Despite the recent interest rate volatility and market stresses, UK defined benefit (DB) pension schemes have been reported to collectively have a surplus of £295 billion. Over the summer, UK DB pension scheme "health" was said to have reached a "new high" by Legal & General Investment Management, since the immediate impact of the pandemic; as at 30 June 2022, UK DB pension schemes could now expect to pay 98.8 per cent of accrued benefits compared to 91.4 per cent in March 2020.

But what is the impact of this rise in "healthier" DB pension schemes in the UK? How should trustees look to manage these schemes that are in surplus? Is it efficient for sponsoring employers to continue to pay money into a scheme that is in surplus? These questions will be of key importance to trustees and sponsoring employers as they seek to navigate the increasingly uncertain and volatile economic climate, to implement new DB funding requirements and, particularly for sponsoring employers, to ensure that they do not end up with a trapped surplus.

**Surplus: what and why?**

A UK DB occupational pension scheme is said to be in surplus when the value of the scheme assets exceeds the value of the liabilities, on the applicable basis. Whilst any return of funds to the sponsoring employer on wind-up of the scheme will be determined on a solvency basis (see further below), the issue of a surplus should start to be considered as a scheme approaches full funding on a technical provisions basis.

The growth of UK DB schemes in surplus has been credited to increases in long-term interest rates reducing the cost of buyout policies and an unprecedented rise in bond yields, to the benefit of DB pension schemes. Whilst on the face of it, this seems like good news to both trustees and sponsoring employers alike, the future of each DB pension scheme should be considered on an individual basis for the news of a surplus to be best welcomed. For example, if there is a plan for the scheme to be transferred to an insurance company, a surplus may be helpful in accelerating this process, and indeed sponsoring employers may be encouraged to continue to build up a surplus for the same reason.

However, with the rise in schemes able to afford to buy out, there are questions over the capacity of the insurance market to meet the increasing number of DB pension schemes looking to transfer risk. Schemes will therefore need to take general market availability into consideration when formulating a plan and, where a buyout is far in the distance, those in the pensions industry have commented that continuing to pay cash into a well-funded scheme will inevitably lead to trapped surplus.

**What do we mean by "trapped"?**

A surplus can become trapped due to the fact that, on wind-up of a scheme, there will be a question around who
owns any "extra" funds following the discharge of all liabilities in respect of the members and their beneficiaries. This question will generally be addressed by the relevant scheme's governing provisions, however there are also statutory requirements in place that must be met before any surplus can be returned to the sponsoring employer, namely:

- the scheme's liabilities must be fully discharged;
- any power to augment benefits that exists must have been already exercised, or a decision must have been made not to exercise it; and
- members must be given at least three months' notice of the proposal to return the surplus to the sponsoring employer.

Additionally, from a tax perspective, a payment to the sponsoring employer must be an authorised employer payment. If the scheme rules set out that any surplus will be paid to the sponsoring employer, it is only after all of these requirements are met that they will receive the surplus funds. Those in the pensions industry have also questioned whether we will see a rise in trustees applying discretionary increases to pensions in light of the cost of living crisis. The return of any surplus to a sponsoring employer is therefore not an inevitability or a straightforward process, despite what, if anything, the scheme rules say.

This "trapped" characteristic, can also raise queries and confusion for accountants dealing with the accounting treatment of the surplus funds, and whether and how such surplus can be recorded on the balance sheet of the sponsoring employer. It can be possible to account for a surplus, even if on a technical provisions basis the scheme is still underfunded, and in all likelihood no monies will ever end up being returned to the employer on a winding-up of the scheme. However, it is in the interests of the sponsoring employer to take into consideration the wider implications of the surplus on their balance sheet, accounting rules need to be carefully considered with input often being required from legal advisers.

### Options for approaching the surplus

Sponsoring employers and trustees should therefore consider how to approach the payment of deficit contributions to the DB pension scheme going forward where it is in surplus on a technical provisions\(^1\) basis. As stated, this will depend on the long-term plan for the scheme in question.

