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Time to bite the bullet:

Employer Support for Defined Benefit Schemes

PwC's new FTSE 350 Pensions Support Index

July 2012

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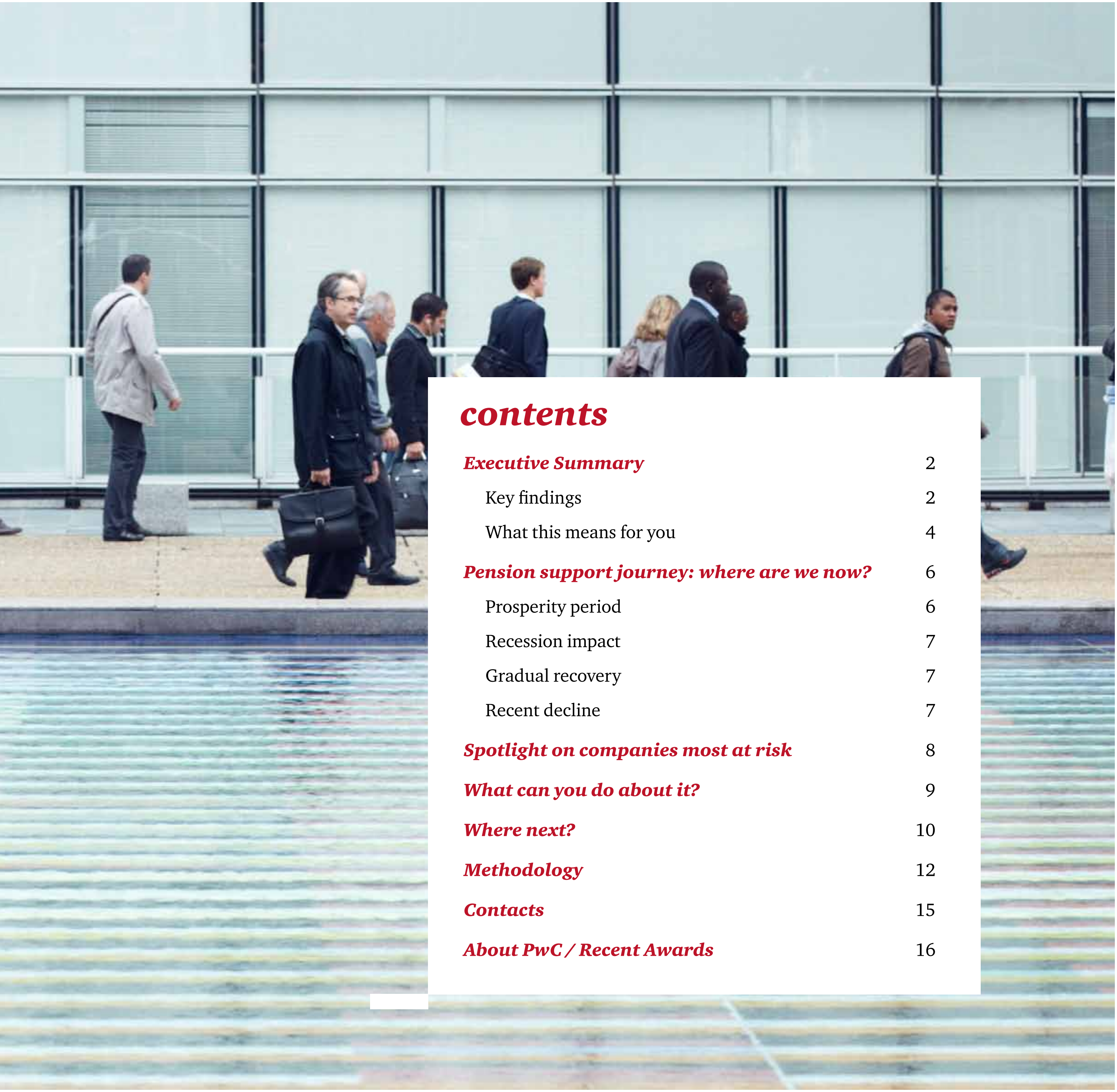

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Executive Summary

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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. This is important because the pensions of millions of people are dependent on investment returns and on future contributions from companies. If economic conditions continue to worsen, companies will have to pay more into their pension schemes and those at the lower end of the Index will be at a higher risk of failure – putting the future of their pension scheme members at risk.

