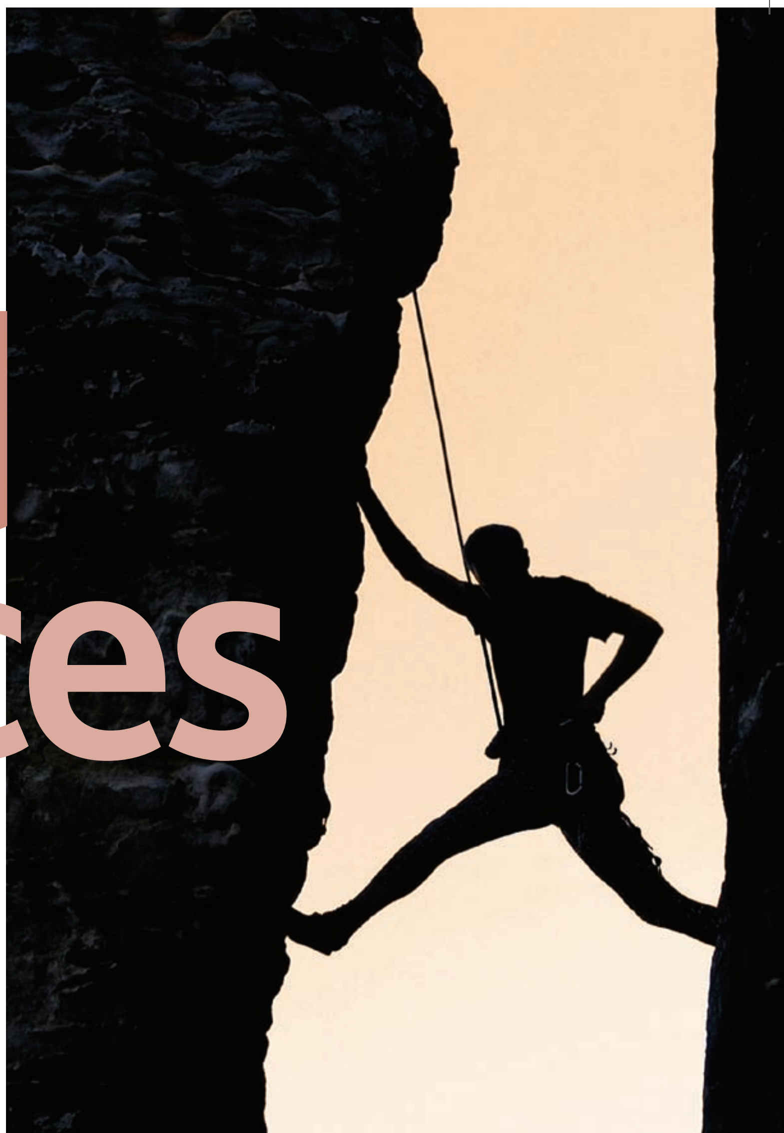
Hard choices



Executive summary

■ The recession is the first major test of the pensions framework introduced in 2005. With scheme deficits ballooning and equity investors running scared, companies are faced with making unpopular decisions about their pension schemes.

The economic downturn and a catastrophic year for equity markets in 2008 have pushed the issue of pension fund deficits firmly back on the business pages. Figures from different sources vary, but most suggest that since the effects of the credit crunch started widening last autumn, pension funds have moved from a position of overall surplus to one of deep deficit. The recession is the first major test of the new pensions framework introduced by the government in 2005.

At the start of March, employee risk and benefits management firm Aon Consulting reported that its Aon200 index, used to calculate the pensions accounting deficit of the 200 largest privately sponsored pension schemes, had widened by a further £16bn during February 2009 alone and stood at £45bn by the end of the month. The FTSE 100 has declined even further since then, hitting new six-year lows.

The Confederation of British Industry (CBI) has expressed concerns that the deficits are "beginning to prey on investors' minds" and warning of a danger of company investors, fund trustees and the government overreacting to the problem.

The CBI suggests that many investors will ignore the "longer-term secure nature" of pension funding and mark businesses down where the pension scheme is in deficit. The organisation fears that this could spark a vicious circle in which share prices fall, scheme liabilities grow and trigger demands from their trustees for greater capital injections, leading to reduced investment, a drop in company performance and further falls in share prices.

To break this spiral, the CBI has urged investors to focus more on long-term approaches rather than spot valuations, and called on fund trustees to allow companies longer recovery times to enable them to manage payments over the economic cycle.

The CBI's deputy director general, John Cridland, says: "An overreaction to deficits could be a factor in sending some firms under and leave the rest struggling for capital at a time they need it most."

