Defined benefit pension schemes Give us a clue

A call for greater corporate transparency around defined benefit pension risk

A study of the extent of accounting disclosures made by corporates in the FTSE 350

Lincoln PENSIONS

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Executive Summary

For financial reporting periods on or after 1 October 2014, Directors of companies with a premium listing on the UK Listing Authority's "Official List" are now required to make a longer-term viability statement in their annual report and accounts ("accounts"). This is a requirement under the 2014 version of the FRC's UK Corporate Governance Code mandating companies to undertake a robust assessment of longer term risks. We believe that this new requirement provides the ideal catalyst and justification for obligatory, additional disclosure in relation to pension obligations. Defined benefit ("DB") pension schemes are, after all, often the longest-term and most volatile liability on the company balance sheet.

We call for listed companies to use this viability statement as a springboard to enhance and standardise pension disclosure across the UK corporate landscape. This will allow investors and other readers of accounts to better understand cash flow and funding risks associated with company pension schemes arrangements.

In particular, we call for the following disclosure to become core elements of the viability statement:

1. The Technical Provisions ("TP") funding target (including key assumptions) and details of the associated recovery plan duration and contributions agreed
2. A standard basis for disclosure of pension scheme funding volatility
3. A more prudent and comparable funding target (eg self-sufficiency or solvency) to enable comparisons between companies and provide a clearer sense of longer term funding targets

Over time, our view is that this best practice should be extended to all company disclosures, listed and non-listed. We believe that many of the issues associated with recent high profile cases such as BHS and Tata Steel could have been highlighted much earlier through greater transparency in the accounts.

To consider the extent to which investors are presently able to assess the risks being run by companies in the DB pension schemes which they sponsor, we analysed the latest accounting (IAS19) disclosures of the companies with UK pension obligations which comprise the FTSE 350.

Our analysis found that disclosure in relation to the actual cash funding of DB was limited:

- Around two-thirds (67%) of companies within the FTSE 350 (with DB pension scheme assets totalling circa £332bn) do not disclose the deficit or surplus position of their DB schemes relative to the actual funding target (TPs) which drives company funding contributions
- More than half (54%) of companies do not disclose the length of deficit recovery plans they are committed to in order to clear the funding deficit on a TP basis

Generally, information to allow readers of accounts to appreciate the scale and volatility of the DB scheme's funded position is unavailable:

- Not one company provided a measure of future funding risk volatility, such as Value at Risk ("VaR")
- Only around a third (37%) referenced the DB pension scheme's hedging strategy, either quantitatively or qualitatively

As one might expect, we found that where DB pension schemes are material, ie large relative to the size of the sponsoring employer, these were more likely to make additional or voluntary disclosure relating to pensions in their accounts. "Best in class"[1] performers included AstraZeneca, Balfour Beatty, Dairy Crest, John Laing, National Grid, Phoenix Group, QinetiQ, and RBS.

"IAS 19 provides a one-size-fits-all approach to disclosure around pensions obligations which, because of scheme and sponsor specific dynamics, gives a very false picture to readers of the accounts."

Matt Harrison
Managing Director, Lincoln Pensions

1 Disclosure of at least 11 out of the 13 voluntary items investigated

Introduction

In our July 2015 report, Defined Benefit pensions schemes – "What lies beneath…" we estimated the level of investment risk being run by FTSE 350 defined benefit DB pension schemes. We suggested that FTSE 350 businesses were underwriting almost £100bn of asset / liability risk as measured on a 95% one-year VaR basis. We also noted that larger schemes relative to their sponsors were taking more investment risk in many cases.

In this report we have again used information included in published accounts, typically through IAS 19 disclosures, to examine the varied level of disclosure among constituents in the FTSE 350.

As employer covenant advisors we regularly need information beyond that which is publically available to piece together the full picture around DB scheme and sponsor risk – it is crucial to understand these risks in order to establish an informed view on whether the employer covenant can effectively underwrite them. But is it right that investors and other stakeholders do not have equivalent information to allow them to perform a similar analysis to inform their decision making?

Do pension scheme members need a clearer source of information to allow them to compare the financial position of the employer with the funding and investment risks being run by their scheme, as this could be relevant to key decisions like transferring out?

"The fact that a majority of the FTSE 350 neither disclose the size of their technical provisions deficit (the key figure for setting funding contributions) or the length of their recovery plans to fund their deficits leaves members and stakeholders in the dark, having to guess the level of commitment a business has made to its pension scheme."

