HOT TOPICS: PENSIONS
KING KONG V ROBOCPO

IN OUR LAST ARTICLE RICHARD FARR, HEAD OF BDO'S PENSIONS ADVISORY TEAM, LOOKED AT HOW DB SCHEMES HAVE BECOME THE 'GORILLA IN THE GARDEN' FOR MANY COMPANIES. NOW HE ASKS WHETHER, AS THE GORILLA GROWS TO KING KONG-SIZED PROPORTIONS, A NEW BREED OF EXPERT IS REQUIRED TO TACKLE IT.

COMETH THE HOUR, COMETH THE CHIEF PENSIONS OFFICER©?

Just as we have seen the rise of the Chief Restructuring Officer or CRO as a means of bringing together all stakeholders to create the best solution during the restructuring process, is an equivalent now needed for the pensions process?

At BDO we have christened this the role of the Chief Pensions Officer© or CPO – not a RoboCop, but a RoboCPO for our times.

Like a CRO, the CPO has a complex task that is vital to the business's survival and requires many diverse skills:

- the actuarial resources to correctly identify liabilities in all their forms
- the accounting acumen to analyse the Employer Covenant
- the understanding of capital markets to deal with de-risking and hedging strategies
- the regulatory knowhow to find room for manoeuvre without ever stepping over the line
- the people and negotiating skills to deal with different agendas all the way from banks and boardrooms to trustees and trade unions.

However, most importantly of all, the CPO needs a clear understanding of the issues of the business and trustees so that the pension solution can be aligned with their goals. In order to deliver the broad range of skills required, BDO has established a pensions team that brings together specialist expertise in all the above areas. Only by doing this can we cover all angles of the CPO task.

However, let's not get bogged down in job descriptions – after all, gorillas don't pay much attention to them. Instead, let's look at the range of issues our putative expert 'RoboCPO' must face if he is to cut King Kong down to size.

FRONT PAGE NEWS

Whether it's concern about BT's reputed £9bn deficit or the recent pension-driven demise of UK Reader's Digest, DB schemes are seldom out of the news. While the press tend to focus on the size of the deficit and the number of people in danger of losing their retirement income, the real question is how such a significant threat has been allowed to grow unchecked. Companies who may otherwise manage risk extremely well in their day to day business often turn something of a blind eye to the gorilla in the garden – letting it grow unhindered between obligatory triennial valuations.

Many companies, perhaps understandably, feel that there are more pressing problems to address before they tackle an issue that may not become 'real' for many years. Yet the likelihood is that your gorilla is already damaging your business: reducing investor confidence, putting off talent, and limiting core investment and capital raising opportunities. It is also building up the inevitable conflict between trustees, employees and management that may one day cause real damage.

But even for those companies who do have the courage to eyeball their gorilla before it reaches King Kong proportions, there are real problems. A lot of time and expertise is needed to deal with the complexity of the issues involved – a big ask at a time when management resources are focused on navigating difficult economic conditions. Combine this with the number of different agendas to be addressed and it makes it even more difficult for management to successfully identify, negotiate and implement an effective, efficient strategic pension solution.

ABOUT BDO

BDO LLP is the UK Member Firm of BDO, the world's fifth largest accountancy network, with more than 1,000 offices in over 100 countries†. In the UK we have offices in Birmingham, Bristol, Cambridge, Chelmsford, Epsom, Gatwick, Glasgow, Hatfield, Leeds, London, Manchester, Northern Ireland, Reading and Southampton.

DON'T LET KING KONG TURN YOU INTO A ZOMBIE

Some DB liabilities are larger than the companies they are attached to (in some cases, many times larger), leaving them as so-called zombie companies.

This is a tough position to escape from.
The company can try and grow their business so that they can afford their liabilities, but this may be difficult when the trustees want all the profits (at the expense of dividends or capital expenditure), the banks won't lend, and equity investors won't invest to fund new acquisitions to grow the size and strength of the Employer Covenant. So, if the company's ability to grow its way out of trouble is constrained, the company must find a way to shrink their liabilities (or at the very least, prevent them from ballooning further) – again, no easy task.

In the most urgent cases, where some sort of crisis has developed, the last gasp before insolvency may be a compromise deal with the Pension Protection Fund (PPF), approved by the Pensions Regulator, so that the Scheme transfers to the PPF and the Company is restructured and lives to fight another day. Of course, between these extremes there are many variations – and a wide range of innovative solutions designed to offer companies ways of navigating them. But, essentially, they all require some trade-off between the Pension Scheme's demands on your business, and your ability to survive as a going (and hopefully growing) concern.

