



In an occasional series, we will be publishing opinion pieces by leading independent industry commentators. In this issue John Hawkins, director of Foresight Trustees Limited, writes about the risks facing the world of occupational pensions.

Looking out over the edge of a cliff where a large section just in front of you has fallen into the sea can be a worrying experience, especially when you are doing so from your bedroom window and you are far from clear whether another section is about to follow.

For most of us this is the stuff only of nightmares, but for many in the financial services industry a similar nightmare has not disappeared with the dawn. Those responsible for the running of occupational pension schemes, whether sponsors or trustees, have not generally considered themselves to be part of the financial services industry, although clearly they interact with it almost continuously. The risks resulting from this proximity are now clearer than ever. Reconsidering those risks at this time may sound like shutting the barn door after the horse has bolted, but the worst is not necessarily behind us.

A good understanding of the macro risk factors at work can benefit both sponsors and trustees. Let us start with the regulatory environment.

The Regulators

The Financial Services Authority (FSA) has come in for a fair amount of criticism over the last few months. Time will tell how much of this is justified. Meanwhile, Hector Sants, the newish Chief Executive (and a fellow alumnus of Phillips & Drew) has openly admitted significant shortcomings and recognised that in future regulation cannot be done on the cheap.

The thought that FSA salaries may be on the increase will no doubt come as a relief to a few recently unemployed bankers – to some people turning from poacher to gamekeeper has always had a certain appeal, especially when the alternative was the gibbet. Lord Turner of Ecchinswell, the even newer Chairman, has said that the era of light touch banking regulation is over. This is interesting and bears examination. The light touch of the FSA in the past has been the result of the political unacceptability of a heavy touch.

In the good times, the vast tax revenues generated by financial institutions meant that even if not immune to interference, they could at least dictate the terms on which it took place. With many banks now having sufficient losses to avoid paying UK taxes for several years, their political influence will clearly be less. Not to mention the fact that the government will be a shareholder in several and a guarantor of practically all.

Of course this alone should not make us sleep at night. Local authorities complying (apparently) with central government best practice guidelines managed to invest hundreds of millions of pounds with Icelandic banks, doubtless having heard from the Audit Commission that this was a 'good thing'. Some lessons seem hard to learn; how long ago was it that local authorities lost money with BCCI and by dabbling in interest rate swaps? In the future, the FSA may start to file its teeth, but will this also be true of the Pension Regulator (tPR)?

Alas the initial signs are that probably it will not, notwithstanding the proposed increases to tPR's powers that are currently being debated (as one observer commented, these are a bit like fitting another reverse gear to a Formula 1 racing car). A Financial Support Direction for Sea Containers, a Contribution Notice for the previous owners of Focus DIY and the (temporary) appointment of independent trustees at telent provide most of the public examples of tPR's interventions thus far.

No doubt more has gone on behind the scenes, but before the teeth are filed it would be fair to assume that the dentures need to be fitted. Will this change? The simple answer is only if the government leans on tPR to take a more robust position; this does not seem likely in current market conditions. This would require the government not just to begin to exert pressure, but to do so in a direction that is opposite to that in which it seems to have been pushing thus far. In fact, the recently announced DWP consultation on the employer debt regime suggests the opposite may indeed be the case.

Greater funding of pension schemes inevitably requires cash to be raised from (or denied to) other stakeholders. As we shall remind ourselves later, this is not always a bad thing for shareholders if correctly analysed, but its public perception is frequently negative. The accepted wisdom of tPR to date may be summed up as: if a company has enough money to pay off a pension scheme deficit, it does not need to do so; if it does not have enough money, it should not be forced to do so. Even with the commitment of the major banks to restore lending to 2007 levels, the access of most commercial and industrial companies to debt is likely to remain limited over the next couple of years at least. This is not the time to expect the government to ask tPR to visit the dentist.

Ah, I hear you say, what about the backstop of the Pension Protection Fund (PPF)? As a child of the 1950s, a Children's Favourites request that occasionally comes to my mind is Danny Kaye's rendition of The Emperor's New Clothes. If you had to choose a current example, the PPF would probably come

closest to the Emperor. The PPF staff are totally honest. They are the first to admit that the level of premiums being collected is completely inadequate to compensate for the risk being underwritten by the fund (roughly half of which, incidentally, they believe to be due to asset-liability mismatch risk).

