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pensions.surplusconsultation@DWP.gov.uk

Department of Work and Pensions
Caxton House
Tothill Street
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Dear all

APPT response to DWP consultation: Surplus Flexibilities for Defined Benefit Pension Schemes

I am writing on behalf of the **Association of Professional Pension Trustees (APPT)** in response to the above consultation.

The Association of Professional Pension Trustees acts as the representative body for trustees of occupational pension schemes who fall within the Pension Regulator's description of professional trustee as set out in its August 2017 policy document.

The APPT acts as the collective voice of the profession. Our 450 accredited members sit on many trustee boards for defined benefit (DB) and defined contribution (DC) schemes including DC master trusts. Our members each typically work on multiple appointments and, across DB and DC are in total responsible for managing schemes with assets of over £1,200bn.

Introductory remarks

We are pleased to respond to the Department for Work and Pensions' ("DWP") consultation *Surplus Flexibilities for Defined Benefit Pension Schemes: Unlocking Value for Employers and Scheme Members* ("the Consultation").

The principle of surplus release and the overall policy objective are supported by us, based on a framework of sufficient and robust safeguards.

Professional trustees are ready to play a central role in implementing a fair and transparent surplus framework that balances security, flexibility, and economic contribution. There must, however, be simplicity in the process as the risk of a lengthy and bureaucratic process that results in protracted debate on how a surplus is used will deter trustees from embarking on the process.

The Draft Regulations make it clear that it is the trustee who is the decision maker, but there is potentially ambiguity about the roles that other parties have in the process. There must be transparency to members, but they must not be given the

false impression that they have a role in assessing amounts and the appropriate division of a surplus between the relevant stakeholders, nor that they have the power to object to a decision. It is, therefore, essential that the Regulations once finalised make it clear that trustees are making decisions having received relevant advice that goes beyond just the actuary and investment valuation as implied in the Draft Regulations. It is, however, also essential that the advice requirement is proportionate.

We recognise that, in part, some of our responses and comments will be addressed through the Pensions Regulator's (TPR's) guidance that will be consulted on later this year. As this can only be in the context of the Regulations, the Regulations must provide a workable framework that promotes appropriate consideration of surplus distribution by trustees.

TPR issued a statement on 10 June and there are two points relevant to the Consultation:

- The statement advocates trustees having a surplus policy. Through the Regulations, the surplus policy could be given a similar legal status to the Statement of Funding Principles and Statement of Investment Principles. This would address at an early stage the need to consult with the employer, provide transparency to members and establish a process that makes it easier to conclude on the recipient of the surplus.

Our view is that such an approach would be an option in addition to the process set out in the Draft Regulations. We explain this further in our response to Question 11 where we also set out how the notification process for members set out on the Draft Regulations could be onerous. In many cases, the option to provide transparency on the principles should be sufficient information for the stakeholders.

In particular, it would also help ease the process by which a phased release of surplus can be effected. We explore this further in our response to Question 9

- TPR appears to expect there to be employer consent. The Draft Regulations refer to employer consultation in Regulation 8 when determining the provisional amount and consent in Regulation 9 when the "provisional amount" is paid. There needs to be consistency and as the clear intent is for this to be a trustee decision, subject to any process established by the Rules or elsewhere, consultation is the more appropriate approach.

Such consultation would also enable consideration of the consequences on the employer of benefit augmentations. Such a decision has a direct impact on an employer's reported results and could increase reliance on the covenant.

Separately, the expectation must be that TPR will review the notifications of surplus sharing which it receives. Although the Draft Regulations require notification to TPR after the point of surplus release, this is part of an important regulatory role and this is not evident from the Draft Regulations. The ability of the Regulator to utilise a risk based approach to identify where interventions may be necessary and to use its existing powers must be apparent. A particular risk that exists is for an employer to achieve its preferred outcome by either placing undue pressure on a trustee board or for a board to be replaced. TPR's powers would be an important safeguard if such situations were to arise.

We are also aware of discussions about the payment of surplus directly to a separate defined contribution scheme/arrangement connected to the same employer. Subject to any view that HMRC may have, we would consider such a use of surplus to be appropriate, but only if it follows a decision by the trustee to distribute surplus to the employer and the employer then instructing how that surplus is to be paid so that the scheme is acting as a "paying agent". In such a situation, the employer should recognise the surplus as having been distributed to it, albeit that the flow of value was directly to another party.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact Vassos Vassou, APPT Deputy Chair at Vassos_vassou@dalriadatrustees.co.uk

Yours sincerely

Rachel Croft

Chair

On behalf of the
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Response to questions from the Association of Professional Pension Trustees (APPT) to DWP consultation: Surplus Flexibilities for Defined Benefit Pension Schemes

Question 1: Draft regulation 2 defines ‘appropriate advice’. Do you agree with this definition?

