Using Pension Scheme *Surpluses*

Michelle Galpin
michelle.galpin@bwcigroup.com

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The UK Chancellor's speech on 29 January set out several strategies aimed at generating growth in the UK economy. One of the policy areas to be developed is to *"introduce flexibilities for well-funded defined benefit schemes to release surplus funds where it is safe to do so"*. The Chancellor went on to say that this would allow the surplus funds to be invested in the *"fastest growing industries"*.

Using pension scheme surpluses for anything other than providing additional security for members' accrued benefits is likely to cause some concern for many trustee boards; it would need careful consideration. With this in mind, the Association of Consulting Actuaries "ACA" has published a policy paper "Unlocking DB Pension Scheme Surpluses" proposing seven key areas that could underpin a framework for future surplus-releasing legislation and guidance:

1. Which schemes?

The ACA notes that currently there around 5,000 DB[1] schemes in the UK. However, these vary considerably in size; the largest 300 schemes have assets of around £850bn. To put it another way, the largest 6% of schemes hold 75% of total pension scheme assets. The ACA expects that these largest schemes would be best able to support the proposed political strategy. Therefore, the surplus-releasing regime should be designed with this is mind, to avoid further regulatory requirements on smaller schemes.

2. Member protection

If a scheme is to be release surplus, the regulatory regime should ensure that there is a very low risk that the scheme members would not receive their full benefits; trustees would have an important role to play here.

[1] Defined Benefit

3. Impact on the PPF

The UK pension safety net, the Pension Protection Fund (PPF), could potentially be adversely affected by schemes which release surplus. This is because it might then increase the risk of those schemes subsequently having to be supported by the PPF. Therefore, the regulatory framework should be designed to protect the PPF from this additional risk.

4. Investment strategy

There are a number of considerations here; should schemes that have released surplus be required to adopt a very low risk investment strategy to minimise the risk of members not receiving their benefits?

On the other hand, if there is a mechanism in place to release future surplus, might some schemes with a strong employer covenant, adopt a higher risk/ expected return strategy with the prospect of some of the additional return being returned to the employer.

5. How should trustees consider requests for surplus release?

The request for the release of surplus is likely to be initiated by the employer. However, the trustees would need to agree how it could be achieved, bearing in mind their fiduciary duties to act in the members' best interests and ensure that benefits are paid in full. They would also need to consider any past practice of awarding discretionary increases and if these were to continue. The ACA highlights this as an area where a clear legislative framework and guidance will be required.

6. Period over which surplus is released

The ACA suggests that a gradual release of any surplus is likely to be preferable to a large one-off payment. A phased release of surplus would also limit trustees' "regret risk". The ACA suggests that the concept of a surplus recovery plan could be developed, which would mirror the deficit recovery plans previously used to eliminate deficits.

7. Flexibility or restrictions on use of surplus

At this stage it is unclear if the UK Government will impose any restrictions on how an employer could use any released surplus. Trustees will want to ensure how any surplus is used was not expected to adversely impact the sponsoring employer's covenant going forward.

One use of the released surplus might be to support pension contributions to the employer's defined contribution pension arrangement, without having to incur tax and then reclaim corporate tax relief.

Conclusions

The flexibility to release pension scheme surpluses to the sponsoring employer and to support the economy is to be welcomed, provided that an appropriate mechanism and safeguards can be put in place to ensure that members will receive their full benefit entitlements.