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A fresh look at pension risks

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The financing of pension liabilities is now a stubborn boardroom issue for most multinationals. Over the last couple of years, many chief executives would be forgiven for thinking of pensions as a naughty child seeking attention by continually creating bad news and difficulties even for the well-run corporation. Having muscled its way up the corporate agenda, pensions now stand as an issue needing a disciplined approach. This article will cover several issues of concern to pension plan sponsors, including pension risks, how pension liabilities affect the balance sheet, and some insights into how analysts are viewing pensions.

Risk or risky business "At the overall portfolio level, risk is related to failure to meet objectives." – **Tim Gardener, Mercer Global Investment Leader**

Casinos offer gamblers opportunities to take risks – more precisely, uncompensated risks. The chance of winning, and sometimes winning big, thrills customers and lures millions to take these uncompensated risks daily. How can risks be "uncompensated" if every day some gamblers walk out of casinos as winners? Although each gambler hopes to win, he actually expects to lose because the odds favour the house. Stated differently, casino management engages in a "**risk** business" (conservative risk management to ensure financial stability) while their customers enjoy "**risky** business" (expecting to lose but paying for the thrill of possibly winning).

The question that pension sponsors and trustees worldwide must ask is "Are we managing our pensions as a *risk* business or simply enjoying the thrill of *risky* business?" Plan fiduciaries are responsible for acting in the best interest of participants, so fiduciaries should choose the *risk* business paradigm over that of the risky business paradigm.

This article highlights some basic risk decisions that pension fiduciaries face and provides a framework for analyzing policies and actions. We then look at the issues from the viewpoint of the company sponsor, and finally summarise some emerging thinking on the part of equity and credit analysts on the impact of risk decisions on shareholder value and sponsor credit.

Pension risk decision framework

Five key policies are established by sponsor management and plan fiduciaries: (1) benefit design, (2) funding, (3) investment, (4) accounting, and (5) governance. Although pension governance structures vary by country, they share the duty to manage plan assets in the participants best interest. Many pension professionals talk about "funding risk" or "volatile expense," but the only policy that can change the risk profile today is investment policy. Certain funding and accounting policy decisions can "smooth" financial outcomes, but not the real cost.

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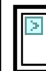

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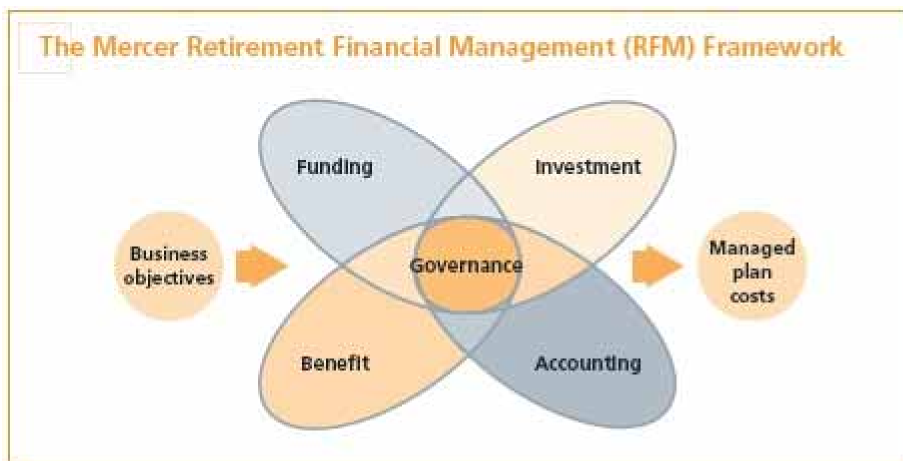

Risk management – Lesson 1

Rational risk management has three basic principles:

1. **Seek compensable risks**: Take only compensated risks; hedge all risks that are both hedge-able and uncompensated.
2. **Establish an amount of risk capital**: Know how much capital you can afford to lose; this amount becomes your "risk budget".
3. **Spend your risk budget efficiently**: Choose a collection of compensable risks that maximizes expected return but is limited by the risk budget.

