19 April 2024

Response from the Pensions Management Institute to DWP call for evidence: *Options for Defined Benefit schemes*

Pensions
Management
Institute

Moving pensions forward

Registered Office:
Devonshire House
60 Goswell Road
London
EC1M 7AD

T: +44 (0) 20 7247 1452
W: www.pensions-pmi.org.uk

Response from the Pensions Management Institute to DWP call for evidence: Options for Defined Benefit schemes

Introduction

PMI is the professional body which supports and develops those who work in the pensions industry. PMI offers a range of qualifications designed to meet the requirements of those who manage workplace pension schemes or who provide professional services to them. Our members (currently some 7,500) include pensions managers, lawyers, actuaries, consultants, administrators and others. Their experience is therefore wide ranging and has contributed to the thinking expressed in this response. Due to the wide range of professional disciplines represented, our members represent a cross-section of the pensions industry as a whole.

PMI is focused on supporting its members to enable them to perform their jobs to the highest professional standards, and thereby benefit members of retirement benefit arrangements for which they are responsible.

We trust that the feedback in the following pages proves helpful.

Question 1: Would a statutory override encourage sharing of scheme surplus?

A statutory override would *permit* the return of scheme surplus to the sponsor. Whether *sharing* of scheme surplus is encouraged will depend on the structure of the override and its operation.

Question 2: What is the appropriate balance of powers between trustees and employers? Should a statutory override allow trustees to amend scheme rules around surplus at their sole discretion, or should such amendments be contingent on an agreement between trustees and the sponsoring employer?

We consider that agreement between trustees and the sponsoring employer is the most appropriate balance.

Question 3: If the government were to introduce a statutory override aimed at allowing schemes to share surplus with sponsoring employers, should it do so by introducing a statutory power to amend scheme rules or by introducing a statutory power to make payments?

Question 4: Should the government introduce a statutory power for trustees to amend rules to enable one-off payments to be made to scheme members, or do schemes already have sufficient powers to make one-off payments?

We understand that a statutory power would be needed to enable trustees to make one-off payments to members, as this is not possible under the current regime.

Question 5: What impact, if any, would additional flexibilities around sharing of surplus have on the insurance buyout market?

All else equal, fewer schemes may choose to target (or be able to afford) bulk annuitisation (at least, initially), although we would expect that a large number of schemes/sponsors would still continue to wish to annuitise.

Question 6: What changes to the tax regime would support schemes in delivering surpluses to distribute as enhanced benefits?

We do not consider that further changes are required, beyond that already implemented from 1 April 2024. This would presumably need to be kept under review over time, if corporation tax changes, to avoid potential arbitrage.

Question 7: Are there any other alternative options or issues the government should consider around the treatment of scheme surplus?

Government should consider whether mechanisms to share surplus with members via benefit enhancements or one-off payments should include *all* members (including those not yet in receipt of a pension) – to ensure inter-generational fairness associated with member benefit enhancements.

Having regard to the policy objectives of avoiding trapped surplus and allowing for investment returns, it is noted that some schemes already make use of separate reservoir trusts into which payments are made. These can have the benefit incentivising payments from employers into well funded schemes. Also the payment out of reservoir trusts can be structured in a manor which reduces the need for fiduciaries to be required to exercise their discretion in respect of surplus repayment. Providing for reservoir growth trust funds on a statutory basis may potentially assist with the question in practice, in addtion to the current proposals

Question 8: Under what combination of these criteria should surplus extraction be permitted? If you feel alternative criteria should apply, what are they?

We consider that a low dependency funding basis, plus a buffer, might be an appropriate level which would provide a reasonable level of protection for members (but would be less prudent than buyout pricing). Whilst a variable margin would be better reflective of the level of investment risk in a scheme, it would make the criteria more complicated. Similarly, we agree that trying to factor in a measure covenant assessment would be over-complicated.

Question 9: What form of guidance for trustees around surplus extraction would be most appropriate and provide the greatest confidence?

We consider that this guidance would sit more naturally within the new draft funding code, noting our previous comments to the original call for evidence that a key behavioural challenge to overcome here is to change the ingrained mindsets of trustees who have for years been directed to reduce investment risk.

Question 10: What might remain to prevent trustees from sharing surplus?

