Bite the bullet

PENSION SCHEME DEFICITS HAVE CREATED A SIZEABLE CORPORATE AND PERSONAL HEADACHE. **GRAHAM BUCK** LOOKS AT THE OPTIONS OPEN TO COMPANIES WHEN TACKLING THE PROBLEM.

Pensions risk has been moving steadily up the corporate agenda. Treasurers can expect the issue to remain controversial for many more years, given the rising cost of pension provision and the UK's adverse demographics as longevity improves and the population ages.

Pension scheme deficits have sharply widened. Even the strong stock market rally in 2009 failed to provide relief. A report last December by Aon Consulting estimated that the combined shortfall of the UK's 200 largest pension schemes had increased over the year to a record cumulative £103bn.

The report cited what are generally regarded as the three major contributory factors to the sharp deterioration: major investment losses incurred by most pension schemes during the recession; increases in both the rate of inflation and the cost of pension provision; and the growing demands caused by an ageing populace.

Separate estimates issued by Pension Capital Strategies (PCS), a subsidiary of insurance broker and risk management group Jardine Lloyd Thompson, suggest a combined pensions scheme deficit at the end of February 2010 of £84bn for the FTSE 100 companies and £96bn for the FTSE 350 companies, compared with deficits of £73bn and £83bn respectively in February 2009 (although at the 2008 year-end, both figures still showed a modest surplus, of £12bn and £7bn).

PCS broke down its estimates of the total defined benefit (DB) pension scheme funding position as shown in Figure 1, with corresponding figures for the year before.

Charles Cowling, PCS managing director, says that 2010 will not be an easy year for UK pension schemes. “However, there are signs that UK companies are starting to take significant measures to sort out their problems,” he adds, “with liability reduction measures becoming normal and the closure of DB schemes accelerating, thus capping the growth in new liabilities.” This then could be the year

"when UK plc finally turns the corner in the management of its pension liabilities".

But according to Aon, only "proactive management" offers a realistic means of reducing pension scheme deficits. The consultancy estimates that repairing the funding gap relatively painlessly would require annual investment returns of 11% (roughly the equivalent of the FTSE 100 index soaring to the 9,000 level), annual company contributions of £15bn, or a combination of both approaches. As Aon notes, a more likely prospect is that companies will resort instead to reducing members' benefits to keep their deficits under control.

ONLY "PROACTIVE MANAGEMENT" OFFERS A REALISTIC MEANS OF REDUCING PENSION SCHEME DEFICITS.

Aon's pessimistic outlook for defined benefit schemes partly reflects the move towards more rigorous pension funding. Defined benefit schemes are already in a 20-year decline. The National Association of Pension Funds says that the schemes had an all-time-high membership of 5.6 million employees at the end of the 1980s; since then, the rate of decline has steadily accelerated, with the past 10 years marked by a drop of two million.

Indeed, while most companies have already barred new members from their defined benefit schemes in recent years, 2009 saw several high-profile names, including Barclays and Vodafone, go further and close the schemes to existing members too.

Aon also monitors defined contribution (DC) pension schemes, its regularly issued Tracker gauging how the UK's DC pensions market is faring. And the news is no better here, with Aon reporting that members of such schemes saw the value of their combined assets and projected retirement incomes deteriorate in the first weeks of this year. Aon suggests that the typical defined contribution scheme is entirely reliant on the performance of UK and overseas equities, so altering the investment strategy to make different asset choices, such as a mixture of cash and gilts, would substantially improve the position.

Over the past five years, there has been an evident trend of pension "de-risking" as many schemes move from equities to liability-driven investing (LDI) and diversify their investments into alternative assets, according to independent pension trustee and ACT member Jonathan Clarke.

"Finance directors want to cap the risk and financial markets have grown increasingly sophisticated, which has been reflected in the structuring of investment portfolios with diversification into alternative assets such as hedge funds and commercial property," he says. "Trustees have to consider the three main factors of interest rates, inflation and longevity trends in deciding which investment strategy is appropriate."

Meanwhile companies are under pressure from the Pensions Regulator to improve their pension scheme funding by contributing more. The Pensions Regulator has recently shown greater readiness to protect workers' benefits by ensuring that companies with large pension fund deficits take action to erase them over a reasonable period of time. It has clashed with the pension trustees and executives of BA and BT, two of the UK's biggest schemes that have particularly large deficits (£3.7bn and £9bn respectively), over how each calculates its liabilities and how much extra cash needs to be contributed to cut the shortfalls.

In February this year, the Pensions Regulator blocked a proposed deal between the US parent of Readers Digest Association UK and the Pension Protection Fund (PPF), under which the pension fund trustees of the British operation would have received £10.9m plus a third of Readers Digest UK's equity to help reduce a £125m fund deficit. The veto led to Readers Digest UK being placed in the hands of the administrator after the board said the veto left it unable to meet its pension obligations and maintain its operations.

