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Pensions Support Index
What is the 'new normal' for pension funds?

PwC's FTSE 350
Pensions Support Index

November 2012

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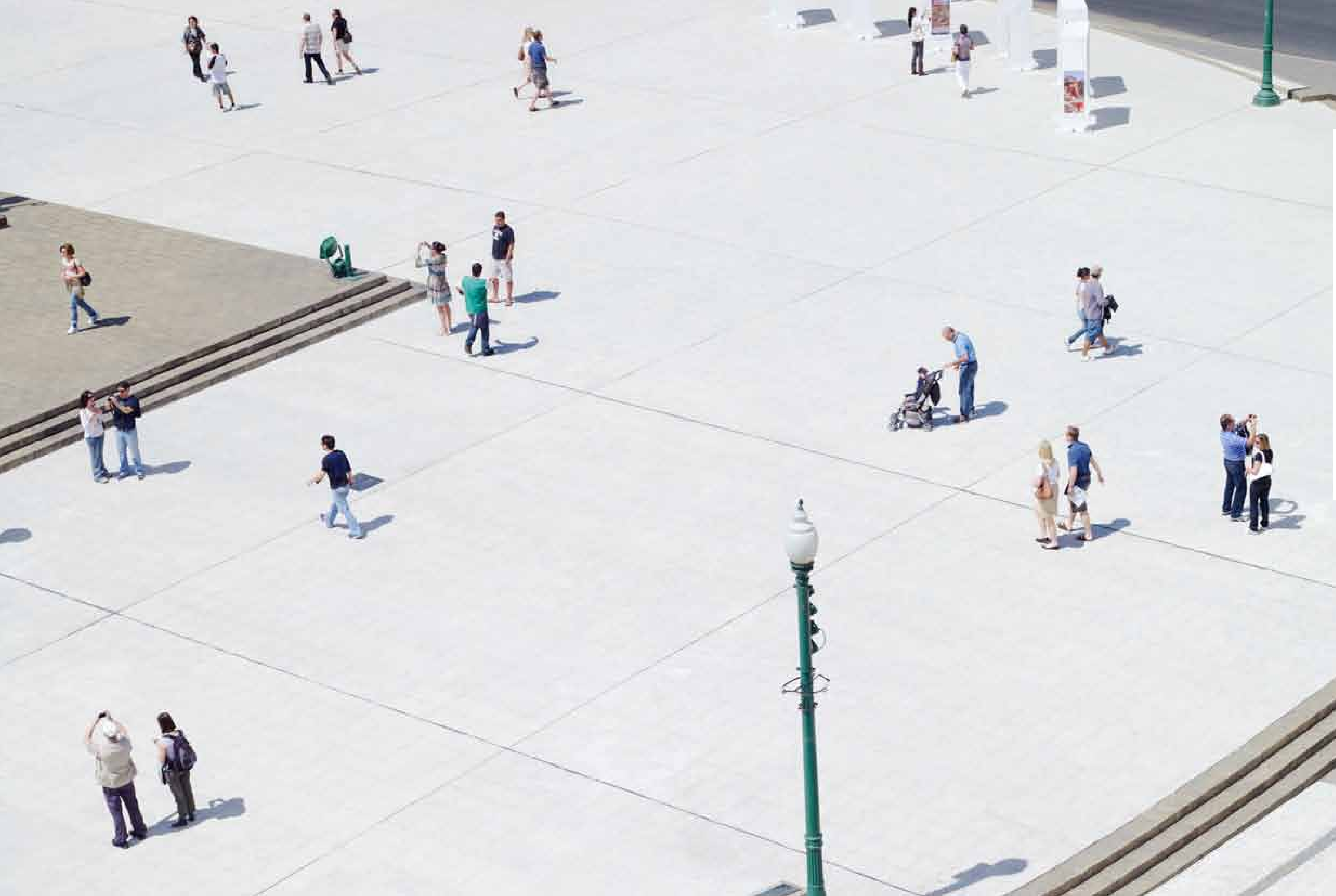

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Executive summary

Jonathon Land

Partner
Leader Pensions Credit Advisory

"In this release of our Pensions Support Index we analyse the changes in the Index during the first half of 2012.

