Spotlight

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Powers to pay defined benefit (DB) surpluses

Options for DB schemes – consultation response and Pension Schemes Bill

On 29 May 2025 the Department for Work and Pensions (DWP) published the outcome of the Options for Defined Benefit Schemes consultation. On 5 June 2025 the Government introduced the Pension Schemes Bill into Parliament containing amendments to the existing framework for surplus extraction from DB schemes that intend to remove barriers while maintaining stringent funding safeguards to protect members' benefits. The Bill passed its Second Reading without on 7 July.

New guidance from the Pensions Regulator
Additionally, the Pensions Regulator has also published its new guidance for trustees and employers to help them consider their options once a scheme reaches full funding and to assist them in deciding what is the right endgame solution for them.

This Spotlight focuses on how the DB scheme surplus landscape will be changed by the new reforms.

Current choices around scheme surpluses

Currently the treatment of a DB scheme's surplus will be determined by several factors:

- Whether the scheme is winding up (with full buy-out of liabilities), or is a continuing scheme
- What current legislation requires, which includes section 37 of the Pensions Act 1995 where a DB scheme is continuing and not being wound up
- Whether a resolution was made under section 251 of the Pensions Act 2004 before 6 April 2016 to allow for a surplus to be paid before a scheme winds up in the case of continuing schemes
- The scheme's governing documentation and rules
- The fiduciary duties that apply to the scheme's trustees under established trust law
- The balance of powers in the governing documentation between the trustees and the sponsoring employers.

Some of these requirements are seen as too restrictive for continuing schemes given that private sector DB schemes are currently experiencing high levels of funding with roughly three-quarters of them in surplus and approaching or exceeding a 'low dependency basis'.

Low dependency basis – a new key metric
This basis has been introduced as part of the new scheme funding regime with the new Code of Practice that came into force last year. What a low dependency basis means is that the existing funds in the scheme are sufficiently high that no further employer contributions would be expected to be needed in order for all liabilities to be met. It is a strong position but not as strong, or as expensive, as a full buy-out basis where funding is such that insurance companies can guarantee the payment of pensions with annuities.

It is recognised that many schemes may choose, or wish to choose, to 'run on' rather than buy-out. Running on entails paying the benefits as they fall due until all liabilities have been discharged and/or the remaining liabilities are transferred to an alternative provider.

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With a longer time horizon, a scheme that chooses to run on can also invest more in growth assets that give a higher return (including productive assets), as opposed to more secure but low return assets.

New legislation on surplus release

In the Pension Schemes Bill, the Government is seeking to make surplus release easier for trustees of continuing schemes. The rationale is that employers could use this funding to invest in their businesses, increase productivity, boost wages or utilise it for enhanced contributions to their defined contribution (DC) schemes. There is also the possibility that some of the funding could go towards increased pensions for members, such as providing discretionary increases to pensions in payment.

New modification power and repeal of section 251
The Bill introduces a statutory power for trustees to modify their scheme rules. This would include the ability of the trustees to "*remove or relax any restriction imposed by the scheme on the exercise*" of the power to make a surplus payment. In addition, the current requirement for trustees to have passed a resolution under section 251 before 6 April 2016 will be repealed. The new legislation will not mandate how any surplus released as a result of these changes will be used. It will though make it clear that trustees must act in accordance with their overarching duties to beneficiaries, which will remain unchanged.

Taxation of surplus
The Government noted that the tax payable on DB surplus returned to the employer had been reduced from 35% to 25% from April 2024 and confirmed that it believes the pensions tax framework to be broadly balanced and fair in this area.

Threshold for surplus release
The Government is considering amending the threshold when a surplus release can happen so that, instead of the current position where the continuing scheme must be funded on a buy-out basis before any release can happen, the threshold will be set at full funding on a low dependency basis. However, further details on this will be set out in secondary legislation; the content of which will be consulted upon in advance. Importantly extraction of any surplus will be subject to the scheme actuary providing a certification of funding adequacy. In due course the Pensions Regulator will also develop and publish further guidance on this area.

100% PPF underpin option rejected
One option that the Government had canvassed views on was the option for trustees to opt into paying a higher "super levy" to the Pension Protection Fund (PPF) in return for it providing 100% coverage of the scheme's liabilities in the event that its sponsors went insolvent and the underfunded scheme could not meet its liabilities. Following a number of responses that highlighted the risks with the idea, the Government has decided that an opt-in 100% PPF underpin is not feasible since it would likely be unaffordable for most schemes and there would remain concerns about the potential for such an arrangement to create serious moral hazard in the DB sector.

Sharing surplus with members
Another area which the Government canvassed views on was about members receiving some extra benefit from the surpluses in schemes. A number of respondents commented on the merits of a statutory power allowing for direct payments to members. The Government said that it would "*continue to consider this*" but noted that trustees will continue to be responsible for these decisions and already have a number of options available to them, such as benefit augmentations.

The Government will work with the Pensions Regulator in developing guidance around surplus release including the options for trustees to bring benefits to members.

A potential public consolidator?

An idea that the Government has consulted upon is whether a public sector DB consolidator could and should be set up to complement the existing commercial DB market solutions for buyout and consolidation. In this regard it is worth noting that the Pension Schemes Bill also legislates for a 'superfunds' regime. Superfunds are schemes that do not have an employer sponsoring them but instead are backed by a capital fund put up by investors that acts as a buffer, and which may accept the transfer of DB scheme liabilities with supporting assets. They will provide an alternative solution for schemes that cannot afford buyout.

