Institute and Faculty of Actuaries

August 2023

Institute and Faculty of Actuaries response to call for evidence:
Options for Defined Benefit schemes

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide and oversee their education at all stages of qualification and development throughout their careers.

Overview:

- we appreciate the challenges faced and desire of the Government to increase investment in UK productive assets.
- we also think there are several challenges and opportunities currently for DB schemes. For schemes closed to new entrants:
    - most (but by no means all) DB schemes have become better funded and nearly all are becoming more mature with shorter time horizons.
    - many are now reassessing their journey plans and end games.
    - some are looking to secure benefits in full and wind-up.
    - some would like to be able to run on and continue to take modest levels of risk and are looking for the regulatory framework in which they operate to be supportive.
    - small schemes face much more limited opportunity sets, whether in terms of investment, settlement, or governance.
    - there are still some stressed schemes and sponsors with material deficits to address.
    - all these schemes ultimately have a finite time horizon.
- For open schemes:
    - Most currently do invest more substantially in higher growth assets.
    - They would like a regulatory framework which does not create disincentives or place hurdles in the way of continuing to invest in this manner, which balances security and ongoing affordability.

- We note that the consultation does not define what is meant by productive assets. There are a wide variety of illiquid assets that schemes could invest in. Some, such as certain infrastructure investments, might not actually significantly increase risk for schemes and indeed may contribute helpfully to their cashflow matching aims. There may be opportunities for packaging such infrastructure and other investments into a form that makes them more attractive to schemes, perhaps even with some form of direct or indirect government guarantee. Such assets could be usefully included in DB scheme strategies without necessarily significantly increasing overall risk. At the other end of the scale are investments in e.g., private equity, that are likely to have a higher risk/return trade off than most other assets in which DB schemes typically invest. We note that the questions imply that to increase investment in productive assets will automatically mean that DB schemes are taking more risk. This may not be the case where the assets have attractive cashflow matching properties, or where the investment is a result of restructuring current growth asset investment, rather than changing the scheme's overall allocation to growth assets.

- We can see the attraction from a UK-wide perspective of increasing DB pension schemes' investment in various types of productive assets, especially if any additional surplus, if generated, can be used to support improved benefit adequacy for DC savers. We can also see the potential benefits to sponsors of such investments, if they are able to be rewarded for the extra risk, for example through return of surplus and/or lower ongoing contributions to schemes. However, the position for sponsors of pure DB schemes (with no DC members) is more nuanced. At the very least, any change in approach should not make it less likely that members will receive their DB benefits in full when they fall due. But most trustees will want to go further than this and see some upside for the scheme and membership if they are to take more risk and take this risk for longer, for example, through discretionary benefit awards to members or by improving overall funding to reach higher funding targets than would be possible just through a derisked strategy and employer contributions.

We have addressed the questions below as asked but would therefore note this important context. Under the current DB legislative framework, it is ultimately the trustees who make the decisions on how a DB scheme will invest, usually after consultation with the employer. In our view this balance of power has worked successfully to date, since (for most schemes) funding needs to be agreed between the employer and trustees, so that an appropriate balance of investment and funding risk is generally adopted. As this is a trustee power, it does mean that several the suggestions set out below will only work if the appropriate structures and incentives are created for DB trustees to see advantages for the scheme and their members of investing in such assets.

We also note that several the questions and issues raised below would likely be very welcome to DB pension scheme sponsors, and possibly also trustees, for example making it easier to access surplus, or having a means to select PPF coverage that extended to full benefits. Such changes may, but are not guaranteed to, make investment in higher growth and higher risk assets more attractive for DB schemes. There is a wide pool of assets, both UK and non-UK, that would meet these criteria. In addition, for very well-funded schemes, it may be possible to generate surpluses and take advantage of some of the mechanisms set out below to access surplus even if only targeting relatively low returns. It is therefore less easy to predict the extent that such changes would directly increase DB scheme investment in productive assets. For this to happen, it may be that there will need to be direct incentives specific to this asset class – for example, tax incentives, or regulatory incentives such as easier transfer to insurers or perhaps even favourable treatment in PPF levy calculations (subject to considering the impact on existing PPF members and other levy-payers).

