THE
INVESTMENT
ASSOCIATION

'Options for Defined Benefit Schemes' Policy Team
Department for Work and Pensions
By email: pensions.consultations@dwp.gov.uk

19 April 2024

Dear Sir/Madam

RE: Investment Association Response to the public consultation on 'Options for Defined Benefit Schemes'

The Investment Association (IA)[1] welcomes the opportunity to respond to the DWP consultation on options for Defined Benefit (DB) pension schemes. With just over £1.4 trillion in assets[2] DB schemes make a significant contribution to the funding of the UK economy and public services via investments in gilts, UK equities and corporate bonds.

The government's plans to take forward changes to the treatment of scheme funding surpluses are timely, since with scheme funding having improved significantly since interest rates began rising at the start of 2021, there is an opportunity, under certain conditions, to change trustee incentives around DB investment strategies in order to encourage greater allocation to riskier assets, including those associated with UK 'productive finance'.

A number of the consultation questions concern points of detail that are best answered by pension schemes, commercial consolidators and their advisers, and we instead focus our comments more broadly on the thrust of the overarching reforms.

1. Allowing the extraction of DB scheme funding surpluses, with appropriate guardrails to ensure benefit security, could incentivise schemes to run on and take more risk than today

In our response to the 2023 call for evidence we set out our support for measures to free up the extraction of surplus once a given level of funding is achieved. If DB schemes run on (rather than transferring assets to the buyout market) they will continue to support the UK economy and public services via their holdings of gilts, UK corporate bonds and UK equities. Subject to certain guardrails being put around surplus extraction such that benefit security is not weakened, the ability to extract surplus could provide an incentive to build surpluses up by taking more investment risk, in line with the government's broader objectives.

[1] The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.8 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 48% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.
[2] PPF 7800 Index, March 2024

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Of course, the net impact on UK investment at the macro level would also depend on how insurers invest the assets they receive in a counterfactual scenario where fewer schemes run on. Our expectation is that at least some of these insurance assets would be in the UK. Certainly, that is what the proposed reforms to Solvency II seem to imply.

Nonetheless, there are micro-level benefits to schemes running on, with the ability to build up and release surpluses, which are not available when scheme assets are transferred to insurers. These include the ability to increase benefits for members (e.g. raising the level of inflation protection), subsidising higher DC contributions, or freeing up capital to invest in a sponsor's business.

We therefore support the introduction of a statutory override that permits schemes to make payments from surplus funding.

Guardrails around the extraction of surplus

The starting point should be that any changes do not undermine the security of DB scheme members' benefits, nor increase the funding obligation for the employer. Any approach to releasing surplus should therefore have significant guardrails in place.

In our response to the summer 2023 call for evidence, our initial view was that at a minimum, benefits should funded somewhere moderately above full buyout basis before any additional surplus can be extracted e.g. 105-110%. This would provide a margin to absorb any losses incurred when taking additional risk, ensuring both the security of member benefits and giving sponsors the incentive to take this risk.

Considering the options discussed in the consultation paper, we note that maintenance of buyout level of funding is only one of the options under consideration and that there are further options proposed where surplus extraction is permitted if a scheme is fully funded at a minimum on a low dependency funding basis, which, by design, means the scheme's assets are invested according to a low dependency investment allocation[3].

On its own we are wary of surplus extraction against a baseline of low dependency funding, even with a margin on top (be that a fixed or variable margin linked to the level of investment risk or covenant strength). Even though this would be a prudent funding basis, it would still be below full buyout level and while the low dependency investment allocation should be resilient to short-term market volatility[4], there remains the risk that such an investment strategy can still be subject to significant losses under certain market conditions: for example, the autumn 2022 gilt market shock saw a large and rapid repricing of gilts that created losses on gilt portfolios[5] that would normally be seen as relatively low risk. In a system where surplus extraction was linked to a low dependency investment allocation, there is still a risk that portfolio losses could erode member security.

However, we recognise the need for some flexibility if the proposed easements are to work and in that regard are strongly supportive of the government's proposal to increase the PPF underpin to 100% of scheme benefits. In our view this provides the assurance to members that surpluses can be extracted safely, even at a level of funding lower than buyout, including low dependency funding. That being the case, **a requirement to be funded on a low dependency basis combined with a 100% PPF underpin may be an appropriate set of safeguards under which surpluses can be extracted**.

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[3] The Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024, regulation 6(2)-(3).

[4] For reference, regulation (5) of The Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024 defines a Low Dependency Investment Allocation as being one where *"the assets of a scheme are invested in such a way that the value of the assets relative to the value of the scheme's liabilities is highly resilient to short-term adverse changes in market conditions so that further employer contributions are not expected to be required to make provision for the scheme's liabilities."*

[5] By late September 2022, the yield on 30-year gilts had risen by 130 basis points in just three days of trading – a move three times larger than any other historical move over a similar period. The very large and rapid rise in gilt yields meant sharp falls in gilt prices.

