



Run-on proposition: BW SAVE

Designed to help Defined Benefit Pension Schemes build surplus assets.





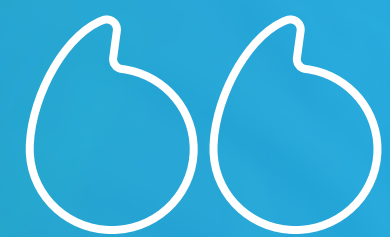
Introduction

Defined benefit (DB) pension schemes have long been viewed as a millstone around UK PLC's neck. The economic environment over the last couple of decades has meant that funding deficits never seemed to go away.

Many sponsors felt that they were constantly being asked for more money and so it's not surprising that many are now looking to offload their schemes into the insurance market.

The funding regime has encouraged schemes to 'get to buy-out' and for many trustees, there was an implicit assumption that once there, they would fully insure and then wind-up their schemes. But there is another way.

BW SAVE is a new and exciting option for sponsors and trustees of medium-sized and larger DB schemes. It enables you to run your scheme on with confidence for the mutual benefit of both scheme sponsor and scheme members, until the point where it makes sense to buy-out.



Achieving significant cost savings and maximising value for your scheme.



Key benefits



For scheme sponsors

[Click here](#)

For scheme members / trustees

[Click here](#)



For many schemes the value opportunity is huge. For a £200m scheme that is currently fully-funded on buy-out, the value of the surplus that can potentially be extracted over time is likely to be more than £20m after costs. For a £1bn scheme, it could be over £100m.




The opportunity: how it works

Our proposition enables you to maximise, and then share, the value from current and future surpluses that emerge in your scheme. Importantly, most schemes are now either in a buy-out surplus position or are expected to be in the next few years, even without additional contributions – so BW SAVE is relevant to most schemes.

Surplus is expected to emerge for three main reasons:

1. The expected return on the assets will be greater than that implied by the buy-out price. Importantly, this doesn't mean investing in a risky or aggressive manner – a fully-matched, conservatively-invested strategy is likely to generate at least c. 1% surplus per annum (net of costs).
2. As the scheme matures, it's likely that the buy-out price will come down. This is especially the case for less mature schemes - it could be of the order of 0.5% per annum.
3. Members are likely to make individual decisions which will generally improve the buy-out funding position. For example, if a member decides to commute pension for tax-free cash at retirement, the buy-out funding position is likely to improve. This will be very situation-specific but could be very significant – potentially in excess of the other two factors.



Over time the opportunity is very significant. It could easily be the case that the total surplus expected to emerge is of the order of 10-15% of assets.

The chart on the right shows how much surplus could be generated from investment returns alone for a typical well-funded £500m scheme. We compare this to the surplus that might be expected if the scheme adopted a gilts-only investment strategy.

The analysis shows clearly that significant surpluses are expected to be generated – of the order of 1% of assets expected per year.

