ASSOCIATION OF CONSULTING ACTUARIES

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Dear all

Options for Defined Benefit schemes: a call for evidence

I am writing on behalf of the **Association of Consulting Actuaries** in response to the above call for evidence.

We are supportive of schemes being given more encouragement to invest more in productive assets, provided there is an upside for both scheme members and scheme sponsors, as well as supporting UK growth prospects and wider society. The development of CDC schemes also aligns well with the proposed objective, and we believe should be a natural starting point for growth focussed pensions reform

We are also supportive of more flexibility on the use of surplus. It may be possible to design a statutory over-ride allowing refunds of surplus to take place where scheme funding is above a given threshold, perhaps in combination with discretionary benefits to members or with more flexibility for schemes which remain open to future service. We also support a reduction in the tax rate on refunds of surplus and more flexibility for employers to use DB surplus to meet contributions for current employees' pensions, be those DB, DC or CDC. This additional flexibility could encourage more investment in productive assets.

We agree that greater PPF guarantees – in particular an option to provide 100% protection of benefits – could result in greater investment freedom and could also encourage schemes to invest in productive assets. There are however some key challenges that would need to be addressed. The fact that the PPF does not currently provide full benefits is an important protection against moral hazard, particularly as trustees have unilateral power to set investment strategy.

We are supportive of the development of commercial superfunds and scheme liabilities transferring to them where this is in the members' interests. We would expect Superfunds to be well placed to invest in productive assets. We are also supportive of DB Master trusts and other forms of operational consolidation that can enable greater investment in productive assets.

A public consolidator would need to be restricted to prevent market distortion and concentration of risk. We agree with the comment in paragraph 13 of the consultation document that a public sector consolidator should be focused on schemes “which are not attractive to commercial consolidators”, provided this assessment assumes the scheme assets would be sufficient to meet the commercial premium. This is likely to mean that a public consolidator would focus on smaller schemes for which buy-out is not a realistic prospect.

Our responses to your specific questions are set out in the appendix to this letter.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful including attending any interviews or information gathering sessions. In that event, please contact Peter Williams, Chair of our Pension Schemes Committee, at peter.williams@aon.com or on 01372 733763.

Yours faithfully

Steven Taylor
Chair
On behalf of the Association of Consulting Actuaries Limited

APPENDIX

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

We are supportive of schemes being given more encouragement to invest more in productive assets, provided there is an upside for both scheme members (including past and potential future members) and scheme sponsors, as well as supporting UK growth prospects and wider society.

The development of CDC schemes also aligns well with the proposed objective as productive assets are likely to be particularly well matched for CDC scheme benefit targets. Given this, and its potential to significantly contribute to improved member outcomes, we believe CDC is a natural starting point for growth focussed pensions reform.

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?

If schemes increase their investments in productive assets, this is likely to increase risk. The recent direction of travel for DB funding in the UK has been to reduce risk, led by the regulatory environment, and – under new legislation expected to come into force in 2024 - to plan to reduce risk further by requiring all schemes to set a journey plan to low dependency as the scheme matures. Encouraging schemes to invest more in productive assets would be a significant change in direction that would need to be reflected in the statutory objectives and the approach of the Pensions Regulator and in regulatory guidance – and a reconsideration of the new regime about to come in to force (where our view is that the proposed regulatory requirements for low dependency are too restrictive and that the legislation should be sufficiently flexible to allow employer covenant to be taken into account beyond significant maturity).

In our view, a change in approach is particularly appropriate for open schemes. In our response to the DWP's draft Funding and Investment Strategy Regulations, we called for a carve-out for open schemes. We argued that the new proposals were disproportionate for schemes that are not maturing or are not expected to reach significant maturity in the foreseeable future. Investing in productive assets seems particularly well aligned with schemes that remain open to future accrual.

Even under a more flexible regime, scheme sponsors might not want to take additional investment risk if there is potential recourse to additional contributions in the future. In addition, trustees are responsible for setting investment strategy and need to act in the best interests of members. Covenant strength will be key in deciding whether it is appropriate to maintain exposure to the sponsor for longer, regardless of whether there is a surplus or not. Trustees will also need to take a view on the lock-in terms with illiquid assets. Having sufficient flexibility to be able to transact a buyout in the future would be preferred by many trustees and this may be more difficult with illiquid assets.

