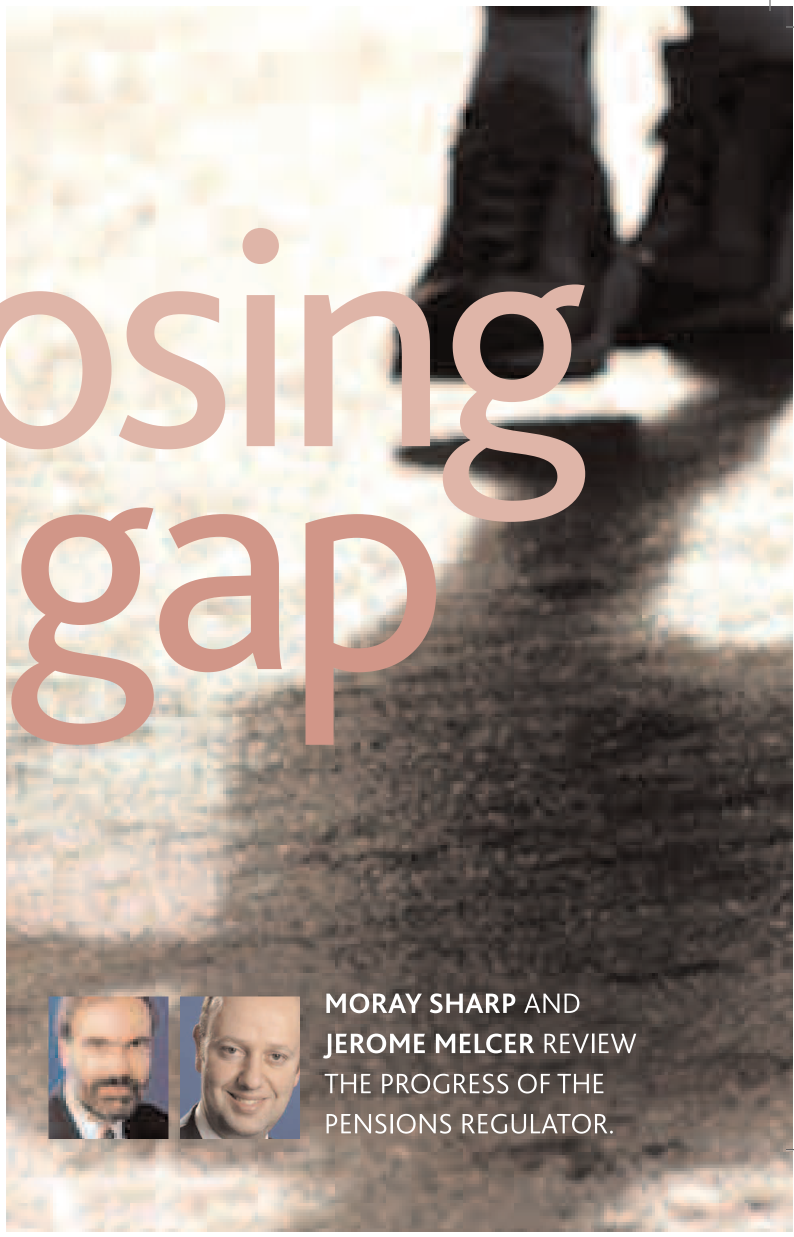
Closing the gap



MORAY SHARP AND **JEROME MELCER** REVIEW THE PROGRESS OF THE PENSIONS REGULATOR.

The impact of the Pensions Regulator in UK boardrooms has been clear. Pension issues now sit near the top of the agenda for most employers, and lie firmly within the remit of the treasurer. Of the Regulator's various activities that will have been noticed at board level, the most visible will have been the "clearance" process, whereby the Regulator undertakes not to employ its substantial powers, but at a cost. The Regulator can force associated or connected parties to fund or otherwise support scheme deficits, with the corporate veil cast aside in the process.

TWO KEY STEPS Looking at the Regulator's approach over the last year, two steps seem key to achieve clearance:

- Approach the trustees in advance and provide details of the transaction or restructuring; and
- Negotiate with the trustees to agree a financial package that will offset any adverse impact on the ability of the company to fund the scheme resulting from the event in question.

The Regulator will normally expect trustees to have taken independent financial advice on the impact of the transaction or restructuring, and the adequacy of the offer. But what is an adequate financial offer for this purpose? The Regulator has made it clear that for now, in most cases, it would expect any scheme deficit under the relevant accounting measure to be eliminated as part of a clearance-related proposal, either immediately or normally within five years.

The accounting measure (which requires liability valuations in line with the FRS17 *Retirement Benefits* or IAS19 *Employee Benefits* standards, as applicable) is a relatively harsh measure – only five FTSE 100 companies are in surplus on this basis, and solvency levels are generally lower for smaller corporates. Consequently, in most cases, clearance will come with an immediate price.

This has led many corporates to conclude that clearance will not always lie on the best path for a successful transaction or restructuring, and that any decision on a clearance application should only be made after a careful cost/benefit analysis. Yet of the 330 clearance applications the Regulator received over the year to 31 March 2006, all but two were successful, although many required some tweaking to pass muster.

