February 2024

Purposeful Run On – a new destination for DB Schemes

isio.

Workplace defined Benefit schemes have long been perceived to be a problem for sponsors – even surpluses can be perceived as an industry "problem". With the aggregate surplus across the UK's c.5,000 private sector DB schemes estimated at £250 billion, Isio's Matt Brown looks at an exciting alternative destination for schemes which we call Purposeful Run On (PRO) – investing beyond full funding on a buy-out basis to share surpluses between members and sponsors gradually over the medium to long-term.

© Isio Group Limited/Isio Services Limited 2024. All rights reserved

© Isio Group Limited/Isio Services Limited 2024. All rights reserved

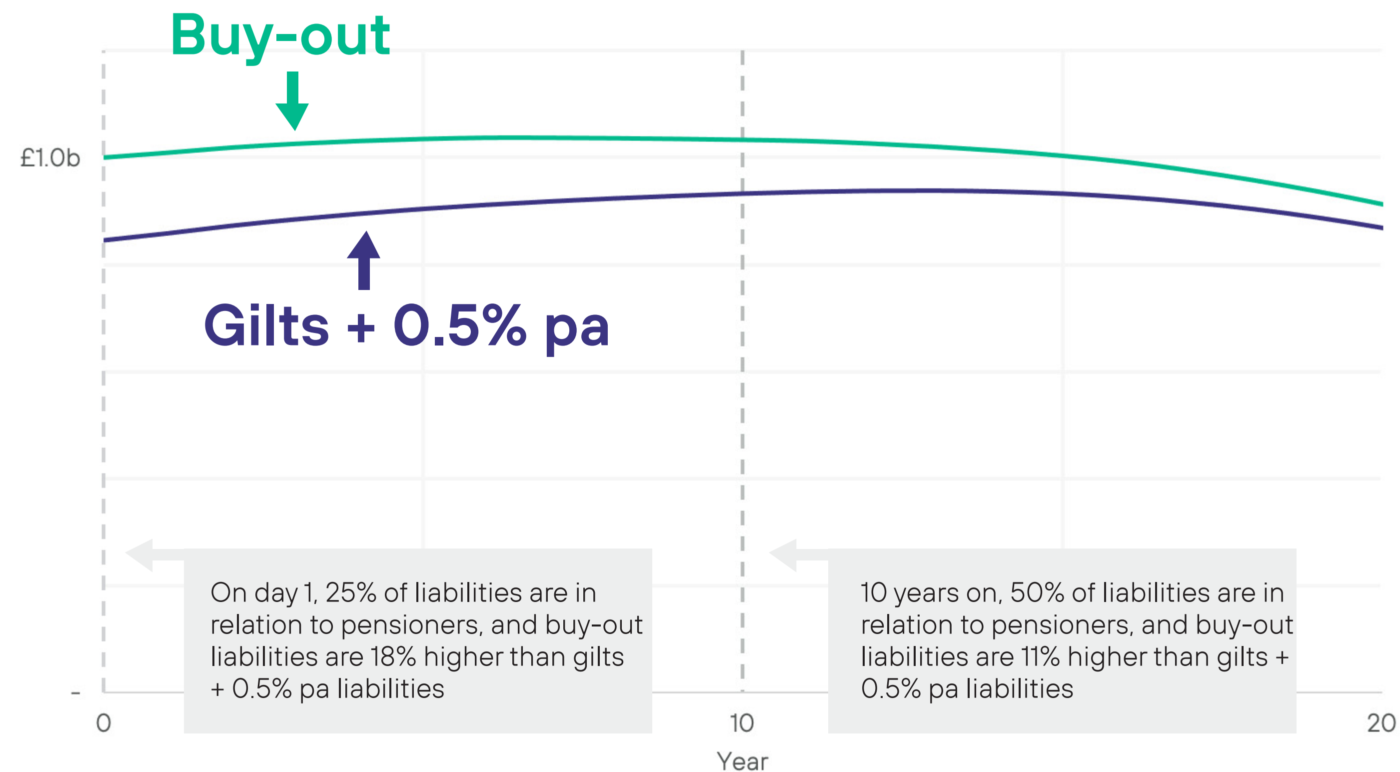
What is PRO?

