PENSIONS AND LIFETIME SAVINGS ASSOCIATION

OPTIONS FOR DEFINED BENEFIT SCHEMES: A CALL FOR EVIDENCE

PLSA RESPONSE

5 SEPTEMBER 2023

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ABOUT THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION

The Pensions and Lifetime Savings Association (PLSA) is the voice of workplace pensions and savings. We represent pension schemes that together provide a retirement income to more than 30 million savers in the UK and invest more than £1.3 trillion in the UK and abroad. Our members also include asset managers, consultants, law firms, fintechs, and others who play an influential role in people's financial futures. We aim to help everyone achieve a better income in retirement.

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EXECUTIVE SUMMARY

Investing in productive assets

- As is widely recognised, UK pension schemes already invest over £1 trillion in UK assets (equities, Government and corporate bonds, alternatives) and these provide support for the UK economy and society. That being said, we believe it is right that the industry and policymakers should consider whether pensions could play a bigger role.
- We therefore welcome the release of this call for evidence on the options for defined benefit (DB) schemes and support the Government's aim of exploring different ways to incentivise DB schemes to invest more in 'productive assets'. The DB pension landscape has changed significantly over the last two years due to the rise in interest rates and the positive impact this has had on the funding levels of DB schemes, so the time is right to examine whether pension assets are working as effectively as possible for members, schemes, sponsoring employers and the UK economy. Any consideration of this issue must not undermine the fiduciary duties of trustees to invest in the interests of the savers who benefit from the schemes and, at the same time, must maintain appropriate security for members' benefits.
- The scale and distribution of assets across the pensions sector is expected to alter substantially over the next decade, during which time we expect the volume of assets in DC pension schemes to double to around £1 trillion and the value of assets in the LGPS to increase to around £500 billion. The value of private sector DB pension funds is expected to stay roughly the same as today's high value (£1.5 trillion). The opportunities for DB schemes to invest in unlisted equity assets will largely rest with open private sector DB schemes (£321 billion) and open funded LGPS (£400 billion) rather than with closed DB schemes (£1.2 trillion). This potential will be all the greater if a wider definition of UK growth-related assets is used (notably, private credit as well as private equity). (It is also worth noting that the investments that best suit pension funds will be later stage private equity investments due to the high volatility and failure rate of early stage investments.)
- DB pension schemes always need to invest in a wide and diverse range of assets, however as part of a balanced portfolio even the very largest closed schemes would typically not invest more than around 5% in private equity. The illiquid, high risk and uncertain nature of private equity investments are not well suited to closed DB pension schemes. They are in need of more predictable assets, in particular, private market investments such as private credit and government or corporate debt such as might be useful for the funding of UK infrastructure.
- Moreover, a key component of unlocking investment is policy certainty, and setting out a clear plan for the future of the UK economy, for example on the Green Transition or through the national infrastructure plan, which will help draw pension fund investments. Supporting and incentivising domestic investment for critical national infrastructure developments would also be welcome. This is an area where Government itself has a key role to play.
- At present, the vehicles to invest in the UK in the manner sought by the Government do not exist in sufficient quantities. We note that the Government is looking at ways in which the remit of the British Business Bank (BBB) could be expanded to allow it to support companies that need scale up capital, and to create or partner with funds that can bundle up the assets in a form that would potentially improve the opportunity for pension schemes to invest in UK growth assets. We are supportive of the Government's initiative to explore ways in which the BBB can play a greater role in this area and have been facilitating roundtable discussions between the BBB and PLSA members. Indeed, we called for action on this issue in our report, Pensions & Growth: Supporting Pensions Investment in the UK (June 2023).

- A further significant way of attracting open DB pensions to invest in UK private equity would be to provide fiscal incentives, such as the LIFTS regime, and by having the right regulatory environment in place, including exploring the forms of tax incentives that are used in some other countries.
- However, the potential for greater investment by open DB schemes in UK growth assets will not be possible unless additional flexibility is introduced by The Pension Regulator (TPR) into the DB Funding Code for open DB schemes and large closed DB schemes with genuinely long-term time horizons (see our response to Q2 for more details). The draft Code is currently under review, with a proposal to reduce the flexibility available to DB schemes, so it is imperative the Government acts quickly to ensure the new Code, due to be finalised soon and come into force in April 2024, is amended to reflect the Government's aims regarding growth. Given the size of the open private sector DB pensions pool (£321 billion), changes to the DB Funding Code to give certain trustees greater flexibility could potentially result in increased investment in riskier assets.

Building and use of surpluses

- Many of our members (44% of those recently surveyed) are supportive of opportunities to enable sponsoring employers to benefit from a return of a DB fund surplus prior to wind-up, provided adequate protections are put in place for scheme members, such as the DB scheme continuing to be well funded on a low dependency basis. They also hold the view that where schemes operate on a shared cost basis, with contributions coming from both the employer and the employee, it will be important to give full consideration as to how scheme members could also benefit from a surplus.
- We believe that the benefits of introducing a statutory over-ride should be examined to enable employers and schemes to return pension fund surpluses on a consistent basis, subject to adequate member protections (eg. sufficient funding above the scheme's low dependency target, the employer is in a good financial position, and there is a strong employer covenant in place). It will be important however to assess how this may impact the overall balance of powers in scheme trust deed and rules.
- Where DB surpluses are released, we believe that the normal Corporation Tax Rate of 25% should be applied (rather than the current 35% free-standing tax that currently applies to authorised surplus repatriation payments). Given that there are currently £400 billion of assets in pension fund surpluses, this could result in a net benefit to Government, as the tax on the surplus repatriation would be applied at an earlier point than would otherwise be payable when a scheme winds up (where a surplus repatriation may never be realised).
- Also, we believe that consideration should be given to establishing a legislative mechanism by which a DB scheme's surplus could be used to finance contributions to benefit DC members in a different scheme used by the same employer group (or the same scheme in the case of hybrid funds), without incurring tax penalties that arise under the current rules, subject to appropriate conditions around the DB scheme continuing to be funded to an appropriate level. Many of our members (51% of those recently surveyed) are supportive of this proposal.

Consolidators

- There are a number of advantages of DB scheme consolidation, including helping to bring about economies of scale and improving scheme governance. There is no doubt that very large schemes can invest more cheaply in a wider range of assets, including private equity and in illiquid assets typical of private markets. This is because larger schemes usually have greater bargaining power, governance capabilities and resources than smaller schemes.
- DB schemes already benefit from a number of consolidation options: buy-out and buy-in with an insurer; consolidation of administration and other services with a DB Master Trust; and Superfunds, though the latter still awaits a primary legislation under-pin.

