

# ***Pensions Support Index***

## PwC's view of defined benefit pensions covenant across the FTSE 350

*Pensions Support Index*

*June 2017*



# Don't bet on your defined benefit



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## Defined benefit members shouldn't take future pensions for granted

### Key considerations

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#### Overall support falls

Low gilt yields post the EU referendum continue to drive up the present value of pension liabilities, outweighing growth in corporate strength and scheme asset performance.



A

K



#### Recovery is potentially further off

The recent move in the US Federal interest rate could start an interest rate shift, but the UK will be slow to follow due to Brexit uncertainty.



K

J



#### Is time running out?

There is increased pressure to act as some schemes, particularly those with weaker covenants, begin to reach maturity.



J

Our Pensions Support Index (PSI) measures the ability of companies in the FTSE 350 to support their defined benefit promise. Rather than just looking at the absolute size of the obligations, we compare the deficit number to the cash generation, profitability and assets of companies supporting their schemes.

Our last report highlighted that continued low gilt yields had been suppressing the Index, and these fell even further during 2016. This is feeding through into 2017 valuations, where schemes that are well hedged against this risk have been the winners.

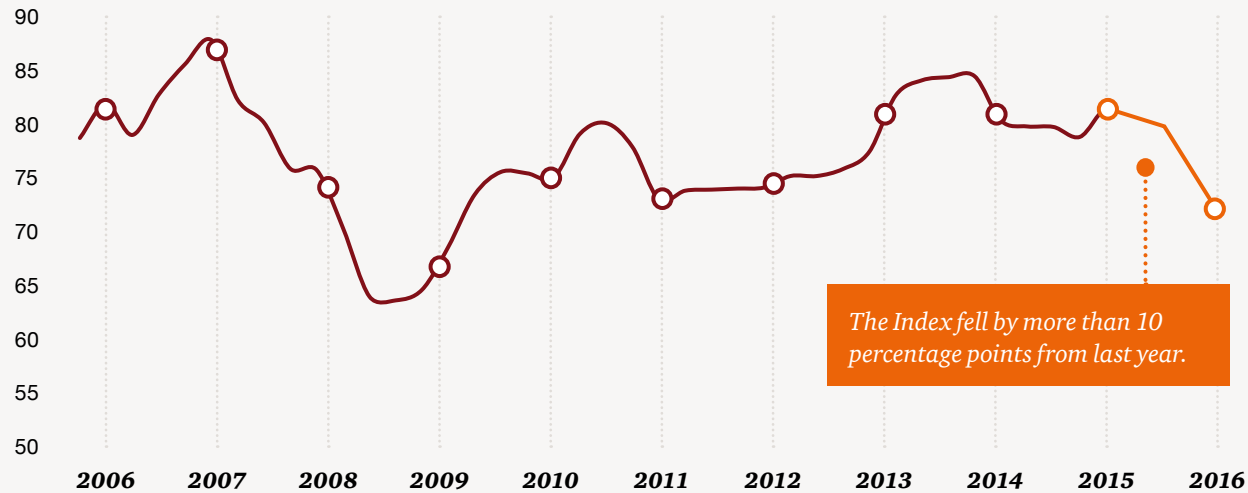
However, there has been ongoing divergence in covenant strength for others, particularly with some sectors and schemes boosted by the impact of the weaker pound on their businesses and investments. The Pensions Regulator has highlighted this stress on defined benefit pensions – estimating 5% of schemes in this valuation cycle are at risk of, or already failing to, meet obligations.

How can schemes hedge their bets and manage returns? There is a growing appetite for “matching plus assets” as a viable option to achieve this.

To successfully navigate this challenging environment, schemes will also need to pay close attention to what's around the corner. We anticipate a tougher regulatory environment, an emphasis on integrated risk management and the potential transition from the Retail Price Index to Consumer Price Index. Technology will also be a key influence impacting the pensions market.

With the current global political uncertainty, now more than ever, schemes need to focus on the hand they play.

## PwC's Pensions Support Index: tracking corporate health versus defined benefit pensions deficits



### Today's Index: Biggest fall since the last recession?

2016's political surprises have taken their toll on UK defined benefit pensions.