Peter Murphy of pensions law firm Sacker & Partners suggests that the Pensions Regulator evidently felt that the offer made was not necessarily the best that could be expected. "Whatever the case," he says, "it is now clear, if it was ever in doubt, that the regulator has a mind of its own and will not simply act as a rubberstamp following agreements in principle made by either pension scheme trustees or the PPF."

The introduction of the Solvency II regime, with its tougher capital adequacy requirements, is expected to increase the cost to pension schemes of purchasing annuities. The Accounting Standards Board has also proposed that risk-free discount rates be used in determining

Table 1: Funding position of defined benefit pension schemes

At 28 February 2010				
	Assets	**Liabilities**	**Surplus/(Deficit)**	**Funding level**
FTSE 100 companies	£386bn	£470bn	(£84bn)	82%
FTSE 350 companies	£446bn	£542bn	(£96bn)	82%
All UK private sector pension schemes	£980bn	£1,161bn	(£181bn)	84%
At 28 February 2009				
	Assets	**Liabilities**	**Surplus/(Deficit)**	**Funding level**
FTSE 100 companies	£311bn	£384bn	(£73bn)	81%
FTSE 350 companies	£358bn	£441bn	(£83bn)	81%
All UK private sector pension schemes	£767bn	£940bn	(£173bn)	82%

how the pensions deficit is shown on the company balance sheet.

The Pensions Regulator's other main role is to limit claims made against the PPF, which was set up in 2005 as an employer-financed lifeboat to provide compensation (financed by an annual levy) for members of eligible defined benefit schemes where the sponsor company had failed.

Recently the regulator has been pursuing a claim for a portion of the assets of Canadian telecoms equipment maker Nortel, which filed for creditor protection in both North America and Europe at the start of 2009. Nortel's UK unit has a pension scheme deficit of £2.1bn, and although the group has been selling assets over the past year its approach to the PPF to request a rescue threatens to make it the PPF's largest casualty so far – particularly as North American courts ruled early in March that the claim could not be considered as it was submitted too late.

In January the PPF and the regulator jointly published the fourth Purple Book, their latest annual analysis of how the UK's most vulnerable defined benefit schemes are faring during a period of economic turbulence. The contents are based on 97% of the defined benefit schemes that have become eligible for PPF compensation since the fund was set up in 2005.

Information in the fourth Purple Book was derived from returns which schemes provided to the regulator up to the end of March 2009, and includes scheme valuation, asset allocation and membership. It offers few crumbs of comfort. As the PPF's chief executive Alan Rubenstein notes, the latest edition "highlights how the dramatic deterioration in the economic and financial environment during 2008/09 – not just for the UK but for most major economies – led to heightened risk for the schemes in the PPF universe". The PPF paid a total of £37.6m in compensation payments over the year 2008/09 against £17.3m in 2007/08, and the total for the year just ending is likely to show another sharp increase.

ORGANISATIONS AND INVESTORS ALIKE WOULD BENEFIT FROM IMPROVED INFORMATION ABOUT HOW MUCH PENSION RISK COMPANIES ARE TAKING

How should companies be responding? Many of the UK's biggest enterprises have stepped up payments to their defined contribution schemes despite the recession, according to a survey by professional services firm Towers Watson. Although companies have frozen salaries and closed their defined benefit schemes, the average maximum contribution available to employees of FTSE 100 companies who take full advantage of "matching" contributions from their employer has risen to 16.5% of salary, against 15.3% a year ago and 13% in 2003.

Paul Macro, a senior consultant at Towers Watson, attributes the trend to companies carefully targeting increased pension payments to employees who are willing to put in more of their own pay, and also some companies, having closed their defined benefit scheme, feeling duty bound to offer a less unattractive alternative.

What are the other options? According to Brian Peters, a partner at PricewaterhouseCoopers, there are various ways to manage pensions risk that are in the interests of shareholders. Those ways include pension scheme buy-outs, enhanced transfer value or pension increase exercises. However, how to report such a transaction or exercise is often open to interpretation.

As a consequence, investors may not recognise that risk management activity in this area may be achieving a positive impact, which, in turn, may lessen companies' appetite for managing pension risk even where it makes sound economic sense.

"Accounting disclosures need to be updated to bring clarity and ensure companies get the market credit they deserve for taking steps to control the costs and risks associated with their pension obligations," Peters says. "Organisations and investors alike would benefit from improved information about how much pension risk companies are taking, which could be assessed using a standard measure such as value at risk."

Peters adds that although some finance directors might be reluctant to highlight their exposure to pension risk, investors and others could assess how much risk is removed when a company performs a complex pension transaction.

The government should also be doing much more to avert a future pensions crisis, according to the National Association of Pension Funds (NAPF). Ahead of the election, the NAPF has outlined what it says are three key issues it would like to see in this year's Budget and which must be addressed to support the future of workplace pensions:

- a review of pensions accounting and the application of mark-to-market accounting;

- the issue of more long-dated and index-linked gilts by the government; and
- a reversal of the government's decision to scrap tax relief on pension contributions. The NAPF wants the relief replaced by a reduction in the annual contribution allowance (currently £245,000, and rising to £255,000 in 2010/11) to a more modest range between £45,000 and £60,000.