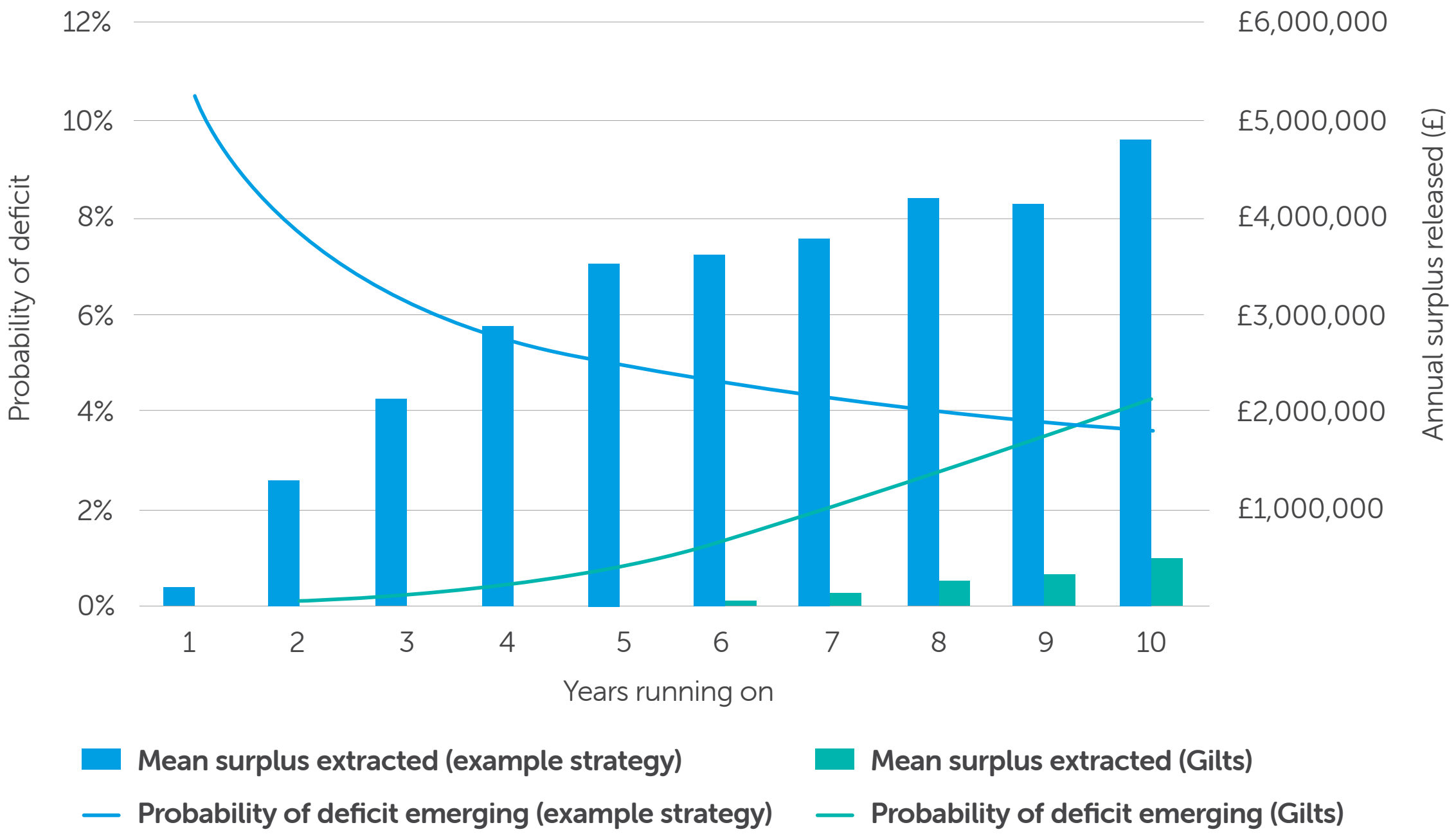
Of course, this needs to be put in the context of risk – and in particular, the true risk that the scheme actually has insufficient assets.

A scheme that is currently fully funded on a buy-out basis and has a reasonable employer covenant still behind it already has a very substantial buffer, and so our analysis suggests that the risk of there being insufficient funds to pay all benefits in full and on time is remarkably low. It is therefore expected that substantial surpluses will emerge over time, even in relatively pessimistic scenarios.

The analysis also shows that there remains a small, but not immaterial, chance of a deficit emerging that needs to be funded. However, in most scenarios the modelling suggests these deficits are usually temporary in nature and any contributions paid in will ultimately result in larger surpluses later.

This analysis **understates** the opportunity for most schemes. It only looks at surpluses that emerge through investment issues (i.e. point 1 above) and ignores surpluses that are expected to emerge from other issues (i.e. points 2 and 3).

Further detail on the modelling can be found in one of our [recent blogs](#).



How implementation works

SAVE protocol

To implement our proposition, the sponsor and trustees need to agree a **SAVE ('Surplus Assets Value Enhancement') protocol**. This defines, in advance, the scenarios and conditions when surplus can be accessed and how it will be used. Every year, the funding position is evaluated against the SAVE protocol and surplus assets are allocated and used accordingly. Apart from this, the scheme broadly runs-on unchanged.