Key findings

The level of support provided by FTSE 350 sponsoring companies to their DB pension schemes is lower now than in 2006.

This is despite considerable action having been taken by companies and trustees over the last six years to shore up the level of support provided to their pension schemes. What is worrying is that the level of support provided is on a downward trend showing that the position is getting worse rather than better.

Our Index, which provides a measure of the level of support, shows that pension schemes were in a good position in mid-2007 when the Index reached its highest point. Assets had performed well, deficits were low and companies were growing off the back of a strong economy.

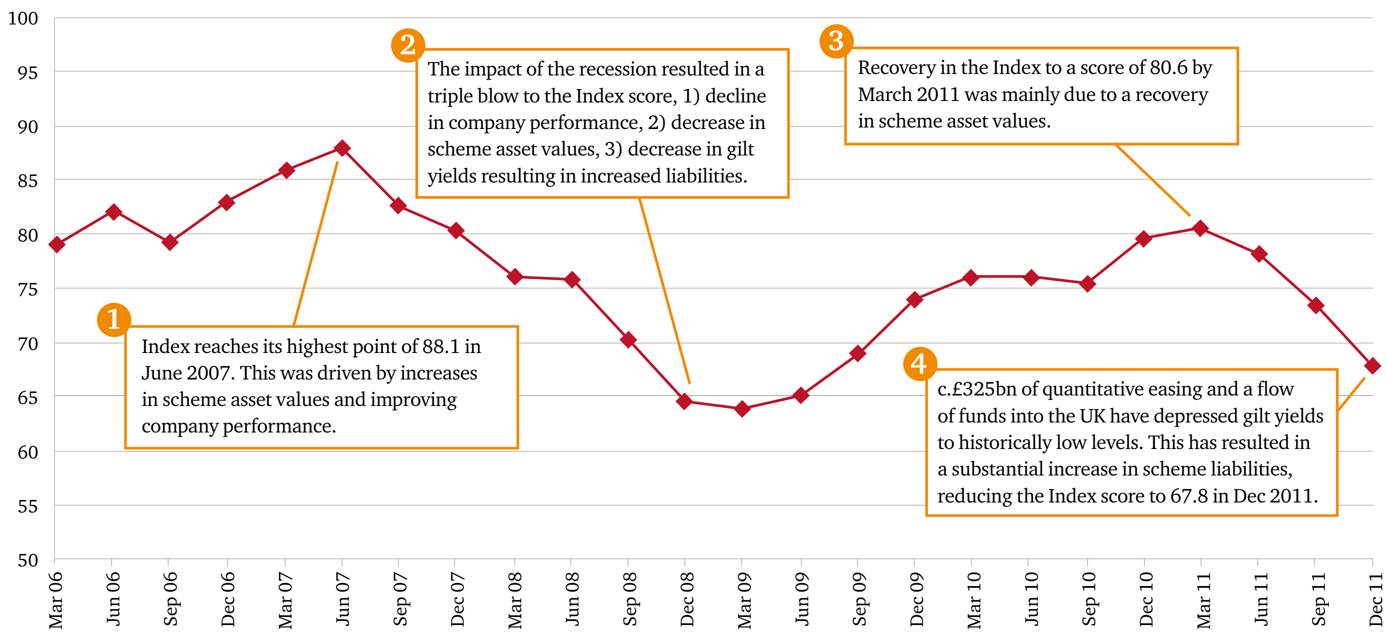
In the following 21 months, the level of support declined to reach a low in March 2009. This downward movement was driven by a decline in the value of assets held by pension schemes combined with a drop in company performance following the credit crunch. In the subsequent two years to March 2011, as the value of assets recovered the position improved. However, that recovery was short lived. Over the last year the downward trend has recommenced with the Index falling again.

The recent decline has been primarily driven by falling gilt yields. Gilt yields are used as a starting point for discounting future pension scheme obligations. The lower the gilt yields, the higher the present value of pension scheme liabilities. Gilt yields are at their lowest level since the 1890s, which has increased pension liabilities over the last year and increased deficits.

The recent worsening of the Index is likely to mean that companies need to focus more of their resources towards addressing their pension scheme deficit, meaning management time and company cash being diverted away from operational activities. For many organisations, pensions are firmly on their risk register.

The outlook does not look good. The combination of continued low gilt yields, the impact of a potential further downturn in the UK economy, and growing pressure from Europe for pension schemes to be funded on a more prudent basis, represents a potential triple blow for future pension support.

