XPS Pensions Group

XPS Insights
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Government seeks to make DB surplus extraction ‘in line with trustee duties’

What you **need to know**

- The Department for Work and Pensions (DWP) has launched a further consultation, signalled in the 2023 Autumn Statement, on options for Defined Benefit (DB) pension schemes. The consultation runs until 19 April 2024 and covers surplus extraction and establishing a public sector consolidator.
- The surplus proposals seek to make running on for surplus a legitimate use of DB schemes subject to safeguards for members. A key safeguard is to provide guidance for trustees through adapting the funding code, a new surplus code or guidance from The Pensions Regulator (TPR).
- A statutory override will be provided to allow all schemes to extract surplus. The DWP is consulting on the level at which surplus can be extracted, including options below buyout but above low dependency funding.
- The DWP intends to establish a public sector consolidator by 2026, managed by the Pension Protection Fund (PPF) Board. Schemes that cannot access a commercial consolidator will be eligible to use the consolidator. It will be funded in a similar way to commercial superfunds and employers will need to pay off any deficits on entry over time.

Actions you can take

- **Review your endgame options** in light of the potential changes. Trustees can look to be prepared to respond to possible new proposals from their sponsors.
- **Consider whether running on for surplus could be of value for your members** in the context of the ongoing risks that would need to be managed.
- **Review surplus, benefit augmentation and wind-up powers** to support decision making.
- If considering consolidation or settling benefits, determine the relevance of a public sector consolidator by **reviewing the range of commercial third-party options** available.

Surplus extraction options set out in the consultation

Surplus assets in excess of liabilities on:	Proposed protection
1. A low dependency basis plus a fixed margin	Use of the margin which is viewed to maintain a level of security above regulatory funding requirements.
2. A low dependency basis plus a variable margin	Use of the margin, linked to actual investment strategy which is viewed to maintain a level of security, based on risk, above regulatory funding requirements.
3. A low dependency basis plus a margin subject to a covenant test	As above with either an additional requirement of a minimum level of sponsor covenant strength; or basing the margin on covenant strength.
4. A buyout basis (current regulatory threshold)	No specific additional protection but see note below.*

***Note:** In addition to the protections above, the Government will look to put in place additional regulatory guidance or a code of practice to support trustees considering extraction of DB surplus.

The finer detail: Key consultation points

Treatment of scheme surplus	
Government aims	The Government is looking to remove barriers to extracting surplus (such as those in scheme rules) and to bring surplus extraction in line with trustee duties. It believes this will support its aim of schemes investing for surplus using productive asset allocations.
Core propositions	The Government sets out core propositions on surplus extraction which are: a) surplus should only be extracted where safe to do so from a member benefit perspective; b) trustees would retain responsibility for managing scheme funding levels, and c) extracting surplus will not be conditional on use of funds for particular purposes.
Statutory override	Two options are being considered to allow surplus payments: either a statutory power for schemes to amend their rules to allow payments from surplus funding; or a statutory power for trustees to make payments.
Tax – surplus and benefits	Views are sought on changes that could help with making one-off payments to members from surplus, given concerns such payments may be unauthorised.
Safeguard – funding level	One safeguard proposed is a minimum funding level for any surplus extraction. Defining surplus assets relative to a low dependency target or buyout funding are being considered. Three options proposed on calculating surplus relative to low dependency are i) a fixed margin, ii) a variable margin reflecting investment risk and iii) a minimum covenant requirement or a margin linked to covenant. The Government is not in favour of iii) due to challenges in quantifying covenant.
Safeguard – trustee support	As a further safeguard for members, the Government will introduce additional guidance for trustees when considering extraction of DB surplus. Options being considered here are to add an additional module to the funding code, introduce a new code on surplus or through new guidance from The Pensions Regulator.
Alternative safeguard – PPF underpin	As an alternative to the above, the Government wants views on whether an option to pay a super levy in exchange for 100% PPF compensation for members is needed to run on for surplus. Its own assessments warn the cost of this will be high.

Model for a public sector consolidator	
Government aims	The Government intends to establish a public sector consolidator by 2026, run by the PPF, to provide an alternative endgame option for schemes unattractive to commercial consolidators. This will aim to support investing in high-growth UK assets while protecting members. A further aim will be to minimise potential distortions in the superfund and buyout market.
Eligibility	Managed by having a statutory objective to offer an option specifically for schemes unattractive to commercial consolidators. May include a requirement for trustees to demonstrate this and a size limit on the public sector consolidator.
Underwriting	Proposed to operate under superfund funding requirements. This will require underwriting by either the Government or the PPF.
Operation	Areas consulted on include pooling assets; simplifying scheme benefits; requiring any deficit on entry to be paid off over time; and a prudent investment strategy with allocation to productive assets.

For further information, please get in touch with **Tom Froggett** or **Zoe Huppert** or speak to your usual XPS Pensions contact.

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