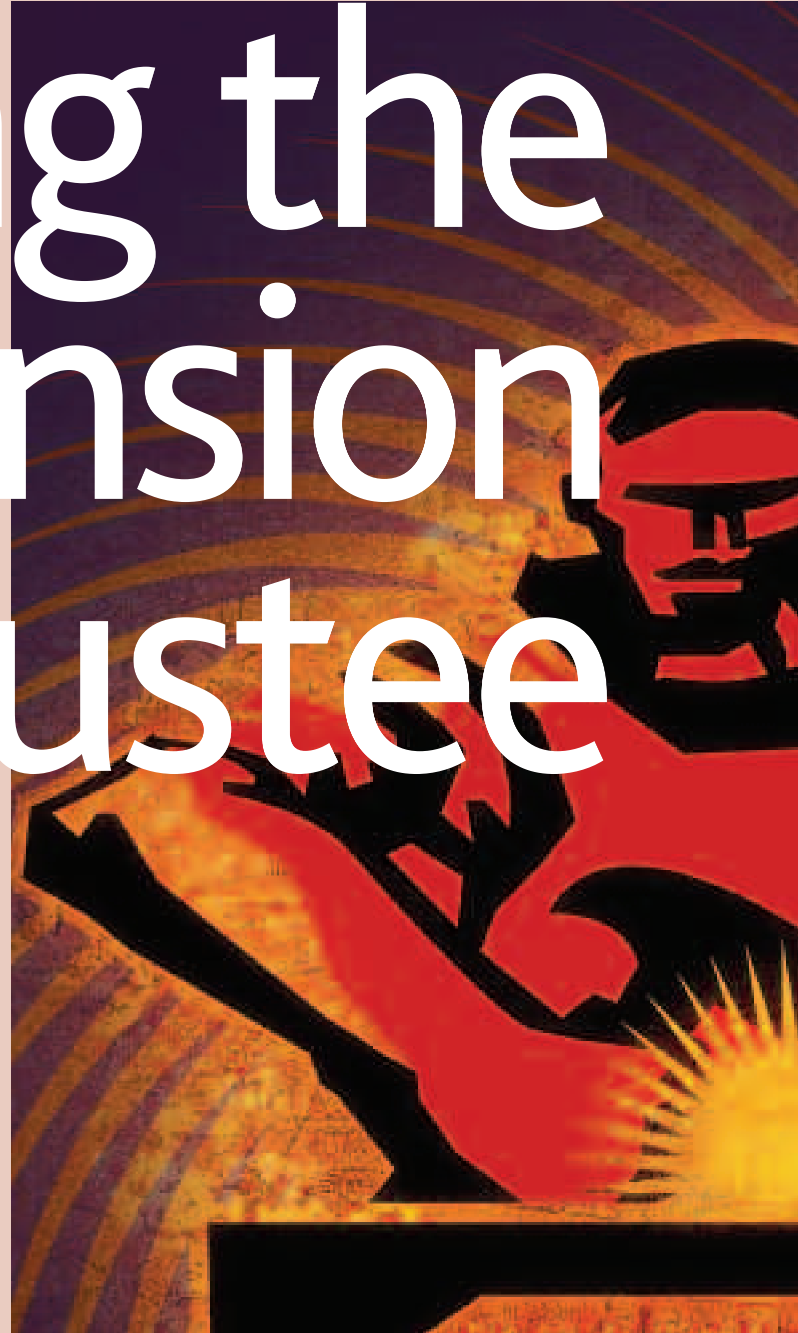
Forging the pension trustee



JOHN HAWKINS AND **CLIFF SPEED** LOOK AT HOW PENSION FUND TRUSTEES ARE THE NEW BANKERS AND CONSIDER SOME TOOLS FOR CORPORATE CREDIT RISK MITIGATION.

In June 2003 the government announced that it would no longer be possible for corporate sponsors to walk away from deficits in defined benefit pension schemes, finally crystallising the rather hazy nature of the pension deficit. In March of that year the FTSE 100 index had fallen below 3300; pension scheme deficits were at an all-time high due to the combination of weak equity markets, low interest rates, prolonged contribution holidays, the Chancellor of the Exchequer's taxation of dividends and improving longevity. The new accounting standards FRS 17 *Retirement Benefits*, and later IAS 19 *Employee Benefits*, ensured that the relative scale of pension deficits and corporate assets was increasingly obvious to all.

