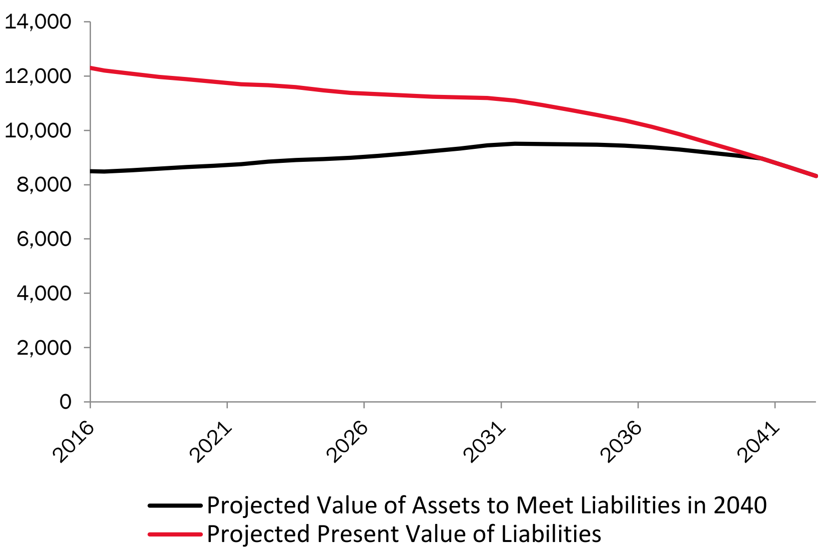
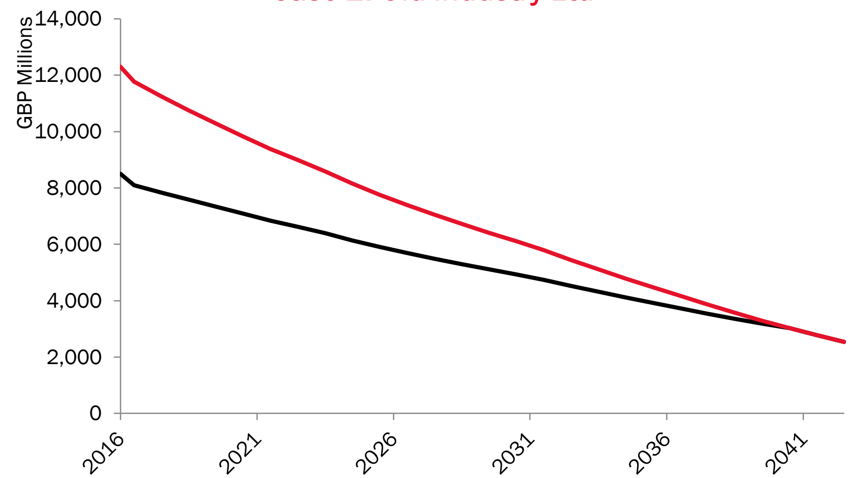
Windchill – The Impact of Maturity

Case 1: New Co. Inc



Case 2: Old Industry Ltd



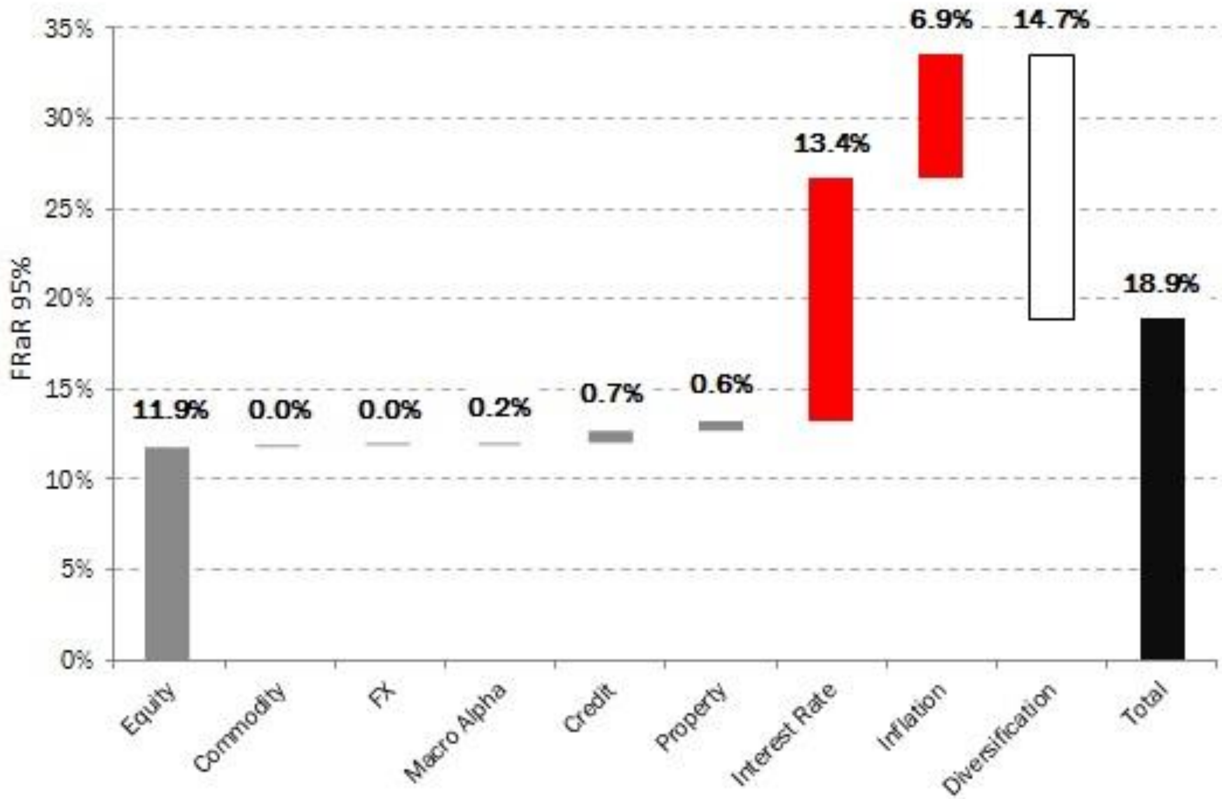
	Case 1
Required Return to 2040 Gilts +	Gilts +2.2%
VaR 95% (£m)	£1.57bn
FRAR (%)	10.3%
Required Return following adverse event (95% 1-year)	**Gilts +3.3% p.a.**

