XPS Pensions Group

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How DB pension schemes can support UK growth and protect members

A joint analysis from XPS Pensions Group, Premier Miton Investors and Burges Salmon

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Foreword

As independent, UK-centred firms active in servicing the UK's long-term savings sector, and in response to the positive challenge set out in the Chancellor's Mansion House speech, we have worked together to consider whether changes in approach within the defined benefit (DB) pensions market are desirable and feasible. We have carefully considered whether different approaches can safely deliver additional value for both members and employees, and deliver investment in UK businesses to the benefit of our country's equity investment potential without adding risk to DB benefits.

We strongly believe that beneficial change is achievable and set out our proposal in this paper. Our proposal is, we believe, straightforward, realistic, legally supported and actionable, with minimal changes to the risk profile of the DB market. Furthermore, the additional DB benefits, Improvements in retirement savings and potential investment back into UK businesses is financially significant and should last for many years.

This proposal must be considered alongside other useful changes being proposed to the pensions market, in both the DB and the defined contribution (DC) areas, as well as those to the broader long-term savings sector and the UK's markets for both private and public equity capital investment.

Bluntly, UK firms must prosper if we want to grow the UK economy and create the wealth that our society needs and depends on. We must therefore ensure that we support UK long term risk capital formation and investment in UK businesses at all stages of scale and growth. Increasing reliance on international capital for our investment needs puts our economy and society at risk and removes the significant benefits to us of ownership. Equally, having UK long-term savings deployed primarily in international markets or in non-risk bearing assets means our UK businesses lose out with damaging long-term effects for our wealth and health as a nation. This goes hand in hand with the need to help improve retirement savings for younger employees to increase the chances that people retiring many years into the future will be able to support a good standard of living.

This approach will not be right for every pension scheme and we expect that a large number will rightly continue to seek to settle and secure benefits with an insurer. Our proposal does, importantly, create an opportunity for those schemes where it may be appropriate and facilitates the ability to generate material value for DB members, DC employees and employers. Doing so would then create the scope for this to benefit growth areas of the UK economy.

This paper is for discussion, and we are available to debate the underlying work and important issues that it raises.

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Key findings

With appropriate protections and regulatory guidance, it is feasible for meaningful numbers of DB schemes to run on instead of insuring pension benefits. These schemes represent over two-thirds of UK private sector DB scheme assets.

The approach will not be appropriate for all schemes and we expect many to still seek to secure benefits with insurers. However, for those for which it is right, running on can materially improve outcomes for DB members and DC employees and direct investment into the UK economy.

£100bn in surplus can be safely generated by 2034, and £150bn by 2039, by running on.

£4.5bn surplus can be generated each year from 2024, ramping up to £10bn a year by 2030.

This surplus could be used to improve benefits for DB members, increase employees' DC savings and invest in employers' UK operations.

The approach requires changes to surplus rules to give employers and trustees the right to access, and agree how to use, surplus above buyout on a tax-free basis, guided by a new code of practice.

The approach provides a credible way to mitigate the impact of inflation on DB members, improve inter-generational inequalities in pension savings and help support Government policy to drive investment in UK business.

No change in cover provided by the Pension Protection Fund is required, avoiding potentially introducing new systematic or moral hazard risks.

Since the Chancellor's 10 July Mansion House speech there has been much debate on how to get pension funds investing more in UK growth. When it comes to private sector DB schemes this has been met with justified scepticism. There are several reasons for this:

- Private sector DB schemes are in a much-improved place after many years of managing risk and high levels of deficit contributions. In aggregate, schemes now have enough assets to secure 95% of benefits with insurers, compared to only having half of what was needed in 2008. This hard-won security is in sharp contrast to twenty years ago when, in the event of a corporate failure, many people lost their jobs and their pension, notably in the case of Allied Steel and Wire.

- The Chancellor's plans require investors who can invest and hold risky assets for the long term, tolerating illiquidity and volatility in market values. This is not the case for most private sector DB schemes today. After a long period of DB pension deficits impacting company cash flow, employers are seeing deficit payments stabilise and reduce, allowing better visibility on investing in their business. It is unlikely, given the one way bet for employers, that they would bear a return to volatile deficits and unexpected cash calls.
- Given their responsibilities and the hard-won protections for members, it is hard to see how trustees would be willing to re-risk pension investments and how their advisers would tell them it is acceptable to do so.