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- DB schemes are highly supportive of having a range of options to achieve the "DB endgame", particularly as there is a very large (and growing) buy-in/buy-out queue forming.[1] While the assets in closed private sector DB pension funds amounts to around £1.2 trillion, over the last 5 years the insurance buy-in/buy-out market has averaged around £20-£30 billion per year. Although this year the level of buy-in/buy-out is predicted to be much higher (£45-£60 billion) and the insurance industry believes it should be possible to sustain this level, it is still far below the total demand.
- In this context it makes sense for Government to promote other consolidation options. We believe that DB Master Trusts make sense as a solution for some smaller schemes. DB Master Trusts can help to reduce costs for some schemes by providing economies of scale through pooling governance, legal, actuarial, administration and investment functions.
- We also believe that Superfunds can provide an affordable option for employers, by creating an incentive and achievable goal for them to make a one-off payment to reach self-sufficiency funding levels, without having to pay for the more expensive – and as outlined above capacity constrained – insured buy-out option. Once they have achieved sufficient scale, Superfunds would have more opportunity to invest in productive investments, such as unlisted equity and fixed income.
- We therefore strongly support the introduction of primary legislation for Superfunds as soon as possible, to ensure that the final Superfund regime offers at least the same level of protection to scheme members as the DB funding regime. If primary legislation is not forthcoming, DB Superfunds will cease to be a viable option and consolidation will likely be slower than the Government wishes.
- The views of PLSA members are mixed on whether the Government should establish a public consolidator to operate alongside commercial consolidators. In a recent PLSA survey, only 26% of our members agreed that this would be beneficial, while more members (36%) disagreed. This is no doubt due to the very high-level nature of the current proposals. Some forms of public consolidator might undermine the effective operation of the PPF's compensation arrangements for scheme members but other forms might be complementary.
- Our initial view is that it is too early to establish a public consolidator, given the recent positive changes in the funding levels of DB schemes and the fact that we believe Superfunds would provide a very effective private sector solution, once the Government adopts a primary legislation regime to encourage confidence in them as an option for consolidation.
- If a public consolidator were to be established, we believe it should be targeted at smaller schemes – i.e. those with less than 100 members (which account for 1,836 private sector DB schemes and around £17.4 billion in assets)[2] – that cannot easily achieve buy-in/buy-out. At this level, a public consolidator is unlikely to interfere with the commercial consolidation market. We do not believe there is a need for a public consolidator for larger DB schemes.

PPF as a public consolidator

- The PPF has played a vital role in the UK pensions framework protecting members as an insurer of last resort. It is important that nothing is done to destabilise the current operations of the PPF.
- There are a number of ideas being proposed by various think tanks and commentators about expanding the PPF's remit to take on the role of a public consolidator. At this stage it is unclear which of these proposals is being considered by the Government.

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[1] It's also worth noting that the Bank of England recently sounded a warning about the potential risks posed by the use of reinsurers to pave the way for increasingly popular deals to offload pension liabilities. The Bank warned insurance groups that relying on reinsurers to help meet a surge in demand for corporate pension deals risked creating a "systemic vulnerability" for the sector.

[2] The Purple Book 2022, page 5.

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- In a recent survey of PLSA members, almost half of respondents (48%) said that the role of the PPF should not be expanded to become a public consolidator of DB schemes, with only 18% of members believing it should.
- The PLSA's view is that the role of the PPF should not be expanded to act as a public consolidator unless either:
    (a) It is closely aligned with its current role of providing compensation payments to under-funded DB schemes with no prospect of improved funding levels in the future; OR
    (b) Its role is simply to act as a consolidator for DB schemes that want to consolidate but cannot find a market offering from a DB Master Trust, a Superfund, or through buy-in/buy-out with an insurer.
- If option (b) were adopted and the PPF was to be given the role of being a new public consolidator, we believe that there should be total separation (ring-fencing) between the existing PPF and any new 'PPF II' consolidator. To do otherwise would, in our view, place unreasonable risk on the PPF members and the sponsor levy payers.
- In any event, we believe it is too early to establish a new public consolidator. More time is needed with the commercial consolidators in operation (including DB Master Trusts and Superfunds) to determine what, if any, market failures or gaps exist, before establishing a completely new regime.

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INTRODUCTION / GENERAL COMMENTS

1. The PLSA welcomes measures which improve access to invest in a broad range of assets. Pension schemes will always be interested in exploring investments which have a strong likelihood of generating good returns, within their risk tolerances, and in the interests of their respective members.
2. As is widely recognised, investments totalling around £1 trillion by pension funds in UK assets already support economic growth and are a major source of long-term investment in the UK economy. But at present the vehicles to invest in the UK, in the way (and in the amounts) that the Government would like pensions schemes to, do not exist in sufficient quantities.
3. It is important and very welcome that pension schemes' ability to direct their own investment strategy in the best interests of their members has been protected.
4. Of the roughly 5,300 private sector DB schemes, 505 schemes (or around 10%) remain open to new members and around half remain open to future accrual, representing £321 billion in total assets and 2.06 million members in open DB schemes.
5. Given the robust health and improved funding position of DB schemes in the current higher interest rate environment, it is sensible to review the DB regulatory landscape to ensure the right balance is struck between protecting members' benefits and investing productively.
6. As announced by the Chancellor in his Mansion House speech in July, the Government is exploring various ways to incentivise private sector DB schemes, along with other sectors of the UK pensions industry, to invest more in productive assets. For DB schemes these include:
    - Exploring alternative ways in which DB surpluses can potentially be used – for example, to encourage trustees to take on greater investment risks or perhaps allowing employer-sponsors to use DB surpluses to provide additional contributions (over and above statutory minimum contributions for auto enrolment) for defined contribution (DC) members;
    - Considering whether a public consolidator should be established to operate alongside commercial consolidators such as DB Master Trusts and Superfunds; and
    - Exploring whether the responsibilities of the PPF could be expanded to take on the role of a public consolidator.
7. It will be important for the Government to consider how the combinations of potential reforms can work seamlessly together across the entire pensions framework. To assist with this, we have provided responses to the specific DB-related questions raised in this call for evidence in the following section.

