Options for Defined Benefit schemes: a call for evidence

Insight Investment response

September 2023

Insight INVESTMENT

BNY MELLON | INVESTMENT MANAGEMENT

Executive summary

Insight Investment is one of the UK's largest asset managers. We manage £453bn of assets for UK defined benefit (DB) pension funds, of £671bn in total across our global business.[1]

We support the objectives of the consultation. It is a once-in-a-generation opportunity to expand the important role of DB pensions capital in investing in the UK economy, while ensuring the best possible outcome for members and retaining a robust gilt market. We would like to highlight the following points:

- Pension funds de-risked, increasing investments into government and corporate bonds, due to a number of factors including the natural transition of DB pension schemes from accumulation to decumulation, as well as a desire to manage risks prudently. Despite some recent rhetoric, it was not driven by any artificial construct of accounting rules. This sensible and prudent management of risk has created one of the healthiest pensions regimes in the world, providing retirement security for millions of plan members.
- We would argue that pension schemes have indeed been investing into productive assets. Investments in gilts and corporate bonds are extremely important for the UK economy and are productive. Pension schemes' investments in gilts have played a very important role in funding the UK government; and investments in corporate bonds have played an important role in providing funding to corporates, albeit at a different level of the capital structure to equities, but one that we would argue is equally important and productive.
- Today, DB pension schemes are at a fork in the road. With many now in surplus, they have the ability to take investment risk with that surplus without putting at risk their ability to make pension payments. This means they have scope to invest excess surpluses in equities and other higher-risk assets (including unlisted equities, business start-ups, infrastructure, etc) if appropriate changes are made to the current regulatory, legislative and tax framework.
- If appropriate changes are not made, then the vast majority of the c.£1.5trn of DB pension scheme assets will be transferred to insurers via insurance buy-outs. This is likely to lead to material sales of gilts over time, and a shift towards different types of debt investments. Bulk annuity insurance portfolios tend to have a significantly lower allocation to gilts and equities relative to pension portfolios.
- With regards to consolidation, we support the scope for governance and efficiency gains that may be available from consolidation, especially for smaller schemes. However, we believe a public sector consolidator, whether through the Pension Protection Fund (PPF) or another entity, should only be considered if there is evidence of market failure by the private sector, and we believe it is too soon to determine this. We are concerned that a public sector consolidator could lead to effective nationalisation of DB pension schemes.
- If the PPF were to be the public sector consolidator of choice, there are number of complex issues that must be resolved: who would fund the PPF consolidator, who bears the ultimate risks/benefits in the event of a downside/upside, how the PPF consolidator would be ring-fenced from the PPF lifeboat, and how conflicts of interest would be managed between the PPF's role as a lifeboat to the pension industry and its role as a public consolidator.
- In our view, the priority should be to improve the role of the PPF as a lifeboat. At the end of July 2023, the PPF reported a funding ratio for the UK DB pension industry of 146.4%[2]. The current level of protection provided by the PPF is no longer relevant as even if a corporate sponsor failed, there would no longer be a reason for most schemes to enter the PPF. We believe the floor provided by the PPF should be increased to reflect the increase in underlying pension scheme assets. We estimate that even an increase in the guarantee to 100% of pensions promised to scheme members would involve the PPF taking less risk to that taken a few years ago when schemes were generally in deficit. This would then increase the comfort for trustees to continue to run on pension schemes, and to invest a proportion of a scheme's excess surplus in equities and other higher-risk assets.

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[1] As at 31 March 2023. Assets under management (AUM) are represented by the value of cash securities and other economic exposure managed for clients. Figures shown in GBP. Reflects the AUM of Insight, the corporate brand for certain companies operated by Insight Investment Management Limited (IIML). Insight includes, among others, Insight Investment Management (Global) Limited (IIMG), Insight Investment International Limited (IIIL), Insight Investment Management (Europe) Limited (IIMEL) and Insight North America LLC (INA), each of which provides asset management services.
[2] Source: PPF 7800 index, August 2023 update.

The UK DB pension system is a huge success story

The journey taken by UK DB pension schemes is a success story which should not be understated. Thanks to years of prudent management, DB pension scheme funding levels have been steadily improving – and as they have done so, pension schemes have sought to consolidate this position by focusing on assets that provide clearly defined cashflows to help meet pension payments (i.e. gilts and corporate bonds).

This investment in gilts and corporate bonds has played a vital role in the UK economy: alongside the Bank of England, UK DB pension schemes are likely to have been the largest buyer of government bonds over the last 15 years. This has helped to fund vital public services through a period of significant economic uncertainty.

A different approach for DB pension schemes could deliver on member outcomes, a strong gilt market, and the UK's position as a financial centre

With many DB pension schemes now in surplus, appropriate changes to the current regulatory, legislative and tax framework would mean they had the ability to take additional investment risk without jeopardising their ability to make pension payments.

This is an unparalleled opportunity to realise a wide range of potential benefits for individuals, corporates and wider society. We note that alongside the Mansion House Reforms, announced in July 2023, Chancellor Jeremy Hunt announced three golden rules: "to secure the best possible outcome for pension savers; to always prioritise a strong and diversified gilt market as we seek to deliver an evolutionary, rather than revolutionary, change in our pensions market; and to strengthen the UK's position as a leading financial centre to create wealth and fund public services"[3].