For example, in simple terms the SAVE protocol may specify that surplus is accessible if the buy-out funding position is above 105% and that 75% of surplus value above this threshold is refunded to the sponsor, with the remaining 25% being used to enhance members' benefits.

Defining this upfront is important - it gives both sponsor and trustees clarity on the benefits so enables them to be confident that our proposition is in their interests. For example, the sponsor will continue to underwrite the scheme and so will require confidence in its share of future surpluses in order to agree to do this, given it is taking the majority of the downside risk.

The SAVE protocol can of course be changed with the agreement of all parties; however, it will generally be better to consider upfront the scenarios in which it may need to be adjusted and build these in initially.

It won't always be possible to agree a SAVE protocol. For example, if the covenant is weak then there are greater risks to members in running-on than if the covenant is strong. A weak sponsor is also likely to require a higher share of the surplus to justify running-on.

Our proposition works best for schemes with strong, or tending to strong covenants. It's unlikely to work at all for the schemes with the weakest covenants. Smaller schemes may find that the running costs of their scheme mean that it's impossible to generate sufficient surplus to justify running-on, especially considering the risks that will remain.

So, the first step to considering BW SAVE is to complete a feasibility study to investigate whether it's right for you and whether a mutually acceptable split of surplus is likely to be achievable.



Once the scheme has reached full-funding on buy-out the aim is to keep it there - the investment strategy and the SAVE protocol will be designed with this in mind. There would be an annual review of whether the proposition remains right for the scheme and the trustees and sponsor can both choose to pivot the strategy to an immediate buy-out if not. The scheme will be run in a 'buy-out-ready' way, to ensure that this is possible.

Your scheme will be managed highly efficiently. Advice to the trustees will rely heavily on template advice and model portfolios used across all schemes using BW SAVE - this keeps the cost low, providing reassurance that the value of the opportunity for both members and sponsor is maximised. That said, advice will always be appropriately tailored to the needs of each scheme.

The sponsor continues to underwrite the scheme. It is possible, albeit unlikely, that further contributions may be required in an adverse scenario. The SAVE protocol can be drafted so that these further contributions must be refunded back to the sponsor before surplus sharing recommences. This gives the sponsor confidence that running-on will be in its financial interests.




Sharing surplus with our proposition

The sharing of surplus will be negotiated upfront as part of the SAVE protocol. Ultimately, it needs to be agreed so that it is in both members' and sponsors' best interests. The right split will depend on a variety of sponsor-specific and scheme-specific issues.

Generally, we expect that most sponsors will only agree to running-on if they receive the majority of the benefit. From the sponsor's perspective there needs to be an attractive risk/return trade-off to running-on and so their share of the surplus needs to be large enough to make it attractive, especially given they will usually be underwriting 100% of the risk.

Trustees will usually also require some share of the surplus for members. Whilst the risk to members will be low, it is definitely the case that allocating a share of the surplus to the sponsor reduces the security of members benefits at that point, all else being equal.

Trustees will primarily need to be satisfied that any deterioration in security is reasonably small but will usually still require that a share of the surplus is allocated to members, to at least compensate for this deterioration in benefit security. How much this will need to be depends on the threshold at which surplus can be accessed and the strength of the employer covenant.



We can help both sponsors and trustees come to an acceptable SAVE protocol by providing modelling of different outcomes and discussing how the protocol parameters can be set to come to a mutually beneficial agreement.



Using surplus with our proposition

BW SAVE is flexible in how surplus is used. Generally, most sponsors will want to receive a refund of their share of the surplus where it's tax-efficient to do. However, surplus could also be used within the DB scheme to provide value to the sponsor. For example, the sponsor may want to use its share of the surplus in lieu of its DC contributions, or perhaps even to re-open the DB scheme to accrual. If it's not efficient to take its share of the surplus immediately, for tax reasons for example, then it could be ear-marked within the scheme for the sponsor to access later.