The downward trend in the Index during 2011 has stabilised during the first half of 2012. However, the Index is almost 15 points lower than the level achieved in mid 2007. Our analysis shows that we have entered a 'new normal' economic environment which comprises low interest rates and investment returns in western economies and higher rates of headline inflation. These factors may continue to depress real asset returns and hold scheme liabilities at their current levels.

We expect these factors to mean increased reliance will be placed on cash contributions into schemes or contingent assets in order to cover the deficit rather than schemes relying on investment returns. Traditional thinking on investment strategy needs to be challenged; should government bond holdings be reduced and exposure to potential winners in emerging markets be increased?

There is also growing divergence between strong and weak companies when looking at individual company scores. This highlights the importance of assessing covenant when formulating a scheme's financial management plan as the plan will look very different depending on whether the sponsor is strong or weak."

Key findings:

The Index, which is a measure of the level of support provided to the defined benefit ('DB') pension schemes of companies in the FTSE 350, has remained flat between December 2011 and June 2012. The downward trend in the Index has been arrested, pointing towards a greater level of stability.

The score of 74 remains significantly lower now than the level experienced in early 2007 (when the Index reached a score of 88) and below the level of 90 which, if achieved over the longer term, would indicate that companies have their legacy DB pension issue under more control.

Over the last 18 months, decreasing gilt yields have put pressure on companies by increasing the value of pension scheme liabilities.

Economic forecasts point towards continued slow growth in the major western economies and low interest rates. This means that investment returns are likely to remain low by comparison with the pre-2007 period.

We therefore expect greater focus to be placed on cash contributions or contingent assets rather than investment returns when looking at how pension deficits are going to be met. This will add further pressure on those companies that are already weak.

In addition, strong growth in Asia and emerging markets is contributing to a world of high and volatile energy and commodity prices – pushing up headline inflation rates. As many pensions are index linked, to the extent that this is not already factored in, it could drive up deficits. If investment returns remain low and company earnings do not rise in line with inflation, companies will find that, over time, they are paying a greater share of their profits towards covering the pension deficit.

In order to escape this cycle, schemes could consider a much wider range of investment options. This could include investing in well-diversified international businesses with the potential for dividend yields substantially in excess of interest rates and the prospect of capital growth, rather than holding government bonds which may no longer provide an attractive yield in the 'new normal' economic climate.

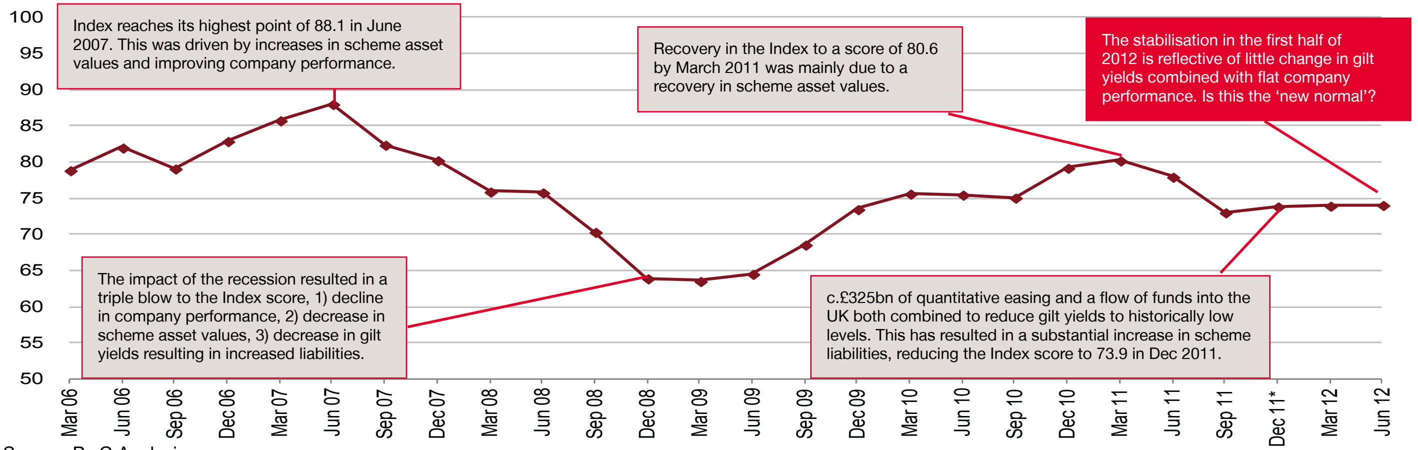
In our previous edition we set out that there was a wide divergence in the individual scores of companies in the Index. Our latest analysis shows that there continues to be a wide range of individual scores and the proportion of companies at the top and bottom ends of the Index have both increased. This indicates a potential widening between the strong and the weak.

