Options for Defined Benefit schemes

Response to DWP consultation

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Contents

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Executive summary

Crucial endgame decisions

DB schemes are at a **once-in-a-generation** financial inflection point. Scheme surpluses and proven alternative endgames have transformed defined benefit security. Many trustees and employers are re-thinking what success looks like.

The DB sector is in great shape. Reserves to pay pensions have grown materially, from £700m in 2006 to £1.4trn now. DB schemes have excess capital estimated at £225bn and growing. Decisions about endgames could materially affect retirement outcomes for many people, and determine where the £1.4trn is invested.

Sustainable surplus sharing needs mutual consent

DB pensions always put their members first, but they have other stakeholders too. We welcome this consultation's intent to make surplus sharing easier so it benefits not only members, but all the stakeholders that got DB to this point. To create value responsibly and sustainably, surplus sharing must be based on **mutual consent between sponsors and trustees**.

Schemes should also have **long-term sustainability** in mind when sharing surpluses. As part of a broader strategy, surplus sharing is a crucial part of reconnecting generations of savers, which should be a government pensions priority. Sponsors could use an element of the distributed surplus to enhance future DC savings, develop collective DC arrangements, or reopen and modernise DB if the employer covenant is strong.

Easier surplus management could also lead to responsible investment to help the planet. For example, with longer time horizons through run on, trustees and scheme sponsors could invest more capital for longer in productive finance opportunities that promote positive climate impact and biodiversity.

A clear role for trustees

One obstacle to sharing surplus is the perceived role of trustees. Their focus on the security of accrued benefits has crowded out other considerations. Now benefits are more secure, trustees can take a holistic view. But to make a meaningful decision, **trustees must be clear on their role**. Given how much the DB landscape has changed, the industry might need to reconsider exactly what the role of a scheme trustee can be. This could meaningfully impact decisions on all the endgame options and their outcomes.

PPF underpin is not a priority

Sharing surplus should have minimum conditions so that accrued benefits aren't put at risk. But **we don't consider the proposed 100% PPF underpin to be a priority** to stimulate productive finance or to enable schemes to run on. Third-party capital arrangements are creating the options that schemes need to realistically consider running on without the need for a PPF underpin.

A public consolidator on sound gateway principles

We support the PPF becoming a public-sector consolidator in principle, if it fills a gap in the commercial endgame market and improves member outcomes where full benefits would otherwise be at risk.

We consider the bulk annuity and emerging consolidator markets strong enough to rise to the stimulus of a PPF consolidator, provided it's designed with the health of the commercial market in mind. It must be **designed according to the right gateway principles**, and the government must be clear about **what happens if it were to fail**. A consolidator fully underwritten by the government **must not be a way to nationalise DB by the back door** – doing so would deter new commercial entrants or lead to commercial capital taking flight.

We hope our response stimulates thought about DB and pension saving more broadly, and we'd welcome the opportunity to carry on the discussion.

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Hymans Robertson LLP is one of the UK's leading independent pensions and financial services consultancies. We work alongside employers, trustees, local authorities and financial services institutions; offering independent pensions, investments, benefits and risk consulting services and technology solutions.

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Chapter 1: Treatment of scheme surplus

Statutory override

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

Introducing a statutory override on an ongoing basis and at wind-up would help encourage sharing scheme surplus. More flexibility in sharing surpluses would be helpful, otherwise there's a risk that the £225bn of excess capital that DB schemes hold will be inaccessible to sponsors or members.

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?

Surplus sharing should be based on mutual consent between sponsors and trustees. Agreement should be required before a scheme can use any statutory override enabling a refund of surplus.

A statutory override that allows trustees to amend scheme rules at their sole discretion seems unfair – the employer has funded pensions for years and may still be underwriting risk. An override would discourage the collaboration likely to create and distribute value responsibly and sustainably.

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?

