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Department of Work and Pensions (DWP)

Options for Defined Benefit (DB) schemes

Response from ICAS

Department for Work and Pensions

Options for Defined Benefit (DB) schemes

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Any enquiries should be addressed to Christine Scott, ICAS Head of Charities and Reporting via connect@icas.com.

General comments

ICAS welcomes the opportunity to respond to the DWP's consultation Options for DB schemes which was published on 23 February 2024.

The primary objective of any reforms arising from this consultation must remain ensuring that there are robust safeguards in place to secure promised defined benefits.

Subject to robust safeguards being in place, the options for Defined Benefit (DB) schemes considered in the consultation are an opportunity for employers to use a surplus to provide pension benefits to current employees or to enable them to reinvest in the growth of their business.

Enabling employers to access a surplus, provides an opportunity to create intergenerational fairness by avoiding a surplus created by employer contributions being used to enhance defined benefits over and above promised defined benefits.

However, we have reservations about creating a statutory override to enable the use of surpluses as this could be problematic from a trust law, property law and human rights law perspective as protecting the accrued rights of scheme members and other beneficiaries is fundamental to the fiduciary duty of trustees and the legal environment in which pension schemes operate.

Also, we envisage that any return of surplus or the use of a surplus to enhance the pension benefits of current employees will be a realistic option for DB schemes with assets of over £100 million only.

We have responded to the questions on the treatment of scheme surpluses only. Our comments on these questions are set out below.

Consultation questions

Treatment of scheme surplus (Questions 1 to 14)

Question 1
Would a statutory override encourage sharing of scheme surplus?

While this may be the case, we do not believe that a statutory override would be an appropriate or workable solution to the sharing of a scheme surplus. We say more on this topic in our responses to questions 2 and 3.

Question 2
What is the appropriate balance of powers between trustees and employers? Should a statutory override allow trustees to amend scheme rules around surplus at their sole discretion, or should such amendments be contingent on an agreement between trustees and the sponsoring employer?

In relation to the specific question on a potential statutory override, given the cash funding provided by employers to DB schemes following the closure of schemes to future accrual, we do not believe that it would be appropriate for an amendment power to be at the sole discretion of trustees. Such a power should be a joint power with the employer, requiring the agreement of both parties.

We would expect scheme trustees, in exercising any powers in relation to a scheme surplus, to engage with the sponsoring employer, and for any decisions made to be in accordance with the scheme rules.

Ultimately, the employer will be responsible for the funding of any future deficit which may arise. Therefore, the trustees in exercising their powers should have regard to the strength of the employer covenant.

Where a surplus is being distributed to the sponsoring employer, it is self-evident that the details of any arrangement will need to be agreed with the employer.

Question 3
If the government were to introduce a statutory override aimed at allowing schemes to share surplus with sponsoring employers, should it do so by introducing a statutory power to amend scheme rules or by introducing a statutory power to make payments?

We do not support the introduction of a statutory override to facilitate the sharing of a surplus with sponsoring employers through either the introduction of a statutory power to amend the scheme rules or through the introduction of a statutory power to enable the trustees to make payments to employers without the need to amend the scheme rules.

However, if a statutory override were to be introduced, we would prefer this to be by way of a power to amend the scheme rules. As mentioned in our response to question 2, any amendments should require the agreement of both the trustees and the sponsoring employer.

A statutory override could be problematic from a trust law, property law and human rights law perspective as protecting the accrued rights of scheme members and other beneficiaries is fundamental to the fiduciary duty of trustees and the legal environment in which schemes operate.

Solutions would need to be tailored to the scheme rules and to the specific circumstances of each scheme. If the trust deed and scheme rules are silent, could government policy (and then legislation) determine what happens to the surplus? This may be difficult when it comes to accrued benefits as trust law and property rights are a factor. We believe that new legislation could reasonably apply to future benefits only, and therefore could not impact on the existing scheme rules of the many schemes which are closed to future accrual.

