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BlackRock

Keep the plan?

The case for running-on defined benefit pension schemes



Executive summary

- For UK defined benefit schemes, strong funding positions and regulatory changes have put focus on endgame planning.
- A Run-on basis could provide benefits to both members and the sponsor by potentially allowing for the release of trapped surplus as well as the potential to generate future surplus.
- Investment strategy for Run-on should deliver consistent returns in a simple and low risk way.
- BlackRock's strong and broad investment platform that integrates public and private markets is perfectly positioned to help schemes who decide to Keep the Plan – we illustrate this using example portfolios.
- Partnering with a global provider who can evolve your portfolio over time to move inline with both changes in your objectives and market opportunities will be key.



The UK pension landscape has undergone a remarkable transformation over recent years with a record 90% of defined benefit (DB) schemes now in surplus and the aggregate surplus close to a staggering £470 billion¹.

The average funded ratio for the top 200 U.S. Corporate pension plans is likewise at the highest level seen in 15 years. As a result, we recently discussed if US Plan sponsors should either reopen their plans or increase benefits – see our recent paper on the topic [here](#). We believe similar factors may also apply to UK schemes and so discuss the potential to ‘Run-on’ in this paper.

This improvement in funding has led many schemes to attempt to ‘lock-in’ gains and adopt a lower risk asset allocation with a high proportion of assets invested in liability-driven investment (LDI) strategies and other fixed income assets.

The PPF’s latest Purple Book shows that the average scheme’s assets are invested 69% in bonds (including LDI), 18% in equities, and 13% in other assets; a continuation of the longer-term rotation out of equity into fixed income.

Chart 1: PPF historical change in size of aggregate surplus/ deficit

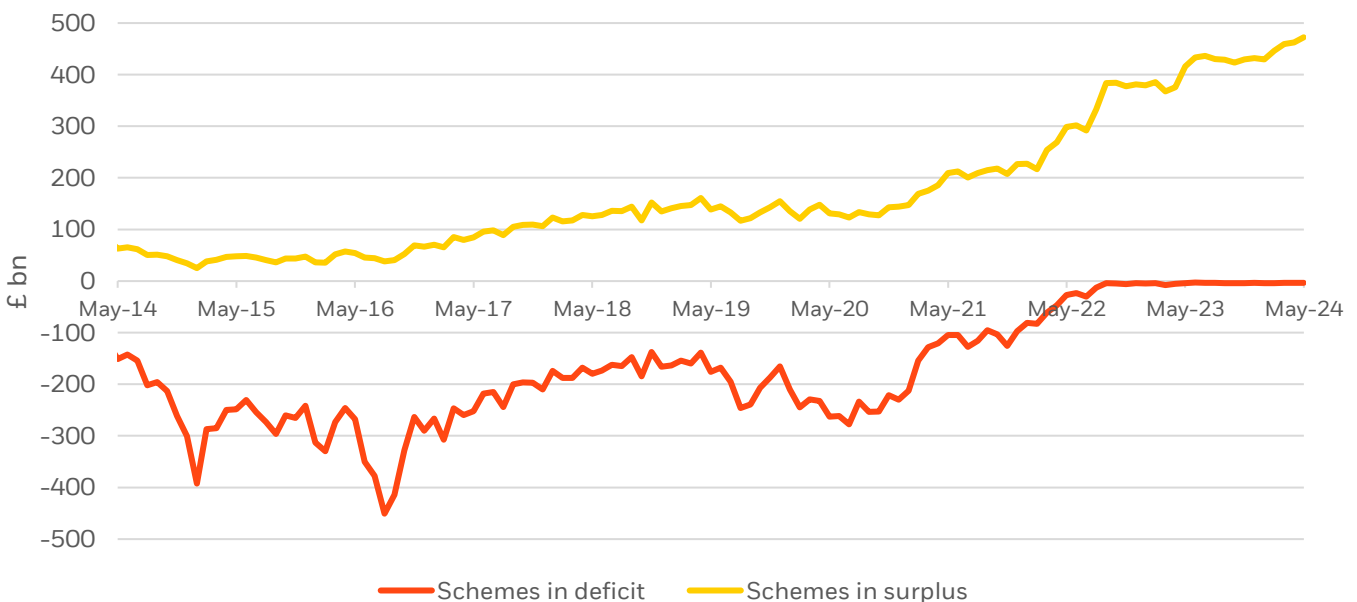
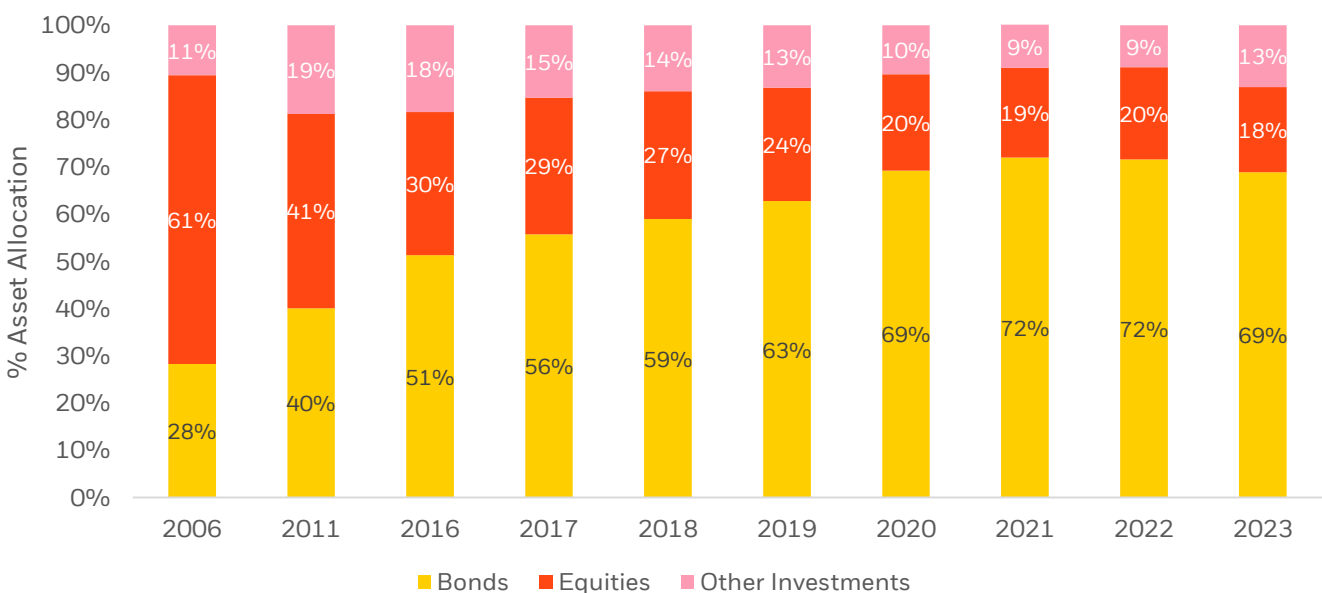


