August 2024

# Scheme run on

## Survey of professional trustees

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# Contents



# Executive Summary

83
professional trustees

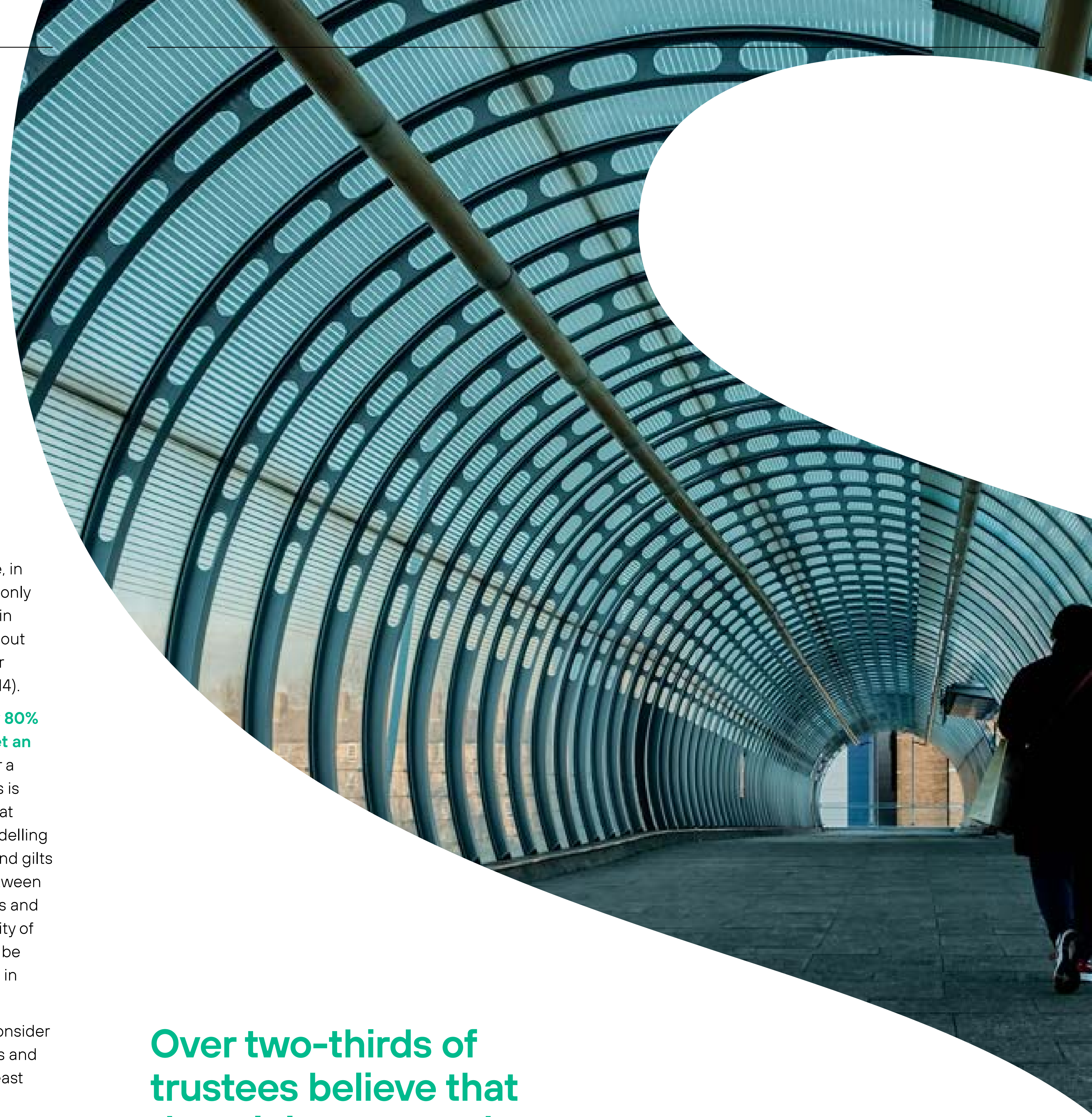
Managing over
800
pension schemes

With over
£350bn
in assets

## Highlights

- There is a **place in the market for both insuring schemes at the earliest opportunity and running schemes on** over the medium to long term. Page 7 sets out what professional trustees see as the main advantages of each.
- To date it has been extremely rare for trustees to release surplus to sponsors before schemes enter wind-up. Professional trustees believe that **balanced and comprehensive guidance from the Pensions Regulator would be most effective in removing behavioural barriers to sharing surplus** between sponsors and members for ongoing schemes. Page 9 shows the other changes that professional trustees believe would facilitate ongoing release of surplus.
- The most important factors for professional trustees in deciding whether to run schemes on for the medium to long term after reaching full funding on a buy-out basis are the strength of the sponsor's covenant and the views of the sponsor (see page 10).
- The proportion of the surplus used to improve member benefits was important to professional trustees for deciding whether to run on, but less so than the two factors above. Of those that have already formed a view, **more than two-thirds of professional trustees are comfortable that a member share of 40% of the surplus would be sufficient to justify running on** over the medium to long term after insurance first becomes affordable, with 35% of professional trustees being believing that the minimum member share of surplus to justify running on is less than 20%. (see page 13).
- Whilst more permissive legislation for releasing surplus from ongoing surplus would be welcome, in practice over half of professional trustees would only be comfortable to return surplus to an employer in ongoing schemes that are overfunded on a buy-out basis. Many schemes can do this today using our Purposeful Run On (PRO) framework (see page 14).
- Of those that have already formed a view, **nearly 80% of professional trustees would expect to target an investment return of gilts + 1.5% p.a. or less** for a run on strategy (see page 15 for more detail). This is understandable given the de-risking journeys that many UK DB schemes have been on, but our modelling suggests that a target between gilts + 1.5% p.a. and gilts + 2.0% p.a. will typically give a better balance between targeting sufficient expected upside for members and employers whilst maintaining a very low probability of moving into a technical provisions deficit – it will be interesting to see what market practice emerges in this area.
- Three-quarters of professional trustees would consider run on for schemes with at least £250m of assets and over half would consider it for schemes with at least £100m of assets (see page 16 for more detail).
- Employers with strong covenants can be encouraged that most professional trustees have an open mind to different 'end games' and see the employer's views as key for deciding an approach. It can be **easier to agree the sponsor's preferred approach if it is raised early,** so it is important for sponsors to model and assess different options (see page 17).



