DB Pensions: the CFO perspective

Keeping afloat

They are the financiers supporting over 11 million current and future pensioners' retirements. While trustees may be tasked with looking after members of pension schemes, it is CFOs who are responsible for footing the bills that enable DB schemes to honour their pension promises.

Yet CFOs could be forgiven for regarding their defined benefit (DB) pension obligations as a particularly unwieldy millstone. Companies have pumped £500bn into pension schemes since 2000, but the overall deficit has tripled to circa £800bn. The costs of meeting a benefit promise to predominantly former employees has grown far more onerous than anyone envisaged.

The situation is growing acute. As pension schemes receive the results of their 2016 triennial valuations, many will learn that yet again their funding deficits have grown despite the billions that have been poured into schemes over the past three years.

There are three main reasons why.

We'll expand on these reasons – and how their effects can be managed – throughout this series of articles.

Our interest was discovering and examining CFOs' views on this issue and many others. Unlike trustees, whose sole responsibility is to look after a pension scheme, CFOs have a wide range of priorities and concerns on their to-do lists. Just how far up their agenda are DB pension liabilities? What are their goals for their DB pension schemes? Finally, what are the business risks that are keeping them awake at night?

The survey

"Hymans Robertson commissioned YouGov to conduct a survey of Chief Financial Officers that have defined benefit pension schemes. YouGov interviewed 51 CFOs over the telephone from 11th January to 22nd January 2016. The CFOs all worked for UK businesses with more than 1,000 employees."

Worse things happen at sea

A wide range of risks are occupying CFOs' minds in 2016. Geopolitical risk is the number one issue they identified as a threat to their business, with 63% identifying it as their top worry.

Second on the list was capital market volatility, with 39% of CFOs citing it as a major concern. Given the uncertain start to 2016 and dire forecasts by some economists, it's no surprise that CFOs are concerned about this issue. One CFO said: "The global stock market right now is a big concern as we are an international company."

Other CFOs looked inwards. Over one in three (35%) rated business-specific risks as their top risk.

DB pension schemes were also a significant cause for concern. Around one in seven CFOs believed their DB pension scheme to be one of the biggest risks to their business in 2016. Given the wide range of macroeconomic factors they could have identified as a top risk during these turbulent times, we think it's revealing that DB scheme risk is so high up the agenda of many CFOs.

On this figure* a Finance Director at a Financial Services firm commented:

> "It does surprise me in that it is lower than I would have thought. Financial Services companies are very aware of the risk that DB pensions present to the balance sheet but I suspect that CFOs of other organisations would be shocked at the capital required to cover a 1 in 200 year scenario."

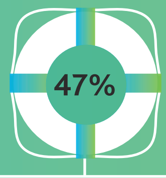
One CFO explained: "Regarding the DB scheme we are trying to find a solution to prevent further risk, and greater deficit."

CFOs are right to be concerned. Research by the Pensions Policy Institute indicates that around 1,000 sponsoring employers' businesses – representing one sixth of the schemes in the Pension Protection Fund Index – are expected to become insolvent. Their December 2015 research, The Greatest Good for the Greatest Number, aligns with the one in seven CFOs who identified their DB pension scheme as one of the biggest risks to their business in 2016.

There are positive steps that CFOs can take to address these risks.

Inflation, low productivity and a rise in interest rates were other top concerns for CFOs - see infographic overleaf for full list of risks.