Pensions Support Index Q1 2006 to Q4 2011



Source: PwC analysis

What this means for you

Despite the overall Index having a score of 67.8 in December 2011, individual company scores range from 13 to 100. What the Index means for you depends on what your current score is.

High scoring companies

Companies with a high score should seek to articulate to their pension scheme trustees the strong level of support that is being provided.

If a company is able to clearly demonstrate its strength, then this ordinarily results in less prudent assumptions being used for the triennial actuarial valuation. This, in turn, would result in a lower deficit to be funded meaning more cash being made available for operational activities.

The peaks and troughs of the graph suggest that there have been optimal times for schemes to take action in relation to their investment strategy. For example, mid 2007 and March 2011 were good times to de-risk by undertaking a buy-in or a buy-out.

Middle scoring companies

Companies with an Index score of between 25 and 49 will find it harder to make a case for less prudent funding assumptions to be used for the actuarial valuation – resulting in a bigger deficit.

In these cases both parties (companies and trustees) may struggle to balance the cash needs of the company and the cash needs of the scheme.

The solution to this impasse could involve the company providing contingent support to the scheme (e.g. guarantees or security). These contingent options help to conserve cash in the company whilst protecting the scheme against the downside risk.

However, where these solutions are being considered, trustees need to assess carefully and understand how they would obtain value from these contingent assets in the event of a corporate failure.

Low scoring companies

For those near the bottom of our Index (a score of less than 25) there is a heightened risk of the company not being able to meet its pension obligations and members failing to receive their full benefits.

Companies with a score of less than 25 are likely to be under increasing financial pressure which may result in the pension scheme being asked to consider compromises, payment contribution holidays or back-end loaded recovery plans which can exceed 20 years.

However, a constant deferment of contributions is not sustainable. In some cases, in order to avoid a situation where the corporate becomes insolvent and the pension scheme enters the PPF, a restructuring of the pension scheme could result in value being maximised for all stakeholders, including the scheme members.

In these situations the company will need to enter into detailed discussions with its scheme in order to understand the options available and to identify the optimal solution. For many schemes the option of doing nothing is behind them: it's time to bite the bullet!

Pension support journey: where are we now?

Minesh Rana
Pensions Advisory

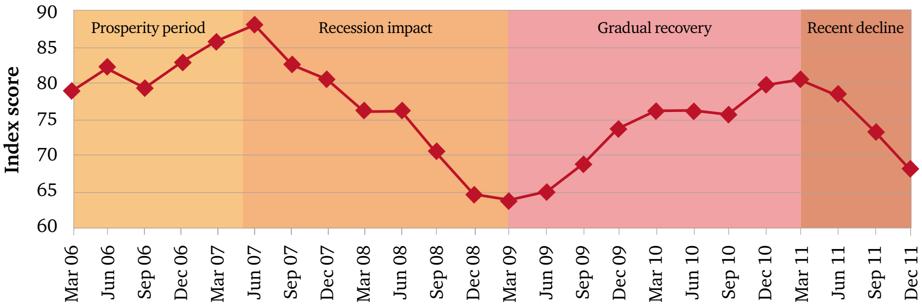
It is a huge problem that companies and trustees of pension schemes have been wrestling with. Faced with alarming pension deficits that continue to grow many companies have been forced to adopt plans that, in many cases, involve closing DB pension schemes to new members, or closing the scheme to all future accrual.

Has the action taken by companies made any difference to their ability to support their pension schemes?

How able are companies to repay the deficits in their pension schemes and eventually secure their long term future?

Key to answering these questions is to understand how the level of pensions support has changed over time. This is best done by considering the key movements within the Index since March 2006 and the key drivers for these changes.

Pensions Support Index: Four distinct periods of activity



Source: PwC analysis

Prosperity period

Between March 2006 and June 2007 the Index increased by 9.2 points to reach its highest point of 88.1.

The increase was driven by two factors: improving company performance and increases in the value of pension scheme assets.

The Pensions Act and the formation of the Pensions Regulator meant that schemes were using a higher funding target – resulting in more company cash being used to eliminate deficits.

Cash generation of companies within the Index improved during this period meaning most companies were able to afford these higher payments in their pension schemes.

Additionally, many pension schemes took active steps to de-risk, with strong demand for long-dated bonds and other safer investments as opposed to holding equities.

