Summary
- Defined benefit (DB) funding levels could present an opportunity to boost defined contribution (DC) pensions and in turn improve the expected retirement outcomes for younger savers.
- Practical challenges remain in accessing DB surpluses, but campaigns and efforts to change this are underway, particularly given the potential benefits for the broader economy.
- Appetite and practical take-up for this option is yet to be proven, although anecdotal evidence reveals growing interest.

Sharing is caring

As DB funding levels remain strong, Sophie Smith considers how employers and trustees can unlock the benefits of current surpluses and potentially boost DC savings

It is no secret that DB pension schemes have seen significant funding improvements recently, with many industry experts suggesting that most DB schemes are in their healthiest state in a long time.

Conversations around DB surpluses, which had been consigned to the past, have re-emerged, as trustees and sponsors consider 'what next'.

And whilst the bulk purchase annuity market is expected to see record activity, conversations are rapidly broadening.

The Pensions Regulator (TPR), for instance, recently emphasised in its response to the Work and Pensions Committee's (WPC) DB inquiry that "buyout is not the only option".

There has also been increasing discussion as to how best to utilise these new DB surpluses. Surpluses that WTW head of UK retirement business, Rash Bhabra, says should be viewed as "very much an opportunity for as wide a group of beneficiaries as possible", including employers, and both DB and DC savers.

And with concerns around DC adequacy remaining high, one option highlighted by a number of recent reports is utilising DB surpluses to improve DC contributions, and share recent gains with younger savers.

A win/win

LCP partner, Jonathan Griffith, agrees that DB pension surpluses could be one option to reduce the "huge gulf" between DB and DC savings at retirement, arguing that this would also give schemes an incentive to invest for the long term.

In fact, according to Griffith, sponsors may even be able to reduce their pension spend whilst still improving contributions, presenting an attractive financial opportunity and provide a competitive advantage.

Mercer partner and UK wealth strategy leader, Tess Page, agrees that "everyone loves the idea that we could take this excess and give it to generation DC, who have never been in DB".

The cost-of-living crisis could also

make the intergenerational sharing of pensions wealth a more attractive option, as Page notes that while some employers are on the "dash for cash", others are keen to demonstrate their social credentials and support for employees.

However, Zedra Governance client director, Dan Richards, argues that whilst a shift of DB pension wealth to DC could be seen as a proxy for intergenerational gaps, given the direction of retirement provision in the past three decades, most trustees are not thinking about this in terms of an intergenerational perspective.

"Our duty is to our current members and the benefits they have accrued to date – future benefit provision is the domain of the sponsor," he stresses.

Despite this concern, Griffith clarifies that the pension benefits a DB member will not directly change as a result of using any available surplus to finance/improve DC pension benefits.

"Indeed, for members that have both DB and DC pensions, their overall pension position can be improved," he says. "Furthermore, it is possible in some circumstances that, as part of the process, the scheme may be able to use some of the surpluses to improve DB benefits leading to a win-win for all parties."

For employers with a DB and DC scheme in the same trust, the transfer of pension wealth seems particularly well suited. Yet despite the potential benefits, Page warns that, in practice, it's not always very easy structurally.

"It's very dependent on your individual scheme rules," she explains, "and even then, it might be a bit woolly in the rules. There could be talk about discretion or employer consultation."

The devil in the details

"It's totally dependent on scheme rules – in particular, whether the surplus goes to augment existing DB members' benefits, or back to the employer," agrees Gowling pensions partner, Chris Stiles, clarifying that often, but not always, trustees have some discretion over this.

"If the surplus is payable to the employer, the employer could use it to fund DC benefits for younger employees, if it chose, as an alternative to taking cash out of the scheme," he explains. "This could be attractive as taking surplus out as cash attracts a 35 per cent tax charge."

However, Stiles confirms that if the rules require surpluses to go to existing DB members, there is less room for manoeuvre, even though this would exacerbate the DB/DC divide.

Bhabra also admits that, in reality, most employers don't have their schemes in the same trust, creating an even more difficult situation. Agreeing, Page warns that, even where there is a shared employer, there could be practical issues in moving the surplus between schemes.

TPR also says that unless a DC scheme is part of the same trust, this is unlikely to be an option without the surplus first going back to the employer (with any associated tax charges) who may then distribute as they please, which could include funding DC contributions.

Campaigning for change

However, there are some changes that could make it easier for employers and trustees to get the best bang for their buck from DB surpluses.

WTW's recent whitepaper, for instance, encouraged the government to provide a straightforward legal route by which DB surpluses can finance contributions to a DC scheme used by the same employer, provided that the DB scheme remains fully funded on a cautious 'low dependency' basis.

In addition to this, Bhabra suggests the government consider revising TPR's statutory objectives to take account of members' wider interests or the adequacy of workplace pension provision.

"If we made TPR's objectives broader, the steer it provides to the pensions industry would likely make trustees feel less nervous about spending surplus in any shape or form," he argues.

