Defined benefit pension schemes

Give us a clue 2

Greater transparency still needed around corporate accounting disclosures of defined benefit risk

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

Lincoln PENSIONS
Part of the Cardano Group

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Introduction

Since we issued our first Give us a Clue report in 2016, we have seen the high-profile demise of two household names: BHS and Carillion. BHS was seen by many as the slow lingering death of a faded retail formula, but Carillion was seen as the new face of Government outsourcing. It is interesting to note that having obtained a clean audit report sign off from KPMG, the Group was placed in liquidation within 12 months of that date. So why is this so relevant to our report of defined benefit (DB) pension scheme disclosures (despite pensions not being the only cause)?

The Carillion accounts disclosed a £0.6bn IAS 19 deficit. We now know that its Technical Provisions (TP) deficit was about the same (the amount the trustees had negotiated with the employers to fund over time). The equivalence of amount is not uncommon.

What is more surprising is the Pension Protection Fund (PPF) deficit (the amount "insured" by the PPF on a prudent but reduced benefit basis) was nearer £0.9bn. It was clear that the Carillion trustees were unable to persuade the employers to fund even to that minimum basis. But the biggest shock was to discover that the cost to eliminate the schemes from the Group's balance sheet was £2.7bn (the S75 buy out basis). Whilst many CFO's ignore this figure as irrelevant ("because we are not buying out"), this is a critical indicator about how much total DB pension risk the Group was actually running as well as the schemes' claim on insolvency.

It is interesting to consider if these numbers had been disclosed in the financial statements over previous years whether the shareholders would still have received their dividends, the banks and suppliers given so much credit, and the Government would have continued to include Carillion on its approved supplier list?
But surely Carillion was a one off? We just don't know! Unless the financial statements of all listed companies disclose these figures and more, we will never know until it is too late.

What are we calling for?

We are asking that the following disclosures become core elements of any FTSE 350 company disclosures who have a DB scheme:

1. **The TP funding position and details of the associated recovery plan duration and contributions agreed.** This will show the actual cash funding commitments to the scheme, and will point towards those who need longer to pay.
2. **A standard basis for disclosure of pension scheme funding volatility.** Whilst Value at Risk (VaR) has many detractors, we believe it can be useful if modelled correctly and understood appropriately by its users, to understand the inherent risks of both the assets and the liabilities.
3. **A more prudent and comparable funding target (e.g. self-sufficiency, risk free or solvency) to enable true comparisons between companies.** This will also provide a clearer sense of longer term funding targets as well as revealing the full reliance being placed upon the employer covenant.

Over time our view is that this best practice should also 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, Tata Steel and Carillion could have been highlighted much earlier through greater transparency in the accounts.

As anyone experienced in refinancing and restructuring will tell you, denial is the biggest obstacle to an effective and efficient solution for all stakeholders. Full disclosure of significant pension risks is essential.

Without full disclosure, how can any financial statements ever be true and fair?

Richard E Farr
Managing Director

Executive Summary

Our previous study in 2016 found that there were significant disparities among FTSE 350 companies in terms of the quantity and quality of corporate disclosures of their DB pension scheme obligations. In particular, we found that:

- Only a third (33%) of companies disclosed the technical provisions deficit or surplus position of their DB schemes.
- More than half (54%) of companies did not disclose the length of deficit recovery plans which they were committed to in order to clear scheme technical provisions deficits.

The result is that the readers of the above accounts would not be able to understand the size of the scheme deficit or the amount of cash that the companies had committed to paying into the scheme to clear the deficit.

Our current study focuses on 177 companies in the FTSE 350 who sponsor DB pension schemes. In this study, we are pleased to find that disclosure quality as a whole appears to have improved significantly.

The following findings were particularly noteworthy:

- 79% of companies now disclose their funding deficit or surplus position.
- 81% of companies disclosed the actual amount of deficit repair contributions which they were committed to paying into their schemes, with 74% also disclosing the length of time over which these contributions were required (i.e. the length of the recovery plan).
- Nearly all companies (98%) now disclose sensitivities of how their scheme's funding position (on the accounting basis) would be impacted by changes in key market indicators, such as interest rates and inflation (in comparison, 92% of companies disclosed sensitivities in our previous study).

These improvements mean that readers of the accounts can now better understand the size and extent of companies' funding obligations to their pension schemes, as well as some fundamental insight into the level of risk being run by the schemes.

However, whilst the improvement clearly marks a welcome step in the right direction, we would still strongly recommend for full disclosure of the above and other critical items by all companies with DB obligations.

