Broadstone

Call for evidence Response

Options for Defined Benefit Schemes

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Guide and Information

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Executive Summary

When discussing changes to the UK DB pensions landscape, it can be easy to forget that this covers a huge range of schemes in terms of size, member number and complexity.

4,000 of the 5,800 remaining schemes have less than 1,000 members but these represent only around 10% of the total asset base and 10% of the total membership of DB pension schemes *(source: Purple Book 2022)*. Of these schemes c1,800 have fewer than 100 members are closed and, on their journey, to buy-out. Most of our clients are within this sub 1,000 members category, and it is unclear whether many of these proposals are designed to assist or benefit them in any way, or if the proposals are targeted at the larger end of the market. We do see some benefits for consolidation, but they may yet be several years away.

Ultimately, when reviewing the DB pensions landscape we are keen to see solutions for these employers that help them to close off their legacy DB obligations and secure member benefits (as that is the desired path for most of these closed schemes). Certainly, a fundamental rethink around the level of risk aversion within the proposed new scheme funding regulations would be welcomed, but we would be wary of changes that further complicate the market, add to governance or regulatory requirements, or leave smaller schemes further disadvantaged compared to larger schemes who we are already seeing dominate access to the limited capacity within the (competitive) buy-out market.

We can see the possibility of advantages for consolidation at the smaller end of the market from a governance, cost and regulatory perspective. Of course this depends on the form of consolidation that is taking place as there is a range from master trust all the way to insurance buy out. With the recent significant improvement in funding many schemes are now ready to explore buy-out while insurance companies are unable or unwilling to quote for them all, and innovative thinking is welcomed to provide solutions to this apparent capacity crunch. The PPF's expertise being used to power a public consolidator has potential and could offer other solutions together with reducing the supply issue.

In our response we have tried to focus on the key goal of driving better outcomes for members and schemes. However, it seems clear that the proposals are driven, mainly, by a desire to influence the use of assets. As a result, we anticipate they are likely to be targeted at a much smaller number of larger schemes who arguably could be accessing such investments already if it was economically attractive and they were encouraged by regulation to do so.

In terms of the proposals put forward, we are most encouraged by:

- The potential of any intergenerational upside sharing for those in DC schemes. The practicalities may be insurmountable, but it is an interesting thought.
- The creation of a public-sector consolidator could provide risk transfer opportunities for smaller schemes and those with challenging benefit structures or legacy issues.
- The PPF board would be an appropriate choice to oversee a new public consolidator based on their experience as a consolidator for insolvent schemes. We should stress that we believe a public consolidator should be set up as a separate entity to the PPF as it currently is.

And have raised concerns about the practicalities for:

- any activity that encourages the increase of risk and reduction in member security for their deferred pay.

- The practical difficulties of any intergenerational upside sharing.
- A rewrite of the DB funding code (and the underlying regulations) which would be required to allow risk to return in the investment portfolios of most schemes who have de-risked. This would be a dramatic change of direction and call into question the credibility of the regulatory framework that has been in place for many years. We question the belief that better funded schemes would re-risk even if permitted to do so.
- The use of funding surpluses prior to schemes securing member benefits in full. The government may have their eyes set on scheme assets totalling billions to be invested more broadly. However, protection of members' benefits must be paramount and once this is assured the size of surplus assets may appear disappointingly small.
- Greater PPF protections to allow greater risk taking in schemes is a slippery slope and should not be a consideration under the current regulatory model, whereby scheme trustees are expected to act without consideration of the PPF as a lifeboat. Acting with PPF compensation as the backstop to risk taking would challenge the Pensions Regulator's (TPR's) own moral hazard powers.
- Funding and underwriting of the public-consolidator represents a significant challenge.

We would welcome the opportunity to discuss this with you further once any proposals reach a more advanced and detailed stage.

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Responses

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

It would have been helpful to include reference to the evidence you note. You may have been referring to this: A roadmap for increasing productive finance investment | Bank of England although it only briefly refers to DB schemes. It is also anecdotally well known, for instance, that Canada's teachers' pension plans access private equity/infrastructure assets.

However, if we take it as read that UK DB schemes have not invested as heavily in private markets as pension plans in other countries, this can be explained by a few key points.

