A fragile recovery

Executive summary

- With pension scheme deficits narrowing or even moving back into surplus, talk of crisis is receding. But obstacles remain – not least the steadily increasing longevity of scheme members – and volatile markets could still undo much of the improvement.

No cake or candles marked the event, but November marked the seventh anniversary of FRS 17. The retirement benefits accounting standard was issued in 2000 by the Accounting Standards Board (ASB) and stipulated that a company's pension surplus or deficit should henceforth appear as an item on the corporate balance sheet. By treating pension liabilities as debt, FRS 17 aimed to give investors a more realistic assessment of the company's value and the risks it faced.

Jerome Melcer of the corporate mergers and acquisitions (M&A) team at actuary Lane, Clarke & Peacock says that the implementation of FRS 17 marked a "line in the sand", ending the cosy assumption by many companies that they need not be overly concerned by the pensions issue.

"FRS 17 confirmed that there are liabilities to be shown on the balance sheet and blew many of the old conceptions out of the water," adds Melcer. With bond yields posited as the new benchmark, the change measured pension scheme funding on a stronger basis and moved many into deficit. As the equity markets of late 2000 were still riding high – if slightly off their peak during the dotcom boom – initial reaction was muted. However, as stocks headed lower during 2001, 2002 and the early months of 2003, so pensions moved up the corporate risk map. FRS 17 highlights a failure to match assets to liabilities, with companies no longer given the option of offsetting the impact by using a higher discount rate for liabilities.

In addition to the strictures of FRS 17 (and its international equivalent IAS 19), the Pensions Regulator has provided further clarity in recent years. It has been a welcome development, narrowing the "grey area for debate between the company and the trustees" and lessening the scope for differing interpretations, says David Scriven, Group Treasurer for Yell Group.

The scrutiny of the Pensions Regulator means that if a scheme deficit opens up, the employer and trustees cannot merely hope for things to improve, but must act. The trustees will demand a scheme top-up or cash contribution from the employer; hence the numerous deficit repairs and contributions of recent years.

THE LOW POINT By early 2003 the accumulated deficit of FTSE 100 pension schemes was £60bn, but March that year marked the low point. The stock market rout was over and equities began to recover, although schemes remained heavily in the red at the end of 2005. But the past two years have seen the rate of improvement in the funding position accelerate, helped by strong equity markets and increasing real yields from long-dated bonds.

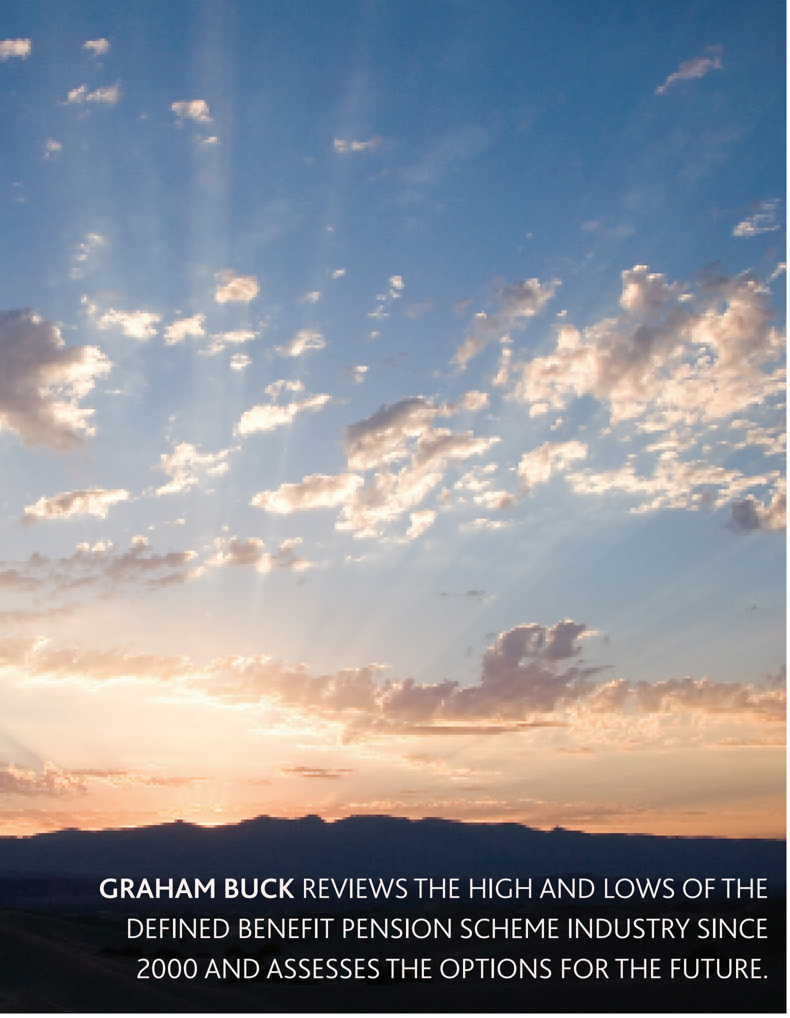
Recent years have also seen companies steadily close their defined benefit schemes to new members. Indeed, many expect the remaining schemes to close their doors as well over the next decade, leaving a lengthy run-off period as liabilities to existing members are steadily paid off.