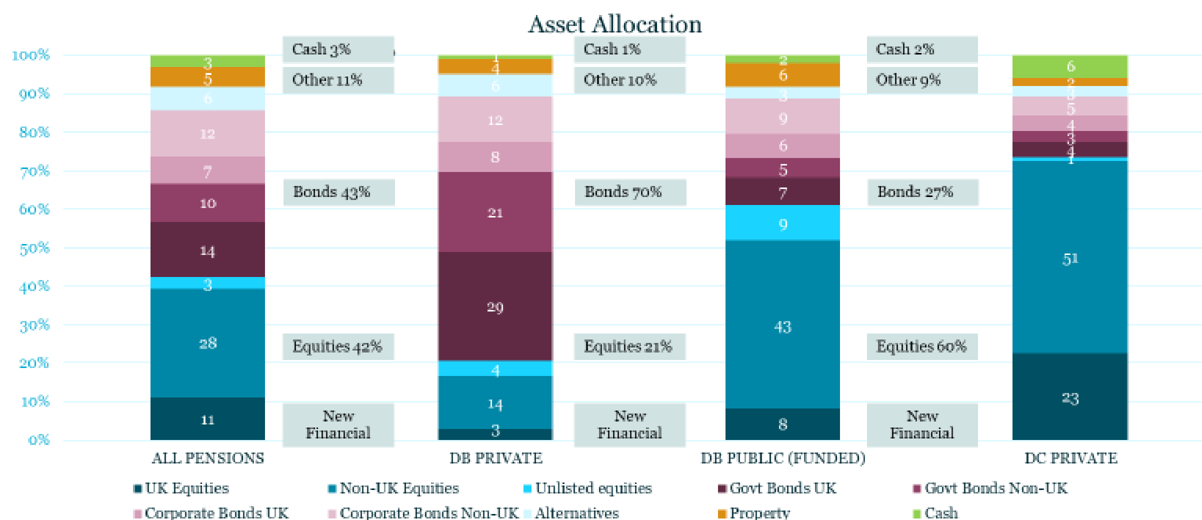
RESPONSES TO CALL FOR EVIDENCE QUESTONS

Investing in productive assets

> **1. Do you agree with the assessment of the position [that DB schemes are underinvested in productive assets compared to international comparators]? Is there evidence to the contrary?**

1. Taking all UK pensions together, assets overall are invested around 42% in equities, around 43% in bonds, with 11% in alternative assets. Looking at scheme types, the chart below shows that for the largely closed DB pension schemes in the private sector, only around 21% of scheme assets are in equities, around 70% in bonds, with about 6% in alternatives. In the case of the open public sector DB funds, the story is very different, with around 60% in equities, about 27% in bonds, and around 3% in alternatives. Finally, in the case of DC schemes, 75% are in equities, around 16% in bonds, and about 3% in alternatives.

ASSET ALLOCATION BY SCHEME TYPE



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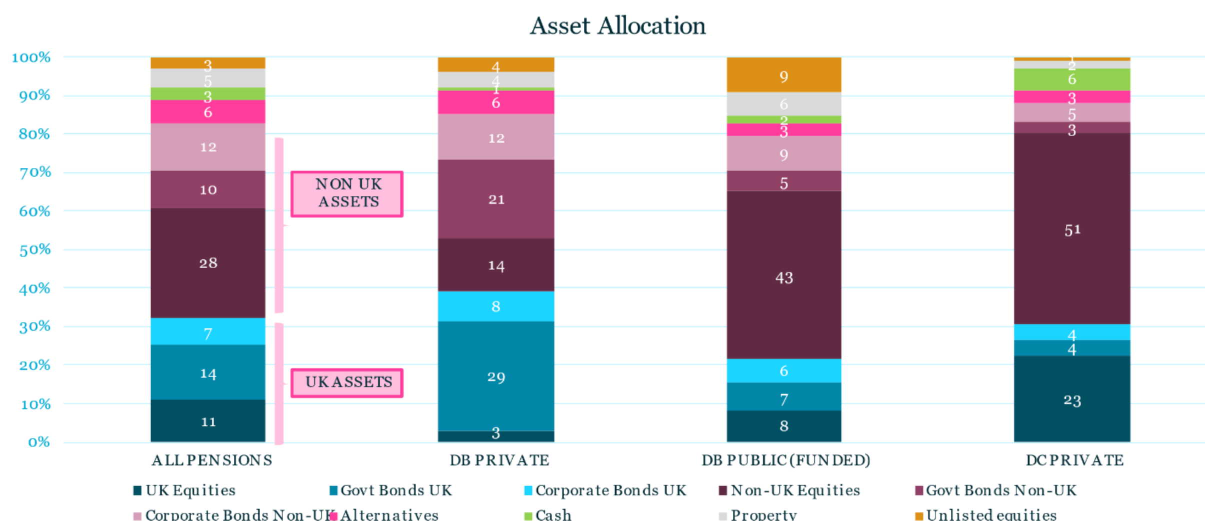
Source: New Financial estimates based on analysis of date from Pensions Regulator, Pensions Policy Institute, Investment Association, Bank of England, Association of British Insurers, HMRC, Association of Investment Companies, ONS, company reports

Note: Numbers might not add up due to rounding.

2. When it comes to which assets are based in the UK, we get a different picture again. At the composite level, about 32% of assets are invested in the UK (equities and bonds), around 50% outside of the UK (non-UK equities and bonds), and around 11% in property and alternatives. In the case of private sector DB (largely closed), the allocation is 40% UK (equities and bonds), 47% non-UK, and 10% in property and alternatives (many of which are UK). In the case of open public sector DB funds, 21% are in UK assets (equities and bonds), 57% in non-UK assets, and 9% in property and alternatives (some of which are UK). Finally, for DC pension schemes, 31% are in UK assets (equities and bonds), 59% in non-UK assets, and 5% in property and alternatives (many of which are UK).

ASSET ALLOCATION: UK VS NON-UK



PENSIONS AND LIFETIME SAVINGS ASSOCIATION

Source: New Financial estimates based on analysis of date from Pensions Regulator, Pensions Policy Institute, Investment Association, Bank of England, Association of British Insurers, HMRC, Association of Investment Companies, ONS, company re

Note: Numbers might not add up due to rounding.

3. Commentators often make generalised statements about UK pension funds' asset allocation containing lower proportions of growth assets, or that they invest less in their national market, than other pension schemes. This does not, however, reflect why there are good reasons for this approach – for example, the choice of asset type (equity, bonds, alternatives) is generally linked to scheme type (DB, DC) and scheme maturity (especially whether open or closed). The Pensions Regulator strongly encourages DB schemes to match liabilities with bonds/LDI, as they become more mature.

