Focus on action

THE ACT ANNUAL PENSIONS CONFERENCE HELD IN LONDON IN JULY ATTRACTED A GOOD AUDIENCE KEEN TO LISTEN TO AND DISCUSS THE KEY PENSION ISSUES FACING TREASURERS TODAY. **PETER WILLIAMS** REPORTS FROM THE EVENT, WHICH WAS SPONSORED BY BNY MELLON, HEWITT AND HSBC GLOBAL ASSET MANAGEMENT.

The key role that treasurers can play in managing pensions was underlined by conference chairman Crispin Southgate. He denied trying to flatter the conference, saying that treasurers combined an ability to understand what was going on with the ability to explain the issues both to the sponsoring corporate as well as the pension fund, its trustees and members.

Southgate, a director of Institutional Investment Advisors, set the scene for the day. According to Pension Protection Fund section 179 figures, collectively many UK schemes are still carrying a substantial deficit. The picture has improved since March 2009, when it touched £250bn, but hovering around the £100bn mark it has changed little in seven years. There are some schemes in surplus and their position has improved over the same period – the latest figures stand at around £60bn but that is a long way off the £140bn peaks seen in 2007 and currently seems to be heading in the wrong direction.

Southgate also pointed out that the difference between long-dated AA versus swaps stood at 150 basis points – much narrower than at the height of the financial crisis but still 100 basis points higher than when FRS 17 was introduced in the mid-1990s. Is it still right to use the AA corporate bond rate for discounting pension liabilities? The central roles for treasurers will see them managing the deficit, the covenant, and the assets and liabilities using their understanding, expertise and influence for both employers and trustees. In addition, corporates will look to treasurers to be involved in explaining the pension issues as part of investor relations.

ENTERPRISE RISK Integrating pension risk into enterprise risk is still a holy grail, according to Martin Bird, head of longevity and risk solutions at Hewitt. Bird said that the key risks were well understood and well managed, but that he had seen no example of their integration into enterprise risk management.

However, he said that this would be the trend in the market over time. The risks are known (see Box 1) and treasurers and trustees should be asking how their scheme differs from the population at large. For instance, a scheme could be exposed to a particular risk and if it dealt with that its whole risk profile would change. Bird cited one scheme where 4% of the members accounted for 40% of the liability, a huge concentration risk. He said it was possible to tailor a solution for that small part of the population that would dramatically reduce the liability.

He identified four levers for managing liability risk: future benefits, accrued benefits, good housekeeping and market options. The past few years have seen more action by companies to de-risk the pension scheme, with the most popular actions being closing the scheme to new entrants, making extra contributions, sharing the risk, changing benefits and closing to new accruals. According to the Hewitt Global Risk Survey 2009, many other companies are contemplating similar actions.

Bird said the key message was that there was a wide range of actions available but trustees had to be ready to act quickly to take advantage of windows of opportunity. He urged schemes to look at longevity risk in particular. Some see longevity as a risk they don't like while others see it as a diversifier.

MANAGING PENSION OBLIGATIONS One company that has been actively managing its pension risk is international transport business FirstGroup. It has 136,000 staff, a pension liability of £3.7bn, a deficit of £300m and various pension schemes in the UK, Canada and the US. The company is highly unionised. John Chilman, the group reward and pensions director, told the conference that the group was managing pensions through investment strategy, longevity hedging, enhanced transfer values (ETVs), buy-outs and buy-ins, and benefit design. The group has identified its keys risk as investment, mortality,

interest and inflation rates, and type and size of benefits provided.

Chilman suggested that the role of the treasurer was to bring new ideas and fresh thinking to the trustees, who would otherwise carry on as they always had done. He said that FirstGroup had an excellent relationship with its pension scheme's trustees and an excellent internal relationship with finance, especially the group treasurer, and that there was continuous liaison on the big issues. He added that it was necessary to have an open and honest relationship with all stakeholders, especially the unions and employees.

A RECOVERY PLAN Treasurers and trustees grappling with recovery plans in 2010 are faced with larger deficits than in previous years, weaker company covenants and serious cash constraints on employers. With that background, planning ahead is vital for treasurers and trustees approaching valuation and recovery plans. Paul Thornton of Gazelle Corporate Finance told the conference that the key in approaching valuation and recovery plans was to assess and know the strength of the sponsor covenant, as this informs both the funding and the investment strategy.

Planning should start about six months ahead of the valuation date and the aim is to bring together the employer covenant assessment, the investment strategy and the discussion of the funding and recovery plan assumptions. Thornton suggested it was vital to build in time to spare for negotiations. The regulator has stopped warning against back-end loading recovery plans and started recognising it is not in anyone's interest for trustees to make demands that could ultimately send the sponsoring company into insolvency.