The Pensions Act 2004 brought into being a Pensions Regulator and the Pension Protection Fund. The former told trustees to start thinking like any other unsecured company creditor – in other words, like a banker. The latter was required to base 80% of its levy on a risk basis of assessment. At least initially, risk will be measured by the scale of any deficit and the company's creditworthiness.

Trustees and sponsoring companies of schemes with deficits need to start a dialogue, especially if the creditworthiness of the sponsor is other than first-class. This article considers some of the tools available for corporate credit risk mitigation. We will not discuss here trustees' investment strategy, although trustees clearly cannot view corporate credit risk in isolation.

Credit risk mitigation techniques can be categorised in a number of ways, some of the more useful of which are:

- funding;
- documentation enhancement (including security);
- third-party financial support; and
- use of market instruments.

The 'no free lunch' concept applies to risk mitigation. Any steps taken to improve the security of a pension scheme are likely to have an adverse impact on 'third-party' debt and thereby increase its cost. These incremental costs may be indirect (i.e. through increased credit spreads) or direct (i.e. increased bank borrowing rates, guarantee fees or insurance premiums). Since other lenders will invariably be affected, negotiating improved security arrangements will always be easiest when the credit outlook of the employer is relatively benign. In some cases the formal consent of the employer will clearly be required; in others it will be a practical necessity. Unless a risk mitigation strategy is about to be executed in the rare situation of a clear and present difficulty, there must always be an argument for the trustees and employer to work together.

FUNDING From the trustee's perspective, the benefits of additional funding, and thereby deficit reduction, are obvious. There can also be benefits for the employer. The first is tax advantage. Borrowing more

Executive summary

- The Pensions Act 2004 created the Pensions Regulator and the Pension Protection Fund. The former told trustees to begin to think like any other unsecured company creditor – in other words like a banker. The latter was required to base 80% of its levy on a risk basis of assessment. At least initially, risk will be measured by the scale of any deficit and a company's creditworthiness. Credit risk mitigation techniques include funding, document enhancement, third-party financial support and the use of market instruments.

to fund contributions will have tax-deductible interest for companies in a tax-paying position. 'Ordinary' pension contributions by employers are also tax-deductible. Once paid into a scheme, the interest received on incremental fixed-income investments will be tax-free.

The second is the reduction in the PPF premium, which will be related to the size of the deficit.

There can also be a third, cosmetic benefit. If the contributions are invested in assets with an expected return higher than the interest cost of the borrowings, there will be a benefit to earnings under FRS 17/IAS 19.

Finally, additional contributions should translate into employee goodwill and may be useful in wage negotiations.

DOCUMENTATION ENHANCEMENT The two principal documents relating to scheme security are usually the trust deed and the schedule of contributions. Enhancements to documentation may well involve one or both of these, but can also involve additional documents. The main areas that should be addressed are as follows:

- **Priority** The concept of priority (i.e. where a lender ranks in relation to other lenders for the repayment of principal and interest in the event of insolvency) for loan documentation is very familiar. Most pension obligations of sponsors are unsecured and trustees should be concerned about the ability of sponsors to create prior ranking debt. The majority of bank loans contain *pari passu* clauses (i.e. a prohibition or restriction on the creation of prior ranking debt). In structured deals certain classes of debt such as bank loans are typically ranked ahead of others such as bonds. There is a sound argument for trustees requiring at the least an undertaking that no prior ranking debt will be created, and in some cases there may be a case for seeking prior ranking, although opportunities for negotiating this may be limited.

- **Security** This can come in a variety of forms. Charges over property would be one, although the property involved should be readily marketable in case of corporate insolvency. Charges over inventory, trade investments and shares in subsidiaries are all possibilities, although in the last category care needs to be taken to comply with self-investment restrictions. In at least one case, a charge was taken over a pool of ring-fenced assets (trade receivables), although the cost of implementing such strategies can be high. For companies that have an issue with the timing of payments, a cash or bond escrow arrangement may make sense, although this will not produce the same benefits as an actual contribution.

