# Managing Defined Benefit Scheme Surpluses

## What are the options?

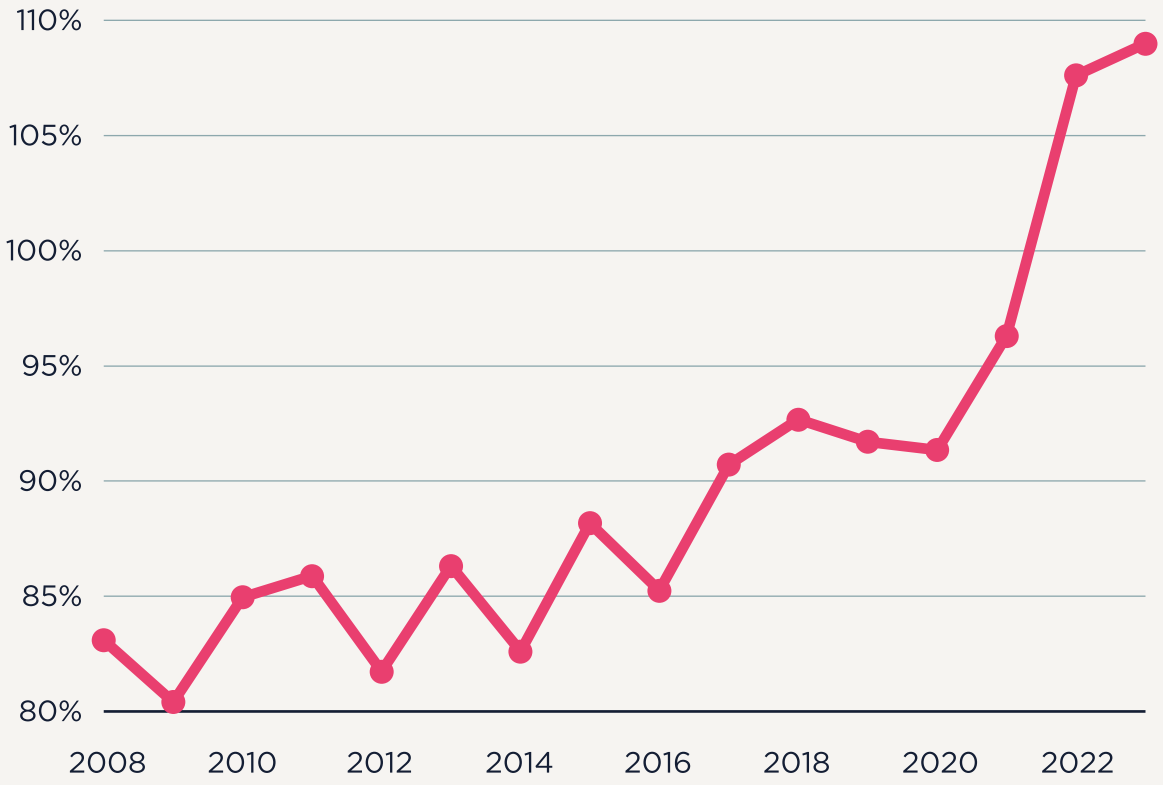
May 2025

# Introduction

Irish defined benefit (DB) pension schemes have seen material improvements in funding levels in recent years, notably accelerating after the significant rise in interest rates in 2022, a fall back in inflation expectations and the strong performance in recent years of growth assets such as equities.

Analysis completed as part of LCP's Annual Pensions Accounting Briefing indicated that the defined benefit pension schemes of many large Irish employers are now reporting a surplus in their company accounts with average funding levels reported of c110%.

**Average funding level**




**Source: LCP Ireland Pensions Accounting Briefing**

## Introduction continued

Analysis of Pensions Authority statistics also showed an improvement in aggregated funding levels. The most recent Pensions Authority published statistics on defined benefit pension schemes (published in November 2024 and covering stats up to 2023) show 98% of schemes meeting the statutory funding standard in 2023 (up from a mere 41% in 2013).

