LCP powering possibility

LCP on point

Understanding the economics: Examining the financial case for running on a DB pension scheme beyond buy-out affordability

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Introduction

Many of the UK's Defined Benefit pension schemes have now reached very strong financial positions. The £1.2 trillion invested in DB schemes is now estimated by TPR[1] [1]to include £160 billion of collective surpluses relative to what is required to pay member benefits, even when assessed on a "low dependency" basis.

This is creating options for pension schemes that are willing to run-on (and carry the associated upside and downside risk) beyond when they can afford to fully insure and/or potentially share surpluses ahead of reaching this point under the Government's recently announced pension reforms.

As part of a wider analysis of different endgames, this paper looks at the economics of running on through a corporate finance lens for schemes of average maturity, as a taster of the type of scheme-specific analysis that can be done to answer the question "what is an appropriate period, if any, to run on beyond the point that the trustees can afford to fully insure?"

This paper seeks to put a value on the potential future cash flows paid to/from a DB scheme that defers insuring and instead actively runs on beyond the point of buy-out affordability. In this context, from the sponsor's perspective, the cash flows are defined as amounts that could be released to the sponsor and/or members (positive cash flows) and any contributions that may be required to be paid by the sponsor into the scheme to restore a deteriorated funding position (negative cash flows).

Considered through this corporate finance lens, a typical £1bn DB scheme that is now fully funded on an insurance buy-out measure, and able to release on-going surpluses on a buy-out measure, may have a positive net present value of around £100m-£250m over a run-on period of, say, 20 years. These funds could be available to sponsors and/or members, with relatively small probabilities of the sponsor needing to pay in cash to restore funding.

The extent of any surplus value, and timings of it being realised, will depend on the asset and surplus-sharing strategy agreed with the trustee, and any future legislative easements that are introduced to access buy-out surpluses ahead of wind-up. The total surplus extracted will also reflect actual investment and member outcomes (ie it may be less if asset allocations are defensive, investment returns are poor and/or members live longer than expected). However, for a well-hedged scheme, with a well-managed surplus release mechanism, the likelihood of material additional sponsor support is relatively small compared to the likelihood of a potentially significant surplus value over the medium to long term.

[1] Estimated DB scheme universe funding splits and assets under management | The Pensions Regulator

The timing of surplus releases and the potential for additional deficit contributions to be required would also be impacted if surpluses were released at levels below buy-out funding (which is expected to be possible from 2027).

Allowing surpluses to be released at these lower levels, using a discount rate of gilts+0.5% pa, could be expected to yield similar net present values, though with more funds released earlier. It should also be noted that while the initial surpluses released would be higher, so is the likelihood of sponsors needing to top-up funding positions further down the line. In practice, we expect that sponsors and trustees (and potentially The Pensions Regulator (TPR)) may prefer to include buffers above low dependency before releasing and sharing surpluses.

Unsurprisingly, the results for a typical well-funded, de-risked scheme differ from those which are less well-funded and less de-risked (as was typical 5-10 years ago). This highlights the importance of re-testing previous thinking and updating previous analysis.

The results also vary considerably depending on scheme size due to proportionately higher fixed costs for smaller schemes. Larger schemes are more able to generate higher surpluses, both in absolute terms and as a percentage of the starting asset base.

For a well-funded DB scheme with sufficient risk appetite, a well-managed run-on strategy could:

- represent a material return of value to the sponsor (for example, through future regulatory changes allowing surplus release mechanisms or through, say, funding future DC contributions);
- provide additional benefits to scheme members, for example, to members with non-increasing or capped pensions, or the membership more widely; and/or
- potentially provide funds to direct to further retirement support for current employees (through potentially enhanced DC contributions or financing a move to CDC).

Whilst the probabilities of requiring additional funding are relatively low when buffers are included within the surplus release mechanism, they need to be considered in the context of the specific covenant support available from any given sponsor and the likelihood of this support being available over the relevant time period, as well as the circumstances where contributions may be required.

Furthermore, whilst this paper focuses on the economics from a sponsor’s perspective, a similar analysis can be done from the perspective of the trustee and members, building in a wider range of factors, including interpretation of trustee fiduciary duties, broader attitudes to risk, ESG and member experience considerations, and any specific powers under the scheme rules.

01 Modelling approach and summary of results

For the purposes of this section of the paper, we make the simplifying assumption that any surplus above the cost of full insurance can be released to the sponsor and/or members, and any deficit on a "fast track" technical provisions basis requires funding through sponsor contributions.

We also assume that mechanisms are available and in place to access surplus on an ongoing basis. In practice, this may require some or all of the following to deliver some of the modelled outcomes for a particular scheme:

- sufficient ongoing company DC contributions to be subsidised using sponsor share of DB surplus (note this is easier where DC is in the DB trust, but possible if not);
- individual scheme rule changes; and/or
- new legislation, under the Pension Schemes Bill 2025, expected to be in force from 2027, to allow the ongoing release of surplus to sponsors.

Further detail on the approach and assumptions used is set out in the Appendix.

A side note on scheme-specific analysis

Each individual scheme has its own circumstances and stakeholders, and no single answer will be correct for all. The modelling in this paper is intended to inspire scheme-specific analysis as an input into endgame strategy decision-making.

This scheme-specific analysis would allow fuller trustee and sponsor consideration of scheme-specific circumstances, including:

- the sensitivity of the results to the run-on period chosen;
- the resilience of a run-on strategy to the extreme financial shocks;
- the impact on members, including probabilities of receiving their benefits in full under different scenarios and consideration of intergenerational issues;
- any downside risk mitigations required by the trustees in return for continuing to run investment and demographic risks beyond the point of buy-out affordability and/or as part of any arrangements to share surplus with the sponsor; and
- whether a buffer should be built up before any distributions can be made on an ongoing basis, or whether surplus should only be distributed at the point of wind-up when all assets and liabilities are known.

The above analysis would facilitate a "side-by-side" comparison of a scheme-specific run-on strategy, either indefinitely or for a period, to the alternative of securing member benefits with an insurer and potentially winding up in the shorter term.

We see this analysis leading to a range of strategies: we expect many schemes will see value in the certainty of shorter-term insurance, and potentially buy-out, but we expect others to see value in deferring insurance and running on.

Case study

We consider here a scheme that is fully funded on an insurance measure, which offers two potential streams of cash flows to its corporate sponsor and/or scheme members:

- **Scenario 1:** Transfer the risk to an insurer and wind-up the scheme, resulting in no further money flowing to or from the scheme to the sponsor. This discharges the trustee's obligations to members who will in future receive their benefits from an insurer authorised and regulated by the PRA and FCA. It also largely extinguishes the sponsor's risk and removes the scheme from the corporate balance sheet.
- **Scenario 2:** Run the scheme beyond buy-out affordability and agree a mechanism between the trustees and sponsor for the sponsor to access (some or all of) any surpluses in return for funding any deficits that emerge through time. This leads to the potential for either positive or negative cash flows, which can be projected out over time and valued, similar to any other corporate finance project.

The table below shows the modelled value associated with these cash flows under two long-term run-on options for a typical £1bn scheme fully funded on buy-out, alongside the counterfactual of using the assets of the scheme to insure and buy out immediately. In this scenario, we have assumed the scheme targets an investment return of gilts +1.25% pa.

