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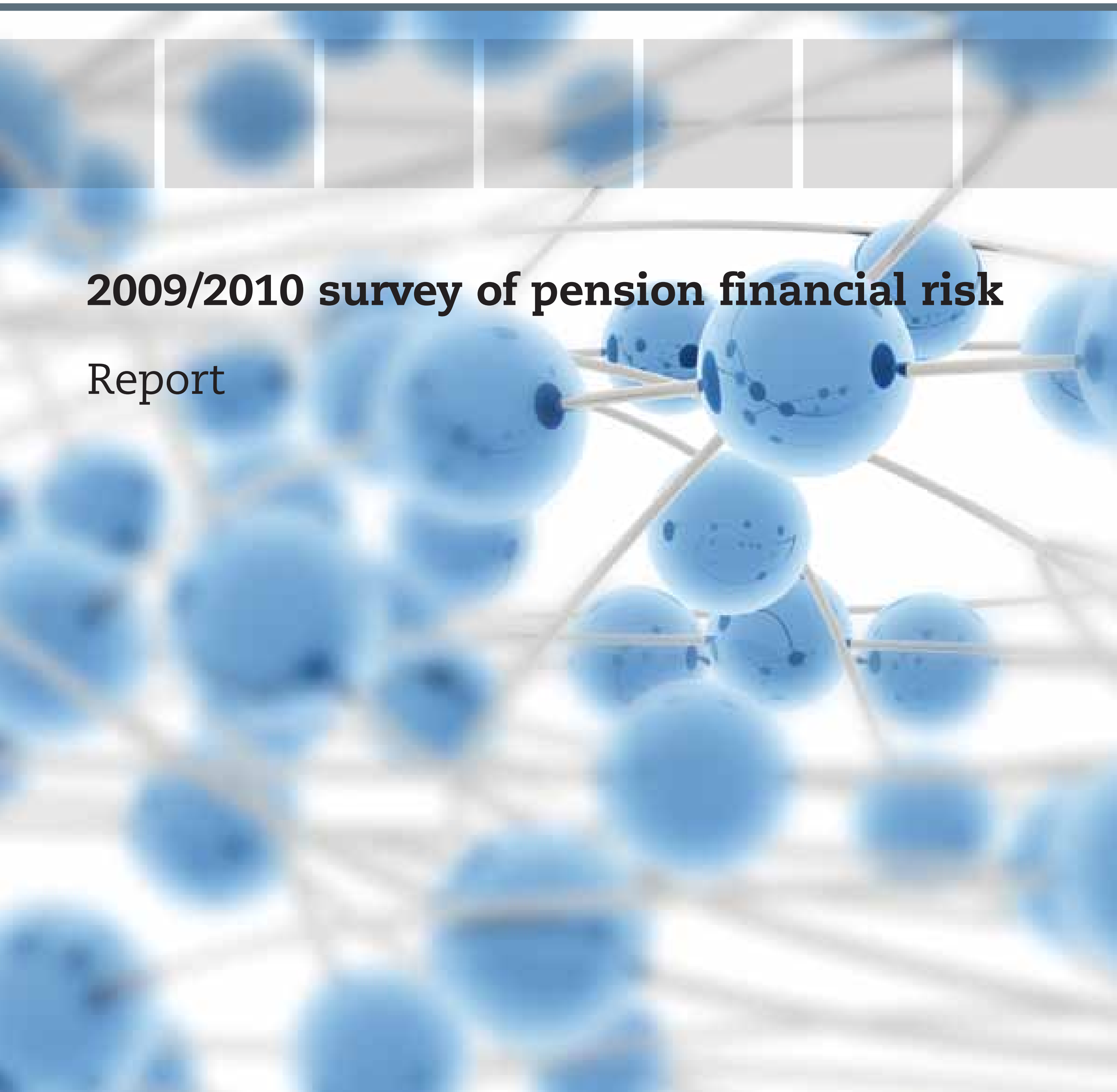


2009/2010 survey of pension financial risk

Report

During late 2009 and early 2010, Mercer and the Association of Corporate Treasurers approached the chief financial officers and treasurers of substantial companies to take part in their fifth survey on managing pension financial risk.

This survey sought to determine:

- The extent to which pension schemes and their deficits are viewed as significant corporate risk issues
- Perceptions of stakeholder attitudes and pension accounting measures
- The prevalence of some specific and topical risk management actions

This report summarises the 51 responses received, from mainly FTSE 350 and equivalent organisations.

Key findings

- Despite pensions issues already featuring high on the stakeholders' agendas at the time of our previous survey, the latest findings suggest that recent market events have led to stakeholders viewing pension risks as even more important.

- Around half of respondents have received requests by their scheme trustees to provide additional financial support as a result of falls in their schemes' funding levels – with cash injections being the most common form of additional support requested. Where such requests were received, the majority of participants had agreed to some form of additional support, and cash was also the most common form of support offered. For many companies agreeing to trustee requests, the main secondary driver for doing so was a desire to reduce Pension Protection Fund levies. Several respondents also indicated that additional funding was agreed as a bargaining tool in other pension negotiations, demonstrating that companies are increasingly looking to address their various pension issues through a packaged solution.

- Just over half of respondents indicated that as a result of recent falls in pension scheme funding levels owing to mismatched assets and liabilities, they are now more likely to reduce their exposure to risk. However, the majority viewed this as a long-term project. Some respondents indicated concerns that the current trustee governance structure was not ready to implement a de-risking investment strategy; however, the majority felt that they either already have a framework in place or are getting there.

- Although the majority of respondents indicated that they were keen to de-risk, around 65 percent did not view the purchase of a bulk annuity policy, followed by a wind-up of the scheme, as their ultimate goal – with the presumed alternative being to run the scheme down on an ongoing basis. A similar percentage has also never transacted or sought quotations for a bulk annuity policy. In general, respondents felt that the bulk annuity market offered less competition than we believe to be the case, although this may be a perception carried over from the reduction in annuity market activity observed in late 2008 and early 2009.

