PENSIONS AND LIFETIME SAVINGS ASSOCIATION

WORK AND PENSIONS COMMITTEE: INQUIRY INTO DEFINED BENEFIT PENSION SCHEMES

PLSA RESPONSE

26 APRIL 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

- The PLSA welcomes the opportunity to provide this submission to the Committee's call for evidence as part of its inquiry into defined benefit (DB) pension schemes and the challenges and opportunities they pose to members, trustees, employers and the Pensions Regulator (TPR).
- In general, the PLSA and our members are **supportive of the current regulatory framework for DB schemes**, which hinges on well-funded schemes supported by strong sponsoring employers and should continue to do so. **There is a strong regulatory system in place**, with TPR having sufficiently wide-ranging powers to support and regulate schemes and the Pension Protection Fund (PPF) in a good position to protect pension scheme members if needed.
- As noted in the Committee's "Saving for later life" report[1] released in 2022, **DB schemes remain of critical importance in the provision of pensions in the UK**, including finding that people with access to a DB pension were more likely to be on track for an adequate income in retirement.
- **For open schemes**, our members are keen to ensure that the **new DB funding regime** that is in development (consisting of the Pension Schemes Act 2021, the DWP's draft funding and investment regulations, and TPR's draft DB Funding Code) **adopts a flexible approach to DB schemes that are not maturing**, or have a very long time horizon before reaching the point of significant maturity.
- **The number of DB schemes in surplus is expected to rise** in the coming years, allowing schemes greater opportunity for buy-out or buy-in. Indeed, buy-in and buy-out volumes are expected to reach a record high in 2023, likely surpassing the £44 billion record set in 2019.
- **We might be on the verge of a lack of insurer capacity** becoming an issue. With more and more DB schemes approaching the insurance market than ever before, insurers are finding it difficult to quote on all transactions, prioritising those that give them the best chance of securing a transaction. Those schemes that have laid the groundwork will be best equipped to gain insurer engagement. There is also an added challenge for schemes looking to achieve buy-in or buy-out resulting from **capacity constraints within administrators and within specialist de-risking teams** at consultancy firms. Many of our members (41% of those recently surveyed) feel that there is insufficient capacity mainly due to a lack of resources.
- There are of course other **alternatives to buy-in/buy-out**, including schemes continuing to run on, or perhaps consolidating in different vehicles such as **DB Master Trusts** or **Superfunds** – the benefits of which are discussed in greater detail within this submission.
- Although there may be a number of advantages of DB scheme consolidation, including helping to bring about economies of scale and improving governance, **we do not believe that scheme consolidation should be mandatory**. In our view, there is a place for DB pension schemes of all sizes that are well funded and deliver excellent benefits and high-quality (often more personalised) services. It should be left up to trustees and employers to determine whether to merge with another scheme or to wind up the scheme, which could be for a number of reasons. The majority of our members (68% of those recently surveyed) feel similarly.
- 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.

[1] "*Protecting pension savers – five years on from the pension freedoms: Saving for later life*", Work and Pensions Committee (September 2022).

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- The treatment of scheme surpluses are set out in the scheme's governing provisions (i.e. Trust Deed and rules) and varies from scheme to scheme. In all cases (whether in relation to ongoing or winding-up schemes), we believe that **surpluses should continue to be treated in accordance with the scheme's governing provisions** as well as with the statutory requirements in place governing the payment of surpluses to sponsoring employers. The majority of our members (68% of those recently surveyed) support this view.
- With the PPF now close to achieving its financial resilience target, we support the significant reduction to the PPF levy proposed to be collected in 2023/24 (down almost 50% to £200m from £390m in 2022/23). However, at some point in the future – during what the PPF calls the 'run-off stage' when the it has reached sufficient funding to cover outstanding risks in the system with a high degree of probability – there should be a **discussion involving the industry around how any excess funds held by the PPF are treated**, given a significant part of the PPF's funding has come from DB schemes and sponsoring employers (along with investment growth and recoveries).
- Broadly speaking, the PLSA supports stability in the structure and operations of the PPF compensation and Financial Assistance Scheme (FAS). **We support the current compensation and assistance regime, which we believe continues to operate effectively.** Before any decision is taken on changing the basis for PPF compensation or FAS assistance (including whether or not compensation payments from the PPF should be indexed), consideration should be given to the impact this would have on the PPF's current funding levels, its reserves, the operational impacts for the PPF, the outcomes across member cohorts and the risks to future levy payers. This is discussed further in our response to question 9.
- We believe the current fraud compensation regime is confusing for savers and industry alike and **government should consider building a more robust fraud compensation regime** that offers protection for all pension savers and is future proofed. Potential considerations in building a more robust fraud compensation regime include:
  - Merging the Financial Compensation Fund (FCF) and the Financial Services Compensation Scheme (FSCS) to create a single entity responsible for compensating all financial services firms against claims (including pension schemes that fall victim to scams).
  - Reconsidering any future increases to the Fraud Compensation Levy (FCL) ceiling, which was increased from the 2022/23 levy year despite near universal opposition to it in DWP's consultation in 2022, and for which the costs are ultimately passed onto scheme members.

