

Independent Actuarial Advisers

One of our concerns with the running of the Pension Funds, especially given the increased powers of Trustees, is the role of the Scheme Actuary. **At the moment Watson Wyatt advise both the Bank and Trustees and although there is no criticism of their performance we believe there could be a perceived conflict of interest that can only be resolved by the Trustees appointing their own actuarial advisers.**

Whilst the potential for a conflict of interest has always existed, the fact is that now, when the schemes are in deficit, the Group would normally prefer to minimise, whilst the Trustees would prefer to maximise, the rate of employers' contributions.

In these circumstances the Trustees, and more importantly the members of the fund, need to be sure that their actuarial advisers are wholly independent of the Bank and acting in their best interests. The Trustees should appoint their own, independent actuary.

The Way Forward

The next actuarial valuation under the new funding regime is not set to take place until 2008. LTU have written to the Trustees asking them to bring forward that valuation now and appoint an independent firm of actuaries to carry out that work on behalf of members of the Scheme. A similar valuation should be carried out for the No 1 Fund. Only then will we have a clear picture of the state of the Funds.

I will report back to members in due course. Members with any questions or comments on this Newsletter can either contact the Union's Bedford Office on 01234 262868 or they can email me at Mark.Brown@ltu.co.uk.

Mark V Brown
Assistant General Secretary

Glossary of Pensions Terms

- **Actuarial Assumptions**

In a defined benefit scheme the set of assumptions made by the actuary as to rates of return, inflation, increase in earnings, mortality, etc which form the basis of an actuarial valuation or other actuarial calculation.

- **Actuarial Valuation**

An investigation by an actuary into the ability of a pension scheme to meet its benefit promises to members. This is usually done to calculate the recommended contribution rate, which takes account of the actuarial values of assets and liabilities of the fund.

- **Bond**

Certificate of debt issued by a company, government or other institution. Bond holders are creditors of the issuer and interest is paid at the rate stated at the time of issue.

- **Defined Benefit Scheme**

A scheme in which the pension and other benefits that will be paid to the members and/or their dependants are stated clearly in the rules of the scheme.

- **Funding Method**

The approach used by an actuary in an actuarial valuation. A variety of methods can be used, but whatever method is employed should be described adequately in the valuation report.

- **Investment**

The process by which contributions and net income of a scheme are used to increase the value of pension fund assets by means of cash deposits, the purchase and sale of equities, bonds, property and other assets as authorised by the trust deed and by law.

- **Liabilities**

The obligations of a scheme to make payments, either immediately or in the future, where payment is dependent on unpredictable future events (such as the death of a member) are called "contingent liabilities".

29th January 2007

All TSB Heritage Members

Pension Deficit Time Bomb

A report commissioned by LTU blows a hole in the Bank's carefully crafted pension deficit strategy and raises important questions about the Group's future profitability.

An Executive Summary of that report is attached to this Newsletter and the full report has been sent to the Trustees and the Bank. Hymans Robertson, a leading firm of UK Actuaries, have concluded that under the new funding regime the ongoing deficit in the LTSB No 2 Pension Fund could potentially be in excess of £1.3 billion. That is significantly more than the £372 million deficit announced to the City. Hymans Robertson have also concluded that the annual contributions needed to eliminate a £1.3 billion deficit over 10 years could potentially be over £150 million a year. Moreover, the contributions required to fund benefits accruing in future, allowing for future salary growth, could potentially be over 30% of pensionable salaries not 22.7%.

Members will recall that the Bank announced last year that it would make annual contributions of £51 million for the next ten years in order to reduce the deficit of £372 million. It even suggested that it could reduce the deficit in 6 years with additional voluntary contributions. More recently the Bank announced that its decision not to augment the pension

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entitlement of employees taking early retirement would reduce the Group's pension liabilities by up to £125 million. However, the pension liabilities suggested by the report are much greater than anyone dared to think and rather than reducing its contributions the Bank could have to increase them significantly in future.

Deficit Over £1.3 Billion Not £372 Million

In our Newsletter detailing the Bank's proposals to eliminate the deficit, we said "... on the basis of the information we have seen thus far the Union is content that the Trustees have agreed a plan that is in the best interests of pension scheme members and will see the actuarial deficit eliminated in a reasonable timescale."