If this upward trend in the Index had continued DB pension schemes would have looked safe.

Recession impact

Between June 2007 and March 2009 the Index decreased by 24.2 points to reach its lowest point of 63.9.

The decline was driven by the recession, with Northern Rock reporting problems in Q3 2007 and Lehman Brothers going into administration in September 2008.

Over this period, the FTSE 350 declined by 41%, having an adverse impact on both the market capitalisation of sponsoring companies and the value of assets held by schemes.

During this period, UK gilt yields started to decrease resulting in an increase in funding deficits. In contrast, corporate bond yields, which are used as a basis for calculating the accounting liabilities, increased. This meant that whilst funding deficits were getting bigger, some companies were reporting a pension surplus in their accounts.

With declines in profitability and cash generation, companies were struggling to fund these higher deficits.

Gradual recovery

From March 2009 to March 2011 the Index recovered from its low point of 63.9 to reach a score of 80.6.

The 16.7 point increase over two years could be segmented into two halves.

The first half (12.1 point increase) was largely characterised by a 46% increase in the FTSE 350. This drove an increase in scheme assets and increased the market capitalisation of companies in the Index. Gilt yields increased by c.1%, reducing funding liabilities.

In February 2010, the Pensions Regulator issued a statement setting out that asset performance after the valuation date could be taken into consideration when setting recovery plans. This provided some breathing space for companies.

The second half (4.6 point increase) was largely driven by improved profitability of companies. A small reduction in the gilt yield was offset by asset returns and, for some companies, the switch to CPI, ensuring that funding deficits did not change materially.

Recent decline

At the end of March 2011 many companies had been through a cost reduction phase and, in some cases, had undertaken a balance sheet restructuring. As a result, there was a general feeling that things were starting to return to a more stable footing.

Since March 2011, the downward trend in the Index has recommenced with the Index falling 12.8 points to 67.8 in December 2011.

The key driver for this change was a c.1.5% decline in gilt yields. This increased deficits substantially. The decline in gilt yields was driven by two factors: 1) the c.£325bn of quantitative easing; and 2) investors moving cash out of mainland Europe and into the UK which drove up the price of gilts and reduced rates.

With the UK economy not expected to experience significant short term growth, declining company performance, combined with low gilt yields and pressure to use more prudent valuation assumptions is putting ever greater pressure on companies and trustees. The future looks uncertain.

Spotlight on companies most at risk

Although the Index score has remained above 60 over the last six years, there is significant variation in the scores of individual companies.

If a company has a score of less than 50 there's a higher risk of failure of the sponsoring employer, which is more likely to result in a cut to members' benefits.

The diagram below shows the proportion of companies which have a score of less than 50. During the first two years of the Index, on average, one in eleven companies had a score of less than 50.

By the end of 2008, this had increased to almost a third of companies having a score of less than 50.

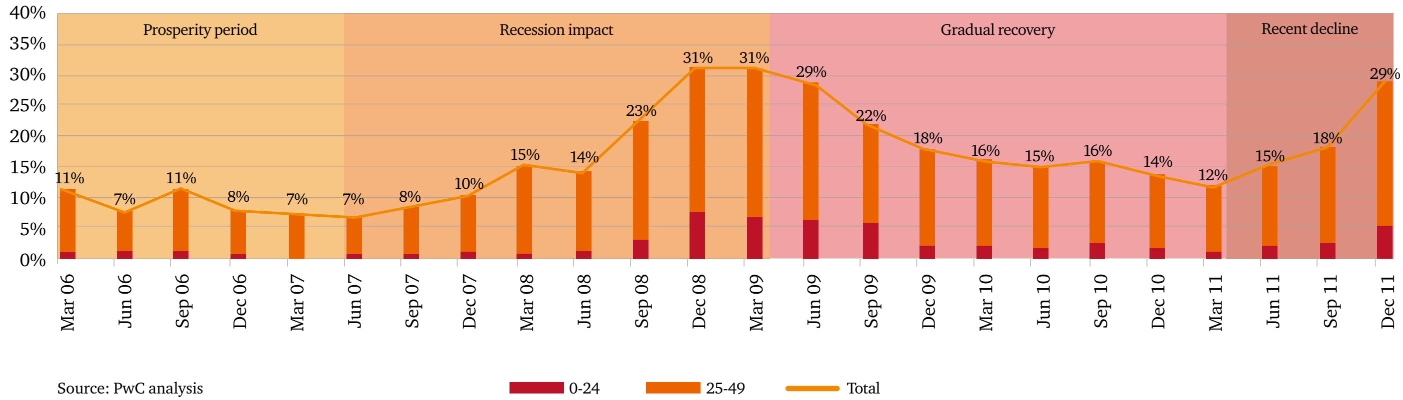
At this time there was a real risk that large swathes of the UK population could have missed out on the pensions that had been promised to them.

