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The resurgence of pension scheme surpluses

By **Dan Naylor**, **Sheamal Samarasekera**, **Niall Fitzpatrick** | March 31, 2023

For most defined benefit schemes, surplus has been a theoretical issue for much of the past 20 years.

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However, with recent improvements in gilt yields, many schemes are finding that they are in a much stronger funding position and that the time horizon to their preferred endgame has shortened significantly.

Accordingly, we expect to encounter an increase in potentially difficult discussions concerning the proper application of surplus and an increase in “trapped surplus” scenarios.

The potential for controversy around the use of surplus can be seen in the press reporting of the political interest in the Bristol Water Section of the Water Companies Pension Scheme.

Here, we highlight some key considerations for sponsors and trustees when thinking about surplus issues.

Scheme rules and legislation

The starting point for any discussion between the sponsor and trustees around the use of surplus is the scheme rules. Many schemes allow any ultimate surplus to be returned to the sponsor on the winding up of the scheme. Often, this will be – subject to a requirement or a discretion on the part of the trustees to first use surplus to augment benefits – sometimes limited by reference to pre-April 6 2006 tax limits.

Amending rules to allow surplus to be returned to the sponsor at all, or without first needing to augment benefits, may appear an attractive option to sponsors worried about overfunding. However, any restrictions in a scheme’s power of amendment will need careful consideration.

Often there will be a restriction that specifically prevents amendments that facilitate a return of surplus to the sponsor. More broadly, framed restrictions prohibiting amendments that prejudice the rights or interests of members (or similar) will also need to be looked at closely.

Legislation also places restrictions on the return of surplus on winding up. These include requirements to first provide notice to members and give them a chance to make representations.

Exercising trustee discretions

Decisions about surplus can clearly give rise to tensions between trustees and sponsors and involve potentially difficult reputational issues for both. In our experience, this is particularly the case where any return of surplus is preceded by a trustee discretion to augment benefits, or where the trustee discretion only arises if the sponsor has first terminated the scheme. This can contribute to a “stand-off”, leading to a negotiated outcome.

In exercising any discretionary powers, trustee duties include exercising those powers for their proper purpose, having regard to relevant factors while ignoring irrelevant factors.

When applying these principles to the distribution of surpluses, trustees generally need to take account of the scope and purpose of the relevant power, the source and size of the surplus, the financial position of the sponsor, and the needs of the members. These are all variables that will change from scheme to scheme.

When it comes to considering the source of a surplus, even in a balance of cost scheme, it is often difficult to pinpoint what gave rise to a surplus. Lord Millet, speaking extra-judicially on cases including In the case of Thrells Ltd v Lomas, Lord Millet discouraged the idea that there was a 'mathematical' answer to who owned surplus:

"Attributing attributing a surplus to past contributions can never be more than rough and ready. It is impossible to identify the contributions which were responsible for generating the surplus".

It is clear, however, that trustees can have regard to the interests of the sponsor in making decisions on surplus. This factor might be given significant weight in circumstances where any surplus had clearly arisen due to a one-off contribution from the sponsor to facilitate an insurance transaction.

Sponsor discretions

While not very common, some rules provide a formal role for the sponsor in allocating surplus on a winding up. For example, any trustee discretion to augment benefits prior to a return of surplus may be subject to a requirement for such augmentation to be authorised by the sponsor.

Unlike trustees, sponsors will not usually be under a fiduciary duty when exercising powers in pension scheme rules. Sponsors can have regard to their own financial interests. Some sponsors will be more sensitive than others to the reputational implications of receiving a return of surplus – possibly more so in the current high-inflation environment, which members may see as justifying the use of surplus to top up pension increases.

Other sponsors will feel there is a compelling narrative that a return of surplus is fair, the sponsor having underwritten the downside risks of the scheme. Given the potential for challenge, it would be sensible to produce contemporaneous evidence setting out their decision-making process to defend any claims that the sponsor had breached any duty of good faith owed to employees.