## Over two-thirds of trustees believe that the minimum member share of surplus to justify running on is 40% or less

# The purpose of the survey

With UK DB schemes better funded than they have been for decades, the possibility of running schemes on over the longer term is a hot topic of debate, and the views of professional trustees will clearly be crucial for determining how common it becomes.

**Our survey sought the views of professional trustees about key considerations for running schemes on, including:**

- The pros and cons of running schemes on over the medium to long term compared to moving to insurance at the earliest opportunity, which factors will be most important in informing this decision.
- The changes that would be required to make releasing surplus more common in ongoing schemes.
- For schemes that do run on, the factors that will be most important for setting an effective run on framework.
- The practical considerations for running on e.g. minimum scheme size, how to invest scheme assets, and the minimum funding level at which surplus can be released etc.
- The biggest risks with running schemes on over the medium to long term after insurance first becomes affordable.

We would like to thank the professional trustee community for a high response rate to a relatively detailed survey which has provided valuable insight into how trustees are approaching the topic. We are delighted to share this insight with our clients and the wider pensions community.

For every response received, Isio donated £10 to our charity partner myBnk. Information about the amazing work that myBnk do to bring managing money to life and empower young people to take care of their futures is available here .

## Purposeful Run On (PRO)

The survey looks widely at run on in general rather than focusing narrowly on our PRO framework. However, we have commented on how some of the results apply for PRO. More information about PRO can be found here.



# Advantages of buy-in and run on

**We asked professional trustees for up to three main advantages for purchasing a full scheme buy-in at the earliest opportunity and up to three main advantages for running on beyond the point at which buy-in first becomes affordable.**

## Top reasons to buy-in

| Removes funding downside risks | Facilitates an eventual buy-out | Enhances the security of member benefits | Removes concerns about reputational/ regret risks |
|---|---|---|---|
| 82% | 69% | 67% | 36% |

## Top reasons to run on

| Enhances member benefits | Allows refunds to sponsors | Allows valuable member options to continue | Allows trustees and sponsors to retain more control |
|---|---|---|---|
| 59% | 51% | 49% | 39% |




We believe that there is a place in the market for both insuring schemes at the earliest opportunity and running schemes on over the medium to long term and several good reasons for each are shown to the left. Most trustees will be open to different options, but as illustrated by the quotes below there is wide variation in the starting points for professional trustees.