4. We would note also the general trend for pension funds around the world, especially in developed markets, to invest more in non-domestic assets during the last 20 years. For example, the 'big eight' Canadian mega pension funds only invests about 14% of their assets in Canada's domestic market.[3] Similarly, the share of Dutch pension funds' investments locally is a relatively low 18.3% (although it has increased slightly from 15.7% since the start of 2022). The UK's experience is in line with this trend and, when compared to 6 other OECD countries with major pension sectors, it is clear that UK pension funds invest in the domestic market, a little above the average.

5. It is worth highlighting that the reasons schemes have shifted their asset allocation are rational. Over the past 20 years we have seen greater globalisation and diversification in investments (eg. the growth of the BRICS as well as other opportunities). In contrast, the UK FTSE 100 Index by comparison has hardly grown.[4] Also, DB schemes have matured significantly and many are now closed to new accrual leading to changes in need (i.e. trustees have taken prudent decisions to de-risk). Indeed, in a recent survey of our DB members, the top 3 reasons given by respondents for DB schemes not investing in unlisted equity were:

    - "We have de-risked our portfolio and do not intend to take more risk again." (46%)

[3] The vast majority of Canada's pension assets (around 86%) is invested overseas, with around 36% invested in the US, 26% in Asia Pacific, 18% in Europe and 6% in Latin America.

[4] On 31 December 2019, the FTSE 100 stood at 7542, just over 600 points higher than the same date 20 years earlier (i.e. 31 December 1999). Price-wise, that equates to an average annual return of 0.4%.

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- “We do not think unlisted equities have the right risk and return characteristics for the objectives of our scheme.” (44%)
- “The trustees are concerned that unlisted equity results in certain high costs but uncertain high returns.” (31%)

6. There have also been various accounting and regulatory changes which have encouraged employers to reduce balance sheet volatility (eg. IFRS 17) and also encouraged trustees to take a lower risk approach to their strategy (eg. managing downside risk).
7. Ultimately, different schemes have different needs. As stated above, DB schemes have matured significantly and many are now closed to new accrual leading to trustees having taken prudent decisions to de-risk. In less mature sectors of industry, and where schemes are still open, the investment profiles are very different. Public sector DB schemes and DC schemes have a very different risk appetite and a much higher allocation to equities (and to UK equities). They each have about 55% of their assets in equities, with around a quarter of that in UK equities. This profile is much closer to the asset allocation of private sector DB schemes 15 to 20 years ago.

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?

8. With the right policy and regulatory initiatives, and support from the right type of fiscal incentives, there is a potential for a win, win, win – for pension savers, schemes and the UK economy.
9. There are a number of things Government can do to facilitate investment in the UK, for example amending the rules applying to the auto enrolment (AE) market, introducing more flexibility in the DB Funding Code for open DB schemes and closed schemes with long time horizons, and supporting the good governance of the LGPS scheme. Fiscal incentives such as LIFTS are also helpful, as is ensuring there is a pipeline of suitable investment assets, including private sector growth-oriented funds.
10. DB pension schemes always need to invest in a wide and diverse range of assets, however as part of a balanced portfolio even the very largest closed schemes would typically not invest more than around 5% in private equity. The illiquid, high risk and uncertain nature of private equity investments are not well suited to closed DB pension schemes. They are in need of more predictable assets, in particular, private market investments such as private credit and government or corporate debt such as might be useful for the funding of UK infrastructure.
11. It is also worth noting that the investments that best suit pension funds will be later stage private equity investments due to the high volatility and failure rate of early stage investments.
12. In a recent survey of our DB members, the top 3 changes that respondents felt might incentivise trustees and sponsors to consider investing in productive assets were:
    - “The Government underwriting some of the downside risk of such assets.” (46%)
    - “The Government adopting a long-term approach to industrial strategy, eg. the Green Transition, to help pension funds identify productive assets.” (37%)
    - “Fiscal incentives (eg. tax breaks) from Government for investment in such assets.” (32%)
13. At present, the vehicles to invest in the UK the way the Government would like pensions schemes to do not exist in sufficient quantities. We note that the Government is looking at ways in which the remit of the British Business Bank (BBB) could be expanded to allow it to support companies that need scale up capital, and to create or partner with funds that can bundle up the

assets in a form that would potentially improve the opportunity for pension schemes to invest in UK growth assets. We are supportive of the Government's initiative to explore ways in which the BBB can play a greater role in this area and have been facilitating roundtable discussions between the BBB and PLSA members within various sectors of the pensions industry.

14. In terms of incentives specifically for trustees of DB schemes, we believe greater flexibility should be introduced by TPR into the DB Funding Code for open DB schemes and large closed DB schemes with genuinely long-term time horizons. With the new Code due to be finalised soon and come into force in April 2024, it is imperative the Government acts quickly to ensure the new Code is amended to reflect the Government's aims regarding growth.

15. Given the size of the open private sector DB pensions pool (£321 billion), changes to the DB Funding Code to give certain trustees greater flexibility could potentially result in increased investment in riskier assets. It is important to ensure that the final funding and investment strategy regulations do not funnel schemes (particularly open DB schemes and large closed DB schemes with genuinely long-term time horizons) into excessive de-risking. In particular, the proposed requirements around having 'highly resilient' asset allocations at the point of low dependency could impact schemes' ability to target returns that could otherwise be expected to generate a surplus. Strong consideration should be given to exempting open DB schemes with strong employers supporting them from the requirement to fund for low dependency.

16. Considering all these barriers are addressed, and DB schemes invest in productive assets successfully, how to use the additional returns provided by these investments, such as the ability to extract surplus in a sensible way, is also a necessary part of the equation.

Building and use of surplus

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

17. The starting point for any discussion between the sponsor and trustees around the use of surplus is the scheme rules. Many schemes' rules allow surpluses to be returned to the sponsor on the winding up of the scheme.

18. However, it is unclear exactly how many DB schemes allow a return of surplus to the employer prior to wind-up. According to the results of a recent survey of our members, a quarter of respondents said that their DB scheme permits a return of surplus other than at wind up (25%).

19. While our survey only represents a small sample of the universe of DB schemes, it would appear that the majority of DB schemes' rules only allow the extraction of the surplus at wind-up. As outlined in our responses to the questions 4 and 5 below, we believe there is an opportunity to consider revisiting this.

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

20. Based on feedback from PLSA members, the overriding condition that needs to be met before any extension is introduced to the criteria to allow the extraction of a DB surplus is that the DB scheme needs to be well funded on a low dependency basis (although our members have noted that low dependency targets differ from scheme to scheme, so the factors for consideration would need to be consistent and set out in guidance or regulation).

21. In other words, a condition could be set such that, in order to extract a DB surplus prior to wind-up, the scheme's funding level should be a certain percentage above the scheme's low dependency target (for example, at least 105% above).