In our view, these goals are achievable, but under the current landscape this future may not materialise. Despite the long-dated nature of pension liabilities, there are limited incentives for trustees and corporate sponsors to invest for the long term. Instead, the conventional wisdom within the pension industry is that schemes should move to buy-out. Trustees perceive a potential liability in not pursuing a buy-out once affordable, and there is a sense that transferring to an insurer is a risk-free action. These misperceptions naturally push schemes into the insurance sector, and we believe that addressing these misperceptions should be a priority for the committee. As most trustees and sponsors focus on their schemes being able to transfer their assets and liabilities to an insurer, via a buy-out in the near to medium term, their investment timeframe is significantly reduced.

As we set out below, we believe the three goals would be best achieved by UK DB pension schemes running on, enabled by reforms of rules and incentives, rather than through the transfer of assets and liabilities to insurance providers or through public sector consolidation.

- **Secure the best possible outcome for pension savers:** DB schemes in surplus have the scope to secure members' retirement income and to potentially also provide discretionary increases, such as to protect members' real income in periods where inflation is above most pension scheme's inflation caps (benefits are often linked to inflation up to 5% per annum).
- **Prioritise a strong and diversified gilt market:** DB portfolios today invest a substantial portion of their portfolios in gilts, which are the most secure source of future cashflows for sterling investors. Incentivising DB schemes to run on would avoid a switch to insurers, ensuring that DB schemes maintain their substantial existing gilt holdings.
- **Strengthen the UK's position as a leading financial centre to create wealth and fund public services:** Pension schemes have greater flexibility in how they invest than insurers. Once members' retirement income is secured, a pension scheme can 'afford' to invest its excess surplus in higher-risk investments that may not be possible in the insurance regime. This can include delivering the capital needed for successful UK businesses to start up and scale up. Excess surplus could also be used for the sponsor's DC pension contributions, reducing costs for UK corporates and therefore the UK economy as a whole. In contrast, a transfer of pension assets to insurers is more likely to result in a shift towards different types of debt investments, rather than equity and other higher risk assets.

We believe that this could create a win-win-win solution, where pension plan members win through potential benefit increases, sponsors win by benefiting from excess surpluses (subject to safeguards), and the UK economy overall benefits from greater deployment of risk capital by pension funds.

[3] Chancellor's Mansion House Reforms to boost typical pension by over £1,000 a year, 10 July 2023, HM Treasury.

A public consolidator needs careful thought

While we welcome the scope for governance and efficiency gains that may be available from consolidation, especially for smaller schemes, we don't believe the private-sector solutions to consolidation have been given enough time yet to fully develop. Regulations for 'super funds', for example, were only announced recently, and sufficient time should be given to judge these private-sector solutions before a public-sector solution is considered. In our view, the dramatic change in funding levels experienced by most schemes over the last 18 months is likely to make it far easier for trustees to explore and adopt these options.

As the PPF is currently funded via a levy on pension schemes, with such funding intended to cover the risk of future pension schemes falling into the PPF due to sponsor insolvency, it would be inappropriate for this funding to subsidise or support any future role the PPF has as consolidator for reasons other than sponsor insolvency. Clear governance structures would be needed to ensure that any conflicts of interest of the PPF playing both roles are managed carefully. There is also no clarity in the proposals regarding who would suffer any downside risk, or benefit from any upside of a public consolidator, and the governance of such an entity would need to include representatives from the stakeholders that are exposed to such upside gains or downside losses.

Ultimately, we also believe the unintended consequence of any public consolidator could be reliance on the taxpayer if a deficit were to develop. Whilst the proposals are not clear with regard to the role of taxpayers, we do not support the UK taxpayer taking on this burden, via the effective nationalisation of DB pension schemes.

In our view, the priority should be to improve the role of the PPF as a lifeboat. We believe the floor provided by the PPF should be increased to reflect the increase in underlying pension scheme assets. We estimate that even an increase in the guarantee to 100% of pensions promised to scheme members would involve the PPF taking less risk to that taken a few years ago when schemes were generally in deficit. This would then increase the comfort for trustees to continue to run on pension schemes, and to invest a proportion of a scheme's excess surplus in equities and other higher-risk assets.

The changes needed to unlock the potential of DB pension schemes

The key to unlocking the potential of DB pension schemes is creating the right incentives for trustees and sponsors to continue managing DB pension schemes for the long run, and in a way where investing to support start-ups, scale-ups and domestic listings of UK companies is consistent with their responsibilities and objectives.

For corporate sponsors, in our view, it would be appropriate to consider ways in which they are able to benefit from the surpluses built up within DB pension schemes, which are partly thanks to their contributions made over many years. For example, permitting excess surplus to be directed to a sponsor's DC pension scheme without adverse tax implications could help to close the intergenerational gap between the benefits of DB and DC pension scheme members that exists today. Also, an appropriately controlled mechanism for corporate sponsors to extract part of an excess surplus, beyond full funding and with a prudent buffer, and without punitive tax implications, could be a meaningful incentive.

For trustees, it may help to make appropriate adjustments to trustees' roles and responsibilities to provide clearer guidance on the relative merits of running on. For example, this may include enabling them to consider members' benefits more holistically (e.g. the potential for discretionary increases when inflation is high, as the annual inflation linkage of pension payments is typically capped at 5%) and providing guidance to address the perceived personal risk to trustees of deciding to run on a pension scheme rather than conduct an insurance buy-out.

