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International investment in the UK — a perfect marriage (with a pensions dowry)

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If there was a dating app looking to match-make global investors with UK businesses, until recently the existence of a UK defined benefit (DB) pension plan would have been a big turn-off. Investors may well have listed "no DB plans" in their key matching criteria. However, a combination of different economic conditions and an evolving regulatory and tax regime is starting to change that view.

When providing access for an employee to a DB pension plan, an employer is promising that a defined level of pension benefit will be paid to the employee in their retirement. The benefit formula is normally based on a fraction of pensionable salary multiplied by the period of pensionable service. This creates a quantifiable pension liability. Actuaries are appointed to forecast what the total future liabilities of the DB plan will be, taking into account likely market conditions (more later on the different ways of calculating liabilities).

As many funding deficits have turned to surpluses and it has become less penal for sponsoring employers to extract the surplus, the negativity towards DB plans may be starting to wane.

Contributions are paid into the pension plan, and invested for growth, to cover the predicted future liabilities. When assets are forecast to exceed liabilities, the DB plan has a surplus. Decisions can then be taken as to how the surplus is allocated, either paying extra benefits to members or crediting it back to the employer.

When liabilities are forecast to exceed assets, the DB plan has a deficit. UK legislation requires employers to clear the deficit over time. If the employer collapses the deficit crystallises into a debt which is an unsecured claim in the insolvency of the employer.

As many funding deficits have turned to surpluses and it has become less penal for sponsoring employers to extract the surplus, the negativity towards DB plans may be starting to wane. In fact, investors may be increasingly attracted by the surplus potential of a DB plan and the plan's sponsoring employer may now be seen as a good catch.

'A big no'

Global investors have traditionally been very cautious about investing in UK businesses that sponsor DB plans. For the last couple of decades, these pension plans have tended to have large deficits when calculated on a solvency basis.

The solvency basis is just one of the ways of calculating pension liabilities. Others include:

- the company accounting basis — used to generate the number that goes into the employer's accounts;
- the Pension Protection Fund (PPF) basis — used to determine the compensation that the PPF would pay if the pension plan wound-up with a deficit;
- the technical provisions basis — used for assessing the funding obligation in relation to ongoing pension plans;
- the self-sufficiency basis — used when a pension plan is to run on with no employer support.

Of these, the solvency basis is the most prudent and equates to the cost of securing benefits in full with an insurance company so as to fully discharge the employer from its obligations. Deficits tend to be at their biggest when calculated in this way.

In 2005 the employer debt regime switched (from a much weaker measure) to this solvency basis. This meant that most employers would need to make a big cash injection to walk away from their DB pension obligations.

There followed numerous examples of pension deficits thwarting take-over deals and attempts to rescue struggling business collapsing due to the underlying pension liabilities.

'Not ever'

The risk for a brave investor was made even greater by the establishment (also in 2005) of a powerful and proactive Pensions Regulator (TPR). TPR was given the specific duty to avoid scenarios where solvent employers could walk away from their DB pension obligations. Over the years that followed more and more powers were added into TPR's toolbox, with the latest example being the new criminal offences around avoiding a pensions debt introduced by the Pension Schemes Act 2021.

As TPR started to flex its muscles (albeit very selectively), and examples emerged of overseas parent companies being pursued for a UK pension plan funding shortfall, the international investor community started to give sponsors of DB plans a wide berth.

The pensions 'pre-nup'

Even if the pension trustees could carefully manage their DB plan's funding position towards a surplus position, there were lots of hurdles (found in legislation and plan rules) over which an employer would need to jump in order to access the surplus. Not to mention a 35% tax charge. So, there was a big down-side risk to taking on a UK DB plan and not much of a potential up-side to compensate for it.

> *Regulatory change is making it increasingly viable for employers to extract a pension surplus to boost their financial position.*

The risk of the pensions deficits crystallising into a debt has meant that some potential bidders have refused even to engage with targets who have a DB plan.

Time for a rethink?

Fast forward to 2024 and a lot has changed in a short space of time. DB plan funding positions tend to have improved significantly over the last couple of years. The aggregate surplus of UK DB plans, calculated on the PPF basis, stood at £458.3bn at the end of April 2024.

Liz Truss' short tenure as UK Prime Minister in 2022 is most remembered for her "mini-budget," when the markets were spooked by her economic policies. Gilt values (referring to bonds issued by the UK government) were sent tumbling, materially reducing pension asset values and often driving down pension liabilities even more. The outcome has been that many DB plans now find themselves with a funding surplus, even when calculated on a solvency basis.

A warming of the mood

Meanwhile regulatory change is making it increasingly viable for employers to extract a pension surplus to boost their financial position. The tax charge on the payment of a surplus to an employer was reduced from 35% to 25% from 6 April 2024 — this was announced in the Chancellor's 2023 Autumn Statement and then implemented by a Parliamentary Order which varied the Finance Act 2024. The tax due is normally deducted by trustees before any surplus is paid to the employer, in order that the tax amount can then be paid across to His Majesty's Revenue and Customs.

Building on that tax reform, the new Labour government is now exploring incentives to encourage UK pension plans to invest more adventurously with a view to driving growth in the UK economy. When DB plans are fully funded, they normally attempt to lock-out investment risk to help maintain that healthy position.

The new policy idea is that employers could be encouraged to support their DB plans maintaining an appetite for risk, and targeting an over-funding position, if the employers are given more flexibility around accessing and utilising any resultant surplus.

Ideas being explored include removing some of the hurdles from surplus extraction and allowing the surplus to be used tax-efficiently by the employer to fund other employee benefits.

Let the courting begin

We are already seeing private equity houses being more open-minded about investing in the sponsor of a UK DB plan. Where vendor due diligence highlights the existence of a DB plan, the follow up question now tends to be "what is its funding position?" Where a surplus is identified, this might now represent a potential source of funds and a sweetener for the deal.

If the government proceeds with its pension reform programme, that view could become more mainstream. The existence of a DB plan may increasingly be seen as an attractive feature, encouraging the investor to get to know the target more.

Investor 'dating' tips:

- Check for the existence of a DB plan.
- Check its latest funding position, calculated on a solvency basis.
- Check the surplus refund provisions under the plan rules.
- Keep an eye on evolving UK government policy in this area.

About the author

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