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Citigroup: the new player in the UK pension buy-out market?

The recent acquisition of the Thomson Regional Newspapers' pension scheme by the multi-national bank Citigroup has been regarded by many commentators as a significant development in the market for buying out pension liabilities. Have Citigroup really found an innovative new solution which could help companies with closed pension schemes dispose of their pension liabilities?

Background

To acquire the pension scheme Citigroup bought the shell company Thomson Regional Newspapers ("TRN"). The TRN accounts for the year ended 31st December 2006 reveal that the company is a holding company, and does not trade. The company's only significant asset was an amount of £46.7 million owed to it by other companies within the Thomson Corporation, and the only significant liability was also in respect of an inter-company loan, this time for an amount of £23.3 million. These loans led to a net asset figure of £23.4 million.

The company is also responsible for a defined benefit pension scheme. This does not appear directly on the balance sheet since the scheme is not in deficit. The notes to the accounts reveal that on what appear to be fairly reasonable FRS17 assumptions the pension scheme had assets of £218 million and liabilities of £194 million, leading to an "unrecoverable surplus" disclosed in the accounts of £24 million at 31st December 2006. This corresponds to a fairly healthy FRS17 funding level of 112%.

However, the FRS17 disclosures are somewhat misleading. The pension scheme held annuity policies which were valued at £114 million at 31st December 2006, corresponding to over half of the total asset value. These match the liabilities of some of the current pensioners, and as such the scheme is not exposed to any investment or longevity risk in respect of these members. Removing these pensioners and the corresponding annuity policies from both the assets and the liabilities suggests that the scheme had assets of £104 million and liabilities of £80 million. Therefore, in effect the £24 million surplus actually corresponds to a funding level of 130%. This is probably getting close to the funding level which would be sufficient to secure the benefits of the scheme through an insurance company buy-out.

The pension scheme is closed to new entrants and is fairly mature, since it has circa 800 deferred pensioners and 2,800 current pensioners.

The deal

By purchasing TRN, Citigroup have assumed full responsibility for the operation of the pension scheme. Since the Pensions Regulator has granted Clearance for the transaction, the company's former owners have effectively washed their hands of the pension scheme, removing all risk associated with it.

The sponsor of the scheme will continue to be TRN. Therefore, it will be TRN that the trustees will turn to if they require any additional contributions in the future. The only change due to the transaction is that TRN will now be a subsidiary of Citigroup, rather than a subsidiary of The Thomson Corporation.

The pension scheme itself is unchanged by the transaction. The trust deed and rules governing the pension scheme will not change, and the trustees will still have the same level of responsibility, whereas in the case of a buy-out with an insurance company the trustees obtain a "clean-break".

The trustees themselves will also be the same, except that Citigroup have the power to add a company-appointed trustee to the board. Therefore, the trustees will continue to have control over the operation of the scheme, including the investment strategy, and they will only be required to consult with Citigroup. Although the company-appointed trustee will be able to make suggestions to the other trustees, there will be no requirement for the trustees to heed this advice.

This deal differs from a traditional insurance company buy-out since Citigroup will be transferring the investment and longevity risk onto its own balance sheet, so will be governed by pensions rather than insurance regulation. This would allow Citigroup to adopt a more adventurous investment strategy than an insurance company would be allowed to, although it is likely that the investment strategy will still be fairly prudent. However, they will require trustee support before making any changes to the investment strategy.

Citigroup has indicated that it plans to use a liability-driven investment approach to reduce the scheme's exposure to investment risk. Currently, around half of the scheme's assets are held as annuity policies, probably to match the liabilities of current pensioners. Most of the remaining assets are held in gilts, with around 13% of the assets being held in equities. This appears to be a fairly prudent investment strategy, since the value of the annuities and the gilts should correspond closely to the value of the liabilities as calculated on the FRS17 basis. The equity holding is broadly comparable to the amount of the surplus, so could be considered to be unmatched, and used to maximise expected investment returns.

Reading between the lines

Although Citigroup have not disclosed the details of the deal reached with TRN, it is possible to speculate on the detail of the arrangement.

The only change to the pension scheme as a result of the transaction is a possible change in the strength of the employer covenant. Since Citigroup are a large multinational bank, we can speculate that the trustees did not consider that the transaction would weaken the employer covenant. It is also likely that the Pensions Regulator agreed with this assessment, since he granted Clearance in respect of the transaction.