- More than half of respondents indicated that they had used derivatives in their pension schemes, mainly for currency hedging. Of those undertaking interest rate and inflation hedges, this was mostly carried out directly, using interest rate and inflation swaps, with around one-third making use of pooled funds ("bucket funds") to achieve the hedge. In general, reported derivative use had increased markedly since our previous survey in 2008.

- Most respondents had a balanced or positive view on the recent announcements by the Pensions Regulator around funding in the current economic climate, although a significant minority viewed these as negative or unclear.

- The majority of respondents expressed a negative view on current pension accounting rules as an objective and transparent measurement of pension costs. In addition, the majority of respondents had concerns that users of accounts do not understand the true business impact of pension obligations. Of the changes suggested, the most common was a call for greater disclosure of sensitivities to assumptions used, aimed at giving users a greater understanding of the risks and uncertainties involved.

As ever, there is no single right or wrong level of risk that should be acceptable to a pension scheme and its sponsor, but the need to consider such matters is now widely accepted. Once this has been done, trustees and sponsors can make informed decisions about whether to modify that level of risk and, if so, how they should do so.

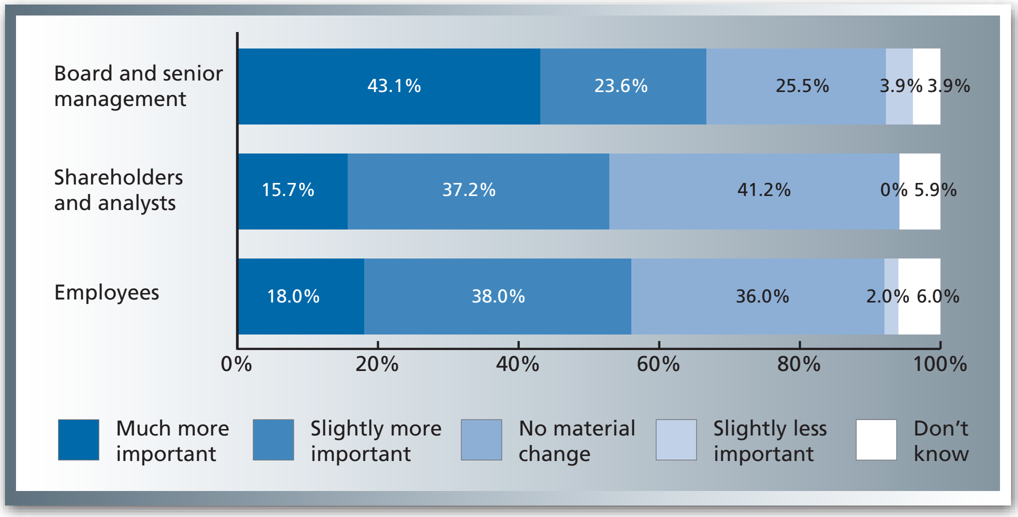
The Financial Strategy Group within Mercer works with corporate and trustee clients to assess pension risks both within pension schemes and between schemes and their sponsor, as well as identifying means of risk management and mitigation and assisting in the implementation of solutions.

Results in detail

1. Changing attitudes to pension risk

Participants were asked to what extent different stakeholders' perceptions changed regarding the importance of the funding level and investment strategy of their company's pension scheme over the year.

Chart 1a: Change in perceived importance

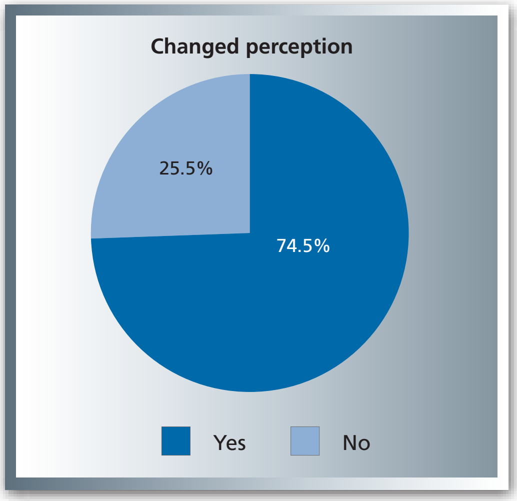


Our previous survey had indicated that while a significant proportion of boards and management teams still considered pension risk issues to be of growing importance, the single largest percentage of stakeholders felt that there had been no material change in perceived importance over the previous year. After all, economic volatility and increasing regulation had already ensured that pension risks were acknowledged to be a key issue for many stakeholders.

It is therefore notable that respondents of this survey have indicated a further strong increase in the importance that stakeholders across the board place on pension risks – with the majority perceiving them as slightly or much more important. Respondents also report an increase in the perceived importance of pension risk issues as viewed by shareholders and analysts; something that we have also noted in dealing with our clients.

Participants were also asked whether they thought that trustees' perceptions of sponsor credit had changed as a result of recent upheaval in credit markets.