Since that Newsletter we received a copy of the 2005 Actuarial Valuation for the No 2 Pension Fund and LTU asked Hymans Robertson, one of the biggest firms of Actuaries in the country, to comment on the assumptions underlying the 2005 Actuarial Valuation, carried out by Bank's actuaries Watson Wyatt. We also asked Hymans to consider to what extent those assumptions would need to be modified significantly following the introduction of the new funding regime which was introduced last year.

The Pensions Regulator has said that in making assumptions under the new funding regime, Trustees should act "prudently" and aim for a strong funding target. In reviewing the latest actuarial valuation Hymans Robertson have adopted 'middle of the road' actuarial assumptions and their conclusions will make uncomfortable reading for the Group and interesting reading for the Trustees.

Hymans Robertson have looked at the actuarial assumptions adopted in the Actuarial Valuation of the LTSB No 2 Pension Fund and subjected them to the test of 'prudence'. When reviewing the assumptions underlying the Actuarial Valuation, Hymans Robertson have looked at investment returns, pension increases, life expectation after retirement and cash at retirement (where people have the option to take some of their future pension immediately in the form of a cash payment).

Investment Returns

The key when investing is to produce returns over and above those that are achievable for gilts and bonds. But additional returns mean additional risk. The decision the Trustees have to take is about how much extra return might be received, balanced against the risk that it might not be achieved, particularly in the short term.

It is generally accepted that the best estimate for likely returns from equities and property investments over the long term is between 3% and 4% p.a. above gilts. Corporate bonds will outperform gilts by between 0.5% and 1% p.a. **Hymans Robertson have said that allowing for the mix of assets held by the Scheme and the degree of prudence required under the new funding regime, they have suggested an investment return assumption of 6.6% p.a. pre-retirement and 4.6% post-retirement. Those two changes alone would increase the pension scheme liabilities of the No 1 Fund by some £385 million.**

Pensions Increases

At the time the valuation was carried out the Bank of England's 20 year inflation estimate was 2.76% and Hymans have suggested that an inflation assumption of 2.7% is reasonable.

