SLAUGHTER AND MAY

BESTrustees

Ongoing surpluses - could I?

The mechanics of surplus release and what trustees and employers need to think about when determining if it is possible or feasible

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This paper looks at how trustees and employers can agree to "run on" a DB scheme and release surplus – both under current rules and the new legislative and regulatory framework. It answers the question "Could I?" and is followed by a second paper which looks at "Should I?" and considers what trustees need to think about before saying "yes" to surplus release.

Introduction

From April 2027, new legislation should open up more opportunities for DB schemes to consider running on with a view to distributing surplus to the employers and benefiting members.

However, notwithstanding political enthusiasm for expanding the use of surplus capital by schemes, the decision as to whether to run on or pursue an alternative endgame such as a buy-out represents a clear scheme inflexion point where robust, independent decision-making is essential – not only to avoid regret risk and missed opportunities, but also to ensure that trustees feel confident enough to make appropriate decisions without feeling they are at risk of member and/or regulator censure.

This paper does not seek to rehearse all of the issues which trustees, employers and their advisers need to consider when making decisions around run-on and surplus distribution. Rather, it focusses on the main factors trustees need to consider in determining whether run-on is a plausible and legitimate option.

Legal and regulatory framework

Legislation: Currently, refunds of surplus are only permitted if a scheme is fully funded on a buy-out basis and it is in the interests of members. In addition, trustees were required to pass a resolution confirming their ongoing surplus refund powers by 6 April 2016; otherwise, any existing power to refund ongoing surplus fell away. In addition, it is not permitted to introduce new ongoing surplus refund provisions even where the rules allowed it.

From 6 April 2027, the Pension Schemes Act 2026 and forthcoming regulations will provide trustees with the power to amend their scheme by resolution to include or change a power to distribute ongoing surplus. Making a change by resolution means section 67 of the Pensions Act 1995 and any restrictive conditions in amendment powers can be by-passed. The "interests of members" condition will be removed and the required funding level is likely to be reduced to low dependency.

Any refund of surplus to an employer will be taxed at 25%. Any payments to members will need to be authorised.

Scheme documentation: Trustees must check their trust deed and, currently, whether a surplus resolution was passed and what it says. If a resolution should have been passed and was not, that is the end of the line until 2027.

After April 2027, trustees will need to consider what their rules provide and, if there is no power or a restrictive one, whether to pass a resolution to amend that. In reaching that decision, they will need to take into account all relevant factors, including any specific restrictions on allowing refunds to the employer under the scheme rules.

If they do decide to introduce a power, they will need to decide what conditions should attach to it and whether to negotiate anything for members. Where an agreement is reached to improve member benefits, thought needs to be given as to how this can be done under the scheme rules.

Regulations: Under both the current and new regimes, 3 months' notice of a proposed distribution of surplus will need to be given to members, including the amount and the proposed date of payment. However, members do not need to be given the chance to make representations.

An actuarial certificate confirming the funding position will also be required. Currently it would need to confirm that the scheme will remain funded on a buy-out basis. Under the new regime, it will need to confirm that the scheme will remain fully funded on a low-dependency basis and be as likely as not to remain funded on that basis for 3 years.

The Pensions Regulator will need to be told under both regimes within a week of any payment being made to the employer.

Guidance: The Pensions Regulator has issued guidance setting out its early views on how trustees should approach surplus distribution, with a view to more detailed guidance being in place by April 2027. It has also issued guidance on endgame planning which sets out how trustees should balance a decision to run-on against the possibility of buy-out or other endgame strategies.

Trustees should have regard to the guidance as it sets out the Regulator's expectations. However, it is worth noting that it does not have any statutory force so they are not obliged to follow it if they consider a different course of action would be more appropriate.

Scheme funding

The "new" framework in the Pension Schemes Act 2026 potentially offers greater flexibilities for "running on" arrangements, but in so doing places considerable responsibility upon scheme trustees.

Level of funding: As noted above, the new regime will move from a requirement to be fully funded on a buy-out basis to a requirement to be funded at low dependency. This means that there is an increased risk that releasing surplus may prevent a scheme from reaching buy-out funding levels in the future.

Risk assessment: The nature of scheme funding is dynamic – with a long history of market shocks either materially reducing or increasing scheme funding levels. It follows that, absent careful analysis and mitigations, the possibility of "regret risk" for trustees and employers is real – depending on scheme funding levels.

The Regulator has said that trustees should consider *"[w]hether the scheme's funding position and/or employer covenant are sufficiently strong to face potential risks materialising, such as future underperformance or employer distress"* and the *"impact on the scheme's funding position of a range of stress tests."*

Given the obligations on trustees in any running-on decision – particularly if a low dependency threshold is used – and the potential strains on an employer should material downside risks crystallise, it follows that a comprehensive analysis of both funding and covenant risks is essential; and that mitigations are in place to address material identified adverse risks.

It is easy to assume that any downside risk crystallisation is a "trustee problem". But in practice, correcting such an adverse event is likely to make demands on the employer – potentially when they are facing financial challenge.

Liabilities: Any assessment of funding will depend on an accurate understanding of the liabilities and there is a long history of the law deciding that liabilities may be greater than previously understood. To take a few examples:

- Many schemes are still working through GMP equalisation, and wider GMP compliance issues.
- Barber equalisation was, in many cases, not effective from the date originally thought and this only becomes clear in later due diligence exercises.
- Virgin Media raised the possibility of deeds of amendment being void because of a failure to comply with contracting-out formalities. The Pension Schemes Act 2026 allows for retrospective confirmation of amendments, but that is not an automatic fix and may not save all problematic deeds.
- There are a number of cases where amendment powers have been interpreted by the courts as being more restrictive than thought, meaning that past amendments are invalid.
- Mistakes or misunderstandings where benefits paid do not reflect what the trust deed requires.