It would be helpful to increase the level of pension benefits that the PPF guarantees, given the PPF's data shows aggregate scheme funding levels approaching 150%[4]. The current level of guarantee is so far below the actual funding level of pension funds that the PPF guarantee is very unlikely to be called upon. If improved levels of protection were available, again subject to appropriate safeguards, it could provide greater comfort for trustees to deploy some excess surplus assets towards investments that had the potential to generate higher returns over the long term.

As this would reduce the downside risk potential to DB members if a scheme's sponsor was to become insolvent, it would also improve the incentives for running on a scheme – which could ultimately include investing more in equities and other

[4] Source: PPF 7800 index, August 2023 update.

higher-risk assets. This would need to be managed while fulfilling the trustees' wider responsibilities to manage risk prudently through an appropriate regulatory framework.

By increasing PPF compensation to 100% of benefits promised to scheme members, moral hazard risk increases. This could, for example, be addressed by only permitting schemes that are well funded (e.g. those with more than 100 funding level on a discounted rate in line with gilts plus 50bp pa) to be eligible for 100% PPF protection.

Another risk to which the PPF would be exposed is discretionary increases being awarded, leading to an impairment of funding – this risk could be addressed by permitting discretionary increases subject to maintaining a high level of funding (e.g. schemes have to maintain a funding level of more than 105% or 110% on a discount rate in line with gilts plus 50bp per annum, post discretionary increases).

Questions and answers

Background

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

Yes, we agree with the broad assessment provided that there is some evidence that UK DB schemes are more invested in bonds than equities compared to international comparators. Our position is in line with research on this issue[5].

This asset allocation has evolved over time and reflects the maturity (the shift from accumulation to decumulation) and healthy funding status of UK DB schemes. The existing regulatory framework has led to UK DB pension schemes establishing a strong funding position, meaning they can largely secure their members' future retirement income. Their asset allocation provides a level of protection and benefit to members that is unparalleled among other international pension peers.

The success of the approach of UK DB pension schemes is demonstrated by their aggregate funding position, as measured on the PPF's Section 179 basis, having improved from c.93% to c.146% over the past 10 years to July 2023.[6]

DB schemes are currently at a fork in the road where there is an opportunity to reverse the historical investment trend and increase the investment in equities and other higher-risk assets (including unlisted equities, business start-ups, infrastructure, etc) within the existing DB pensions framework. This is an unparalleled opportunity to realise a wide range of potential benefits for individuals, corporates and wider society. With many now in surplus, schemes can 'afford' to invest their funding surpluses into higher-risk investments, which means there is scope for them to invest in equities and other higher-risk assets, while retaining security for members.

There are currently limited incentives for trustees and corporate sponsors to run on. This is because trustees and companies only see the downside: trustees fear the potential of not paying members' benefits in full if they chose to run on rather than transferring their assets and liabilities to an insurer; and sponsors see limited ability to extract surplus and therefore see no upside to investing in equities and higher risk assets. Therefore, most trustees and sponsors focus on their schemes being able to transfer their assets and liabilities to an insurer, via a buy-out – in effect reducing their investment time horizon to the target date of buy-out (which is often a few years). This significantly curtails the ability of pension funds to invest in line with the true horizons of their liabilities which span decades and serves to limit their investment flexibility. We set out our thoughts on how changes can be made to incentivise pension scheme trustees and sponsors to strike a better balance in our response to **Question 2.**

We would also highlight that the scope of productive assets for the UK economy spans across many different asset classes. In our view, pension schemes have indeed been investing into productive assets. Investments in gilts and corporate bonds are extremely important for the UK economy and are productive. Pension schemes' investments in gilts have played a very important role in funding the UK government; and investments in corporate bonds have played an important role in providing funding to corporates, albeit at a different part of the capital structure to equities, but one that we would argue is equally important and productive.

Alongside the Bank of England, UK DB pension schemes are likely to have been the largest buyer of government bonds over the last 15 years, which has helped to fund vital public services through a period of significant economic uncertainty. A diversified investor base, including across DB pensions, DC pensions and insurance, can help to deliver an efficient balance between the different financing needs of the government.

We believe the most effective approach to achieving the chancellor's three golden rules is for changes to be made to the regulatory, legislative and tax framework, to incentivise pension funds to run on and create the ability for the plan members and corporate sponsors to benefit from surpluses. This would enable pension schemes to both secure member benefits and deploy their surpluses partially into higher risk and higher return assets for mutual benefit of plan members, corporates and the economy overall.

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[5] For example, please see Global Pension Assets Study 2022 (PDF), Thinking Ahead Institute.
[6] Source: PPF 7800 index, August 2023 update.

We illustrate this in the table below. This compares some of the asset types in which UK DB pension schemes might invest, both at present and with changed incentives, relative to insurance companies, which are currently set to receive a substantial proportion of DB pension assets in the coming years.

Investment	Role	UK DB pension schemes (current)	UK DB pension schemes (improved guidance and regulations)	UK annuity insurers	Comment
Gilts	Help fund public services	✓	✓	✗	Insurance portfolios driven by regulation typically have very different asset holdings, with lower allocations to gilts
Debt-based company financing	Support companies in raising capital to invest	✓	✓	✓	All approaches likely to provide a high level of debt-based financing for UK companies
Illiquid assets	Help finance infrastructure, property etc	✓	✓	✓	Illiquid asset allocations are typically higher for insurers, but creating the right incentives for UK DB schemes – and so increasing their effective investment timeframes – could increase UK DB schemes' illiquid asset allocations
Risk capital	Provide risk capital for UK companies to start up and scale up	✗	✓	✗	Current pension scheme incentives and insurance regulation discourage the provision of risk capital to UK companies to start up and scale up. Creating the right incentives for UK DB schemes could unlock this.

