

# NAPS Fund Deficit

## Frequently asked questions

### 1. Why is there a deficit?

Over the past 5 years or so world economic performance has not been as good as it was assumed it would be. The result is that NAPS, like most other UK schemes, has a large deficit. This deficit reflects lower investment returns in bond and equity markets and, to some extent, increasing life expectancy. Because of the long-term nature of NAPS - if the current structure is maintained the fund is expected to grow to be 2 or 3 times the size it is now over the next 20 to 30 years - small differences between assumptions and reality can create large changes to the funding level. It is expected that the period of low interest rates will continue and this will further reduce the level of income from the NAPS investments predicted at the last valuation.

The 2000 valuation showed a deficit of £220m and this had increased to £928m by the 2003 valuation. Early indications are that the 2006 valuation will show a further increase in the deficit despite the extra contributions the Company has been paying. This expectation is one of the reasons the Company is now expressing concern about the ongoing cost of NAPS.

Whilst the deficit position is an indication that in the longer term there are likely to be funding problems we should emphasise that NAPS has the funds to continue paying pensions and other benefits as they fall due. However the long-term problem does need to be addressed now as there could be particular problems if the Company were to become insolvent and was not around to maintain contributions in the future.

### 2. What are the duties of the Trustees in relation to investments?

The Trust Deed, which established NAPS in 1984, provides the Trustees with wide powers of investment although, in accordance with general trust principles, they are expected to act prudently when making investments. They are also required to act in the best financial interests of the beneficiaries. In practical terms they need to take expert advice and then strike a prudent balance between risk and return. The Trustees want to generate a reasonable level of income for the Scheme without taking undue risk.

### 3. Why does NAPS have such a high proportion of the funds in equities?

It is generally accepted that the returns from equities will, over time, outperform say index-linked bonds. Most of the benefits building up in NAPS are in respect of active members whose benefits increase each year in line with pay and are not expected to be paid for many years. Pay usually increases at a quicker rate than the Retail Price Index and the resulting pension benefits are impossible to match even with low-risk / low-return bonds. So if investments are to keep pace with the build up of benefits it is important that a reasonable proportion of the funds are invested in an asset which is most likely to deliver strong returns. As a result the investment strategy set by the Trustees has a high weighting towards equity and most UK pension funds with a similar structure of liabilities have done the same.

Investments in equities do carry risk and have the disadvantage of exposing NAPS to volatility on the stock markets. However, it has the advantage of generating much larger longer-term returns than say bonds. If the Trustees weighted the NAPS portfolio more heavily to bonds, NAPS would have shown a larger deficit as the future investment returns would have been expected to be lower. Our fund managers have also invested well and generated above benchmark returns.

**4. Why is it necessary to take any action? If stock markets pick up then the funding could correct itself.**

It is theoretically possible that economies will boom, income from investments will significantly increase and that the trend of people living longer will reverse. But all reasonable assessments indicate that the Trustees cannot prudently rely on that to be the case. The Trustees have a legal obligation to try to ensure the right balance between expected contributions, investment income and benefit payments. They also have a legal obligation to aim to ensure the Scheme is fully funded over a reasonable period and consequently, they cannot rely on investment income alone to extinguish the deficit. They will need to engage with the company to find a solution to the longer-term funding problem.

**5. What will the Trustees do if the Company proposes a rule change?**

The duty to act in the best financial interests of the beneficiaries is a key Trustee responsibility. The Trustees will undoubtedly need to consider the specifics of any proposal and obtain detailed legal advice as to the extent that any proposal is compatible with their duties to beneficiaries. They will need to establish the impact the proposal will have on the deficit and the company's long-term ability to support the Scheme.

The Trustees have noted the concern expressed by some members of the Scheme in relation to the Company's consultation.

The formal position is that to amend the terms of the trust, two thirds (8 out of 12) of the Trustees must vote in favour of any alteration.

However, it is not anticipated that any proposal will be put to the Trustees until after the Company has finished its discussions with staff and the TUs in the spring of 2006.