Options for Defined Benefit schemes: a call for evidence

Response from the Pension Protection Fund

September 2023

About the PPF

The Pension Protection Fund (PPF) was established to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover PPF levels of compensation[1]. Since inception, we have consolidated over 1,000 DB schemes into the Fund, and now have around 300,000 members, to whom we paid £1.2 billion in 2022/23. We protect a further 9.6 million members of DB schemes.

The PPF is a statutory fund run by the Board of the PPF, a statutory corporation established under the provisions of the Pensions Act 2004. The PPF became operational on 6 April 2005.

In 2009 the Board of the PPF was also given the responsibility of being the scheme manager for the tax-payer funded Financial Assistance Scheme (FAS). FAS provides assistance to around 142,000 members of around 1,000 eligible underfunded defined benefit schemes that started to wind-up between 1 January 1997 and 5 April 2005, or between 6 April 2005 and 27 March 2014 where an employer insolvency event occurred before 6 April 2005.

Key points:

- **Trustees and employers of closed, corporate DB schemes are focused on reducing risk and volatility as rapidly as possible. For many, this is with a view to buying out with an insurer. Increasing investment in UK productive finance does not fit with this. It requires a willingness to accept risk and volatility and to invest over a 10-to-15-year time horizon.**

- **If DB pension scheme investment is to support productive finance objectives, investment objectives need to be changed. This will not happen within the current framework. Adjustments to incentives – such as easier access to scheme surpluses – will not secure a substantial increase in DB allocations to productive finance.**

- **However, this can be achieved through consolidation and removing the link with the employer covenant. A consolidator – aiming to invest for growth over the medium to long term allied with scale and professional asset management - will lead to greater allocations in productive finance while providing security for members.**

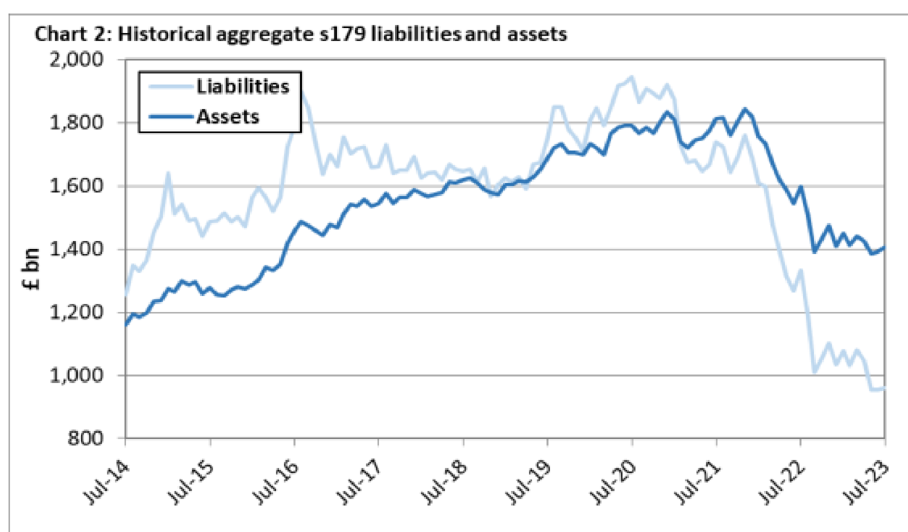
- **The PPF is well placed to take on an additional and separate function as a public sector consolidator should this be the government's preferred solution. Our existing investment strategy, which has an allocation of around 30% in productive finance assets (Equity, Alternative Credit, Infrastructure, Real Estate and Timberland/Agriculture), is an example of what could be achieved with a well-diversified portfolio. The maturity of our operating model means we can take on an additional role without affecting the successful delivery of our existing functions.**

[1] What being a PPF member means | Pension Protection Fund

General comments

We welcome the opportunity to respond to this call for evidence. The government has set clear objectives to secure the best outcome for pension savers, prioritise a strong and diversified gilt market and strengthen the UK's competitive position as a leading financial centre. We note this call for evidence and our response is focussed on Defined Benefit (DB) schemes and assets; there are other initiatives ongoing to achieve this in the Defined Contribution (DC) space, where the focus on growth assets aligns well with the government's agenda.