- **Negative Pledge** Taking security may be impractical as a result of a lack of suitable assets, or restrictions in borrowing agreements. In such cases trustees could look for a negative pledge, i.e. an undertaking from the employer that it will not grant security to other lenders.

- **Financial Covenants** The breach of financial covenants in loan agreements usually triggers a default and the right of the lender to immediate repayment. A similar arrangement can be put in place for a pension deficit, with a deficit becoming immediately payable in full, or a contribution schedule becoming accelerated, as a result of a deteriorating financial covenant.

- **Cross Default** This provision makes the deficit (as in the case of a loan cross default) immediately payable in the event of a default on other borrowings.

- **Change of Control** This clause already exists in many schemes and makes the deficit payable in the event of a controlling interest in the principal employer changing hands.

- **Limitation on Use of Disposal Proceeds** A clause of this type can be especially relevant for companies downsizing significantly, particularly as it is increasingly common for pension liabilities in respect of retired and deferred members not to be transferred when assets or businesses are sold, increasing the relative burden on the retained businesses. Such clauses might well involve some of the proceeds being used for additional contributions.

- **Cross Guarantees** The Pensions Act 2004 permits the Pensions Regulator to issue contribution notices and financial support

directives to related parties to a principal employer, even where the party is not itself a participating employer. Contractual cross-guarantees from other companies in the group make the support obligations of these companies clear from the outset.

- **Other Clauses** Any restriction or covenant dreamt up for a loan agreement can also be applied to a pension deficit, including limitations on acquisitions, restrictions on new businesses, etc.

THIRD-PARTY SUPPORT One of the most straightforward ways to improve a credit position is to obtain a guarantee or credit insurance policy from a third party. However, a guarantee and an insurance contract are fundamentally different. Insurance law has a number of concepts, such as full disclosure, that are very different from those in company law, which normally governs guarantees.

Even if the guarantor or insurer is no more creditworthy than the employer, a guarantee diversifies away from the concentrated credit risk exposure the trustees have to the scheme sponsor. Usually a guarantor or insurer will be required to have not only a strong credit position (probably equivalent to at least AA), but every likelihood of maintaining that position.

- **Guarantees** A guarantee can take many forms, from a standard format letter of credit to a specially designed document. Calling conditions can vary from on-demand to highly conditional (for example, related to a specific credit event). Often, however, there will be a provision that if the guarantee is not extended at the end of its initial term, the beneficiary will be entitled to call the guarantee or receive a cash amount equivalent to the guaranteed sum. Most frequently guarantees will be sought from highly creditworthy institutions including:

- banks;
- general insurance companies;
- specialist monoline insurers;
- special purpose third-party guarantee vehicles (usually supported by collateral).

The question arises of why a sponsoring company might wish to provide a guarantee rather than borrow the money and inject it into the fund, particularly as the latter brings a probable tax advantage. While the fee payable on a guarantee line may be significantly lower than on a loan, this is relatively unlikely. Likewise, it is unusual these days for a company to have easier access to guarantee facilities than borrowing facilities. The most common reason is that a company genuinely believes the deficit situation is temporary and does not wish to risk creating a surplus that is then difficult to extract.

- **Credit Insurance** Credit insurance has been around for many years particularly in connection with supplier credit, often in the context of export credits. A number of commercial firms have always specialised in domestic credit insurance. Some, together with certain reinsurance companies, have proved willing to provide quotations to trustees for credit insurance on sponsoring companies. The difficulty with such policies is that they are valid for a limited period of time, typically one year, after which they lapse. Since there tends to be no 'extend or call' provision attached to them, their ongoing value is limited. If a sponsoring company's credit position deteriorates during the course of a year, it is likely that the cost of extending the cover will be higher, or it may simply not be available at the expiry of the initial contract.

MARKET INSTRUMENTS The fundamental principle is that market instruments should increase in value as the creditworthiness of the sponsoring company deteriorates. Ideally, they should be capable of liquidating a deficit in its entirety in the event of the insolvency of the employer. In practice, this is difficult to achieve economically and within the constraints placed on pension schemes.

