



FTSE 100 PENSION SCHEMES ARE BACK IN SURPLUS BUT IS IT TIME FOR COMPANIES TO LOCK IN THOSE GAINS?

Dear Sid

The latest PCS analysis of the pension schemes of the FTSE100 will show that in total they have just moved into surplus for the first time in more than 5 years. At 30 June, we estimate that the total pension surplus in the FTSE100 was £4bn. This is a remarkable turn around in the last few months. It reflects the combination of a bullish equity market as well as rising bond yields (reducing the cost of the liabilities).

This is good news for companies and shareholders, but it does raise some very tricky questions for the Board:

- If we now have enough pension assets to cover our liabilities, why are we still taking risk in the investment strategy?
- If the trustees' rationale for taking investment risk is to generate additional returns, who benefits from those additional returns?
- Will shareholders be able to benefit from any pension surpluses generated?
- Analysts treat our pension deficits as debt, but do they give us any credit for pension surpluses?
- How might we be affected by accounting standards, which restrict the surplus that can be taken to the balance sheet?
- How are trustees taking into account company interests in setting investment strategy?
- How quickly are trustees responding to changing market conditions?

Central to this debate is therefore the dual question of what assets are needed to cover the pension liabilities and what happens to any surplus assets? Companies therefore need a clear strategy on what their "endgame" is with the pension scheme and what they should do when they get there. This needs clear understanding of the implications of changing accounting standards, analysts' views on pension liabilities, changing longevity and possible closure or buy-out solutions.

Since 11 June 2003, it has been absolutely clear that the company bears all the risk of investment underperformance in the pension scheme. If the company and shareholders are not getting the full benefit of any upside in the pension scheme investment performance, then the investment risk in the pension scheme becomes inefficient and costly for shareholders. We therefore believe that for many companies the optimal strategy will now be to encourage pension trustees to lock in recent investment gains in the pension scheme by moving to a much lower risk investment strategy.

How do analysts view pension surpluses and deficits?

The 2006 PCS survey of analysts' views on pensions demonstrated that analysts increasingly view pension deficits as hard debt in much the same way as bank debt. However, that same clarity does not apply to pension surpluses, where it is much less certain that analysts treat them as a balance sheet asset of the company.

A particular insight into analyst thinking can be gained from studying Standard and Poor's Corporate Ratings Criteria. This sets out much of the S&P methodology for the setting of credit ratings and a considerable part of this document is given over to the impact of pension schemes. Key points made in this document are:

"Standard and Poor's Rating Services views unfunded liabilities relating to defined benefit pension plans and retiree medical plans as debt-like in nature."

"Although Standard and Poor's views unfunded postretirement obligations as debt-like, the surplus relating to overfunded plans generally cannot be viewed as a cash equivalent."

It can be seen therefore that whilst analysts might view pension deficits as debt, equivalent credit is not given to pension surpluses.

- The last few months have been very good for pension scheme investments
- FTSE100 pension schemes are now in surplus overall
- Analysts treat pension deficits as debt but do not give equal credit for pension surpluses.
- There are increasing risks of irrecoverable surpluses.
- Trustees are often too slow to react to changing markets – companies must take the initiative.
- We believe the optimal strategy for many companies will be to lock into recent gains

How do accounting standards treat pension surpluses and deficits?

The accounting standard, which governs the reporting on pension schemes for the large majority of companies, is IAS19. This standard treats the pension surplus or deficit (net of deferred tax) as a balance sheet asset or liability of the company. However, it does make it clear that there are restrictions on the asset that can be taken to the balance sheet. The standard states:

“An asset may arise where a defined benefit plan has been overfunded or in certain cases where actuarial gains are recognised. An entity recognises an asset in such cases because:

(a) the entity controls a resource, which is the ability to use the surplus to generate future benefits;

(b) that control is a result of past events (contributions paid by the entity and service rendered by the employee); and

(c) future economic benefits are available to the entity in the form of a reduction in future contributions or a cash refund, either directly to the entity or indirectly to another plan in deficit.”

This means that the maximum surplus that can be credited to the balance sheet is the present value of possible future refunds and reductions to future contributions. However, refunds of surplus funds are unlikely to be possible. Moreover, numbers of employee members of pension schemes are dwindling as schemes are closed to new entrants (and, in an increasing number of cases, to all future accrual). This means that the value of any reduction in future contributions may be limited. In turn this means that the maximum surplus that can be taken as a balance sheet asset may well be limited.

To make matters worse, a recent Board meeting (20 June 2007) of the International Accounting Standards Board clarified the circumstances under which a company can recognise the value of a possible reduction in future contributions as a balance sheet asset. This clarification is likely to put more pressure on companies to justify that any balance sheet asset has real economic benefit to the shareholders and has not arisen because of trustee demands for higher funding.

All of this means there is an increasing likelihood that any pension scheme surplus may not be allowed to be treated as a balance sheet asset of the company. Indeed this is already happening. For example in its recently published accounts as at 31 March 2007, British Airways records an “irrecoverable surplus” in one of its pension schemes of £306 million.

So what should companies be doing?

Companies need to look again at their strategy for managing the pension scheme and particularly the investment strategy in light of current market conditions. The problem that companies face of course is that pension investment strategy is controlled by the trustees, who are not always answerable to companies and shareholders. Moreover, trustees are not renowned for making quick decisions and rapid changes to investment strategy.

Companies should therefore check that their pension investment strategy continues to make sense from a shareholder perspective. If it does not, there needs to be an urgent discussion with the trustees on the investment strategy. In many cases we believe it would make sense for companies to lock into recent gains and encourage a significant reduction in risk taking in the pension scheme. Moreover, we believe that trustees will generally welcome a move to reduce investment risk. This is therefore a great opportunity to have those discussions now.

Yours sincerely



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