We suspect a statutory power to make payments is likely to be more practical, given the complexities of scheme rules. However, scheme rules might need to change in either case: to allow sharing surplus with employers or to ensure the appropriate statutory powers are referenced. A full answer requires a legal view.

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?

Anecdotal evidence suggests that many schemes don't have the powers to enable one-off payments to members, and the associated tax payments mean that they don't often make such payments anyway. A statutory power combined with more favourable tax treatment would give schemes more flexibility to make one-off payments to members, even if the scheme rules don't permit doing so.

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

They may have modest benefits. Schemes could avoid engineering solutions to manage the risk of a trapped surplus, such as variations on escrow arrangements. Removing these solutions could smooth the process to insure or transfer to a superfund.

Flexibilities could make run-off more attractive. However, we still expect many schemes to target buy-out. A scheme's running costs are fixed, so most schemes are too small to generate sufficient net value from running on beyond buy-out funding. By running on, they'll become an economic risk on the sponsor's balance sheet. Flexibilities are therefore more likely to affect the behaviour of large schemes.

In some ways, the regime already distorts behaviour: for practical purposes, schemes in surplus have to insure and wind up to access any surplus. So the proposed change could remove this distortion, whether or not it affects the buy-out market in other ways.

Taxation

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

We welcome the recent tax cut to the equivalent corporation tax rate for pension scheme sponsors that wish to distribute surplus. But tax incentives would only be effective as part of reframing objectives for DB schemes.

Tax benefits could give employers an incentive to enhance DC benefits, even when the DC pension operates in another trust or a group personal pension arrangement. We'd welcome further tax benefits to employers that use their share in a DB surplus to enhance DC benefits for employees and help mitigate the future retirement crisis.

Tax incentives could be used to align DB scheme choices with society's wider aims, and should help the economy. For example, tax benefits when sharing a surplus with an employer could be more generous if the employer invests at least some of the surplus in productive finance or climate transition initiatives.

Using tax to direct behaviour is superior to mandating DB assets to be invested to a political agenda. It also aligns with the 'societal contract' of favourable tax treatment on which DB schemes were created.

The government and its successors must maintain a stable tax regime to allow businesses to plan for the long term and foster productive enterprise. Any changes to the tax regime should support this principle. This kind of political confidence is especially important when making long-term investment decisions.

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

Letting trustees and employers make one-off payments to members would give schemes more ways to share surplus. A scheme could make a one-off payment or several payments to members, similar to how a surplus could be shared with employers. We welcome further thought on how a scheme would make one-off payments, and whether spreading these over a year could still fall into this category of payment.

We'd welcome a review to ensure accounting standards don't deter companies from generating and sharing scheme surpluses. A company's profit and loss measure is often an important figure for owners, shareholders and directors. Sharing a surplus with scheme members can be seen as a one-off past service cost, similar to the accrual of general benefits.

Safeguards for member benefits

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

A scheme should be required to maintain a minimum funding level and security of accrued rights after surplus distribution. A scheme should only consider surplus distribution if it meets these requirements.

This minimum threshold test might be based on 100% of a low-dependency basis with an additional margin. However, this basis is unlikely to cover the cost of insurance or a transfer to a superfund. The DB funding code is expected to set the low-dependency basis at gilts + 0.5% pa. This basis isn't intended to represent an endgame situation, and even with a fixed margin it may not be enough to insure benefits if needed (or move benefits to a consolidator). Neither does the basis have a clear and direct link to the cost of insurance or consolidation.

If the minimum threshold was linked to the low-dependency basis, it would therefore need to include additional criteria or margins linked to the employer covenant and potentially investment strategy. Trustees would need robust advice to quantify subjective covenant and investment assessments into an additional margin, but creating flexibility would help schemes that want to share surplus, subject to these safeguards.