No

The definition should be utilised to emphasise the breadth of advice trustees will take.

In Draft Regulation 6, “Appropriate Advice” has a limited role in the process as it is only referred to as part of valuing the Scheme Assets.

The Scheme Actuary also has a clearly defined role in the Regulations to provide advice and a certificate, but in practice trustees will seek advice on other factors, including surplus strategy, investment strategy, covenant and guardrails. This advice is likely to be provided by separate parties. Such advice needs to be proportionate to the circumstances and does not need to be and should not be defined, but there will be few circumstances where a release of surplus would be based solely on the measurement of the assets and the liabilities.

The Regulations should, therefore, recognise that such advice is important and Regulation 8 (1) could be amended accordingly by adding a further role for appropriate advice:

- (1) The trustees may decide after taking appropriate advice a provisional amount for payment to the employer where:

.....

The definition of “Appropriate advice” should also be tightened so that it explicitly refers to trustee appointed advisers.

Question 2: Is the scope of the power sufficiently clear?

Yes

The Regulations should, however, explicitly exclude from the proposed process single trust schemes that have different sections where one section is already able to fund another.

Question 3: Regulatory own funds schemes were included in the 2006 Regulations; is there a continued need for their inclusion within the Regulations?

We are not responding to this question

Question 4: Do you have any comment on the considerations of factors to be taken into account for the assessment of assets and liabilities?

The factors are appropriate as they are a measure of the total assets and liabilities.

However, these factors could be tightened by either prescribing the valuation principles or the need to assess any impairments on certain asset classes. The approach to the assessment of assets and liabilities when there has been a buy-in is also important to clarify especially where there are either residual liabilities or a balancing premium to be calculated.

As explained in our response to Question 1, there are also other factors to be considered:

- Covenant
- Investment strategy
- Guardrails/mechanisms to cease the sharing of surpluses

These can be addressed through the guidance issued by TPR and the suggestion in our response to Question 1.

Question 5: Do you have views on the proposed funding test, based on full funding on the low dependency funding basis?

The “low dependency funding basis”, whilst implicitly referring to the Funding Code, should be defined within the Regulations as, if drawn from elsewhere, it could either change over time or the terminology become redundant. With such clarity, there is a lower risk of it becoming a point of contention between trustees and employers either immediately or in the future.

We note that the DWP’s explanatory text and the TPR statement both refer to there being a “buffer”.

Although not explained within the Draft Regulations, there does appear to be some expectation of a “buffer” above low dependency funding and we would concur with such an approach in most circumstances. In the absence of a specific requirement, the expectation of a buffer would be stronger if the Draft Regulations Condition 1 was “at least the low dependency level” and if in addition to a) to d) a further point to consider “any other factors the trustees consider relevant” was added.

Defining a buffer is challenging and we expect that this will be covered in TPR’s guidance.

Question 6: Do you have any views on the proposed payment process as proposed in the regulations, including whether it is workable in practice and sufficiently clear? Please provide details.

The process is clear, but the required role of the employer in the process must be consistent. In Draft Regulation 8, in determining the “provisional amount”, there is a requirement to consult with the employer. In Draft Regulation 9, at the point of payment, there is a requirement to obtain consent. There is a significant difference between consultation and consent and the different requirement at different stages to the process may be confusing. In order for the objective of surplus distribution being a trustee decision, consultation seem to be a better approach for the employer’s role at all stages.

A forward looking element has also been introduced.

A target date is being set at least three months in advance as there needs to be a three month notification period for members. The target date does not appear to serve any other purpose and it would probably be better to have the notification to members (although we question this requirement – see our response to Question 11) commencing on the point at which the provisional amount has been agreed rather than some notional future date. This would also address, in part, the issue of phased release which is established in advance and which would under the draft Regulations require a process of continual notification as each individual payment making up the aggregate provisional amount would require its own target date.

Please also see our response to Question 9 where we consider further phased payments.

Question 7: Are the regulations clear on the process of obtaining actuarial certification and paying the employer within 5 working days?

The process is clear, but the condition of five working days is potentially challenging.

A pension scheme is not necessarily holding cash or investments in daily traded funds. Whilst it is arguably a known payment, there are conditions which are only satisfied with the actuarial certification and there may be changes in circumstances ahead of the formal certification. Rather than payment being within five days, that period could be for irrevocable instructions for disinvestments to be given with a limit of, say, 15 days for settlement.

Question 8: Do you have any comments on the proposed 3-year forward-looking assessment in Condition 2?

The “is at least as likely as not to be greater” criteria appears subjective and could, therefore, be a point of technical debate between a sponsor and a trustee. There should also be clarification of how either an existing buy-in or intended buy-in is factored into such an assessment. TPR and Financial Reporting Council guidance must reduce the level of any subjectivity.