But DB schemes do not need to switch to higher risk assets to contribute to UK growth and help improve pension savings. DB schemes could run on, invest safely, and build up surplus reserves – much like an insurer who takes on a scheme following buyout and safely generates returns for its shareholders. In this paper we have set out a case study of a £500m pension scheme where this approach can lead to an additional 2% pension increase for DB members, triples DC employees' retirement income and increases employer CapEx spend by 30%.

If this was extrapolated across a subset of the universe of DB schemes that could run on, the potential to improve outcomes is substantial. Assuming a target investment return of 1% above risk-free rates, surplus of £4.5bn a year in 2024, increasing to £10bn a year by 2030, can be generated. Along with existing DB surplus for schemes that are already fully funded above an insurance buyout measure, this generates a total surplus of £100bn by 2034.

With a conditional change to surplus rules, namely removing the free-standing 35% tax charge on surplus payments and providing a statutory override to pension rules to give employers and trustees the right to access and agree how to distribute surplus, these DB surplus reserves could be used to improve DB benefits, DC pension savings for employees and invest in employers' UK operations.

The headline benefit of the above approach is it presents a way for DB schemes to contribute to UK growth and help improve the level of pension savings for those in DC pension, without asking DB schemes to invest in higher risk assets or move away from their appropriate investment strategies.

A key challenge will be how to ensure that any surplus distributed in this way ends up invested in UK companies and UK equity, either through DC savings or in employers' UK businesses.

Changes to surplus rules and a clear regulatory code on how to manage schemes in surplus can materially improve DB member benefits, DC savings levels and investment in UK employers.

The challenges in asking DB private sector schemes to directly invest in UK growth

On 10 July in his Mansion House speech the Chancellor made it clear that a key policy aim of the Government is to identify ways to encourage or incentivise greater investment of UK pension assets in growing UK businesses. This can take many forms, but a clear target is investment in UK private equity and venture capital. Reflecting this, the Mansion House Compact among large UK DC master trusts was a pledge to directly invest 5% of pension assets in private equity by 2030.

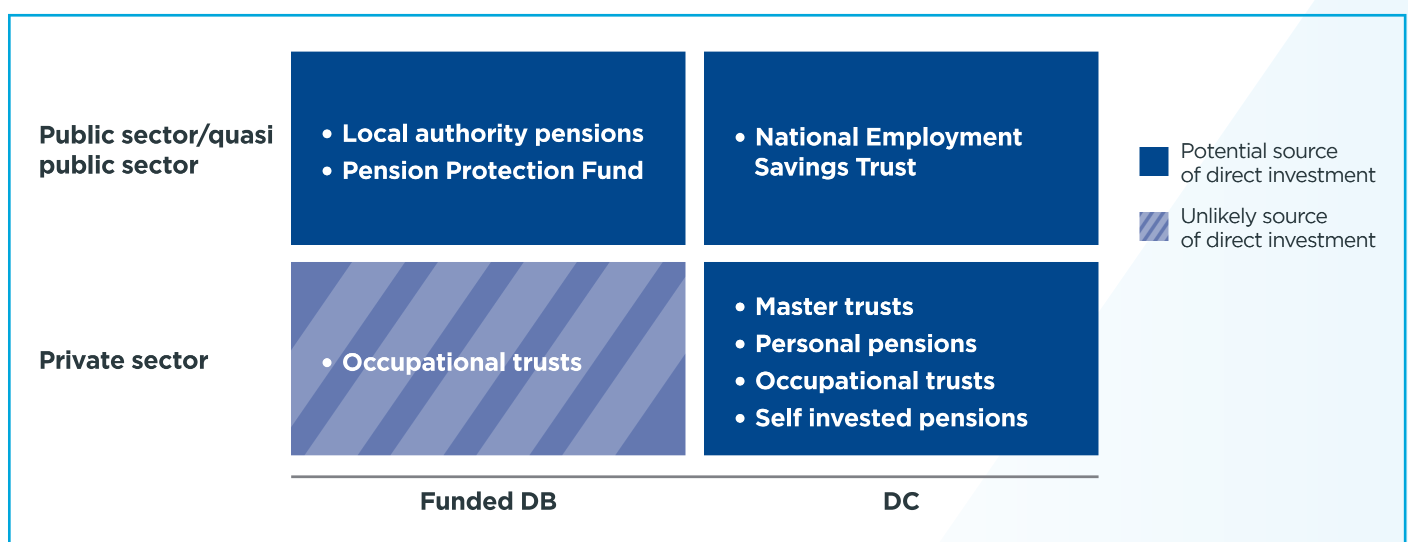
The structure of UK pension provision is, however, widely varied. This ranges from extremely large unfunded state arrangements (such as the NHS Pension Scheme) through to small private self-invested pension pots. It does not follow that investing in long-term, illiquid, riskier assets is right for all. Looking at public versus private and defined benefit versus defined contribution pensions, the type of arrangements that are most suitable to invest in long-term growth are those that:

