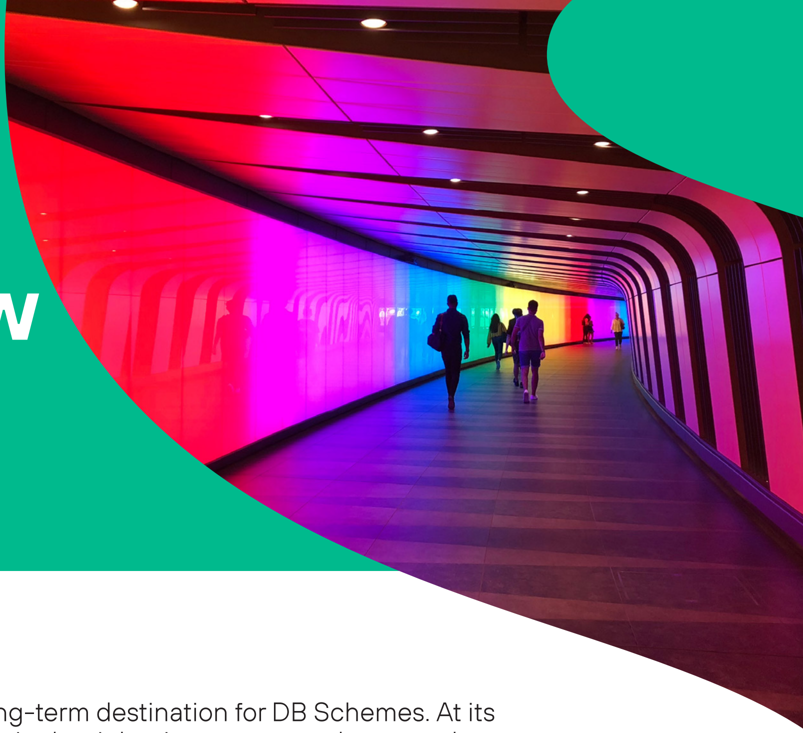
Purposeful Run On (PRO) – a new destination for DB schemes



What is PRO?

PRO is an exciting new long-term destination for DB Schemes. At its heart PRO recognises that in the right circumstances there may be a better way for scheme members and employers to benefit from reaching very strong funding positions.

Importantly, PRO can be implemented now for many schemes. The Government is consulting on introducing overriding legislation that would make this even easier. Government is also keen to change mindset about how sponsors and trustees think about future options for DB schemes. For many schemes PRO can be implemented now but for some it may be preferable to wait for overriding legislation to make refunding surplus possible irrespective of scheme rules. However, adopting PRO does require a change of mindset.

How does PRO work?

The funding level is tested each year and if the surplus on a buy-out basis exceeds an agreed buffer, surplus is immediately distributed. For example, if the buffer is set at 3%, and an annual test shows an estimated buy-out funding level of 105% then the value of the surplus distributed across members and the sponsor would be 2% of buy-out liabilities.

Members may receive their share through a discretionary pension increase or, potentially a lump sum (if the Government proceeds with consultation proposals) and sponsors through a refund. In the example above, if the surplus were shared evenly members would receive a 1% discretionary increase (or potentially a lump sum of equivalent value) and 1% of buy-out liabilities would be refunded to the sponsor in that year.

What are the key principles?

The PRO framework is not prescriptive. However, in our view there are two key principles:

1. There needs to be a meaningful share for both members and sponsors that incentivises both trustees and sponsor to agree to run on over the medium to long term after buy-out is first affordable.
2. Surplus needs to be shared gradually. This avoids inequalities between different generations of Scheme members and gives the sponsor confidence that it will receive a fair share of the surplus rather than relying on trustees applying discretions on wind-up many years into the future.

What does this mean for investment strategy?

Trustees and sponsors of very well funded schemes expecting to buy-out in the near term have understandably focused on managing short-term downside risks. The expectation of investing over the long-term and meaningful upside for members and sponsors requires a different perspective, and will typically lead to higher return targets.