Consider DB pension one of biggest risks to their business in 2016



Have slightly or much lower appetite for risk in DB scheme vs core business

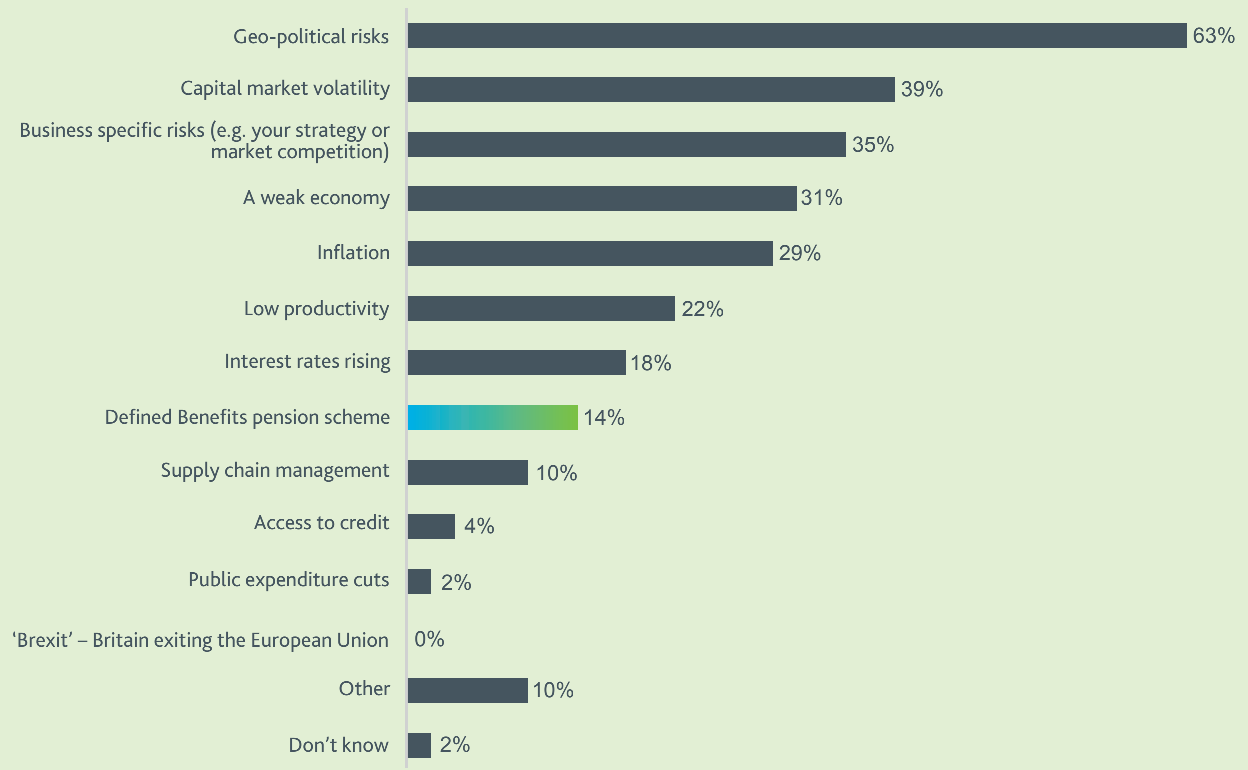
*Around one in seven CFOs believed their DB pension scheme to be one of the biggest risks to their business in 2016

We also asked CFOs how their appetite for risk in their DB pension scheme compares to risk within their core business. Overall, almost half (47%) had a slightly lower or much lower appetite for risk within their pension scheme than their business. Another 39% said they had a similar risk tolerance for scheme risk to core business risk. These CFOs would clearly rather take risk in their core business, their area of expertise, rather than in running insurance company style risks in their pension scheme.

> "I can understand that. It is probably easier to explain to investors/customers/members financial volatility due to the underlying business than it is financial volatility due to the company pensions scheme. I suspect the latter is not an area that investors/customers/members would expect the company to be taking risks."
>
> Finance Director, Financial Services Firm

Only the minority (8%) said they had a slightly greater appetite for scheme risk than core business risk. This reinforces the point that CFOs are generally aware of the threat that pension scheme risk can pose to their overall business and recognise the need to balance the portfolio of risks they take throughout their business and their scheme.

We asked CFOs which three of the following would you say are the biggest risks to your business in 2016?



A port in a storm

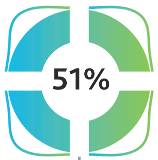
To achieve success, it's important to lay the right foundations. We asked CFOs what their ultimate goal was for their company's DB scheme. Almost a fifth said they didn't know.

With so many competing demands on their time, it's perfectly understandable that some CFOs haven't formulated a clear plan for tackling the complex issue of DB pension liabilities. However, without setting a goal and deciding on an underlying strategy, CFOs are at risk of making plans on shifting sands.