THE PENSION RISK QUADRANTS©

If you picture your pension commitments as a pipeline running 20-30 years into the future, then if you were to cut it at any point you would find the same four risk quadrants: Scheme Liabilities, Employer Covenant, Scheme Assets and Governance/operations. Only by examining each quadrant in detail, then looking at how all four relate to each other both now and in the future, can you deal effectively with the situation.

Set out below are six steps that we follow in analysing each of the Pension Risk Quadrants©.

Scheme Liabilities – what the members have been promised

The most important figure of all – so why can no one agree on it?

Actuarial valuations and assumptions are just one part of the jigsaw – you need to build the whole picture to really understand the risks.

1. **Cash flows by member:** Analyse the shape of the liability cash flows by member and translate into simple metrics.
2. **Assumptions:** Understand the key drivers (interest rates, inflation and mortality) and how they affect your assumptions.
3. **Reducing liabilities:** Stop exercising discretions (eg enhanced early retirement) and trade cash for benefits.
4. **Forward planning:** Apply approved risk policy and overlay risk preferences.
5. **Liability VaR:** Construct Value at Risk analysis with variable interest rates, inflation, economic scenarios etc.
6. **Hedge/exit:** Hedge your risks with interest rate derivatives, as well as longevity and inflation swaps. Consider buy-out or liability risk transfer.

Employer Covenant – how the employer is going to pay in the future

For many pension schemes, the Employer Covenant is its most valuable asset – but is it being squeezed to death?

To deliver an effective corporate strategy, business and pension planning must be properly aligned. Remember, a growing pension deficit needs a growing company.

1. **Covenant strength:** Measure the strength and stability of the Employer Covenant and use that measure to your best advantage.
2. **Corporate structure:** Understand the entity organogram, conduct an entity priority review and analyse corporate restructuring events.
3. **Corporate preferences:** Identify your risk budget, your corporate goals and how they may be affected by the Pension Scheme.
4. **Scheme funding:** Construct a recovery plan to maximise payments to the pension scheme as a manageable constraint to the employer.
5. **Contingent Assets:** Consider innovative methods of offering security over payment of recovery plan payments to allow the company to better control the timing of contributions to the pension scheme.
6. **Run-off plan:** Define the end-game – what happens if the pension scheme is well funded?

The company can try and grow their business so that they can afford their liabilities, but this may be difficult when the trustees want all the profits (at the expense of dividends or capital expenditure).

Scheme Assets – what the employer has paid so far

It's not so much what the scheme assets are worth today that matters – it's what they will be worth in the future.

Crystal ball gazing is rarely a sound route to success – so how can you be sure that your pension assets will deliver in a way that matches your risks?

1. **Asset cash flows:** Build projected asset cash flows using bond payment and equity return assumptions and compare this with the liability flows to construct a deficit/surplus valuation and future projection
2. **Assumptions:** Test your assumptions through peer and market review.
3. **Investment strategy:** Review your asset mix against benchmarks and your individual goals.
4. **Forward planning:** How will your investment strategy need to change if the funding position of the pension scheme or the value of the employer covenant changes?
5. **Asset VaR:** Construct value at risk analysis with variable interest rates, inflation, economic scenarios etc.
6. **Hedge/exit:** Hedge your assets via options, forwards, caps & collars and consider the costs and mechanisms of buy-out.

Governance/operations – how employer promises (past and future) will be managed

Their agendas may be different, but everyone should be working efficiently towards a common goal.

From prospective pensioners to current employees, and from actuaries to key management and the Pensions Regulator, the board of trustees needs clear direction and timeframes to operate effectively.

1. **Balance of powers:** Establish a common basis of understanding for key issues.
2. **Roles and objectives:** Optimise board structure and adviser quality and mix.
3. **Controls and compliance:** Build a framework for sharing information between company and trustees.
4. **Administration:** Ensure scheme administration is cost effective and fit for purpose.
5. **Member communications:** Are your communication processes up to the job of an overhaul of the pension scheme?
6. **Regulatory:** Ensure you are aware of all regulations and possible breaches/notifications/conflicts of interest/non-compliance.

*(*) Source: [xxx –] [NB BT The £100bn was quoted by Richard in the previous piece.
The 90% figure is from BBC website 2'12" into the video on this page http://news.bbc.co.uk/1/hi/business/8540425.stm]*

CONCLUSION

In the film, King Kong finally tasted defeat under a hail of bullets. But it was too late for many of Manhattan's finest buildings, which lay in ruins. The aim at BDO is to take a more measured approach to your gorilla and – by taming or terminating it – our RoboCPO can ensure that King Kong does not trample your business into the ground.

If you would like to discuss any of the issues raised in this article, or to understand RoboCPO further, please contact **Richard Farr** on **+44 77 64 90 30 60**

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