Summary edition

A new centre of influence in corporate pensions

This is the summary of a study which explores the changing role of Finance Directors in pensions decision making in the UK.

The genesis of this study came when we heard a warning. We were told that "the cosy pensions status quo will be overturned by a new entrant into the pensions conversation - Finance Directors". We were told that FDs (as we call them here) no longer subscribed to "woolly HR-based ideas about pensions having value as a recruitment tool". Whilst FDs had not been closely involved in Pensions before, they were now starting to become more involved, we were told. FDs would change the cosy cardigan-wearing world of pensions as we knew it. FDs, we were told, were ruthless lycra-wearing cost-cutters who gave not a whit for the happiness of employees if this in any way conflicted with their obsession for strengthening of balance sheets.

We were slightly flummoxed by this warning. But we were intrigued. If it was right, then there would be a consequence: pensions-related suppliers to companies, including asset management firms, who had previously focused their selling energies on the traditional pensions decision makers within the corporate environment - Trustees, Pensions Professionals and Heads of HR - would need to think again. If FDs were to get involved this much in pensions then they needed to be targeted as buyers of services. This would be a big change in the way that pensions relationships were built and fostered.

Clearly at some stage we had to test whether FDs were a New Centre of Influence in Pensions in the UK.

This project is that test. Our conclusion is that they are.

In a full report we set out in some detail what the FDs and others we spoke to said, since it is our view that passing on their comments adds real value in this project. However for those with less time to look at these comments in depth, this summary edition shows what the overall themes are.

January 2012

Project sponsors

STANDARD LIFE

Allianz Global Investors

FriendsLife

Pyramis Global Advisors | Fidelity Asset Management

Russell Investments

NAPF Securing the future of pensions

accountancy

In addition we have received Project Collaboration from pwc

Spence Johnson
Investment Marketing Intelligence

15 Abchurch Lane
London EC4N 7BW UK
+44 20 7112 2131
www.spencejohnson.com

Finance Directors are a new centre of influence in corporate pensions in the UK.

Summary of conclusions

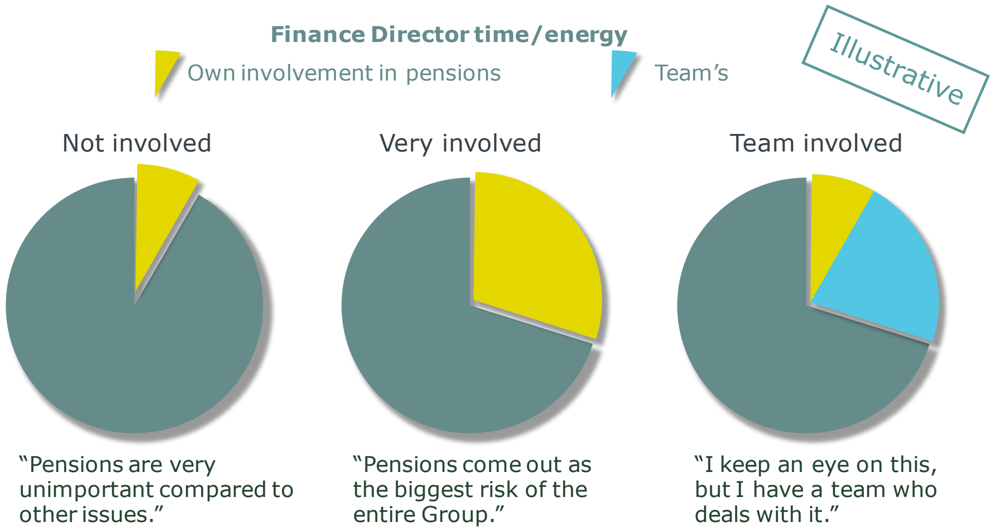
- New regulations and stockmarket volatility have prompted a revolution in the role of FDs towards pensions. They are getting more involved.
- FDs are more closely involved in pensions decision making than many think. Their footprints can be seen at all pensions decision making levels.
- FDs are effectively leading the decision on contribution levels, and in so doing are also indirectly (or directly) leading the conversation on derisking.
- We set out to research behaviour in large companies in particular. Our conclusion: FD involvement in pensions is much greater in larger firms.
- HR, once seen as leading on pensions matters, is now increasingly handing over leadership on pensions to Finance colleagues.
- The annual running costs of pensions are not the key issue for FDs. What causes them most concern are the contributions to paying off deficits.
- The caricature of FDs, that they only care about the Balance Sheet, is wrong. FDs in large business think that being nice to employees is sensible, not paternalistic.
- FDs are closely involved in investment derisking decisions, but often avoid the detail.
- FDs are not currently involved in DC as much as in DB. When they focus on DC, they see advantages in getting rid of the Trustees.
- Our prediction is that FDs and their teams will eventually take the lead at all pensions decision levels, even Implementation and Selection.
- The research was carried out among 43 firms, mostly large companies in Summer of 2011. We spoke to 25 FDs at larger companies and 35 others involved in pensions.

