ASSOCIATION OF CONSULTING ACTUARIES

Unlocking
DB Pension Scheme Surplus

A 2025 Series Policy Paper

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Foreword by ACA Chair, Stewart Hastie

Dear Chancellor and Pensions Minister

Unlocking DB Pension Scheme Surplus

I am writing on behalf of the **Association of Consulting Actuaries (ACA)**.

We recognise the importance of unlocking growth and productive finance in the UK to the Government's agenda and to the UK corporate employers with which we work.

The Chancellor's speech on 29 January described legislative change to permit surplus Defined Benefit (DB) pension scheme assets to be extracted where there is agreement between employers and trustees. We welcome the possibility of new surplus flexibilities and can see how this could be to the benefit of all stakeholders and the UK economy, as part of a long-term sustainable regime for DB schemes in the UK.

Members of the ACA are all qualified actuaries – mainly Fellows of the Institute and Faculty of Actuaries. Members provide advice to thousands of employers and pension schemes and trustees on the design and financial management of occupational pension arrangements. Our members advise the majority of the largest schemes in the UK with total private sector assets exceeding £1 trillion, as well as many public sector pensions arrangements. We are therefore responding in the capacity of a representative body for professional advisors who provide advice to a range of occupational pension schemes including in the statutory role of Scheme Actuary.

Our members are deeply involved in advising the pension scheme trustees who will need to make those decisions and to be satisfied that the resulting arrangements provides adequate security to their members.

To aid officials in considering the detail of the legislation needed, we propose seven key areas that any framework of legislation and supporting guidance should satisfy. Our paper is based on our extensive technical knowledge and wide practical experience in what can be a very complex area.

I would like to thank fellow consulting actuaries James Allinson, Richard Gibson, Chintan Gandhi, Steven Taylor and Debbie Webb, who all contributed to this paper.

We would be happy to discuss further and provide technical input into potential changes. Please contact me at Stewart.Hastie@isio.com

Yours sincerely

Stewart Hastie
Chair
On behalf of the Association of Consulting Actuaries Limited

February 2025

Unlocking DB Pension Scheme Surplus

We set out below the seven key challenges that any framework of legislation together with supporting guidance must address:

1. Which schemes will the DB surplus flexibility regime target?

There are nearly 5,000 private sector DB schemes in the UK however only around 300 schemes hold three-quarters (ca.£850bn) of DB assets[1].

The sector therefore has a long tail of small pension schemes who are struggling with the burden of regulation developed with larger schemes in mind.

We expect the Government's policy aims will be met by focusing on a practical solution for medium and large pension schemes and that these schemes are most likely to have the economy of scale to take up the flexibility. Unlike the DB funding regime that applies to all schemes, we suggest the surplus regime can be largely designed with medium to large schemes in mind and still support the government's aims without adding to the burden of regulation for all schemes. For the avoidance of doubt, we are not proposing that any new regime is restricted to schemes of a particular size. We envisage that smaller schemes could still make use of new flexibilities but would need to either meet the relatively higher associated governance costs of scheme run-on or consider consolidation options that help achieve greater economies of scale.

2. What level of protection is needed for the members of a scheme releasing surplus?

The assets in the DB pension scheme after releasing surplus – together with any supporting covenant and security – must provide a high degree of confidence to the trustees that members will still receive their existing benefits in full.

We expect that Government will wish to set a policy intention around their regime such as ***"Schemes participating will have a [very] low likelihood that members will not receive full benefits."*** which could form a key principle within any legislation. We also suggest that scheme protections should be scheme-specific consistent with the UK funding regime approach.

This might take the form of a test that the remaining assets cover a specified percentage of the scheme's liabilities measured on a conservative funding measure with downside risk management in place. Such an approach could be made broadly consistent with TPR's DB funding code. Alternatively, it might be preferable to specify a regime by a set of principles only, with new regulatory guidance to help trustees and sponsors. This could enable a scheme specific approach, within a clear legislative framework.

It is essential that trustees have a formal role in assessing and agreeing any rule changes, and in determining any actual refund of surplus to the employer. This has the benefit that the trustees can flexibly assess the situation taking account scheme and sponsor specific circumstances. If guidance were to set out the acceptable funding level under specific circumstances (for example, expressed as low dependency plus a margin or a percentage of insurance buy-out cover) then trustees will be able to gauge the level of margin appropriate to their scheme's circumstances taking into account

[1] PPF Purple Book 2024

additional security provided to the scheme and the status of the employer and level of investment and funding risk, without needing legislation to specify every eventuality.