The appeal of the deal to Citigroup relies upon their ability to maintain the surplus within the pension scheme, and eventually tap into it. Although it is fairly difficult to get access to a surplus within a pension scheme at the current time, since the benefits of all members must be secured with an insurance company before any surplus can be reclaimed by the sponsor, Citigroup should be able to take a long-term view on the release of surplus. The recent de-regulatory review also proposed making it slightly easier to remove surplus funds from pension schemes, so it is possible that it may become easier for Citigroup to remove the surplus in the future.

Due to the healthy funding position of the pension scheme on an FRS17 basis, with good use of a liability-driven investment strategy Citigroup would need to be fairly unlucky not to be able to run off the scheme with the existing assets, leaving some surplus funds. Indeed, given that the surplus revealed in the FRS17 disclosures at 31st December 2006 was calculated using a discount rate of 5.0% per annum, Citigroup are likely to be confident that they could achieve an investment return in excess of this over the long-term, further increasing the level of surplus within the scheme.

Citigroup are also likely to appoint a new company trustee to the trustee board, in order to increase their influence over the investment strategy followed by the pension scheme. They may also be keen for the scheme to invest in Citigroup's own liability-driven investments, in order to ensure access to the scheme's investment expenses.

However, since Citigroup will not have any direct control over the investment strategy there is a risk that the trustees will not adopt the investment strategy desired by Citigroup. There is a risk that the trustees use the surplus to "de-risk" the investment strategy of the scheme, moving all the equity investments into gilts and buying more annuity policies, reducing the amount of surplus in the scheme. The trustees may consider this to be particularly appropriate due to the relatively weak covenant which the shell company TRN provides. Crucially, the trustees will not be interested in maximising the surplus which is eventually returned to Citigroup; they would much rather reduce the level of risk within the scheme and increase the security of members' benefits.

Another risk to Citigroup is that the pension scheme moves into deficit at some stage in the future, and the trustees demand deficit contributions from TRN (now a subsidiary of Citigroup) to remedy this. We speculate that in this event

the sponsor would need to recall part or all of the inter-group loans payable to TRN, and use these to fund the deficit. However, if more than the £23.4 million currently outstanding on the company's balance sheet was required, we speculate that it is unlikely that Citigroup would be on the hook to pay this. Although they may prefer to pay any additional amount to avoid negative publicity, they would probably be able to let TRN become insolvent, with the pension scheme falling into the Pension Protection Fund.

Although Citigroup have not revealed details of the value of the transaction, it is possible to speculate. The value of the company depends on the value placed on the risks associated with the pension scheme. However, due to the maturity of the pension scheme and its healthy funding position on the FRS17 basis (particularly after making allowance for the annuity policies held), it is probable that TRN was fairly attractive to Citigroup. In addition, Citigroup were probably in a reasonably strong bargaining position, since the only alternative way to dispose of the pension scheme was through a buy-out with an insurance company, at considerably higher expense. We might therefore speculate that the vendor received some limited credit for the FRS17 surplus within the scheme – possibly valuing the surplus at up to £5 million.

Conclusion

A host of insurance companies have entered the UK buy-out market in the past year, but most have been unable to convince pension schemes that the expense of buying out their pension liabilities is worthwhile.

Although there has been considerable press speculation suggesting that Citigroup may be about to become a major player in the UK pension buy-out market, this seems to be fairly unlikely. It appears that they will only be interested in closed pension schemes which have a very mature membership, since they are likely to want to limit their exposure to longevity risk.

A similar deal occurred when PIC bought the Thorn pension scheme recently. Again the scheme was well funded on the FRS17 basis and the sponsor was of a relatively insignificant size compared to the pension scheme. In these circumstances it is not surprising that another company would be interested in acquiring the pension scheme through the purchase of the company, speculating that with careful management of the pension scheme they would eventually be able to release some of the surplus.

However, these circumstances are few and far between. Indeed, a relatively insignificant company with a well funded pension scheme may consider there to be little risk connected to the pension scheme, so may see little benefit in selling it on. As such, it seems unlikely that solutions of this type will be appropriate for many more closed pension schemes in the UK.

Where can I get further information?

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