HYMANS ROBERTSON

DB surpluses and run-on: understanding your key risks

In our first article in the series, we explored why the emerging discussion around Defined Benefit (DB) scheme surpluses and run-on is becoming increasingly important to scheme sponsors.

The government response to the consultation on options for DB schemes was released 29 May, with the draft Pension Schemes Bill now expected before Parliament's summer recess. The Pension Schemes Bill will contain provisions that remove barriers to surplus extraction (subject to funding conditions) without prescribing how surplus must be used. **This offers a once in a generation opportunity for both employers and members to benefit from the improving strong funding positions, with greater benefits and opportunities for the wider economy**.

In this article, we turn our attention to the key risks of running on and what they really mean. There are some solutions available to manage these risks, but this is an evolving area and we expect more innovation in the future.

We see understanding the risks, and how they sit relative to your risk appetite, as the fundamental determining factor as to whether run-on is right for you and, if so, how best to build a robust framework to manage these risks.

For a deeper dive into these issues, join our webinar on 5 June, when we'll discuss how to future-proof your DB pension run-on strategy. You can access via this link.

1 INVESTMENT AND FUNDING RISK: ALIGNING STRATEGY WITH RISK APPETITE

A major appeal of DB run-on is the potential to invest for growth, capitalising on a scheme's strong funding position to deliver long-term value. However, investing in return-seeking assets brings a higher level of risk to your strategy.

The level of investment risk should reflect the scheme's objectives. Is the strategy focused on long-term run-on, or is it designed to remain flexible to allow a pivot to buy-out at short notice? Exposure to illiquid assets can create challenges when liquidity is required, particularly in the event of a buy-out. Moreover, ensuring your strategy is well placed for a transaction at the appropriate time remains a key consideration. For those pursuing flexibility, asset portfolios should have a core allocation that aligns with insurer pricing, to avoid a mismatch that could erode value.

Subject to government reforms, above what threshold will surplus be shared and how often will this be shared?

The government favours specifying the low-dependency-funding-basis as the threshold for surplus extraction, and will consult on draft regulations to make it so. More frequent distributions at lower thresholds may appeal, but must be weighed up against the risk of more contributions being required and the level of covenant or additional security that can be provided to support the scheme. It's all about finding the right level that fits your risk appetite and strategic objectives.

We show on the following page the impact of annual distributions above three possible thresholds for a scheme that is 100% buy-out funded today, running a gilts + 1.5% pa strategy in place with no longevity risk solutions in place. Of course, if the threshold shown was updated to be the low-dependency basis, more surplus would be available, however the potential for downside would be greater.

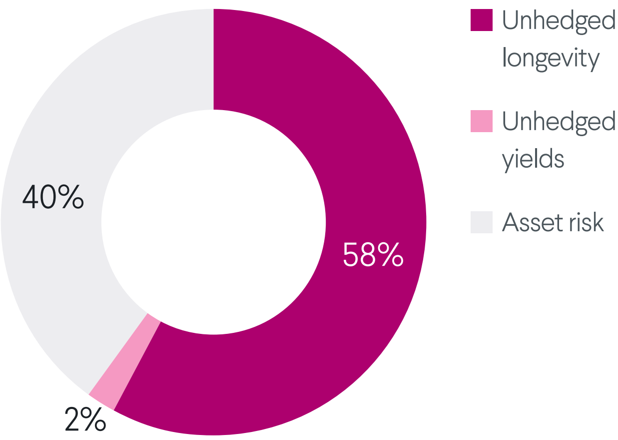
	THRESHOLDS FOR DISTRIBUTION	100% OF BUY-OUT	105% OF BUY-OUT	110% OF BUY-OUT
Cumulative surplus distributed after 15 years	1 in 6 best outcomes	£247m	£234m	£221m
	Median	£164m	£148m	£131m
	1 in 6 worst outcomes	£83m	£61m	£40m
Funding level in 15 years' time, after distributions	Median	100%	105%	110%
	1 in 6 worst outcomes	98%	104%	110%
	1 in 20 worst outcomes	89%	96%	102%

From the analysis undertaken, it's clear that if buy-out is your main contingency and if you have a preference of not falling below this level, then allowing for a risk-buffer is sensible. But would you be willing to give up potentially £33m of surpluses over 15 years, in exchange for 13% greater downside protection?

The profile would look very different for those schemes that aim to build a surplus over time and distribute at a set point. However, there may be difficulties in agreeing such an approach, as shareholders may not be willing to play the long game and trustees may prefer regular sharing of surpluses with members in order to ensure equitable treatment across the membership.

2 LONGEVITY RISK: LESS UNDERSTOOD, NO LESS IMPORTANT

While setting your investment strategy is often the focus, assessing your approach to longevity risk can be equally, if not more, material in a run-on context. Our modelling suggests that longevity risk could now represent more than half of the total risk in a typical scheme considering run-on.



