OPENING PANDORA'S BOX

THINGS HAVE CHANGED FOR THE PENSIONS INDUSTRY. NOT ONLY THE ECONOMIC CLIMATE BUT THE REGULATORY ONE TOO. SO WHAT DOES IT ALL MEAN FOR THE TRUSTEE? **BOB THORNE** AND **MAX ZIFF** OF BARCLAYS CAPITAL FIND OUT.

Changes to the regulatory and accounting environment have opened a Pandora's box in the UK defined benefit pensions industry, at a time when market movements are reducing the asset values of a large number of pension funds. Assets and liabilities, which for years have been 'off balance sheet', with investment performance smoothed from year to year, are now going to be valued on a much more transparent basis in line with market values for assets and using a bond discount rate for liabilities.

The fair value of surpluses and deficits – although not the assets and liabilities themselves – will hit the company balance sheet. There will also be a significant secondary effect (the potential size of which it is easy for some companies to underestimate) on P&L volatility as volatility in asset values in one year feed through to the other finance income line in the P&L in the next year.

Accordingly, the pension scheme's financial impact (under the new FRS 17 accounting basis) will be publicly available in the company's accounts, and there are already signs that equity analysts will use this information to strip out 'distortions' caused by pension fund investment policy so they can focus on comparing the operating performance of companies in similar businesses.

How will the market react to this new information? How should asset allocations change, if at all, in response to the increased disclosure requirements? Pension schemes have long been invested heavily in equities, which for many years has proved beneficial both to members and scheme sponsors. But things have been changing – schemes have been maturing, guaranteed benefit levels have increased mainly as a result of legislation, yields and equity markets have fallen significantly from their peaks as, arguably, has the equity market risk premium (just as the risk itself – as measured by equity market volatility – has been increasing). This leaves a large number of firms with smaller surpluses or deficits in their pension plans.

WHAT SHOULD THE PENSION FUNDS DO? A debate rages widely about what pension schemes should be doing in response to FRS 17. Boots has upped the ante considerably with the switch of 100% of assets into bonds (see December issue of *The Treasurer*, p20). Will other companies follow, and, if so, how far will they go?

While people still argue about the line pension schemes should take there seems to be a consensus on one thing: that pension schemes will switch far more heavily into bonds over the coming years. Estimates vary widely as to the potential scale of the moves, but with a mere 10% of aggregate assets representing about £80bn, the expected moves are significant. The sterling credit market, for example, is about £250bn in size. A 10% shift out of equities would merely take the UK down to the long-term US average of 60% – and many actuaries expect schemes to go further. While there are many tools to satisfy the increased demand by tapping alternative markets, capacity constraints necessitate that pension funds tread carefully in their pursuit of increased bond exposure.

Overall, therefore, there are some hard questions to ask. For example, what are the performance characteristics of equities relative to fixed coupon and index-linked bonds (and, importantly, also to pension fund liabilities)? Are pension schemes an appropriate vehicle for shareholders and members to take equity risk? What are the benefits to the various stakeholders if risk is rewarded? What is the downside if not? Are pension schemes affordable without the outperformance we have had in the past from equities? What is the best way to manage the transitions into bonds to protect the interests of the pension fund beneficiaries at a time of rising bond demand?

GRIST TO THE MILL? Fortunately, as investment bankers, it is not our job to give direct input on pension fund investment strategy (as opposed to views on the implications for overall corporate financial strategy and, where appropriate, on transition management). But it will be interesting to see whether our well-intentioned characterisation of the 'traditional view' versus the 'new paradigm' (see *Table 1*) adds grist to the mill. There is still certainly plenty of scope for debate about the intellectual rigours of pension fund investing. For now, we will leave the intellectual debate to others. We can, however, be reasonably confident that there will be a significant degree of switching into bonds over time. In the remainder of this article, we look at implementation – the challenge of constructing large bond portfolios in a capacity constrained marketplace.

TABLE 1
TRADITIONAL VIEW VS NEW PARADIGM.

To add spice to the debate, let's take a quick look at a few of the 'traditional' arguments for pension funds to continue to be invested substantially in equities and re-visit them in light of the 'new paradigm' now being put forward by some.