Thornton suggested that the treasurer was uniquely placed to mediate between the company and the trustees in the negotiations. For instance, treasurers know the company finances well and so may be able to identify worthwhile contingent assets.

Trustees are looking for openness and a balanced constructive approach and, added Thornton, it could be useful to let advisers and the treasurer explore ways forward without those ideas being seen as explicit commitments.

GETTING THE ACCOUNTING RIGHT Producing the right accounting standard on defined benefit plans is proving a challenge for the International Accounting Standards Board (IASB). Published at the end of April 2010, the key proposals to amend IAS 19 Employee Benefits would require companies to:

- account immediately for all estimated changes in the cost of providing these benefits and all changes in the value of plan assets (often referred to as removal of the "corridor" method);
- use a new presentation approach clearly distinguishing between different components of the cost of these benefits; and
- disclose clearer information about the risks arising from defined benefit plans.

According to Steve Cooper, a board member of the IASB, one of the key challenges is to clarify the presentation of defined benefit pension expenses. Cost can be recognised in different expense categories. In the exposure draft this is substantially simplified. The draft also tries to focus on disclosure of the characteristics of an entity's defined benefit plans, identifying and explaining the amounts in financial statements resulting from defined benefit plans, and describing how defined benefit plans affect the amount, timing and variability of future cashflows. The new standard will also attempt to clarify areas of diverse practice such as expected future salary increases, classification of employee benefits as long or short-term, and the disclosure of the reduced return on plan assets by administration costs. The exposure draft Defined Benefit Plans is open for comment until 6 September 2010 and amendments to IAS 19 are expected to be completed by mid-2011.

Box 1: Pension risks

Equity; interest rate; longevity concentration; longevity trend; inflation; reputation; salary growth; demographic; legislation changes; and expenses and levies.

Box 2: The elephants in the room

According to Con Keating, any discussion of defined benefit pensions will rapidly turn to the inherent risks. And he suggested that there was one paramount event: sponsor failure, which is the sole event that can result in pensions being reduced – in all other circumstances pensions are paid in full.

The other factor to which Keating drew the conference's attention was the cost of pension scheme administration. He said that the ratio of pension scheme administration expense as a proportion of pension payments had increased markedly, from around 3.5% in the early 1990s to around 6.5% recently. He blamed this increase partly on the compliance burden of the pension regime and said the expense was a friction which severely restricted future benefits attainable.

Keating suggested that if a pension scheme was inefficient, then it should be closed down as quickly and cheaply as possible.

ASK THE EXPERTS The ACT took advantage of the presence of so many pension experts to hold an interactive voting session to elicit the views of the audience on the key pension issues. It is clear that cash is important to pension funds. Asked if the pension scheme they were associated with had received additional support, nearly 25% of those who voted (and 50% for whom the question was relevant) said the schemes had provided cash, while smaller numbers had provided security/collateral or other contingent assets. However, as many had seen no extra support at all as had seen cash provided.

It is clear that the recent falls in pension scheme funding levels has made those involved more risk-averse. Nearly six in 10 said they were more likely to reduce risk, and there was an even split between no change and less likely to reduce risk.

A question designed to discover the use of derivatives produced some fascinating answers: currency hedging and interest rate hedging remained the most popular areas for hedging but inflation hedging also had a significant take-up. Only a small minority were hedging against longevity.

Following on from the session on accounting for pensions, delegates were asked what changes to pension accounting they would introduce: 36% wanted greater disclosure of sensitivities. The second favourite change was the use of a risk-free rate to discount liabilities. Proposals that won less support included recognising actual rather than expected scheme asset returns through the profit

and loss account, removing pension charges from the P&L entirely, and making the assumptions more prescriptive.

Around a third of participants said that their scheme's collateral arrangements had been reviewed, or were in the process of being reviewed, as a result of the credit crisis. But it was by no means a universal response.

Perhaps the most revealing question asked about the ultimate goal of the organisation's pension scheme. Nearly six in 10 said it was buy-in/buy-out, and another 10% said the end-game was wind-up.

THE TRUSTEES AND THE CORPORATE Dealing with pension schemes has become a lot harder over the past 15 to 20 years as a result of increasing regulation of pension schemes. Structures in pension schemes are evolving and governance needs to continue to evolve. And all pension schemes should conduct a governance review to ensure they are meeting modern standards.

