



Surplus Flexibilities for Defined Benefit Pension Schemes: Unlocking Value for Employers and Scheme Members

Isio response to the DWP consultation
02 September 2026

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Document classification: Confidential

Isio response

Executive summary

Isio supports the approach being taken by DWP to allow employers with well-funded defined benefit schemes to maintain important protections for members when releasing surplus to employers. We consider that the proposed combination of actuarial certification, trustee involvement and regulatory oversight should provide a robust framework that delivers a shot in the arm to DB schemes.

Release measure - We agree that low dependency is an appropriate level above which surplus can be released – provided it is used in tandem with an assessment of employer covenant strength and the other safeguards being suggested. Realistically, we expect trustees will apply surplus buffers so there is ample headroom to accommodate future funding volatility.

Trustees' role - We fully support the central role that trustees will have in determining when to release surplus. We expect the forthcoming guidance from The Pensions Regulator will help steer trustees through the decision-making process, with a focus on having appropriate safeguards so that surplus release does not materially reduce benefit security (rather than seeking to negotiate large member enhancements).

Member notification requirements - We have some suggestions for improving the process put forward by DWP for the member notification. This is currently geared towards one-off payments, which would result in repetitive communications and appears unwieldy. In practice, we expect to see surplus frameworks being agreed that may result in a longer series of releases if certain tests or requirements are met. Such approaches would be better served by adding more flexibility into the proposed notification process.

Member payments - We welcome the creation of a new type of lump sum payment to members above normal minimum pension age and to deferred members. Making the authorised member surplus payments practical to award and administer for members that are yet to retire is key. We note there is a separate consultation on this topic.

In a similar vein, it raises numerous issues relating to how the new payment will interact with the usual rules around pensions, early/late retirement factors, whether it can be taken as a pension commencement lump sum and whether it will be possible for members to transfer it. We would want to avoid situations where schemes are left with modest separate pots for small lump sums.

Certification requirements - The proposed three year look forward is an appropriate look-forward period, but as described in the draft regulations appears to place actuaries in an awkward position

because it is unclear on the level of analysis required to satisfy the requirements. The proposed specification for "on each and every day over the next three years" may be construed as introducing a requirement for stochastic modelling.

We think the regulations should be amended to clarify that the test should be carried out on a deterministic basis that uses actuarial assumptions which are consistent with the scheme's expected future funding position. This should be sufficient for the actuary to certify that the scheme meets the low dependency funding requirement at the specific point relating to the refund and would be expected to do so in three years' time. This would also be broadly consistent with the approach undertaken for Schedules of Contributions and Recovery Plan certification.

Surplus as employer contributions – Beyond this consultation, but still relating to the use of surplus, we think it would be helpful if legislation could facilitate surplus use specifically to fund future contributions in a separate pension arrangement. Allowing surplus funds to be passed directly as contributions into another vehicle sponsored by the employer, be it a defined contribution (DC), collective DC (CDC) master trust, stand-alone trust (including other DB schemes) or to a group personal pension, would make it easier for employers to reallocate historic pension contributions to current employees. We understand that legal views differ on whether this is possible under existing legislation and clarification that it is possible would be welcome.

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

This appears reasonable and consistent with terminology used elsewhere in pensions legislation, but the definition would benefit from TPR guidance making clear that, depending on the circumstances, "appropriate advice" should include covenant, investment, legal, actuarial and contingent asset advice, not solely advice on asset values and liabilities.

TPR's guidance has an important role to play in driving the right behaviours so schemes can successfully execute surplus release. This should be consistent with the legislative objective of only releasing surplus in the context of safeguarding members' existing benefits.

Given TPR's recent (21 August) [amendment](#) to its statement on operating surplus flexibilities, it should take great care not to give trustees unrealistic expectations of how far they should attempt to negotiate benefit enhancements (including illustrations with very material releases to members). TPR's final guidance should be consistent with the legislation and the general purpose of the trusts so that it does not discourage sponsors from supporting schemes to run on, by implying a requirement for trustees to negotiate or ensure a minimum level of additional member benefit.

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

We think it best that the regulations avoid prescribing a single model by which discussions about surplus release are initiated and consider it preferable to allow trustees and employers to agree a process that is appropriate to the scheme's governance arrangements, trust deed and rules, and wider circumstances.

We generally consider that this scope is clear in terms of payment of surplus to the employer.

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

We believe it would be fine to exclude Regulatory Own Funds from the scope of the power, but it may be reasonable to omit them completely if TPR can establish if there remain any such funds available.

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

We support the proposed approach which does not require audited asset and liability values in order to meet the requirements of the actuarial assessment.

However, we are not sure that the move to using a low dependency funding basis (LDFB) is entirely effective. If the Government intends that this is the objective, as seems to be implied by regulation 5(4)(b)(ii), it needs to be made clear that this should be consistent with the approach to setting the LDFB for the purposes of the Statement of Strategy, rather than solely for this legislative purpose.