Currently, the majority of DB schemes are delivering on the first of these objectives (securing the best outcome for pension savers), particularly in light of the improved funding position of many schemes. Our 7800 update in August 2023 estimated the improved funding ratio (assets as a percentage of s179 liabilities, which are the liabilities needed to pay PPF compensation) at 146.4 per cent at the end of July 2023[2]:



It is clear, however, that – in aggregate – the objectives and constraints of typical closed, corporate DB pension schemes are not consistent with the government's objectives of preserving the integrity of the gilt market and investment in UK productive finance.

The current objective for the majority of such schemes and their sponsors is to get to self-sufficiency / buy-out in the least volatile way. With the improvement in funding levels, this has resulted in sales of productive finance assets and buying of gilts and corporate bonds, to reduce balance sheet volatility and get to the end-game as soon as possible. It's not compelling under current objectives / constraints for them to reverse this process to re-risk and increase their holding of productive finance assets.

In the process of transferring the risk to an insurance company, the current experience is that trustees need to sell productive finance assets because there is limited appetite from insurers to accept these assets in part payment of the insurance premium. Insurers have tended to prefer gilts, cash, and UK investment grade corporate bonds. Following the transfer to the insurer,

[2] The monthly 7800 update gives the latest estimated funding position based on adjusting the scheme valuation data supplied to TPR as part of the annual scheme return. As a result the 7800 update does not reflect actual movements in individual schemes' asset and liability values since the last valuation submitted to TPR. A scheme's s.179 liabilities represent, broadly speaking, the premium that would have to be paid to an insurance company to take on the payment of PPF levels of compensation. This compensation may be lower than full scheme benefits.

many of the gilts transferred in part payment of the insurance premium are also likely to be sold because insurers' investment strategies tend to be predominantly focused on investment grade cashflows which generate high returns. This means that insurers will typically buy both listed and unlisted credit assets including but not limited to corporate bonds, loans, and mortgages.

We therefore believe that to achieve the government's objective, for a substantial increase in DB allocations to productive finance, a step change in the structure of the DB market will be needed. This must secure fundamental changes in the objectives and focus of DB asset management so that they align with government objectives. It will require:

1. time – productive finance assets require time horizons of 10 to 15 years to generate the expected returns, and an acceptance of potential year-on-year volatility on the balance sheet: most pension funds are sufficiently well funded and do not need to generate the higher returns offered by an equity stake in productive finance assets; schemes that have existing investments in UK productive finance have reducing appetite to continue holding them as they approach their end-game, and if that is buy-out, the limited options for transferring these assets as part of a buy-out transaction further reduces the time horizon for holding these assets
2. diversification – the ability to invest in a wide range of productive finance assets while maintaining a strong gilt market
3. interest rate / inflation risk management - by using the gilt market extensively
4. scale / professional management – scale allows diversification of investment into productive assets together with experienced investors allocating capital; this is beyond the reach of a large part of the extremely fragmented DB universe, in which the smallest 4,500 schemes account for around £200bn of assets (15% of the total DB assets)

We believe the only way to achieve this to any significant degree without mandation (which would conflict with trustees' fiduciary duties, and could undermine confidence in pensions saving) is to remove the link to the sponsoring employer covenant, through a consolidator focussed on long-term self-sufficiency and member security.

The PPF demonstrates what can be achieved through scale. We are a consolidator (of over 1,000 DB schemes whose employers have become insolvent), have a long-term time horizon and invest to grow our funds in the most efficient way possible within our risk budget. This leads to an asset allocation in line with the government's objectives. We invest in a broad range of asset classes including significant allocations to gilts (c. 35% of total assets) and to productive finance assets (c. 30% of total assets, in Equity, Alternative Credit, Infrastructure, Real Estate and Timberland/Agriculture); within the latter roughly 20% is in the UK. Our investment portfolio – the majority of which is now directly managed by our in-house team – has delivered a long-term (since 2011) average annual return of more than 9%, helping us establish a strong funding position and substantial reserves to the benefit of our members and levy payers.

Beyond our investment success, we have significant and externally recognised in-house experience of transferring DB schemes into the PPF with an efficiency not previously seen in the market, including retirement processing (including online), benefit payment (most recently recognised as the winner of the Pensions Age Pensions Administration Award 2023), and a close working relationship with our panel firms who support us in providing a high level of service during the assessment period.