This increase in divergence in the scores of individual companies highlights the importance of assessing the covenant when formulating a financial management plan for a scheme. The financial management plan for a scheme with a strong covenant will be very different to that of a scheme with a weak covenant.

We would expect a company with a strong covenant to have greater flexibility in relation to determining its funding assumptions, investment strategy and recovery plan.

In the rest of this document we explore the implications of the 'new normal' economic environment in further detail as well as providing a suggested approach for preparing financial management plans for individual schemes.

Pensions Support Index Q1 2006 to Q2 2012



Source: PwC Analysis
*Revised following updated information

What is the ‘new normal’ for pension funds?

Dr Andrew Sentance[1]
Senior Economic Adviser

> *“The Pension Support Index has stopped falling – is this a temporary halt? Will the Index come back to its pre-2007 levels or have we reached a ‘new normal’? To understand this we need to look at the broader economic environment.”*

As the major western economies emerge from the turmoil of the global financial crisis, we find ourselves in a strange and uncertain world.

Growth rates are disappointing relative to the experience before 2007. In the UK, economic growth averaged 3% per annum from 1982 until 2007, more than doubling the size of our economy in 25 years. The only comparable period of sustained UK economic growth was the post-war “golden age” of the 1950s and 1960s. But since the trough of the recession in 2009, UK economic growth has averaged not much more than 1% per annum.

Other major western economies are also struggling. In the three years 2011-2013, US economic growth is set to average around 2% and the euro area is projected to grow by less than 1% per annum. Emerging and developing economies – by contrast – are performing much more strongly.

Even though growth has slowed down in some of the emerging superpowers like China and India, the IMF is still projecting growth of 5.5-6.0% in the emerging and developing world this year and next.

With strong growth outside the West pushing up energy and commodity prices, we are living in a world of relatively high inflation. Volatility in financial markets is continuing to add to uncertainty about economic prospects and access to finance. These are all features of a ‘new normal’ economy which reflects big changes in the economic environment from the world before the financial crisis.

Easy money, cheap imports and strong confidence supported growth for over two decades prior to the financial crisis – these drivers are no longer available to support growth in western economies. The UK and other western economies are going through a prolonged period of structural adjustment to the ‘new normal’ world of more restricted finance and higher and more volatile energy and commodity prices. And this adjustment is likely to continue through the mid-2010s.

[1] Andrew Sentance is a former member of the Bank of England Monetary Policy Committee (2006-2011) and former Chairman of the Investment Committee for the British Airways Pension Funds.

A long period of strong consumer-driven growth in the West has come to an end and export opportunities in emerging and developing economies are now more likely to be an engine of growth, which is why export-oriented economies like Germany and Sweden have performed better than other western economies over the recovery so far. Another aspect of the adjustment is that indebted consumers and governments need to adjust their spending and debt levels downwards to more manageable levels.

But even though the macroeconomic environment has become more difficult, there are still new opportunities arising – driven by technology, social and demographic trends and growth opportunities in Asia and other emerging market economies. While businesses and investors need to be cautious about over-extending themselves in a volatile and uncertain environment, it would be unwise to totally neglect growth opportunities. At the same time, the adjustment to the ‘new normal’ world implies further business restructuring – particularly in sectors heavily dependent on consumer growth in the UK and other western markets.

So what does this ‘new normal’ economic climate mean for pension funds?

1 Slow growth in the major western economies and historically low interest rates mean that investment returns are likely to remain low by comparison with the pre-2007 period. PwC’s latest analysis of projected investment returns for the FSA[2] pointed to lower real and nominal returns for all asset classes, with the biggest reduction in government bond yields – where most pension funds are heavily invested. This will make it difficult for schemes to rely on investment outperformance to make up the deficit in the scheme.