Chart 1b: Change in perceived sponsor creditworthiness

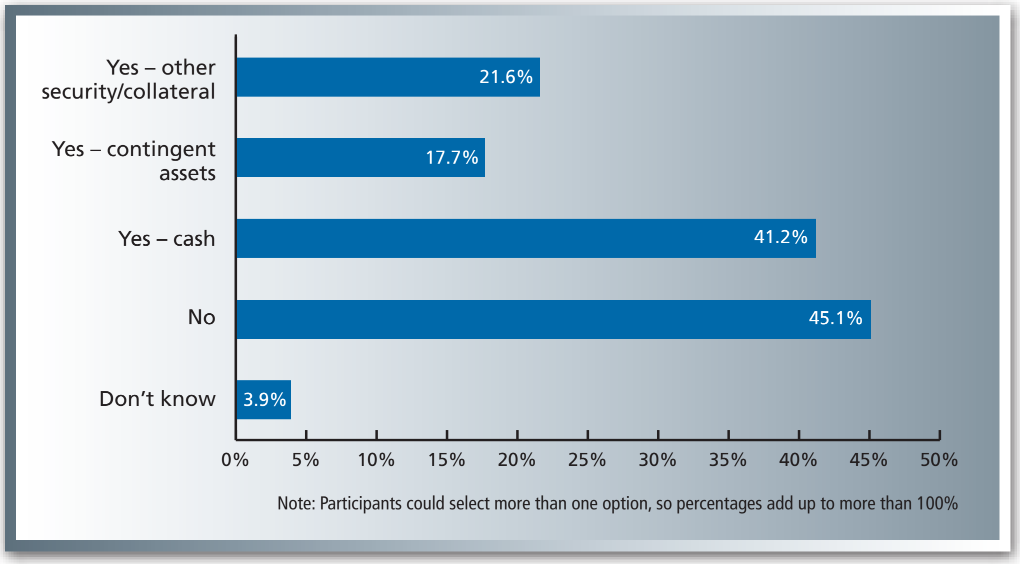


Almost three in four respondents felt that there had been a change in perception of sponsors' credit risk, compared with just over half in the previous survey. In light of the number of high-profile and large companies which have run into financial difficulties or gone into administration, it is hardly surprising that there is a higher perceived risk in sponsor creditworthiness. In addition, the regulatory funding regime places a greater emphasis on trustees to consider sponsor creditworthiness, and this is likely to have come to the fore in the light of recent economic conditions.

2. Contributions

Participants were asked whether their scheme trustees had requested that they offer additional security to the scheme as a result of falls in funding levels and, if so, to state the form of additional security.

Chart 2a: Request for additional funding/security

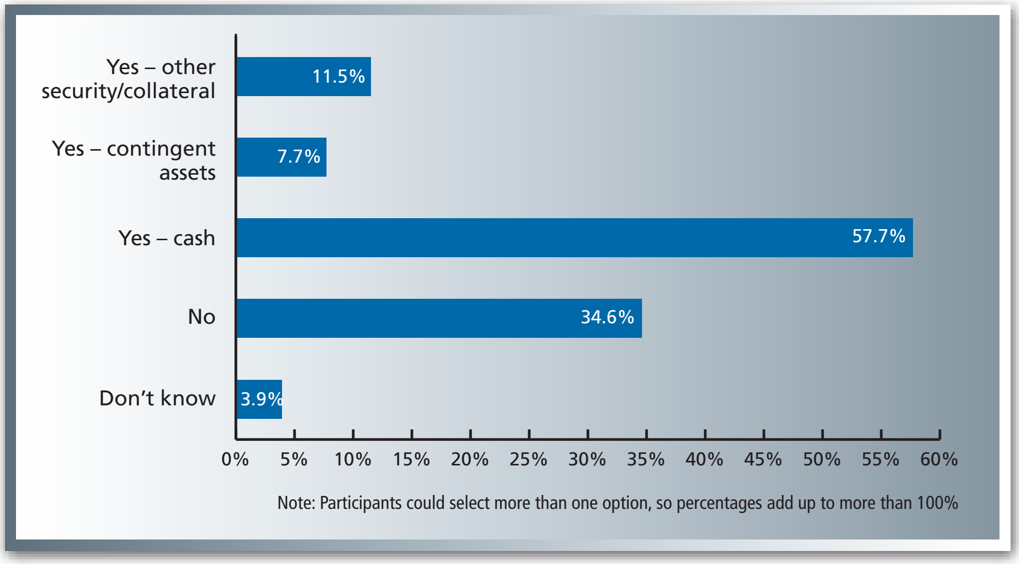


Around half of respondents had received requests for additional funding or security as a result of falls in funding levels, with cash, unsurprisingly, being the most popular support requested. Although the other half of respondents had received no such requests, this may simply reflect a timing feature of the legal UK funding framework, with many trustees delaying requests for additional funding until their next triennial funding valuation.

Respondents who had received requests for additional funding/security from trustees were also asked whether they had agreed to these requests and, if so, to state:

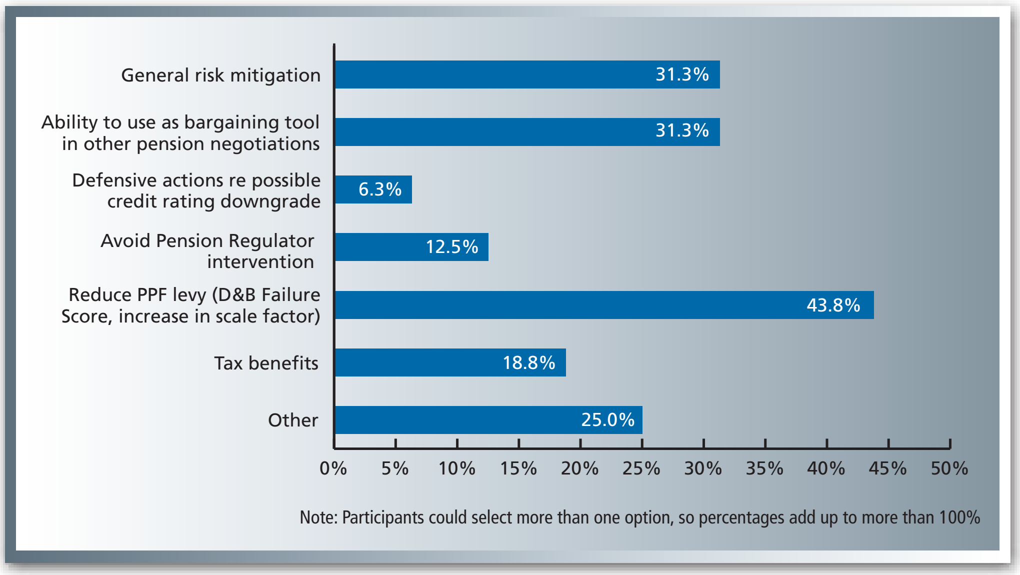
- The form of support granted
- Any secondary drivers behind granting the support
- Whether there were wider financial considerations to overcome before providing the support

Chart 2b: Agreement to additional funding



The majority of respondents indicated that they had agreed to the trustees' request and cash contributions were the most common form of support granted.

