

The corporate pension viewpoint

The importance of governance in a run-on strategy

For those companies with defined benefit (DB) pension schemes considering a run-on strategy, with an objective of material surplus generation, the interaction between the business and the pension scheme will need to be considered going forward.

For many years, DB pension schemes have been a major financial commitment for companies, drawing in significant amounts of cash, being a material risk on balance sheets and a drain on management time. For example, we estimated that in 2023 deficit reduction contributions of around £350bn had been paid into DB pension schemes since 2006.

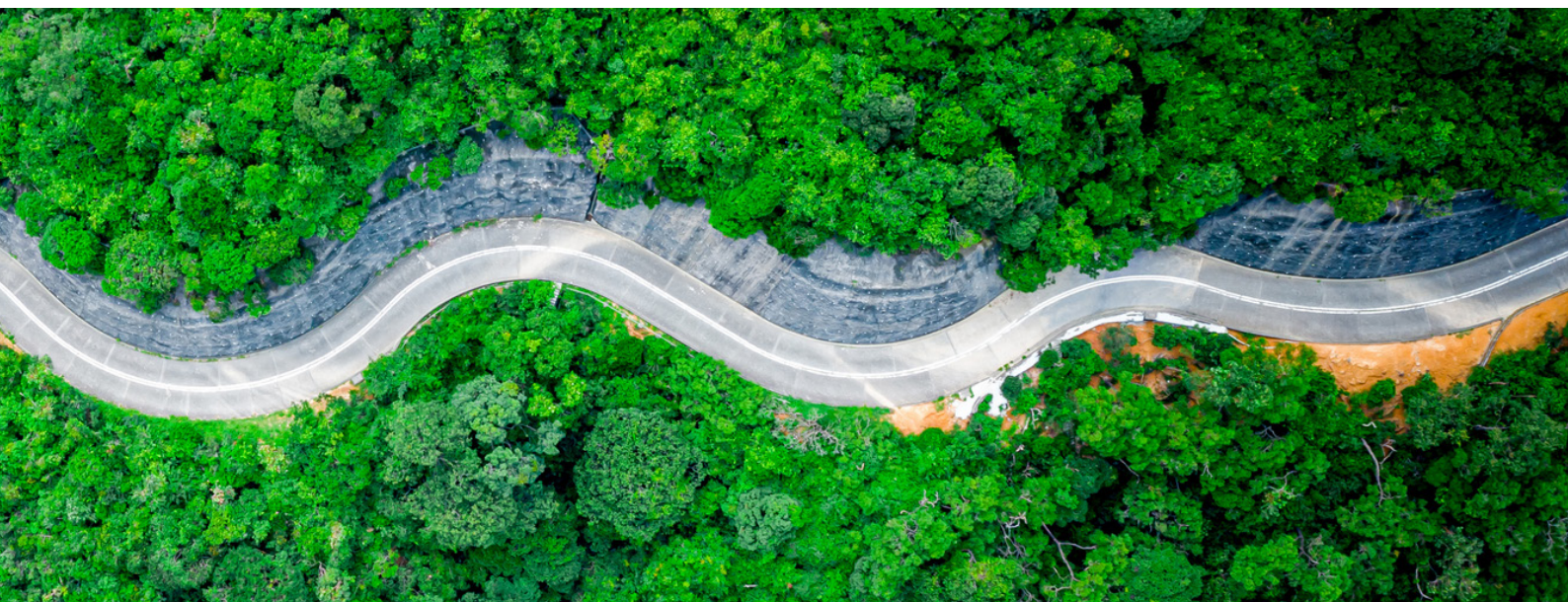
With improved funding levels and the current direction of travel around introducing greater flexibility on the use of DB pension assets, corporates who have dealt with decades of deficits, might now have the potential to gain access to future surpluses.