The Department for Work and Pensions (DWP) is currently consulting on substantial changes to the rules around refunding surplus from pension schemes. The proposed changes to the rules will make it a much more attractive proposition for a much wider group of schemes and sponsors, but many schemes already have sufficient flexibility in their scheme rules to take advantage of BW SAVE.

We would generally expect the members' share of surplus to be used to enhance members' benefits. It may be possible, however, to pay members a one-off lump sum.

Some schemes will want to 'skew' the distribution of surplus to certain groups. For example, if a scheme has a cohort of members with low, or even zero, guaranteed pension increases and another cohort with more

generous increases then it may be appropriate to provide a greater share of the surplus to the group with the low increases. Whatever method is used, the trustees will need to be satisfied that it is fair and reasonable (for example, taking account of different historical member contribution rates), and the associated costs will need to be considered.

It will often be better to agree a sensible and pragmatic solution, such as all benefits increased by X%, rather than incur potentially substantial incremental advisory fees to work out exactly how to allocate surplus in a more sophisticated way.

Setting the right strategy

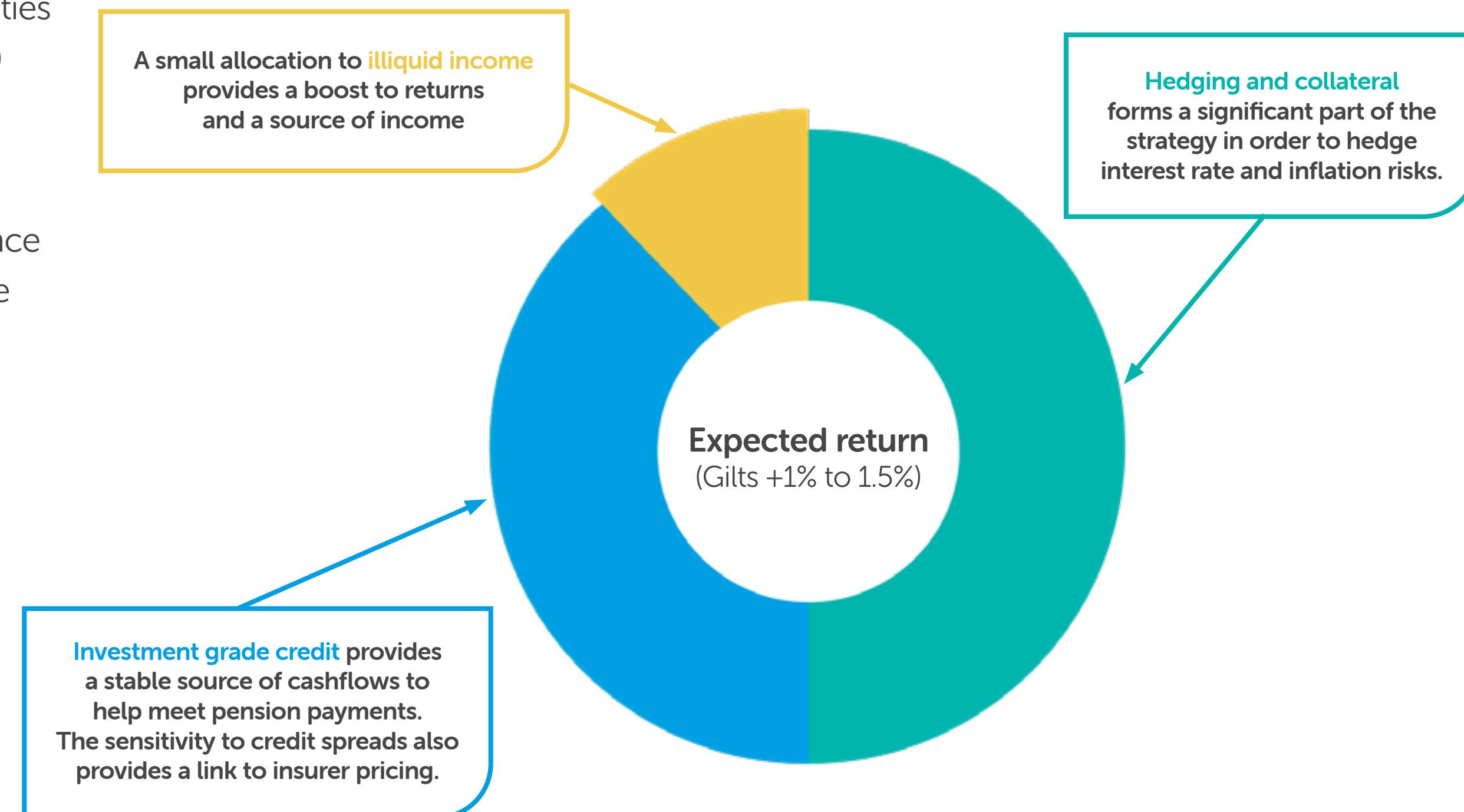
The proposition investment strategy is designed to maintain a strong funding position on a buy-out basis whilst generating a modest degree of predictable out-performance.