We have the capability and experience to assume a new consolidator role to support the government's productive finance agenda and improve outcomes for members, and are enthusiastic about the opportunity to extend our remit in this way.

We have set out below our thoughts on the specific questions posed.

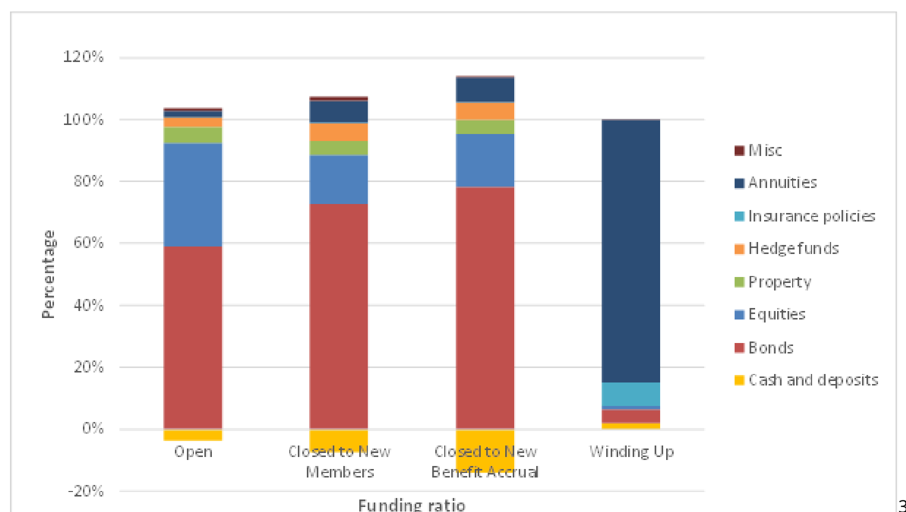
Responses to questions

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

We agree there are international comparators that have greater allocations to productive finance than is typically true of UK DB schemes. However, this reflects the different objectives of these schemes. Closed, corporate UK DB schemes are typically focused on de-risking as funding improves. This is in order to meet employer and trustee objectives to pay full benefits to their members and minimise the balance sheet volatility posed by the scheme. In line with this, many schemes will be looking to move towards buy-out or self-sufficiency as quickly as possible. In light of recently improved funding levels, the time horizon for those schemes targeting buy-out has reduced quite significantly. Increasing investment in productive finance would be unlikely to fit their objectives. For larger, closed DB schemes targeting self-sufficiency, investment in productive finance could better suit their objectives but it is not clear that these schemes have the headroom to increase significantly their investment into these assets, nor that corporates would be prepared to support the additional risk.

Where objectives are different that is reflected in different asset allocations. DB schemes that are open to future accrual, for example, will be aiming to continue to invest for growth over time within a defined risk budget (to reduce the cost of the scheme to the sponsoring employer while limiting the extent of downside risks the sponsor is exposed to). This leads to asset allocations more in line with the government objectives set out in this call for evidence.

Data from the Purple Book 2022 on asset allocation by scheme status demonstrates that open schemes invest the most in growth assets while schemes that are winding up have around 1% of their assets invested in growth assets. The percentage of total assets invested in bonds increases as schemes become increasingly closed. Schemes that are winding up have the majority of their assets invested in annuities:



[3]

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?

[3] The weighted average proportion of assets held in cash and deposits being negative represents a number of large schemes with significant negative cash holdings which are likely to be related to investments such as swaps and repurchase agreements.

Increased investment in 'productive assets' would require schemes to increase risk and lengthen their investment time horizons to accommodate the longer holding period for these assets. This is in direct contrast to the objectives many trustees and employers are pursuing, especially those targeting some sort of risk transfer to an insurer as their end-game. As funding improves trustees want to reduce risk to secure member benefits, and employers want to reduce the risk to their balance sheet. Both parties want to achieve this as quickly as possible.

For schemes targeting self-sufficiency, increasing their investment in productive finance may be more easily accommodated due to their longer investment time horizon. But even then it is not clear what incentives exist to take more risk than is necessary to achieve their long-term funding objectives.

