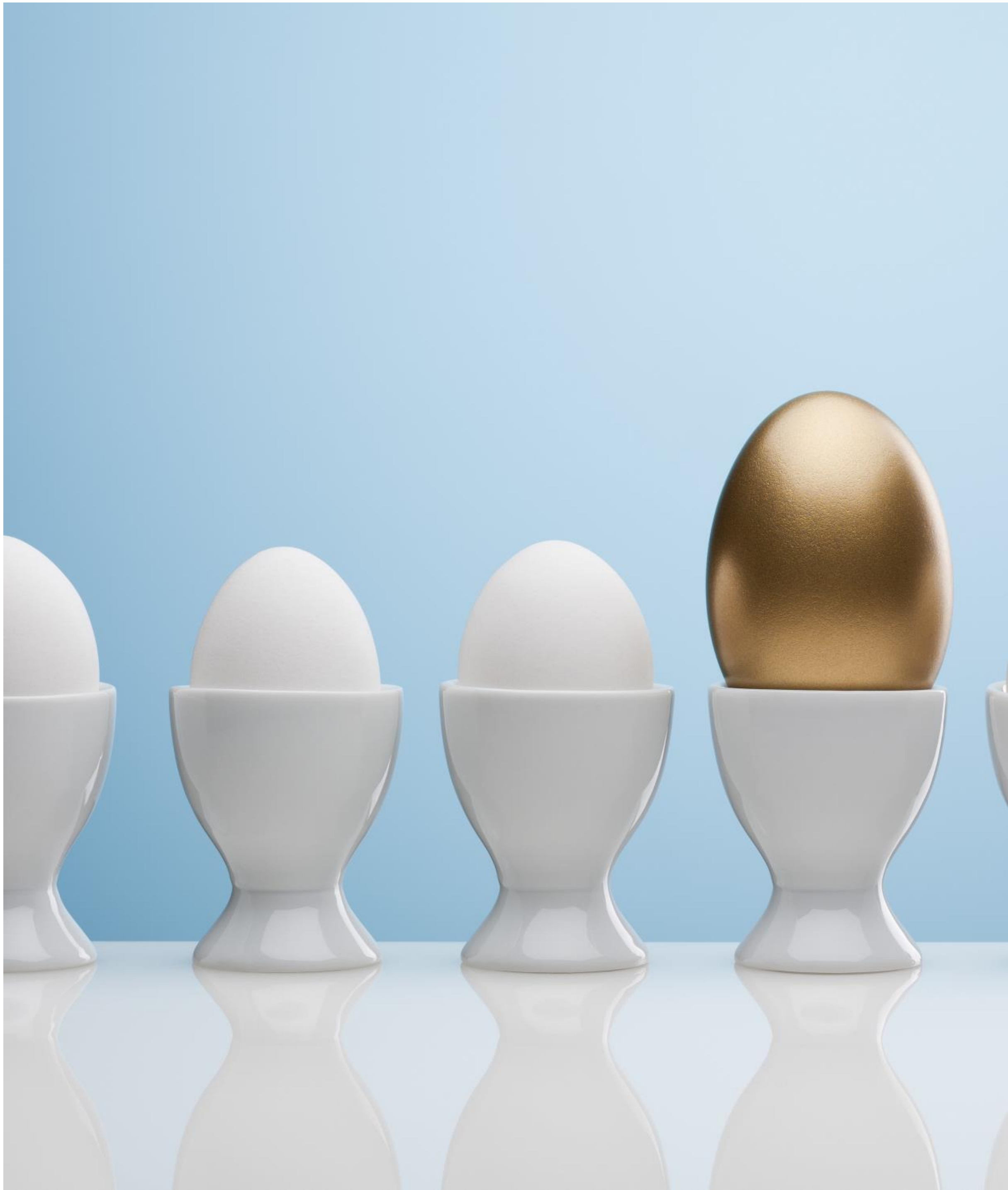
Managing pensions risk in a financial services business



6 February 2015

Agenda

Background

Capital requirement for pension risk

- Evolution of market approach
- Other capital considerations
- Illustrative modelling approach

Retail bank ring-fencing requirements

Q&A

UK pension obligations
Background

- Banks and insurers in the FTSE 100 have total defined benefit staff pension obligations of almost £150bn.