The Department for Work & Pensions consultation on options for Defined Benefit schemes seeks to make running schemes on for longer more attractive. PRO is framework for doing this in a risk-controlled way with material upside for members and sponsors, by sharing surplus between employers and members gradually as it emerges. PRO can be implemented now for many schemes, but it requires a change of mindset. Before explaining PRO it is worth reminding ourselves of the main traditional long-term destinations.

Until now most schemes have targeted one of two long-term destinations – buy-out or self-sufficiency. But in most cases, actually running the scheme down on a self-sufficient basis is very unlikely. The idea of self-sufficiency is to reach full funding on a low-risk basis and then invest cautiously so that you stay there - neither moving into a position where employer contributions are required nor reaching full buy-out funding. In theory, the scheme should grind along for many years as an operational burden for its sponsor that offers little economic benefit.

While less mature schemes could stay within the range between Technical Provisions and buy-out for several years, as schemes mature these liability measures will converge. This is illustrated by the chart below which shows how the buy-out liability and gilts + 0.5% liability are expected to evolve as a scheme matures. For a closed scheme with three-quarters of liabilities relating to non-pensioner the buy-out liability is around 18% higher than gilts + 0.5% liability. However, after 10 years the gap reduces to around 11% and in 15 years' time the gap is expected to be around 8%.

Liability projection



With reducing scope for funding to stay within these narrowing boundaries, schemes will likely reach a point where either contributions are required or buy-out becomes affordable . The latter is more likely because experience should be better than prudent assumptions, e.g. the target investment return should be higher than the self-sufficiency discount rate. The upshot is that having self-sufficiency as a long-term objective is really a plan to get to buy-out slower by taking less investment risk towards the end of the journey.

At its heart PRO recognises that, having built up tens or hundreds of millions of pounds in assets over time (and usually at a significant level of cost and risk), in the right circumstances there may be a better way for scheme members and employers to benefit from reaching very strong funding positions.

Under PRO schemes set a target buffer above full buy-out funding and once this is reached surplus is gradually shared between the employer and members. The assets continue to be invested to continually replenish surpluses with the expectation of releasing an average of around 2.0-2.5% of assets per year without taking excessive levels of risk. Unlike traditional self-sufficiency, schemes can realistically maintain a PRO strategy over the medium to long-term, at least until nearly all the members are pensioners, which for many schemes could be 10-15 years away. There would be flexibility to change approach during this period and target an insurance transaction e.g. if there were a material decline in sponsor covenant.

Importantly, PRO can be implemented now for many schemes. The changes that the Government is consulting on would introduce 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. We estimate that around a quarter of schemes are well enough funded to start distributing surplus now under a PRO framework (higher when weighted by asset size). For other schemes agreeing PRO as a target destination now (particularly how and when future surplus will be used) will help in making decisions today, such as regarding investment strategy and member options.

How does PRO work?

The table below illustrates how surplus would be released in a given scenario where funding levels vary over the next five years. We use an example scheme with £1 billion of assets targeting a buffer of 3%. Instead of buying-out at the earliest opportunity the scheme is run on and the estimated buy-out position is assessed annually. Whenever this assessment shows a funding level of more than 103%, surplus is released to bring the funding level back to 103%.

Year	Assets (£m)	Buy-out proxy liabilities (£m)	Buy-out funding level before surplus release	Surplus released (£m)	Cumulative surplus released	Buy-out funding level after surplus release
0	1,000	1,000	100%	-	-	100%
1	945	900	105%	18	18	103%
2	969	950	102%	-	18	102%
3	954	900	106%	27	45	103%
4	833	850	98%	-	45	98%
5	962	925	104%	9	54	103%

Members' share of the surplus is applied by paying additional benefits whereas the employer's share of the surplus is taken from scheme assets.