Clearly, a mechanism to share additional returns generated from investments between the scheme members and the scheme sponsor would make investing to achieve a surplus more likely to be attractive to both trustees and employers, as discussed below.

Changes to the taxation of surplus refunds, as discussed below, would also support the policy objective.

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

Although we do not have ready access to this information, we suspect that rules allowing surplus to be refunded for ongoing schemes are not typical. Refunding surpluses in ongoing schemes has certainly not been a common feature of UK pensions in practice.

Although this is a legal question, we suspect that – even if wind-up is on the horizon - there may be several rules that need to be taken into account to assess whether a scheme sponsor is likely to benefit from part of the surplus being returned to them or not. For example, in addition to the rules relating directly to surplus, the rules on augmentations, payment of DC contributions and the ability to trigger wind-up may be relevant. The full answer, reflecting how the various rules combine, will be scheme specific and there is likely to be a 'rules lottery' on the question of whether an employer is likely to be able to obtain a refund in practice.

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

We are supportive of more flexibility on use of surplus. It may be possible to design a statutory over-ride allowing refunds of surplus to take place where scheme funding is above a given threshold (perhaps in combination with discretionary benefits to members).

Before extracting surplus, there would need to be a financial test to ensure that the assets of the scheme are likely to be sufficient to meet the cost of the accrued liabilities on an appropriately low risk basis as outlined below. The more stringent the test, the less risk will be posed to members, the sponsor (in future) and the PPF; but the more stringent the test, the less likely it is that surpluses will be able to be extracted, so the policy will be less likely to achieve its aims of encouraging investment in productive finance.

In view of this, we would propose that the test be covenant-based, with the objective of ensuring that the scheme remains highly likely to be able to pay benefits in full in future. The precise details would need consultation and testing with industry to avoid unintended consequences. A requirement for the assets to satisfy some sort of stress test may also be appropriate. The framework for this could build on the work the Pensions Regulator has already carried out as part of the consultation on the DB Funding Code.

In practice, this would likely mean that – unless there are appropriate contingent assets - only strong sponsors would be able to extract surplus in advance of buy-out, which seems reasonable in view of the risks to members and the PPF if weak sponsors were allowed to remove surplus – unless they were still able to buy-out.

As investment strategy is set by the trustees, there will need to be some benefit for scheme members in order for trustees to agree to 'invest for future surplus', and this will need to be reflected in any statutory over-ride. This could be by including a requirement for trustee consent (and so the share of any distribution of surplus between the sponsor and scheme members can be negotiated) or by setting a prescribed share for scheme members. Our preference would be to rely on a requirement for trustee consent, to achieve suitable solutions.

Ideally there would be an appropriate level of consistency between a scheme sponsor's ability to extract surplus from a scheme and a commercial consolidator's ability to extract profit.

It may be appropriate to set different conditions – allowing more flexibility – for schemes which remain open to future service. For these schemes, refunds might be allowable based on a margin above technical provisions – although in our view trustee consent should always be required.

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?

Yes, enabling trustees and employers to extract surplus in this way is likely to encourage more risk to be taken in investment strategies.

Employers would be able to benefit from excess assets accumulated within the pension scheme. However, some sponsors may be cautious about taking investment risk to accumulate surplus due to the risks discussed below. They may also be concerned about future regulatory change, for example that the ability to extract surplus may be removed again in future.

As you have already identified, one of the main barriers for trustees in taking investment risk is their duty to the members. Trustees would need to see their members benefit in some way before surpluses can be refunded. We would expect trustees to require some assurances or regulatory guarantees that their members will also benefit when any surplus payment is paid to the employer, for example through a requirement for trustee consent, supported by regulatory or DWP guidance on the factors which trustees should take into account before agreeing to any refund (perhaps including consideration of current and future benefits).

For both sponsors and trustees, the main risk associated with extracting surplus before wind-up will be that a deficit later emerges. This poses a future risk to the sponsor as any funds extracted today increase the risk that the sponsor will have to pay contributions to the scheme at a future date. This would be exaggerated if the sponsor has to improve benefits (for example) before extracting surplus as the pension scheme's liabilities would be increased.