For illustrative purposes only. Symbols are used to indicate the broad freedoms and incentives under different regimes.

Going forward, whether UK DB pension schemes continue to invest – realising benefits for members, sponsors and wider society – will be driven by the regulatory, legislative and tax framework in which schemes and sponsors operate. If the legislative environment allows key stakeholders to benefit from a pension scheme surplus (see response to **Question 2**), and the regulatory framework continues to ensure schemes maintain a high degree of security for their members, UK DB schemes could not only maintain their investments for longer but extend their investments in other asset classes including equities and other higher-risk assets – potentially delivering a range of benefits.

This offers the opportunity to strengthen the UK's position as a leading financial centre to create wealth and fund public services. Once members' retirement income is secured via strong funding levels, a pension scheme can 'afford' to invest in higher-risk investments that are not possible for insurers under insurance regulation, thereby offering a significant potential source of capital for UK businesses. Excess surplus could also be used for the sponsor's DC pension contributions, reducing costs for UK corporates and therefore the UK economy as a whole; or to benefit either existing DB members or sponsors.

We are therefore faced with a once-in-a-generation opportunity to ensure that c.£1.5trn of DB pension scheme capital continues to invest in UK gilts and wider markets, without compromising the security of members' benefits. Appropriate adjustments to the regulatory, legislative and tax framework for DB pension schemes could result in ongoing investment in gilts and high-quality corporate bonds, with the ability to invest a proportion of excess surplus assets in equities and other higher-risk 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?

As noted in our response to **Question 1**, DB pension schemes are on a journey, and today they are at a fork in the road. With many now in surplus, schemes can 'afford' to invest to take more risk, which means there is scope for them to invest a proportion of excess surplus assets in equities and other higher-risk assets (including unlisted equities, business start-ups, infrastructure, etc), while retaining security for members.

Yet, despite the long-dated nature of pension liabilities, there are limited incentives for trustees and corporate sponsors to invest for the long term. This is because trustees and companies only see the downside: trustees fear the potential of not paying members' benefits in full if they chose to run on when they could afford an insurance solution (even if all known risks are addressed, there is potential for 'unknown unknowns'); and sponsors see limited ability to extract surplus assets and therefore see no upside to invest for the long term, while also being aware of the historical strain of pension scheme contributions on companies. Therefore, most trustees and sponsors focus on their schemes being able to transfer their assets and liabilities to an insurer, via a buy-out – in effect reducing the timeframe for many schemes to under 10 years. Insurance portfolios tend to invest far less in gilts and equities than DB pension portfolios.

This means that, as things stand, the chancellor's three golden rules are unlikely to be met. To achieve them – to provide the best outcome for scheme members, establish a strong foundation for gilts, and support the UK's position as a financial centre – we need to unlock the potential for DB pension schemes. The key is to change the incentives of pension scheme trustees and sponsors such that they have a longer-term time horizon. A suitable framework would incentivise pension scheme trustees and sponsors to continue investing over the longer term, reflecting their liabilities, which may extend over many decades. Changes might be broadly categorised as to: 1) create greater upside potential, 2) reduce downside risk, and 3) provide clearer guidance that running on a scheme is considered an appropriate path.

For corporate sponsors, possible incentives that could encourage run-on and the investment of some excess surplus assets into equities and other higher-risk assets would focus on improving the upside potential of schemes, such as:

- The ability for some excess surplus to be directed to a sponsor's DC pension scheme without any tax implications, including where DC arrangements do not form part of the same trust. This could also help to close the intergenerational gap between the benefits of DB and DC pension scheme members, as well as reduce pension costs for UK companies.
- The ability to have some refund of excess surplus without being faced with a punitive tax rate applied to such refunds, subject to protections to preserve a pension scheme's health.

For pension trustees, possible incentives that could encourage them to run on pension schemes and invest in equities and other higher-risk assets include:

- Provide greater clarity and guidance that pension trustees can continue to run on pension schemes if managed responsibly, reflecting the potential upside for members and pensioners more broadly, rather than driving schemes to conduct an insurance buy-out once affordable.
- Increase the level of pension benefits that the PPF guarantees. This would be helpful to shift the balance of risks for trustees in favour of investing in more equities and other higher-risk assets, as it could potentially remove the risk of DB members facing reduced benefits if the scheme's sponsor was to become insolvent. There is sufficient pension capital available to support this and current funding levels have made the existing level of guarantee less relevant. Please see our response to **Question 6** for more information.
- Simplify the process for agreeing discretionary increases of members' benefits from excess surplus, particularly at times when inflation is higher than the typical caps that apply to the annual inflation linkage for pension benefits.
- Reduce the perceived personal liability to trustees if they choose to run on a well-funded pension scheme. In other words, the perception that buy-outs remove all liability from trustees, whereas running on maintains the potential for liability in the future, should be addressed. Current guidance and incentives can encourage a shorter-term perspective focused on achieving buy-out, rather than a longer-term perspective focused on the overall liabilities of the scheme.