NPVs shown for illustration as amounts to sponsor (net of any amounts to members)	Illustration 1: All surplus above buy-out is available for Sponsor	Illustration 2: Surplus is shared 50-50 between sponsor and members[3]	Illustration 3: Immediate buy-out with no additional contribution required from the sponsor
Net Present Value (NPV) of net cash flows payable to the sponsor (median)	+£163m	+£72m	Zero
Range of value in 90% of all simulations (5th-95th %ile)	+£44m to +£299m	+£1m to +£142m	Zero
% of simulations that lead to a negative net value to the sponsor over a 20-year period	2%	5%	Zero

The above table's NPV calculations assume that potential future cash flows are discounted at 7% pa to reflect the broad cost of capital for a debt-financed business. Tax impacts for the sponsor are excluded from the analysis above, and throughout this paper more generally. Details of the other assumptions used are provided in the Appendix.

Note that, while the analysis shows a positive expected net cash flow to the sponsor in more than 95% of cases, there remains the risk of more extreme negative tail risk outcomes, which the sponsor and trustee would need to be comfortable with and supportable.

The results of the above are sensitive to:

- **The period over which the DB scheme is run-on for –** there is more value associated with larger schemes running on over longer periods than smaller schemes. For a typical £1bn scheme, the value associated with running on drops off over time, with the most value within the earlier years, potentially dropping off after around 20 years (see chart in the following case study). Time periods will likely differ for schemes of different maturity profiles, with more immature schemes seeing greater value in running on for longer periods of time than more mature schemes.
- **The investment strategy employed by the DB scheme –** targeting a higher return (gilts + 1.75% instead of gilts + 1.25%, say) can significantly increase the expected value of a run-on strategy (albeit with a wider associated range of outcomes and with the potential for a more painful journey along the way). This form of higher risk/return strategy is likely to require a strong sponsor, who is more willing and able to pay contributions in "bad times" in the expectation of surplus being returned later if/when markets recover. The length of the expected run-on period, and the conditions that could cause a decision to insure to be accelerated, are important when making this judgement. This higher risk/return approach will also usually require more protections to be in place for members to provide comfort that the covenant can be expected to support these levels of risk.
- **The size of the scheme –** larger schemes have higher values associated with running on, both in £ terms and also % terms. As the scheme size reduces, there can be a tipping point where the expected "value" associated with run-on can become negative due to the fixed costs associated with running a DB scheme.
- **The decision to hedge longevity risk –** the analysis in this paper assumes that longevity risk remains unhedged and life expectancies are as expected, and so the funding position is exposed if life expectancies get longer. The range of potential outcomes could be narrowed for schemes choosing to hedge longevity risk (either through longevity swaps or buy-ins). However, the costs of hedging would need to be factored into the analysis, and so the expected surplus amounts may be lower.

Note that the starting position of a DB scheme has a big influence on the value of run-on cash flows. For schemes in deficit (as was historically the case), negative cash flows in the early years are expected (as the deficit requires funding).

For this reason, the risks/value associated with run-on should be considered with a clear mind, noting that the historical experience of less well-funded and less well-hedged schemes may not be directly comparable. Parallels for sponsors could potentially be drawn with an investment period during a corporate project, with negative early-year cash flows followed by positive later-year cash flows. This should also be seen in the context of any contributions or other protections that might need to be agreed with the trustee as part of the overall endgame package.

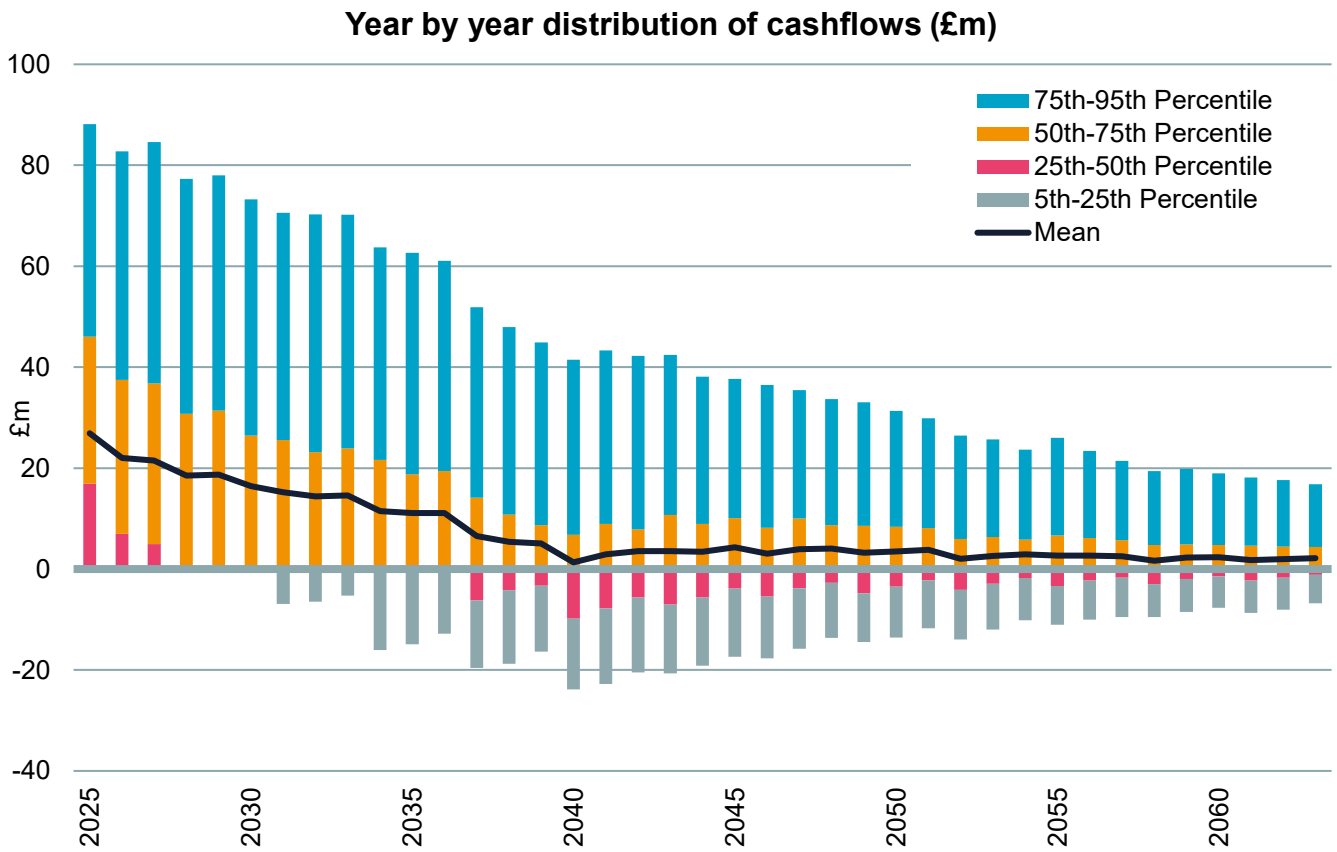
02 Calculating the value of running on a £1bn DB scheme

In this example, we look at the bookend option of all emerging surpluses being returned to the sponsor, and later, we show sensitivities to different proportions of the surplus being shared with members.