For example:

- None of the companies disclosed a VaR estimate, which would provide stakeholders with important insight into the level of investment risk being run by the scheme, and takes into account the scheme's investment strategy and how well the investment strategy mitigates the risks which are inherent within the scheme's liabilities.
- With the exception of a handful (less than 10) companies, no one disclosed their pension scheme's funding position on any alternative valuation bases (i.e. solvency, PPF, best estimate), which, if disclosed, would give stakeholders a complete picture of the size of the sponsor's obligations to the pension scheme under various, highly relevant, scenarios.

DB pension schemes are often one of, if not, the largest financial obligations of a corporate sponsor. As such, we believe that a continued push for improvements in corporate disclosure around pension scheme obligations is necessary. With this key information, readers of company accounts will be able to understand comprehensively the size of a company's cash funding obligations to the scheme, the risks that the scheme's assets and liabilities are exposed to, and how the scheme's funding position looks under various different valuation methodologies reflecting plausible real-life scenarios.

IAS 19 – what is currently disclosed and its limitations

How good are existing disclosures 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" view 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 TP 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, and the risks being run.

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 and Carillion 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.
- Disclosure of the pension scheme's funding position on additional alternative valuation bases (i.e. solvency, PPF, best estimate).

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.

What should best practice in pension scheme disclosure look like?

The following section details the areas which we believe require improved disclosure, which 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 requirement of corporate disclosure.

At present IAS 19 falls well short of providing clarity around scheme funding requirements and risk. Voluntary disclosure, although positive and seemingly improving, has not developed sufficiently such that this type of disclosure is universal.

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

1. Detail about 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 fully by employers. This disclosure will provide an understanding of key information in relation to the funding requirements of the scheme, including:

- The pension scheme's funding position, which determines cash contributions required from the company.
- The recovery plan commitments that companies have made in order to address any deficit (and, a key assumption, the extent of asset outperformance allowed for).
- The timing of the next triennial valuation to reassess the scheme's funding position.

2. A standardised measure of funding volatility

In addition to knowing the cash funding requirements, it is also important to understand how volatile the scheme's funding position is, either due to unhedged liability risks (e.g. interest rate, inflation) or as a result of the scheme's investment strategy.

Understanding this inherent volatility will allow users of accounts to assess whether the pension scheme's scale and risks pose a threat to the solvency of the sponsor in downside economic scenarios.

A commonly used measure of funding volatility is the 1-in-20, 1 year, VaR. However, there is no market standard calculation methodology for VaR, and its calculation is often complex and time-consuming.

Therefore, it may be more proportionate and comparable for companies to disclose the impact of a small number of standardised, deterministic, funding stresses.

Combining a measure of funding volatility with the above information on scheme funding requirements will provide stakeholders with answers to the following key questions:

1. How big is the scheme's TP deficit?
2. How much does the company have to pay to repair this deficit, and for how long?
3. How much could this deficit improve/worsen by, given certain economic scenarios?

With this information, stakeholders should then have a better sense of the extent to which the sponsor may be required to underwrite the funding and investment risk inherent in the pension scheme.

3. Alternative valuation measures

The answers to the previous questions should provide stakeholders with a good sense of the funding requirements and inherent volatility within the pension scheme on an ongoing basis, i.e. assuming the sponsor stays solvent and continues trading.

Should this assumption cease to be correct, member benefits would then be valued under different assumptions. We believe that disclosure to reflect these alternative funding measures would give stakeholders a complete picture of the size of the sponsor's obligations to the pension scheme, under various economic scenarios.

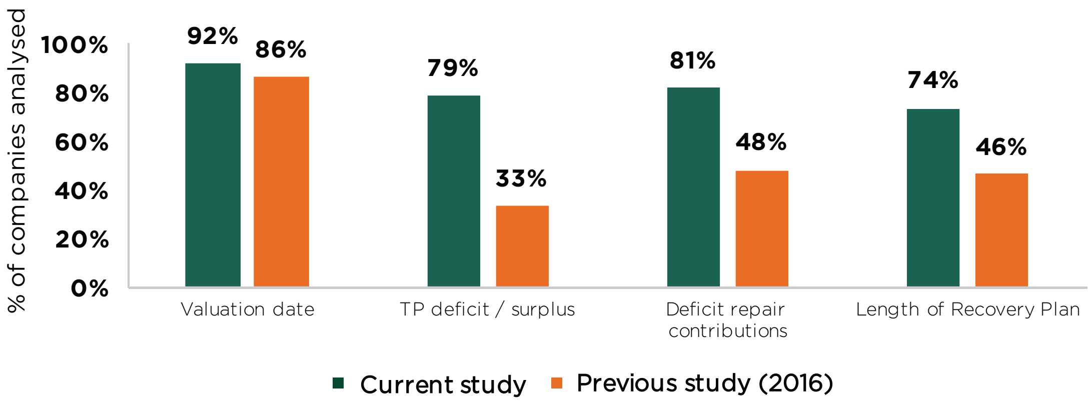
In particular, we believe that disclosure should include the valuation of the pension scheme on the following additional bases:

a. Solvency – an estimate of the amount needed to secure scheme benefits with an insurance company, should the sponsor be wound up.

b. PPF – the funding level of the scheme should the sponsor enter insolvency.

c. Neutral/Best estimate – to understand what the funding level of the scheme would be if the assets performed under a best estimate or "realistic" basis, as opposed to the conservative/prudent estimates used in the triennial valuation (this measure will reveal the best possible outcome for the scheme).

