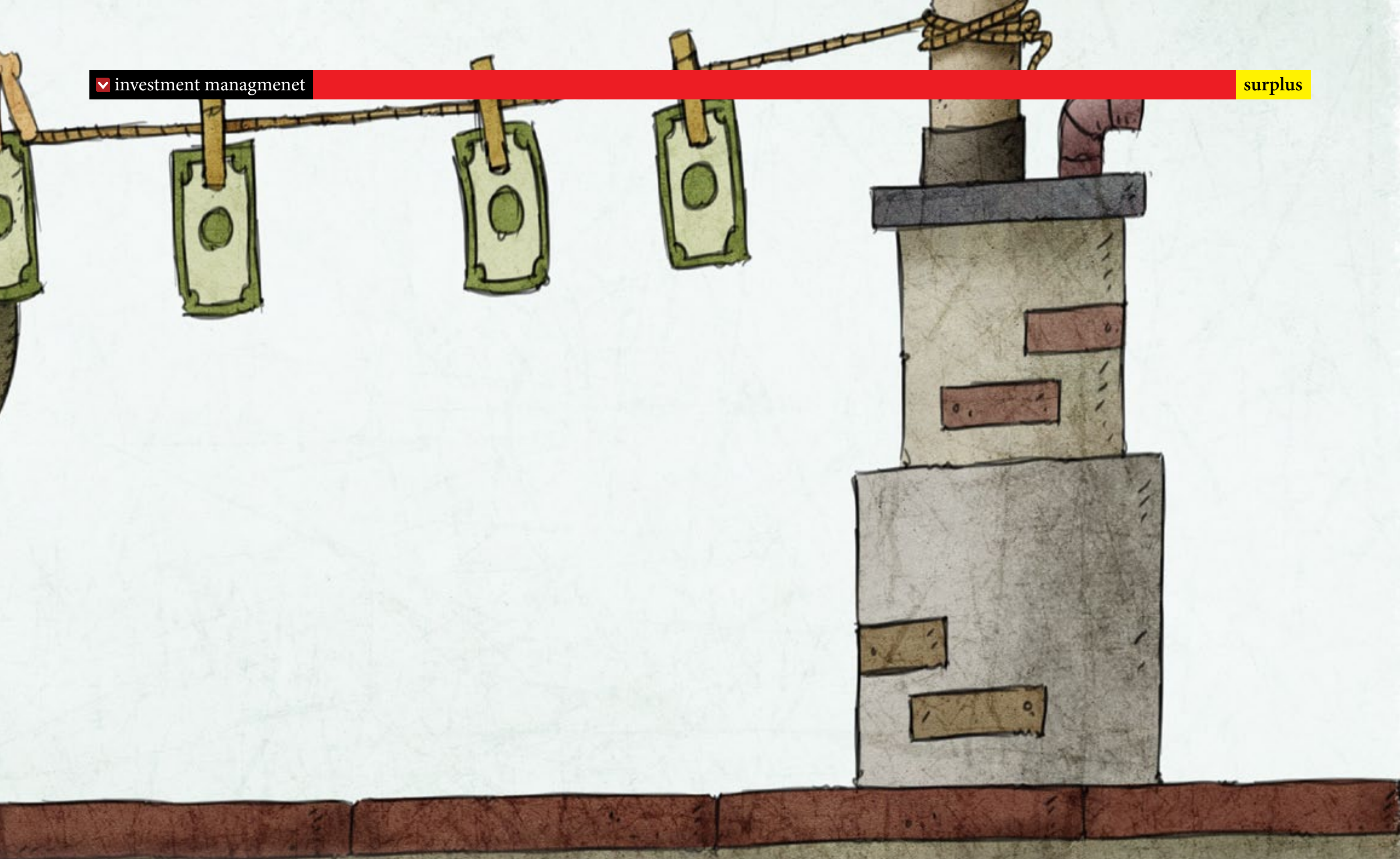
Searching for surplus

Following both the Royal Mail and M&S' pensions surplus announcements, Lynn Strongin Dodds explores whether there are lessons to be learnt in how to decrease deficits

Summary
- M&S and Royal Mail both recently posted pensions surpluses, although with Royal Mail this was aided by the government taking over the scheme's deficit. M&S attributes its surplus to higher than expected returns on assets and company contributions.
- Schemes that are improving their positions typically use a combination of three factors: investment strategy, employer contributions and liability matching strategies.
- Pension funds may be finding it difficult to decide how to implement LDI strategies in the current environment. Pension funds are encouraged to look beyond tried and tested LDI strategies.
- The use of asset backed funding (ABF) is also gaining momentum over the past year.

At first glance Marks & Spencer and Royal Mail pension schemes seemed to buck the deficit trend that has plagued so many of their defined benefit peers. A closer look reveals though that the healthier coffers were aided by special circumstances rather than any new investment plans that others could emulate.

In the case of the Royal Mail, the postal group had a helping hand from the UK government, which took over the scheme's £10 billion deficit and £38 billion of liabilities before the company was privatised in 2013. This left the reformed Royal Mail Pension Plan (RMPP) with an £830 million surplus. Contrary to its projections though the postal group scheme, along with the smaller Royal Mail Senior Executives Pension Plan, reported a combined gain of £3.2 billion in March under the IAS 19 accounting standard, compared with £1.7 billion last March and £2.1 billion as of 28 September 2014, according to the company's latest annual report covering the financial year to 29 March.