PERFORMANCE RISK

- **Traditional view:** 'Equity markets generally outperform bonds, and while there is a degree of risk, pension fund liabilities are often long-term and equity market risk is diversifiable by time'.
- **New paradigm:** 'Granted that equity markets have often out-performed, but there can be sustained periods of underperformance. Risk needs to be factored in more explicitly, with a bias towards asset and liability matching, unless there is a positive reason to mismatch on a risk-adjusted basis. There is not much in the way of substantive empirical evidence to support the proposition that equity market risk is diversifiable by time. (There are simply not enough independent observations for a statistically robust result to be obtained in respect of, say, successive 20-year periods.) In any event, it should be the (shorter) time horizons of shareholders, rather than of pension fund liabilities, that really matters'.

HEDGE VS INFLATION

- **Traditional view:** 'Equities are a good hedge against inflation and hence final salary related pension liabilities.'
- **New paradigm:** 'The best hedge against inflation is inflation-linked bonds. In any event, inflation now looks to be low and stable for the foreseeable future. There is not much in the way of substantive empirical support for the proposition that equities are a good long-term hedge against inflation.'

FRS CHANGES NOTHING

- **Traditional view:** 'FRS 17 is only an accounting policy. Nothing in the real world has changed.'
- **New paradigm:** Markets are driven by the availability of information on risks and rewards for different activities. Much more information will now be available and it will be used. In any event, FRS 17 is likely to be accompanied in due course by a new 'funding standard', which will replace the minimum funding requirement, to be determined by actuaries. Much will depend on the nature of this standard and any changes to the priority of pension scheme members' benefits on voluntary wind up of the pension scheme or company insolvency.'

TIMING

- **Traditional view:** 'All this is fine, but with equity markets still weak and the bond market strong, now is not the time to make the change'.
- **New paradigm:** 'Timing is important and everyone couldn't switch at once, even if they wanted to. The whole point is that there is a need to develop a transparent analytical framework to manage the risks as well as the rewards. Pension funds should be looked at like deconsolidated finance subsidiaries, with asset and liability mismatches subject to rigorous analysis and controls, and economic (or value-at-risk) capital allocated to reflect risks being taken. It is only against this background that strategic and market timing decisions can be made.'

'PENSION SCHEMES WILL NEED TO ENSURE THEY TAKE APPROPRIATE CARE IN ESTABLISHING PORTFOLIOS'

ADDRESSING THE CHALLENGES. In the recent years, we have seen a major expansion of the bond markets in Europe. We expect this to continue and provide some of the capacity needed to execute the expected transitions out of equities into bonds. The scale of shift in demand for bond products may, nevertheless, lead to a capacity problem in the sterling bond markets if the full range of available avenues are not utilised by the pension funds. This requires a broadening of the product set pension funds seek to utilise.

Going forward, we would expect pension schemes to make full use of the following products:

- increasing reliance on primary issuance, bespoke assets, structured credit products, swaps and derivatives (when appropriate) as a way to achieve the desired bond exposure – at least pending a decision on the UK entry into the euro;
- increased use of non-sterling product wrapped with derivatives to get around the capacity issues that may emerge in the sterling bond markets; and
- growth of the index-linked bond and gilt markets (RPI and LPI).

Pension schemes will need to ensure they take appropriate care in establishing portfolios and also take advantage of the full range of available credit products which the traditional pension fund mandates may not be designed to capture.

This is particularly true in the case of liability matching products, which are in high demand from insurers and pension funds. These products tend to come onto the market infrequently and are bought quickly by investors geared up to make fast decisions. The traditional trustee structure can lead to delays in the decision-making process that are not suffered by insurance companies seeking to match similar liabilities.

The recent Myners Report on institutional investment proposed that trustees establish investment sub-committees to provide the focus and level of expertise needed for investment decision taking. A sub-committee structure should also improve the timing of decision-taking in this area.

SUMMARY. Whatever the merits of the intellectual arguments on asset allocation, the strong evidence is that pension schemes are – and will continue – to shift out of equities and into bonds. The sterling credit market has limited capacity to absorb large transactions and pension funds may move the markets against themselves if the bond portfolios are built without the due market expertise. Both trustees and their advisers will need to take care in establishing portfolios and utilise a greater breadth of products than has historically been the case. With the appropriate degree of care and diligence applied to the transition process we believe these issues can be overcome.

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