

# Addressing the UK pension funding deficit

June 2006



# **Overview**

**George Rose**  
**Group Finance Director**

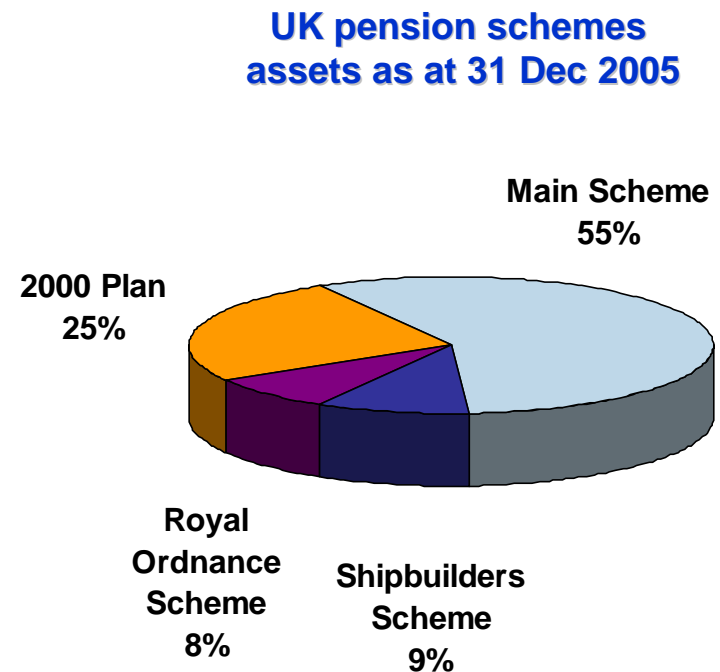
# Introduction

## Background

- Four principal UK pension schemes
- £3.1bn funding deficit\*
- Longevity sensitivity

## Objectives

- Retain Defined Benefit schemes
- Share costs and risks
  - Company
  - Employees



\* Based on most recent valuation data

# UK pension scheme funding summary

	Total	
Increased employee contributions*	466	
Increased company contributions*	642	
Benefit reductions	770	
Salary sacrifice provisions	126	
Company one-off and additional payments	1,087	
<b>UK funding deficit reduction</b>	<b>3,091</b>	<b>£m</b>

\* recurring

# Objectives and Principles

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- **Seek to maintain a Defined Benefit scheme for those people given that promise at joining**
  - **Defined Benefit schemes are very valuable**
  - **Promise is only as good as the company behind it**
  - **Solution to be shared between company and members**
  - **Accrued benefits to be protected**
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# **Consultation and Implementation**

**Alastair Imrie**  
Group HR Director

# Approach

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- **Resolve to address the problem**
    - **“Do nothing” not an option**
    - **Constructive approach through extensive consultation**
    - **Trade Union involvement throughout**
    - **High quality communications**
    - **Take time**
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# Communications

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- **Executive team commitment**
- **Regular PRCC meetings**
- **Multiple mailings to employees**
- **Trade Union ballots and all employee telephone surveys conducted**
- **Employees - clear majority votes for acceptance**
- **Benefit changes and funding agreed by Pension Trustees**

# Funding Deficit Reduction - Main Scheme

## Phase 1

- **Hybrid plan with final salary component for all new hires after April 2003**
  - **Company contribution 8.1%**
  - **Employee contribution 4.0%**
- **Company contributions increased for existing employees**
  - **From 11.7% to 18.21% implemented for Main Scheme**
- **Employee contributions increased**
  - **Main Scheme increased from 5.0% to 9.29%**

# Post phase 1

## - Increased longevity and lower investment returns

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- Longevity has increased substantially
    - from average 16 years in retirement in 2002 to average 20 years in 2005 for an individual now at age 65
  - ....and is expected to continue to increase
    - changes agreed now must remain relevant to future longevity increases
  - Investment returns were lower than previously assumed
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# Funding Deficit Reduction - All UK Schemes

## Phase 2: Recurring contribution increases

- Employee contributions increased in a similar approach to the increase to Main Scheme contributions
- Company contributions similarly increased