There is an option to make use of BW SAVE model portfolios - this keeps the cost of advice down, maximising the surplus that can be shared. It will be heavily bond-based with asset cashflows matched to liability cashflows and fully hedged for interest rate and inflation risks. It will of course always be tailored to the specific situation and the scheme's own unique liabilities as well as fully integrating Environmental, Social and Governance (ESG) considerations.

Because the scheme may want/need to pivot the strategy to buy-out, the strategy will be mostly invested in liquid funds, to ensure an insurance premium can be paid quickly and efficiently. This is not to say that there can be no illiquid assets, but it is important to consider the level of liquidity both in the context of the additional returns/risks it brings and the expected timeline for running-on.

Where a scheme is likely to run-on for, say, more than ten years before buying-out there is greater scope for investing in illiquids than where a scheme is only expected to run-on for say, three or four years.

Larger schemes may choose to develop a bespoke investment strategy. This will likely be similar to the model portfolio, albeit there is room for a greater level of sophistication and inclusion of the trustees' and sponsors' own views. However, we would encourage schemes to follow the same underlying principles as our model portfolios because these have been designed to manage risks, generate out-performance, and maintain strategic flexibility.



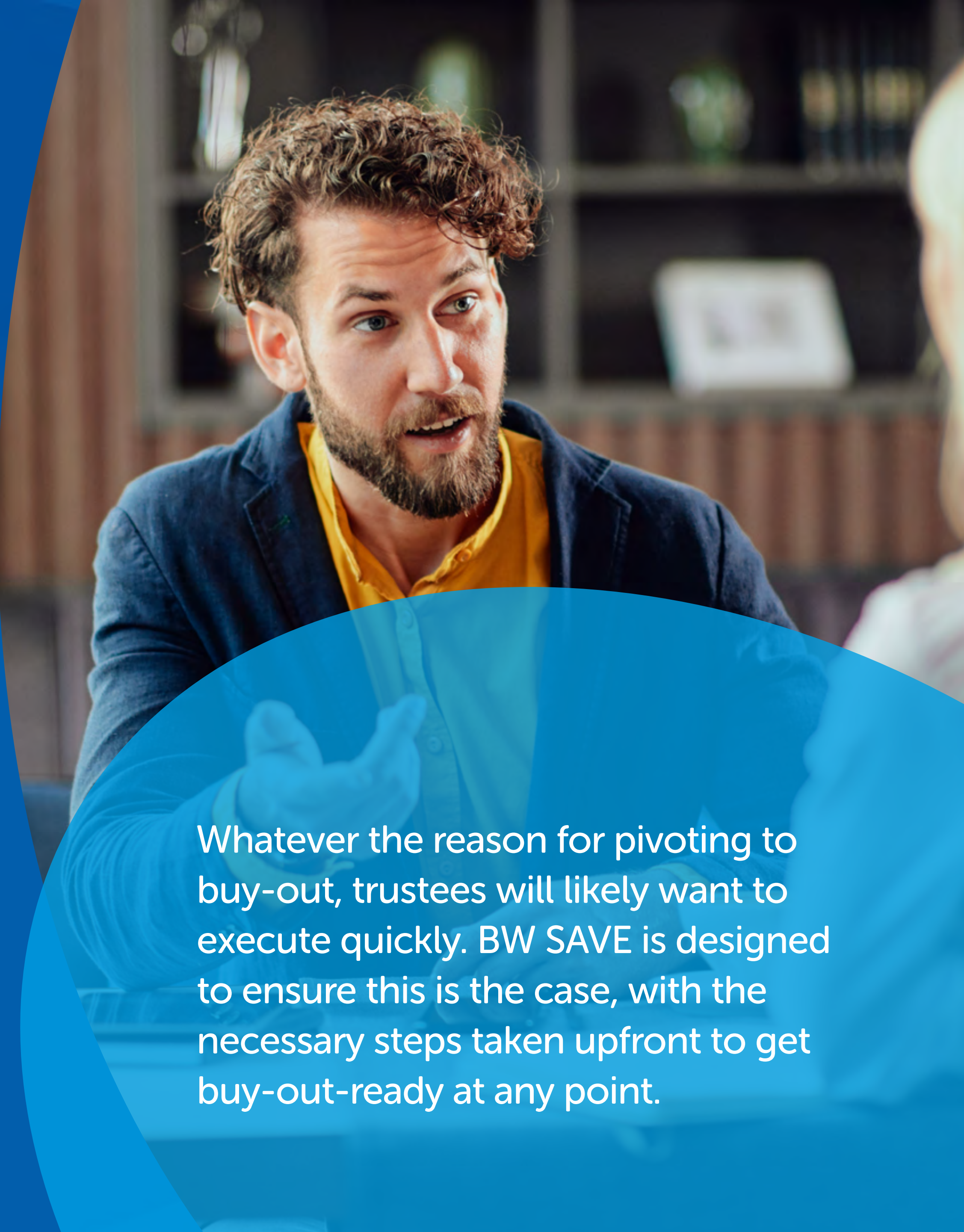
Making it easy to move to buy-out

Most schemes will, at some point, want or need to buy-out. Our proposition is likely to be most attractive when the scheme is larger and less mature. As it contracts in size, as all closed DB scheme inevitably will as benefits are paid out, the fixed running costs will become proportionately larger, adversely affecting the attractiveness of running-on.

Similarly, as the scheme matures the amounts of surplus that will be generated each year will fall. At some point in the future, it will be more attractive to buy-out, forgoing any future accrual of surplus in return for certainty.