For schemes targeting risk transfer to an insurer, there tends to be a focus on making sure their assets are 'buy-out/buy-in ready'. This typically means holding gilts, sterling investment grade corporate bonds and cash, which are the mainstay asset classes that an insurer will accept as part of the insurance premium to be paid. More recently there has been increased flexibility by insurers to consider a transfer of a wider range of assets on buy-out/buy-in, but nevertheless many pension funds are likely to limit their allocation to less liquid UK productive finance investments as they approach buy-out/buy-in.

Increasing investment in productive assets therefore requires a fundamental change in the objectives of corporate DB schemes. We do not believe this can be achieved to any significant extent within the current framework. From the corporate perspective, when de-risking and potentially a buy-out is within reach, there is no rational reason (for the vast majority of employers) to take on more risk – outside of their core business – putting their balance sheet at risk and negatively impacting shareholder appetite to invest in the company. We therefore think it will be essential to change the framework and in particular to sever the link to the sponsoring employer covenant.

We acknowledge that, based on the asset allocation data from the Purple Book (above), changing the framework to encourage schemes to remain open or consider re-opening could also achieve the same goal.

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

We hold no data on this.

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

Maintaining a high level of security for members must be the overriding consideration. We have seen first-hand how quickly employer covenant can deteriorate, and there can be limited notice this is occurring. It is equally important that schemes do not take risks the sponsor cannot support. With this in mind we would expect schemes to be funded on a prudent, low dependency basis, having reached their long-term objective and with a buffer before any extraction of surplus could be considered. At the point of extraction, it would be important to understand the outlook for the sponsor's covenant.

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?

As set out in our response to question 2, we believe it is now extremely difficult to change the majority of trustees' and employers' objectives, especially as schemes get better funded. There

may of course be examples of employers where for particular reasons the proposition is more attractive, but overall we expect changes to the surplus extraction rules are unlikely to make a significant difference to the strategies being pursued by schemes.

Any incentive would be limited by:

- the safeguards put in place e.g. a requirement to attain a prudent level of funding plus a buffer before any surplus would be extracted would mean the availability of any upside is limited
- the need to share upside with all stakeholders – all parties would need to be sufficiently incentivised to re-risk the scheme, meaning any upside would (as a minimum) need to be shared between employer and scheme members, limiting the extent of the benefits any one party could secure.

Even if some schemes were incentivised to re-risk it is uncertain whether this would lead to increased investment in UK productive finance assets. They are complex and difficult to manage, so challenging for many schemes to invest in. As long-term patient capital, with a 10 - 15-year time horizon and potential year-on-year volatility, they could be beyond what schemes are looking for or prepared to invest in. Schemes need to be sufficiently large to invest in these types of assets cost-effectively while maintaining adequate diversification in their investment strategy, and many trustee boards won't have the level of investment knowledge and understanding to be comfortable investing in these types of assets. And if they do, they still may not choose to invest in the UK.

Careful management would also be needed to avoid the potential risk of employers 'gaming' the system if preferential tax treatments are introduced. For example, an employer of an overfunded scheme could opt into the new regime, then extract some of their surplus at reduced tax rates before buying out their benefits with an insurer without having adjusted their asset allocation in any way.

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

For the reasons set out above, we do not believe such a change would make a meaningful difference in the level of productive finance investment, though of course there may be other benefits for schemes and employers, including providing full confidence that member benefits will be paid if a scheme is not moving to buy out but instead seeking to run on.

However, there are important implementation issues and risks that would need to be considered and worked through. These vary according to the overall design. For example, providing full benefits for <u>everyone</u> would have significant funding and levy implications. If on the other hand, greater levels of PPF protection is a <u>voluntary</u> option for schemes, where they opt in to paying additional levy in exchange for a guarantee of full benefits, we would expect the number of schemes taking up the proposition to be low. Risks and issues to be considered in this scenario include:

- *How to ensure the cost of claims can be met in all scenarios* - the proposition depends on the PPF *guaranteeing* full benefits. That means the government would need to be clear as to how the cost of claims would be met including in tail scenarios. The PPF's financial strength provides a high level of security to its current and future members but our legislation provides for benefits to be reduced and the levy to be increased to address a funding emergency. Neither option is likely to be available under this proposition. It would not be a guarantee if benefits could be reduced, and we expect the number of schemes taking up the option would be below what is necessary to provide adequate risk pooling. In other words, if we sought to fund for tail scenarios through a levy, the charge would be unaffordable. We

therefore consider that it will be necessary to have access to capital from elsewhere in order to provide the necessary level of security. The government could choose to use the PPF's existing funds for this. However, this would effectively mean schemes within the standard PPF structure were underwriting the risk posed by those who had opted into higher levels of protection. The government would need to consider carefully whether this is an acceptable use of PPF funds and an acceptable risk to place on existing levy payers. Clearly the extent of that risk will depend on a range of factors including the take up rates, the credit rating of participating employers and the funding and investment strategies of the schemes in question.

