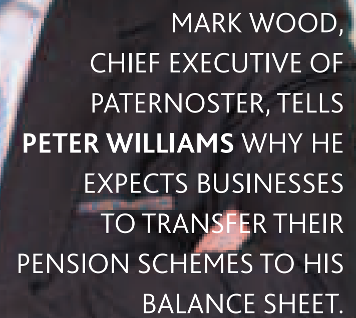
Pension promise

MARK WOOD, CHIEF EXECUTIVE OF PATERNOSTER, TELLS **PETER WILLIAMS** WHY HE EXPECTS BUSINESSES TO TRANSFER THEIR PENSION SCHEMES TO HIS BALANCE SHEET.



PHOTOGRAPHER: ROGER HARRIS

Who could resist the lure of a new billion-pound market? According to Mark Wood, Chief Executive of defined benefit pension buy-out company Paternoster, the UK pension buy-out industry is worth £600bn. And it is a new, virtually untapped market. The assets of the UK's 10,000 largest pension schemes amount to £1 trillion. Included in that figure are those of the FTSE 100, which total £400bn. Wood sees the buy-out market prospering in the 9,900 companies outside the FTSE 100, which have assets of £600bn.

When asked whether he is doing something new, Wood says he sees an entirely new market forming. "Over the last decade we have seen the development in the UK insurance market of pensions buy-outs. These have involved almost exclusively the transfer of the pension schemes of insolvent companies. At the point a company is insolvent, the pension scheme is detached, wound up and obligations and assets transferred to an insurance company." Now, solvent companies are eyeing up the possibility of doing something similar with their pension scheme.

Paternoster's argument is that several factors – extraordinary increases in life expectancy, FRS 17 tightening the disclosure rules, the introduction of the Pensions Regulator with the power to direct a company's cashflow to shore up a deficit, and the related Pension Protection Fund (PPF) levy – have conspired to persuade the directors of companies that the uncertainties of the cost of the defined benefit (DB) pensions are risks they would rather not carry.

Wood says: "We are at a nascent stage of City analysts beginning to factor in the cost of both the pension scheme and the uncertainty when coming to strike a company valuation. Many companies now find they have a large population of pensioners compared with the size of the present company and its payroll. The obligations are out of scale with the balance sheet and can impact the cost of capital through the cost of debt finance."

Wood says that it is to the benefit of pensioners that the pension buy-out market for solvent companies is already competitive. "The consequence is that pricing is already tight and we are resolved to maintain our pricing discipline to ensure we secure an adequate risk premium. And yet we are a rapidly growing business, doubling our assets over the previous quarter." He admits, though, that this is relatively easy to achieve as a startup in the growth phase. But not growth at any price. He says Paternoster has stood back from transactions where it judged them not to be economic.

Wood is clear where he believes the market is heading: over the next five to 10 years it will be increasingly anachronistic for medium-sized companies – FTSE 250-1,000 companies – to have defined benefit obligations on balance sheet. The result, he says, will be a significant transfer of assets from corporate balance sheets to insurance companies' balance sheets in order to provide protection for pensioners.

Wood denies his company is a business set up to address the pension crisis. Rather, he says, Paternoster provides a mechanism whereby a treasurer or a finance director can mitigate risk on the corporate balance sheet. "It is clear to anyone who has looked at DB pensions as they have evolved over the last 15 or 20 years that the extent to which the DB scheme represents a call on the balance sheet is difficult to quantify [see *Box 1*]. Our job is to take on the risk that the cost of the DB scheme is different to the figure projected."

If there is a pension crisis it is because obligations have been locked in at a time when life expectancy has improved rapidly and the capital markets are not providing a sufficiently large and liquid pool of assets to match the cashflow needed to meet pension scheme obligations.

Paternoster replaces the promise that the pension scheme has made to its members with an insurance policy. Members of the scheme draw on the insurance policy to pay their pension rather than looking to the promise made by the company through the pension scheme to pay them an income in retirement.

Regulated by the Financial Services Authority (FSA), Paternoster is obliged to carry solvency capital to protect pensioners from the

Box 1. An unknown call

In 1997 a massive change took place in the way pension benefits were accrued when everything became an employment right. As a result of legislation, benefits that trustees previously had discretion over in essence became contractual; from then on, companies were committed to offer those benefits. Discretionary adjustments can no longer be made in the UK.