Deficit  
reduction

466

642

770

126

1,087

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3,091

£m

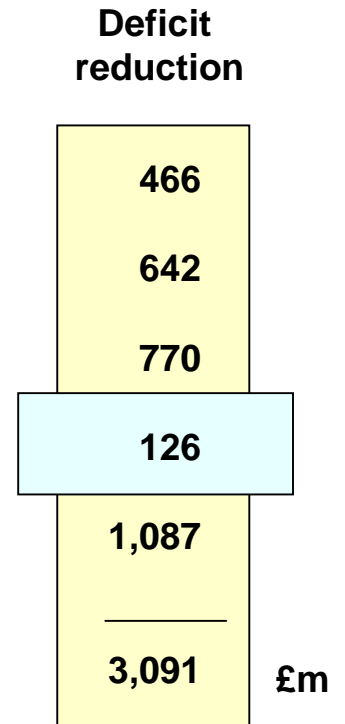
# Employee Benefit Reductions

	Total	Deficit reduction	
Life expectancy adjustment*	166		
Pension increases capped @ 2.5%	164		
Deferred pensioners early retirement	126	466	
Pay averaging	93	642	
Early retirement factors	84	770	
Ill health earnings impairment	68	126	
Level 200 optional contribution	66	1,087	
Change to normal retirement age	10		
Pensionable pay freeze	7		
Widows pension	(14)		
(£m)	<u>770</u>	<u>3,091</u>	£m

\* Longevity calculated using PA 92 medium cohort tables adjusted for actual scheme experience

# Salary sacrifice scheme

**Salary sacrifice scheme introduced**



**“The strength of the BAE Systems agreement lies in the way they conducted the consultation process.**

**The Company were clearly committed to working closely with both the unions and their employees to find a way forward acceptable to everyone. We were all involved in helping develop the solution and had full visibility of the information. This, combined with the fact that we have a joint understanding of the basic principles of a strong pension scheme, including maintaining a viable final salary scheme for existing members, allowed all parties to come to a Final agreement.**

**I would like to see more companies take this lead.”**

**John Wall – General Secretary CSEU**

**13 June 2006**

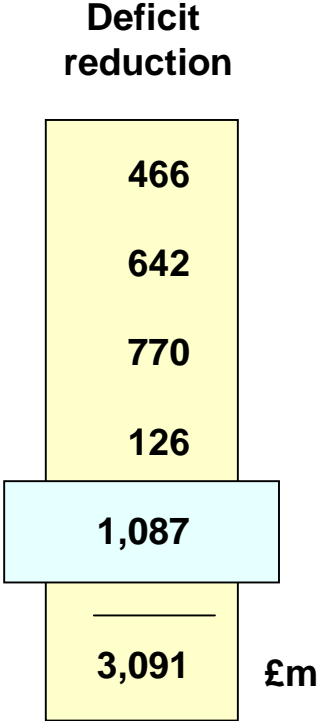
# **Financial Effects**

**Peter Lynas**

**Director, Financial Control and Reporting**

# Company one-off contributions

- **2006**
  - Assets and cash £661m
  
- **Beyond 2006**
  - Cash over 10 years £426m



# **IAS 19 Accounting**

## Pension Deficit – IAS 19

- **Headline deficit @ 31 Dec 05**

	UK	US	Other	Total
<b>Scheme assets</b>	<b>10,833</b>	<b>1,628</b>	<b>-</b>	<b>12,461</b>
<b>Scheme liabilities</b>	<b>(15,492)</b>	<b>(2,130)</b>	<b>(145)</b>	<b>(17,767)</b>
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<b>Gross Deficit</b>	<b>(4,659)</b>	<b>(502)</b>	<b>(145)</b>	<b>(5,306)</b>
<b>Allocation to equity accounted investments</b>	<b>1,210</b>	<b>-</b>	<b>-</b>	<b>1,210</b>
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<b>Net Deficit</b>	<b>(3,449)</b>	<b>(502)</b>	<b>(145)</b>	<b>(4,096)</b>

# IAS 19 deficit - key assumptions

## IAS 19

- Assets based on balance sheet date valuation
- Liabilities discounted using 'AA' bond rate
- Deficit allocated to participating employers including Equity Accounted Investments

## Sensitivities

- Assets 'mark to market' approach
- 1% increase in real discount rates = circa £2.2bn reduction in gross deficit

