CARTWRIGHT

Industry Update

Is Sterling's current weakness an opportunity to accelerate deficit contributions from overseas parent companies?

This Update builds on our July 2016 Update in which we briefly covered some of the immediate implications for DB schemes in light of the UK's EU Referendum result, and will be of particular interest to trustees and employers of UK defined benefit ("DB") pension schemes where:

- The scheme's sponsoring employer views the world in a currency which is not £ Sterling (e.g. there is an overseas parent company or a substantial part of the business comes from outside the UK); and
- Deficit recovery contributions have already been agreed or are being finalised.

Long-dated gilt prices (and, broadly, pension scheme liability values) generally rose over the first half of 2016, rising faster and further in the aftermath of the EU Referendum. This reflected the consensus view at that time that UK economic growth is likely to be less than expected, the Bank of England is likely to keep short-term interest rates lower for longer, risk averse investors moved from equities to bonds, and the Bank of England announced an extension of its bond buying programme.

However, since August, gilt prices, and therefore pension scheme liability values, have fallen as the short-term economic data and investors seem to be more positive than originally thought. This then reversed a little since the end of October, probably as attention moved to the US Presidential election (which so far today has had limited impact on key financial markets).

Given that the typical UK DB pension scheme invests in assets that are quite different in nature to the liability value (even the bonds are often a poor match), we have seen some substantial volatility in the deficit. The deficit is the difference between these two much larger asset and liability numbers, and so there is also a gearing effect. This deficit volatility is shown as the blue line in Chart 1 below: the deficit has increased from £20m as at 1 January 2016 to c£27m now (see under the charts for details of the assumed typical scheme).

Along with gilt yields and equity prices, £ Sterling has also been volatile. It has gradually weakened this year, but fell dramatically after the EU Referendum, and again in September when Theresa May's Conservative party conference speech was interpreted as there being a higher chance of a "hard Brexit". Chart 1 also shows a UK pension scheme's deficit from the point of view of someone who thinks in terms of other currencies. We have shown the £ deficit in US$, euros and yen – the deficit has not increased as much in these other currencies. Please let us know if you would like to see the impact in a different currency.

However, whilst the underlying deficit can be volatile when measured on a daily basis (Chart 1), trustees and employers tend to review and fix the employer's contributions once every three years. If a trustee board fixed the employer's contributions at the start of 2016 based on a funding deficit of £20m, this would be equivalent to US$30m, 27m euros or 3600 million yen at that time.

Due to £ Sterling weakness this year, an overseas parent company could save money by paying that 'fixed' £20m funding deficit (or part of it) now, i.e. by paying only US$25m, 22m euros or 2600 million yen (exact amount depends on when it is paid, and £ Sterling could of course strengthen or weaken from here). That is a saving of US$5m, 5m euros or 1000 million yen, and a happier trustee board!

Suggested action:

- Trustees to consider asking the employer to accelerate some or all of the planned deficit recovery payments into the scheme to take advantage of current £ Sterling weakness; and
- Trustees and employers to consider whether they should now reduce the deficit volatility, and whether their scheme is sufficiently well-diversified across different investment risks.

Chart 1: Impact of both rising gilt prices and falling Sterling on the funding deficit

