A perfect match

THERE IS ENORMOUS VALUE IN BRINGING CORPORATE TREASURY DISCIPLINE TO PENSION RISK MANAGEMENT, AS **MIKE WALLACE** AND **DAVID MORTON** EXPLAIN.

A typical FTSE 350 company has pension liabilities of around 25% of its market capitalisation, mostly unhedged, leaving it exposed to material financial risks – principally equity, interest rate and inflation risk. That makes the skillset of the treasurer perfectly suited for managing pension scheme risk.

In recent years, companies with defined benefit pension schemes will have experienced significant pension scheme volatility, with demands for additional funding from pension scheme trustees at a time when credit has been hard to come by. This volatility stems chiefly from the mismatch between the assets held by pension schemes and the nature of the pension obligations.

Figure 1 shows a breakdown of the typical risk profile for a UK pension scheme. Arguably, the typical investment strategy illustrated in Figure 1 was more appropriate in the past, when a large proportion of the pension obligation was discretionary. However, the environment has changed substantially: companies have been made fully liable for any shortfalls in their pension schemes; many pension schemes have closed to future members, so they now have a finite, albeit still very long, lifetime and less cash income to pay benefits; and a decade of poor equity market performance and significant falls in interest rates have left most schemes with insufficient assets.

As with any financial risk, capital market solutions are available to help. This is where corporate treasurers' skills come into their own.

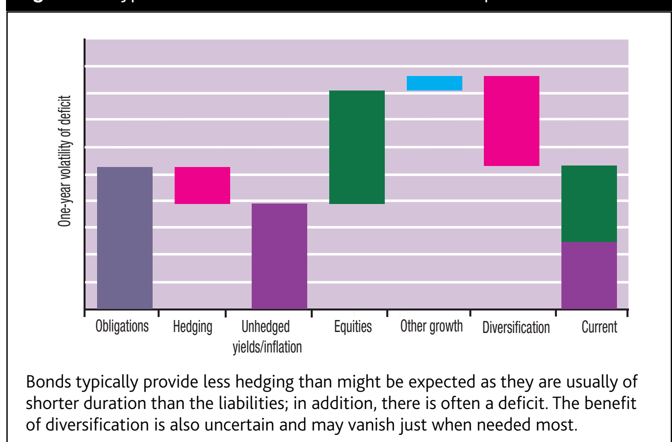
THEORY INTO PRACTICE Marks & Spencer pension scheme is a circa £5.5bn arrangement. Given its size relative to the size of the business, it is important for both member security and shareholder value that the risks and funding requirements are well managed.

M&S implemented a property-backed funding partnership in 2007 to provide greater security for the scheme while managing company cashflow. Subsequently, as part of the 2009 valuation, the property partnership was extended and combined with a funding and investment strategy to manage the deficit resulting from the market turmoil in the wake of the Lehman failure.

During 2010–11, with the scheme's funding position improving and a lower level of future investment return required, the opportunity was taken to reduce the allocation to return-seeking assets (including equities) at relatively high market levels, and increase the level of interest rate and inflation hedging of the liabilities. The result was a reduction in the scheme's one-year value at risk by between £100m and £150m. The changes have helped to protect the scheme's funding position as the 2012 actuarial valuation approaches.

More recently, despite continuing market volatility, it has been possible to further improve the efficiency of the scheme's investments by restructuring the interest rate and inflation hedge to capture higher yields, while still maintaining the same level of cover.

Figure 1: Typical risk breakdown for a FTSE 350 pension scheme



Bonds typically provide less hedging than might be expected as they are usually of shorter duration than the liabilities; in addition, there is often a deficit. The benefit of diversification is also uncertain and may vanish just when needed most.

Further derisking opportunities should arise in the future, and are not necessarily dependent on a return to strong economic growth. With this in mind, M&S and Hymans Robertson, working in conjunction with the scheme trustees and in-house pensions team, have developed a robust risk management and monitoring framework to identify what action to take and when.

Pension scheme risk management is not a one-off solution but a journey requiring the capital market expertise typically found in corporate treasury teams. We expect to see corporate treasury functions increasingly given responsibility for enhancing and protecting shareholder value by working with scheme trustees to actively manage companies' legacy defined benefit pension liabilities.

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