RESPONSES TO INQUIRY'S CALL FOR EVIDENCE

1. Is the right regulatory framework in place to enable open DB schemes to thrive?

1. Our members generally support the current regulatory framework. The current regulatory regime for DB schemes hinges on well-funded schemes supported by strong sponsoring employers and should continue to do so. The PLSA believes there is a strong regulatory system in place and the Pension Protection Fund (PPF) offers good outcomes for pension scheme members when their scheme sponsor is unable to meet its obligations to the scheme in full.
2. In our view, TPR has wide-ranging powers to support and regulate schemes and the PPF is well placed to absorb claims (particularly given their £11.7 billion in reserves as of 31 March 2022) and pay compensation to thousands of pension scheme members. The protection that the PPF offers may be, in many cases, the best outcome for pension scheme members when their scheme sponsor is unable to meet its obligations.
3. For **open schemes**, our members are keen to ensure that the new DB funding regime that is in development (consisting of the Pension Schemes Act 2021, the DWP's draft funding and investment regulations, and TPR's draft DB Funding Code) adopts a flexible approach to DB schemes that are not maturing, or have a very long time horizon before reaching the point of significant maturity.
4. In our recent response to the DB Funding Code consultation[2], the feedback from our members in relation to open schemes was that:
   - The degree of flexibility in the Code around the level of allowable risk is helpful, particularly for open schemes which are not expected to mature for some time.
   - However, there is a lack of clarity and consistency between the Code and the draft regulations in terms of the level of allowable risk, which needs to be clarified.
   - There is support for the position in the Code that open schemes could make an allowance for new entrants and future accrual – thereby funding at a lower level – without necessarily undermining the principle that security should be consistent with that of a closed scheme. However, this allowance is expected to be limited, and may do little to mitigate the increase in costs which potentially threaten the viability of some open schemes.
   - There is concern that the focus on de-risking in the DB funding regime could inadvertently lead to the premature closure of some open schemes, potentially significantly damaging sponsoring employers and the sectors/industries in which they operate, and crucially damaging member outcomes.
   - It would be helpful if all the requirements that are relevant to open schemes were packaged together in their own separate section within the Code.
5. All these changes we have recommended to the new DB funding regime are required simply for DB schemes to continue operating effectively as they have done for many years (rather than 'thrive'). Of the roughly 5,300 private sector DB schemes (with around £1.4 trillion in assets), 505 schemes (9%) remain open to new members, representing £321 billion in total assets and 2.06 million members in open schemes. Half of DB schemes (50%) remain open to future accrual – up from 48% in 2021.[3]

[2] "*TPR Consultation: Draft DB Funding Code*", PLSA response (24 March 2023).
[3] *"Annual report on UK defined benefit and hybrid schemes"*, The Pensions Regulator (Dec 2022).

6. The data covering public service occupational DB pension schemes is presented separately to that covering private sector occupational DB pension schemes. Public service pension schemes provide pensions for civil servants, the judiciary, local government, teachers, health service workers, members of fire and rescue services, members of police forces and members of the armed forces. These schemes cover over 17.2 million memberships, and around 25,000 individual employers.[4]

7. In order for open DB schemes to 'thrive', it would be helpful for TPR to give greater focus to member outcomes as a whole (rather than focusing disproportionately on protecting members' past service benefits), including the continuation of affordable, sustainable and attractive future service DB benefits.

8. As noted in the Committee's "Saving for later life" report[5] released in 2022, DB schemes remain of critical importance in the provision of pensions in the UK, including finding that people with access to a DB pension were more likely to be on track for an adequate income in retirement. But the reality is that DB schemes are unlikely to return as the predominant pension offering in the private sector – see our response to Q2 regarding the projected decline in DB scheme numbers and active members.

9. That said, it is worth noting the success and growth of the Local Government Pension Scheme (LGPS), which is a statutory DB pension scheme for employees of local authorities with over 19,000 participating employers, around 6.9 million members (of which, around 2.3 million are active) and assets totalling over £330 billion.[6]

2. Is there sufficient capacity in the buy-out market to meet demand from DB schemes? If not, what are the alternatives?

10. There are currently around 5,300 funded DB trust-based private sector schemes, with signs of a small and slow decline in terms of scheme numbers. They cater for about 10 million memberships. Their assets amount to around £1.4 trillion.[7]

11. PPI modelling projects that the percentage of active members will halve from 13% to 6% between 2018 and 2030, while the proportion of pensioners will rise from 42% to 52% over the same period.[8]

Source: "Approaching the endgame: The future of Defined Benefit pension schemes in the UK", PPI (Oct 2019)

[4] *"Annual report on UK defined benefit and hybrid schemes"*, The Pensions Regulator (December 2022).
[5] "*Protecting pension savers – five years on from the pension freedoms: Saving for later life*", Work and Pensions Committee (September 2022).
[6] *"The Local Government Pension Scheme: Today's Challenges, Tomorrow's Opportunities"*, PLSA report (June 2022).
[7] *"Annual report on UK defined benefit and hybrid schemes"*, The Pensions Regulator (December 2022).
[8] "Approaching the endgame: The future of Defined Benefit pension schemes in the UK", PPI report (October 2019).