The background to this scheme is as follows:

- Total assets of £1bn and fully funded on a buy-out measure – ie it could transfer all the assets and liabilities to an insurer at no additional cost to the sponsor. This is the "exit now" route where trustees have discharged their obligations, and the scheme could be wound up and moved off the sponsor's balance sheet.
- The sponsor proposes to the trustee not to insure its scheme and that, for illustration, surplus above 100% of the buy-out liability measure is paid to the sponsor in some form.
- The sponsor remains on the hook for any future funding deficits. In this example, recovery plans aim to pay off any deficits arising using a discount rate consistent with the Pensions Regulator's 'Fast Track' approach under the new funding code. If trustees wanted funding restored more quickly and/or to a higher level, this would increase the likelihood of sponsor contributions.
- The trustees operate an investment strategy targeting an investment return of 1.25% pa above the return available on government bonds (net of fund management fees).
- The scheme fully hedges interest rates and inflation risks. Longevity risk is unhedged, so the scheme retains the downside risk that life expectancy will rise.
- Our modelling does not explicitly allow for the potential of more systemic risks, such as climate change, which is another source of uncertainty for all investors and has the potential to lead to more extreme downside outcomes.
- No allowance is made for potential changes in insurance pricing over time (other than as a result of market movements and changes in the scheme's membership profile). A hardening of future insurance terms could act to reduce the value to the sponsor if surplus can only be accessed in excess of full buy-out funding levels and/or if the scheme wishes to retain flexibility to insure at some future point.
- No allowance is made for the costs of any additional covenant protections that may be necessary for the sponsor to put in place to support the above arrangement.

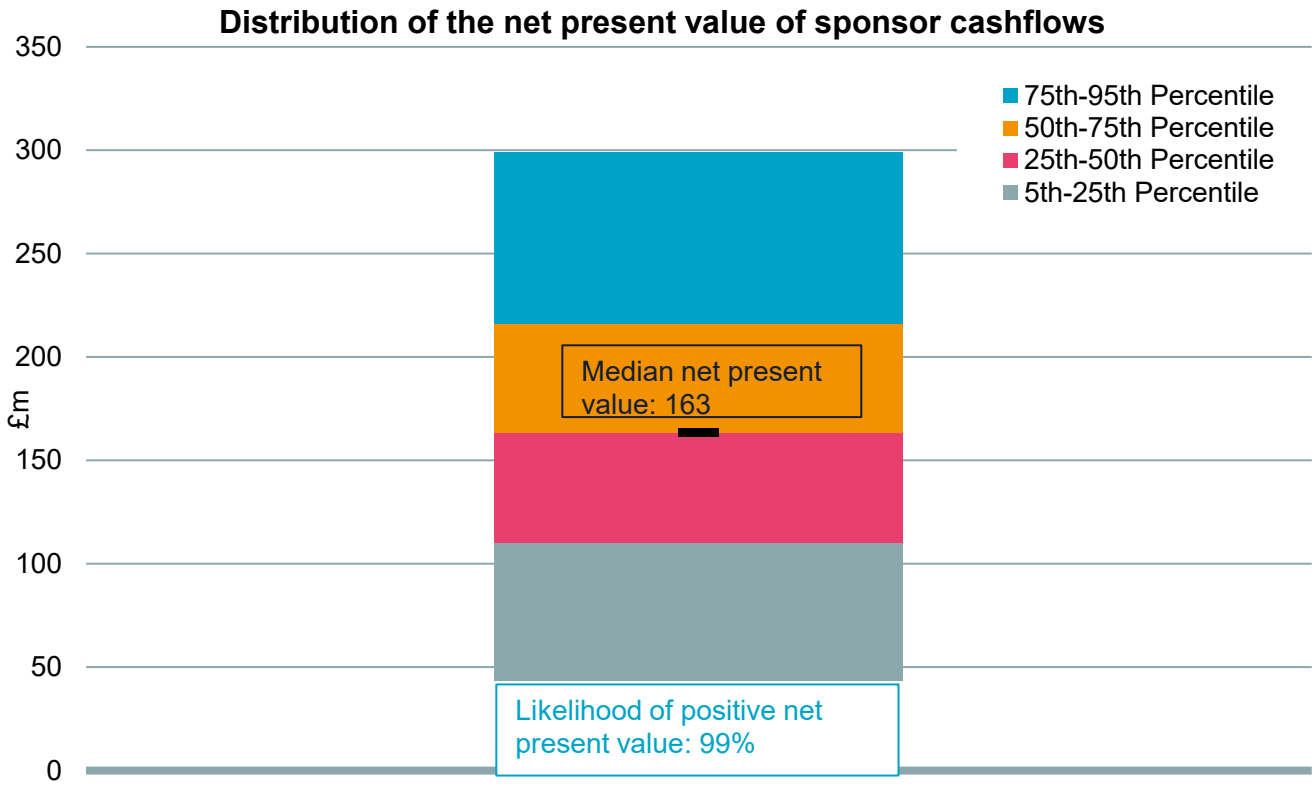
The chart below shows the expected annual cash flows to/from the scheme over its lifetime (in red). The blue bars show the modelled percentile ranges around these expected cash flows. Note that we only show 90% of all simulations, with 5% of simulations being above these bars and 5% being below - ie it ignores more extreme tail risks. In practice, the comfort of trustees and sponsors with these risks will be a key part of designing any run-on strategy.



Based on the assumptions set out above, cash flows are expected to be positive in the majority of simulations. The cash flows tail off significantly beyond 20 years as ongoing expenses start to become similar in magnitude to the expected investment returns being generated, and as buy-out pricing improvements plateau as members complete the move from deferred to pensioner status. The “biggest wins” are expected to be in the early years, when asset bases are largest, and the combinations of headwinds (on fixed running costs vs asset returns) and tailwinds (on insurance pricing improving as the scheme matures) are expected to be greatest. Beyond these early years, the potential for negative cash flows increases. The potential for negative outcomes in relation to unknown or challenging to hedge risks (such as those related to climate change, which are not covered by the analysis) or any risks that the scheme has chosen not to hedge, such as longevity risk, is also greater over longer time periods.

From a sponsor's perspective, a key question is what value to place on the cash flows, similar to assessing other corporate projects, and what reasons might lead to a different outcome. As an example, the chart below illustrates the distribution of the net present value (NPV) of cash flows to/from the sponsor for the case study example above, along with a range around it, assuming a 7% discount rate as a broad representation of the cost of capital to a sponsor.

Note that even with a positive NPV, contributions may still be required in a given year (as shown in the above chart). Sponsors may not necessarily have the opportunity to recoup any such losses through future surpluses in all cases – for example, if a deterioration in the funding position or covenant strength prompts the trustees to revise strategy and pivot to insurance.

