Your best bet?

David Norgrove, Long Acre Life, considers whether pension buyouts are necessarily the best use of shareholder funds

The latest headline pension deficit figures, which suggest that the total defined benefit (DB) pension deficit of UK plc has more than doubled over the past year, provide yet more evidence that schemes are continuing to run extremely large, and unhedged, risks. While some schemes may bemoan that bond yields and equity markets have been especially unkind over the past year – which is true – doing so misses the point. It is becoming increasingly clear that continuing to run such large bets on equity prices, interest rates, inflation and longevity – bets that have consistently gone against pension schemes for many years – threatens the financial viability of some corporate sponsors.

Indeed, the financial health of many of the UK's large public companies is intrinsically linked to their DB pension scheme, with the funding position acting as a conservative indicator of how much cash the company is likely to have to contribute into their pension schemes in future years. Left unmanaged, DB pension risk leads to funding volatility with implications for a company's balance sheet, cashflow and income statement. In most cases, these risks are far from insignificant. Indeed, the FTSE 100 is home to no fewer than ten companies with pension liabilities greater than their market capitalisation. And other companies are pension zombies: they really only exist to support their pension schemes.

What is more, regulatory and accounting changes are not only making the impact of pension risk more pertinent, but also making it more visible to the markets, with knock on effects for shareholders and other stakeholders. The increasing visibility of pension risk is having a growing effect on borrowing ability, with lenders becoming more cautious given recent high profile insolvency cases where pension schemes have been given "super-priority" – requiring pension liabilities to be paid prior to any other debts.

Looking for opportunities

Against this backdrop, de-risking DB pension schemes is now one of the most crucial challenges faced by scheme sponsors. And with the "end game" the desired destination for most, the only remaining questions centre on how they get there and whether they are large and sophisticated enough to efficiently manage the journey themselves – and effectively become an insurance type undertaking – or instead pass the problem on to an insurer.

What is more, with companies' cash flow growing 40% since the depths of the financial crisis, many companies are looking for opportunities to put shareholders' funds to good use. Whether it makes sense to use this excess cash to transact on a pension buyout depends very much on the individual company and its alternative use of capital. That said, innovative approaches to pension buyouts may increase the appeal from a corporate finance perspective, with positive accounting implications to boot.

The return on capital

To address whether a conventional pension buyout is a good use of a company's capital, we must first consider the economics of the transaction in more detail. Buyouts have commonly been priced at about 140% of the valuation of a scheme's liabilities on an IAS19 basis – made up of the insurer's best estimate of the value of the liability (say roughly 120% of the IAS19 liability) plus an additional 20% that represents the insurer's profit. That 20% of profit counts towards the capital the insurer is required by the regulatory authorities to provide to back its liabilities. Then, roughly speaking, the insurer itself is required to put up another 20% of capital as equity, making a total of 40% of capital to back the 120% liability.

Typically, the insurance profit component of the buyout premium is calculated by targeting a return on capital (ROC) of 12–15% per annum (this is what the insurer's shareholders expect to earn). To put it simply, in a conventional buyout, pension scheme sponsors are implicitly renting capital at 12–15%. Whether it makes sense or not to do so depends entirely on the company's alternative use of its capital.

With managements sometimes reluctant to return cash to shareholders for fear of being seen to lack investment opportunities in their businesses and with equity markets relatively strong in comparison to expectations for the economy, most companies are either opting to re-invest excess capital in their day to day business operations or just sit on it, earning very low returns.

Compared to re-investment in the business, if the company's ROC is equal to or exceeds 12–15%, then entering into a conventional buyout to remove all of its DB exposures would in fact prove a more economically attractive option. However, if the ROC of the business is lower, a conventional buyout may represent a

Norgrove more innovative approaches

In a nutshell

- the cash position of UK plc is relatively healthy and, as such, many companies are looking for opportunities to put shareholders' funds to good use
- whether it makes sense to use this excess cash to transact on a pension buyout depends very much on the individual company and its alternative use of capital
- innovative approaches to pension buyouts may increase the appeal from a corporate finance perspective, allowing pension schemes to recapture some of the profit that would otherwise be transferred to an insurer.

significant transfer of value from the company's shareholders to those of the insurer.

Analysing the decision in this way raises an important question – if the buyout premium contributes half of the insurer's regulatory capital, why not consider making an equity investment to recapture all of the insurance profit? After all, this approach mirrors the captive solutions used by many large companies to manage other risks (such as property and casualty). This approach – which has been adopted by Long Acre Life – reduces the eventual cost of buyout as it allows the retention of some or all of the profit (at a 12–15% ROC) that would be paid to an insurance company. And so long as there is an appropriate proportion of external capital, the pension scheme should not need to be consolidated on the company balance sheet.

From an accounting perspective, this structure involves an initial hit to the profit and loss account similar in value to a conventional buyout. However, the key point here is that the equity investment (which can be up to 20% of the total value) will be recognised as an asset on the company's balance sheet.

Without going too deep into the technicalities, regardless of whether a sponsor accounts for its investments on a fair value or equity accounting basis, it can expect an immediate increase in the value of its initial investment – with this increase recognised as a profit in its income statement at the time of buyout. This profit will partially offset the buyout loss recognised in the sponsor's financial statements and may reduce the final buyout cost from 140% to around 120% of the value of IAS19 liabilities.

A matter of timing

However, even with the availability of solutions which allow pension schemes to recapture some or all of the profit that would otherwise be passed on to an insurer, there remains a reticence on the part of sponsors and trustees to transact. Some wish to avoid locking into a transaction when funding levels are low, others feel that they can benefit from an unmatched growth strategy.

The first of these concerns is perhaps the more legitimate – indeed, the absolute price of buyout is intrinsically linked to the individual scheme's current funding measure and therefore linked to its position with respect to volatile investment markets. Given global long term economic uncertainty (which has reduced pension scheme assets) and record low interest rates (meaning large pension liabilities, as they are discounted using this value), funding levels – and hence the cost of buyout – compare unfavourably to those before the financial crisis, or even the start of last year.

However, companies may have to accept that better conditions continue to recede into the future. Indeed, interest rates have been at record lows for three years, with little indication this will change in the foreseeable future. Add to this the fact that many pension schemes have already completed interest rate swaps – mitigating their risk, but also reducing their upside benefit from interest rate swings as well as moving the valuation of liabilities closer to that of an insurer – and one could argue that there may be no better time than now to prepare to remove pension liabilities from the balance sheet.

The idea that an unmatched growth strategy may be in some way beneficial is also fundamentally flawed. Indeed, bets made against interest rates, inflation, or longevity have to date destroyed tens of billions of pounds of shareholder value, with corporate sponsors forced to pour cash contributions into their schemes to make up funding shortfalls. And although interest rates are currently low, the expected benefit over the next three years from being underhedged is not significant – so pension schemes should have a plan in place to reduce this risk, along with any others they may be running.

To do so, schemes need to engage with buyout experts able to advise them on the potential routes through the thickets. Risk transfer activities such as longevity swaps, synthetic buyins or deferred buyin/buyouts are all legitimate precursors to a full buyout, for instance, moving schemes well on the way to an insurer's best estimate of the liability and reducing the extra cost of a buyout. The journey towards a buyout may be a long one for some schemes, but this makes it all the more important for them to get started.

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