- can **tolerate illiquidity in assets** and still comfortably meet pension payments;
- can **allocate a material portion of their assets** to higher risk investments that they can hold for over ten years; and
- are of **substantive scale** to make any such investment meaningful.

This would suggest that large, open defined benefit schemes such as the local authority pension funds and large scale defined contribution funds including NEST and the large master trusts are realistic places to look for sources of direct investment in UK growth companies.

The case is less clear for private sector DB pensions that are largely closed with a focus on protecting promised benefits and managing the cost impact on employers.

Types of pension funds that could support more direct investment in UK private equity and venture capital:



DB private sector occupational trusts do not readily fall into the profile of investors that are suitable for the Government's plans. Given trustee duties and exposure for members and employers alike, there is little appetite in the industry to re-risk. But carrying on as they are DB schemes will generate excess funds and these can be a powerful source of improving savings and increasing investment in UK growth, so while an unlikely source of direct investment they can make an indirect contribution.

An innovative approach for private sector DB schemes to contribute to UK growth

The UK pension system has changed drastically since the turn of the century. UK private sector occupational DB schemes have arguably never been in a better position. In aggregate at the end of June 2023, these schemes had enough assets to meet 95% of the cost of insuring all benefits. This compares to scheme assets only covering 50% of the cost in 2008. Funding volatility has been materially reduced by being able to invest in better matching assets and employers are less likely to see material calls for cash funding that impact on business investment opportunities.

Some DB schemes do fail, but ultimately only because their sponsor becomes insolvent. In July 2002, around 1,000 Allied Steel and Wire (ASW) workers faced the devastating double blow of losing their jobs and their pension. In stark contrast the Pension Protection Fund, introduced in response to cases like ASW, has protected the pensions of some 300,000 members and has a healthy £12bn surplus on assets of £32.5bn (as at March 2023). This is made up of the assets of schemes it takes on, recoveries from insolvent employers and importantly levies from those schemes and companies paying levies. The PPF works, in part, because it can raise levies on a risk-based approach from the DB universe.

Given this history and the hard-won security achieved, it is not appropriate for UK DB schemes to now make large-scale reversals to asset strategies. It is challenging to see how trustees could satisfy themselves that this would be in line with their fiduciary duties. It is also unlikely that employers would countenance being exposed to volatility in markets with the consequence that deficits could re-emerge leading to a return to large scale cash funding demands.

A chance to reconsider pension surplus

Despite the comments above, the potential to responsibly generate significant surplus exists in DB schemes. A scheme that is fully funded on a buyout basis that follows a low-risk investment strategy can generate meaningful surplus over its lifetime without the employer or the trustee having to redirect assets to any higher risk growth assets. This surplus, once achieved, could be directed to areas where investment in UK growth is possible such as large-scale DC investments. Not only could this help with UK growth but it maintains the security of DB investments to pay pensions over the long term and which remain invested in other productive parts of the economy such as financing Government borrowing and large-scale UK corporate debt.