Whilst corporate performance has been respectable (particularly for overseas revenues benefiting from weak sterling), the rush for safe assets has pushed gilt prices up and yields down, hitting the valuation of defined benefit liabilities very hard.

The net result for the PSI is the lowest score since the last recession, but with less and less time to fix things as schemes approach maturity.

*As schemes start to mature, the persistent low yield environment leads to vital questions:*

#### How to balance risk with returns?

Schemes that have hedged interest risk have fared best, but how can this be balanced against returns in the current environment?

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#### Are people moving away from gilts-plus valuations?

Many with strong covenants have questioned whether the valuation method should more closely reflect their investment strategy.

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#### Will rates stay lower for longer?

Whilst there are positive signs from the Fed's lead, will rate increases be held up by Brexit?

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#### What's next for the pensions space?

Ongoing evolution of the pensions market, from the Pensions Regulator through to "gamification" to aid member communications.

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# How to balance risk with returns?



**Sinead Leahy**  
Pensions Investment Partner

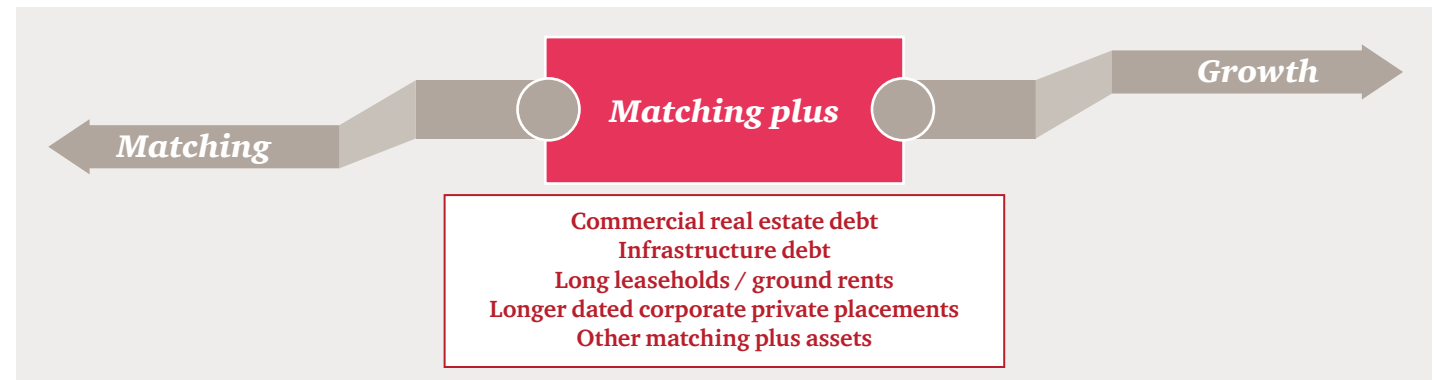
*“Schemes that continue to wait for yields to rise are running a dangerous strategy if they can’t handle the downside risk. Many are now facing the difficult question of when not if their schemes will become cash flow negative.”*