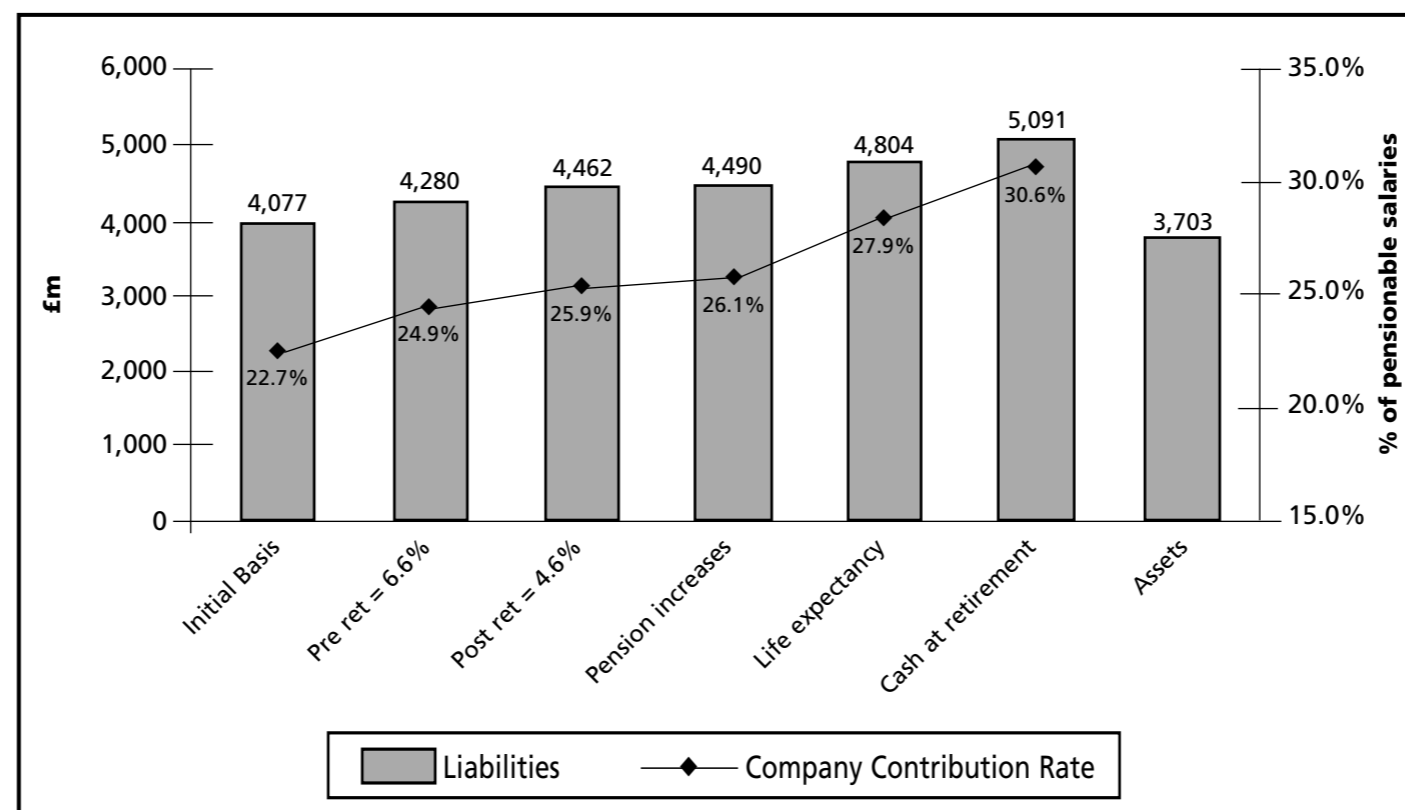
Pension increases are capped at either 4% p.a. or 5% p.a. Currently Government policy is to maintain inflation at a level around 2% p.a - 2.5% p.a. and inflation is not expected to rise above 4% p.a. for the foreseeable future. **Hymans Robertson suggest that future pension increases should be assumed to be at the same rate as a predicted inflation rate of 2.7%. That figure compares with the**

assumptions of 0.3% pa and 0.1% pa below inflation that were used in the formal valuation. That would add £28 million to the Scheme's liabilities.

Life Expectancy

Not surprisingly key drivers of change in pension schemes are the assumptions that are employed for the length pension scheme members live based on mortality rates. Defined benefit schemes provide a certain level of pension for the rest of a pensioner's life, so the value of pension liabilities are determined by how long pensioners are expected to live. The bases of such projections are hotly contested amongst the actuarial profession and it's true to say there is no single consensus view. However, commonsense would say that generally speaking employees in the financial services sector are likely to benefit from the factors driving improved life expectancy.

In their Executive Summary Hymans Robertson say that "... the most recently published projections for future improvements in life expectancy would result in life expectancy around 2 years longer than the assumptions made. If this more prudent life expectancy assumption is adopted, it could increase the liabilities by around 7%. That change alone equates to an increase of £314 million in the liabilities of the No 2 Pension Fund.



Cash At Retirement

All members have the option to exchange part of their pension for cash at retirement. The Formal Valuation has allowed for all non-pensioners to take advantage of this option. But it's cheaper for the Scheme to pay cash rather than a pension and if members don't take cash then the Scheme would have to pay for the full pension but that is not reflected in the Formal Valuation. Hymans Robertson have said that it would be more prudent to assume that members take their full pension rather than cash. Such an assumption would add £287 million to the liabilities of the pension fund.

Valuation Results

The effect on the liabilities and contribution rates of the changes in assumptions is set out in the graph above. According to Watson Wyatt the liabilities of the fund as at June 2005 were just over £4 billion whereas Hymans Robertson have said the figure under the new funding regime is potentially over £5 billion. According to Hymans Robertson the actual pensions deficit is potentially in excess of £1.3 billion. They have said their estimate of the annual contribution that would be required to fund the Scheme and correct the shortfall over a period of 10 years using their proposed assumptions could be over £150 million a year.

We believe that given the state of the Group's various pension funds the Trustees should adopt prudent assumptions about the future now rather than being overly optimistic in the vain hope that the deficit will disappear over time.