# IAS 19 vs Funding Deficits

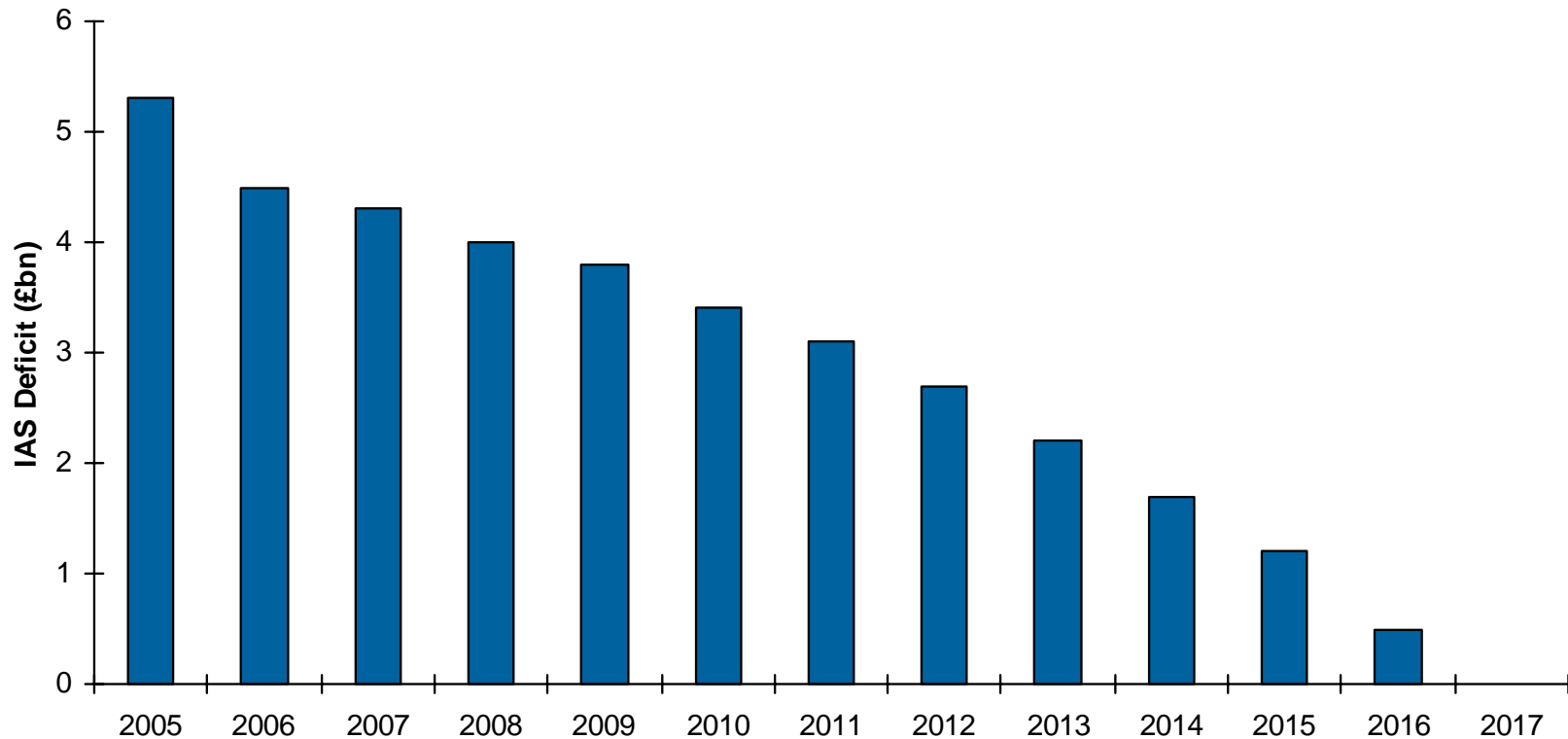
## Primary differences between IAS 19 and Funding Deficits

- **Discount rates for liabilities (circa £1.5bn)**
  - IAS 19 uses 'AA' Corporate Bond rate
  - Funding uses blended rates to allow for equity returns in line with investment strategy
- **Others (circa £0.6n)**
  - Funding assumes different 'real' salary escalation rate
  - Unfunded schemes (Atlas, Hagglunds, Bofors)
  - Timing of valuations (balance sheet date vs scheme dates\*)

\* triennial for UK schemes

## IAS Deficit Reduction (All Schemes)

The IAS19 deficit will reduce as the ongoing funding deficit is addressed



**Assumes no change in investment returns or discount rate over time**  
**IAS 19 Deficit reduces to zero progressively**

# IAS 19 - P&L

## Key points

- **EBITA charge = net cost of one year's accrued benefit**
- **Finance cost = net of:**
  - (i) **expected return on assets at start of year**
  - (ii) **one year's unwinding of discounted liabilities**
- **Any movement from expected return flows through reserves**

## Year on year sensitivities

- **Change in benefits**
- **Change in discount rate**
- **Change in expected returns on assets**

# Summary

- **Plan eliminates current UK funding deficit estimates on long-term actuarial basis**
- **Agreements address future active member longevity change**
- **Funding plan addresses recent increases and future expected improvements in longevity**
- **Defined benefit schemes retained as valuable skills retention tool**
- **Delivers pension funding solution shared by company and employee**
- **Will reduce future IAS 19 deficit**

# Questions

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|-----------------------|--|
| <b>George Rose</b>    | - <b>Group Finance Director</b>              |
| <b>Alastair Imrie</b> | - <b>Group HR Director</b>                   |
| <b>Peter Lynas</b>    | - <b>Director Fin. Control and Reporting</b> |
| <b>David Brent</b>    | - <b>Group Treasurer</b>                     |
| <b>David Brief</b>    | - <b>Ch. Investment Officer BAPFIM</b>       |
| <b>Nigel Tinsley</b>  | - <b>Pensions Director</b>                   |