© Isio Group Limited/Isio Services Limited 2024. All rights reserved

What can PRO achieve?

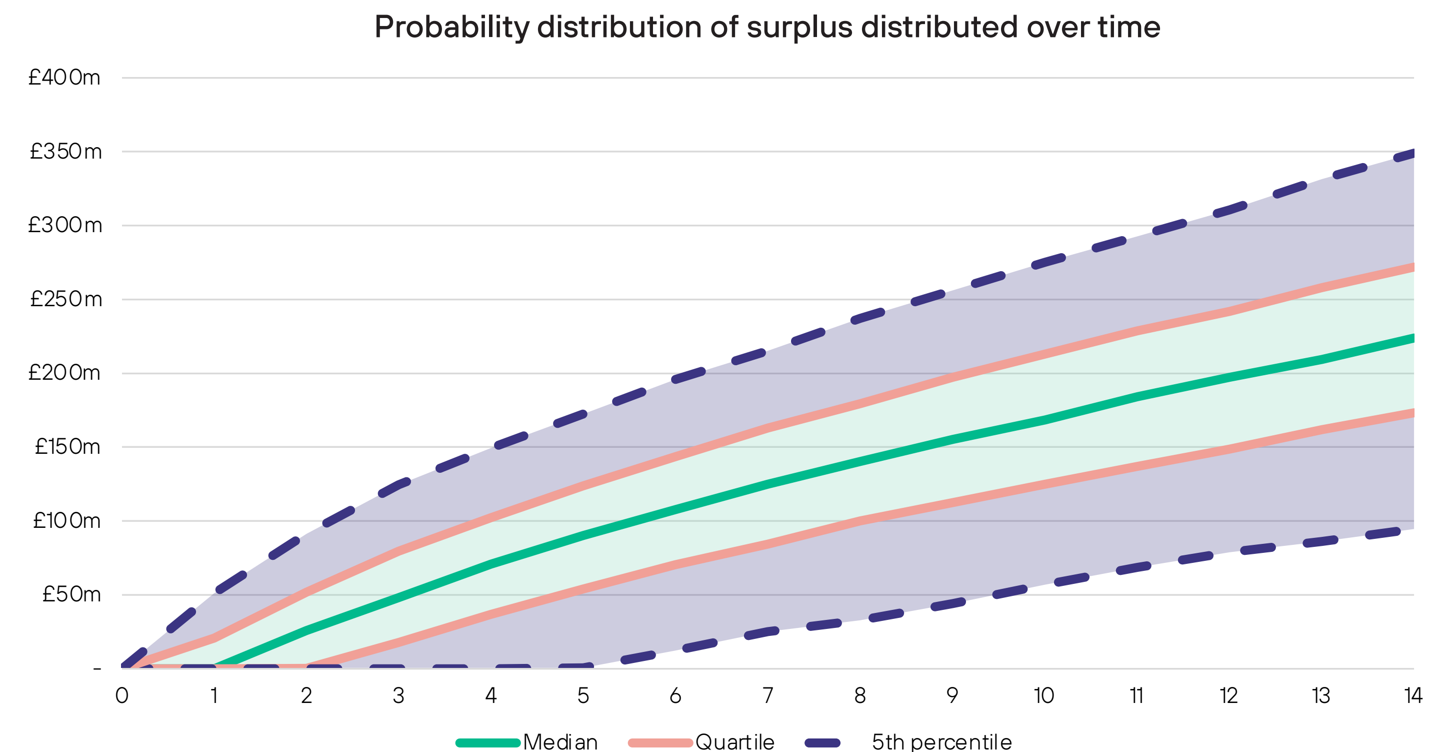
After allowing for meeting running expenses, the buy-out funding level is expected to improve by around 2.0-2.5% a year for two reasons:

1. The target investment return exceeds a comparable discount rate underlying insurer pricing.

2. Insurance pricing improves as schemes mature – mainly because insurers are required to hold higher levels of capital when insuring younger members, especially those who are yet to retire. The rate of improvement is highest for schemes with a high proportion of non-pensioners and slows as schemes mature.

