

THE GORILLA IN THE GARDEN

By Richard Farr

For companies with one or more of the 7,000 or so defined benefit (DB) pension schemes in the UK, now is the time to get to grips with the risks. A combination of equity performance and a reduction in corporate bond interest rates has led to a shift in defined benefit accounting disclosures. The FTSE 100 has moved from a small surplus before the credit crunch began in mid 2007 to a deficit of around £73 billion as at the end of June 2010 (according to JP Morgan).

Richard Farr, BDO Pensions, looks at the issues for management, trustees and banks and explains why an unattended DB pension scheme is as risky as ignoring the 200kg gorilla in your garden.



Why compare a DB pension scheme to a gorilla? Because the size of the deficit that many companies face, the fact that directors can, in certain circumstances, be held personally liable for any shortfall, and the possible conflicts of interest around DB pension schemes, mean that they have the potential, if unchecked, to cause huge damage to you and your company.



COMMUNITY COMMENT

Steven Haberman
Deputy Dean & Professor
of Actuarial Science,
Cass Business School

“The gorilla analogy is striking... a gorilla suddenly appears in your garden, but how applicable is this to the management of defined benefit pension schemes?”

In one sense, this is a poor analogy. As Richard acknowledges in this article, such pension schemes are operating over long time horizons and the financing of the underlying benefit obligations is similar to any long-term business plan that needs to be financed.

In another sense, however, the analogy is good because of the accounting rules which tend to ignore both the long-term nature of this financing and the fact that the scheme sponsor is attempting to budget for costs over the long-term. The accounting rules force us to focus on a comparison of the market value of the assets and a particular calculation of liability values at a particular point of time. The value thus calculated for accounting purposes can be completely different from the one that is being used for pension scheme funding purposes. These accounting measures can fluctuate wildly. For example, for the FTSE 100 firms, the aggregate deficit of £90bn at the start of 2010 had become £73bn by the end of June 2010 (according to JP Morgan). They tell us little about the ability of any company to meet its ongoing obligations.

I believe that we have allowed inappropriate accounting measures to dictate how we see and assess the viability and financial strength of defined benefit pension plans. I believe that this inappropriateness is a contributory cause (not the only one) of the demise of defined benefit pension plans that we are currently witnessing. Further, the use by actuaries of terms like ‘valuation’ has not helped in this regard in that they have masked the true nature of the scheme funding exercise, which is instead concerned with long-term budgeting to meet future obligations.”

So consider this. If you opened your curtain one morning and saw a 200kg gorilla in your garden what would you do? Close the curtain and check again in three years time? Probably not. Yet, effectively, that is the decision corporates and trustees are taking when they leave their DB pension schemes to tick over between triennial reviews and valuations.

Of course, there are good reasons why CEOs and CFOs don’t address their DB pension schemes as fully and frequently as they would like to. There are governance and strategy issues all the way from the boardroom to the shop floor, differing valuation methods that make it hard even for a CFO to keep track of liabilities and, of course, the rather more pressing need to steer your business through exceptionally challenging times. Add the fact that DB pension schemes are operating on a 20-30 year timeframe, or longer – perhaps with little demands on current cash flow – and the temptation to leave the gorilla in the garden is easy to see.

MARKET CONDITIONS

There may be some comfort in thinking that at least it is not getting any bigger. In fact, as equity prices and credit spreads have improved since the credit crunch began, many companies have experienced a reduction in their deficits, albeit without a return to the heady days of surpluses. However, actuaries are reducing the bond rates on the grounds that they are unrealistically high, and the trend towards calculating liabilities using interest rates based on gilts, together with ever increasing projections of longevity (each extra year of longevity assumed rises the liability calculation by about 3 per cent), makes it best to remain cautious even if the DB pension scheme’s assets are rising in value.

In fact it is vital that you act now. The credit crisis has exposed the real risk in defined benefit pensions and this has raised awareness among all the stakeholders – from shareholders and trustees to lenders and potential new recruits. Investors and management talent are going to be wary about getting involved with companies who haven’t faced the future with clarity.

FINDING SOLUTIONS

The good news is that, if you take action now, the situation may not be as intractable as you think - as long as it is approached realistically and addresses the full range of issues.