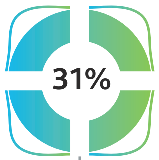
In our 2015 Trustee Barometer survey, we asked trustees whether they had a measurable strategy and a set timeframe to meet their scheme goals. Worryingly, almost half (40%) of trustees hadn't determined a timeframe for reaching their goal, despite 88% saying they had a measurable strategy in place.

It seems there is a great opportunity for trustees and CFOs to collaborate, bringing their range of skills and perspectives to the table. While their objectives may differ, with a primary focus on members' benefits and shareholder value respectively, they have a common interest in a pension scheme that remains affordable for the business that sponsors it. Developing an agreed plan to meet that objective is in everyone's interests.

Yet interestingly, not all CFOs believe trustees share their objectives. Nearly one third (31%) responded "No" when asked "Do your Defined Benefit pension scheme trustees share your objective?"



Believe trustees share their objective



Don't believe trustees share their objective

Where there is misalignment of objectives, it can be much harder for CFOs to influence scheme strategy. Since CFOs are picking up the bill, this can prove a costly position to allow to continue.

In a later article in this series, we will explain the importance of working towards a common goal, and how trustees and CFOs, whatever their current relationship, can make collaborative working a reality.

"In relation to the "biggest risk" to the business, I would not describe it as such. I would view the liabilities as one of the most volatile elements in our balance sheet and this is compounded by the fact that there is little the CFO can do to manage this volatility in the short term as it is so dependent on factors outside our control (global bond yields, inflation etc). It is therefore an uncomfortable factor and "noise" in explaining a business to its owners when you would rather be focusing on operational risks.

On alignment with trustees, it is essential to have a strong working relationship with the trustee group – we ultimately have a common objective. There may be points of disagreement along the way but we need to stay aligned for as long as possible on the journey to sufficiency."

Alan Williams, CFO, Greencore Group Plc

As we have witnessed in recent years, economic sentiment can change fast in response to a plethora of geopolitical factors. It's important to be prepared for anything – and we'll talk about how CFOs can lay solid foundations for funding their DB schemes in a subsequent article.

Around a third of CFOs (35%) simply want a sustainable DB scheme, where investment risk is taken over the long term but at a level where any funding gaps that emerge are affordable to the business. Meanwhile, 16% sought for their scheme to become self-sufficient, where they would run a very-low-risk strategy with only the chance of very modest funding gaps emerging.

Others would prefer to go further still and have the pension scheme off their balance sheet altogether. Overall, nearly one in three (29%) of CFOs are targeting a full buy-out.

> "Developing an agreed plan to meet objectives is in everyone's interests."

Which of the following best matches your ultimate goal for your Defined Benefit pension scheme?

Batten down the hatches

Undoubtedly a successful strategy starts with an in-depth understanding of your long-term objectives. If you don’t know where you’re going, you’ll probably end up somewhere else.

CFOs are eager to achieve their DB pension scheme goals as soon as possible. An ambitious 37% wanted to achieve their goal in 2016 (which we took to mean they would start towards their goal in 2016), while another optimistic 18% were determined to do so in the years leading up to 2020.

Interestingly, 63% of the CFOs who are targeting self-sufficiency want to make progress this year. Similarly, over half (56%) of CFOs who want to have a sustainable scheme hope to make progress towards their goal this year. It certainly seems that CFOs have the bit between their teeth and are planning on taking steps today to help to get closer to reaching their long-term objectives.