- Diversification/fragmentation of the market – in the UK, DB pension scheme assets are spread across approximately 5,800 pension schemes, each with their own individual time horizon, membership/liability profile, strategy and sponsoring employer whose ability to underwrite risk or support the scheme in the long term could vary significantly (and be quite different to a long term, industry wide arrangement). Even where there is the potential risk budget to support the use of productive finance, the relative lack of scale (a few percent of a much smaller pot) may mean that this may not be a practical/cost-effective option for trustees to consider.
- Regulatory pressure – In part due to high profile cases, but also the desire to nail down volatility and risk and also wider pressure from IORP directives, DB pension schemes have been consistently encouraged to reduce risk and be wary of illiquid and more complex investments. Equities, diversified growth funds, LDI, corporate bonds and gilts are well understood by trustees and their sponsors and readily accessible through a variety of relatively low-cost funds. Using these assets allows for controlled growth and risk reduction, measured against the liabilities of each scheme.
- Lack of risk appetite - It is worth remembering that DB schemes are not money-making machines, and aside from those needing to invest within their risk tolerance, many other (stronger) employers have a self-imposed lower risk stance. These (predominantly closed) schemes are looking to make as much money as they need to pay the benefits they've promised, rather than aiming for higher reward where there is increased risk. The one-sided nature of the regulations, with pressure to urgently address any downside experience and regular strengthening of the funding targets has made many sponsors risk averse and keen to rid themselves of a DB burden.
- The end goal – perhaps unlike some of the international comparators you are referring to, which may have much longer time horizons, the short to medium-term aim of most UK sponsors is to remove the DB funding risk from their balance sheet through a risk transfer to an insurer. Assets with longer term time horizons before the gain is realised and/or that are illiquid do not fit well with this sort of strategy.

It is arguable that large schemes open to new members and future accrual could see these longer-term assets as part of their strategy. However there are not many such arrangements, and they remain under the same regulatory framework, pushing lower risk.

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

Re-write the draft DB funding code – the proposed new regulations for the funding code would appear to be in complete contradiction to the desires of HM Treasury. The journey that DWP and TPR have been on for 4 years or so with the new regulations has been to lock down risk through bond (largely gilt) investment.

Huge progress has been made during this time, further accelerated by the significant reduction in the present value of liabilities brought about by rising gilt yields. As a result, the new regulations are unnecessarily heavy handed and would promote less risk-taking on investments as trustees and employers race to rid themselves of the DB albatross.

For investment in higher risk assets to be attractive, schemes need to have longer time horizons (which cannot be freely engineered – it depends on the demographics of the scheme membership) and a clear upside from taking this risk.

Surplus – There has been much talk in the pensions press of the use of surpluses. The size and scope of surpluses on a buy-out basis may be exaggerated as in reality it would not be viable (both in terms of insurer capacity and availability of suitable assets) to secure all UK DB benefits at current pricing. However, the fear of a "trapped" surplus is one which concerns some sponsors and drives behaviour. For many others affordability is the key (and only) consideration. Sponsors are reluctant to over fund and trustees are much more wary of downside risk than motivated by potential upside gain. Sponsors also will have the view that capital is better allocated to run their business than sit within an overfunded pension scheme (and in some cases, possibly supporting their competitors).

Ultimately, if you are not changing the risk budget/appetite of DB schemes (because you are concerned about maintaining appropriate security) then you need to incentivise investing in these specific assets over others. Realistically this will mean some sort of financial incentive that more than outweighs the costs associated with investigating, monitoring and maintaining such exposure. Removal of downside risk (underwriting them in some way) would help but simply moves the risk from the pension scheme onto the taxpayer (probably).

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

We cannot quantify this directly as all scheme rules can be different. Further, schemes were required to make a resolution to keep such powers under section 251 of the Pensions Act 2004. Not all may have chosen to do so or managed to make the resolution before the deadline.

For ongoing schemes the return of any surplus may be permitted but with the discretion of the trustees. This will be difficult to achieve with trustees keen to ensure the security of members' benefits and so they would need to be sure the risk of underfunding returning is low, or even close to zero. This makes the position in the rules relatively moot. The statutory requirement for a scheme not in wind up is included in Pensions Act 1995 section 37 which put the onus again on the trustees to be sure this is in the members' interests and that they are advised by giving three months' notice.