But what can you do?

Of course, each case is different and requires careful individual analysis, but the key points

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David Cheyne
Chairman, Criticaleye

“There need not be conflict between the company and the trustees/their advisors - although there often is!

If the company representative (generally the CFO) develops and maintains a good relationship with the Chair of Trustees, and if they both conduct themselves professionally and with integrity, then the appropriate solution can be reached without intervention from the Regulator or other third parties. To achieve this there will have been:

- Open, honest and effective communication
- Mutual respect and understanding of each others’ roles and duties
- A good dose of common sense and pragmatism
- Advisors who can balance the ever changing technical requirements with the softer aspects of a negotiation, whilst simultaneously protecting their respective clients from challenge

As discussions around solutions to pensions issues are not often ‘black and white’, when there are shades of grey, the professional integrity and values of the personalities involved will be tested.”



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Ian Harley, Chairman, Rentokil Initial Pension Trustees

“The key to all of this is the trustees’ view of the employer’s covenant, and the regulator’s view of the same. Having a professionally, and independently validated view of the covenant’s worth, and therefore its longevity, is an essential precursor to any debate about the funding position. If this view is shared with, and shared by, the employer, it makes for a much quicker and easier dialogue. The opposite, unfortunately, is equally true! Nonetheless, it is still a good idea to seek such a third party validation up front: it gives the trustees a firmer jumping off point in any negotiations; it inserts a buffer between the trustees and the employer if things get sticky; and it reassures the regulator that the trustees are taking their responsibilities seriously. Everyone wins.”

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Why compare a DB pension scheme to a 200kg gorilla? Because, unchecked, it can cause huge damage to your company

generally apply both to the employer and the trustees. Here are some thoughts:

1. Don't ignore conflict – address it

It is inherent in pensions governance that there will be conflict. Trustees have different priorities to the corporate management team and, even within the boards of both, there will be different agendas.

By addressing these head-on and seeking compromise, progress can be made. After all, both have a common aim in the success of the business and achieving a well-funded pension scheme.

2. Identify and calibrate your risks and then monitor them continuously

If you picture your pension commitments as a pipeline running 20-30 years into the future then, if you were to cut it at any point, you would find the same four risk quadrants:

- Liabilities
- Assets
- Governance
- Employer Covenant

By examining each segment of each quadrant, and looking at all four together, you will get a much better understanding of your position.

How recently have your risks been calibrated between the stakeholders? Do they match your corporate risk? Are they doubling up? Does the company have the same view as the trustees on interest rates and inflation? Which, if any, of the ‘seven dwarfs’ (the various pensions/ valuation/ liability methods) should you be most

concerned about? And, over the life of your pension liabilities, how are each of the four risk quadrants likely to change?

3. Build a strategy and execute it at the right time

It may be better to act now, or it may be better to address problems over the next five or ten years. Either way, only by putting a clear strategy in place now can you address your risk and stop the pension scheme from taking control of your future.

BUT WHAT IF THE GORILLA IS ALREADY IN THE GARDEN, DEMANDING BANANAS?

The sudden, often unexpected, appearance of the gorilla (and the associated demand for bananas – recovery plan payments) can cause management and the company’s banks to rethink cash flows and lending facilities.

Companies and their banks will wish to review their financing terms and ask:

1. Does the recovery plan affect the ability to pay interest?

If the company agrees a schedule of recovery plan payments with the pension scheme, should these be included in the Interest Coverage Ratio calculation to ensure that the company can continue to make interest payments? Can the company borrow from the bank to make payments to the pension scheme?

2. What about King Kong?

If the company is liquidated, the accountant gorilla in the garden will get much larger indeed. The pension fund will have an

unsecured claim against the company for the difference between its assets and the estimated cost of buying-out the pension scheme liabilities in full with an insurance provider (the s.75 buyout deficit). The bank may find that any unsecured facilities that it has with the company suddenly have to share liquidation proceeds with King Kong, not the accountant gorilla. Should this be reflected in the Net Debt Coverage Ratio for unsecured borrowings? Should the Bank ensure that all borrowings are secured?

¹ The so-called seven dwarfs of pension deficit valuation are: transfer values, FRS17/IAS19, Pension Protection Fund basis, Scheme Funding, Economic (swap rate), gilts-matching, S75 Buy Out.



