PMI

KEEP CALM AND RUN ON

Sackers

Introduction

Many schemes are finding themselves better funded than they have been in decades. The Government's 29 May outcome to its consultation on options for DB schemes (the "Government Response") and 5 June Workplace Pensions Roadmap (the "Roadmap") referred to "approximately 3 in 4 schemes in surplus on a low-dependency basis and around £160 billion of surplus assets being held" This seems to be encouraging investment and innovation in the "endgame" space and introducing optionality for both trustees and sponsoring employers. Confirmed plans to ease access to surplus funding (in the Government Response and Pension Schemes Bill) and a drive towards schemes unlocking significant funds for UK productive finance, have intensified the spotlight on "endgame" strategy. Sponsors may now view schemes as possible revenue generating assets and there will benew opportunities and challenges for trustees.

Against that backdrop, it was already prudent to investigate and assess the various options, establishing which are viable for you in practice, and working through what the best approach may be in your specific circumstances. This is reinforced by the Pensions Regulator's guidance on new models and options for DB schemes ("TPR Endgame Guidance") released on 3 June which states "[trustees] should regularly review the best way to deliver members' promised benefits".

of schemes are in surplus on a buy-out basis

Endgame option 1: buy-in leading to buy-out

What is it?

Buy-in is when an insurance policy is held in the name of the trustees as an investment for the benefit of the scheme as a whole. The investment, interest rate, longevity and inflation risks ("key risks") attaching to the secured liabilities are matched by the insurance contract. The scheme keeps its employer's covenant (and Pension Protection Fund access) and gains the insurer covenant. Plus members get the protection of the Financial Services Compensation Scheme (FSCS).

On buy-out, the trustees' policy is "shattered" and members have individual annuity policies with the insurer. The key risks pass wholly to the insurer with the scheme winding-up and the trustees being discharged.

The security of members' benefits now depends on the insurer's covenant alone. Members will no longer have recourse to the PPF but will retain access to the FSCS.

What schemes might this suit?

Schemes will need assets at a level that will fund the insurer's premium – or a sponsor prepared to make up the difference. Suitable powers of investment and termination (or the ability to introduce these) are also a must.

Ideally one or more of the following will apply:

- Strong funding position combined with weaker or uncertain sponsor covenant
- Good data and visibility of historic legal and administrative practice
- Employer keen to proceed.

Endgame option 2: Commercial Consolidators

What is it?

DB consolidation continues to gain traction and traditionally ranged from shared services and asset pooling to single governance models such as DB master trusts. These arrangements are more add-ons or "wrappers" for an otherwise ongoing scheme and so not "endgame options" as such. It also remains unclear how any public consolidator would operate, as the Government Response provided limited additional detail.

We are focusing on commercial consolidators ("superfunds"), which take on all assets and liabilities of the scheme, severing the employer link, usually in exchange for a one-off amount (above technical provisions but below buy-out premium levels).

The superfund's "covenant" replaces that of the employer. It is typically a capital buffer provided through external investment that sits within the superfund structure, with a mechanism enabling returns to be payable to persons other than members or service providers. Post transfer, member protection continues from the PPF (at PPF compensation levels).

Clara is currently the sole authorised superfund and has an explicit "bridge to buyout" model, aiming to transfer schemes to insurers once affordable. Others in due course may take a "run-off" model, managing liabilities over the longer term.

What schemes might this suit?

A superfund transfer requires clearance from TPR which depends on compliance with the regulatory framework governing superfunds.[1]

Currently schemes must demonstrate that these gateway principles have been met:

- Cannot access buy-out now;
- No realistic prospect of buy-out in the foreseeable future, given potential employer cash contributions and the insolvency risk of the employer; and
- Transfer must improve the likelihood of members receiving full benefits.

Trustees need a "comprehensive rationale" for transferring to a superfund and must be satisfied that it is in the members' best interests.

Superfunds may therefore be particularly suitable if one or more of the following apply:

- Large scheme with a reasonably good funding position but underfunded on a buy-out basis
- Sponsor is weak, stressed or long-term covenant risk is high.

[1] Currently governed by interim guidance from TPR (last updated in July 2024) until DWP publishes the legislative framework.