22. Other conditions that our members believe should apply before an extraction of surplus prior to wind-up is allowed include: (a) that the employer is in a good financial position, and (b) that there is a strong employer covenant in place.

23. Before any decision is taken to extend the criteria for extracting surpluses, we believe that the exact conditions that should apply will need further consideration and testing with trustees as part of a broader industry-wide consultation process.

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?

24. On face value, there is some appeal for allowing trustees and employers to extract a potentially 'trapped surplus' in a DB scheme prior to wind-up. Firstly, neither employers nor their current or past employees stand to benefit from DB pension schemes being significantly 'over funded'. Second, the aggregate effect is contrary to the Government's desire for UK pension assets to support economic growth by investing more in productive finance.

25. Currently, legislation requires a scheme to be fully funded on a buy-out basis before a refund of surplus is permitted.

26. As noted in the response to Q3 above, it would appear that the majority of DB schemes' rules only allow the extraction of surplus at wind-up. That being said, we note that many of our members (44% of those recently surveyed) believe that DB pension schemes would welcome opportunities to enable employers to benefit from a return of surplus prior to wind-up, provided adequate protections are put in place for scheme members.

27. We believe that the benefits of introducing a statutory over-ride should be examined to enable employers and schemes to return pension fund surpluses on a regular basis, subject to adequate member protections (eg. sufficient funding above the scheme's low dependency target, the employer is in a good financial position, and there is a strong employer covenant in place). It will be important to assess how this may impact the overall balance of powers in scheme trust deed and rules. The source of the surplus should also be a consideration for the creation of a statutory over-ride, since for a shared cost scheme some of the surplus is attributable to members.

28. Arguably, lowering the legislative threshold for allowing refunds of surplus could potentially encourage trustees to adopt a more ambitious mindset and take on slightly riskier investment strategies for their DB assets (including greater investment in UK assets), if they know that any significant over-performance (i.e. 'excess returns') could potentially be extracted sometime in the future. This could also benefit employers as it would not result in assets becoming 'trapped' in the scheme, which could potentially lead to an alignment between trustees' and employers' investment philosophies around taking on greater risk.

29. Given DB schemes' trustees main objective is to comply with their fiduciary duty, considerations to use the surpluses to improve member benefits, such as discretionary increases, should also be considered. While this is of course an option for schemes now, it will typically require sponsor consent, and the experience over the past couple of years is that some sponsors are declining to grant discretionary increases even where DB schemes have healthy surpluses. Trustees may also view the potential to improve benefits for DB members as a necessary condition for taking more investment risk (e.g. investing in productive finance), so we consider benefit improvements to be an important part of this equation.

30. The risks that could arise by enabling trustees and employers to extract surpluses prior to wind-up include:

    - It may encourage some sponsors experiencing financial difficulties with a scheme in surplus to want to try to access the money.
    - There may be a conflict within the trustee board (eg. where there are employer nominated representatives) that could potentially create moral hazard risks.
    - Situations could arise where a scheme is in surplus today and so part of the surplus is returned to the sponsoring employer, however an unforeseen event occurs at some point in the future that significantly impacts the scheme's funding position.

31. However, we believe that all of these risks can be sufficiently mitigated with the right regulations and protections in place (including those mentioned in our response to Q4 above), along with the retention of trustees' fiduciary duty to ensure trustees act prudently and responsibly, and in the best interests of the scheme beneficiaries.

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

32. Many of our members have said told us anecdotally that the PPF underwriting the downside risk could potentially act as an incentive for schemes to take on the risks of investing in productive finance assets, particularly where some of the initiatives have less of a track record of success.

33. That said, this is not borne out in our recent member survey, which showed that more of our members disagree (31%) than agree (23%) that having greater PPF guarantees of benefits would actually result in greater investment in productive finance.

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?

34. At present, any authorised surplus payment to the sponsor is subject to a 35% free-standing tax charge.

35. There is broad agreement among PLSA members that consideration should be given to reducing the tax rate on refunds of surpluses to an employer (possibly to align with the Corporation Tax Rate of 25%) so that, in circumstances where using the surplus to pay for future pension provision is not achievable, employers are not penalised for funding their scheme well and remain incentivised to invest in a manner that should generate surpluses without the fear of punitive tax treatment where a refund ultimately arises.

36. Given that there are currently £400 billion of assets in pension fund surpluses (on a PPF basis), this could result in a considerable tax payment to Government (and at an earlier point than would otherwise be payable when schemes wind up).

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?

37. Currently, this is very difficult and happens only in exceptional cases via complex bulk transfers. However, many of our members (51% of those recently surveyed) believe that consideration should be given to establishing a legislative mechanism by which a DB scheme's surplus could be used to finance contributions to benefit DC members in a different scheme used by the same employer group, without incurring tax penalties that arise under the current rules, subject to appropriate conditions.

38. For example, the legislative mechanism could include conditions to ensure that DB benefits remain funded to an appropriate level (eg. that the scheme remains fully funded on its low dependency basis).

39. However, it is worth noting that the wording of the AE legislation would likely have to be reviewed to ensure that such a mechanism would be permissible from a legal perspective (i.e. that financing DC contributions out of DB surpluses meets the AE requirements to "pay contributions").

40. Importantly, there is a consistent view among our members that the decision on whether a surplus should be extracted from the DB scheme should remain with trustees, based on the specific circumstances of the scheme.

41. We believe that employers could be encouraged to use the surplus either for future investment or for improving the pension provision of employees who are not part of the DB scheme (thereby retaining the assets in the pension system). However, once a surplus is extracted and repatriated to the sponsoring employer, it is ultimately up to the employer to decide how it uses that surplus repayment (i.e. whether that is to finance contributions of DC members in a different scheme, invest in the business etc). We believe this should continue to be the case.

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

42. So far, there is no evidence to suggest that this would be the case. However as noted in our response to Q4 above, there should be strict rules/conditions around the circumstances under which a DB surplus can be extracted and repatriated to sponsoring employers to guarantee that no misuse of scheme funds can occur.

43. We believe that if these conditions, including the level at which the DB surplus is extractable, is set at the appropriate level, then the risk to the scheme (and to its members) should be manageable.

44. It is also worth noting the potential use of escrow accounts and contingent assets. For example, the DB surplus could go into an escrow account for a period or, rather than being taken out of the scheme, the trustee could ask for a contingent asset charge instead if they feel it is necessary.

Consolidators

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?

