Options for DB schemes – call for evidence.

Options for Defined Benefit schemes: a call for evidence - GOV.UK (www.gov.uk)

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Executive summary

- We welcome the DWP's call for evidence and are encouraged to see the Government looking at creative options for improving the operation of DB pension schemes.

- We believe that the Government should look to develop proposals that would make it easier for DB schemes to allow refunds of surplus to be paid on an ongoing basis. Any refunds should be coupled with the provision of a benefit improvement for members. This would incentivise both trustees and sponsors to run-on DB schemes. This would also require a change in the focus of for trustees and regulators from purely looking after existing benefits to one that incorporates recognition of benefit improvements.

- The consolidation of DB schemes is a good idea and should be encouraged. We already see the success of operational consolidators, which allow DB schemes to be run more effectively, and bulk insurers, which allows member benefits to be secured in full and transferred off sponsor's balance sheet. Commercial superfunds should be given both time and support, via a formal and balanced regulatory regime, to establish themselves as a third option.

- We do not believe that there is a need for a public consolidator to be established. A public consolidator is likely to distort the pensions market if it can offer terms that are not commercially viable or expose the taxpayer to unreasonable risks. Equally, a public consolidator would probably introduce regulatory arbitrage, with the potential for gaming of the system that leads to members and sponsors who start in the same position getting different outcomes on price or protection.

- We believe that allowing ongoing refunds of surplus and greater consolidation would lead to DB schemes setting slightly higher investment return targets, compared to the existing regime which encourages lower risk and return strategies. However, this is unlikely to increase investment in UK productive assets, other than at the lower risk end of the range (e.g. private debt) and with schemes more likely to invest on a global basis.

- If the Government is keen on increasing investment in UK productive assets, we would suggest that they should look to make it easier for insurers to hold these assets and look to take steps to make these assets more attractive for pension schemes to invest in.

We would be happy to expand on any of our answers and meet with DWP to discuss our experience and views.

Question 1: Do you agree with the assessment of the position? Is there evidence to the contrary?

- It is true that UK DB schemes have been moving to invest in assets with lower risk/return characteristics. This has primarily been driven by regulation that has pushed trustees to prioritise member benefit security and reduce downside risks.
- In addition, DB Schemes have been increasingly closed to new members or further accrual. This results in DB Schemes being seen by sponsors as more as a legacy financial issue than an HR issue. Sponsors prefer less volatile contribution rates which lower risk investment strategies ought to promote.
- As most closed DB schemes are on a journey towards transferring to an insurance company, most of the asset classes being referred to as "productive assets" are not attractive in this context, given their high risk levels and illiquidity.
- HMT are currently reviewing the solvency rules that apply to UK insurers. If these changes result in it being more attractive for insurers to invest in "productive assets" then it would make it easier these assets to be accepted as part of a bulk insurance deal. For maturing DB schemes, who are focussed on transferring to an insurer, this should help to reduce one of the main downsides of holding these assets (i.e. their illiquidity and inability for insurers to accept them).

Question 2: What changes might incentivise more trustees and sponsors of DB schemes to consider investing in productive assets while maintaining appropriate security of the benefits promised and meeting their other duties?

- In the first instance, trustees and sponsors would need to be encouraged to adopt higher risk/return investment strategies.
- The funding and investment rules would have to be amended to promote the acceptability of higher investment return targets and longer investment time horizons. The draft funding code would be the place to start, particularly the treatment of open schemes and the targeting of a low dependency investment allocation at the point of significant maturity.
- Trustees and sponsors would need to be incentivised to increase investment risk. This could be achieved if well-funded schemes could, on an ongoing basis, be given the power to refund surplus and increase benefits. This would require legislation that overrides scheme rules and which moves trustees focus from singularly protecting existing benefits to allow a wider view that includes the potential for future improvements for current and future pension scheme members.
- Aligning the taxation of pension surplus with corporation tax would make building up a surplus more attractive for sponsors.
- Such changes would help some DB schemes to increase their level of investment risk taking and lengthen their investment horizon. However, this wouldn't necessarily increase investment in UK productive assets. To do this would require further incentives to make these assets more attractive (relative to all other asset classes). Ideas might be for schemes that invest above a minimum % investment in UK productive assets to pay lower TPR/PPF levies, have lower surplus tax rates, use lower funding trigger levels for surplus, etc.
- CDC schemes would naturally have an incentive to invest more aggressively than DB schemes do currently. Assuming there would only be a small number of whole-life CDC arrangements, they are going to have large amounts of asset under management, so are more likely to be able to allocate larger holdings to UK productive assets.