This was one of the clear conclusions from the panel session at the conference. On the panel were: Andrew Corvesor, principal of the corporate pension consulting group at Hewitt; Con Keating, head of research at BrightonRock; Neil Smith, chief executive of the E.ON UK pension scheme; and Mike Verrier, group treasurer of Wolseley.

The discussion considered the relationship between pension schemes and trustees, with the panel confident that in their own situation there was a good relationship between all parties and that a compromise acceptable to all could ultimately be reached. In fact, it was claimed relationships had improved. At one scheme the employee trustees had stopped having pre-meeting meetings.

The culture of the pension scheme is likely to reflect staff relations at the company. But when issues do come to a vote, the ballot does not necessarily follow company/employee lines. Nor could the panel identify occasions when a treasurer or other professional would feel so conflicted they would have to withdraw from a discussion/meeting.

Treasurers acting for companies were urged to think like trustees before they went in to negotiations. Planning was important for the pension scheme because trustees couldn't act quickly or take advantage of opportunities if they hadn't previously thought about what to do in particular circumstances.

Peter Williams is editor of The Treasurer.
editor@treasurers.org

Figure 1: Have you agreed to additional financial support?

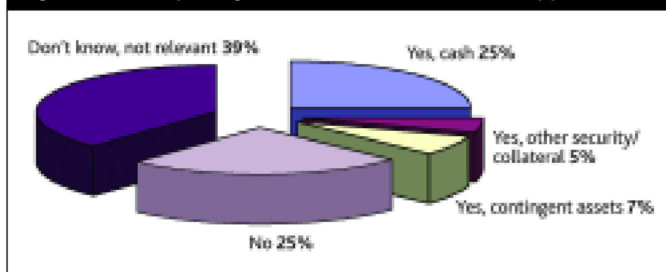

Figure 2: What was the driver for secondary funding?

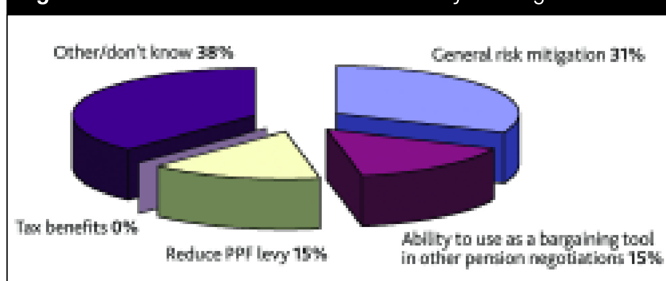

Figure 3: What is your scheme's primary use for derivatives?

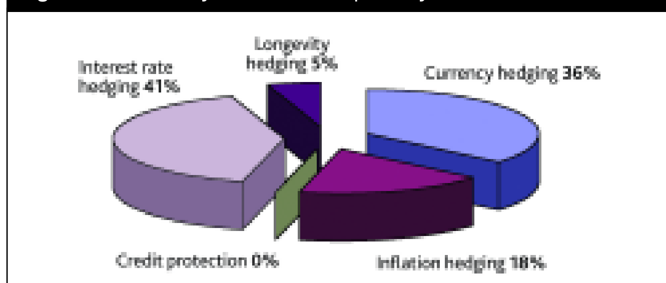

Figure 4: Has credit crisis led to review of collateral arrangements?

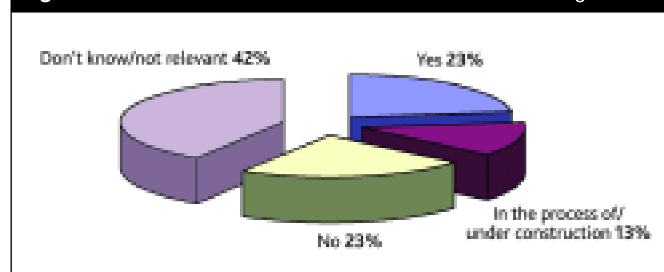

Figure 5: What is the ultimate goal of your pension scheme?

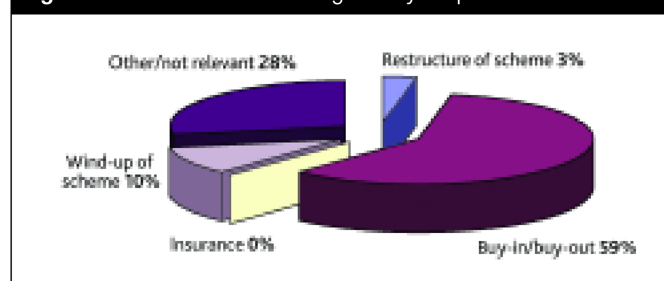

Figure 6: Do the accounting rules help users on pension issues?