Summary edition

New regulations and stockmarket volatility have prompted a revolution in the role of FDs towards pensions. They are getting more involved.

New regulations together with stockmarket volatility have prompted a revolution in the role of FDs towards pensions - more formality, more rigour, more resource, more focus.

FDs have a notoriously wide range of responsibilities, and in the past pensions did not claim their attention. This is still true of many who in the illustration to the right we have called the "Not Involved".



But this is changing, and pensions are becoming a high priority. There are increasingly FDs like those who we characterise here as the "Very Involved". In some companies this happened many years ago, in others it is just happening. It does not mean FDs get involved in the detail. They tend to focus on DB and leave DC to others. Pensions are creeping up the league table of risk according to the scoring system adhered to by most larger companies, and certainly high enough up to warrant attention from FDs.

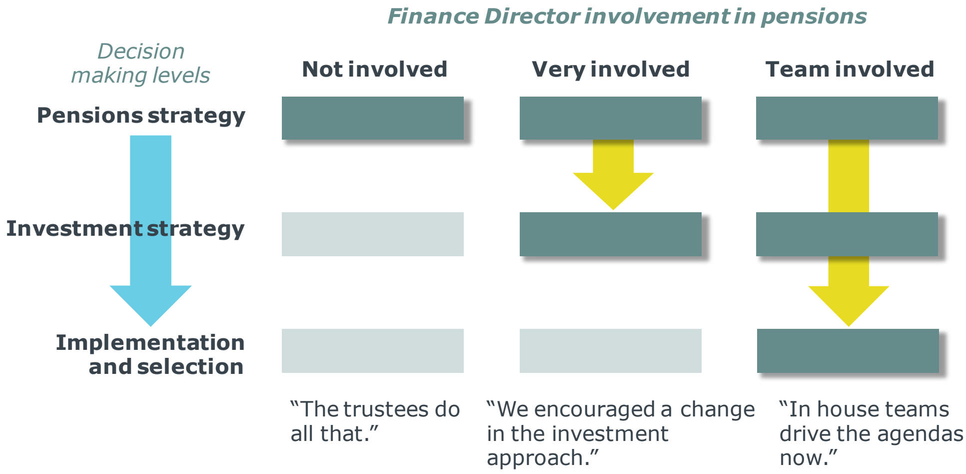
But there are also FDs in larger companies, who whilst not personally involved, are building significant team resources dedicated to pensions, who act as their eyes and ears. It is a mistake to think that the FD is the only Financially driven person within companies that matters. Within the FDs team are several functions which carry out his edict on pensions, and increasingly this team includes the in-house pensions administrators as we discuss later.

"I don't get involved in the pension scheme itself and I don't get involved in any of the strategic decisions. I think that could change, I think I could see myself trying to exert more influence." FD/68

"Pensions is a very significant element on the risk list which is looked at on a regular basis by the company. It's not the top one, but it is certainly towards the top of the list". FD/42

"Our in-house pensions team resources are developing fast and we're taking more and more of that away from our investment advisors. When we drive the agendas for our meetings we base our thinking on a collective melting pot of intellectual capital including conversations with managers, investment banks as well the investment advisors themselves." FD/4

FDs are more closely involved in pensions decision making than many think. Their footprints can be seen at all pensions decision making levels.