12. The aggregate **surplus** (total assets less total s.179 liabilities) of the schemes in the PPF 7800 Index is estimated at £359.3 billion at the end of March 2023.[9] The position has improved significantly from December 2021, when a **deficit** of £129.3 billion was recorded.[10] The recent improvements in funding levels were largely driven by rising gilt yields. The number of DB schemes in surplus is expected to rise in the coming years, allowing schemes greater opportunity for buy-out or buy-in.

13. Indeed, buy-in and buy-out volumes are expected to reach a record high in 2023. Consultancy firm LCP predicts that buy-in and buy-out volumes will this year break the £44 billion record set in 2019, with high demand for buy-ins and buy-outs following an average around 15% improvement in the buy-out funding positions of DB schemes over 2022.[11]

14. Following on from funding improvements seen in 2022, pricing will likely continue to be attractive for schemes that are properly prepared. However, schemes will likely have to 'work much harder' than in the past to secure active insurer participation given the capacity constraints in the buy-in/buy-out market resulting from increased demand from pension schemes. With more DB schemes approaching the insurance market than ever before, insurers are finding it difficult to quote on all transactions, prioritising those that give them the best chance of securing a transaction. 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.

15. There is an added challenge for schemes looking to achieve buy-in or buy-out resulting from capacity constraints within administrator firms, leading to potential data quality issues. Many of the PLSA members we speak to tell us that the administrator firms they are dealing with are short of staff – particularly experienced staff – and this is seriously hampering any kind of data-dependent work, such as preparation for Pensions Dashboards and, in the DB context, helping to get schemes ready for buy-ins and buy-outs. We understand that similar capacity constraints exist with respect to specialist de-risking teams at consultancy firms.

16. It could be argued that we might also be on the verge of a lack of insurer capacity becoming an issue. However, this is not 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. If a significant number of smaller (sub-£100m) schemes start looking at buy-out solutions at the same time, then the way the market currently operates means many schemes will not be able to secure deals. It will likely be the smaller schemes (whose members would arguably most benefit from buy-out) that tend to miss out. 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.

17. Insurers and advisers know the likely increase in demand is coming and many are strengthening their front- and back-office staffing to be able to increase capacity. There are also potentially several new entrants to the market, with 2023 having the highest chance of seeing a new entrant entering the buy-in/buy-out market for some years given changing supply and demand dynamics in the market. However, this is most likely to be an existing insurer because of the high barriers to entry, and even for an existing insurer there will be a considerable lead-in time as they recruit and develop their capabilities.

[9] PPF 7800 Index, Pension Protection Fund (31 March 2023).
[10] PPF 7800 Index, Pension Protection Fund (31 December 2022).
[11] "*2023 set to be a record-breaking year for de-risking after the rollercoaster of 2022*", LCP Media Centre (3 January 2023).

18. Other alternatives to buy-in/buy-out include schemes continuing to run on (although arguably not indefinitely), or perhaps consolidating in different vehicles – for example, DB Master Trusts which can give trustees greater control over the journey to endgame where the scheme is not in a position to achieve a full insurance buy-out and help set a clear path to a low-risk target, which ultimately reduces the sponsor's contribution burden. DB Master Trusts can help sponsors to move to a low-risk target over time, which then gives them the option of either running the scheme off within the DB Master Trust, or bridging to a full insurance buy-out target when this becomes achievable.
19. There is also the developing "Superfund" market that might provide a different but potentially desirable home for some schemes. Superfunds can potentially 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 insured buy-out option.[12] Although untested, the potential result is reduced risk to members' benefits that may arise from a future insolvency and a reduction in the potential burden on the PPF. However, as discussed in our response to Q4 below, we believe that the Government should proceed with quickly finalising the Superfunds legislation it consulted upon in 2020. It is important that the final Superfund regime ensures at least the same level of protection to scheme members as does the DB funding regime.
20. In order to make it easier for schemes to consider run-off/on (as opposed to buy-in/buy-out or consolidating into different vehicles), the regulations could be amended to make run-off/on a more viable option – for example, allowing trustees of DB schemes to use contingent assets beyond the 'relevant date' and allowing them to take the strength of the employer covenant into consideration when determining the appropriate level of risk to take. This could also make it easier for schemes to continue to invest in more "productive" assets, rather than selling these/running them off in the lead up to a buy-out transaction, as is often the case.

3. What should The Pensions Regulator do to improve the quality of trustee boards?

21. Governance standards vary widely across the thousands of pension schemes. There are a number of things TPR could do to improve the overall quality of trustee boards. However, any new regulatory requirements must be purposeful, proportionate and pragmatic. In particular, they must allow good schemes of all shapes and sizes the space to continue to thrive. They must also be undertaken as part of a clear-sighted and coherent assessment of the bigger issues around scheme governance.
22. **TPR focus on disengaged trustees:** There is a difference in the scale and type of regulatory challenge presented by those schemes that currently engage very little with regulators and/or advisers (and whose governance practices are generally poor) and those schemes that do engage but need to improve their standards of governance. We believe TPR should focus on identifying and regulating the most disengaged schemes rather than setting new and higher standards for all schemes, as there are also substantial parts of the system whose governance practices are of a high/very high standard.
23. **Quality of advice received by trustee boards:** There is currently a lack of publicly available and easily accessible data on what kind of advice trustees are getting, or even where they are getting it from. However, many of our members (41% of those recently surveyed) feel that TPR should focus on the quality of advice received by trustees. We believe it would be helpful for TPR to undertake research into the quality of external scheme advice on issues including communications,

[12] It should be noted that Superfunds can only take schemes up to certain funding levels, so some of the better funded DB schemes would not be eligible.