Chart 2: Historical Asset Allocation Chart - Purple Book



Another notable trend stems from the reduced appetite for illiquid assets², with many schemes looking to reduce their allocations further over the coming year. These two trends combined illustrate the desire to both reduce risk and increase the liquidity of schemes.

With many UK schemes now reaching or exceeding their funding targets, the question of what to do next becomes more pressing. For some schemes, the answer may be to pursue a buy-out with an insurance company, which would transfer the risks and liabilities of the scheme to a third party and provide a 'clean break' for the sponsor. Indeed, the bulk annuity market has seen a surge in demand in recent years, with 2023 being a record year for pension risk transfer (PRT) transactions which are estimated to have exceeded £50 billion³. Insurers are indicating expectations for another record year in 2024, as more schemes look to de-risk and lock in their funding gains. However, buy-out or buy-in are not the only options available for schemes with surplus assets. In fact, for some schemes, they may not be the best option at all.

A Run-on basis could provide benefits to both members and the sponsor by potentially allowing for the release of trapped surplus as well as the potential to generate future surplus. Suddenly DB pensions, which have long been considered an obstacle to corporate sponsors, may now present a sizeable opportunity akin to the expected profits insurers expect to make from writing bulk purchase annuity deals.

The significant growth in surplus has led the Department for Work and Pensions (DWP) to hold a [public consultation](#) on measures to make surplus extraction easier⁴. The DWP indicates that it is considering a statutory override to scheme specific rules that may have in the past caused a stumbling block to surplus extraction, which may make Run-on an appealing option for a greater number of trustees. In addition, in April 2024, the government reduced the tax payable by sponsors on surplus extracted from 35% to 25%. We are supportive of the work that the DWP is doing to drive better outcomes for pensions savers, although note that it may take a while, particularly given the UK election, before the DWP are in position to provide details on next steps. This provides trustees with an opportune time to review the end-game options available to them.

If run on is back on the table, this creates several interesting questions for trustees, including whether they are right to keep their aversion to the potentially enhanced returns and diversification of risk that private markets can bring and whether they are working with the right partner for the coming new regime.

