Facing the challenge

Treasurers have a key role in the pension debate, according to conference chairman Crispin Southgate, as they straddle the roles of pension fund investor and sponsoring company. The corporate has a dual interest as it has given a pension covenant and is an issuer into the capital markets. The question for treasurers is how to bring their influence to bear on dealing with issues such as longevity and helping the pension fund find the road to recovery.

Defined benefit (DB) pension schemes can now be the largest part of debt capital for many corporates. Southgate, a director with Institutional Investment Advisors, said the capital markets reflected the DB deficits and volatility that schemes were experiencing. Equity value, real yields and longevity were all real risks faced by pension funds. Pension funds and treasurers had to reduce risk. First the risk has to be identified – it would be a mistake to assume it would go away on its own and it has to be managed using skills that are core to a treasury expert.

Treasurers need to help pension funds seize opportunities such as changing the investment approach. In the long run DB schemes have to move to either a buy-out or self-sufficiency. One option would be to switch to defined contribution.

While the present market conditions do create opportunities, Southgate was under no illusion that treasurers face considerable challenges to make a difference because of factors such as weak governance, unchallenged and inadequate advice to trustees, glacial decision making, reliance on broken markets, groundless faith in assumptions and a lack of focus on markets.

DEALING WITH DEFICITS Andy Corvesor, principal at Hewitt, looked at how corporates could deal with pension deficits at a time when cashflows are under pressure. The funding level of a typical DB scheme has fallen both on an accounting measure to around 90%, and – particularly – on a cash funding measure linked to gilt movements: such funding could be down to 70%, Corvesor pointed out. This could come as a shock to many trustees as most stories in the press focus on the accounting measure. Market events are driving schemes to reconsider their funding approach and Corvesor said corporates should be clear on their long-term strategy for pensions and to maximise the chances of success should take the initiative. He added that there were four pension cash management levers which corporates could pull. These are:

- Remove excess prudence from technical provisions
- Negotiate recovery plan parameters with the trustees
- Use non-cash funding and security
- Manage the benefit promise.

The role of the Pensions Regulator is to ensure that technical provisions are strong enough but the office has recognised that in the economic downturn recovery plans may need to be made longer and/or back-end loaded. Companies should look to remove excessive or ‘lazy’ prudence from technical provisions. Any company wanting to negotiate a recovery plan should get organised, start early and be clear on its long-term strategy. Many schemes have no articulation of future investment strategy, which can lead to implicit decisions being made through the choice of funding basis. Corvesor illustrated how a company could reduce the annual amount of funding by looking to lengthen recovery periods and to use an adjusted, but still sensible, asset return basis. Managing the benefit promises can also help. Such techniques include closing to future accrual, capping pensionable salary increases and performing a benefit audit.

Executive summary

- The ACT annual pensions conference, co-sponsored by Hewitt and the Royal Bank of Scotland, heard from treasurers, regulators, bankers and the pension industry as the day explored both today’s challenges and tomorrow’s opportunities.

PETER WILLIAMS LISTENS IN TO THE DEBATE AT THE ACT ANNUAL PENSIONS CONFERENCE.

Eyewitness

Members of the ACT told the conference of their experiences of managing challenges in their companies' pension schemes. Marcel Miller, director, treasury middle office, Diageo, told of the company's pension risk management journey. In 2006 Diageo identified the pension fund had high equity content, long duration of liabilities, liabilities and assets not correlated, longevity risks and a £200m funding deficit. It undertook a value at risk (VAR) analysis to understand the magnitude of risk and asset diversification through investing in broader real estate investment, increased fixed income allocation and active currency trading. It also engaged in dynamic de-risking by switching from equities to bonds as IAS 19 deficit reduced. The governance processes were reviewed. Miller said challenges remain including deficit funding (again), ongoing significant VAR and longevity risk. Stephen Pugh, finance director of brewer Adnams, explained how the DB pension scheme, which started in 1955, closed to new members in 2002 and closed to all accrual in 2005. The decision to close the DB scheme was triggered by the growing size of the deficit, the desire for risk mitigation and cost control. Pugh also emphasised the desire to be fair to all staff and to take a long-term perspective.

