Even though there are plenty of ways to solve the problem of balancing pension costs, with de-risking a key option, the choices require careful consideration.

The equation is simple: the more you pay, the less risk stays on the company’s books. But the costs can become prohibitive. Finding the right point of balance is more than a tap of the calculator away – it requires plenty of thought and, more importantly, plenty of communication between the stakeholders.

From this starting point, a Financial Director web seminar, sponsored by Aon Hewitt, analysed the various decisions to be made to manage a defined benefit pension scheme. The backdrop for pension schemes has, in recent years, been relatively stable – but this has been “deceptive”, warns Paul McGlone, a partner at Aon Hewitt.

The majority of pension schemes are still substantially exposed to movements in interest rates and inflation. Although investment by schemes into equities has been made to diversify portfolios, it is also another area to risk-profile.

“It’s something the [pensions] regulator is paying a lot of attention to, in that it requires schemes to put a ‘value of risk’ figure on there,” says McGlone. “We think that’s the regulator’s way of just reminding schemes that there is quite a lot of risk in them still.”

With bond yields falling, schemes are “very much still risky beasts”.

Alastair Murray, CFO of Premier Foods, probably echoes the sentiment of many of his contemporaries when he claims that the company pension scheme could be thought of as its “financial services division”.

Premier, which has one of the biggest pension schemes outside the FTSE 100, restructured its pension scheme a year ago, granting its trustees security of up to £450m, launching a rights issue, and subsequently lowering its annual contributions by £161m.

“It may well be the case that [a scheme is] bigger than the company itself – it may have different dynamics and it’s operated under a completely different set of objectives,” he explains. “So it is critical as an FD that you understand what’s happening in your pension scheme and that you engage with it.”

Finance chiefs must take a holistic view of the situation. They must gauge the pension scheme position (this is likely to be a deficit), understand how it is represented in the accounts, and appreciate the risks it faces. From that point, a strategy must be formed, and then communicated to the trustees.

Jim Smart, a multiple trustee chairman as associate at BESTrustees, says that his peers should be striving to gauge the waltz of risks facing both the scheme and the business and gain appropriate funding. Part of this strategy needs to involve an understanding of the company’s attitude to the scheme.

“Trustees have this legal responsibility to see if the money is available, and over a long period of time all companies change and managements change. You can only take so much on trust the company is willing and able to pay those risks when they occur. So there is a natural push for trustees to improve their funding level as a way of de-risking the scheme,” he says.

Quite simply, the tension between the trustees and company executives will sit where there is disagreement about the strategy laid out to manage the scheme. For example, McGlone explains, it is difficult to manage the accounting for a scheme while providing it with ‘full’ funding: “You can’t do both at the same time, at least not to the same extent, so you need to build consensus about what you’re trying to do.”

One of the biggest differences between the two parties is in the timescale in which they think. Smart suggests that a trustee may see liabilities that will stretch out for decades, where company executives may think of three years as a long term. Conversely, corporate strategy over those few years may be pivotal in securing its future, and the future of the scheme funding, for many years ahead.

“You can’t be blind to the company’s plans. If you demand a lot of money that takes cash away from investment that would strengthen the company, then you’re not doing any good to your long-term prospects of paying your pension liabilities,” says Smart.

Take the lead
While three years is a long time, Smart wants long-term relationships to be formed that sit outside communication between the two that is often focused on the actuarial valuation.

“It is important for companies to take time and explain to trustees what the plans are in the short term, the medium term and the long term. To explain why the company management think that it is possible for them to run the extra risk they want to run, and pay for it when it’s crystallised rather than give all the money to the pension fund up front,” he says.

Premier Foods’ Murray believes that companies should take the lead in
better communication, particularly as they experience change in the business environment on relatively regular occasions, particularly with more substantial schemes. External advisers can help in such discussions, Murray points out. Smart concurs, explaining that even in the most extreme situations there is always some common interest between the two parties.  
“"In the 'Venn diagram' of things that are in the interest of the company and things that are in the interest of members, there is always some in overlap," says Smart.  

Aon Hewitt’s McGlone says that openness and transparency of the full situation, for both sides, tends to help bring them together towards a common goal. An external adviser, taking a quasi-mediation role, can provide a description of the nature of the risks to which the scheme is exposed as well as potential solutions, including timescales and the costs involved, he suggests.

