Something of the spotlight

JOHN HAWKINS REPORTS ON THE MERCER/ACT 2008 SURVEY OF PENSION FINANCIAL RISK.

Executive summary

- The fourth annual Mercer/ACT survey found pension schemes were aware of, and had coped with, the implications of an unholy alliance of low interest rates, market turbulence, shifting mortality assumptions and major accounting changes.
- Pension scheme risk is still viewed as high by the various stakeholders although awareness may have reached its peak. With many schemes continuing to make special contributions, pensions look set to stay a major issue and firmly on the treasurers' agenda.

During June and July 2008, Mercer and the ACT approached chief financial officers (CFOs) and treasurers for the fourth annual survey on managing pension financial risk. As in previous years, the survey sought to determine the extent to which this group viewed pension schemes and their deficits as significant corporate risk issues, and their perception of stakeholder attitudes towards such risks. This year, 89 responses were received, with FTSE-350 companies well represented. This article summarises those responses. Several of the questions asked were deliberately similar to those of previous years, but we have again tried to address additional issues that have become increasingly high profile over the last 12 months.

Anyone who has had the misfortune to experience a hurricane knows the eerie silence that can occur when the eye passes over them. In some respects the responses to this year's survey suggest that schemes may be in that eye of the storm. Clearly, most schemes have put behind them the worst of the unholy alliance of low interest rates, a deep bear market, a dawning realisation of the inadequacy of mortality assumptions and the first round of major accounting changes.

In terms of the present, reductions in reported pension liabilities (from widening corporate bond spreads) have managed largely to shelter balance sheets from falls in pension scheme assets over the first half of 2008. While this offers some relief, in many cases it has obscured significant cash funding shortfalls that have built up and

will require correction. Ahead lies the prospect of further accounting changes, steep increases for some schemes in the Pension Protection Fund (PPF) risk-based levy, further strengthening of mortality assumptions and increasing long-term inflation expectations.

Reportedly high levels of hedging and pension buy-outs suggest that some trustees and sponsors agree with this analogy. Battening down the hatches can make sense while there is still time to do so.

Changing perceptions of pensions risk Survey respondents were asked how they thought pension funding and investment strategies had changed in importance for various stakeholders over the past 12 months.

Although a majority thought that board/senior management and employees were attaching more importance to pension funding and investment strategies, an increasing proportion thought that there had been no change. This suggests that these issues are already high on the agendas of many boards. Increased shareholder/analyst interest continues to be less in evidence.

Contribution drivers and mortality assumptions Participants were asked if they had made any special contributions (over and above normal contributions) to company pension schemes in the UK or abroad during the past year. Those who had were asked to state the principal drivers and whether they had undertaken a specific financing arrangement in connection with the special contributions. Also, respondents were asked to comment specifically on changes to scheme mortality assumptions.

The proportion of schemes making special contributions continues to grow, up from 58% to 66%. The number of contribution-specific financings, however, continues at a very low level, down from 20% to 11%, roughly the level in 2006. The most important driver this year was general risk mitigation, while tax, strengthened mortality assumptions and general pressure from trustees (the major driver last year) continue to play their part. It is encouraging that discretionary risk mitigation is considered by some sponsors to be rewarded.

AS THE MARKET IN PURE LONGEVITY HEDGING DEVELOPS, WE MIGHT ALSO EXPECT TO SEE AN INCREASED FOCUS FROM TREASURERS IN THIS AREA.

Among other reasons offered by respondents, one of the most interesting was the utilisation of strong cashflow from operations, suggesting that at least some sponsors are beginning to recognise that improved scheme funding levels can add value to the business by one means or another. Another specific reason worthy of comment was a contribution related to an agreement between sponsor and trustees relating to discretionary benefit increases.

Although more than a third of respondents had strengthened mortality assumptions, this still left a clear majority that had either not done so, or were unaware of whether they had done so. The more interesting part of the response related to the mortality bases from which schemes had moved and where they had moved to, where there was a wide divergence of views. While we would expect to see a variety of assumptions tailored to the specific experience of schemes, it would not be surprising in future to see a significant number of these schemes being forced to strengthen their assumptions even further, particularly given recent pronouncements by the Pensions Regulator. As the market in pure longevity hedging develops, we might also expect to see an increased focus from treasurers in this area.

