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Preparing for surplus extraction: *Legal & General (L&G) Head of Endgame Solutions, Mathew Webb, looks at why schemes should 'invest like an insurer' to ready themselves for surplus extraction* **p42**

Run-on with a plan to pivot: *L&G's Head of Solutions Distribution, Lara Edmonstone-West, and Head of Endgame Solutions, Mathew Webb, delve deeper into the new DB endgame landscape* **p43**

Defined benefit pensions focus:

Rethinking the final moves


Mathew Webb, Head of Endgame Solutions, and Lara Edmonstone-West, Head of Solutions Distribution, L&G

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Surplus extraction is here: What should DB schemes do now?

L&G Head of Endgame Solutions, Mathew Webb, outlines what DB schemes should do now as surplus extraction rules evolve

The government is making it easier for well-funded DB schemes to release surplus, when 'safe to do so', and trustees will need to set out their proposed approach to surplus extraction as part of their statement of strategy. As we weigh up this crucial issue of 'safety', let's look to the insurance market to consider how DB schemes might run on and extract surplus for now, while preparing to pivot to buyout if needed.

What has been announced so far?

The government has set out its intention to amend the rules on surplus extraction, "to allow trustees of well-funded DB schemes to release money back to employers and their scheme members, when 'safe to do so', unlocking some of the £160 billion surplus funds to be reinvested across the UK economy and boost business productivity and deliver for members". Following consultation, it will bring forward legislative changes as part of the Pension Schemes Bill 2025, including regulations that will specify the minimum funding level at which surplus can be extracted, currently expected to be full funding on a low-dependency basis.

The Pension Regulator (TPR) has issued guidance on new models and options in DB schemes to help trustees and employers to assess the range of new endgame models and options available across governance, financial, and insurance. Once legislation is enacted, TPR will consult and publish further guidance on releasing surplus.

With approximately three in four schemes in surplus on a low-dependency basis, endgame planning and whether to choose buyout, run-on, or both will be a key question for DB schemes.

DB schemes: Have a plan for endgame and for surplus

TPR has issued a call to action that 'schemes should have documented policies regarding their long-term objectives and endgame options, including surplus'.

A key consideration for trustees considering surplus release will be this question of safety, balancing multiple objectives to:

1. **Manage scheme assets** to pay pensions and remain fully funded on a low-dependency basis
2. **Improve security for members** and prepare for contingent events
3. **Release surplus** under a framework agreement with the sponsor to, for example, enhance member benefits, make payments to a DC scheme, or make payments to the employer

When is it 'safe to do so'? Learn from the insurance industry

The history of pension scheme legislation protecting against releasing surplus will no doubt be on the mind of many trustees. The concept of safety is therefore hugely important. Insurers paying benefits until all liabilities have been discharged have similar objectives to DB schemes that are running on – what can we learn from the prudent capital framework that underpins the financial security of the insurance regime?

1. Manage scheme assets 'like an insurer'?

TPR's DB Funding Code of Practice requires DB schemes to determine a funding and investment strategy to provide benefits over the long term, so that when the scheme is fully funded on a low-dependency basis and invested in the low-dependency investment allocation, no further employer contributions would be expected to be required.

This framework has many similarities with the 'Matching Adjustment (MA)' framework for insurers, suggesting that well-funded DB schemes in run on may consider 'investing like an insurer', but with more flexibility:

Potential actions include:

- **Update liability basis:** refresh **assumptions** for a low-dependency basis, **including an expense reserve, reviewing prudence** and deploying a dynamic discount rate that is sensitive to credit spreads
- **Create a low-dependency matching portfolio:** invest cashflow-generative or liquid and low-volatility assets to pay pensions, manage risks, and generate surplus against the low-dependency basis:
  - Consider a cashflow-aware approach that includes cashflow matching as well as investing in short-dated credit with reinvestment risk (see Endgame portfolios: making the most of CDI and Playing the 'weighting game')
  - Consider public and private-credit-based assets and their potential transferability to an insurer (or if they are not transferable, understanding their

investment horizon and liquidity terms – see Illiquidity innovation)

2. Improve security for members by planning for contingencies?

Both pension and insurance frameworks include provisions to address contingent events, such as short-term adverse changes in market conditions or longevity (beyond the assumptions made in the low-dependency framework) or a deterioration in the employer covenant, potentially requiring a new course of action.

