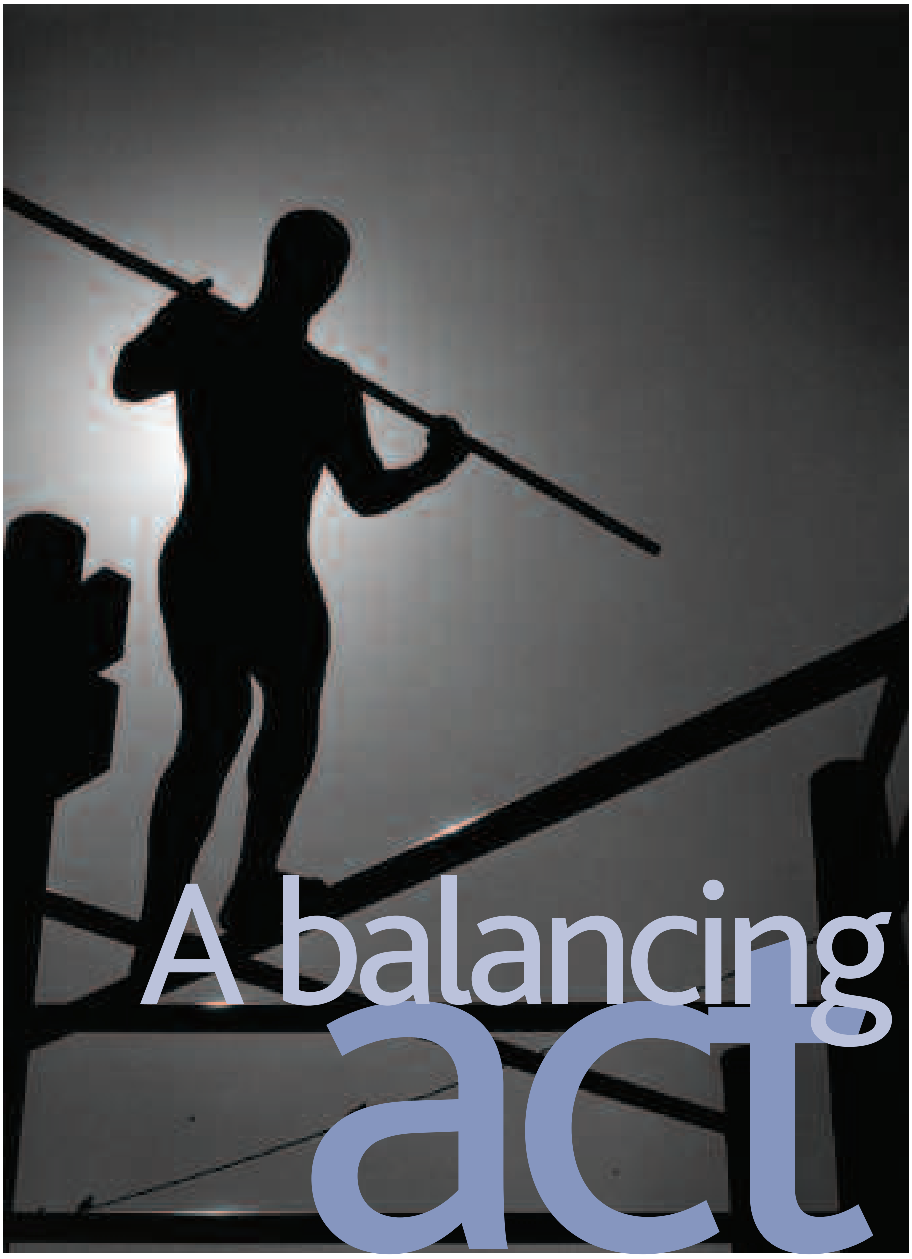


In the first of a series of articles which will look at how treasurers should respond to the pension challenge, **Sinead Leahy, Eddie Doyle** and **Guy Whitby-Smith** of the RBS Pension Solutions Group consider the importance of establishing a risk framework.

Executive summary

- The pension risk that companies run can often be many times bigger than the foreign exchange and interest rate risks that treasurers have been managing in a systematic way for years. Treasurers need to manage this pension risk in a similar way. However, as ultimate decision making regarding pension investment lies with trustees, treasurers need to balance the needs of the company sponsor with those of the trustees.

From a position of obscurity, pensions have come to dominate the corporate finance scene in a way that was unimaginable a few years ago. A lethal cocktail of factors including adverse market moves, governance issues, regulatory environment and financial reporting standards is altering the landscape in which corporates are having to operate, and has pushed pensions onto the boardroom agenda.

Once the preserve of actuaries and pension trustees – and only of passing interest to treasurers, finance directors and their advisers and backers – pension planning is now a top and urgent priority to ensure that the pension deficit does not at best distract and at worst destroy the whole company. Anecdotal evidence suggests that the time commitment is about 20% of many treasurers' working week. It is a material amount of time and it cannot be avoided.