Chart 2c: Secondary drivers for funding



Where companies have provided additional support, the most important secondary driver this year has been to reduce the PPF levy. For many companies, PPF levies have increased significantly in recent years, and the potential to reduce these is seen as a strong motivation to pay contributions or offer contingent assets/collateral. General risk mitigation (the major driver last year) continued to play its part, while a further important factor listed was the use of additional contributions as a bargaining tool in other pension negotiations – illustrating the increasing trend for companies to view pension solutions (including investment, funding and benefit design/liability management) as part of a financial package.

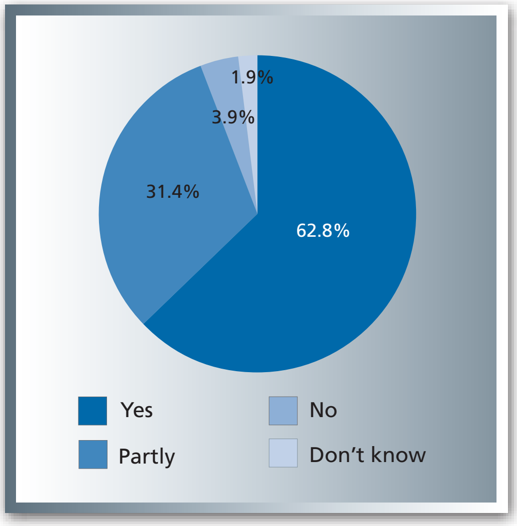
Before granting any support to the scheme, the main additional barriers/considerations to be handled were aligning this support with reductions in other staff costs and balancing the needs of the pension scheme and business at a time when capital expenditure is being cut back.

3. Funding regulation

Over the year, the Pensions Regulator reinforced its view that the existing pension framework was adequate to deal with the economic climate and that no significant changes were required. In addition, back-end loaded recovery plans and longer recovery periods may now be more acceptable to the Regulator than before the economic crisis, if this is justified on grounds of the sponsor's reasonable affordability.

The UK legislative regime treats pension schemes as an unsecured creditor of the company, leading the Pensions Regulator to recently remind trustees that pension schemes have priority status relative to equity holders. Participants were asked to confirm whether their companies viewed their pension schemes as an unsecured creditor.

Chart 3a: Pension schemes viewed as unsecured creditor



Trustees will be pleased to see that the vast majority of respondents confirmed that they did at least partly view their pension schemes as an unsecured creditor, in line with the legal reality.

Participants were also asked how they viewed the Regulator's recent announcements around pension funding in the current environment.

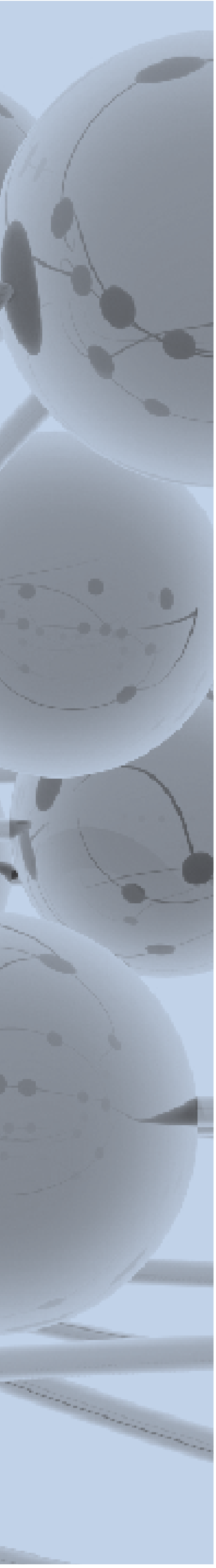
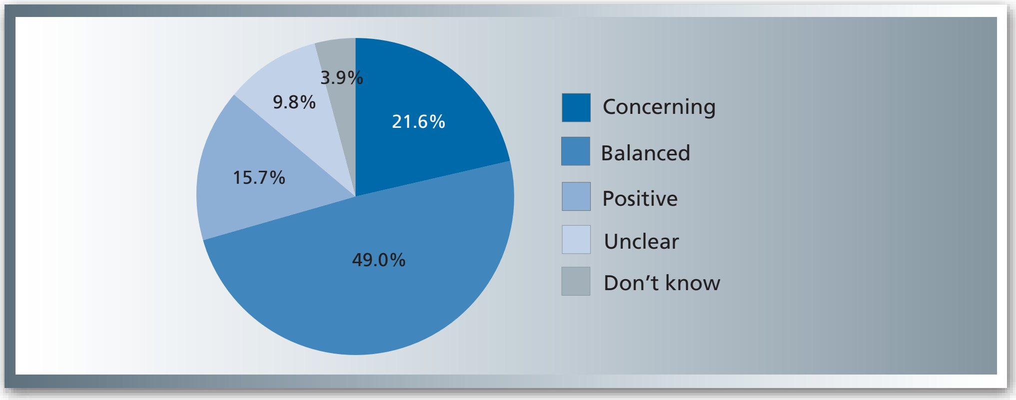


Chart 3b: Views on the Pensions Regulator's recent announcements on funding



Around half of participants had a balanced view of the Regulator's announcements, with a further 16 percent viewing the announcements as positive. However, almost a third of respondents thought the announcements were either concerning or unclear.

4. Investment risk management

Recent falls in pension scheme funding levels have highlighted the risks from mis-matched assets and liabilities. Respondents were asked whether they were now more likely to reduce or remove mismatching risks and, if so, how soon they intended to implement this policy.