LCP is also calling for change, as Griffith argues that the significant costs and administration attached to making it possible to use DB surpluses to improve outcomes for DC savers is "not efficient".

"In our view, the ability to use a DB pension surplus to pay DC contributions should be an option available to all scheme sponsors and trustees," he says. "We are campaigning, and our 'Powering Possibilities' proposal sets out our vision for how we believe we can make better use of DB pension assets to drive growth and generate value to share between DB members, DC savers, and UK plc."

However, TPR says further consideration is needed, stating: "As we understand one proposal in particular (from LCP) this approach would be limited to well-funded schemes and any surplus distributions limited to particular funding levels and 100 per cent Pension Protection Fund (PPF) protection for members. More consideration is needed on whether additional safeguards would be needed in legislation, but these changes would materially alter the nature of the risks and incentives involved."

Getting the timing right

Timing is everything, and these reports were purposefully shared ahead of the Chancellor's Mansion House speech *[see page 10]*, which unveiled a package of reforms designed to boost pensions and increase investment in UK businesses. Indeed, Page says that getting money back into the economy "obviously presents a great argument" for change.

In line with this, commentators have been quick to highlight the benefits for the UK economy, arguing that better use of DB surpluses could be a win/win/win.

In fact, Bhabra says not making better use of current DB surpluses could be a "wasted opportunity", not only in terms of the boost for DB and DC members, but also the wider economy.

"DB surpluses are currently trapped capital that could be put back in the economy," he says, arguing that enabling employers to get value from their

surpluses would give them an incentive to do something other than simply cut risk.

TPR also acknowledges the possible benefits for the UK economy, given the potential financial and societal benefits from schemes being able to invest in a wider pool of investment options. However, the regulator says there are risks involved from running a DB scheme on generally; namely that funding could deteriorate, putting pressure on the sponsor.

Running on to allow surplus distributions can also present specific risks, according to TPR, the nature of which will depend on the future framework put around any surplus distribution model.

Griffith, however, says that while sponsors still need to consider the risks of such an approach compared to a buy-in or buyout, LCP's analysis shows that significant surpluses can be extracted whilst still maintaining a low-risk, well-matched investment strategy.

A missed opportunity?

Whether this work will be relegated to the 'too difficult' box remains to be seen.

And even where sponsors are looking to make use of the surplus, it might be for their own benefit, rather than the member, as Page notes that some employers are instead looking to use these funds to subsidise their costs, which wouldn't have intergenerational benefits.

"That's just the employer having their costs reduced," she adds, arguing that while employers often say they "would love to do more for DC if it wasn't for all those pesky DB contributions", there is no evidence it would happen in reality.

Despite industry cynicism, Bhabra says the response to WTW's paper on unlocking the benefits of DB surpluses has been "overwhelmingly positive", with some discussions with clients underway.

"As schemes have got better funded, appetite has definitely increased," he says, noting that whilst it is a "small number of cases" currently, it has the potential to become mainstream.

Increased scrutiny could also force employers to be more engaged, particularly amid the cost-of-living crisis.

Although some experts are dubious as to whether members are engaged enough to scrutinise schemes' use of surpluses, concerns are already emerging.

The WPC, for example, wrote to the Water Companies' Pension Scheme, after members raised concerns that the trustees had transferred the remaining surplus to the employer "without adequate consultation or explanation".

Queries on using DB surpluses for DC savers were also raised at the first hearing in WPC's DB inquiry in June.

Scrutiny could be faced on the other side though, as Richards warns that if something goes catastrophically wrong after such a change, there will be serious questions about how and why any surplus was eroded to the point of failure. This could be a particular concern as debates around the true state of DB funding continue.

Written by Sophie Smith

One piece of a bigger puzzle

The potential use of DB surpluses to boost DC savings, whilst well-intentioned, also raises broader questions about where this drive for change should be coming from, as PLSA deputy director of policy, Joe Dabrowski, argues that, rather than using DB surpluses to boost DC contributions, more holistic reforms are needed.

"If you're thinking that your DC savers are in need of a boost, then you should really be thinking about that for the long-term, rather than just focusing on a temporary solution by boosting contributions through DB surpluses," he says.

However, Dabrowski says that recent DB funding improvements could make this easier, as many employers won't have to be as concerned about DB contributions or PPF levies, meaning they might have more flexibility in their overall employee benefits package. "For my part, I think people should look at the simpler choices, which are less about a redistribution of DB surpluses and more about how you improve DC in a ring-fenced way," he says.

Page also queries whether it is the private pension system's duty to fix intergenerational wealth concerns, arguing that if the government had a clear economic policy, inflation was managed, and auto-enrolment rules were adequate, "we wouldn't have this problem".

"It's putting the pressure on trustees to look after pensioners, who might be struggling, look after DC savers, who are not really getting enough, all while employers are snapping at their heels asking for some of their money back, since it was their contributions that have led to this surplus," she says.

However, Page clarifies that whilst more consistent UK economic policy growth would be helpful, "this is where we are", arguing that using DB surpluses to boost DC savings would be "one way to put a pound in the pocket of younger people".