A more realistic threshold might be linked to the cost of moving to a commercial consolidator or even a public-sector consolidator. A minimum threshold aligned to a margin over the actuary's estimated cost of a buy-out would ensure enough assets to insure accrued benefits after allowing surplus distribution. In this case, there would be less need to allow for aspects like covenant.

On balance, we'd suggest a minimum threshold linked to the low dependency basis that gives flexibility for surplus to be distributed, subject to conditions like a strong enough covenant and mutual consent between trustees and employers. We'd suggest a more straightforward approach for very well-funded schemes. In practice, we think most schemes would aim for something over the minimum.

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

A separate code would be appropriate. Surplus sharing isn't relevant for many schemes, and requires specific trustee guidance. A separate code would also help employers, as a scheme should only target surplus sharing under a collaborative framework with the agreement of trustees and employers.

The guidance should set out the appropriate framework to support a surplus sharing objective, and cover:

- Investment strategy, and how the assets used to ensure the security of the buy-out cost interact with the assets used to generate a surplus in future.
- Funding measurements and minimum thresholds, with clarity on how these would work in practice, including once a surplus has been shared.
- Trustee and employer duties, including the primary duty to fund for accrued rights, and how to consider provisions for sharing surplus with members and employers.
- Governance and scheme size. The ongoing costs and governance for a small scheme may erode into the value generated, so surplus sharing may be only be economically attractive for larger schemes.
- Legislation and scheme rules, outlining the approach between complex rules and statutory overrides if these are introduced.
- The member perspective, including clear communication and intergenerational fairness.

Clear examples of how this could be applied practically would be helpful.

We'd also favour using 'sharing' or 'distribution' rather than 'extraction' – language can influence attitudes and behaviour.

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

A lack of clear guidance on their role may prevent trustees from targeting run on with the purpose of sharing a surplus with members and sponsors. For instance, trustees have a fiduciary duty to act in the best interests of members. Many trustees interpret this duty as protecting accrued benefits. It's not clear whether a trustee's duty extends to improving member outcomes by generating surpluses to be shared with members. Further guidance would support the trustee's role.

Stringent rules around surplus use would also prevent surplus sharing, as would trustees feeling uncomfortable to go against employers if a statutory override was in place. Before targeting run-on with a view to sharing surplus, trustees and employers should agree how surplus might be shared. Trustees might not share surplus if they aren't comfortable that the minimum threshold for surplus distribution is prudent enough to ensure security of accrued benefits.

Alternative safeguard: 100% PPF underpin

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?

We don't consider a 100% PPF underpin necessary or economically attractive as designed in the current landscape. The current estimated cost of a super-levy, at 0.6% of buy-out liabilities a year, is too high to make 100% underpin viable, and would eat into any value that could be shared with members and employers. A materially lower levy may make a 100% underpin more suitable.

If a 100% PPF underpin were introduced, the super-levy shouldn't be mandated, as this may deter trustees and sponsors from sharing surplus. However, if take-up is low and the super-levy optional, the PPF may need to levy more than 0.6% of buy-out liabilities a year.

The US has onerous Pension Benefit Guaranty Corporation premiums, which are used to broadly guarantee benefits earned in individual pension plans through a central fund. Many sponsors are using risk transfer to reduce these premiums, according to Milliman's 2023 *Global pension risk transfer market outlook*. We don't want a much higher mandated levy to create a similar situation in the UK.

Many schemes looking to distribute surplus can't do so for several years, so they'd need to have strong views of covenant longevity. The 100% PPF underpin would be less viable for these schemes. If a scheme built up a large enough surplus, it could even run on after the employer becomes insolvent – again reducing the reliance on such a levy.

A public-sector consolidator would be more effective in ensuring that benefits above the minimum PPF level are protected if funding deteriorates and the scheme can't use insurance or commercial consolidation. However, surplus sharing and run-on is only economically attractive for large schemes.

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

Based on the proposed levy amount, we don't see the 100% underpin as a viable solution.

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?