We have identified three layers of pensions related decision making that are relevant to suppliers of investment services. Pensions strategy, Investment strategy and Implementation and Selection. We have explored and tested FD involvement at each of these levels.

FDs are deeply involved in **Pensions strategy,** which is the phrase we use to cover all the big decisions on scheme type and structure. But crucially from an FD's perspective it also covers forming policy on how and when to pay off any deficit in the DB scheme. These decisions are now typically taken at board or near board level, and invariably include the FD at the heart of the debate.

Investment strategy is in theory for the Trustees to decide in a DB scheme. But FDs are deeply interested in what contributions they have to make to the deficit each year, and this amount is in turn influenced by investment performance. FDs are deeply involved in this. We see evidence that many FDs are heavily influencing Trustee Investment Committees.

Implementation and Selection is the detailed decision making level which covers the implementation of investment strategy and selection of investment and other suppliers. Again this is in theory the job of Trustees.

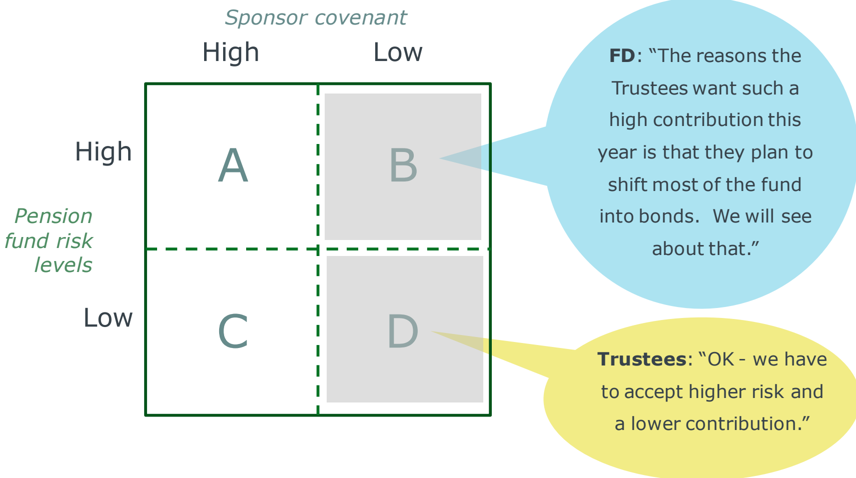
There is little evidence that FDs themselves are taking the lead in Implementation and Selection. However, in house Finance or HR teams can be closely involved, so the corporate footprint is not entirely absent.

Consultants play a vital role in advising FDs but not all larger firms rely on them as much as they used to. Consultants have traditionally acted as advisers to Trustees but are increasingly also advising companies, particularly FDs. Increasingly larger firms have the confidence to form their own strategies, and they are relying for guidance less on advisers and more on the experience of their own in house teams, sometimes staffed by ex-consultants.

"The finance interests predominate when establishing investment policy for the pension scheme. We have a joint trustee company investment committee and the Finance Director is a crucial part of that investment committee, and we work out how we want to run the thing." FD/7

"I can talk about pensions strategy, but I don't get involved in details like selection of suppliers. We have participated with the trustees in the thinking behind the manager selection process, but the trustees make the ultimate selection and you would do better to speak with them about how they rate the current fund managers." FD/48

FDs are effectively leading the decision on contribution levels, and in so doing are also indirectly (or directly) leading the conversation on derisking.



FDs are effectively taking the lead in investment conversations with trustees to ensure they get the investment strategy they want – the one which reduces their annual contribution to paying off any deficit to as low a level as is reasonable.

This does not mean there are conflicts or that FDs are in any real sense seeking to disenfranchise Trustees. As FDs have become lured into decisions in pensions, so they have interacted more with Trustees. Relations are usually very constructive, discursive and non adversarial, although things get strained when company covenant weakens. But many FDs privately express their weariness with the Trustee model.

There may be several factors which drive risk appetite according to FDs. It is not easy to predict from the outside what stance any FD or Trustee will take in any situation, since we have observed varied reactions to quite similar circumstances.