The funding position has further improved as companies have made capital injections into their schemes, in some cases also increasing the amount paid in by employees.

The most recent survey for the ACT, carried out by Mercer Human Resource Consulting, canvassed 103 companies in the FTSE 350 and found 60% were making special top-ups, over and above normal or statutory contributions, to reduce their scheme deficits. The main drivers for these extra contributions regularly change, but most recently were as follows:

- general pressure from the pension trustees (nearly 50%);
- strengthened mortality assumptions (18%);
- general risk mitigation (17%);
- Pension Protection Fund (PPF) levy considerations (15%); and
- reasons related to corporate transactions (15%).

The overall result is that, as of the end of September 2007, the combined deficit of the FTSE 100 companies has fallen to £2bn, compared with £44bn a year earlier, according to adviser Pension Capital Strategies. But this overall figure masks a wide divergence. PCS reckons around 40 of the top 100 are in surplus, while British Airways still runs a deficit representing 30% of its market value and BT has the single largest pension liability at £38bn.



GRAHAM BUCK REVIEWS THE HIGH AND LOWS OF THE DEFINED BENEFIT PENSION SCHEME INDUSTRY SINCE 2000 AND ASSESSES THE OPTIONS FOR THE FUTURE.

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MISMATCHED ASSETS AND LIABILITIES So is the pension funding crisis over? On a narrow accounting aspect it has improved considerably, says Melcer, although market volatility means the recovery is still fragile. Equities on average represent more than 50% of fund assets, with the balance in bonds. The equity portion of the asset base is mismatched to liabilities – as is the bond part, if to a lesser extent.

The ticking time bomb that threatens to upset projections is the likelihood that many companies seriously underestimate future life expectancy. Last November, the Office of National Statistics again revised its estimates upwards and said that, based on mortality rates for 2003-05, men aged 65 could expect to live a further 16.6 years and women for a further 19.4 years.

According to PCS, many companies need to add from one to three years to their longevity projections, which could swell the total pensions deficit by up to £40bn. An extra year on male life expectancy typically adds at least 3% to a pension scheme's liabilities.

"There is an increasing level of focus on assessing how long scheme members are likely to live, now the Pensions Regulator and others are turning their attention to projected average lifetimes," says Chris Tavener, mortality specialist for Lane Clark & Peacock.

"The task for treasurers is to ask the actuary what the current life expectancy assumptions are and to what degree these assumptions are likely to change. Is the downside worth worrying about – for example, the impact on cashflow or the change in the deficit entered on the balance sheet?"

Projected life expectancy for pension scheme members varies between companies, but assumptions are becoming more sophisticated, Tavener adds. They will reflect differing levels of affluence and socio-economic profiles, as well as where scheme members are living.

"There has been a rather lazy assumption of a north-south divide, with people living in the south living longer," says Tavener. "It's rather less straightforward and the breakdown by postcode can now be considered – an individual street can show significant variation from its immediate neighbour, and identifying the differences is becoming far more sophisticated."

OPTIONS FOR TREASURERS Treasurers have several options for managing the results of increased longevity. They include transferring the risk to specialist insurers such as Duke Street Partners and Paternoster, which have attracted considerable attention.

Some schemes have offered inducements to members of final salary schemes to transfer out, such as immediate cash payments or an increased transfer value. As Jonathan Guthrie, Enterprise Editor of the *Financial Times*, recently wrote, the concept of "managing down liabilities" could more realistically be termed "bribing people with their own money to act stupidly".

The tactic has been noted by the Pensions Regulator, which at the start of this year announced its concerns over the practice and said scheme members should be fully informed of the implications of tampering with their retirement income and encouraged to seek independent financial advice before agreeing to transfer out.

The option of handing the scheme over to a buy-out insurer such as Paternoster has considerable attractions, but is not one that comes cheap, says Yell's Scriven.

Pension trustees can opt to assess the scheme's liabilities on the basis that the equities and property portion of the investment portfolio will, over time, provide above-average returns. On this basis, the value of liabilities is often less than it would be under IAS 19.

However, this approach is sustainable only if the scheme remains a going concern, supported by the sponsoring company, which can then be looked to for making good the shortfall if the returns from equity and property fail to deliver.

A buy-out company such as Paternoster must make rather more prudent assumptions about future returns and liabilities and will charge accordingly for this more conservative stance. The regulator's agreement to trustees offloading a scheme's liabilities to a third party is contingent on this higher level of certainty being provided.