Based on the proposed levy amount, we don't see the 100% underpin as a viable solution.

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

Commercial consolidators or a public-sector consolidator could give security to schemes running on. Other capital-backed solutions, such as capital-backed journey plans, could also help to ensure the ultimate security of unreduced member benefits.

Chapter 2: Model for a public sector consolidator

Approach to eligibility

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

Whether a scheme is 'unattractive' to commercial providers means different things to different people. From our experience, we don't see parts of the DB industry unable to access the insurance market, although appetite and pricing varies. We don't find many schemes have unaffordable benefit structures. Many schemes have terms that give trustees a degree of freedom if they can't precisely replicate all aspects.

Schemes that wish to transfer to a public-sector consolidator would be required to simplify benefits, and we'd expect that the same simplified benefits would be transactable for a commercial provider. If any scheme could simplify benefits, a public-sector consolidator would never be the only option for schemes with complex benefits.

A public-sector consolidator would therefore only unlock access to consolidation if there were easements that made it easier to implement the proposed simplifications. Easements could make simplification possible where complying with section 67 requirements were prohibitive, either due to expenses or due to a need to augment benefits to provide the necessary certifications.

The clearest market for a public-sector consolidator appears to be schemes that have triggered a PPF assessment, and schemes that can ultimately settle benefits with a commercial provider but would prefer not to. They might not want to because of cost, risk or expenses incurred until settling is affordable.

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?

We understand the government is considering a public-sector consolidator to fill a potential gap in private-sector provision. It's also part of the Mansion House agenda: it would change schemes' options, with a view to encourage more schemes to run on and invest in productive finance. The consolidator could therefore disrupt commercial alternatives. It could be a direct competitor, or it could affect their pipeline if it's a trusted contingency option that lets schemes run on with more confidence that members will get full benefits.

To minimise the impact on commercial alternatives, and avoid deterring potential new entrants and capital flight, a public-sector consolidator should be subject to stringent eligibility requirements that are regularly reviewed.

These requirements should be linked to sub-optimal outcomes for stakeholders, where commercial options are unavailable or where transacting with a commercial alternative is disproportionately burdensome for trustees or sponsors.

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?

A size limit is neither necessary nor appropriate, as the PPF has a proven record of taking on schemes on a standard benefit structure. A public-sector consolidator could significantly improve outcomes for underfunded schemes in PPF assessment. If the sponsor of a large scheme failed, we'd want the trustees to have all tools available, and a public-sector consolidator shouldn't be ruled out due to an arbitrary limit.

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

The superfund gateway tests could evolve particularly for schemes in PPF assessment with a strong motivation to settle benefits in the short term. The tests could have a specified hierarchy of outcomes of insurance, commercial consolidation and public-sector consolidation, with third-party oversight.

The consolidator has to decide if it's there to enable schemes to settle benefits when they can or if it only becomes an option once the sponsor gets into difficulty.

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

We'd expect the consolidator to require an affordability assessment and to reject any scheme that can't afford PPF-level compensation. We'd expect it to be open to all schemes in PPF assessment that can afford more than PPF-level benefits, but can't secure benefits with a commercial consolidator, given the potential for an immediate improvement in member outcomes.

To support good functioning of commercial entities, we'd expect that the public-sector consolidator would be required to admit a qualifying commercial consolidator in some scenarios (for example, when a wind-up trigger is met).

Apart from schemes in PPF assessment, schemes that meet the relevant criteria for entry into the public-sector consolidator wouldn't be rejected, given the potential for worse member outcomes if funding deteriorates. This factor could affect the PPF's resourcing requirements.

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

We recommend considering whether there are any scenarios where members will get less than full benefits. The consolidator would also need to be set up with a clear plan for how it will use a surplus that would arise.

Proposed model: structure

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?

