Holistic risk

WITH SIGNIFICANT RISKS REMAINING UNHEDGED IN PENSION SCHEMES, **RUSSELL CHAPMAN** AND **JON HATCHETT** EXPLAIN HOW TAKING AN INTEGRATED VIEW OF RISK CAN HELP AND THE KEY ROLE TREASURERS COULD PLAY IN THE PROCESS.

Corporate treasurers are ideally placed to improve the corporate risk management of legacy defined benefit liabilities. These liabilities are long-dated, and are driven by a complex mixture of financial and non-financial risk factors, which are co-dependent with other financial risks within the remit of a treasury function, such as interest rate risk. This co-dependency means that a holistic view of a company's risk exposure, and its hedging plan, can generate material shareholder value.

Over the past 12 years, cash contributions to pension schemes from UK employers have increased around threefold, while deficits over the same period have broadly doubled. If you add into the mix the fact that most schemes have closed to new members or the accrual of further benefits, you can see a clear failure of risk management. Much more cash has produced a worse outcome from both a financial and an employee benefit perspective.

As schemes have closed, pensions have become less about employee benefits and more about managing legacy liability run-off. Given their responsibility for risk management and their skills, treasurers are well placed to pick up the mantle. Indeed, while the drivers of the deficits are myriad, the largest impact has been due to pension schemes' exposure to equities and falls in long-term interest rates. In other words, the key causes are financial, and within the remit of treasurers to manage actively in future. This is something that we are increasingly seeing in the market.

PENSIONS ARE AFFORDABLE (FOR MOST) The aggregate FTSE 350 accounting deficit moves by tens of billions of pounds on a month-to-month basis due to capital market fluctuations. While these large figures can be attention-grabbing, what is more important is the ability of the companies backing these schemes to support the financial risks that they run. For many companies, the pension scheme is not a significant burden and a relatively small proportion of corporate earnings is used to support the scheme.

For example, Figure 1 shows the number of days' earnings required for FTSE 350 companies to pay off their accounting deficits. While three-quarters of these companies could pay off their IAS 19 deficit with less than half a year's earnings, a few companies would require more than three years' earnings to remove their IAS 19 deficit.

RISKS REMAIN Significant risks remain unhedged in typical UK pension schemes. For instance, well over half of FTSE 350 companies expose over 10% of their market capitalisation to pensions risk through unhedged liabilities in their pension schemes. From a shareholder perspective, the pay-offs from these pension schemes are highly asymmetric. Companies are generally

unable to share in any surplus, so there is real shareholder value created by plans actively managing de-risking, as and when affordable.

While pension scheme trustees are the ultimate guardians of scheme assets, companies that actively engage in a positive way with trustees can certainly influence the agenda. The most significant risks in a typical scheme are growth asset values and long-dated real and nominal interest rates. Pensions schemes have generally been drifting towards lower-risk strategies over the past two decades as their schemes have matured. However, companies that agree clear plans and governance processes with their trustees can get ahead of the pack. As with any corporate risk, the key is to assess the exposure, consider the relative costs of immunising against the risk, and mitigate the risk when the price is right.

Importantly, companies today have more flexibility around using derivative strategies such as leveraged inflation or interest swaps, or synthetic equity exposure, to manage risk on inflation, interest rates and growth assets independently. Traditionally, pension schemes had a one-dimensional approach – more bonds = fewer equities – so less interest rate risk implies less growth asset risk and vice versa. Today, companies can assess their risk appetite for the different potential returns separately, giving a wider solution set.

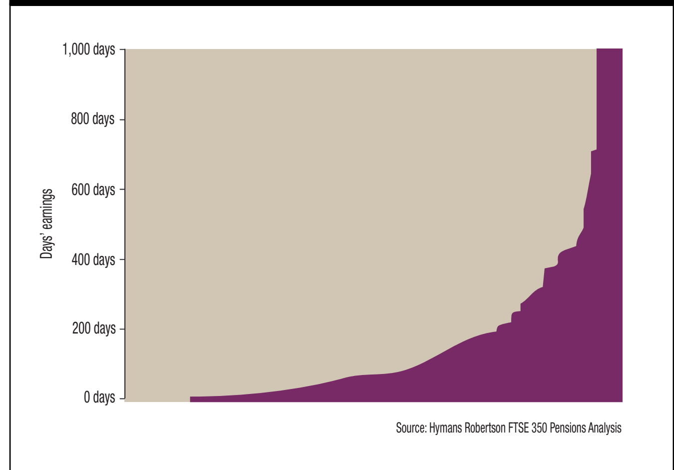
HOLISTIC OUTLOOK To assess the risks posed by pension schemes to company finances, treasurers are ideally placed to take an integrated view. For instance, for many companies the long interest rate exposure in corporate debt provides a partial economic hedge to the short interest rate exposure in their pension schemes.

As the simple example in Box 1 shows, by taking an integrated view of risk, treasurers can achieve lower net risk positions on their balance sheet. However, maximising the advantage of the natural hedge is not straightforward, due to the segregated nature of the pension assets from the sponsor and the treatment of pensions in the income statement. Companies should take different approaches depending on whether their primary driver for risk control is cash, the income statement or the balance sheet. Depending on their objective, they would also potentially need to engage the scheme trustees with any plan. In our experience, with the right communication approach it is not too difficult to obtain trustee buy-in to a strategy that lowers corporate risk without coming at a cost to the scheme.

CLARITY ON CASH AND ANALYSTS' VALUATIONS Many companies could put an affordable, long-term and steady cash contribution structure in place to materially de-risk their schemes over time. With their understanding of risk and reward, treasurers' skills are well suited to judge the value in removing unrewarded pension risk in exchange for a more certain, but potentially longer-dated cash contribution promise to the pension scheme. It is worth remembering that due to the long-term nature of pension scheme liabilities, risk can be removed from the scheme immediately but only paid for in cash over time.

Many companies appear to be taking more risk within their schemes than they need to, without having a clear plan in place to remove the risk when market opportunities are attractive. Capital market moves over the past few months have shown yet again how quickly large deficits can emerge if schemes are not actively controlling their risks.

Figure 1: Affordability of accounting deficits for FTSE 350 firms



Box 1: Example of integrating interest rate risk management

For a company that is 50% geared and has issued £1bn of debt at a duration of eight years, the PV01 of that debt is £800,000. If the company sponsors a typical scheme with 20-year duration with £300m in liabilities which is 50% hedged, then the pensions PV01 is £300,000. So if rates fall, the company can roll over existing debt on more beneficial terms, just as the value of liabilities in the pension scheme is increasing. In net terms, the PV01 exposure is £0.5m. If the company, along with many others, wishes to immunise this rate exposure by undertaking fixed to floating swaps, and hedges out all the rate risk on balance sheet, it will be left with a net £300,000 exposure to its pension scheme.

In our experience, taking a lower-risk approach can really improve share prices over the medium term. Many analysts would welcome a steady cashflow stream to schemes rather than the lumpy profile that they often see.

Furthermore, many analysts will significantly discount or even ignore contributions promised in many years' time. Companies that do this well help increase shareholder value and also largely remove the management distraction of the legacy benefit promise. Treasurers have the ideal skill set to deliver this.

Russell Chapman is partner and head of financial risk management at Hymans Robertson.
Russell.Chapman@hymans.co.uk

Jon Hatchett is strategic risk management consultant at Hymans Robertson.
Jon.Hatchett@hymans.co.uk
www.hymans.co.uk

HYMANS ROBERTSON
The Spirit of Independence