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administration, actuarial and investment governance, regulatory and other relevant issues and to use this research as the basis for their work on trustee standards, and other regulatory work, in this area. It would also be helpful for TPR to collect and make available pension scheme cost benchmarking data to assist trustees in assessing how well their scheme is doing against their peers.

24. **Trustee board diversity:** We support the introduction of reporting requirements to show whether trustee boards are taking action to become more diverse. It is important that this information is made publicly available and given the momentum for change, focuses on the work being undertaken now as opposed to longer-term outcomes.

25. **Professional trustees:** We do not believe that it should be mandatory for every scheme to engage a professional trustee. However, where a professional trustee is in place, TPR should ensure that they are held to a higher level of trustee knowledge and understanding (TKU).

26. **Trustee skills and expertise:** Many of our members (51% of those recently surveyed) believe that TPR should place greater focus on schemes possessing appropriate collective expertise across the relevant technical areas as well as a functional working dynamic based on a diverse range of backgrounds and perspectives, and an appropriate balance of softer skills. This could potentially be achieved, with the assistance of the PLSA, through the issuing of best practice guidance in this area. More qualitative characteristics, such as the interpersonal skills necessary for working with fellow board members; a hunger to learn; probity; commercial acumen in negotiating with external parties; or the communication skills needed to engage with members and sponsors are also vital. While these capabilities are often harder to measure, we believe they are just as important as more formal qualifications and experience, and should be treated as seriously by regulators.

27. **Role of the Chair:** The role of scheme Chair is particularly important in creating an effective working dynamic, in terms of setting the scheme's strategic direction, ensuring appropriate prioritisation and encouraging frank but open and constructive discussion at meetings. Therefore, the authority of the Chair and the diversity of the wider governance body should be a consideration as part of the appointments process[13] and a priority for regulatory monitoring.

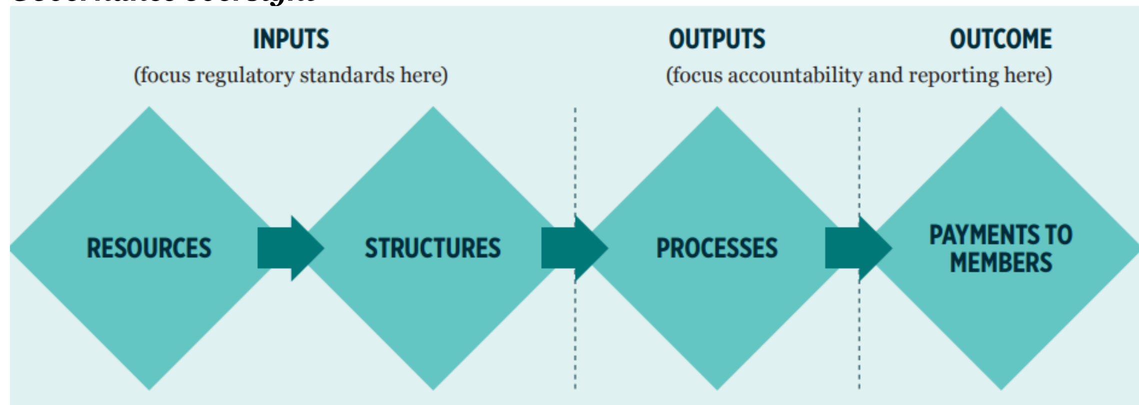
28. **Executive support:** One area which we believe is worth highlighting for TPR's consideration is that of executive support (either external or, in particular, internal). We do not believe that in its work on governance to date, TPR has sufficiently explored how to support scheme trustees and decision-makers to achieve well-resourced and efficient executive support and what such executive support looks like across a variety of scheme sizes and types.

29. **Sole trustees:** There have been concerns expressed by TPR in the past about sole trustees, mostly focused on the potential for a lack of diversity of thinking and/or of suitable means to review decisions. However, in previous discussions with our members, it was noted that there are many circumstances under which a sole trustee model is appropriate, including where a closed DB scheme is moving to buy-out and where the trustee's decisions are primarily around the issue of liability management. Therefore, if TPR was considering any regulatory intervention in this space, we would urge the regulator to first undertake further research into the nature of issues (if any) associated with sole trusteeship.

30. **Shift in regulatory focus:** The highly-varied standards of pension scheme governance suggests that current regulatory approach to governance is not working as well as it perhaps could. We believe that a regulatory approach more focused on governance inputs – the individuals that comprise governance bodies and the structures in which they are situated – is needed.

[13] It is worth noting that schemes have different processes for appointing the Chair – i.e. for some schemes there is a formal selection process, whereas for others the Chair is simply appointed/selected from one of the current trustee board members.

Governance oversight



Source: PLSA discussion paper: "Good Governance – How to get there", PLSA (August 2017)

A greater focus on inputs would involve the dedication of TPR's resources to oversight of appointments to boards and committees and the structure of governance bodies, and then making sure standards are met and maintained. We recognise that this would represent a significant shift in the regulator's focus, but such a shift would make a positive difference to the fundamental ingredient of good governance – the people charged with delivering it.