See Q9 – changing the ingrained behaviours from years of guidance and regulations is likely to be a challenge. There may also be pressure from some members/unions not to “gamble” with members’ benefit security (even with the potential for members to share in that surplus); which might depend on their assessment of the sponsor covenant.

Question 11: Would the introduction of a 100% underpin have a material impact on trustees’ and sponsors’ willingness to extract surplus? If so, why and to what extent?

As we noted in our response to the original call for evidence, established case law has directed trustees to ignore the presence of the PPF when making investment strategy decisions. Unless this is amended, strictly, the answer should be “no”.

We see no reference to this point in this latest consultation, however, if this position were amended, then yes, combined with the surplus extraction / member augmentations point already covered, we can see that this could support trustees & sponsors being encouraged to take additional investment risk (although as previously noted, whether this would be via investment in UK productive finance is a separate question).

The same is true if trustees were afforded some other form of additional security to underwrite the additional risk being run when targeting an ongoing surplus. Many forms of additional security already exist (for example: escrow, guarantees, asset backed contributions, contingent assets, letters of credit, surety bonds, credit default swaps). As such, and particularly given the high indicative levy rate, we do not believe that an additional 100% PPF option would, in itself, materially change the number of trustees/sponsors willing to target surplus extraction.

That said, having an additional option to consider would likely prove of interest to *some* trustees/sponsors. We assume that sponsors and trustees would assess the value and merits of a 100% PPF option alongside other established forms of additional security which may be available to them.

Question 12: Are there other benefits to a 100% underpin that the government should consider?

No.

Question 13: If you consider a 100% underpin could deliver valuable benefits, what does the government need to prioritise to ensure an effective design? For example, does the way the "super levy" is calculated need to ensure that the "super levy" is expected to be below a certain level? How high a level of confidence does there need to be that the PPF will be able to pay a 100% level of benefits?

As set out in Q11, whilst we do not believe that a 100% PPF underpin would particularly change the number of schemes who would consider targeting surplus extraction.

If such an option were to be made available, we agree with government's assessment that any 100% PPF option (and funds) should remain separate from the existing PPF fund, with the "super levy" payable in addition.

Question 14: Are there other methods outside of the PPF that could provide additional security to schemes choosing to run on?

Yes – see our response to Q11.

Question 15: Would the proposed approach to eligibility allow schemes unattractive to commercial providers to access consolidation? Would it be attractive to such schemes?

As set out previously in our response to the original call for evidence, we are not convinced that a public sector consolidator, if eligibility were genuinely limited only to those schemes which were unable to access existing forms of consolidation, would have any meaningful impact on the extent of investment in UK productive finance – i.e. meet the key policy objective.

As such, whilst we have provided responses to the subsequent questions, these are subject to our overall scepticism over the concept and merits of a public sector consolidator.

Repeating our previous observations:

> *"Commercial consolidator markets are only incipient, so have not yet had the time or scale to draw a firm conclusion on this question. Our assumption would be that in the first instance, such vehicles would be aiming to quickly build scale, and therefore would be focussed on larger schemes.*
>
> *Buy-out markets are more established and can cater for smaller schemes (we are aware of recent transactions down to the low single-digit £Ms), although the demand for bulk annuities vs supply for these markets means that insurers are likely to focus on larger schemes in the first instance.*
>
> *Taken together, then arguably there could be a gap in the market for an alternative Public Consolidator for very small schemes (as identified in the Departmental review of the PPF). However, by definition, the assets associated with such schemes will be small, even taken in aggregate. So, even if such a consolidator were mandated to invest a proportion of assets in UK productive finance assets, we would expect the overall impact would presumably be small."*

If, however, government still believe there is merit in pursuing this approach, then we would consider it unnecessarily onerous (and open to manipulation) for a scheme to have to prove that it cannot access commercial consolidation or insurance buyout. We instead consider that a fixed limit on asset size under which a public consolidator were available, would be a better eligibility criteria.

As we noted previously, we are aware of schemes down to low single digit £millions who have successfully achieved insurance buyout (and of course, individual annuities can also be purchased below this level), so consider £1M might be a reasonable entry level. This entry level criteria should be subject to periodic review, depending on the evolution of commercial consolidation and insurance buyout markets over time.

Such a limit would also avoid the need to set any limits on the size to which a public sector consolidator could grow (because, even in aggregate, it would be small).