COMMUNITY COMMENT

Anthony Arter, London Senior Partner & Head of Pensions, Eversheds

“From a legal perspective, the changes to the scheme funding regime in 2004 have required both employers and trustees to rethink their approach to managing scheme deficits in both financial and governance terms. In addition, the Regulator is taking an increasingly active role in dictating the issues which employers and trustees need to address in assessing scheme funding. The Regulator is also developing its own powers, including intervening where it feels scheme funding is not appropriate. As this article neatly highlights, this means there are considerable challenges for those involved with DB pension schemes which, when added to the changing economic landscape, means it is vital both for employers and trustees to keep scheme funding high on their agendas and under constant review.”



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Geoff Eaton, CEO, Uniq Plc

“For many companies with legacy pension schemes, the scale of their deficits has become disproportionate to the scale of the surviving employer covenant. The treatment of this pension deficit as a debt threatens the solvency of the employer. In these cases, the pension trustee and regulator face quite a challenge in determining what is in the best interests of the pension members. There are a number of options:

- They could facilitate a **debt for equity swap** and accept the risks and rewards of ownership in the hope that the business value can grow to satisfy the needs of the scheme
- They could improve the ability of the employer to service the pension debt through facilitating the **raising of new capital to strengthen the covenant**. This approach increases the chance of delivering full benefits, with lower risk, but does require the return on new capital to be unfettered
- If the risks of business recovery are too great, or the cash needs of the scheme are more immediate, they can elect to optimise the short term cash that can be raised by the employer in a **final settlement of the pension debt**. In this case, if there are sufficient assets in the scheme, an insurance policy can be purchased to secure benefits above the pension protection fund.

To help employers and trustees optimise the value of the business and to judge what is in the best interest of members, there is a need for a clear set of guidelines. Uncertainty caused by disproportionate pension deficits undermines business confidence and limits the potential for value creation for the benefit of all stakeholders.”

3. Do recovery plan payments constitute a preference?

Are recovery plan payments being paid from the company’s profits, reserves or borrowings? Should each recovery plan payment be accompanied with a pro-rata reduction in the bank’s unsecured borrowings, or a rebalancing between unsecured and secured borrowings?

WHAT ABOUT THE TRANQUILIZER GUN?

For many pension funds, the value of the employer covenant is their most significant asset. Yet, for the company, the pension

Discussions around pensions issues are not often ‘black and white’. It is in the shades of grey where the professional integrity and values of the personalities involved are tested

deficit can prevent them from successfully operating as a business. Companies and banks may be thinking about the tranquilizer gun – how to restructure the business and the DB pension scheme successfully in order to maximise the future opportunity for the success of the business, the repayment of bank debt and the payment of benefits by the DB pension scheme. In any restructuring, the starting point is the provision of a fair and externally verified enterprise value of the company to the bank and the trustees, to allow the corporate management team to put a value on the employer covenant. For the trustees, a restructuring solution may be a realistically achievable next best option either to ‘business as usual’ or liquidation and provide the pension scheme with a one-off payment that might not be capable of realisation once the Air Force has been sent in to liquidate King Kong.

Where the scheme’s assets are insufficient to purchase a level of benefits in excess of those provided by the Pension Protection Fund (the PPF), the company and its banks will need to negotiate the terms of the restructure with the PPF instead of the trustees. The PPF will generally only act once the insolvency of the company appears inevitable, will

only consider any proposed restructure if it offers a significantly better outcome than would be achieved via an ordinary insolvency (and is considered fair given what other creditors and shareholders are to gain) and will seek to take an ‘anti-embarrassment’ equity stake in the restructured company of 33 per cent (or 10 per cent if new money is put at risk in the restructured company).

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Richard leads the BDO Pensions Advisory Firm. Prior to this, he was head of Pensions at Swiss Re. Richard led the Pension Corporate Advisor initiative at PwC and has also advised the Pension Protection Fund on its initial risk-based levy and the Pensions Regulator on its original Clearance Guidance rules. Richard has also Co-founded two high-profile public to private turnarounds, including the first ever pre-pack, as well three highly successful IPOs.

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