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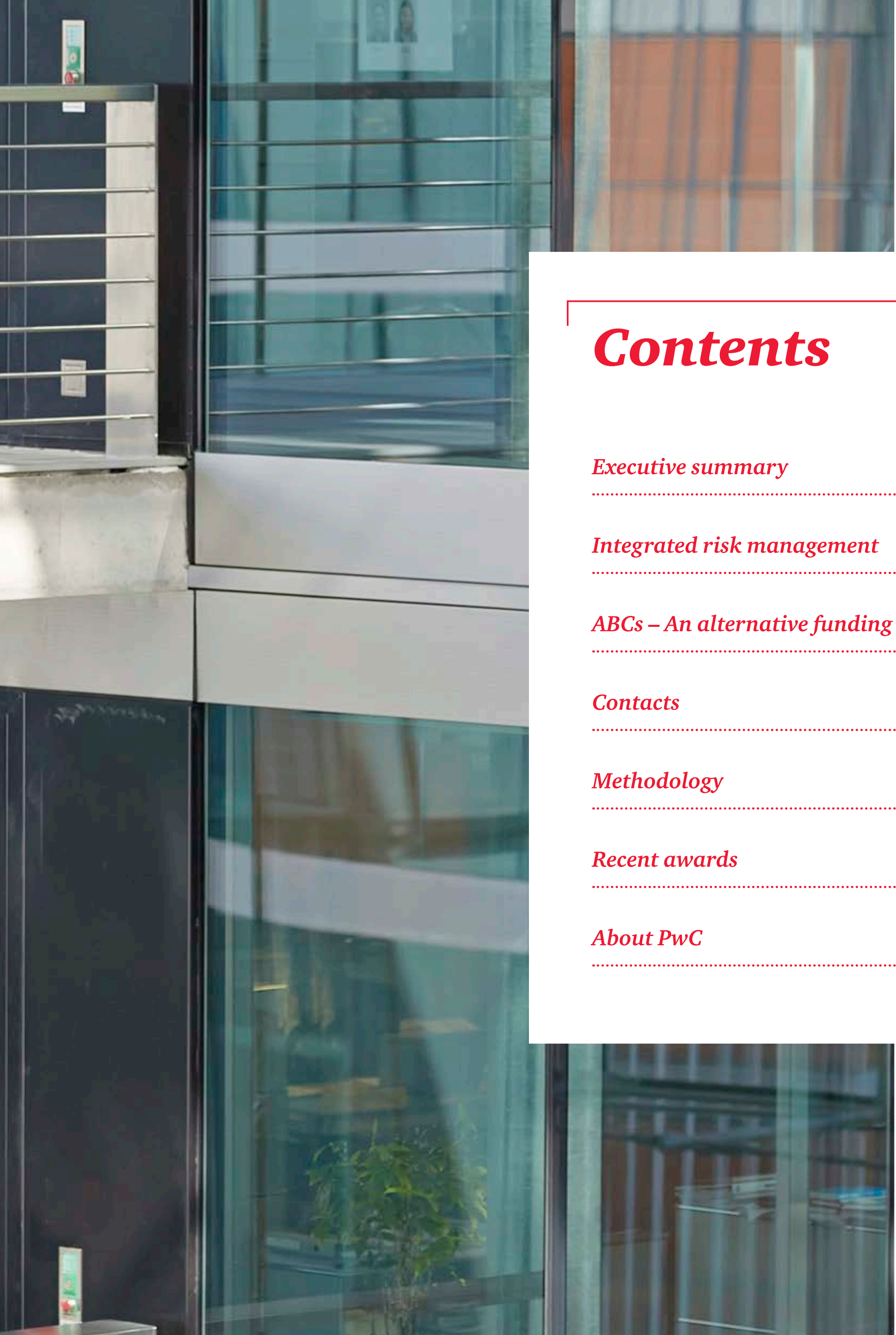
Pension Support Index

The impact of increasing defined benefit obligations on funding and investment strategy decisions

PwC's FTSE 350 Pensions Support Index

May 2015



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Executive summary

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'The UK economy may be out of recession, but pension schemes are not'

Despite continued UK economic growth and inflation trending to 0% in 2014, the Pensions Support Index (PSI), which is a measure of the level of support provided to the defined benefit (DB) pension schemes of the companies in the FTSE 350, has shown a 3 point deterioration from 83 to 80 (out of a maximum possible score of 100) for the period to 31 December 2014. This is the first fall in the PSI score since September 2011, and is driven by a large increase in pension scheme deficits over the year.