Between March 2009 and March 2011, the position returned to pre-recession levels before climbing back up to an average of 21% of companies in the nine months to December 2011.

This recent change suggests an increase in the number of companies facing difficulties supporting their pension schemes.

It is important to understand this trend because, if economic conditions continue to worsen, companies at the lower end of the Index will need to enter into detailed discussions with their schemes, and in some cases a restructuring of the pension scheme may be required.

Proportion of companies with a score of < 50



Source: PwC analysis

What can you do about it?

Many **companies** have started to take action to reduce their DB pension scheme risk by, for example:

- Closing schemes to new members and / or to future accrual;
- Making larger cash and contingent asset contributions;
- Undertaking tailored member incentive exercises to reduce the size of liabilities; and
- Using buy-out mechanisms to transfer certain risks associated with their pension obligations to a third party, which removes the obligation on the company and can significantly increase member security.

These steps, along with improved investment returns on assets in the schemes, should in the longer term reduce pension obligations to a more manageable size over time.

If you are a director of a company you may wish to demonstrate to the trustees that they have a low cause for concern due to the level of support offered.

You could also consider working with your scheme's trustees to formulate a contingency plan in order to set out the steps to be taken in the event that the position of the scheme worsens.

For **trustees** this means understanding the issues and taking control, not waiting until it's too late. Once the sponsoring employer has gone into insolvency and the scheme is in the PPF, trustees will have no control over the outcome. Trustees should understand how capable the sponsoring employer is of supporting their scheme on an ongoing basis and what would happen to the scheme if the employer were to become insolvent.

For some trustee boards, this will be a reassuring exercise; however, for others there'll be a realisation that the level of support isn't as strong as they may have thought. If this is the case, there are many mitigating actions that trustees can take to help improve the position of the scheme. In some cases these will be similar to the actions a bank would take to protect its position if it had lent money to the company.

These actions could include taking security over assets, getting guarantees from other group companies, or setting up more innovative contingent asset solutions.

Contingent asset solutions involve assets such as property being used to help fund and support the scheme if the need arises.

We see an increasing number of cases where the pension scheme, as the largest creditor of a company, has become the primary economic beneficiary. This will, with greater frequency, lead to cases where the scheme will look to carry out a restructuring, such as a debt-for-equity swap. This may result in the scheme also becoming the ultimate decision maker on the future direction of the company. This is a route banks have historically taken when companies are no longer able to support their debt.

This is a sobering thought for **shareholders** whose shares may be worthless as the pension scheme has absorbed all the company value.

Where next?

It's clear that DB scheme deficits have been and will remain a challenge for years to come. One of the most serious ongoing problems is the impact that quantitative easing has had on reducing gilt yields to historically low levels. This in turn has led to a substantial increase in pension funding deficits.

The increased deficits have contributed towards the Index falling 12 points over the past three quarters alone and a rise will have to be fuelled by either improving market conditions or significant additional cash from companies.

The Index is now lower than it was in 2006 and is approaching a similar level to that of early 2009, when many companies and trustees were locked in discussions to balance the cash needs of their pension schemes with the cash availability of the sponsoring employer.

We have seen banks taking a more cautious view on lending to companies with DB pension schemes given that pension scheme claims could potentially (with regulator action) rank ahead of the bank in an insolvency scenario. We've seen a shift over recent years in the way shareholders value pension deficits; moving from shareholders valuing pension deficits on an 'Accounting Basis'* to a 'Scheme Funding Basis'*. More recently we've seen some private equity houses, when making acquisitions, pricing in adjustments close to the 'Buy-out Basis'*.

Given these external pressures, companies are increasingly looking at ways to reduce or eliminate their pension scheme exposure. Our Pensions Support Index shows that there have been optimal times to de-risk or buy-out liabilities e.g. mid 2007 when deficits were lower and companies had more free cash. It is often very difficult to identify an optimal time to de-risk a pension scheme; this Index may help companies and trustees with this decision.