Figures show the drivers that would increase the deficit in the average of the worst 5% outcomes. It is calculated as a one-year risk.

Longer-than-anticipated member lifespans can increase liabilities significantly over time. This may be due to underestimating the life expectancies of your current membership, or improvements in life expectancy being higher than expected. If longevity risk is a key concern, sponsors looking at run-on should consider how best to manage this.

A simple solution may be to hold a buffer in your strategy against longevity risks, although this would delay future surplus distribution. Determining what the right level of that buffer is would clearly depend on your risk appetite and the profile of your members. However, extreme longevity events (eg a medical breakthrough) are possible and hard to predict – in these scenarios a simple buffer may not be sufficient. If this is a concern, then other mitigation options exist to protect against longevity risk, such as a longevity swap. However, sponsors should weigh up the cost and benefit of these options (given their circumstances) to ensure a balanced approach.

3 REGULATORY RISK: AN EVOLVING ENVIRONMENT

The regulatory environment for DB schemes is evolving, with implications for those looking to run-on.

The new DB Funding Code of Practice emphasises the importance of long-term funding plans and a clear journey to low dependency. However, we expect that some schemes looking to run-on will need to go down a bespoke compliance route involving more evidential burden and regulatory involvement, even if their funding level is very strong. The Pensions Regulator will be releasing more guidance for those looking to run-on soon.

Meanwhile, the Pensions Act 2021 (PA21) introduced heightened scrutiny of corporate activity, with stronger regulatory powers and potential criminal sanctions – creating significant risk for company directors considering run-on strategies. Many organisations are lobbying for changes to these standards.

Further change is also on the horizon. The eagerly anticipated Pension Schemes Bill is expected to be laid before Parliament and will contain provisions that remove barriers to surplus extraction, subject to funding conditions. This will be a positive step towards better supporting those schemes running on.

The consultation response suggests that the Pension Scheme Bill:

- Will amend the requirements of surplus payments to employers from being in the "interest of members", to now being in accordance with trustees' overarching duties to beneficiaries, arguably providing a better balance between employers' and members' interests.
- Will permit rule changes by trustee resolution to facilitate surplus payments to employers.
- Will set out the threshold above which surplus can be distributed (the government is favouring a low-dependency threshold).
- Will not prescribe use of surplus.
- Will not create a 100% PPF underpin option.
- Will not amend the authorised surplus payments tax charge from 25% (although we expect the tax situation to be an area that warrants further reform).

However, there's the risk of future legislative shifts, perhaps under a new government in 10 years' time, who want to revert to current legislation or have their own pensions agenda. Having a flexible strategy that pivots to insurance when required helps mitigate this risk, in the scenario where future legislation, regulation or case law impacts your ability to successfully run-on.

PRACTICAL CONSIDERATIONS: FROM STRATEGY TO EXECUTION

There are many practical considerations of implementing a run-on framework that carry risk. Here we cover a few of the key considerations:

- Understanding the balance of powers is essential, in particular any potential changes to rules in light of recent announcements.
- There is a risk that governance arrangements, both within the company and the trustee board, do not evolve to support the long-term oversight required for a run-on strategy. This can be mitigated by strong collaboration between trustees and sponsors from the outset. Expertise on trustee boards will be key, whether that be provided through a professional trustee or senior finance representation on trustee boards. Corporates will need to ensure there are clear processes for pensions reporting within the business, when funds are returned to the employer. Clear articulation of strategy and monitoring will be essential to ensure shareholders are on board.
- Surplus sharing mechanisms require careful design, balancing the needs of all stakeholders. Potential options for using surplus are funding DB member benefits through discretionary increases or meeting future accrual, funding DC benefits within the same trust or to a separate pension arrangement, or as a refund to the employer. These will all be subject to the balance of powers and any tax penalties.
- From an accounting perspective, run-on can help protect surplus and any pension asset on the balance sheet but there is a risk of profit and loss volatility from member benefit augmentations. We set out potential mitigations for this volatility in our article **here**.

CONCLUSION

While a run-on strategy offers clear appeal, especially where surpluses are significant, it is far from risk-free. A sound understanding of the investment, longevity and regulatory risks, as well as the practical considerations of implementation, is critical to making informed decisions and delivering long-term value.

Following our **webinar on the 5 June**, we'll be sharing a checklist for corporates that sets out the actions to take to ensure your run-on strategy is resilient to future risks.

If you would like to discuss anything further, or have any questions, please reach out to one of our authors below or get in touch **here**.

SACHIN PATEL

Head of DB Corporate Consulting

sachin.patel@hymans.co.uk

0121 210 4391

AIMEE LEESE

Senior Actuarial Consultant

aimee.leese@hymans.co.uk

020 7082 6129

London | Birmingham | Glasgow | Edinburgh

T 020 7082 6000 | www.hymans.co.uk