45. There are a number of advantages of DB scheme consolidation, including helping to bring about economies of scale and improving governance. There is no doubt that very large schemes can invest more cheaply in a wider range of assets, including private equity and in illiquid assets typical of private markets. This is because larger schemes usually have greater bargaining power, governance capabilities and resources than smaller schemes. However, access to such assets with the benefits of scale economies can also be provided by pension schemes of any size investing in dedicated growth-type funds, eg. LTAFs or other funds, provided by external managers.

46. There are already some very large DB and DC pension schemes. As consolidation takes place over the next 10 years, we expect schemes to be able to invest in wider asset classes at low cost, with potentially more being invested in UK growth assets. It is worth mentioning that, provided the assets meet the risk/return characteristics needed by trustees, such investments are already an option for schemes, but often the cost of investing can be prohibitive.

47. Consolidating individual elements of DB schemes can bring real benefits. Shared administration services, pooling of assets and shared governance can, to one extent or another, bring material reductions in cost and tangible improvements in investment returns. The wide variation in costs and quality of governance between schemes – principally between schemes of different sizes but also between different schemes in the same size band – makes this an obvious target for delivering greater efficiency and better value for money.[5]

48. In addition to the inability to leverage economies of scale and attract the quality of skills needed to operate and invest efficiently, smaller schemes often do not have the same governance capabilities and resources as their larger counterparts. They can also find it harder to navigate the highly intermediated nature of the UK pensions system. All this can result in significant value leakage, which could be addressed by greater consolidation at the smaller end of the DB market.

49. However, there is a very large (and growing) buy-out queue forming, so in that context perhaps DB Master Trusts make sense as a solution for some smaller schemes. DB Master Trusts can help to reduce costs for some schemes by providing economies of scale through pooling governance, legal, actuarial, administration and investment functions. In October 2021, the PLSA launched a DB Master Trust self-certification regime, which encourages Master Trusts to complete a standard template that provides information on their structure and how they operate. The concept of self-certification for DB Master Trusts stems from DWP's 2018 DB White Paper[6], which highlighted the need to draw attention to the wider benefits of consolidation, including DB Master Trusts.

50. DB schemes are generally supportive of additional paths to endgame. Superfunds provide an affordable option for employers, creating an incentive and achievable goal for them to make a one-off payment to reach self-sufficiency funding levels, without having to pay for the more expensive – and in many cases unachievable and capacity constrained – insured buy-out option. Once they have achieved sufficient scale, Superfunds could have more opportunity to invest in more productive investments, such as unlisted equity and fixed income.

51. We note that the Government is looking got bring forward legislation "as soon as parliamentary time allows", with primary legislation to provide for a new compulsory framework applicable to Superfunds and other relevant models of consolidation, and secondary legislation to set out further details.

52. We support the industry moving beyond the current interim regulatory regime. We have said for some time (including in our response to the Work and Pensions Committee inquiry earlier this year) that, to ensure that the final Superfund regime offers at least the same level of protection to scheme members as the DB funding regime, the Government should proceed with quickly finalising the Superfunds legislation it consulted upon back in 2020. If it is not forthcoming soon, Superfunds will remain in stasis and cease to be a viable option.

53. Importantly, we do not believe consolidation should be mandatory, whether to achieve scale or for any other reason. We support DB schemes being provided with various options to

[5] The DB Taskforce report: "*The Case for Consolidation*" (2017) outlines further benefits of consolidation in the DB sector.
[6] "*Protecting Defined Benefit Pension Schemes*", Department for Work & Pensions (March 2018).

consolidate (DB Master Trusts, Superfunds etc) and leaving it to trustees to decide the best course of action for their scheme and their members.

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

54. We believe that insurers are doing their best to provide sufficient access to DB schemes looking to achieve buy-in/buy-out. Indeed, many of our members (34% of those recently surveyed) believe that existing private sector buy-out market is providing sufficient access to schemes that are below scale but fully funded.

55. However, with more schemes approaching the insurance market than ever before, there is a potential for concentration risk to become an issue going forward in terms of the amount of DB pension assets that could be held by a small number of insurers.[7] Also, insurers are finding it difficult to quote on all transactions, prioritising those that give them the best chance of securing a deal. Those schemes that have laid the groundwork will be best equipped to gain insurer engagement. More complex and smaller transactions may well be de-prioritised, even though the schemes may be fully funded.

56. It could be argued that we might be on the verge of a lack of insurer capacity becoming an issue, with buy-in/buy-out volumes expected to reach a record high in 2023. However, this is not only due to a lack of capital or appetite, but a matter of limited human resources. Many of our members (41% of those recently surveyed) feel that there is insufficient capacity due to a lack of resources. The way the market currently operates means that, if a significant number of smaller (sub-£100 million) schemes start looking at buy-out solutions at the same time, many schemes will not be able to secure deals. And it will likely be the smaller schemes, whose members would arguably most benefit from an insurance solution, that will unfortunately tend to miss out.

57. Increased automation of the bulk annuity process, including greater standardisation of data provision, pricing processes and terms of business, could help address in part the concern of smaller schemes missing out in a busy market. We understand that several insurers have developed/are developing streamlined solutions for smaller schemes to reduce the manual processing required to provide a quote and complete a transaction.

58. Insurers and advisers (including specialist de-risking teams at consultancy firms) are aware that this increase in demand is likely to continue for some time and many are strengthening their front- and back-office staffing to be able to increase capacity, which should help smaller schemes going forward.

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

59. The advantages of establishing a public consolidator to operate alongside commercial consolidators include:

- The potential to facilitate the consolidation of DB schemes that are not able to buy-out and that are unlikely to be attractive to commercial consolidators.
- Having a public consolidator (separate from PPF) could potentially be economical to run.

[7] It is worth noting that, in June 2023, the Bank of England sounded a warning about the potential risks posed by the use of reinsurers to pave the way for increasingly popular deals to offload pension liabilities. The Bank warned insurance groups that relying on reinsurers to help meet a surge in demand for corporate pension deals risked creating a "systemic vulnerability" for the sector.

60. The disadvantages include:
    - Establishing a public consolidator could potentially be market distorting and crowd out private sector solutions.
    - It is unclear if there is in fact a need for a public consolidator – we believe the case has yet to be made.
    - If a separate PPF-type fund is established, or an extension is made to PPF's remit, it would require significant statutory changes. It may also necessitate a change in compensation structure, and create disparities of member protections.
61. We believe there are a number of questions that need to be explored more fully before any decision is made on whether or not to establish a public consolidator, including:
    - Who would carry the downside risk?
    - For the various options being considered that would require schemes to 'opt in' to the public consolidator, how long would the qualifying period be?
    - Would schemes be able to opt out?
    - Would a public (non-PPF) consolidator be able to run on a commercial basis and have the necessary competencies?
    - Would a public consolidator crowd out private sector provision of consolidation solutions or distort the buy-out market?

