Pension funds – the opportunity for treasurers

Corporate treasurers can play a crucial role in analysing risk in pension schemes and dealing with trustees, argues Richard Thomas of Law Debenture.

In our work as professional pension scheme trustees, we are aware of the financial risk for corporates in the pension schemes which they sponsor. Under pressure from finance directors, some companies have made well publicised moves towards money purchase pension provision, where these financial risks for corporates can be eliminated at a price.

However, most occupational pension schemes in this country of any size are still on a 'final salary' basis, where the sponsoring company is underwriting the risk that the net outturn of various financial events may be different from the assumptions on which the financing of the scheme has been based. These risks have always been there but they have been brought to painful prominence by the minimum funding regulations (MFR) and the declining yield on gilts.

Corporate treasurers are well equipped to assess, describe and control these financial risks and it will be to the advantage of pension schemes and corporates alike if the debate is not confined within corporate pension departments and their actuaries, but is widened to include those with financial responsibilities inside the corporates.

The context

UK pension funds are worth a figure approaching £1,000bn. Of course this is approximate, given the changes recently in stock market valuations. The size of the UK pension sector can also be judged by the fact that it approximates to one year of the UK's GDP. It also compares with the near £1,750bn market capitalisation of the FT All Share Index.

In anybody's language these are big numbers, but it is particularly important to note the size of UK pension funds relative to UK corporates. Changes in the valuation of one will impact on the valuation of the other.

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The mysteries

Despite the apparent precision of pension scheme valuations, pension schemes are set up to deal with four questions which can only be answered precisely when the last member has died. The questions are:

- how long will the members live?;
- how big will their pensions be?;
- what will the assets in the pension fund realise?; and
- what income will the assets generate in the meantime?

Richard Thomas

The assumptions

It is possible to make assumptions in answering these questions, but it is always important to remember that they are no better than assumptions. The assumptions are:

- the level of future investment returns;
- the rate of future salary growth;
- the size of future pension increases;
- future inflation; and
- the rate of growth of dividends in the future.

The demographic issues can be addressed by making assumptions on mortality, retirement age, marital status etc.

My background is in corporate finance and project finance, and when I started in the pensions industry I was astonished to find that the sensitivity analyses that I was used to seeing could not readily be provided by pension scheme actuaries. The solvency of pension schemes and the future contribution rates that they needed were assessed by reference to a single set of financial and demographic assumptions.

Happily this has now changed thanks to increasing computer power, and it is conventional now to see sensitivity analyses presented in a matrix of results.

But how to express the results?

Unfortunately there are many different ways in which the financial status of a pension scheme can be expressed and the differences between them can be huge. Treasurers who get involved in their companies' pension schemes will need to be aware of what they are looking at or the results can be seriously misinterpreted.

Without going into the intricacies of the different approaches which are available to actuaries, the big debate is

between 'smoothed' and 'market value' approaches for ongoing pension schemes.

The smoothed approach discounts assets and liabilities to present values in a way that smoothes out the volatility of investment markets. The success of this method can be seen from a comparison between the smoothed actuarial valuations of assets which follow the long term trend line of market values over the last 20 years without succumbing to the upward and downward spikes of short term market movements.

Given the very long life of pension schemes, there was a lot to be said for the smoothed approach, but the declining significance of dividends in investment returns has undermined its validity.

Pressure from the accounting bodies and changes in the way companies are rewarding their shareholders are encouraging actuaries to move to a more market value-based way of evaluating pension schemes. While this may appear more objective, it is certainly more volatile

Another way of valuing pension schemes is the MFR approach. This is a single set of financial assumptions adopted by the government which is used to give a measure of solvency and determine minimum contribution rates for pension schemes. The MFR valuation basis also uses the actual dividend yields of equities and gilts and therefore is linked to market values.

The government actuaries department (GAD) has a wholly prescribed basis used to determine the maximum funding of a pension scheme if it is to retain full tax-exempt status. This GAD approach is cautious and very few schemes are affected by it.

Then there is the SSAP 24 approach (soon perhaps to be FRED 20), which is used by corporates to reflect their economic interest in pension schemes on the face of the corporate balance sheet. The financial assumptions here can, under SSAP 24, be chosen by the corporate and need not be the same as any of the others. FRED 20 is more prescriptive, but that is another story.

All of the above approaches are applied to on-going pension schemes and use a discounted cashflow technique.

A further way of valuing pension schemes is the so called discontinuance valuation. This is the purest market value approach and it assesses the solvency of the scheme on the basis that the scheme is closed or wound up there and then, with the liabilities being valued using annuity prices. Assets and liabilities are therefore valued on a purely market basis as at that date.

Trustees and corporates need to understand that the various valuation bases serve different purposes and are not consistent

Naturally each of these different ways of valuing a scheme produces a different answer and this can make for a confusing picture. Trustees and corporates need to understand that the various valuation bases serve different purposes and are not consistent.

Pensions Act – the investment duties of trustees

The investment duties of trustees provide the entry point for the corporate treasurer in assessing the financial risks posed to the corporate by the pension fund. These duties have been consolidated in the Pensions Act. This says that trustees have a general duty of care. In particular, trustees must;

- take advice on the investment strategy of the pension fund;
- consult with the employer;
- consider the kind of investments, the balance between different kinds, risk, expected return, realisation, diversification of assets, and the suitability of assets;
- ensure compliance with the MFR; and
- choose the investment manager.

In short, the trustees set the investment policy, but only after consulting with the employer. This sets up by law a need for dialogue between the corporate and the pension scheme trustees. It is up to the corporate itself to clarify what its own interests are and what it would like the investment strategy of the fund to be. Because the corporate cannot dictate the pension fund's investment policy, success for the corporate will depend on the care of its analysis and on its skill at getting its point over, as well as an appreciation of the freedom of action that the trustees themselves have.