The fall in the score was not uniform; the PSI improved by 2 points to 85 in the first half of 2014 due to favourable equity market conditions. However, this reversed in the second half of the year as gilts and equity performance dropped. This fluctuation in the score illustrates the importance of pension schemes being appropriately hedged.

As at December 2014, aggregated pension scheme deficits on a s.179 basis[1] reached £266.3bn, compared with £46.4bn in January 2014. This is due to a 29% rise in pension liabilities in the period, while pension assets only rose by 10%. This trend has continued into 2015, with pension deficits rising a further £101bn to £367.5bn in January 2015 alone.

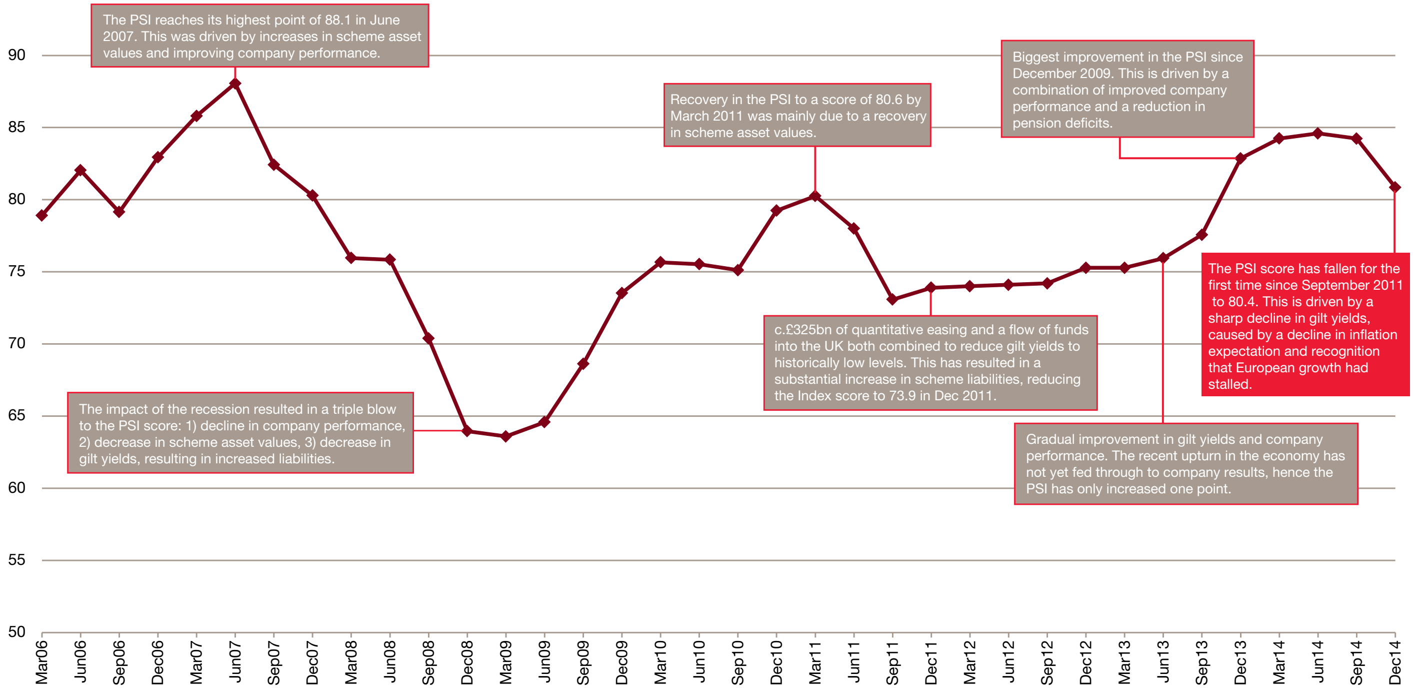
This steep increase in pension liabilities has been driven by a sharp decline in gilt yields, with 15 year gilts yields falling by 138 basis points over the year to 1.8% in January 2015. Gilt yields are often used for discounting future pension obligations, with lower gilt yields leading to higher pension liabilities.