Citi and other banks, which instead of a buy-out will take the pension scheme assets and invest them more aggressively to produce higher returns, effectively represent a half-way house, says Scriven. The company must still be there to act as guarantor in the event that this more risky investment strategy proves unsuccessful.

Mercer's latest survey also found more pension schemes resorting to derivatives to modify asset returns and better match their liabilities, with a significant number employing interest rate hedging or inflation hedging.

According to John Hawkins, Principal in Mercer's Financial Strategy Group, the trend is unsurprising given the regulator's pressure on trustees to seek higher funding levels.

He says the arguments for raising finance to fund schemes are quite straightforward, not least the opportunities to reduce tax and the risk-based proportion of the PPF levy. Even if bond and equity markets continue to be favourable and narrow scheme deficits further, more treasurers and chief financial officers are likely to turn to borrowing as a means of funding pension schemes.

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The recent case of Telent highlights the fact that many companies, having trimmed the deficit, are reviewing the cost of an insurance company buy-out of their pension scheme and the possibility of pitting two or more insurers against one other by means of an auction.

But the Telent case went a step further than this. The company, born out of the remains of Marconi, itself previously the old GEC, sponsors a £2.5bn pension scheme responsible for the retirement income of 62,000 past and present workers.

Telent agreed a £398m takeover offer from a Guernsey-based vehicle set up by Pension Corporation, which buys companies for their pension funds. Its acquisitions include off-licence chain Threshers and the old Thorn TV rentals group. Pension Corporation's intention was to sell off the operating units post-acquisition and to retain the pension scheme. The Pensions Regulator, unhappy with the proposed deal and lack of any communication with the Telent scheme trustees, effectively blocked it by replacing them with three trustees of its own to prevent Pensions Corporation from imposing its own preferred investment strategy on the scheme.

"From the regulator's perspective, if the risk is transferred, there needs to be some safeguard that the trustees' interests aren't adversely affected. Abandonment can only be done if it can be shown to be in the best interests of scheme members," says Melcer.

"It's a very broad issue. How much money should trustees ask for as a *quid pro quo* for consenting to abandon the operating company? It needs to be looked at very carefully and assessed against the more traditional route of an insurance company buy-out."

Paternoster, representing the traditional insurance route, has written about £500m of assets under management. The new-style risk transfer represented by Telent was potentially for a significantly higher figure, with many other corporates poised to follow the same path had the deal proved successful.

The regulator's concerns also extend to the rash of private equity-led leveraged buy-outs, says Scriven, and the adverse impact on the pension schemes resulting from the heavy debt loads involved.

"In May, the regulator stiffened the resolve of trustees in companies subject to leveraged buy-out, instructing them to insist funding levels for the pension scheme that were at least the equivalent of those required by IAS 19," he says. "Effectively, the regulator told them to behave as though they were unsecured creditors and to be equally fierce in protecting their rights."

WEIGHING THE OPTIONS With the risk transfer option the most attractive for most companies, the other options are continuing the scheme as it is, or setting boundaries around the risk.

A handful of companies are in the fortunate position of having a sizeable pension scheme surplus. Shell's was £4bn at the end of 2006 and, thanks to improved yields, will have improved further since, which lets the company take a pension holiday. AB Foods' surplus is now more than £180m and other companies, such as Resolution Life and Johnson Matthey, have also moved out of the red.

But even a modest upward adjustment to mortality assumptions could easily soak up the majority of these surpluses. Viewed positively, they may allow companies to be more realistic in their assumptions of life expectancy given the recent increases – although trustees are required to make prudent assumptions at all times on the longevity of scheme members.

When the scheme trustees review the various methods of funding they will consider the possibility of gradually lifting funding levels so that benefits can be secured through buy-out before all remaining benefits are due and the scheme ultimately wound up, says Melcer. Over the next 20 to 30 years, surpluses can be used towards this goal.

Treasurers may adopt a different view, preferring to negotiate with trustees and make smaller contributions into the fund, utilising the remainder as a backstop through an escrow account, letter of credit or parent company guarantee. This approach has the virtue of making contingent cash available to fill any future hole in the funding should the performance of the equity markets fall below expectations. It's also one that the regulator is happy to endorse. So there is frequently a divide between the trustees and the company, with the former adopting the view that cash is king. As a result, under the new scheme funding regime the trustees may ask the company for, say, £10m and get the response that the company either cannot or will not provide the money.

Under the current cycle of scheme funding, the regulator has given trustees more time to devise a plan where agreement between the two parties has proved elusive, but may ultimately impose its own funding solution where they consistently fail to reach any resolution. This hasn't yet happened, but regulator-imposed settlements remain a likely scenario for 2008.

Graham Buck is a Reporter on *The Treasurer*.
editor@treasurers.org
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