We'll continue to track the Pensions Support Index at regular intervals, providing members, trustees, companies and other stakeholders with relevant and valuable information on the level of support offered to the FTSE 350 pension schemes.

* See Methodology on page 12 for definition

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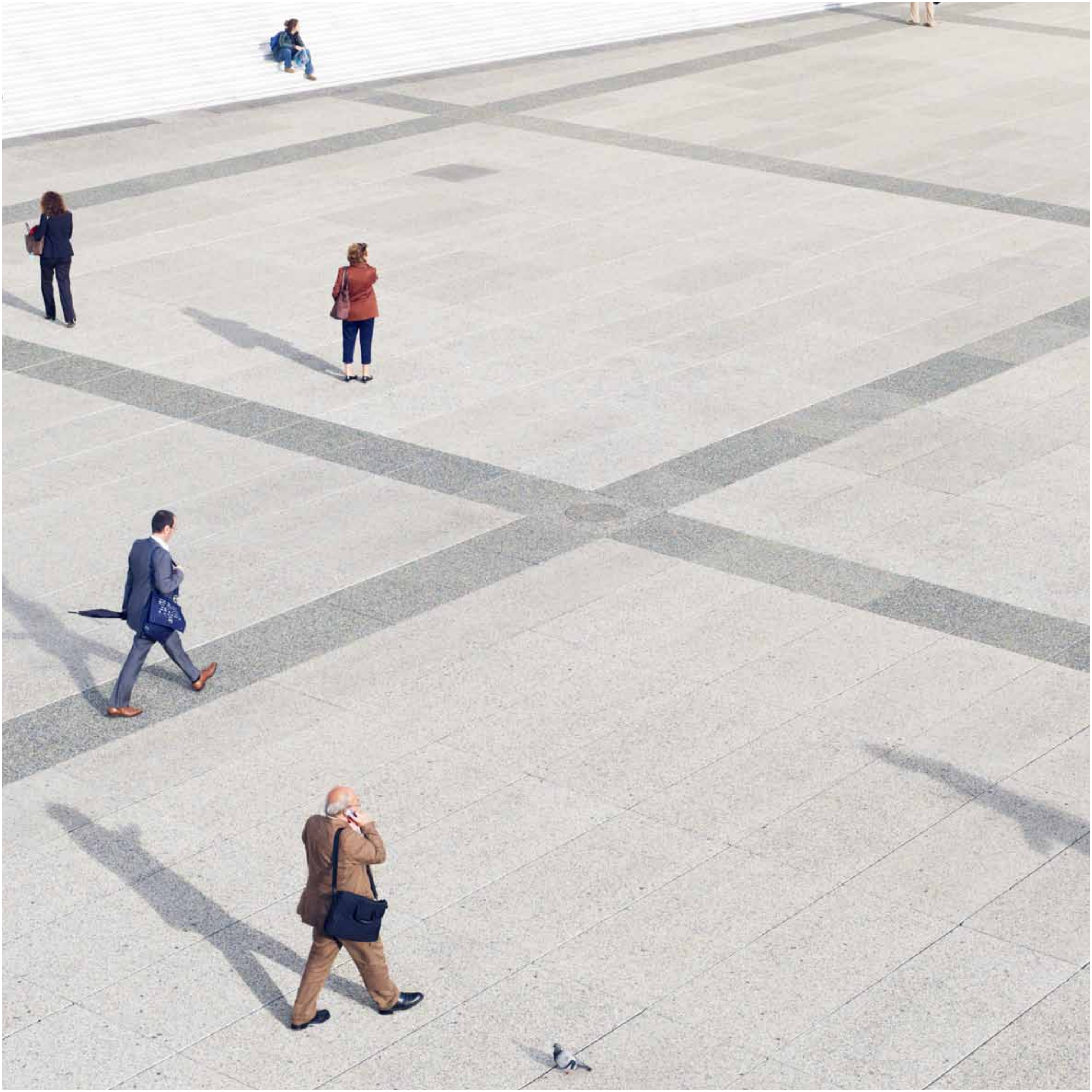
The Pensions Regulator, in its recent statement, showed recognition that the current environment is challenging. Schemes should therefore think carefully about the appropriate way to value the liabilities and the allowance for future investment performance. The Regulator's statement sets out that there is sufficient flexibility in the current funding regime to cope with current market conditions.

