

# THE GORILLA IN THE GARDEN



For companies with one or more of the 7,000 or so defined benefit (DB) pension schemes in the UK, 2010 is the year to get to grips with the risks. A combination of equity performance and a reduction in corporate bond interest rates has led to a shift in defined benefit accounting disclosures. The FTSE 350 have moved from a small surplus before the credit crunch began in mid 2007, to a deficit at the beginning of 2010 in excess of £100bn. Richard Farr, BDO Pensions, looks at the issues for management, trustees and banks.

Why compare a DB pension scheme to a gorilla? Because the size of the deficit that many companies face, the fact that directors can in certain circumstances be held personally liable for any shortfall, and the possible conflicts of interest around DB pension schemes mean that they have the potential, if unchecked, to create huge damage to you and your company.

So consider this. If you opened your curtain one morning and saw a 200kg gorilla in your garden what would you do? Close the curtain and check again in three years time? Probably not. Yet, effectively, that is the decision corporates and trustees are taking when they leave their DB pension schemes to tick over between triennial reviews and valuations.

Of course, there are good reasons why CEOs and FDs don't address their DB pension schemes as fully and frequently as they would like to. There are governance and strategy issues all the way from the boardroom to the shop floor, differing valuation methods that make it hard for even an FD to keep track of liabilities and, of course, the rather more pressing need to steer your business through exceptionally challenging times. Add the fact that DB pension schemes are operating on a 20-30 year timeframe, or longer – perhaps with little demands on current cash flow – and the temptation to leave the gorilla in the garden is easy to see.

## MARKET CONDITIONS

There may be some comfort in thinking that at least it is not getting any bigger. With equity prices rising strongly in 2009, and the corporate bond rates used to calculate liabilities remaining relatively high, many companies will expect deficits to steady or even fall. However, actuaries are reducing the bond rates on the grounds that they are unrealistically high, and the trend towards calculating liabilities using interest rates based on gilts, together with ever increasing projections of longevity (each extra year of longevity assumed rises the liability calculation by about 3 per cent.), makes it best to remain cautious even if the DB pension scheme's assets are rising in value.

In fact it is vital that you act in 2010. The credit crisis has exposed the real risk in defined benefit pensions and this has raised awareness among all the stakeholders – from shareholders and trustees to lenders and potential new recruits. Investors and management talent are going to be wary about getting involved with companies who haven't faced the future with clarity.

## FINDING SOLUTIONS

The good news is that if you take action now the situation may not be as intractable as you think – as long as it is approached realistically and addresses the full range of issues. That's why our team combines high-level experience in the corporate, regulatory, capital markets, actuarial and restructuring spheres. This breadth means we can help you find pension solutions that work alongside your corporate goals.

**SO WHAT CAN YOU DO? OF COURSE, EACH CASE IS DIFFERENT AND REQUIRES CAREFUL INDIVIDUAL ANALYSIS, BUT THE KEY POINTS APPLY IN GENERAL, TO BOTH THE EMPLOYER AND THE TRUSTEES.**

### 1. Don't ignore conflict – address it

It's inherent in pensions governance that there will be conflict. Trustees have different priorities to the corporate management team, and even within the boards of both there will be different agendas. By addressing these head-on and seeking compromise, progress can be made. After all, both have a common aim in the success of the business and achieving a well funded pension scheme.

## 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.



## 2. Identify and calibrate your risks and then monitor them continuously

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: Liabilities, Assets, Governance and Employer Covenant. By examining each segment of each quadrant, and looking at all four together, you will get a much better understanding of your position.

How recently have your risks been calibrated between the stakeholders? Do they match your corporate risk, are they doubling up? Does the company have the same view as the Trustees on interest rates and inflation? Which, if any, of the 'seven dwarfs' (the various pensions valuation/liability methods) should you be most concerned about? And over the life of your pension liabilities, how are each of the four risk quadrants likely to change.

## 3. Build a strategy and execute it at the right time

It may be better to act this year, or it may be better to address problems over the next five or ten years. Either way, only by putting a clear strategy in place now can you address your risk and stop the pension scheme from taking control of your future.

## BUT WHAT IF THE GORILLA IS ALREADY IN THE GARDEN, DEMANDING BANANAS?

The sudden, often unexpected, appearance of the gorilla (and the associated demand for bananas - recovery plan payments) can cause management and the company's banks to rethink cash flows and lending facilities.

Companies and their banks will wish to review their financing terms and ask:

### 1. Does the recovery plan affect the ability to pay interest?

If the company agrees a schedule of recovery plan payments with the pension scheme, should these be included in the Interest Coverage Ratio calculation to ensure that the company can continue to make interest payments? Can the company borrow from the Bank to make payments to the pension scheme?

### 2. What about King Kong?

If the company is liquidated, the accountant gorilla in the garden will get much larger indeed. The pension fund will have an unsecured claim against the company for the difference between its assets and the estimated cost of buying-out the pension scheme liabilities in full with an insurance provider (the s.75 buy-out deficit). The bank may find that any unsecured facilities that it has with the company suddenly have to share liquidation proceeds with King Kong, not the accountant gorilla. Should this be reflected in the Net Debt Coverage Ratio for unsecured borrowings? Should the Bank ensure that all borrowings are secured?

### 3. Do recovery plan payments constitute a preference?

Are recovery plan payments being paid from the company's profits, reserves or borrowings? Should each recovery plan payment be accompanied with a pro-rata reduction in the Bank's unsecured borrowings, or a rebalancing between unsecured and secured borrowings?

## WHAT ABOUT THE TRANQUILIZER GUN?

For many pension funds, the value of the employer covenant is their most significant asset. Yet for the company, the pension deficit can prevent them from successfully operating as a business. Companies and banks may be thinking about the tranquilizer gun – how to successfully restructure the business and the DB pension scheme to maximise the future opportunity for the success of the business, the repayment of bank debt and the payment of benefits by the DB pension scheme. In any restructuring, the starting point is the provision of a fair and externally verified enterprise value of the company to the bank and the trustees, to allow the corporate management team to put a value on the employer covenant. For the trustees, a restructuring solution may a realistically achievable next best option to either business as usual or liquidation and provide the pension scheme with a one-off payment that might not be capable of realisation once the air force has been sent in to liquidate King Kong.

Where the scheme's assets are insufficient to purchase a level of benefits in excess of those provided by the Pension Protection Fund (the PPF), the company and its banks will need to negotiate the terms of the restructure with the PPF instead of the Trustees. The PPF will generally only act once the insolvency of the company appears inevitable, will only consider any proposed restructure if it offers a realistically achievable next best option to insolvency and will seek to take an 'anti-embarrassment' equity stake in the restructured company of 33 per cent, or 10 per cent if new money is put at risk in the restructured company.

## CONCLUSION

To go back to the gorilla in the garden analogy: the longer you leave it, the bigger and hungrier it may get. Feed it, learn how to communicate with it or reach for your tranquiliser gun, but don't, whatever you do, ignore it.

If you would like to discuss any of the issues raised in this article please contact **Richard Farr** +44 77 64 90 30 60.