- Key challenges are:
    - New standards Solvency II and Basel III means enhanced focus on modelling of pension risk in base and stressed scenarios
    - Broader PRA/EBA stress tests need to consider pension risk
    - Retail bank ring-fencing requirements mean pension obligations need to be segregated

Capital requirement for pension risk

Capital requirement for pension risk

Evolution of market position

- In recent years, some significant capital add-ons applied to both banks and insurers by the PRA due to concerns around inadequate modelling of pension risk.
- Specific concerns vary from case to case, but general theme is an increase in the level of detail/sophistication expected in modelling year on year.
- Specific reasons for add-ons include:

Use of IFRS/accounting deficit, rather than cash funding deficit	No stress-testing/inadequate stress-testing	No consideration of mortality stresses

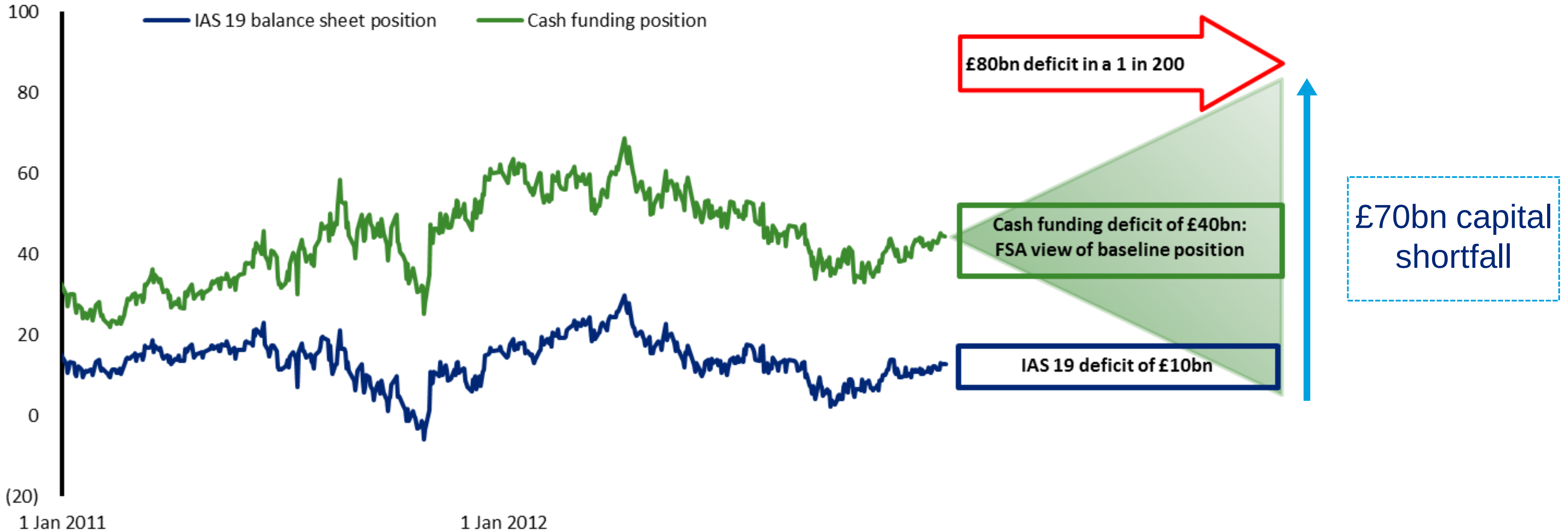
- Add-ons may be determined using broad-brush techniques.
- Robust, detailed approach to modelling can lead to a significantly lower capital requirement than may be required if an add-on is applied.

