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

Pensions Management Institute

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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 6,000) 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: Do you agree with the assessment of the position? Is there evidence to the contrary?

Your assessment could well be correct, but we believe that international comparisons should be drawn carefully. The investment decisions of DB schemes will be determined by many factors, including maturity and the regulatory framework under which they operate. These factors can differ enormously across different geographies.

For example, the UK has a larger and more mature DB landscape than many other countries, with a much larger weight to DB vs DC than the majority of other countries.

Further, the UK DB regulatory framework (and further direction of travel under the draft Funding Code of practice) have directed trustees and sponsors to target low risk strategies – which are typically not well-aligned with some of the asset classes included in your definition of 'productive assets'.

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?

We view the answer to this question as being in two parts:

A) How can trustees and sponsors be incentivised to target higher return/risk assets?
B) Assuming A can be achieved, how can trustees and sponsors be incentivised to achieve that higher return/risk via investment in productive assets?

In relation to part A, the first observation we'd make is that legislation current places the power to set the investment strategy with trustees – sponsors only need to be consulted with. So, whilst some sponsors do have an *influence* on the strategy, it is largely *Trustees* that need to be incentivised to target higher returns.

In that respect, trustees' behaviour will be influenced by the regulatory and legislative requirements. As mentioned under Q1, for many years trustees have been directed to target lower risk strategies (and that direction of travel is expected to continue under the draft Funding Code). As a result, trustees typically seek to target the minimum level of return required to meet their objectives. Even if these regulatory and legislative requirements were to be amended, it may prove difficult to change the ingrained mindset and behaviours of some trustees.

Further, on average, DB schemes are materially better funded now than they have been in recent memory, and so the *need* for additional returns is typically lower than in the past. There is very little incentive for trustees to target the build-up of funding surpluses (or for sponsors, for that matter, given that refunds of surplus are typically only available at the point a scheme is wound up, and are heavily taxed at a rate of 35%). For some sponsors, there may also be corporate accounting disincentives to targeting surpluses – something that is presumably outside of Government's power to amend.

Changes which could be made to incentivise the targeting of higher returns could therefore include:

- Introducing mechanisms for sponsor extraction of surplus before the point a scheme is being wound-up.
- Lowering the rate at which surplus refunds are taxed (perhaps to align with corporation tax rates i.e. broadly mirroring the reliefs that sponsors may have received when contributing to the scheme).
- Introducing mechanisms for surplus to be used for enhancing members' benefits (these already exist for some schemes via discretionary increases, but trustees typically see their duty as protecting/delivering the promised level of benefits, rather than actively seeking to target additional benefits). Sponsor consent is often also required to enhance members' benefits (and there is often little/no incentive to provide that consent).
- Lowering the PPF levy "stress test" impact of investing in the productive assets desired (which are also expected to be mirrored in TPR's "Fast Track" criteria).
- Amending legislation/regulations/Statutory TPR objectives (including the pending Funding Code) to encourage additional return-seeking (including, for example, relaxing expectations about the speed at which sponsors are expected to recover any emerging deficits, should these assets underperform).

In relation to part B, trustees typically have a globally diverse universe of options to consider the best outcomes for their members (and have a fiduciary duty to do so). Therefore, trustees would need to be persuaded that UK productive assets are an attractive place to invest, relative to those other options.

Part of that assessment will consider the expected risk/return characteristics of the investment (including, potentially, an allowance for a reduction in the overall expected return of a portfolio, if global diversification is reduced).

There are other characteristics which will also be important. For example, mature schemes require a predictable and liquid stream of income with which to meet members' benefit obligations (e.g. contractual cashflows). This was brought into sharp focus following last year's "mini-budget" and resulting LDI-crisis – which has left many schemes with an already higher proportion of illiquid assets than they were targeting. Many of the asset classes included in DWP's definition of 'productive assets' do not possess these characteristics.

Further, there are a number of (usually large) DB sponsors operating in the industries (or related wider supply chains) which would be the recipients of increased investment in productive finance assets (e.g. construction/infrastructure). It is hard to imagine that the trustees/sponsors of those schemes would themselves wish to increase their investments in such asset classes, given the obvious concentration of risk that would pose.