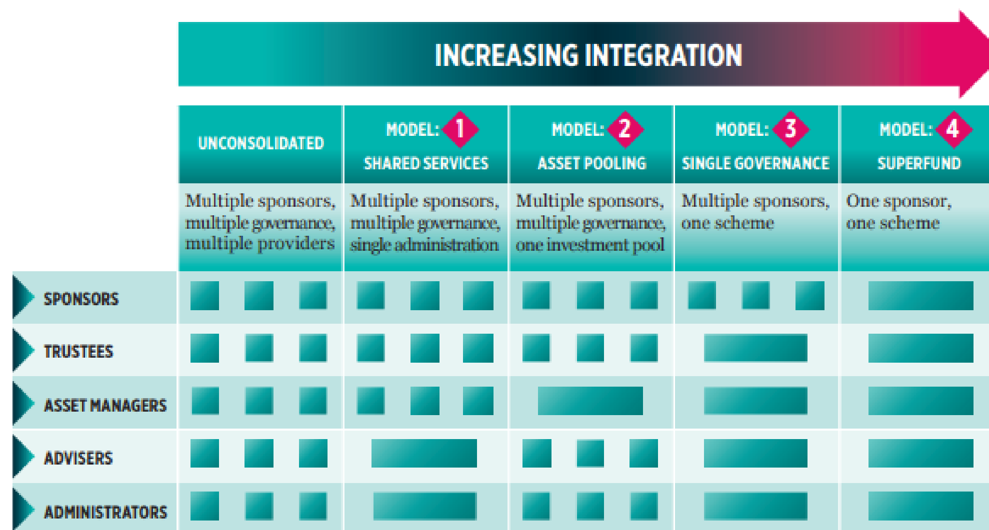
31. **Trustee Toolkit:** We have previously called for TPR's Trustee Toolkit to be enhanced, and indeed a number of our members feel that it is not sufficiently demanding. We would therefore encourage the regulator to consider whether its Toolkit is pitched at a sufficiently stretching level, or whether it is framed in the right way. This is particularly the case if TPR was considering mandating completion of the Toolkit amongst trustees. While the Toolkit as currently constituted can be a helpful learning and development tool, we do not believe that completion of the Toolkit in and of itself provides sufficient evidence of the requisite level of knowledge and understanding to be a scheme trustee in a way that will ensure good scheme governance. This is particularly the case given the increasingly complex legal, policy and financial world which trustees must navigate. Consideration could also be given to encouraging trustees to pursue other qualifications, such as the Award in Pension Trusteeship offered by the Pensions Management Institute (for non-professional trustees), with perhaps a higher standard for professional trustees.

4. What, if any, further steps should be taken to encourage DB scheme consolidation?

32. Consolidation has multiple interpretations and can mean different things to different people. As discussed in the DB Taskforce report: "The Case for Consolidation", there are four basic consolidation models/structures:

- **Model 1: Shared services** – Many schemes share one set of administrative functions, thereby achieving cost savings through economies of scale.
- **Model 2: Asset pooling** – The assets of distinct pension schemes are consolidated into asset pools to be managed centrally on behalf of the different schemes. Schemes retain their governance, administration and back office functions and most of their advisers.
- **Model 3: Single governance** – The assets of distinct pension schemes are consolidated into a single asset pool and governance, administration and back office functions are merged.
- **Model 4: Full merger** – Superfunds are created to absorb and replace existing DB pension schemes. Under this model, employers and trustees would be discharged from their obligations in respect of benefits that are paid from the Superfund.

Models 1, 2 and 3 involve the consolidation of core elements of a scheme's operation. Model 4 is a fundamentally different model, involving the consolidation of schemes following the discharge of the individual DB schemes by scheme employers.



Source: DB Taskforce third report – "Opportunities for change", (September 2017)

33. There are a number of advantages of DB scheme consolidation, including helping to bring about economies of scale and improving governance. Depending on the particular model chosen, consolidation can help to reduce costs for schemes by pooling governance, legal, actuarial, administration and investment functions.

34. As mentioned in our response to question 2 above, DB Master Trusts and Superfunds are two vehicles that can help to encourage DB scheme consolidation and are viable alternatives to buy-in or buy-out solutions for some trustees.

35. As one of several consolidation options, **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[14], which highlighted the need to draw attention to the wider benefits of consolidation, including DB Master Trusts. The PLSA self-certification regime is intended to help scheme trustees and employers who may be considering DB Master Trusts among their consolidation options to understand the key features.

36. Also, we believe the Government should proceed with developing/finalising the Superfunds legislation. **Superfunds** provide a new option for underfunded schemes, and especially for those with weaker employer covenants, to protect member benefits. They create an incentive and achievable goal for employers to accelerate funding into their scheme(s) in exchange for greater certainty over their ongoing obligations. Superfunds are distinct from buy-outs, based on differences in affordability, definition, regulatory requirements and on international determinations on the inherent contrasts between pensions and insurance.