Question 9: Do you agree that the process proposed in the regulations is sufficiently flexible to enable a phased release of scheme surplus over a number of years, while preserving member benefits via certification of each individual payment?

The Draft Regulations do not easily allow phased payments with planned instalment dates over a period of time, which could be capped in the Regulations.

The requirement for a certification of each payment is probably a disincentive to have such an approach and could, therefore, result in a larger single payment being made. If a bureaucratic process has resulted in a larger single payment, those funds are no longer within the scheme and so the impact would be greater. This is a risk as, if there were to be any change of circumstance, a single sum may not be easy to recover, but in a phased release, future instalments could be stopped.

In practice a phased programme of surplus release would, in all likelihood, be subject to pause/termination through the terms of a separate surplus release policy,

separate contractual conditions and/or guardrails. Such a policy, which should require employer consultation, could be set out in a formal scheme document that explains the principles and timeframes (as explained in our Introductory remarks).

A phased release can be monitored through the annual funding report and if the programme is no longer suitable (due to poor experience or a deteriorating covenant, for example) then the release can be switched off. The next triennial valuation will reset either a recovery plan, or a new surplus release plan. In extremis, in the light of very poor experience, the trustees could call an early valuation.

A comparison can also be drawn to the process of deficit contributions being paid. These are agreed on a triennial basis between the trustees and the employer. In reaching agreement, many factors are considered. The release of surplus is, effectively, the reverse of that process, which is very clearly on a triennial basis. The risk to members is, of course, far greater in a scheme requiring deficit contributions than one considering surplus distribution, but the Draft Regulations provide a more bureaucratic process for surplus.

We explain further the framework for a surplus release policy in our response to Question 11.

Question 10: Should earmarked schemes be included in the scope of these regulations?

We are not responding to this question

Question 11: Do you think the notification requirements in regulation 11 are sufficiently clear?

The requirements are clear, but they could be overly onerous.

Consideration must be given to the purpose of the notification. Giving three months suggests it is a consultation, but it is not. The explanatory notes suggest the purpose is to “communicate over the decision....” and emphasises that the decision is solely in the hands of the Trustees.

It is possible that, through the notification process, unrealistic expectations are being set, although the Draft Regulations presume that there is a payment to the sponsor and a possible payment to the members (Regulation 11(1)).

Transparency is important, but for most other scheme-wide decisions being made by trustees, the notification is after the event and not in advance. When there are deficits, for example, which is a greater risk to member security, communication of the agreement with the sponsor is made only once a valuation has been signed off.

The possible real-world situation that must be considered is if members (individually or collectively), having been notified, raise challenges and, following a response considered unsatisfactory by the members, then raise a complaint through the Internal Dispute Resolution Procedure.

In some circumstances, transparency could be achieved by preparing and making available a legally compliant surplus release policy, in the same way as a Statement

of Investment Principles, and providing suitable notification after the event (also see our Introductory remarks and our response to Question 9). This would need to be at least three months ahead of the first surplus distribution to which it relates and be subject to a three year review or, if earlier, a change to the principles.

There would then be two possible approaches for trustees to give three months' notice:

- Either the process as set out in the Draft Regulations for a single payment; or
- Or the publication of a surplus release policy at least three months in advance and subject to at least triennial review which allows either a single distribution or a phased/on-going distribution.

The surplus release policy should require employer consultation.

Question 12: Do you think the notification requirements in regulation 12 are sufficiently clear?

The requirements are clear, but the responsibility of TPR should also be clear. TPR's responsibility could be formally structured to take a risk based approach and be dependent on factors such as size, the extent of any buffer above low dependency, complexity and availability of additional security.

In particular, TPR should consider if there has been any lack of independence in the process such as either the application of undue pressure by an employer or the replacement of a board specifically to achieve a surplus distribution.

The potential for TPR to use its existing powers should be evident.

Question 13: Are the proposed rules for sectionalised schemes and employer consent workable and clear?

We are not responding to this question

Question 14: Are the draft regulations clear for excluded schemes? If not, where would further clarity be helpful?

We are not responding to this question

Question 15: Are the draft Regulations clear on revaluation of deferred awards?

We are not responding to this question

Question 16: Are the draft Regulations clear on how deferred awards affect members' statutory right to take a transfer value?

We are not responding to this question

Question 17: Do you foresee any issues or concerns arising from proceeding without transitional provisions following the revocation of the 2006 Regulations? If so, please provide details.

We are not responding to this question

Question 18: Do you foresee any issues with revoking regulations 36 to 39 of the 2014 Regulations?

We are not responding to this question

Question 19: Does the proposed certificate in the Schedule capture all the relevant details that will be required?

It provides the necessary information at a basic level, but the notification to TPR must provide sufficient information to enable it to assess risk and identify any inappropriate decisions that require an intervention (see our response to Question 12).