Purposeful run-on

Is surplus extraction the way forward for DB schemes, asks Chloe Whelan

With the government consultation on defined benefit (DB) surplus extraction coming to a close this month, significant regulatory changes for endgame options seem all but certain. However, the scope and extent of these changes remain unclear.

Many pensions decision makers may have hit pause as they wait for the regulatory environment to evolve; others see potential for run-on to surpass buyout as the endgame option of choice.

These impending regulatory changes may unveil exciting innovations that enhance member benefits, incentivise sponsors and even benefit the UK economy as a whole. However, there are still challenges and considerations that must be considered.

Summary

- Purposeful run-on (PRO) has emerged as an alternative endgame for defined benefit (DB) schemes, focusing on surplus extraction.
- The regulatory landscape, although poised for change, lacks clarity, presenting challenges for trustees, sponsors and members.
- Proponents of PRO envision benefits for pension savers and the broader UK economy, with potential for enhanced member benefits and investment in productive assets.

How run-on can be made more attractive

The government has flagged its intention to reform the DB endgame landscape, making it more attractive for schemes to invest in the UK. Similarly, Labour has said, if it's successful at the next election, it will tackle "cultural and regulation-induced risk aversion" in the pensions landscape.

Much of this rhetoric targets purposeful run-on (PRO) – running on a scheme not for self-sufficiency or on the road towards buyout, but for the explicit purpose of generating and using a surplus.

For instance, in March it was announced that the authorised surplus payment charge will be reduced from 35 per cent to 25 per cent, with the aim of making surplus extraction more attractive for sponsors.

"That change certainly moved the needle. It incentivises sponsors to keep their DB scheme running beyond the point of buyout," says Pensions Management Institute (PMI) president, Robert Wakefield.

However, two key stakeholders still need to be brought on board.

Insight Investment head of solution design, Jos Vermeulen, says: "Trustees have been trained to be highly risk averse. They need clear regulatory practice that emboldens them to choose run-on.

"On the other hand, members need to be kept informed. They need communication to let them know that running on is secure."

Vermeulen adds that if the regulatory environment develops in these ways – sponsors are incentivised to keep DB schemes running, and trustees and members are assured about the security of run-on – he believes most DB schemes will choose this option.

"From our perspective, why would a scheme choose buyout when the regulations for PRO may become much more favourable," he says.

"In the world of pensions, time is your friend. While you wait to see how regulations develop, your membership matures and you have time to draw down outstanding risks, meaning buyout becomes more affordable."

Hymans Robertson head of corporate consulting, Leonard Bowman, took a more moderate position, saying he believes a "non-trivial minority" of schemes may choose PRO.

"I suspect there'll be a substantial minority that decides their projected surplus is large enough to justify running on," Bowman says.

"I don't see some huge transformation occurring, but I think the discussion will lead some schemes to make a different decision than they may have a few years ago."

"To conduct a purposeful run-on, you need scale to access the upside but you also need to understand the downside"

Initial estimates support the substantial minority view. Pension management consultant Isio, for instance, says it expects around 40 per cent of schemes by asset size to invest beyond full funding levels in the next 10 years, returning around £100 billion in surpluses to sponsors and members.

However, as notes Bowman, the current pace of regulatory change may have unintended consequences by creating an air of instability among DB stakeholders.

"When I talk to senior decision makers, they are concerned by consistency of policy," he says.

"Changes in the tax rate, for example, are welcome but what boards want to know is how the tax rate will change in 10 years, when their modelling shows they'll have a substantial surplus to utilise.

"That's what will help stakeholders feel confident going down the PRO route. They don't need to know what the letter of the law will be, but they want to know what the goal will be."

The schemes considering PRO

There is a specific subset of schemes for which PRO may be a good fit – namely larger, well-funded schemes with strong sponsor backing, which have both the financial and administrative security to run a successful run-on strategy.

"With buyout, part of the cost is funding the profit of the insurer," says Wakefield.

"For larger schemes, it may be possible to mimic the activities of an insurer in terms of scale and administration. In that case, why spend extra money on buyout when you can keep it within a scheme?"

Schemes considering PRO must also have the security to absorb potential risks, such as by being funded on a low dependency basis. LGIM head of endgame solutions, Matthew Webb, says: "To conduct a PRO, you need scale to access the upside but you also need to understand the downside. From a trustee's perspective, you need to be strong enough for the downside to mean you're no worse off – you can still execute a buyout if you need to.

"If you're 120-130 per cent funded, your sponsor is really strong and you have a lot of security, those downside risks diminish."

Practicalities of PRO

With the regulatory framework yet to be formalised, surplus extraction remains relatively uncharted territory. Corporate discussions about the topic are still rare but gaining attention.

Currently, focus rests on gauging internal receptiveness towards the concept.

Aon head of alternative endgames, John Harvey, says: "Initiating such discussions requires high-level, conceptual dialogue between trustees and sponsors to establish a potential framework for surplus management – when you will consider extracting surplus and under what conditions.

"This sets the stage for subsequent analysis to explore how surplus may build up. Finally, you have to determine how to use that surplus, the options for which will be determined by further regulation."

Stakeholders envision two avenues for using surpluses: Sharing between sponsors and members – particularly during high-inflation periods, when discretionary increases are welcome – and bolstering associated defined contribution (DC) schemes. The former holds potential for win-win outcomes, where companies are incentivised while members receive enhanced benefits.

According to some commentators, these incentives to keep DB schemes running are broadly beneficial for the UK economy.

Vermeulen says: "If the government makes the regulatory landscape more attractive for PRO, it's a winning scenario for all.

"Surplus extraction is a fantastic opportunity for DB members, because during the next cost-of-living crisis, it can be used to fund discretionary benefits. Surplus can also be used for DC pensions, which are heavily underfunded, meaning a greater likelihood of a stable retirement for the next generation.

"It also allows DB to invest in productive UK assets – research and development, infrastructure – which benefits society as a whole."

Challenges of running on

A major challenge of PRO is the risk-aversion that is so endemic to the DB landscape – particularly while the regulatory environment remains unclear.

Webb says: "The risk we have is, given the personal responsibility of trustees, how can a trustee justify letting money leave the system if, in the future, it turns out that wasn't a good idea?

"Trustees would need to demonstrate the thought process to justify that course of action. As long as there is no code of practice, no regulatory statement, that will be very difficult."

Regardless of the regulatory environment, there is still the personality factor – some stakeholders simply do not have the appetite for PRO.

Bowman says: "What is their appetite to live with the unknown? Some companies have strong covenants, their surplus feels real and the potential for it to go away feels remote. They may think, 'Let's run with this strategy.'

"There are other companies who believe DB pensions have been the bane of their lives for the past 20 years. They may simply want it off their balance sheets so they can focus on their core business."

As always, the security of members' benefits must come first.

"First and foremost, members should get the benefits to which they are entitled. That has rightly been the mantra of our industry for decades," Bowman says.

"These regulatory changes may mean we can achieve more for members. That's the exciting part."

Written by Chloe Whelan, a freelance journalist