The rules of a scheme are likely to reflect the period in which the scheme was set up. For example, a scheme set up in the post-Maxwell period would be unlikely to permit the sharing of a surplus with the sponsoring employer, but a more modern scheme would be more likely to permit this.

Where current scheme rules give trustees sole discretion to determine the use of any surplus, in particular where the employer has provided significant cash contributions to repair any deficit, we consider that it would be beneficial to issue regulatory guidance to provide a framework for such decisions. For example, requiring trustees to justify why it is reasonable to enhance benefits.

Question 4
Should the government introduce a statutory power for trustees to amend rules to enable one-off payments to be made to scheme members, or do schemes already have sufficient powers to make one-off payments?

The enhancement of benefits, to the extent permitted by the scheme rules, is already possible. For benefits to be enhanced beyond the extent permitted by the scheme rules, the agreement of the sponsoring employer would be required. This is on the basis that the employer would be responsible for making deficit contributions if at a future date the scheme had a funding deficit.

For those schemes where one off-payments would be regarded as 'unauthorised payments', allowing the scheme rules to be amended to permit discrete one-off payments to members would provide flexibility for simpler agreements between employers and trustees in relation to the use of any surplus. Our point on agreements being simpler is in contrast to their relative complexity in relation to agreements to enhance future pension benefits. We consider that any such payments to scheme members should require the agreement of both the trustees and the sponsoring employer.

Question 5
What impact, if any, would additional flexibilities around sharing of surplus have on the insurance buyout market?

We do not have any detailed comments to make in response to this question. However, to the extent that it creates uncertainty for the insurance buyout market, additional flexibilities around the sharing of surpluses, could have the potential to make buyouts more expensive.

Question 6
What changes to the tax regime would support schemes in delivering surpluses to distribute as enhanced benefits?

We have no specific suggestions to make about possible changes to the tax regime in this context.

However, we observe that providing small enhancements to members' benefits may result in an unexpected tax charge for the individual. We encourage consideration of this to be given as part of any final proposals.

This observation is given in the context that proposals for sharing surpluses with the sponsoring employer should be of benefit to scheme members. Therefore, if there is an agreement to share a surplus with the employer, it may reasonably include some element of benefit enhancement for members.

Question 7
Are there any other alternative options or issues the government should consider around the [taxation] treatment of scheme surplus?

We have no comments to make in response to this question.

However, we do support the recent reduction, through the Finance Act, in the rate of tax applicable on the distribution of scheme surpluses to align this with the main corporation tax rate. We believe this alignment should continue, as this allows surpluses to be used efficiently. For example, to provide pension benefits to current employees or to encourage 'smaller' regular payments to sponsoring

employers rather than large one-off payments. Large one-off payments to employers may be favoured in circumstances where there is a perceived likelihood that the rate of tax on the distribution of surpluses could become higher than the main rate of corporation tax at a future date.

Question 8
Under what combination of these criteria should surplus extraction be permitted? If you feel alternative criteria should apply, what are they?

We agree that there needs to be sufficient safeguards in place to protect scheme benefits. Scheme benefits are protected when those benefits have been secured. In recent decades there has been caution around scheme funding and investment as many schemes were in deficit resulting in recovery plans and cash contributions from employers. In the past, schemes have been stripped of their assets by employers, leading to tighter regulation. The regulatory approach in recent times has therefore been to secure scheme benefits and then consider what to do with the excess.

The ability of a sponsoring employer to extract a surplus from a scheme depends on the scheme rules and we believe that this should continue to be the case. A comparable scenario, illustrating the fundamental importance of scheme rules, is the move by schemes to apply the CPI (Consumer Prices Index) rather than the RPI (Retail Prices Index) to pension increases. Some schemes could not move to CPI as RPI was hardwired into the scheme rules. Also, some schemes have rules which give members the right to the scheme's surplus.

An employer should be able to extract a surplus, when there is evidence that the employer has put money into the scheme, i.e. when the employer has made deficit contributions. Determining who has the right to the surplus is trickier if a surplus has arisen solely from asset returns. Where historic deficits have been funded by the employer and this has led to the scheme being overfunded, it is reasonable for them to recover the surplus, when the security of promised benefits is robust.