Professional standards now require actuaries advising trustees and sponsors considering insurance transactions to consider credible alternatives including run on. In our view a quantitative analysis is normally required e.g. to assess the potential enhancement to member benefits and sponsor refunds (the highest scoring reasons to run on) against the funding downside risks which are removed (the highest scoring reason to buy-in).

Interestingly, nearly 50% of professional trustees included maintaining valuable member options that insurers may be unwilling to administer (e.g. Pension Increase Exchange and Bridging Pension Options) within their top three reasons to run on. This illustrates that a quantitative comparison of the two approaches will need to be supplemented with an assessment of more qualitative factors,

Finally, only 4% of professional trustees included supporting long-term investment in "productive assets" to benefit the UK economy in their top three reasons to run on. This is not surprising given trustees fiduciary duties to focus on outcomes for their members.

### Quotes from trustees responding to our survey:

"I am fully supportive of run on. Members receive noticeable downsides from buy out for any business that does not fail. I think where economics make sense, the argument should be why to buy out rather than why to run on - as ultimately that is how most trusts were designed."

"I question whether run on is the best long terms interests of members exposed to company covenant risk."

# Changes required to facilitate run on

Although it is often allowed under scheme rules, to date it has been extremely rare for trustees to release surplus to sponsors before wind-up. The previous Government consulted on changes that would introduce overriding legislation to make it easier for trustees and sponsors to agree to share surplus for ongoing schemes.

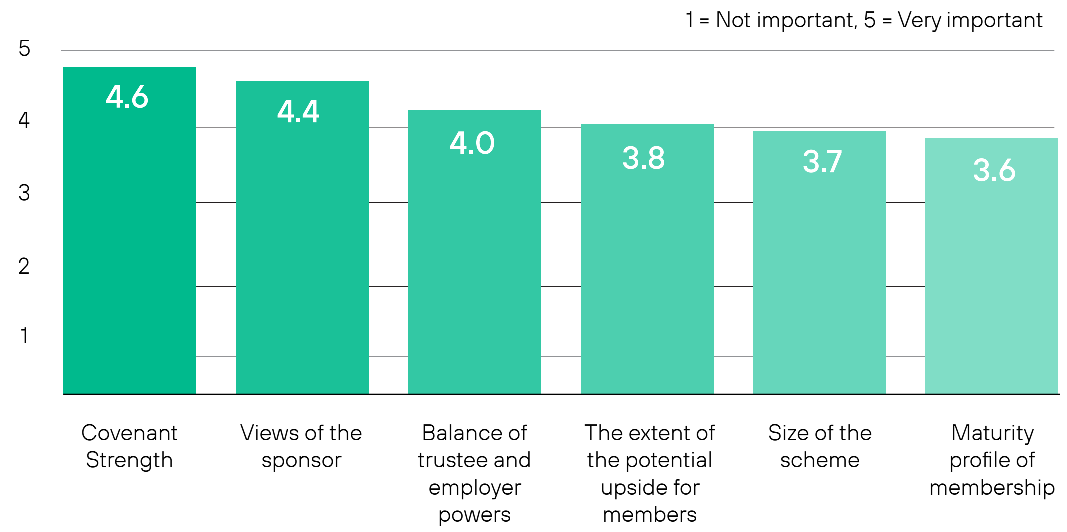
**We asked professional trustees to choose up to 3 changes that would be most effective in removing behavioural barriers to sharing surplus between members and employers for ongoing schemes.**

It's clear from trustees that balanced and comprehensive guidance from the Pensions Regulator would be most effective in removing behavioural barriers to sharing surplus between members and sponsors for ongoing schemes. We agree with this, and we believe that sponsors would also welcome this.




# Factors for deciding whether to run on

**We asked trustees how important each of the below factors are when deciding whether to run on or move to insurance at the earliest opportunity.**




It's not surprising that the covenant strength of the sponsor scored highest. Members' benefits will be paid in full if the sponsoring employer(s) remain solvent. Depending upon the strength and longevity of the employer covenant, additional insolvency security may form part of a run on solution.

The views of the sponsor came in a close second. This emphasises the need for trustees and employers to collaborate on end game planning, ideally before insurance is first affordable and certainly before either party becomes wedded to a particular approach.

