FAREWELL TO RISK

THE COSTS OF RUNNING A DEFINED BENEFIT PENSION SCHEME CONTINUE TO CLIMB. BUT FORTUNATELY REMEDIES EXIST, SAYS JAY SHAH

From a corporate perspective, being a pension scheme sponsor means maintaining an open-ended commitment for a very long period. This can have dramatic effects on your company's share price and limit strategic options – including refinancing, debt restructuring, investing in the business and paying dividends – and, ultimately, damage the very security of the commitments the sponsor is pledged to maintain.

This commitment has, over the past few years, been at the eye of a perfect storm, which has driven the defined benefit pension scheme up the corporate agenda, away from the HR department and into the CFO's inbox. A range of somewhat disparate factors has whipped up this storm. These factors include recent (and not-so-recent) legislative changes, the European economic crisis, healthier lifestyles and monetary policy. At a macro level, the damage this perfect storm has done to the defined benefit pension system is probably too significant to undo. For an individual FD who is trying to manage shareholder sentiment, however, the significant and seemingly endless sums paid out to support an increasingly remote pension scheme only increases the desire to lock down risk and end the volatility.

Out of all the disparate factors, the many legislative changes over the past few decades have perhaps been the most damaging to pension funds and the most costly to corporates. The recent changes to the accounting standard IAS 19, *Employee Benefits*, make pension scheme liabilities stand out even more starkly on the corporate balance sheet. But this is just the latest rule change to push up the cost of running a defined benefit pension scheme. Since the 1970s, tighter regulation, mandatory pension indexation and more conservative investing have added about 45% to the cost of providing a defined benefit pension in the UK. Regulatory changes include the removal of advance corporation tax for equity dividends and the introduction of the Pension Protection Fund levy.

But for sponsors, the recent amendment of the IAS 19 accounting standard is perhaps a change too far. It will, in all probability, impact corporate profits by increasing deficits – and substantially in some cases. This will heighten the pressure on the FD to close any pension fund deficit quickly, and then keep the company's scheme fully funded. This is unlikely to be cheap. Pension adviser Towers Watson has estimated that the changes to the accounting standard could wipe 3% off restated corporate profits. Shell, for example, saw an (admittedly) exceptional £12.3bn wiped off its balance sheet this year after implementing the revised IAS 19 rules. Another consultancy, Barnett Waddingham, estimated last year that finance and manufacturing companies in the FTSE 350 would see their profits reduced by around 2.5%, due to the changes.

The issue is in large part a result of the fact pension funds have not historically matched their assets with their liabilities. Instead they have relied on the return on risk assets, such as equities, to outperform any increase in liabilities over the very long term. The new rules mean that the discount rate used to calculate pension fund liabilities has to be based on AA-rated corporate bonds, however, rather than risk assets, such as equities, which has previously been the case. This will reduce expected returns and effectively increase the gap between assets and liabilities.

In addition, there is a secondary issue that hits continental pension schemes more than those in the UK: the removal of the so-called 'corridor' method. This had allowed volatility in the pension scheme's funding position to be smoothed out, potentially leaving the way open to under-reporting of liabilities and therefore an undermining of the benefits that have previously been accrued. It has now been removed, exposing the corporate balance sheet to further volatility in the pension scheme. For better or worse, the rules now enshrine mark-to-market accounting for pension funds across Europe.

The typical duration of a pension fund's liabilities are about 20 years (ie the average time they have to invest money to meet future pension payments is 20 years), but the duration of gilts held in a typical pension fund is 15 years. This means that the liabilities in a typical pension fund are more sensitive to movements in gilt yields than the gilts in the pension fund, because of the duration mismatch. Pension schemes are therefore highly susceptible to movements in the gilt yield affecting the value they place on their obligations (future pension payments).

This is why the financial crisis has been such a disaster for pension scheme sponsors. The ongoing economic crisis, combined with loose monetary policy, has had the disastrous effect, from a pension fund sponsor's perspective, of keeping bond yields at, or almost at, historically low levels.

There are signs that yields may be rising with speculation about the end of quantitative easing in the US and the UK. Meanwhile, a sell-off in gilts over fears of a bubble led to a rise in yields of almost 25% during June, bringing liabilities down. This had a positive impact on insurance pricing for pension insurance buyouts – these have been the first material rises in overall affordability of pension insurance since July 2012. The direct result has been a number of significant transactions taking place during July, with around £3bn of liabilities being insured in the UK in that month alone.

The bad news is that the impact of market movements on deficits will vary considerably between pension schemes, however. Those schemes that are not fully matched in gilts, and are invested in growth assets diversified away from equities, would have seen the biggest benefit. This is because their liabilities would have come down without the value of their gilt holdings declining in equal and opposite measure.

But the question for FDs remains: is this rise a flash in the pan, or are higher gilt yields here to stay?

Recent Japanese events and the experience of the US in the Great Depression may prove instructive. The Japanese banking crisis and subsequent deleveraging has kept 10-year bond yields at extraordinarily low levels for the past 15 years. Despite recent Herculean efforts undertaken by the Japanese authorities, yields remain stuck, stubbornly low. In the US, 10-year bond yields went below 3% in 1933 and stayed there until 1956.

So the question is open-ended and it would be wise to plan for the worst-case scenario, whereby yields remain low for an extended period. Corporates have been finding increasingly creative ways to help close deficits, from giving trustees surety over inventories of whisky (Diageo) and cheese (Dairy Crest) to joint ownership of retail warehouse parks (Kier Group) and many others.

But, ultimately, the best way to remove risk from a pension fund is to insure the liabilities. This means paying an insurance company to take on the risks associated with paying the insured pensions, including the risk of increased payments associated with people living longer than projected. These transactions can be tailored to the specific requirements of the client and can insure all or part of the liabilities.

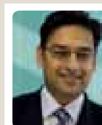
Although the UK has perhaps been the most active in terms of numbers of transactions, there have been a couple of substantial transactions in the US, with General Motors and communication company Verizon completing buyouts. There has also been movement to lock down pension liabilities in the Netherlands and Ireland. Given the proof of the concept, it can only be a matter of time before corporates in other countries seek to insure their pension liabilities.

The many legislative changes over the past few decades have perhaps been the most damaging to pension funds

THE BIGGEST BUYOUT IN BRITAIN

In July 2013, the biggest insurance buyout of a British pension scheme to date took place when music group EMI's pension liabilities of £1.5bn were transferred to specialist insurer Pension Insurance Corporation. Citigroup had acquired EMI from private equity firm Terra Firma in 2011. After selling off the group's operating businesses, it wanted to secure EMI's pension risk under an all-risks transfer structure, providing price certainty for the sponsor.

The transaction means that responsibility for paying benefits to the 20,000 members of EMI's pension scheme will now fall on Pension Insurance Corporation. Swapnil Katkar of Citi's Pension Solutions team said that the bank "ran a disciplined process" that resulted in both the pension fund trustees and Citi getting risk cover on competitive terms. He noted that the transfer was achieved ahead of plan "despite the low interest rate environment and volatile market conditions".



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