Importantly, 0.5%-1.0% of the expected annual improvement in buy-out funding level comes from maturing of the scheme. Less mature schemes and those that offer at retirement options such as a Bridging Pension Option or Pension Increase Exchange might expect to achieve the higher end. In our view, trustees and employers can have a high degree of confidence that improvements through maturing of a scheme will materialise.

The chart below is based on stochastic analysis of the PRO framework from Isio Labs. It shows the progression of the range of cumulative surplus released over time for a £1 billon scheme that has 60% pensioner liabilities and is initially 100% funded on a buy-out basis. The target buffer is 3% and the expected investment return is gilts + 1.8% pa. This analysis allows for investment risk (both upside and downside) only – Trustees and sponsors designing a PRO framework will also want to consider other risks such as longevity risk, regulatory change and changes in the insurance market.



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.

© Isio Group Limited/Isio Services Limited 2024. All rights reserved

Distribution of surplus

Where a trustee and employer have decided to run a scheme on for the long-term, surplus needs to be released gradually. The main upside of PRO for members is the expectation of future discretionary improvements to benefits. If this is done through increasing pensions older pensioners would not benefit from a single large discretionary increase in (say) 10 years' time, so it would be unfair to delay distributions unduly. It is also harder for sponsors to support running on if they cannot start to realise the benefits quickly.

There is a commercial imperative to share surplus gradually too – both parties require confidence that continuing to run the scheme has purpose for them and that years into the future the other party won't renege on an agreed approach for sharing the surplus.

In many cases employers will prefer to take their share of the share of each surplus release as a refund. Gradual refunds would currently be made under section 37 of the Pensions Act 1995. This power to return surplus prior to wind-up has been rarely used by trustees to date, but the PRO framework overcomes the two key barriers:

1. **There needs to be a buy-out surplus:** Payments to employers are only made following an annual assessment showing a surplus on a buy-out basis, with the payment being less than the surplus.

2. **The payment must be in members' best interests:** Surplus is refunded to the employer alongside awarding a discretionary increase to all members that the employer only consents to because it is receiving the refund. If the trustee is comfortable with the proportion of surplus members are receiving then the refund payment is demonstrably in members' best interests.

Some scheme rules prohibit refunds of surplus in all circumstances. PRO can still be achieved now but, assuming the scheme is closed to DB accrual, a DC section needs to be established with the employers share used to meet part of its DC contributions. Alternatively the overriding legislation being consulted on would potentially resolve this without the need for a DC section (see page 9).

A pragmatic and fair way to apply discretionary pension increases could be to apply the same percentage increase to all benefits irrespective of whether they have come into payment. This is simple to communicate and allows trustees to justify releasing surplus to the employer to all cohorts of members. But there is flexibility to do things differently, for example providing additional non-increasing pensions that are more efficient to hedge. Also, while in a broad sense an across-the-board benefit increase means that younger members get more value in return for bearing greater exposure to the remote risk of things going wrong, trustees and sponsors might look to be more nuanced, e.g. focussing more on those whose core benefits were accrued on less favourable terms than others.

© Isio Group Limited/Isio Services Limited 2024. All rights reserved

Government reform

From 5 April 2024 the tax on refunds will be reduced from 35% to 25% - a welcome benefit for employers who expect to receive refunds from their schemes. For most employers the 25% tax on refunds will be the same as the corporation tax relief forgone where surplus is used to meet part of an employer's contributions to a DC section, so there will no longer be a tax incentive to use DC sections as the method of releasing surplus to employers.

That said, where scheme rules prohibit refunds to the employer establishing a DC section is currently the only viable way to implement PRO. Helpfully, the Government is consulting on a statutory override that could facilitate surplus payments from all private sector DB schemes irrespective of restrictions under the rules. This would remove the current "rules lottery", but the legal detail will be important and is yet to follow.