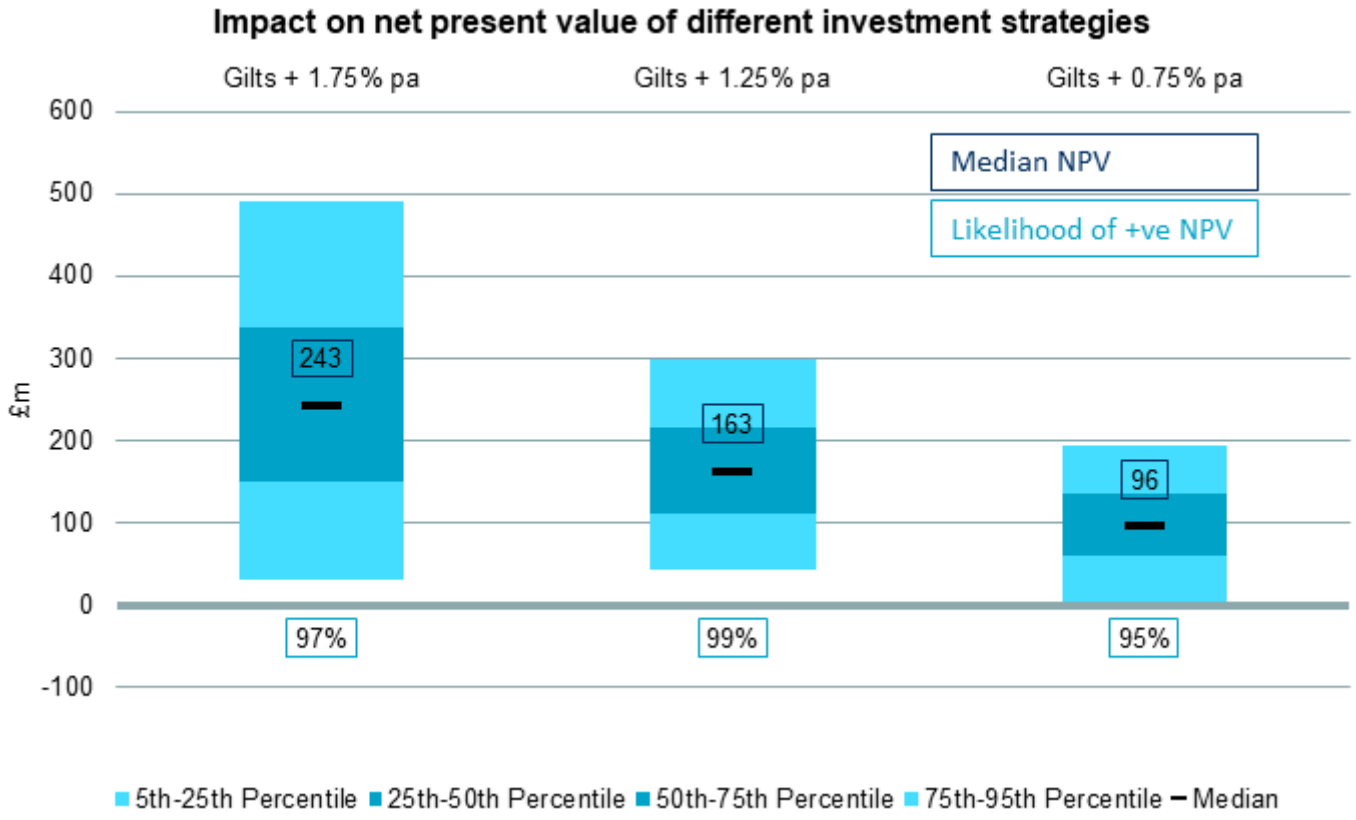


A sponsor could also use this framework to include other internal costs associated with running on the DB scheme and providing any mitigation packages to the trustee/members, as well as stress-testing the strategy's resilience against extreme risks not modelled in the analysis above.

03 Impact of investment strategy

The choice of scheme investment strategy is key to the value delivered through run-on. The charts below show the same net present value as shown above (and its range), assuming different investment return/risk profiles.

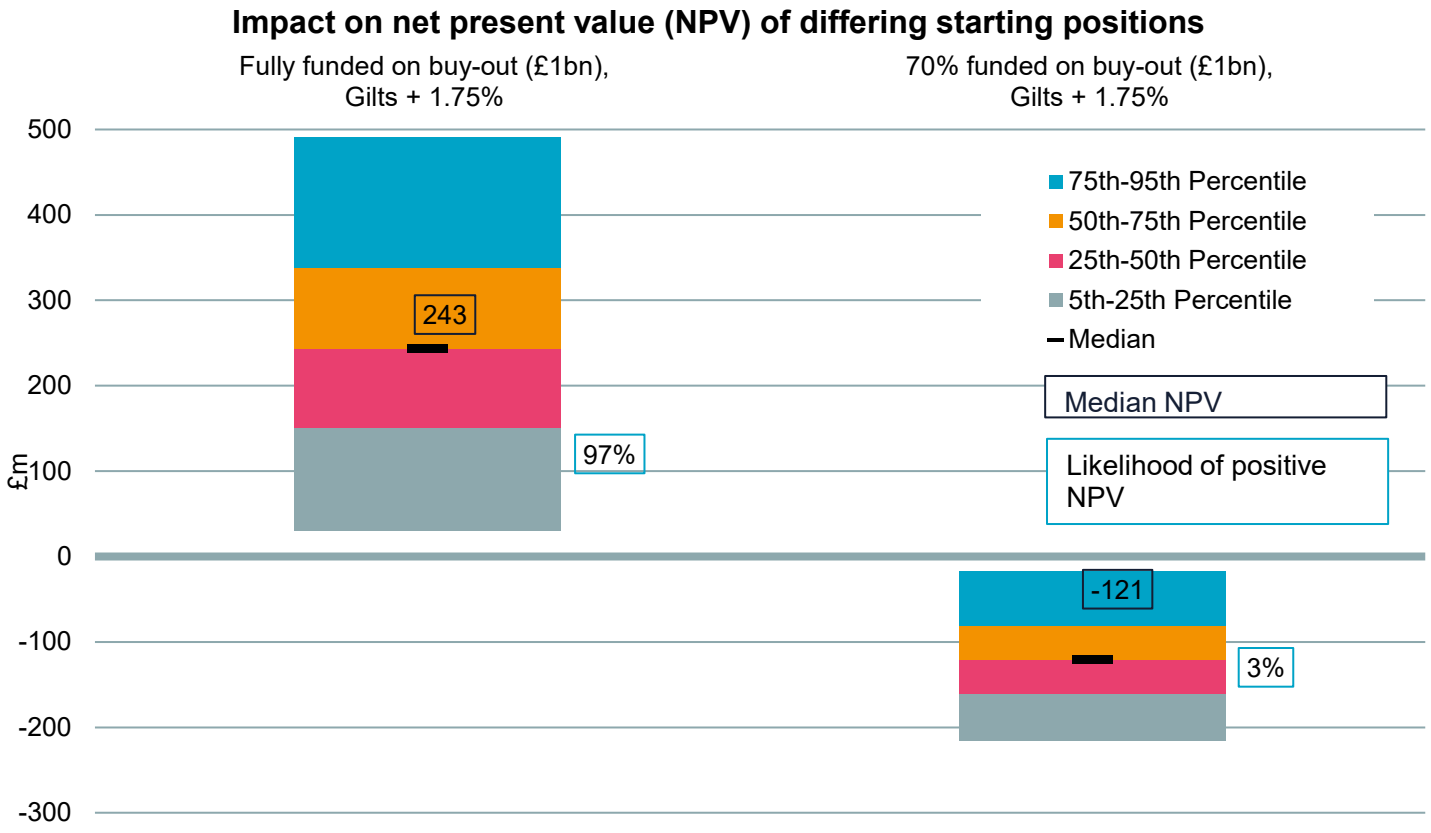
Higher-returning strategies have the potential to deliver greater value over the longer term, but also present risks associated with additional volatility (such as the potential for unexpected sponsor contributions in the shorter term). Lower-risk strategies present a narrower range of projected outcomes.

