Summary

- Most DB schemes are currently in a funding surplus; last time this was the case was the 1980s/1990s.
- The surpluses of the 1980s and 1990s were based upon a more relaxed valuation and funding regime.
- Surplus extraction, market movements and greater governance scrutiny swung DB schemes from surplus to deficit.
- Until DB schemes' liabilities are completely removed through an insurer, there remains the risk that schemes could now fall back into deficit. However, these scheme surpluses being based on a more prudent basis than the past, along with greater investment in low-risk assets such as bonds, and stricter regulation, minimises this risk.

Turning back time

DB schemes are currently enjoying funding surpluses, but haven't we been here before? Laura Blows considers the changes and challenges that have occurred since the previous era of DB surplus in the 1980s/1990s, and the lessons to be learnt from that time

The current world of surpluses that most DB schemes are living in feels like a welcome relief from the many years labouring under stubborn funding deficits. But this is not the first time that DB schemes have been in surplus. In the 1980s and 1990s, DB schemes were also enjoying a funding surplus, and, like now, debates were had then about how best to utilise that surplus. So, are we reliving the same scenario as 40 years ago, and what lessons can we take from last time to ensure DB schemes' funding positions do not swing back to a deficit once again?

A more relaxed, return-seeking time

To explore the similarities and differences, let's cast our minds back to how things were.

BESTrustees president, Alan Pickering, begins with the 1970s, when DB schemes were heavily invested in equities, and remained so even during the oil crisis affecting the markets in 1974/75, "on the basis that a leaky bucket with some money going into it is better than a bucket with none".

DB schemes investing heavily in equities, property, etc, continued during the 1980s and 1990s, as a return-seeking investment strategy was logical for these immature schemes that were still open to new members and future accrual.

Also, during this time, actuarial funding methodologies would implement a 'smoothed' funding process, "using the then-common assessed value method of asset valuation", ACA committee member, and WTW partner, Debbie Webb, says.

However, actuaries assuming 'future credit' from expected investment returns, which made schemes seem in surplus, was fine 'if' markets behaved "as expected", LCP partner, Jonathan Camfield, says.

If markets did not behave as expected, its impact was somewhat diminished by schemes not having to guarantee to provide any pension increases in payment, Webb adds.

The combination of strong investment returns (and future expectations of more) and a 'relaxed' funding regulatory requirement meant that many schemes were considered in surplus, based on the valuation approaches in use at the time.

Clouds on the horizon

But, unlike now, these surpluses were not necessarily seen as a reason to celebrate; more a problem to be solved, Pickering says.

Schroders global co-head of client solutions, Ajeet Manjrekar, highlights how, in the mid-1980s, a 5 per cent cap on surplus with tax on extraction was introduced by *[then-Chancellor]* Nigel Lawson.

Also, the 1986 Finance Act determined that pension schemes could be no more than 105 per cent funded on a prescribed valuation basis.

This was because the government was worried that employers were claiming too much tax relief by "shovelling money into their pension schemes to shelter profits from corporation tax", Pensions Archive Trust director, Jane Marshall, says.

This meant that the surplus needed to be removed, through such ways as refunding money to the employer, subject to a 40 per cent tax charge, or discretionary enhancements to past service benefits for members, or the sponsor taking a contribution 'holiday' of up to five years.

Similar to now, there was much debate around how to determine whether the employer or the member should receive some, or all, of the excess.

However, the 1987 *Courage* court case, which set out an approach to handling DB surpluses (i.e. that the surplus does not 'belong' to members, but they can expect trustees to press for them to share in it), became the authority, Marshall says.

The desire to access DB scheme surpluses also became a factor in corporate transactions, with companies with well-funded schemes targeted for acquisition. Sometimes a well-funded scheme acquired as a result of the transaction was merged with a less well funded (or underfunded) scheme elsewhere in the corporate group to make use of surplus, Marshall states.