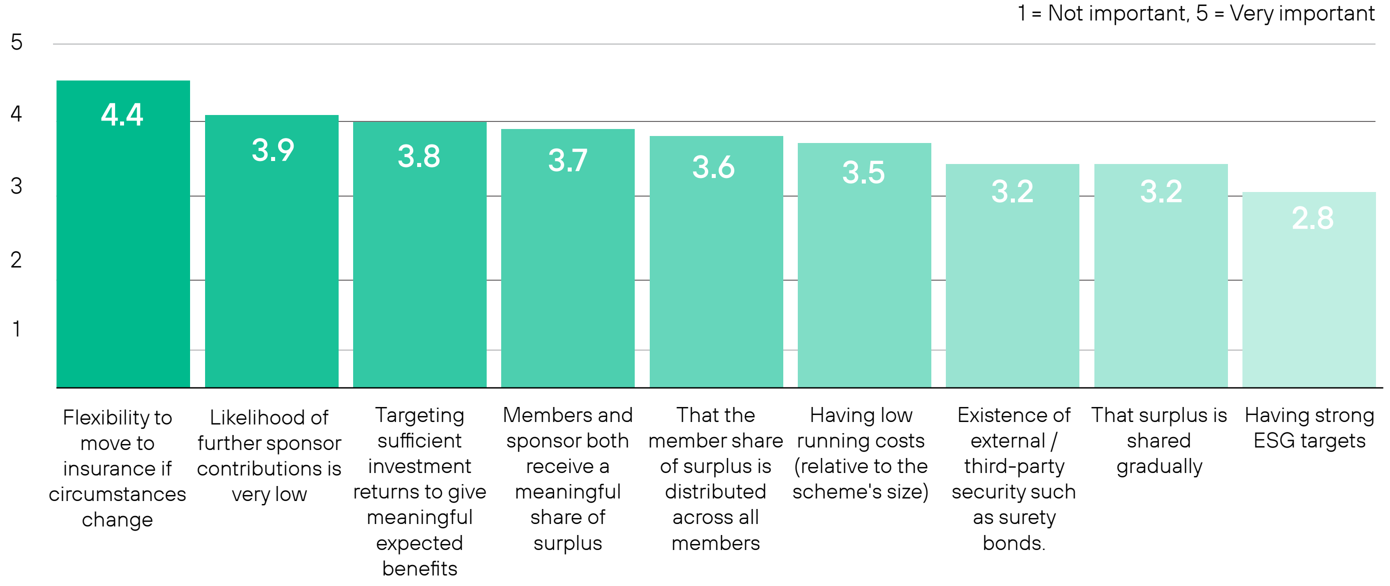
Finally, the balance of trustee and employer powers scores highly. Introducing a statutory override making it possible to return surplus to employers from all schemes would reduce the "rules lottery", but even then we expect that the balance of power to trigger wind-up and discretions or requirements for applying surplus will remain important. There will not be a one size fits all solution!

### Quote from a trustee responding to our survey:

"I would suggest the biggest game changer for a trustee to agree to running on would be security on the possible insolvency of an employer, e.g. surety bonds, escrow, charge over assets etc."

# Key features of a run on framework

**We asked trustees how important each of the below features were for an effective run on framework.**




The highest scoring four features identified by professional trustees all fit well with our PRO framework. Briefly, PRO involves testing the funding level each year and if the surplus on a buy-out basis exceeds an agreed buffer, surplus is immediately distributed. Members receive their share through a discretionary pension increase (or potentially a lump sum if the new Government proceeds with consultation proposals) and sponsors through a refund.

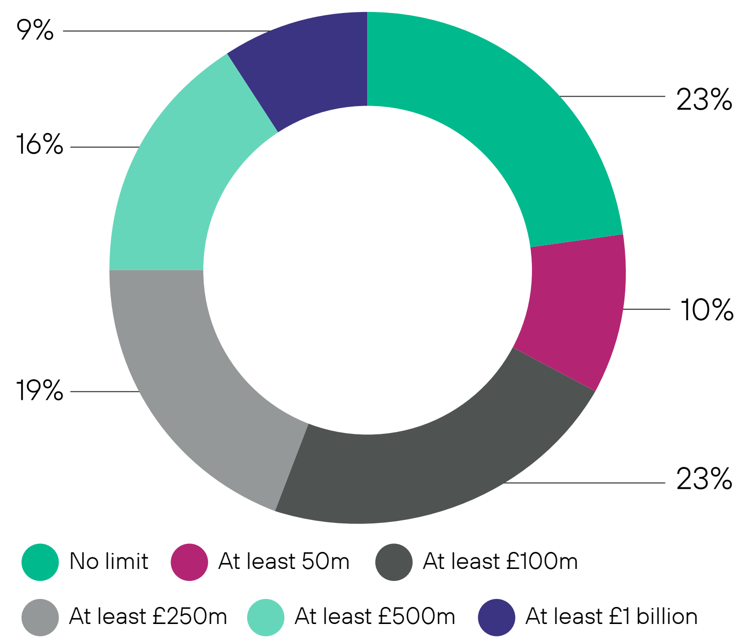
However, professional trustees scored sharing surplus gradually (rather than immediately before or during wind-up) relatively low compared to other important features for a run on framework. If the run on period is short then we agree that the other features may be more important. However, we expect gradual surplus sharing to be a prerequisite for employers when running on for the medium to long term beyond the point at which insurance is first affordable.