In this paper, we will explore what Run-on is, who it is likely suitable for and why it may be preferable to buy-out or buy-in. We will assess what portfolios might look like and some of the benefits of re-introducing the flexibility to take advantage of the private market space and why BlackRock's strong and broad investment platform that integrates public and private markets is perfectly positioned to help those schemes who decide to Keep the Plan.

BlackRock edge for run on – Three key areas:

1

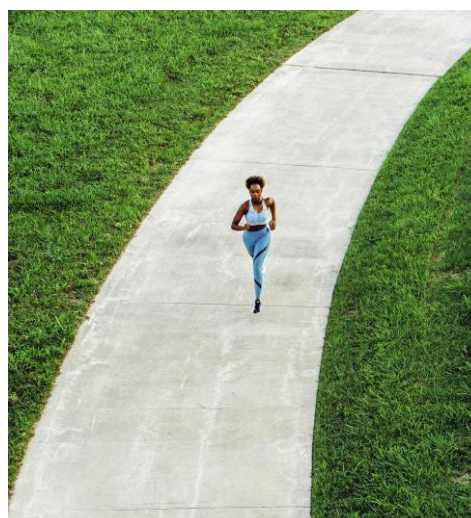
Full breadth of public and private market access

2

Solutions specialists with pensions and fixed income expertise

3

Risk management and reporting all integrated on the Aladdin platform



Who is Run-on likely suitable for?

There are several characteristics that make Run-on more suitable for specific schemes. We highlight a number of these below.

A strong starting position

Schemes that already have a surplus position or are close to their funding target may have a greater appetite for Run-on, as opportunity to extract surplus is possible sooner.

A meaningful surplus relative to the cost of Run-on

The surplus generated by the scheme needs to be meaningful enough to warrant the effort and outweigh the costs of continuing to run the scheme (e.g. administration, governance, investment etc).

Strong covenant

The sponsor's ability and willingness to support the scheme is crucial for the success of Run-on, as it provides security to the members and confidence to the trustees. The covenant strength would continue to be regularly monitored and assessed. The sponsor and Trustee may agree on additional safeguards in the case of covenant deterioration which amongst a variety of options may include a parent company guarantee, a charge over balance sheet assets, a release of funds in escrow etc.

Relatively immature schemes

Schemes that have a longer time horizon and a lower proportion of pensioners may benefit more from Run-on, as they have greater opportunity to benefit from extracted returns. Moreover, the cost of insuring active and deferred members is typically higher than the cost of insuring pensioners, which may make buy-out or buy-in less attractive for immature schemes.

Potential for illiquid assets

Schemes that hold illiquid assets, such as property, infrastructure, or private equity/debt, may find Run-on more appealing, as it allows them to continue holding these assets without forcing a sale (potentially at a discount / haircut). Illiquid assets may offer alternative risk premia which a Run-on scheme could take advantage of given the longer- term investment horizon – we discuss investment considerations in a following section. Even for schemes without existing illiquid assets, the decision to run on can unlock opportunities in private markets that may otherwise be missed.

Why Keep the Plan?

By 'Keeping the Plan', schemes can potentially access the current surplus that is locked in and benefit from any future improvements in the funding level, which may result from positive asset returns or better than expected mortality experience. If the scheme opts for a buy-out or buy-in, it would give up the potential gains from any such improvements, as they would be transferred to the insurer.

Keeping the Plan may also offer several other advantages over buy-out or buy-in:

