



Run-on with a plan to pivot

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

▶ 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

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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