Chart 4a: Propensity to reduce/remove risks

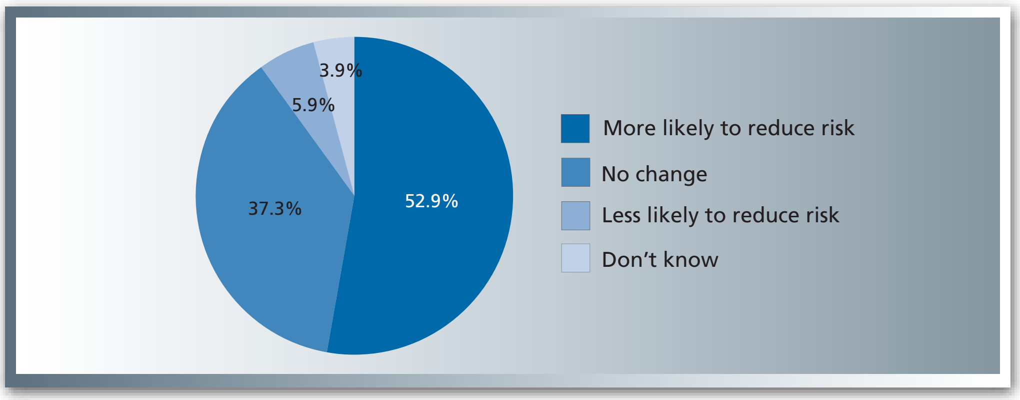
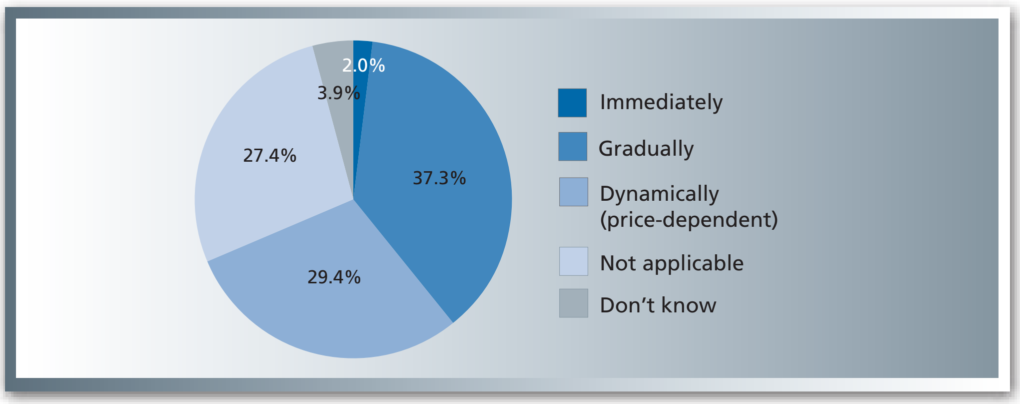


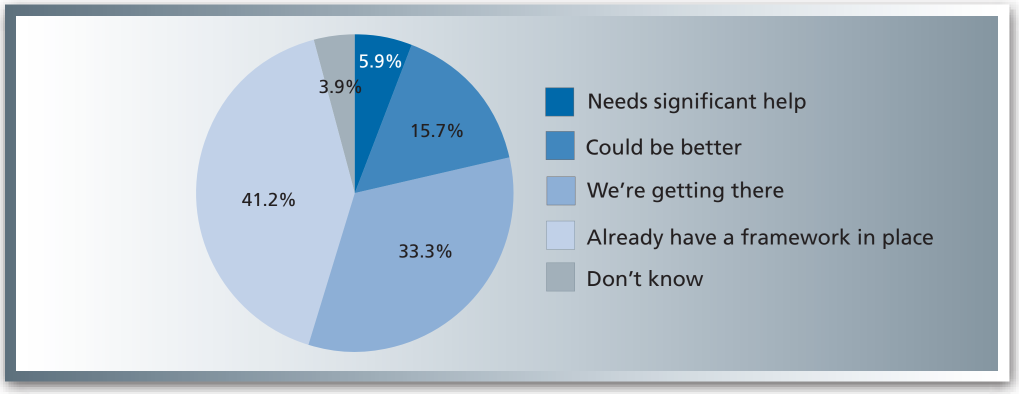
Chart 4b: Implementation timing of risk reduction/removal



The majority of respondents were keen to reduce/remove investment risks, indicating a strong desire to manage volatility in funding levels. However, views differed on how they would like to carry out its implementation, with a gradual removal being the most popular option, followed by a dynamic approach, which is price-dependent. Only a small proportion of respondents wanted to reduce risk immediately, most likely due to cost constraints.

Chart 4c: Ability to implement a de-risking investment strategy by the trustees

Implementing a de-risking strategy can lead to increasing complexity in a scheme's investment arrangements. This could be viewed as another hurdle in implementation of a de-risking investment strategy. We therefore asked the participants to consider the ability of their scheme's governance structure to implement a de-risking investment strategy.

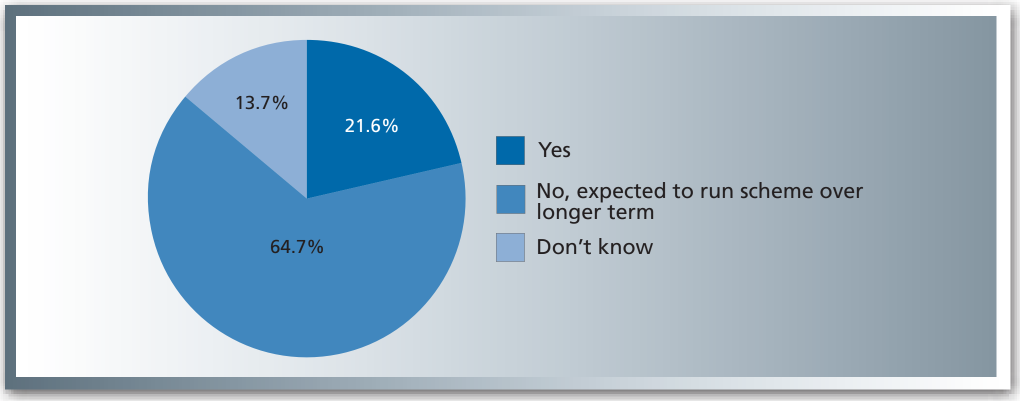


Some respondents thought that the trustees' current governance structure needed significant help or could be better to allow for de-risking strategies to be implemented. However, the majority of respondents indicated that they already had a framework in place or were getting there. This view is a little ahead of what we typically see and we would recommend that any company looking to de-risk materially takes an initial step of vetting thoroughly the governance processes currently in place.

