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XPS Express for Employers

Bringing you the latest pensions news for employers

Managing defined benefit pension scheme surpluses

At a glance

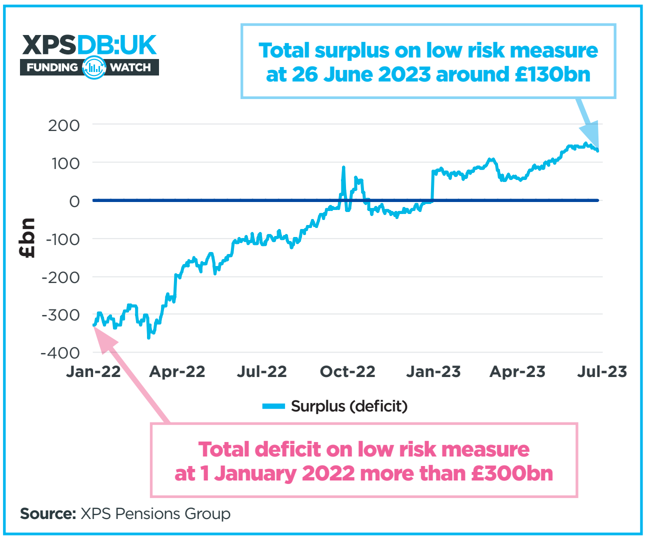
After so long addressing deficits in defined benefit (DB) pension schemes, employers are faced with a new issue to consider: managing surplus

We estimate that across all UK DB schemes there was an aggregate surplus of £130bn against their long-term funding targets at the end of June 2023

There are a range of steps available to help avoid a surplus arising. Some employers may decide, once accrued benefits are secure, to purposefully run on their schemes. This can generate 'responsible' surpluses for the benefit of both the employer and scheme members (e.g. by funding discretionary pension increases). Once a surplus has arisen there are a number of options for how this can be used

Early engagement with pension scheme trustees will be critical to ensure the employer's interests are considered

Funding levels transformed by significant increases in gilt yields



Source: XPS Pensions Group

Steps to help avoid a surplus arising

Escrow arrangement	Pay funds into an escrow arrangement/ charged bank account that the scheme can call on if needed.
Asset-backed funding structures (ABF)	Contributions paid over a much longer period and switch off once an agreed funding target is reached.
Investment strategy	De-risking assets reduces outperformance, but may lead to increased cash demands on the sponsor.
Review prudence	Review all areas of prudence to ensure these are appropriate, e.g. carry out member analytics to inform demographic assumptions.
Consider how expenses are met	Meeting expenses from the scheme can avoid a surplus arising. Review any expense reserves to ensure these are realistic.

Actions employers can take

1. **Check best possible buyout pricing**
2. **Review powers and discretions within your scheme's rules to understand which options are possible**
3. **Set up a joint working party between the sponsor and the trustees to:**
   - **understand** the objectives of key stakeholders
   - **acknowledge** the sponsor is a possible beneficiary of any surplus
   - **agree** the appropriate strategy to take
   - **agree** how to use powers and discretions each party may have

Options for using scheme surplus

Run scheme on	• Provides opportunity to generate further investment returns to support with objectives below.
Improve member benefits	• For example, surplus could be used to grant discretionary pension increases. • Likely to be easiest to agree with the trustee but may not represent good value-for-money for the sponsor.
Surplus refund	• Likely to require trustee decision at point of wind-up not to augment member benefits. • Refunds on surpluses are currently subject to a 35% tax charge.
Fund deficits in other DB schemes	• Surplus in one scheme can (in certain circumstances) be used to clear deficits in other DB schemes within the employer's group.
Fund DB accrual	• Any surplus could be used to meet the cost of ongoing future accrual. • A closed scheme could be temporarily reopened for the purposes of utilising the surplus through additional DB accrual.
New DC accrual	• The most straightforward approach is likely to be to set up a new benefit tier within existing DB benefit sections. • Some implementation work required if scheme does not already provide ongoing DC accrual.

Case study

Using trapped surplus to meet ongoing pension costs

XPS recently helped an employer make the best use of a very substantial surplus in one of its DB schemes. The surplus was used to:

- fund deficit contributions to another underfunded DB scheme within the group;
- subsidise future employer DC contributions. The surplus is expected to cover 5 years of employer contributions; and
- allow guarantees from the parent company to be released.

This was achieved with full support from the trustees of the scheme in question and without triggering a £50m+ tax charge that would have applied if the surplus had been refunded back to the employer.

I have been delighted with XPS's work. Their collaborative approach has allowed us and the Trustee to work together at pace to achieve a mutually acceptable solution. XPS are insightful, innovative, and practical in a way that goes beyond the role of a traditional consultant.

Large multinational corporate client

For further information, please get in touch with **Jim Heal** or **Peter Black** or speak to your usual XPS Pensions contact.

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