This sharp fall was driven by an increased recognition that the engines of growth around the world were all in danger of stalling. As a result, there was a growing expectation that the monetary authorities would continue to loosen fiscal policy with the associated impact on longer term bond yields. The advent of quantitative easing (QE) in Europe justifies this previous concern and the impact of such a large and on-going stimulus is making itself felt in the markets.

[1] A scheme's s.179 liabilities represent the premium that would have to be paid to an insurance company to take on the payment of PPF levels of compensation.

Sponsors and trustees should be asking themselves what longer term impact this sharp fall in rates should be having on their investment strategy. To many, the answer may be no change. For schemes that have strong sponsors and whose current investment strategy has the combination of matching assets and a well-diversified growth portfolio, changing strategy now may result in increased deficits for no real reason. Indeed, sponsors and schemes who moved into a matching policy for strategic reasons may now be asking themselves if they should take gains for tactical reasons. Those who find themselves in this position, who think further falls are unlikely, should still consider the cost of long term rates rising slower than expected, which to some is perhaps a more realistic proposition that would still have a negative impact on funding levels. It is also worth noting that Trustees and their advisers often have an emotional attachment to derisking – hence overall few are likely to re-risk.

Pensions Support Index Q1 2006 to Q4 2014



For others who have a strong desire to move along a Journey Plan to a better matched portfolio, the basic economics may well need to be ‘recalibrated’. This may involve pushing out the desired end date or changing the contribution/asset return dynamic, but a well-constructed Journey Plan should have identified the potential levers in advance.

Finally, there may be a group for whom this increase in deficit should result in a major rethink on pension strategy. If the scheme is now in such a situation that it cannot really bear the potential volatility but at the same time locking into current levels would impose such a cash strain upon the sponsor that would threaten the viability of the underlying business then a potential restructuring of the pension liabilities may have to be considered.

Nonetheless, the short term impact of ballooning deficits is likely to lead to robust debates about higher demand for cash. This could lead to difficult funding negotiations, particularly if a scheme has a 31 December 2014 or 31 March 2015 valuation date. However, the Pensions Regulator is increasingly stressing how important it is to consider the extent to which the employer can support the scheme (employer covenant) and the scheme investment strategy when setting the discount rate.

In schemes with a stronger employer covenant, the discount rate can take credit for a prudent level of investment out-performance over and above gilt yields. Are trustees truly factoring the employer covenant into the assumption setting process?

It is also important to strike the right balance between giving sufficient cash to the scheme to repair the ongoing deficit and ensuring enough cash is left in the business to facilitate growth. Corporates will also want to protect against the risk of surpluses in pension schemes over the next 10-15 years. One way to deal with this is to use alternative non-cash funding mechanisms, such as Asset Backed Contributions (ABCs). This provides additional security to the scheme but avoids large up-front cash contributions and the risk of trapped surpluses in the future.