This also means that the discount rate (which is normally based on gilts) used for calculating the present value of pension liabilities is expected to stay low over the short to medium term. A lower discount rate results in higher liabilities.

There may be a greater focus on cash contributions to fund pension deficits which will add pressure to those companies that are already weak.

2 Headline inflation rates are expected to be relatively high for a while, as strong growth in Asia and emerging markets contributes to a world of high and volatile energy and commodity prices. Relatively high unemployment is containing wage growth, so a 1970s-style wage-price spiral is an outside risk. But a lapse into sustained deflation also seems unlikely. Central Banks and governments have provided a lot of support to the financial system through the financial crisis and its aftermath to head off deflationary risks. These large monetary and liquidity injections could yet manifest themselves in the form of higher inflation or some other form of financial instability.

Higher inflation could lead to larger pension deficits as pension payments are linked to inflation. There is also a risk that if company earnings do not grow at the same rate, the company will need to pay an increasing proportion of profits into the scheme in order to meet the deficit.

3 There should still be solid investment returns in the private sector for firms able to tap into growth opportunities in the emerging and developing world and who are able to exploit the potential of new technologies and other forms of innovation. With the potential for dividend yields substantially in excess of interest rates, and the prospect of capital growth, pension funds should ask themselves whether investing in these companies represent a better risk return trade off than holding government bonds in the ‘new normal’ economic climate.

The ‘new normal’ world we have entered implies a reappraisal of pension fund investment strategies relative to the “old normal” rules which prevailed pre-2007. Pension funds should not assume that we are in a standard economic cycle, in which economic conditions bounce back to previous trends. Major structural shifts are underway in the global economy, contributing to a prolonged period of disappointing growth in the major western economies.

A recovery in growth and investment returns will need to be supported by new drivers, which are as yet not clear. So it makes sense to adjust to current economic conditions, while remaining alert to new opportunities which could eventually underpin the next growth wave.

[2] See “Rates of return for FSA prescribed projections”, FSA/PwC, April 2012: http://www.fsa.gov.uk/static/pubs/other/projection-rates12.pdf

Financial management plans

Jeremy May
Partner

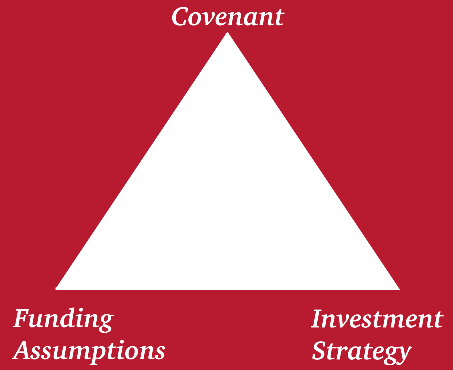
Minesh Rana
Director

> *"The growing divergence of individual company scores highlights the importance of formulating a financial management plan based on covenant strength."*

Since the formation of the Pensions Regulator the way in which trustees approach scheme funding has changed significantly. In the mid 2000's, when assessing the reasonableness of funding assumptions, a key factor driving decisions for many trustees was to ensure that the deficit was set at a level that was affordable for the company. Investment strategy was looked at independently. The concept of covenant (a measure of the ability of a company to meet its pension obligations) was new and the need to link covenant to funding assumptions and investment strategy was not typically drawn together.

Over time, trustees have become accustomed to assessing covenant and linking the output to investment strategy and the actuarial assumptions in order to determine the scheme funding deficit (as shown by the diagram above). Trustees have also linked funding assumptions, deficit reduction payments and investment outperformance in order to formulate the recovery plan.

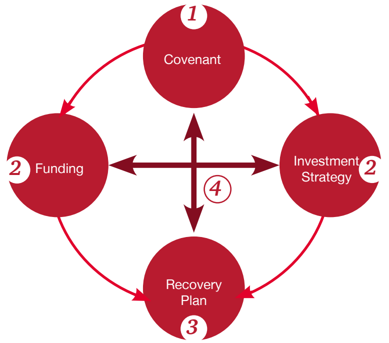
Current approach to linking covenant to funding assumptions and investment strategy



In its April statement, the Pensions Regulator highlighted the importance of financial management plans. In our view this should be a clear articulation of how the company and pension scheme together achieve the long term security of members' benefits, namely:

- Ensure that the ultimate objective of the scheme, whether it is to buy-out the liabilities, to achieve self sufficiency or to undertake a restructuring of the pension liabilities, is clearly defined and there is a clear plan to achieving that goal;
- Understand the risks and articulate the link between the covenant, investment strategy and funding assumptions to determine the cash required to meet the recovery plan; and
- Document the financial management plan and action plans for dealing with adverse events.