37. In December 2018, the Government put forward detailed proposals for the regulation of Superfunds in a consultation. However, since then the Pension Schemes Act 2021 was passed without provisions for Superfunds.

[14] "*Protecting Defined Benefit Pension Schemes*", Department for Work & Pensions (March 2018).

38. In June 2020, TPR published guidance for DB Superfunds, following their consultation, resulting in Superfunds being required to complete an assessment process with TPR before they can accept the transfer of a scheme. Although there is no specific legislative authorisation framework for Superfunds, TPR uses its existing powers if funding, personnel or governance of a Superfund is not fit for purpose.

39. The regulation of Superfunds before the legislation is in place is one of the key outstanding issues associated with Superfunds. The PLSA believes that the industry needs to move beyond this interim regulatory regime and therefore the legislative framework for Superfunds needs to be established as soon as possible. It is important that the final Superfund regime ensures at least the same level of protection to scheme members as does the DB funding regime.

5. Are there any circumstances in which consolidation should be mandatory?

40. No. We do not believe consolidation should be mandatory, whether to achieve scale or for any other reason. Notwithstanding the natural benefits of scale, size alone is no guarantee that the best outcome will always be delivered to members. For example, smaller schemes can find it easier to maintain their tailored approach to member engagement and delivering high-quality services. There is a place for DB pension schemes of all sizes that are well funded and deliver excellent benefits and high-quality (often more personalised) services.

41. It is also worth noting that some pension schemes that have deeply held ethical frameworks may find it difficult to replicate these within a Superfund or other similarly integrated structures, which is another reason that scheme consolidation should not be enforced.

42. It should be left up to trustees and employers to determine whether to merge with another scheme or to wind up the scheme, which could be for a number of reasons. For example, if the trustee and the employer are unable to put an adequate funding solution in place, trustees and employers might decide that winding up the scheme and transferring the members/benefits to another scheme is the most appropriate course of action. However, we do not believe there are any circumstances in which consolidation within the DB sector should be mandatory.

43. Even in the DC sector, where the proposed Value for Money (VFM) reforms are seeking to identify underperforming schemes, we do not believe mandatory consolidation is the appropriate solution. In the DB sector, where sponsoring employers ultimately bear the risk of underperformance, there is even less of a case for mandatory consolidation.

6. Do the recent improvement in funding levels change the future role of DB schemes in UK pension provision?

44. Yes. The recent improvements in funding levels make open DB schemes an even more viable proposition in terms of ongoing UK pension provision.[15]

45. As stated in our response to question 2 above, PPI modelling projects that the number of DB schemes in surplus is expected to rise between now and the end of 2030, which will increase the likelihood of many schemes seeking buy-out.

46. The number of DB schemes that will be in a position over the next 10 years to enter an endgame scenario (whether that be through an insurance solution, investment or administration mergers or consolidations) is anticipated to grow as funding levels improve. However, the shape of the future

[15] It is worth noting that recent improvements in funding levels were largely driven by rising gilt yields, which may not continue going forward and indeed could reverse.

market will depend on a series of factors, the impacts of which are currently difficult to predict. These include:

- Sponsor appetite for specific approaches, particularly the extent to which the challenges to covenant strength (eg. Brexit, Covid-19, higher inflation and interest rates, climate change and the cost-of-living crisis) persist and continue to factor into the forecasts used for employer covenant assessments.
- The availability of greater consolidation and the emergence of Superfunds.
- The capacity of the insurance sector to meet increased demand for bulk annuity solutions and the effect on pricing.

47. Although many DB pension schemes are preparing for their endgame scenarios, PPI modelling suggests that even those schemes that are closed to further accrual will likely be in existence for another 26 years, rising to 35 years for the few open to new entrants.[16] Despite the events of 2022 and the resulting improvements in funding levels, for many DB schemes, sponsors and members the journey to endgame could still be a long one.

48. As schemes mature, they will generally start to de-risk. Although, in addition to the maturity of the scheme, the de-risking journey should also be dependent on the strength of the employer covenant, where more risk can be taken if the covenant is strong. Otherwise, as we argued in our response to the recent DB Funding Code consultation, for mature schemes with strong employer covenants, this leads to a perverse scenario where they are essentially forced to ignore the strength of their covenant when they reach significant maturity and act as if the covenant is not in place (and therefore have to start de-risking). In our view, this seems an unreasonable and impractical outcome and potentially conflicts with trustees' fiduciary duty – i.e. forcing them to ignore covenant strength and de-risk.

7. How should scheme surpluses be treated? For example, should they remain in the scheme or be shared between employers and scheme members? Are the issues different for open and closed schemes?

49. The treatment of scheme surpluses are set out in the scheme's governing provisions (i.e. Trust Deed and rules) and varies from scheme to scheme. The scheme rules may define or restrict options on the treatment of an actuarial surplus and the making of payments to an employer in a scheme, and may give powers to the employer, the trustees, or the scheme actuary in relation to the steps to be taken.

50. ***Ongoing schemes*** – When the question of who owns surplus has been put to courts in relation to ongoing DB pension schemes, it has usually been phrased in the context of how such surplus can be utilised. The provisions in the Trust Deed and rules may help to determine what utilisation is appropriate — eg. whether it should be:
    - repaid to an employer;
    - used to improve benefits;
    - used to reduce employer or member contributions;
    - used to facilitate investment de-risking while maintaining contribution levels; or
    - retained in the scheme as a reserve.