Life expectancy has also played a major part. The rate at which it is increasing is astonishing: the average 65-year-old man enjoys a life expectancy improvement of five hours a day. The extraordinary rate of life improvement, according to Wood, makes it hard for a board of directors "to get a clear line of sight on what the liabilities will eventually be for a pension scheme".

Finally, there is a growing body of regulatory control around defined benefit pension schemes that may eventually lead to a requirement to put solvency capital behind a pension scheme. But in any event, the cost of retaining a defined benefit scheme has changed beyond anything that anyone could have reasonably planned for a decade ago.

possibility of investment markets not producing the anticipated returns or life expectancy moving beyond a company's best estimates. Its investment approach and life expectancy calculations are monitored by the FSA, which has the power to ensure the business is run prudently.

Once corporates make the decision to move their pension scheme off the balance sheet, in order to strike the deal they have to provide data on individual members of the pension scheme – age, salary, gender, residential postcode, type of job – which along with a slew of other factors is used to assess how long each individual in the pension scheme is going to live. From that information Paternoster calculates the cashflow required to pay the pensions over the next 50-odd years.

Armed with the cashflow, Wood and his team will agree a price with the company. If the scheme has a deficit, the company will have to make an additional contribution so it reaches a certain level of funding before it transfers the scheme across to Paternoster's balance sheet. "When the trust is wound up and the insurance policy is in place, the trustees are released from their obligation." The whole process can take between a few weeks and a few months.

Wood argues that in general the beneficiaries of the pension scheme recognise that the company is taking its obligations seriously and is trying to secure the promises that have been made. He says that the cashflows of the company that were supporting the pension payouts are replaced by solvency capital. "In capitalising our company, we have raised equity to pledge against the pension schemes to ensure we can pay the pensions going forward."

Although these deals are struck with solvent companies, the PPF ensures there is a safety net for pensioners whose company has become insolvent. For insurance companies, the equivalent underpinning of the PPF is the Financial Services Compensation Scheme, a pool of money all insurance companies pay into in the form of a levy proportionate to their insurance premium. In other words, if it all goes horribly wrong, Paternoster pensioners have a pension of last resort.

Paternoster hopes to make a profit over the coming decades by getting its carefully crafted sums right. "We are making a very detailed assessment of life expectancy and running an investment portfolio which is matched to the predicted cashflows. We get paid a risk premium for doing that."

Around 2-3% of the best estimate liabilities of the pension scheme are charged by way of the risk premium. The premium is the profit, the reward for protecting the pension scheme against investment market and life expectancy fluctuations.

Calculating the cashflow forecast is half the equation. The other is clearly the asset portfolio to produce the cashflows. Paternoster typically buys large tranches of new issue corporate bonds and plans to hold them to maturity, exploiting the illiquidity premium and therefore getting a marginally higher return over that period as long-term holders. There is a small proportion of gilts in the portfolio and a tranche of super senior collateralised debt obligations (CDOs). The vast majority of the portfolio is in sterling. Non-sterling assets the company finds which it deems suitable it will swap out the currency risk. So those fixed income instruments are put in place to mirror the expected cash outflows. Wood emphasises the business model is low risk and not predicated on outperforming the market to make the required return. He calls it "a pedestrian approach to investing our assets".

Sadly, the ACT cannot claim Wood as one of its own. But he does have treasury experience looking after £180m-£200m of Commercial Union's "loose change". Wood says he was on the cusp of becoming a member of the ACT in the early 1980s but left to join Barclays so, at that time, barring himself from membership.

In essence, Paternoster is designed to be the longest run-off company in history. Wood rather modestly describes his role as "sitting back and letting a team of experts get on with it". But he is clear why he is involved: "When you see something that you have conceptualised taking form, it is extremely exciting. The market potential is enormous and it is quite unusual in one's career to be around at a time when an entirely new market is developing. The equity that exists in UK residential property is valued at £1.5-2 trillion in 23 million households. The wealth that exists in pension assets is the next biggest. Over the next few years some of this £600bn will shift across from corporate balance sheet to insurance companies."

Box 2. Career path

Mark Wood began his career with Price Waterhouse London, where he qualified as a Chartered Accountant and specialised in financial services – in particular, life insurance. He has held a number of senior positions in the financial services industry at Commercial Union, Barclay, Axa UK, where he was Chief Executive from 1996 to 2001, and Prudential (UK and Europe), where he was Chief Executive from 2001 to 2005.

Initially backed by Numis, and then £500m of equity financing from a number of institutions, Wood set up Paternoster in December 2005.

He was Deputy Chairman of the ABI between 1997 and 2000.