Potential actions include:

- **Stress test assets:** adapt investment guidelines to constrain the low-dependency investment strategy within an acceptable level of risk, for example a one-year, one-in-six Var measure
- **Create a surplus / growth buffer portfolio:** surplus assets in excess of the low-dependency funding level do not have to be invested in accordance with the low-dependency investment allocation:
  - Consider a three-pot approach so that some of the surplus could be a risk buffer against adverse experience of the matching portfolio versus liabilities, with the rest invested in short- or long-term growth (see Running on into retirement?)
  - Put a plan in place to move surplus assets between the matching and surplus portfolios to maintain the low-dependency funding level

3. Release surplus by agreeing an extraction policy?

So what's new? TPR's guidance states 'If you decide that you wish to extract surplus, the level at which you consider that surplus can be extracted is a matter for you as a trustee to decide. Current legislation only allows surplus release in relation to buyout funding levels. Any changes to this basis will be set out in future legislation.

"Trustees can start to plan now, and prepare to 'invest like an insurer' to preserve their low-dependency funding level and seek to grow surplus, while retaining flexibility to pivot to insurance if you want to or need to in the future"

Subject to this, in situations in which the scheme is likely to remain fully funded on a low-dependency basis and there is no realistic risk of employer insolvency, it is unlikely that TPR would have reservations about the release, subject to you having considered any other relevant matter related to the circumstances of the scheme and the sponsoring employer.'

By contrast, in the insurance regime, the minimum funding level for extracting profit is the total of their technical provisions, the risk margin, and the solvency capital charge. However, many insurers will also hold excess 'own funds' above this amount and maintain a higher solvency capital coverage ratio than 100 per cent before releasing profit. For example, Legal & General Group's Solvency II coverage ratio on a regulatory basis was 232 per cent as at 31 December 2024.

A potential action:

- **Scenario analysis:** Before setting an extraction policy (and subject to future legislation), trustees may wish to carry out scenario analysis and/or stress testing to better understand the range of possible future outcomes following surplus release, taking account funding level projections as well as future covenant strength projections. Trustees will need to balance a trade-off between surplus extraction (the opportunity to share surplus with current members) versus benefit security (safeguarding benefits for future pensioners), see our blog: Unlocking surplus in the endgame.

Prepare for surplus now, put a plan in place for the future

While we await further legislation to clarify opportunities around surplus extraction, in particular around ensuring that it is 'safe to do so', trustees can start to plan now, and prepare to 'invest like an insurer' to preserve their low-dependency funding level and seek to grow a surplus, while retaining flexibility to pivot to insurance if you want to or need to in the future.

If you would like to find out more about how we can help you reach your endgame destination please do get in touch am.landg.com/bridge

Written by Mathew Webb, Head of Endgame Solutions, L&G


Run-on with a plan to pivot

L&G's Head of Solutions Distribution, Lara Edmonstone-West and Head of Endgame Solutions, Mathew Webb, sit down with Natalie Tuck to talk about how pension funds can prepare for surplus extraction when it is 'safe to do so', whilst keeping the option to buyout on the table

The concept of being 'safe to do so', and with it the expectation that schemes will need to be fully funded on a low dependency basis, will be central to surplus extraction. In your view, what should 'safe to do so' mean in practice for trustees?

Lara Edmonstone-West (LEW): The ultimate objective for trustees is to make sure that members receive their benefits. This new legislation doesn't change that. What it does, is it pivots trustees to a different direction in terms of how they meet that objective. Ultimately, what's 'safe to do so' comes back to answering the same question, will my members benefit and will they still get the money that's owed to them? Trustees now have a range of options on the table, but they still need to remember their ultimate duty.

Mathew Webb (MW): The Pensions Regulator's (TPR) recent guidance on new models and options in defined benefit (DB) pension schemes is very helpful in providing a framework for trustees to help review endgame planning. To me, it really comes down to two main objectives, which is an extension of the way pension schemes already look at their funding risk; one on an ongoing basis, and the other on an insolvency basis. On an ongoing basis, the question is, 'how do we run on the scheme in compliance with the DB Funding Code, pay pensions and maintain a funding level above low dependency?' – the key point here is the low dependency requirement – i.e., a limited expectation of future contributions from the sponsor. The second, on an insolvency basis – which we hope is never needed – asks what happens if the sponsor defaults and insolvency forces trustees to rethink their endgame strategy. A common option is buyout. So, the question becomes: 'how can we maximise the chance of buyout in that scenario?'. That depends on funding. If a scheme is already at buyout level, it must preserve that position; if not, the goal is to improve or maintain it. This varies by scheme, based on funding, investment strategy, and covenant strength, including contingent assets.

What practical steps can trustees take now to start 'investing like an insurer' while maintaining flexibility for buyout?

LEW: This is a good opportunity for trustees to go back and revisit their investment beliefs, to understand what it is they're looking to achieve in their pension scheme. Then, understanding how those investment beliefs align with the investment options on the table. I think the key for trustees is receiving the right education and support to help them make informed decisions.