[16] "*Approaching the endgame: The future of Defined Benefit pension schemes in the UK*", PPI research report (Oct 2019).

A number of court cases have considered the question of who owns the surplus and/or how it can be applied in an ongoing scheme. Broadly speaking, while each case has been dependent on the governing provisions of the relevant pension scheme, the courts have tended to re-emphasise that:

- members of balance of cost DB schemes do not have absolute legal rights to surplus assets;
- in schemes where trustees have a discretionary role as to the disposal of surplus assets from an ongoing scheme, members may have a legitimate expectation of benefitting from at least part of any surplus, eg. in the form of benefit improvements;
- in circumstances where the employer has a power in the trust deed and rules to apply the surplus for its own benefit, the employer must use that power in accordance with its implied duty of good faith, i.e. the employer is 'subject to the implied limitation that the power should not be exercised so as to destroy or seriously damage the relationship of confidence and trust between the company and its employees and former employees'. This means taking account of members' reasonable expectations. However, as the employer is also entitled to take its own interests into account, there is a lower level of obligation towards scheme members when it comes to exercising a surplus power.

51. ***Winding-up schemes*** – A surplus can become 'trapped' due to the fact that, on wind-up of a scheme, there will be a question around who owns any "extra" funds following the discharge of all liabilities in respect of the members and their beneficiaries. This question will generally be addressed by the relevant scheme's governing provisions, which will usually specify how any assets remaining, after the scheme's liabilities have been secured or met, should be used. The winding-up rules will:

- usually, but not necessarily, provide for the possibility of using surplus assets (or at least part of any surplus) at the discretion of the trustees to improve benefits, with any balance thereafter being returned to the sponsoring employer(s);
- sometimes provide that any surplus assets should simply be returned to the employer(s).

However, there are also statutory requirements in place that must be met before any surplus can be returned to the sponsoring employer, namely:

- the scheme's liabilities must be fully discharged;
- any power to augment benefits that exists must have been already exercised, or a decision must have been made not to exercise it;
- members must be given at least three months' notice of the proposal to return the surplus to the sponsoring employer; and
- from a tax perspective, a payment to the sponsoring employer must be an authorised employer payment.

If the scheme rules set out that any surplus will be paid to the sponsoring employer, it is only after all of these requirements are met that they will receive the surplus funds. The return of any surplus to a sponsoring employer is therefore not an inevitability or a straightforward process, despite what (if anything) the scheme rules say.

Issues can arise where the scheme rules do not expressly address how surplus assets are to be applied on a scheme wind-up. In such cases, general trust law will apply. In particular, where assets are placed on trust for a particular purpose and ultimately those assets are not required to meet the relevant purpose (in the case of a pension scheme this means the provision of benefits for scheme beneficiaries in accordance with the governing provisions of the scheme), the trustees will be deemed to hold the excess funds on a 'resulting trust' for the benefit of the parties who contributed the excess assets, i.e. the sponsoring employer(s).

52. Another option potentially available to trustees of hybrid schemes is to use a surplus arising in the DB section of the scheme to augment another section of the same scheme (subject to this being allowed in the scheme's Trust Deed and rules).

53. PLSA's view is that, in all cases (whether in relation to ongoing or winding-up schemes), surpluses should be treated in accordance with the provisions of the relevant scheme's Trust Deed and rules, as well as with the statutory requirements in place governing the payment of surpluses to sponsoring employers. The majority of our members (68% of those recently surveyed) support this view.

54. We note that TPR are aware of the issue of potential 'trapped' surpluses and, as part of the new DB funding regime (i.e. DB Funding Code and regulations), they are working with the DWP on ways to increase flexibility within the regulations. It will be important to ensure that any changes to the Code or the regulations do not act as an additional barrier to trustees and employers managing how to approach dealing with scheme surpluses or exacerbate the risk of trapped surpluses.

55. Also, to the extent that employers are required to have an expense reserve, the expense reserve should be able to sit outside the scheme (eg. in an escrow account, which already exists for DC Master Trusts) to reduce the potential risk of a 'trapped' surplus in the scheme. And where there is a legal obligation in place for an employer to cover the scheme's expenses, that should be sufficient to avoid the need to pre-fund expenses (even if the obligation sits outside the scheme's rules).

8. What are the implications of improved funding levels for the Pension Protection Fund?

56. On 29 September 2022 the Pension Protection Fund (PPF) released the outcome of its most recent Funding Strategy Review, in which it announced a significant strengthening of its financial position over recent years (to the point that it holds £11.7 billion in reserves as of 31 March 2022). This is the direct result of improved DB scheme funding levels over recent years and fewer DB scheme insolvencies requiring member compensation by the PPF.

57. With the PPF saying it is now close to achieving its financial resilience target, it is taking active steps to significantly reduce the levy to be collected from DB schemes. In 2023/24 the total amount to be collected will be £200m, which represents an almost 50% reduction on the £390m levy collected in 2022/23.[17] We support this significant reduction, which will result in almost all levy payers seeing a reduction in their levy next year.