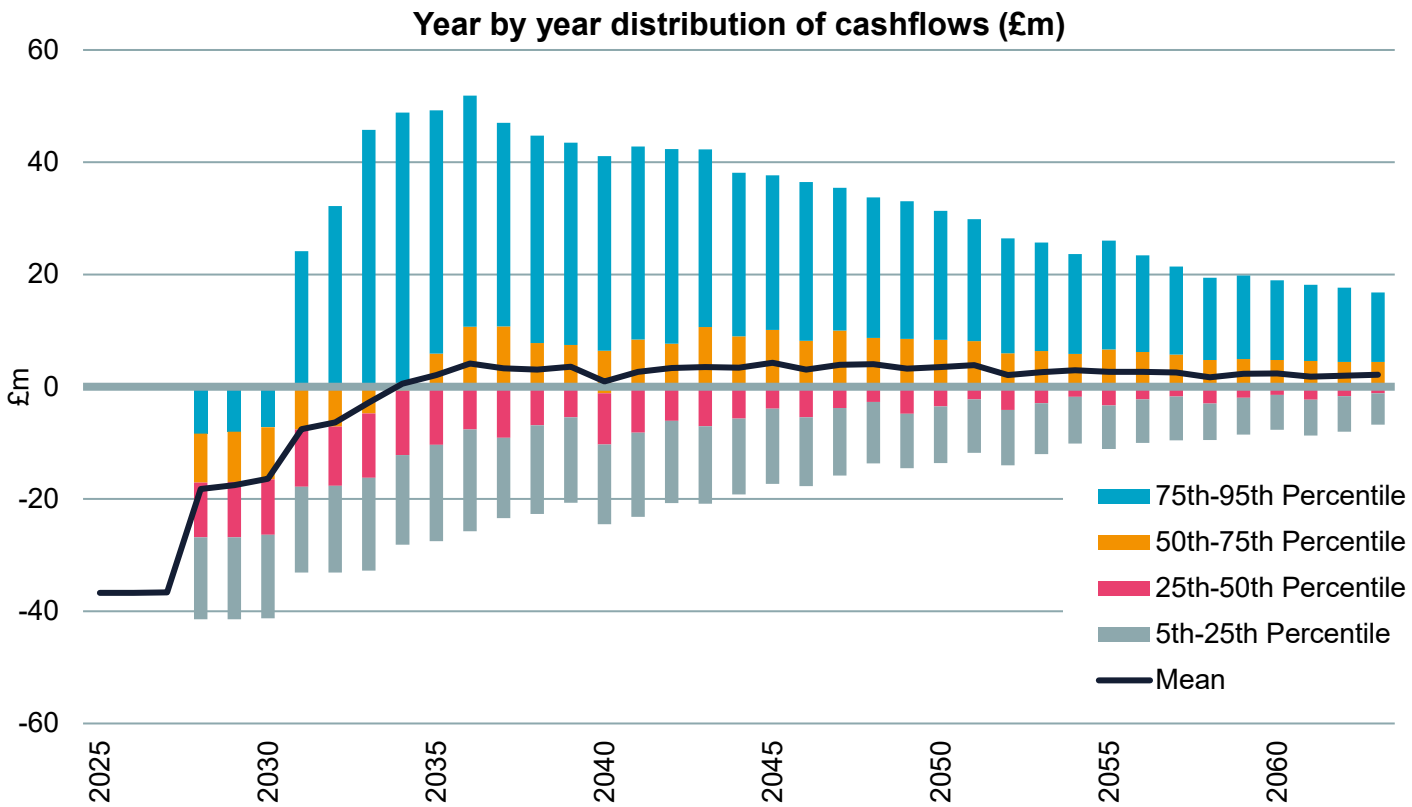


Although overall cash flows are likely to be more positive for the higher-risk strategy, the journey is more volatile due to the potential for more significant negative cash flows and an increased likelihood of a large funding deficit emerging. As a result, these higher risk/return strategies may be more appropriate for sponsors and trustees with stronger covenants and/or a greater willingness to implement a more robust risk mitigation package to complement the run-on strategy. There is also a greater likelihood that, as part of this mitigation package, trustees would want the ability to exit the strategy and secure insurance in the event of a downside scenario. This provides security for members, but it could also lock in a downside outcome for the sponsor.

04 Impact of improved funding positions and changing rules

If we applied the same scheme but assumed it was only 70% funded on a buy-out measure and 70% hedged, rather than 100%, how would that affect the value and expected cash flows? This is perhaps more typical of the historical position of a DB scheme rather than the much stronger funding levels we typically see today. The following graph shows the distribution of cash flows to/from sponsors in relation to a scheme targeting a return of gilts +1.75% pa; the higher return reflects a more realistic strategy for a scheme at 70% funded on a buy-out measure.





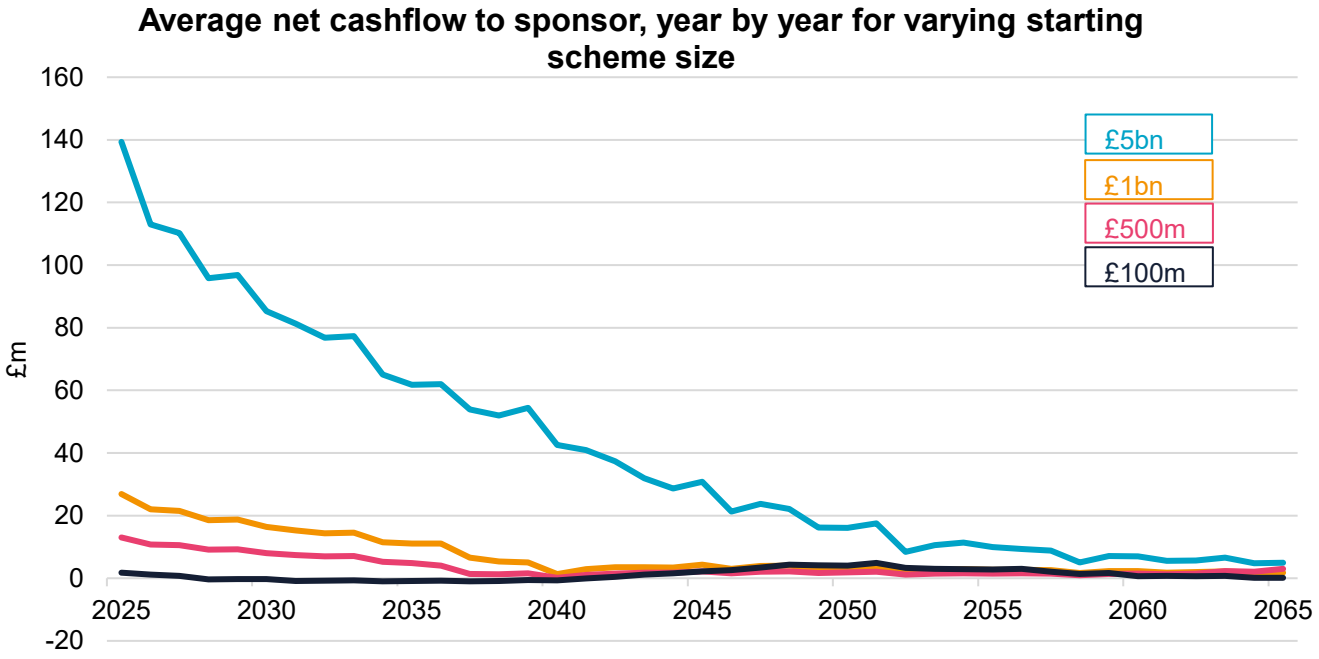
Over the past decade, typical DB schemes have moved from the right-hand side of the above chart (70% funded) towards the left-hand side. Policymakers' direction and attitudes towards DB schemes are also changing to reflect this changed economic outlook. In light of this, we think it is natural for sponsors and trustees of DB schemes to recalibrate their plans for the scheme's current funding position with an open mind.

