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EDITIONS

Our latest views

Authors
Vikram Chatrath
Jo Myerson
Akash Rooprai
Tegs Harding

SOCIAL SURPLUS

In this month's publication of Editions, we consider the concept of Social Surplus. As many schemes see buoyant balance sheets, it is sensible to have meaningful debate on the use of the capital over and above what is required to meet members' expectations. This may well lead to a rethink of the traditional management of pension scheme risk and return by considering wider social considerations. Collaboration between employers and trustees is essential to creating benefits that could be far ranging for scheme members, employees, and wider society.

Many schemes are in a better position than they have been before, some unexpectedly so (due to the gilt crisis last year). Typically, trustees, employers and indeed the advisers are focused on the securing of benefits though settlement (i.e. a buy-out) as the "best" endgame solution.

Market projections see a potential annual volume of £50-100 billion for bulk annuities over the next decade, much greater volumes than the market has ever transacted before.

However, there is the question as to whether the buy-out/buy-in market can cope with such volumes. The market continues to innovate, and new insurers are looking at entering the market. Despite the possibility of more insurers or innovation, due to people resources and most of these solutions are chasing broadly the same set of assets, little additional capacity exists in the foreseeable future. This may mean schemes currently looking to settle their liabilities are unlikely to be able to do so in their desired timeframe.

For a significant proportion of the market, run-off is the objective, for now or as an overall aim. This can be due to considerations such as covenant strengths of sponsors vs insurers, a paternalistic approach to pension provisions by sponsors or balance sheet requirements.

Pension Scheme Financing: "S" within "ESG".

There is a debate to be had on pension scheme financing, particularly the utilisation of any surplus. Indeed, the Government has called for better investment of pension scheme assets to help grow the economy – playing more of a part in the "S" within "ESG".

Innovation is already happening.

Sponsors are looking at novel ways to access surplus where they have a legitimate claim on at least part of the surplus and where there is comfortably an excess of funds in the scheme above a prudent level required for member security.

Some schemes are utilising assets to meet employer contributions for DC members, where this is possible. This works well in a hybrid scheme but becomes more problematic with the separate DB and DC schemes – a more common problem now transfers to master trusts.

Surplus as unencumbered capital

Can we think of surplus as free capital - not shackled by a requirement to meet a return objective or earmarked to make pension payments? By its definition, a surplus is the resource above which a trustee can meet the pension expectation of members while having little to no reliance on the sponsor to make up shortfalls.

We can extend this point to assert that the returns on any surplus negligibly impact the security of the scheme.

If we consider surplus as assets free of the traditional Asset-Liability management constraints, could the spectrum of what becomes a viable investment for the scheme widen

Therefore, if we consider these assets are free of the traditional Asset-Liability management constraints, could the spectrum of what becomes a viable investment for the scheme widen? Trustees could consider investing in areas not traditionally pension scheme fodder, such as use of surplus for the benefit other employees.

Trustees do of course have their duties, primarily focussed on the members. But where a scheme is so well funded, it seems sensible to consider wider objectives, subject to scheme specificities.

The metric of decision making

If trustees can think about investing the surplus in a different way, removing the traditional risk / return metric, what then becomes the metric of 'good'? This is where we consider the concept of the Social Surplus, where success is measured as improving various aspects of society more widely.

Many argue that pension schemes have contributed to generational inequality within the UK (directly and indirectly). It is also argued that the regulatory environment for pension scheme funding and investment has not been conducive to investment in the UK economy. This contrasts with pension funds in other countries who have been known to invest in the growth of their own countries.

The pursuit of diversification

Let’s consider in more detail this regulatory regime and why it hasn’t helped UK companies. Around 15 years ago; many pension schemes invested in UK equities and bonds with allocations replicating the 60/40 mantra. The market looked to manage risk and used geographies as a form of diversification. Schemes moved from being UK equity centric to allocating based on more global indices; the UK broadly equates to c.10% of the market capitalisation.

This flight to international territories would have seen limited net losses in institutional flows if the approach was respirated by foreign schemes. However, our international counterparts have remained relatively domestic. It has been estimated that the investments in listed UK equities have declined from 50% of asset allocation in 2000 to 4% in 2021.

We have a regulatory regime which advocates de-risking pension schemes into assets higher up the corporate structure. By its very nature, this results in schemes investing in more debt like instruments – where ultimately government debt has been a predominant receiver of capital within pension scheme portfolios. While this has been beneficial to the debt financing of the UK economy, it has arguable been detrimental to the” real” economy.

The market-to-market valuation of pension schemes has contributed to companies having to fund over shorter timeframes through higher levels of pension contributions and potentially over the lifetime of the scheme pouring in more capital than ultimately may be required. The rise of aggregate surpluses to £378.6bn by the end of April (as suggested by PPF 7800 Index) demonstrates the extent to which this has already happened.

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This framework has resulted companies having to balance the level of dividends to shareholders versus paying contributions to pensions, with the latter taking a greater share. DC returns for the younger workforce are predominately driven by equity market returns and therefore lower dividend can result in a lower return.

This has created additional equitability issues. Companies have certain constraints on finances and the size of each function’s budget. Given the DB framework, we contend that DB schemes are taking the lion’s share of the pension pie with DC members therefore losing out through a lower contribution rate. It seems highly likely that DC members will be less comfortable in retirement than their DB peers.

We are therefore at a crossroad where schemes, sponsors, trustees, and their consultants are uniquely placed to consider investments of assets that are not only in the interest of Scheme members but also to assist in social balancing. This is what we are calling the Social Surplus.

How do we make a surplus social?

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How can these assets be used in a more socially responsible way? We can find a potential example if we look to the housing crisis. The UK is suffering a significant housing market issue particularly with 'generation rent'. At the same time there has been a reduction in the number of planning applicants and firms, which have been trying to work in the social housing arena have folded. Is there a place for our social surplus to be used in this context; by providing a lower cost of capital to the market, are we able to enact change and development of under resourced areas?

To enact the case for the Social Surplus requires new and bold thinking, open and collaborative discussion between trustees and employers and potentially regulatory change. The benefits could be far ranging for members, employees, and wider society.

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