Ross Trustees

part of INDEPENDENT GOVERNANCE GROUP

FROM PLAN A TO PLAN B: COLLATERAL CONSEQUENCES

EDITIONS, APRIL 2023

EDITION 3

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WHAT WILL PENSION TRUSTEES BE CONTENDING WITH IN 2023?

KEY TAKEAWAYS

In order to contend with revised funding positions, trustees are looking to focus on risk transfer. It is equally important to have a Plan B in place. Trustees need to be willing to adjust their strategies and plans through flexibility and avoiding rigid thinking and execution. As we navigate the newly emerged landscape of collateral management, the successful achievement of a scheme's objective rests on how we balance the preparing for immediate opportunities and their back-up plans.

Over the last five months we have seen trustees have to interpret advice and guidance from multiple stakeholders; regulators, consultants, sponsors, and investment managers.

As we end the first quarter, we see further guidance issued by the Financial Policy Committee (FPC) of the Bank of England regarding collateral adequacy for schemes which employ leverage to manage their interest rate and inflation rate exposure.

However, despite multiple parties considering the issue of collateral advice and guidance tends to be consistent: increase collateral buffers to withstand greater increases in rates; and ensure that there are sufficient liquid assets in the event these buffers are exhausted. The FPC guidance reinforced that these more prudent collateral levels are here to stay.

You cannot really argue that an ability to withstand short term volatility is the part of the DNA of a pension scheme. However, with the continual focus on all matters collateral, as an industry, we should ensure this is considered in tandem with a scheme's long term aims and plans.

In the last 15 years we have seen schemes needing to deal with the fall out caused by shifts in the macro-economic environment. Post the Great Financial Crisis (GFC), schemes were dealing with the exposure to leverage credit products and more recently the Liability Driven Investment (LDI) crisis. Each have brought about issues whereby an ability to reach end-game solutions have been rendered cumbersome due to decisions made to allocate to illiquid assets in the 2010's.

Most of this period was spent searching for yield to close funding deficits relative to flight plans; which is now creating disinvestment issues for schemes looking to reallocate assets either due to the collateral guidance or as they seek to take advantage of improved funding positions. It results in a need to consider how decisions made today may impact a scenario in the future.

Plan A has historically meant risk transfer.

We see schemes continue to investigate the risk transfer market. Many trustees and scheme sponsors have historically regarded this as Plan A. Given the volume of schemes making enquiries, insurers have the pick of deals. This is particularly acute for smaller schemes which have benefited though the LDI crisis and may now wish to tailored risk transfer solutions to secure member benefits. However, such schemes have limited bargaining power given the commercial attractiveness of various deals in the market. Before receiving pricing quotations they often involve signing exclusivity contracts and supplying templated information

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CONSIDER A PLAN B

Following the LDI crisis, we have seen that schemes' buy-out deficits have widened and schemes are no longer as close as was first thought, post December 2022, to the risk transfer utopia. Therefore, we need a plan B.

The need to consider a Plan B has been brought to the forefront due to IAS19 surplus values aiding sponsors with positive balance sheet contributions and the profitability benefit that is also provided. This is a novel position when compared to years of accounting losses caused by occupational pension schemes. This helpfully comes at a time of depleted balance sheet valuations and increase cost pressures.

In this scenario, Plan B is a continued running-on of the scheme, either to rebuild any lost surplus, retain levels of surplus (with a view to transact at a later stage) or to deliver corporate benefits.

Adjustments to collateral should therefore be allowed for as part of the wider risk management of a scheme's strategies. We should be considering the various paths to our end game and how the strategy we adopt responds to the options available to the scheme and how the consequences impact stakeholders.

SQUARING COVENANT, INVESTMENT AND FUNDING

If we consider the pillars of funding, investment, and covenant as part of scheme management then the push for higher and more liquid collateral can have implications on the pillars.

Recent FPC guidance suggest that LDI funds should be able to meet margin and collateral calls without engaging in asset sales that could trigger feedback loops and so add to market stress. While directed at LDI funds/mandates, such guidance tends to translate into wider asset allocation decision making. At its extreme interpretation this would move schemes to holding more liquid and lower yielding assets (assuming an inverse relationship between yield and transactable liquidity).

This in turn reduces the expected return on asset portfolios, in some instances below that assumed under the funding principles. This may present limited issues for schemes whose funding levels, today, can be considered as buoyant. As we move through the next round of valuations there is potential to see bases re-adjust, and schemes seeking contributions from employers to close emerging (or growing funding gaps). Therefore the balance between the pillars could swing rather than be balanced over the trajectory of a scheme's funding journey.

CREATE FLEXIBILITY IN OUR DECISIONS

Trustees and advisers need to consider all routes to achieve a scheme's aim, which at its core is fundamentally to ensure members' pensions are paid. However in achieving this, stakeholders in schemes need to ensure that decisions made today do not lock a scheme into a single path and strategic decisions allow for future flexibility.

As we know events rarely happen as we wish.

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