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

We believe using a LDFB basis is a sensible approach, assuming the intention is to set a minimum funding level for consideration of surplus release. We don't think the protection of a further margin (above the LDFB basis) before surplus can be released is necessary in statute, and we consider that this is something that should be determined by trustees according to the circumstances of their scheme. In some cases, they may require more of a cushion, but in others they may be comfortable at levels close to a low dependency level.

The strength of covenant support will be a key factor in trustees' decisions, and in practice trustees will likely only consent to release with the presence of some margin. There should be a clear expectation that Trustees should consider covenant as part of their decision-making, and we understand that TPR will set out further guidance providing more detail on their expectations of trustees on this point.

In practice, the advice received by trustees (on funding, investment, covenant, balance of powers and legal points) will determine how much surplus is considered for release. TPR's guidance can help trustees correlate buffers to scheme-specific details and any improvements to benefits, so that schemes are able to release surplus while maintaining security.

Under draft regulation 8(1)(b) the trustees cannot proceed if they do not receive an actuarial assessment showing that assets exceed liabilities on the LDFB. In principle, this seems reasonable - subject to our comment in response to Q4 above, about the LDFB being appropriately defined.

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 core process is understandable, but in places it appears overly prescriptive. We support a practical framework in which trustees obtain an actuarial assessment, consult the employer, notify members, obtain final certification and then make any payment. However, we feel the regulations should focus on the outcomes to be achieved rather than prescribing a strict sequence and suggest that the DWP make

clear that the regulations set the required safeguards, not a fixed order for each procedural step.

We note the helpful flexibility provided by the effective date of the actuarial assessment being capable of being any date – there is no requirement for it to be within a certain period of the payment to the employer. There is a case for introducing a time limit, with the actuarial assessment not taking place before the effective date of the last completed actuarial valuation. This, together with the further assessment for the actuarial certification just prior to payment ought to provide adequate protection.

Another improvement would be if the legislation could make it clear that the final payment to the employer could be different to the amount proposed under draft regulation 8 (even if the amount is capped at the proposed amount communicated to members under draft regulation 11). For instance, if just before the date of payment, market movements meant that the trustees might be more comfortable making a refund of a lower percentage of the amount originally proposed. It would be sensible if this is possible without going through the process again, including further notification to members. This flexibility would be particularly valuable if it were possible for the notification to set a decision to make a sequence of payments over a period of time.

A further improvement would be if the legislation could allow for a 'formula approach', so that the notification to members outlines how the surplus to be distributed would be calculated, without providing a specific monetary amount (or amounts).

We consider that further thought should be given to an alternative, more workable framework for regular distributions, which might, for instance, require the actuarial certificate to be given before each surplus release. The remainder of the process, particularly the 3-month member notification requirement before every surplus distribution, could be scaled back to a framework for regular distribution that is agreed between trustees and employer, e.g. a shorter member notification requirement where members have previously been notified about the agreed framework. TPR guidance could then include expectations of a governance framework for any agreements regarding regular distributions.

We think trustees would be more likely to agree to smaller regular surplus payments under a framework where each payment is only made if agreed safeguards are met at the time. The combination of a disproportionate member notification process for regular payments and trustee reluctance for one-off payments could potentially mean fewer schemes choose to run on and instead opt for risk settlement.

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

The actuarial certification requirement is clear, but the five-working-day payment requirement may prove difficult to operate in practice, given the variety of trustee governance, asset liquidity, banking processes, administrator involvement and employer-side approvals that schemes would have to navigate.

We would suggest replacing the fixed five-day requirement with a longer period, or wording such as “as soon as reasonably practicable” and within a specified maximum period, provided the trustees remain satisfied that no material change has occurred which would compromise the actuarial certification.

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

The wording “at any given time during a three-year period... the value of the scheme’s assets is at least as likely as not to be greater than the amount of the scheme’s liabilities...” can be interpreted as allowing a deterministic approach to certification. However, we think it can also be read as requiring more time-consuming stochastic projections, with the phrase “at any given time during” the period potentially being interpreted as meaning “throughout” the period. That would be a much more onerous test if the requirement was to be expected to remain above the threshold on every day of the period, allowing for typical levels of volatility under a stochastic model.

The certification and forward-looking assessment process should be proportionate and designed to avoid duplication of work already completed during the scheme’s existing funding and valuation work. As such, clarity on the test being a deterministic check at the end of the period based on consistent assumptions should be reflected in the final drafting.

We support the three-year test remaining in legislation as a baseline statutory safeguard, with TPR guidance setting out how trustees and actuaries can consider covenant, investment, demographic and endgame risks over longer periods.

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?