CONFLICTING DRIVERS?

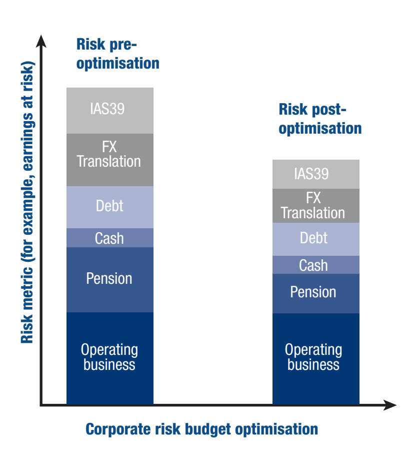
Trustees	Company
Funding level	Use of capital
Level of risk return	Accounting figures
Contribution timing	Cashflow flexibility
Company covenant	Overpaying

Trustees and company sponsors do not always see everything from the same perspective. Trustees want to ensure that a strong funding position is maintained to be confident that the scheme can meet its pension obligations in full. Company sponsors want some control on the level of contributions and to understand what risks the corporate pension scheme is running. Ensuring that the needs of both parties come together can be a delicate balancing act.

ENGAGING WITH TRUSTEES While ultimate decision-making regarding investments lies with trustees, after taking advice from their investment consultants, it is vital that the company engages with the trustees at every stage. This can be mutually beneficial, as the trustees benefit from the risk management experience of the company's treasury department while the company buys into the risk strategy adopted by the scheme. This is key, particularly as, following scheme-specific funding valuations, a deficit funding programme will need to be agreed with reference to the risk strategy and company covenant, and this will directly impact company cashflow.

Many companies are taking steps to

Figure 1. Risk budget optimisation



THE PENSION PROBLEM IS CAPABLE OF RESOLUTION IN WAYS THAT WORK FOR BOTH SHAREHOLDERS AND MEMBERS OF THE PENSION FUND.

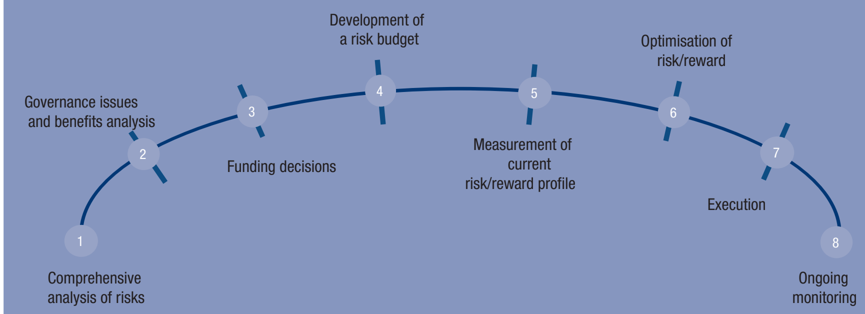
ensure they have appropriate representation on the trustee board. Where the treasurer is also a trustee, this creates conflicts that need to be managed; however, it does help boost risk expertise at a time when the trustees' already tough job is becoming tougher.

The Pensions Regulator is demanding more of trustees. Trustees are being encouraged to manage their pension fund risk better – in the same way as a corporate or financial institution manages its risk. It is becoming a requirement for trustees to understand a wider range of financial instruments, far beyond the traditional equity/bond decision of the past.

THE PROMISE OF RESOLUTION The good news is that the pension problem is capable of resolution in ways that work for both shareholders and members of the pension fund. While no one vested group has all the answers, trustees and corporates share many common objectives. They both want a viable pension scheme over the long term which delivers on its promises for all stakeholders. Trustees and corporates seek certainty over the size and timing of cash outflows and inflows. Treasurers might seek to reduce accounting volatility (see *Figure 1*).

Case study

Over the next few months we will explain how a typical UK corporate deals with its pension issue as it sets out on the journey down the pensions track.



This month we will introduce our example company and understand the make-up of its assets and liabilities.

COMPANY BACKGROUND

ABC plc

A FTSE 100 company with a market capitalisation of £3bn.

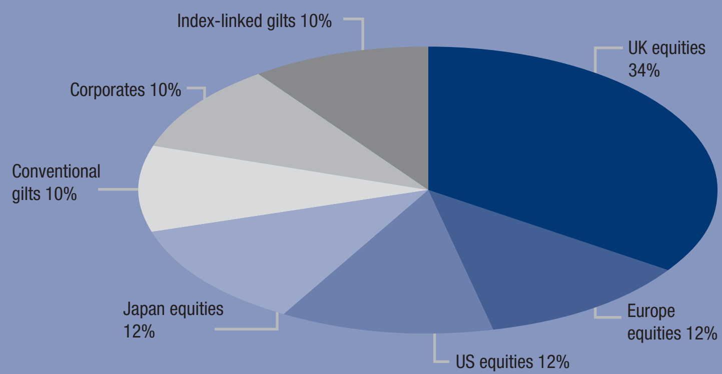
BBB-rated.