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Looking at liabilities, hedging risks

A company s offer of lifetime retirement income through defined benefit plans accomplishes a very specific workforce goal – attracting and retaining the right workers. Typical benefit provisions vary by country, but all plans create debt for the sponsoring company. Because the total payments for each participant are uncertain, the amount of the "debt" is influenced by both capital market risks and demographic risks. Common demographic risks include age at retirement and (most importantly) age at death. These risks can be estimated actuarially for a given population but can never be known for certain at the individual level.

The capital market risks embedded in pension obligations are nominal interest rate risk and inflation risk. These are non-compensable risks that can be hedged through appropriate allocation of nominal bonds, inflation-indexed or real-return bonds in countries where these investments are available, and a collection of fixed income derivatives including swaps and futures. By hedging non-compensable risks (risks that offer no incremental expected return), a risk budget can be more productively allocated to compensable risks.

Going back to "Lesson 1" above, capital market risks embedded in pensions can be hedged, while demographic risks cannot – one reason why annuities appear expensive. There may also be many logical arguments for not hedging in this way and budgeting for risks that are compensable – for example, supply and demand issues or taking the risk of equity investment in order to enjoy the return.

A footnote: while this might be straightforward in one currency, remember that a multinational company must also consider the nominal currencies of both assets and liabilities, wherever held.

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Through the looking glass: Assets, risks that are compensable

Turning to the asset side, the decision on the optimal risk profile for assets is typically viewed as the allocation among equity and other investment classes, including private equity, venture capital, real estate, and hedge funds. Deciding how much of the total fund should be allocated to compensable risks should be based on the following factors:

1. Relative size: The size of pensions worldwide should be considered relative to the size of the sponsor on a number of bases. Currently, credit analysts and equity analysts use plan deficits relative to total debt and total shareholder value as key measures. Although useful for current valuation, the plan deficit measure does not indicate the potential for future problems, particularly when there is no deficit. Only by comparing the total of all pension obligations worldwide to the balance sheet of the sponsoring company and projecting these obligations into the future can one get a clearer picture of risk.

2. Corporate sponsor strength: The sponsor s credit rating is a fundamental measure of a company s financial strength. Stronger ratings can justify greater risk budgets and more compensable risk-taking. Companies with weaker ratings should adjust risk "budgets" down accordingly.

3. Plan s funded status: Large surpluses in pension funds can insulate the corporate sponsor from future funding requirements and a larger risk budget can be justified. But large surpluses can also erode quickly, as we saw during the bear markets of 2000 – 2002, when some sponsors lost surpluses that were equal to or greater than the liability.

Looking at these dimensions more closely from the point of view of the company sponsor, we can see pension liabilities as an integral part of the company s overall balance sheet.