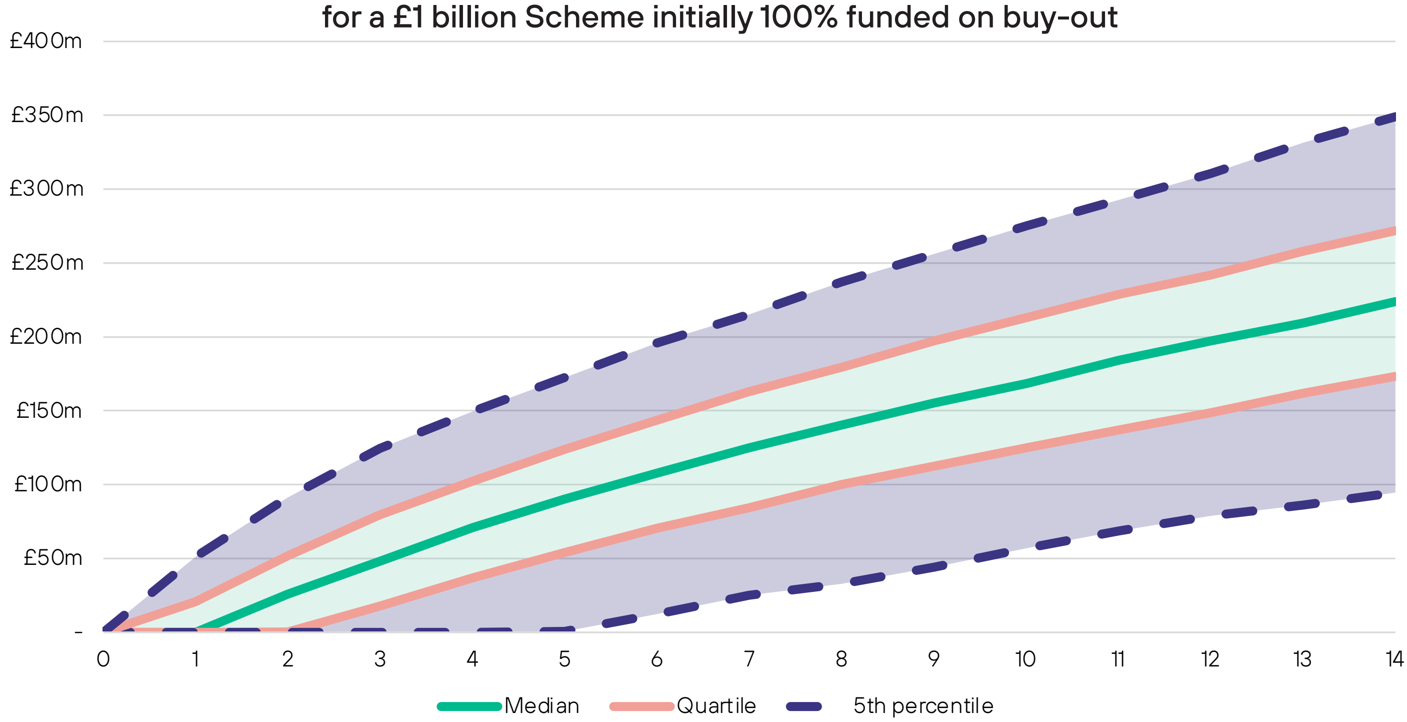
Typically, we'd expect a long-term target return of around gilts +1.5%-2.0% pa. Schemes can use their greater flexibility and regulatory advantage over insurers to invest in a wider range of assets diversifying risks.

What can PRO achieve?

The long-term average improvement in funding position is expected to be 2.0-2.5% of assets per year. Of this, 0.5%-1.0% comes from maturing and members exercising options – this can be achieved with a high degree of confidence. The remainder arises from higher expected investment returns (net of running expenses) than the discount rates implicit in insurer pricing bases.

Our stochastic modelling shows that after 10 years of running on, a typical PRO approach gives better outcomes for members and sponsors than insuring at the earliest opportunity in over 95% of scenarios. In the median case a typical scheme gradually releases 17% of initial assets over the first 10 years (shared between members and sponsor).

Probability distribution of surplus distributed over time for a £1 billion Scheme initially 100% funded on buy-out



After 10 years approximately £170m of surplus is released in the central scenario. Even in a 1-in-20 downside over £50m is released after 10 years.

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