Separate sections could allow for the failure of one section without killing the consolidator as a whole. If the consolidator is to operate with a government guarantee, then a run-on pooled arrangement would be appropriate. If it acts as a bridge to a commercial provider, it would have far less impact on the commercial de-risking market, as it would act to delay commercial settlement, but not alter the ultimate expected outcome. This model is perhaps less aligned with wider government objectives.

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

We see limited merit in segregating these schemes. The consolidator would pay lower benefits indefinitely, subject to the PPF compensation floor, based on consistent pricing for underfunded schemes.

The consolidator would be open to ceding sponsors agreeing a plan for deficit payments, with benefits ultimately reduced if these aren't paid (for example, in the case of insolvency). The schemes in this scenario wouldn't need to be segregated. The reduction would be based on a formula set out at the start, and wouldn't depend on the general performance of the consolidator's assets.

Segregation would only make sense where the pricing differential arises from benefit security. We're not commenting further, because we don't think the consolidator is envisaged to offer better pricing to underfunded schemes.

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

Whether the consolidator is attractive depends on the risk of reduced benefits, and whether it has (or is seen to have) a government guarantee. We recommend that the consolidator sets out any scenarios where members may get less than full scheme benefits, as is the case for commercial alternatives.

If full benefits are certain to be paid, its structure wouldn't much affect how attractive it is.

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

Open pension schemes tend to be large and comfortable with their governance. They aren't looking to settle benefits, so a public-sector consolidator wouldn't appeal. Open schemes have specific challenges that a consolidator would need to address, such as the cost of future service, if a consolidator specifies this for a given benefit structure.

Some schemes are open because of a salary link that is challenging to break under the scheme rules. These schemes may welcome a consolidator that's willing to offer them a settlement option, although we fully expect a public-sector consolidator would be unwilling to take on salary increase risk.

There may be some interesting opportunities for the public-sector consolidator to be part of a framework for sponsors on a range of options for future benefits. But we believe the consolidator should initially focus on closed private-sector DB schemes.

Member benefits

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?

We're not sure if the industry will take a positive or negative view of benefit standardisation to support a public-sector consolidator. If using this consolidator will be less costly than settling with a commercial provider, the potential savings could let trustees augment benefits when reshaping, mitigating any adverse member outcomes.

Trustees can't amend benefits if meeting the section 67 requirements, and this is a high barrier to simplifying benefits. Almost all trustees with complex benefits conclude that it's preferable to accept and pay any additional insurance premium than to seek to reshape benefits using section 67. Few schemes that have been required to use section 67 have been able to settle benefits. Many schemes' rules already permit a degree of benefit flexibility within the rules for winding up.

Easements to streamline benefit restructuring for a transfer to a public-sector consolidator could make commercial settlement attractive or affordable. Specific easements for settlement with a public-sector consolidator that couldn't be used for commercial entities wouldn't be reasonable or sustainable. Simplifying benefits could significantly narrow the range of any part of the market deemed to be underserved, potentially negating a benefit of the public-sector consolidator.

Where benefits are standardised, trustees shouldn't change the shape and profile of the expected payments to members and dependants. Trustees would need to maintain the date when the pension could be drawn without reduction, the overall exposure to inflation for any increases, the link to common inflation measures, the dependant pension definition and amount, and any temporary pensions, such as those payable to state pension age.

Question 26: If standardised benefit structures are applied, what should these benefit structures be?
The PPF design document suggests that the PPF envisages offering a range of simplified benefits. Standardisation is likely to focus on unusual benefit designs, such as 'higher of' tests. If standardisation is needed, this direction of travel is reasonable.

Question 27: What effect will this have on the existing market of commercial consolidators?
Schemes would only be able to simplify benefits in the proposed way if there were easements to make simplification easier. It will partly depend on relative costs.

If reshaping includes a degree of 'rounding up' benefits and a public-consolidator is seen to give a high level of security to members, we expect trustees wouldn't see restructuring as an insurmountable barrier. Restructuring by itself wouldn't limit the potential market for a public-sector consolidator.