Building surplus

Question 3: How many DB schemes' rules permit a return of surplus other than at wind up?

- In recent history, we are not aware of any schemes that have returned a surplus to the sponsor other than on winding up. In our experience, some DB schemes have specific exclusions with fewer having explicit permissive wording. It is more common for rules to be silent on returning surplus before a wind-up (which should be sufficient to mean it is possible) so the barrier appears to be lack of precedent cases and typical adviser/trustee views that insuring the minimum legal benefits and winding-up as soon as it is affordable is preferable.
- We note that some DB schemes also have restrictions on returning surplus on wind-up, e.g. the trustees have a discretion to enhance benefits prior to any surplus being paid to the sponsor or where they are required to do this. This can lead to sub-optimal outcomes e.g. 'stand-offs' where employers are not willing to trigger wind-up as the Trustee will then be required to use all of the surplus to improve member benefits.

Question 4 What should be the conditions, including level of surplus that a scheme should have, be before extended criteria for extracting surplus might apply?

- The exact metrics would need to be considered, but in our view the principle should be that after payment of the refund of surplus (and any accompanying benefit increase for the DB members) there remains a high probability of remaining well funded on an insurance basis over the medium term. Many schemes are already funded at such levels and others would be expected to approach it more quickly if they invested in higher expected return/risk assets.
- A simple interpretation would be to set this as a minimum buyout funding level (e.g. 90%, 95%, 100% funded) following the surplus refund/benefit improvement being granted.
- Clearly, when setting any minimum level, there is a trade-off between any reduction in the probably of members receiving their benefits in full against making it more attractive for sponsors to continue to run a scheme on to potentially receive a refund of surplus. The lower the bar the more relevant the covenant of the sponsor would be to the regime.
- A more complex approach, which could better capture the level of investment risk being taken, would be to use a stochastic model and set a minimum % chance of remaining over the target buyout funding level over a longer period. For example, there would need to be a 95% chance of being 95%+ buyout funded over a 5-year period after the refund/benefit improvement. This approach could be simplified, by applying a stress test to the assets/liabilities rather than a stochastic analysis.
- In practice, any 'buyout basis' would probably need to based on prices relative to gilts/ bonds to do this sort of calculation. PPF assumptions could be used as a proxy if a standardised basis is preferred. It would also be worth considering TPR's regime for Superfunds, which does a similar calculation to define minimum capital requirements.
- Equally, consideration would need to be given to the other regimes that would be in force (e.g. the superfund regime) to avoid any potential regulatory arbitrage. We would recommend that any proposals that are brought forward are discussed with the industry to ensure they are practical and avoid any unintended consequences.
- Given the complexities within DB scheme rules, there would need to be a statutory override introduced to make this approach work in practice.
- To recognise the unique situation and history of each scheme, we would recommend that the split of any surplus in an ongoing scheme between benefit improvements and a refund

should be down to negotiation between the sponsor and trustees. We would expect TPR to provide guidance on the issues that should be considered in reaching agreement and in any associated certification or reporting.

Question 5: Would enabling trustees and employers to extract surplus at a point before wind-up encourage more risk to be taken in DB investment strategies and enable greater investment in UK assets, including productive finance assets? What would the risks be?

- Yes, in our view enabling employers to extract surplus before wind-up would encourage more risk to be taken in DB scheme investment strategies.
- While investment strategies may target higher levels of return, they are still likely to invest in a relatively prudent manner to avoid any deficit emerging. As such, it is unlikely that they would invest significantly in productive finance assets. If they did, it would probably be at the lower end of the risk spectrum, e.g. private debt. Without any incentive for favouring the UK over the rest of the world (beyond the currency alignment) it is likely that most schemes would invest in productive assets on a global basis.
- The most plausible, and fair, way to share surplus would be gradually e.g. a series of small employer refunds each accompanied by a benefit improvement for DB members as and when they can be afforded. This can only be plausibly achieved before entering wind-up.
- Our understanding is that legislation already allows this in certain circumstances, but we find that individual DB pension scheme rules often preclude it. The most effective new legislation would override such restrictions in individual scheme rules as well as revisiting TPR's regulatory objectives.
- There would be the risk that a DB Scheme pays a refund and grants a benefit increase then subsequently finds that its sponsor becomes insolvent and its funding level is below a level when benefits can be secured in full with an insurer. By having a high bar before any refund could be paid the chances of this happening should be relatively small.
- There would also be the, even smaller, risk of claims on the PPF from sponsors that could have secured benefits in full (or above PPF levels) if they hadn't paid an ongoing refund. However, ongoing DB schemes would still be paying a scheme-based levy (it is unlikely they would be paying any risk based levy) which should help increase the PPF's assets by more than any claims.
- Other implications of any change to the ability to extract surplus from a scheme or the tax applicable to refunds of surplus could have a knock-on impact to accounts of sponsoring employers (e.g. increasing the amount of pension scheme surplus that can be recognised on the company sheet).