Capital requirement for pension risk

Evolution of market position

- The PRA's 2011 and 2013 guidance stated that the capital requirement calculation should reflect:
  - The 'technical provisions' deficit agreed with the pension trustees
  - Stressed for a 1-in-200 downside event
- Consistent approach for banks and insurers.

Estimated aggregate pension deficits for FTSE 100 financial services companies



Capital requirement for pension risk

2014 Solvency II developments

- As Solvency II regulations and guidance have developed over the course of 2014, requirements for pension risk modelling have become clearer.
- SII requirements differ significantly from the approach which had been evolving to date. Article 9(1) of the Delegated Acts on Solvency II requires that assets and liabilities other than technical provisions be valued in accordance with IFRS:

> *"Insurance and reinsurance undertakings shall recognise assets and liabilities in conformity with the international accounting standards adopted by the Commission…"*

- PRA consultation paper issued November 2014 confirms that defined benefit staff pension schemes should be measured in accordance with IAS19:

> *"The Solvency II Regulations require that most financial liabilities, including pension liabilities, should be recognised and valued in accordance with in accordance with International Financial Reporting Standards."*

- **Use of IAS19 can mean that the stressed position of the pension scheme is actually *better* than the base position, due to credit spread increases.**
- However, notwithstanding the above for SII, some insurers expected to maintain the technical provisions measure for economic capital modelling purposes.

Capital requirement for pension risk

Recent banking Pillar 2 consultation

- PRA consultation paper 19 January 2015 “Assessing capital adequacy under Pillar 2”.
- Moves focus onto IAS19 basis, rather than technical provisions. Firms should carry out their own assessment of the appropriate level of capital for pension obligation risk and are “*not restricted to using the IAS19 basis in carrying out this assessment*”.
- Firms must also determine the capital requirement under two specified 1-in-200 stress scenarios; this will be the benchmark against which the PRA will assess the adequacy of the firm’s calculated position.

	Stress scenario 1	Stress scenario 2
Fall in equities	15%	30%
Fall in property	10%	20%
Reduction in gilt yields	10%	15%
Increase in inflation	0.5%	0.75%
Change in credit spreads	-25%	+25%
Increase in liabilities due to longevity	3%	6%

Other capital considerations

Governance and risk management

- Explicit additional capital requirements for weaknesses in these areas: "*firms with significantly weak risk management and governance should hold additional capital…to cover the risks posed by those weaknesses until they are addressed*."
- Particular challenge on pensions that most data held outside business and most changes need trustee agreement

Indirect pension risk

- PRA acknowledge that pension obligations can arise not only through direct contractual/statutory obligations of the regulated entity, but also as firms may make payments to pension schemes not directly sponsored by them "because of a moral obligation", due to imposition of a CN/FSD or for some other reason.

Obligations greater than accounting/technical provisions

- Under banking consultation, firms will be required to disclose the section 75 funding position and articulate how to deal with the pension scheme under relevant extreme scenarios bearing in mind potential additional loss and available management actions.

Illustrative modelling approach

Illustrative modelling approach

A four stage methodology

- Key aim of pension modelling should be to:
  - develop a robust assessment and understanding of pensions risk;
  - ensure the approach will withstand regulatory scrutiny; and
  - avoid an overly prudent assessment of capital requirements.

Illustrative modelling approach

Stage 1: Assessing the baseline

- The baseline position is sometimes ‘mechanistically’ updated by rolling forward the liabilities from the previous formal triennial valuation or IFRS balance sheet.
- However, the baseline position should be based on a realistic view of the position at that date e.g. likely outcome if the trustees and company were to strike a valuation at the calculation date.