Darren Redmayne
CEO, Lincoln Pensions

The long term viability statement – an opportunity for pension disclosure

Pension risk will be highly relevant under the FRC's new version of the UK Corporate Governance Code ("Code"), which is applicable for all financial years beginning on or after 1 October 2014. Directors of companies with a premium listing on the UK Listing Authority's "Official List" are now required to make a long-term viability statement:

Taking account of the company's current position and principal risks, the directors should explain in the annual report how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate.

Whilst the Code does not specify a required time period for assessing viability, it is anticipated that this will be "significantly longer" than the 12 months traditionally associated with going concern statements (early examples have largely been three years). The viability statement is separate from, and additional to, the Board's current going concern statement; but it is underpinned by the Board's broader, ongoing responsibility for risk monitoring and for those risks themselves.

Where a pension scheme is material relative to the size of the company, this will require in-depth consideration of the pension scheme and its associated key risks.

In this regard, companies and their boards will be considering in some detail the obligations and risks associated with pension schemes within their viability assessments. This is on the basis that the Code itself requires additional disclosure around "integrated risk management" and mitigation of "principal risks". However, the extent to which further disclosure (beyond IAS 19) is made in respect of pensions will be an area to watch.

We believe that the long-term viability statement provides the ideal catalyst for improved pension disclosure for listed businesses and, beyond that, to drive best practice in this area for all sponsors of DB pension schemes.

Our study indicates the current paradigm of voluntary disclosure in the notes to the accounts is too varied to allow meaningful comparison. What is comparable is often irrelevant. Furthermore, disclosures very often exclude information which, as employer covenant advisors, we consider fundamental to the assessment of the level of risk inherent in the pension scheme. This should not be allowed to continue, particularly as pension scheme funding continues to grab the headlines and creates real challenges for many sponsors and investors.

As pension deficits grow and the spotlight falls on DB pension scheme risk in the wake of BHS and Tata Steel, it is becoming increasingly untenable for uniformity of disclosure to take primacy over commercial reality.

What should best practice in pension scheme disclosure look like?

Having reviewed existing disclosure, we believe there are three key areas where existing pension scheme disclosure should be enhanced:

1. Detail with regard to the triennial valuation of the scheme

It is important to understand the ongoing funding commitments that a company has made to its DB pension schemes. We believe it is essential for the outcome of each triennial valuation to be reported by employers. This disclosure should provide an understanding of:

- The pension scheme's own funding target which determines cash contributions
- The recovery plan commitments that companies have made in order to address any deficit (and the extent of asset outperformance allowed for)
- The timing of the next triennial valuation

2. A standardised measure of funding volatility

What is the risk to the balance sheet strength and equity value posed by the pension scheme?

Could the pension scheme's scale and risks pose a threat to the solvency of the sponsor in downside investment scenarios?

To answer these questions, investors and other readers of accounts would significantly benefit from clear and comparable information relating to the funding volatility inherent in DB pension schemes. Among investment consultants funding risk is often measured through a 1-in-20, 1 year, VaR. However, there is no market standard calculation methodology for VaR. Therefore it may be more proportionate and comparable for companies to disclose the impact of a small number of standardised funding stresses.

Combining this funding volatility with the TP deficit of a scheme will give stakeholders a good sense of the extent to which the sponsor may be required to underwrite the funding and investment risk inherent in the pension scheme (the concept of "Employer Dependence" introduced in our July 2015 "what lies beneath…" report).

3. Longer term funding target

In addition, disclosure of a standardised longer term funding objective, eg self-sufficiency (possibly calculated using a gilts-flat discount rate) or solvency (based on latest available insurer pricing), would give a sense of how far a pension scheme is from a position where it no longer has to place reliance on the covenant of the sponsor. This would, of course, produce some significant deficit figures in the current financial climate, causing potential negative impact on investor perception. However, it provides a meaningful and comparable metric across pension schemes and sponsors, and raises the profile of the potential longer term exposure companies have to their pension schemes.

We note that, in 2015, RSA disclosed a buy-out deficit of £3bn associated with its DB pension schemes, although this disclosure by RSA appears to an outlier and we note that this was considered by some market commentators to represent a 'poison pill' warning to deter any take-over of the business at that time.