1. Detail about the triennial valuation of the scheme



Voluntary disclosure around the triennial funding valuation is still not consistent. However, we do note that disclosure standards have improved significantly since our last study, especially in respect of the following:

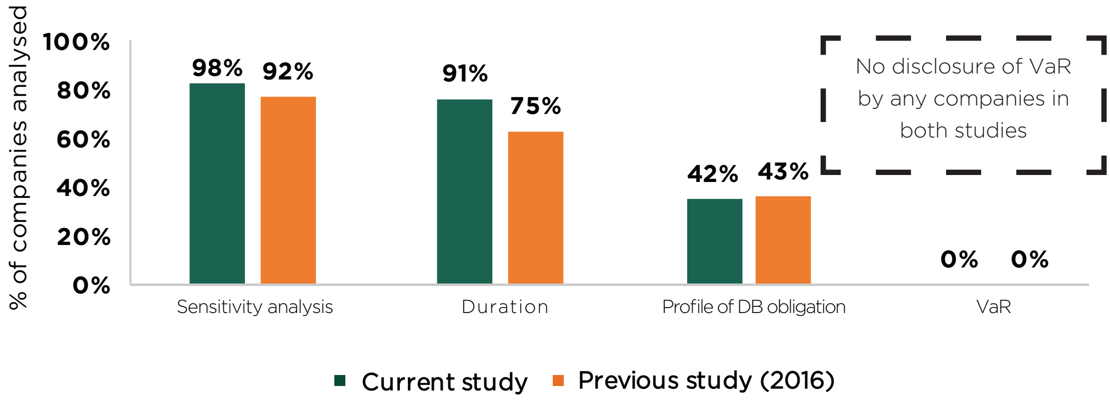
- 79% of companies disclosed their deficit (or surplus) positions, compared to 33% last time.
- 81% disclosed the amount of deficit repair contributions agreed with the trustees, compared to 48% last time.
- 74% disclosed the length of the recovery plan, compared to 46% last time.

For at least three quarters of companies, readers of the accounts are likely to be able to understand the pension scheme's funding positions and, for those in deficit, the amount and length of the cash requirements needed from the company to clear those deficits. Whilst this is a significant improvement from the quality and consistency of disclosures compared to our previous study, we would still strongly recommend full disclosure of the above items for all companies.

DB pension funding requirements are often one of, if not, the biggest demands on a company's resources.

As such, it is imperative that readers of their accounts understand the nature and extent of this funding requirement and inherent risk.

2. A standardised measure of funding volatility



As noted above, being able to understand the near-term funding requirements for DB pension schemes is vital. However, due to the long-term nature of pension schemes, it is also important to look at the risks associated with their assets and liabilities, which will impact funding requirements.

The chart above highlights the quality of disclosure in relation to long-term risks. It is encouraging to see that the majority of companies disclose the liability duration and sensitivities, which indicate how liabilities are expected to move following changes to key market indicators such as interest rates and inflation expectations.

It is interesting to note that while most companies disclose the overall sensitivities and duration, less than half (42%) opt to disclose more details of the breakdown of liabilities (e.g. into active, deferred, and pensioner members).

This result is consistent with our previous study, which found that only 43% of companies disclosed the liability breakdown.

Although the above indicates that disclosure of liability risks is reasonably comprehensive, by stark contrast, none of the companies disclosed a VaR estimate, which provides a holistic measure of the investment risk being run by pension schemes and which takes into consideration the investment strategy, i.e. asset allocation.

Whilst more and more schemes are adopting investment strategies to match their liabilities (for example, by adopting a liability driven investment approach), schemes' holdings of volatile growth assets such as equities remains significant in most cases.

Disclosure of a VaR estimate would allow the readers of the accounts to understand the level of investment risk being run by the pension scheme.