Question 6: Would having greater PPF guarantees of benefits result in greater investment in productive finance? What would the risks be?

- In our experience PPF benefits are of greater concern for schemes with weak sponsor covenants. We expect that schemes with stronger sponsor covenants are the ones that would be most likely to invest in productive finance over the long-term rather than insuring benefits (and improving the level of PPF benefits would not change this). Our view is therefore that having greater PPF benefits would not materially increase investment in productive finance.
- If the PPF were to guarantee benefits in full, this would introduce significant moral hazard risk, as there would be no incentive for trustees to manage funding or investment risks. The PPF's current structure was explicitly designed to minimise these risks.

- Equally, trustees have to date been informed that they cannot rely on the PPF when making investment decisions, so this would need to be addressed as part of any extension of the existing PPF regime beyond taking on underfunded schemes on insolvency.

Question 7: What tax changes might be needed to make paying a surplus to the sponsoring employer attractive to employers and scheme trustees, whilst ensuring returned surpluses are taxed appropriately?

- In our view the legal restrictions to employers benefiting from surpluses is the main barrier rather than the 35% withholding tax charge on refunds.
- Given that most employers will receive corporation tax relief at 25% on pension contributions, our view is that it would make sense for the withholding tax charge on refunds to be aligned with corporate tax relief.
- If this change was introduced, we would expect it to be accompanied by some for of anti-avoidance (or spreading) requirements to avoid the 'recycling' of contributions as surplus.

Question 8: In cases where an employer sponsors a DB scheme and contributes to a defined contribution (DC) pensions scheme, would it be appropriate for additional surplus generated by the DB scheme to be used to provide additional contributions over and above statutory minimum contributions for auto enrolment for DC members?

- This may already be possible for Schemes that have DB and DC sections under the same trust (depending on their specific rules).
- In our view it would be appropriate to make employer contributions for DC members from DB surpluses. Ideally, this should be for any contributions. Changes in legislation to allow DC contributions to be paid to a different trust from the DB scheme or contract arrangement would make this more attractive.
- If the tax rate for paying surplus refunds was aligned with Corporation tax, then making these changes may be unnecessary as a Company would be able to use the refund to offset their DC payments at source.

Question 9: Could options to allow easier access to scheme surpluses lead to misuse of scheme funds?

- In our view this should be manageable (provided that the withholding tax rate is not reduced below the corporation tax rate).

Consolidators

Question 10: What impact would higher levels of consolidation in the DB market have on scheme's asset allocations? What forms of consolidation should Government consider?

- In our view higher levels of consolidation would have a beneficial impact on scheme asset allocation. Asset classes that can be challenging or prohibitively expensive for smaller schemes to invest in could be more appealing if the small scheme joins a consolidation vehicle where having a larger pool of assets enables greater investment options at lower cost.
- DB master trusts are a tried and tested approach for consolidating defined benefit pension schemes. We believe that greater encouragement by Government of these forms of

consolidation would benefit members, trustees and employers by making available a greater range of investments at lower cost for DB pension assets. We have lots of experience operating these arrangements and would be happy to meet with your team (or other civil servants / ministers) to share more detail.

- The Government should be encouraging all forms of consolidation, from existing operational consolidators (such as master trusts, where schemes are run collectively to improve governance and investment efficiency), superfunds and the bulk insurance market. We believe that trustees having more choice and access to a wider range of solutions will ultimately be beneficial to all stakeholders.

Question 11: To what extent are existing private sector buy-out/consolidator markets providing sufficient access to schemes that are below scale but fully funded?