Back then, "there was no real concern about the funding and security of pension schemes", because "the system had worked and people assumed that it would always work", she adds.

But then, come the 1990s, and things started to change, not least due to the Maxwell scandal *[where media mogul, Robert Maxwell, misappropriated millions of pounds from his company's pension funds into his failing businesses]* generating greater scrutiny of the management of DB schemes.

This resulted in the 1995 Pension Schemes Act, which required pensions to be converted from a 'best endeavours' basis to employers having to meet the full cost of insuring the scheme if they chose to walk away. It also established The Occupational Pensions Regulatory Authority (OPRA).

The 1990s also saw former Chancellors Norman Lamont and Gordon Brown respectively reduce, and then abolish, tax relief on dividends resulting in a material deterioriation in scheme surpluses.

Pension accounting rules were also changed, bringing volatility to companies' balance sheets, and asset values fell during the bursting of the tech equity bubble. New ideas about pension funding emerged, Webb says, which argued that pensions should be valued and considered using gilt-based methodologies, and that the high equity strategies were too risky.

As we moved into the new millennium, the 2004 Pensions Act resulted in the formation of the Pension Protection Fund, and OPRA being replaced by The Pensions Regulator (TPR). The regulator required that a pension scheme be funded prudently, so

"Surpluses are likely to be more persistent than those in the past, with the funding overall expected to be rather more stable"

"basic things that we're used to now were not a requirement pre-2004. There is now a regulatory regime that is not just a little bit stronger, it's enormously stronger", Camfield highlights.

These changes, both the decrease in the funding position, and the increase in regulatory red tape, made DB schemes less attractive to employers. Therefore, over the years, they closed their DB schemes to new members and to future accrual.

"These closures in turn meant schemes were maturing quickly, which itself provided a further incentive to reduce exposure to return-seeking assets as a result of the shorter periods over which uncertain returns from riskier assets could be smoothed," Webb says.

"And then, after the 2008 crash and its aftermath, and as schemes were increasingly looking to invest in gilts and credit, interest rates fell further."

Different this time

The result was a "perfect storm", Webb says, which swung DB schemes into deficit, based on the more conservative funding approaches now employed.

"With the benefit of hindsight, some schemes looked back at the benefit improvements and contribution holidays of the 1990s and regretted that they had not chosen to keep the surplus in the scheme, or taken a different approach to measuring the liabilities and assets," Webb says.

This period of DB funding levels in deficit continued until both the 2022 gilt 'crash' and the current inflationary environment swung many DB schemes back into surplus.

Today's surpluses are not the same in structure as the surpluses of the 1980s and 1990s though.

The measures used to assess surplus now are much more rigorous and conservative, based on assuming very low future returns and building in prudent allowances for future mortality improvements. Downside risks are mitigated through interest and inflation swaps, lower exposure to volatile return-seeking assets, and through buy-ins and longevity swaps to mitigate longevity risk.

"So, there is a belief that the surpluses are likely to be more persistent than those in the past, with the funding overall expected to be rather more stable," Webb says.

One similarity, however, are the conversations about how to distribute the surplus to the employer or (DB/DC) members. Yet, "there is much less flexibility in the funding regime now than there used to be, hence concerns over 'trapped' surplus", Marshall says.

The government's response to last year's consultation on options for DB pensions, and its plans to lift restrictions on DB schemes accessing surplus, is expected in the spring.

"Before considering any surplus release, trustees will typically carefully consider remaining downside risks and investigate scenarios that could cause a deficit to recur," Webb says.

DB schemes' current surpluses could be redistributed back into the sponsor's business as recompense for the many years it put money into the scheme to try and plug its deficit. Or, the surplus could be used to fund DC benefits; or to provide discretionary increases for some pre-1997 benefits that have never received any pension increases.

Manjrekar highlights how trustees need to have careful consideration for the Trust Deed and Rules, member expectations for discretionary increases and the guardrails for surplus release (e.g. subsequent deterioration in scheme funding, covenant weakness, or scope to re-claim released surplus).