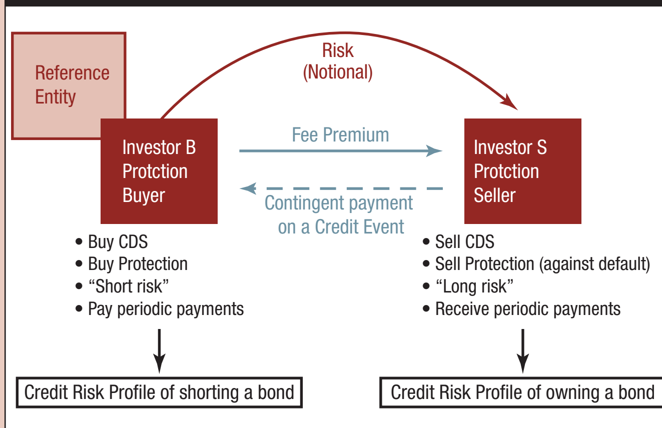
There are a number of issues with trustees using derivatives. First, many trustees are outright distrustful of derivatives, a position often based on ignorance; the education process can be time-consuming and difficult. Second, International Swaps and Derivatives Association (ISDA) documentation is not considered straightforward by many treasurers and trustees find it even less so; the credit annex can be even less comprehensible than the master agreement. Third, derivatives contracts entered into by pension funds almost invariably involve the granting of collateral by both counterparties; some trustees find the concept of granting collateral to a bank even more difficult to accept than entering into a derivative in the first place. Fourth, the Pensions Act 2004 effectively restricts the use of derivatives and it is not entirely clear what uses will ultimately be considered acceptable.

As a general rule, trustees should always ensure that risk mitigation steps are consistent with those risks. This is particularly the case with derivatives, where there may be considerable basis risk in hedging what is essentially a debt with non-debt instruments; this usually calls for sophisticated and dynamic strategy implementation.

- **Credit Default Swap (CDS)** A CDS is a traded investment which, in exchange for a premium, provides a payout in the event of insolvency or default on debt; in other words, a tradable form of commercial insurance. The payout on default is the difference between the face value and the market value of the reference asset, which is usually a bond issued by the sponsor. Pension schemes should ensure the reference bond has a similar repayment priority to the pension deficit. As the price at which the bond will trade after a default event is not known, the payout from a CDS is not known in advance. CDS payouts can be triggered by a corporate restructuring, which provides security to trustees where a sponsor's covenant is financially weakened by a takeover, or other restructuring. Large CDS purchases are likely to affect the credit spread of the sponsor's existing debt. More sophisticated strategies include buying a CDS on the sponsor and recovering some (or all) of the premium cost by simultaneously selling CDSs on a basket of companies. This would give the trustees credit exposure to a diversified portfolio of companies rather than just the sponsor. The trustees receive payment in the event that the sponsor becomes insolvent and in exchange will make payments if any of the companies they have sold CDSs on become insolvent.

- **Constant Maturity Credit Default Swap (CMCDS)** A CMCDS is a financial instrument where a fixed premium is paid in return for a payment that depends on the credit spread of the sponsor. This allows the trustees of a pension scheme to hold an asset where the income increases as the credit risk increases (as measured by the credit spread of the sponsor). This would address the problem of the trustees requiring higher payments the weaker the financial position of the sponsor. A CMCDS is cancelled if the sponsor behind the reference debt instrument becomes insolvent. It usually

Figure 1. How a Credit Default Swap works



has a cap on the maximum floating payment receivable although this is usually set at a high level (for example, 6% credit spread).

■ **Equity Default Swap (EDS)** An EDS provides a predetermined payout if the share price of the sponsor falls by a given amount, usually 70%. The underlying assumption is that when the company is in financial distress the equity price will fall, so the trustees will need to look elsewhere for finance to plug any deficit.