Absent any action from the Government, it is unlikely that this will happen on a large scale. There is currently little to no incentive for employers to run schemes on to generate surplus. Rules on surplus last revisited in 2006 have not moved on. These rules originated with the aim of preventing tax avoidance based on a concern that employers may overfund their DB schemes. But employers today do not run their pension schemes for tax breaks. Instead, supporting a DB scheme is now a one-sided bet for employers – they must fund any deficit but are penalised for any surplus (through a 35% free-standing tax). It is also extremely difficult and costly for employers to be able to efficiently redirect surplus from one of its pension schemes to another. It can be done depending on each individual scheme's rules (which is something of a 'rules lottery') but at high expense.

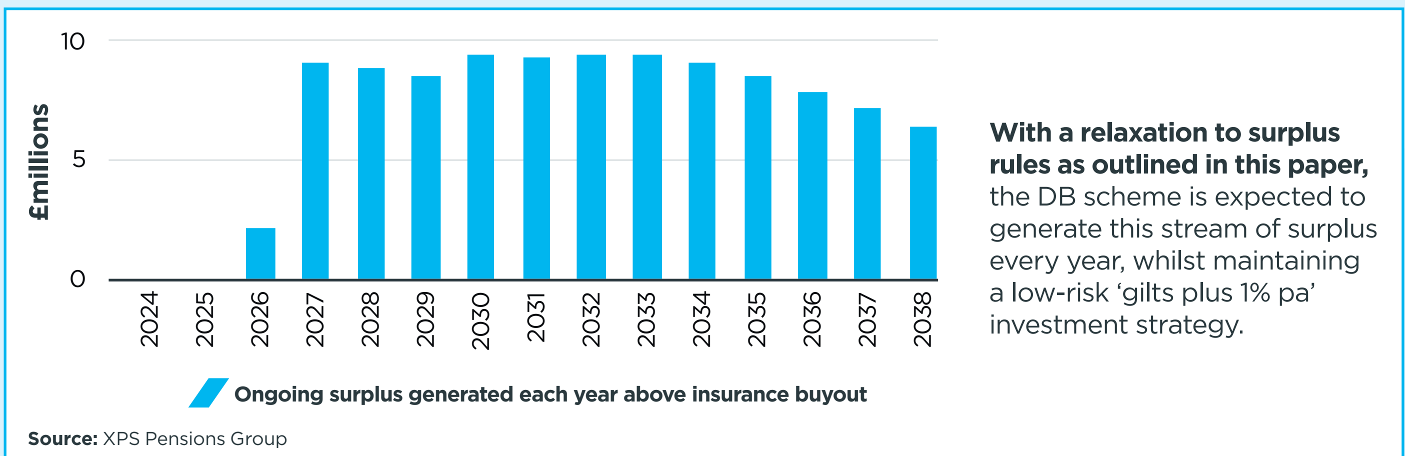
Given the improved position of these schemes and the markedly different environment for surplus, it is imperative to look at whether a change in surplus rules and taxation is needed and desirable. The best way to show the value that can be created by a safely and responsibly managed surplus is through an example case study. On the next page we show the value that can be created for DB members, DC employees and the employer.

Case study

Under the proposals in this paper, it would be for the employer and trustees to decide on a split of surplus under the new rules. This case study highlights the potential outcomes which could be achieved through this process for members and employers. All of this is achieved within a framework whereby the DB scheme remains fully funded on an insurance buyout measure, following a low risk investment strategy providing high levels of security for DB members. It is based on a UK manufacturing business with the following characteristics:

The employer	• **Annual turnover of £250m** with a **profit margin of 10% (£25m)** • **40% of profits (£10m) re-invested** into the business through CapEx or Research & Development expenditure
The workforce	• **Workforce of 1,000 employees** with an **average salary of £25,000 pa**
The pension schemes	• **DB scheme has assets of £500m** and is 95% funded to insurance buyout • **DB scheme closed 10 years ago;** pensions now provided through a **DC master trust** with **auto-enrolment** minimum contribution rates (**5% employees + 3% employer**)

The impact on the pension scheme surplus



With a relaxation to surplus rules as outlined in this paper, the DB scheme is expected to generate this stream of surplus every year, whilst maintaining a low-risk 'gilts plus 1% pa' investment strategy.

