Assessing the impact of pension liabilities on credit ratings

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Abstract The European pensions debate continues with vigour as companies take action to address defined benefit (DB) scheme deficits and the UK has already passed legislation to protect scheme members. It is the intent of this paper is to provide insight into how Fitch assesses the impact of pension liabilities as part of its credit rating process. It will also cover the increased pressure placed upon UK corporates to channel incremental funds into defined benefit pension schemes, a measure which is likely to constrain operating and financial flexibility.

Keywords: *credit rating; credit ratios; debt; methodology*

Background

There is a common misconception that the debate has been fuelled by the decline in the equity markets which commenced in 2001. Markets are only now returning to growth. While this is largely true for the UK, where the pension schemes are specifically invested in these types of assets, this is not necessarily the case for the rest of Europe, where pension funds are provided on the companies' balance sheets rather than being invested in specific assets that carry their own risk characteristics.

According to Mercer Human Resource Consulting,¹ FTSE350 defined benefit (DB) pension scheme deficits remained broadly stable during 2004 despite the increases in the equity market. Its projections are that the deficits amounted to £71bn, down from £73bn the previous year. The calculations are based upon FRS17

figures. Fitch comments that while many companies are putting increased funds into their schemes, the liabilities continue to grow as discount rates are lower and further adjustments are made to other assumptions in the calculation.

Credit methodology

The general pan-European rise in pension liabilities led to some modification to Fitch's financial ratio analysis with the publication of its methodology report in March 2003.² This methodology was devised as an approach for both funded and unfunded pension liabilities. Ratio adjustment is required on both leverage (net debt to earnings before interest tax depreciation and amortisation [EBITDA]) and coverage (EBITDA divided by interest) to reflect this and is similar to how the agency approaches other liabilities, for example operating leases.

These ratios are not the leading part

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of the agency's analysis, but enable Fitch to quantify more accurately the effect that pension fund deficits have on credit ratings and thereby improve transparency for the investor. Pension liabilities are long term in nature and the extent of the liability has been currently heightened by the decline in equity markets since 2001, although market recoveries may mitigate this. This was not the case in 2004 as previously noted, however. Adding pension deficits to other long term liabilities such as financial indebtedness gives an appropriate financial means of measuring pension liabilities.

To date, Fitch's European corporate credit ratings have not changed in a wholesale fashion because of this issue.³ It is expected, however, that some increased volatility will occur in the UK related to the provisions of the Pensions Act 2004 (discussed below).

Five key jurisdictions

Fitch examined the practice and requirements of DB pension provision in five key European jurisdictions — UK, Germany, Italy, France and Spain — to determine the status of the pension creditor upon insolvency and the accounting practice.

This analysis showed a difference between countries where DB pensions have historically been provided by the private sector and those where reliance is primarily upon the state pension scheme. It further highlighted that where reliance is placed upon the corporate to provide the pension promise there are two key ways of executing this.

Funded schemes

This model, used in the UK and the Netherlands, involves the creation of a pension scheme through a trust which

names the pensioners (current, deferred and future) as the beneficiaries. The trust appoints trustees who are typically representatives of the beneficiaries and also the sponsoring employer and the trustees manage the scheme according to the trust deed. The powers granted to the various parties through the trust deed can vary considerably. Contributions from the sponsoring employer are used to purchase assets, which are expected to generate a return to pay the liabilities that the scheme accrues on behalf of the members, ie the pensions promised to members.

In reference to the UK, prior to 11th June, 2003 it had been the case that a solvent employer could wind up a pension scheme without satisfying the full liability. Subsequent to that date, the full buy-out liability must be satisfied, effectively translating the scheme into a debt on the company. This is also the claim that the scheme would levy against an insolvent employer following 15th February, 2005. It should be noted, however, that the pension scheme creditor remains an unsecured creditor and would therefore rank after secured and alongside senior unsecured debt.

Unfunded schemes

Unfunded schemes are prevalent in the German corporate landscape. In this case the company builds the liability on the balance sheet, effectively using the provision as a source of internal funding.

Adjusted credit ratios

Following its analysis of pension liabilities, the agency introduced a number of adjustments to leverage and coverage ratios to ensure consistency of measurement across the corporate landscape.

