

Government to make DB surplus more accessible to employers

This edition of XPS Express considers **the UK Government's recent indications to make it simpler for employers to access surplus from defined benefit (DB) pension schemes.**

At a glance

The UK Government has published its response to the Department for Work and Pensions consultation 'Options for Defined Benefit Schemes', introducing a statutory power for trustees to enable surplus extraction in the Pension Schemes Bill.

The response indicated a potential change in the threshold for extracting surplus from buyout to a low dependency basis, providing greater scope to utilise DB surplus.

Where running on for surplus is viable and in employers' interests, employers should seize the opportunity to formulate a proposal to their scheme trustees and drive decisions on how surplus can be extracted.

Additional guidance has also been issued by The Pensions Regulator around endgame options, confirming its support for run-on in the right circumstances.



Putting forward a proposal

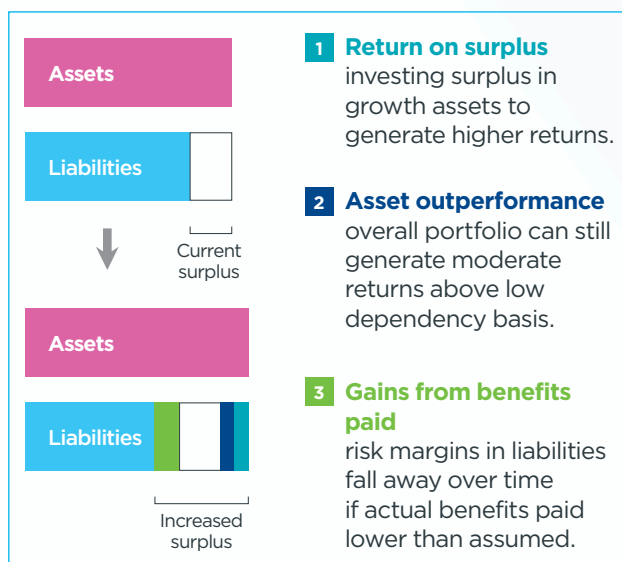
The statutory power lies with trustees, so employers will need to be proactive in presenting a compelling argument for running on:

Areas	Key risks
Balance of powers to distribute surplus and augment benefits	If employer holds the powers: may still need to convince trustees to run on (e.g. potential upside for members). If trustees hold the powers: greater need for employer to prepare arguments to trustees to distribute surplus to employer.
Nature of member benefits	Trustees may focus on augmenting benefits that have been eroded by (high) inflation.
Risk buffers	Impacts when surplus can be extracted. A greater buffer will give more protection but delay extraction (see page 2).
Protections	Employers may need to offer more covenant support to protect against downside risks (e.g. guarantees).



How can surplus be generated over time?

Significant returns could be generated through careful design of the investment strategy, sufficient governance and monitoring of scheme funding, via:



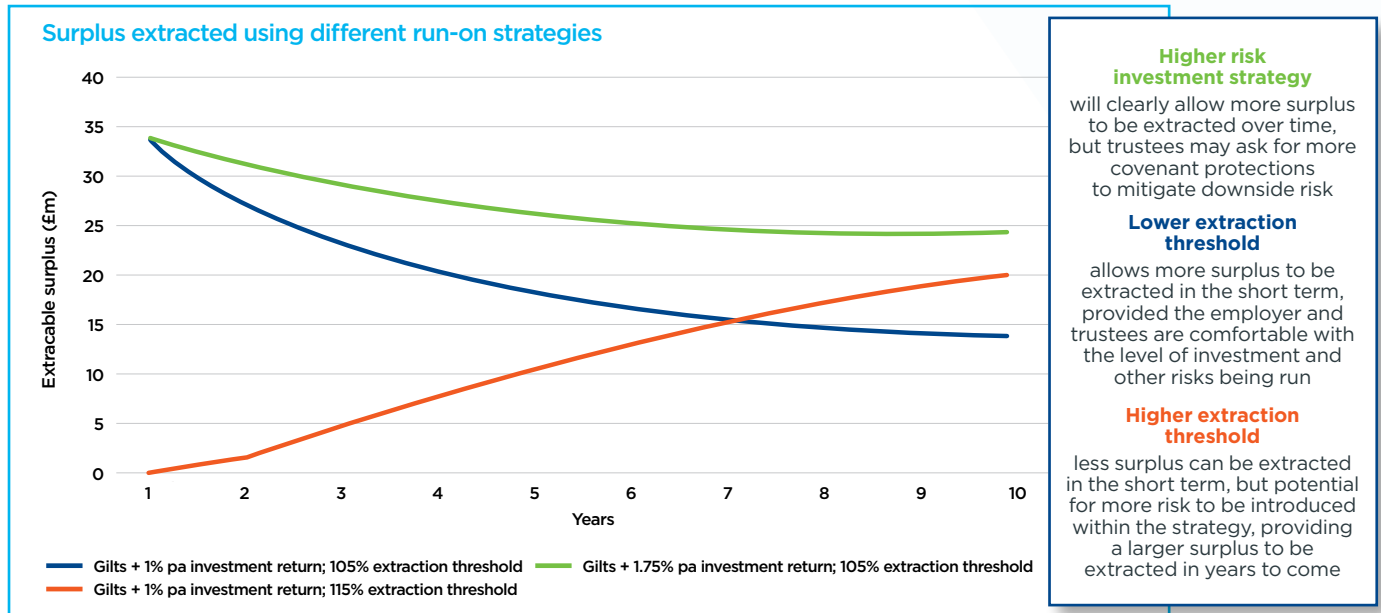
Actions employers should take

- 1. Carry out a feasibility study** to assess the balance of powers, how much surplus could be generated and options for how the surplus can be used.
- 2. Formulate a proposal** to take to scheme trustees on how to run on and begin negotiations, in the context of the balance of powers, the scheme's long-term objective and wider business objectives.
- 3. Set up a framework** with scheme trustees on the basis for running on and extracting surplus, and how surplus may be shared between the employer and members.
- 4. Consider obtaining legal, accounting and tax advice** on the impact and practicalities of surplus extraction.

How could different run-on strategies impact surplus extraction?

How much and when surplus can be extracted will depend on the employer and trustees' attitude to risk and the protections that are put in place within the run-on strategy.

XPS modelling shows that run-on can provide a variety of different extraction outcomes. The examples below are based on a scheme with assets of £1.6bn and a surplus of £150m, where half of the surplus above the stated threshold is distributed to the employer on an annual basis.



Uses of surplus

The Government will not mandate how surplus is used, so a wide range of options could be considered.

How could DB surplus be used?	What risks should be considered?
- Capital expenditure to drive business objectives without paying more cash - Discretionary benefits for members - Fund contributions for the employer's DB and/or DC schemes - Ability to provide enhanced member options - Improvement of covenant through additional cashflows	- Accounting impact (e.g. P&L charge for discretionary benefits) - Operational risks and costs around ongoing administration and advice - Reputational risk, if all stakeholders are not fully considered in surplus extraction (e.g. member complaints) - Security of members' benefits in a downside scenario (which may result in additional covenant support e.g. guarantees being requested)

Find out more

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