In transition

Executive summary

■ Even without the credit crunch, treasurers have a daunting array of issues to juggle with when considering the company pension scheme. The ACT annual pensions conference, sponsored by Mercer and RBS, heard from a host of major players in the pension world on the key issues expected to affect pension schemes and their sponsors.

How is the credit crunch affecting pension investments? Should more companies take a serious look at the pension buy-out market? And what essential information on pension funds should be readily to hand for any treasurer?

These were some of the issues addressed by this year's ACT annual pensions conference in late June, chaired by Paul Thornton, a veteran of Watson Wyatt and now managing director of the pensions advisory team at Gazelle Corporate Finance. He introduced the sessions by noting the changing perspectives, with corporate pension schemes now treated as just one element in the overall remuneration package rather than the principal means of attracting and retaining employees by rewarding their loyalty. The transformation has been accompanied by a cutback in pension provision on a "worrying scale" by the private sector.

Previous years saw a fairly clear-cut division of duties in pursuing the overall aim of improving scheme benefits over time. Benefit provision was the function of the HR department, budgeting for the finance costs was handled by the finance department, and the investment risk/reward trade-off was decided by the trustees.

OUT OF ALL RECOGNITION In today's more complex environment, de-risking has taken over as the main function of the finance department, which will consider such options as hedging strategies or a liability transfer/buy-out. The finance function's relationship with the pension trustees has also been transformed out of all recognition. The latter must be regarded as creditors of the scheme, raising a potential for conflicts of interest that didn't exist in the old days.

The role of the trustee has also evolved. Regulatory compliance has moved ever more firmly onto the agenda, with the formation of the Pensions Regulator and the Pension Protection Fund.

Other key drivers of change are rising costs, which have sharpened the emphasis on economic and investment conditions and opportunities, such as the periodic windows of opportunity for buying out liabilities in the insurance market; increasing longevity that appears to be both accelerating and becoming less predictable; and new financial reporting rules that aim for greater transparency.

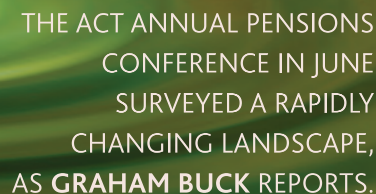
COUNTING THE COST OF THE CRUNCH Does the credit crunch actually matter to pension funds? Most definitely, suggested Richard Boardman, a director of the pensions solutions group at RBS. As it has affected all asset classes, so the past year has seen a reappraisal of their financial dynamics. Over this period, so-called growth assets have taken a hammering and gilt yields have moved lower, while AA spreads have widened significantly and the pensions buy-out industry has continued to thrive.

Pension funds are still significantly driven by equities and other growth assets, credit bonds, risk-free cash and duration assets, Boardman said. The fund deficit measure has been "enormously volatile" since the end of 2001 but, thanks partly to rising equity prices in 2005 and 2006, was no worse in late May 2008 than it had been more than six years earlier despite the credit crunch. More recently, though, this has ceased to be so as markets have moved lower and the deterioration has accelerated.

"A fall in real rates coupled with a fall in equities is the worst possible outcome," said Boardman. "Indeed, it represents the perfect storm for a pension fund."

In this difficult environment, what opportunities remain for pension funds? Boardman suggested that their assets and, to some extent, their liquidity currently offer them an advantage over other players such as hedge funds. His own best picks from those available in the current market conditions were the following:

- **Cash credit bonds.** These are means of buying assets that may have been oversold. Spreads are off the wides, but there is still plenty of value and a number of rating bands and sectors are worth considering.
- **Funding trades.** Banks that traditionally funded sub-Libor, pay L+



THE ACT ANNUAL PENSIONS CONFERENCE IN JUNE SURVEYED A RAPIDLY CHANGING LANDSCAPE, AS **GRAHAM BUCK** REPORTS.

for term funding. Pension funds with Libor obligations can benefit from secured deposits, and asset-rich pension funds can access L+.

- **Credit alpha mandates.** Wider spreads mean that stock pickers can add value again. Total return (L+) mandates to back swaps are worth considering.

- **Leveraged loans.** Loans, as an asset class, have very low loss given default (LGD) rates. According to Boardman, this is an oversold asset class and a valuable one in a downturn as the recovery rate is "enormously high".