The PPF estimated in its 2023 Purple Book that for those schemes with a surplus, there was a surplus of assets of £200bn against the estimated cost of insurance in the UK DB universe. The future flow of cash back to the corporate, as well as possibly to members, could be extremely significant and transformative for a business.

For those considering such a run-on strategy, how does this change the dynamic between the business and pension scheme, and what could it mean from a governance perspective?

We'll consider three main areas:

- Day-to-day business interactions;
- Interaction with shareholders and the external market; and
- Trustee boards.



Day-to-day business interactions

For a company looking to run on its pension scheme and generate a material surplus, the scheme could be thought of as a division or subsidiary of the broader business, with its own reporting lines. This will bring about its own complexities. For instance, thought will need to be given to how the pension scheme interacts with current wider business forecasting.

Due to the significance of the potential surplus to the wider business, it may be that pensions will need to be reviewed at least annually and there may be various KPIs introduced on pensions, beyond the current framework in place. Metrics to consider could include:

- Funding position relative to any minimum surplus sharing thresholds;
- Projected future surpluses;
- Likelihood of a future downside risk event occurring; and
- Pension circumstances relative to the Pension Act 2021 requirements.

This could become interesting where a pension scheme looks to forecast surpluses over a longer-term period, in comparison to the usual, and likely shorter, business forecasting timeframes.

In-house pension expertise in some form will also probably be needed, although with larger schemes, this is likely to already be in place. However, it is worth noting the potential change in focus from ensuring 100% benefit security, to an objective of surplus generation and use of excess funds.

Interaction with shareholders and the external market

Consideration needs to be given to how third parties such as shareholders and the external market may react or change their approach to a company that decides to run on their DB pension scheme.

Third parties may prefer insurance solutions due to past negative experience of DB schemes. To convince and educate third parties of run-on, there will need to be:

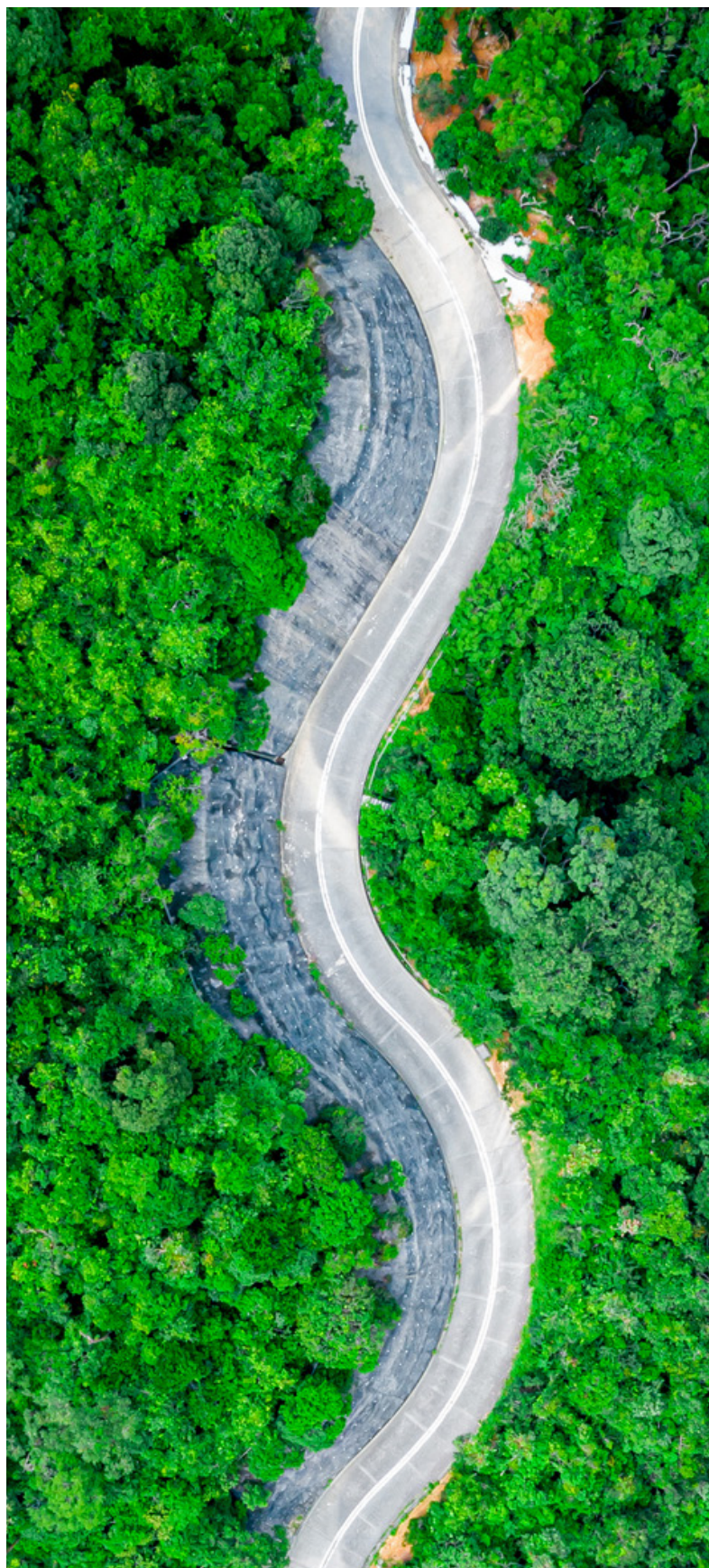
- strong messaging around the robustness of the strategy in place;
- information on the risk profile;
- details on the protections in place against downside risks (particularly black swan events); and
- an idea of the upside to shareholders and the external market.