Enabling surplus to be extracted also poses a risk to member benefits or the PPF if too much surplus is extracted and conditions change, and the scheme sponsor becomes insolvent at a time when the schemes assets are not sufficient to secure the members' benefits in full.

It is not clear why UK productive assets would be disproportionately favoured over other global productive assets, without some form of specific tax incentive. Trustees need to ensure their asset portfolio is sufficiently diversified and that applies at the geographical level too. For example, a move from (UK) gilts to (global) productive assets could result in less being invested in the UK, if those productive assets are spread over a range of global productive assets.

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

Greater PPF guarantees of benefits could result in greater investment freedom for trustees, and greater investment in productive finance – provided the higher level of PPF protection is combined with the flexibilities discussed above on refunds of surplus, including enhancements to member benefits. If the higher level guarantee is optional, the impact will also depend on the price of the additional cover.

In particular, if the PPF was to provide 100% protection of benefits then trustees would be assured that scheme members would receive their benefits in full, whether the scheme sponsor remained in business or not, and their members may be able to achieve higher benefits if scheme assets are invested for surplus. This would provide a strong incentive for trustees to invest for surplus.

For scheme sponsors the position is more nuanced. They would also potentially benefit from future surpluses. However, there may be increased costs, through higher PPF levies, and an increased risk of additional contributions being required to fill the deficit if the assets do not perform well.

There are however some key challenges that would need to be addressed. The fact that the PPF does not currently provide full benefits is an important protection against moral hazard, particularly as trustees have unilateral power to set investment strategy. If full member benefits are protected, this could potentially encourage trustees to invest in much higher risk assets – with no downside for members but significant additional risks for employers.

A key question is whether the PPF would still have the ability to reduce benefits in future if it became underfunded (as is currently the case). If so, this diminishes the value of the guarantee and the extent to which it may alter trustee behaviour. Alternatively, if there is no facility to reduce benefits, there would be a risk that a small number of future continuing levy payers (mostly open schemes) will end up paying very high levies – unless the Government underwrites the guarantee.

There would also be challenges in designing a demonstrably equitable 'opt-in' levy system and being fair and equitable in how the current PPF surplus is used in future, both for ongoing schemes paying the levy and members already in receipt of payments from PPF.

If such an option was made available, if would be important for scheme sponsors to decide to move from the current level of PPF protection to full protection of benefits (possibly in combination with trustees, although we suspect that trustees would nearly always opt to have the higher level of protection, as this would be in the best interests of members, with the scheme sponsor ultimately meeting the additional costs).

Careful consideration would need to be given to selection against the PPF. For example, the option may need to be a 'one way' opportunity – with no option to revert to the lower level at a later date. In addition, there may need to be some restrictions on the financial health of sponsors wishing to adopt the higher level of protection – particularly if the option to opt-in to the higher level was available over an extended period.

If the PPF protection was increased but still remained below the full benefit level, the impact is likely to be significantly less than provision of full protection.

Trustees may also need legal advice – past cases (eg Independent Trustee Services Limited v Hope, 2009) have indicated that trustees cannot take PPF protection into account in making certain decisions. It would need to be clear that trustees could take 100% PPF protection into account when making investment decisions in order for the protection to have the impact we have suggested above on investment freedom.

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?

Refunds of surplus are currently taxed at 35% - this is a penal rate which discourages investing for surplus and we would support a reduction.

One approach might be to align the surplus charge with the corporation tax rate. Alternatively, the tax-rate on surpluses might be aligned with the rates paid on returns on investments held directly by the Sponsor – as we would expect returned surpluses to only arise where schemes have achieved positive investment returns, and these returns would be largely tax-free within the pension scheme.

There would be no additional tax on the trustees if the surplus is used to enhance benefits – but those benefits would generally be taxed when paid to members. This seems reasonable.

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, this would be appropriate, subject to the conditions in (4) above.

We note that sponsors whose schemes provide both DB and DC benefits may already have the option of using DB surplus to fund DC contributions. A statutory over-ride could help with schemes where this is not the case – and, with amendments to tax legislation, potentially also for employers that have separate DB and DC arrangements.

Even if the requirements for surplus refunds are not amended, consideration should still be given to allowing DB surplus to be used to meet DC contributions, even if these are made to a separate arrangement. This supports DC adequacy, especially where DC contributions exceed automatic enrolment minimum levels.