- DB master trusts and pension platforms provide below scale DB schemes access to consolidation whether or not those schemes are fully funded. The cost reduction benefits of these forms of operational consolidation mean that schemes that join are more likely to be in a position to move to further financial consolidation options such as buy-out or superfunds earlier than if they continued as a standalone scheme. Given this, and their status as established forms of consolidation, we believe that greater encouragement of DB master trusts is most likely approach to lead to higher levels of consolidation of DB pension assets.
- As no superfund deals have been done yet, the market is unproven. However, it has been hampered by a very cautious regulatory approach to date and having its pipleline significantly impacted following the rise in interest rates. Given time and regulatory support, we believe a commercial superfund market can grow. If it does start to gather momentum, it is likely to focus on larger schemes to build scale quickly. It may be in the long term that below scale schemes will be included, but it may be many years off.
- The insurance market has been the only consolidation option that allows liabilities to be moved off balance sheet. As the volume of large schemes approaching the insurance market continues to increase, we expect to see it becoming more difficult for well-funded, but below scale, schemes to transact with an insurer. In recent times these schemes have effectively been required to agree exclusivity with an insurer to get a quote.
- While some small fully-funded schemes may find it hard to engage an insurer, we don't believe this causes any significant problems as they may either have to be more patient or, more likely, the market will continue to innovate to develop solutions.

Question 12: What are the potential risks and benefits of establishing a public consolidator to operate alongside commercial consolidators?

- If the public consolidator was to be established and able to offer terms that were more attractive than a commercial provider (e.g. it had an explicit Government guarantee), then it is likely to halt the development of commercial superfunds. As noted in our response to Question 11, we believe that the commercial superfund market is still at an early phase of development and should be given time and support to develop.
- A public consolidator would likely cause wider market distortions to both the ongoing funding regime and bulk insurance market. If it was only made available to schemes that can't access insurance or a commercial consolidator this would come with potential moral hazard risks (e.g. larger schemes being split into smaller schemes).

- The key question with any potential public consolidator of ongoing schemes (i.e. not those where there is an insolvency event) is who would underwrite the risk and what protections would apply to members.
- The Government has always been keen to stress that the PPF is not guaranteed (i.e. if it gets into trouble it can cut benefits). Benefits transferred to a bulk insurer have their capital requirements and ultimately the Financial Services Compensation Scheme to fall back on.
- If the Government was willing to guarantee the benefits being provided by this entity it would make it attractive and put it on a par with insuring (or potentially ahead if it offered better pricing).
- A public consolidator would have to be established and operate effectively, with all of the accompanying operational risks (e.g. administration and customer service, investment management, etc).

Question 13: Would the inception of a public consolidator adversely affect the existing bulk purchase annuity market to the overall detriment of the pension provision landscape?

- Yes, but It would depend on how the public consolidator is designed. If it is designed in such a way that would lead to existing providers ceasing to engage with certain sectors of the industry that might cause detriment to both those sectors (reduction of choice) and to the industry overall (a smaller market and fewer economies of scale for existing providers).
- However, it may be that with the volume of schemes coming to the insurance market smaller schemes will be crowded out of being able to insure and a public consolidator would be an efficient way for them to be transferred off balance sheet and their benefits secured. But this problem hasn't been widely observed and we would expect the industry to look to innovate in response to this challenge.

Question 14: Could a public consolidator result in wider investment in "UK productive finance" and benefit the UK economy?

- Potentially yes, depending on how the consolidator was set up and what restrictions or requirements was placed on its investment strategy.
- However, if the consolidator was more able to invest in such assets compared to other consolidation options, for example due to differences between their regulatory regimes, then it would need to be considered whether those differences were appropriate, fair or might risk unintended consequences.

Question 15: What are the options for underwriting the risk of a public consolidator?

- As noted in the other responses, we would be considered that any public consolidator would distort the market and introduce moral hazard risks.
- However, if a public consolidator was to be introduced, the simplest option would be to provide a government guarantee. It would expose the risk of claims on the government and has the potential to damage the wider market (if it is too easy to access and is able to offer terms that commercial consolidation options can't compete with).
- It could be that, like the PPF, the consolidator is given the ability to reduce benefits (either on a temporary or permanent basis) in certain situations. This would be more aligned with the qualities of a CDC arrangement but would make it a less attractive option (although it could potentially include the option to make benefits improvements too).

- Schemes accessing the consolidator could be charged an explicit entry premium or implicit premium via its terms, which could effectively help fund a reserve to underwrite downside risks. However, this approach would effectively be a public insurer rather than consolidator.
- Although it doesn't feel appropriate, the remaining defined benefit pension schemes could underwrite the risk of a public consolidator. See the reasons set out in our comments to question 17 below for PPF levy payers (effectively a similar group).

Question 16: To what extent can we learn from international experience of consolidation and how risk is underwritten?

- The UK pensions market is sufficiently different in terms of history, the balance between private and state provision and overall scale that comparisons with other countries are probably not that easy or meaningful.

