MIKE SMEDLEY AND WAYNE SEGERS BELIEVE COMPANIES CAN BETTER MANAGE PENSION RISK IF THEY TAKE AN EARLY LEAD ON FUNDING.

Taking an early lead

Pay down the FRS17 pension deficit over 10 years. This is the stock answer to the question of funding UK pension deficits. The Pensions Regulator has widely quoted this benchmark and major plcs have announced contribution plans along these lines. This approach is appealingly simple. But it's a bit like saying that all corporate borrowings should be in sterling over five years at fixed rates. There might be nothing wrong with it, but a one-size-fits-all approach isn't optimal for corporate debt, so why should it be right for pensions?

So how can the creativity and diversity of approach in the debt markets be applied to funding pensions? And how can we be creative and meet the needs of the Pensions Regulator and trustees?

There are similarities and differences between pension deficits and debt and they should inform pensions funding. In particular, companies need to consider the question of cash contribution patterns in the new legislative environment – and how companies should be approaching their forthcoming actuarial valuations.

The key message is that companies can only achieve cashflow flexibility and control if they take an early lead in discussions with trustees – as they would with any other stakeholder.

DEFICIT OR DEBT? A company's defined benefit pension promises differ from corporate debt in a number of ways. The key difference is that most UK pension schemes are funded, i.e. the obligations are backed by assets. FRS17 puts the net deficit onto the balance sheet, not the gross asset and liability values. Looking at the pensions deficit as debt is misleading. The entire liability is effectively debt, and the pension fund assets represent the collateral that the company has put up.

This critical distinction indicates that pension debt is not paid down by making contributions to the pension plan – it is only settled as payments are made to beneficiaries. Pension contributions are simply a decision about the extent of collateral provided.

There are other key distinctions:

- pension debt is longer term than corporate debt;
- pension liabilities rely on many assumptions, including mortality;
- timing of the obligations is uncertain;
- there is no liquid market in pension liabilities;
- it is prohibitively expensive to settle pensions debt outright;
- the collateral typically behaves very differently to the pension obligations.

These differences have important implications for pensions funding. In particular they highlight the risk of fixating on an FRS17 measure of deficit or pension debt as at a valuation date. Pension deficits are a moving feast.

HERE TODAY GONE TOMORROW Mark-to-market pension deficits are highly volatile. *Chart 1* shows the development of the FRS17 deficit for a typical scheme over the last nine months. A company

Executive summary

- A one-size-fits-all approach is not appropriate for corporate debt and is not right for pensions.
- The whole pension liability is debt not just the deficit and it is this liability that companies should manage.
- If a company takes the lead in funding under the new rules it will be better placed to manage pension risks.

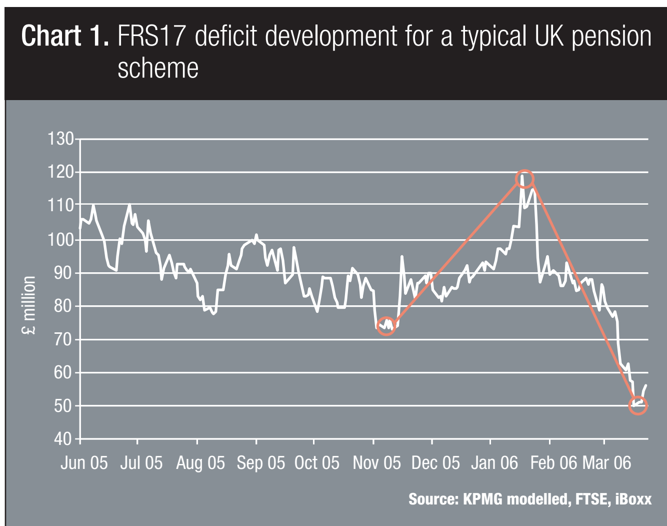

Chart 1. FRS17 deficit development for a typical UK pension scheme

that agreed to fund a deficit of £70m in November might have thought they were contributing far too little by mid January 2006 and far too much by end March 2006. This highlights that it is not enough to manage a pension scheme by fixing a debt amount at a valuation date under FRS17 and then paying that down over a period. Rather, funding is about achieving a level of security with which the trustees and the Pensions Regulator are comfortable, that protects pension scheme members, and supports the company's business objectives and protects it from pension risks. Chasing a volatile target for the next 30 to 40 years is not good risk management.

