Loading the dice

AMONG THE ISSUES COVERED BY THE ACT'S ANNUAL PENSIONS CONFERENCE WAS THE KEY ROLE TREASURERS CAN PLAY IN HELPING TRUSTEES UNDERSTAND DEFICITS, MODEL CASHFLOWS AND DECIDE HOW TO USE THEIR ASSETS TO FUND SCHEMES. **PETER WILLIAMS** LISTENED IN.

In the America Square Conference Centre near the Tower of London, treasurers gathered for the ACT Annual Pensions Conference in June could gaze on a section of London's Roman Wall preserved in the building. Those gazing on the remarkably well-preserved structure could have been forgiven for fearing that some of the seemingly intractable problems around company pensions could end up lasting just as long as the near 2,000-year-old ruin.

The pension landscape, though, is altering. Treasurers involved with corporate pension schemes are increasingly likely to be confronted with defined contribution (DC) issues as well as wrestling with defined benefit (DB), schemes, according to Crispin Southgate, chairman of the event, entitled "The next throw of the dice".

In providing a snapshot of pensions, Southgate, who is a director of Institutional Investment Advisors, said that treasurers of quoted companies should be aware of movement in their company's s179 deficit number because it was a figure that was closely watched by stock market analysts.

Perhaps one of the major ongoing themes in pensions is what Southgate called the "frustratingly low level" of real yields. He suggested that everyone was interested in ideas for finding real yield, at a reasonable price. The search for the investment return you seek was, he suggested, the next throw of the dice.

One other risk which Southgate believes may be on the horizon is European-inspired regulation, which could do for pensions plans what Solvency II is doing for the insurance industry by strengthening the capital adequacy rules. The European Insurance and Occupational Pensions Authority (EIOPA), part of the European system of financial supervision, is looking at revamping its supervisory framework.

June Mulroy was well placed to pick up on Southgate's assertion that DC schemes were becoming of greater importance. As executive director for DC, governance and administration, at the Pensions Regulator, Mulroy is leading the regulator's review of its approach to DC. She told the conference that the pensions landscape has altered dramatically, with the pensions agenda changing markedly over the last few years. Notable features have been scheme closures and auto enrolment, with the prospects of greater merger and acquisition (M&A) activity bubbling under.

The regulator's motto is educate, enable and enforce only where absolutely necessary. Mulroy said: "We have waved a big stick around a lot and it has been heartening to see businesses, trustees and treasurers responding to the challenge." The regulator is prepared to use its powers (see Box 1) if it sees an employer avoiding its pension liabilities, although Mulroy added that it was the intention of the regulator to be risk-based. It did not set out to be a supervisor – indeed, it was not created to be one – but would become involved when a scheme was at high risk.

She emphasised that it was better to approach the regulator to talk through any concerns before major events – such as a takeover – had proceeded too far. If the implications for a pension scheme of a major corporate event are not considered early on, an undignified last minute scramble may ensue. Even if no major event is on the horizon, Mulroy said that trustees should ensure their scheme is well run, with the correct governance and administration in place.

The regulator has just issued its fifth governance survey. Mulroy said: "It is encouraging to see that awareness of our record-keeping guidance has improved, especially in light of our education drive earlier this year. As we have highlighted previously, levels of governance and understanding tend to be lower in smaller DC schemes. Good governance is particularly important given the risks that members carry in DC schemes such as investment performance, value for money and converting their pension pot into an income."

Will Spinney, associate director of education at the ACT, then outlined to the audience ways to understand pension deficits. He said that it should be possible in a society where GDP is growing to meet the obligations created by a pension scheme. Companies running pension schemes need to make an attempt at valuation in order to decide how many, and what kind of, assets they needed to deploy to fund the scheme.

This is where treasurers have a vital role to play. Their expertise makes them good at taking decisions both in terms of the nature of the investment required and the overall risks involved.

Box 1: Prepack incurs £60k contribution notice

Days before June Mulroy spoke to the conference, the Pensions Regulator had issued a contribution notice (CN) against Michel Van de Wiele in relation to the Bonas group pension scheme. In a settlement a CN has been issued for £60,000 following a prepack administration in 2006.

The Pensions Regulator's chief executive Bill Galvin said: "We will investigate vigorously attempts to avoid pension liabilities and, where appropriate, we will not hesitate to use our powers where we believe there may be an opportunity to improve the outcome. This includes examining closely the circumstances of insolvency events to ensure that outcomes are fair for pension scheme members and the PPF."

Box 2: Too many variables create risk

- Interest rates and inflation (real, nominal, yield curve)
- Returns – equity, bonds, other assets (property, hedge funds, commodities, etc)
- Variability of returns
- Correlation of returns
- Variability of correlation of returns
- Longevity
- Future salaries (if open to accruals)
- Sponsor risk (note that subsidiaries can be sponsors)
- Regulatory influence

All of these variables are multiplied by the number of countries where pension schemes are in place.