Many rules will have restrictions around use of surplus (e.g. requiring augmentations to member benefits ahead of (or even instead of) a refund to the employer). It will be important for the government to consider how any new regulations would interact with such requirements, which could otherwise prevent new flexibilities having any practical benefit.

Any rules around ongoing funding (including covering longevity, interest rate and inflation risk), ongoing running expenses and member protections to be in place will result in a much smaller value of surplus assets than perhaps the funding figures would initially suggest. This smaller number that could be used for alternative assets would need to be compared to any increased risk on member benefits not being paid in full before determining if any changes are worthwhile. Presumably the government would prefer for more than the surplus assets to be allocated to "productive assets" and so increasing risk on member security.

We also need to consider the reputational risk for any employer that invests in productive assets but where the funding position worsens and increases the risk on members' benefit security.

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

We agree that current rules on surplus are one of the reasons behind the rush to buy-out, albeit not a significant one. Others (such as the ever-increasing regulatory burden and constant moving of the goal posts to increase costs for employers) mean that, for many schemes, you are unlikely to significantly change behaviour by tinkering with these rules.

Ultimately any changes should have member security at heart, and you should be wary of potentially encouraging inappropriate behaviour (e.g. trustees being encouraged to take inappropriate short-term risks in order to satisfy a particular trigger, or trustees actively managing assets in order to avoid triggering a refund to the employer because of wider funding concerns).

Realistically, drafting hard regulations that will work sensibly and fairly for all types of schemes may prove challenging. Guidance for trustees to help determine the scenario when a surplus could be returned for an ongoing scheme, to then be applied in a scheme specific manner with suitable professional input, might be more achievable. You will also need to consider to what extent it can or should completely override existing conditions within scheme rules.

We still see significant political downside for any scheme that pays out surplus and is then unable to secure member benefits in full. With that in mind, it is tempting to suggest that funding should be in excess of buy-out levels, with margins for expenses, and potential downside (e.g. increases in insurer pricing, adverse member experience). However, this is then unlikely to have any material impact in behaviour as such schemes would buy out rather than run on.

If looking to accept a weaker measure and encourage schemes to run on to generate potential surplus for use by the sponsor, then you should consider this in conjunction with funding regulations. Indeed any surplus appearing or increasing is not a given, even with investment in "productive assets". Many of the same themes would be relevant in terms of covenant strength/visibility, investment strategy and ensuring that benefits are properly understood and funded for. The recent court case on section 37 is a very good example of "unknown unknowns"

that can bite unwary schemes. As was GMP equalisation which represents a major headache and cost for virtually zero-member benefit.

Further, the sponsor may feel they can obtain better return on investment by using cash within the business rather than paying it to the pension scheme.

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

In theory yes, but as the trustees control the assets there is little incentive in them taking this extra risk, except in the ultra-secure position described above. We question the other side of the equation too as many employers have been burnt by rising DB costs in the past and may be reluctant to push for too much risk, particularly for smaller schemes where the margins are smaller, and often the sponsor is smaller.

If you do start getting schemes that are well funded (but not fully buy-out funded) and are then taking out 'surplus' periodically if/when it arises then you would expect more risk to be taken but this is also at the expense of member security.

Even if more risk is taken, it's a further leap to assume this will generate much greater investment in UK assets, including productive finance assets. These need to be attractive to investors in terms of their risk versus reward profile. As part of a diversified growth strategy, an allocation of productive assets may end up being a very small part of the pot (if any).

The ultimate concern is if the sponsor is unable to provide sufficient support to get the scheme to buy-out. Members are then left with less than full benefits when money has been taken out of the scheme or tied up in riskier assets that have underperformed, or the scheme's time-horizon has shortened.

For completeness we note that the DB Funding code and underlying regulations would also need to be revised to allow for surplus extraction.

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

There are two questions here – firstly whether greater PPF guarantees would encourage greater taking of investment risk. TPR has consistently instructed trustees not to take account of the PPF when determining their strategy and many schemes are already well beyond 100% PPF funding. There is also case law supporting this see Independent Trustee Services Limited v Hope and Others aka "The Ilford Case". Increasing to 100% cover for those under retirement age, albeit with PPF pension increases, AND allowing trustees to act with the knowledge of this security blanket would start to change behaviours but would significantly increase exposure for the PPF (if unchecked). There would also be a political decision to be made about members who have already transferred to the PPF.