# Is there a minimum scheme size for run on?

## Many market commentators argue that there is a minimum scheme size for run on to be purposeful for members and employers. This is because running costs are a higher proportion of assets for smaller schemes and so are a greater proportionate drag on expected surplus generation.

**We asked professional trustees whether there was a minimum scheme size below which they wouldn't consider running on.**

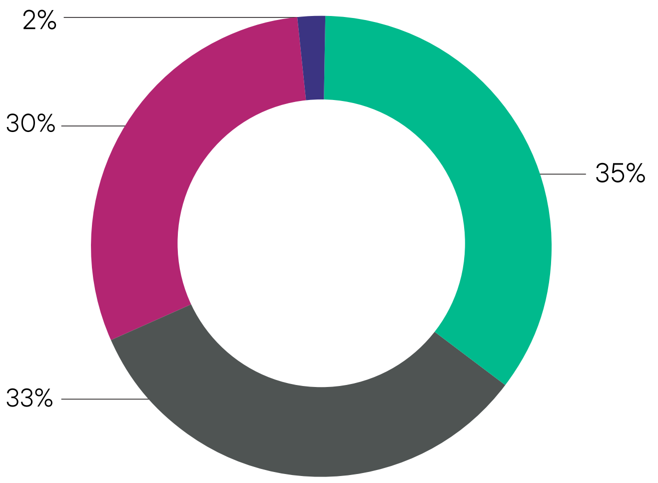



It is encouraging that 56% of trustees surveyed who have formed a view on this believe that schemes with at least £100m (and indeed 23% suggested that there is no limit). This aligns with our view – for schemes with c.£100m of assets the drag on surplus generation should be significantly outweighed by expected investment returns and the improvement in insurance pricing from members ageing. Nonetheless trustee and sponsors of smaller schemes looking to run on should consider how to do this efficiently.

Also, no one parameter can be considered in isolation. For example, run on may be attractive for very well funded immature schemes that are smaller than £100m in size, since the pace of improvement in insurance pricing from retirements and ageing is greater for immature schemes. Also, US owned employers of small schemes may also push their trustees to run on because the accounting treatment for buy-out is often unfavourable.

# Approach to sharing surplus

## With our PRO framework, criteria need to be agreed for how and when surplus is released. We asked what minimum share of surplus would typically need to be used to improve member benefits to justify running on from a trustee perspective.




Less than 20% · 20% to 40% · 40% to 60% · 60% to 80%

### Quote from a trustee responding to our survey:

"I believe that pension funds are held as collateral against company promises and therefore, surplus naturally 'belongs' to the sponsor."

Over 30% of trustees answered that they have not yet considered this – more than for any other question we asked. Of those that have already formed a view, more than two-thirds of professional trustees are comfortable that a member share of 40% of the surplus or less would be sufficient to justify running on over the medium to long term after insurance first becomes affordable.