Table 1: Comparison of five key jurisdictions

	UK (FRS17)	Germany	France	Italy	Spain
Status of pension creditor	Unsecured	Unsecured	Preferred	Preferred	Unsecured
P&L charge	Service cost	Service cost	Service cost	Cost of TFR — 7.41 per cent of salary	Service cost
Balance sheet	Reflects separate asset and liability	Generally shows unfunded pension accruals/provisions	Either balance sheet provision or disclosure of liability in the notes to the accounts	TFR provision shown on balance sheet — unfunded	Supplementary pension liabilities, which have not yet been externalised, are reported as a provision on the balance sheet
Discount rate	'AA' corporate bond	Maximum 6 per cent	Disclosure of this is recommended but not compulsory	Only current sum accrued shown on balance sheet, rather than future liability	A full set of assumptions are used rather than a single defined discount rate
Salary growth Assumption	Disclosed	None permitted	As above	TFR adjusted annually by 1.5 per cent plus inflation adjustment	Part of the set of assumptions applied

Source: Fitch

Leverage ratios — Capitalisation of pension deficit

Fitch recognises that pension liabilities are essentially debt-like but are also long term in nature, with no requirement to fund the deficit immediately. As such the adjusted ratios attempt to capture this aspect of the liability.

- For unfunded schemes the agency uses a debt figure in proportion to the balance of debt to equity in the business at the most recent balance sheet date to reflect the long-term nature of the liability.
- For funded schemes the agency adds the full pension scheme deficit (as measured by FRS17/IFRS19) in its calculations. Surpluses are not netted across schemes sponsored by a particular company, since their recoverability is unclear. In the UK the Pensions Act 2004 has effectively restricted the ability of company sponsors to repatriate the surplus.

Coverage ratios

For unfunded schemes the cost of carrying the liability is calculated using either a reported interest cost or an imputed cost.

For funded schemes, Fitch calculates both adjusted gross and net coverage ratios. The gross coverage ratio is deemed the more important of the two since it measures the cost of carrying the liability without the expected return of the assets, which may or may not be achieved.

Qualitative aspects

In addition to the quantitative ratio adjustments Fitch also takes into account various qualitative factors in its analysis. These include:

- distribution of investments;
- actuarial valuation versus IFRS19 (or FRS17) valuation versus full-buy out cost;
- profile of scheme members: current employees, deferred pensioners, current pensioners;

Table 2: Fitch worked examples of ratios

UK Plc			
Cash	30	Financial debt	200
Current assets	170	Trade creditors etc	250
Fixed assets	400		
Goodwill	150	Equity	300
Total assets	750	Total liabilities	750
Net pension liability/ deficit (FRS17 scheme deficit net of deferred tax)			100
EBITDA			120
Interest expense 10 per cent on 200			20
Service cost (FRS17 charge to operating profit or current service cost)			10
Net interest cost = 5 (Net of return of 20 and expenses of 25) (FRS 17 discloses expected return on pension scheme assets and Interest on pension scheme liabilities; in some cases Fitch will have to derive an interest cost where FRS17 disclosure is not adopted)			
Normal Ratios			
Leverage – Net Debt: EBITDA			1.4x
Coverage – EBITDA: Net interest			6.0x
Adjusted ratios			
Leverage – net debt + pension deficit: EBITDA + pension contributions			
Coverage on net interest basis – EBITDA + pension contributions:		$2.1 \times (= 170+100:120 +10)$	
net interest + implied interest + pension contributions		$120+10: 20+10+5 = 130:35 = 3.7x$	
Coverage on gross interest basis – EBITDA + pension contributions:			
net interest expense + gross interest on pension scheme liabilities + pension contributions		$120+10:20+25+10 = 2.4x$	
German AG			
Cash	30	Financial debt	200
Current assets	170	Trade creditors etc	150
Fixed assets	400	Pension provision	100
Goodwill	150	Equity	300
Total assets	750	Total liabilities	750
EBITDA			120
Interest expense 10 per cent on 200			20
Pension contributions (<i>Personnel expenses of which ...</i>)			10
Pension liability added to debt = [Total debt/(total assets-pension liability)]*		$[200/(750-100)]*100 = 31$	
Pension liability			
Implied interest cost			$31*10\% = 3$
Normal Ratio			
Leverage – Net Debt:EBITDA			1.4x
Coverage – EBITDA:Net interest			6.0x
Adjusted Ratios			
Leverage – Net debt + adjusted pension liability: EBITDA + pension contributions		$170+31:120+10 = 1.5x$	
EBITDA + pension contributions: Net interest + pension contributions		$120+10: 20+10+3 = 130:33 = 3.9x$	
+ implied interest cost			
Wording in italic represents line items in company accounts.			