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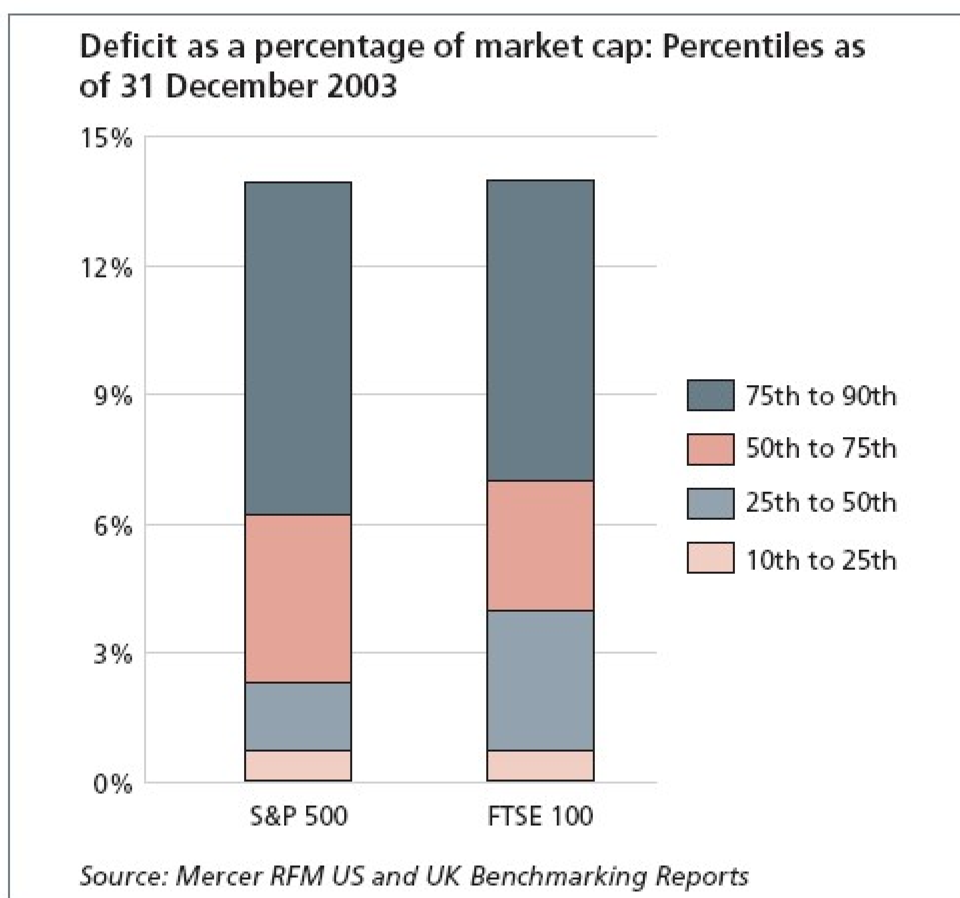
A closer look at pension liabilities

As of the end of 2003, of the FTSE 100 group of companies in the UK, 25 had pension liabilities that exceeded 40 percent of their market capitalisation. For another 25 companies, pension costs represented at least 11 percent of operating profit. Pension liabilities for US S&P 500 companies were also material – nearly two-thirds of the companies listed had pension deficits and, in fact, 20 companies had estimated liabilities in excess of their market capitalisation. There are many metrics worth reviewing, but a good overall one is the relative pension deficit to market capitalisation, as gleaned from US and UK 2003 financial statements.

The chart below shows 2003 pension deficits as a percentage of market capitalisation for the S&P 500 and the FTSE 100 companies that maintain underfunded defined benefit plans, grouped into quartiles. To avoid skewing, the chart shows only interdecile data – that is, the upper and lower 10 percent of each sample have been omitted. By coincidence, both the S&P 500 and the FTSE 100 data top out at 14 percent. That is, when the companies in each group are ranked from worst to best, top to bottom, showing the percentage their pension deficits represent of their entire market cap, the worst offenders are at 14 percent in both cases.