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?

62. The views of PLSA members are mixed on whether the Government should establish a public consolidator (i.e. to operate alongside commercial consolidators). In a recent PLSA survey, 26% of our members agreed that this would be beneficial, but more members (36%) disagreed. We believe this disparity in results mean more information about how the public consolidator would function is needed for schemes to be able to appropriately assess its value.
63. Similarly, the views of our members were mixed on the impact that a public consolidator would have on the existing bulk annuity market and the overall pension provision landscape. Our recent survey showed that nearly a quarter of our members (23%) believe a public consolidator would adversely affect the existing bulk purchase annuity market, with a similar number disagreeing (24%).
64. We believe the case has yet to be made around the need for a public consolidator. As part of the future market analysis on whether to establish a public consolidator, our members believe it would be sensible to assess whether an open market tender would provide fresh solutions for this service.
65. If a public consolidator were to be established, it should be targeted at smaller schemes – i.e. those with less than 100 members (which account for 1,836 private sector DB schemes and around £17.4 billion in assets)[8] – that cannot easily achieve buy-in/buy-out. At this level (smaller schemes with < 100 members) a central consolidator is unlikely to interfere with the commercial consolidation market. But this begs the question, would it be economical to run a public consolidator whose objective is just absorbing these smaller schemes? We understand that the Government may looking for larger schemes to be consolidated, but this could potentially 'crowd out' private consolidators. Also, as stated above, it is unclear whether there is a need for a public consolidator for larger schemes.

[8] The Purple Book, page 5.

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

66. Potentially. As with any form of consolidation, the establishment of a public consolidator that is structured appropriately and well run has the potential to bring together assets in sufficient scale to enable investment in a wider range of assets, particularly illiquid ones such as infrastructure or ESG specific assets that can deliver long-term sustainable returns for savers. By extension, this includes the ability to invest more in UK productive finance, with a resulting benefit for the UK economy.

67. However, the public consolidator would still need to pay the benefits as they fell due. This is unavoidable. And if it has to carry more risk in its investment strategy, this will need to be underwritten. It is worth noting that although the PPF has scale, its investment approach (fitting its purpose) carries less risk than DB schemes in general.

68. Also, the benefit to schemes, savers and the wider UK economy really depends on the purpose/function of the public consolidator.

69. Investing in infrastructure, which requires a lot of scale and expertise and can be expensive, can be achieved much more easily in a consolidated market, such as Australia where the top 15 mega-funds dominating their superannuation sector have each amassed assets of around AU$100-200 billion (£52-105 billion). Greater scale has resulted in superannuation funds increasing their average allocation to infrastructure to 20%. An increasing amount of Australia's A$3.4 trillion (£1.8 trillion) superannuation pool is now going into private equity.[9]

70. Interestingly, the views of our members are mixed as to whether establishing a public consolidator would result in wider investment in "UK productive finance" and benefit the UK economy. The results of our recent survey showed that 29% of PLSA members agreed with this sentiment, while a similar number (25%) disagreed.

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

71. The options for underwriting the risk of a public consolidator include:
    - Through levies applied on DB schemes (i.e. existing levy payers).
    - The Government underwriting the assets and liabilities taken on by the public consolidator, which could be significant.
    - Through the public consolidator having the ability to cut members' benefits.
    - Operating on a non-commercial basis could create the wrong investment incentives and/or create market distortion (against other providers).

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

72. Encouraging the pensions industry to embrace consolidation has been seen across Europe and more widely in countries such as Australia, whose pensions system is often cited as a great example of what consolidation could look like in the UK. Its pension system has undergone enormous consolidation over the past two decades – following a series of major policy changes

[9] AustralianSuper (the largest Australian superannuation fund) announced in May 2022 that it would invest A$13 bn (£7 bn) into private equity globally over the next 2 years to help deliver strong long-term returns for members. Hostplus, Australia's 6th largest fund with almost A$90 bn (£47 bn) in assets, has nearly 50% of its default option invested in private assets.

such as greater governance requirements. In recent years we have seen mergers involving several of the larger players in the market. This has resulted in the development of much larger funds and even mega-funds (with assets under management exceeding $100 billion) dominating the Australian superannuation landscape.[10] APRA, as their prudential regulator, continues to encourage smaller funds to explore mergers with larger players, applying varying levels of pressure.

73. The recent '*Your Future, Your Super*' reforms in Australia have also contributed to a number of superannuation funds exiting the market. Funds which are more than 50 basis points a year below the benchmark are deemed to have underperformed, with potentially severe consequences, including being prohibited from taking on new members. This has contributed to a number of smaller (sub-scale) funds merging together in order to achieve the scale necessary to gain access to more productive and profitable investment deals (such as investment in infrastructure and other illiquids), or exiting the market entirely.

74. Back in the early days of consolidation, Australian superannuation funds collaborated to invest in big infrastructure projects. Nowadays, they often team up with other big pension funds and institutional investors around the globe to invest in even bigger and better opportunities.

75. However, notwithstanding the above, our members have been keen to impress upon us their view that the Government should take a cautious approach when making comparisons with overseas pension markets that may not be directly comparable. In the case of Australia for example, as noted above, they have a very different history of how their regulatory framework has developed (and is continuing to develop) and different market dynamics, which has naturally led to their current pension landscape (with fewer large/mega funds) being what it is today. And it should also be noted that the evolution of their superannuation system has taken place over many years and the funds that remain are now largely DC funds.

PPF as a public consolidator

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

76. The PPF has played a vital role in the UK pensions framework protecting members as an insurer of last resort. It could be that expanding its remit could be a workable way for Government to consolidate closed under-funded DB schemes. However, it could potentially have far reaching consequences, including denying scheme members the chance of receiving a full pension.

77. The advantages of the PPF acting as a consolidator for some schemes include:

- The PPF could take on underfunded DB schemes at a premium.
- The PPF is in a strong financial position (current surplus of £12.1 billion as at 31 March 2023) and it currently only receives around 30 claims a year compared to around 200 claims a year about 10 years ago, so it may be that the number of claims it receives going forward could remain low.
- The PPF could pay 100% benefits by either: increasing benefits to 100% (although this would require primary legislation change and consideration would need to be given to the benefits already in payment) OR by being allowed to take on any schemes (and pay 100% benefits) for a higher levy.

[10] It is worth noting that in Australia the vast majority of superannuation funds (around 87% of total pension assets) are in DC schemes.