Source: Fitch Ratings

- assumed rates of return and discount rates applied;
- size of deficit relative to net assets of company; and
- management attitude and commitment to funding pension scheme.

Responses to pension scheme deficits

Since Fitch published its methodology in March 2003² corporates have responded in a variety of ways to the matter. The key implications are discussed below.

Table 3: Illustrated example of pensions-related issuance — funded schemes

Cash	30	Financial debt	200
Current assets	170	Trade creditors etc.	250
Fixed assets	400		
Goodwill	150	Equity	300
Total assets	750	Total liabilities	750
Net pension liability/deficit			100
EBITDA			120
Interest expense (10% on 200)			20
Service cost			10
Net interest cost (Net return of 20 and expenses of 25)			5
Normal ratios		Fitch adjusted	
Leverage (x)	1.4	Leverage (x)	2.1
Coverage (x)	6.0	Net Coverage (x)	3.7
Debt Issuance	50	Gross Coverage (x)	2.4
Normal ratios		Fitch adjusted	
Leverage (x)	1.8	Leverage (x)	2.1

Source: Fitch

Pensions-related debt issuance

The USA set a precedent for debt issuance when General Motors Inc ('GM') issued US\$13.2bn of bonds to finance its pension deficit in 2003. This was followed in the UK by Marks & Spencer plc ('M&S'), which issued a £400m bond in March 2004 and directed the proceeds to the pension scheme.

For funded DB schemes such as M&S this is a credit neutral step since the adjusted leverage metric remains constant, as illustrated in Table 3. The additional leverage and coverage ratios are devised to track such changes.

For unfunded schemes, partial funding of the scheme will not have as severe an effect on the adjusted credit ratios as in the case of funded schemes, reflecting the fact that only part of the provision is treated as debt-like. In the case of full funding of the scheme, there is likely to be a cross-over point between the treatment of the scheme as funded or unfunded.

Funding of such a scheme should be viewed in the context of the regulatory environment, which does not require funding as of March 2005.

Asset allocation

An example is ICI's creation of an 'asset backed guarantee' for £250m to support its pension fund in case of corporate insolvency. The assets were trade receivables and were placed in a subsidiary of which the pension scheme is the only creditor. This has effectively subordinated the bondholders' position, a result which could lead to a rating action.

Such a step effectively creates a conditional contribution whereby the guarantee is available to the scheme should the creditworthiness of the company decline. It is not, however, as definitive as a formal contribution to the scheme, since if the scheme were to enter surplus the guarantee remains unused or is reduced, rather than the company clawing back the surplus through reduced contributions during an undefined future timescale.

UK pension schemes — Influencing corporate flexibility

Various recent developments that are particular to the UK have led Fitch to believe that the increased pressure on corporates to channel incremental funds

into their pension schemes may constrain their operating and financial flexibility to some extent.⁴

These developments can be summarised as follows:

- ‘Funding Defined Benefit Pension Schemes’⁵ a paper published by partners at leading actuarial firms and presented to the profession. It calls for increased exercise of the rights of scheme trustees to ensure their schemes are adequately funded, improved clarity from the actuarial profession on the funding status of such schemes and what this provides to members. The paper concludes that in many situations the optimal policy is to fully fund on a solvency basis and to invest in low risk bonds.

This paper also recommends the pension deficit be treated as an unsecured loan from the pension fund to the corporate sponsor. As such the likelihood of payment is closely aligned to the credit rating of the corporate sponsor. A pension scheme in such circumstances should therefore take credit ratings into account in setting risk limits. This is echoed in the proposals by the Department of Work and Pensions (DWP) (in its consultation on Pensions Act 2004 Code of Practice⁶) that a breach of a bank covenant or a change in credit rating to ‘sub-investment grade or ‘junk’ (ie below BBB-) should be notifiable events to the Pensions Regulator if combined with other circumstances.