*Schemes should consider having a proportion of matching plus assets.”*

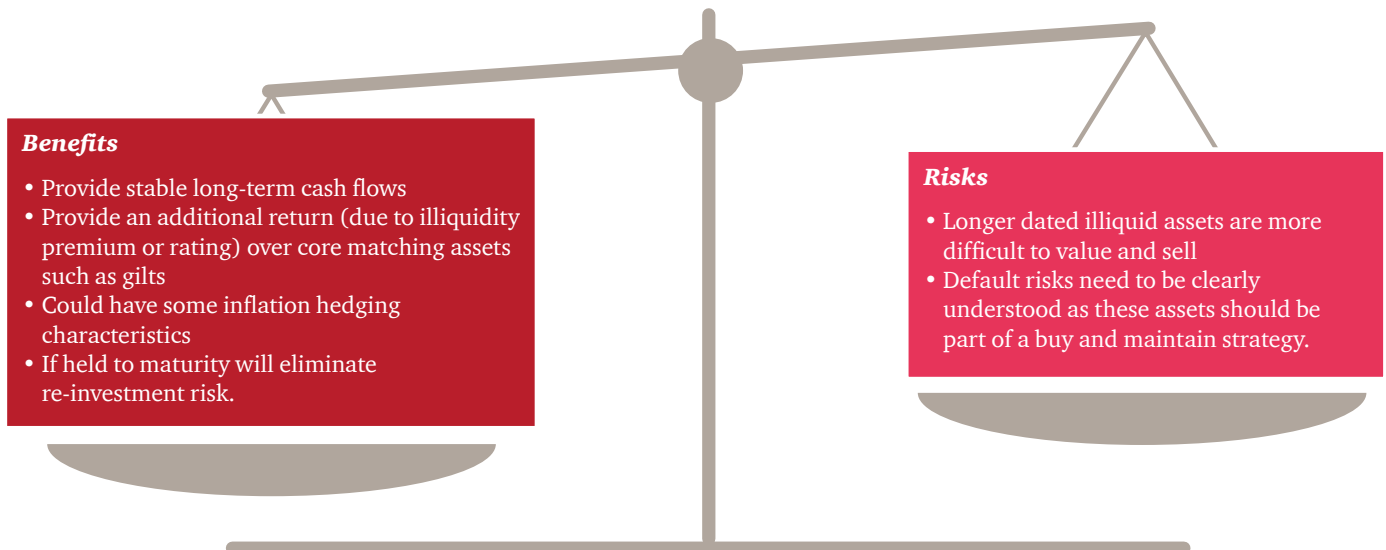
## Managing risk and return in a low yield environment

With gilt yields being the primary driver of the fall in the PSI score, whether and how to hedge interest rate risk remains a key concern. But as schemes continue to mature, attention is increasingly turning to meeting scheme cash flow obligations – both transfers out and pensions in payment.

There is a desire by many to understand the risk of negative cash flows and the likelihood of becoming a forced seller of assets to pay liabilities. The fall in yields of traditional matching assets has opened up appetite for matching plus assets that hedge risk but also provide a better return, particularly as schemes approach maturity.



## Benefits and risks of matching plus assets



The Pensions Regulator's Annual Funding Statement notes that "the current debate on the approach to discount rates focuses on whether historical relationships between gilt yields and returns on other asset classes still hold true for the future".

As investment strategies broaden to encompass a variety of non-gilt long-term matching asset classes, there can be an argument to consider an asset-led discount rate that better reflects the returns of the investment strategy. However as the Regulator's note points out "when reviewing the discount rate approach, trustees should consider its suitability taking into account their plan for achieving their long term objective and their current position relative to it" and trustees changing the method used to set the discount rate following their review should have a sound rationale behind the change and document it clearly.



## A question of valuation methodology?



**Richard Cousins**  
Scheme Financing Leader

*"As schemes move towards more of a cash flow matching approach questions often arise as to the most appropriate way to value the liabilities for Scheme Funding."*

*A discount rate that prudently reflects the expected return across all assets may prove a better fit in the context of the company's covenant, appetite for risk and views on investment strategy."*

# Will rates stay lower for longer?



**Andrew Sentance**  
Senior Economic Adviser

*“Whilst the recent US interest rate increases represent a turning point in monetary policy, there is still a way to go before other major advanced economies follow.*

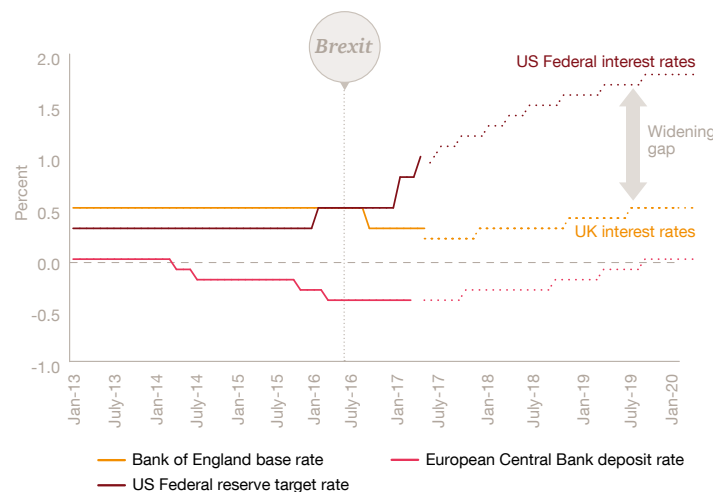
*In the UK, pension schemes with strong employer covenants are more likely to be able to weather the current low interest rate environment. However, schemes with weaker covenants need to think seriously about the level of risk they can tolerate and devise contingency plans.”*