They will also admit that increasing premiums to a 'market' level is politically unacceptable; in fact, they would probably have admitted this even before Lehman Brothers went to the wall. The fact that the PPF team has worked a minor miracle in bringing the organisation into existence so promptly and professionally does not detract from the fact that its finances are terribly flawed – it has been likened to a reverse tontine, with fewer and fewer funds responsible for an ever-larger deficit. Despite its length, the latest levy consultation will do nothing to solve this. Like the new clothes, however, for this to be mentioned (outside of a very limited circle) is quite unusual. By the time this article is published the PPF may have announced the identity of its third Chief Executive in something over four years. Whoever it is needs to tackle the hard political issues equally vigorously.

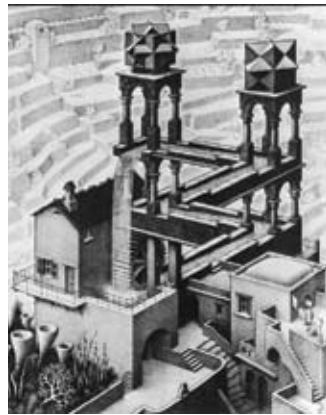
There is, incidentally, a possible solution to the PPF problem (even leaving aside the Argentine option of nationalising private sector pension schemes) – the government could simply admit that water can only be made to flow uphill Escher-like for so long and renege on the principle that the PPF will always be funded. After all, it has always been intended that the Financial Assistance Scheme should be paid for on a 'Pay As You Go' basis. Oddly enough the government might just get away with this for the PPF as well under current circumstances. It has always been intended that the Financial Services Compensation Scheme (FSCS) will be funded by post-event premiums levied upon those parts of the financial services industry that have contributed to claims upon it. By funding losses immediately from the public purse and only later seeking to reclaim these (as it has done over the last few months), the government has pleasantly surprised a great many claimants. Of course, the overall scale of the bail-out has been such that the incremental FSCS sums involved might be considered relatively paltry (although probably not from the perspective of an Equitable Life investor).

In a global economy we cannot ignore the actions (or not) of regulators and pseudo-regulators in other markets, the most important of which is clearly the US. The Federal Reserve, Treasury and Federal Deposit Insurance Corporation have certainly acted decisively, albeit making up the rules as they went along and failing to keep everyone happy all of the time; their respective heads, Bernanke, Paulson and the lesser known Sheila Bair are all generally deemed to have had a 'good crisis' so far, although Paulson has been more criticised and will have departed by the new year (his successor, Tim Geithner, previously of the New York Fed, is also seen as having grown recently in stature). The Securities and Exchange Commission has hardly been a bit player, but, now that the status of the last two major investment banks has changed, has to rank behind the first three in terms of importance. There are, however, two other institutions of relevance.

The legal status of the Pension Benefit Guaranty Corporation (PBGC) is not a mystery – its incorporation documents are easily available and written in plain English. What is less clear

is what they mean when it comes to government support in the event of insolvency. The closest analogies are probably Fannie Mae and Freddie Mac, so that the US Treasury's decision to bail them out (after decades of apparently poor management) should come as a relief to those with a possible claim on the PBGC. This group is likely to increase rather than decrease in size over the next few years. A feature of PBGC claims is that they tend to be clustered around industry failures – good recent examples are the airline and steel industries. While the financial services industry may just have escaped dumping its pension obligations on the PBGC en masse, this may not be the case with the highly concentrated remnants of the automotive industry.

Meanwhile, the investment strategy of the PBGC under its relatively new director has begun to travel in a retrograde manner. A previous director, Bradley Belt (now involved with Palisades Capital) had two quite controversial views: first, he listened to academic advice and moved more towards a liability matching asset portfolio; and second, he considered the old FAS87 accounting standard (which did not incorporate pension deficits on a sponsor's balance sheet) as "Alice in Wonderland"



accounting. While the accounting standard has changed and is unlikely to be reversed (notwithstanding the shenanigans elsewhere in connection with mark-to-market valuations), the PBGC did announce recently that it would be increasing its holding of equities, in order to "reduce long term funding costs". This argument is not new and what passes for a sensible discussion can be had on the merits of equity investments for pension schemes with strong sponsors. To use this argument in connection with the investment strategy of a guarantee fund, the claims on which are likely to be highly correlated to the under-performance of equity markets, is nothing short of bizarre.