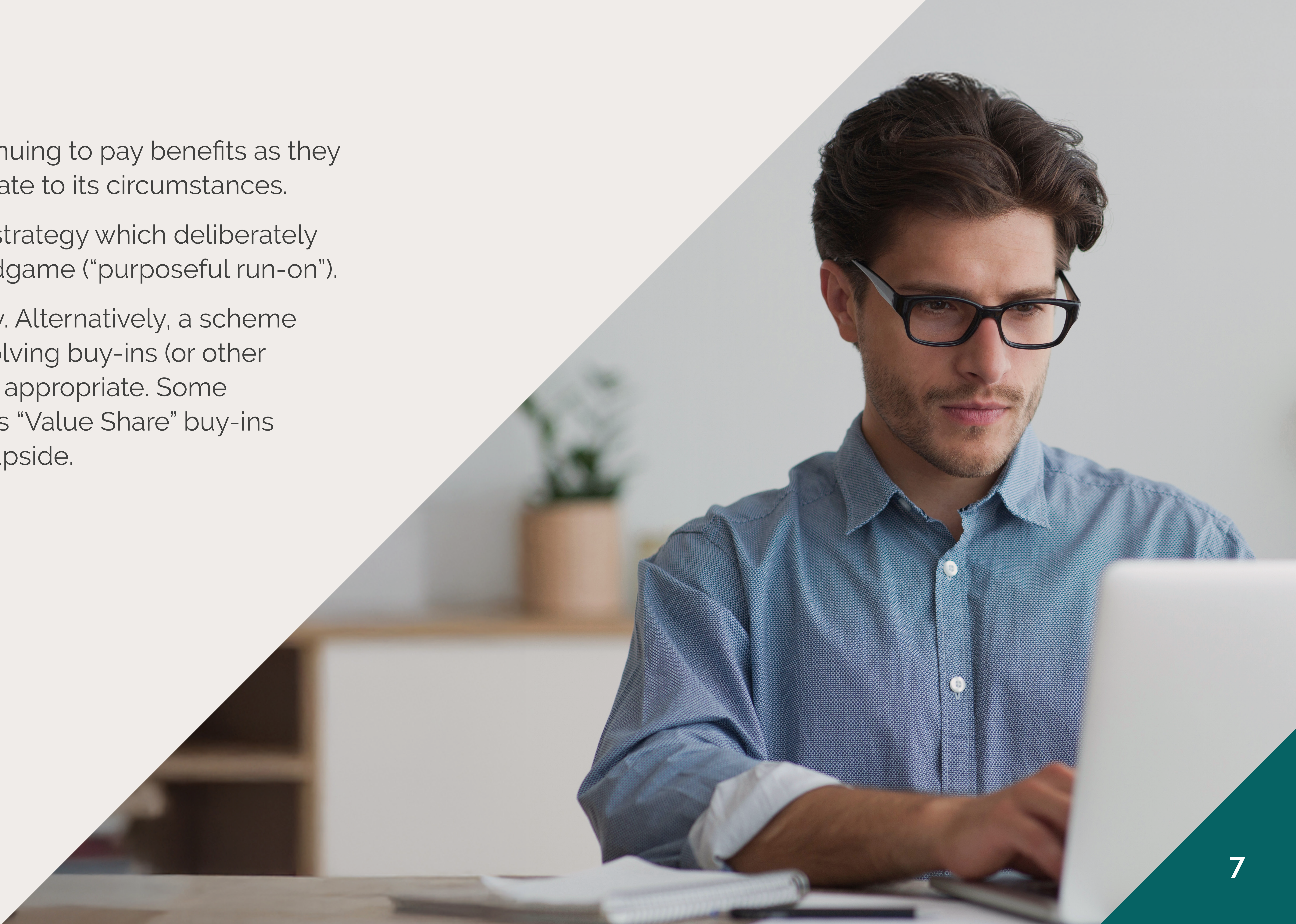
Endgame option 3: run on

What is it?

In one sense, this is simply the scheme continuing to pay benefits as they fall due with an investment strategy appropriate to its circumstances.

However, the term is increasingly used for a strategy which deliberately doesn't envisage buy-out as the ultimate endgame ("purposeful run-on").

Run-on can continue until the last beneficiary. Alternatively, a scheme might run on within a long-term strategy involving buy-ins (or other liability-matching options) when strategically appropriate. Some interesting developments tie into this, such as "Value Share" buy-ins that allow employers to participate in some upside.



What schemes might this suit?

Important considerations include:

1. **Control?** How do the key powers in your rules (termination, winding-up, expenses, amendment and surplus) work? Who holds them?

2. **Funding and investment.** Schemes farfrom buy-out funding will have little choice but to run on. Those in a stronger position will need to consider carefully how to preserve that position.