Any return of surplus to the sponsor will be subject to a 35 per cent free-standing tax charge. Given the constraints and reputational concerns associated with return of surplus and the tax implications for the sponsor, sponsors are increasingly looking at alternative ways of using surplus.

Contribution holidays

Where the scheme has both a DB and a defined contribution section, it may be possible to use surplus to “pay” the ongoing employer contributions in connection with the DC section – or even DB for those schemes still open to DB accrual.

The scheme’s rules would need to expressly authorise such an arrangement. Many scheme rules already incorporate the possibility of using surplus in this way. Where the rules are silent, trustees and sponsors will need to be satisfied that an amendment can properly be made that allows surplus to be applied to fund contributions for future accrual.

The High Court confirmed in Barclays Bank v Holmes [2000] that an amendment could achieve this outcome in that particular case, but any such proposal would need careful consideration. Again, the terms of the amendment power and general trustee duties will be relevant, as will any provision pertaining to the “purpose” of the scheme.

A material “unknown” for proposals to run schemes on and use surplus for meeting future service contributions – or to augment benefits – is the extent to which the new funding and investment regime (and the way this is regulated by the Pensions Regulator) will allow schemes to stay in a state of perpetual low dependency rather than move towards buyout.

The use of a low-dependency surplus to fund future service benefits could be seen to be at the expense of the security of a buyout. The strength of the covenant could be a highly relevant factor as to whether trustees are comfortable with such an arrangement.

Scheme mergers

Where group entities sponsor two or more DB schemes and one has a surplus, the group may wish to merge the well-funded scheme with the less well-funded scheme. The trustees of both schemes would generally need to consent to a merger and have obvious competing interests.

The trustees of the well-funded scheme will have concerns about the dilution of its funding position and may only agree to a segregated merger, which might defeat the sponsor's aim, in the short term at least. Sponsors may have to consider providing further contingent support (eg, in the form of parent guarantees or other security) or other benefit commitments in order to achieve their objectives.

But there will be space for well-designed initiatives around surpluses that do involve scheme mergers – with perhaps the incentive to trustees being early access to surpluses for benefit improvements in circumstances in which the sponsor would not otherwise contemplate consenting to this and/or sponsor commitment to further derisking.

Other solutions

Where their scheme is not currently in surplus but there are concerns about future trapped surpluses, sponsors may seek to negotiate escrow accounts or other contingent funding arrangements. We expect to see sponsors seeking to negotiate changes to surplus rules as part of regular funding discussions under the new funding regime, where part of giving the sponsor confidence to fund to target the agreed endgame will be comfort that any ultimate surplus will be returned.

It is of course possible to agree schedules of contributions that “switch off” deficit repair contributions when the scheme becomes fully funded on an agreed funding basis. It is often a feature of these arrangements that deficit repair contributions will recommence if the funding position deteriorates.

Given the proposed changes to the funding regime, we would expect trustees to set the trigger for switching off contributions at or above the proposed low-dependency funding position. Trustees would need to keep such funding arrangements under review and should revisit them where there has been a material weakening in the sponsor covenant.

Careful consideration

Many sponsors and trustees are likely to need to grapple with surpluses in the near future as schemes mature, funding levels improve, and the regulatory regime pushes schemes towards long-term objectives.

Sponsors’ ability to get surplus back will be subject to scheme rules and legislative restrictions. Their willingness to do so will increasingly be influenced by reputational concerns and, as we apparently enter a recession, their own financial fortunes. Might a return of surplus be a shot in the arm for some struggling sponsors?

There are a number of ways in which a surplus can be utilised falling short of a return of surplus. These will need careful thought in the specific circumstances.

Assessing the financial health of a scheme inevitably requires some crystal ball gazing. The potential for volatility in a scheme’s funding position should lead both sponsors and trustees to carefully consider the implications of any proposal to utilise scheme surplus, particularly where the scheme is ongoing.

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