Unmanageable UK Pension Debts

Unmanageable pension debts can lead to sponsor insolvency. This session provides an independent trustee's (IT) perspective, touching on -

0. (Leveraged borrowing)
1. Investment
2. Employer covenant
3. Actuarial
4. Legal aspects
5. Regulatory/Governance
6. Cases and further reading

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0. Borrowing, but not as we know it

- Consider borrowing £150,000 to buy a house from a high street bank
- Assume a 5% per annum interest rate
- Repayment over 12 years requires £16,500 per annum

- But why not borrow £450,000 and invest £300K in equities?
- Assume return on equities of 7.5% pa and loan interest at 5% pa; Pay off the £150K at only £6,500 per annum after 12 years

- Did anyone mention a free lunch?
- Stanford, Madoff, Ponzi?
- Sympathy with EIOPA?

1. Investment; Summary

- Risk v return (> and < S179)
- Ability to withstand downside
- Cash contribution v assumed “investment contribution”
- Timescale of recovery

1. Discount Rate

- Set by reference to the underlying investments, employer covenant, with a degree of (aspirational) prudence of the Pensions Regulator

Employer Covent (Including pension scheme)	Strong	Tending to strong	Average	Tending to weak	Weak
Discount rate*	Gilts+2.5%	gilts+2%	gilts+1.5%	gilts+1.0%	gilts+0.5%

- *pre retirement. Post retirement also a function of "end game" or business plan

2. Employer Covenant; Basics

- Legal, structure, industry, enforcement
- Assets
- Profits (paper?)
- Cash flow
- Dividends, CAPEX, liquidity
- Affordability and prospects
- Other e.g. location, entry cost

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2. Employer Covenant

- Independent assessment essential (but not compulsory)
- Length of recovery period, investment risk, scale of scheme/deficit v company
- New entrants, continued accrual, maturity, end game
- Security
- Escrow funding
- Affordable contributions
- Guarantees - cross, parental or other
- PPF levy

2. Employer Covenant; Security

- Most deficits are unsecured (few deliberately underfunded)
- Most corporate lending ranks ahead of pension scheme debt
- Although closed to new entrants, many schemes have continued accrual with many key staff retained/rewarded
- Future HR issues re. recruitment, comparisons between generation of employees and ability to retire
- Getting security is difficult in practice
- Increasing use of contingent assets especially property and parental guarantees
- Second ranking charge behind banks or other lenders also used
- Innovative use of company assets – brand (GKN), whisky (Diageo), Property (M&S)

2. Employer Covenant; The Corporate Cake

- CAPEX, investment in people, systems, innovation etc.
- Debt servicing, bank first!
- Reward – shareholders, management, key staff
- Balance – especially (special) dividends and share buy backs
- Balance each year and/or over time
- Not disproportionate; Shareholder exit plan?
- Bank – exposure reduction?
- Flexible recovery plans – profit related, shaped re CAPEX, in due course, secondary target of buy out/in and or risk reduction, escrow funding towards end game. Capitalised cost of running off scheme – scary
- March 2013 Budget – new “growth” consideration

2. Employer Covenant

- 3 big Regulator considerations –
  - trustee knowledge and understanding (TKU),
  - conflicts (hence ITs) and
  - employer covenant assessment.
- Shareholders = management; best judges?
- Shareholders = management = main scheme beneficiaries (PPF cap)
- Overseas owners – understanding + uncertain enforceability
- Goodwill – price payment history, distress value?
- Distressed asset values, 10% or –ve?
- Re-financing (!)

2. Employer Covenant

- Asset rich but not using assets profitably – slow train crash?
- Business model/structure; Transfer pricing
- Conglomerate – different business parts in different countries vying for cash (collected at 5.00 p.m. ever Friday and transferred to Head Office)
- Company strength = their people; but remuneration dictates their loyalty
- Risky operating subsidiaries = statutory employers with S75 liability but wealth/assets held in Topco which owns limited liability subsidiaries
- Reputation may or may not be an issue
- Manufacturing – legacy benefits/employees + equalisation burden
- Balance

2. Employer Covenant; The Crunch

- Independent and objective assessment
- Company management
- Prospects
- Competition
- Affordability
- Attitude
- Only working to support legacy pension scheme?
- Support, Regulator dialogue and powers
- Too big to fail (TBTF) or Small enough to tumble (SETT)

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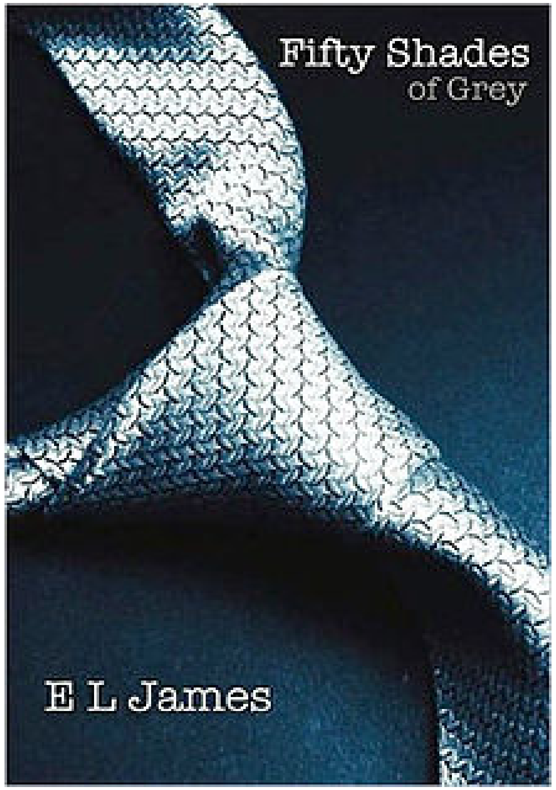
3. Actuarial; Basics