Integrated risk management

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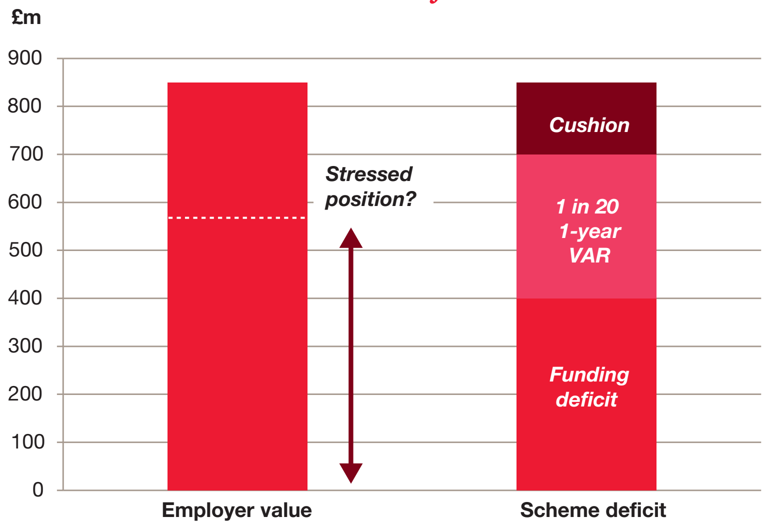
The fall in the Pension Support Index ('PSI') to 80 (from 83) despite an improving economy is attributed to a sharp decline in gilt yields which has increased pension scheme liabilities. However, this fall is by no means universal. The impact of better economic conditions affects the extent to which employers can support the scheme ('employer covenant') in different ways. In its 2014 code of practice, the Pensions Regulator ('tPR') emphasises the importance of understanding employer covenant in the context of its new objective: sustainable growth.

Sustainable growth ensures the employer's ability to grow is not compromised by the needs of its pension scheme. To achieve this, tPR encourages an integrated approach to the management of covenant, investment risks and funding risks ('IRM'). This means that trustees should:
(i) assess the extent to which the covenant can support a 1 in 20 Value at Risk[2] ('VaR') event (see diagram below), and (ii) ensure they factor in the employer covenant when considering their funding valuation assumptions and investment strategy.

Relative value of the employer compared to size of the pension scheme's deficit



[2] After running simulated projections of the scheme's assets and liabilities based on the current investment strategy there is (for example) a 5% chance (1 in 20) that the deficit will increase by more than £xm. The £xm is known as the Value at Risk (VaR).

As part of an IRM strategy, trustees should look to set an investment strategy that finds the right balance between the scheme's risk appetite (its desire to reach full funding within a certain timeframe) and the extent to which the employer can support the scheme should investment returns not to be achieved. We are seeing tPR become increasingly focused on this area, often asking trustees to assess the sponsor's ability to support a 1 in 20 VaR event by assessing the affordability of the increased contributions that would be required in such a scenario.

Rigorous 1 in 20 VaR analysis may have allowed trustees to forecast the potential deterioration of the PSI for their scheme, as it would have identified the risk of gilt yields falling further. Using this information, trustees could either conclude that the employer covenant's strength mitigates the need to hedge interest rate risk or make them consider if de-risking or moving to an alternative investment strategy, such as interest rate swaps, is more appropriate.

tPR also expects the actuarial assumptions chosen by the trustees to link to both the employer covenant strength and the investment strategy. A stronger covenant would typically allow schemes to take a higher level of investment risk, and use less prudent valuation assumptions. If the covenant is weak, the employer may not be able to meet any additional costs if investment returns are not achieved as expected and so a lower discount rate is appropriate. In our experience, the reverse is often found in practice. PwC's 2013 Pension Scheme Funding Survey found that only 27% of schemes set their discount rate in line with an IRM approach.