There are a range of estimates as to the actual size of the overall deficit. According to Pension Capital Strategies (PCS), a division of broker Jardine Lloyd Thompson, deficiencies in the accounting rules have masked the true magnitude of the pensions gap. PCS recently reported that the pension schemes of FTSE 100 member companies collectively enjoyed a surplus of £12bn as at 31 December 2008, compared with a deficit of £8bn at the end of 2007.

However, given that last year saw the FTSE 100 index decline by 31.4% – the worst annual performance since its inception in 1984 – it seems highly unlikely that pension funding positions actually improved during the year as these figures might at first glance indicate. As PCS points out, accounting rules link the value of a company's pension liabilities to the value of AA bonds. As these have fallen in value during the credit crunch, so has the accounting value of pension liabilities.

The firm's managing director, Charles Cowling, says: "The fact that AA bonds have fallen in value is not a good reason to regard your pension liabilities as being a lot lower. It is just a quirk of the accounting rules that is hiding the problems that many pension schemes currently face."

PCS recorded a "noticeable growth" in the number of FTSE 100 member companies where the pension scheme "now represents a material risk to the business". It calculates that the total pension liabilities of British Airways, BT, Lloyds TSB and HBOS (the latter two, of course, now the Lloyds Banking Group) grew to more than double their equity market value by the end of last year, and adds that those of RBS and Barclays grew significantly in the first weeks of 2009.

PCS estimates that if pension liabilities at the end of 2008 were valued on more normal levels of credit spreads (with AA bond

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GROWING PENSION DEFICITS AND VOLATILE MARKETS ARE FORCING COMPANIES TO MAKE SOME TOUGH DECISIONS. **GRAHAM BUCK** REPORTS.

"AN OVERREACTION TO DEFICITS COULD BE A FACTOR IN SENDING SOME FIRMS UNDER AND LEAVE THE REST STRUGGLING FOR CAPITAL AT A TIME THEY NEED IT MOST."

discount rates at gilts +80-100bp), the collective surplus of £12bn would turn into a deficit of £100bn and impact heavily on companies with the largest pension schemes relative to the size of the company. This would also include Marks & Spencer, FirstGroup and BAE Systems in the list of companies with the greatest exposure.

EMPLOYEE DISILLUSION The downturn has inevitably focused employees' attention on the issue of pensions, with heavier liabilities and reduced earnings apparently set to hasten the demise of final salary pension schemes in the private sector.

Surveys by bodies such as the National Association of Pension Funds (NAPF) suggest that not only are many final salary schemes set to close to new members over the next few years, but that a sizable number may also be closed to existing contributions.

As recently as last July, an NAPF survey of members indicated that many businesses still aimed to keep their pension schemes open, but further stock market falls and the onset of recession have triggered a rethink.

More recently, the association reported that just over a quarter of 8,500 private sector final schemes were still open to new members, but more than half of them were likely to close the door over the next five years. A quarter of companies are likely to go further over the same period by also closing their final salary scheme to existing contributors. Not surprisingly, the NAPF noted that employee confidence in workplace pensions had collapsed.

In February, the Pensions Regulator issued guidance to employers sponsoring defined benefit schemes. It confirmed that it was permissible for those companies badly hit by recession and in financial difficulties to reduce their cash contributions to schemes by renegotiating the recovery plan. However, it warned that, except in exceptional circumstances, the pension scheme "should not suffer to enable companies to continue paying dividends to shareholders".

The regulator's official line is that scheme funding regimes should be flexible enough to cope with the downturn, but acknowledges it is often difficult for the scheme's trustees to distinguish between when the downturn is having a temporary effect on the sponsoring employer's cashflow and when it is making longer-term structural changes to the sponsor's strength.

PCS suggests that the Pensions Regulator's warning will persuade more companies to remove the pension liabilities that weigh on their balance sheet through a pensions buyout. Despite some predictions that the cost of scheme buyouts is set to rise sharply and make buyouts a less attractive option, PCS expects prices to rise only modestly this year and for the market to exceed £8bn in 2009 and reach as much as £12bn next year.

BANKRUPTCY RISK As the recession deepens, so the rising level of corporate insolvencies poses an even greater threat to the retirement provision of many workers.

Data from the Insolvency Service shows that 4,607 companies were liquidated in the fourth quarter of 2008, a 12% increase on the third quarter and 52% up from the same period a year earlier.

The consequences for pension scheme members of the scheme sponsor going bust should be less severe than in previous recessions, thanks to the formation of the Pension Protection Fund (PPF) in 2005. The PPF has so far fulfilled its remit of compensating members of eligible defined benefit pension schemes when the employer becomes insolvent and the scheme's assets are insufficient to cover its liabilities. But, as Watson Wyatt senior consultant Sean Weaver notes, the pension fund trustees' actions "can make the difference between members getting PPF compensation or something better if the company does collapse.