Similar considerations apply when considering the various proposals for consolidation. For a DB trustee board to opt for any option which severs the link between scheme and sponsor, they need to be convinced that there is a good likelihood that outcomes for members will be improved by such a transaction, when compared with continuing to run the scheme in its existing form.

Question 1

There is some evidence that DB schemes are underinvested in productive assets compared to international comparators. Do you agree with the assessment of the position? Is there evidence to the contrary?

[Awaiting further input from F&I Board)]

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?

- As noted above, DB scheme trustees will, rightly, first and foremost be concerned with ensuring that members receive their benefits in full as they fall due. Defining what is meant by “appropriate security” and facilitating ways for trustees to maintain this will be key to any changes in behaviour.

- Trustees are also more likely to be prepared to take additional investment risk if there is some upside for the scheme and members, such as the possibility of discretionary benefit increases or, ultimately, the chance to reach the full funding required to buy-out the benefits more quickly where this is not likely to be achieved by a low risk strategy, and may be unaffordable for sponsors.

- Sponsors are likely to support and encourage trustees to take additional risk where there is some advantage to them in taking this approach. Historically, when schemes were generally much less well funded (as well as less mature) sponsors supported risk taking to the extent that it reduced the required cash contributions to the scheme. With schemes now in surplus, for risk taking to benefit the sponsor they need to get some advantage from further surpluses that might accrue – for example in the form of refunds of surplus or by using the surplus to fund ongoing accrual (whether DB, DC or CDC).

- To facilitate this, it should be possible to allow trustees and sponsors to agree ownership/distribution of a surplus in an ongoing situation, subject to the scheme rules and the scheme still being able to meet full benefits as they fall due. In this context, a surplus could potentially be calculated on something weaker than a full buy-out basis, but it must be subject to trustee and sponsor agreement, and we’d expect trustees to be acting in members’ best interests. This mitigates sponsor concerns about excessive funding or additional returns leading to ‘trapped surplus’. It would also be possible for the trustees to seek alternative security, for example through contingent asset arrangements.

- Some schemes, particularly those large enough to have the governance and scale to take advantage, and those open to new entrants, already invest significantly in illiquid assets, both in the UK and elsewhere.

- Another way of looking at this, would be to consider whether to introduce direct incentives to invest in productive assets (for example through tax breaks) rather than the indirect measures considered above.. but it could have unintended consequences and disruptive impacts on other asset classes.

- Further steps that would remove disincentives to invest in productive assets include:

    - Make it easier to agree a refund of surplus to the employer in conjunction with trustees and employers agreeing benefit improvements and augmentations where there is sufficient surplus, so the advantages of funding and investing for surplus can be shared.

- Ensure that the current and intended future regulatory and supervisory framework for DB pension schemes does not discourage risk taking and the focus on removing risk. As set out in our response to the DWP and TPR consultations on scheme funding and our evidence to the Work and Pensions Committee, in our view the proposed new funding regulations go significantly further than is necessary in limiting investment risk once schemes become mature. They also do not allow trustees to consider contingent assets when considering funding targets and levels of investment risk post significant maturity. In our view such contingent asset arrangements could well be an important element in any change in approach which encourages a less risk averse approach by trustees, since it can be a flexible and attractive way to ensure any trustee security concerns are addressed. The funding regulations should support such approaches. Furthermore, as noted in our Work and Pensions Committee response, consideration should be given to widening TPR's objectives and focus, so that the DB supervisory regime is not solely focused on security for past service accrual, as is currently the case.

- One disincentive for schemes investing in productive assets is that most insurers will not want to take on such assets as part of a buy-in or buy-out transaction. If there was any way to make it more attractive to insurers to take on such assets at outset then schemes would not need, as currently, to disinvest in these in the years preceding a planned insurance transaction.

Building surplus

Incentives for employers to invest for surplus are currently quite weak. Employers have little to gain from any surplus, their access to which is strictly limited, and they are entirely responsible for any deficit that might emerge if investment does not perform well. Any deficit would have to be filled by additional employer contributions and would have to be reported on the company Balance Sheet. This could affect the company's market capitalisation, and the company's ability to borrow and attract the investment needed to grow.