We know there has been some consideration of increasing the level of compensation available from the PPF to full scheme benefits in order to give trustees greater confidence in agreeing to release surplus. There are a number of significant financial and operational considerations to achieving this that would require significantly more analysis and industry consultation - not least the impact on PPF levy costs and future PPF levy risk. We suggest question (1) above is relevant here. If it is Government's policy intention for the DB surplus regime to be adopted widely across all 5,000 DB schemes then a wider safety net for the increased pool of schemes could be provided by increased levels of PPF protection or by the backstop of a public sector consolidator. However, if the policy intent is aimed primarily at medium and large schemes that want the option to run-on, then a flexible regime built around required funding levels and a holistic package of supporting security reflecting scheme specific circumstances would be sufficient.

As highlighted above, there are a number of significant considerations to amending the PPF to provide higher or 100% protection of benefits to schemes as part of the DB surplus regime. In particular it would give rise to increased moral hazard risk, reduce appetite to secure pensions, and higher levy costs for less well-funded schemes, immature and open schemes and those schemes (particularly smaller schemes) that are less likely to benefit from increased DB surplus flexibility. Furthermore, the long-term risk of higher PPF levies in future may also deter some strong employers and well-funded schemes from running their schemes on.
There would also be significant operational implications for the PPF or potential for 'winners and losers' if the current form of PPF benefits is continued.

We suggest policy should also consider consistency of the DB surplus regime with the regime for DB superfunds including the principles for determining reserving and the terms under which profits could potentially be drawn out of commercial superfunds.

3. What protection is provided to the PPF?

Taking assets out of a pension scheme has the potential to cause risk to the PPF if there is a future insolvency event. This will be of interest to the Pensions Regulator given their statutory objective to reduce calls on the PPF and in turn could concern PPF levy payers (who are UK employers and schemes).

We suggest that this is addressed by adopting a principle along the lines that ***"the surplus regime will not cause material extra risk for the PPF and will not cause material extra cost for levy payers in aggregate"***.

It may be that the level of security reached under question (2) above is sufficiently strong that the likelihood of a material cost to the PPF is considered low by policymakers. However, if there is any uncertainty on this issue then a requirement under the regime could be to include a test to ensure that an individual scheme's funding position on a PPF Section 179 basis (which is primarily used to determine scheme levies) is sufficiently protected.

We observe that the PPF is itself a pension scheme with a sizeable surplus at present and expect that consideration is already being given to how that surplus could be applied to reduce levy payments and improve benefits and security for existing PPF members.

4. What asset strategy will schemes who release surplus be allowed to pursue?

The ability of pension schemes collectively to take on asset risk is supported by the broader covenant of UK employers giving security to the pension schemes. In the absence of a surplus regime, schemes have and are typically moving towards asset strategies that target returns lower than those that might typically be targeted by insurance companies backing similar liabilities.

In conjunction with employer covenant and security arrangements, we would expect future asset strategy to be a major component of the considerations for the trustees in agreeing to surplus release.

In particular, we would expect schemes to invest in a way that is consistent with the principle that any surplus release carries a very low probability of loss to members. For example, schemes might invest their assets to support their liabilities in a way that is comparable to the level of return and risk taken on by life insurance companies in bulk purchase annuity contracts. Trustees should be able to take a level of risk/return which takes into account the scheme's financial position and the covenant / security support in place to absorb the associated downside risks.

A surplus regime that supports large pension asset pools to adopt risk/return strategies that are more closely in line with insurance companies would lead to a systematic basis with modest additional return with limited additional risk. As large investors in UK gilts, DB schemes running on to generate and release surplus over time would also slow down the current systemic disinvestment from UK gilts that arise on pension schemes transferring to insurance. For schemes that choose to run-on because of the new surplus flexibility regime, it would also relieve some of the pressure to sell down illiquid assets (including UK infrastructure and commercial credit holdings) as part of preparing for an insurance buy-out. The accelerated asset sales by UK pension schemes are frequently at a material discount or 'haircut'.