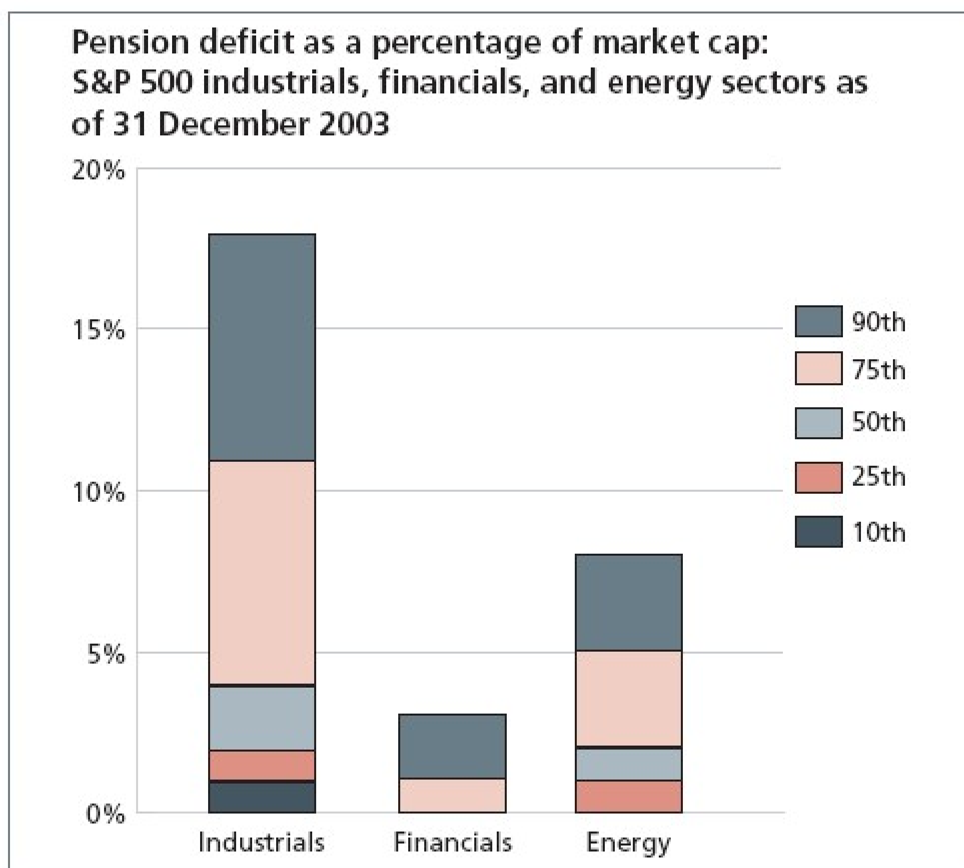
As we will see below, some very insightful observations can be made as we delve into specific industries.

Pension impact differs by industry

A business s history will be a key driver of the relative size of pensions. It is fairly obvious that historical factors can be common to many companies in a particular industry – which can also share other factors affecting the financial business model.

Although no business is "average," benchmarking against corporate averages or norms can give useful insights. Analysis against competitors can provide some clues in determining whether certain actions on pensions or the adoption of particular policies could conceivably be a source of competitive advantage. Taking a couple of simple ratios, such as deficits versus market capitalisation and annual deficit recovery as a proportion of net cash flow, demonstrates some marked differences among industries.

The graph below shows pension deficit as a percentage of market capitalisation for three particular sectors of the S&P 500: industrials, financials, and energy. As we can see, each sector has a very different story to tell with regard to this statistic. Not surprisingly, financial companies, which typically have large reserves of ready cash available to fund pension liabilities, have a relatively low pension deficit as a percentage of market capitalisation. Old-line industrials, which often have high capital and labour costs, typically have less money to fund towards pensions and higher pension liabilities. The end result is a high pension deficit, nearly 20 percent of market capitalisation at the 90th percentile! The energy sector is somewhere in between, with more variability between the percentiles.The last few years have been good for many energy companies, and several have made substantial funding to their pension plans, thus reducing deficits. But this trend has not been seen uniformly across the sector.



Simple analysis such as that shown above can be very valuable for organisations. Comparing your results to your peers can help provide a context for a business within which funding, risk management, and plan governance can be prioritised and better managed.

Increasing transparency

Recent changes to pension accounting standards (the implementation of FRS 17 in the UK, application of IAS 19 in Europe and elsewhere, and more disclosure requirements under US GAAP) have greatly increased the transparency of pension funding at the corporate level. As a result, analysts and other users of financial statements now have access to enough information to incorporate pensions-related risks into their models, and indeed are doing so. In many cases, these financial stakeholders have very different perspectives from those of company management and employees. In the UK, another emerging stakeholder is the Pensions Regulator – requiring plan sponsors to supply funding information and leading companies to pre-clear business deals as part of the mechanisms designed to support the new Pension Protection Fund.

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Emerging views of credit analysts and equity analysts

While analyst and rating agency perspectives are not uniform, it is important for company executives to be familiar with the principles they are commonly applying. Moreover, much of the theory behind these principles is difficult to apply in practice. But understanding and closing these gaps can allow your company to adopt a suitable, clearly

defined position for managing its pension funding risk.

Most of the major analyst firms (including ABN Amro, CSFB, Goldman Sachs, HSBC, JP Morgan, Morgan Stanley, and UBS) have issued research on pensions within the last three years. The depth of analysis evident in these papers is impressive, and the opinions expressed are remarkably consistent.