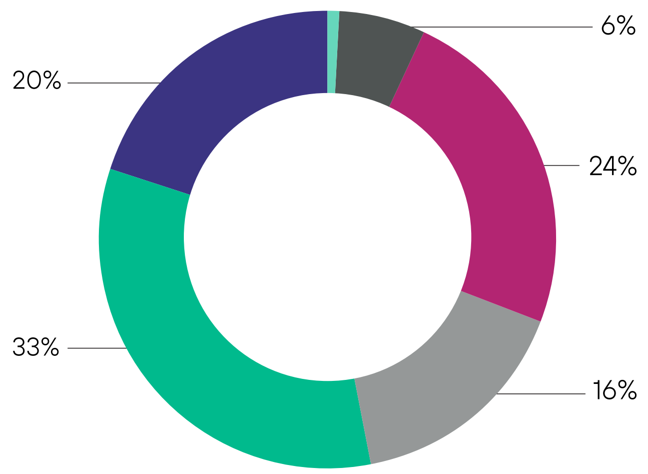
It is interesting that 35% of professional trustees that have formed a view believe that a member share of less than 20% of surplus would justify running on. A low member share could be easier for trustees to support where there is a strong covenant and / or external security and where the employer has a unilateral right to surplus on wind-up. It suggests that many trustees see wider benefits to members in running on than simply receiving higher benefits – this is consistent with retaining member options (e.g. Pension Increase Exchange and Bridging Pension Options) scoring highly amongst the main advantages of running on.

Under our PRO framework members and employers both receive a meaningful share of surplus (consistent with the results above). The actual share for each scheme needs to be considered as part of the package (e.g. high levels of security may help to justify a higher employer share). However, on average trustees appear willing to reflect the fact that employers take on 100% of downside funding risks with a higher employer share of surplus – aligning with the position that we expect most employers to take.




**We asked about the funding level at which professional trustees would be comfortable to release surplus.**

Under current legislation, ongoing schemes can only refund surplus to employers if the Scheme Actuary certifies that the scheme remains over funded on a buy-out basis after making the payment. Our PRO framework fits within this because surplus is only released if it exceeds and an agreed buffer on a buy-out basis. However, the previous Government's consultation sought views on more permissive legislation whereby surplus could be refunded at lower funding levels e.g. if more than 105% funded on a low-dependency basis. If permissive legislation were introduced, we asked about the minimum funding level at which it would typically be reasonable for trustees to start sharing surplus between members and the sponsor?



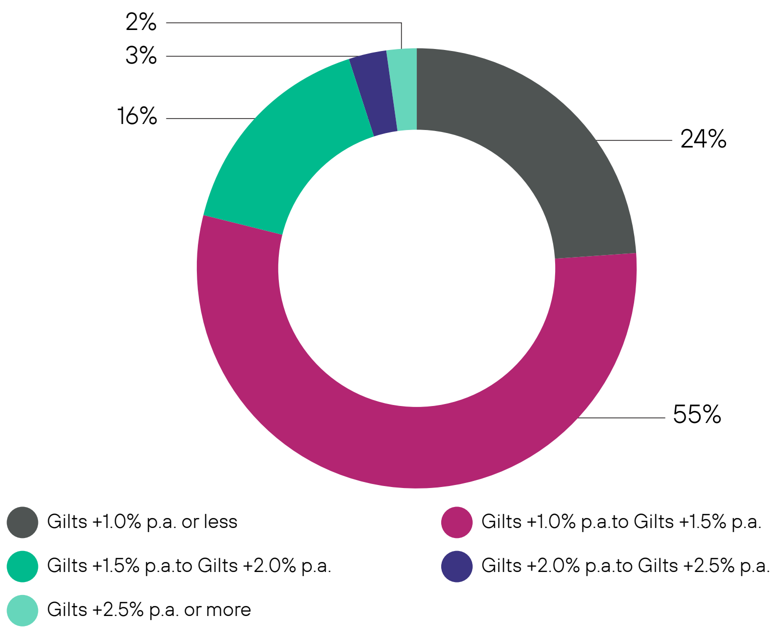

Over 100% funded on Technical Provisions · Over 100% funded on low-dependency · Over 105% funded on low-dependency · Over 100% funded on estimated buy-out · Over 105% funded on estimated buy-out · Over 110% funded on on estimated buy-out

We would favour permissive legislation, with balanced guidance from the Pensions Regulator about how to agree surplus sharing frameworks. Nonetheless, in practice over half of trustees would only typically consider releasing surplus if the scheme remained at least 105% funded on a buy-out basis afterwards. This fits with our "buy-out plus buffer" framework for PRO under current legislation. Subject to the scheme's rules allowing it, many sponsors and employers could agree surplus release now for very well funded schemes.

# Investment strategy

## Along with a maturing membership, investment out-performance above the discount rates implicit in insurance pricing is a key source of expected surplus generation under a run on strategy.