With UK growth still considered to be low, there is a heightened risk that the Bank of England could use further quantitative easing to inject liquidity into the economy. Therefore gilt yields could remain low over the short to medium term. Accordingly, companies and trustees will continue to face difficult decisions in relation to determining how these larger deficits will be funded.



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.

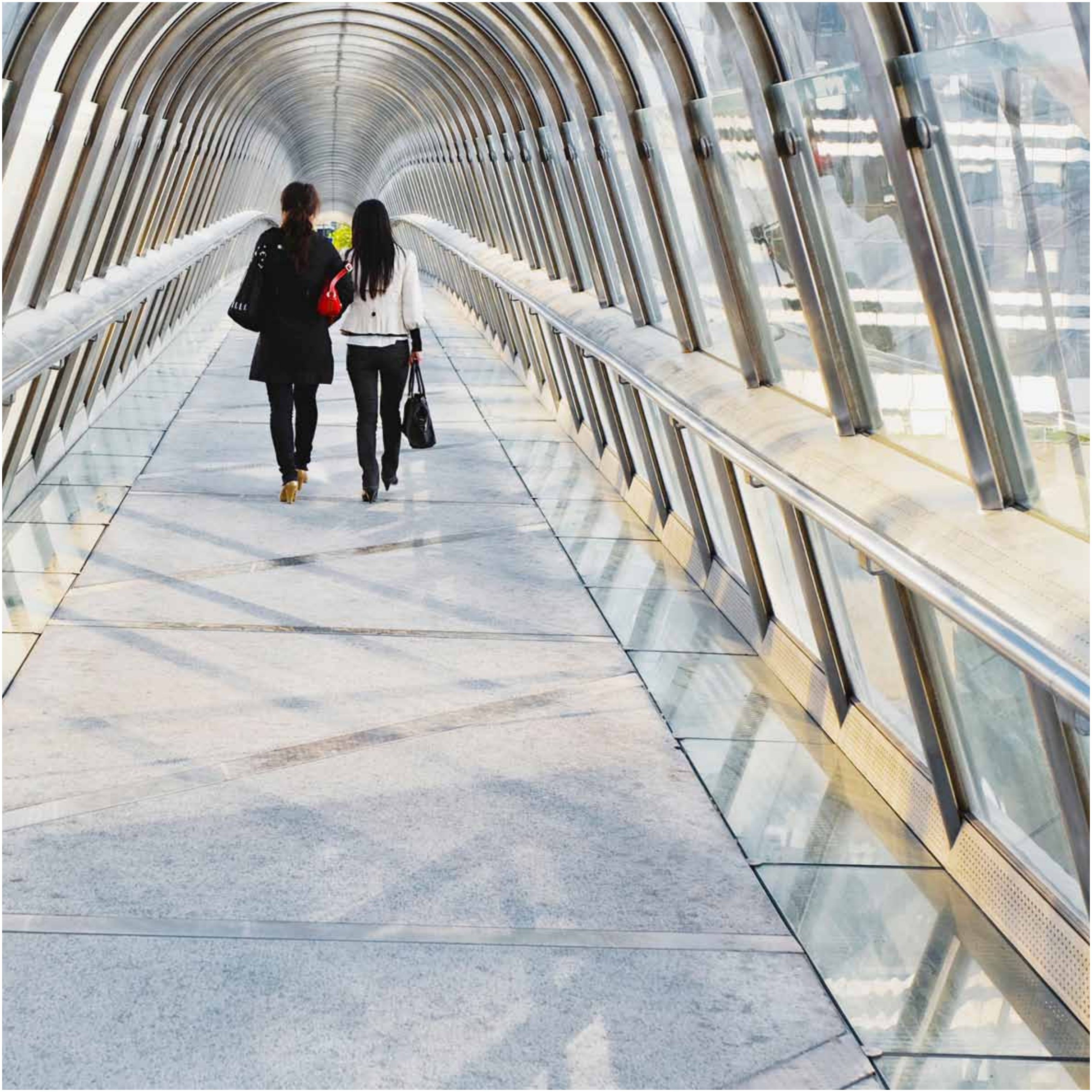
'Buy-out Basis':

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 the 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 relative to the size of their sponsoring employer, and for these schemes there's a material risk to members' 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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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 analysis. As such, clients benefit from specialist pensions advice supported by teams with wide-ranging commercial acumen and business knowledge.

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