An alternative to buyout

Michael Burdett explains why run-on solutions are increasingly popular for DB pension schemes

Rising interest rates prompt re-evaluation of endgame options

In the face of rising interest rates seen since early 2022, defined benefit (DB) pension schemes have seen a rapid and remarkable change in their financial situations. Many have tipped into surplus, prompting trustees to evaluate their endgame options more closely and over much shorter time horizons than previously anticipated. Traditionally, a buyout with an insurance company has been viewed as the 'gold standard' for DB pension schemes. However, many are challenging whether conducting a buyout as soon as possible is the optimal solution for their scheme.

As a result, alternative strategies, specifically run-on strategies, are gaining traction. Approximately one in five schemes, are setting run-on as their most likely endgame strategy[1]. Run-on is where the pension scheme pays off liabilities (pensions, expenses, transfer values etc.) as they fall due over time. To achieve this, a pension scheme will typically aim to be 'self-sufficient'. This means it will seek to establish an investment portfolio that gives it a high probability of fulfilling all its pension obligations, with a no or 'low dependency' on the sponsoring employer. The liabilities are typically run off until the incremental cost of a full insurance buyout is acceptable relative to the costs and risks associated with governing the scheme on an ongoing basis. But why are run-on strategies becoming increasingly relevant in the current market?

In our view, this industry shift is driven by three factors: Changes to legislation that incentivise run-on, uncertainty around financial and practical capacity in the insurance market, and paternalistic sponsors wishing to remain at the helm.

Legislative changes: A catalyst for run-on strategies

The Mansion House speech, delivered by the Chancellor in July 2023, and built on by the Autumn Statement, in November 2023, provided further incentives to run-on DB schemes. In the Autumn Statement, the Chancellor made it clear that the government will encourage alternatives to buyout and look to increase the opportunities available for schemes to invest in productive finance, focusing on UK assets.

As part of the statement, the Chancellor proposed the tax applied to return surplus from the scheme to sponsor would be cut from 35 per cent to 25 per cent, further consultations on how surplus is repaid to sponsors and the ongoing role of the PPF; with the PPF being able to cover 100 per cent of member benefit payments in exchange for a higher levy and being able to act as a consolidator for schemes that are deemed "unattractive to commercial providers". As part of these reforms, we identify three potential benefits to trustees, namely, the ability to enhance benefits for existing DB members, a more streamlined way of returning surplus to sponsors and greater clarity on de-

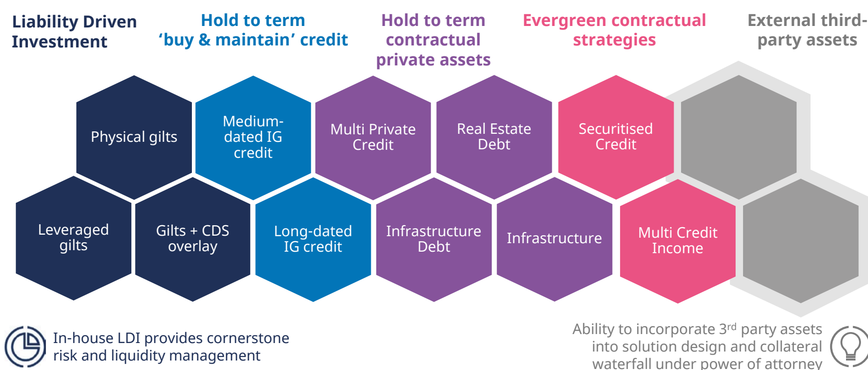

Figure 1 - The core building blocks of a run-on solution

risking standards, which allow schemes to run-on for longer and potentially secure better insurer pricing in the future. Ultimately, the increased flexibility given to DB schemes encourages investment in productive assets, in a risk-controlled manner, which can be beneficial to all stakeholders.

Potential limitations in the insurance market

Looking more closely at insurer capacity, the significant rise in interest rates has led to a surge in trustees and sponsoring companies looking to transfer their DB schemes to insurance companies.

According to the Pension Protection Fund (PPF), as of 31 October 2023 there were only 473 schemes in deficit whilst there were 4,658 schemes in surplus; as a comparison, there were 1,752 schemes in deficit and 3,379 in surplus as of 31 March 2022 when longer-dated yields were under 2 per cent. The increased demand for insurance has created a capacity constraint in the near term. Most participants expect insurers to become more selective around which schemes to quote for. Larger schemes (over £1 billion for example) will retain the most interest, and technology may help increase capacity for smaller schemes (under £100 million). For the swathe of schemes in the middle, uncertainty over capacity is an important factor in determining how to run your investments today. A risk-controlled approach, investing predominantly in contractual assets protects the funding progress built up over recent years, whilst making incremental gains towards funding on a solvency basis. Running-on allows trustees the flexibility on risk, return and timeframe, whether the ultimate goal is an insurance solution or not.

The investment skills needed from a run-on solution partner

There are three key attributes needed from an investment partner, to help you deliver a run-on solution:

Technical: The first skill required is to have strong strategy design skills in cashflow-driven investing (CDI). Your partner needs to have the design modelling, the risk tools, and the reporting to provide you with the full-service package.

Implementation: Any CDI solution manager needs an efficient way to implement the core building blocks. Hedging from corporate bond assets needs to be fully integrated into the liability hedging assets, and efficient collateral and liquidity management is paramount.

Breadth: It is important to partner with a firm who can both provide you with an appropriate range of asset classes going forward, but also deal with legacy issues, including careful management of legacy illiquid assets.

Conclusion

The evolving market and legislative landscape have led DB pension scheme trustees to consider alternatives to traditional buyout strategies. Run-on solutions, particularly those using a CDI strategy, are emerging as viable alternatives, offering control, flexibility, and certainty of outcomes.

At Schroders Solutions, our integrated team is ready to help navigate these complex decisions, providing bespoke solutions that meet each scheme's unique needs. As the pensions landscape evolves, we remain committed to delivering outcome-focused solutions that cater to this new reality.

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In association with Schroders solutions

[1] **Source: Trustee poll, PLSA Investment Conference 2023**

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