Keeping eye on pensions

RICHARD GILES ASSESSES THE IMPLICATIONS FOR TREASURERS OF BORROWING TO FUND PENSIONS AND ASKS WHETHER IT IS BETTER TO HOLD EQUITIES OR BONDS IN A PENSION SCHEME.

Pension funding is becoming an increasingly important issue for equity and debt investors. In response, treasurers and other finance managers are exerting greater influence on the management of pension assets and liabilities.

ANALYST AND CREDIT RATING PERSPECTIVES Historically, published financial statements have provided rather opaque information on the funded status of companies' pension arrangements. The available data has done little to allow users of corporate accounts to assess relative levels of risk and funding between companies. As a result, valuation models employed by analysts and others have been difficult to adjust for pensions and, in practice, pensions have largely been ignored.

FRS 17 *Accounting for Retirement Benefits* and IAS 19 *Employee Benefits* disclosure requirements make schemes' funding positions highly transparent. This has increased interest in pension funding issues. Equity analysts and credit rating agencies are now able to employ far greater sophistication in their analyses and recommendations.

A number of the major equity analyst firms and credit rating agencies have issued research papers on pensions within the last three years. The depth of their analyses is impressive and the opinions expressed are remarkably consistent. While analysts will vary in their views, it is now widely accepted that pension fund deficits should be treated as corporate debt.

In October 2004 Standard & Poor's wrote: "Standard & Poor's Ratings Services views unfunded liabilities relating to defined benefit pension plans as debt-like in nature. Any company more burdened with such retiree costs than its competitors will be penalised in the assessment of its overall cost position."

It is unsurprising that analysts take this view, as any shortfall in funding typically requires extra employer contributions. Invariably, where an analyst adjusts company financials for pension underfunding, the FRS 17 deficit is treated as debt. Mercer estimates the aggregate FRS 17 deficit for all UK pension schemes at 31 March 2005 to be £140bn.

PENSION DEFICIT OR CORPORATE DEBT – WHICH IS MORE ATTRACTIVE? In a simple model, borrowing to fund a pension scheme deficit makes no difference to a company's financial structure. A pension scheme deficit can be viewed as a loan from scheme members to the company, and a special contribution simply involves raising a loan from outside parties to pay off the money borrowed from scheme members. If all lenders and pension fund members were treated equally, there would be no impact on credit rating. Taking this basic view, borrowing to fund is neutral at a primary level. Factors that provide support for borrowing to fund include:

- Raising debt to fund a pension scheme has tax benefits. Interest payments on borrowings attract tax relief, while investments in a pension scheme have some tax benefits, particularly if invested in bonds.
- The new Pension Regulator has powers to interfere with transactions, such as share buybacks and dividend payments, which may reduce a company's ability to fully fund its pension scheme. It is also encouraging trustees to behave as creditors would. The Regulator and trustees are less likely to interfere in corporate activity if the pension scheme is fully funded.
- From 2006 it is expected that the size of the Pensions Protection Fund (PPF) levy will be linked to the scheme funding level. This will increase the attractiveness of reducing pension debt and increasing corporate debt. Details of the risk-adjusted PPF calculation basis are expected later this year.
- Improvements in scheme funding will increase goodwill from trustees and members.

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Executive summary

- It is now widely accepted that pension fund deficits should be treated as corporate debt.
- Employing a borrow to fund strategy will be attractive to some companies.
- There is a growing belief that shareholder value is maximised by defined benefit pension funds investing in bonds and not equities.
- However there is a clash between the bond theory and the practical issues which encourage managers to hold equities.
- In the past trustees have driven investment strategy, in the future this may not necessarily be the case.

This simple model hides some important underlying factors. A credit rating describes the security of external lenders, who take priority over pension scheme members if a company becomes insolvent. In fact, borrowing to fund deficits may not be neutral in credit terms, because each £100 put into a pension fund (which is legally separate from a corporation) puts £100 beyond the reach of other creditors in the event of corporate insolvency. Though rating agencies have said that some specific transactions were "essentially" neutral in credit terms, caution should be applied in drawing such conclusions. This is particularly true where pension deficits are large to existing outstanding debt or in relation to the size of the organisation. Of course, the cost of raising capital is a further consideration for companies thinking about borrowing money to fund their schemes.

So, employing a borrow to fund strategy will be attractive to some companies but not all. Intriguingly for those companies for which raising additional borrowing is out of reach, trustees will want to negotiate hard to receive additional funds to pay off a deficit, or

Box 1 Overlooked liabilities

"Corporate pension funding in the UK is becoming an increasingly important issue for investors. For shareholders there is the concern that higher contributions to pension funds will reduce earnings growth and the amount available to be paid out as dividends. For debt/bond holders there is a growing realisation that pension liabilities have been overlooked when assessing credit worthiness."

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alternative forms of security for members. In these situations the interest of trustees and employers will be quite different.

Is shareholder value maximised by investing pension fund assets in bonds? Traditionally, pension fund investment strategies have aimed to maximise the return on scheme assets, subject to the risk and affordability constraints of sponsoring employers. The resulting asset mix has been heavily biased towards equities, as they are expected to deliver the highest returns (albeit with high risk levels). In performing funding valuations, actuaries have generally taken expected levels of future investment return into account when setting contribution rates. As a result, the contribution requirements for schemes with higher levels of equity have tended to be lower than for identical schemes invested in bonds.

Given this, conversations with trustees about reducing equities in favour of bonds quickly converge on the affordability of the resulting higher cash contribution. Consequently, the idea that shareholder value can be maximised by eliminating pension fund equity exposure can appear counterintuitive.

In January 2004, UBS wrote: "We reiterate our belief that shareholder value is maximised by defined benefit pension funds investing in bonds and not equities, irrespective of the performance of equity markets. Where possible, companies should immediately correct deficits, change asset allocation to eliminate equity investment and replace pension leverage with more efficient financial leverage in their capital structure."

However, the view summarised in the UBS comment is becoming increasingly popular among analysts and is also closely aligned with some fundamental principles of corporate finance. It is based on the simple idea that £1 of bonds is worth £1 of equities. Higher expected future returns from equities are offset by their increased associated risk. For companies, the higher level of risk associated with equities increases the cost of capital, which offsets any expected gains from holding them. Therefore, at a first order level, whether a company holds bonds or equities does not alter its value.

Then, there are second order effects to consider. These include the tax benefit of holding bonds versus equities and the lower management fees involved, leading many commentators to conclude that, to maximise shareholder value, schemes should invest in bonds.

The preferred investment strategy will depend on the complex mix of stakeholders and their objectives. Historically, trustees have driven investment strategy. Going forward, finance managers will want more influence as fluctuations in asset and liabilities values could have major implications on profits, balance sheet strength and cashflow.

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