Establishing a DB pensions framework that enables key stakeholders (both members and corporate sponsors) to benefit from a pension scheme's surplus, above a prudent level of funding, could provide the appropriate incentives for this capital to be utilised appropriately. This would require a change in the regulatory, legislative and tax framework such that key stakeholders can share and access excess surplus more easily while still ensuring that pension scheme members' benefits remain secured. A suitable mechanism must be established for any extraction of excess surplus; we believe it would be appropriate that this includes approval from trustees (see our response to **Question 4**).

Building Surplus

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

We do not have the information to answer this question. This may be better answered by investment consultants or those with access to this information.

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

A suitable mechanism must be established for any extraction of excess surplus in a controlled manner to avoid unintended consequences. We believe that any extraction of surplus should require approval from trustees, and this can be assisted via regulatory guidance on minimum funding levels after the transfer takes place, as well as a risk assessment of the remaining investments. A key criterion is that members' benefits should remain secure after any surplus is extracted, as otherwise the strong funding position of UK DB pension schemes could be at risk.

The conditions as to what constitutes 'excess surplus' that can be extracted could include a minimum funding level on a low-dependency basis (including criteria on the discount rate and longevity assumptions). This would help ensure that capital could only be extracted once the security of members' retirement income is prudently protected.

For example, the excess surplus might only represent assets above a 105% or 110% funding level on a discount rate in line with gilts plus 50bp per annum. This discount rate would be consistent with the narrowest level typically observed for investment grade corporate bond spreads, while the level of overfunding would provide a buffer to offset potential downside risks (e.g. longevity risk). It is also a level of funding above which DB pension schemes can 'afford' to invest in higher-risk investments while retaining a high level of security for members' retirement income in a downside scenario.

For schemes with a prudent level of funding, with a portfolio that passes suitable resilience tests, it could therefore be argued that the excess surplus could be extracted without compromising the fundamental aim of the pension scheme to provide security of members' retirement income. We would propose the DB funding code be amended to reflect this.

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 the risks be?

We would argue that pension schemes have indeed been investing into productive assets. Investments in gilts and corporate bonds are extremely important for the UK economy and are productive. Pension schemes' investments in gilts have played a very important role in funding the UK government; and investments in corporate bonds have played an important role in providing funding to corporates, albeit at a different part of the capital structure to equities, but one that we would argue is equally important and productive.

We agree, however, that enabling trustees and employers to extract excess surplus before a pension scheme winds up should encourage more risk to be taken in DB investment strategies, which could enable greater investment in UK assets, including equities and other higher-risk assets (including unlisted equities, business start-ups, infrastructure, etc). The key is the incentives for trustees and employers.

The reason for this, as per our response to **Question 2**, is that the ability of trustees and employers to extract surplus could incentivise them to continue managing DB pension schemes for the long run. By shifting to a longer-term horizon, DB pension schemes are able to unlock their potential, including taking more risk and investing in UK equities and other higher-risk assets, in a way that is consistent with their responsibilities and objectives to DB pension members. Alongside this, consideration should be given as to how to ensure UK equities and other higher-risk assets are attractive relative to global opportunities.

The efficient deployment of excess surplus could result in a number of significant benefits, enabling trustees and/or sponsors to:

- offer enhanced benefits for members who have worked for many years to build up their pension savings, and offset the erosion of the real value of their benefits by high inflation (the annual inflation linkage of pension payments is typically capped at 5%);
- reimburse some of the capital that sponsors have historically contributed to enhance the security of pension benefits;
- improve the intergenerational equity and security of pension provision through support for DC schemes of their sponsor; and
- provide finance to support economic growth through the investment in equities and other higher risk assets.

More widely in relation to investment in UK assets, UK DB pension schemes are major holders of gilts. Enabling trustees and employers to extract surplus at a point before a scheme winds up would incentivise UK DB schemes to run on pension schemes, which means they would continue to hold gilts for the long term. In contrast, insurers typically hold fewer gilts, meaning a large transfer of pension assets to the insurance sector would likely apply upward pressure to gilt (and UK corporate bond) yields and so increase government financing costs, negatively impacting the UK economy.

The risks of enabling trustees and employers to extract surplus are that:

- Surplus extraction may reduce the security of DB pension benefits. This can be mitigated through the use of appropriate controls around surplus extraction (see **Question 4**).
- Investing in risk assets, such as equities and other higher-risk assets, is likely to introduce more risk than existing investments, which could negatively impact a pension scheme's funding levels if assets are impaired. This can be mitigated through trustees continuing to manage risks in line with the relevant enhancements to the revised DB funding code, such that they are not taking more risk than they can 'afford' in a stressed scenario.

We believe that the wider benefits of enabling the extraction of excess surplus are attractive, and the risks outlined above can be managed effectively.

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

Yes, we believe having greater PPF guarantees of benefits could encourage greater investment in equities and other higher-risk assets (including unlisted equities, business start-ups, infrastructure etc). As per our response to **Question 2**, the key to unlocking this potential is creating the right incentives for trustees and sponsors to continue managing DB pension schemes for the long run, and in a way where supporting start-ups, scale-ups and listings of high-growth UK companies is consistent with their responsibilities and objectives.

Increasing the level of pension benefits that the PPF guarantees would be helpful to shift the balance of risks for trustees in favour of investing in more equities and other higher-risk assets, as it could potentially remove the risk of DB members facing reduced benefits if the scheme's sponsor was to become insolvent. This reduction in risk would help trustees to make the decision to run on a scheme for the longer term, rather than seek to conduct an insurance buy-out, and also give them comfort that they can afford to invest in equities and other higher risk assets without undermining member security.