Last, but not least in term of importance, is the national regulation of the US insurance industry. Those readers familiar with this sector will have spotted what appears to be an error – the US insurance industry is regulated on a state by state basis, something the states have fought long and hard to maintain, not by a single national regulator. Each state has an insurance commissioner, who as a group sit together on the National Association of Insurance Commissioners (NAIC), a body that attempts to co-ordinate capital and other requirements. Not all voices in the NAIC are equal, with some state commissioners, New York being an obvious example, having had a stronger say than others over the years. What this group was singularly ill-placed to do was organise the rescue of AIG when it became clear that it had serious problems (albeit little to do with traditional insurance), at which point the myth of state regulation was broken; even New York would have had problems coming up with \$150 billion or so (and rising).

Again this cloud has a silver lining. There are many observers (some with a vested interest) who believe the US mono-line insurers (i.e. the issuers of what amount to financial guarantees) may still suffer a further financial deterioration. If this were to be the case, a very large amount of bank assets would have to be written down further, something the US Treasury would presumably be very keen to avoid, given the extraordinary amounts of money it has committed directly thus far and the backstops it has provided to Citibank and JP Morgan Chase/Bear Stearns. Perhaps the most likely

outcome (notwithstanding US Treasury denials) is that at some stage part of the \$700 billion US Treasury fund is used to recapitalise, quietly, the mono-lines, but other salvation routes are possible.

So what should our working macro-level assumptions be? Within a few weeks this list might look outdated or even laughable, but for what it is worth, here goes.

- UK scheme trustees will bring more pressure on sponsors to fund, but will not be strongly backed by tPR. Recovery periods are actually more likely to increase than decrease over the next valuation cycle.
- The group of banks 'too big too fail' is probably larger than any of us would have guessed a year or two ago, but further actual defaults are not beyond the realm of possibility, particularly for banks from smaller economies.
- With AIG already having had to be rescued by the US government, it is possible that other insurance companies will find themselves in difficulties (although AIG's exposure to credit derivatives seems to have been uniquely high). In the UK this would mean further claims on the FSCS and thus increased costs for the survivors; it could be some time before we see a return to 'ultra cheap' bulk annuity quotations.
- We know that changes are coming to the PPF, but it may be easy to underestimate these. In particular we should not forget that the PPF does have some flexibility on the level of benefits it chooses to pay.



Let us now look more closely at some of the implications arising from these assumptions. There is no intent for the topics covered to be comprehensive and we shall deliberately steer clear of the 'normal' risks faced by pension schemes, some of which may have been exacerbated by recent events.

Sponsor-trustee tension

The tragedy of Robert Maxwell's raid on the Mirror Group pension scheme was not its impact on the scheme's members; it was the contents and selective implementation of the Goode report that followed. The report provided a golden opportunity to redefine the occupational pension scheme model, but failed to do so. Instead, it concluded that the trust model, already shown to be deeply flawed, should be continued. The report did have some sensible recommendations that were implemented, but in terms of promoting the long term future of the defined benefit pensions scheme they were about as effective as re-arranging the deckchairs on the Titanic.

Despite successive pension acts, schemes are still run by trustee boards that are not legally required to include any members with relevant experience. This should be contrasted with the requirements imposed by the FSA in connection with the management of banks and insurance companies. Rules regarding member representation have been introduced and strengthened, but the real tensions lie not across the trustee table, but away from it.

Financial crises and recessions have a direct impact on both schemes and their sponsors. In general they will have a negative impact on both. The natural reaction of the trustee will be to return to the position enjoyed before the situation deteriorated. Sponsors, on the other hand, will find themselves in a position where they have increased calls on their financial resources from a number of directions. Under such circumstances it is always going to be tough for sponsors and trustees to see eye to eye and the reality is that each will seek to gain some negotiating advantage in achieving a difficult middle ground. In this crisis the situation will be exacerbated by the fact that many schemes are now either closed or frozen.

Governance

The speed with which the most recent stages of the credit crisis have struck will have tested the systems of the most sophisticated of financial institutions. (We will not here debate the use of the word sophisticated in connection with some financial institutions that clearly did not stress-test their business models sufficiently). As we have already noted, however, most pension schemes do not consider themselves to be financial institutions and with the best will in the world have only been able to be reactive, and slowly at that. It is not too late for schemes to consider whether they should make immediate changes to their governance structure, although inevitably such changes will come with a cost attached. Examples could include:

- Delegating more decision making (within an agreed framework) to those already employed by the trustees (sometimes referred to inelegantly as 'implemented consulting').
- Holding more frequent trustee meetings, either of the whole board or of appropriate sub-committees.
- Strengthening the permanent staff of the fund with one or more people skilled in financial risk analysis and control, or at least ensuring that someone on the staff with appropriate skills and experience (e.g. the Chief Investment Officer) has this explicit responsibility.
- Strengthening the trustee body, either by highly focused risk training, or recruiting (probably externally) for people with the requisite experience.
- Ensuring that the risk register contains not only a comprehensive list of risks and mitigation steps that have already been taken, but further steps that can be taken if the need arises.

