Pension Fund Surplus in the United Kingdom
by Helen James (UK)

1. INTRODUCTION

1.1. The purpose of this paper is to provide a brief outline of the treatment of surplus in UK Company Pension Funds.

2. BACKGROUND

2.1. This paper is written against the background of a typical UK Pension Plan. The benefits of such a plan are based on final salary close to retirement, the members contribute some 4% or 5% of salary and the Company pay the balance of cost. Pensions in payment are increased periodically (typically every one to three years) to compensate pensioners to some degree for the increase in the cost of living. An increase averaging some 60%-80% of the increase in the RPI (Retail Price Index) would not be uncommon.

2.2. The meaning of surplus depends on the context of its use and, in particular, on the funding objectives of the plan and on the audience being addressed (e.g. employer, unions, accountants, regulators).

2.3. A definition along the lines of:-

"an excess of assets over those required according to the funding objectives and actuarial basis being employed" seems the most appropriate.

2.4. In practice, in the UK, surplus in the past has meant any one of the following depending on the particular funding objective:-

a) The excess of the market value of the existing assets over the amount required to provide the benefits arising on discontinuance of the plan.

b) The excess of the actuarial value of the existing assets over the actuarial value of the liabilities attributable to past service with allowance for future salary increases.

c) The excess of the actuarial value of the total prospective assets, including future contributions over the actuarial value of the total prospective liabilities for existing members.

The last of these is most closely associated with the aggregate method of funding which, until recently, has been the most frequently used for valuations of the largest UK pension plans.

2.5. The view of surplus in a UK Company Pension Plan changed significantly following the Finance Act 1986.

3. THE FINANCE ACT 1986

3.1. The legislation governing the calculation of surplus came into effect on 6th April 1987.

3.2. The main features of this legislation were as follows:-

a) At each actuarial valuation carried out after 6th April 1987 a surplus test has to be made using a method and basis prescribed by the Government. The test involves a comparison of the actuarial value of the existing assets with the actuarial value of the benefits attributable to past service, based on projected final salaries.

b) If the surplus test shows that the value of the assets exceeds the value of the past service liabilities by more than 5%, then the trustees must reduce the surplus to not more than 5% in one or more of the following ways, if the funds are to remain free of tax on investment income:-

   i) by increasing the benefits provided by the plan, subject to Revenue limits

   ii) by reducing the level of the employer's and/or the employees' contributions for up to 5 years

   iii) by a refund to the employer to the extent that the remaining surplus is at least 5%.

c) Tax at the rate of 40% is payable on any refund of surplus to the employer (unless the employer is a charity) and it is not possible for the employer to offset this tax in any way.

d) If the surplus is not used as in b) above then the investment returns on the excess part of the funds will no longer qualify for tax exemption. In some cases this approach can be more advantageous than c) above.

4. THE RATIONALE FOR THE LEGISLATION

The Government's stated aims for this legislation were:-

a) While Trustees should be able to maintain a fund sufficient to meet a plan's accrued liabilities together with a reasonable contingency margin, excessive surpluses should not be built up.

b) Where an 'undue' surplus has accumulated there should be clear rules for reducing it to a reasonable level.

c) A refund of surplus to the employer should be available under the legislation where the Trustees consider it desirable or necessary, for example to avert a cashflow crisis or to aid expansion, but there should not be tax incentives for overfunding.

5. THE PREVIOUS POSITION

5.1. Prior to April 1986 the Revenue had the power to require a surplus to be reduced.

5.2. The early 1980's had seen a period where investment returns had exceeded the rate of salary inflation by a large margin and thus, in general, final salary schemes had moved from a low funding level to a relatively high funding level.

5.3. The main problem was that it was very difficult for the Revenue to decide whether a plan was overfunded as actuaries used a wide variety of assumptions and bases and no one basis or method was required as the norm. For example, from method c) in 2.4 it can be seen that it was very easy to eliminate 'surplus' simply by reducing the future rates of contribution taken into account. Thus there was inadequate control over the size of the existing pool of money on which tax reliefs had already been granted.