- *PPF levy charge* - the scale of the PPF levy charge (in return for guaranteeing full benefits) could have an impact on the attractiveness of the proposition. The amount that needs to be charged will depend on the factors noted above. The extent to which levy funds are expected to meet claims risks (and what risk will be covered by other capital) is particularly key. As an illustration, however, if there were a reasonable pool of risk-based levy payers and the levy were set to meet the cost of claims in the majority of scenarios (minimising the likelihood of calls on other capital), then we estimate the levy (on top of the standard PPF charge) would need to raise at least 60bps of the total buy-out liabilities of participating schemes each year. Individual scheme levies would be higher or lower depending on their specific credit worthiness, funding level, and investment strategy.

- *Moral hazard risks* – it was recognised from the outset that the introduction of the PPF creates a moral hazard risk. Raising the level of protection provided to full benefits will increase this risk and ensuring this can be effectively mitigated will be key.

  In the *ITS v Hope* judgment, it was decided that PPF protection wasn't a relevant consideration for trustees to take into account when making some decisions. This principle was confirmed by the High Court in August this year in the *BRASS Trustees v Goldstone* judgment. A change to the law would, therefore, be required for trustees to have regard to PPF protection when setting their investment strategy.

- *Significant new legislation and associated processes would be required* – including to support a new and separate levy charge and amend how PPF assessment periods and compensation work (reflecting the shift to protection of full benefits). In parallel we would need to establish new capabilities and systems and processes. If the take-up rate for the option is low, this will limit the extent to which expenses can be spread across schemes without making the option unaffordable.

- *Cost & time for schemes and employers* – employers and trustees would need to consider carefully whether entering into this arrangement (with increased costs and risks) were appropriate for their scheme. This process would be likely to take some time (including to establish a revised investment strategy and agree how any investment upside would be shared between different stakeholders). We would envisage detailed covenant, actuarial, investment and legal advice would all be required before any final decision could be taken.

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 have no comment on this.

Question 8: In cases where an employer sponsors a DB scheme and contributes to a DC pension 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?

We have no information on the extent of DB schemes' sponsors' (or trustees') interest in re-risking their DB pension funds to generate excess returns and consequent surpluses for meeting their pension obligations to employees who are members of their DC scheme. In the event the government decides to proceed with this option, consideration would be needed on whether it would be open to support DC schemes which were not part of the same trust in this way.

If the policy intention is to address a DC adequacy issue, it should be noted that there are c5,200 DB schemes, versus 1.5 million employers who have an obligation under automatic enrolment, so such a proposal would be unlikely to make a material difference to the overall problem. We understand from anecdotal evidence that, where an employer sponsors both a legacy DB and a current DC scheme, in most cases the DC scheme is relatively generous. Any DC inadequacy isn't generally in that part of the DC market.

We would note that any commitment to make regular payments into a DC scheme from DB surplus doesn't automatically lead to investments in UK productive finance. We would also suggest that the more employers are restricted in what they can do with any surplus, the less likely it is to be an attractive option.

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

The Pensions Regulator (TPR) has a range of anti-avoidance/anti-abuse powers including powers to make Contribution Notices, Financial Support Directions and Restoration Orders. While these are part of the scheme for reducing moral hazard, they are designed to deter and remedy specific instances of abuse or detrimental action. With these safeguards it is relatively difficult to envisage circumstances of deliberate misuse. A more likely scenario is an increasing risk to members, with the inherent risk around 'too much' money being taken out of the scheme, and the risk of an inappropriate investment strategy.

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

Greater consolidation can create the scale necessary to allow the consolidated DB liabilities to be run off in a way which would facilitate investment of the assets backing those liabilities in both gilts and UK productive finance. We base this on the way in which we manage our own investments.