The covenant has a bearing on risk profile as does the size of deficit, the proportion of active members, as does the sector of a company. In the matrix above we have chosen to illustrate the four broad approaches to risk that sponsors can take - all four options are possible. We encountered Low Risk and High risk strategies in High Covenant companies, and vice versa.

There is one set of outcomes which is most frequent, and which helps to highlight the typical nature of FD/Trustee dialogue. In low (or medium) quality covenant companies, very often Trustees take the position shown in Box D in the matrix, above, and very often also FDs take the position of Box B. In the illustration we have attempted to characterise how the debate that starts off focused on contribution levels required from the sponsor quickly shifts to a conversation about investment strategy. The quotation (FD/44) to the right also helps to make this point.

In most examples of this debate that we were told about, the contribution level that an FD wanted to achieve was usually what was eventually agreed. Trustees are largely powerless in this negotiation. Based on this, we conclude that FDs are effectively leading the decision on contribution levels, and in so doing are also indirectly (or directly) leading the conversation on derisking in many firms.

"Trustees might ask me for £XXm as an annual contribution to the deficit, and I can only afford 65% of that. So I will need to find out what's driving their request. And that takes me into investment territory because the reason the Trustees want so much is that they are being cautious in their investment strategy, much too cautious for my liking. So we sorted that out by encouraging a change in the investment approach. Net result, the scheme got the 65%XX that we had offered." FD/44

"There are real disagreements about when derisking is appropriate and it does not follow a simple pattern. For example in an unprofitable business you will hear one of two views. Some will react by saying: 'The company is really weak we've got to put it all on black and hope we get out of jail'. But others will react by saying: 'The company is basket case, we need to stuff it all in Government bonds'. Now in strong companies you also get two views, for the exact opposite reasons. There are the risk takers whose pension scheme is 75% in equities because the company is strong so it can take lots of risk. But you also get strong companies whose pension scheme says, 'Great well that's the opportunity to take risk off the table so we will'." A/9

We set out to research behaviour in large companies in particular. Our conclusion: FD involvement in pensions is much greater in larger firms.

One of the main objectives of this project was to understand how FDs in larger companies in particular were thinking about pensions. Previous research on this topic had focused generally on (easier to access) FDs in small firms. What we have discovered is that the approach taken by FDs in larger firms is different to that in smaller ones.

FDs in larger firms show a much greater tendency to get deeply involved in Pensions Strategy. 30 of the 43 companies we spoke to revealed 'known' evidence* that their FD was involved in making Pensions Strategy decisions, and these 30 tended to be much larger firms than the rest of the sample as is shown in the table below.

	All	Known pensions strategy involvement	Rest	Known investment strategy involvement	Rest
Number of companies	43	30	13	15	15
Average number of employees	12,672	14,967	6,936	12,783	17,333
Average DB Pension Assets £m	3,203	4,004	263	4,265	3,787
Average % of members Active	20%	19%	23%	19%	20%
Average % Deficit:Liabilities	-12%	-12%	-10%	-10%	-15%
Maturity of business *4 = Very mature*	3.0	3.1	2.8	2.9	3.3
Profitability of business *4 = Very profitable*	2.8	2.9	2.6	2.9	2.9

We looked for other drivers of this involvement, such as each firms' deficit levels, their maturity and their profitability, but none of these appear to be the cause of this behaviour as can also be seen in the table.

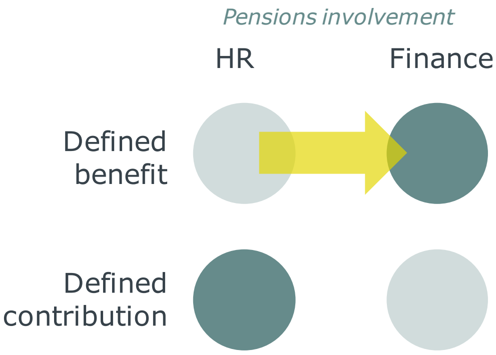
As for the next level of decision making, Investment Strategy, the evidence was less clear. The 15 firms we encountered which showed clear FD involvement at this level of decision making, were of a similar size to the rest of the sample where we could measure to some extent this behaviour. We think that the findings here are unclear because of the difficulty, that we encountered throughout this project, of defining with precision 'involvement' and the cut-off between the decision levels, and indeed the cut-off between functions.

