

# Pension surplus – are you kidding?

May 2007

**Rising bond yields and a strong performance from equities have served to reduce pension accounting deficits in recent months. Our research shows that the aggregate FTSE 100 deficit is now at its lowest in 5 years. We estimate that at least 30 companies in the FTSE 100 now have a pension surplus on the IAS19 measure. Good news, but there may be unintended consequences which companies need to consider carefully.**

## Background

You may think that pension surpluses are generally a feature of the past but there is the possibility that the conditions which led to huge accounting deficits may, albeit gradually, reverse in future. Some pension schemes are now in this fortunate position and if present trends continue then many more may be soon. An accounting surplus may not equate to a funding surplus, but it does raise new issues for companies. First it may create a tension between having a reported accounting surplus (and the inevitable demands for benefit improvements) whilst continuing to pay cash contributions for a higher funding target that may have been agreed with the trustees under the scheme's contribution strategy. Additionally, for sponsors of closed schemes, it raises the potential dilemma of having to contribute to the pension scheme without the benefit of the additional contributions counting as an asset in the balance sheet. This is because accounting standards require that a company can only recognize the pension surplus as an asset in their balance sheet if they expect to derive economic value from it, and for closed schemes may be increasingly difficult.

## What can companies do about this?

Some companies will already have anticipated that funding to a higher target than the accounting standard will one day lead to the situation described above, and may already have in place a strategy for dealing with it.

Others may be less well prepared, but now may be the time to consider some of the following strategic options:

- 1 Put in place a contingent funding solution.** For companies with closed schemes, particularly where the liabilities in respect of previous employees are disproportionately high and they are pursuing a return seeking investment strategy, the prospect of trapped surpluses has always loomed on the horizon. An accounting surplus is a clear sign that the horizon has shortened and this should be another trigger for thinking about how to deal with a trapped surplus when it arises. Given the nature of UK pension legislation, it is very difficult to extract surplus from

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occupational pension schemes so it is better to avoid getting into this situation in the first place. The merits of contingent funding solutions may be worth considering.

- 2 Spend some surplus to reduce your balance sheet risk.** In the new environment of volatile balance sheets and more focused risk management, a pension accounting surplus may provide companies with an opportunity to de-risk the investment strategy or seek to transfer some risk to an insurer. This may need careful management to avoid a one off impact on the P&L charge or cash cost. However, solutions can be implemented in a measured way to mitigate these effects.
- 3 Finance accruing benefits from surplus.** This is not a new concept but a possibility for the many closed schemes who have defined contribution sections for new hires. For them another solution to the problem of a trapped surplus, if the rules permit, may be to suspend contributions into the DC section and cross charge them against surplus in the DB section. This will require agreement of the trustees which is more likely as part of the general discussions for agreeing investment and contribution strategies well before the trapped surplus becomes a reality.

### Do you have a surplus already?

If so, you might already be under pressure to provide improved benefits, which may not appeal because of the knock on effect on the cash contributions. At the same time, given the increasing attention from all quarters on the uncertainty regarding the future improvements in longevity, there may be pressure building to raise the level of accounting liabilities. If you feel that you may have to take steps to address this at some stage in the future then you might find that now is a good time to have another look at the longevity assumption and consider whether some of the accounting surplus should be applied towards strengthening it.

A surplus on any measure is always good news. However, companies who wait for this to happen before deciding how to deal with it might find their options limited. Accounting surpluses are transient, and any resulting opportunities are likely to be short lived. Have you got the monitoring systems in place to alert you to these opportunities, together with the strategy and governance to take advantage of them?

### How can we help?

Watson Wyatt has a wealth of experience in helping our corporate clients deal with the issues raised in this bulletin. We have developed many practical solutions, from optimal plan design to innovative funding and risk management solutions. If you would like to discuss any of them, please call Andrew Reid on 020 7222 8033 or Steven Dicker on 0161 839 1600.