How do you prepare a financial management plan?



A suggested approach to preparing a financial management plan is as follows:

1

Covenant: Assess the overall objectives of the scheme by looking at the strength of the covenant using the latest scheme and company information. Covenant tends to be assessed into one of four or five categories between strong and weak.

Recent movements in the Index show that a greater proportion of companies have a score of less than 50. There is a growing gap between the strong and the weak and this highlights the importance of understanding the strength of the covenant before starting to prepare a financial management plan. The plan for a scheme with a weak covenant will look very different to that of a scheme with a strong covenant.

2

Funding and investment strategy: Covenant should then be used to set the investment strategy and the scheme specific funding assumptions.

Investment strategy is determined by a wide range of criteria. However over recent years covenant has become an increasingly important factor. This involves assessing the risk associated with the investment strategy and ensuring that the covenant can support this level of risk.

In addition, schemes should understand the level of correlation between the company (such as its sector and geographical vulnerabilities) and the investment strategy in order to diversify the risk profile of the combined scheme and company.

Scheme funding is then driven by a wide range of actuarial assumptions as well as, over recent years, a combination of the investment strategy and covenant as discussed above.

3

Recovery plan: Based on the investment strategy, determine the likely level of investment outperformance to be built into the recovery plan and the cash contributions required.

Consideration should also be given to the role of non-cash funding i.e. contingent assets.

Schemes should assess the affordability of contributions based on forecast cash flows, and together with expected levels of investment outperformance, establish a recovery plan which sets out the timeline for the cash contributions that need to be made into the scheme.

4

Action: Schemes should seek to bring the covenant, investment strategy, funding assumptions and recovery plan work streams together into one integrated financial management plan. This should include documenting the following:

- Objectives of the scheme;
- Strength of the covenant;
- Investment profile and how this is expected to change over time;
- Actuarial assumptions;
- The likely range of investment outperformance that could be expected based on the investment strategy that has been adopted;
- Recovery plan split between cash contributions and investment outperformance;
- The use and operation of any contingent assets;
- Risks and stress tests of each element of the financial management plan (for example 1 in 20 or 1 in 200 stress tests on the investment strategy); and
- Trigger points, as well as where appropriate, agreed mitigating actions that may be set by reference to changing covenant, funding level or investment strategy under/over performance.

It should be recognised that the development of the financial management plan is likely to be an iterative process, with a need to circle back and reassess the objectives at a number of points during the plan's development. The financial management plan should also be kept under regular review and the actions agreed retested at appropriate intervals.

Ideally the financial management plan should be simple enough to be set out in 2-3 pages and be understood by everyone on the trustee board, as well as other key stakeholders.

Appendix: Methodology

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

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 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; and
- **Market capitalisation**: which has been used as 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.

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

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.

These scores are then amalgamated to provide an overall Index reading of between 0 and 100.

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

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':

The position whereby a scheme is sufficiently funded with investment risk minimised such that it is not reliant on support from its sponsoring company.