So we have to rely on judgement here, but our overall conclusion remains that FD involvement in pensions is much greater in larger companies.

* By 'known' evidence we mean that in these cases we know there is evidence. In the rest we either established there was no involvement, or we could not be sure.

HR, once seen as leading on pensions matters, is now increasingly handing over leadership on pensions to Finance colleagues.

In the past HR tended to take the running on pensions, but as active membership declines there is a clear shift of responsibility on closed schemes to Finance. The interplay between HR and Finance on pensions can be very complex and nuanced in large companies. The shift to DC and auto-enrolment is giving HR renewed roles in pension leadership.



"As the DB loses its active members, so it becomes a Finance challenge rather than HR one."

There were other organisational findings from the research. One relates to the team that surround FDs. It is a mistake to think that the FD is the only Financially-driven decision maker that matters. Within the FDs team are several functions which carry out the FDs edict on pensions, particularly Treasury and Pensions specialists. Company pensions specialists, excluding those who report directly to Trustees (of which there are an increasing number), tend report in either to the FD or HR, sometimes both, but increasingly it is to FDs or a Finance function. Also often involved in Pensions issues, and sitting within the FDs team are Risk Managers and Financial Controllers.

Another key finding relates to Consultants who often play a vital role in advising FDs on pensions matters. Actuarial and investment consultants have traditionally acted as advisers to Trustees but are increasingly also advising companies, particularly FDs. In many cases it is the pensions teams within audit firms who capture this business.

There is another trend, less favourable to consultants: in the larger firms in particular Pensions-focused teams are being built by FDs, and they growing to the extent that they have the confidence to form their own strategies, and they are relying for guidance less on advisers and more on the experience of their own in house teams, sometimes staffed by ex-consultants.

"As our scheme shifts in character from being one that is supporting a large number of active members, to being a scheme that has, in our case virtually no active members, it changes from being a challenge for HR to being a challenge for Finance." FD/26

"Anything we do on pensions will impact on HR and vice versa. Mostly it impacts both teams, so we form a project team where one or other person leads that project and we make sure the others are involved. I think in most of those things we find ourselves very aligned and we figure out what the right thing to do is and it's very easy to find agreement." FD/24

The annual running costs of pensions are not the key issue for FDs. What causes them most pain are annual contributions to paying off deficits.

FDs hate the uncertainties of pensions contributions, and they long to be rid of the burdens of having to pay them. They also resent the other costs like advisers fees, PPF levies, and the costs they see coming from auto enrolment. DB pensions present a real threat to survival of some companies. But it is not the annual running costs that FDs tend to mind so much, these are often considered to be below the radar of FDs. What matters most are the enormous annual contributions they are required to make to the deficit, these have far greater impact on their P&Ls and threaten their Balance Sheets.

There are other pensions-related concerns that FDs express. Pensions tie up capital that could be better used elsewhere - given the choice FDs would prefer to invest resources in business growth than in reducing pension deficit. Pension deficits are making it difficult to buy and sell businesses. Shareholders are sometimes watchful on pensions issues.

FDs say that the wide range (some say 7) of DB valuations they are given is a recipe for disaster. They are particularly scathing of the absurdity of putting so much store on gilt yields. FDs hate uncertainty and they find the way that pensions numbers change so much makes their job unnecessarily difficult.

FDs often play a key role in liaising and negotiating with Trades Unions, particularly on pensions matters. Unions place a high value on final salary pensions, and FDs live in some fear of the threat they pose in supporting this position. But FDs working to reduce the burden of expensive schemes are willing to go to extreme lengths to achieve this.