It's therefore crucial that strict eligibility requirements apply. These requirements could include eligibility when no commercial provider can transact on full benefits and the trustees believe that benefits would otherwise be reduced.

Governance

Question 28: Will this proposed governance structure achieve effective administration and public confidence in the public sector consolidator?
A PPF-run consolidator is preferable to a new entity. The PPF has a strong image in the industry, so a PPF-run consolidator would benefit by association. It would also have access to established teams and infrastructure.

Question 29: What alternative governance structures should be considered?
Most schemes and commercial consolidators outsource functions to external providers, including administrators. The desire to standardise benefits is presumably driven by a desire to use PPF administration and systems. By using readily available systems and tools that already administer benefits, the consolidator could make standardising benefits less complex.

Funding

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?
The industry accepts that the capital standards of the superfund regime are less stringent than those of insurance. Superfunds therefore offer the opportunity of a lower entry price. Part of the assessment and advice framework when transacting with commercial providers is to gauge the risks to member outcomes.

The government must set out what would happen if the public-sector consolidator's funding were to deteriorate, and how the consolidator would be supported.

Mirroring the framework for commercial superfunds makes sense if the aim is a comparable level of security – otherwise, the superfund standards are less relevant.

The consultation states that part of the reason for proposing this approach is to avoid unfair competition. We think this funding requirement does little to achieve that stated aim. To avoid unfair competition, the public-sector consolidator's cost of capital would need to be similar to that of commercial providers.

Question 31: Is the proposed entry price approach using the technical provisions basis feasible? What alternative entry pricing approach might appeal to the consolidator's target market whilst still meeting the overall aims?

The entry price should be lower than for commercial consolidators so the public consolidator can be available to schemes that have a pressing need to settle benefits but can't access commercial providers.

The entry price needs to have tightly defined restrictions to minimise market distortions. It would depend on the risks to members if funding deteriorates, and will naturally result from setting the amount of assets to meet the target level of resilience.

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

With tightly defined restrictions to limit the market distortion from the consolidator, it would be reasonable for the consolidator to use a surplus to improve pricing. It should do so with a view to getting more schemes than the PPF, so that more members can get unreduced benefits.

Treatment of entering scheme deficits and surplus

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?

Schemes in deficit transacting with reduced benefits would minimise the reductions that would result from entry into the PPF or insuring less than full benefits – so long as the sponsor repayment schedule would ensure that the consolidator would always pay more than PPF-level compensation.

Transferring all assets to the consolidator may be a reasonable framework, with pricing acting as a floor for eligibility, below which benefits would be scaled back. The consolidator would appeal to schemes underserved by the commercial market. These schemes wouldn't be able to access full benefits otherwise, so full restructured benefits would be the best outcome available. This framework is likely to need moral hazard provisions akin to PPF powers.

Investment strategy

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

An investment strategy that supports a prudent funding basis is consistent with the aims of keeping members' benefit secure.

However, a prudent funding basis is likely to be similar to the basis that commercial consolidators and the insurance market use. It's likely to lead to having a large allocation in investment-grade assets that produce cash flows, such as corporate bonds. Therefore, it's hard to see how a public-sector consolidator can offer more attractive terms than a commercial consolidator or an insurer, absent taxpayer capital.

If it can invest in a broader range of assets, including high-growth UK assets, the public-sector consolidator may be able to offer keener pricing to take on liabilities. But if its aim is to support a prudent funding basis, any allocation to high-growth assets is likely to be small if there is any risk of consolidator failure, so it probably won't increase returns enough to offer materially more attractive pricing. The prudent basis is therefore unlikely to result in an investment strategy with a meaningfully greater allocation in high-growth UK assets.

The consolidator can usefully achieve its aims through investment in private or illiquid assets that provide natural cash flow and some inflation linkage. It could invest like this if it were subject to different regulations than those governing insurers and commercial consolidators.