There are similar issues with incentives for trustees. There are many varied drivers that lead trustees to decide how much risk to take with pension scheme investments. Scheme trustees are concerned with ensuring members get the benefits they have been promised and will want to limit risk that could threaten members' interests; they may therefore prefer contributions from the employer to relying on uncertain investment returns. There is little incentive to invest to drive funding to a higher level than is needed to meet the pension promises.

For businesses which are running both a DB and defined contribution (DC) fund, there is currently limited ability to transfer surpluses to help bolster DC funds whilst protecting the member benefits for the DB funds.

Question 3

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

- It is difficult for us to comment definitively on this as it is rightly a question for scheme lawyers, but our view is that currently this is likely to be unusual, although there will be schemes that have such provisions. We note that there are many variations in how scheme rules address a return of surplus. Some will be entirely silent on the matter, with no current provisions for a return of surplus. Some will prohibit refunds to the employer, while in others there may be specific conditions attached. It is also likely that in some schemes it will be the (complex) interaction of a number of different rules that will ultimately determine the position. These will be very scheme specific.

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?

- Firstly, our view is that provisions in the Trust Deed and Rules should be respected, although we would support legislative change that would permit trustees and employers to negotiate and agree changes to these provisions where they are historic and drafted to address concerns different to those that apply today). Such discussions would take account of the current and likely future circumstances of the scheme.

- In our view any refund of surplus to the sponsor must only be possible with trustee consent, as a key protection for members will be the trustees' duty to negotiate arrangements that in their view are in the interests of the members.

- We would suggest that a specific funding level is not required, but that instead any refund of surplus is subject to the trustees being satisfied that:

    - there is no material worsening in the likelihood that members will receive their benefits in full as they fall due after the refund has been made, taking into account sponsor covenant and any contingent asset arrangements.

    - that the trustees are confident that, should a shortfall arise in future, the sponsor is likely to have the resources to make this good over a relatively short period. Such assessment could also consider the likelihood of future deficits (the greater the current funding cushion, the less this will be a concern).

- We note that there is some precedent for such an approach in the "Funding Test" that applies to Scheme Apportionment Arrangements (SAAs) and Flexible Apportionment Arrangements (FAAs) under the Occupational Pension Schemes (Employer Debt) Regulations 2005. In our view a stronger version of that Funding Test (with criteria along the lines suggested above) would be preferable to arbitrarily defining a funding level above which a surplus refund was permitted. Our experience is that trustees have taken careful and extensive funding and covenant advice, and often also negotiated contingent funding arrangements, as part of the process of agreeing an SAA or FAA, and we would expect this to apply to a heightened degree in the case of considerations around a refund of surplus.

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?

- As we noted in the introduction, making extraction of surplus easier would be very attractive for DB scheme sponsors, who have long been concerned about trapped surplus. It may also be attractive to trustees, especially if discretionary benefit increases are included in any arrangement. The possibility that surplus could be used in this way is likely to improve the risk-reward trade-off considerations for investment in higher growth, higher risk assets, making them a more attractive proposition. There is, though, a wide pool of assets, both UK and non-UK, that would meet these criteria. It is therefore less easy to predict the extent that such changes would directly increase DB scheme investment in productive assets. For this to happen, it is likely to require direct incentives specific to this asset class – for example, tax incentives.

- The obvious downside risk is that money is returned to the sponsor, a shortfall subsequently arises, and the sponsor is then unable to make it good. This would carry risks for schemes and the PPF. The principles that we think would need to be met before refunds could be made as set out in Question 4 above are intended to significantly mitigate these risks.

- We would also note that an arrangement where surplus is shared between members and the sponsor seems less likely to be subject to misuse, which is why we would not favour a statutory override and would prefer trustees to retain some power in these decisions to ensure members' interests are fully taken into account.

- We would also note that some forms of access to surplus (for example, for use purely as a means of increasing DC savings) would result in much more gradual use of the surplus than would be the case with a one-off lump sum refund and could be turned off relatively quickly if the situation changes. There may be merit therefore in considering allowing such arrangements even if it is decided not to change the current legislative provisions around full surplus refunds.