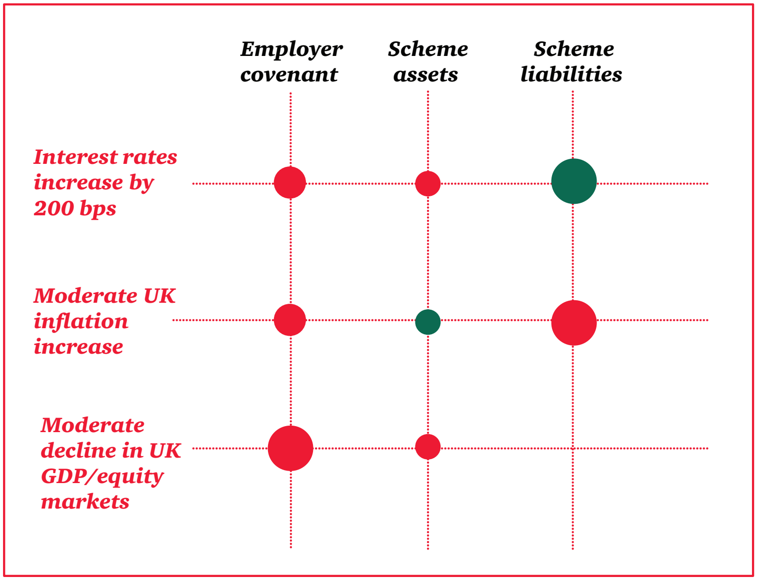
Trustees of schemes with stronger covenants are often keen to de-risk and lock-in more prudent assumptions (and possibly higher cash contributions) given the inherent uncertainty in assessing the longer-term outlook for businesses. Conversely, schemes with weaker covenants have sponsors which are often unable to afford the higher contributions and funding requirements to allow for de-risking. Taking an integrated approach to risk management should involve sponsors and trustees engaging on the scheme's longer-term strategy and objectives, and this can help shape consensus on the optimal route for reaching those objectives.

Trustees could also analyse where to allocate the scheme 'risk budget' by assessing the correlation between sponsor and scheme risk. This analysis can, at least initially, be at a high level, and the objective would be to identify where trustees should prioritise risk reduction measures. There may be natural hedges between the sponsor and scheme, for example if a rise in inflation would be negative for the sponsor but be partly offset by the positive effect on scheme assets (see diagram overleaf).

Conversely, there may be macroeconomic scenarios that adversely affect both the sponsor and scheme at the same time. In addition, the scheme's key investments may be correlated with sponsor performance, either as a result of being exposed to the same industry as the employer, or being subject to similar macroeconomic trends. Trustees may decide to undertake more sophisticated modelling, for example using stochastic modelling techniques for both sponsor and scheme performance, where they identify particular risks and then take steps to mitigate these risks, at the very least to ensure that the residual covenant is strong enough to support the scheme in the event that these risks materialise.

Going forward, tPR considers effective risk management to be an ongoing process as employer covenant, investment performance and scheme funding levels can change rapidly. Trustees are expected to monitor these changes and review the appropriateness of their strategy. Again, we are seeing tPR becoming increasingly proactive in this area; not only around the level of monitoring that schemes should be doing, but whether schemes have agreed appropriate contingency plans and actions in the event that downside risks materialise.

Matrix showing the correlation of company and pension scheme risks



ABCs – An alternative funding solution

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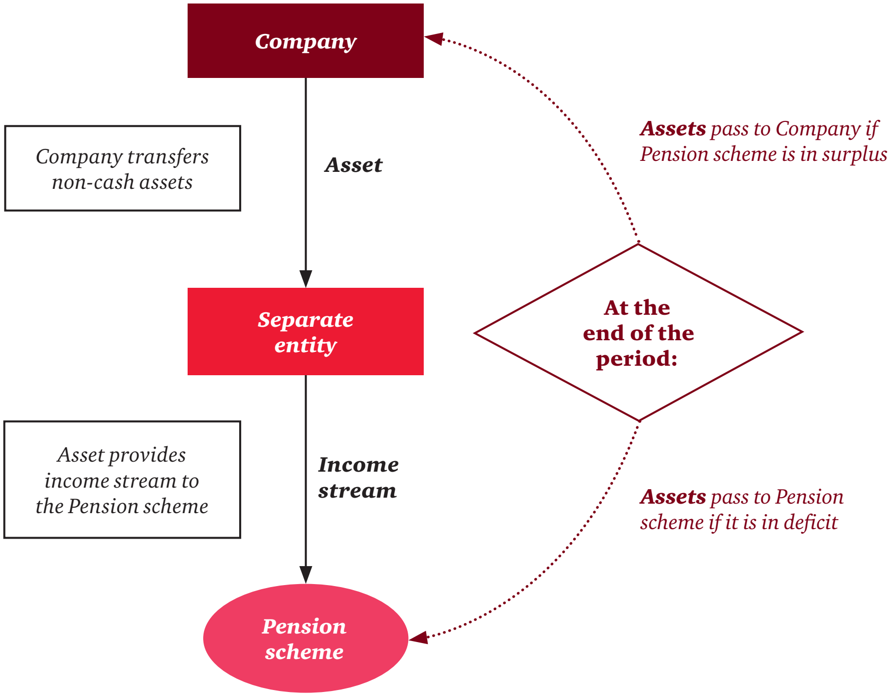
The recent increase in pension deficits and accompanying higher cash demand from pension schemes has encouraged even more trustees and corporates to consider innovative non-cash funding mechanisms such as Asset Backed Contributions ('ABCs').