Shareholders and the external market will be especially keen to understand what protections are in place against the downside risks. Whether that's the use of some form of external capital (for example a letter of credit, bank guarantee or surety bond) or another solution, they will want to know that the likelihood of any further cash being needed into the pension scheme is minimal, or arguably nil.

Third parties will need convincing of the mechanics of surplus distribution, including the timeframes. Any potential surpluses projected will be based on modelling at a point in time and in reality, the surplus distributed will probably differ from these projections. Expectations should be managed appropriately to show the uncertainty around the timing and quantum of any surplus distribution. It may also be that a return of surplus payment is required early in the process to convince third parties and company management of the viability of this strategy.

For listed companies any surplus distribution included in forecasting and market statements will have an impact on share price, so again clear messaging around the strategy will be required. However, there will be greater complications with this, given the need to provide the market with guidance on business activity, yet this may be difficult to do so given the likely uncertainty around the amount of future pension surplus generated. Consideration will need to be given on how any surplus will be used, whether that's as a special dividend to shareholders, to fund capital expenditure, M&A activity or in part to be shared with employees and pension members.

The accounting implications of such a strategy will also need to be considered, as this will help form views of the external market on how pensions should be valued for the business. Read our [separate publication](#) which covers several of the accounting implications of a run-on strategy in more detail.



Trustee boards

The way corporates and trustees work together will need to be very collaborative. Any run-on strategy with material surplus generation will need absolute alignment between parties on the strategic objectives. A collaborative framework with joined-up advisers will be key to this.

The dynamic of Trustee boards will also likely change. Following decades of senior finance individuals and companies pulling away from defined benefit schemes, it may be that more of these individuals come back to Trustee boards given the materiality to the wider business (and in the context of very securely funded schemes with minimal reliance on future company covenant). Complications of ageing member-nominated trustees and lack of diversity amongst trustee pools will present further challenges over the coming years. The role of professional trustees and diversified trustee boards will be key issues for a long-term run-on strategy.

Conclusions

There will be much to consider around the topic of corporate governance for a run-on strategy, to which a collaborative framework with clear objectives for key stakeholders will be essential. However, in the right circumstances, the investment to get this right will figuratively and actually “pay dividends”.