£m	Actual agreed position 31 December 2013	Approximate projection 31 December 2014	Realistic projection 31 December 2014
Assets	1,600	1,700	1,700
Liabilities	(1,600)	(1,900)	(1,850)
Surplus / (Deficit)	(0)	(200)	(150)
Funding level	100%	89%	92%

Illustrative reduction in deficit: 25%

Illustrative modelling approach

Stage 2: Stresses to apply

- The PRA have stated the following stresses as a minimum:

Equity falls	Property falls	Long term interest rate falls
Credit spread changes	Price and salary inflation changes	Longevity improvements

- Stresses on additional assumptions should be considered, although materiality/variability may mean detailed modelling on these assumptions not required:
  - Commutation
  - Transfer-out
  - Expenses
  - Proportion married

Illustrative downside stress: equivalent to 30% of liabilities

Illustrative modelling approach

Stage 3: Management actions

- Robust arguments can be made for a number of actions which are likely to be adopted in a stress scenario to mitigate the downside risk, for example:
  - Closure to accrual of future benefits
  - Change in discretionary practices
  - Change in actuarial terms applied for member options
  - Change in negotiation approach with pension scheme trustees
  - Liability management exercises
- PRA guidance suggests that management actions are likely to be acceptable if they meet the criteria below:

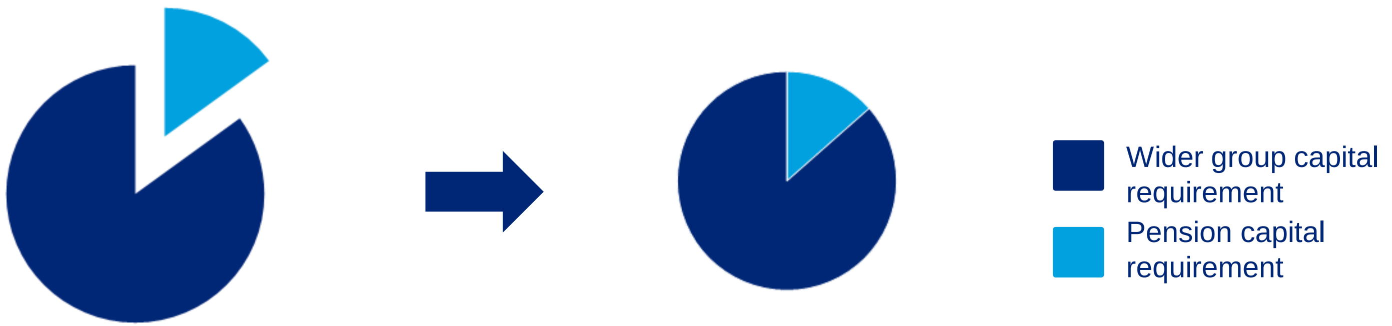
Financial performance	Third parties	Immediacy
Offsets and management actions are more likely to be acceptable if their efficacy does not depend on assumptions as to the future financial performance of the firm, either before or after a stress.	Offsets and management actions are more likely to be acceptable if their efficacy does not depend on assumptions as to the future agreement or behaviour of third parties.	Offsets should reflect a risk mitigation benefit that is already effective when the offset is taken. Management actions should be capable of taking effect quickly enough to mitigate the stress to which they are proposed as a response.

Illustrative reduction in deficit: 10%

Illustrative modelling approach

Stage 4: Diversification with other risks

- The pension scheme modelling should be linked through to the modelling of the group's overall regulatory capital requirements
- Consideration of the stressed pension position in 1 in 200 economic scenarios as used in other areas of the capital assessment may result in offsetting adjustments leading to a reduced overall capital requirement.