Absence of information and advice is seldom a major problem for trustees, acting on that advice and information within an acceptable timeframe can be.

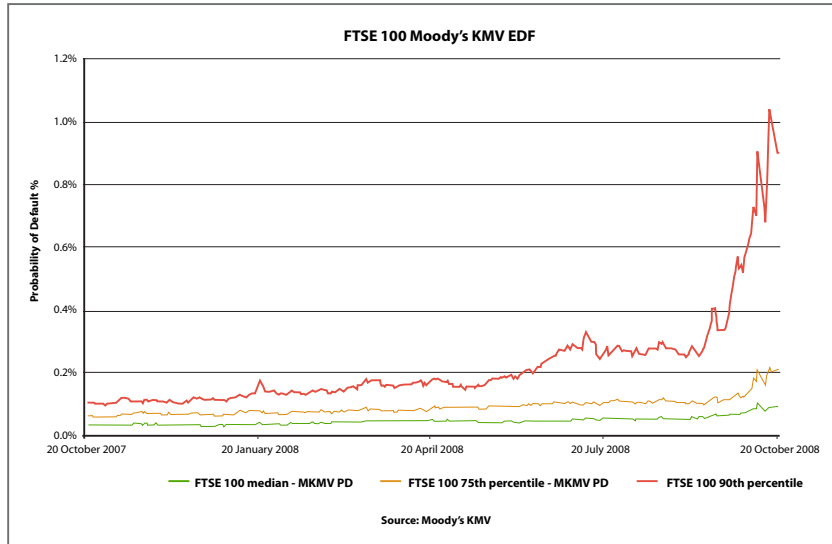
The sponsor covenant

Both sponsors and trustees need to be realistic about the strength of the sponsor covenant. Despite what is likely to continue to be a relatively strong negotiating position in many cases, sponsors will need to deal with increased nervousness from trustee boards. This is not entirely unjustified if one considers how the creditworthiness of some companies is viewed by the market, as opposed to by the rating agencies.

The credit rating agencies have come in for their own share of criticism over the last year or so, not least in connection with the ratings assigned to structured products. Another, longer standing, criticism is the slowness with which rating agencies tend to react to adverse news, to which they normally respond by reminding users that they rate 'over the cycle' and have a specific objective of 'rating stability'. (Debating whether these objectives are sensible is again best left for another day.) With this in mind, the average long term rating of those constituents of the FTSE 100 that are rated is today A3. This is clearly in investment grade territory, although we should remember that even an A3 rating implies a ten year default frequency of over 2%. However, there are other ways in which we can look at creditworthiness, not least using data derived directly from securities markets.

Two of the best known ways are to look at a company's bond spreads, or the price of its credit default swaps. The general argument is that the widening of either or both is driven in part by an increased likelihood of default, although there are other important factors such as expected recovery rates and liquidity. Equity prices and volatility can also be used to generate default probabilities, the most convenient method being to apply one of the widely available proprietary models, such as Moody's KMV[®]; with the output from models of this type it is then possible to work backwards to a market implied rating (MIR). Using KMV to generate an average MIR for the FTSE 100 leads to a rating of Baa1, only one notch lower; in fact, if one had made the same comparison at the beginning of 2008, there would have been no difference at all (both were then A3). This should not be surprising given the way that MIRs are mapped to actual ratings. However, when we look at individual companies, or industrial sectors, the picture can be very different. This is clearly demonstrated below, where

we show how the KMV expected default frequency (EDF) has changed for the FTSE 100 over the last 12 months. For the 10% of companies most at risk (represented by the red line on the chart), the EDF doubled during the third quarter of 2008.