Even if more investment risk were to be taken, it is not necessarily true to assume that this risk budget would be used to invest in productive finance and specifically UK opportunities unless restrictions or incentives were put in place to specifically channel funds in this way. Even for schemes who do have exposure in this area, their investment allocation would typically be small as part of a broader and diverse portfolio.

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

We are not tax experts but, in our view, the rates should be less penal relative to corporation tax but without going so far that this could become a tax management tool with money pumped into the pension scheme solely for tax purposes, just to be withdrawn a year or two later.

From the trustee perspective, tax considerations are unlikely to be relevant to their decision to refund surplus, although they will influence when/whether an employer requests one. In simple terms we see any changes as good news for trustees if rules were such that employers were more inclined to put more money into the scheme. For example, they might be better able to negotiate quicker recovery of deficits (for example) if there was a viable way for money to come back out if it was later found to not be needed. However, we still envisage reluctance from the employer who loses control of the funds in the meantime; and cashflow still constrains what many employers can contribute.

We anticipate that sponsors will be reluctant to increase their DB pension commitments so whilst ideas around allowing surplus to be repaid if accompanied with a small increase to member benefits sound like a potential win-win, they are perhaps unlikely to be used very often. More innovative thinking, such as a one-off bonus/'dividend' cash payment to be made to members at the same time as a refund of surplus to the sponsor would seem to hold greater potential appeal.

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

The question of intergenerational fairness is an interesting one and we agree it is worth considering how to start to redress the balance as many members of DC schemes will have received relatively low DC contributions whilst large amounts of deficit payments were being paid into a legacy DB arrangement.

However, from the DB scheme trustees' perspective, we are not sure that this intent would make it any easier to agree to a payment out of the DB scheme or incentivise them to want to generate such profit. The money will be immediately paid out rather than reinvested in the business so there is no improvement to the employer covenant (beyond the argument that higher DC contributions would aid staff retention). It is therefore hard to argue the trustees are doing anything other than worsening the security for their members unless benefits can be guaranteed in some way - which probably involves tying up the assets in some form of

insurance, therefore restricting the ability to generate surplus in the first place. It is hard to see how sponsors would also be incentivised to create a surplus either.

Ultimately, the devil would be in the detail of such an idea – for example, is the money to provide one-off DC bonuses or potentially used to fund additional contributions over an extended period (in which case these funds then need to be held, monitored etc.). We would welcome the chance to discuss this further with you if/when you have progressed this idea.

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

Yes, it is theoretically possible, although this also partly depends on your definition of 'misuse' - whether it is for illegal purposes or just not your 'preferred outcome'. The requirements on trustees, who ultimately control the scheme assets, should act as a barrier.

Those trustee boards who are made up of company directors (or potentially employees who could face significant pressure from management) are likely to find it harder to manage (perceptions of) conflicts, especially if something were to then go wrong in future. This is particularly true if surpluses that are taken out are immediately used for higher dividends / executive bonuses.

In the absolute extreme, you would not want any new rules (or easements) to help criminals circumvent money laundering rules in any way, passing funds through the pension scheme to make them appear legitimate.

There is the political risk of a one high profile misuse of any easement which reduces member security for individual gain which would be highly criticised. The government would need to be clear that evidence base exists that such easements would create benefits for society and not loss to members, that may be difficult to achieve.

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

Higher levels of consolidation should lead to fewer schemes, and these should each have a larger asset base, all else being equal. This in turn should result in better ability to access investment options (including productive finance) that might not be available to smaller schemes or cost effective for them to consider (e.g. due to minimum investment levels or fees).

For smaller schemes investment advice is sometimes restricted to reduce costs and so valuable opportunities to manage risk can be missed resulting in higher allocations to riskier assets.

Where investment advice is commissioned, trustees of schemes often look to diversify their asset allocation to manage risk, and so having fewer, larger schemes could mean schemes are investing in a wider range of funds than currently.

If consolidation is aimed at smaller schemes, this would benefit more schemes individually and unlock more opportunity but have less of an impact overall, as the combined assets of the 4,000 schemes with less than 1,000 and c1,800 even smaller schemes with less than 100 would still be relatively small.

If the focus is on the larger schemes, then there is greater potential for meaningful investment in productive finance but arguably some of these opportunities already exist. Also, the benefits to those running larger schemes would be less, and so some form of incentive or compulsion to consolidate may be required.