The consultation also seeks industry views on changing the tax rules on lump-sum discretionary payments to members so that they are no longer unauthorised payments. This could allow members' share of surplus to be extracted more easily and without increasing ongoing DB risk (as would be the case for discretionary pension increases).

The consultation also considers reducing the required funding level for releasing surplus. Currently this can only be done if the scheme remains fully funded on a buy-out basis after the payment. The consultation puts forward an example of being 105% funded on a low-dependency basis for feedback which might typically be below full buy-out level but will vary depending on scheme maturity and other actuarial assumptions made. Whilst this potentially increases the likelihood of a surplus repayment, this could reduce benefit security so we expect there will be a range of industry views on what is acceptable.

What is a fair share of surplus between members and employer?

Typically employers have contributed significantly more than members and have borne downside risks. For schemes that buy-out at the earliest opportunity but accidentally overshoot the required funding, or even where trustees delay for a few years whilst illiquid assets roll-off, it would seem equitable for all the surplus to be returned to the employer. The Pensions Ombudsman helpfully recently determined that the Trustee of the Water Companies Pension Scheme acted reasonably in refunding Bristol Water plc all the surplus in their section.

Choosing to run on for the long-term is different to accidental overshooting. It is hard to see how trustees could agree to it without material upside for members. Equally employers wouldn't agree to continue bearing funding downside risk for longer than necessary without material upside for them.

Typically each party needs the other to play ball to adopt PRO. Employers often control the timing of wind-up or can safely de-participate if there is nil section 75 debt. Trustees often control how surplus is shared once entering wind-up and can unilaterally de-risk / de-return investment strategies including purchasing buy-in policies. Where the rules have balanced trustee and employer powers it would seem hard for either party to agree to run-on over the long-term unless both members and employer receive a meaningful share of surplus, likely at least a quarter. This needs to be considered as part of a package – for example where the employer provides strong security the member share might be towards the lower end of this range.

© Isio Group Limited/Isio Services Limited 2024. All rights reserved

How should schemes invest?

The chart below shows a possible portfolio.

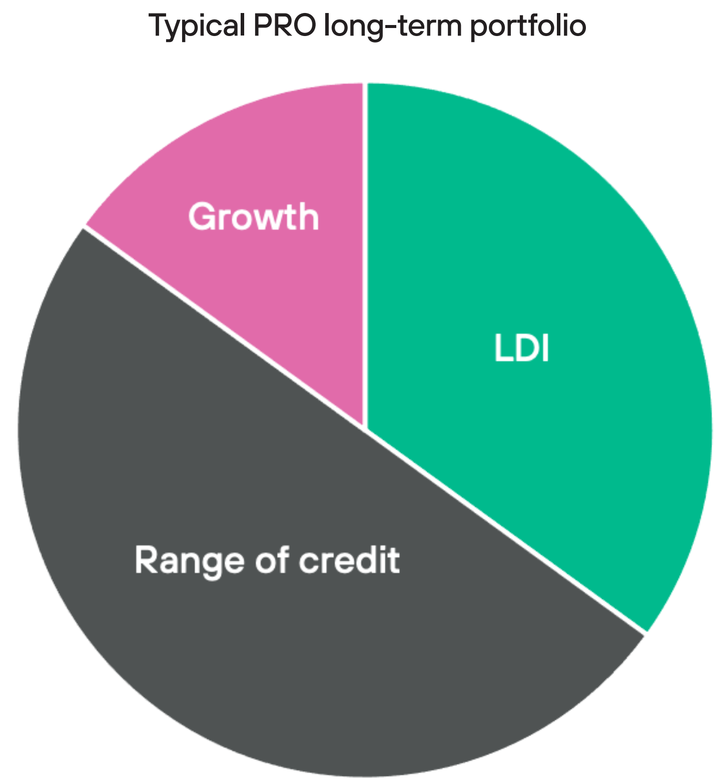
This is just an illustration – in the same way that schemes operate a wide range of strategies to reach buy-out there is no blueprint for investing beyond it. However, we think there are some useful principles.