Question 6

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

- Despite the initial reservations of many, the PPF has been very successful in its current role, to provide a good level of compensation to members of schemes whose sponsors become insolvent when the scheme is underfunded, and to charge levies generally seen as relatively fair to schemes depending on the risk they pose to the PPF (based on their level of funding and the strength of their sponsor). It is in our view essential that no changes are made that weaken the PPF's ability to continue in this role, and we would not be supportive of anything that resulted in a change to the PPF's fundamental purpose and effectiveness as the "lifeboat" for schemes whose sponsors become insolvent.

- However, the PPF currently has a substantial surplus, and has rightly commenced a dialogue with stakeholders, and levy payers in particular, on how this surplus is to be utilised, bearing in mind that the surplus has been funded by current and former levy payers, and the schemes that have entered the PPF over time. We welcome this important debate on the future of the PPF.

- A significant question we would raise before any considerations about greater future PPF guarantees, is the extent to which it would be fair and equitable to also consider whether compensation should be enhanced for those already in the PPF. Recent high levels of inflation will have significantly eroded the real value of compensation currently being received by pensioners, for example. The views of current levy payers on future use of surplus should also be central to any such discussions.

- We would therefore note that the comments below assume that prior to any change to future levels of compensation there is comprehensive consultation and consideration of how existing PPF surplus should be utilised between existing members, levy payers, and higher benefits coverage for some/all schemes in future.

- Following the ITS vs Hope case, the legal position has been that trustees should not explicitly factor into their decision making the existence of the PPF as a guarantor, and that actions should not be taken which are seen as "gaming" the PPF. For increased PPF coverage to result in changes to behaviour, the legal position on this would need to be clarified and if necessary legislative changes made to give effect to the government's policy intention.

- Whether higher PPF compensation will change behaviour will depend on a number of factors, including:
    - Whether full scheme benefits are covered, or simply more generous benefits than those currently provided. If there is still some shortfall between PPF compensation and full scheme benefits, the risk that trustees will "game" the system will be lower, but so will any incentive to follow a higher risk investment strategy. If full benefits are to be guaranteed, this would very fundamentally change the day to day operation of the PPF. Guaranteeing the full level of benefits promised by ceding schemes would significantly increase the complexity of taking on new schemes, and would exponentially increase the administrative complexity of running the PPF in future (it is these administrative issues that make insurers and the current consolidators so reluctant to take on small schemes and it also complicates the "onboarding" process on a change of administrators. The PPF would not have the luxury of being as selective about which schemes it took on)
    - There is also the question as to which party would 'stand behind' the guarantee in the event of investment underperformance. If the ceding employer, then this would act as a significant disincentive to transferring schemes into the PPF, as employers would still be 'on the hook' for future cash calls. However, if the PPF underpinned the guarantee, the question arises as to whether this should be supported by levy payers or the government.
    - The question also arises as to whether this "guarantee" would apply to all schemes, or only to those that "opt in" to the higher benefit levels. If it applies solely to well-funded schemes who opt in, there are questions around selection risk and overall impact. Is the lack of a full PPF guarantee the barrier currently to such well-funded schemes investing in higher growth assets?. It is also unclear how such opt in would operate over time in a way that was fair and avoided selection risk. A one-off option would avoid schemes opting in only when they perceived the risk of insolvency to be high enough to warrant the additional levies, but would also limit the benefits and be perceived as unfair by schemes currently not well funded enough to opt in, but who may be will funded enough in future. An opt-in system is also likely to make the challenges of creating a fair and equitable levy system across the whole DB universe greater. However, if it applies to all schemes, the tried and tested approaches to calculating levies could more easily continue to apply. If it applies to all schemes though, the increase in PPF levy could be very unwelcome to less well funded schemes who are not yet at a point where they could cover even the existing levels of PPF compensation.
    - Whether (as currently) the PPF would have the legal option to reduce compensation for all those in the PPF in future should a PPF shortfall arise that could not be met by future levy collection. In our view this was and remains an essential feature of the current PPF framework to ensure it is sustainable in the long term. However, if this feature is retained, then the benefit of a PPF guarantee of full scheme benefits would be undermined, as there would be a risk that this could change in future. If it is not retained, then there may need to be an ultimate government guarantee of the fund to ensure that PPF levies do not become unaffordable in the event of a shortfall at some future date.
    - How investment in productive finance was taken into account in any PPF levy calculations, and the way any changes to the PPF levy structure were implemented. The upside benefits of the increased investment would need to outweigh any higher levies from a scheme perspective. From a PPF perspective though the levies would need to be high enough to support the extra risk being underwritten.
- As previously noted in our covering letter and in our response to Question 5, even assuming the changes could be implemented and that they would, for some schemes, make investment in higher growth assets attractive, it is not clear that they would result in higher investment specifically in UK productive assets without direct incentives relating to this asset class.