There have been exceptions to the general rule of eliminating the accounting deficit, most notably in connection with the 2005 sale of the Marconi telecoms business to Ericsson. The transaction left behind a £2.4bn pension fund, attached to Telent, a relative minnow (about to be acquired for £346m, at the time of writing). Although the accounting deficit was a "mere" £109m, the Regulator sought a capital injection of £675m in exchange for clearance (£490m of that sum was placed in escrow, rather than paid direct to the scheme). The Regulator's reasoning seemed to be that the strength of the corporate sponsor relative to the pension scheme was so severely reduced by the transaction that it was much less capable of supporting the scheme in the long term. Its stance here should be a sobering thought for those looking solely at balance sheets for a steer on corporate pensions risks.

Executive summary

- After the Pensions Regulator's first year, its strategy for managing risks to scheme members, and the resulting impact on corporates and other parties to transactions, are both clearer. But what can be done to protect against regulatory action, and what alternatives are available for treasurers when negotiating funding terms with newly empowered trustees?

TRUSTEES IN CHARGE While successful in moderating corporate attitudes and behaviour toward pension deficits, the clearance regime has directly influenced funding on only a relatively small number of schemes. Thus the Regulator's stated aim of reducing risk to members has been achieved only in part, with the substantial majority of schemes requiring further "encouragement" on funding. Hence, the recent introduction of a new regime on scheme funding for pension schemes – often referred to as scheme-specific funding – which will affect the vast majority of the UK's defined-benefit pension schemes.

BOX 1. A funding plan

Consider the following scenario. A scheme actuary has advised that a suitably prudent funding target is £100m (the funding target being equal to the accounting measure). Scheme assets are valued at £80m, and the resulting deficit of £20m could be met by annual funding of £2.5m over a 10-year period. The treasurer feels this would place an unacceptable strain on corporate finances, but a lesser commitment of £1.5m a year could be managed. The scheme actuary advises that such a funding plan could hit the target, but only if investment performance over the 10-year period averages 7.5% a year or above – and there is a substantial risk of missing that target.

To manage that risk, the treasurer offers the trustees a charge over a readily marketable company-owned property against which the trustees can claim any shortfall in funding at the end of the 10-year period, specifically resulting from asset underperformance against the 7.5% target.

From the trustee perspective, the contingent asset provides a safety net in case the asset strategy does not pay off. This will enable the trustees to defend the funding plan against probing by the Regulator. From the treasurer's perspective, the outcome reduces pressure on cashflow, maximises resources available to the company, and minimises the prospect of a funding surplus arising should asset performance exceed expectations.

Scheme-specific funding represents a break with the past, where in many cases companies had control of, or at least a veto over, the contribution rate. Now, trustees are empowered to set funding targets according to the circumstances of the scheme and, for the first time directly, to consider the strength of the employer. Moreover, there is an overarching requirement for trustees to act prudently, and they have to consult with the employer on funding issues. What constitutes "prudence" remains undefined in law but the Regulator has made its expectations clear: in particular, trustees that agree to funding targets short of the accounting measure, or allow sponsors to deal with a deficit over a period longer than 10 years, may have to justify their position to the Regulator.

The new regime will certainly result in fresh upward pressure on scheme funding, with the Regulator clearly keen to back trustees. From a corporate perspective, this squeeze on free cash diverts resources away from investment and potentially affects dividend policy. For some, less well-capitalised corporates, the funding gap may be completely out of reach – a situation that will be of genuine concern to the Pension Protection Fund, as well as the Regulator.

On top of that is the longer-term position, where fully funded schemes under the new regime may move into substantial surplus – particularly if trustees maintain equity holdings – with limited prospects of these being refunded. This 'stranded asset' scenario represents a highly inefficient use of capital for most corporates.

CONTINGENT ASSET STRATEGIES These challenges have not gone unnoticed by the Regulator. Recent guidance to trustees makes it clear that whereas adequate cash funding is much the preferred route, there are satisfactory alternatives that will let trustees meet their obligations under the new regime while providing corporates with breathing space in allocating capital resources. Specifically, the Regulator has allowed trustees to include what it calls "contingent assets" within a scheme funding negotiation.

Under these arrangements, the trustees will receive additional funding if certain specified events occur in the future. Triggers could be linked to a number of events, including scheme solvency levels, scheme asset performance, key financial performance indicators for the company or even corporate insolvency.

Security for the trustees could take various forms, including a charge over cash or property within the company or a broader group, an intra-group or parent guarantee, or a letter of credit. The Regulator has laid out some general guidelines for trustees in terms of the minimum requirements for such an arrangement to be deemed effective within the new regime, but is clearly looking for trustees to make their own decisions in this area (see *Box 1*).

CLOSING THE GAP The Regulator is looking to push on with its objective of closing the funding gap in private sector pension schemes. This will further test the capabilities of treasurers, who will need to juggle their existing commitments with trustee-led pressures on funding costs. The funding toolkit is now substantially bigger, however, giving all parties the chance to explore a more creative approach. Treasurers may wish to consider now which approach might fit best within their overall financial management strategy for the business, and how to secure a suitable and affordable long-term pension funding plan.

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