5.4. A refund of 'surplus' to the employer was normally only permitted if other measures would not reduce the funding position to a more reasonable level within a relatively short period of time. Also, the rules of the plan would have to allow for a refund to be paid.

5.5. Thus the request for a refund to the employer often resulted in some protracted negotiations with the Revenue.

5.6. Unfortunately the Revenue's decisions did not always appear to be consistent .

5.7. In retrospect it was appropriate that guidelines should be set; although at the time they came as a surprise to the pensions industry, and some aspects are still unsatisfactory.

6. VALUATION GUIDELINES UNDER THE FINANCE ACT 1986

6.1. The funding method to be adopted is the Projected Accrued Benefit method. Under this method the value of the investments is compared to the value of benefits based on service to the valuation date and final salaries projected to retirement date.

6.2. The intention is that a consistent basis should be used from valuation to valuation to enable the progress of the plan to be monitored. The main actuarial assumptions to be used are detailed below but other factors can be included (e.g. allowance for turnover) provided they are appropriate to the circumstances of the plan.

6.3. The main actuarial assumptions for valuing the liabilities are as follows:-

a) rate of interest - 8½% per annum

b) the difference between the rate of interest and the rate of general salary inflation - 1½% per annum

c) the difference between the rate of interest and the rate of increase to pensions in payment:-

   i) 2% - if pensions are guaranteed to increase in line with the retail price index (RPI)

   ii) 8½% less the actual guaranteed rate of pension increase if pensions have a fixed guaranteed rate, but the difference must not be less than 2%

   iii) if discretionary pension increases are provided under the rules then allowance should be made as in (ii) above but the difference should not be less than 3%.

d) Salary scale - a specific scale may be used or an allowance of up to 1% per annum may be deducted from the net yield in (b) above.

6.4. The assets of the plan are valued by discounting future income at 8½% p.a. Income from variable interest investments other than indexed gilts e.g. equities is assumed to increase at 3½% p.a. The income that is discounted may be that generated by the assets actually held or that generated by an appropriate standardised portfolio.

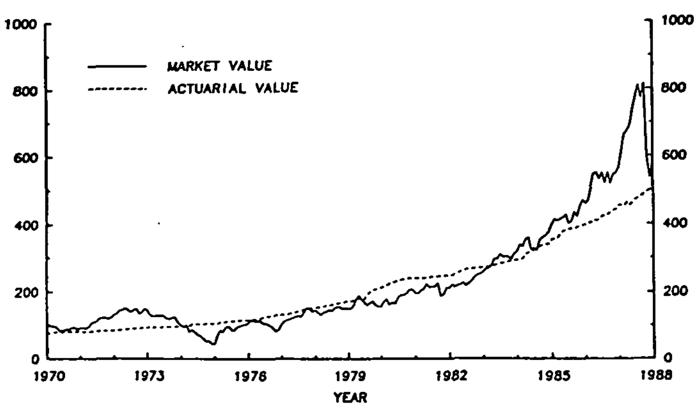
6.5. The intention is that the actuary should select a standardised portfolio which is, in his opinion, appropriate to the liabilities of the plan.

6.6. In the case of a final salary pension plan where the pensions in payment are increased by almost the full increase in the RPI a standardised portfolio which involved 100% investment in UK equity shares might be appropriate. In this case the standardised portfolio would probably be invested in the shares underlying the Financial Times - Actuaries All-Share Index.

6.7. The use of an actuarial value of assets instead of the market value ensures that the determination of the surplus position is not influenced by the day to day fluctuations of market value. For example, from the end of September 1987 to the end of December 1987 the Financial Times - Actuaries All-Share Index fell by 28% but the actuarial value of the standardised portfolio would have increased by some 4%. In particular the actuarial value of the assets on the basis of 100% investment in this index would have been 60% of the market value of the assets at 30th September 1987 and 86% of the market value of the assets at 31st December 1987.

6.8. The following graph compares the market value of the shares underlying the Financial Times-Actuaries All-Share Index with the corresponding actuarial value over the period 1st January 1970 to 31st December 1987.