	Case 2
Required Return to 2040 Gilts +	Gilts +3.2%
VaR 95% (£m)	£1.54bn
FRAR (%)	10.1%
Required Return following adverse event (95% 1-year)	**Gilts +5.0% p.a.**

A Five Point Plan

12 May 2016

1. Control the Controllables



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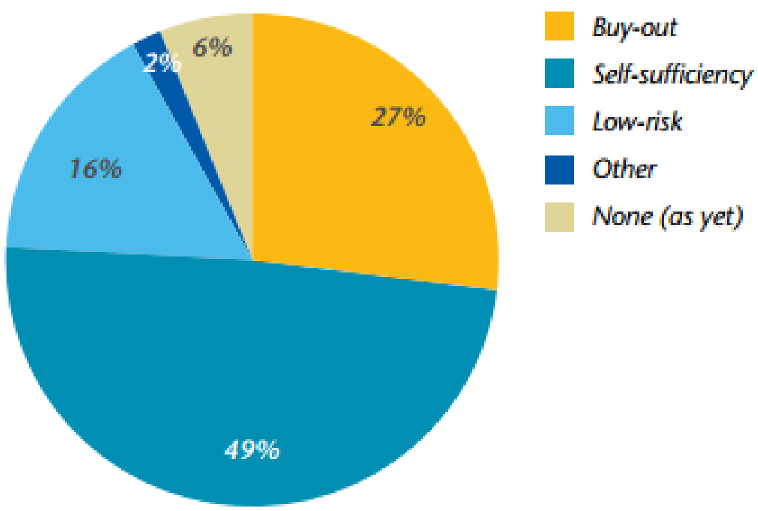
2. Set Clear Objectives