ABCs are a contractual arrangement between a defined benefit pension scheme and the sponsoring employer's group, under which the employer or another group company agrees to transfer an asset to a 'special purpose vehicle' ('SPV'). The pension scheme then receives a pre-agreed income stream which is generated by the asset for a specified period. Trustees will usually give this a net present value and treat it as an asset that will go to reducing their scheme deficit. At the end of the period, any surplus value in the SPV can either be returned to the employer if the scheme is in surplus, or to the pension scheme if it is still in deficit. The scheme may also have security over the assets in the SPV over the life of the structure, providing additional protection in the event of insolvency.

Structuring an ABC



The first ABC was put in place in 2007 by Marks & Spencers, who transferred a £500m interest in a property to their pension scheme. Since this date, the total value of ABC transactions has reached over £9bn. Costs of implementation continue to fall, allowing smaller schemes as well as larger schemes to consider such vehicles.

This rise in popularity is driven by the sharp increase in pension deficits, which means schemes are increasingly turning to ABCs in an attempt to immediately improve funding levels, whilst also reducing the cash burden on the employer and minimising the risk of trapped surpluses in the future. Implementation has also become more straightforward, with ABCs now operating in an agreed tax and regulatory framework.

Although property remains the most commonly used asset to support an ABC structure (representing 66% of transactions) over the past three years, we have seen an increased number of clients using a wide variety of assets and SPVs. We have seen first-hand the use of loan notes (DMGT), property (Qinetiq) and shared equity debts (Persimmon) as assets, and six reservoir trusts used as SPVs since 2008, including by BAE Systems and Invensys.

ABCs provide a number of benefits to both the employer and the scheme. Firstly, ABCs can help to reduce the scheme's funding deficit and the levies payable to the Pension Protection Fund ('PPF').

Secondly, by deferring or reducing the cash cost of funding the scheme, the employer can invest the cash savings in business development. This in turn may strengthen the employer's long-term covenant, thereby reducing future funding requirements as part of an integrated risk management approach.

Other benefits include: an ability to take either up-front or deferred tax relief (subject to HMRC's requirements being met); reducing the risk of trapped surplus in the scheme; and providing additional security to the scheme against investment risk and employer covenant risk.

Despite these benefits, ABCs have become increasingly scrutinised by the Pensions Regulator ('tPR'). Concerns include: the reduction in cash contributions even when, in some cases; the employer's affordability is unchanged; the long term nature of ABC structures leading to an extension in the recovery plan and increased risk of the scheme being underfunded if the employer fails before the end of the payment term; and the inflexible nature of the pre-determined income streams. The latter two issues should be addressed if an appropriate structure is put in place that will provide security to the scheme in the event the employer goes insolvent. Any shortfall in the pre-determined income stream should also be identified as part of the scheme's triennial valuation and additional cash contributions should be agreed.

tPR also highlights the importance of trustees taking independent valuation and legal advice to ensure they are comfortable that the asset used in the ABC provides adequate support for the payments promised, they have sufficient legal claim over the asset, and they appreciate the risk of any change in law which could impact the validity of such arrangements.