Source: XPS Pensions Group

The outcomes for members, employees and the employer

The surplus released could make a real difference to the DB scheme members, the DC workforce and the company. For example, if the surplus was split in equal proportions amongst those groups, it could have the following impact:

2% pa

Additional increase to pensions in payment for DB pensioners

These additional increases would provide a timely boost for pensioners at a time when many are facing 'capped' below-inflation increases.

225%

Increase in retirement income from DC pots for current employees

The additional surplus would fund an increase in the total contribution rate from 8% to 18%, transforming retirement outcomes for the DC workforce.

30%

Boost to annual Capex and R&D spend for the employer

This spend would strengthen the business, which would contribute to the UK growth agenda as well as strengthening the covenant of the DB scheme's sponsoring employer.

Surplus potential across the DB universe

Extending the ideas in the case study across the universe of DB schemes for which the option to run on may be appropriate clearly shows the value that can be generated to improve benefits, pension savings and investment in UK business. All of these outcomes will contribute to the Government's agenda for UK growth.

We have modelled the universe of UK DB schemes using XPS's proprietary DB:UK model[1]. We estimate that on 30 June 2023 in aggregate UK DB schemes had enough assets to cover 95% of the cost of insuring all UK DB schemes. The situation will vary by scheme, but this means that a significant number of schemes will already have a meaningful surplus relative to their buyout cost.

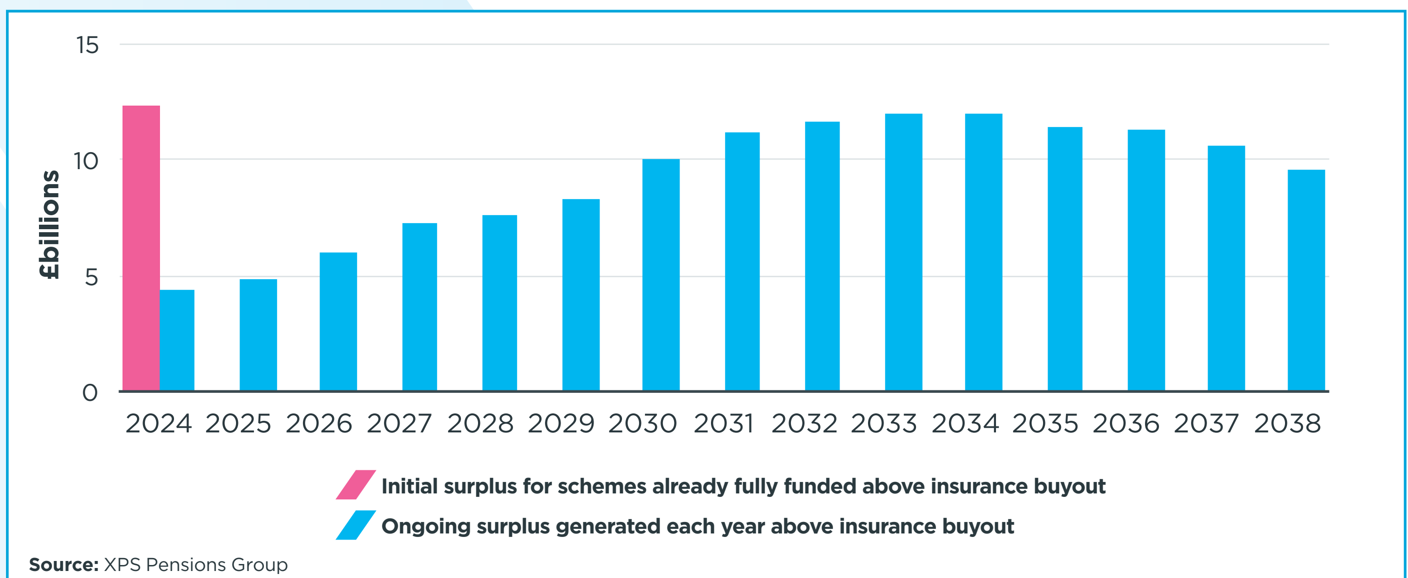
Surplus in schemes most suited to run on

It is unlikely that running on and generating surplus will be right, or cost effective, for all schemes and employers. Given ongoing governance requirements involved with running a scheme, and needing a robust process to release surplus, it is unlikely to be cost effective for small schemes to follow such an approach. A number of the UK's very largest pension schemes have already developed structures to run on for the long term without generating surplus but instead investing in contingent assets such as asset backed funding arrangements that allow an easier flow of funds between scheme and employer.