The emergence of a pension scheme surplus gives rise to new opportunities and considerations for the pension scheme trustees and sponsors alike. Indeed, we recommend that trustees and employers revisit their journey planning now in light of recent market movements to consider their strategy in relation to a number of items including:

+ **Surplus recognition and ownership of surplus**
+ **Use of Surplus including:**
    - De-risking the scheme investments
    - Discretionary increases to benefits
    - Amendment to scheme factors
    - Paying expenses from assets
    - Refund to the employer
+ **Acceleration to settlement of benefits including:**
    - Bulk annuities (pensioners and members not yet retired)
    - Enhanced Transfer Value exercise using the scheme surplus

In many cases the Trustees and Employers interests and objectives are aligned. However, this is not always the case when discussing ownership and use of surplus. It is important, therefore, that trustees and employers receive advice that is clear, aligned with their objectives and unconflicted.

If you are looking for ways of managing your pension scheme surplus, please contact our Head of Actuarial Consulting, Conor Daly FSAI (conor.daly@lcp.com or 01 – 6144393), or the LCP Consultant who normally deals with you.

# Surplus recognition and ownership of surplus

The Trustees are ultimately responsible for all the assets held by a DB Scheme. In many cases, the trustees will look to use a surplus to de-risk the investments or enhance member benefits (see below). However, the employer may have a preference for an alternative use of a surplus – and may even be seeking a refund of some or all of the surplus to the company.

In that context, it is important to understand the relevant provisions under the scheme's Trust Deed and Rules. Typically, the Trust Deed will prescribe or provide a strong steer as to who holds the balance of power (i.e. between the trustees and sponsor) in the use of surplus. In addition, the specific provisions within a pension scheme's rules are key in determining how any surplus is handled in a final settlement and wind-up.

Generally, the trustees' fiduciary duties will require them to give a high priority to the needs of the scheme members. Note however, even in cases where trustees have a discretionary power to apply the surplus as they see fit, it does not necessarily automatically follow that the full surplus would be applied to members. Indeed, a recent Pensions Ombudsman case  in the UK found that trustees were not in breach of their duties when they decided to return a surplus to the employer upon securing all members' benefits though an insurance buyout (rather than use the surplus to enhance the members' benefits).

Another key question for the employer would be the extent to which a pension scheme surplus should be recognised in the company balance sheet. Accounting rules set out the circumstances under which it is appropriate to recognise a surplus (e.g. does the company have an unconditional right to derive an economic benefit from the surplus at some point during the lifetime of the scheme?).

This consideration will include a review of the relevant provisions of the pension scheme Trust Deed, consultation with the actuary and discussion with audit.

In many cases, where the surplus is not being recognised in the company balance sheet (e.g. where it is deemed that there is not an "unconditional right" to the surplus) the company may feel that the surplus is trapped. Note even in cases where the pension scheme surplus is recognised in the company balance sheet, the company should understand the implications for the P&L and balance sheet in the event that the scheme is settled and a surplus returned.

# Use of Surplus

Once it is established that the Scheme has moved (or is likely to move) into surplus then there are some key considerations around the use of that surplus.

## 1. De-risking

One obvious area where the objectives of trustees and sponsors should be aligned is in the de-risking of well-funded pension schemes. In simple terms, a scheme in surplus with a low required investment return should generally not be investing in a high risk/return basis.