Our interpretation of the draft regulations is that they most naturally cater for scenarios where there is a decision to release surplus as a

single payment, and there would still be a substantial surplus against the low-dependency funding basis after the release.

But where a release of surplus would leave the scheme with a small margin above the LDFB, we think it would be more appropriate to allow some flexibility, so that the amount released could change between agreement of the provisional amount and the payment.

It would be more practical to allow for trustees and employers to agree a lower amount to be paid at the final stage, given that a significant amount of time is likely to elapse between the original agreement (and actuarial assessment under regulation 5) to the payment being certified. This would allow a lower amount to be paid without requiring the process to restart and could be achieved by amending the draft regulations to specify that the provisional amount is the maximum that will be released.

Where a staged release of surplus is intended it is not clear to us that the draft regulations offer sufficient flexibility in their current form. As noted above, the time from the agreement to later payments will be even longer so the facility to pay a different (lower) amount if the situation changes without restarting the process is likely to be helpful. It is not clear whether the regulations as they stand would require the trustees to obtain a new actuarial assessment under regulation 5 each time they wish to exercise their power, or whether the same assessment could be used for multiple exercises. We also note that there is no requirement around how recent the actuarial assessment must be. Specifying that the actuarial assessment must at least be the most recent funding valuation in regulations would be suitable.

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

We do not object to inclusion where all liabilities for the relevant member, beneficiary or estate have been secured or paid in full and trustees have taken appropriate advice. The draft regulations impose those conditions for earmarked schemes.

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

The notification requirements are clear and recognise the importance of transparency where surplus is released from a pension scheme.

However, as per our response to Q.6 in relation to a framework for regular surplus release, we are concerned that the 3-month notification requirement would be very cumbersome to carry-out on a regular (e.g. annual) basis, with no clear benefit in practice if there is no material change in scheme circumstances.

We also note that the requirement is for notification, rather than consultation (which we support). However, where there is feedback

from members to the notification, trustees might understandably decide to pause the process whilst they consider the feedback. This could potentially push timings back and mean that the target date is not met. It would be helpful if clarification could be included as to whether there can be any flexibility in the ultimate payment date (beyond the communicated "target date") provided that the Regulation 9 actuarial certificate has been provided.

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

The draft regulations require notification within "one week". We think it would be preferable for this to be at least "10 working days" or "as soon as reasonably practical" with TPR providing further information in guidance.

It would be helpful if either the regulations or TPR guidance clarified that the information in 12(a), (b) and (c) is all intended to be taken from the actuarial assessment under draft regulation 5.

The consultation states TPR will provide further guidance on the notification, but where trustees and employers follow the regulatory process, we would not expect TPR to have any call to follow up or respond to such a notification. Responses should be limited to cases where there are regulatory concerns. Schemes will want confirmation that where they are acting in line with the regulations and guidance, they will not experience additional regulatory engagement after the event.

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

The rules for sectionalised schemes appear workable and the clarification that the modification power can be used by sectionalised schemes is welcome. The draft regulations appear to carry forward the basic approach, under which a multi-employer scheme can be treated by reference to separate sections where contributions and assets are segregated. This appears to meet the intention to allow sectionalised multi-employer schemes to use the new surplus powers as if each section were a separate scheme, avoiding the need to rewrite restrictive scheme rules (and the rules of specific sections) which is welcome.

Where sectionalised arrangements are intended to operate as separate schemes for surplus purposes, it would be helpful if DWP and HMRC could clarify the position where an individual section is winding up but the wider scheme continues, particularly regarding authorised surplus payments.

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

No comment.

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

We support the proposed additional flexibility for authorised member surplus payments, that will provide trustees with another option to ensure that members can receive surplus distributions without increasing schemes' ongoing liabilities. However, our preference is to provide trustees with as much flexibility as possible so that they can use deferred awards in the most appropriate way for their specific circumstances.

Examples where trustees would benefit from additional flexibility are:

- Where the payment of a deferred award immediately on a member reaching NMPA may be more difficult than paying it at retirement for administrative reasons.
- The ability to set how the authorised lump sum payments revalue (if at all) and when they are paid (provided they are not paid before NMPA).
- Allowing lump sum distribution to members under NMPA to be provided on a money purchase basis.

The potential payments also raise numerous issues relating to how the new payment will interact with the usual rules around pensions. For example, will early/late retirement factors be applied, can it be taken as a pension commencement lump sum, and will it be possible for members to transfer it.

We would want to be careful to avoid situations where schemes are left with modest separate pots for small lump sums.

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

We believe the draft Regulations are clear on how deferred awards affect members' statutory right to take a transfer value.

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 do not anticipate any issues because of this.

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

No comment.

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

The proposed certificate in the Schedule captures most of the relevant details, but it could also include the pension scheme registration number, as required on most notifications to TPR.

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