De-risking defined benefit pensions. A CSFI/PIC round-table discussion with John Llewellyn (Llewellyn Consulting), Inder Dhingra (Law Debenture), Jonathan Smith (Schroders) and Jay Shah (Pensions Insurance Corporation).

Held on Tuesday, October 21, 2014, at the London Capital Club, 15 Abchurch Lane, London, EC4N 7BW.

De-risking defined benefit pension schemes is a big issue and Llewellyn Consultancy's report, "The influence of DB pensions on the market valuation of the Pension Plan Sponsor", helps explain why: companies that stand behind a large defined benefit pension scheme feel its weight overhanging their shares. The three main findings are:

- The market value of the FTSE 100 companies examined reflects the size of the pension fund deficit.
- On average the implied value of the net liabilities is 20% higher than the reported number – investors are probably upping it by this much as a "rule of thumb".
- Size matters – even if the scheme is in balance, the larger the liabilities, the greater the impact on market value.

So it could be argued that if a company can shed the liabilities, it should be rewarded via the share price. An alternative view was that the impact on market values could reflect the high cost of de-risking, the interventions of The Pensions Regulator and the additional contributions it required.

Trustees have focused on de-risking through liability driven investment (LDI), and hedging interest and inflation rate risks. They have an incentive not to kill the goose that lays the golden egg because they want the covenant with the corporate sponsor to be sustainabie. Smaller companies tended to under-estimate the risks and to ignore the gearing effect of the fall in yields, which this year could have led to a 50% increase in an average fund's deficit.

Questions over the way liabilities are measured included: whether the discount rate was artificially low (because of regulatory action suppressing yields), whether the volatility of market rates was appropriate for long-term funds and whether investment returns should be allowed for in the discount rate.

It was pointed out that the present value of the liabilities would matter in insolvency, and that pension obligations were a contract that cannot be broken – so scheme members naturally wanted to see that the company could stand behind its promises. A persistent deficit did not demonstrate that.

De-risking was driven by the view that the obligation is a debt, which looks like a bond, hence the desire to provide matching income streams and to minimise volatility by holding bonds. But it was pointed out that this form of LDI was expensive at current rates and there were nowhere near enough index-linked gits to match the £1.1tr of UK pension liabilities. If swaps and synthetic gilts were employed to offset inflation and interest rate risks, the risk switched to counter-parties at investment banks.

Because of the high price of "safe" bonds, many funds would still be investing in growth assets, such as equities. But there was a warning about the trap of looking for a better-returning asset class, since the trustees' objective is to meet the liabilities as they fall due. One person in the audience did defend asset selection to try to increase value: this was possible with an employer with a strong balance sheet standing behind the covenant.

Full buy-out is the ultimate version of de-risking. Companies did these deals not for quantitative reasons but to tackle investors' and analysts' concerns. They were willing to pay a premium over the disclosed liabilities to make that concern go away.

Returning to the controversial issue of putting a number on the liabilities, one explanation was that it boiled down to risk. At the accounting level, there was a 75% chance that the number would not be greater; at the actuarial level, a 90% chance; and buy-out gave you 100% assurance – but the price would be 30-50% higher than the accounting number.

As one person summed it up: This is a promise to a group of individuals. The question is who pays if the debt can't be serviced? The members? The company? Society?