5. Bulk annuities/insurance products

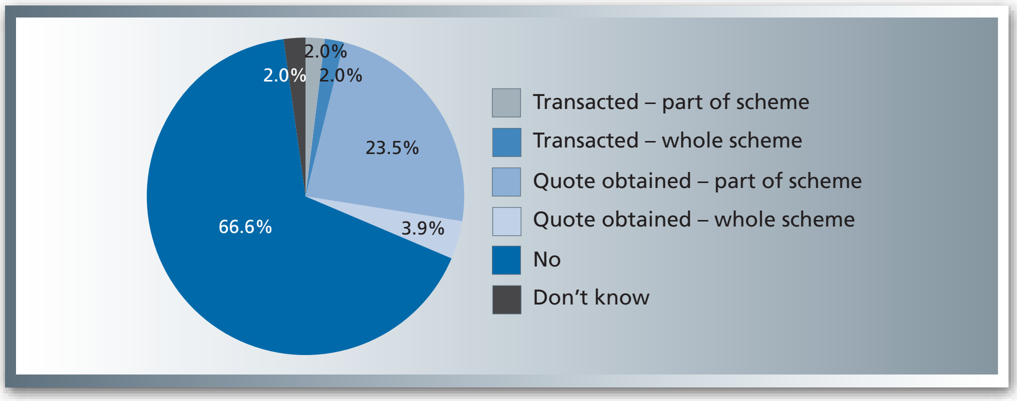
Respondents were asked their views about bulk annuities and similar products (buyouts, buy-ins, synthetic buyout/-in); in particular, whether insurance and scheme wind-up is viewed as an ultimate goal for their scheme, details of any previous dealings with bulk annuity providers, and their understanding of the current state of the UK bulk annuity market.

Chart 5a: Propensity to purchase a bulk annuity and subsequently wind up the scheme



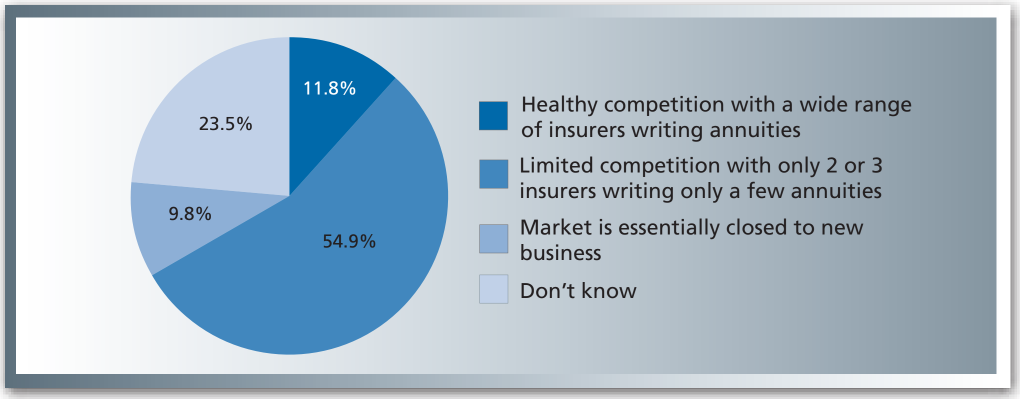
Although the majority of respondents had indicated that they were keen to reduce or remove investment risks, only 22 percent viewed the purchase of a bulk annuity accompanied by winding up of the scheme as their ultimate goal. This may be the result of bulk annuity policies being viewed as an expensive option and/or a willingness to continue with the schemes while managing the risks rather than completely removing the risks.

Chart 5b: Previous quotations/transactions on bulk annuity policy



The majority of respondents had not sought quotation nor transacted a bulk annuity policy in the past. About one in four respondents had obtained a quote for buying out at least part of their schemes, but only 4 percent of respondents had actually transacted on a bulk annuity policy.

Chart 5c: Understanding of the current state of the UK bulk annuity market



Despite new entrants to the market over recent years and a number of deals being announced late in 2009, over half of respondents viewed the market as characterised by limited competition, with only two or three insurers writing a few annuities. This view, which we see as understating the true level of current competition, may also be a barrier to bulk annuities being viewed as a long-term goal.

6. Use of derivatives

Participants were asked whether their pension schemes in the UK or abroad had used derivatives.

More than half of respondents indicated that they had used derivatives, mainly for currency hedging, followed by interest rate hedging and inflation hedging. Credit protection was used to a small extent, as was longevity hedging. Overall, derivative usage was 50 percent to 100 percent higher across most areas than in our 2008 survey.