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

We do not have exact statistics on this point, but would expect the number to be relatively small.

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

In order to protect the security of members' accrued benefits, it would appear sensible to require the scheme to be suitably well-funded (perhaps with a buffer) before any surplus can be extracted. We believe that this funding level should be somewhere between 100% funded on a schemes' technical provisions basis, and 100% funded on a solvency basis (at which point, members would likely be better-served by the scheme being bought out).

Full-funding (or a buffer above) on a low-dependency funding basis (of the type envisaged in the draft Funding Code) might be a suitable level that falls within the range above. There may/should also be parallels with the conditions under which commercial consolidators are expected to be able to extract profits, to avoid any regulatory arbitrage.

As noted above, requiring any surplus above this level to be shared in some proportion between members and sponsors would act to align the interests of these stakeholders (and encourage trustee support, to the extent that this is required – which we would suggest is made a condition). There is a question of inter-generational fairness here too – i.e. how to structure any benefit enhancements such that younger members are not just underwriting the risk of additional benefits being granted to current pensioners.

Requiring certain levels of security (either via sponsor covenant or additional security) would further strengthen member protections, however this would likely be more subjective and difficult to implement, and would likely disincentivise sponsors from targeting the build-up of surplus.

Finally, there ought to be some consideration of liquidity of a scheme's remaining assets. By definition, surplus extraction will require (and reduce the scheme's remaining) liquid assets, and as commented previously, many of the asset classes within your definition of productive finance assets may be relatively illiquid. This could form part of the trustees' consent considerations.

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 be risks be?

Enabling surplus extraction before wind-up would likely encourage more risk to be taken (i.e. Part A of our response to Question 2). It does not necessarily follow that this additional risk would be sought via investment in UK productive finance assets (i.e. Part B of our response to Question 2).

The principal risks associated with this strategy would be the jeopardy of members' benefits (in situations where the riskier investment strategy underperforms and the sponsor is unable to make this good). Relatedly, this would indirectly place more risk on the PPF (and other levy payers).

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

If this position were amended, then yes, combined with the surplus extraction / member augmentations point already covered, we can see that this would 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).

Presumably, it would be within Government's power to amend the terms of the PPF such that the greater protection would *only* apply to those schemes who invest a certain proportion in the desired assets. This would amplify the moral hazard / cross-subsidy risks highlighted in our answer to Question 5, however (unless a segregated sub-fund were created within the PPF for this purpose – which would also come with questions about how this is funded).

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?

As noted in our response to Question 2, we would expect a reduction from the current 35% tax would be required in order to make this attractive to employers (trustees will presumably have little interest in this rate). Clearly, the lower the rate (together with a change to enable access to this prior to wind-up), the greater the sponsor's incentive to target surplus funding.

A rate aligned in some way to corporation tax would appear to us to have the most merit, although careful thought would need to be given to the precise details, both to avoid arbitrage opportunities, and to ensure longer term stability and confidence in the policy.

Corporation tax has been subject to regular changes over time, and sponsors will be mindful of the risks of making additional contributions (or underwriting additional investment risk) based on an expectation of economic value, only to find that the withdrawal tax is higher at a future point of surplus extraction.

Clearly, the more certainty that can be offered to sponsors, the more likely it is that the desired behaviours will occur. Many will still remember the clampdown on DB surplus (and introduction of taxation of value extraction) in the 1980s, which arguably contributed heavily to the retreat from UK DB private section pension scheme provision.

Sponsors will therefore view with caution any policy which could change based on political whims in the future.

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?

Yes – indeed we are aware that this already happens in some schemes where the DC provision is via the same trust (for *all* DC contributions, not just those above AE minimums). We would suggest the same considerations as for surplus extraction should apply to this mechanism. If the Government wished to incentivise this further, then it could widen the ability to fund DC contributions beyond trust-based arrangements (i.e. make such surplus transfers also permitted to contract-based DC arrangements).