The NAPF is also working on devising an improved method of pensions accounting in response to concerns over the impact of UK and international pensions accounting rules on defined benefit pension plans. It says it aims to replace the Accounting Standards Board's FRS 17 accounting procedures, which have been the standard for the past 10 years, with one more suited to the needs of UK pension funds. The NAPF's chief, Joanne Segars, has suggested that the reduced access to defined benefit pension provision over this period is a direct result of the introduction of FRS 17.

Meanwhile, companies are now only two years away from the April 2012 introduction of Personal Accounts, the government-backed national pension plan to top up the state system. Personal Accounts will be based on automatic enrolment, thereby forcing many employees to start saving towards a pension for the first time – unless they specifically request to opt out – and also requiring their employer to contribute. For workers earning up to £35,000 a year, this will involve a minimum contribution of 4% of their earnings and 3% from their employer.

Company will be required either to enrol employees in a Personal Account, or include them within the existing pension scheme provided it offers benefits at least equal to those available from a Personal Account. They are also expected to inform employees of the implications of the scheme in the run-up period to its introduction.

PwC recently questioned whether existing plans to raise the minimum age for claiming a state pension from 65 in 2020 to 68 by 2046 are adequate to meet the challenge of coping with an ageing population. It says the plan should be accelerated so the minimum age is 67 by 2030 and 70 by 2046. Clearly, the pensions issue will remain near the top of the corporate agenda for many years to come.

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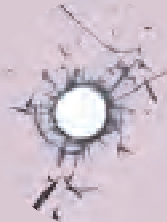
Box 1: How Rolls-Royce got back on track



Huge pension scheme deficits at BT and BA have attracted publicity, but Rolls-Royce was in a similar position back in 2003. It was even labelled one of a "dirty dozen" blue chip companies whose scheme deficit exceeded their market cap.

Equities fell sharply following the end of the telecom boom and the shock of 9/11, with Rolls losing its coveted A rating. The group's assistant treasurer, Iain Foster, says it was a significant development given that Rolls is a long-term business that needs to assure customers that it will still be around in another 20 years. So addressing the pension fund deficit became a joint project between the treasury department and the pensions department.

"As my colleagues would agree, there are three main levers that you can employ for the task: contributions, benefits and investment strategy," Foster says. "Over the period 2005 to 2007 our investment strategy became far less equity-led as we wanted investments that provided returns that were in tandem with our liabilities."

At the end of this period, the introduction of a lower-risk investment strategy was proposed to the trustees and agreed on. In return, Rolls put a lump sum payment of £500m into the scheme.

In mid-2007, just before the credit crunch began to bite, the scheme's investment portfolio began shifting out of equities; with the pace accelerating slightly as stock markets began to move lower.

"The ratio changed from 70% equities and 30% bonds to 80% LDI and 20% return-seeking investment," says Foster. "We hedged both our inflation and interest rate exposures, although we are still exposed to actuarial assumptions on longevity, which are regularly revised as the average lifespan increases. So we were locked into very favourable interest and inflation rates by the second half of 2007, with smaller deals following in 2008. The strategy has stood us in good stead since the onset of the financial crisis."

He adds that the changed strategy has produced a far more stable funding level for the scheme, with which the trustees are comfortable. This has been helped by calculating the position the scheme would be in had it remained heavily skewed towards equities. That position would be a sizeable deficit.

As it is, on an accounting basis the scheme shows a modest surplus of £334m, with liabilities amounting to £6.714bn and assets, on a fair value basis totalling £7.048bn.

However, even this relatively strong position could quickly be undermined by a pick-up in inflation, a further trimming of interest rates or an upward revision to longevity assumptions adding a year to average life expectancy – the latter alone would add £134m to the scheme's liabilities.

On a more positive note, Foster says: "Since the hedge was put in we've been in the fortunate position of investing in liquid assets, meaning that we can take advantage of gilts yielding more than swaps." So the scheme has enjoyed good investment returns from asset swap gilts that pay LIBOR plus a margin.

Rolls is certainly not the only group that has reduced its pension scheme's dependency on the performance of equities, but others have often followed a more partial strategy.

Foster says there are two strong reasons why it is logical for schemes to move to greater LDI.

"First, shareholders don't invest in the group for our ability to select the right investment funds, which largely dictated our policy up to 2003. Second, we wanted to reduce volatility and the knock-on effects on our credit rating and the resulting cost of funds.

"Greater certainty also puts management back firmly in control of the business. As has been demonstrated, the Pensions Regulator has the power to overturn corporate decisions that don't meet with its approval. So while gaining that certainty may come at a slightly higher cost, the trade-off is worth it."