First Briefing, June 2024 – An introduction to scheme run-on

The mini-Budget in September 2022 had a dramatic impact on the Defined Benefit scheme landscape.

Within months, the focus of many trustee boards switched from strategic discussions on deficit management to deciding what to do with a healthy surplus. Buy-out seemed to be the default and obvious short-term option for many schemes at this point. But with insurers reaching full capacity, could 'running-on' your scheme be a sensible option?

What is scheme run-on?

Scheme run-on is a medium- to long-term framework focused on retaining, building up and potentially extracting economic value from schemes over time.

The overarching responsibility of the scheme under a run-on framework remains the same: to pay member benefits as they fall due. But by targeting run-on, the hope is that members can benefit from a share in any of the upside too.

Importantly, the decision to run-on is not an irreversible one and can (and probably should) be revisited as often as necessary.

Why now?

The rise in gilt yields over the last three years means buy-out could be more of a short-term reality than an aspiration for the two-thirds[1] of schemes already considered to be fully funded on a buy-out basis.

However, if you compare the £920[1] billion in assets held by these 'fully solvent' schemes against the £50[2] billion of premiums written by the insurance sector in 2023, there is a clear demand and supply issue which is unlikely to go away anytime soon.

With this challenge comes the inevitable question about value: with transactions often requiring exclusivity with a single insurer (particularly at the smaller end), and with schemes and advisers in such a scramble to do a deal, how can schemes be sure that buying-out is delivering value for money for both the sponsor and members?

The current Government recently committed[3] to a "bold range of measures" that "will ensure that the assets held in UK pension schemes can work harder for scheme members… and support the growth of the wider economy".

When considered alongside the latest consultation[4] on how to remove the "behavioural" and "practical barriers to surplus extraction" in schemes, the political support to "making it easier to share scheme surplus with employers and scheme members" is clear.

This recent shift in emphasis is perhaps the reason for the change in tack taken by The Pensions Regulator which, in its latest Annual Funding Statement,[5] encouraged those scheme trustees who have seen material improvements in funding levels to "reassess their long-term targets and consider run-on, consolidator or insurance options".

Which schemes are likely to be right for run-on?

Run-on is an option that should be considered by all schemes. But it won't be right for everyone.

As running-on indefinitely is unlikely to be economical once assets fall below a certain size, 'perpetual run-on' is only likely to be viable for those schemes with the right scale, covenant and governance.

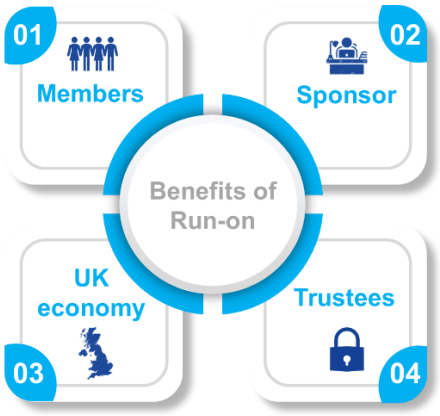
However, for many other schemes, running-on as a 'bridge to buy-out' over the medium term could be a 'win-win' option for sponsors and members alike, and could (and perhaps should) be considered a necessity given the current market dynamics.

Having said that, size isn't everything. Smaller schemes that are still open to accrual with complex (perhaps uninsurable) benefits, data issues or longer-

term, evergreen covenants may find the principles of run-on equally attractive. Careful management of running costs and governance will be critical to making the numbers work here.

What are the benefits of a run-on approach?

While each run-on framework will be different, there are three (potentially four) likely beneficiaries.



The benefits of run-on from both the **members' and sponsor's** perspective are perhaps the most tangible, with the clearest potential benefit being the ability to share in any surplus over time.

From the **members' perspective**, this surplus share could manifest itself through continued benefit accruals, discretionary benefit increases, enhanced support or additional money purchase benefits.

From the **sponsor's perspective**, the obvious hope is that the profits which would otherwise have been ceded to an insurer on buy-out are redirected. Whether those assets are subsequently reinvested in the business, redirected to current employees or create further economic value elsewhere, there is flexibility to tailor the framework accordingly.

From the **trustees' perspective**, the benefits are perhaps less financial in nature. However, by deferring the decision to buy-out in favour of run-on, the greatest benefit is that it gives trustees time to:

- Avoid the capacity crunch with third-party administrators and insurers
- Target member discretions and financial support in a way an insurer may not be able
- Obtain maximum value from the gradual disposal of any illiquids and any eventual approach to the insurance market.

The broader social and financial benefits are more aspirational in nature. The Government has been hopeful that by facilitating run-on, it may be able to unlock the huge value that currently sits in schemes, boosting outcomes for pension savers and supporting investment in productive finance.[6]

What are the risks?

Run-on is not a risk-free solution.

Member benefits are not safeguarded in the same way as in the insurance regime. Downside risks – market, longevity and covenant – remain with the sponsor and, indirectly, with the member. Although perhaps second order in nature, governance, running costs, and legal and political risks also persist. Finally, while schemes defer the decision to buy-out, there is a lingering risk that pricing will harden and move away from the scheme over time.

The risk of requiring further financial support from the sponsor in the future cannot be ignored.

What next?

Although we await the response to the Government's consultation on the "Options for Defined Benefit schemes", which closed on 19 April, The Pensions Regulator's expectations of scheme trustees who find themselves ahead of target is clear:

> "This step change in position gives trustees and employers an opportunity to reassess their long-term targets and consider run-on, consolidator or insurance options."

We encourage trustees and sponsors of all schemes to do exactly that – align with the long-term target for your scheme and frame all future decisions with that target in mind.

Whether run-on works better as a target destination or an immediate opportunity, it still won't be right for every scheme. Run-on will demand a change of mindset for many, and the risk of regret will need to be carefully managed against the aspiration of better outcomes. However, we expect to see the conventional wisdom – which views buy-out as the gold standard of outcomes – to face greater challenge in future, as run-on pushes itself on to scheme agendas.

What run-on looks like will differ widely between schemes, reflecting both their current position and future aspirations. Keep an eye out for our next briefing, in which we will explore the various design considerations and questions you should be asking in more detail.

References:

[1] DWP consultation: Options for Defined Benefit schemes, Annex
[2] First Actuarial Bulk Annuity Briefing, Q1 2024
[3] DWP consultation: Options for Defined Benefit schemes, Ministerial foreword
[4] DWP consultation: Options for Defined Benefit schemes, Chapter 1: Aims
[5] The Pensions Regulator, Annual Funding Statement 2024
[6] Mansion House 2023

Get in touch

To discuss the contents of this briefing, and how it may impact your scheme, contact your usual First Actuarial consultant or one of our run-on experts:

Rohit Siqueira
E:rohit.siqueira@firstactuarial.co.uk
T:01256 297 741

Vicky Greenwood
E:vicky.greenwood@firstactuarial.co.uk
T: 0161 348 7421

Steve Deverell-Smith
E:steve.deverell-smith@firstactuarial.co.uk
T: 0161 348 7439

Adam Michaels
E:adam.michaels@firstactuarial.co.uk
T:01256 297 706

Indranil Chakraborty
E:indranil.chakraborty@firstactuarial.co.uk
T:01256 297 758