Later this year The Treasurer is planning to look in more depth at some of the case studies where treasurers have been deeply involved in managing the pension situation at their companies, including those talked about at the conference.

FUNDING ALTERNATIVES Darren Mason from Grant Thornton built on Corvesor's ideas by looking in more detail at some of the alternatives to the cash funding of the pension scheme. Alternative financing can provide benefits such as being tax efficient, and can also reduce the Pension Protection Fund (PPF) levy. A range of options exists for use as contingent assets including charges, guarantees, letters of credit, insurance, escrow accounts and property partnerships. One example of this type of approach is the Marks & Spencer pension funding solution where the company entered a property partnership with the pension fund. The move reduced the deficit while spreading the company's cashflow obligations over a longer period. In return the fund received an income yielding assets backed by a property portfolio. After 15 years all rights to income and property of the partnership reverted to the company and as the partnership was part of the group there was no impact on the value of property assets on the M&S balance sheet.

Trustees entering such deals need to carry out their own due diligence in order to understand the claimed benefits. Mason pointed out that they needed to look at issues such as legal capability and cost of enforceability. For instance, when entering a property deal the due diligence required by the pension fund would include confirmation of legal and security documentation; the property management strategy; compliance with health and safety requirement; and controls to collect cash. Given the current economic climate there is likely to be increased interest in such schemes, and while the set-up costs can be considerable for complex solutions, Mason suggested that the simple is often effective.

KEY POINTS FOR THE REGULATOR The three key areas of interest to the Pensions Regulator are DB scheme funding and transitions, defined contribution engagement and governance and administration. Picking up on points made in previous presentations, June Mulroy, executive director of business delivery at the regulator, said there was a balance to be struck between robustness and flexibility. She said that while the technical provisions do need to be robust they must also reflect the situation as it really is, not as we may like it to be. She also confirmed that recovery plans can be flexible if needed. On the issue of contingent assets she warned that these must have a value. She said three principle risks face pension funds: member or PPF; scheme governance and employer risk. Problems under scheme governance include misuse of scheme assets such as fraud and employer-related investment and poor administration/record keeping which can have a material impact on proposed buy-out values. On employer risk, the regulator is highlighting the dangers of lower pension contributions, opportunistic behaviour such as inducements and scheme closures and setting imprudent technical provisions. UK pension schemes are looked after by 140,000 trustees and one of the important tasks of the regulator is increasing levels of education and awareness among that population. The external approach adopted by the regulator is to communicate with schemes and employers about the flexibility of the scheme funding system. It is also increasing focus on the importance of good scheme governance and boosting interest in the ever-more complex defined contribution (DC) landscape. Mulroy said there were five key DC risk areas: administration, investment practices, member communication, retirement options and charges and she said the regulator was working with bodies such as the FSA and the Pensions Advisory Service.

SURVIVING THE CRISIS Surviving the crisis was the theme of the presentation given by Sinead Leahy, head of UK pension solutions, RBS global banking and markets. Leahy said that surviving the crisis is about reducing volatility and exploiting market opportunities. Market-based advice is needed to assist both strategic and tactical risk management decisions. Corporate sponsors have a role in making sure trustees understand the risk they are running. Corporates may wish to consider making new contributions conditional on improved risk management. Exploiting the liquidity position of pension funds, Leahy said banks can offer pension fund investment opportunities. For instance, guaranteed spreads over LIBOR can be achieved through collateralised deposits with banks, where deposits are secured on assets such as corporate loans where pension funds are not at risk if the loan defaults. In dealing with equity volatility, Leahy said there was an opportunity to monetise volatility by selling equity upside above a certain level. The scheme maintains its current equity holdings but then in a second step implements a programme of selling rolling, out of the money call options. Strike dates can be staggered to reduce sensitivity to single day moves.

Peter Williams is editor of The Treasurer
editor@treasurers.org