3. **Covenant.** Running on as an active preference to buying out means retaining an employer's covenant potentially excluding an insurer's. So less likely to be appropriate with a weaker or less visible sponsor covenant. In TPR's words – "where trustees have no material concerns with covenant longevity, this may support running on".

4. **Governance.** This isn't a "one and done" decision – as TPR's annual funding statement (AFS) states, if schemes decide to run on, they will need to weigh the benefits against the ongoing risks and put in place suitable monitoring and management strategies. The potential scale of this is well illustrated by the run-on case study in TPR's Endgame Guidance.

An evolving DB pension landscape and a Government with a growth agenda means that run-on may become increasingly popular, particularly as the Government is committed to unlocking regulatory barriers which it views as "[inhibiting] the potential for surplus…to be invested in smarter ways and benefit members".

Surplus – a game changer?

The Government intends to lift restrictions on surplus access for well-funded DB schemes – further details came thick and fast on 29 May and 5 June.. The prospect has prompted considerable focus on the implications for DB scheme strategy, including endgame. Notably, respondents to the DB options consultation "anticipated that new flexibilities could encourage more schemes to run on.

The current framework

Returning surplus from an ongoing scheme currently requires:

- Express power (explicitly preserved by resolution before 6 April 2015)
- Actuarial valuation and certification showing surplus on a solvency basis
- Trustees are satisfied that it is in members' interests
- Notices to TPR and members.

Given these hurdles, many with surplus currently use it within the trust. For example, to fund ongoing scheme expenses, DB accrual, discretionary increases, or DC contributions (for hybrid schemes).

What is changing?

We're clearly at an inflection point, although the Roadmap anticipates final legislation only "by the end of 2027". Key aspects are:

- Trustee power to amend rules to permit distribution of surplus (and remove restrictions including requirement for a resolution before 2015);
- Funding threshold expected at full funding on a low dependency basis - actuarial sign-off will continue;
- Members' interests will not be specifically mentioned – but trustees' fiduciary duties will still apply;
- TPR guidance;
- No PPF guarantee of 100% of benefits (despite discussion of an option to pay a "super-levy" in return for this).
- No change to the 25% tax on surplus.
- Ongoing consideration of ways to facilitate direct payment of surplus to members.

Steps to take now?

Information remains incomplete. But trustees and sponsors can develop their views on how any surplus might be allocated and how they might exercise any discretion. The AFS and TPR Endgame Guidance both emphasise the importance of planning ahead on this

How to choose an endgame strategy

Choosing an endgame strategy is one of the most significant decisions trustees and sponsors will face. There is no “one-size-fits-all” approach; trustees must weigh up various considerations, manage any conflicts of interest appropriately and comply with their key fiduciary duties:

1. fulfil the purpose of the trust (i.e. to provide members with their due benefits)
2. treat all members fairly, and
3. invest assets prudently.

How these are balanced and the weight attributed to different factors in any cost/benefit analysis will inevitably vary. However, the following will almost certainly be key.

Member security – Trustees' primary duty is to fully secure the benefits to which members are entitled. Therefore, trustees must assess whether an endgame option improves or weakens member security (including over the likely lifetime of the particular endgame solution). So strong funding but with a weak or unclear covenant points towards an option which reduces or eliminates residual reliance on sponsor covenant.

Member fairness – This doesn't mean absolute financial equality between beneficiaries, but trustees should consider the effect any endgame option might have on different categories of members, and whether any difference in outcome is appropriate.

Member experience – Some options (e.g. running on and during buy-in) are largely invisible to members but that changes at the point of buy-out or superfund transfer. So operational capabilities and their ability to provide a positive member experience needs considering.

Funding – Bluntly, exit to an insurer or superfund needs enough funds. Running on, in contrast, can be continued on lower funding levels but carries long-term risks. Could employer contributions be available to bridge any funding gaps?

Feasibility – is affected by:

- Market capacity
- Scheme preparedness
  - legal, investment (including liquidity), governance
- Scheme complexity.

Sponsor views – This has both a "hard" angle (is employer agreement needed under your rules or for funding) and a "soft" one (case law established that it is proper for trustees to take the sponsor's interests into account when making decisions).

Conclusion

We started this piece by suggesting everyone "Keep Calm…" and we meant it! There's a lot going on. Emerging reforms around surplus extraction could significantly reshape the pensions landscape, offering new flexibility and incentives for both employers and trustees. Commercial innovation is alive and kicking too, bringing more complexity and choice. However careful thought and planning really are the key to successful endgame strategy and execution.

Find out more

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