Turning now to the banks, at the beginning of the year the average actual rating for banks in the FTSE 100 was Aa2 and the MIR A2, already a three notch difference. By late October the actual rating and MIR were, respectively, Aa3 and Baa2, now a five notch difference; the average ten year default frequency on a Baa2 credit was around 4%; if one were to choose an individual bank to examine, even larger differences could be easily found. Since the rating agencies

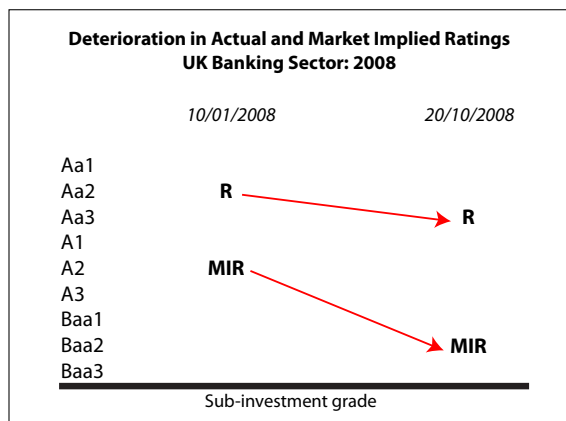
produce both types of ratings, they have to be able to justify the difference, which is normally done by stating the circumstances in which the MIR would prove to be correct. To look at it another way, this explanation can tell you what the market is saying about the future, as opposed to the rating agency or the rated company.

Sponsors can quite justifiably respond that periods when there is a negative gap between actual and implied ratings are quite common. Moreover, when the gap diminishes it is often by the MIR improving rather than the actual rating deteriorating. On the other hand, this does not mean that trustees should be complacent – the KMV charts for Enron and WorldCom in the months before their failures are particularly instructive.

With these facts in mind, the funding agreements entered into between sponsors and trustees should be no less comprehensive than a loan agreement between a sponsor and its bank, notwithstanding significant differences in the legal framework underlying each.

Among the areas that should be addressed are the priority of the claim (in comparison with those of

other creditors), security (actual and potential), group cross-guarantees and limitations for the sponsor and guarantors to pay dividends and make upstream and downstream loans. In particular, the consequences of a deterioration in an objectively assessed covenant should be built into the agreement, for example the provision of additional actual or contingent assets at key trigger points. The advantages of such agreements for a trustee are self-evident; for sponsors they may seem overly-constraining compared with what they may have achieved previously, but by reducing uncertainty and increasing the confidence of trustees, the contribution to a more professional relationship may well be beneficial.



One other thought on credit ratings. A credit downgrade is a 'notifiable event' in terms of tPR guidance. When the relevant code of practice was written it would seem pretty clear that this was envisaged to be a conventional credit downgrade by a 'recognised' credit rating agency. Logic would also dictate that a small downward movement in a MIR (by its nature a volatile number) ought not to give any cause for concern. But what about the movement in a MIR from, say, A2 to Baa2? All other things being equal trustees ought to have a prima facie concern by such a movement, and so should tPR. There are other areas where trustees may find a negotiating edge, if this is what they are looking for. Breaches of banking covenants are also a notifiable event, but what about the renegotiation (or waiver) of covenants by a sponsor to avoid such a breach? At the end of the day these are legal questions, but even asking them can help trustees develop a negotiating position and sponsors prepare their defence.

As for the rating agencies themselves, at least one person now seems to think that enough is enough - Charlie McCreevy, the European Commissioner for Internal Markets and Services. He has publicly stated his desire to see EU legislation, famously referring to the agencies' voluntary code of conduct as a "toothless wonder". We shall see.

Counterparties

Those pension schemes that had entered into derivatives transactions with Lehman Brothers will know by now whether their documentation was robust and their collateral secure. (Many of Lehman's derivative counterparties were other banks and the initial signs are that most of these did have satisfactory collateral arrangements.) Those schemes that had entered into transactions with other counterparties will have had the opportunity to undertake a similar review under slightly less pressure. It is unlikely that it will be admitted in polite company, but some of those schemes that had allowed investment managers to negotiate on their behalf may have been less than delighted with what they found, particularly in 'umbrella' arrangements arranged on their behalf.

However, security of the existing position is only part of the story. In many instances it will have been possible to determine precisely the loss (or gain) on a derivative, or collection of derivatives, at the moment of default. Recovering this gain through collateral or otherwise may also well be possible. Replicating the position elsewhere in sufficient size may be another question entirely, particularly in the area of inflation swaps.

Various strategies are possible. If the perfect asset is not available, a substitute might be (at a price). Buying index linked gilts rather than entering into an inflation swap may introduce basis risk, but this could be the lesser of two evils and may even be the cheaper alternative in current market conditions. In any event the key is to understand the fallback strategy if the problem does arise and to put contingency plans in place.

Another swap related issue is LIBOR generation, to meet

the floating leg of swap payments. Of course it now seems obvious, but the reason funds aiming to generate LIBOR plus some number of basis points were able to do so is because of the risks they took, both credit and otherwise. Some schemes may wish to continue to take such risks in the future - there is nothing inherently wrong with this, as long as they do not consider the cash so invested to be 'risk-free'. Those schemes that do adopt 'risk-free' cash policies (e.g. by investing in very short dated government securities funds) will inevitably face a LIBOR shortfall and one way or another should adjust the coupon on the fixed leg of the swap appropriately.