The 100% PPF underpin

In our view, a 100% PPF underpin is the critical measure needed to make surplus extraction work in a manner that ensures member benefits are not put at risk. From a member perspective, 100% protection of their benefits removes any argument that running a scheme on (as opposed to transferring to an insurer) is not in their best interests.

However, we see two key design issues to address if a 100% PPF underpin is to operate effectively:

- **Addressing moral hazard and adverse selection:** with no conditions to a 100% underpin, any scheme seeking to take advantage has an incentive to permit the extraction of significant surpluses and take on excessive investment risk, secure in the knowledge that if downside risk is realised, the PPF will provide 100% cover (the moral hazard issue). This also creates an issue of adverse selection if only the riskiest schemes (the most underfunded schemes with the weakest sponsor covenants) seek to avail themselves of the 100% underpin as a result, since the PPF becomes exposed only to the riskiest schemes. We believe these issues can be addressed by setting eligibility criteria for the 100% underpin such that schemes are required to be fully funded on a low dependency basis both at point of entry to the 100% underpin scheme and on an ongoing basis. This balances member security and the need to take some risk to generate surpluses with the problem of some schemes seeking to take excessive risk.
- **The cost of a PPF 'super levy' for a 100% underpin:** a higher PPF levy is clearly necessary if the level of underpin is increased from current levels to 100%. However, we are concerned that that an annual levy of 0.6% of buyout liabilities discussed in the consultation may be too expensive. In common with others in the pensions industry, we advise the government to consider reducing the potential cost by treating the PPF as a single pool of insurance, rather than segregating the existing PPF pool and the proposed 100% cover pool as the government currently intends. Spreading the cost amongst a larger pool of schemes while still charging a higher rate to those eligible schemes seeking the 100% underpin is likely to result in a more reasonable cost of protection.

2. The case for a public sector consolidation option for corporate DB pensions has not yet been proven

In its response last November to the summer 2023 call for evidence, the government noted that there was no strong industry-wide support for a public consolidator and that a number of negative impacts on private sector consolidation options could occur if a state-backed provider was set up. Nor was any evidence presented that particular types of DB scheme are struggling to access the commercial consolidator market. In light of the lack of evidence and consensus on the need for a public consolidator at this time, we do not think there is a basis to proceed with the proposal at this stage.

As we set out in our response to the summer 2023 call for evidence, we do not see that a case has been made for a public consolidator to operate alongside commercial providers. Such a significant intervention would only be justified by a major market failure, such as a segment of DB schemes being unattractive to commercial consolidators, leading to a situation where these schemes have no other consolidation option.

The DWP has indicated that it will legislate to introduce a permanent 'superfunds' regime to encourage the development of new commercial consolidators. A superfunds regime could be a significant addition to the consolidation market, providing an option for schemes to run on either on a long-term basis or as a bridge to insurance solutions. This framework needs to be legislated for first and the market given sufficient time to develop, with an appropriate number of transactions taking place before any decision is made to introduce a public consolidator.

A public option would then only be appropriate in the event of a market failure – in this instance lack of a private consolidation option to serve a significant number of DB schemes. This test has yet to be met given that the DB consolidation market is only in its nascent stages.

Prematurely seeking to launch a public consolidator risks damaging the competitiveness of the broader pensions industry ecosystem - professional trustees, lawyers, investment consultants and actuaries, investment managers, and private sector DB consolidators such as superfunds and bulk annuity insurers. Much of the work involved in servicing UK pension schemes is done by individuals based around the country. In light of general government concerns around the competitiveness of the broader UK financial and professional services sector, a move that reduces the size of its customer base at the expense of the public sector would be unhelpful and send a negative signal about the competitiveness of the UK as a market and regulatory jurisdiction.

We note that the private consolidation market has been constrained by aspects of regulation that limit asset allocation, notably Solvency II requirements that are now subject to review. With the ability to allocate in a more economically efficient manner, the insurance market should be in a better position to invest in UK productive finance alongside other investment opportunities to help deliver effectively for pension scheme members whom they serve.

With regards to the PPF specifically, it serves an important function in the UK DB system by acting as a type of insurance against employer insolvency for badly underfunded schemes, ensuring that members in such schemes receive at least some of their promised benefit. This core focus should not be diluted without good reason, which we do not think has been demonstrated as yet. Particularly if the government chooses to expand the PPF's coverage to a 100% underpin, which would mean a significant increase in its size and workload under its existing mandate.

Nonetheless, if the government does continue to pursue the creation of a public sector consolidator, it must be done in an evidence-based manner to create a very tightly targeted model, so that it only fulfils any demand that is genuinely caused by a lack of private consolidation options and does not displace any private sector activity. *A priori* the target market is likely to be small schemes that are poorly funded, have inadequate governance structures, and a weak sponsor covenant, meaning that they are unlikely to achieve the sorts of funding levels needed to access private consolidation options. Any change in the target market for the public consolidator would need to be backed up by an impact assessment of such a change on the UK's pensions industry.

I hope this response is helpful and I would be happy to discuss it further.

Yours sincerely

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(by email)