Avoiding the trap

With DB funding levels having improved significantly over 2022, the issue of trapped surpluses has been exercising minds, but sponsors looking to claw back their capital may well end up being disappointed

The quasi-margin calls made on pension funds following the LDI liquidity crisis in late September opened up a veritable Pandora's Box of problems for the UK's entire defined benefit (DB) supply chain.

On the trustee and sponsor side, headline-grabbing cash injections have understandably caught plenty of attention. Even in early November, news was still funnelling through of high-profile DB rescue packages or liquidity mitigation plans, with Sainsbury's revealing in its interim results that it had set up a three-month £500 million loan facility on 18 October to ensure its DB scheme could cope with any future collateral needs on its LDI facilities.

At the same time, almost paradoxically, further scrutiny has been placed on the strong solvent position of the UK's DB system. In early November, PwC reported that its new Buyout Index had maintained a broadly unchanged funding level, with a surplus of £170 billion, meaning that many DB funds are in a position to enter buyout agreements. In the same month, the PPF 7800 Index indicated that the aggregate surplus of the UK's DB schemes had increased to £374.7 billion in October 2022; a year-on-year rise of £271.5 billion.

Rising gilt yields have clearly reduced DB liabilities over 2022, but in some cases, fresh capital boosts during the gilt crisis have led to immediate and lasting improvements to funding. And as WTW retirement business senior director, Edd Collins, points out, other factors have also contributed to the change. "The longer-term impacts of Covid-19 are leading to reductions in future life expectancies, and caps on inflationary pension increases have had an impact in a high inflation environment," he says. "While some of these impacts could reverse in future, a number of schemes will have taken steps to lock in these funding improvements by reducing the risk they are running. It is therefore likely that dealing with surpluses is something that many more DB schemes and their sponsors will need to consider than has been the case for many years."

Summary

- Cash injections following the LDI liquidity crisis have both emphasised and shed further light on DB schemes' strong funding positions.
- Schemes will be expected to work out how accessible a surplus is for a sponsor, what it means for a scheme's endgame and whether or not to continue to de-risk.
- The danger of 'trapped' surpluses has risen, as a result, and cumbersome scheme rules, statutory requirements and accounting systems, may mean that employers never get their capital back.
- Direct ways of avoiding a trapped surplus include stopping contributions, funnelling them elsewhere and augmenting pension benefits.
- Indirect methods include revised LDI strategies.

Although the situation is a welcome relief from years of grappling with deficits, it has also created new puzzles. In a recent report produced by LCP, the consultancy stressed that the realistic prospect of long-term surpluses mean that schemes will have to review their overall strategies. LCP says that when viewed through the IAS19 accounting measure, FTSE100 organisations have the potential to realise over £150 billion of value – if their schemes are run on. Given such a number, schemes will be expected to work out how accessible a surplus is for a sponsor, what it means for a scheme's endgame and whether or not to continue to aggressively de-risk.

The trapped surplus

In some cases, scheme trustees and sponsors may have to act quickly to avoid surplus money becoming 'trapped'.

This scenario can occur when there is a question mark over who owns the surplus in the event of a wind-up, once a scheme's liabilities have been discharged. In a blog published in October, Dentons partner, Eleanor Hart, wrote that this query is usually addressed within a scheme's rules, but there also statutory requirements in place that must be met before any surplus can be returned to the sponsoring employer. For example, any power to augment benefits that exists

must have been already exercised, and members must be given at least three months' notice that the surplus is to be returned to a sponsor.

Aside from following the rules to the letter, there could also be some confusion over how to account for a surplus on a sponsor's balance sheet. "It can be possible to account for a surplus, even if on a technical provisions basis the scheme is still underfunded, and in all likelihood no monies will ever end up being returned to the employer on a winding-up of the scheme," writes Hart.

"The return of any surplus to a sponsoring employer is therefore not an inevitability or a straightforward process, despite what, if anything, the scheme rules say," she warns.

Ending contributions

One way of avoiding a trapped surplus problem may be to stop contributions or divert them into another vehicle.

Collins says that in cases where a scheme is fully funded on its Technical Provisions basis, the sponsor may want to stop paying contributions. The nature of this discussion will be scheme-specific, but there are a number of examples where agreements to stop contributions have been reached, he says – both in relation to deficit contributions and also contributions for future benefit accruals.

"Before trustees agree to contributions stopping, they are, however, likely to want to agree when contributions restart, should positions subsequently deteriorate," says Collins. "Trustees can also protect their position by adopting a buffer above 100 per cent funding that needs to be reached before contributions turn off, or requiring the scheme to have remained fully funded over a specified period of time. With improving funding positions, we anticipate more corporates and trustees wanting to build automated switch-on and switch-off contribution mechanisms into future valuation agreements to avoid the need for ad-hoc agreements to be reached as funding positions change."

EY-Parthenon head of pensions alternative financing solutions, Eimear Kelly, says that for many corporates and trustees, the use of a structured vehicle – which sits outside the corporate – is one of the best ways to solve the contributions conundrum. "It offers an innovative, agile, and secure solution for both parties," she says. "It allows companies to efficiently manage capital, as the structure will funnel money into either the pension scheme or the company, as needed, whilst trustees and schemes can benefit from the security of a vehicle that provides adequate funding and is not at risk of bankruptcy from the corporate."

Other avenues

In XPS Pensions Group partner, Adam Gillespie's, experience, most trustees are very practical over the issue of a surplus, and generally believe that it should return to an employer if possible.

Nevertheless, in the current general cost-of-living crisis, there is a possibility that there will be widespread discretionary increases to pensions. As Gillespie says this could be quite tricky, as augmenting member benefits would involve working out how much to pay each cohort, while being as fair as possible.

"It has come about due to the high inflation environment, obviously, as virtually all pension payments are capped at either 5 per cent increases or lower. Current pensioners aren't getting full inflation increases, so there's been there's been talk about possibly using surpluses, to provide some sort of respite for pensions in that regard."

Gillespie has also heard stories about employers with multiple schemes, where one scheme is in surplus, and one scheme is in deficit, wondering whether they can merge the schemes together, and effectively share all the assets and all the liabilities.

Natural erosion

Avoiding a trapped surplus could also occur due to the change in LDI strategies that has taken place since the gilt crisis.

As the LCP report states, LDI managers have permanently imposed lower limits on leverage levels, typically around 1.5x to 2x (compared to 3x before late September 2022) as a "new normal". In essence, this means schemes will either have lower hedge levels or alternatively lower allocations to growth assets in order to maintain high hedging levels at lower leverage.

"It is possible that as schemes revisit their investment strategies and funding positions, some schemes find that they have to allocate more assets to maintain the same hedge positions and as a result forego returns on growth assets," says Hymans Robertson co-head of DB investment, Elaine Torry.

"In this case, the aggregate future expected return on scheme assets may be lower than previously assumed, as there are fewer assets invested in return seeking asset classes. The extent to which this eats into schemes' surpluses will depend to a large extent on what funding basis the surplus exists on. The greater the strength of the funding basis that the surplus exists on, the more likely it is that the scheme doesn't need the extra return and hence the less likely it is that the surplus will be eroded."

A great problem to have

Although losing out on DB surplus capital would naturally be viewed as a highly undesirable outcome, Gillespie says that over the course of time, it could still be viewed in a positive light.

"While an employer might not be able to get all their money back and they've paid more into the scheme than they needed to, they've reached nirvana, the ultimate goal. They're got more than enough money to get the pension scheme off their balance sheet and get all their defined benefit promises fully secured with an insurer.

"That's an absolutely great outcome."

Written by Marek Handzel, a freelance journalist