MW: Trustees may consider a two-step approach which aligns with the DB Funding Code. Firstly, to evolve the matching portfolio from a liability-driven investment (LDI) basis to a low dependency one – still focused on paying pensions, hedging risks, and generating surplus, but investing more like an insurer in cashflow-generating assets, and secondly, to invest residual assets in a surplus portfolio. Pension schemes can benefit from the flexibility of a broader opportunity set, for example adopting a cashflow aware rather than a cashflow-matching approach, accepting some reinvestment risk to access the best yielding assets across the credit curve. That's especially important now, with relatively low credit spreads, where shorter-dated credit or securitised assets may be more attractive. Crucially, it still leaves room to shift towards a longer-dated cashflow-driven investment (CDI) portfolio as yields evolve. Private market assets can also be an opportunity. Insurers are already major investors here - they're long-term investors, aiming to capture the illiquidity premium until the last pension is paid. Pension schemes in run-on can do the same, using illiquid assets to enhance returns. At the same time, there is an opportunity to invest in non-insurance eligible assets that provide a different risk profile. However, trustees need to be mindful of what the liquidity horizon is, should they need or want to pivot in the future. And finally, the surplus portfolio can hold a range of non insurance eligible assets, for example private market growth assets, to act as a buffer for unexpected market conditions, to generate regular surplus income or to focus on longer term growth in excess of low dependency.

Do you think there's a significant knowledge gap among trustees when it comes to how insurers invest, given that it's not necessarily something they're familiar with?

LEW: A lot more schemes now use a professional trustee. I think that question 10 years ago, it would have felt more of a hurdle, but we've definitely seen a specialisation of trustee roles, which could mean in theory, the changes that are happening now are easier for schemes and trustees to digest.

MW: The phrase **'invest like an insurer'** is becoming widely used across the industry. Curiously, the DB Funding Code reads very similarly to aspects of the Solvency rules around how insurers invest.

Will smaller DB schemes with fewer resources/capital come across more challenges in regard to preparing for surplus extraction? If so, how can these challenges be overcome?

MW: This market has traditionally been very good at innovating in larger schemes and then synthesising that down to smaller propositions. For example, LDI began in the segregated space and quickly evolved into pooled fund solutions. Structurally, schemes of all sizes can address this in some way. The real question is whether it's cost-effective. How much yield is left after costs? How much risk remains, and how accurately can it be hedged? The smaller the scheme, the higher the costs, the less accurate the hedging, and the greater the residual risk. It's about finding the right balance. While some suggest £100 million as a minimum size, I believe innovation will drive that figure down over time.

Do you expect the new legislation to change trustee appetite for run-on versus buyout strategies?

LEW: What I love is that you don't need to make an immediate decision. It's good to have options on the table. For decades, trustees have focussed on getting to full funding on a technical provision and then often opted for buyout. Going forward, there are more options, but trustees can keep more than one path open to build flexibility in their journey plan.

MW: I'd tie it back to the fact that there's an obligation under the DB Funding Code to submit a statement of strategy every year as part of the triennial evaluation, which sets out the endgame plan for schemes, and most importantly, what they will do with surplus. I agree with Lara that having more options is a good idea but schemes will need to have a plan. They'll need to write down what they're going to do, and they'll need to set out maybe more than one option on how they might pivot between them.

What risks should schemes be mindful of when using surplus extraction as part of a wider endgame plan?

MW: I think there are two main risks that are in contrast and balance with each other. The first is regret risk, that you give the money away now and then later on you have a funding shortfall, which begs the question, why did you give the money away? The second one is intergenerational fairness. If you keep the money forever as a buffer, just in case, then current members can't benefit from the surplus. There's going to need to be a balance between these two. What we're seeing is that trustees want the best of both.

How can trustees effectively navigate pressure from sponsoring employers to release surplus while ensuring they uphold their fiduciary duty to protect member interests?

LEW: There has always been negotiations between sponsors, trustees, and their advisers to find pragmatic solutions to agreeing journey plans. I expect that will continue – so the first step is to discuss.

MW: The close of TPR's guidance sets out the construct of a framework agreement. This might set out a primary objective to run-on and generate surplus, with criteria around extraction levels and frequency. It should also include a secondary objective to ensure that the scheme can also pivot to buyout in the future if the trustees need to or want to, and describe how they will get ready for that. I do have a concern about the potential for undue influence - the obvious question people might ask is, well, 'if I'm the sponsor, could I not just appoint another trustee board that will say yes to my proposal?' There has been a significant rise in professional trustees, for the good, over recent years and so I would expect that the pensions industry should be mindful of this and adapt accordingly. Finally, the Pension Schemes Bill aims to drive consolidation, institutional investment, and a long-term growth agenda. With around 5,000 schemes tackling the same problem in different ways, we need a smart, adaptable, scalable solution. Innovation is coming – watch this space.

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