05 Impact of scheme size

What if the scheme were smaller or larger? What if it were £500m? Or £5bn?

The chart below shows the same case example scheme as above and the cash flows associated with varying the size of the scheme, with key conclusions being:

- For a larger scheme, e.g. £5bn and above, the value associated with run-on continues for a longer time period, e.g. 40 years, vs around 25 years for a £1bn scheme.
- For smaller schemes, the value, both in £ and % terms, is less, and the value tails off quicker as ongoing scheme running costs are more prominent. The analysis suggests that a £100m scheme may generate additional value over the first few years following reaching full buy-out funding, but the potential benefits tail off fairly quickly.

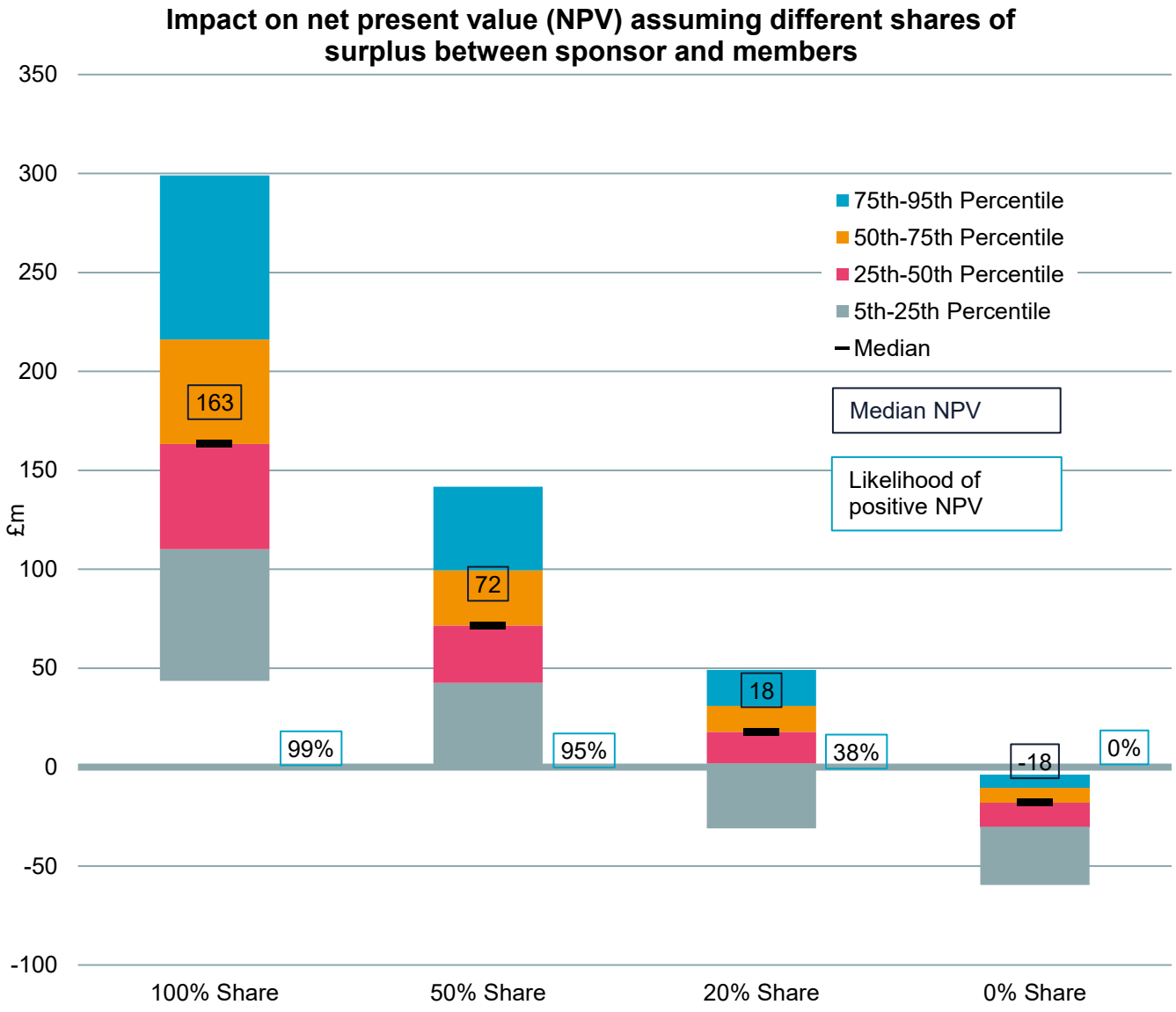


06 Impact of the level of surplus sharing between sponsor and members

The analysis shown so far assumes the surplus solely benefits the sponsor.

In practice, the most likely set-up is an attribution of surplus to both members and the sponsor, driven by scheme circumstances, scheme rules, and regulatory changes. Careful consideration will need to be given to the approaches and the form of sharing, and we note that some approaches may have P&L implications for sponsors.

For the previously shown £1bn example scheme, we have modelled scenarios whereby surplus is shared between the sponsor and members in different proportions. We still assume that all of the emerging DB surpluses are utilised. Still, only a certain proportion of it is available to the sponsor, with the rest being used for the benefit of members (for example, this could be paid as extra contributions into a suitable DC scheme, or to provide additional money purchase benefits to DB scheme members). In these scenarios, the centrally assessed present value of the DB scheme would remain positive to the sponsor even if up to 80% of potential surpluses were allocated to scheme members. The greater the allocation to members, the greater the potential for negative value to the sponsor, given that the sponsor still underwrites all downside risks. We note that tax impacts are excluded from this analysis.