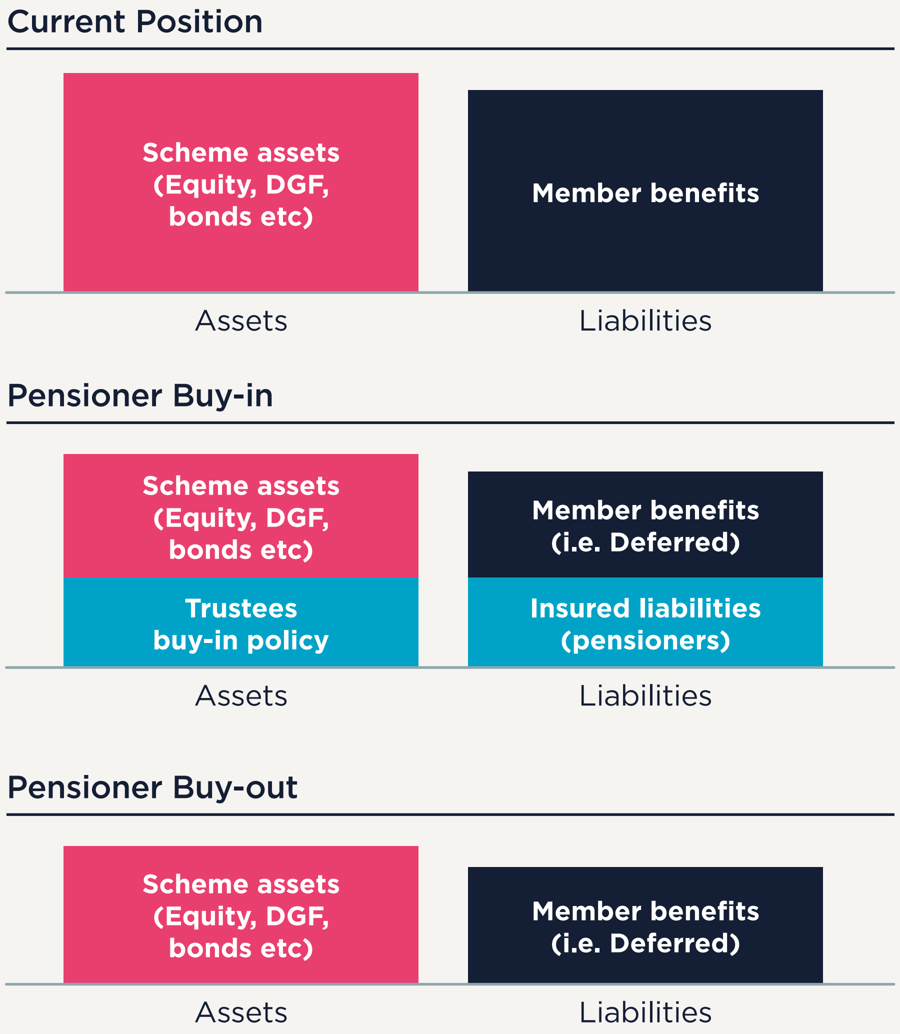
Indeed, in many such cases the risk is somewhat asymmetric for the company – a high return may result in an even higher – potentially "trapped" - surplus whereas a poor return may erode the surplus and result in an increase in future contribution requirements.

A key first step is therefore to consider the investment risk inherent in the scheme investment strategy and discuss affordable steps to reduce this risk with an investment advisor.

Note however an understanding of the ultimate objective and timeline is key in setting the appropriate level of de-risking. A target of buyout within the next 5 years, say may have a higher required return when compared to a target of long term run off paying the benefits when due - trustees and employer alike will wish to avoid de-risking to such a level that the agreed target is no longer likely to be achieved.

## 2. Bulk annuity transactions

A bulk annuity transaction occurs when a pension scheme transfers the responsibility for paying pensions to an insurer in exchange for an upfront premium. This can be structured as either a buy-in, where the insurance policy is held in the name of the trustees and remains an asset of the scheme, or a buy-out, where the insurance policy is assigned directly to individual pensioners, removing the corresponding assets and liabilities from the scheme.



# Use of Surplus continued

There are key differences from a company accounting (P&L) perspective in a buy-out when compared to a buy-in and the company should seek advice and understand which is the most appropriate approach.

Bulk annuities in the form of buy-ins or buy-outs are increasingly attractive as a way of eliminating investment and mortality risks. Generally, such transactions will result in a reduction in the accounting surplus (as the premium payable is higher than the accounting liability) but the existence of surpluses and the level of bulk discounts currently available mean that many companies should be actively considering whether such a transaction is appropriate.

Historically, bulk annuities were primarily used in scheme wind-ups. However, they are now increasingly viewed as a strategic funding and investment tool and a practical way to manage longevity risk. This shift has been supported by improved funding levels, enabling schemes to adopt lower-risk investment strategies aligned with annuity pricing.

## 3. Deferred annuities

To date, only immediate annuity products (i.e. for current pensioners) have been available for schemes to use on a large scale. There has been progress with the development of a deferred annuity product, with one insurer targeting a deferred annuity product in 2025 and another two insurers actively developing propositions.

Once available, such products will allow schemes to transfer risks relating to their non-pensioner liabilities, meaning that full scheme settlements by way of annuities will be possible for Irish pension schemes. A full settlement in this way would potentially satisfy trustees obligations to secure member benefits on wind-up and will bring the distribution of any residual surplus into sharp focus.

Deferred annuities are expected to be more expensive than immediate annuities due to the additional inherent risks, including longer duration liabilities and the reinvestment risks associated with assets backing these liabilities. Trustees and employers considering this route should therefore have regard to the expected cost and timing of such a transaction when considering funding and investment strategies.

