Exchanging uncertainty for certainty

JOHN TOWNER EXPLAINS HOW UNDERTAKING A PENSION BUYOUT CAN TRANSFORM A COMPANY'S PENSION DEFICIT INTO A MORE ATTRACTIVE AND STABLE LIABILITY

Imagine you are about to go into a meeting with your FD to provide an update on a number of treasury initiatives. You have been looking forward to this meeting for a while, as several of your projects are nearing completion and things generally are ticking along well, but then there is your pension scheme. If you are like most companies in the UK, the news on this front will not be good.

The Pension Protection Fund estimates that defined benefit pension scheme deficits have increased from £158bn in May 2013 to £302bn in March 2016. Although deficits fluctuate, they have increased by £80bn from the start of the year to the end of March alone. This increase can be seen in the context of the near £190bn that companies have contributed to their respective schemes since 2008.

While the pension scheme may feel like the proverbial black hole, your situation does not have to be all bad news. On the bright side, FDs – compared with other stakeholders involved in pension schemes – can think more holistically and consider how the pension scheme fits into the wider capital structure of the company. Within this wider context, an interesting question to ask is whether there are ways you can transform your pension deficit into a more attractive liability.

One way this can be accomplished is by funding a pension deficit through a bond issue or other form of financing and then undertaking a buyout with an insurance company. A buyout, which is achieved with the help of specialist advisers, would transfer the responsibility of meeting your pension obligations to an insurer, thereby enabling you to remove the deficit from your balance sheet. Companies in the US, such as Kimberly-Clark, have used this approach to replace their volatile pension debt with contractual debt. A similar rationale exists in the UK.

UK pension deficits have several unattractive characteristics compared with other forms of debt, which could make this course of action attractive. First and foremost, pension debt is risky and volatile. A pension scheme's liabilities are a complex combination of interest rate, inflation, longevity and other investment risks, which are difficult to hedge, let alone manage. While pension trustees and their advisers have made great strides over the past 10 years increasing risk management within schemes, they nonetheless continue to struggle with low interest rates, volatile markets and increasing life expectancies, as evidenced by persistent deficits.

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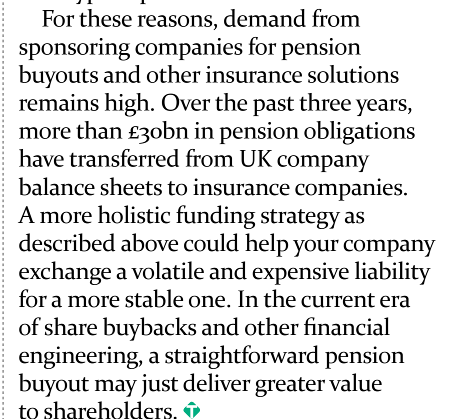
Secondly, the covenants that underpin pension deficits are difficult to control. Trustees have considerable power under UK pension regulation to call on sponsoring companies to make extra cash contributions when deficits arise; not to mention the regulations themselves are subject to change. In addition, pension deficits tend to arise in less favourable economic environments at exactly the same time that a company may have less cash on hand.

Finally, the costs of running a pension scheme are significant and often underappreciated. To keep a pension scheme running, an entire food chain must be sustained. Asset managers, consultants, actuaries, administrators, lawyers and dealing counterparties all extract fees before any investment return is generated, irrespective of how successful (or not) the pension scheme is at generating return. For many pension schemes, these costs can run in excess of 0.50% per annum. While this may not feel like much, the scheme will essentially leak this amount every year, and if expenses were provisioned for in the valuation, they would have the effect of adding another 7.5% to the value of the liabilities today for a typical pension scheme.

For these reasons, demand from sponsoring companies for pension buyouts and other insurance solutions remains high. Over the past three years, more than £30bn in pension obligations have transferred from UK company balance sheets to insurance companies. A more holistic funding strategy as described above could help your company exchange a volatile and expensive liability for a more stable one. In the current era of share buybacks and other financial engineering, a straightforward pension buyout may just deliver greater value to shareholders.



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