A call for improved pension disclosure

We believe that enhanced disclosure in these areas would enable investors and other stakeholders to make more informed judgements, allowing for any material pension risk dynamics and potential cash funding demands placed on a sponsor by its DB pension obligations. In our view, this kind of clarity should be a key objective of corporate disclosure.

As we will see, at present IAS 19 falls well short of providing clarity around scheme cash flows and risk. Voluntary disclosure, although positive, has not developed sufficiently such that this type of disclosure is commonplace.

IAS 19 – what is currently disclosed and its limitations

How good is existing disclosure in corporate accounts?

Under IAS 19, sponsors are required to make certain mandatory disclosures in respect of their DB pension schemes, however these are quite limited (see Appendix).

IAS 19 is not scheme-specific and represents a "best estimate" put forward by the Directors using a standardised discount rate determined by reference to market yields on high quality corporate bonds of duration appropriate to the discounted mean term of the liabilities. This is often quite different to the discount rate that is actually used by pension schemes to determine their Technical Provisions and consequential cash demands on the business. The consistent basis of IAS 19 facilitates comparison between companies, but offers little help in understanding the real economic challenges faced by the DB scheme and the sponsor in relation to cash funding calls.

Under IAS 19, a pension scheme's actual cash flow requirements (beyond the subsequent year) and funding targets are not necessarily disclosed. Neither is there any requirement to disclose information in respect of a pension scheme's funding / investment volatility or hedging arrangements.

Cases like BHS demonstrate that the current accounting disclosures do not give a true reflection of the underlying pension issue or fairly reflect the risk that the scheme poses to all stakeholders.

To understand these potentially crucial factors properly, investors would be reliant on voluntary disclosure in notes to the corporate accounts.

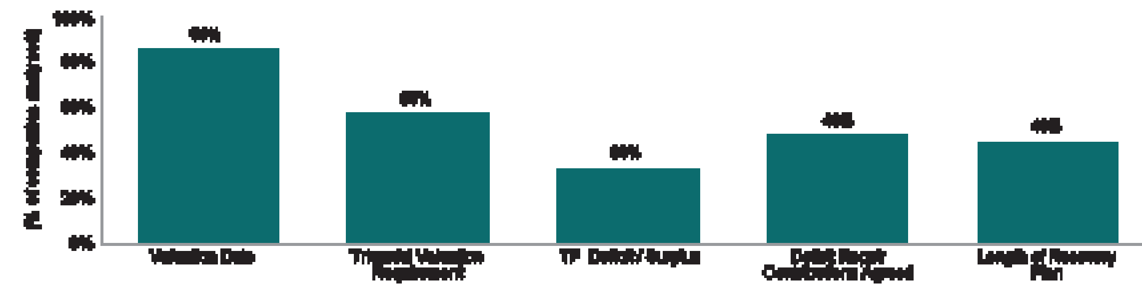
To investigate the level of this informational scarcity we consider the extent to which FTSE 350 companies with pension obligations are making voluntary risk-related disclosures in respect of their DB pension schemes, with a particular focus on the following aspects:

- Disclosure in respect of a scheme's triennial valuation
- Risk related scheme dynamics
- Risk mitigation measures

In the same way that trustees should provide members with enough information about their DB benefits, readers of company accounts need to have sufficient information to fully understand DB pension shortfalls and volatility, especially where pension risk is material relative to the corporate.

The triennial valuation and funding process

PENSION SCHEME FUNDING DISCLOSURES



Voluntary disclosure around the triennial valuation is far from uniform.

86% of companies disclose the timing of their actuarial valuations which determine the cash funding obligations to the pension scheme. However, we found that only:

- One third of companies disclose their funding position on a TP basis
- 46% provide detail in relation to the length of the recovery plan to fund that deficit

So, while readers of the accounts are likely to know when the funding target and plan is determined, they may then be left in the dark as to what that funding target actually is, or over how long the company is committed to make cash payments to repair a deficit.