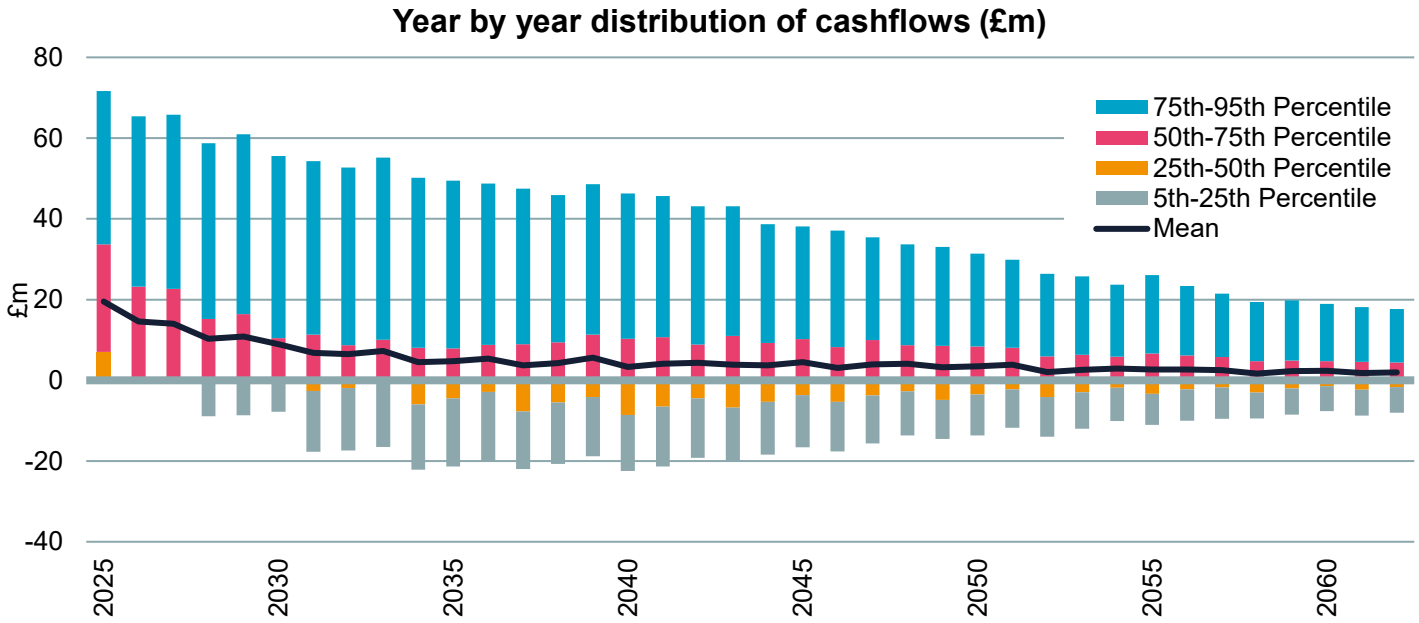


In some situations, it may be desirable/necessary to defer any cash payment to the employer (for example, paying some or all of the positive cash flows in the chart into an escrow rather than back to the sponsor, subject to certain rules, or distributing to the sponsor and members only at the point the scheme buys out and winds up). These sorts of strategies can also be modelled to calculate the impact on NPV from the sponsor's perspective and overall resilience from the trustee's perspective.

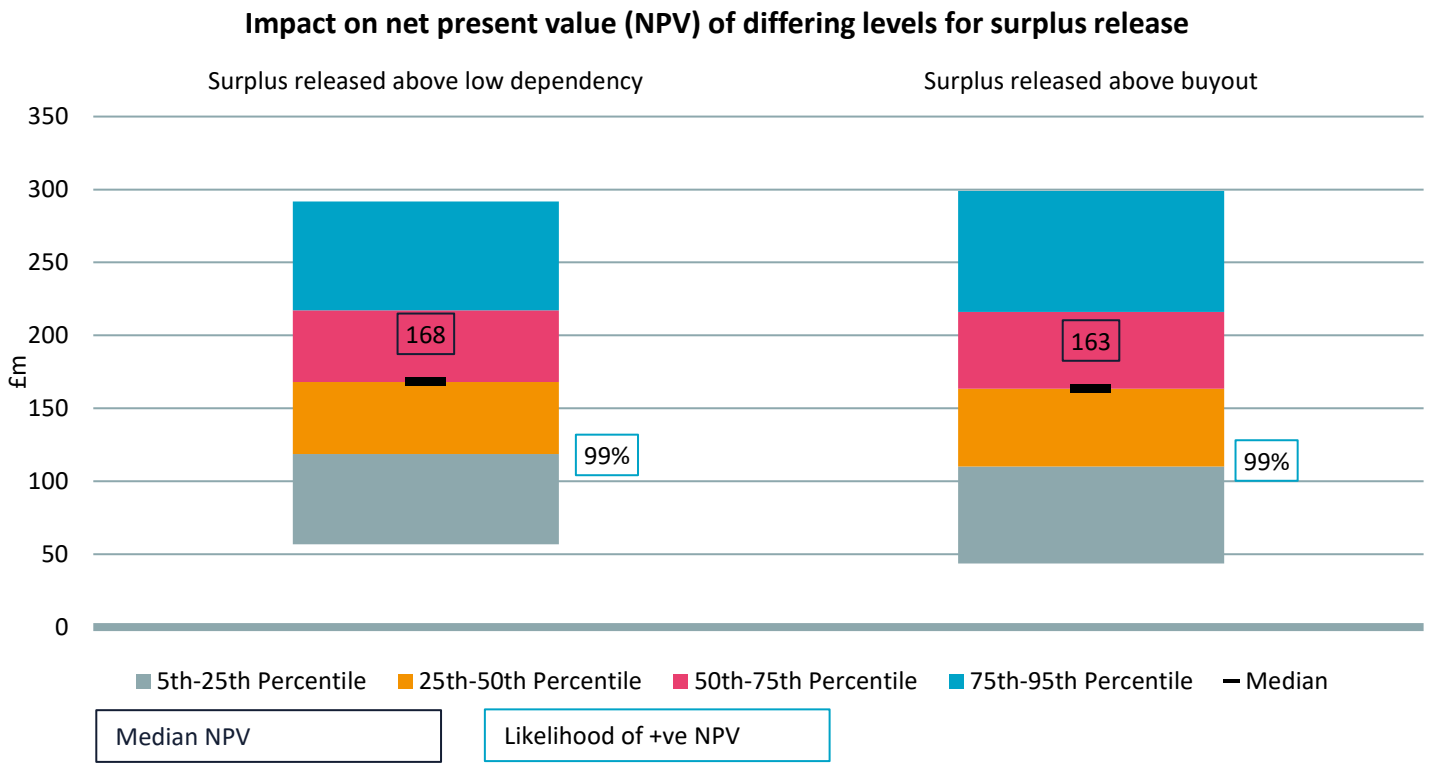
07 Impact of changing the point at which surplus is accessed

Under the draft Pensions Schemes Bill 2025, from 2027, it is expected that surpluses will become available for release above a “low dependency” funding measure (rather than above full funding on a buy-out measure).

The charts below show the same example scheme as before, but with cash flows released at a lower “gilts+0.5% pa measure”.



Note that the above chart shows the range of potential additional surplus generation over the years ahead. In this scenario, there is also an initial surplus distribution of c£65m - the starting surplus above the low-dependency funding target. Once this initial surplus is released, the expected levels of additional surplus generation are lower due to the smaller remaining assets, higher discount rate of the reference liability measure (and other smaller factors).



Some comparison observations are as follows:

- A higher upfront surplus can be released, given the example scheme is fully funded on buy-out and, therefore, already has a surplus on this measure.
- The net present value of the scheme increases, but not by much. Ultimately, releasing surpluses at a lower threshold significantly impacts the timing of surplus release but doesn't make a significant difference to the overall magnitude.
- The cash flows to/from the sponsor tend more towards a "coin flip" as the scheme matures, given that the funding requirement also tends towards "gilts+0.5% pa" under the current Fast Track funding requirements, albeit the assets are still expected to outperform prudent assumptions on average. This suggests that sponsors who do not wish for cash flow volatility may prefer to put in place a buffer before releasing surpluses (to the extent this isn't required under future TPR guidance).
- The above bullet point may be particularly important for sponsors that agree on significant sharing mechanisms with trustees, as the downsides are likely to be required to be funded in full, yet the upsides are shared, therefore potentially resulting in an expectation of negative cash flows emerging to the sponsor.