"We did this scary graph looking out twenty years to see what would happen, even with just longevity rates as they are. The result was that the pension scheme annual contributions threatened to engulf the profitability of the business to such an extent that we wouldn't even be able to afford our basic running costs." Ch/8

"The sooner I close the deficit the better because then my PPF contributions are lower and my P&L charge is lower as well. So I've got fairly good incentives for closing it. The PPF's levy is a particular incentive for closing it because it does feel like while you're making large contributions and paying a PPF levy you're being taxed." FD/22

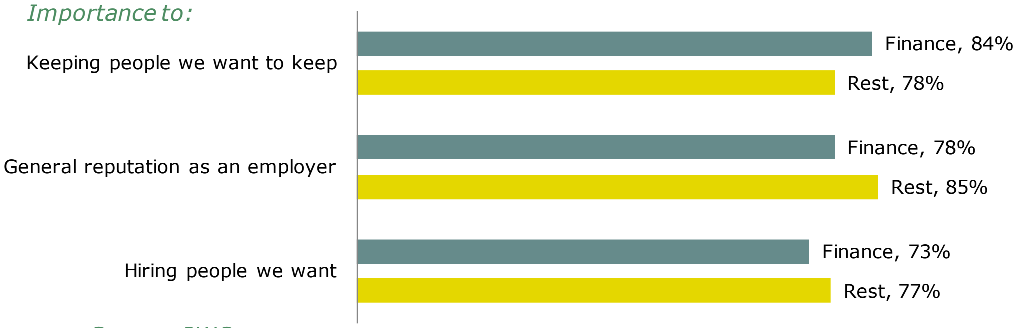
"When you are making acquisitions, you look at companies with DB plans, and there is always such uncertainty. Is the problem £Xm? £Ym? Is it twice £Ym? It makes it difficult to make a decision when you've got that level of uncertainty." FD/44

"Stop confusing the issue by having seven different versions of the truth. I cannot cope with this concept of not understanding what the liabilities in present value terms are worth. I find it completely unhelpful to talk about liabilities using all these different methods." FD/17

"I think the problem is that Governments of all descriptions keep layering legislation on top of legislation. There's going to come a point where you simply have to close the defined benefit and go to a pure DC scheme, because for us complying with the DC rules is a lot easier than it is for DB." FD/22

The caricature of FDs, that they only care about the Balance Sheet, is wrong. FDs in large business think that being nice to employees is sensible, not paternalistic.

How important is good quality retirement provision to achieving the following goals of your organisation?



Source: PWC

FDs of larger companies (and it is really only the very large that this applies to) work very effectively to achieve two apparently conflicting goals: they want to be a good employer *and* also zealously guard their balance sheet. FDs of larger companies are genuinely 'nice' and concerned with employee interests. Being 'nice' is not really about being paternal or altruistic. A strong company provides a more secure pension, so the balance sheet matters to everyone. Being 'nice' to employees is second nature to FDs in large companies because it makes good business sense - employees will be happier and more productive. FDs also know if they are not 'nice' they will be in the newspapers.

Independent survey data supports this. In a 167 respondent Pensions survey carried out by PWC in 2011, 49 (27%) were in Finance. In exclusive analysis of this data, we have shown how Finance and non Finance responses vary. It suggests revealingly that Finance people think the same way about most pensions issues as other functions. An example is shown above, which reveals that Finance think in a very similar way to other functions on supposedly 'soft' issues such as the importance of retention of key staff.

FDs are very conscious of the divisive effects of DB pensions. They create conflict between members and non members, which has a drag on morale, and gives an advantage to firms without DB costs. DB pensions also cause conflicts between UK and non UK divisions, and between age groups. These are all concerns for FDs, just as much as they are for HRs.

FDs are aware of various ways in which they face personal conflicts in relation to pensions. Schemes with no senior executives are much more likely to be closed, and some FDs, whilst having a clear idea of their own pensions needs, are said to have lost a sense of the needs of others lower down the company. But others behave in a 'straight' way to avoid conflict.