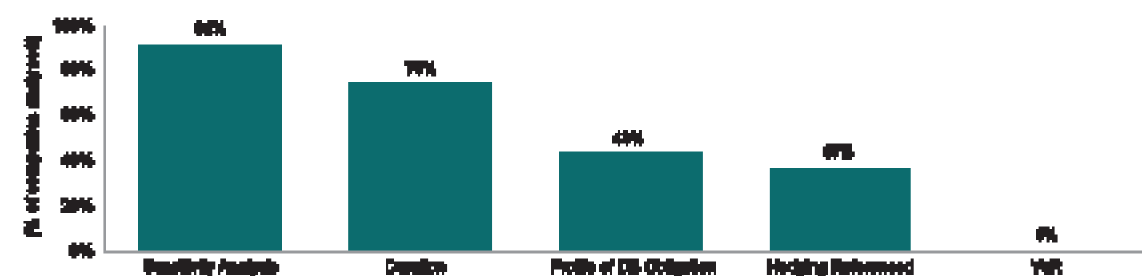
Risk related pension scheme dynamics

We move away from the near-term cash requirements associated with pension schemes, to look at the risks to the funding position and how these risks may be mitigated.

The chart below highlights a number of relevant areas, in particular that:

- Sensitivity analysis relating to the liabilities is commonplace
- 75% of FTSE 350 companies disclose the duration of their pension scheme's obligations on an IAS 19 accounting basis
- A little over a third (37%) make reference, either qualitatively or quantitatively, to the pension scheme's hedging strategy
- None provide a holistic measure of the investment risk being run by pension schemes, which is typically expressed as a VaR estimate

RISK RELATED PENSION SCHEME DISCLOSURES



Risk mitigation measures

It is also helpful for readers to understand measures that may have been taken to limit or manage the risks in the scheme. In this regard we looked at whether companies made disclosure relating to liability management exercises within their pension schemes or contingent asset arrangements which were in place to protect members in a downside scenario.

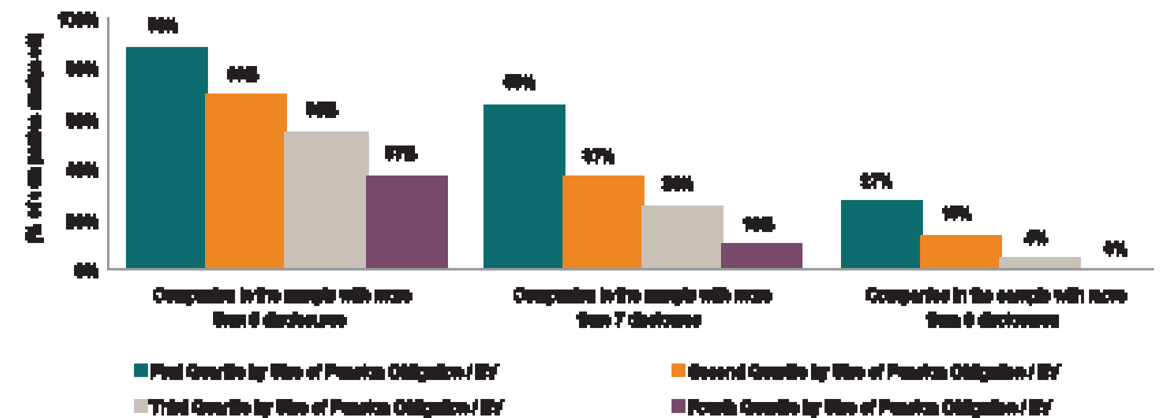
We noted that around 38% of companies gave an indication of liability management exercises undertaken, giving a helpful perspective on risks that have been removed from the pension scheme. Interestingly, we have found that 15% of companies disclose contingent asset structures in favour of the pension scheme such as an escrow account or asset backed funding structure.

Best in class disclosure

We observed a general trend that companies with more significant pension obligations disclose more than the other companies in the sample.

Specifically, the chart below, looks at the voluntary disclosure statistics analysed in relation to the relative size of the pension scheme obligations to the enterprise value ("EV") of the sponsor.

VOLUNTARY DISCLOSURE BY MATERIALITY OF PENSION SCHEME



Where the scheme is largest relative to the employer (dark green bar), voluntary disclosure in relation to the 13 items we assessed is demonstrably more fulsome.

This makes logical sense; where the pension scheme is more material, it becomes a real value driver and investors and other stakeholders demand more information. In this regard there are eight "champions" in our sample which have disclosed eleven or more of the thirteen items assessed (although none have provided a VaR estimate).