## 4. Enhanced Transfer Values ('ETV')

One option that has recently become popular for Irish DB schemes is the use of Enhanced Transfer Values ('ETV'). An ETV exercise offers members a once-off opportunity to transfer the value of the pension, on enhanced terms, to another pension arrangement. This helps provide members with the option to plan their own retirement in a manner that best suits their own personal needs rather than staying within the DB scheme.

The benefit for the sponsor in carrying out an ETV exercise is it can significantly reduce risk within DB schemes, generate accounting and funding cost savings while also offering very attractive terms to members. It can also reduce the size of the scheme liabilities thereby reducing the time horizon to full settlement.

Trustees tend to approach such initiatives with caution and are likely to insist that such exercises are presented in a clear and unbiased way and that members are offered independent financial advice before taking up any offer.

# Use of Surplus continued

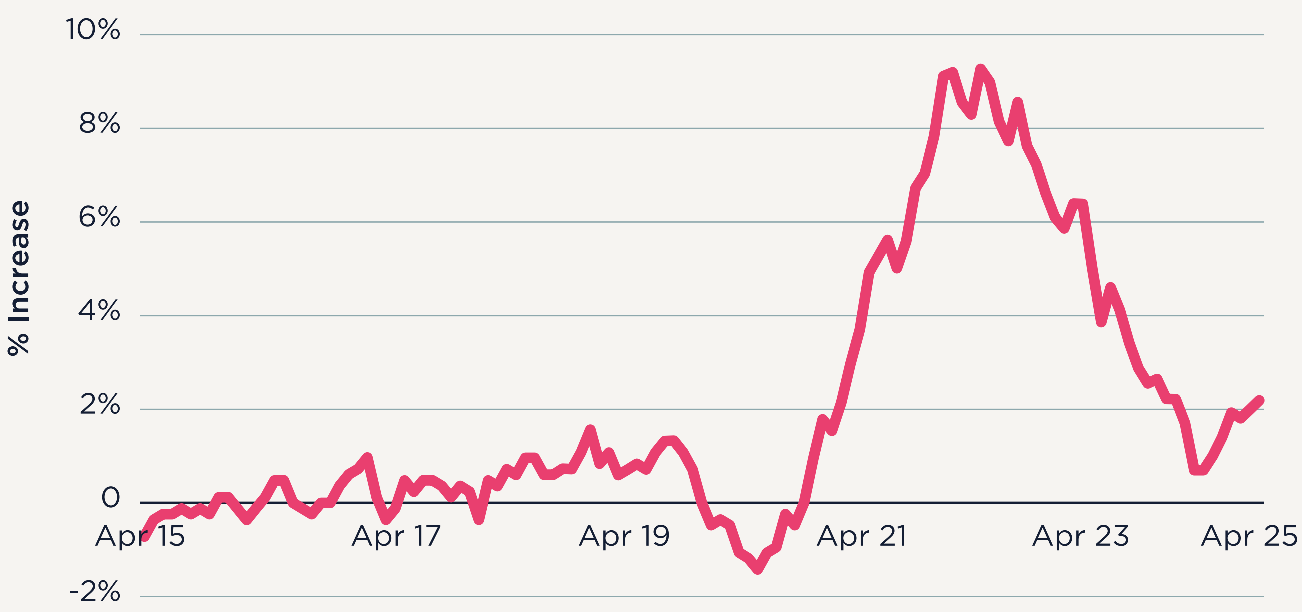
## 5. Enhancing member benefits

In certain circumstances – such as when a scheme is in surplus, supported by a strong sponsor covenant, and already operating with a low-risk investment strategy - trustees may consider enhancing member benefits. In considering benefit enhancements, trustees and sponsors must not only have regard to the scheme's governing documentation and applicable legal requirements, but also remain mindful of broader considerations such as fairness between members and the potential for unintended consequences, including selection risk.

Many pension schemes do not provide guaranteed increases to pensions in payment (the provision may have been removed as part of benefit amendments agreed following the financial crisis in 2010-2013 or may never have been included in the scheme Rules). In those cases, pension increases are generally granted on a discretionary basis – with a requirement for the consent of the sponsor being a common feature.