"It does worry me, the intellectual and political firepower being directed at pension schemes as a source of surpluses," Pickering says. "My mind goes back to those earlier decades when having a surplus was a source of industrial discontent, rather than euphoria."

However, there is confidence that DB scheme's surpluses are more persistent this time. "A return to pre-2022 levels of gilt yields is, in our view, unlikely," Webb says, "but potential risks could include a sudden acceleration in longevity improvements, or very low inflation or deflation. It is therefore likely that trustees will be seeking to retain appropriate buffers and/or contingency arrangements to absorb such fluctuations and risks, before considering using surplus in some way."

So, might there be a chance, however slight, of history repeating itself and DB schemes swinging back into deficit?

After all, as Pickering says, "there's no guarantee that if we're in surplus now, we'll be in surplus in the future".

"We might then be forced to go back to invest pension scheme assets in a much less adventurous way, which would not only make pension provision more expensive, but would undermine the growth that they're all assuming," he adds.

However, last time DB schemes were in surplus, it was while they were heavily invested in equities. In contrast, this era of surplus comes with DB schemes mainly holding bond assets. Therefore, a future stock market crash is less likely to affect DB schemes' funding positions, and "the gilt crisis of 2022 simply changed gilt prices and actually improved scheme funding for many", Camfield says.

However, "whilst some schemes are now in surplus, many are still on a primary pathway to secure members' benefits with a third-party insurer", Manjrekar says.

"We've pretty much learned all the lessons of the past – arguably too well"

It is still a long time until all DB schemes have substantially removed risk though, Camfield warns.

"Insurance capacity for buyouts is around £50 billion a year so far; there is still around £1 trillion of uninsured DB pension assets that could still be negatively affected by future developments", he explains.

It is these potential future risks that makes Pickering feel uncomfortable about rejoicing in today's surpluses.

"Deciding to run on the scheme must not be a purely financial issue," he warns. "I, as a trustee, would feel very exposed if I'd gone along with a solution that risks members' pensions; if I turn my back on this opportunity to cement that good financial position of the DB scheme."

Yet, the industry is now "so focused on taking risk off the table" that this surplus era is "too little too late" for risk attitudes to really change, Marshall says.

Lessons learnt?

So, with its cautious approach to DB scheme funding, even in a time of surplus, it appears that the pensions industry has learnt its lessons from the previous era of surplus to deficit swings.

In fact, according to Marshall, politicians, regulator and the industry have learnt the lessons – "or got burnt" – from the past "too well", with all the subsequent rules and regulations ultimately resulting in the retreat of private sector employers from the DB space. "I'm sure that wasn't intended, but that has been the consequence," she adds.

Meanwhile, "if I were to roll back to three or four years ago, I would say there are still more lessons to learn, as there are still some DB schemes that are invested in a way that is probably too risky for their employer covenant", Camfield says.

However, TPR's new Funding Code, with its emphasis on integrated risk management, has materially mitigated that concern, and so, "we've pretty much learned the key lessons of the past – arguably too well", he adds.

Camfield suggests that many DB schemes in surplus can now afford to take on slightly more risk than they currently do if they wanted to, by unlocking some of their assets to invest in return-seeking assets, such as those targeting a return of 1 per cent a year above gilt returns – "assets that are still quite safe, but not 'super-duper' safe".

Meanwhile, in contrast to the 1980s government, which wanted DB surpluses released for greater tax receipts, this government has expressed its desire for some of the excess funds be invested into the wider UK economy.

While the legislation for surplus extraction is still being determined, Marshall states that it would be an "own goal" if the rules remain "tied up so tight that it becomes difficult for many employers to sensibly take advantage of what is quite a welcome situation".

Whether in the realm of DB surpluses or deficits, determining the right balance between flexibility and returns, with security and prudence, is the lesson the industry grapples with throughout its past, present and, undoubtedly, future.

Written by Laura Blows