The size of the deficit

The media's general reaction to the latest estimates of the size of the FTSE 100 aggregate deficit has been one of surprise, not least because by some counts it has actually been a small surplus. A significant proportion of such schemes retain a sizeable investment in equities (perhaps 50% on average), which at the time of writing have seen major losses (down around a third over the last twelve months). However, this has been more than offset by the fact that liabilities are discounted at a AA bond rate. With spreads on AA bonds at near an all time high (not least because many of them are issued by financial services companies of one sort or another), it should not be surprising that the present accounting value of liabilities is low.



As we have already discussed, increased default risk is only one of the reasons that bond spreads increase, relative illiquidity at times of financial turmoil may also be a major determinant. Regardless of which is the major driver, does it really make sense that the balance sheet value of a scheme's liabilities should be marked down because of increased corporate default risk or reduced liquidity? The various accounting standards boards generally think not and, although it is not a foregone conclusion, there is a strong likelihood that the basis of the discount rate will be

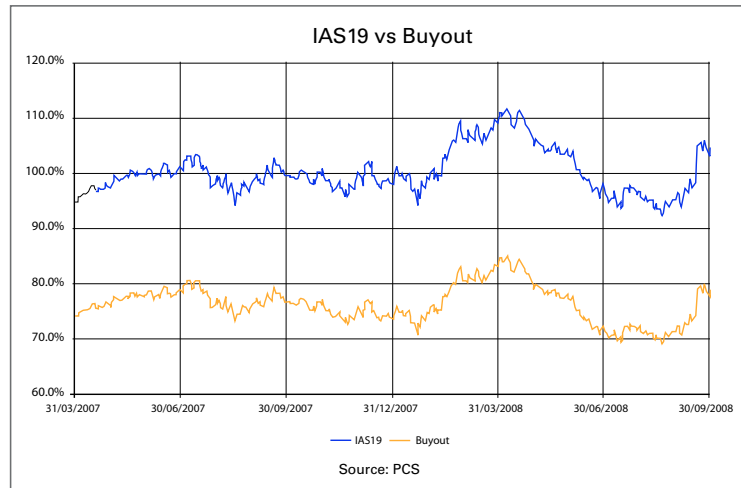
changed to one of the 'risk-free' alternatives within the next five years.

Meanwhile, sponsors that believe the FRS17/IAS19 deficit is a realistic estimate of their economic liabilities are deluding themselves; on the whole, trustees focus much less on this measure anyway. There is one easy adjustment we can make to the accounting deficit estimates to bring them nearer to where trustees might be, which is to replace the AA bond discount rate with a risk-free rate. This would obliterate the small surplus and result in a deficit of perhaps £150 billion for the FTSE 100 (using a gilts discount rate) at 30 September 2008. The scale of this difference should not really be surprising - the underlying asset and liability numbers are both large and volatile, so the difference between them will be even more volatile.

This is well illustrated by data from the most recent Pension Capital Strategies (PCS) survey of FTSE 100 pension schemes. The aggregate FRS17 position showed a surplus of £18 billion as at 30th September 2008 as against a deficit of £8 billion three months earlier and a surplus of £36 billion six months earlier. As at 31st December 2007 the deficit had been £8 billion. The difference between today's small

surplus and that of six months ago is that today it would be much harder to 'lock-in' the position – the AA bond market simply is not deep enough to make this feasible and swap markets today are also far less liquid. The daily IAS19 and buyout funding positions over the last eighteen months is shown in the chart below (source: PCS).

The consequence of the equity market decline and resulting economic deficits is that, at the margin at least, some trustees who have previously allowed themselves to be persuaded of the long term benefits of equity investments may not be so easily swayed in future. Those that wish to do so may also find high profile publicly available examples of significantly increased exposure to bonds, such as in the case of Rolls Royce.



Should we fund?

Economic deficits will generally have increased recently anyway as a result of the fall in equity markets, so the start point of any analysis is not the same as that of even a few weeks ago. Also, modelling the impact of increased pension scheme funding levels on a company's stakeholders is a non-trivial task. Simple models based on option pricing theory suggest that scheme members almost always benefit as a result of increased funding, unless the act of funding pushes the sponsor significantly closer to default. However, in principle shareholders can benefit simultaneously due to the funding subsidies provided by the government through reduced taxation and a lower PPF premium.