If one does not know to which port one sails, no wind is favourable
- Seneca

Chart 5 – Long-term objectives



Source: AoN Hewitt Global Pension Risk Survey 2015

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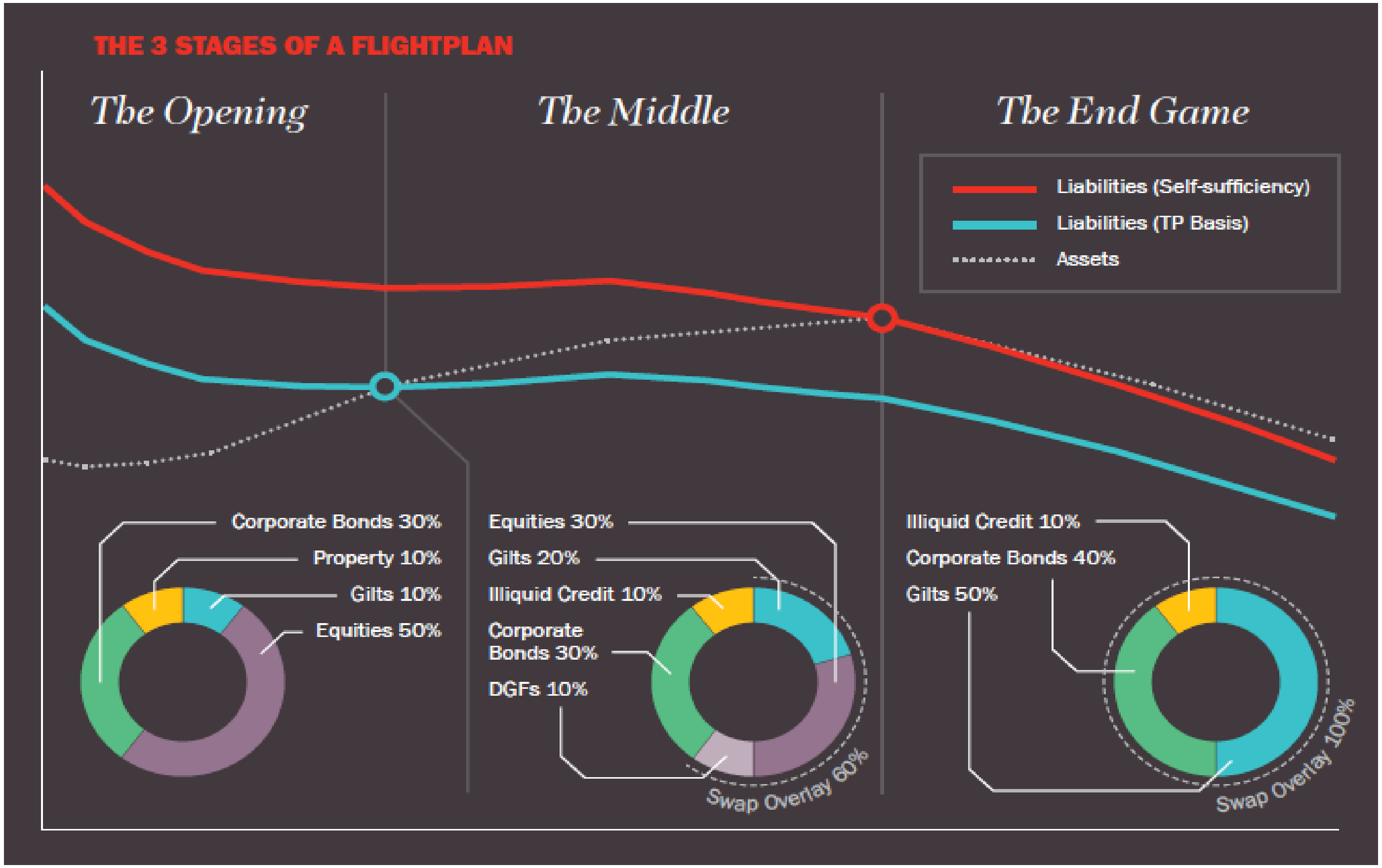
3. Know Where You Are



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4. Use a Framework

Stick to the plan - knee jerk decisions are rarely optimal

Focus on things that matter

Get stakeholders aligned/explain decisions

Capitalise on unexpected good news

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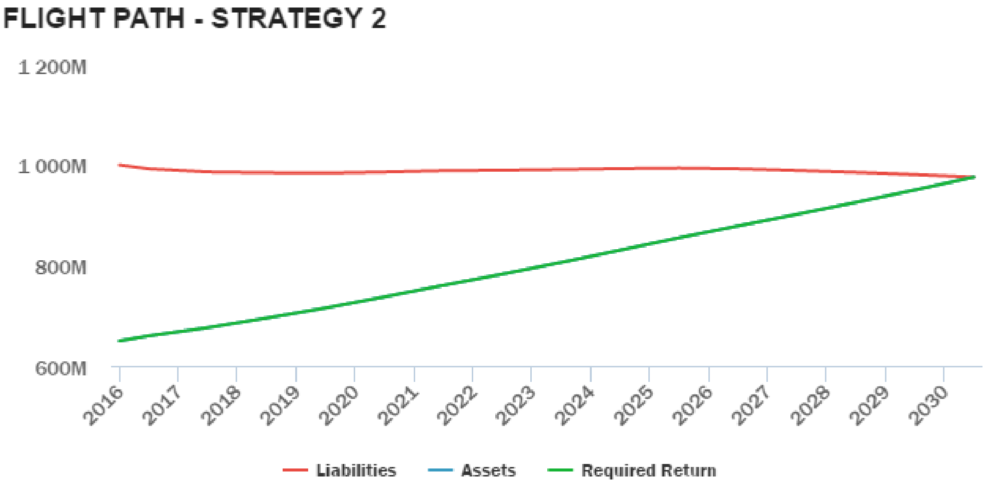
5. Monitor to Stay on Track



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A Five Point Plan

1. Control the Controllables
2. Set Objectives
3. Know Where You Are
4. Use a Framework
5. Continuously Monitor to Stay on Track

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Questions

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