The implications of the MFR

While the investment duties of the trustee provide the entry point for the corporate treasurer, for many schemes it is the MFR that will become the pivot of the dialogue between them. The MFR is essentially a set of asset allocation models and discount rates that must be applied to the rights of the various types of members in the scheme – pensioners, those still in employment with the company and those who have left the company but whose pensions have not yet become due for payment (and taking account of the ages of the members).

The result of the MFR calculation is an assessment of the solvency of the scheme against minimum standards and the calculation of a minimum contribution rate payable by the employer. Companies whose schemes fall badly below the MFR minimum solvency will find that they are required by law to put cash into the scheme in short order. The MFR could therefore have implications on the company's:

- cashflow;
- profitability;
- balance sheet; and
- the ratings given to its shares by analysts.

Sadly the final implication of the MFR is that the results can be perverse. Actuaries regard the MFR models as simplistic; where real life is more complicated, the MFR results can be unexpected and unwelcome.

Hence the MFR model is now under review by the government. It is not yet clear how it will change, though there is general agreement that reform is necessary.

The interests of the company

To look at the company's interests in a different way, many corporates are concerned about the volatility of company contributions, economy and efficiency. There is a tension between these, as volatility of company contributions can be reduced by moving to a 'money purchase' pension scheme arrangement. In this a member's pension is simply what the money in his 'pot' will buy at the time. Since the company's contributions

are fixed, the volatility of company contributions has been eliminated.

However, this will have been at the expense of economy and efficiency, as money purchase schemes are more expensive to administer, the investment choices made by the members are generally sub-effective and pensions provided from an annuity are more expensive than those from a pension scheme.

There will be some companies for whom the trade off between volatility of company contributions, economy and efficiency mean that money purchase pension schemes are the answer, but for the rest, (perhaps for the majority) final salary schemes will remain the answer.

Companies are also keenly interested in the delivery of the pensions promise, and its adequacy. They also dislike surprises. Again, these issues impinge on cashflow, profitability and ratings.

The opportunities for treasurers

To sum up, pension schemes deal with uncertainty. Or, to put it another way, with risk. These risks can be quantified but the techniques for managing the risks are not straightforward except to those (like treasurers) who are already financially aware.

The ways in which the financial position of a pension scheme can be expressed are varied and you need to be financially aware to interpret the results sensibly. In addition, there are always differences between the outturn of events and the financial assumptions and these need to be understood, analysed and explained.

These are all financial issues, and the treasurer should be well placed to deal with them.

This leaves the question of whether the treasurer should deal with these issues as a trustee of the scheme, as well as being an officer of the company. These are two distinct roles and the combination may pose conflicts of interest. Perhaps in many cases no actual conflict would arise, and the case study illustrates how the two sets of interests can be synthesised. However, where there is conflict, the treasurer's trustee duties must come first. The law is clear that if he is a trustee, then the corporate hat must be taken off.

But whether the treasurer should be a trustee or not is really a second order issue. The most important thing is his role as the expert acting for the company is getting the strategy right.

A pension scheme should be a partnership between the trustees and the employing company, and the investment duties of trustees provide the framework for one element of this partnership to be managed effectively.

Corporates are facing financial risk in relation to their pension schemes, and who better to analyse these risks and the company's attitude towards them than the treasurer? Who better than treasurers to present the answers and discuss them with the trustees? ■

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Case study: a large UK exporter

This is a real life example of partnership and constructive co-operation between an employer and the trustees of a company pension scheme.

The problem

A large UK plc exports most of its UK production and also manufactures abroad. Over 80% of its earnings is in currencies other than sterling. Its profit and loss account is thus very exposed to sterling strength. The pension scheme's liabilities are also expressed in sterling.

The scheme has no surplus. Mindful of the company's wish to bear down on the long-term costs of funding the scheme, and of the strength of the company's covenant, the assets are invested mainly in equities.

Unfortunately these pose short-term risks. The trustees have a responsibility to keep the fund consistently solvent on a MFR basis. The risk of failing MFR arises from the mismatch of the assets and liabilities on an MFR basis, which would require all sterling assets and a larger bond content in the portfolio. Put simply, short and long term objectives clash.

The MFR test could thus fail as a result of sterling strength or because equities underperform bonds. An MFR failure could force the company to have to make additional contributions to the scheme at a most unwelcome time. What could be done?

The solution

The scheme has a portfolio of assets and the trustees use several external investment managers. The trustees are legally bound to address the MFR risk. Using the existing portfolio they employed an additional investment manager for tactical asset allocation.

The technique used in this case was to overlay the investment portfolio with positions in the financial futures markets. Exposures to markets could be reduced without going short. The result, if the tactical manager were successful, ought to reduce significantly the risk of the scheme being mismatched against the MFR, but will not remove it altogether. The company still faced the possibility of a demand for additional contribution, particularly if the manger exacerbated the situation.

The company does not itself own the portfolio of investments and therefore could not use futures on its own account without incurring contingent liabilities. It can however use options, like an insurance policy, which are not cheap, but which expire without liability at the end of their term.

The company in this case therefore purchased a number of bespoke option contacts which would be valuable in the event of an adverse movement either in the currency mismatch or in the equity/bond mismatch, ie a circumstance when the MFR test might fail. Money generated by the exercise of these options could help to fund an additional contribution to the scheme required in such a circumstance.

Summary

Such a solution could not have been devised without a clear understanding of the issues by both the company and trustees.

The actions by the company and the trustees were contractually separate and stood alone as justifiable actions by each party in its own role, but at the same time stood together as complementary parts of the overall strategy and purpose. ■