Impact of accounting standards changes Participants were asked if changes in accounting standards (such as the introduction of a risk-free discount rate or profit and loss recognition of all pension gains/losses) currently under consideration by the major standards

setters would be likely to lead to changes in pension scheme funding and investment strategy or (where schemes remain open) to the rate of future benefit accruals. They were also asked if, given these changes, they were likely to consider annuity purchase more seriously in the future.

The high percentage of respondents likely to react to accounting changes (60%) ought to come as no surprise. We may surmise that at least a proportion of those that do not envisage any reaction (20%) have already taken action in anticipation of change, or expect limited changes actually to emerge.

Responses to the second part of the question were evenly distributed, with a small bias towards considering buy-out more seriously (40%). Although small, the figure will come as a comfort to the old and new participants in the buy-out market, most of whom regularly describe a substantial "pipeline" of impending deals.

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Use of derivatives Participants were asked if their schemes had used derivatives for interest rate, inflation, currency, credit, longevity or other hedging/protection purposes in the UK or abroad.

Use of interest rate and inflation hedging instruments has barely changed year-on-year, with both stable at around 20%; the use of currency hedging is also virtually unchanged at 25%. Credit protection is still used to a negligible extent and longevity hedging not at all. There continues to be some use of other types of derivatives; the most frequently mentioned type was equity derivatives, suggesting that some substantial 'in the money' positions may exist following recent market falls.

Interest rate and inflation hedging Participants were asked if they had entered into interest and inflation derivatives using direct swaps, bucket funds, or some other method.

The principal method of entering into interest rate and inflation derivatives continued to be direct swap agreements (over 77%), with a significant minority using bucket funds and bespoke arrangements.

Responsibility for negotiating derivatives documentation Respondents were asked who had taken the lead in negotiating the derivatives documentation and whether collateral arrangements had been reviewed recently as a result of recent credit market turmoil.

Where derivatives documentation had been negotiated, the trustees took the lead 54% of the time and the sponsor 17%. There is also a material amount of delegation to investment managers (21%).

Despite the financial press headlines devoted to the credit crunch, most schemes seem fairly relaxed when it comes to the security arrangements supporting derivatives, with only 33% having specifically reviewed collateral arrangements.

Contingent assets Participants were again asked if they were using contingent assets as part of their scheme funding strategy in the UK and, if so, into which PPF category they fell.

Use of contingent assets appears to be down slightly even on last year's low level, from 17% to 11%, back to the level of 2006. Of those schemes using contingent assets the proportion using 'type A' (in other words, guarantees given by parent/other group companies) remained constant at 60%. Again several respondents were using other types of contingent asset: 20% used type B (security over cash and other assets) and 10% type C (letters of credit/bank guarantees).

Investment strategy and the PPF risk-based levy Participants were asked if they would revisit their investment strategy with a view to implementing further de-risking if this were encouraged by the Pension Protection Fund – for example, by modifying the basis of the risk-based levy, or for other reasons.

Almost 53% said they would, which is probably not a surprise but nevertheless a relief for investment managers specialising in liability-driven investment-type solutions and annuity providers. The question assumes, of course, that any change to the PPF basis is material, but this is probably now a reasonable assumption given that the PPF has already approached and retreated from this position on one occasion. Respondents were also asked to provide other reasons why they might de-risk further in the future, to which there was a very wide variety of answers. The following reasons were representative:

- adoption of specific scheme risk budget;
- to offset increased sponsor credit risk;
- contribution towards business-wide de-risking;
- peer group pressure;
- increasing scheme maturity;
- more risk-averse sponsor following acquisition;
- reduction of scheme funding level volatility; and
- changes to US accounting standards.

Impact of legislation on corporate activity Participants were again asked if they believed the regulatory regime introduced by the Pensions Act 2004 was having an adverse impact on corporate activity, both generally and for their own company.

The results are remarkably consistent with those of last year, with the general and specific adverse impact levels at 31% and 55% respectively. One explanation for the fact that respondents consider their own companies to be more affected may be that businesses are running into problems about their own pension schemes fairly frequently, whereas the number of such situations receiving a high press profile is still quite small.

THE YEAR IN PERSPECTIVE It is clear that the degree of involvement of treasurers in the affairs of pension schemes for which their businesses act as sponsor is still highly varied at both a strategic and operational level. In particular, the limited involvement with derivatives documentation and collateral arrangements is quite surprising. Nonetheless, de-risking of schemes seems likely to continue and this must surely be an area where treasurers can add increased value.

John Hawkins is principal at Mercer.
john.hawkins@mercer.com
www.mercer.com