3. Alternative valuation measures

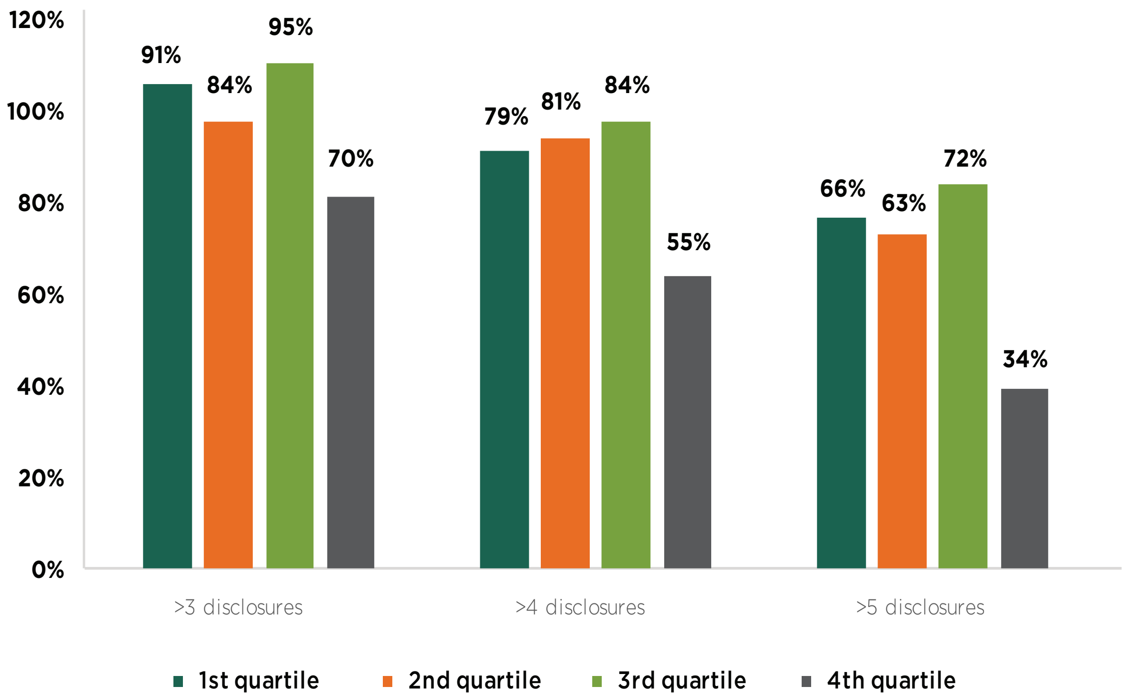
As noted previously, we believe that best-practice disclosures should include information on the pension scheme's position on a number of other valuation bases, including solvency, PPF and neutral/best estimate. This information would allow readers of the accounts to understand the level of the scheme's deficit under certain scenarios other than the current ongoing scenario, for example, if the benefits were to be wound up and insured with a regulated insurance company.

Our study found that, except for five companies who disclosed their scheme's solvency deficit, no other disclosed their scheme's solvency deficit and no other companies in the sample disclosed the pension scheme deficit under any alternative valuation measures.

We therefore believe this to be a key area of focus for improved disclosure.

The relationship between the size of pension obligations and disclosure

As with our previous study, we observed a general trend that companies with more significant pension obligations disclose more than the other companies in the sample.



The above chart shows the disclosure statistics for the companies in the sample, broken down into four quartiles based on the size of each company's pension obligations as a proportion of its enterprise value ("EV"), with the first quartile representing the highest proportion (i.e. companies with the most relatively significant pension obligations).

Where the pension obligations are the largest relative to the size of the employer, disclosure in relation to the 11 items we assessed is demonstrably more complete.

This makes intuitive sense: for companies with bigger relative pension obligations, it is arguably more important that disclosure in relation to these obligations are as detailed and complete as possible to add values to both current shareholders and potential investors.

Of the companies in the sample, just over 20% had disclosed seven of the items assessed, but two companies (Aggreko plc and HSBC) disclosed eight items, (including their schemes' solvency deficits).

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, i.e. 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, e.g. 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 20 June 2018:

- **Valuation date:** mention of a previous or upcoming actuarial valuation date.
- **Technical Provision deficit/surplus:** 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.
- **Investment volatility:** mention of expected investment volatility, e.g. using Value at Risk.
- **Solvency funding position:** the amount needed to secure scheme benefits with an insurance company.
- **PPF funding position:** the funding level of the scheme should the sponsor enter insolvency.
- **Best estimate/Neutral funding position:** the funding level of the scheme if assets performed under a “realistic” basis.

About Lincoln Pensions

Lincoln Pensions is the specialist covenant advisory business of The Cardano Group. We are the leading, multi-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. We provide specialist, 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 2018, we won three industry leading awards: The Professional Pensions Awards, Sponsor Covenant Provider of the year; the FT Pension and Investment Provider Awards, Covenant Review Provider of the year; and the European Pensions Awards, Sponsor Covenant Provider of the year. We are pleased to be recognised as a leader in our industry.

For more information: **www.lincolnpensions.com**

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 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.

For more information: **www.cardano.com**

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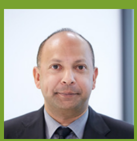

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