Ultimately, if those responsible for the consolidated pension arrangements have the same regulatory oversight as currently, there is unlikely to be a material shift away from the current trend to invest in low-risk assets.

The government should consider all forms of consolidation from the most radical (i.e. the superfunds whereby the employer can walk away), to master trusts (where employers participate in a larger segregated scheme), to pooled services (such as introduced by the LGPS to pool investment services). We would be very wary of compulsory consolidation, particularly at the initial stage.

Our expectation is that the government should focus its attention on those options that sever the link to the employer, such as superfunds; a public consolidator; and the bulk annuity market, as the master trust framework is already well established. You should ensure there is a viable and cost-effective route to market for the many smaller schemes that are well funded but are struggling to access these options currently.

The decisions as to what will be most suitable (or attractive) will depend very much on your objectives and the relative balance between protecting members/acting in their interests and influencing (or controlling) how pension fund assets are invested. Member security and investment strategy are very much linked, and it is difficult to see a scenario in which mandating schemes to increase investment risk is likely to be in the best interest of members.

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

With improved scheme funding positions over the last twelve months, there is a great deal of appetite to either buy-out or move to one of the superfunds, that would ultimately result in breaking the link between the scheme and the sponsor. We have seen reports that over 25% of schemes are fully funded and that over the next 5 years over 50% of schemes are expected to be fully funded.

That’s a huge increase in demand in the buy-out and consolidator market and unsurprisingly there do appear to be capacity issues. The lack of access to existing buy-out and consolidator markets is a significant factor in preventing smaller schemes from taking this step.

Commercial consolidators have not yet completed a transaction and have shown minimal interest to date in offering a solution for small schemes. It is likely that when the superfunds do start to take on schemes, they will prioritise the larger schemes over the smaller ones. Some innovative thinking is needed to remove the shortage gap for solutions in relation to smaller schemes or schemes with unusual benefit structures or assets.

In the buy-out market, the capacity issue appears to be driven by a lack of resources in processing the significant increased number of applications and then administrating the schemes post transfer. We suspect it is also impacted by insurers’ risk appetite and availability

of reinsurance. This is resulting in insurers refusing to quote for smaller schemes. Even so, where we can secure quotes, we have found that quotes for smaller schemes have less competitive tension and so are high and, we suspect, that will continue while there is excess demand. There are many well-funded, smaller schemes, fully de-risked and invested in bonds, potentially having to run on for many years.

Wind up is being held up or value lost due to other issues, and we have provided some examples below. These relate to actual experiences of particular schemes in PPF assessment, but such considerations will also apply to some ongoing schemes. Having a public consolidator could potentially unlock solutions here:

- Illiquid assets – wind ups are often delayed as insurers or consolidators won't accept illiquid assets. Having an end game that will take these on and unlock the value is likely to result in better outcomes. Loan notes are an example here e.g. for one client the market was approached to sell these and the value offered was less than the next payment due.

- Trapped assets – we have dealt with schemes that held guaranteed annuity rate options (GARs). The insurer was no longer writing new business and other insurers were not willing to accept the policy as an asset, so the policy had to be surrendered and no value was given for the GARs. Whereas if an arrangement had taken the policy over, the GARs would have provided significant value.

- Recoveries – where a company has become insolvent and funded in excess of PPF levels often the wind up can only be finalised once the recoveries are received. Insurers may not want to engage until there is clarity over the amount and timing of the recoveries which then leaves the scheme in limbo. Having an arrangement that can take on the liabilities and then uplift if any further recoveries do come in should make things significantly more efficient.

In the existing consolidator market where the employer link is not broken (e.g. master trusts), we would expect the significant up-front costs in transferring administration and investment to a consolidator is the barrier, as well as concerns over the level of control / flexibility once transferred. Without severing the link to the employer, there is unlikely to be much increase in demand in this area.

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

The key benefit is that it can be designed specifically to meet the needs of the government, and other stakeholders. This could mean providing a gold standard of security to employers and members, flexible investment strategy to invest in 'productive finance' and with economies of scale to reduce costs.

As previously stated, the current consolidator market is not expected to provide sufficient access to a cohort of schemes (generally the smaller schemes and those with benefit and or asset oddities) in the foreseeable future and so a public consolidator can help fill this gap, without distorting the current market.