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

Yes, although we would expect the introduction of the conditions in (4) above, along with individual scheme rules, to mitigate against this risk. Of course, this is an area in which the specific details will be important.

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?

We are supportive of the development of commercial superfunds and scheme liabilities transferring to them where this is in the members' interests. We are also supportive of DB Master trusts and other forms of operational consolidation that can enable greater investment in productive assets.

Consolidation means access to bigger pools of assets to be able to invest in a more diversified way across more asset classes, including illiquid assets. We would expect Superfunds and DB Master trusts to be well placed to invest in productive assets.

Putting in place a long-term Superfund regime will clearly be helpful in establishing a commercial consolidation market. The Superfund market, together with the remaining schemes, will need to ensure sufficient manager diversification across asset classes and providers.

As discussed below, any public consolidator would need to be restricted to prevent market distortion and concentration of risk. We agree with the comment in paragraph 13 of the consultation document that a public sector consolidator should be focused on schemes "which are not attractive to commercial consolidators", provided this assessment assumes the scheme assets would be sufficient to meet the commercial premium (i.e. a public consolidator should not be able to target larger schemes which are only unattractive to commercial consolidators because they cannot afford the commercial premium to secure their liabilities).

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

In our view the buy-out market is working well.

Operational consolidators such as DB Master trusts are serving the market well although Government policy could further support and encourage this through reducing friction in transfers and making it easier to simplify benefits.

The commercial consolidator market is still in its infancy – we expect it to develop over the coming years and a permanent regime will help in its development.

There is quite a narrow band of funding in which schemes might consider consolidation a viable option: a scheme must be sufficiently well-funded to be able to afford the cost of joining the consolidator, perhaps with an additional lump sum payment from the employer, but not so well funded that buy-out is a realistic prospect in the foreseeable future. The recent volatility in funding positions means that many schemes that were in the right funding band 12 months ago may well now see buy-out as a realistic prospect and some schemes that would not have been in a position to consider consolidation may now be sufficiently well funded to do so. We would expect the pipeline of schemes considering consolidation to be more stable in most future years, and this will help with the development of the commercial consolidator market.

There is however likely to be a gap in the market for small schemes, which are not attractive to commercial consolidators. A public consolidator could help with this area of the market.

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

Unless suitable restrictions are placed on any public consolidator, there is a significant risk that it would curtail the development of commercial competitors. This is a particular risk if plans for a public consolidator, without suitable restrictions, are set out while the development of the commercial consolidator market is still in its infancy. Without suitable restrictions, a public consolidator will also significantly increase the concentration of risk in the pensions industry and given the size of this industry, for the UK as a whole.

We would suggest that a 'gateway test' should be applied for a public consolidator. Schemes should only be eligible for voluntary entry to the public consolidator if they have been unable to secure their benefits with commercial consolidators. As noted above, we agree with the comment in paragraph 13 of the consultation document that a public sector consolidator should be focused on schemes "which are not attractive to commercial consolidators", provided this assessment assumes the scheme assets would be sufficient to meet the commercial premium.

Any public consolidator should be a voluntary option for the consideration of the trustees of schemes which are not in scope of the commercial consolidator market – i.e. smaller schemes. The proportion of such schemes which are likely to see it as an attractive option will depend on the costs of entry to the public consolidator and the level of security.

There are also two areas which require clarification:

- Whether the public consolidator would have any form of government guarantee. Unless the government makes it clear that this is not the case, an implied government underpinning would give a public consolidator an unfair competitive advantage, making the gateway test we propose above crucial;
- Whether the public consolidator would be separated from the existing PPF fund for insolvent employers. Our view is that the two funds should be separate – the surplus in the existing PPF fund results from the levies charged to ongoing schemes and their employers over the last two decades and should be used to reduce levies or improve PPF benefits towards the level of the members' original scheme benefits.

There will be significant practical difficulties for the PPF in consolidating large numbers of small schemes, all with different benefit structure (unlike schemes taken into the PPF, for which all members are provided with prescribed PPF-style benefits). It can take significant periods for schemes to be taken on by PPF, even with their standardised structure.

It would help both operational consolidators and superfunds if there was a mechanism to simplify scheme benefit structures – to a standard format - as part of consolidation.

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?