"Also, PPF benefits do not come with a copper-bottomed guarantee. Unlike pension scheme benefits, the legislation does allow PPF benefits to be cut."

There is also the risk that the forthcoming casualties of the recession will include more high-profile schemes such as Woolworths and Nortel UK, increasing pressure on the PPF.

Trustees of pension funds are placed in a difficult position as scheme deficits continue to widen. They want to safeguard the interests of scheme members, but are pragmatic enough to realise that demanding too much from a sponsoring employer struggling to survive – such as an immediate cash injection – could be enough to tip the scheme into the PPF lifeboat.

"The strength of sponsoring employers' covenants should be at or near the top of trustees' agendas," says Deborah Cooper, a principal at Mercer. "If economic uncertainty continues, and funding levels remain weak, trustees will have to balance putting pressure on sponsoring employers for additional security for scheme members with considering the effects on the company's financial strength and future prospects.

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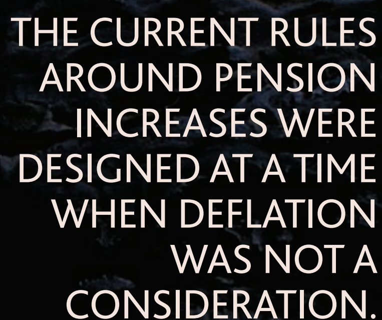

"It is likely that some trustees will be seeking additional funding or security to provide a boost to the security of member benefits, while sponsoring employers still have some resources to hand. This will place additional pressure on corporate sponsors at a time when they can least afford it."

IAS 19 FEARS As if scheme trustees didn't already have enough headaches, the International Accounting Standards Board's planned changes to IAS 19 Accounting for Employee Benefits has also created alarm. Its proposals, if adopted, would oblige companies to recognise actuarial gains and losses on defined benefit pension schemes in their profit and loss statements. The proposal has drawn criticisms on the basis that it would add even more volatility to the company balance sheet.

Accounting firm PricewaterhouseCoopers is one of many organisations critical of the proposed changes to IAS 19. It warns that putting all gains and losses in the company's pension scheme – such as daily movements in the equity market – through the profit and loss account would create huge volatility and accounting inconsistency. Currently, most companies either put such gains/losses through the statement of recognised income and expense, or spread the impact over time.

PwC suggests that the method employed should be consistent with the way the company accounts for its other volatile assets and liabilities.

The question of how pension scheme deficits can be reduced is likely increasingly to involve corporate treasurers in delicate negotiations with the scheme trustees.

Treasurers can be proactive in explaining a company's financial position to trustees, suggests Adrian Bourne, senior consultant at Watson Wyatt. For a start, scheme trustees are likely to welcome someone from the finance function attending their quarterly meetings in order to provide an update.

"I sense that there is now a much greater flow of information between the scheme trustees and that they better recognise the position they occupy as creditors," says Bourne.

However, he adds that it would be unusual for trustees to be given any financial information on the company that was not already in the public domain, such as its free cashflow figure.

"Indeed, employers themselves are generally unclear on where the economy is headed and how much funding they can commit to," he says. "Where and how the funds are invested is an issue increasingly involving treasurers, who are increasingly looking at both investment assumptions and mortality trends. The big picture is affordability."

Mercer's Cooper adds: "Increased deficits in final salary schemes will make employers look again at the type of pension provision that is affordable.

"However, they cannot step away from some form of pension provision. The introduction of auto-enrolment into qualifying pension arrangements is expected from 2012."

DEFLATION DANGER Complying with auto-enrolment regulations is expected to cost cash-strapped UK businesses a further £3bn and force them to make significant scheme design changes. Before then, they face the prospect of a period of deflation, during which they will have to maintain the value of pensions being paid out under their schemes. As Aon Consulting points out, although unable to benefit from deflation, businesses will be hit when inflation inevitably returns and schemes will be required to pay increases.

Aon has recently lobbied the government to allow deflation to be offset against future inflation when increasing pensions.

"Flexibility over benefit structures is needed to allow employers to deal with their defined benefit pension promises," says Aon actuary and consultant Sarah Abraham. "The current rules around pension increases were designed at a time when deflation was not a consideration.

"Although increases to deferred members allow negative inflation to offset positive inflation, increases to pensions in payment do not have this flexibility. We believe that to review the rules at this time is both a rational and proportionate response."

The group acknowledges that making such a change "would not be without its difficulties; it would mean a cut to the long-term value of members' benefits compared to the current position, and is something that would not be popular with members, unions or pensioner groups".

Unfortunately, the pension obligations currently burdening many companies have become so heavy that ruffling a few feathers now looks inevitable if they are to continue shouldering them.

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