Pension Protection Fund as a consolidator

Question 17: What are the potential risks and benefits of the PPF acting as a consolidator for some schemes?

- Assuming this question is discussing consolidation where the link to the sponsoring employer is broken, then the PPF would take on all ongoing risks in relation to the provision of benefits. This would then give rise to the question of who would underwrite that risk if there is adverse future experience.
- To date, PPF risk is largely borne by PPF levy payers and, ultimately (though theoretically at this stage) by members. It's unclear to us whether that would be appropriate if the PPF were to become a consolidator, e.g. whether it would be perceived that levy payers who remain responsible for their own pension liabilities might end up paying for adverse experience in relation to pension liabilities from other entities that have benefitted from passing those liabilities to the PPF.
- Therefore, if the PPF was to act as a consolidator in non-insolvency situations, we believe it should be done through a separate fund from the existing arrangement. The surplus in the existing PPF fund should be used to reduce (or potentially refund) levies and improve existing member benefits.
- The PPF has a track record in consolidating and operating at large scale so it would be a credible option for consideration as a public consolidator. However, a key decision would be whether ongoing consolidation cases would be replicating existing scheme benefits (as per a bulk insurer) or whether all benefits would need to be converted onto a single (or small selection of) structure (as per the existing PPF).
- As noted in the responses above, we are not supportive of the concept of a public consolidator. If the PPF was able to offer better terms than a commercial consolidator or insurer it is likely to result in material market distortion and moral hazard.

Question 18: Would the Board of the PPF be an appropriate choice to operate a public consolidator?

- There could be a range of options for the operation of a public consolidator. We note the PPF is probably the most aligned existing public body to this role, with considerable experience of UK pensions including successfully operating as an investor and administrator.
- However, a public consolidator of ongoing schemes, would have a different nature from the existing PPF operationally and in terms of the risks being managed. For example, the PPF pays a standardised form of compensation in relation to schemes that enter based on particular events and facts (i.e. a qualifying insolvency event occurs in relation to an

underfunded scheme). Whereas a consolidator might deal with a range of different benefit structures where entry might be optional depending on whether a third party (the former trustees and employer) consider that consolidation will be beneficial to them and their members.

Question 19: How could a PPF consolidator be designed so as to complement and not compete with other consolidation models, including the existing bulk purchase annuity market?

- This would be very challenging. A public consolidator might be less likely to compete with other consolidation models if it focusses on areas of the pensions industry which are more difficult for those other models to serve efficiently. For example, this could be very small pension schemes with either a maximum asset size or membership number applied to gain entry. However, any restrictions would need to be carefully designed to avoid gaming of the system, e.g. larger schemes being split into smaller ones to qualify.
- A public consolidator would likely come up against the same issues that make such schemes difficult for other consolidation models, and those inefficiencies might make it challenging for the consolidator to be able to invest at significantly greater levels in UK productive finance. It may be that the Government would want to make it easier for trustees of eligible schemes to be able to arrange a transfer (e.g. lower advisory hurdles, automatic acceptance based on set criteria, enabling benefit changes to allow common benefit structures, etc).

Question 20: What options might be considered for the structure and entry requirements of a PPF-run public consolidator for example:

• Are there options that could allow schemes in deficit to join the consolidator?

• What principles should there be to govern the relationship between the consolidator and the Pension Protection Fund?

• Should entry be limited to schemes of particular size and / or should the overall size of the consolidator be capped?

• How could the fund be structured and run to ensure wider investment in UK productive finance?

• How to support continued effective functioning of the gilt market?

- The assets that would have to be transferred to join the consolidator would have to be set by the consolidator transparently. Depending on where this level was set, it may be that Schemes who are in deficit on one basis (e.g. buyout) could be able to enter, or may have a sponsor willing to make a contribution to bridge the gap.
- We believe that any PPF run consolidator for non-insolvent sponsored DB schemes should be run separately from the existing PPF fund. They should look to maximise running and investment efficiencies across both arrangements, but the investment funds should be ring-fenced from each other.
- Yes, if this is going to work at all we believe that entry should be limited to smaller schemes, although the overall size of the consolidator shouldn't be.
- The consolidator should be required to act in the best interests of providing members with their full benefits. It may be that in return for providing any guarantee or wider support the government looks for the fund to hold a minimum level of investment in UK productive assets. However, our preference would be for government to work to make these investments more attractive rather than applying restrictions on the consolidator's investment freedoms.
- We would expect any public consolidator to continue to invest in gilts, as per the existing PPF fund and the wider UK pensions industry.