"BEST IN CLASS" DISCLOSURE

	Valuation date	Triennial valuation requirement	Technical provision	Deficit reduction contributions	Recovery plan length	Sensitivity	Duration of DB obligation	Profile of DB obligation	Hedging	Investment volatility (e.g. VaR)	Liability management	SPV / Escrow	Plan closure
AstraZeneca PLC	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓	✓
Balfour Beatty plc	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓	✓
Dairy Crest Group plc	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓		✓
John Laing Group plc	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓	✓
National Grid plc	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓	✓
Phoenix Group Holdings	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓	✓
QinetiQ Group plc	✓	✓	✓	✓	✓	✓	✓		✓		✓	✓	✓
The Royal Bank of Scotland Group plc	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓		✓

Although there are clearly some companies which embrace DB pension disclosure, the key question remains – does this allow investors to form a rounded view on the pension scheme risks and volatility?

Our view is that it does not – and that there is some way to go before readers of accounts have the tools available to make informed judgements around these areas.

Appendix

IAS 19 disclosure requirements

Below is a summary of the IAS 19 disclosure requirements for pension schemes (for the full standard see ifrs.org):

- General description of DB obligations
- The opening and closing balances of the DB obligation (on an IAS 19 basis) and the fair value of pension scheme assets
- Cost relating to the DB obligation over the relevant financial period, ie service cost, net interest cost, curtailments and settlements
- Breakdown of the proportion of each type of asset held in the pension scheme
- Principal actuarial assumptions used to value DB obligation, eg discount rate, inflation, salary and pension increase assumptions, mortality assumptions adopted

Additional disclosure items investigated

The analysis was done on the latest released annual report and accounts as at 12 October 2016.

- **Valuation date:** mention of a previous or upcoming actuarial valuation date
- **Triennial valuation requirement:** reference to valuations being required every three years
- **Technical Provision deficit / surplus revealed:** note of the TP deficit amount (or separate TP liability and asset values)
- **Deficit repair contributions:** indication of deficit repair contributions agreed beyond the next accounting period
- **Recovery plan length:** period over which deficit reduction contributions will be made
- **Sensitivity:** of the DB obligation to major assumptions
- **Duration of DB obligation:** declaration of the weighted average term of discounted benefit payments
- **Profile of DB obligation:** breakdown of projected benefit payments over time or membership split by headcount or liability
- **Hedging:** qualitative or quantitative discussion of asset hedging including hedging ratios, Liability Driven Investment, or derivatives
- **Investment volatility:** mention of expected investment volatility, eg using Value at Risk
- **Liability management:** reference to measures such as Pension Increase Exchanges, Enhanced Transfer Values, benefit changes, longevity swaps, or buy-ins / outs
- **SPV / Escrow:** mention of Special Purpose Vehicles, Scottish Limited Partnerships, Escrow accounts, or other alternative funding structures
- **Plan closure:** indication of closure to new members and/or future accrual

About Lincoln Pensions

Lincoln Pensions is the independent covenant advisory business of The Cardano Group. We are the leading, award winning, UK provider of employer covenant analysis and related independent financial advice to schemes and sponsoring employers. Our senior team possesses a breadth of experience unrivalled by any of our competitors including credit analysis, corporate finance, regulatory, legal and actuarial expertise. By providing advice to either trustees or companies, our clients can benefit from both perspectives in funding negotiations. Lincoln Pensions provides independent, solutions-focused, covenant advice which can be used to support negotiations relating to scheme funding, M&A, or other corporate events.

We have a differentiated corporate finance-based (rather than accounting or actuarial) approach to sponsor covenant assessment which provides clear advice complementing the actuarial, investment consulting and legal advice already received by schemes, sponsors or other key stakeholders. In 2016, we have won two industry leading awards: The Professional Pensions Awards, Sponsor Covenant Provider of the year; and the FT Pension and Investment Provider Awards, Covenant Review Provider of the year. We are pleased to be recognised as a leader in our industry.

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About The Cardano Group

The Cardano Group was founded in 2000 to help pension schemes achieve their financial objectives in a steady, predictable way by applying robust investment and risk management techniques.
The Group currently employs around 200 people based in London, Leeds and Rotterdam with clients whose assets total in excess of £300bn.

In the UK, the Group offers fiduciary management and investment advisory services as Cardano UK, and specialist covenant advisory services through its independent subsidiary, Lincoln Pensions. Cardano UK aims to help clients achieve a steady, predictable improvement in their funding ratio in all market conditions without significant loss.

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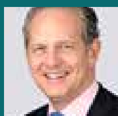

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