So, trustees need to take into account the risk that a surplus may turn out to be rather lower than it appeared.

Operational and relationship matters

What does the employer want? Employers clearly have an interest in a decision to run-on and will need to be involved in any such decision as it will form part of a scheme's funding and investment strategy.

There may be reasons why an employer would not wish to run on: they might want to buy-out to take away funding risk and management distractions – particularly if there has been a history of difficult funding discussions. Alternatively, they may not consider that they have the expertise to manage – or fully understand – certain of the funding decision-making points and scheme guardrails.

Trustees cannot assume that employers will be unconditionally willing counterparties to run-on, particularly if they present material risk to them.

Governance and administration: There are two key areas of a run-on arrangement where a careful consideration of governance and administration processes is essential:

- Run-on arrangements are likely to have periodic tests or triggers – for example, surplus release guardrails preventing release if prescribed conditions are not met – and it is essential that both trustee and employer governance processes are in place to monitor and take any necessary action.
- Where an option to trigger a buy-out is in place, it is essential that the usual pre-transaction processes – such as data-cleansing – are in place, otherwise the buy-out may not, in practical terms, be deliverable.

Advice**:** Trustees will need advice in a range of areas including investment strategy; funding and funding evolution; and covenant (looking at employer longevity, free cashflow and potential sensitivities). This requires an advisory team which works well together in an integrated way; and is credible with employers as well as trustees.

Conclusions

The developments around running on and releasing surplus create exciting opportunities for schemes and employers – but also potential risks which need to be considered and appropriately managed. If planned and executed well – with the parties taking advice, following guidance and working within agreed guardrails – such arrangements could deliver significant value to all parties.

However, run-on might not be the right solution for all schemes. In our second paper – "Should I?" – we consider a range of factors that trustees and employers should address before making any decision to release surplus and run on.

Some examples of how it might all work

Example 1: Haloco leads by example

Haloco is a listed company with a strong reputation for corporate governance. It has a leading market position and has delivered strong, and growing, financial results for a number of years.

Haloco sponsors a DB pension scheme which is currently funded at approximately 106% of the buy-out level.

The trustees and the employer have a collaborative and mutually respectful relationship and have been discussing strategic options for the scheme.

Both parties have received extensive investment and covenant advice and discussions have moved to a "running on" solution. The scheme rules permit surplus release in line with statutory requirements.

The key components which the parties agree include:

- A periodic release of surplus above a level set at 105% of the buy-out funding level.
- 80% of the surplus released being used for a combination of member benefit augmentation and contributions to Haloco's DC scheme.
- 20% of the surplus released being passed to Haloco for specific investment in projects which, with the agreement of the trustees' covenant advisers, are deemed to be covenant-enhancing.
- A series of guardrails and triggers leading to either "turning off" surplus release temporarily if appropriate or, at the trustees' discretion, the cessation of the arrangements and the pursuit of a full buy-out of member benefits.

Example 2: Thereorthereabouts thinks twice

The Finance Director of Thereorthereabouts, a family company, has been approached by the company's DB scheme trustees to discuss running-on the scheme. The trustees seem optimistic that such an arrangement could improve members' benefits – whilst providing a release of funds to the company.

The scheme's trust deed and rules permit the proposed arrangements. The scheme is well funded – just above the buy-out level. The trustees explain that their covenant advice is that the company has sound covenant reliability for the medium to long term.

The Finance Director is aware of some possible material changes to the company – including prospective Board retirements and changes. They also consider the covenant assessment to underestimate market challenges.

The Finance Director explains to the trustees that the company does not wish to underwrite any underfunding risk and feels that the trustees' covenant advice is over-optimistic. They provide well-articulated, evidence-based reasons for their views.

In the end, and by mutual agreement, all parties believe that the most prudent option is to pursue a buy-out – and efforts are applied to execute a swift transaction.

Example 3: The Chancerco Retirement Benefits Plan

It is 2028 and the new surplus release legislation is in force allowing surplus release – where appropriate – above the low-dependency funding basis. This has been music to the ears of Chancerco which has had a chequered history.

It was bought out of a distressed refinancing by specialist investors and is seeking to reposition its business and reduce costs by the rapid introduction of AI and investment in its manufacturing operations.

The funding position of the Chancerco Retirement Benefits Plan has in recent years oscillated around full funding on a low dependency basis; but current market conditions have increased the funding level to between low dependency and a buy-out.

Management assert strongly that the introduction of AI and the expansion of Chancerco's manufacturing operations will transform the company's fortunes. The management team approach – and seek to pressurise – the trustees to agree to release surplus to finance the company's investment needs. With some reluctance, management have suggested that 5% of the surplus released can be applied to enhance members' benefits.

The Plan's covenant advisers, already unpersuaded of Chancerco's reliable longevity, are sceptical about the likely success of management's investment proposals. The management team seek to "hold a gun to the head" of the trustees by stating that, absent the surplus release and investment, the existing investors will lose interest and the business will almost inevitably go into insolvency.

Notwithstanding the current funding level, the trustees do not consider that the covenant longevity of Chancerco, even with the investment of the monies from surplus, is sufficiently reliable and decline to agree to release "members' monies" to finance a speculative investment programme.