<p>Ability to utilise the surplus generated</p>	<ul style="list-style-type: none"> • The surplus generated by the scheme may be used and possibly shared between the sponsor and members in various ways. For instance, the sponsor may decide to use the surplus to re-invest capital back into the sponsor's business. • The government's recent changes reduced the tax rate on pension surpluses from 35% to 25%, making this option more attractive. The surplus could also be used to protect members' standard of living by enhancing benefits such as granting discretionary increases or by providing a defined contribution supplement.
<p>Potentially secure better insurer pricing in the future</p>	<ul style="list-style-type: none"> • Run-on does not preclude the possibility of pursuing a buy-out or buy-in in the future, if the scheme decides that it is the best option. In fact, Run-on may provide the scheme with more flexibility and bargaining power to secure better insurer pricing in the future, as it can choose the timing and terms of the transaction. • Insurer capacity is currently limited, and the demand for bulk annuities may exceed the supply, which may drive up the prices and reduce the availability of PRT solutions. • Run-on may be a suitable alternative or 'low dependency' waiting ground while benefiting from improvements to the funding level and waiting for more favourable market conditions or insurer appetite.
<p>Invest with greater flexibility and in line with Trustee preferences</p>	<ul style="list-style-type: none"> • Run-on allows the scheme to invest with greater flexibility and in line with trustee preferences, both today and an ongoing basis, rather than being constrained by the insurer's investment approach. For example, the trustee may have a greater focus on ESG factors, which may not be fully reflected by the insurer's policies or practices. • The bulk annuity market is also changing rapidly, with new entrants, mergers, and acquisitions, which may affect the ultimate owner and ESG credentials of the insurer. • Moreover, the trustee may have more freedom to choose the type and mix of assets that suit its objectives and risk appetite, such as illiquid assets, growth assets, or UK assets, without being restricted by the insurer's regulations or capital requirements.
<p>Preserve member experience and benefits</p>	<ul style="list-style-type: none"> • Run-on allows the scheme to preserve the member experience and benefits that may otherwise be lost or redesigned under a PRT exercise. For example, members may prefer to remain with the employer that they are familiar with and trust, rather than being transferred to an unknown insurer. • This in turn, may hold 'paternalistic' value for the sponsor. In addition, members may benefit from the 'esoteric' or flexible benefits that the scheme may offer, such as early retirement options, which may not be replicated by the insurer or may be subject to different terms and conditions.

Investing for Run-on

Many low dependency portfolios are structured heavily around a combination of LDI and corporate bonds. While this may present a relatively low risk portfolio that will deliver cashflows as required, with credit spreads currently low, the level of returns is lower than it would have been previously and a risk of interim drawdowns still exists.

If Run-on is indeed a scheme's longer-term objective, the trustee may want to re-visit taking advantage of investing in illiquid assets as this can materially enhance expected returns (due to diversification benefits). Keeping the flexibility of only holding very liquid assets comes with its own costs in terms of risk and return.

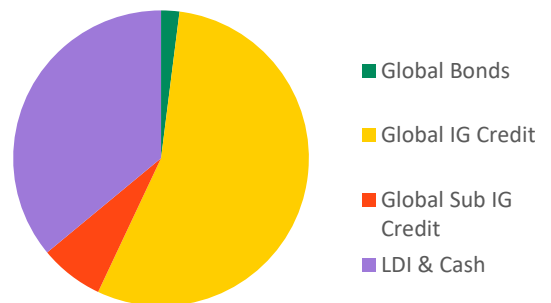
We have illustrated below example portfolios highlighting a variety of building blocks that may feature in a Run-on portfolio. Each example portfolio targets the same level of risk for comparison purposes, but higher risk portfolios could be targeted if the trustee was comfortable with their covenant risk.

A

Run-on and maintain the existing surplus level – a buy-out ready portfolio

- Full hedging of interest-rate and inflation risk
- Core allocation to global IG credit to hedge against buy-out pricing
- Buffer to protect against longevity improvements

(Gilts + 0.2%)*

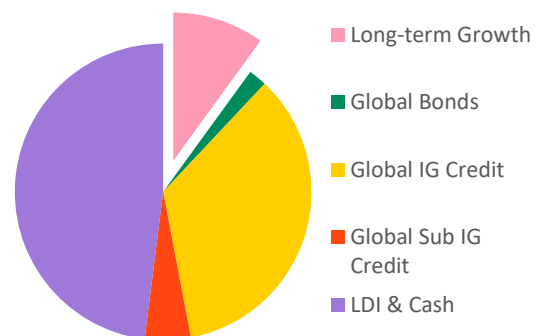


B

Run-on and build additional surplus – whilst maintaining the flexibility to go to buy-out

- Core portfolio principles inline with portfolio a), to allow the trustee the optionality to buy-out at short notice
- Allocation to liquid long-term growth assets (such as equities) to provide an additional return driver and build surplus

(Gilts + 0.5%)*

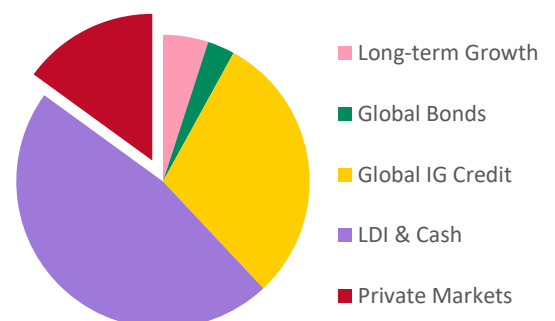


C

Run-on and build additional surplus over the longer term

- Maintenance of credit allocation to allow steady cash flow match to the liabilities
- Allocation to long-term growth assets and private debt markets to provide higher returns and diversification of risk