Nest is a good example of how this could work in practice. Nest provides universal access to a relatively low cost auto-enrolment compliant DC arrangement. It has a one size fits all

approach, and limited options to members, which means it is not suitable for all employers, but does provide an option for those that need it and therefore, provide better outcomes for all members.

The public consolidator with its “come all” approach will also be able to take on those that have certain complexities e.g. where illiquid assets will take time to sell, guaranteed annuity rates and recovery issues (see question 11). Addressing a certain corner of the market could be a feature of any design at the outset. This may address competition concerns if the public consolidator is taking on schemes deemed too difficult by the commercial alternatives.

The key downsides of a public consolidator are that it disrupts the current market, and you need to determine who is responsible for meeting any shortfalls. If it is a non-profit entity competing with commercial operators, then this could result in unfair competition, stifle innovation in the market and prevent new entrants (maybe even encourage market exits).

In terms of who should foot the bill, whilst a public consolidator would no doubt be designed with strong intentions, we have seen a number of pensions ‘crises’ over the years, some of which could not have been foreseen. If member benefits are in any way at risk, then this could prevent trustees from agreeing to transfer across, and if taxpayers are to be put at risk of meeting any shortfall, then there may be limited political appetite to set up the scheme in the first place. However, if well-funded schemes are transferring the risk could be low – especially if the consolidator is a not-for profit organisation.

Finally, a public consolidator will be subject to political pressure that means that its purpose evolves over time (as demonstrated by the consultation on the future of the PPF). Pressure to invest in productive finance (or other areas, subject to political pressure at the time) could mean that members’ benefits are at greater risk or that entry is made available to less well funded schemes so as to have control of more funds. This in turn could result in selection bias so that only the riskiest schemes are interested in participating and whoever is underwriting the downside risk will immediately be more exposed.

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

A public consolidator could potentially disrupt the existing bulk annuity market for the reasons set out above.

A public consolidator, with some form of regulator ‘kite mark’ could be a very attractive proposition to trustees. To the extent that given the option between choosing a private sector consolidator (even possibly an insurer) or a public consolidator, trustees will likely choose the public one as there is less risk of criticism if things go wrong. The impact would be adverse if it ends up reducing competition, reducing investment in technology, or reducing innovation.

Where it could improve the current market is in filling the gap that currently exists and is unlikely to be resolved by the market in the near future, where demand is outstripping supply. This would certainly benefit those well-funded smaller schemes looking for a home, although it potentially discourages new entrants from joining the market (we would note that the barriers to joining the market are already high).

When schemes cannot access the bulk annuity market it is usually because the business is less profitable to write. This could be, for example, because the scheme is too small to warrant the

upfront costs of transacting, there is some uncertainly over the viability of the transaction, the benefits to be insured are too complicated or some of the benefits are not known with certainty. Would a public consolidator be able and willing to take on these schemes, provide security to members and still deliver value for money to taxpayers?

The best way to prevent any adverse effects on the current market is to ensure the bar to enter any public consolidator is high, i.e. it really is the only option for the scheme as all other routes are closed. A form of gateway test. However, this will again, by definition, leave the public consolidator picking up cases that are higher risk and/or financially unattractive.

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

Yes, this could be a possible outcome. However, as there has been little appetite to invest in productive assets to date, something will need to be done differently for a public consolidator to do so. We cover our thoughts on this background in our response to question 1.

One option could be to mandate or restrict the investment options available to a public consolidator. If so, who would make these decisions and who would be held responsible if the investments did not perform as expected. Who would determine which assets 'qualified' under these criteria? As stated previously, would any shortfall be met by the employers, taxpayers or scheme members?

The alternative is to relax the current regulations around DB scheme investment, which are only going to be restricted further when the new funding code and regulations are published. One option could be to relax the rules for a public consolidator. If a public consolidator is given greater flexibility than the rest of the market, then the challenge is to be able to demonstrate than members' benefits are as secure whilst justifying why such behaviour would otherwise be inappropriate. This may also give the public consolidator an unfair competitive advantage over commercial consolidators if this is reflected in the entry price.

The key for a public consolidator would be to increase the overall level of investment in productive finance whilst also ensuring the security of member benefits, without the cost falling on either the taxpayer or employers should things not go as expected.