The emergence of pension scheme surpluses has resulted in pressure on many company sponsors to approve discretionary increase requests from trustees and/or members. The recent sharp rise in the cost of living has also contributed to this renewed pressure (while inflation has fallen back the impact of the price increases from 2021-2023 remains).

**Inflation trends**




# Use of Surplus continued

It is important that corporates therefore consider clearly the implications of the granting of discretionary increases on the company accounts (both P&L and balance sheet). In many cases an agreed protocol for the consideration of discretionary increases can help provide a framework for such discussions.

Improved surplus has also led to trustees revisiting the actuarial factors used to calculate member transfer values (i.e. a more generous basis than the standard transfer value by reference to statutory guidance), early retirement reduction factors (less penal factors for members retiring early) and commutation factors (a more generous basis to convert pension for lump sum).

Adopting a less prudent basis for these calculations would require consideration of several issues, including the likely impact on a scheme's surplus on various bases, fairness and equality between members and safeguarding of benefits for non-transferring members.

Employers may have concerns about "surplus leakage" and should seek an input into the deliberation process. The Trust Deed and Rules are again key in determining the balance of power (i.e. is company approval and/or consultation required for a change or do the trustees have unilateral power to make changes). In some cases enhancement to member benefits are tied into corporate restructuring to help manage any potential industrial relations issues.

## 6. Full settlement (transfer values in lieu of deferred annuity)

In some cases, the level of surplus has risen to such a level that the company may consider full settlement. This would involve a bulk annuity transaction of pensions in payment.

As deferred annuity products are not yet available in the Irish market, non-pensioner liabilities would generally be secured by way of a payment of a cash-equivalent transfer value in lieu of a pension – the transfer values would typically be considerably higher than the standard transfer value (and often higher than those offered under an ETV exercise). The calculation of such transfer values is generally carried out by the Scheme Actuary on behalf of the trustees and would be completed on a prudent basis. The company should therefore ensure it has received independent advice before going down such a route so as to ensure that the level of surplus could support such payments.

Trustees may resist approaches to settle non-pensioner benefits via a transfer payment as it fundamentally changes the nature of the pension benefit to the member (from a defined benefit payable at an agreed date to a large transfer amount which requires investment and management). They are likely therefore to instruct the Scheme Actuary to determine any such settlement transfer values using an ultra prudent basis – resulting in a high cost of settlement.

While settlement can be relatively costly from a company perspective, the existence of material surpluses as well as the increased governance costs associated with operating defined benefit pension schemes has resulted in more companies carrying out independent analysis on the potential for settlement. The existence of surplus also allows employers to again consider merging smaller defined benefit pension schemes – retaining member benefits while significantly reducing the governance cost associated with operating multiple schemes.

# Conclusion

The significant improvement in funding levels of Irish DB schemes presents both opportunities and challenges for trustees and sponsors. With surpluses becoming more common, it is crucial to carefully consider the options available for managing these funds. Common approaches include de-risking investment strategies and exploring bulk annuity transactions. The development of deferred annuity products will further expand the options for transferring risks and ultimately full settlements.

Enhanced Transfer Value (ETV) exercises offer an additional avenue for reducing scheme liabilities, while discretionary pension increases, adjustments to transfer value bases and adjustments to early retirement, late retirement and commutation factors are examples of ways that such surpluses can be used to specifically benefit certain membership cohorts. Each option requires thorough analysis and consultation with financial and legal advisors to ensure that decisions align with the scheme's objectives and regulatory requirements.

Ultimately, the effective management of DB scheme surpluses can lead to improved financial stability for both the pension scheme and the sponsoring company, while also providing valuable benefits to scheme members.

LCP can help you to understand the strategy that is best suited to meeting your objectives.

# Contact us

Conor Daly, Partner

conor.daly@lcpireland.com

+353 (0)1 614 4393

John Lynch, Partner

john.lynch@lcpireland.com

+353 (0)1 614 4393

Martin Haugh, Partner

martin.haugh@lcpireland.com

+353 (0)1 614 4393

Roma Burke, Partner

roma.burke@lcpireland.com

+353 (0)1 614 4393

Oliver Kelly, Partner

oliver.kelly@lcpireland.com

+353 (0)1 614 4393

*At LCP, our experts provide clear, concise advice focussed on your needs. We use innovative technology to give you real time insight and control. Our experts work in pensions, investment, insurance, energy, financial wellbeing and business analytics.*