Summary
- Hybrid schemes vary significantly in terms of their structure and format.
- Surpluses may be an initial positive for hybrid scheme trustees, but this structure still lacks flexibility.
- A DWP consultation is assessing how a DB surplus as part of a hybrid scheme can be accessed.
- Administrative challenges are heightened for those working on hybrid schemes, especially given how complex and unique these arrangements can be.
- The Pensions Regulator does not offer specific advice for hybrid schemes but there are many best practices those in the industry can follow.

Getting to grips with the hybrid scheme challenge

Hybrid schemes are not typical and can pose real dilemmas to the trustees working on them

Like the wider DB pension world, the hybrid pension landscape is continuing to shrink in the UK. Data published by The Pensions Regulator (TPR), in February 2024, revealed in 2022 the total number of DB and hybrid schemes had reduced by 2 per cent, from 5,378 to 5,297. Many hybrid schemes are the result of legacy decisions and a Frankenstein's Monster of various DB and DC components – however, these schemes' administrative characteristics are now receiving unprecedented attention.

Although reducing in number, the hybrid scheme landscape is vast, as Gallagher chief actuary, Sarah Brown, explains: "The definition of a hybrid scheme is very wide.

"In its purest form you have a DB scheme with a DC section and that structure is quite common and well understood. They can seem quite standard and bland, but those are the ones we'll be talking about most over the next six months or so."

In different shapes and sizes, hybrid schemes can also often be a by-product of a since-closed DB scheme rolled into a DC-format for the benefit of members.

RSM UK partner, Karen Tasker, says "historic arrangements" have meant many DB schemes have closed to future accrual, with employers wanting to offer something to employers short of a gold-plated arrangement.

She adds: "Also, with the onset of automatic enrolment (AE) some DC sections were set up as trust-based arrangements within the DB arrangement. However it is also common to have separate DC contract-based arrangements for the AE element."

More money, more problems

One key characteristic of these hybrid schemes, which has come to the fore in recent years, is the abundancy of surpluses in the sector. In regards to overall DB and hybrid funding activity, TPR recently revealed scheme funding levels had improved in between 2022 and 2023, with the total deficit more than halving from £63.6 billion to £27.7bn. Depending on the hybrid scheme, Brown says this can be "very powerful" with a DB surplus potentially able to be paid as benefits through the DC mechanism.

Using the surplus in a hybrid scheme, however, is the source of much discussion, as there are debates about who should receive this and how. The DWP is now consulting on the issue and Brown says this is highlighting the intricacies of hybrid schemes.

"Effectively we have a lot of DB schemes sitting on surpluses, they have more assets than they need to meet the required benefit payments," says Brown. "In those situations, we're having lots of discussions about whether or not the sponsor can access that surplus? And what safeguards need to be put in place to ensure the scheme remains well-funded in that situation? And if you were to refund the sponsor, what's in it for the members?"

The DWP consultation is ongoing, but Gallagher is proposing the solution of one-off lump sum payments being allowed in the eyes of the HMRC.

"We think allowing those extra payments to made in that situation would really help square the circle and allow everyone to benefit from a surplus," adds Brown. "It would also improve the long-term stability of pension scheme arrangements overall."

Complexities to encounter

Surpluses are just one area of complexity in hybrid schemes, and changes in market conditions have brought this into sharp focus. Womble Bond Dickson pension team partner, Tracy Walsh, explains how these schemes can challenge administrators, with different sections having unique requirements.

"The benefits are more complicated under a hybrid scheme, especially combination schemes, and the administrators are at much greater risk of administering the incorrect benefits, creating the risk of member claims," says Walsh. "Schemes are dealing with different cohorts of members, large projects that take a long time to complete, and a constant stream of regulatory and tax changes.

"Communication with members is also more complicated and open to being unclear or misleading, as there are so many permutations and different options available to the members with their combined benefits."

The complexity of hybrid schemes can also mean a lack of flexibility, according to Royal London director of policy, Jamie Jenkins, who points to challenges when attempting to draw benefits from the DC section.

"For example, *[employees]* may not be able to take a cash sum without triggering the income they have accrued under the DB section," explains Jenkins. "With increasing demand for people to take tax-free cash early, or draw money prior to full retirement, this can create some challenges."

A further challenge is presented for those schemes pursuing buyout and, with more schemes in surplus, this is becoming an increasingly common concern. Cartwright consultant, Rob Chandler, explains that in these situations, trustees of hybrid schemes must fully understand how their hybrid benefits work and ensure any future changes don't impact how members receive benefits.

"This can be problematic and requires close liaison with advisers and the sponsors to review all options," says Chandler. "If the trustees are close to a DB endgame, having hybrid benefits can be problematic and issues may need to be resolved before the insurer market can be approached."

"Although reducing in number, the hybrid scheme landscape is vast"

As established, not all hybrid schemes are the same and some will have varying degrees of complexity within their structure. The non-standard nature of hybrid schemes can mean their reputation precedes them, and Mercer partner and senior investment consultant, Tessa Page, questions how this impacts engagement from the financial advisers.

"If the scheme does offer financial advice at retirement, I don't think hybrid benefits are necessarily well understood by the IFA community," says Page. "That's not universal but it might be harder for members to get personalised financial advice at that point. For instance, some IFAs will prefer not to look at things like DB transfers, and therefore think this is an area of concern."

Making a hybrid scheme work

With hybrid schemes being so varied, there lacks a guide for how to manage these. Many in the industry can point to general guidance on TPR's website, but Irwin Mitchell pensions partner, Penny Cogher, says these resources are "limited".

"There is some very general guidance on its website; however, *[TPR]* state very clearly that its extensive DB and DC guidance will apply to the DB and DC aspects of the scheme respectively and should be heeded," says Cogher. "Advisers offer trustees and employers guidance tailored to the particular scheme and it would be a good investment to request a bespoke 'user guide' to help train trustees and others on how the scheme operates."

Despite the absence of detailed roadmap on how to manage a hybrid scheme, there are best practices in the industry trustees of these schemes can adopt.

Tasker says adopting clear terms of reference, to ensure trustees spend adequate time on DC matters as well as the DB section, is crucial.

"Set up a DC sub-committee to ensure there is a focus on DC risk as this is very different from DB risk, being the member bears the risk not the scheme. Ensure there is a separate risk register for the DC section," adds Tasker. "And ensure there is a separate bank account for DC transactions. Ensure cyber and fraud is high on the agenda for the trustees to enable those DC members pots to be secure and protected from ransom attacks and scammers."

Some hybrid schemes may pose administrative challenges and be more complex than their peers. For this reason, Page recommends these schemes establish a common understanding between all parties. Even a one-pager explainer could help align everyone's work and provide much-needed clarity: "I would also say to trustees don't be afraid to check what you have to do with your legal advisers – sometimes trustees feel they must know it all automatically. And be positive about the benefits, it's a really valuable thing to have a DB underpin – how many of us now have DB in any form?"

Written by Jon Yarker, a freelance journalist