One option would be to continue to fund the scheme to speed up the de-risking process (to lock in any gains made) and complete a buyout. There has certainly been an increase in this pathway in light of the rise of healthier DB schemes; the UK pension risk transfer market completed £12 billion worth of buy-ins and buyouts in the first half of 2022.

As mentioned, however, the insurance market will likely not be able to meet the demand of so many DB pension schemes in a position to complete a buyout. Therefore, where this is not on the near horizon for the scheme, how will sponsoring employers be able to approach reducing contributions to the scheme and will trustees be comfortable with this?

In these circumstances, it may be worth discussing the introduction of an escrow arrangement, where a sponsoring employer continues to make contributions but, instead of them going into the pension scheme immediately, they are put into a separate escrow account. There are different ways of documenting this arrangement and we can provide assistance. In particular, the trustees may well expect that the account be secured in their favour with a first-ranking priority charge over the account (and there are standard form contingent asset agreements available from the Pension Protection Fund which can be used for this purpose). This will give the trustees the security of having recourse to funds in a changing economic climate, and will provide reassurance for sponsoring employers that any
surplus funds on wind-up will not be “trapped” in the pension scheme.

Placing the surplus funds instead in an account with more straightforward release mechanics, but protecting the access to these funds by creating a charge over them in favour of the trustees, thus strikes a balance between the interests of all parties, as is the intended result under the current DB funding framework.

**Surplus and long-term DB funding**

Of key significance when considering the future position of UK DB pension schemes is the new DB funding regime on the horizon. The Department for Work and Pensions is currently consulting on draft regulations set to be introduced to implement the new long-term funding and investment requirements for UK DB occupational pension schemes. Once implemented, the regulations will operate alongside the new DB funding code of practice being prepared by the Pensions Regulator (TPR). According to the draft regulations, trustees will be required to set a funding and investment strategy, which is a strategy to ensure that benefits can be provided over the long term. Additionally, TPR’s DB funding code of practice is due to be published for a second consultation towards the end of the year. The first consultation in March 2020 set out a proposal for schemes to be required to meet specified funding targets and detailed a requirement to pay more over a shorter timeframe

The pensions industry has noted that the new funding regime will need to retain the flexibility it currently has to ensure that funding targets and contributions are tailored to the long-term objective of the scheme. If not, there will be an added risk of long-term overpayments, as scheme investment strategies provide returns well in excess of that assumed within their funding basis.

On top of the need for flexibility to prevent long-term overpayments, the recent news around surges in gilt yields highlights the requirement for trustees to be able to react swiftly to market developments. Often DB pension schemes will take advantage of arrangements under derivative contracts, which can suddenly expose them to requirements to pay in large amounts of collateral where the value of an underlying asset decreases substantially, as seen with the gilt market. It is noted that UK DB pension schemes may decide to hold more liquidity and cash in order to plan for any further rapid changes in the market. These types of decisions around strategy will soon need to be considered against the backdrop of a new funding regime, emphasising the need for it to be flexible to meet the demands of our fluctuating market.

Indeed, the future of the economy remains uncertain, with potential further rises in inflation and interest rates and concerns about the cost of living. There have already been some reports of a fall in the funding position of UK DB pension schemes. Whilst the collective surplus currently sits at £295 billion, it had reached £313.8 billion at the end of August. Trustees and sponsoring employers should ensure they continue to have contingency plans in place and not be complacent by the news of “healthier” schemes. Given the rate at which market developments are changing and impacting investments, awareness of dealing with any surplus will assist trustees, and sponsoring employers, as they approach the new funding regime.

1. This measure, used in pensions valuations by scheme trustees as part of the mandatory triennial scheme valuation, is used to determine any deficit contributions to be made by the sponsoring employer based on the deficit as at the effective date of the valuation. However, an improvement in the funding position of the scheme post-valuation can mean that deficit contributions could still be due under the schedule of contributions, even though the scheme is fully funded on a technical provisions basis.
2. For further information on the new DB funding regime, please see the piece on our website here.

**Your Key Contacts**