Yes, a public consolidator could impact on the annuity market unless there are suitable gateway tests to limit or remove overlap with this market. We would suggest an additional gateway test should be similar to the test applied to commercial consolidators – that a scheme can only enter the consolidator if it is not so well funded that buy-out is a realistic prospect in the foreseeable future.

It is essential for a gateway test along similar lines to be included, or the impact on the existing bulk purchase annuity market is likely to be significant.

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

Yes, but we question whether a public consolidator would be preferable to commercial consolidators in achieving this objective.

If, as we argue for above, there is no government guarantee for the public consolidator and a relatively level playing field in terms of regulatory requirements then consolidators of similar size should be equally likely to invest in UK productive finance.

Generally, we would expect any consolidator's investment strategy to be diversified by asset class and geography. The investment strategy may contain an allocation to UK productive finance, but that asset class shouldn't dominate the strategy. Those responsible for the consolidator would also need to consider overall liquidity and payment of member benefits when setting an investment strategy.

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

One option would be for the public consolidator to have a government guarantee. Clearly this carries a risk that the government will end up with additional liabilities if assets do not perform in line with expectations. It would also provide the public consolidator with an unfair advantage if it was able to compete directly with commercial consolidators or bulk annuity providers.

Another option might be to combine the public consolidator with the existing PPF fund, which has a significant surplus. As noted above, our view is that the two funds should be separate – the surplus in the existing PPF fund results from the levies charged to ongoing schemes, effectively to their sponsors, over the last two decades and should be used to reduce levies or improve PPF benefits.

Our preference would be for a public consolidator to set premiums for entry which will allow it to reserve prudently, to meet benefits within an acceptable level of risk. It is not clear why the resulting premiums should differ materially from the costs of commercial consolidators.

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

The UK market has a quite specific history and circumstances which we expect to make comparisons with other countries challenging.

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

There would be a benefit to members if schemes which are unlikely to be able to secure benefits with a bulk annuity provider or commercial consolidator have an option to secure member benefits using a public consolidator, provided this reduces the risk of the benefits not being paid in full.

There may also be wider benefits if the economies of scale which a public consolidator can achieve allows investment in a wider range of assets, including productive finance.

A key risk is that a public consolidator could negatively impact on the commercial consolidator and bulk annuity markets. The gateway tests which we discuss above aim to reduce this risk.

There would be a significant concentration of risk in the public consolidator.

There would also be significant operational risks for a public consolidator, particularly if this takes on large numbers of small schemes.

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

We have no reason to think that the Board of the PPF would be less effective than any other public body in managing a public consolidator.

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, this could be achieved through suitable gateway tests, so that a public consolidator focuses on small schemes that are not likely to be of interest to commercial consolidators and that are unlikely to be able to buy out their benefits in the foreseeable future.

We agree with the comment in paragraph 13 of the consultation document that a public sector consolidator should be focused on schemes "which are not attractive to commercial consolidators", provided this assessment assumes the scheme assets would be sufficient to meet the commercial premium (i.e. a public consolidator should not be able to target larger schemes which are only unattractive to commercial consolidators because they cannot afford the commercial premium to secure their liabilities).

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

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

The premium payable should secure the members' full benefit entitlement where the scheme sponsor is not insolvent. Whether this would allow a given scheme in deficit to enter the public consolidator would depend on how the entry premium compares to a scheme's technical provisions, and whether the scheme sponsor is prepared to meet any shortfall. We would expect the premium to be broadly consistent with premiums charged by commercial consolidators – the public consolidator should not be allowed to target schemes which cannot afford the commercial premium.

The existing PPF fund for insolvency should be kept separate from any new fund set up as a public consolidator. In our view, the PPF surplus should be used to reduce levies or improve member benefits towards the levels they were originally expecting, as outlined above.

Gateway tests should apply for entry to a public consolidator, as discussed above. This is likely to mean that only small schemes will enter.

Those responsible for making investment decisions for the public consolidator should be required to act in the best interests of the membership, and with a view to ensuring that members benefits are paid in full. They would need to consider investment in UK productive finance along with other investments in terms of risks and expected rewards.

We do not think this initiative will have any significant implications for the effective functioning of the gilt market. Even if the initiative to promote more investment in UK productive finance is very successful, the UK gilt market is likely to remain a much more significant investment category for UK pension schemes and consolidators.

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