Question 7

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

- In our view the tax rate on the return of surplus should be the same as the employer's marginal tax rate. This would mean that returns of surplus would be cost neutral, and simply reverse the tax relief the sponsor gained when contributing to the scheme.

- In order to counter a risk that sponsors might seek to build up an extractable surplus in a tax-favoured investment growth environment, there is also the option of introducing legislation to restrict the amount of refund by reference to the amount of employer contributions that have historically been paid – in either nominal or inflation adjusted terms.

Question 8

In cases where an employer sponsors a DB scheme and contributes to a 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?

- We are very supportive of any measures which seek to improve the adequacy of DC provision over and above the auto-enrolment minima. In our view ensuring adequacy of future DC pension provisions is essential for the current generation of employees who will not benefit from historic DB accrual.

- We therefore believe it would be appropriate to develop a legislative mechanism to support use of surplus in this way. We note that, where DB and DC benefits are provided within the same Trust and the scheme rules permit it, it is already possible for this to happen, and we are aware of schemes in surplus where such arrangements are in place currently. We note though that, notwithstanding any provisions in the rules, there are good controls currently in place supporting such arrangements. They will have been negotiated between the employer and trustee, and the (usual) requirement for the Schedule of Contributions to be agreed between the trustees and employers gives the trustees an explicit role. Further protection is afforded by the requirement for any Schedule of Contributions to be certified by the Scheme Actuary as expected to continue to meet the Technical Provisions (assuming there is no Recovery Plan). We note that such arrangements, subject to Trustee agreement, could cover all DC contributions, not only those above the auto-enrolment minimum.

Whether such arrangements are within the same trust or not will depend on historic circumstances and the views of historic company decision makers. In our view there is merit in attempting to level the playing field so that employers with separate schemes can benefit from this subsidy in the same way. Indeed, we are aware of some sponsors considering how to bring schemes back under the same trust to access the flexibility, and who have arranged complex transfer arrangements to achieve this outcome. A simple legislative mechanism for subsidising DC contributions would therefore be attractive to employers, avoid these complex restructurings and create a level playing field for all sponsoring employers.

- We note that there would be challenges involved in designing such a legal mechanism, in particular to ensure that any surplus extracted is in fact used to benefit DC members rather than simply providing capital to the employer. A policy decision would be needed on whether it could be used for all DC contributions, only those above auto-enrolment limits or only to supplement DC contributions already being paid (even if already higher than auto-enrolment minima). On balance, our view is that the second option (to support contributions above auto-enrolment limits) would be appropriate if the aim of the policy is to improve DC adequacy, but if the policy is to avoid unfairly penalising employers who already provide more generous contributions to DC schemes than the minimum requirements.

- From a trustee perspective, similar issues arise to those noted in Question 2 above, with the wider DC adequacy not a concern or relevant factor in the DB trustees' decision-making. As previously, the trustees would (as a minimum) need to consider such a use of surplus as not being detrimental to the interests of the existing DB members, and ideally to see some upside for their membership. Similar conditions may be appropriate to those we set out in Question 4 although we note that ongoing smaller surplus withdrawals may pose less of a risk to member security, and could be designed with protections to enable them to stop if funding deteriorates, so that the threshold for use of surplus in this way could perhaps be lower than for a one-off refund to the sponsor.