Our view is that consolidation is the only way to achieve the government's objectives, and must include breaking the link with the employer covenant to bring about the shift in investment incentives needed. If that were done, that would enable the consolidator to follow an investment strategy similar to the PPF. Our Strategic Asset Allocation effectively mirrors that envisaged by the government, and shows what can be achieved through scale and taking a similar approach. As an illustration, if the smallest 4,500 schemes, accounting for around £200bn of assets, were to be consolidated in this way, this would suggest c.30% (£60bn) could be allocated to productive finance assets.

The government could design a public sector consolidator to meet its objectives; this could involve informing the investment risk budget, and setting parameters for the target asset allocation. A public sector consolidator could also pick up schemes which have not proved attractive to the private market.

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

Commercial consolidators have not yet completed a transaction. Our understanding, including from anecdotal evidence from our SME Forum[4], is that commercial consolidators are primarily interested in larger schemes in order to achieve scale as rapidly as possible.

SME Forum representatives have also relayed to us the significant increase in demand for buy-outs over the last 12 months, and that while they have noted that new providers have entered the market, providers have significant resource constraints so are naturally focussing on the larger cases.

Meeting the insurance funding threshold is not necessarily the only barrier to transacting a buy-out; for example the types of assets held, the scale, and the quality of scheme data can also be an impediment. We see from our work with schemes during the assessment period how scale is important to attract the interest of the buy-out insurer market. This inevitably reduces the options available for smaller schemes, and makes it very challenging for schemes to transfer their risks. Panellists[5] also report that for smaller schemes to get attention and traction in the market, they need to demonstrate a higher degree of readiness (in terms of alignment of investment strategy and data readiness) and a greater commitment to trade (i.e. funds available from scheme / sponsor, a strong demonstrable motive to trade, a governance process in place and approval from key decision makers).

We have worked with some small (in this case less than £50m), fully-funded schemes on risk transfer and seen that this has meant for them:

- Engaging with providers early on to gauge interest and help inform priorities, preparation work, and timescales – the outcome of which may mean schemes having to be flexible on timing, join a long queue, while resource becomes available
- Adapting approach to focus on working with a single provider 'exclusively', which has reduced competitive pricing pressure
- Managing the costs of the exercise, which has been helped with advisers developing more streamlined or focused propositions to help these schemes
- Re-arranging their assets to be 'buy-out ready', which prevents them from adopting longer investment time horizons needed for productive finance investment because insurers are not prepared to accept their pooled private market holdings in part payment of the buy-out premium

In tandem, buy-out insurers have attempted to streamline their approach and to meet the demand for smaller fully-funded scheme transactions. This continues to be an evolving area, with incredibly high demand that's unlikely to change in the short-term.

We would note also that smaller schemes in PPF assessment that are funded above PPF levels, but below full scheme benefit funding, (PPF +) bring even more challenges than their fully-funded equivalents. Ultimately there is more for insurers to do following buy-in than for fully funded cases, as insurers need to work with the schemes to allocate any assets above those needed to insure benefits at PPF levels. The industry is nevertheless trying to work with insurers to try to find solutions where possible, for example process efficiency, or combining schemes (where possible).

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[4] A forum of representatives of and advisers to DB schemes of small and medium-sized enterprises, established by the PPF in 2019, to improve communication and mutual understanding

[5] Representatives of PPF-appointed panels of qualified trustees and advisers to help take schemes as efficiently as possible through the assessment period

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

The public consolidator would potentially be competing for the same assets - this could be addressed by limiting access to schemes of a particular size. Care would need to be taken to ensure the consolidator can still achieve adequate scale including to meet the government's productive finance agenda. However, given the overall scale of DB assets, it seems unlikely this would be a particular barrier. For example, if the consolidator were opened to all of the smallest 4,500 schemes, that would still only cover £200bn or 15% of the total DB assets. We also believe there could be significant benefits to a public consolidator, including: increased capacity and choice in the marketplace; the government could more readily design a public consolidator to meet its objectives; the public consolidator would not have any profit motive or desire to maintain the status quo; and the public consolidator could pick up schemes which have not proved to be attractive to the private market due to scale.

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?

A public consolidator could be complementary if, for example, its target market were focussed on smaller and/or weak (underfunded with weak sponsor covenant) pension funds. We would note though that the more the size of scheme is restricted, the less the consolidator's investment strategy will be able to have an impact on the government's productive finance goals - the extent of the benefit to the government's agenda will depend on the level of assets consolidated.