Understanding the likely timeline of surplus evolution and eventual buy-out is crucial for deciding to run-on, and so we conduct an initial feasibility study to estimate extractable value and optimal buy-out timing. Given the uncertain future, this analysis is reviewed annually to decide between continuing to use BW SAVE or switching to a buy-out strategy.

Sponsor insolvency may require buy-out, with trustees likely opting for full buy-out and using surplus for member benefit enhancements. For surpluses or small deficits, consolidator solutions can be considered, as in the recent Debenhams case. The risk of benefit cuts for members is low.



Whatever the reason for pivoting to buy-out, trustees will likely want to execute quickly. BW SAVE is designed to ensure this is the case, with the necessary steps taken upfront to get buy-out-ready at any point.

Administration considerations

Our proposition works best with BW as actuary, investment adviser and administrator. This brings cost synergies, which will ultimately result in better financial outcomes. However, it's flexible and can be implemented with any good administration team. We understand moving administrator may not suit every scheme's circumstances, so if you're only expecting to run-on for a few years before pivoting to buy-out it may be most efficient to leave the current administrators in place.

But BW SAVE works best if the administration of benefits is codified to the maximum extent – just like an insurer would, and that data is cleansed to the same level it would be were an insurance transaction being carried out. This keeps subsequent costs down and maximises the benefits to both sponsor and members.

As you will eventually want to buy-out anyway, this work is necessary at some point. Spending the time now to consider ways in which the administration of benefits can be made more efficient going forwards results in increased confidence in the level of surplus that can ultimately be shared.