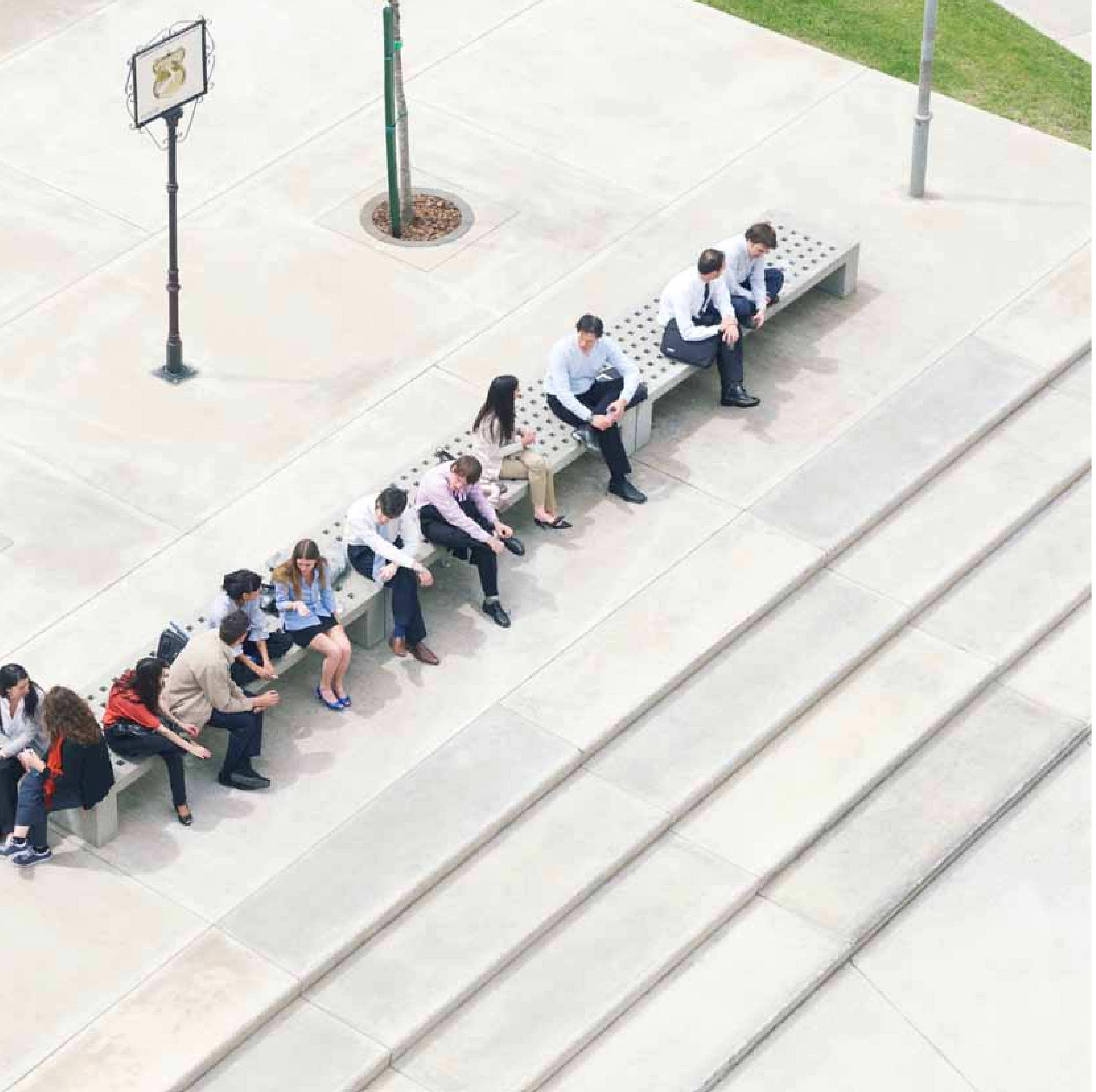
'Buy-out Basis':

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. Many of the constituent companies in our Index have a much higher or lower individual company score than the current Index average.

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 issue. 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 relatively to the size of their sponsoring employer, and for these schemes there's material risk to member's benefits.
Less than 50	Would indicate that there are many schemes where there's a risk of a cut in members' benefits resulting from the failure of the sponsoring employer.



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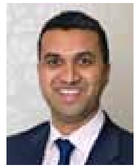

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About PwC

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.

Recent awards

Covenant Review Provider
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Pension Scheme Accountant of the Year
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Covenant Review Provider
Pensions & Investment Provider Awards 2011

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Pensions Accountant
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Acruary Consultancy
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Until now, most commentary about the relative risk of Defined Benefit ("DB") schemes has concentrated on the size of the pension scheme deficit. But, while that gives a snapshot of the state of a scheme at a particular point in time, it's not the whole picture.

The important question isn't the size of the pension deficit – it's whether, in the absence of sufficient investment returns, a company (the sponsoring employer to the scheme) has the ability to pay its obligations and how quickly this is likely to happen.

Our Index provides a reliable independent barometer of the level of support to DB schemes.

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