GRAPH COMPARING THE MARKET VALUE OF THE SHARES UNDERLYING THE FINANCIAL TIMES-ACTUARIES ALL-SHARE INDEX WITH THE CORRESPONDING ACTUARIAL VALUE OVER THE PERIOD 1st JANUARY 1970 TO 31st DECEMBER 1987



7. EFFECTS OF THE LEGISLATION

7.1. The Finance Act 1986 effectively sets an upper limit on funding bases as funding on a stronger basis would mean that the plan often broke surplus limits.

7.2. In general, Companies are, understandably, preferring to keep the funding level of their plans below the maximum allowed in the surplus test. This has resulted in:-

a) a tendency for pension plans to be funded on the projected unit credit method rather than the aggregate method or the entry age normal or attained age methods.

b) a weakening of the actuarial basis.

7.3. In the longer term this weakening of the funding position might result in lower pension increases and, if investment conditions worsen, in a trend towards money purchase plans.

7.4. Funding on a basis consistent with the surplus test can lead to conflicts with the proposed UK accounting standard, currently ED39. In addition, the surplus test is not consistent with the US accounting standard FAS 87.

7.5. A company may only have a refund of surplus if it has a surplus under the Finance Act 1986. However a plan which does not have a surplus under the Finance Act 1986 may still have a surplus on an appropriate basis and thus the Trustees may still be able to provide benefit improvements or be able to allow the Company to have a contribution holiday.

8. OWNERSHIP OF THE SURPLUS

8.1. In a UK final salary pension plan where the Company pay is the balance of the cost the surplus may be said to belong to the Company. The rationale that if the Company has to pay additional contributions when times are bad and investment returns are low then this implies that the Company should reap the benefit when times are good.

8.2. Not all members or Unions take the view expressed in 8.1. above. They feel that if times are bad the Company would stop the plan or raise the member contribution rate. Therefore there is sometimes pressure on a Company to 'share' the benefit of the surplus with the members.

8.3. In some cases the Company wishes to use part or all of the surplus for the direct benefit of the members.

8.4. Another factor has to be considered if the Company wishes to have a refund from the pension plan rather than a reduction in contributions. Most pension plan trust deeds prohibit the payment of monies from the plan to the employer. It is often considered reasonable for the trustees to agree to a change in the deed to allow a refund to the Company if, in turn, the Company agrees to using part of the surplus in providing additional benefits for the members.

8.5. Ownership of surplus can also come into dispute on the sale of part of a Group of Companies where the Group Pension Plan is in surplus.

9. USES OF THE SURPLUS

9.1. Corporation tax in the UK is currently below 40% and falling. Companies receive tax relief at corporation tax rates on allowable contributions to pension schemes. As described in 3.2.(c) any refund to the employer is taxed at 40%. In general it is not in the Company's interest to have a refund of surplus and a Company would normally prefer to reduce the surplus by means of a Company contribution holiday.

9.2. If the surplus is to be used for the benefit of members it is appropriate that it be used to improve benefits in relation to past service. Any improvement in future service benefits would lead to an increase in the Employer contribution rate in the future once any contribution holiday ends. In addition, the surplus has arisen in respect of contributions made in the past and it is therefore reasonable that benefits in respect of past service should be improved.

9.3. In some cases the Company has benefited from the whole of the surplus and in other cases the members have benefited from the whole but in general there has been some sharing of the surplus. A survey carried out indicated that, on average, over 50% of the surplus benefited the Company and under 50% directly benefited the members.

9.4. When considering the members' share of the surplus, a higher priority is usually given to the provision of increases to pensions in payment, than to the provision of increases to in-service members' benefits or to a temporary reduction in members' contributions.

10. CONCLUSION

10.1. The aim in this paper has been to describe the background to the treatment of surplus in a UK Company Pension Plan and to highlight some of the issues arising.

10.2. The main points to emerge are that the Finance Act 1986 has focused attention on funding methods and surplus. It has reduced funding flexibility but has enabled refunds to be obtained more easily. Initially Companies have benefited directly from the larger share of a pension plan surplus, with members having some benefit. However, there is a concern that the lower funding level could lead, in the longer term, to reduced benefits being paid. This would probably be seen in lower increases to pensions in payment and a move away from final salary plans to money purchase.