Chart 6a: Use of derivative hedging

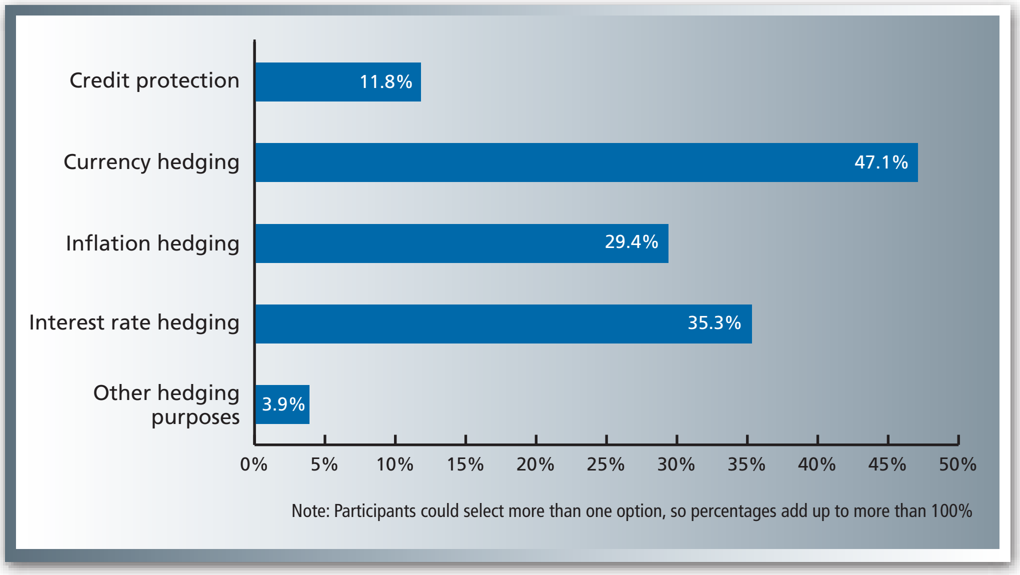
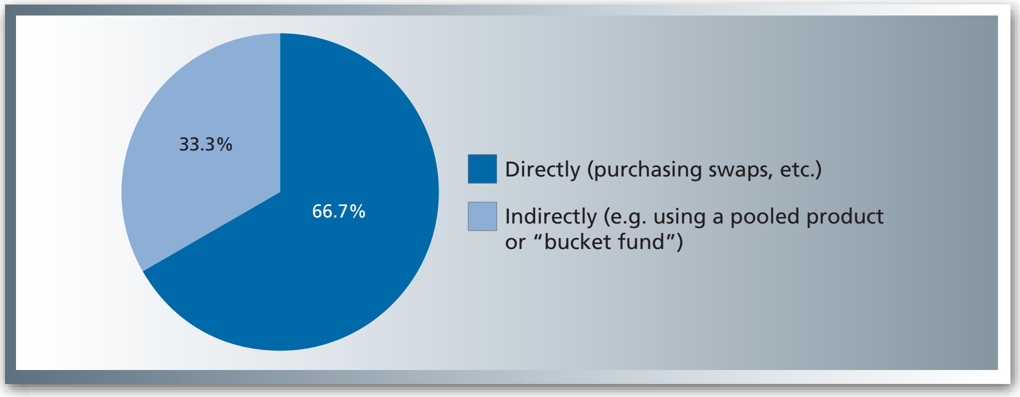


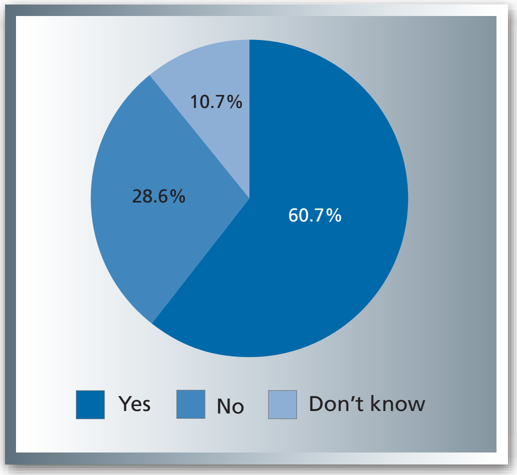
Chart 6b: Methods for entering into hedges

Participants were also asked how they entered into interest rate and/or inflation hedges.



The principal method of entering into interest rate and inflation derivatives continues to be direct swap agreements, with a significant minority using bucket funds. This picture is broadly similar to that seen in 2008.

Chart 6c: Review of collateral arrangements



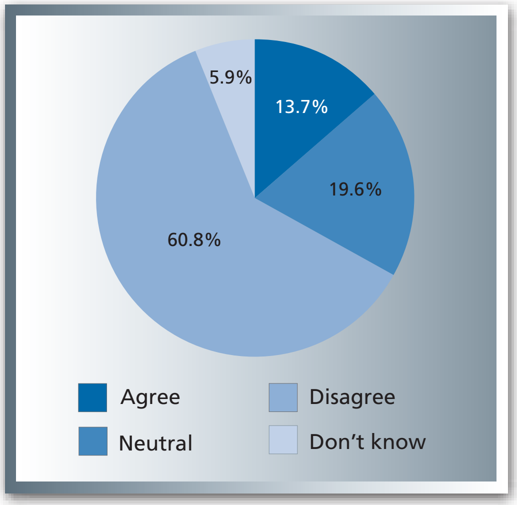
Respondents were asked whether collateral arrangements had been reviewed as a result of recent credit market turmoil.

About 60 percent of the respondents had recently reviewed their collateral arrangements, representing a significant increase from the figure of 33 percent in our previous survey. Management of counterparty risk now appears to be a key component of hedging programmes.

7. Pension accounting

Participants were asked whether they believe that current accounting rules offer an objective and transparent measurement of pensions costs.

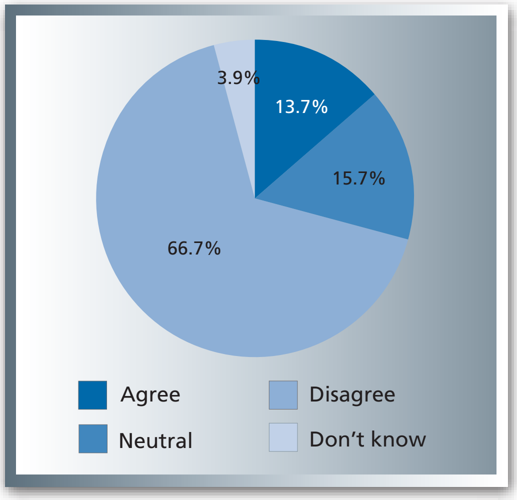
Chart 7a: Objective and transparent measurement



The majority feel that current pension rules fail to offer an objective and transparent measurement of pension costs. This is supported by the views we generally hear from finance and treasury officers.

Further, participants were asked whether they believed users of accounts are able to understand the true business impact of pension obligations.