- We also note that, if such a mechanism was introduced, it could be extended to also support contributions to other alternative pension arrangements, for example CDC schemes.

Question 9

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

- Yes. Wider access will need to be regulated to avoid misuse, and the protections we outlined in Question 4 above would be important.
- As noted above, the risks of misuse are mitigated where trustee agreement is required and where appropriate “gateway” tests such as those proposed in Question 4 are adopted.

Consolidators

For sponsoring employers who want to move their defined benefit scheme off their balance sheet, there are currently limited options other than going to insurance buyout. However, the insurance buyout market is not within reach of all schemes. We want to gather evidence around possible options for the entire spectrum of DB schemes, whilst recognising the important role played by insurers in offering buy-outs to improve security for pension fund members in this market.

The Government is supporting the development of superfunds for those schemes for whom there is no realistic prospect of buying out on the insurance market. In this call for evidence the Government is exploring the potential benefits and drawbacks of a public sector consolidator. Through the design of a public consolidator the Government may be able both to ensure investment objectives are met and promote long-term investment timeframes that would support investment in UK productive finance.

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?

Consolidation has been proposed to address a number of different, but related, issues, and the government needs to first consider which issues consolidation is aiming to address. This will inform which approaches to consolidation should be supported and facilitated by the legislative framework. In our view the different purposes are:

- Consolidation of small schemes to address the issues caused by lack of scale – this includes high costs relative to assets, the challenge of implementing effective governance arrangements and the limited investment opportunities available to small schemes. Within the DC market, Master Trust arrangements have successfully been used to address these issues.
- Consolidation to improve scale and effectiveness of investments, not only for very small schemes. Larger schemes have more freedom to invest in a diversified portfolio, more ability to use their scale to withstand higher charges (both investment, research and advisory), and a greater ability to smooth out liquidity needs. Therefore it is currently only the largest schemes who typically invest in more complex

illiquid assets and have the scale and governance to support this. It is also such schemes who are able to develop the expertise and tools to use successful cashflow matching run-off strategies akin to those adopted by insurers. Consolidation could provide access to such strategies for smaller and medium sized schemes. As used by insurers, such strategies may already invest in some types of productive assets, and therefore this approach could facilitate such investment in future.

- Consolidation to improve member security. This is where the existing employer covenant is weak, and the position is such that buy-out is unlikely to be a possibility, and where superfunds are currently expected to be attractive.

- Consolidation as a mechanism to allow employers to sever the link to the scheme and move the liabilities off balance sheet at a cheaper cost than buy-out. For such consolidation to work, someone (the government?) would need to step in as guarantor.

We note that investment consolidation, while providing the scope for increased investment efficiency and sophistication, would not ultimately change the time horizon or longevity of the benefits being underwritten. A large collection of mature schemes will still, on average, have the same finite duration as a single mature scheme. It is only the genuinely open DB schemes (and the new CDC schemes) who can expect to invest indefinitely in growth assets given their very long investment horizon.

We also note that DB consolidation is significantly more challenging to achieve than DC consolidation. One reason is that replicating existing benefits is complex and difficult to achieve, as each scheme has its own peculiarities in how benefits are calculated. As noted above, the reliance on sponsor covenant, and its possible removal, also make consolidation a much more difficult option for DB scheme trustees.

- As per the above, we do believe consolidation has the potential to improve the efficiency and sophistication of DB asset investment. It could also be a good opportunity for smaller schemes who currently lack governance and resource to improve member outcomes. To work though, careful thought would need to be given to if, when and subject to what constraints consolidation severed the link between employer and scheme. Small scheme consolidation would also be significantly facilitated if it was made legally easier to change the shape of the DB benefits on consolidation (subject of course to ensuring that the overall actuarial value of the benefits remained unchanged). Such reshaping to a more standard benefit structure would make DB Master Trusts considerably more attractive from a provider perspective.

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?

- *Waiting for further input from Boards across IFoA.*

Question 12

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

This will depend heavily on:

- Who acts as the public consolidator (the PPF or someone else?). If the PPF, would this be in a separate fund? We think a separate fund would be essential to ensure that those currently receiving PPF compensation and current and future PPF levy payers are protected. As noted above, it is also important the current PPF surplus is used equitably.