The latest estimates of aggregate funding levels of UK DB schemes suggest that the average scheme is in surplus, even when measured on a prudent basis; this suggests that PPF could provide a meaningfully higher level of protection (up to possibly full protection) without taking undue risk.

For the PPF's existing liabilities, it has conducted analysis that suggests the cost of increasing the level of benefits could be covered while retaining a healthy surplus within the PPF.[7] We note that the most recent funding strategy review conducted by the PPF concluded that it is in a strong position, meaning it is almost halving the levies it is seeking to raise, and shifting from "building to maintaining its financial resilience"[8].

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[7] Please see the written evidence from the PPF to the Work and Pensions Committee's call for evidence on defined benefit pension schemes (April 2023), available here (PDF). This letter outlines the challenges, but we believe this is both achievable and desirable to maximise the security of pensioners' retirement income.
[8] Source: PPF to significantly reduce levy as funding strategy review concludes, 29 September 2022, PPF.

Any potential moral hazard concerns of the PPF uplifting its benefits would be mitigated by the proposed DB funding code with relevant enhancements to enable the use of a well-funded DB pension scheme's excess surplus, while requiring pension schemes to manage their risks prudently.

There are also risks to the funding level of the PPF of increasing benefits. This risk, as well as the potential moral hazard, could be mitigated by only offering increased benefits to pension schemes that are above an agreed funding level. This would act as a qualifying criterion and encourage well-funded schemes to invest in equities and other higher-risk assets; such schemes would have excess surplus and therefore be best placed to do so. Another risk to which the PPF would be exposed is discretionary increases being awarded, leading to an impairment of funding – this risk could be addressed by permitting discretionary increases subject to maintaining a high level of funding (e.g. schemes have to maintain a funding level of more than 105% or 110% on a discount rate in line with gilts plus 50bp per annum, post discretionary increases).

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?

We believe that changes to the tax system would help in creating the right incentives for sponsoring employees and scheme trustees such that surpluses can be utilised. As per our response to **Question 2**, the key to unlocking this potential is creating the right incentives for trustees and sponsors to continue managing DB pension schemes for the long run, and in a way where supporting start-ups, scale-ups and listings of high-growth UK companies is consistent with their responsibilities and objectives.

Regarding ensuring surpluses are taxed appropriately, we would note that the funding of DB pension schemes represents a transfer from individuals and companies into a trust with the purpose of providing pension benefits for members. We believe that, so long as the principle of using these assets to fund pensions is maintained, then using a DB pension scheme surplus to fund DC schemes should not incur additional tax. In contrast, the return of surplus directly to the sponsor should continue to incur tax, but potentially with a review of the effective rate to ensure that, subject to prudent guidelines, return of excess surplus to corporate sponsors is not subject to penal tax treatment.

Possible tax changes that would help with the incentives to run-on and invest in equities and other higher risk assets (including unlisted equities, business start-ups, infrastructure etc) therefore include:

- The ability for some excess surplus to be directed to a sponsor's DC pension scheme without any tax implications (see our response to **Question 8**). For example, rules could be changed so that surplus extraction does not attract additional tax, as long as the sponsor's contribution to its DC scheme exceeds the amount of the surplus extracted in that year. This could help to close the intergenerational gap between the benefits of DB and DC pension scheme members, as well as reduce pension costs for UK companies.
- The ability to have some refund of excess surplus without being faced with a punitive tax rate applied for such refunds – this rate discourages surplus extraction and so likely generates limited tax revenue.

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, we believe permitting excess surplus generated by a DB scheme to be used to provide additional contributions over and above statutory minimum contributions for auto enrolment for DC members could be an appropriate way to improve the incentives for sponsoring employers and scheme trustees to run on a scheme and unlock the potential benefits that could arise – subject to appropriate safeguards.

The funding of DB pension schemes represents a transfer from individuals and companies into a trust with the purpose of providing pension benefits for members. We believe that, so long as the principle of using these assets to fund pensions is maintained, then using a DB pension scheme surplus to fund DC schemes should not incur additional tax. Indeed, at present we believe this is already possible, but only if DC assets form a part of the same trust as the DB scheme. This concept could be broadened to allow more sponsors, who may have adopted an outsourced approach to DC provision (e.g. via Master Trust) to also benefit. For example, rules could be amended so that no additional tax would be charged on excess surplus extracted, as long as the sponsor has made DC contributions of at least the same amount extracted in that year. This would widen the number of sponsors who would benefit from these principles.

This could help to close the intergenerational gap between the benefits of DB and DC pension scheme members. It could also reduce costs for UK companies, thereby helping the economy more widely.

This could be extended to cover the use of surpluses for any DC contributions, rather than just those above the statutory minimum, to improve the incentives for companies of running-on their DB scheme.

We believe this option should be enabled for sponsors and trustees, rather than be mandatory.

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

Yes, allowing easier access to scheme surpluses could lead to misuse of scheme funds if not managed appropriately.

As per our response to **Question 4**, for schemes with a prudent level of funding and with a portfolio that passes suitable resilience tests, it might be argued that the surplus could be extracted without compromising the fundamental aim of the pension scheme to provide member benefit security.

Consolidators

Question 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?

