Active Solution To Run-On

A New Endgame Strategy for Defined Benefit Schemes

What is Active Run-On?

Active run-on is the strategy of operating a well-funded pension scheme with the explicit intent of building up surplus assets, then using that surplus to benefit the key stakeholders of the scheme; the members and sponsor.

There are many ways that members can benefit from active run-on. In some cases, simply running on (and not buying out) will allow members to continue to have access to valuable benefits and options that can otherwise be challenging and/or expensive to insure. For example, our data suggests around 30% of schemes currently offer options or support at retirement that is typically not insured at buyout. In addition, building up surplus allows enhanced member benefits to be funded over time, such as discretionary pension increases.

Sponsors can also benefit in multiple ways. Surplus maybe recognised on the balance sheet. For a US-owned sponsor, targeting appropriate levels of asset return may also have a P&L benefit. However, for many sponsors, surplus only has tangible value if there is a clear way to access it. That is why a good active run-on strategy needs to come with an agreed surplus-release mechanism, that allows surplus assets to contribute to a company's free cashflow.

This alignment of stakeholder interests is of critical importance in making active run-on work. Trustees need to be comfortable they are acting in members' interests with any strategy they adopt. Equally sponsors provide very valuable contingent security against tail risk for schemes who operate any run-on strategy. It is appropriate that they receive financial compensation for the ongoing exposure and for any discretionary benefits they agree to award.

Active Solution To Run-On

Active Solution To Run-On (ASTRO)

ASTRO is our newly developed framework for active run-on, based on four key pillars (to the right). It is designed to enable employers and trustees to run pension schemes past the point of full solvency funding with security and confidence, whilst actively trying to build an economic surplus that delivers value to members and sponsors.

Using the ASTRO framework, we have the tools, insight and modelling to build a run-on strategy that delivers surplus and security. Furthermore we have the solutions and expertise to execute the strategy across all the key areas; actuarial, investment, covenant, risk settlement, DC and governance.

Our modelling shows that a scheme choosing to run-on for 20 years under the ASTRO framework rather than buy out can do so with:

	Surplus Share	
	100% to sponsor	⅓ discretionary benefits ⅔ to sponsor
Benefit Security	>99.5%	110%
20 Year Value Release	15-20%	10–14%

*Average proportion of benefits paid/insured and average after tax present value of surplus released to the employer. Based on a £1Bn scheme, 100% solvency funded with a 20-year core ASTRO run-on.

Four Key Pillars

1 Invest Like an Insurer

- Cashflow Driven Investment
- Credit and LDI
- Gilts +1.5% target returns
- Low volatility versus buyout

2 'Triple Layer' Security

- Well funded, with ongoing buyout option
- Good covenant supporting rapid deficit repair
- If needed, backed by contingent assets

3 Member Benefit

- Maintain scheme factors
- Preserve member experience
- Discretionary increase option remains

4 Sponsor Payback

- Sponsor compensated for residual risk
- c. 2% pa surplus generation
- Subsidy of DC contributions

Note: All pillars are fully customisable enabling scheme-specific solutions to take place

Key Features of ASTRO

Best Practice Concepts

- In the interest of all stakeholders
- Appropriate for short and long-term run-on
- Compliant with regulations
- Very low risk of failure
- Flexible enough to be scheme specific
- Implementable under current legislation
- Demonstrating security under run-on. For schemes that can afford a buyout, are ‘insurance-ready’ and have a good covenant, run-on offers a high degree of security
- ASTRO framework is fully customisable to enable bespoke strategies meeting scheme-specific needs

Value Generation

- Standard ASTRO model targets c. 2% p.a. of steady build-up of solvency surplus
- Value release compensates sponsor for residual risk and can also fund discretionary benefits if desired
- DC contribution holiday is tried and tested and tax-efficient way to access this value
- May require reorganisation of employer DC provision
- Short-term alternative of a sponsor refund after wind-up (net of 25% tax) — subject to scope for future innovation / flexibilities scheme rules

Investment Strategy

- A Cashflow Driven Investment (CDI) approach:
  - Match short to medium term cashflows with credit asset proceeds
  - LDI used to match residual cashflows
  - Used by all UK bulk annuity insurers
- Investing like an insurer is expected to deliver stable year on year profit:
  - Short-term ASTRO targeting >Gilts + 1% p.a., aiming for high liquidity
  - Long-term ASTRO targeting >Gilts + 1.5% p.a., using (core model) carefully selected illiquid bonds
- Provides a material degree of hedging against volatility in average insurance market pricing

Funding and Governance

- Low-dependency funding and investment target, with a dynamic discount rate approach
- Highly resilient funding level and cashflows broadly matched
- High quality covenant supporting rapid deficit repair
- Modelling suggests >99.5% benefit security compared to insurance regime benchmark
- A ‘triple-dip’ covenant giving dynamic optionality/control and rolling visibility with a very low default risk. This is further backed by contingent assets and total capital level targeting a ‘zero exit cost’ to flip to buy-out

How Secure Is It?