We would anticipate the employer link is severed and so taxpayers or cuts to members' benefits appear the two main options.

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

The main options are likely to be:

- A government guarantee whereby any shortfalls are picked up by the taxpayer as and when they arise. As seen with current unfunded public sector pensions this can be significant. However, the government could justify spreading this cost over a number of years (or until the position has improved). However, questions may be asked as to why the taxpayer should support schemes where the employer has chosen to transfer the risk.

- An initial financial buffer to protect against swings in funding. This would be similar to the current superfund model and would need to be kept under review. The advantage of this is that it is not an unlimited liability (like a state guarantee would be) and could be considered in an initial investment to encourage greater investment in productive finance. The downside is that the money would need to be found upfront and if private investment is to be used, this will need to be financed, but this may not be available to a public consolidator. Perhaps some of the funding could come from the existing PPF surplus given the sponsors of the schemes benefiting from this consolidator have contributed towards this via their levies? Whether this is a fair or equitable use of funds that are ring-fenced for members whose employers have failed should be considered.
- Charge a higher premium to schemes to enter. Higher premiums could be used to ensure only the best funded schemes have access and help preserve competition in the market. This would help with maintaining a high barrier to entry but provide a route for those well-funded smaller schemes.
- Some form of levy, similar to the PPF levy. This could be paid by current buy-out providers, on the basis that the consolidator is picking up the schemes they do not want or met by potential employers (especially if PPF levies are no longer needed). It is most unlikely that either would be palatable.

Provided there is sufficient high bar to enter, for example higher initial premium from schemes, then the underwriting risk would be low unless there is too much risk in the investment strategy.

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

We agree it makes sense to consider this but have no immediate insights in this area.

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

The PPF is a known quantity with a proven track record of scaling up quickly and managing risk and funding. It may be easier for some trustees to accept a transfer to a “household name” like the PPF, with a connection to government, than to a commercial consolidator.

If running as a non-commercial venture, the PPF acting as a consolidator could offer access to consolidation to schemes which are currently unattractive to existing consolidators (see our answer to Question 19). We suggest that it should, however, be designed as a “provider of last resort” where there is no other option, rather than a new ‘gold standard’ solution.

There is an efficient system in place for schemes potentially transferring to the PPF (in an assessment period). Advisers with specific PPF expertise are appointed to the scheme via specialist panels – comprising trustees, actuarial and administration services, legal, auditors, and member tracing. Much of the process, including member communications and advice reports, are standardised. This makes the process of transferring to the PPF run smoothly and, in most cases, this is achieved within 24 months. It may be of benefit if a similar process could be adopted for consolidating schemes through the PPF with a streamlined due diligence/assessment process too.

However, the PPF has been able to achieve what it has due partly to streamlining of the compensation structure. The PPF's administration system will be considerably less complex than that needed by an insurer to run an annuity portfolio. If the PPF were to be successful as a consolidator, there could be a requirement to convert scheme benefits to the PPF structure, with some safeguards e.g. consultation with members. If this was not possible, there would need to be significant investment in the PPF to develop the knowledge and systems required. Alternatively, the PPF could retain the existing scheme administrators to operate the schemes but would still need additional actuarial resource to understand and value its commitments.

For the trustees' part, they would need to be satisfied that consolidating through the PPF is the best option for the scheme – particularly if benefits are to be changed or potentially reduced, depending on the design. In some cases, consolidation through the PPF may appear to be the only option (destinations of last resort); however markets can and do change rapidly. Indeed, schemes which might previously have met the gateway test for a consolidator or been relatively poorly funded have found that rising gilt yields have brought buy-out within reach (if only there was an insurer willing to quote).

On a similar note, if there is to be a similar gateway test for using the PPF as a consolidator, this needs to be practically designed. We consider this further in our response to question 19 below.

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

As outlined above, the Board of the PPF have relevant expertise and may be able to pivot, depending on the model put forward.

There would be costs of setting up and administering a public consolidator. If the PPF considers it has surplus above its long-term sufficiency needs, it may be sensible to use part of that surplus to cover such costs. To be clear we believe this should be a separate fund to the PPF. However, this should not come at the expense of current levy payers, who could perhaps expect some refund rather than see their payments used for purposes other than intended.