Accessing these types of illiquid investment opportunities may lead to more competitive terms, which would benefit schemes that can't afford insurance or commercial consolidators. It could also let small schemes access investment opportunities otherwise unavailable to them. Finally, the scale of the consolidator could give it the purchasing power to negotiate more attractive fees with asset managers, increasing the return achievable net of fees.

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

The public consolidator is likely to target smaller schemes, which might be a hindrance to achieving scale. The consolidator would need to offer particularly attractive terms to attract many schemes. If it can't achieve scale fast enough, it could be trapped in a vicious circle. But it could start a virtuous circle once scale begins to grow.

Pricing is an important consideration, and so is fairness between early and late entrants. Early entrants might face a less efficient investment strategy, due to lack of scale. Later entrants could benefit from a more diverse range of investments as a result of scale, so they might achieve a better risk-adjusted return.

We'd expect the consolidator to use the existing asset capabilities of the PPF, managed appropriately if the scheme is limited. Depending on how the costs are allocated between the main PPF fund and the consolidator, the consolidator could operate at a point where costs are proportionate. This could require the consolidator to reach more than £1bn, for example.

Underwriting

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

The method depends on the strength of the link between available capital and member outcomes. If a commercial consolidator's capital was ever eroded, member benefits might be reduced, for example if the wind-up trigger was breached for a superfund. Providers have the option to recapitalise, but this is a commercial decision.

The government must be clear about whether a public-sector consolidator would offer the same security as the minimum requirements for superfunds, or some other specified measure. It must also be clear on whether members' benefits would be at risk from a funding deterioration.

If the consolidator guaranteed that benefits would be paid in all scenarios, then the underwriting method becomes irrelevant. So does the question of whether the consolidator is funded at all.

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

The government should start by clarifying the target level of benefit security, and the steps it will take if the consolidator becomes materially underfunded.

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

If full benefits are guaranteed through a government guarantee, the consolidator would be seen as the most secure option, and will disrupt the commercial market. At the other extreme, if the government allowed the consolidator to fail as a commingled entity, it would wind up and remove a valuable option for some schemes.

If the government were to fully underwrite the consolidator, this would be akin to nationalising the schemes that had transferred. This wouldn't be in the stakeholders' best interests, although we see less reason to object if the government took a proactive view on how it managed those nationalised assets.

If the consolidator had access to finite capital and was at risk of failure, the PPF should be able to set the investment strategy to optimise member security against its other objectives. The consolidator shouldn't reduce benefits due to asset underperformance, or as a result of investment risk that's beyond the PPF's risk appetite or unnecessary to match liabilities. It may be reasonable for the PPF to have an obligation to consult with government, akin to the relationship between most trustees and sponsors of schemes.

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

The risk to the taxpayer would be minimised if the consolidator took on only the risk it needed to protect the funding position. This is in tension with the government's ambitions to support productive finance, which might need the consolidator to grow its capital reserves.

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

PPF reserves should never be used to support the consolidator, for the same reasons that the consolidator should be managed separately from the PPF.

PPF reserves come from levies paid by pension schemes and are there solely to make up the shortfall caused by providing PPF-level compensation for distressed schemes. This compensation would otherwise be unaffordable.

Using these reserves to underwrite the consolidator raises two concerns. The PPF shouldn't set the levy rates knowing that the resulting reserves might be used to support the consolidator and its schemes, because it would have an incentive to set higher levies or seek levy payments for longer.

The other concern is that PPF reserves would in effect be a cross subsidy. Payments from the PPF, which pays reduced member benefits, would be used to sustain the full value of member benefits in the consolidator.

Using PPF reserves in other ways would be far more appropriate – for example, moderating the benefit reductions previously applied to members of schemes in the PPF. The only scenario where we see a role for PPF reserves is if the consolidator itself had to enter into the PPF, just like any other eligible scheme.