"Our job is to make profit for our shareholders, that's all we're here to do. But there's clearly a whole load of constraints which are legally driven, morally driven. Our philosophy is that if you deal with people in a pretty straight open way, you don't try and rip them off, you don't try to abuse the power you have, that's what counts. There is an overlay about acting straight, being fair, doing things in a decent way." FD/24

"We've got only 200 hundred people out of 600 employees that have some association with the scheme. The ones who don't would rather be rewarded for what they are doing now rather than all my efforts go to rewarding a whole stack of people who chose not to stay with the company." FD/21

"The problem we had was that all the Executive directors were all in the scheme and a hard close would hurt them disproportionately. The FD was particularly conflicted, he was a recent joiner but stood to benefit from a full pension on retirement, and he was resisting closure like crazy." Ch/8

FDs are closely involved in investment derisking decisions, but often avoid the detail.

Closing a DB fund does not necessarily reduce its risk, but it reduces the escalation of it. Cost is a major reason for closures, but there are other drivers. As funds close in a market, recruits do not value the DB offer of those that remain. HR can find the admin of DB funds very burdensome. As active membership falls, final closure becomes inevitable.

Buy-outs had few advocates among FDs in this project. The cost is unrealistically high. Anyway, the risk ultimately remains with the company - the counter party risk is too great. Nonetheless it remains a long term goal for some.

Several FDs talked favourably of their LDI programmes, which were seen as effective equity reduction programmes over time. None of those we talked to about Fiduciary Management were yet converted to this solution, but it was significant that most FDs did not know what it was.

FDs had not often formed views on Longevity Swaps. The idea of applying a hedge to specific cohorts did hold appeal. ETVs are attractive to some, as are use of triggers. Some companies express suspicion of packaged solutions provided by asset managers or advisers, and describe their own in-house designed derisking solutions with some pride.

There may be several factors which drive risk appetite according to FDs. The degree of derisking and the size of deficit ought to be correlated, but in fact it is difficult to predict any one company's attitude. The covenant has a bearing on risk profile. The proportion of active members also has a bearing on risk appetite as does the sector of a company.

"We would never sell to a buyout because we'd have to pay an enormous amount and we would still continue to hold the ultimate risk." FD/14

"To be shot of the plans and the risk and the volatility associated with them would make me extremely happy, just like it would them, so we are aligned philosophically, that's not the problem. But being shot of the risk comes down to a matter of price and we've not had a meeting of the minds on that one." FD/48

"We are doing our own LDI, with my investment manager, my advisor, ourselves all agreeing how we do that. Effectively we're overlaying a nominal interest rate swap and an inflation swap - that gives me a real interest rate swap – and that's all we do. It's simple. I can see what's going on, the transaction costs are cheap because inflation swaps trade in the market and interest rate swaps trade in the market. Of course as soon as I accept a packaged service, I'll be paying premium." FD/17

FDs are not currently involved in DC as much as in DB. When they focus on DC, they see advantages in getting rid of Trustees altogether.

When looking at where FDs attention goes, it is DB and not DC that is the focus for FDs. DC only gets into FD consciousness when it goes wrong or because it carries a residual reputational risk. Once a DC scheme is set up, it requires minimal FD time to maintain. FDs see a need for member education, but they are very wary of getting too involved.

FDs are seldom involved in the minutiae of DC planning or running, and often admit that they are not familiar with some of the jargon in this area, such as the difference between Trust and Contract based. But FDs that are familiar express a preference for Contract based, and like not having to deal with Trustees or provide a lot of corporate governance.

"On DC, not a lot needs doing, more to do with making decisions about how we reduce the admin burden and cost, getting the right solution for the Group, but pretty much now that's in place or has been put in place, a limited amount of involvement, it's more down to the business units to roll it out themselves." FD/69

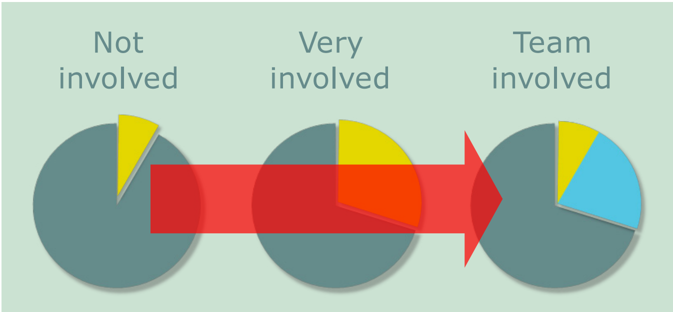
"When the discussion came up on whether to have a trustee based scheme for the DC schemes or whether we'd have it on a pure contract basis, I fought quite hard for having it on a contract basis. It's difficult to recruit trustees sometimes because of the personal obligation. So it's not necessarily right for the members I accept, but in terms of the burden on trustees I fought long and hard for going the contract route." FD/47