- Whether there would be any 'gateway test' applied for a public consolidator, and what this should be. One option would be for the gateway test to be that the scheme was only eligible for voluntary entry to the public consolidator where they had failed to secure access to a commercial consolidator (or insurer).

- What the terms of entry for these schemes would be? Set too high, it would not be attractive for many small schemes. Set too low, there would be a risk it would be unviable in the longer term (unless a government guarantee was provided – see below)

- Whether benefits would be guaranteed in full, and by whom. If there is no guarantor, and benefits could be reduced, this would be a major disincentive for trustees to enter the public consolidator. If there is to be a government guarantee, then this would be a significant advantage over commercial consolidators, and therefore the issues above re suitable gateway tests and the level of funding required to enter the public consolidator would be critical.
- As we have already observed, there are significant practical and administrative challenges in consolidating small schemes while continuing to replicate existing benefit structures, with significant work to "onboard" schemes and then material ongoing complexity in administration. These are key reasons why small scheme are not attractive to commercial consolidators, and a workable solution to this issue would need to be found for any public consolidator. Of course, the existing PPF has its own solution to this issue as it provides a streamlined benefit structure. However, this only works in combination with stringent entry conditions, a statutory discharge for trustees (otherwise they could not agree to a revised benefit structure and potentially reduced benefits), and no element of choice as to whether to enter.

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?

- We expect there would be an impact, although it may be more limited if the current gateway test applies, namely that the scheme is not expected to be able to secure benefits in full through insurance. We also note the small number of insurers in the bulk annuity market and the associated lack of capacity to consolidate schemes via the insurance route represents a barrier to consolidation, especially for small schemes. New entrants to the consolidation market would be a positive development, provided they are well-regulated to protect members and the "gateway" tests appropriately designed. However, the administrative complexity problems we describe above seem likely to mean that consolidators would still favour larger schemes over smaller ones.

Question 14

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

- To the extent that a public consolidator (or indeed any of the commercial consolidators) was successful in consolidating the many smaller schemes that currently are unable to use more complex and sophisticated investment strategies, this could perhaps lead to an increase in wider investment in "UK productive finance" as part of the more diversified strategies which such consolidators would be likely to pursue.

- A public consolidator though would not necessarily access UK productive investment more than a private one, or the existing bulk annuity insurers, unless it has a particular mandate. Any mandate would have to be made public and would influence the choice of the schemes selecting a consolidator. The existence or otherwise of a direct Government guarantee could also influence significantly how the scheme was invested, and the Government itself may have views on the level of risk it is underwriting.

Question 15

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

- This is a very important part of the overall design of the consolidator, and difficult. Options would include:

    - Using the PPF as the consolidator and not using separate funds for the consolidation and ongoing PPF operation. This would mean that current levy payers (who are of course a diminishing group) would effectively underwrite the scheme, and that current surplus was used to fund this. In our view this would not be appropriate.

    - No underwriting, other than setting prudent reserves for the consolidator and appropriate funding requirements on entry. This would be more akin to the position for commercial consolidators, but might well make trustees more reluctant to effect a transfer other than in situations where their current employer covenant was weak.

    - A Government guarantee. This would be very attractive for trustees and schemes, but could only work if the "gateway" tests for the consolidator where such that it was not directly in competition with commercial consolidations. This option is also not without difficulties.

Question 16

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

Pension Protection Fund as a consolidator

11. The Pension Protection Fund (PPF) has a track record of investing for long-term objectives. It is a credible option for a body to run a public consolidator for any schemes that could benefit.

12. One idea is to consolidate some schemes into a fund managed by the Board of the PPF. This would address incentives by breaking the employer link, and it would also drive scale, enabling a more sophisticated and productive long term investment approach.

13. The Departmental review of the PPF recently recommended that Government consider extending the Board of the PPF's remit to include "acting as a consolidator or provider of aggregated services for schemes which would benefit from this, but which are not attractive to commercial consolidators". The Department is therefore collecting evidence on whether the PPF's remit could be expanded to allow it to act as a public consolidator.