Current market conditions can have a material impact on this type of analysis.

- Increased volatility increases the value of options, which when combined with increased funding usually favours scheme members.
- An increase in sponsor default risk will place a higher value to members on any sponsor contributions.
- Higher funding costs do need to be taken into consideration by sponsors, but so also do the higher yields available on the investments that will be made with the additional contributions.
- The assumption of a tax shield needs to be tested in view of the coming recession.

In the short term, the impact of markets on the PPF levy is likely to be highly company specific, even if possible changes being discussed by the PPF (e.g. in relation to reflecting investment risk in the levy) are not introduced. In the longer term, expect the levy to continue to increase, possibly dramatically – the artificial constraints on increases can only be held for so long if the façade of adequate funding levels is to be maintained.

Is scheme de-risking rewarded?

Before we try and provide an answer to this question we need to revisit some economics. Leaving aside the odd bit of arithmetic, the answer provided by classical financial economics is quite straightforward: yes. This implies that the least risk (i.e. fully matched) position for the scheme should be determined and then departed from only to the extent that the sponsor and trustee believe that there is a mutual benefit, which will inevitably involve a detailed analysis of the sponsor covenant.

Unfortunately the real world is slightly more complicated, one also has to consider the impact of behavioural economics, in other words how people

actually behave, rather than how they are supposed to behave. Using this approach a more subtle question needs to be posed: what strategy should be adopted that will be most highly rewarded by all of a firm's stakeholders, including scheme members?

To put the question slightly differently, does the market reward pension scheme de-risking in practice, and is this likely to have changed over the last few months? We should first try to answer this from the sponsor's perspective and we ought to consider both anecdotal and empirical evidence. Most of the anecdotal evidence comes into a similar category to the dog that did not bark in the night. Pension scheme de-risking can come in all shapes and sizes and there are now few schemes that have not travelled to at least 'first base'.

Most surveys by consulting firms suggest that the proportion of scheme assets invested in bonds has been increasing slowly, but steadily, for most of the last decade. Of course there are still some hold-outs, especially among the very largest schemes, but the statistics are undeniable. If anyone can recall media commentary to the effect that a specific scheme has too high a proportion of bonds I would be interested in a copy to add to my very small collection. At second base are the schemes that have adopted liability driven investment (LDI) strategies to a significant extent. Quite possibly such schemes may be experiencing operational issues in current market conditions (e.g. swap counterparty risk, 'risk-free' LIBOR generation, etc.), but it is very rare to see media criticism of such de-risking action directed towards specific schemes

Then there are those schemes that have reached third base (buy-in), or fourth base (buyout). If there is any real doubt as to how such transactions are perceived by the financial press, take a look at the cuttings for any representative deals, for example Emap and Cable & Wireless. (In fact, one recent comment actually implied C&W had not unloaded enough of its liabilities.) It is too soon to say whether the subsequent share price behaviour of those companies that have done this and remain listed have out-performed the market, but I would be disinclined to bet against this and some recent analysis by PCS supports this view.

From time to time various firms undertake surveys of equity analysts to determine their attitude towards de-risking. At least one such piece of analysis this year (again by PCS) revealed that a high proportion of respondents were neutral to positive about buyouts, even where a premium to FRS17/IAS19 funding levels was required. This would have been unheard of just a few years ago. Private equity firms are even more likely now to wish for pension issues to be dealt with once and for all. Certainly we may suppose that Duke Street Capital may have had thoughts along these lines following its requirement by tPR to invest a significant sum of money into the Focus DIY pension scheme a year after it had been sold.

Buy-ins and buyouts

The relative advantages of buy-ins and buyouts have been rehearsed at length over recent months. The safest approach is simply to remember that there is no such thing as a free lunch. Buy-ins for pensioner liabilities only may look cheap (and represent genuine attractions for trustees), but it is far from clear that they will always offer the most cost effective risk reduction strategy for sponsors.

Estimates of bulk annuity levels (whether buy-ins or buyouts) for 2009 and beyond are almost as volatile as the FTSE 100 aggregate deficit. It is clear that there is potential high demand at a price (the much vaunted 'pipeline'), but until market conditions stabilise determining any price valid for more than a few hours is going to continue to be difficult; whether that price is acceptable to potential buyers may also be less likely for the immediately foreseeable future.