78. The disadvantages of the PPF acting as a consolidator include:

    - The PPF is invested very conservatively, so consideration needs to be given to how the assets would be invested given PPF's cautious investment strategy compared to most DB schemes. It is also worth noting that part of PPF's investment strategy is to invest away from the UK in order to reduce exposure and concentration risk, which runs counter to the Government's desire for consolidated pension assets to be invested more in UK growth. Additionally, the PPF's (conservative) investment strategy should be considered against the backdrop of insurers re-risking the assets when they take on schemes, which is ultimately how they make a profit.
    - Currently, PPF pays a simplified benefit structure (and would probably like to continue to do so), although we understand that one of the options being considered is to retain DB schemes' current administrators who would continue to pay benefits under the current benefit structure.
    - The PPF does not have the experience/track record of paying scheme benefits (but rather it pays compensation which is much simpler), so this could be a challenge.
    - It potentially creates moral hazard for sponsors who would benefit from the separation.
    - It would be unfair on those sponsors who have laboured, and are still labouring, to deliver benefits promised in full.
    - The appetite for well-run businesses to transfer their scheme to the PPF is likely to be very small given the reputational risks – i.e. the notion of a scheme entering the PPF is not what employers would want to associate themselves with. In addition, scheme members would likely associate their scheme entering the PPF with insolvency, and thus "bad".

79. We believe there are still a number of questions that need to be explored more fully before any decision is made about the PPF acting as a consolidator, including:

    - Who should be allowed to transfer schemes over to the PPF? One of the proposals being considered is that it would be for schemes that have run out of options (last resort, employer insolvent etc). This is fundamentally different to solvent/well-funded schemes making a choice to take advantage of this opportunity to transfer to the PPF.
    - Also, what happens when something goes wrong – would we see a reduction in benefits for members, as permitted by the Pensions Act 2004?
    - The economic viability for the PPF of such a proposal is unclear if only a few schemes were interested and willing to pay the 'super levy', particularly if only really well funded schemes would be able to choose that option.

80. The PLSA's view is that the role of the PPF should <u>not</u> be expanded to act as a public consolidator unless either:

    (a) It is closely aligned with its current role of providing compensation payments to under-funded DB schemes with no prospect of improved funding levels in the future; OR

    (b) Its role is simply to act as a consolidator for DB schemes that want to consolidate but cannot find a market offering from a DB Master Trust, a Superfund, or through buy-in/buy-out with an insurer.

81. If option (b) were adopted and the PPF was to be given the role of being a new public consolidator, we believe that there should be total separation (ring-fencing) between the existing PPF and any new 'PPF II' consolidator. To do otherwise would, in our view, place unreasonable risk on the PPF members and the sponsor levy payers. Doing so would also involve an unacceptable cross-subsidy.

82. The current PPF funding model, under which the PPF is funded by pension schemes outside the PPF remit, would not be appropriate for the PPF operating as a consolidator. DB pension schemes outside the PPF should not be funding or subsidising those that choose to consolidate. In our view, this means that the UK taxpayer could effectively be called upon to bear the risk of any potential future deficits, should they occur, of the PPF acting as a consolidator. We do not believe the UK taxpayer should be taking on this burden.

83. Regardless, we believe it is too early to create a new public consolidator, given the recent changes in the funding levels of DB schemes and the fact that Superfunds have not yet been given a primary legislation regime to encourage confidence in them as an option for consolidation.

84. In a recent survey of PLSA members, almost half of respondents (48%) said that the role of the PPF should not be expanded to become a public consolidator of DB schemes, with only 18% of members believing it should.

85. As stated in our response to Q13, if a public consolidator were to be established (and it was decided that the PPF should play that role), it should be targeted at smaller schemes – i.e. those with less than 100 members (which account for 1,836 private sector DB schemes and around £17.4 billion in assets)[11] – as well as underfunded schemes that cannot easily attract insurer interest. We question the need for a public consolidator for larger schemes.

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

86. It is important that nothing is done to destabilise the current operations of the PPF. It is also unclear how much demand there would be for this initiative especially as the price will be linked to the security offered to scheme members.

87. At present, there is insufficient detail to assess whether the Board of the PPF would be the appropriate choice to operate a public consolidator. We believe this would need to be examined in greater detail, including whether any conflicts of interest would arise or whether a regime that is more akin to the FCA authorisation for insurers would be needed.

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?

88. There have been a number of ideas proposed by various think tanks and commentators about expanding the PPF's remit, including:
    - PPF allowed to take solvent small schemes that cannot buy out
    - PPF allowed to take any schemes (for a premium)
    - PPF benefits to increase to 100% schemes (with no wider framework changes)
    - PPF allowed to take any schemes (100% benefits) for higher levy
    - PPF operating on the same basis as a commercial consolidator.

89. With any change, there is a question of whether PPF should be allowed to cross-subsidise operational costs or whether it should have to fund all new activities through separate means.

90. It is worth noting that there are a number of different proposals that have been raised in terms of how exactly the PPF acting as a public consolidator would operate. The industry would need to know the full details of the proposal before it can provide considered views on the final design of any PPF consolidator.

[11] The Purple Book, page 5.

91. But regardless of which proposal is being considered, as stated in our response to Q17 above, we believe it is too early for the Government to create a new public consolidator. Many of our members also share this view, with almost half of our survey respondents (48%) saying that the role of the PPF should not be expanded to become a public consolidator. However, if the PPF was to act as a consolidator for some schemes, it should operate on a commercial basis (i.e. on the same basis as a commercial consolidator) rather than as a not-for-profit.

92. Also, as stated in our response to Q17, there are a number of questions/issues that need to be explored more fully before any decision is made about expanding the PPF's role to act as a public consolidator.

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 the continued effective functioning of the gilt market?**

93. As stated previously, we do not believe now is the right time to create a public consolidator. More time is needed with the commercial consolidators in operation (including DB Master Trusts and Superfunds) to determine what, if any, market failures or gaps exist, before establishing a completely new regime.

94. If however, at some point in the future, a decision is taken to expand the role of the PPF to act as a public consolidator, then the relationship between public consolidator and PPF should be set – everything else (i.e. the principles and conditions outlined above) will then flow out of this.

95. Based on the results of a recent PLSA survey, our members believe that the 3 most important structure and entry requirements of a PPF-run public consolidator (from the examples listed in this question) were:

- Principles should be established that govern the relationship between the consolidator and the PPF. (45%)
- How to support the continued effective functioning of the gilt market. (34%)
- The PPF-run consolidator should be limited to DB schemes of a particular size (although what that size should be was not specified). (23%)

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