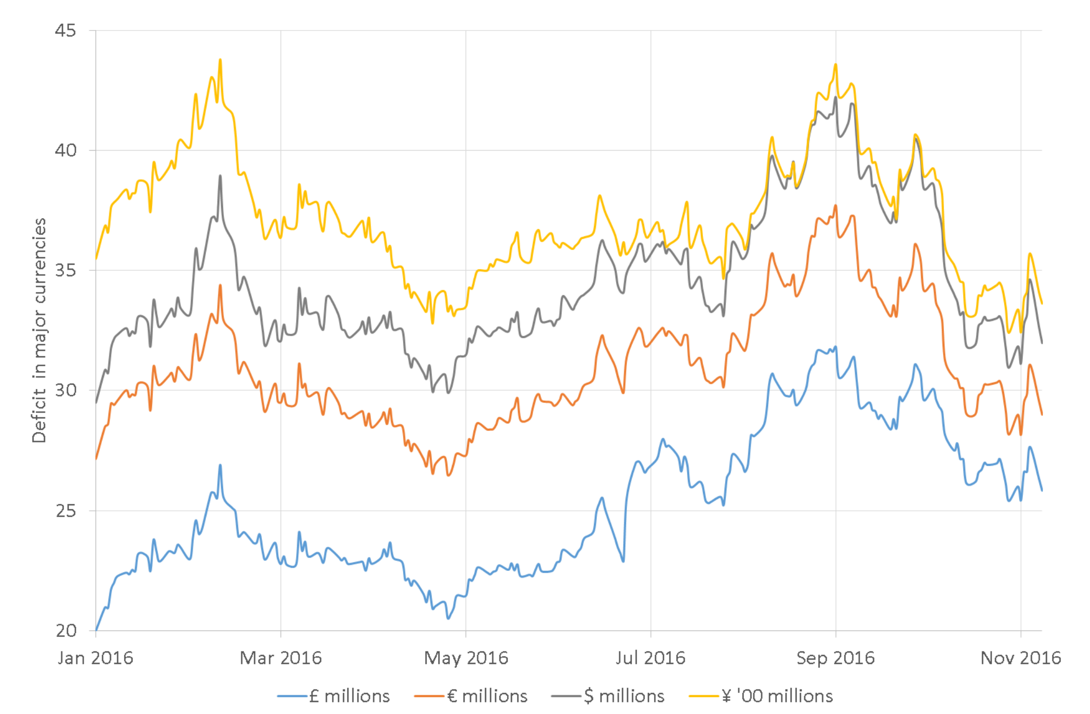
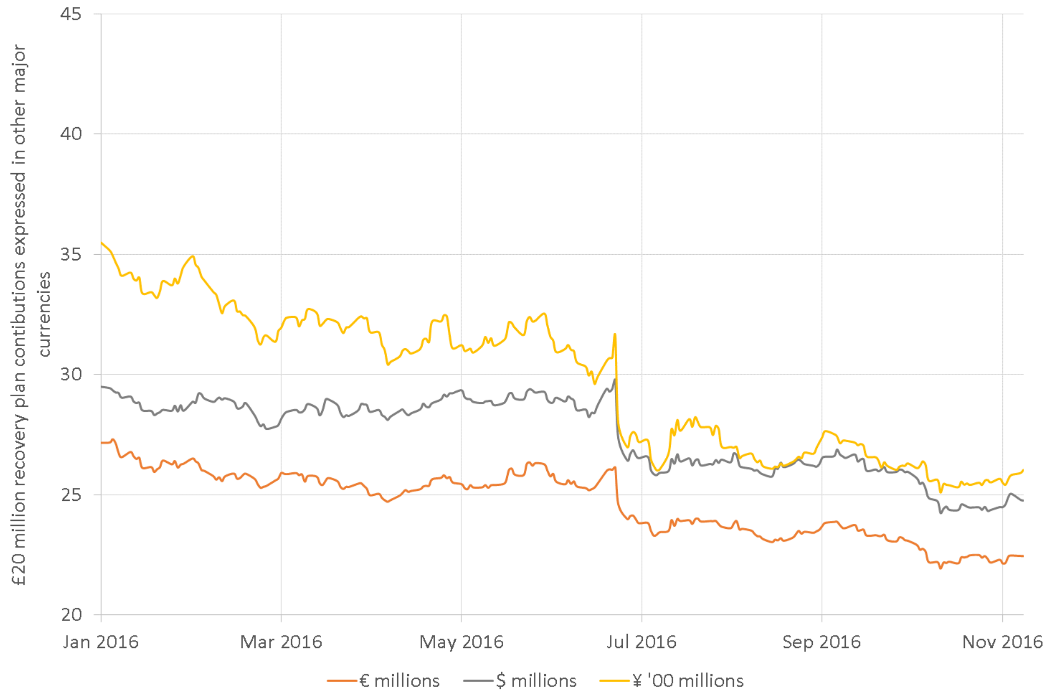


Chart 2 – impact of falling Sterling on a 'fixed' funding deficit



Source: Thomson Reuters and analysis by Cartwright. Assumes at the start of the period a scheme with a liability value of £60m (duration 20 years and inflation sensitivity of 50%) and an asset value of £40m (60% global equities and 40% corporate bonds). Charts show the period from 1 January 2016 to close of business on 8 November 2016.

If you would like to discuss this further please get in touch with your usual contact at Cartwright:

Mill Pool House
Mill Lane
Godalming
Surrey GU7 1EY

T: 01483 860201

E: enquiries@cartwright.co.uk

250 Fowler Avenue
Farnborough Business Park
Farnborough
Hampshire GU14 7JP

T: 01252 894883

E: enquiries@cartwright.co.uk

Marlborough House
Victoria Road South
Chelmsford
Essex CM1 1LN

T: 01245 293300

E: enquiries@cartwright.co.uk

The Mansley Business Centre
Timothys Bridge Road
Stratford Enterprise Park
Stratford-upon-Avon
CV37 9NQ

T: 01245 293300

E: enquiries@cartwright.co.uk