1. Take a long-term view

2. Consider insurance pricing, rather than investing like an insurer

3. With the first two principles in mind, make use of your greater flexibility

Typical PRO long-term portfolio



Investment outperformance above insurer discount rates will drive at last half of expected surplus for most schemes (with the remainder coming from maturing). The strategy needs to balance targeting sufficient expected returns against limiting downside risks. This means accepting that the scheme may move back into a buy-out deficit from time to time (based on benefits that may have already been enhanced) but the likelihood of a significant Technical Provisions deficit that triggers new employer contributions needs to be very low. The right balance will depend on each scheme's circumstances, but a target return of 1.5-2% above gilt yields is likely to give better outcomes than very low risk strategies over the long-term (other than in extreme tail events).

Given that being overfunded against buy-out with a buffer is the requirement to share surplus, it is helpful to include assets that approximately hedge insurer pricing like LDI and investment grade credit. However, pension schemes are not subject to the constraints on allowable assets for regulatory capital testing applying to insurers so they have a regulatory advantage to achieve better risk adjusted expected returns. We'd suggest having an allocation to liquid growth assets such as equities and utilising a wider range of credit than insurers. Schemes adopting PRO and taking a long-term view (with good sponsor covenant visibility) could also acquire illiquid private assets - perhaps at a discount on the secondary market from other schemes for whom the right approach is the pursue short-term insurance transactions.

© Isio Group Limited/Isio Services Limited 2024. All rights reserved

Member flexibility and support

PRO allows trustees and employers to continue to offer a wide range of retirement options and support that might otherwise cease on insuring the scheme. This could include a Bridging Pension Option and Pension Increase Exchange - both of which allow greater member flexibility and generate savings against insurance pricing over time. The current member support package, which could include IFA advice, can also be retained.

Deferred members would keep their statutory right to transfer out. The transfer value calculation should allow for the long-term investment strategy and may take some account of anticipated future discretionary increases.

Finally, when compared to buy-out, PRO allows schemes to avoid the current capacity crunch in scheme administration by reviewing and correcting their member data over a more measured timeframe, as well as self-managing latent risks that might typically be covered at buy-out by paying for "residual risk" insurance.

Risks to members

For members to be financially worse off from adopting PRO rather than purchasing a full scheme buy-in at the earliest opportunity two things need to happen:

1. The sponsoring employer(s) suffers an insolvency.

2. Following that insolvency the funding position (after recovery of any Section 75 debt) is sufficiently low that members receive less than their "as of right" benefits under the rules at the point PRO is introduced.

Where there is a meaningful short to medium-term concern about the sponsor covenant, trustees would rightly purchase a full scheme buy-in at the earliest opportunity. PRO would only be pursued for stronger sponsors but it will remain important for trustees to manage the potential regret risk of employer insolvency over the long-term with any run-on strategy.

Under PRO the risk of members being worse off in an insolvency (say) 5+ years after the first opportunity to purchase a buy-in is mitigated by the discretionary increases already awarded. Take the example in the table on page 6 - if there were an employer insolvency after year 4 (an unlikely event so soon after adopting PRO) on average the scheme assets would be sufficient to purchase 98% of benefits. However, if members have received half of the previous surplus releases these benefits have been increased by 2.5% meaning that the scheme could buy-out around 100.5% of the "as of right" benefits with zero Section 75 debt recovery. For 50% debt recovery this increases to 101.5%.

One approach to further mitigate this regret risk is for employers to ring-fence security for a scheme adopting PRO. This could involve putting released surpluses into escrow for an agreed period or charging employer assets in favour of the scheme. Where employers can provide material security (say 5%+ of buy-out liabilities) this may justify a higher employer share of surplus (although the member share still needs to be meaningful). Other tried and tested covenant enhancers such as parental guarantees may also have a role.