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

It is difficult to see how the PPF consolidator could be designed so as to never compete. However, there are practical situations in which a scheme may not be attractive to one of the existing consolidators or may be unable to access other consolidation models.

We understand that consolidators are at present focusing on the larger end of the market in hope of achieving scale more quickly. Insurance companies, too, are focusing on schemes over £50 million or so, as these schemes can be more profitable for them to set up and run. It is a significant amount of work to set up a scheme and doing that set-up work once for one £50 million scheme is more efficient than doing it five times for five different £10 million schemes. If the PPF's resources could be set up to act as a consolidator for the smaller schemes that are of

less or no interest to market consolidators, this would aid current capacity issues in the market for schemes that are ready to buy out but are struggling to access a competitive market.

Other than the scale issue, there are other factors that may make a scheme unattractive. These might include an unusual benefit structure, or unusual or illiquid assets such as loan notes or guaranteed annuity options.

For schemes in an assessment period with the PPF, often there are schemes which appear overfunded on the S143 valuation basis but cannot buy out. In addition to the reasons set out above, such schemes may face practical difficulties – value held in existing annuities that the insurer is not willing to reshape; PPF assumptions being optimistic compared to insurer pricing for a specific scheme; or erosion of surplus over time due to e.g. scheme expenses, or recoveries from insolvency being less than expected. These schemes have already had benefits scaled back to PPF compensation levels and had data and benefits cleansed, and so it would be comparatively simple to run these schemes on through the PPF with some percentage uplift to PPF compensation reflecting the surplus. This could potentially achieve a better, and more efficient, outcome for members than waiting until the funding level falls enough to transfer to the PPF.

There is currently a test for schemes who have exited the PPF assessment period, where they are applying for reconsideration with the PPF, that they have been unable to obtain a protected benefits quotation (broadly, a bulk annuity for the lower of Scheme benefits and PPF compensation) within a six-month period, or that the scheme is not able to afford the quotation provided. A similar process might be sufficient to demonstrate that the scheme is not competitive in the market, while not being too burdensome for smaller schemes. A balance will need to be struck to allow sufficient time for schemes to explore the market while not making the process take too long.

Finally, it is worth considering whether the non-compete aspect of the original question is absolutely necessary. A public consolidator could lead to better outcomes for members through enabling a competitive tender process for schemes which are currently able to obtain only one quotation, which may represent poor value if the insurer is aware the process is exclusive.

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

- **Are there options that could allow schemes in deficit to join the consolidator?**
- **What principles should there be to govern the relationship between the consolidator and the Pension Protection Fund?**
- **Should entry be limited to schemes of particular size and / or should the overall size of the consolidator be capped?**
- **How could the fund be structured and run to ensure wider investment in UK productive finance?**
- **How to support continued effective functioning of the gilt market?**

This will depend on the aim of the consolidator. The aim to protect scheme members is at odds with the aim of incentivising investment in UK productive finance.

The meaning of “deficit” would need to be clarified in line with the policy intention. It may incentivise the wrong behaviour if schemes in deficit were to be permitted to join the consolidator. Care would need to be taken to ensure that well-run schemes do not subsidise imprudent risk-taking. However, there may be circumstances where schemes that are in surplus on a buy-out or self-sufficiency basis find themselves unable to access existing consolidation options due to price, i.e. a practical deficit at the point of consolidation. Permitting these schemes to use a public consolidator may be of benefit, particularly if the sponsoring employer is struggling.

Limiting entry to schemes of a particular size may be useful initially, to help the consolidator manage its pipeline. However, this should not be set in regulation, as it may need to change from time to time, and sometimes quickly, in response to market changes if the aim is to avoid competition with other consolidators.

The consolidator should be legally separate from the PPF. It will be important to consider whether the consolidator (or perhaps sections within it) remain PPF-eligible, if the consolidator is to take more risk than the PPF. Again, levy payers would not wish to cross-subsidise a consolidator.

Models proposed for superfunds have included either “run on” with potential profit share to members, or “step to buy-out”. The former might better meet the policy intention of increasing investment in productive assets, although the extent to which this is possible will depend on the regulatory environment.

Finally, we note that defined benefit schemes as a group are maturing, and there is a natural progression towards lower risk assets (driven by relation to insurance pricing as well as regulation) as buy-out remains the goal for most schemes. Options that offer lower security for members may eventually result in less demand for gilts.

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