Trustees also need to be sure that they can sell assets at or near to recent valuation prices, liquidity in certain types of alternative investments can clearly be limited. During the course of 2008 high bond spreads have been one of the contributory factors to fine pricing by providers, largely on the grounds that increased spreads were driven principally by liquidity fears rather than greatly increased default risks. Insurers and the FSA may no longer have such confidence in this explanation.

Increased costs may also become a factor – for example, we have already noted that the FSCS will be looking to various parts of the financial services industry to redeem its initial government funding. So far this may not include the insurance companies, in twelve months time the story may be different.

Capital is also an issue. The shareholders in the new annuity market participants comprise a wide variety of types of institution, some of which are legally committed to providing additional equity funding come hell or high water. Whether banks that now have a government shareholder and private equity funds that have major issues elsewhere will actually wish to meet such capital commitments is another question. Asset price volatility and lack of liquidity are doubtless two reasons for insurers holding off on binding (and in some cases even indicative) quotations at present; preservation of capital is likely to be another.

The PCS estimate of the FTSE 100 aggregate buyout deficit as at 30th September 2008 was around £70 billion (i.e. lower than the risk-free figure quoted earlier, partly as a result of an allowance for salary growth therein); after October's turbulent markets it is a lot higher. Despite the freezing of benefits in some schemes, there is still a net annual accrual of benefits overall, so in the absence of further buyouts this figure would still be expected to grow modestly.

For buyouts to contribute to a major reduction in the figure would require ongoing activity well beyond even the highest early estimates for 2008, which we know now will not be achieved. Pension industry advisers can rest safe for a little longer before contemplating early retirement themselves, or transferring their skills to the insurance industry.

When the bulk annuity market will return to anything like normality (at least as represented by activity levels in the last quarter of 2007 and the first three quarters of 2008) is anybody's guess. Until it does, developing detailed strategies for taking advantage of it is probably not a good use of time, despite pricing that may still appear attractive on an historic basis. If, for any reason, you feel compelled to consider buyout now, keep in mind the following:

- No credit rating agency or financial risk consultant can provide a meaningful assessment of an insurance company's covenant over thirty plus years. Ultimately, anyone who buys an annuity is reliant upon the FSA and the FSCS (or their successors).
- It is possible, at least in theory, to strengthen an insurer's security, for example by taking a floating charge over assets, especially if market conditions are competitive. This will be less likely in the case of a buyout and, in any event, strongly resisted.



Lastly on the subject of insurance companies, both trustees and sponsors should remember that they provide products other than annuities, for example life assurance and trustee liability insurance. Default under such policies is likely to be less critical than under an annuity policy, but could still be extremely embarrassing.

For shorter term business such as this, the ratings assigned to insurers by specialist agencies, such as A M Best, may well provide useful insights. As always, buyers of such products should be sure they know the precise identity of the provider, by whom they are regulated and the relationship with any ultimate parent. In current circumstances particular attention may need to be paid to policies provided by the subsidiaries of overseas insurers and smaller syndicates.

Conclusions

It is customary in articles such as this to finish with a list of recommendations and on a positive note. Dealing with the latter first, things could certainly be worse, a lot worse.

Taken in totality, the financial system has not collapsed, although the astronomical cost of governmental support is only now becoming clear. Further general deterioration could still occur during what promises to be a moderately lengthy recession and there will be some nasty surprises for individual pension schemes when specific counter-party relationships fail. With luck, the PPF and FSCS (in some form) will continue to be available to pick up the pieces in the UK. In the US, a significant part of the PBGC's enormous potential liability is likely to become an actual liability over the next twelve months.

As for recommendations, there is really only one in connection with pension risk management – become

even more professional. Over the course of the next few years, regulators, banks and insurers are going to seek to strengthen their risk management functions; pension scheme trustees and sponsors should do the same. This does not mean tweaking existing systems, it means looking at them with a sceptical eye and more than half expecting the overall approach to be inadequate.

There will be a long list of detailed assumptions and tools that need to be questioned: default probabilities of sponsors, insurers, guarantors and other counter-parties; quantitative risk models and the shape of the statistical distributions on which they are based; long term return and volatility assumptions, including correlations between different asset classes; longevity assumptions – there will be many others. Time, perhaps, for a modest investment in the pension consulting industry?



After almost a quarter of a century as a corporate treasurer and as a specialist in pension risk management issues for the last five years, John Hawkins still writes and consults on pension issues and acts as a pension scheme trustee when not engaged in charitable and other pursuits. He is a director of Foresight Trustees Limited.

The views expressed are solely those of the author and do not reflect the views of Pension Capital Strategies or Jardine Lloyd Thompson

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