On the credit side, Moody s, Standard & Poor s, and Fitch have also released papers describing their approach to analyzing corporate credit. There are some common themes among them. And based on discussions we have had with them, their views continue to emerge – and converge – as they develop new ways to incorporate pension risk into their corporate risk framework.

Below are four emerging pension fund management principles identified by a number of analysts.We suggest that all involved in financing pensions should seek to understand these points – remembering that ignoring good thinking is foolish, but applying theory to practice blindly is foolhardy. Readers interested in more detail on this next section should read our **Global Retirement Insights** publication, which delves further into these issues.

This publication reviews four principles that inform most analysts and rating agencies analysis of corporate pension risk as well suggesting a framework for formulating and implementing retirement financial management policies. If you are not already registered at mercerhr.com, you will need to take a few minutes to complete our brief registration process before reading the summary or downloading the PDF.

Principle 1: Treat pension fund deficits as corporate debt

Defined benefit pension plans typically have the sponsoring company meeting the balance of cost, sometimes offset with employee contributions. So any shortfall in funding represents a liability for the employer. In many respects, this liability is just like other types of corporate debt, and analysts and rating agencies are treating it as such. “Deficit” is typically included as the difference between the market value of assets disclosed in company accounts and the corresponding measure of accrued pension liability.
Treating pension deficits as a corporate financial obligation is starting to affect credit ratings. For example, following a widespread review of the pension obligations of European companies, Standard & Poor s put ten companies on CreditWatch in 2003 based on their pension liabilities.

Principle 2: Companies should fund pensions fully – and, at times through borrowings

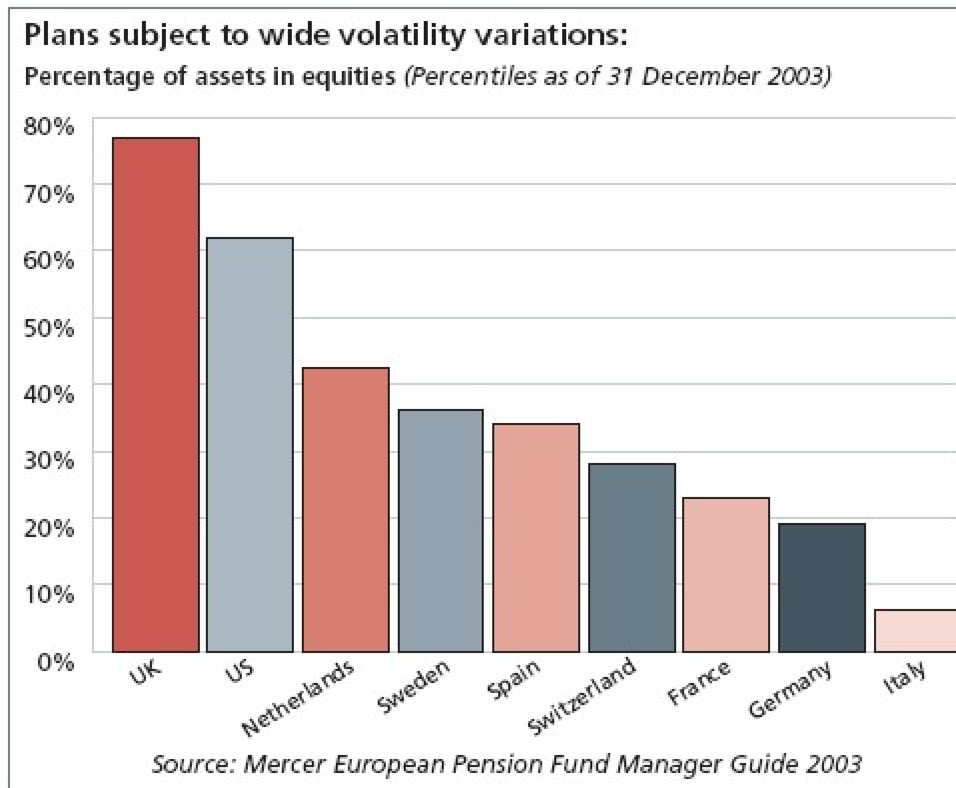
Rating agencies have said that some specific borrowings to fund pension plans that took place in 2004 were “essentially” neutral in credit terms. This is because the current cash requirements of the newly issued debt were no more demanding on corporate resources than the anticipated funding requirements of the pension obligations.We caution against drawing a general conclusion that all debt raising to fund pensions will be “credit neutral,” especially where pension deficits are large in relation to either outstanding debt or enterprise size. That said, rating agencies will focus on whether the debt raising increases or decreases future financial flexibility of the company – if the outcome is positive the effect could be beneficial. What is worth remembering is that discussions with the rating agencies about funding pensions using debt capital will reduce uncertainties related to the credit impact of such transactions.

