HYMANS ROBERTSON

Whose surplus is it anyway?

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When it comes to surplus in a pension scheme, we often encounter starkly different viewpoints:

a) All the surplus belongs to the employer.

b) Any surplus (or at least half of it) should go to scheme members.

You've probably heard statements like these. They're often quickly followed by what the speaker would like to do with the surplus, and why that course is only fair for the price they've paid over many years to get the scheme to its happy funding position.

Strong views abound, and there's a wide gap in expectations on the tricky question of surplus ownership. It sounds like a massive arm-wrestle is needed to sort it all out. It's therefore tempting to ask if we have to get into this right now.

Unfortunately, doing nothing is just going to let the problem grow and expectations become entrenched. We also note there is a regulatory steer for schemes to develop policies on surplus.

So how should you think about allocating a surplus? A useful starting point is to look back before looking ahead. Theodore Roosevelt observed that the more you know about the past, the better prepared you are for the future – the analysis we're suggesting will give you invaluable context to today's surplus.

Where to start?

First off, you should get legal advice on what your scheme documents say. A typical defined benefit (DB) scheme's rules say the scheme is balance-of-cost, and any surplus goes to the employer on wind-up. Sometimes there's consideration to spending some of it on discretionary benefits, and often you need employer support for doing that.

But if you're not about to wind up – for example, if you're running on – then you need to look further. In our view, you also need a surplus history analysis. Despite the name, it's totally relevant to where you are today, and gives a real-life framing for discussions.

Lawyers tell us that you should base decisions on all the relevant factors and ignore the irrelevant ones. There's a great temptation for the parties to settle old scores or include 'nice to haves' because the surplus is seen as an unexpected windfall. A surplus history analysis gives the context for where your surplus comes from, so you can see which factors are relevant.

How to analyse surplus history

We suggest the analysis goes back to when the scheme last had a surplus (typically 25 years ago) and includes five steps:

1. Charting the progress of the funding position.

2. Showing how the membership and their benefit levels have changed.

3. Recording the contributions paid by the company and members over time.

4. Analysing and ranking the main sources (positive and negative) contributing to the return to surplus over the period.

5. Reviewing the timing of other key events, such as covenant commitments, scheme changes and establishment of defined contribution (DC) arrangements.

The analysis is designed to show changes to the scheme and the relative financial contribution of each big change. It doesn't need to be a giant actuarial sudoku with inflation adjusting or re-basing 25 years' worth of numbers onto current assumptions – we suggest keeping it simple.

Method and assumption changes will have played a part in the progress to today's surplus. We don't try to adjust them out of the picture on technical grounds, but keep them in the analysis because they're part of the journey.

What does the analysis show?

How does the analysis help you draw conclusions on a fair and reasonable allocation of surplus? It typically shows that your surplus today comes from favourable investment performance relative to liabilities, and long periods of heavy deficit funding by employers.

In many cases, member experience contributes positively – for example, from high volumes of transfer values taken in 2015–2020. Benefit changes might contribute too, such as scheme closures, when we saw one-off profits from salary-related liabilities becoming linked to lower revaluation rates.

Favourable investment performance, deficit funding and positive member experience, relative to growing liabilities and stronger funding assumptions, can be argued to come from careful trustee stewardship.

Deficit elimination was a shared endeavour between trustees and employers – although we must remember it was the employer who paid. Every scheme has its own history, and the analysis shows how much the 'balance of cost' was for the employer.

Of course, members paid in too (except in non-contributory schemes). However, employers paid more than £300bn into UK pension schemes over the past 25 years – around 25% of schemes' asset values today. It's hard to compare employer contributions to member contributions, as so many schemes closed and contributing member populations shrank. But for most schemes, employer contributions went way beyond the average – 10% of salary from the employer and 5% from the employee – that was typical at the start.

Seeing the numbers for your own scheme is illuminating. They bring perspective to the price paid – under a balance-of-cost scheme – to get your scheme's finances to where they are today.

However, the split of contributions paid doesn't tell the whole story. In most schemes, employers worked with trustees to limit the growth of liabilities and reduce their risk exposure. These actions reduced future benefit expectations for some members, particularly actives still in employment. Although these reductions didn't create surplus, they're still part of the relevant history. The cost savings could be used towards deficit contributions when the total cost of funding ended up many times higher.

In the past 25 years we've seen little use of scheme funds to improve benefits. That's not surprising when the focus was on reducing deficits. However, when many schemes last had surpluses, we find examples of scheme funds being used for redundancy and early retirement enhanced benefits. In addition, many employers spent surpluses in the 1980s and 1990s taking contribution holidays. You'll also find examples back then of surplus being spent on discretionary benefits, mostly pension increases, which weren't a statutory requirement before 1997.

However, assets underperforming liabilities in the 2000s weren't part of some long cycle of 'payback' for how employers spent surpluses in the previous two decades. Surplus history analysis is about today's surplus and how it developed. It only goes back to when you last had £1 of surplus, often around the turn of the millennium. It traces forwards through the long period of deficits, to how you built up to your new surplus. Tracing earlier periods of surplus might be interesting, but it won't give you the story of how today's surplus came about.

Moving forward

Surplus history analysis sheds light on how much your scheme was affected by each of the factors, positive and negative, that have created a DB market where so many schemes can securely pay members' benefits while running low-risk strategies.

The results might be broadly what you expected. However, the history and numbers back up the recollections of your longest-serving pensions, trustee and finance team members.

The analysis:

- establishes facts and clears up misunderstandings
- supports the legal position with how the 'balance of cost' actually worked out
- quantifies relative contributions from all the different sources
- gives context to the risks and how they were mitigated.

Many schemes have long memories and scars from 25 years of arguing about deficit recovery plans. Giving these their proper context helps narrow the differences in expectations about today's surpluses.

We wouldn't claim there's a mathematically or actuarially 'correct' answer to allocating surplus. Trustees should seek legal advice to weigh up all the factors, and the outcome may need to be a commercial and pragmatic agreement between the trustees and employer. However, in this most challenging of today's pension questions, surplus history analysis gives objective evidence from which to consider the relevant factors in the origin of the surplus.

We can help trustees and employers create a clear surplus history analysis, so future discussions start from facts, not assumptions. Leaving this unresolved could make future surplus discussions harder, adding time and unnecessary cost and risk.

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