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While treasurers are capable of working out the scheme cashflows, there are complications. Most notably, the impact of inflation makes the potential cashflows hard to model and it is difficult to find the assets which can act as a hedge against inflation. However, the effect of inflation on pensions planning may have been overdone. Spinney pointed out that as general prices rose, companies were able to put up their prices and so maintain real margins; therefore there was a natural hedge.

The other difficulty is the timescale involved. Companies planning beyond the next five years are launching into areas of enormous uncertainty while in terms of pensions we are expected to look ahead many decades. Spinney said: "A company employs someone for a year but they could be on their books for 70 years."

The biggest risk in a pension scheme is interest rate risk, which vies with equity risk and longevity risk for the top spot. The exposure interest rate risk is far higher in a DB scheme than interest rate risk in the sponsoring company. The exposure is to a mixture of nominal and real rates. Weighing up the risk is difficult because of the large number of risk-creating variables, which Spinney described as "too many to take in". He listed the main variables (see Box 2) and looked at the various ways to measure this risk: the mean variance model, the stochastic model, sensitivity analysis and scenario analysis. Harnessing computing power can help to run multiple scenarios but trustees still run the danger of becoming confused.

The danger of confusion was picked up by Raj Mody, a partner and chief actuary at PricewaterhouseCoopers, as he examined the trends and development in the buy-out/buy-in market. Indeed, the very terms buy-out and buy-in cause confusion. The proper distinction is as follows:

- a buy-out is the complete discharge by the scheme of all assets and liabilities to a third-party provider; and
- a buy-in is where the scheme remains responsible for providing the benefits but for a fee a third party provides a stream of income to trustees which matches the pensions.

The providers are a mixture of insurers, re-insurers and banks. But while it is easy to find businesses that say they provide such services Mody suggested that the players have found a varying degree of success, with some not having completed a deal and others lacking the practical and technical knowhow required to take the deal through to completion. He said that there was no clear market-leading provider in this area and it was hard to predict who would gain most market share over the next two or three years.

Transaction volumes are another source of potential confusion. While around £500m of buy-in/buy-out has been completed so far in 2011, Mody predicted the year would finish strongly at around £4.0bn, compared with £5.2bn in 2010. However, he added that this missed another important part of the market – in-house synthetic buy-ins (ie. bespoke interest rate or inflation rate swaps), which could amount to another £4.0bn by the end of the year.

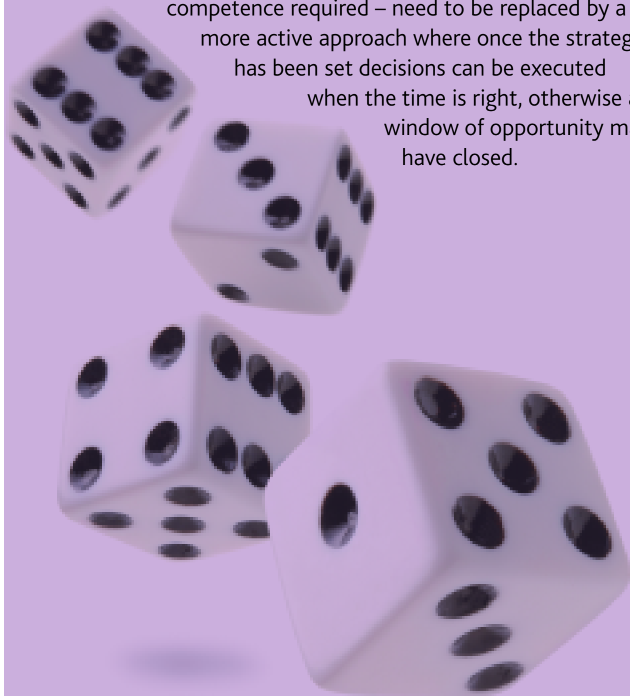
Much of the debate around buy-outs/buy-ins has focused on affordability but Mody advised trustees and companies to ask themselves why they wanted to complete such a transaction. Maybe, he suggested, companies can replace a debt which they don't understand with one they do. But all pension schemes should deconstruct the risk and at the end of that process they may find that a buy-out/buy-in is the right answer for them. If schemes do explore the idea of a buy-out/buy-in, Mody said they should not underestimate the power that the sponsoring company can bring to these structured deals, partly because they may have an ongoing relationship with the counterparties involved.

Box 3: The corporate perspective

The conference heard from treasurers and other financial professionals about their involvement with their company pension schemes. On a day-to-day level trustees, especially if they have been appointed by the sponsoring company, have to be able to identify and deal with identifying conflicts. Ways round the problem include "embracing disclosure", maintaining a register of conflicts, evaluating the severity of potential conflicts and, in the last resort, seeking legal advice.

One of the objectives for trustees is to become self-sufficient in terms of funding so the pension scheme can reduce its reliance on its sponsoring company. Schemes are establishing investment strategies that should enable them to do that, including improving the funding level, reducing volatility and risk, and establishing a matched portfolio by hedging the key risks of interest rate and inflation.

If pension funds are trying to be more active, then the limited number of infrequent meetings of trustees – who in any case may not have the necessary technical and financial competence required – need to be replaced by a more active approach where once the strategy has been set decisions can be executed when the time is right, otherwise a window of opportunity may have closed.



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