**For schemes that intend to run on for at least 5 years beyond the earliest opportunity to purchase a full scheme buy-in, we asked professional trustees what a typical investment return target should be?**




Target returns for run on need to balance having a high likelihood of generating sufficient surplus to make it worthwhile, whilst also protecting against the downside risks – particularly having a very low probability of technical provisions deficits emerging. Whilst it will be different by scheme, our modelling suggests the range of target investment return is likely to typically be between gilts + 1.5% p.a. and gilts + 2% p.a.

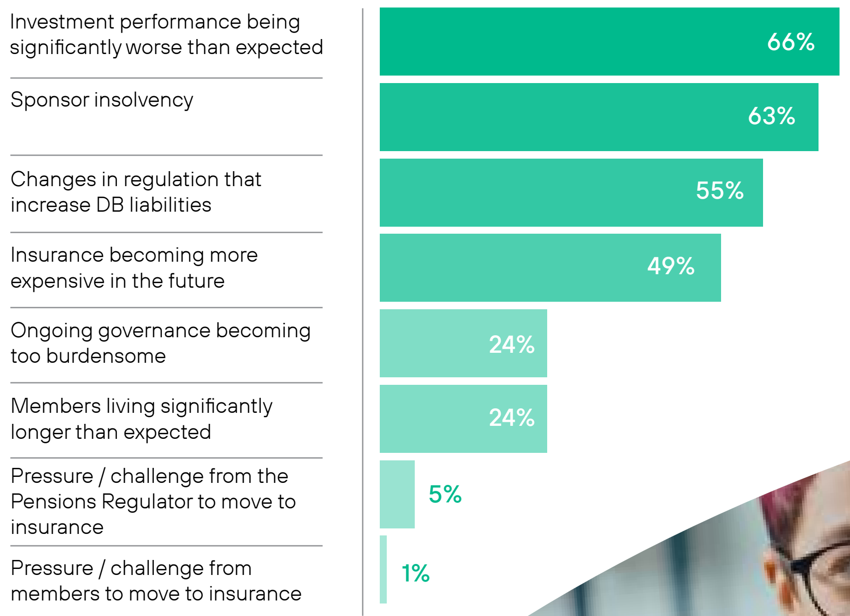
However, we recognise that there may be behavioural barriers to this given the focus on protecting short term downside positions through de-risking over recent years, particularly for well funded schemes. This is shown by the results to the left with a return target of between gilts + 1.0% p.a. and gilts + 1.5% p.a. the clear median for trustees. It will be interesting to see how market practice emerges.