Illustrative reduction in deficit: 10%

Illustrative modelling approach

Illustrative impact of detailed modelling on capital requirements

£m	Actual agreed position 31 December 2013	Approximate projection 31 December 2014	Detailed modelling 31 December 2014
Assets	1,600	1,700	1,700
Liabilities	(1,600)	(1,900)	(1,850)
Baseline deficit	(0)	(200)	(150)
plus 1-in-200 stress		(700)	(550)
Management actions		n/a	(50)
Diversification benefit		n/a	(50)
Capital requirement		(900)	(600)

Retail bank ring-fencing requirements

Retail bank ring-fencing requirements

Key requirements on pensions

- Under the requirements of the Banking Reform Act, ring-fenced banks are required to ensure that they are not liable for the pension obligations of other entities outside the ring-fence.

- This can be achieved either through establishment of new pension schemes or through sectionalisation of the existing scheme.

- There is an extended timescale available for pension ring-fencing – the obligations need only be segregated by 2026.

- Affects all areas of operation of scheme.

Retail bank ring-fencing requirements

Key considerations

Allocation of liabilities/members between entities

- Do records exist to accurately split deferreds and pensioners?
- Are there orphan liabilities?
- Comms process with affected members required

Execution of split

- Assets in illiquid/indivisible investments?
- Should a central asset fund be maintained?
- New governance arrangements

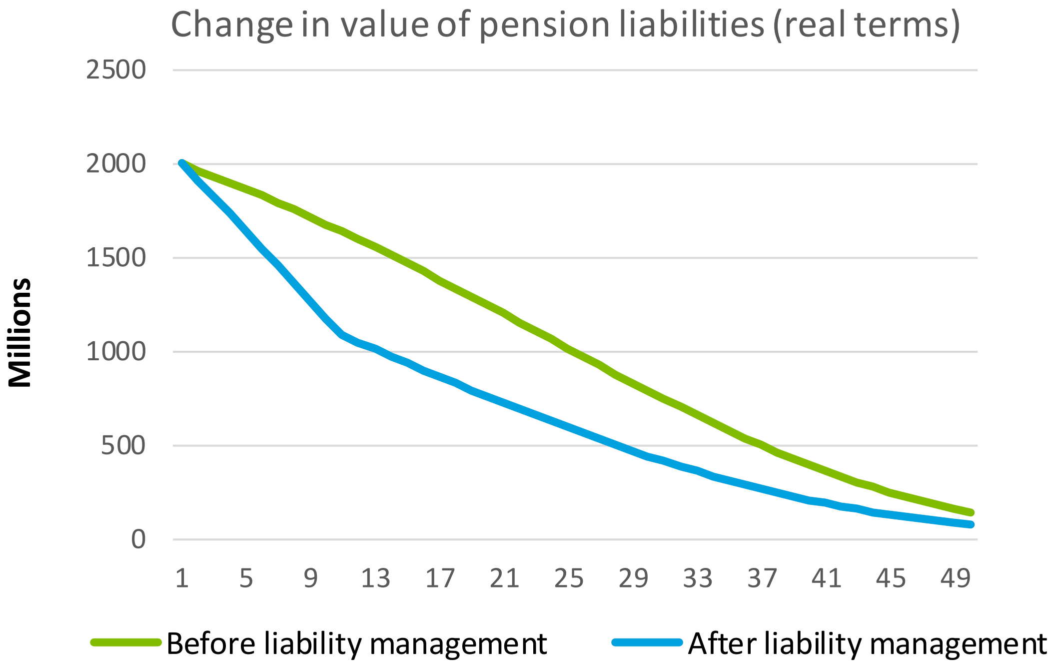
Assessment of employer covenant

- Relative assessment of employer covenant between the entities
- Impact of losing ‘last man standing’ nature
- Change in technical provisions/funding and investment/PPF levy

Retail bank ring-fencing requirements

Opportunities to de-risk

- For pensions, the ring-fencing requirement is only effective from 2026.
- Opportunity to develop a 10 year flight path to reduce and de-risk scheme.
- E.g. programme of retirement transfer offers, early retirement, etc could reduce liability by c.50% over 10 years.
- Reduce the challenges faced when scheme is ultimately segregated.



Q&A