The guidance to trustees from tPR, combined with regulatory framework mentioned above, has made ABCs more understandable and straight forward. We think that over the next few years, ABCs will continue to rise in number and become more innovative despite the volatility in pension deficits. ABCs can prevent the trapping of surpluses when deficits fall, and reduce the cash requirement from the employer when deficits rise.

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Methodology

The Pensions Support Index tracks the relationship between the financial strength of FTSE 350 companies and their DB pension obligations, indicating the overall level of employer support offered to these pension schemes.

Ratio analysis is performed on these financial measures against estimated self sufficiency pension deficits.

Each ratio is given a score with reference to set boundaries which have been determined by applying our experience and market expertise.

Within our Index, we assume schemes have full group support and we take no account of contingent assets. Contingent assets often have a beneficial impact on the level of support available to schemes. Equally, if full group support is not available then this will often have a negative impact on support levels.

The Index should not be viewed as a replacement for an employer covenant review or other professional advice.

Our Index considers the key components of employer support

Net assets
the extent to which the assets held by the company can cover the pension scheme deficit

Operating profit
the ability of the trading profit to cover the deficit in the longer term

Profit before tax
as per operating profit, but also takes into account exceptional charges and net interest costs

Cash from operations
a measure of the extent to which the company is able to generate enough cash to service the deficit in the longer term

Market capitalisation
an indicator of the future value generation of the business in the longer term and the extent to which this provides comfort that the deficit can be met

Deficit measures

'Accounting Basis':

As recorded in the company's balance sheet, under IAS19.

'Scheme Funding Basis':

As calculated by the scheme's actuary for the purposes of the actuarial valuation. This is the deficit that needs to be funded by the company and is generally higher than the Accounting Basis.

'Self-sufficiency Basis':

A self-sufficient basis considers that the scheme will never again have the support of an employer and will have no way of generating income, other than by investing its own funds.

'Buy-out Basis':

The cost of a full buy-out of the liabilities with a regulated insurer.

Index scores – Definitions and characteristics

Similar to the FTSE indices, our Index tracks average performance, in this case the ability of FTSE 350 companies with DB pension schemes to support their associated DB pension obligations, and again, like the FTSE, performance within the Index itself varies considerably.

Index score	*Definitions and characteristics*
More than 90	Would indicate that the legacy DB pension issue in the UK has been largely addressed.
75 – 90	Suggests that the majority of companies will have addressed their pensions issues. However, there will be a need for continual monitoring of individual employers.
50 – 74	Suggests that the majority of companies will be able to meet their pension deficit payments as they fall due. However, there will be a proportion of schemes which are large relative to the size of their sponsoring employer. For these schemes there is material risk to members' benefits.
Less than 50	Would indicate that there are many schemes where there is a risk of a cut in members' benefits resulting from the failure of the sponsoring employer.

Recent awards

Awards include the 2015 Professional Pensions UK Pensions Awards for Sponsor Covenant provider, plus those set out below.

Sponsor Covenant Provider
Professional Pensions UK Pensions Awards 2014

Covenant Review Provider
Pensions and Investment Provider Awards 2013

Covenant Review Provider
Pensions and Investment Provider Awards 2012

Employee Benefits Consultant
Pensions and Investment Provider Awards 2012

Pension Scheme Accountant of the Year
Professional Pensions UK Pensions Awards 2012

Covenant Review Provider
Pensions and Investment Provider Awards 2011

Employee Benefits Consulting
Pensions and Investment Provider Awards 2011

Pensions Accountant
Pensions and Investments Provider Awards 2011

Actuarial Consultancy
Professional Pensions UK Awards 2011

Sponsor Covenant Provider
Professional Pensions UK Pensions Awards 2010

About PwC

PwC's market-leading pensions credit advisory practice is made up of a multidisciplinary team comprising pensions actuarial, investment, reward and administration specialists together with experts in transactions, corporate finance, tax and legal, assurance and accounting, valuation and strategy, structuring, insolvency and credit analysts. As such, clients benefit from specialist pensions advice supported by teams with wide-ranging commercial acumen and business knowledge.

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