- **Addressing funding volatility.** Credit protection can be written on a basket of credit bonds and done with built-in subordination. Wide spreads can be 'monetised', but remain default mode and provide a reasonable accounting 'hedge'.

In addition to the above, it is also possible to smooth out FRS 17 funding volatility in an unfunded format, buying protection against falling equities and falling rates.

BACK TO BASICS The regulatory environment for pension schemes is changing. Ian Mackintosh, chairman of the Accounting Standards Board, said the ASB's recently launched discussion paper aims to replace the current FRS 17/IAS 19 regime for the financial reporting on pensions with a back to basics approach. This should ultimately result in the development of an accounting standard that can be applied globally, but a debate with other European bodies so that input from each country can be pooled is unlikely to take place before 2011.

Among the issues discussed in the paper are:

- the conceptual framework and whether pensions fundamentally differ from other types of corporate liability;

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- smoothing in the form of the treatment of gains and losses;
- smoothing in the form of liability recognition and establishing when one particular type is appropriate;
- measuring liabilities: discount rates, risk and disclosure; and
- the accounts of the pension plan itself.

An update was also provided by the Pensions Regulator, whose strategic development executive director Chris Dobson said its corporate strategy was moving from box-ticking to a more risk-based approach. He also cited the Pensions Bill, which received its second reading in the House of Lords in June. Taking effect from 2012, it will oblige employers to enrol staff into a qualifying pension scheme if they do not already do so or if their current scheme is non-qualifying. Reports have suggested that many companies are unaware of the planned change.

Conference delegates also head from Partha Dasgupta, chief executive of the Pension Protection Fund, which he described as effectively "the insurance policy for final salary schemes should the employer go bust". The PPF, established in 2005, recently set the overall levy for 2008-09 and the following two years at £675m indexed to wages to make up the gap between its liabilities and its inherited assets.

Dasgupta outlined two possible futures for the PPF: one in which it is in run-off by 2018 or even in a position to buy out its liabilities in the market; the other in which the current economic slowdown results in more sponsor failures due to a higher rate of insolvencies.

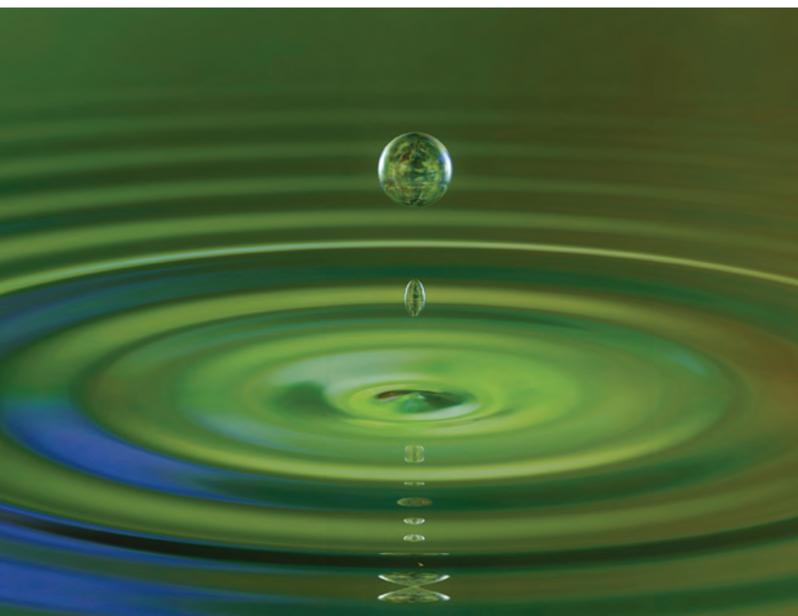
PREDICTIONS OF BIG GROWTH Although still a "nascent market" pension scheme buy-outs have hit the headlines in recent years and will soon become as big as the interest rate swap market, according to Edward Truell, chief executive of Pension Corporation. He said that pension and annuity transaction volumes and deal sizes are steadily growing, as is the menu of risk transfer options that already includes insurance buy-out, pension fund sponsorship, longevity insurance and asset liability management.

Among the key drivers for pension sell-offs, he cited:

- future changes in accounting rules that will require companies to discount pension scheme liabilities and risk-free rate;
- the Pension Regulator's increasing powers for trustees to negotiate funding levels;
- the regulator's suggestion that schemes use long-lifespan improvements for scheme funding calculations;
- competitive pricing in the marketplace; and
- more trustees regard buy-outs as an acceptable solution.