58. The PLSA has been involved in the Industry Steering Group meetings where the PPF shared its approach on how this significant reduction to the levy could be achieved.

59. Our members have also raised with us the desire for a discussion at some point in the future around the use of the PPF's surplus once it has reached sufficient funding to cover outstanding risks in the system with a high degree of probability. While we recognise this is still some way off, there is a strong feeling by our members that a significant part of the PPF's funding has come from DB schemes and sponsoring employers (along with investment growth and recoveries). Therefore, while we recognise that there is a role for government to play in agreeing the final approach, there is a valid argument that levy payers should have a significant influence on how excess funds held by the PPF are treated at the appropriate time (i.e. during what the PPF calls the 'run-off stage').

[17] PPF Long-Term Funding Strategy Review 2022, Pension Protection Fund (September 2022).

9. Should changes be made to the Pension Protection Fund (PPF), Financial Assistance Scheme (FAS) or Fraud Compensation Fund (FCF) to improve outcomes for members?

60. Broadly speaking, the PLSA does not want regular changes to be made to the Pension Protection Fund (PPF) compensation/Financial Assistance Scheme (FAS). This is costly, difficult to implement operationally and would only serve to create uncertainty for members about the levels of protection they will receive, and also risks creating differences in support across member cohorts. We believe the original intent of the PPF compensation/FAS – namely the payment of financial assistance to members of eligible DB pension schemes who lose (or have lost) part or all of their pensions – should be retained and be kept as simple as possible.

61. As part of our mission to ensure better retirement outcomes for everyone, the PLSA fully supports victims of pension scams and shams being fairly compensated. It is vital that we have an effective regime to protect members and ensure they are compensated when they are victims of dishonest behaviours.

62. However, the current fraud compensation regime is confusing for savers and industry alike and we believe the Government should consider building a more robust compensation regime that offers protection for all pension savers and is future proofed.

63. The Fraud Compensation Fund (FCF) was set up in the wake of the Maxwell pensions scandal to tackle fraud by the employer. However its scope has changed over time with the legislation underpinning its creation being challenged by new pension frauds in the form of pension shams as defined by the High Court.

64. We believe there is an opportunity to build a more robust fraud compensation regime for all pension savers that looks at both the FCF and Financial Services Compensation Scheme (FSCS). In particular, consideration should be given to merging the FCF and the FSCS to create a single entity responsible for compensating consumers of all financial services firms against claims that are unable to be met (including pension schemes that fall victim to scams).

65. We note that there has been sustained lobbying for some time for the pre-6 April 1997 component of compensation payments from the PPF to be indexed.[18] While on face value an increase to compensation payments to keep up with rising cost of living pressures may seem appealing, the impact of any decision on whether or not to increase PPF compensation levels should be carefully considered. Based on our discussions with the PPF, we understand that even a small change in indexation levels (eg. matching the pre-97 indexation and post-97 indexation levels at 2.5%) would likely prove to be very expensive for the PPF to implement (potentially costing in the billions of £).[19] This would invariably have a material impact on the PPF's current funding levels – i.e. moving them out of their current 'maturing' phase back to a 'growth' phase[20], where increased levies would be required from DB schemes to re-build the PPF's reserves.

    Other factors to be considered include:

    - Indexing or revaluing the pre-97 component of pension payments was not required under statute for pension schemes. The PPF compensation regime was set up to mirror this.

[18] The part of people's payment relating to their time in the scheme on or after 6 April 1997 increases each year on 1 January, in line with inflation. This increase is capped at 2.5%.

[19] We understand the PPF is in the process of analysing the impact that different levels of indexation to their compensation payments would have on their funding position (based on their current liabilities).

[20] PPF Long-Term Funding Strategy Review 2022, Pension Protection Fund (September 2022).

- Benefits from compensation payments should not exceed scheme benefits and pension benefits (with capped indexation and revaluation levels) most members receive.
- Increasing the pre-97 component risk issues of intergenerational inequity/unfairness across members of DB schemes and levy payers.
- Implementing such an increase would be administratively complex and difficult for the PPF/ FAS as it would be very costly to correct (i.e. to make retrospective payments).
- In addition to the administrative complexity, the cost of making retrospective payments would have to come from the PPF's reserve, which is in place to protect future claimants.
- As mentioned above, there would be significant implications for the remainder of schemes in terms of increasing their future PPF levy payments (and subsequently for sponsoring employers as well).

All these factors would need to be balanced against the marginal increase to the average PPF compensation payment (which we believe to be around £3,500 per person) that a 2.5% indexation increase to the pre-97 component would produce.

66. The PLSA has repeatedly argued that the fraud compensation regime is not fit for purpose and requested a one-year delay to the levy hike, which was consulted on in 2022 as part of the DWP's proposal for an increase to the Fraud Compensation Levy (FCL) ceiling. We were disappointed the Government saw fit to ignore these concerns and followed through with the significant increase from the 2022/23 levy year, despite near universal opposition amongst consultation respondents.
67. In the case of the largest mass membership schemes, these increased costs are likely to be passed on to the members. Many of them operate on a not-for-profit basis and are not able to pass on costs to employers in a highly competitive market. And for multi-employer schemes, the FCL does not actually give any cover to their members, yet they will have to pass the cost of the levy on to them.

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