The Government is continuing to explore whether a small, focused public sector consolidator administered by the Pension Protection Fund (PPF) could play a useful part. Importantly though the Government has ruled out any legislation to establish such a consolidator in the Pension Schemes Bill.

The reason this option is still being canvassed is because there is the concern that existing options may not be viable for every scheme. The rationale is that a consolidator could serve as an alternative, functioning as a single pooled fund on a 'run-on' basis (instead of targeting insurance buyout) and help with a fragmented pensions landscape. The theory is that it would maximise economies of scale and aim to open up new investment opportunities, while raising governance standards so as to benefit members. The classic scenario for such a consolidator could be an underfunded scheme that is already mature and may not be able to use commercial solutions like superfunds. The consolidator would need to be structured to require any linked sponsoring employers to continue to meet any agreed payment schedule to fund liabilities.

Standardising member benefits?
A key issue is whether such a public sector consolidator could standardise benefits so as to create administrative simplicities, save costs and drive economies of scale: and also, whether this would extend permissively to private sector schemes.

Feedback to the Government raised issues about significant winners and losers from such a standardisation, potential legal challenges that might arise for trustees if they agreed to significant alterations, the cost of professional advice around any changes, and the effects of market distortion if only the public sector consolidator had this option. The Government is conducting further work in this area to determine if such standardisation would be appropriate.

New models and options in DB schemes

The Regulator's guidance set out its expectations of how trustees should approach the whole issue of the 'endgame' options for DB schemes. In broad terms it viewed them as:

- achieving self-sufficiency with funding on the low dependency funding basis and no further employer contributions being expected under reasonably foreseeable circumstances
- running on the scheme (once self-sufficiency is achieved)
- transferring to a consolidator (such as a superfund)
- insuring benefits with an insurance company via buy-ins and buy-outs.

It is worth noting that that, once the Pension Schemes Bill's provisions become law, a surplus can be paid either during the running on phase or once the scheme is wound up through buying out its liabilities.

Running on and paying surpluses
Continuing to run on a scheme may be either a preferred permanent strategy or an interim strategy to achieve a certain goal at a later date, such as buy-in or buy-out with an insurer. The potential benefits may include:

- Members may be able to benefit from higher pensions (through future augmentations) if run-on is well-managed and this may outweigh the associated risk of running on
- The scheme can continue to pay discretionary benefits to members, in particular where benefit indexation is not linked to inflation (or is limited), to ensure members retain a pension in real terms
- Trustees would retain control over benefit option terms and continuing to offer other benefit options that may not be offered under alternatives
- Surplus generated from investment returns could fund ongoing DC benefits
- Surplus generated may be paid to the employer once a low dependency basis is achieved
- Run on may allow the holdings of illiquid assets to run off without incurring 'haircuts' on their valuations in any buy-out process
- Run on can still enable an insurance risk transfer transaction to be implemented in the future on a more competitive basis; for example when the membership has matured and the risk profile of the scheme's liabilities has stabilised.

There are a number of important issues to consider with run-on and these include:

- Whether the scheme's funding position and its employer's covenant are sufficiently strong to face potential risks materialising, such as future underperformance or employer distress

- Whether the scheme has sufficient scale to deliver economies of scale for the period the scheme is expected to run on, as the scheme matures and member benefits are paid out.
- Whether it is realistic to manage costs and deliver value for money over such an extended time period.

A surplus policy?
The Pensions Regulator suggests that it would be good governance for trustees to develop a policy on surplus extraction appropriate to the context of their scheme. This should include details of how members and the employer are likely to benefit from the release. The trustees should also set their risk tolerance for surplus extraction and what is the funding level above which it is reasonable for a surplus to be extracted.

The Regulator does warn though that a DB scheme being materially overfunded, for a long period of time, with no plan to distribute excess funding to members or the sponsoring employer, may not be in the best interests of members or the sponsoring employer and may in fact indicate poor governance controls.

Key expectations?
The Pensions Regulator is clear that it expects trustees "*at the very least*" to:

- seek appropriate and proportionate professional advice
- assess the impact of the options on the strength of the covenant to the scheme
- understand the extent to which any option entails some loss of trustee control and take appropriate advice to ensure compliance with their fiduciary duties
- manage any conflicts of interest appropriately
- carry out a full risk assessment of the suitable options considered and how to mitigate any identified risks
- stress test fully the preferred options
- understand if and how any arrangement entered into could be unwound and the potential implications of doing so.

Capita comment

The improvement in most DB schemes' funding situation over the first part of this decade have brought the issue of surpluses into new focus. That said, it will remain important to bear in mind that future market movements (whether asset movements affected by conflict, or bond yields affected by recession and demographics) can also have a significant effect and alter the situation again.

We believe that most trustees will be cautious about the drawing too many conclusions too early. They will be careful in how they fulfil their fiduciary duties. It is also worth noting (as we pointed out in Spotlight 2025/04) that the reforms will not come into force until 2027 following a consultation on the secondary legislation in 2026.

The reforms provide new flexibility which could help employers to release money to invest in their businesses and so potentially increase productivity. There is also the possibility that trustees may be able to negotiate that some of the funding goes towards members' benefits, such as providing discretionary increases to pensions in payment as may have been past practice.

In practice there is no 'one size fits all' option and it will be important for trustees and employers to consider the specific circumstances of their scheme, taking professional advice as appropriate.

We would be delighted to discuss the planned changes further and what they mean for your scheme. Please speak to your usual Capita contact if you have any questions.