THE GOOD NEWS AND THE BAD NEWS The good news is that trustees are not bankers. Although they now have as much – if not more – power than any other unsecured creditor. Given the scale of current pension deficits, thankfully trustees are not working with the same urgency and repayment time horizons.

And the bad news is that the trustees are not bankers. Banks work with companies to provide debt that is priced and structured to reflect the level of risk in the business and the business' needs and plans. Trustees on the other hand are largely unfamiliar with these issues. Now they have the power, the statutory responsibility and the Pensions Regulator's proverbial gun to their head.

The first step in funding negotiations may be to educate the trustees on the company's industry, business plans, financial strength and expected cash and financing needs. Indeed the Pensions Regulator is urging trustees to assess the covenant of the sponsoring employer to the pension plan. Trustees are already starting to commission this sort of financial advice. This is often provided by advisers used to dealing with financial distress situations that take strong positions and use whatever leverage they can. Lay trustees are understandably a long way behind bankers in interpreting and using this advice. Many companies will want to pre-empt this by presenting and explaining the company's position in their own terms.

FIRST MOVER ADVANTAGE Companies do not wait until their banking facilities expire and then let the sitting lender dictate terms. So why let it happen on pensions? In order to ensure an agreement in its best interests, a company should be proactive in approaching the trustees. There is less chance of achieving a funding agreement that reflects company needs if the company waits for the trustees to come to it with its funding demands. Having done a significant amount of work with their advisers, the trustees are likely to be anchored to their position. So, if a company is looking to take the lead in funding what might it need to consider?

WHAT REALLY MATTERS There are a number of risks the company may be looking to avoid when agreeing a funding plan. These include:

- being tied to a long-term commitment that decreases credit strength;
- lack of cashflow flexibility when business needs and opportunities arise;
- a one-way bet where the contributions cannot be reduced but the trustees can effectively demand increases;
- passing too much control over the deficit and funding plan to the trustees;
- overpaying contributions if the ultimate cost of benefits proves to be lower.

While each company's situation will differ, the overriding need of any business will be to maintain flexibility. Once tied down to a contribution schedule it will be difficult to renegotiate this with the trustees if, for example, the business needs to free up cash for a profitable investment opportunity.

GAINING FLEXIBILITY A company may look to gain flexibility in a number of ways, including:

- Providing security other than cash;
- Negotiating flexibility in its payment schedule (e.g. in line with debt repayment or capital investment requirements); or
- Using funding corridors rather than fixed payment schedules to manage risk of over funding.

The aim of using other forms of security is to agree a lower targeted funding level than the trustees may otherwise want if no security was provided. This is beneficial to the company as agreeing too prudent a funding target means that there is a risk of over-funding – and a refund of surplus is virtually impossible. Bear in mind that pension contributions are not debt payments but simply collateral – and non-refundable collateral! The funding process in effect becomes similar to agreeing lending terms with a bank.

AN OPPORTUNITY If a company takes the lead in funding under the new rules it will be better placed to manage pension risks and provide security to members on terms that better suit the business. The new funding rules use the terminology "scheme specific". An appropriate strategy should therefore differ for each scheme but also needs to be company specific. While the regulator will use benchmark trigger points for its risk monitoring purposes it has repeated its openness to commercial agreements between trustees and employers. In the end funding of pension schemes can become as varied as the different types of corporate financing, while at the same time achieving security for scheme members and protecting the company against pension cash calls.

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