ASSOCIATION OF CONSULTING ACTUARIES

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Ruth Saunders
Department for Work And Pensions
Pensions-sft@dwp.gsi.gov.uk

Dear Ruth

Consultation on refund of surplus

I am writing on behalf of the Association of Consulting Actuaries, in response to your consultation on refund of surplus.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

We welcome the opportunity to comment on the options the DWP is considering for relaxing the current regulations that restrict employers' ability to take refunds of surplus from a pension fund. We have sympathy for employers who are concerned that, if they agree to fund the scheme prudently, there is a risk that surplus assets will be accumulated that they cannot access. However, in many cases members also need the security of a well funded pension scheme. Trustees need to be able to balance their obligations to members and to the employer, and we believe there are circumstances in which the existing regulations on refunds of surplus push them too far towards the former.

We would be happy to meet with the DWP to discuss the options proposed in its consultation document and to answer any questions it has about our response.

Option 1 – clarification of the members' interest requirement

We agree that the reference in section 37 to the refund being in the members' interests appears to pose a higher test than would apply under trustees' general duties, had the statement not been included. If the government is not prepared to remove the reference entirely, then perhaps an alternative would be that the refund must not be to the detriment of the members' interests in the scheme.

In principle, it is difficult to see how a refund to employers can ever be in the members' best interests. Any refund will result in lost opportunity to members since, even where the scheme is over funded on a buy out basis, whilst the money is in the scheme it provides more surety and also the opportunity for benefit enhancement. However, if the assets are sufficient to provide the benefits under the rules, then (in the absence of anything to the contrary in the scheme rules) we believe the employer's right to surplus should be stronger than the members' right to discretionary uplift. Provided the refund does not reduce the assets to below the level required to finance the scheme's benefits, then the trustees should be able to provide the refund without any detriment to the members' rights under the rules.

This leaves some open issues:

- The 'assets sufficient to provide the scheme benefits' can be measured in various ways. In principle, the technical provisions calculated for a valuation under Part IV of the Pensions Act 2004 must be sufficient to meet the benefits and include a degree of prudence. The buy out funding level is generally a stronger alternative, but is not always available except as an estimate. Another alternative, which removes any need for judgement, would be a multiple of the section 179 basis. A threshold equal to the minimum of:

    - the buy out basis; and
    - the maximum of multiples (greater than or equal to 100%) of the SFO funding level and the Section 179 funding level might be an alternative.

- There might be issues over how the assets are invested. For example, if they are in equities then the surplus might be a fleeting thing, so that the refund might appear to be to the members' detriment. However, in that case we believe it is the investment strategy that creates the detriment and not the refund. If there were a requirement that the refund could not be made if the outcome were to the detriment of the members' interests then, if the trustees thought it was appropriate, they could move the investments to a less volatile asset class and then a refund would become permissible.

Option 2 – sharing payments between employers and scheme members

We do not agree with this, except in cases where the scheme members also share the 'balance of cost' of the scheme.

The premise here is that if an employer funds a scheme cautiously, then it risks being obliged to increase the benefits originally targeted. Employers should only be required to meet the benefits set out in the rules, unless they choose otherwise. However, where members carry similar funding risks as the employer, then it seems reasonable to share surplus payments to reflect the distribution of risk.

Option 3 – lowering the full buy out threshold

In principle we agree that the normal right to refund should be restricted to schemes that are fully funded on a buy out basis, or multiple of the SFO or section 179 basis as discussed under Option 1. However, there may be other circumstances when it could be reasonable for trustees to agree to provide a refund to an employer. To some degree, this is the logic behind the various different debt solutions permitted under the winding up regulations.

Because the balance of interests between the employer and members is far less clear when the scheme is not fully funded to buy out, it would be reasonable for regulation to provide some clarity about the circumstances in which this would be permissible. For example, refunds could be permitted along the same lines as a withdrawal arrangement (although the actual tests that apply might need to be presented differently – for example, if adequate contingent assets or other forms of guarantees are put in place as an alternative means of funding); or, as in the case of an approved withdrawal arrangement, the Pensions Regulator could be required to approve a refund in other circumstances.

Option 4 – lower threshold for open schemes only

Since it is relatively easy for an employer with an open scheme to access surplus, we do not see the need for a weaker test in this case. In any case, we believe the 'quasi-regulated' provisions suggested under Option 3 would address this better.

Option 5 – encouraging trustees and employers to agree in advance

In many cases, a trust deed and rules will set out the circumstances in which refunds of surplus are to be agreed, but currently these are subsidiary to the legislation. The current framework is not flexible and so we do not see that much would be gained by encouraging trustees and employers to consider what is possible within it. However, if more flexibility was introduced, then we agree that this could be a useful option.

Option 6 – schemes which do not provide for payments to the employer

Certainly consideration should be given to a provision that overrides restrictions to refunds in scheme rules. However, although in some cases the reasons for restricting refunds might no longer apply, in many cases they will have been included for good reason. Consequently, the operation and effect of any override needs to be thought through carefully.

We note that, if it is not made automatic, then trustees might find it difficult to make use of it.

Option 7 – market solutions

Contingent assets and escrow accounts can be expensive to establish and maintain, so for many employers it is more cost efficient to fund the scheme directly. In any case, members have more surety if assets are within the trust, rather than outside. As we have suggested above, these are useful additional tools, but they cannot substitute for amendments to the existing regulatory position.

We hope this is helpful.

Kind regards

Charles Young
Chairman
ACA Pension Schemes Committee