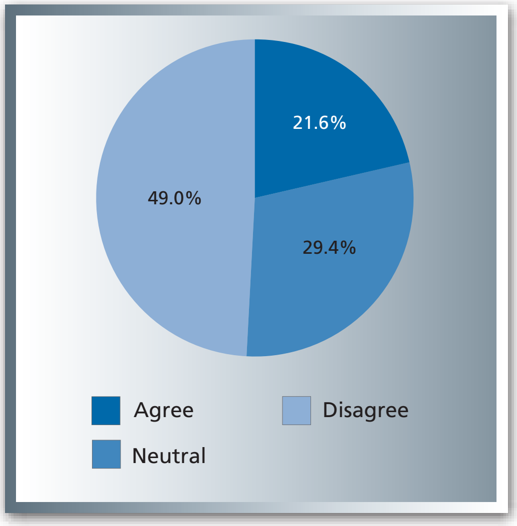
Chart 7b: Understanding of pension obligations by users of accounts



Again, the majority did not have a favourable view and believed that users of accounts are not able to understand the true business impact of pension obligations.

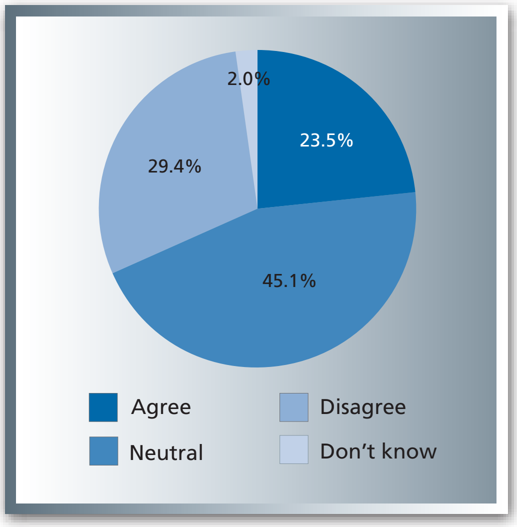
In terms of the assumptions used in accounting, we asked whether it is theoretically sound to use AA-rated bond yields for discounting all companies' pension liabilities and also whether respondents believed that actuaries have too much power in setting pension accounting assumptions.

Chart 7c: Soundness of AA-rated bond yield to measure liabilities



Almost half of respondents believed that the use of corporate bonds was not a sound measure for liabilities. Again, this supports views that we tend to hear from those in treasury/ finance. We did not ask for alternative views, as our experience suggests that different parties prefer a very wide variety of solutions.

Chart 7d: Power to set pension accounting assumptions – are actuaries too powerful?

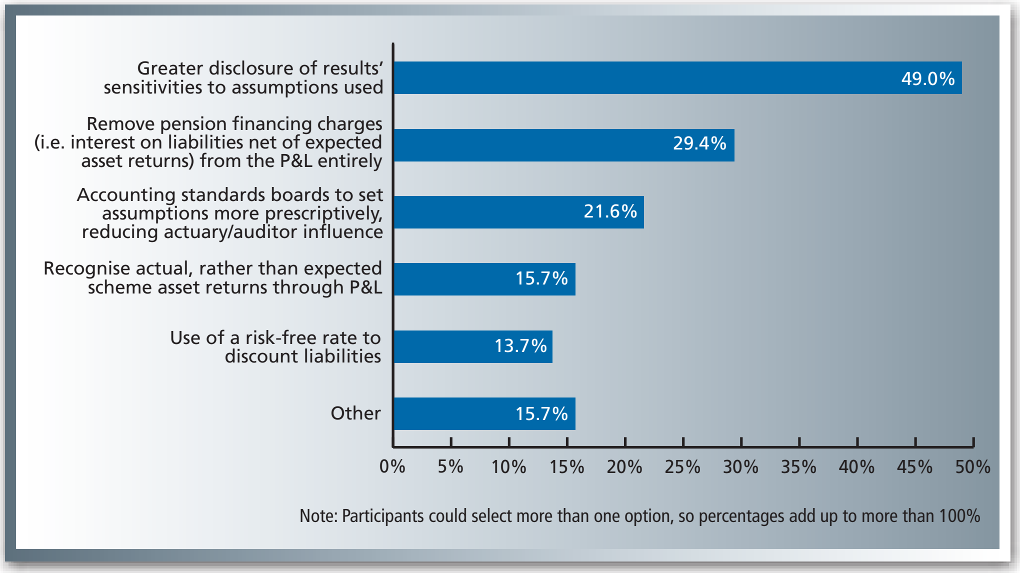


There was no clear view on the role of actuaries in setting pension account-ing assumptions, with the most common view being neutral.

Chart 7e: Changes to pension accounting standards

Overall, responses indicated a fairly negative view of current accounting standards. However, accounting figures continue to be one of the main sources of information on pension issues for stakeholders. In an environment where shareholders and analysts are viewed as placing a greater importance on pension issues, companies may be concerned by perceived discrepancies between actual pensions' financial risk exposure and their accounting figures, as well as how these would be interpreted by stakeholders who may not fully understand the results shown.

Respondents were therefore also asked to comment on changes they would like to see to pension accounting standards.



Note: Participants could select more than one option, so percentages add up to more than 100%

The most popular response sought greater disclosure of sensitivities to assumptions which might enable stakeholders to gain a greater understanding of the uncertainties around pension costs.

Over two-thirds of respondents accepted that a pension financing charge of some description belongs in the P&L result. The recognition of actual rather than expected asset returns and the use of a risk-free rate to discount liabilities were only put forward by a small proportion of respondents owing, we expect, to the negative impact this could have on company accounts.

Other suggested changes related to the allowance for risk management or liability hedging. It was felt by some that current accounting standards do not reflect the shareholder value benefits of pension risk management. Depending on their structure, additional requirements around disclosure of assumption sensitivity might be one means of addressing this. Furthermore, in the context of risk management, the recent IASB proposals to alter the financing charge will potentially reduce the negative impact on a company's P&L from a move to lower risk assets.

For further information

If you have any questions regarding this report, or if you want to find out how Mercer can help your organisation to manage its pension financial risk, please contact your usual Mercer consultant or the author:

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