We note that the PPF's own response to this consultation appears to envisage a far looser eligibility criteria, which could result in far larger schemes seeking to enter (and being considered eligible for) public sector consolidation. Combined with some of the other proposed features of such a vehicle (in particular, the ability to restructure benefits and the source of underwriting – see later), we consider that this could result in unfair competition with the commercial options.

Question 16: Is setting the consolidator a duty to accept transfers from schemes unattractive to commercial providers and mandating certain design features (for example, benefit standardisation) and ensuring no unfair advantage sufficient to limit impacts on commercial alternatives? If not, what alternative approaches would you recommend?

The impracticality of a public sector consolidator administering multiple benefit scales was something we raised in our response to the original call for evidence, so we noted with interest the proposal that benefits could be standardised.

Clearly, however, granting such a vehicle this ability does not result in a "level playing field" with commercial options, and so unless the eligibility to a public sector consolidator was tightly limited (as outlined in our response to Q15); or the ability to re-shape benefits were extended to all schemes (whether seeking to enter public sector consolidator or not); then we would consider this reshape benefits would be anti-competitive, compared to commercial options (where this ability does not exist).

It is also worth noting that collecting the necessary data and carrying out the calculations required to facilitate benefit standardisation would be a material (and costly) undertaking, which may be unfeasible for some schemes (and be disproportionately larger for smaller schemes).

Question 17: Would a limit on the size of the consolidator be needed? If so, how might a limit on the size of the consolidator be set? Would limits on capital and a requirement to meet the same capital adequacy requirements as commercial consolidators suffice, or are there alternatives?

See our answer to Q15 – we consider that a stricter, size-based entry requirement would act to limit the size of the consolidator, such that subsequent limits or reviews would not be required.

In addition, we consider that such a consolidator should be subject to the same requirements as commercial consolidators, to ensure a "level playing field" (where possible, see Q16).

Question 18: How in practice might the public sector consolidator assess whether a scheme could access a commercial consolidator?

See Q15 – we would favour a simple limit based on asset size.

Question 19: On what basis should the public sector consolidator be entitled to reject schemes from entering?

We consider that the only grounds for rejecting a scheme that was sufficiently small would be on grounds of underfunding (i.e. not being able to afford the entry premium, including allowing for any deferred premium arrangement with the sponsor). This level would presumably be determined by the pricing basis, capital requirements and source of funding/underwriting.

Question 20: Do you have additional views on the expected characteristics of the consolidator outlined above?

No.

Question 21: Do you agree that the consolidator should run as a single pooled fund and operate on a "run on" basis rather than target insurance buyout? If not, what alternative structure or operating basis would you propose?

Yes, although see Q22.

Question 22: Should underfunded schemes be segregated to avoid potential cross-subsidy with other schemes?

We consider that the answer to this question depends on how the consolidator is to be underwritten. Segregation would act against the desire for the consolidator to be easily and simply administered (particularly if benefits were to be harmonised). On the other hand, if underfunded schemes were permitted to enter, then this would arguably pose an unacceptable risk to the benefits of other members (and, potentially, the existing PPF). See also Q33.

Question 23: Would schemes unattractive to commercial consolidators be attracted to a public sector consolidator given the model proposed above?

Yes.

Question 24: Should open private sector DB schemes be eligible to enter the consolidator? Should the focus be on closed schemes specifically?

We would consider that the option should be available to closed schemes only, if the link to the sponsor is to be severed. This would also maintain ease and reduce cost of administration.

Question 25: Will this achieve the right balance between limiting the cost of transactions whilst remaining reasonably attractive to scheme trustees and their members? Are there certain elements of schemes' benefits that should always be retained?

Yes, we consider that approach to be reasonable. The more options available, the more onerous the administration, and the more difficult the communication/understanding on the part of members, trustees and sponsors. Conversely, the more likely it would be that members should not experience a material reshaping of their benefits.

We would consider that some form of annual indexation, the provision of a contingent spouse's benefit, retaining the normal retirement age, and no decrease to annual pension amounts, to be important elements. An obvious starting point for the benefit

scale would be the existing PPF benefit structure (which would also make ongoing administration by the PPF more straightforward).

Question 26: If standardised benefit structures are applied, what should these benefit structures be?

See Q25.

