Who gets the money?

As many DB schemes are now experiencing surpluses, *Pensions Age* asks the industry where they would like to see these distributed

The past 20 years of regulation has prioritised the security of benefits that have already been built up over everything else, including future accrual and discretionary benefits. This has led to a narrow focus on de-risking and ultimately fully insuring accrued benefits for some £2 trillion of assets. This position is exacerbated by the complexities of the exact wording on schemes rules as to whether or not any surplus that may exist can be returned to the sponsor.

We believe that a combination of updating trustees' and regulators' duties to include recognition of improving members' benefits and a statutory override to allow surplus to be paid on ongoing basis would be a game-changer for sponsors and help to unlock the huge value potential in UK DB pension schemes. Trustees would probably need incentives too, which we suggest would be tying any ongoing surplus distributions to the provision of benefit improvements or future benefits for current and future members – creating a win-win-win for members, trustees and sponsors.

Ideally, we would like to see the tax rate paid on any surplus distributions aligned with the prevailing rate of corporation tax. This would probably require some additional spreading or anti-avoidance protections to avoid any gaming of the system.

If schemes were to be run on, we'd expect trustees to target slightly higher returning investment strategies. While this is unlikely to meet the government's aim of increasing investment in higher risk venture capital, we would expect it to see increasing interest amongst DB schemes in longer-term, return-seeking assets, such as private debt and infrastructure.

Isio director, Iain McLellan

The sharp increase in scheme surpluses creates a real opportunity for creative thinking. Arguably, the trustees' fiduciary duties to deliver members benefits have at this point been satisfied, giving scope for wider considerations in how surplus assets should be used than simple taxable returns to sponsors.

We believe that pension funds and the assets they hold have an important role to play in supporting a sustainable future for their members and future generations. We would encourage trustees, sponsors and advisers to consider the scope to use surpluses to advance ESG aims and transition plans.

The pensions industry's tradition of innovative thinking, its trail-blazing role in climate reporting and its decentralised governance, allow us to consider ways of tweaking the system to make this work, particularly given the UK government's push for investment in UK plc.

Options could include allowing schemes to provide capital (through targeted relaxations to employer-related investments restrictions) to sponsors to make qualifying sustainable investments. This could reduce funding costs to the sponsor, whilst providing environmental and social benefits.

Another option could be for the government to designate specific "sustainable" infrastructure projects for investment of surpluses, incentivised by ongoing carbon credits or tax relief for sponsors on the return of surplus thereafter.

Cardano Advisory managing director, Michael Bushnell

There are already options for returning or redistributing DB surpluses but generally at the point of wind-up or buyout. There is clearly an incentive for making more productive use of the surplus sooner, where schemes are very well funded, but there are some obvious risks in breaking the link between distributing this excess capital and securing member benefits first. This risk could be exacerbated if at the same time there is a move to investing in higher risk/return assets within the scheme.

There are also some issues to consider in the fairness of distributing surplus,

either in the interests of an older DB population – many of whom may be ex-employees – by augmenting benefits. Or by distributing it to DC members, who are potentially younger on average, and where ex-employees are far less likely to be in scope. In practice, the DB population is likely to have benefited from higher employer contributions, and there may be a moral case for employers to consider distributing the surplus to the DC-only population, in order to bridge this gap a little.
Royal London director of policy and communications, Jamie Jenkins

Superfunds present the DWP with an opportunity. Employers should be allowed access to a scheme's surplus provided the scheme could at least secure full benefits from a superfund should that employer fail. This, together with a few additional protections around trustee consent and investment strategy being de-risked for example, would be a fair and balanced approach that could also meet the government's wider objectives regarding using DB pension scheme assets for the greater benefit of the UK economy.

Reducing the current penal tax rate payable by most employers when being refunded a surplus would also be a positive move, but DWP should think carefully before requiring this surplus to be siphoned off to pay for additional DC provision. Whilst this may make good headlines, it won't be sensible in a lot of cases. What happens if the employer already provides very good DC contributions to its employees? What if the surplus is far in excess of any reasonable pension provision for its existing staff?

Overall, we need to remember why the surplus exists in the first place. In most cases, employers paid the vast majority of the cost, took all the risk and were required to fund at what (in hindsight) turned out to be at too high a level. It therefore only seems right that they should be able to benefit from that surplus, without much restriction, provided member pensions can still be protected.
SPP DB Committee chair, Chris Ramsey

The sooner that employers can gain appropriate access to emerging surpluses with flexibility, the more economically and tax effective their strategy will be.

Options such as using scheme surplus to meet the cost of benefit accrual (whether DB or DC within the same trust or a separate arrangement) and/or the scheme's expenses can help achieve this. More sophisticated provider solutions emerging in the market can help, but they introduce complexity and cost that is not always necessary. Above a certain surplus threshold, a refund on an ongoing basis or at eventual wind up may become appropriate.

There are, of course, practical issues that need to be considered, as not all approaches will be possible for all schemes. Legal advice is essential!

Employers and trustees should agree a plan in advance for how a surplus will be used. It is far easier to work through the details of how to treat a future surplus now and implement any necessary changes, than to seek the trustees' agreement once a surplus has emerged.

In most cases a win-win solution should be possible, with some of the surplus being used to augment benefits (which the employer may want), but care is needed to ensure generational fairness across the membership.
Hymans Robertson partner and head of corporate DB endgame strategy, Leonard Bowman

Using surplus to finance pension contributions is a frictionless way for employers to benefit, especially if refunds continue to be taxed at 35 per cent. With DC arrangements routinely outsourced, there should be a straightforward legal route for transferring surplus to another scheme, provided the DB scheme remained fully funded on a low dependency basis. If the government wanted to support better DC designs, it could allow only contributions above the statutory minimum to be financed in this way.

Trustees, who would like to help repair the purchasing power that DB members lost to high inflation, would find it easier to negotiate benefit improvements with employers if tax rules did not penalise one-off lump sums.
WTW head of retirement, Great Britain, Rash Bhabra