risk management
PENSION SURVEY

What a difference a year makes

TIM KEOGH ANALYSES THE FINDINGS OF THE RECENT MERCER/ACT 2007 SURVEY OF PENSION FINANCIAL RISK.

During May 2007, Mercer Human Resource Consulting and the ACT approached chief financial officers (CFOs) and treasurers for the third annual survey on managing pension financial risk. As in previous years, the survey sought to determine the extent to which this group viewed pension schemes and their deficits as significant corporate risk issues, and their perception of stakeholder attitudes towards such risks. Once again more than 100 responses were received, with FTSE 350 companies well represented. This article summarises those responses. Several of the questions asked were deliberately similar to those of previous years, but we also tried to address new issues that have become increasingly high profile over the last 12 months.

CHANGING PERCEPTIONS OF PENSIONS RISK Participants were asked how they thought pension funding and investment strategies had changed in importance for various stakeholders over the last year.

Once again a majority of respondents thought that board/senior management and employees were attaching either slightly more or much more importance to these strategies – almost two-thirds placed themselves in these categories and only a small minority of each group thought there had been a reduction in importance.

Greater shareholder/analyst interest was a little less in evidence, with 46% reporting increased attention but 40% seeing no material change. Given that increased awareness in all three groups was also identified last year and that by some measures (for example, size of FTSE 350 aggregate IAS 19 deficit) the scale of the problem may be thought to have been diminishing, one explanation might be there was a very low initial level of awareness two years ago.

CONTRIBUTION DRIVERS Participants were asked if they had made any 'special' contributions (that is, over and above normal contributions) to company pension schemes in the UK or abroad during the past year. Those who had were asked to state the principal drivers and whether they had undertaken a specific financing arrangement in connection with the special contributions.

For the second year running almost 60% of respondents had made special contributions, although the drivers have evolved with the maturing of changes in the regulatory regime. Almost half were now prompted at least in part by general pressure from trustees, while the other reasons most frequently quoted (in a multi-answer question) were strengthened mortality assumptions (32%), general risk mitigation (30%), PPF levy considerations (28%) and reasons related to corporate transactions (27%). Tax reasons and Pensions Regulator triggers also received an honourable mention (both around 20%), but avoidance of credit downgrades notched only 3%. The number of respondents undertaking specific financings in connection with special contributions rose significantly, from 12% to 20%. Such financings rarely receive publicity, but it does suggest that the tax, levy reduction and other advantages associated with such financings are increasingly appreciated.

USE OF DERIVATIVES Participants were asked if their schemes had used derivatives for interest rate, inflation, currency or credit hedging/protection purposes in the UK or abroad.

Although the overall percentages were still relatively small, at around 18% and 17% respectively, the use of interest rate and inflation hedging instruments by schemes has trebled in the last year. Given the marketing efforts by investment banks in relation to such projects and their very clear potential to contribute to risk reduction strategies, it would have been surprising if growth of this order of magnitude had not been evident.

A larger proportion (28%) were using derivatives for currency protection, presumably in relation to the increasing overseas component of equity portfolios. Almost 6% were using derivatives (presumably credit default swaps and their variants) for credit protection compared with zero last year – we will examine this in more depth next year. Once again respondents gave several examples of other areas in which they had used derivatives, including transition management, gaining exposure to asset classes and providing downside protection.

Interest rate and inflation hedging Participants were asked if they had hedged interest rates and inflation directly (for example, by using swaps) or indirectly (for example, by using 'bucket funds').

Almost two-thirds of those undertaking such hedges had used

MANY TRUSTEES ARE CONCERNED TO OBTAIN SECURITY ABOVE PPF LEVELS, AND HENCE WILL NEGOTIATE CONTINGENT ASSETS EVEN WHEN FULLY FUNDED ON A PPF BASIS.

Executive summary

- The single most dramatic movement has been an increase in the use of derivatives for hedging purposes despite concerns over pricing, liquidity and documentation, and the failure of the PPF to reward lower-risk investment strategies.
- There continues to be evidence of increased awareness of issues and solutions. Two-thirds of boards are giving more attention to pension issues although the size of the issue has generally been stable. Most respondents thought that board/senior management and employees were attaching more importance to pension funding and investment strategies than in the previous year, although increased shareholder/analyst interest is a little less in evidence.

derivatives directly, while the remaining third had used bucket funds. Combined with the response to the previous question, this strongly suggests that not only are trustees and sponsors becoming more aware of the potential for hedging interest and inflation risk, but also that they are increasingly comfortable with derivatives documentation and the process of collateral management.

Alternative investment classes – commodities and currency Participants were asked if they had used derivatives to gain exposure to a variety of asset classes: commodities, currency and 'other'.

Again, given the efforts recently put into marketing alternative asset classes, we should not be surprised at the appreciable number of positive responses to this question. Almost 10% of respondents were using derivatives to obtain commodity exposure and over 20% currency. Other derivatives-based strategies described included corporate credit exposure, interest rates and macro asset allocation.

CONTINGENT ASSETS In a new question, participants were asked if they were using contingent assets as part of their scheme funding strategy in the UK and, if so, into which PPF category they fell.

Use of contingent assets remains a minority pursuit, but the minority is a significant one at 17%. Of these, 53% were using 'type A' – in other words, guarantees given by parent/other group companies. Several of these respondents were using more than one type of contingent asset, with 47% using type B (security over cash and other assets) and 36% using type C (letters of credit/bank guarantees). 11% of respondents were using contingent assets that did not qualify for PPF levy reduction purposes. While on the face of it, this may be surprising, many trustees are concerned to obtain security above PPF levels, and hence will negotiate contingent assets even when fully funded on a PPF basis. There is additional flexibility in such cases to agree a bespoke solution rather than fitting within the PPF's tight requirements.

IMPACT OF LEGISLATION ON CORPORATE ACTIVITY Participants were again asked if they believed the new regulatory regime introduced by the Pensions Act 2004 was having an adverse impact on corporate activity, both generally and on their own company.

55% of respondents believed that there was an adverse general impact, down very slightly from last year (57%), with 31% disagreeing and 14% unsure. The proportion that thought there was an adverse impact on their company specifically was up slightly, from 31% to 34%.

PENSION ISSUES OUTSIDE THE UK Participants were asked if they had significant pension funding and investment strategy issues outside the UK and, if so, whether these had changed in importance.

The proportion concerned with overseas issues dropped slightly year on year, from around a third to 28%. However, of those that did think the issues had increased, two-thirds thought the importance had increased slightly or significantly, with only a very small number seeing a reduction in importance.

THE YEAR IN PERSPECTIVE So what has changed year on year? The single most dramatic movement is the increase in the use of derivatives, although the surprise is that it has taken so long for them to work their way through into our numbers. Despite concerns over pricing, liquidity and documentation and the failure of the PPF to reward lower-risk investment strategies, the use of derivatives for hedging purposes is climbing. Scepticism that the market may not properly reward business that choose to manage pension risk proactively may be on the wane.

The increased use of derivatives to gain exposure to a wider range of asset classes may have something to do with this. Under pressure to diversify further, it would be ironic if trustees and sponsors sanctioned the use of derivatives for this reason, but remained uncomfortable with their use for the arguably more conservative purpose of hedging duration and inflation risks.

More generally, there continues to be evidence of increased awareness of issues and solutions. It is striking that two-thirds of boards are giving more intention to pensions issues although the size of the issue has generally been stable, and, in the narrow sense of deficit levels, the position has improved. We look forward to next year's survey and are grateful to all those who have responded this year and previously.

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