Question 17

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

- The PPF has operated very successfully to date, and has significant experience in "onboarding" the schemes of ceding employers, from both an administrative and investment perspective. There would therefore be some attraction to using the PPF as the consolidator. However:

    - We note in Question 12 some of the fundamental questions that would need to be addressed for any public consolidator, and these apply equally to the PPF. In our view it would be essential that the PPF's role as consolidator was separate (and used separate funds) to those used by the PPF for its current purpose – acting as the provider of compensation to members whose employers become insolvent when the scheme had insufficient funds to insure PPF-level benefits. It would not be reasonable to expect levy payers to fund the PPF acting as consolidator to schemes of ongoing employers, especially if full benefits were provided rather than the reduced PPF compensation.

  - A decision on the structure of any underwriting of the new scheme would also be needed, and as noted above this is not at all straightforward.

- There are potentially upsides, particularly for schemes who do not have access to a commercial consolidator or the buy-out market. If a critical mass of assets was achieved, there would also be the potential for better, more sophisticated and diversified investment strategies than is possible for smaller schemes, and the PPF has proven capabilities in this regard. If a solution to appropriate underwriting of benefits was achieved, this could also benefit members of schemes whose employers are relatively weak, and who would otherwise be at risk of only receiving reduced PPF compensation.

- As noted previously, there would also be significant operational challenges if current benefits are to be replicated in full, but this would be necessary to avoid creating a significant advantage for the PPF as consolidator over commercial consolidators or buy-out providers.

Question 18

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

- It could well be appropriate given the proven expertise of the existing Board, although as noted previously it should be a completely separate fund, which would have different challenges and objectives to those of the current PPF.

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?

- As noted above, the PPF as consolidator would need to target (or only be available to) those schemes who, either through size or funding, were unable to access commercial consolidators or the buy-out market. Suitable “gateway” tests would be needed to achieve this.

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?

- As previously noted, we think it is essential that the PPF as consolidator is a separate fund from the current PPF, so that PPF compensation for those currently receiving PPF benefits and the interests of existing levy payers are protected. The level of funding of the schemes joining the consolidator (and the level of benefits provided if above PPF levels) should therefore have no impact on existing PPF beneficiaries or PPF levy payers (i.e. potential PPF beneficiaries).

- We also assume that the ‘gateway’ tests suggested above would apply, so that the PPF consolidator was not competing with commercial providers.

- It is of course important to define what is meant by a “deficit” in this context. It would be expected that any schemes would have a deficit on a solvency basis (since they would otherwise be able to buy-out in full) and so the key question is what level of assets would be needed to ensure the fund could operate successfully – and the requirement may need to be that the scheme is fully funded on some appropriate definition of low dependency.

- Another important consideration, once again, will be how the benefits are underwritten and if there is the facility to reduce benefits in future. If the scheme is self-funded, but there is flexibility (in more extreme scenarios) to reduce benefits, then there could be more flexibility over the level of funding required for entry.

- what principles should there be to govern the relationship between the consolidator and the Pension Protection Fund?

- As noted, in our view the PPF and public consolidator should be separate funds (even if both are run by the PPF Board). The purpose of the two would be different – the PPF would remain the vehicle for providing compensation for members of poorly funded schemes with insolvent employers, while the public consolidator would be aiming to provide full benefits to the schemes of ongoing employers who voluntarily chose to transfer and met the necessary requirements in terms of gateway tests and funding levels.

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

- No, in our view there would not be a need to cap the particular size of scheme or the size of the overall consolidator, provided its purpose (and the gateway tests for entry) were structured such that its target schemes were those unable to access either commercial consolidators or the buy-out market.

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

- Any investment decisions taken would need to be based on the best interests of the scheme and its members, so that investment in UK productive finance would only happen to the extent it was appropriate as part of a diversified scheme taking on appropriate levels of risk. The level of risk appropriate would depend critically on whether there was a direct Government guarantee, or the flexibility to reduce benefits in future if needed. A direct Government guarantee, together with an explicit mandate to require investment in UK productive assets may be the only way to ensure that this happened, and we question whether this would be an appropriate approach.

- how to support continued effective functioning of the gilt market?