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DB surpluses and run-on: a checklist for corporates

At our webinar, *From risk to resilience: future-proofing your corporate DB pension run-on strategy,* and in the accompanying publications (what they really mean for corporate sponsors and understanding your key risks), we explored the benefits and key risks facing corporates looking to run-on:

INVESTMENT RISK – the risk that your strategy isn't aligned to your agreed run-on objectives. Depending on these objectives, your investment risk may relate to growth assets, liquidity, timeframes, or misalignment with insurer pricing.

LONGEVITY RISK – longer than anticipated member lifespans can significantly increase liabilities over time. This is often a less understood but material risk in a run-on context.

REGULATORY AND LEGISLATIVE RISK – the regulatory environment for DB schemes is evolving, with implications for those looking to run-on. Although recent government announcements around run-on are a positive step towards introducing flexibilities, there's always the risk of future legislative shifts.

We surveyed our webinar attendees, asking what they see as the biggest risk in their run-on strategy. Interestingly, over 50% responded that they saw regulation as their biggest risk.

This is not surprising given recent announcements. In the space of a week, we had new guidance on endgame strategies, the government consultation response on options for DB schemes and then, on 5 June, the eagerly anticipated Pension Schemes Bill. The regulatory and legislative environment for DB schemes is shifting rapidly and, despite recent changes being for the better, corporates clearly wish to stay ahead of these changes.

As expected, the Pension Schemes Bill confirms a move to modify rules on surplus extraction for well-funded DB schemes. The Bill will permit rule changes by trustee resolution, where necessary, to facilitate employer surplus payments.

However, it leaves much of the detail to regulations, including the minimum funding conditions for a payment to be permitted (the government has expressed a preference for the low-dependency funding basis) and the format of the required actuarial certification.

The direction of travel is clear, the government intends to make surplus extraction more accessible. In turn, unlocking a once-in-a-generation opportunity for both sponsors and members to benefit from stronger funding levels. Corporates should ensure they're well placed for these flexibilities by future proofing their run-on strategies now. Over the page, we've set out a checklist of actions we think corporates should be taking.

YOUR CHECKLIST

1 ASSESS WHETHER RUN-ON IS RIGHT FOR YOU

- First, it's essential to understand whether run-on fits with your broader business objectives and risk appetite. This is the first step before building a resilient run-on strategy.
- Clear advice is needed, and focusing on the principles to start with, with some numbers to support this, can be a helpful way of setting out what's most important to you.
- Collaboration with trustees is key to ensure the agreed way forward aligns to both stakeholders' interests.

2 DEFINE A SHARED LONG-TERM GOAL FOR THE SCHEME'S FUTURE

- Collaborate with your trustees to produce a resilient run-on framework. This framework should be documented and include agreement on:
  - Objectives of running-on.
  - Balance of powers and what resolution would be required to successfully run-on and distribute surplus.
  - The period to lock into a run-on strategy. [1]
  - Frequency for distributing surplus.
  - Thresholds for distributing surplus.
  - Uses of surplus.
  - Risk tolerance of stakeholders and mitigations in place.
  - Detail of contingency plans, a 'plan B' and triggers, including actions required to get 'buy-in ready'.
  - Frequency of monitoring against framework and how this will be reported.
  - How often to assess whether continuing to run-on is still the most efficient use of sponsor and scheme resources.

3 ALIGN INVESTMENT STRATEGY AND OBJECTIVES

- Ensure investment strategy aligns to objectives and framework agreed:
  - There should be a core component focused on matching promised benefits and hedging liabilities (predictable, contractual cashflow generating assets such as gilts, investment grade corporate and consumer credit).
  - If you've agreed to run-on for a long time, and plan to build up a significant surplus before distributing, then agree your growth strategy (equity, private markets and higher yielding assets).
  - If you're looking to run-on but retain the ability to execute buyout at short notice at some point in the future, then you should agree your strategy for liquid assets and focus should be given to achieving the best buyout alignment possible with your matching portfolio.

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[1] We also surveyed the attendees of our recent webinar asking what timeframe they're committing to running on. The majority see the 5-10 year window as being a part of their plans. However, nearly 20% were committed to run-on for over 20 years, generating long-term value for members, themselves as corporates, and the broader economy. This shows the different flavours of run-on strategies.

4 MANAGE LONGEVITY RISK

- Agree the size of buffer to hold against longevity risks.
- If you're concerned about extreme longevity risks, consider the cost and benefit of other mitigation techniques such as a longevity swap, buy-in or less common alternative hedging solutions.

5 STAY AHEAD OF REGULATION/LEGISLATION

- Engage with your advisers to ensure you have a good understanding of current and upcoming regulations and legislation.
- Ensure this is fed into your run-on framework and relevant board reporting and decision making.
- Ensure governance frameworks are flexible enough to respond to future legislative changes.

6 SUITABILITY OF GOVERNANCE ARRANGEMENTS

- Consider the level of expertise within your governance arrangements, through use of a professional trustee or senior finance representative from within the business.
- Consider succession planning to ensure DB pensions expertise within the business is retained and not lost in the future.
- Implement day to day processes, as a part of broader business reporting, that reflect pensions and the return of surplus.
- Agree a third-party engagement plan, and how data about your run-on strategy will be shared. This may include:
  - Educating shareholders or other third parties (brokers, rating agencies etc).
  - Thorough messaging around the robustness of the strategy.
  - Clearly setting out the potential upsides.
  - Information around the risk profile.

7 ACCOUNTING IMPLICATIONS

- Engage with your advisers and auditors early to agree the accounting implications of any strategy up front:
  - Consider P&L implications of improvements to member benefits.
  - Consider accounting implications of returning surplus to the sponsor and interactions with IFRIC14.

WITH NEW FLEXIBILITIES ON THE HORIZON, NOW IS THE TIME TO ACT TO FUTURE-PROOF YOUR DB RUN-ON STRATEGY.

CONTACT US

If you'd like to discuss any of the above in more detail, please do reach out to your usual DB corporate team contact or get in touch here.

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