■ **Contract for Differences (CFD)** A CFD lets an investor benefit from the relative performance between two different assets (or asset indices) without holding the underlying physical assets. The most common CFDs deliver the gains (or losses) of holding an equity (or equity index) in excess of a cash return. This is equivalent to borrowing money to purchase the equities and so provides a geared exposure to the equity. Like many derivative contracts, this gives investor the same economic exposure as buying the physical asset but for a smaller initial outlay than required by direct investment in the physical asset. Pension schemes could enter into a CFD where one of the reference assets was the share price of the sponsor. A scheme could enter into a CFD where the pay-off was the difference between the FTSE 100 total return index and the total return on the sponsor's shares. If the return on the sponsor's shares was below the FTSE 100 return, the CFD would come into the money and have a positive value. Similarly, if the return on the sponsor's shares outperformed the FTSE 100, the CFD would have a negative value. This lets the pension scheme hold an asset that increases (decreases) in value as the sponsor's financial position weakens (strengthens) relative to the market.

■ **Short Selling Securities in the Sponsor** If the sponsor becomes financially distressed, this will usually be reflected in the price of shares and bonds traded on the sponsor. The trustees can use this to their advantage by 'short selling' (i.e. borrowing and selling securities they do not own) in the sponsor. Of course, the borrowed securities have to be returned at some point and so have to be repurchased at a later date. The underlying idea is that securities are sold at current prices, so if the prices fall, reflecting financial distress, the securities can be repurchased at lower prices, with the resultant profit helping to cover any deficit in the scheme. There may be restrictions (or moral prohibitions!) on trustees entering transactions of this kind, but the same effect can be created by using derivatives sold by investment banks.

■ **Purchasing Equity Put Options in the Sponsor** There are numerous strategies involving equity options in addition to simply purchasing put options. The most obvious is to recover part of the purchase cost by simultaneously selling put options on a suitable index; exposure to the sponsor's equity is limited to its performance relative to the index selected. This effectively recreates a contract for difference.

MORE COMPLEX STRATEGIES

■ **Sponsor-Guaranteed Loans** Although the Department of Work and Pensions has issued draft regulations limiting the ability of pension funds to borrow, there may be a case for asking a sponsor to guarantee trustee borrowing if it is not prepared to make an outright contribution (perhaps tying the loan repayment to a schedule of contributions). This might be the case, for example, where the trustees wish to invest in assets such as long bonds. There might also be tax advantages for the employer if a one-off contribution of the scale required was not considered 'normal'.

■ **Special Purpose Vehicle (SPV) Investments** An SPV is a catch-all phrase for a legal construct set up to achieve a given financial objective, usually by splitting cashflows between different parties in a pre-agreed way. SPVs can be used to circumvent regulations – for example, one could be set up so the sponsor retains a direct interest in money paid into a pensions scheme. Many designs are possible, two examples of which are discussed here. (1) The sponsor makes a payment to the scheme on condition the money is invested in an SPV, which then loans it back to the company. This makes explicit the nature of the deficit – a loan to the sponsor – and the SPV can charge a market rate of interest on the loan to the company (i.e. including a variable risk premium as well as a variable reference rate) to reflect the risk of default. In addition, the terms of the loan can be set to ensure that a repayment schedule is fixed in advance and adhered to by the company; this also eases the incorporation of standard loan covenants. (2) A variation is to design a SPV where both sponsor and scheme invest. The returns are split so that returns up to a specified level are paid to the scheme and any excess is paid to the sponsor. This could be used to address concerns a sponsor may have about paying large contributions into a scheme that could result in surpluses.

RISING TO THE CHALLENGE The pension trustee is dead; long live the pension trustee creditor. Trustees have a duty to reinvent themselves as creditors to ensure they manage pension scheme deficits, which, in financial terms, are loans provided to their sponsors. Trustees rising to the challenge will find a wide variety of instruments for mitigating the credit risk to which they are exposed; some of these have been covered in this article. However, many trustees will be challenged to demonstrate they are doing all that a banker would when faced with a comparable credit risk.

John W Hawkins is former Head of Finance and Risk at Invensys and Chairman of The Treasurers' Conference 2005.
johnwh@rakshasa.demon.co.uk
Cliff Speed is Principal Consultant at Hewitt Bacon & Woodrow.
cliff.speed@hewitt.com
www.hewitt.com