Options for Defined Benefit Schemes

Surplus & Consolidation

March 2024

Introduction

The government is continuing its conversation with the industry on options for DB schemes with focus on its overarching goal of getting more of the monies currently tied up in UK pension schemes to be invested in a long-term productive finance asset class.

Two methods for achieving this are:

1. Making it easier for employers to access scheme surplus, thereby providing an incentive to retain more investment risk (as the employer can benefit from upside experience) and keep their pension funds running on – i.e. not targeting a consolidation/risk transfer/buy-out solution.

2. Making it easier for small schemes to access end game solutions through the creation of a public sector consolidator, which would then invest a proportion of (consolidated) assets in this market.

Their latest consultation talks through these options and how they may work and invites comments from the industry on various questions and alternative approaches.

Treatment of scheme surplus

There are a number of practical barriers to refunding surplus to the sponsoring employer while a defined benefit scheme carries on. These can be caused by legislative hurdles and scheme rules. Having now reduced the associated tax charges, the government would like to ease some of these and allow trustees to consider the merits of a refund of surplus as they would any other trustee decision.

A key challenge is safeguarding member benefits and avoiding the worst case scenario for all involved where member benefits were not paid in full following a refund of a surplus. There are questions around the minimum levels of funding that should be required to permit a refund and discussion as to whether this should also be dependent on the level of investment risk and/or the strength of the employer covenant. However, the latter is discouraged, given its subjective and changeable nature.

There are plans for The Pensions Regulator (TPR) to provide trustees with additional guidance as to how they might go about considering a request for an extraction of surplus, with the comment that "we hope this will give confidence to trustees to share the benefits of strong investment returns with employers and members where this is safe to do so."

There is also consideration of an alternative safeguard that would allow schemes to secure a 100% PPF underpin in return for a higher 'super levy'. This additional security would then make surplus extraction easier. However, such an arrangement would likely be subject to strict eligibility criteria and significant costs as the government says this must be kept distinct from existing PPF funds.

Comment

We welcome changes that would remove some technical barriers and help to provide a more level playing field to potential surplus extraction. However, in a practical sense we question whether this is likely to be attractive for most schemes. The requirements for secure funding on a low risk basis, probably with quite low risk investment strategies, and the potential exposure for trustees if things were to go wrong still make this appear a relatively unattractive option for most trustees prior to any end game solution. Meanwhile the eligibility restrictions and cost implications of the PPF super levy (relative to likely investment outperformance) suggest this would have very limited appeal, not to mention the ongoing risk and uncertainty associated with it.

A public sector consolidator

The government intend to use the Pension Protection Fund staff and expertise to build a public sector consolidator by 2026 that will have the remit to provide a home to schemes unable to secure a deal in the commercial sector (perhaps because they are too small to be attractive, or have insufficient funding). It would aim to run on, rather than provide a bridge to buy-out.

The proposal is that schemes with a deficit could transfer to the consolidator, although the employer would need to continue to contribute to make good the funding position with a prescribed payment plan. Otherwise, the employer link will be cut at the point of transaction. If the scheme had a surplus relative to the consolidator's pricing then the trustees and employer would need to agree how to share that surplus with members, by securing higher benefits, or with the employer.

The consolidator would only offer a number of specified benefit structures and there would be a conversion of member benefits to the most appropriate one. This will create a decision point for trustees as this will create winners and losers.

The underwriting of this option is also considered - either by taxpayers (giving government greater influence over the scheme's investment strategy) or potentially using existing PPF reserves.

Comment

There is a challenge with the creation of a public sector consolidator which will distort the market and create a difficult decision for trustees when deciding which option is right for their members. It is unclear how existing market participants (both insurers and consolidators) will respond to this, defining the schemes which are eligible (those 'unattractive' to the market) or if/how it could impact longer term pricing.
However, more fundamentally there are questions about the potential success of such a proposal in speeding up the consolidation of defined benefit schemes. Without a dramatic increase in resources this new consolidator will struggle to take on schemes at a pace anywhere close to that suggested by the government's overall plan, even if you believe that this will be fully up and running by 2026.

We will be responding to the consultation and welcome the views of our clients, which we will consider including in our submission.

Broadstone

Find out more

For more information on how Broadstone can help you, please contact your Broadstone consultant or use the details below.

+44 (0) 20 3869 6830
+44 (0) 7976 198 044
david.brooks@broadstone.co.uk

+44 (0) 20 3869 6849
+44 (0) 7837 369 383
david.hamilton@broadstone.co.uk

Contact

020 3869 6900

corporate@broadstone.co.uk

broadstone.co.uk

@Broadstone_Ltd

in **company/thebroadstonegroup**

Bristol / Glasgow / Liverpool / London
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