Consolidation and asset allocation are entirely separate issues. Asset allocation is primarily driven by liability cashflow profiles, funding levels, return requirements and time horizons and none of those factors would be impacted significantly by consolidation. The objective of consolidation is primarily to improve cost efficiency and governance amongst small schemes that lack resources as a result of their size. Consolidation could also unlock opportunities to invest in certain specialist asset classes where lack of scale can be an impediment. In our view, pension schemes should be encouraged to embrace private-sector solutions to these problems including sole trusteeships, fiduciary solutions, master trusts/pooling, super funds and private-sector consolidators, before a public-sector solution is adopted.

As the benefits of consolidation are focused primarily on improved efficiency, we believe the government should consider voluntary consolidation in a structure similar to that used by LGPS. The pooling of administration and governance functions could present meaningful operational efficiencies for DB pension schemes. In addition, appropriate incentives should be given to enable members to benefit from potential future surpluses, while maintaining an appropriate level of security of benefits in its investments.

We would observe that the current regulations around consolidators have not been given the appropriate amount of time to play out given, for example, that the super fund regulatory regime was only released in July 2023 and the significant increase in DB pension funding levels is a feature of the last 12-18 months only. There should be evidence of a market failure after some time is given to pension funds to pursue private-sector solutions, before public-sector consolidation solutions are considered.

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?

The buy-out market is widely understood but the regulatory guidance related to private-sector consolidators has only been recently issued. As such, it is too soon to draw conclusions about how that market is functioning.

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

As explained in our response to **Question 10**, the benefits of consolidation are focused primarily on improved governance and efficiency. We believe the government should consider voluntary consolidation in a structure similar to that used by LGPS. The pooling of administration and governance functions could present meaningful operational efficiencies for DB pension schemes.

From a risk perspective, we question who would be at risk if a public consolidator were to find itself with a funding deficit. We believe the risks will likely be borne by either the taxpayer, or by members via receiving reduced benefits. We do not support either of these outcomes.

Currently this risk is spread across thousands of corporate sponsors, and ultimately the PPF if one of those sponsors becomes insolvent, with the PPF itself funded by levies on pension schemes.

If a public consolidator were to operate alongside commercial consolidators, then the potential or implied support from the taxpayers would give this entity an unfair advantage over the commercial consolidators. This would reduce competition, increase concentration, and be at odds with the goal of fostering a thriving financial system.

We also question who would benefit from the surplus assets. We are concerned of the potential political risk that could face those assets if a future government were to find themselves in need of funds. As explained in our responses to **Question 4 and 5**, we believe it is more appropriate to incentivise trustees and sponsors to benefit from these excess surpluses which can lead to beneficial outcomes for the UK economy including greater investment into equities and other higher-risk assets.

As we indicated in these earlier responses, we believe the key to driving changes in asset allocation is likely to lie in the incentives for key stakeholders to be able to benefit from the running-on of pension schemes. If there was no clear incentive to run on, or run on via a consolidator, then many pension schemes will very likely opt for an insurance buy-out. To the extent that consolidation occurs via a public consolidator, it is not obvious that members or sponsors will continue to benefit from running on a scheme, and as such, this may actually be detrimental to both members' interests and the prospect of pension capital delivering to its full potential.

Given the above, we do not believe a platform for consolidation should be limited to the public sector and any new approach should offer scope for competition for different solutions to emerge. As long as consolidation remains voluntary, market forces could drive business towards the more attractive provider.

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?

The only way in which a public consolidator could not adversely affect the existing bulk purchase annuity market would be if the consolidator were restricted only to business that the private sector was unable for commercial reasons to take on. As private-sector solutions to consolidation have yet to be given sufficient time to be judged, it is difficult to know whether the private sector may already be in the process of closing this gap. There should be evidence of a market failure in this regard before public-sector consolidation solutions are considered.

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

A public consolidator would have no greater appetite or scope to take risk than private-sector schemes or private-sector consolidators, unless the public consolidator's risk appetite is altered through an external construct. Greater risk appetite could, for example, arise because the liabilities of the public consolidator were underwritten by the government, but this would then put the burden of any shortfall in assets onto the taxpayer, which we would not support.

Asset-allocation decisions are a result of funding levels, time horizons and the capacity to take risk, none of which would change as a result of consolidation.

The benefits from consolidation are focused primarily on improved governance and efficiency.

As described in our response to **Question 5**, appropriate adjustments to the regulatory, legislative and tax framework for DB pension schemes to provide incentives to trustees and sponsors could result in ongoing investment in gilts and high-quality corporate bonds, with excess surplus invested in equities and other higher risk assets (including unlisted equities, business start-ups, infrastructure, etc).

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

Ultimately the risk inherent within a public consolidator would need to be borne by someone and none of the options are appealing. The two most obvious options would be either for members to bear this risk (and potentially risk a reduction in benefits) or that the risk is underwritten by the taxpayer via the effective nationalisation of DB pension schemes. We do not support this as many of those taxpayers would never be able to obtain the benefits they would be underwriting.

As explained in our response to **Question 12**, we question whether any public sector entity should act as a consolidator and there must be evidence of market failure in relation to commercial consolidators before public sector consolidation is considered.

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

We are unable to find a valid international comparison to the UK DB system. The Australian and Dutch systems are often cited as a comparison for the UK but there are significant differences. The Australian regime is predominantly a defined contribution system, and the Dutch system is a very different form of defined benefit, where benefits do not have an inflation link, and can be reduced in certain circumstances. Neither of these systems is a good comparator to the UK DB system.