If we remove all schemes with less than 1,000 members and exclude the largest UK DB schemes, then remaining UK DB schemes can generate:

- **£100bn of surplus** in 10 years; or
- **£4.5bn of new surplus** each year in 2024, rising to **£10bn** each year by 2030, to invest in new pension savings.

The annual surplus that can be generated assuming it is distributed in full each year is shown below:



Source: XPS Pensions Group

The amount of surplus that can be generated increases as more and more schemes reach full funding on a buyout basis over time. We estimate that around 25% of schemes in the population of pension schemes that we have modelled are already fully funded on a buyout basis and have a combined surplus of £12bn.

Asset strategies

Schemes do not need to change from low-risk target investment strategies to generate the surpluses shown above. We expect there will be a range of strategies that will be acceptable to trustees to allow them to responsibly run their scheme on for the long term. Our analysis only requires that schemes target a return of 1% above gilt yields.

[1] **XPS DB:UK** monitors the combined deficit and funding level of UK defined benefit (DB) pension schemes (i.e., all registrable schemes – including hybrids) using data from the Pensions Regulator, Pension Protection Fund and the XPS data pool of member lives.

How the Government can facilitate change

To allow pension schemes to safely run on, generate surplus and ensure this can be used to improve member benefits and support UK growth we believe two key changes are needed:

1. **A change to surplus legislation that overrides scheme rules to allow a refund to employers from surplus above buyout on a tax-free basis. This must be on the condition that the refund is used to increase DC contributions or to fund capital investment in the employer's UK operations.**
2. **A new Pensions Regulator Code of Practice for trustees covering factors to reflect in running a scheme on above buyout and exercising the power to distribute surplus including how to reflect the interests of DB members.**

Background on DB pension surplus rules

Current rules that govern surplus have been in place since 2006. A power to refund a surplus while a scheme is ongoing may only be exercised by the trustees, even where the scheme rules give the power to another party such as the employer.

In exercising this power, the following requirements must be met:

- a valuation has to be carried out on a buyout basis;
- any surplus repayment must be limited to the value of the surplus on a buyout basis;
- the trustees must be satisfied that the payment is in members' interests;
- where the power to refund a surplus in the scheme rules rest with the employer, the employer has requested repayment;
- members have been given at least 3 months' notice of the proposed repayment; and
- The Pensions Regulator must be notified within one week of the payment.

Any repayment is subject to a 35% free-standing tax. In addition, some schemes may not have a power to refund surplus at all (or could have lost such a power by failing to pass a resolution under Section 251 Pensions Act 2004 by 5 April 2016).

1. Proposed changes to surplus rules

With a few straightforward but impactful changes to pension law, the Government can create the opportunity for low-risk DB investment strategies to build surplus and maintain security for DB benefits. This surplus can be deployed to increase DB benefits and improve pension savings for younger employees which are typically invested in long-term investments that aim to deliver a pension pot many years in the future.

We believe the changes required to achieve this are to:

- Remove the 35% free-standing tax on refund of surplus.
- Provide an override to allow employers the right to a refund of surplus from surplus assets above buyout.
- Limit the two points above so that they only apply where any surplus refund is used to fund a minimum level of defined contribution savings for employees or is invested in the employer's UK operations.
- Require the trustee to oversee any distribution or use of surplus.
- Provide for a new Code of Practice where The Pensions Regulator sets out guidance to trustees on how to run schemes on above buyout and oversee the distribution of surplus.

2. Role of trustees and a new Code of Practice

An important part of the proposals is that trustees will retain oversight of any distribution of surplus. This can be a strong safeguard where trustees can agree with employers how they will manage ongoing funding and investment risk in the scheme, the amount and timing of any surplus distribution and how DB members will participate in surplus.