Whilst not essential to the implementation of a new surplus flexibility regime, we suggest that incentives will still be required for pension scheme investors to materially increase their investment in longer-term infrastructure and similar productive assets in the UK. Outside of direct incentives like tax credits, this could include, for example, providing support for a liquidity mechanism so that schemes can invest with the comfort that if they need to sell their investment to facilitate an insurance buy-out (e.g. following a deterioration in sponsor covenant) they can still do this without penalty and risk to members' benefits.

5. How should trustees consider requests for surplus release?

The Chancellor's speech on 29 January envisaged sponsors and trustees must agree to release surplus. We expect that in most cases the proposal will come from the sponsors to the trustees.

In considering any such proposal, we expect trustees will continue to be driven by their fiduciary responsibilities to act in beneficiaries' best interests and to ensure guaranteed benefits are paid in full. In practice, legal advice can often focus solely on a duty to ensure that existing benefits promised to members are paid in full, with little or no weight placed on maximising the benefits payable to members or to maximising growth of the employer, even where the scheme is a legacy arrangement and is already well funded.

In order for trustees to agree, they will need a clear legislative framework and clear guidance on what is an appropriate level of residual funding and security (as outlined in question (2) above). We would then expect trustees and sponsors to consider surplus release in the context and history of their specific scheme including the extent to which surplus might be shared with members – for example if there has been a history of discretionary increases in the scheme, the level of indexation available, and the balance of historic contributions between the sponsor and members.

We observe that mandating any minimum levels of surplus 'sharing' with members in a new DB surplus regime would reduce the flexibility to take account of scheme specific factors and deter some sponsors and schemes.

6. Over what time period should surplus be released?

We submit that most trustees we work with (and indeed some sponsors) would prefer to have a sustainable surplus management agreement that permits a gradual release of surplus funds over time reducing the regret risk of large one-off payments and allowing surplus funds to be generated and released on a more predictable and stable basis.

One example is a mechanism (e.g. an agreed funding level) which would be regularly tested and an agreed amount of surplus above that level be able to be withdrawn. This could be structured as a 'surplus recovery plan' to mirror the 'deficit recovery plans' that currently exist in the DB funding regime. This would be entirely consistent with the regime that has been created for DB pension superfund consolidators and is also how trustees have to date got comfortable with varying contributions over time.

A series of payments could also help address issues of illiquid assets in the pension scheme, would create smoother and more predictable cashflows for all parties and avoid potential controversy or adversarial issues around the choice of a particularly favourable/unfavourable date for surplus decisions.

The time period over which surplus is released could also impact how a sponsor uses such funds. For example, a large one-off surplus release to the sponsor may be subject to greater investor pressure for a special dividend or share buy-back. In comparison, a more gradual release could be factored into a sponsor's investment plans.

The existing practical process for taking a payment of any surplus from a scheme can include lengthy delays given consultation needs. We would expect that new legislation could facilitate a more efficient process for payments that arise from a properly constituted surplus recovery plan described above.

7. What flexibilities or restrictions will apply to the use of surplus?

Much of the regulatory effort of the Pensions Regulator over the past decade has been on ensuring pension schemes in deficit are adequately protected from situations where value within the sponsoring employer is extracted through dividends or corporate transactions. It would be useful to understand whether Government intends to include any requirements on sponsors or trustees on how the release of surplus assets are used.

As part of their considerations, we expect trustees might be interested in the sponsor's intended use of surplus releases but only insofar as it impacts the sponsor covenant and potentially the speed and shape of any surplus releases over time. However, given the complexity of the entities in scope and the limits of their fiduciary duties, trustees will not be in a position to police the manner in which the employer has applied any surplus shared.

Some employers have already been able to use surplus assets in their DB schemes to fund better pensions for their active employees in Defined Contribution (DC) schemes. However, there is a legal lottery as to which employers have set up their pension arrangements to allow this flexibility without incurring the friction of tax on refunds and tax relief of contributions.

We believe that both employers and trustees would welcome the legal flexibility to use surplus DB pension assets to support pension contributions and obligations of the employer in a different trust, without incurring and reclaiming corporate tax relief. Avoiding the need to set up DC (and in future, Collective DC) sections in DB trusts would also be consistent with Government policy for the consolidation of DC schemes and long-term asset pools.

Policy should also address whether surplus can be used to pay an additional lump sum benefit to the DB scheme members without triggering an unauthorised payment and penal tax consequences. This additional flexibility would also make it easier for sponsors and trustees to agree surplus sharing mechanisms that suit their circumstances, without increasing long term DB liabilities (that are also underwritten by the PPF).

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