Pension deficit of £500m.

Pension assets of £1.5bn and liabilities of £2bn.

ASSET ALLOCATION

The scheme has 70% of assets invested in UK and overseas equities and 30% in government and corporate bonds.



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Case study

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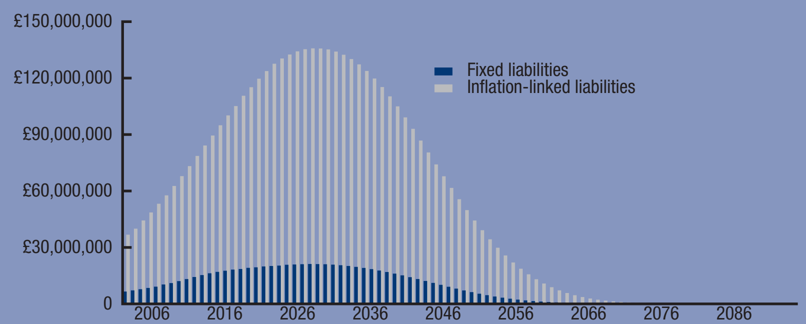
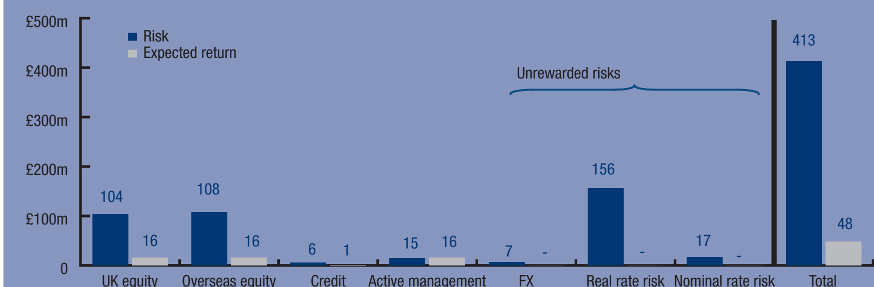
ACCRUED LIABILITY CASHFLOWS



The above graph shows the expected cashflows that the pension fund will need to pay out year on year. The first point to note is that the vast majority of the payments are linked to inflation. The second point is that the cashflows are very long dated, with an average duration of around 20 years.

An initial analysis of the investment risk and reward position of the fund reveals the following.



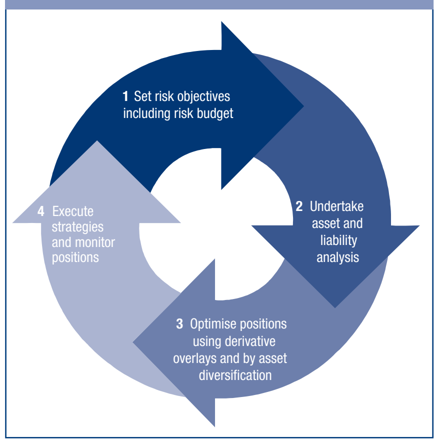
The chart above shows the current risk (defined as the minimum increase in the deficit over a year in a one-in-20-year event) within the scheme (£413m) and the current expected return per year above the liabilities (£48m). We then split this risk and return into the various risk factors that account for it. As with most UK pension schemes, the majority of the risk is from equities and interest rates (mainly real interest rates) and most return expectation comes from equities.

Next month, ABC will agree a series of objectives with the pension scheme trustees, including setting a risk budget and agreeing a contribution plan as well as undertaking a full asset and liability study. This will enable the stakeholders to understand the liability profile and review the unrewarded risks as well as review the current asset allocation.

Members of the pension scheme want to know their pension is safe and will be paid, while the company wants to be able to scope out the extent of its liability.

NEED FOR SINGLE FRAMEWORK All stakeholders' objectives need to be incorporated into a single framework that accurately captures the scheme's specific risks and presents them in a clear and consistent fashion. The integrity of this risk framework is paramount, as it must hold up to the scrutiny of both trustees and corporates alike. By adopting this step-by-step approach with clear objectives and solutions (an example of which is shown in our case study), both parties can understand and be in control of the process.

Figure 2. Risk management framework



The starting point is an understanding of the pension scheme's assets and liabilities, and how these behave together. A detailed analysis of the scheme-specific risks must be undertaken. All parties should then focus on optimising the risk within the fund through risk mitigation strategies and asset allocation decisions. Efficient execution and ongoing monitoring of the pension scheme will follow.

Over the course of the next few months, we will continue along the pension roadmap that we have introduced in this article and work through the practicalities of delivering on each stage. We will also draw parallels to our client case study to bring further clarity to the process.

For more information call the RBS Pension Solutions Group on 020 7085 1362 or visit www.rbsmarkets.com/pensions