We believe that a new Code of Practice from The Pensions Regulator to support trustees in this role should cover areas such as:

- the level of funding at or above buyout that trustees should maintain following any surplus distribution and whether a buffer above buyout is desirable;
- the importance of reflecting employer covenant in any decision to continue to run on and set the level of funding;
- the level of contingent support they may wish to seek from employers;
- how to take account of DB member's interests including reflecting whether existing DB members benefits could be improved and how that may impact decisions on funding and contingent support; and
- best practice in operating, monitoring and distributing surplus.

On the last point above, plans could be incorporated to monitor surplus funding levels at triennial actuarial valuations. At each valuation agreement can be reached on the amount and use of surplus allowing flexibility in accessing surplus over the inter-valuation period. This could be monitored following each annual funding update and if funding levels drop below trigger points then the use of the surplus trust assets could be altered or paused until funding is restored. We think, along with guidance and agreed processes between trustees and employers, this provides appropriate checks and balances without requiring trustees to decide on every individual use of the surplus assets.

The above are our suggestions of areas that can help ensure schemes that run on do so in a safe way and that surplus can benefit current members as well as improve DC savings and investment in UK businesses. We feel it will be beneficial to consult widely on the suggested new code of practice to ensure it appropriately supports and protects trustees and allows for efficient operation of surplus distribution.

Making the changes in law conditional

The proposal in this paper requires any change to surplus rules to be conditional on funds being used for stated purposes and that a formal process is set up so that employers and trustees govern the generation and use of surplus for the benefit of members, employees, and the covenant together.

These conditions are needed because part of the change is to remove the tax on refunds of surplus and to allow the employer a legal right to a refund from surplus assets above buyout irrespective of current scheme rules. Existing scheme rules would be overridden by legislation, but with protections for any pre-agreed surplus arrangements (or other customs and practices) that trustees and employers wish to continue.

Setting an expected level of DC contributions will help improve DC savings while recognising that current contributions differ across employers, and some may already provide a substantial level of DC contributions. This level could be determined in consultation but could require employers will share any refund up to a minimum level of employer contributions for all employees of 15% for example.

Benefits of using DB surplus

The approach outlined in this paper has a number of benefits and supports a meaningful contribution from DB schemes to improve member retirement savings and facilitate UK growth.

The key advantages are:

- It does not require trustees in DB schemes to invest in assets that conflict with their fiduciary duties and the need to manage liquidity in meeting DB benefits as a scheme matures. Trustees do not need to re-risk returns and shift to volatile illiquid assets. As mentioned already, we expect trustees of schemes that run on will want, and need, to put in place safeguards that govern how and when surplus is distributed. This will be important to avoid the double jeopardy of assets temporarily dipping below buyout levels due to market movements and the employer getting into financial distress.
- Changes needed to pension legislation are minimal and focus on providing statutory overrides and amending free-standing tax percentages in certain circumstances.
- Any change to surplus rules can limit benefits to cases where excess funds clearly end up in UK growth through additional DC savings or direct capital investment in business.
- It can directly help with inter-generational pensions savings gaps. While it will not help employees of those businesses that do not have a DB scheme a meaningful impact can be made for the current workforce of employers with legacy DB schemes.
- The approach does not require changes to the Pension Protection Fund cover (because the proposal requires schemes to be well funded above buyout and includes safeguards) which could be fraught with challenges including introducing moral hazard risk if cover is extended on a voluntary basis.
- Avoids the need to drive consolidation now – many small schemes have deficits meaning consolidation is unlikely to bring immediate change. We estimate small schemes have a combined £10bn deficit against a superfund consolidator level. Instead, small schemes need time to improve funding positions and consider consolidation options from a position of strength.

Challenges include:

- Setting surplus incentives at the right level so that a meaningful increase in DC contributions results from the changes.
- Providing similar incentives regardless of whether the DC scheme is in the same trust as the employer's existing DB scheme.
- Co-ordinating any changes to surplus with changes to DC investment opportunities to ensure that funds do find their way into UK growth.
- Ensuring so far as possible that the accounting regime recognises the incentives and intended treatment.
- Developing expertise and robust governance models for the long term continued operation of DB schemes balancing liquidity and surplus deployment.
- Managing the impact of any surplus override on reasonable expectations for existing members and their interest in any surplus assets.
- Ensuring that trustees play an appropriate role in the distribution of surplus without tying their hands.