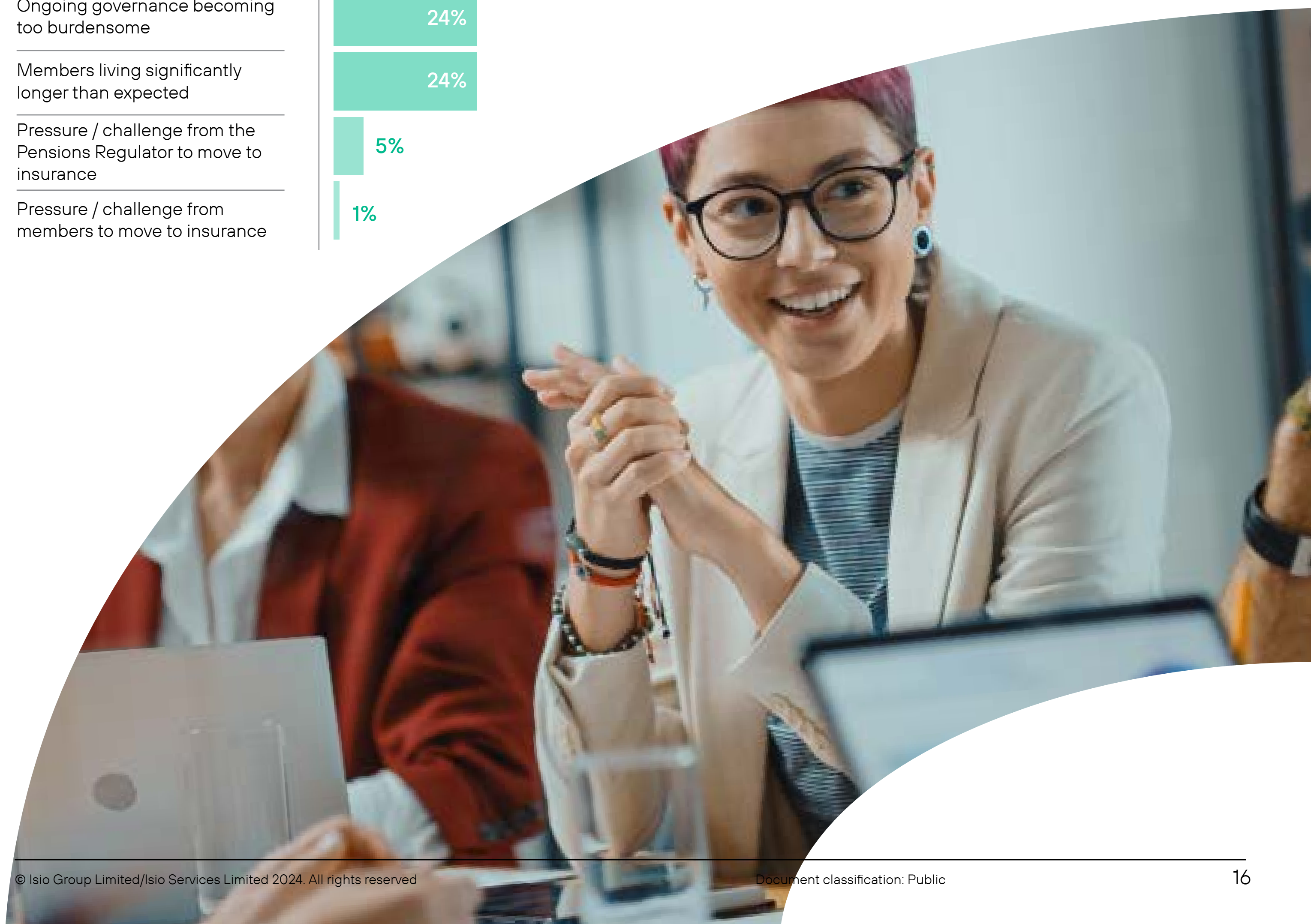

# Risks of running on

## Finally, we explored what trustees thought would be the biggest risks for schemes where the trustees and sponsors agree to run on for at least 5 years beyond the earliest opportunity to purchase a full scheme buy-in.

**We asked professional trustees to select up to three risks which could deter them from choosing to run schemes on.**




The risks with the greatest response rates were investment performance being worse than expected and sponsor insolvency, This makes sense because the biggest regret risk for trustees of not moving to insurance when it is possible is an employer insolvency coinciding with a funding deterioration. Helpfully, these risks can be quantified and managed e.g. providing insolvency security and working within an investment risk budget. Changes in DB regulations that increase liabilities were the next biggest risk identified – whilst less likely in some ways this risk is more troubling because it cannot be managed and we recognise that for many the attraction of removing unknown unknowns via the insurance market will outweigh the benefits of running on.



# What does this mean for employers?

## Most professional trustees have an open mind to different 'end games' and see the employer's views as key for deciding an approach – indeed the views of the employer scored as the most important factor for professional trustees in deciding whether to run on beyond full funding on a buy-out basis.

1. It can be easier to agree the sponsor's preferred approach if it is raised early, so it is important for sponsors to model and assess different options. In our view this should include both quantitative, and ideally stochastic, analysis of the probability distribution for surplus that could be returned to the sponsor compared to the risk of deficit repair contributions being required. Other factors may also be important such as whether the employer has a unilateral right to any surplus on wind-up, management's appetite to continue to run a scheme (often mostly for former employees), owner / shareholder views and the accounting treatment for Purposeful Run On compared to buy-in / buy-out.

2. Many employers may conclude that moving to insurance at (or soon) after the earliest opportunity where no additional contributions are required is preferable e.g. for relatively small and mature schemes. However, employers that would prefer to run on can be encouraged that trustees are keen to work collaboratively with them and that their biggest concern will be insolvency security which employers can improve if necessary e.g. through escrow, parent guarantees, surety bonds etc.

3. We recently hosted a roundtable event for senior executives sponsoring large UK DB schemes. The main themes emerging from the discussion are shown in our report available here. In our view, there are several changes that could help turn DB schemes from a "problem" into an "opportunity" e.g. the legislative changes consulted on by the previous Government and better guidance from the Pensions Regulator that reflects the reality of surplus. However, for many schemes surplus can already be released gradually under existing legislation, and employers should find out whether this applies for their schemes.




**It can be easier to agree the sponsor's preferred approach if it is raised early, so it is important for sponsors to model and assess different options**

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