Development of a new market

The traditional buy-out market for schemes in wind-up is changing as a new DB scheme risk transfer market develops...

- When a DB scheme is bought-out with an insurance company, the costs of pension provision are fixed; the sponsoring employer has no further exposure to:
  - investment risks;
  - mortality risks;
  - operational risks; or
  - Regulatory risks

- Prior to the 2004 Pensions Act, the buy-out market existed for DB schemes in wind-up
Key drivers of growth in the DB scheme risk transfer market

...for many companies the uncertain future cost of providing defined benefit pensions has become a major risk
1. Improving longevity

Are sponsoring employers and trustees content to manage mortality risk...?

**Pace of Mortality Improvement**

**Assessing Mortality**

- Pricing of mortality risk has two components:
  - Base mortality assumptions
  - Future improvement assumptions

- Experience over past 40 years illustrates the difficulty in calling the peak in mortality improvement rates

- Life expectancy improvements are significant

Source: Willets Consulting figures based on ONS data. Improvement rates are weighted by the number of deaths at each age and smoothed over time.
2. Deficit volatility

...or other sources of DB scheme deficit volatility?

- Asset portfolios, unmatched to liabilities, have driven deficit volatility
- Perceived volatility in FRS17 liabilities even if actual portfolio is unchanged due to full matching of assets

CHANGES IN FTSE100 PENSION DEFICIT

NOMINAL AA FRS17 DISCOUNT RATE

Source: Deutsche Bank
3. The Pension Protection Fund

The Pensions Act 2004 established the Pension Protection Fund ("PPF") and the Pensions Regulator ("tPR")

- Statutory fund established to pay compensation to members of eligible DB pension schemes
  - Qualifying insolvency event
  - Insufficient pension assets to cover obligations
- Benefits of immediate annuitants fully protected
- Other scheme members to receive 90% of benefits, subject to £26,050 benefit cap

PPF LEVY

- Scheme-based levy (20%)
- Risk-based levy (80%)
- Calculated with reference to buy-out cost
- Total levy has risen from approximately £300 million in 2005 to £575 million in 2006
4. The Pensions Regulator

The Pensions Act 2004 established the Pension Protection Fund (“PPF”) and the Pensions Regulator

- New regulator established to:
  - Protect DB scheme benefits for all members
  - Improve confidence in DB schemes
  - Minimise claims on the PPF

- Key powers to issue:
  - Financial Support Directions
  - Contribution Notices

- Regulator has ability to intervene in corporate activity if a DB scheme is deemed to be under-funded

- Requirement to disclose funding status to scheme members from September 2006

KEY CHANGES TO REGULATION

- Scheme specific funding
- 10 year plan for funding deficits
- Buy-out funding disclosure
- Monitoring of buy-out funding below 60%
5. Disclosure requirements - tightening-up FRS17

- The Pensions Act 2004 introduced Scheme Specific Funding requiring sponsoring employers and DB scheme trustees to agree and disclose assumptions appropriately.

- Accounting bodies and the investment community are applying pressure on companies also to provide full disclosure on company accounts.
  - the ASB has suggested six recommendations for improving disclosure under FRS17:
  - Indication of degree of independence of scheme from sponsoring employer.
  - Disclosure of mortality assumptions as well as financial assumptions.
  - Illustration of how changes in assumptions could change management of scheme liabilities.
  - Disclosure of buy-out cost as well as FRS17 liabilities.
  - Details of regular and special contributions; to be compared with sponsoring employers’ financial strength.
  - Disclosure by class including expected rates of return.
5. Disclosure requirements - true value of liabilities

Following the Pensions Act 2004, many businesses are reassessing their FRS17 liabilities, closing the gap with buy-out cost.

Note 1: Based on a 1 in 200 year event
DB scheme risk management strategies

A number of strategies are currently available to shrink deficits and reduce volatility of DB scheme liabilities

- Increased employer and/or employee contributions
- Asset return optimisation
- Reduction or reorganisation of scheme benefits
- Full or partial risk transfer
- Transfers of contingent assets
- Liability management

**KEY**

- Deficit reduction
- Volatility reduction/removal

- Full or partial risk transfer is the only mechanism for delivering financial certainty to sponsoring employers and scheme members alike

- Other risk management strategies can be applied:
  - Before risk transfer, thereby potentially lowering cost;
  - As part of risk transfer structure; or
  - Following risk transfer with upside participation for scheme members and/or sponsoring employer
An inevitable structural shift

The risk transfer market will provide a mechanism for a shift in responsibility for pension provision from sponsoring employers and trustees to insurance companies...

**SPONSORING EMPLOYERS & TRUSTEES**
- High deferred employment costs
- Personal liabilities
- Regulatory intervention
- Shortage of expertise
- Volatile risks

**INSURANCE COMPANIES**
- DB scheme risk pricing expertise
- Capital backing
- Willingness to take on mortality risk
- Skills to manage investment risks
- Access to operational expertise

Is pension risk transfer the next stage in corporate reorganisation?

1980s
- Business re-engineering

1990s
- Value chain optimisation

2000s
- Pension risk transfer?
Ignoring the DB scheme risk transfer option

If a DB scheme is not to be transferred to an insurance company, the sponsoring employer and/or trustees implicitly believe...

- FRS17 is an accurate and stable measure of pension liabilities
- Interest rates (and inflation) are currently unsustainably low
- There is certainty that equity markets can close any deficit over time
- Life expectancy can be fully understood
- The sponsoring employer will always be able to make further contributions if necessary
- Legislation will not change to disfavour sponsoring employers further
Paternoster - What, Who and Why?

- **What?**
  
  A new insurance company, regulated by the FSA, to take on defined benefit pension assets and liabilities...

- **Who?**

  An expert Board and Management team with over 250 years of relevant experience...

  Mark Wood, Ron Sandler, Howard Davies, Lord Turner, Lord Leitch, Jeremy Goford.

- **Why?**

  Paternoster represents the combination of senior industry expertise with the largest pool of capital committed to the defined benefit pension market...