- Liability profile
- Concentration risk
- Longevity
- Pensions > PPF cap
- Scheme cash flows
- Other assumptions



3. Investment risk and return

- Mirror history with expected returns and fund decline (all other things being equal)
- Point at which risk reduced and return insufficient to recover deficit
- Trustee and other stakeholder appreciation of risk and return
- Virtuous cycle (security, well-funded, good covenant, margin/cushions) v vicious spiral (no security, weak or weakening covenant, no cash, no hope of raising cash, longer recovery period, more and more heroic investment assumptions
- Who can afford not to reduce risk?
- Down side consideration – unrewarded risks
- Inflation, interest rates, equities, longevity, active manager, diversification

3. Recovery Plan

- Prudent and appropriate (best estimate?) investment return
- Amount of debt
- Affordable contribution and realistic expenses, PPF levy and other costs
- Length of Recovery Plan
- Increase on contributions each year
- Step up in contributions after X Years?
- Allowance for CAPEX for Y Years?
- Watch incidence of normal retirements.
- Incidence of future actuarial valuations
- Don’t forget the existing Schedule of Contributions

3. Recovery (or not) Plan

- Cash contributions (+ increases thereon)
- Extra investment return
- Company growth
- Economic background
- Industry background
- Competition
- S179 drift; Give it three years?

- Reasonableness of assumptions
- Sensitivity
- Model, scenario test

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4. Legal

- Trust Deed & Rules
- Amendment power
- Appointment (and removal) of trustees
- Contribution Rule
- Pensions Act 2004, re. funding

- Statement of Investment Principles (SIP)(consultation)
- Statement of Funding Principles
- Recovery Plan, Contribution rule
- Schedule of Contributions (old and new)

4. Legal (cont)

- Conflicts of Interest Policy
- Regulatory intervention
- Independent trustee(s), independent advice
- Wind up power
- TPR liaison
- Petitioning for insolvency
- S75 Debt - certification – audited accounts – actuarial valuation
- But contributions and/or expenses not paid?
- Specialist advice
- Insolvency practitioner, ITT, experience and costs

5. Regulation

- Powers anti avoidance – Contribution Notice, Financial Support Direction, clearance, trustee appointment(s)

- Professional regulation – actuarial – CPD, TAS R, D, P, M
- Audit – true and fair view
- Investment

- Trustees - G P Noble
- New Trustee Register
- PPF advisory panel
- AAF certification

5. Regulator Statement(s)

- First, 27th April 2012; Still scheme specific funding designed to protect member benefits but without undermining the viability of employers.
- TPR thinks many will get by with modest contribution increases or extensions to their recovery periods - documentation and explanations expected
- Risk management – integrating covenant, investment and funding
- Contingency Plans (B) the degree of detail reflecting the risk
- Technical provisions – still sacrosanct
- Recovery plans – existing RP = starting point, justification of reductions, equitable treatment of competing stakeholders, equity v debt priority and continued accrual. (2013, “allowance for growth” awaited)

5. Scenario Tests

- Consensus?
  - subdued growth, inflation under control, base rates rise slowly
- Utopia
  - strong growth, asset appreciation, modest but controlled inflation
- Rising yields
  -sovereign debt problems, yields rise, weak growth
- 1930's
  - deep and long recession, capital depreciation, bond yields fall or just stay "lower for longer"

- Test, model, debate actions and share with stakeholders.

6. Trustee Responsibility

- Trust Deed & Rules
  - occasional power re. wind up
  - and/or setting contributions.
- Conflicts of interest policy for all
  Trustees (Employer appointed, MNT), paid Independent Trustees and advisers
  (NB Scheme Actuary responsibilities post July 2013)
- TPR re 100% member benefits and PPF – threshold of S179 and risk taking thereafter + “growth” (post 2013 Budget)
- Too big to fail; Royal Mail, UK Coal (initially), banks (2008 & 2013) …
- A big deal done with Kodak, others awaited …

6. Regulatory/Governance; Summary

- Conflicts of interest
- TKU, Independent trustee
- Employer covenant assessment
- Monitoring
- Powers
- TPR risk based approach

- S89 reports

6. And finally

- Investment risks are ever-changing and evolving
- Employer covenant assessment crucial
- Guaranteed legal and actuarial idiosyncrasies
- Certain regulatory scrutiny
- The potential final ingredient is **time**
- Further reading in the Appendices, S89 reports in particular
- Deals waiting to be done