Industry participants note that the improved funding picture can be attributed to an increase in the market value of gilts and derivative assets principally held to hedge inflation and interest rate risk. The strategy was implemented during the initial public offering as part of its agreement with the unions to keep the RMPP open until at least March 2018, subject to certain conditions. The scheme is then expected to dip into the red again although the company cannot comment on any exact figures because it is in the middle of the valuation cycle.

As for the M&S pension scheme, the retailer is sitting on a surplus of £449 million, up from £189 million, partly due to the higher than expected returns on assets as well as a generous contribution of £143 million from the company as part of its triennial valuation, currently based on the 2012 valuation. The company, along with other heavyweights such as Lloyds, Shell, BP, International Airlines Group (British Airways), HSBC and Aviva, are currently undertaking a new review and expectations are that there will be demands for potentially significant increases in employers' funding contributions as pension scheme deficits continue to grow.

The latest figures from the Pension Protection Fund shows there were 4,808 schemes in deficit and 1,249 schemes in surplus, although the aggregate black hole in the PPF 7800 dropped to £241.3 billion at the end of May 2015, from £242.3 billion at the end of April 2015, while the funding ratio increased from 84 per cent to 84.1 per cent.

Unfortunately for pension schemes, there is no magic bullet to whittle down the deficits. Schemes that are improving their positions in the current environment are typically using a combination of three factors: investment strategy, employer contributions and liability matching strategies to limit downside risk from events such as a stock market crash, sharp interest rate movements and high inflation or deflation, all of which could significantly erode their funding levels. One of the biggest challenges is convincing schemes to embark on this route even if the assets are more expensive than they were in the past.

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"If you look at the results of the PPF 7800 index in 2014, the volatility in funding has been driven by liabilities, so one of the key drivers to pension funding was their approach to hedging," says Aon Hewitt partner Tim Giles. "Those that implemented a strategy three to four years ago have performed the best while those that didn't have what is called 'regret risk'. One of the problems is that schemes tend to get anchored in what

prices looked like in the past and what the portfolio looks like today and they do not want to make a move. However, doing nothing is a choice and there is no guarantee that the prices will be better or worse in future."

JLT Employee Benefits director Charles Cowling adds: "Those schemes that took the risk off a few years ago are now sitting pretty and are in a much better position. The problem was that people thought interest rates were going to rise (or at least rise faster than implied by market prices) and they kept delaying their decisions. Now many people can't afford to 'get out of the casino and cash their chips in' at the current rates and they feel they do not have a choice but to carry on taking risk. This way is a dangerous game. The theoretical argument is that interest and inflation risks should be hedged because they are unrewarded."

Although LDI can typically be broken into two parts – assets that manages liability risks and those that seeks to generate appropriate investment returns, the framework will depend on a pension fund's particular requirements, including funding level, contribution rates, market expectations and the strength of the sponsor. In addition, the risk appetite and potential cost should also be reflected.

"There is no right or wrong way to develop an LDI strategy," says Giles. "There is a lot of focus on models but I do not think pension funds should be slavish to them. They should carefully analyse and understand their risks, look at the stochastic outcomes, what if scenarios, liquidity levels, etc and understand the outcomes and the levers they can use such as hedging to control these. The key thing is having the governance to control the outcomes rather than taking comfort in inertia."

Market participants also advise pension schemes to think beyond the tried and tested methods. For example, market level triggers that increase the amount of liability hedging when interest rates rise had become a popular tool before the financial crisis. This approach worked well until central banks flooded the markets with money and predicting interest rate rises became more difficult. Today, funds are advised to look more carefully at the trade and possible expense of relying on external factors instead of the position of the scheme.

"My personal view is that we are in an environment where pension funds are finding it very hard to decide how to implement LDI strategies," says Redington head of consulting David Bennett. "In the past, pension funds often used market-based triggers but the relationship between macroeconomic themes and rate rises that existed before the financial crisis no longer works today. The big question that funds should be asking is whether they have the right-sized risks in each of the risk buckets, whether it is equities, inflation or interest rates."

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The starting point for Bennett would be for pension schemes to establish a pension risk management framework that sets out long-term objectives, risk constraints, a full funding time horizon, liability valuations, the required returns to meet the funding objectives, hedging targets and collateral requirements for the derivatives used. Although swaps and gilts would form part of the LDI strategy, it could also include infrastructure debt, ground rents, long-dated property leases and other assets that offer contractual cash flows and seek to earn incremental returns from illiquidity. The return-seeking portion could comprise of not just equities but also diversified growth funds.

While LDI remains one of the most prevalent tools for whittling down deficits, asset backed funding (ABF) is also gaining momentum. The practice involves a company using its business assets, ranging from property to corporate bonds, intellectual property and intra group loans, to generate cash that is later paid to its pension scheme. A recent report by KPMG shows that the value of these structures rose to £700 million in the UK alone in the six months until the close of March. This number eclipsed the £600 million in asset-backed funding seen internationally in the year up to September 2012.

"We have seen a significant rise in the number of ABFs and other alternative funding arrangements over the 2013 to 2014 period and I think they will continue to increase," says Stewart Hastie, partner at KPMG. "ABFs work well with pension funds that have stubborn deficits and where the company cannot provide the cash quickly. They use business assets to back a long-term income stream, which is treated as an upfront contribution."

Written by Lynn Strongin Dodds, a freelance journalist