- Releasing surpluses ahead of reaching buy-out funding also presents challenges for sponsors with reduced covenant affordability or visibility, given the potential for a sponsor's insolvency to coincide with buy-out deficits. Solutions to protect against this could include any of the following:
    - The mechanism for releasing surplus is covenant-dependent;
    - Additional "escrow" reserves held outside of the scheme to cover buy-out deficits;
    - Third-party capital, letters of credit or surety bonds are being provided to underwrite these covenant risks;
    - Developments within the superfund market that allow for schemes' liabilities to be absorbed at a price below buy-out and closer to "gilts+0.5%" levels; and/or
    - Centralised additional protection is being provided by the Pension Protection Fund ("PPF") either through a "rounding up" of existing protections or acting as a contingent Public Sector Consolidator.

M&A considerations

The above analysis demonstrates that a well-funded, large DB scheme could be seen as a valuable asset, albeit not a risk-free one. This poses the question of whether an acquisitive company should place additional value (or less of a discount) on companies with large, well-funded DB schemes. A selling company may therefore wish to consider how best to demonstrate value and consider a fair price when including the DB pension asset.

International groups may also want to add this analysis when considering whether the DB scheme forms part of an M&A transaction or not, possibly retaining the DB scheme with parent guarantees.

08 Next steps for sponsors and trustees

We would encourage corporate sponsors and trustees to review the strategic aim of their DB scheme, in light of significant changes in many schemes' financial positions and with new rules from the Government on DB surplus release.

As part of this, we suggest that the following actions are taken:

- Consider modelling and valuing the cash flows associated with different options based on the scheme's circumstances. For example, this analysis could test how long the scheme is run-on for, the investment strategy adopted, the level of risk buffers required, and the surplus sharing approach agreed between sponsor and trustee. From the sponsor's perspective, the analysis could be done consistently with its own approach to valuing corporate projects.
- Consider the impact on members. This will likely go beyond simple financial analysis and consider broader factors such as the member experience, as well as the likelihood of receiving their benefits in full, under different strategies.
- Be careful about placing too much weight on historical experiences with a less well-funded or less well-hedged scheme when making decisions on endgame strategy, but remember that downside risks are still real.
- Consider the limitations of the modelling and scenario test conclusions being drawn, including consideration of tail risks, systemic risks and the impact of sponsor covenant or future insurance costs adversely changing. Also, consider how the sponsor and members would fare under different potential endgame strategies if these risks were to materialise.

Appendix – Assumptions made within our analysis

We project the assets and liabilities of the Scheme over long-term periods (up to 100 years) in annual timesteps, at which point the Scheme is expected to be targeting buy-out) for 3,000 simulations.

Assets, contributions and surplus cash flows

We have assumed investment strategies that blend LDI, rolling short-duration credit, matching credit, and return-seeking assets. These strategies vary in their composition, with higher proportions of growth assets and lower allocations to matching credit for higher-returning strategies, and lower growth allocations and more matching credit for lower-returning strategies.

Note, we have assumed that hedging up to the funding level on a buy-out basis is targeted for all strategies. We have restricted the amount of leverage the LDI portfolio has, with the level of hedging being cut pro rata if this is exceeded. We have also made the prudent assumption that assets (eg equities) are held physically rather than synthetically, meaning there may be more collateral room than this in practice.

In all runs, we assume the Scheme has a Technical Provisions measure using a discount rate consistent with TPR's 'Fast Track' approach under the new funding code, with each recovery plan period being calculated based on a five-year length. Valuations are conducted every three years in line with a standard actuarial valuation cycle.

We further assume that surplus over the value of the liabilities on a buy-out funding basis can be released. We have not considered the tax or legal implications of such an arrangement – the focus for now is on the scope of the opportunity from a pure “proof of concept” perspective

Investment assumptions underlying the model

Stochastic scenarios of economic variables and asset returns are modelled using an Economic Scenario Generator (ESG). This model has been calibrated to our standard asset class assumptions and used to produce 3,000 simulations for modelling the Scheme’s assets and liabilities.

How are our assumptions set?

Assumptions, overlaid with expert judgement, are set having regard to:

- Analysis of historical investment returns;
- Analysis of the components of future asset class returns;
- Analysis of consensus forecasts;
- Investment manager fund targets;
- Constituents of composite asset classes; and
- More detailed analysis (such as regression analysis on a group of active managers' investment returns).

Limitations of the model include:

- The use of any model of future economic and investment experience is subject to risks arising from the underlying uncertainties inherent in predicting the future.
- First and foremost, the random variation in future inflation and investment returns over a short or medium period of time may result in an experience that is significantly different to the expected long-term average experience over longer time periods. In short, circumstances that are (reasonably) assumed by a model to be very unlikely to occur may occur.
- Secondly, the conclusions of the modelling process will depend on the structure of the underlying model (particularly the relationships between different economic and investment indicators) and on the detailed parameterisation of the model. All such structures and parameters are based on historic evidence, adjusted for current expectations of future conditions.
- Our modelling is intended to give an indication of the possible range of outcomes for investment strategies. The range of modelled outcomes allows implicitly for a range of 'specific risks,' without making explicit allowance for any particular specific risks. Examples of specific risks include climate change and cyber-attacks. In our view, it is more appropriate to model the impact of particular specific risks using scenario analysis. Through scenario analysis, users can apply subjective judgment on the appropriate inputs to describe these risks in order to better understand their potential impact.
- Finally, the model does not take account of any events after 30 September 2024.

Liabilities, benefits & expenses

Liabilities have been modelled based on a projected set of pension scheme liability cash flows as at 30 September 2024. The cash flows are based on a cash flow profile for a typical pension scheme. Overall, the modified duration of the cash flows at 30 September 2024 is around 15 years.

Unless otherwise stated, we assume that the scheme starts fully funded on a buy-out basis, with starting assets and liabilities on this basis of £100m, £500m, £1bn or £5bn. We assume that the ongoing expenses of running the schemes are not capitalised and are excluded from the funding base, but we do assume that the expenses must be paid out of the assets of the schemes. We further assume that such expenses are linked to inflation. The levels of expenses assumed for each scheme vary by size: for a £5bn scheme, we assume starting expenses of £1m pa, for a £1bn scheme, £0.75m pa and for a £500m and smaller scheme, £0.5m pa.

We assume that the benefit cash flows underlying all bases are “best estimate,” ie they reflect the profile we expect to play out in the central case.

We model the buy-out basis using a discount rate of gilts -0.2% pa at the outset, progressing to gilts + 0.1% pa by 2040, allowing for retirement of the scheme’s deferred members. The discounting on this buy-out pricing is more prudent than might be applied to prudent projected cash flows because (as stated above) we are using “best estimate” cash flows. The margins against gilts are fixed in our analysis, rather than being linked to credit spreads.

We have made allowance for longevity risk in the liability cash flows – we have assumed that year-on-year longevity risk is captured by a normal random variable with a standard deviation of 3% which is uncorrelated with wider investment and market risks. This level of longevity risk applies to all schemes modelled, though we note that longevity risk would be expected to be a higher percentage for schemes smaller than c£100m as smaller membership would be expected to lead to more idiosyncratic risks.

For inflation risks, we have assumed that inflation sensitivity within the liabilities is constant as a proportion of each future cash flow (based on market conditions as at 30 September 2024).

Contact us

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At LCP, our experts help to power possibility by navigating you through complexity to make decisions that matter to your business and to our wider society. We are powered by our desire to solve important problems to shape a more positive future. We have market leading capabilities across pensions and financial services, insurance, energy, health and analytics.

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