Many UK pension schemes are unprepared to take swift advantage of opportunities in the risk settlement market.  
Aon Hewitt’s survey of 135 schemes over the past two years found that, in periods of favourable pricing for settlement transactions, schemes are likely to be jostling for the attention of resource-pressured insurers – potentially missing out.  

“Market opportunities to settle risk can arise at short notice – the current opportunities in the medically underwritten market are an example of that,” says John Baines, principal in Aon Hewitt’s Risk Settlement Group. “Schemes that can demonstrate they are genuinely ready will be taken most seriously by insurers, and typically secure the most attractive terms.”

Paul McGlone, partner, Aon Hewitt  
Paul McGlone is a partner in Aon Hewitt’s Retirement Practice. He is a qualified actuary and has more than 20 years’ experience advising a range of clients from both a trustee and corporate perspective. He has a particular interest in the mid-market, and is passionate about taking the ideas developed for the largest schemes and ensuring that they reach smaller schemes quickly. In recent years, he has led Aon Hewitt’s advice on de-risking through flight plans and trigger strategies. He is a regular speaker on pension topics and a member of the Council of the Society of Pension Consultants.

Jim Smart, associate, BESTrustees  
Jim joined BESTrustees in 2013 and his current portfolio includes six trustee appointments – three as chairman. These pension funds are in diverse sectors such as financial services, construction and manufacturing. In size, they range from £150m to £3,500m and include both DB and DC arrangements.

Prior to joining BESTrustees, Jim held a number of senior positions in finance and HR, including HR director at Abbey National, CFO at Boots Group, CFO at Friends Provident and CFO at Premier Foods. He was also a non-executive director at F&C Asset Management. He is currently non-executive director at the Food Standards Agency.

Jim is a fellow of the Chartered Association of Certified Accountants, a member of the Chartered Institute of Public Finance and Accountancy, and has an MBA.

Alastair Murray, CFO, Premier Foods  
Alastair Murray was appointed CFO in September 2013. Prior to joining Premier Foods, Alastair spent ten years at Dairy Crest Group as group FD, where he helped lead a significant restructuring to simplify the business, creatively addressing its pension deficit and reinforcing its position as an industry leader. Previously, he was the group FD at The Body Shop International.

Earlier in his career, Alastair was a divisional FD at Dalgety plc and spent 13 years in various finance and operations roles at Unilever. He graduated from Cambridge University with an MA in engineering and also holds an MBA from Cranfield Institute of Technology. He is a fellow of the Chartered Institute of Management Accountants.

“Whether [the problem] is to do with interest rate hedging, or longevity, there are a set of solutions and we need to work out which one works for all of us,” McGlone adds.

The panel, turning their thoughts to key short-term risks, flagged up managing interest rates as a key priority. Trustees should be turning their attention to matching their scheme assets against their liabilities to look for risk, rather than looking at market return rates. In other words, invest to minimise interest rate risk by matching cashflows better, Smart suggests.

Premier Foods’ Murray agrees, saying that understanding the risks inherent in growth assets should be second on the agenda: “What risk is being run within the growth portfolio, how diversified is that risk, are there other ways you can do it, are you at the right place on the risk return trade-off within that portfolio?”

Another key risk management issue comes when liabilities are bigger and more volatile than assets – then, dampening the risk in those liabilities must be a focus. “That will pay dividends because it makes it that much easier for the assets to do the job they’re meant to do,” explains McGlone.

The longer-term goal of both the scheme sponsor and the trustees seems well aligned. Trustees want a well-funded scheme with little chance of having to go cap-in-hand to the sponsors, and sponsors want to focus on their business without being hamstrung, or caught out, by a funding issue the scheme. But in achieving that aim, McGlone suggests that the vast majority of schemes are probably over-funded: a “dilemma”, as he describes it.

Issues arising from this can include trustees finding a use for surplus funds to buy out members’ benefits, or the funds staying trapped within the scheme for a long time, when the funds would be better served utilised by the business. But there are options to provide security to trustees without locking away capital – McGlone cites escrow accounts, reservoir trusts and other forms of alternative financing.  

The Financial Director web seminar, Too expensive? Too risky? Getting your defined benefit pension scheme under control, sponsored by Aon Hewitt, is available to view online. Visit financialdirector.co.uk/seminars-
events to access the archived video.

March 2015 | financialdirector.co.uk | 43