"It can't possibly be economic for a medium sized scheme to have Lay Trustees involved." FD/20

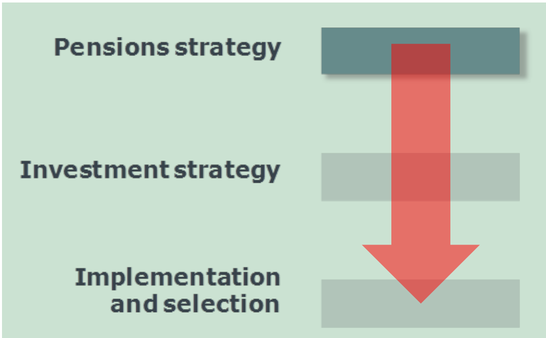
Our prediction is that FDs and their teams will eventually take the lead at all pensions decision levels, even Implementation and Selection.

We conclude by showing what we think are the trends for the future.

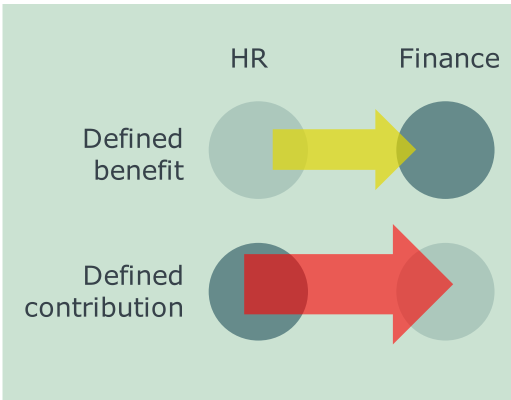
We think that FDs will continue to be come even more involved in pensions. In large companies this will mean that FDs will rely on larger and even better resourced teams that will do this for him (or her).



FDs (and their teams) will increasingly get involved in pensions decision making at all levels from pensions strategy right through to implementation and selection.



And finally We think that FDs (and their teams) will increasingly take over control of DC just as they already have in DB. We have seen clear evidence of this in the US, as well as in larger UK companies. Just because the DC scheme does not directly impact the balance sheet does not mean that FDs will not see many very important reasons for taking leadership in DC as well as DB.



The research was carried out among 43 firms, mostly large companies. We spoke to 25 FDs at larger companies and 35 others involved in pensions.

This research was carried out in the first half of 2011 in 60 interviews.

Excluding the advisers that spoke to us, and avoiding double counting where we spoke to more than one representative within several companies, there were 43 large UK companies included in the survey.

Since we were conscious that so many of the interviewees shared confidential and sensitive information with us, it seemed better in the end not to name any of the contributors. But between them they employ 444,000 employees and have DB pensions assets of £90bn. The total DB pensions deficit of this group was £9bn.

The interviewees were from a range of functions, and their titles are listed to the right. 25 of them were either Finance Directors, or were within a Finance Director's team and were able to speak on behalf of the Finance Director in functions such as Treasury or Financial control.

The others came from a mixture of Pensions related roles, some inside organisations, and some as independent Trustees. Their various roles are summarised in the box to the right. All respondents spoke to us about their own approach to pensions, but many were also willing to reflect on the approach taken by their Finance colleagues.

Categories of respondents

A	Adviser	5
Ch	Chairman	2
FD	Finance	25
HR	Human Resources	9
PP	Pensions Specialists	17
T	Trustees	2

SPENCE JOHNSON
Investment Marketing Intelligence

15 Abchurch Lane
London EC4N 7BW UK
+44 20 7112 2131
www.spencejohnson.com