Trustees and sponsors can both unilaterally cease distributing further surpluses at any time under PRO. So trustees might take this decision and move to a full scheme buy-in (prior to sponsor insolvency) if the employer covenant deteriorated.

© Isio Group Limited/Isio Services Limited 2024. All rights reserved

Risks to employers

The main regret risk for employers is that funding levels deteriorate enough that the scheme moves into a Technical Provisions deficit and deficit repair contributions are required. If the Technical Provisions discount rate reflects a strong covenant and long-term intention to target a return of gilts +1.5% or more, then less mature schemes could have a gap of 10% or more between Technical Provisions and buy-out liabilities. As schemes mature this gap will reduce, eventually to less around 5%.

To put this into context, we have analysed this risk for our example scheme. Using a 50/50 employer / member share of surplus and a 3% buffer, even if the employer immediately met any deficit on an assumed gilts +0.8% Technical Provisions basis at each annual assessment the probability of the employer paying more than it receives net of tax over 12 years is around 1.5%.

That said, there are limitations to PRO over the very long-term. There will come a point when Technical Provisions liabilities are a smaller margin below buy-out, running costs become higher relative to investment returns, and schemes are too mature to take a long-term view of investment return / risk. At this point it will make economic sense to cease PRO and move to buy-out (the buffer can be included in a final release of surplus). The timing of this will depend upon scheme size (larger schemes have proportionally lower running expenses) and maturity,

Employers may be concerned that future changes to legislation lead to higher risks of additional contributions or capital being required. Such a change would be counter to the current Government's plans to encourage DB schemes to invest in productive finance over the long-term, which appears to have cross-party support. The "buy-out plus buffer" approach under the PRO framework means that it would normally be possible to move to a buy-out if there were a significant change in legislation.

Employers will also want to understand the accounting treatment. Under IFRS and UK GAAP there is likely to be a one-off P&L charge when members are informed that there is an intention to award regular discretionary increases, depending on exactly what is communicated. So employers will need to be comfortable with this. Conversely, for those reporting under US GAAP PRO is likely to have favourable accounting treatment compared to a full scheme buy-out. More generally, once surplus starts to be shared gradually – demonstrating that part of the embedded value can be accessed – investors may allow for part of the accounting surplus within business valuations.

© Isio Group Limited/Isio Services Limited 2024. All rights reserved

Other risks

Employers and trustees might also worry about black swan events, such as large unexpected improvements in life expectancy or widespread global defaults on credit assets. While these can potentially be scenario tested, other risks such as legislative change are "unknown unknowns". It will be important for employers to fully understand this and we recognise that for many the relative attraction of removing these risks via the insurance market will outweigh the benefits of running PRO – this needs to be decided on a scheme-by-scheme basis and in many cases buying-out at the earliest opportunity will be the right approach.

Summary

The significant recent improvement in funding for many schemes presents an exciting opportunity for trustees and sponsors of the right schemes to invest past full funding on a buy-out basis and gradually share emerging surpluses over the medium to long-term. Many UK DB schemes now represent an opportunity rather than a problem to solve. PRO provides a framework for members and employers to share in expected upside of around 2.0%-2.5% of assets per year on average over the coming years.

PRO can be adopted today either as a target destination or by starting to gradually release surplus now for very well-funded schemes – it often will not require the proposed new legislation, but it does need a different mindset for employers, trustees and consultants.

Finally, PRO is only a framework. For each scheme careful thought needs to be given to the interaction of funding, size, maturity, covenant (including security), investment risk and balance of powers under the rules. Early collaborative engagement between employers, trustees and consultants will allow stakeholders to get the most out of their DB schemes.

© Isio Group Limited/Isio Services Limited 2024. All rights reserved

isio.

Contact

Matt Brown
Director
matt.brown@isio.com
+44(0)121 227 3556

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

Isio Services Limited is authorised and regulated by the Financial Conduct Authority FRN 922376