Finally, the implied nationalisation of pension schemes, via a public sector consolidator, is unprecedented within developed markets.

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

The PPF has been designed and managed as a ‘lifeboat’ for DB pension scheme members, to ensure members can receive a retirement income even if their scheme and sponsor fail. We believe the focus of the PPF should be to become a better lifeboat in the light of the improving health of pension funds and, as explained above, a better lifeboat would unlock the ability of pension funds to invest their surpluses more effectively. We do not believe the remit of the PPF should be adjusted to act as a consolidator.

The PPF is currently funded via pension schemes, with such funding intended to cover the risk of future pension schemes falling into the PPF due to sponsor insolvency; it would be inappropriate for this funding to subsidise or support any future role the PPF has as consolidator for reasons other than sponsor insolvency. Therefore, any role that the PPF has as a consolidator should be clearly separated and ring-fenced from its role as a lifeboat for pension schemes. This means both separating the assets and liabilities as well as the board and its governance structure.

We are concerned of possible conflicts of interest with the PPF playing the roles of both consolidator and lifeboat for pension schemes, and this would need to be managed carefully. The PPF playing both these roles could create distortions of incentives in the event that deficits were to occur.

If the PPF acts as a consolidator, in the event the consolidated schemes develop a deficit, it is unclear how this would be resolved. It would be inappropriate to rely on funding from pension schemes that are not consolidated. Ultimately, we believe the unintended consequence of PPF consolidation would be reliance on the taxpayer if a deficit were to develop. We do not support the UK taxpayer taking on this burden, via the effective nationalisation of DB pension schemes.

The benefits of consolidation are focused primarily on improved efficiency. We therefore believe the government should consider voluntary consolidation in a structure similar to that used by LGPS. The pooling of administration and governance functions could present meaningful operational efficiencies for DB pension schemes.

Given the above, we do not believe a platform for consolidation should be limited to the public sector and any new approach should offer scope for competition for different solutions to emerge. As long as consolidation remains voluntary, market forces could drive business towards the more attractive provider.

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

The board of a public consolidator would need to have representation from all those parties that could potentially face downside risk of the consolidator as well those that stand to realise the upside benefit of any surpluses. Whilst the proposals are not yet detailed enough with respect to who would bear the deficits and who would benefit from surpluses, depending on its governance and risk structure, it is likely that the board of any public-sector consolidator should therefore also include representation from members and the taxpayer.

As described in our response to **Question 17** above, we believe the governance structure, and therefore the board of the PPF as a consolidator should be separate from the board of the PPF as a lifeboat. Potential conflicts of interest of the PPF as consolidator versus the PPF as the lifeboat would need to be managed carefully.

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?

In our view, it is important to allow schemes sufficient time to adopt private-sector solutions before a public-sector solution is implemented as risks are best borne by the private sector. A public-sector solution comes with implied government support, and we believe this should only be implemented to fill any gaps that result from market failure, rather than distorting markets by directly competing with the private sector. There has not yet been sufficient time given to these private-sector solutions to judge their effectiveness.

As described in our response to **Question 10 and 17**, we question whether the PPF, or any public-sector entity, should be considered as a consolidator unless there is evidence of market failure from commercial consolidators.

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?**

  Yes, with a sufficient capital injection – but there would be a significant question around who should pay for that capital injection.

- **What principles should there be to govern the relationship between the consolidator and the Pension Protection Fund?**

  As described in our response to **Question 17**, any role that the PPF has as a consolidator should be clearly separated and ring-fenced from its role as a lifeboat for pension schemes. This means both separating the assets and liabilities as well as the board and its governance structure. We are concerned of possible conflicts of interest with the PPF playing the role of the consolidator and the lifeboat for pension schemes and this will need to be managed carefully.

- **Should entry be limited to schemes of particular size and / or should the overall size of the consolidator be capped?**

  In our view, the role of a public consolidator should only be to address failures of the commercial consolidation sector as they become clear. Therefore, we believe they would likely be limited to particular size and other factors, but this would be difficult to determine now before a market failure has been observed.

- **How could the fund be structured and run to ensure wider investment in UK productive finance?**

  Whilst scale could theoretically enable investments in some specialist asset classes, the primary role of any consolidator would be to provide governance and efficiency gains. Asset-allocation decisions are a result of funding levels, time horizons and the capacity to take risk, none of which would change as a result of consolidation unless there was implicit taxpayer guarantee which is something we do not support. Indeed, the current assets of PPF are conservatively invested, similar to private defined benefit schemes.

- **How to support continued effective functioning of the gilt market?**

  As mentioned above, asset-allocation decisions are a result of funding levels, time horizons and the capacity to take risk. A change in the incentives of pension scheme trustees and sponsors to continue investing over the longer term reflecting their liabilities, as opposed to the shorter time timeframe driven by pursuing insurance buy-out, would therefore help to maintain the existing gilt holdings of DB pension schemes. A widescale move to insurance buy-out would likely result in a reduction of gilt holdings from these portfolios as explained in our response to **Question 1**.

Contact

Main contact	Vanaja Indra
Title	Head of Public Policy
Telephone	+44 20 7321 1110
Email	vanaja.indra@insightinvestment.com
Address	160 Queen Victoria Street London EC4V 4LA