For better funded schemes, the limited size of the buy-out market means that, notwithstanding innovative solutions to address capacity constraints, there is very likely to be a multi-year queue to purchase bulk purchase annuities (BPA). From the Purple Book, over the past 10 years, the largest amount of buy-out/buy-in business was around £44bn in 2019. If we assume a similar capacity each year, it will take 30 years to buy out / buy in all schemes.

Finally, recent improvements in funding levels means that there is no shortage of well-funded schemes on which buy-out providers can focus. Therefore, we believe the introduction of a public consolidator should prove beneficial to the market without being detrimental to the buy-out providers.

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

Yes. A consolidator structure which breaks the link to the employer covenant could lead to investment objectives which can align with greater investment in UK productive assets. Our own experience shows it is possible to generate a significant return on investments over the long-term with an evolving funding framework and a well-diversified portfolio that invests in productive finance assets alongside traditional liquid asset classes. The extent of the contribution the consolidator makes to the government's productive finance objectives will depend on the scale of consolidation; consolidating the smallest 4,500 schemes could, if the consolidator followed a similar investment strategy to the PPF, suggest c.£60bn could be allocated to productive finance assets.

A particular advantage of a public consolidator is that the government controls the design and can therefore ensure its objectives are achieved. This could involve informing the investment risk budget and setting parameters for the target asset allocation. A public sector consolidator could widen the universe of schemes that can access consolidation by providing a home for small schemes that a commercial consolidator might consider unprofitable. Those small schemes are

unlikely to invest in productive finance assets given the higher governance burden and complexity.

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

We would expect a public consolidator to be run on a prudent basis and if its starting funding level is appropriate, it invests for value and looks to grow steadily over time, it is unlikely to need additional support.

It will still be important however to define what would happen in the unlikely event that such support were needed. There is a possible role for the government here and international examples (discussed later) give some sense of how this could work. Underwriting by the government would give complete reassurance to schemes considering consolidation – it would make the process of transferring to the consolidator significantly more straightforward (as trustees and scheme members would be reassured their benefits were fully protected in all scenarios) which would be particularly advantageous for small schemes. In return for underwriting risks, the government would be able to inform the investment strategy (e.g. setting the risk budget for the fund) in order to support government objectives.

However, the government may also want to consider other options including underwriting by the PPF. This could be either in our current role as a compensator (e.g. if the consolidator's funding strategy failed a claim could be made on the PPF) or by making some use of PPF reserves. The government would need to consider the latter option very carefully, given the potential for knock on impacts to the PPF's funding position and potentially – therefore – on our existing levy payers. It would also limit the availability of any excess reserves to support other outcomes that the government may wish to consider – member groups, for example, would argue that funds should be used to improve compensation levels, while levy payers would argue that funds should be used to their benefit. It is worth noting, however, that different approaches will have different impacts. The use of reserves to provide capital backing could potentially be structured as a loan or investment which over time would be intended to improve the PPF's funding position. In addition, a consolidator providing a secure solution to schemes which may otherwise claim on the PPF would help reduce PPF risks, so supporting better outcomes for members and levy payers. Clearly if a capital buffer were required, the available funds would limit the potential size of a consolidator. In a purely hypothetical scenario where a public consolidator took on the c.4,500 smallest pension funds, we estimate that, once the consolidator reached scale, the ongoing capital reserve that would be needed could be of the order of 10-15% of total liabilities.

In relation to risk underwriting, a key question is whether a public consolidator would accept schemes with a deficit. Doing so could help provide an end-game solution for stressed schemes with the possibility of improving outcomes for members. However, it would present an additional risk. We would anticipate that sponsors would be required to pay off any deficit (at the point of transfer) over time. The government would need to consider carefully what would happen in the event of default. One option would be to reduce benefits payable, ensuring equal outcomes with members of schemes outside of the consolidator, and minimising funding risks.