For further information or support, please contact one of our corporate consulting team.



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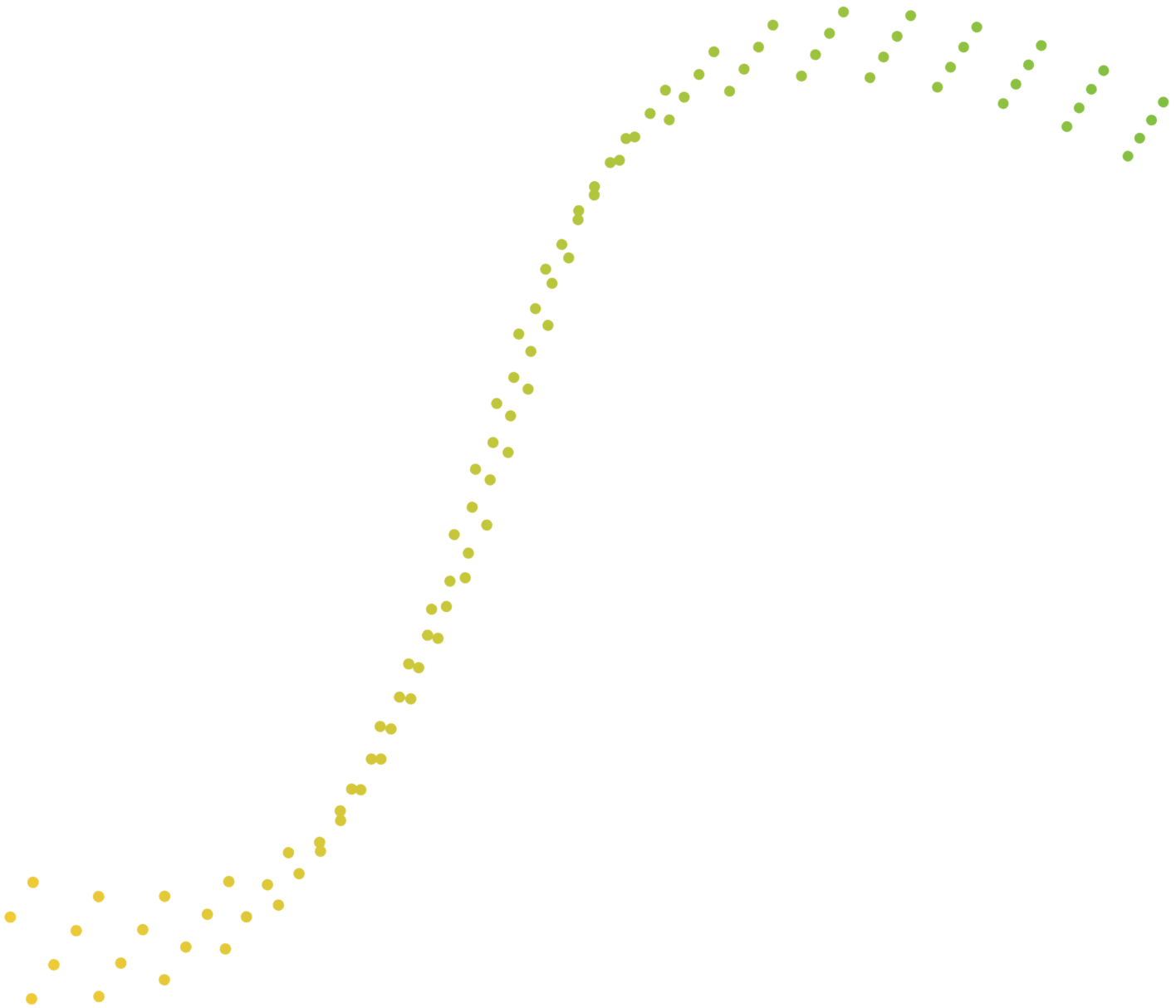
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