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

Yes.

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

The answer to this question will depend on how the consolidation vehicle(s) are invested, which in turn will be influenced by the jurisdiction and terms under which they are regulated.

For example, bulk annuity insurers, are unlikely to be incentivised to invest in UK productive assets (more than they may do already) due to the constraints of Solvency II.

Consolidators that are able to pool investment risk across generations/different schemes (i.e. unsegregated) could potentially have scope to invest in riskier assets for longer, although there are of course drawbacks and risks associated with that approach/structure.

Further, there may also be some economies of scale and greater investment choices via consolidation that opens a wider investment universe (particularly for smaller schemes), although this can already be achieved via fiduciary management approaches.

In general, we are not convinced that additional consolidation options (beyond those which already exist) are likely to materially alter the DB schemes' aggregate asset allocations (and specifically, the level of investment in UK productive finance assets). We consider that incentivising additional risk-taking (as explored in the earlier portion of this call for evidence) will be a far more effective way to achieve this aim.

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?

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 (and, to the point made in Question 10, materially lower than incentivising additional risk-taking).

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

As stated above, we do not believe that a public consolidator is the best way of achieving the Government's objectives, and therefore we see little benefit in this area. As noted above, there may be some benefits to members, sponsors and trustees of small (say, sub-£1M) schemes, who may find consolidation options more challenging to access.

Depending on how such a consolidator were capitalised (and the level of premium required to enter it) then such a vehicle would (a) be in direct competition with other commercial vehicles, unless eligibility was restricted to small schemes only; and (b) would place risk on the funders/guarantors of the vehicle (presumably, ultimately, UK tax-payers). We would struggle to see why that would be in the interests of UK tax-payers.

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?

This would depend on the scope and eligibility criteria for the public consolidator, as set out above; together with the security of such a vehicle. But, potentially, yes.

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

Government could presumably set the investment strategy of a public consolidator in whatever way it wished (assuming it could build sufficient scale – see earlier above). As noted before, however, it is unclear why this would be in UK tax-payers' interests to underwrite such obligations (if this is what is envisaged) – on top of state pension benefits.

As noted previously, we consider that incentivising targeting surpluses will be a more effective way of achieving this.

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

If guaranteed by the UK government, we assume that this would ultimately fall on the UK tax payer, however it is structured (see comments above).

Alternatively, a PPF-style levy could be charged to eligible schemes (but it is difficult to see how this would interact with the PPF-levy, and the burden of underwriting risk would potentially fall on a small (and decreasing) number of schemes).

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

We have no relevant insight to add here.

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

The PPF does have experience of successfully managing and investing DB pension scheme assets. However, this is limited to administering a single (simple) benefit scale. If consolidated schemes were to retain their individual benefits scales (and to do otherwise could be seen as disadvantaging members), then this would presumably require a dramatic increase in the level of PPF resources, which may not be feasible.

We also assume (for reasons set out in Question 6) that a segregated fund (or funds) would need to be created, to avoid cross-subsidy with existing PPF assets/liabilities.

As a minor technical point, TPR would presumably need to have its Statutory objective (to minimise calls on the PPF) altered, if consolidation via such a vehicle were to be encouraged.

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

Yes (noting the differences described above, which would require additional resource and expertise).

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, a limit on the size of the eligible schemes (to say, £1M) would be required.

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?**
  We believe this would be difficult.
- **What principles should there be to govern the relationship between the consolidator and the PPF?**
  We believe that the two funds should be entirely separate.
- **Should entry be limited to schemes of a particular size and/or should be overall size of the consolidator be capped?**
  Yes – see above. If designed only for small schemes, we don't believe that a public consolidator would grow to such a size that concentration (or other risks) were of material enough concern as to require capping the overall size.
- **How could the fund be structured and run to ensure wider investment in UK productive finance?**
  Presumably government could mandate this (although note earlier comments about why this would be in the interests of UK tax-payers).
- **How to support continued effective functioning of the gilt market?**
  We don't believe that a public consolidator would grow to such a size that it would have a material impact on the functioning of the gilt market.