Well-funded schemes can run-on securely over the long-term, provided they adopt a strategy that is fit for purpose.

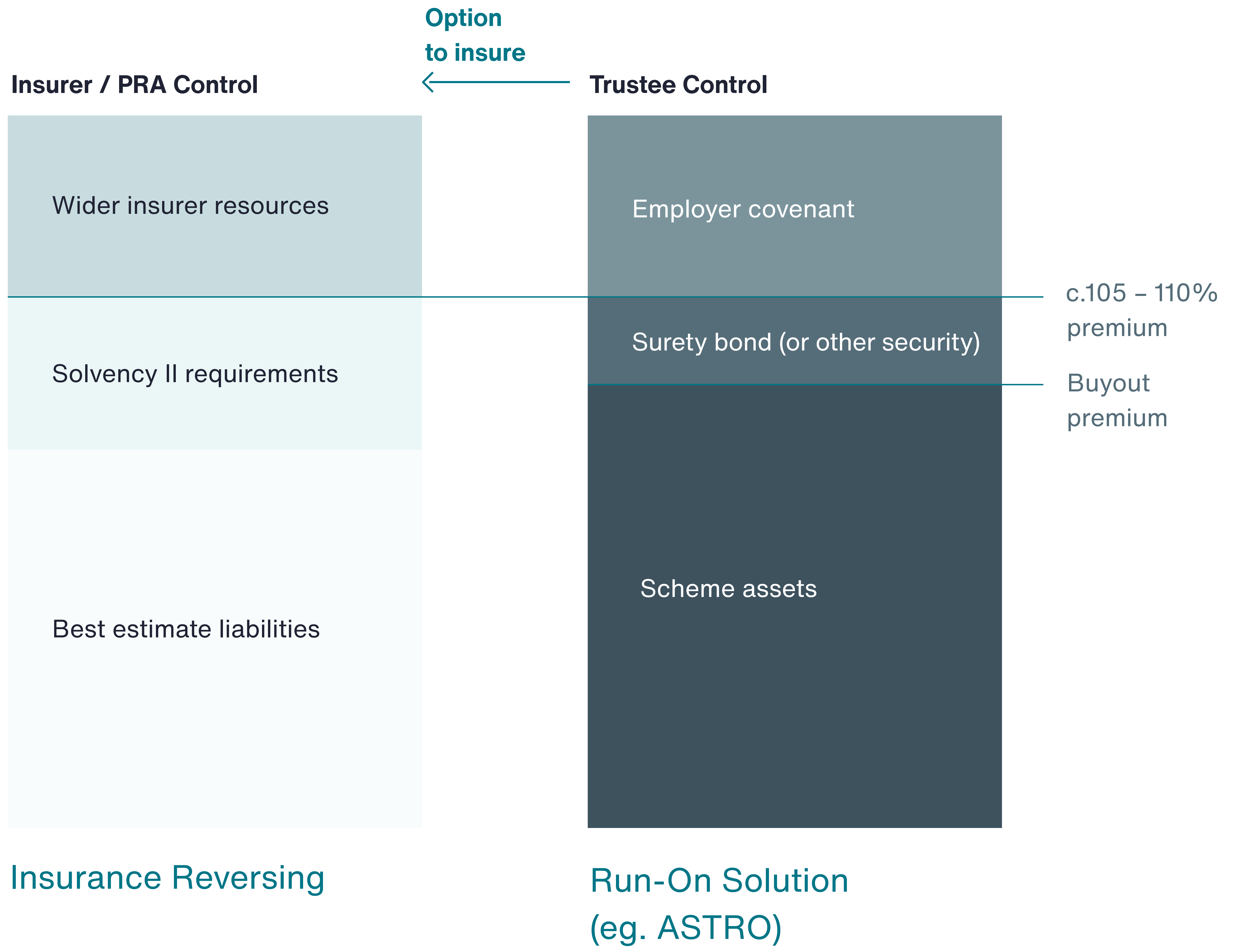
If a scheme is well-funded enough to insure, for example, it already has enough money to run-on and pay out full scheme benefits in the majority of scenarios. Adding in the support of a good employer covenant gives further confidence in some of the less likely 'tail risk' events.

If the employer covenant starts to decline, this needn't be a disaster either. ASTRO seeks to maintain buyout funding levels, so schemes keep the option to insure if risk in the system increases. Maintaining enough money to buyout also means schemes can insure benefits after a rapid 'overnight' insolvency, with no loss to members.

Finally, there is a risk of a simultaneous fall in funding level and rapid insolvency. This combination of events should be very unlikely. However we can further mitigate against loss by adding additional security, such as a surety bond (an insurance policy that guarantees payment of the deficit on insolvency).

On the right we show how the combination of these elements can give schemes access to a similar level of financial resources as if they were insured.

Comparison to Insurance



Which Schemes are Appropriate for Active Run-On?

Well-Funded Schemes

At least 90%+ of solvency

Mid to Large Size

Surplus generation must comfortably cover expenses

Good Covenant

Adequate to downside and decent visibility

Remember
Active run-on is not a once and for all decision

AON

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