## A tale of two tensions

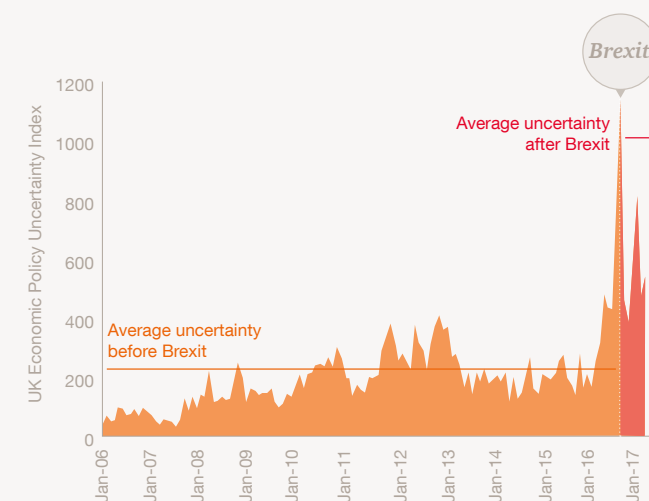
The tightening of US monetary policy last year marked a turning point in the post-financial crisis economic story. Whilst drastic changes aren't expected, if the US can achieve gradual interest rate increases, it is **likely that UK and Eurozone interest rates will increase with a time lag.**

In the UK, we expect the main impact of Brexit to be structural i.e. in relation to government spending and taxation policy. However, the negotiations are expected to create a period of uncertainty during which the Bank of England may be reluctant to act. This could therefore **increase the time lag between US and UK interest rate increases.**

*We follow where they lead?* *Increased uncertainty will keep us back?*



Source: Bank of England Inflation report May 2017



Source: Baker and Bloom, Economic Policy Uncertainty Index



# What's next for the pensions space?

The Pensions Regulator calculates that 5% of schemes in this funding cycle are at risk – which could represent thousands of members who can't bet on their defined benefit playing out as they think.

## A tougher regulatory environment?



The release of the Pensions Regulator's Corporate Plan (2017-20) and 2017 Annual Funding Statement set a tougher tone:

- More 'frontline' intervention
- Focus on equitability of cash use by companies, with focus on dividends versus scheme contributions
- Clarity on expectations of trustees.

## Integrated Risk Management

Following the Pensions Regulator's 'proactive engagement' list, we're seeing real emphasis on Integrated Risk Management:

- Assessing the capacity of the sponsor to tolerate further adverse movements in the scheme
- Including understanding how adverse economic environments would impact the sponsor
- Using this understanding to drive scheme investment strategy.



## "Gamification"

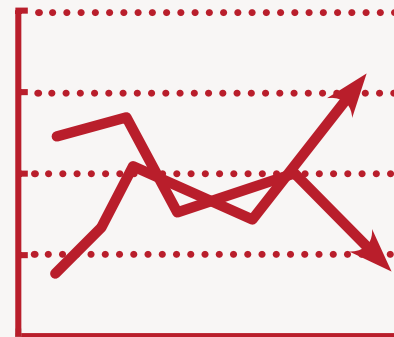
Major institutions are exploring "gamification", using the addictive qualities of computer games to aid important complex information sharing:

- Rewards structures and points systems for task completion
- Competition and leaderboards
- Increasing challenge in tasks.

Some pension schemes are starting to use this approach to help members understand their benefit outcomes and choices.



## How long will Retail Price Index last as an indexation measure?



The Green Paper invites the possibility of moving from Retail Price Index (RPI) to Consumer Price Index (CPI) as the default inflation measure where companies are in distress.

# Our team

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# PSI Methodology

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

## *The PSI considers the key components of employer support*



### **Net assets**

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



### **Operating profit**

The ability of the trading profit to cover the deficit



### **Profit before tax**

As per operating profit but also takes into account exceptional charges and interest costs



### **Cash from operations**

A measure of the extent to which the company is able to generate enough cash to service the deficit



### **Market Capitalisation**

A measure of the value of the business and the extent to which this can cover the deficit

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

# Notes



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