Overall the proposed approach can, with limited regulatory change make a significant contribution to change.

Conclusion and next steps

In looking at whether DB schemes have a role to play in supporting UK growth, we strongly believe that should only be done if:

- the hard-won security of existing DB members benefits is not put at risk;
- the approach considers upside for members and can create clear benefit for them;
- it does not require DB schemes to move their own investments into asset classes that are inconsistent with delivering the benefits in the scheme;
- it does not go against trustees' fiduciary duties; and
- it does not risk increased exposure to funding volatility and deficit contributions for employers.

Given that, we do not feel increasing direct investment by closed DB schemes in illiquid UK venture capital or private equity is appropriate. Instead, DB schemes can be a source of surplus funding for investment in UK growth. This can be achieved by releasing those surpluses to improve DB members' benefits (increasing pensioner income), increasing retirement savings for existing employees and providing capital for direct investment in UK business operations.

The key next steps to achieve this involve:

1	Introducing straightforward, but impactful changes to surplus rules to remove the free-standing tax charge and give the employer a right to a surplus refund above buyout with appropriate conditions attached to this.
2	Setting specific conditions in legislation that direct where such a surplus must go otherwise existing surplus rules apply.
3	Retaining the requirement for any distribution of surplus to be exercised by the trustee and require a new code of practice from The Pensions Regulator that trustees can follow in agreeing at what level and how trustees will distribute surplus, reflecting the employer covenant.

We expect that the Government can facilitate the opportunity to create value for members, employees and sponsors but the exercise of generating and managing use of surplus should still be carefully managed and agreed between trustees and employers to recognise that the circumstances of each scheme and sponsor will be different. Maintaining the scheme specific approach will help manage introducing new risks and prevent the need for any changes to PPF cover which could have unintended consequences.

Overall, we believe the proposals in this paper represent a simple, actionable, and effective way of helping DB scheme surpluses to improve outcomes for members and employers, and in doing so safely contribute to the UK growth agenda.

Appendix: Modelling assumptions

The analysis of DB pension schemes in this paper is based on XPS's proprietary XPS DB:UK model. XPS DB:UK tracks the funding position of UK DB schemes on a long-term target basis and allows real-time monitoring of changes and analysis of the reasons behind any movement.

XPS DB:UK monitors the combined deficit and funding level of schemes (i.e. all registrable schemes, including hybrids) on multiple bases including insurance costs and a low dependency rate using a discount rate of gilts + 0.5%. It combines XPS's market leading **Member Analytics** and the award-winning journey planning tool, **Radar,** enabling real time monitoring of changes and analysis of the reasons behind any movement.

To model the surplus that could be generated by the universe of private sector DB schemes, we have filtered the schemes that may be in scope in practice for a long-term run-on approach by removing the largest and smallest schemes. We have allowed for a distribution of funding levels by extrapolating the ranges seen in XPS's database of around 600 schemes onto the universe of DB schemes as a whole, and batching the schemes into 20 cohorts depending on when the schemes are projected to reach full funding on an insurance buyout basis over the next 20 years.

Assets have been projected forwards based on market conditions at 30 June 2023, with allowance for expected returns on each scheme's assets of 1% pa above government bond yields. No allowance has been made for further deficit reduction contributions from employers for the purpose of this modelling, noting that if anything this will understate the amount of surplus that could be generated. Liabilities have been projected forwards based on market conditions at 30 June 2023, using XPS's in-house insurance buyout pricing basis. Allowance has been made for projected cashflow payments and the impact of membership ageing on the projected cost of insurance.

Data sources include data from The Pensions Regulator, the Pension Protection Fund, the PPF 7800 Index and the XPS data pool of member lives.

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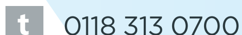
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Premier Miton Investors is a UK-based asset management company, focused on delivering good investment outcomes for investors through relevant products and active management across its range of investment strategies, which include equity, fixed income, multi-asset and absolute return.

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