Principle 3: Investing pension fund assets in bonds maximises shareholder value

In countries where funding has been the norm, pension fund investment strategy has traditionally been set by those managing the plan to maximise return on assets subject to risk and affordability constraints set by the sponsoring employer. In many cases, the resulting asset mix has been heavily biased towards equities.

Why are bonds better for shareholders? This argument depends mainly on transparency and a detailed tax consideration. The transparency point is that given sufficient information, rational investors determine the levels of equity and bond exposure they want in their personal portfolios based on their own objectives. Investing in equities in a pension plan will not alter the value of the assets there today and introduces more risk in a way that is remote and possibly unclear to the company shareholder. Investors would rather control their own risks (and for the same reason would not expect a company to invest in other companies equities).

The detailed tax angle relies on the point that individuals are taxed more onerously on debt than equities. But in most countries, companies can benefit from a tax shield on the interest cost of repaying their own debt while enjoying a tax-free return on pension fund assets. Thus, the shareholder gets more relative tax benefit than the individual from pension plan debt holdings than from equity holdings.



For the practical decisions over asset allocation, the interests of many stakeholders other than shareholders come into play, and the evidence above demonstrates that the historic balance of interests (including legislative and reporting frameworks) must have favoured equities in many countries. This principle is not yet widely held among analysts, being regarded as theoretical. But it has some staunch supporters and it is developing momentum. This principle is worth watching closely.

Principle 4: Adjust financial disclosures to recognise the true retirement cost

Analysts and rating agencies now have enough information available through FAS 87 and IAS 19 accounting disclosures to look past accounting adjustments so as to arrive at their own view of the true underlying picture. This “true cost” view typically removes the smoothing effect of any amortisation and reveals the actual return on assets. But most companies have yet to recognise this factoring out process in making plan management decisions.

Company management often spends substantial time and effort considering alternative return expectations and smoothing approaches. This is not surprising, given the potential impact of pension charges on gross earnings. Given that many analysts back out these adjustments as fast as management uses them, the situation calls perhaps for more recognition of the analysts views in company decisions.

Questions and ideas to consider:

Do you manage your global pensions as a “risk business”? Do pension managers in local geographies take risks that you believe are just “risky business”?

Good risk management avoids uncompensable risks and limits exposure to compensable risks based on a risk budget. Do you have the available frameworks and modelling tools to take a more sophisticated approach to the impact of pension risk on corporate credit and shareholder value – and to monitor it?

As you review the way your organisation manages pension risk, you might consider the following actions:

- Know what equity and credit analysts are saying about your company.
- Mercer s **Multinational Survey Report 2004 on Financial Management of Multinational Retirement Plans.**
- Communicate the relevant conclusions from the benchmarking to each of the local geographies.
- Determine your global pension risk budget and allocate it efficiently.
- Determine the necessary level of global oversight of local geography pension decisions, based on the aggregate level of worldwide pension risk to the organisation.
- Make all those involved in M&A activity fully aware of the corporate view on pensions, and organise an approach to regulatory and rating issues.

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Conclusion

No one needs reminding about the importance of financial risks in pensions. We have attempted in this article to offer a few suggestions for consideration in a hugely important area. If the three principles of property investment are location, location, and location, we would say that for pension finance they are understanding, understanding, and understanding.

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