We are supportive of the principle that surplus sharing can only happen when there is a buffer over a low dependency or solvency basis. The level of this buffer must be considered alongside both the prospects and strength of the employer covenant and modelling of any downside risk in relation to the scheme. The evaluation of downside risk should consider scenarios both impacting the scheme and the employer, focused on understanding what the drivers for those scenarios are and what the associated impact might be.

It may also be appropriate to consider contingent assets to provide downside protection for less likely events.

If government policy evolves to facilitate the extraction of a scheme surplus by the sponsoring employer, we have the following additional observations:

- A regulatory regime which may encourage surpluses to be built up can also lead to schemes being overfunded which may not be an efficient use of capital.

- TPR (The Pensions Regulator) is likely to be concerned about the security of DB schemes. Therefore, the due diligence required would be high so only the largest schemes are likely to be in a position to return a surplus and there would need to be a funding buffer. We envisage that adviser fees incurred to give trustees the level of comfort they would need would be significant.

- The extraction of a surplus means re-risking and therefore moves a scheme a step away from reaching buyout. A policy of enabling employers to use scheme surpluses, including the surpluses of closed schemes, is extending the life of schemes. For schemes with less than £100 million of assets we do not believe that running on for the long-term is a viable option. However, schemes larger than this may be able to do so. A future funding regime which was less prudent would need the employer to underwrite the risk, so covenant is 'king'.

- If a surplus is to be recoverable prior to wind up, we believe that the surplus should be used to reinvest in the business of the employer or to support an employer's pensions offering to current employees. As mentioned in our response to question 6, the tax consequences for individuals should be considered as part of the design of a future arrangement to use DB surpluses to

enhance member benefits. We do not support surpluses being used to enhance promised DB benefits.

- It may be possible to re-open a DC section of the pension scheme as a means of enhancing an employer's DC offering, and then bringing in employees with DC pensions under the same trust. However, this approach could risk re-opening DC sections which are poorly governed. There are normally good reasons for DC sections being closed and, if the funds are small, poor governance is a risk.

Question 9
What form of guidance for trustees around surplus extraction would be most appropriate and provide the greatest confidence?

It would be appropriate for TPR (The Pensions Regulator) to provide guidance for trustees, perhaps in the form of a separate code of practice on surplus extraction, including examples and case studies, or as part of the DB funding code of practice. However, given the length of time an updated DB funding code of practice has been in the pipeline, it may be more practical for a separate code to be developed.

In addition, it will also be essential for TPR to update its guidance for trustees on *Assessing and monitoring employer covenant*, which we understand is in progress.

Question 10
What might remain to prevent trustees from sharing surplus?

The risk appetite of scheme trustees and their advisers is likely to be a significant factor in whether a decision is made to share a scheme surplus.

Question 11
Would the introduction of a 100% underpin have a material impact on trustees' and sponsors' willingness to extract surplus? If so, why and to what extent?

We have no detailed comments to make in response to this question. However, we observe that the level of Levy indicated is likely to make this unappealing to many employers.

Question 12
Are there other benefits to a 100% underpin that the government should consider?

We have no comments to make in response to this question.

Question 13
If you consider a 100% underpin could deliver valuable benefits, what does the government need to prioritise to ensure an effective design? For example, does the way the "super levy" is calculated need to ensure that the "super levy" is expected to be below a certain level? How high a level of confidence does there need to be that the PPF (Pension Protection Fund) will be able to pay a 100% level of benefits?

We have no comments to make in response to this question.

Question 14
Are there other methods outside of the PPF that could provide additional security to schemes choosing to run on?

We have no comments to make in response to this question.

Model for public sector consolidator (Question 15 to 40)

We have not responded to the questions on the development of a public sector consolidator.

Potential take up and impacts (Questions 41 to 49)

These questions are directed at individual DB schemes and have therefore not been addressed in our response.

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