However, there is a need for the capital markets to develop solutions to assist this growth although, as Truell acknowledged, pricing "esoteric risks" isn't currently popular.

One company with direct experience of a buy-out is media group



RISING LONGEVITY EXPECTATIONS HAVE ALSO MOVED UP THE PENSIONS AGENDA, AS CURRENT RESERVING FOR MANY SCHEMES IS GENERALLY INADEQUATE.

Emap, which had significant defined benefit schemes. Over the years, the group regularly acquired and sold off businesses, and the schemes, said its former treasurer, David Wilson, steadily became an obstacle to corporate activity and demanded a disproportionate amount of administration. Emap "wanted to get rid of them" but was deterred by the cost.

Two things changed in the summer of 2007: a review of the group's structure leading to the decision to break up Emap, and the interest of several specialist insurers, including Paternoster, in buying the pension schemes.

But a deal involving the sale of the Emap pension schemes had to be assembled within weeks, said Wilson. It was also crucial to gain the support of the trustees; this was achieved by outlining the sell-off as a window of opportunity that would benefit the scheme members.

THE AUCTION PROCESS Emap opted for an auction, briefing various insurers as well as advisers, lawyers and administrators. Ultimately it was the administrators and Paternoster, the one insurer that "understood what the group was trying to achieve" and was eventually the sole bidder, which carried out much of the work. A framework agreement was successfully concluded between the scheme trustees and Paternoster. Some last-minute price adjustments proved necessary after the due diligence work revealed a number of extra liabilities, but as Wilson observed "all treasury had to do was to write the cheque".

He attributed the ability of both sides to achieve a deal in a limited period to a "lining up" of the various interests. The company and the trustees "had to work together hand-in hand", while the trustees had to gain confidence in the insurer that took over the scheme.

Another ground-breaking deal in 2007 was completed by P&O, the ports operator that was acquired by Dubai's DP World two years earlier. DP World's group head of pensions, Rita Powell, described how P&O's pension scheme, with assets of around £1.3bn, took advantage of new products evolving last year to complete an £800m longevity de-risking deal with Paternoster. A decision was made to opt for the bulk annuity approach – a route that has the approval of the Financial Services Authority. This involves Paternoster acting as annuity provider for around 10,000 pensioners in the P&O scheme, by assuming the full longevity risk and the supporting assets, while P&O continues to be its administrator.

Powell stressed that it was vital to reassure the scheme trustees that the chosen insurer was financially strong (a recurring observation was that trustees, whose basic duty is to act prudently, will be wary of any strategy they regard as opportunistic). The trustees in turn took responsibility for communications with the scheme's pensioners, explaining the plan to them in detail and how it was developed.

INADEQUATE RESERVES Rising longevity expectations have also moved up the pensions agenda, as current reserving for many schemes is generally inadequate, said Kevin McLaughlin, principal consultant for the UK financial strategy group at Mercer.

He pointed to the steady, but only gradual rise in the average lifespan over a period of 130 years from when records began in 1841. But since the early 1970s life expectancy had accelerated and wider differences have developed between various socio-economic groups. Given the choice of short, medium and long life expectancy assumptions through to the year 2020, insurers have tended to follow the medium lifespan assumption but this has left many schemes potentially under-reserved.

Although more sophisticated techniques to measure longevity risk are being introduced, there is still a considerable amount of guesswork. As McLaughlin observed: "Understanding longevity is a key factor in analysing plan risks, and an essential building block for any mitigation exercise."

A number of new products have been developed by banks and insurers for hedging mortality risk. They include:

- **Q-forwards.** Developed by JP Morgan, q-forwards are hedges against improvements in mortality. Typically for a 10-year period (banks are generally reluctant to offer them for longer periods), they tend to be limited to mature pension schemes.

- **Longevity swaps.** These swaps hedge exact scheme exposure and have attracted an upturn in demand this year.

- **Bespoke bonds.** Developed by the capita markets, these bonds are attracting the interest of reinsurers, which have entered the market to support primary insurers.

Do these new products offer value for money? According to McLaughlin, it's difficult to say, although he did note that the price difference "isn't that great" between a straight hedge on mortality risk and a pension scheme buy-out.

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