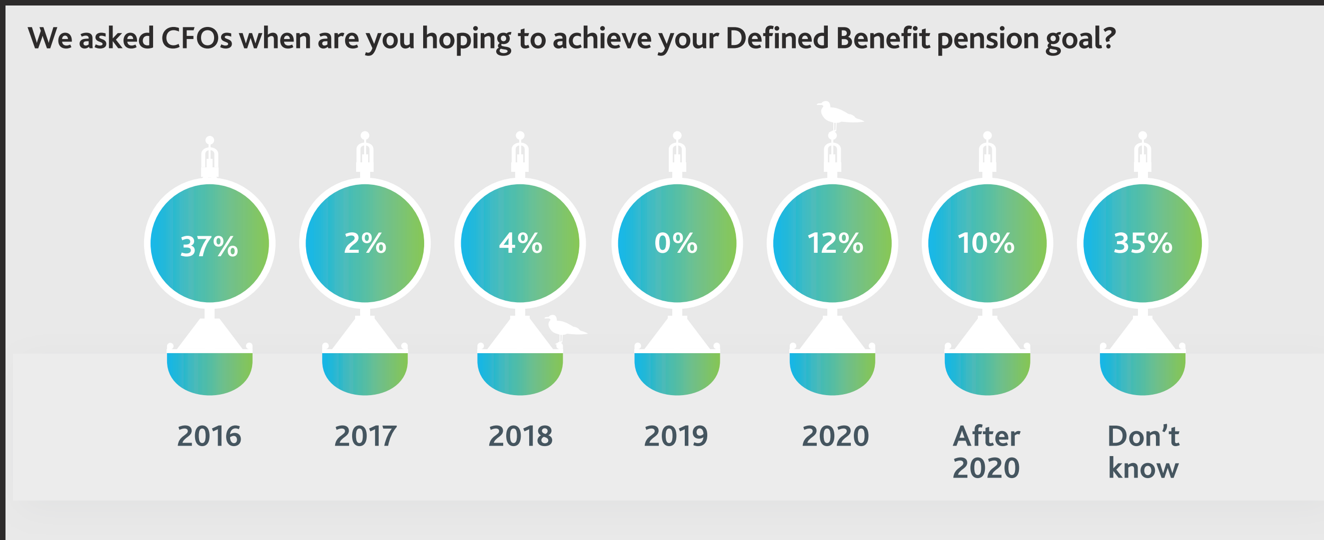
At the other end of the spectrum are the uncertain CFOs. Overall, 18% were unsure of their goal for their pension scheme. In addition, 16% didn’t know when they wanted to achieve their goal. Uncertainty is understandable, but taking a considered and integrated approach to solving the problem will win the game.

CFOs are accomplished problem-solvers who will appreciate the wisdom of breaking down a difficult challenge into a series of shorter-term wins. That’s the logic we apply to DB funding shortfalls.

We think three things are needed to get schemes on track:

1. Purpose: clear long-term objectives and a measurable strategy;
2. Precision: accurate, up to date, on demand management information; and
3. Pace: taking no more risk than required.

Through a fully integrated risk-based approach CFOs can measurably improve the stability of cash demands schemes place on their business.



Slow and steady wins the race

Funding a DB pension scheme is a long-term game. In fact, many pension schemes which are on the road to self-sufficiency will be paying members' pensions until the end of this century. That means there's plenty of time to tackle funding problems.

However, most schemes have adopted a strategy of taking more risk today in the hope of taking less risk later.

As we've seen in recent months, this comes at a price. Despite significant amounts having been paid in deficit repair contributions, many schemes with 2016 valuations will be facing larger funding deficits. This will feel like Groundhog Day for many CFOs. Clearly, the approach of paying more and more and pinning hopes on equity market growth and yield reversion just isn't working.

There are no short cuts to sustainability. Instead, making steady, moderate and stable cash contributions and taking a simple, low-risk approach to investment will shore up scheme funding in the long-term. With the majority of pension schemes targeting self-sufficiency or sustainability, making the shift towards a longer-term view makes better business sense, giving CFOs more certainty about the money they need to put into the scheme.

> "It's very important that the company and trustees are aligned on strategy and objectives so that a productive discussion can take place between the two."
>
> Finance Director, Financial Services Company

More certainty is a win for all parties. The CFO who dreads the possibility of being asked for lump sums to help close unexpected funding gaps will welcome a stable and sustainable approach. Trustees will benefit from greater predictability, which provides a more useful backdrop for planning their scheme's investment strategy and cashflow. Ultimately, it aids them in meeting members' benefits at the end of the line – which is, after all, the point of the DB endeavour.

Over the next few months, we will be releasing further insights from this survey. We'll explore CFOs' views on cashflow negativity, their appetite for and attitudes towards risk transfer, as well as how they are working with trustees in practice.

How risky is your DB pension scheme?

We hope you have enjoyed reading this article. If you'd like to chat through these findings in more detail, or specifically want to know how big a risk your DB scheme is for your business and how you can more effectively manage this risk, please do get in touch.

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