Actuarial considerations

The way in which actuarial advice fits into the whole process is an important element of keeping costs down. The advisor will need to recognise that the scheme will be operating in a much more stable environment in terms of the investment strategy and the strength of the funding position. In turn, this should lead to greater simplicity and/or a low maintenance approach around much of the core actuarial work of actuarial valuations, funding monitoring and actuarial factors.

The scheme will need to continue to comply with the on-going funding regulations, including for example, setting a technical provisions basis. However, a proportionate approach will be taken recognising that the scheme is being run on the basis that the likelihood of additional sponsor contributions ever being needed is low.

It is possible that the approach to setting the discount rate may need to be adapted to one which is more closely aligned to the yield on the underlying assets rather than a 'static gilts +' approach. How sophisticated the approach needs to be will largely depend on the thresholds which are set for extracting surplus and/or the surplus buffer which the scheme intends to retain.



Sponsor considerations

There are a wide-variety of sponsor-specific considerations, such as tax, accounting, and corporate valuation.

BW SAVE will, under the current tax regime, be most attractive to profitable sponsors that pay UK corporation tax. This is because there is an asymmetry in how the tax on surplus extraction is applied compared to the tax relief granted on pension contributions.

Running-on reduces/delays the negative accounting consequences of buying-out. For most companies, buying-out involves removing an accounting surplus from the balance sheet and putting a cost either through the P&L or directly writing off balance-sheet equity. Our proposition doesn't eliminate this effect, but it does reduce and delay it. By running on and getting value for the surplus, the accounting surplus is used on a regular basis, enhancing the effect.

Finally, our proposition should, if properly explained to investors, result in the creation of shareholder value. Investors are probably not expecting the company to get much or any value from the current surplus, but with our proposition significant value can be obtained. Investors/lenders who understand this are likely to be more willing to invest in or lend to your business, potentially on better terms for you.

Member considerations

The main risk to members from running-on with BW SAVE is that there remains a risk that their benefits need to be cut-back in the scenario the sponsor becomes insolvent, and the scheme is underfunded on a buy-out basis. This risk is usually very small, as surpluses are only accessed when the scheme is overfunded.

The covenant should be assessed as part of the annual review on whether to run-on or buy-out. Of course, insurers can also become insolvent. Whilst the regulatory regime is designed to make this a low-chance outcome, it is not zero-risk. Both BW SAVE and the insurance regime are designed to give members a high degree of confidence that they will receive their benefits in full.

That said, members are likely to see increases to their benefits through our proposition in excess of what would be available through an insurance buy-out. Over time, as surplus is shared and benefits are increased, a buffer will be built up which protects members against the risk of an insolvency and a cut-back in benefits.

For example, if members' benefits have been increased by 2%, then it would need a cut-back in benefits of more than 2% for members to be worse off (on average) compared to having bought-out immediately. Furthermore, the possibility of future discretionary benefits remains on the table.

Members with AVC pots or in-trust DC accounts will maintain the current level of flexibility, at least while the scheme runs-on. For example, members often choose to use their DC pots, or AVCs to fund their tax-free cash at retirement – this reduces the amount of pension they commute and means they are likely to be better off over time as a result. This flexibility is often lost when a DB scheme moves to buy-out, but with our proposition it is retained during the period of run-on.

Non-retired members will also continue to benefit from the option terms provided by the scheme in relation to things like cash commutation, early retirement reduction factors and cash equivalent transfer values. These represent another way in which members could get additional value whilst at the same time enabling the scheme to generate additional surplus - which would otherwise be a further source of profit to the insurer.



Is this proposition right for my scheme?

BW SAVE is potentially attractive for schemes from £100m upwards and very attractive for schemes over a few hundred million. The next step is likely to be a feasibility study – this examines the business case in more detail, considering you and your scheme’s specific circumstances. It’s not right for every scheme, but where it is right it can be a substantially better option than an immediate buy-out.

Please do get in touch if you think this could be of interest.

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