Question 27: What effect will this have on the existing market of commercial consolidators?

See Q16.

Question 28: Will this proposed governance structure achieve effective administration and public confidence in the public sector consolidator?

Yes – the PPF has proved to be a capable administrator of a simple benefit structure. It will be necessary to ensure that it continues to be appropriately resourced, over time, as member numbers increase. As an aside, we would consider it hugely optimistic that such a vehicle could be launched by 2026.

Question 29: What alternative governance structures should be considered?

None.

Question 30: Is the proposed funding basis appropriate to achieve the consolidator's aims and in particular its aim to maintain the security of member benefits?

We would consider it appropriate that such a vehicle is subject to the same funding / capital reserving buffer requirements as commercial consolidators, particularly if the entry criteria are looser. We observe that the entry price suggested would appear to be lower than insurance buyout or commercial consolidation, which could result in market disruption.

Question 31: Is the proposed entry price approach using the technical provisions basis feasible?

Yes.

What alternative entry pricing approach might appeal to the consolidator's target market whilst still meeting the overall aims?

n/a

Question 32: How should any surplus generated by the consolidator be treated?

We consider that the same restrictions on surplus distribution as apply to commercial consolidators would be appropriate. For example, if taxpayers have underwritten the

benefits (noting our previous comments on whether that is appropriate – see later) then it would be appropriate for surplus to be returned to taxpayers, where appropriate.

Question 33: Are these arrangements for schemes transferring into the consolidator sufficient to achieve the consolidator aims outlined above? If not, what alternative arrangements would you propose?

The principle of a deferred premium is sometimes used in insurance buyout scenarios, and so would not appear to be unreasonable in this context. Clearly, this places additional risk on the consolidator, and therefore the period and quantum of the deferment will require careful consideration. The proposal to segregate underfunded entries until such stage as they are fully funded mitigates this risk, to an extent, although does not address the situation where the fund subsequently falls back into deficit.

Question 34: Is the proposed investment approach appropriate to achieve the consolidator's aims as set out above?

Presumably, the Board would have flexibility to invest however it wished, subject to fulfilling any statutory or fiduciary duties. UK productive finance will be one of many potential asset classes available to the Board.

As noted previously, it the public sector consolidator is genuinely to be aimed at those schemes not served by existing consolidation options, then we do not believe that it will grow to such a size as to permit a material investment in this asset class.

Question 35: Will the proposed approach also allow the consolidator to reach a scale at which it can operate effectively?

See Q34.

Question 36: What method of underwriting would be most appropriate to achieve the aims of the consolidator, given the expected capital requirements and timescales?

As noted in our response to the original call for evidence, we do not believe that there is an appealing answer to this question. We consider this to be one of the key flaws in the proposal.

On the one hand, we do not consider it appropriate that existing PPF funds be used to underwrite a public sector consolidator. On the other hand, we cannot see a strong argument for why UK taxpayers should provide this underwriting, on top of funding the existing state pensions system.

Relatedly, the consultation refers to "finite" and "limited" funds being made available for this purpose, however we would question whether, having directed the establishment of such a vehicle, a future government could conceivably let it fail. If trustees/sponsors draw the same conclusion, (then notwithstanding what is written in the consultation or subsequently) they may conclude that a public sector consolidator is effectively *fully*

underwritten by the UK government – and the perceived additional security would represent an anti-competitive environment vs existing commercial options.

If government continues to pursue this strategy, then whichever source of underwriting is selected, we consider the points above to be another strong argument for strictly limiting the size (and hence risk) of the schemes eligible to enter.

Question 37: Are there other options that the government should consider to provide underwriting for the consolidator?

See Q36.

Question 38: Should government underwrite the consolidator and set the investment strategy?

See Q36.

Question 39: How could any government underwriting be structured to support the aims of the consolidator whilst limiting risks to the taxpayer?

See Q36.

Question 40: What conditions ought to be met for the PPF reserves to be considered as a source of underwriting?

See Q36.

Question 41 onwards:

Not applicable - PMI is a professional body which does not sponsor a DB scheme.

Contacts for comments

Joe Moore:
joe.moore@aon.com
Member of the Policy and Public Affairs Committee

Clive Pugh:
clive.pugh@burgess-salmon.com
Member of the Policy and Public Affairs Committee