Potential tension between loyalties for trustees who serve a dual role as part of the senior management team of the corporate sponsor is another pressure highlighted in the report. It suggests that in extreme circumstances, trustees could use pension fund objections to achieve

corporate aims. While governance concerns do not directly affect the credit profile of the corporate sponsor, Fitch observes that a strengthened regime could result in increased funding calls from trustees.

- Evidence of increased activism amongst scheme trustees in recent high profile merger cases, eg WH Smith, Marks & Spencer. In both cases the potential acquisitions were abandoned, partly following calls by the pension schemes for incremental funding. Trustees’ powers are determined by the trust deeds, however, and can vary significantly, although all trustees can set the investment strategy. This means that where the risk is perceived to increase the trustees can require that the fund invest in less risky assets.

In the WH Smith case the trustees had the power to set the funding level and, following the failure of the acquisition, a sum of £120m was paid into the scheme in return for a reduced annual contribution.

In the case of Marks & Spencer, the trustees did not have the ability to set the contribution limit. A result similar to that of WH Smith was achieved through illustrating a variety of investment strategies that could be adopted to reflect the increased risk from the corporate sponsor.

- The Pensions Act 2004 (‘The Act’), which passed into law in November 2004 and established the Pension Protection Fund (‘PPF’). The latter will represent an incremental cash cost to pensions schemes, which is likely to be pushed back to their corporate sponsors. The levy will be risk-based from 2006 with a flat-rate levy charged from April 2005.
- The ability of the Pensions Regulator to impose contribution notices, financial support directions and

restoration orders upon companies will divert funds from bondholders to pension schemes. These powers may result in the lifting of the corporate veil, with the ultimate parent company potentially liable for the liabilities of a subsidiary. In particular this could become a stumbling block in private equity transactions where financial sponsors effectively replace equity with debt.

It remains to be seen how these powers will be interpreted in practice. It is suggested that the Allders pension fund could be a test case. Allders, a chain of UK department stores, has recently been placed in administration by its ultimate parent, Minerva, a property company. Allders' parent company, Scarlett Retail, is 60 per cent owned by Minerva, 20 per cent by Lehman Brothers and 10 per cent each by Terry Green (CEO) and Phil Cox (Commercial Director). The wind up cost of the scheme is estimated at £60–75m.

Key questions include:

- Will this scheme be eligible for the PPF?
- Will the Pensions Regulator challenge Minerva as parent of Allders?
- How will the sale of one of the company's key assets to Minerva be viewed?
- The proposed regulatory review of schemes on merger and acquisition may at best delay the takeover process but could also deter consolidation within certain industries should full buy outs of the pension scheme be required. Those in receipt of a clearance statement, however, will have some comfort when entering such deals. The Act is still in the early stages of implementation and therefore some elements remain to be clarified. Fitch will monitor developments to

Definitions

Contribution notice: may be applied to someone who after 26 April 2004 did something designed to avoid a scheme's liabilities. Extent of contribution can be up to the statutory debt level.

Financial support direction: if the employer is a service company or insufficiently resourced this forces funds to be directed into the underfunded scheme.

Restoration order: requires compensating repayment of money or undervalued property transferred away in the two years prior to insolvency or call on the PPF (after April 2004)

determine the extent of any constraint upon corporate flexibility.

These developments are likely to lead to increased rating volatility at the time of merger and acquisition activity as pension trustees wake-up to their new powers and ability to place onerous obligations upon sponsors, to the disadvantage of the predators.

IFRS19

The transition to IFRS reporting will create further transparency and comparability for European companies. Deficits under IFRS19 should not be substantially different from those reported in the UK under FRS17 notes to the accounts. The main difference will be that the profit and loss account will become increasingly volatile.

Conclusion

In summary Fitch believes that defined benefit pensions will increasingly

influence credit analysis and corporate ratings. This is particularly true for the UK where new legislation has increased the prominence of such liabilities and created a regulator with more wide ranging powers than the prior regime. Further, Fitch expects the move to IFRS across Europe will increase the prominence of defined benefit liabilities and may act as a stimulus for further regulation beyond the UK.

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