(Gilts + 1%)*



We highlight below some areas to consider when choosing the ‘building blocks’ within your scheme’s investment strategy and their allocation:



Time horizon: As noted above a key consideration will be the scheme’s time horizon as this may affect the choice and allocation of the building blocks, with some assets being more suitable for a longer-term Run-on strategy. For example, if the scheme has a long-term commitment to a ‘Run-on basis’, it may consider illiquid credit or alternatives such as infrastructure, which may offer higher returns. If the scheme has a shorter-term allocation, it may consider a higher allocation to shorter dated credit, securitised, or ETFs, which may offer more liquidity and flexibility



Risk appetite: The scheme’s risk appetite may affect the choice and allocation of the building blocks, as some assets may have higher or lower risk-return profiles. For example, if the scheme has a higher risk appetite, it may consider modest allocations to equities or alternatives, which may offer higher returns and diversification benefits, but also higher volatility and downside risk. If the scheme has a lower risk appetite, it may consider high quality credit or securitised assets, which may offer slightly lower returns but also lower volatility and downside risk. This may also be reflected in the scheme’s investment principles by the use of a dynamic discount rate.



Level of rates and inflation hedging: The scheme’s level of rates and inflation hedging may depend on the assumptions about the future usage of surplus assets. For example, if the scheme plans to use the surplus assets to provide inflation uplifts or discretionary member benefits, it may need to hedge more of its liabilities, as these benefits would grow with inflation. If the scheme plans to use the surplus assets for other purposes, such as DC top-ups or capital investment, it may need to hedge less of its liabilities, as these benefits would not grow with inflation. In our example portfolios, we assume scheme’s fully hedge both interest rate and inflation risk.



Managing longevity risk: The scheme will need to consider how to manage longevity risk, which is the risk that members live longer than expected and increase the liabilities of the scheme. This may involve entering into longevity swaps or budgeting a specific risk buffer (a percentage of the surplus to protect against longevity improvements).

The considerable accumulation of pension surpluses on the balance sheet of UK sponsors should be considered an asset. To unlock the value of this asset we believe it may be appropriate to reassess your schemes’ objectives and end-game. We think it is essential to be proactive and forward-thinking in considering the most suitable options or new objectives for your scheme. Maintaining total flexibility through liquid public assets comes with its own costs and they should be carefully weighed up against the potential benefits of pursuing a more expansive investment strategy.

How BlackRock can partner with you in run on

Your choice of partners, such as your investment manager, is critical for the success of Run-on. Our dedicated LDI team are experienced in integrating the management of LDI portfolios with other asset allocation building blocks, including incorporating cashflows from private market or illiquid alternative assets. We can provide the effective and efficient risk management that your scheme will need particularly given the high allocation to hedging assets.

Our expertise includes the ability to operate hedges dynamically whilst incorporating each of the asset allocation building blocks into one holistic framework. Our 'whole' portfolio approach is enhanced by, Aladdin, BlackRock's market leading risk system which allows us to manage risk across the solution and also report to you on how the solution is performing. We believe partnering with a global provider who can evolve your portfolio over time to move inline with both changes in your objectives and market opportunities will be key.

Our team is ready to share our insights and continue to partner with our clients as they re-assess their objectives. For further details on how BlackRock can help you reach your scheme's desired outcomes, please reach out to your usual BlackRock representative.

To learn more about LDI at BlackRock offering, please visit our website:

<https://www.blackrock.com/uk/professionals/solutions/fixed-income/liability-driven-investing>

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Sources

1. Source: The PPF 7800 Index: June 2024 Update. The aggregate surplus (total assets less s179 liabilities) of the schemes in the PPF 7800 Index is estimated at £468.8 billion at the end of May 2024. The funding ratio (assets as a percentage of s179 liabilities) of schemes is estimated at 149.4% at the end of May 2024.
2. AON: Global Pension Risk Survey 2023/2024, The Risk Prioritisation Challenge
3. LCP: New entrants push buy-in/out volumes to new record of nearly £50bn – 27 March 2024
4. BlackRock's response to the DWP Consultation on 'Options for Defined Benefit Scheme' can be found [here](#).

* Based on Q1 2024 BlackRock Capital Market Assumptions. Portfolios are illustrative only and do not constitute an investment recommendation. Expected returns are over a 10-year time horizon and are net of typical fees.

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