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

Each country's pension system is different, and the approaches taken by different countries cannot be lifted and dropped into the UK system. We think, however, that there are three key themes that can be drawn from international experience that have relevance to this call for evidence:

i) Across a number of different countries governments and regulators have focused on securing scale in their pension systems through consolidation and have taken active steps to make this happen, for example in the Netherlands, the c.1,000 schemes that existed in 2000 had become 191 in 2022, while Australia in 2002 had 2484 corporate funds, and now has 13[6].

ii) There are clear international examples of consolidation with an element of government involvement, indirect government backing and involvement in objective setting to support outcomes: government-backed funds like the Danish ATP, the Norwegian Global Fund, and the Canadian Plan (which operates at arm's length from government, with the government setting the investment objective) have clear government and parliamentary oversight; the Dutch Central Bank, acting as supervisor, indirectly encouraged mergers through additional regulatory requirements (e.g. reporting requirements, rules governing the composition of the boards of the funds); the Norwegian Ministry of Finance is responsible for setting the investment mandate including the strategic asset allocation, and parliamentary approval is required for major changes.

iii) This implicit government backing has produced the same form of investment objectives that we believe are essential to support productive finance – long term horizons, investing for growth, matched with scale and professional management, and allowing for an element of domestic investment bias. The outcome can be seen in the asset allocation - large, consolidated funds in other countries operate markedly different investment strategies than typical UK DB schemes with a greater allocation to productive finance type assets. The table below shows the asset allocation, where comparable, of ATP, a state backed social security fund and PFA, a large scheme in Denmark, Netherlands (ABP) and Australia (Australia Super):

	ATP[7, 8]	**PFA[9]**	**ABP[10]**	**AustraliaSuper[11]**
Equities	17%	60%	27%	50%
Home country	7%			22%
International	10%			28%
Private Equity	17%	13.5%	9%	6%
Infrastructure	12%	0.4%	5.4%	16%
Real estate	14%	6.9%	11%	7%

Purple Book data show that in 2022, UK pension schemes had an average 27% allocation to equities. The average UK DB pension scheme had a 3% allocation to property.

[6] What the UK pensions industry can learn from Australia | Standard Life Employer

[7] ATP, Annual report, 2022 -market value of the portfolio
[8] The market value is distributed base on type of investment rather by legal structure. For example infrastructure could have shares in infrastructure companies or infrastructure funds plus derivatives that are used to hedge investments
[9] PFA, Actual distribution of PFA plus optional asset class 75/25 (between high and low risk fund). June 30 2023
[10] ABP, Annual report 2022
[11] AustraliaSuper, Annual report, asset allocation for balanced fund

Questions 17 and 18: What are the potential risks and benefits of the PPF acting as a consolidator for some schemes? Would the Board of the PPF be an appropriate choice to operate a public consolidator?

The review of the PPF published in December 2022 stated that "the PPF investment team has built up significant experience and expertise and has achieved very strong returns, directly and through its selection and monitoring of external fund managers", and its first recommendation was that "DWP and the PPF should work together to explore whether it is feasible for the PPF skills and capabilities to be used in other ways for public benefit; for example, in managing investments for Government or acting as a consolidator or provider of aggregated services for schemes which would benefit from this, but which are not attractive to commercial consolidators."

The PPF, with a proven track record of delivering on investment objectives and outperforming investment targets, has the skills and experience to take on an additional, separate function to act as a public consolidator and improve outcomes for members and support the government's productive finance agenda. Our strategy of investing for value over the long term, allied with our professional investment management, has seen our investment portfolio deliver a long-term (since 2011) average annual return of more than 9%. The in-house team manages assets of around £33 billion. Our asset allocation is scalable and is already aligned with the government's objectives to support the gilts market and investment in UK productive assets. The 'Matching' portion of our investment portfolio has been structured to maintain security of payments to our current members and invests largely in gilts and other assets producing investment grade cashflows. The 'Growth' portion of our investment portfolio has been structured to grow reserves conservatively over the long term and results in c. 30% of total assets being allocated to productive finance assets, with c.20% invested in the UK.

Beyond our investment success, we have significant experience of preparing schemes for transfer to the PPF (or an insurer), and have successfully driven down the time it takes to do so. Having successfully insourced much of our investment work and all of our (now award-winning) member services, taken on the scheme manager role for the Financial Assistance Scheme, and dealt with an entirely new class of claims on the Fraud Compensation Fund, we have shown that we are well able to respond to the challenge of major change.

The Board already runs the PPF, FAS and the Fraud Compensation Fund as separate effective structures. We are enthusiastic about the potential opportunity to extend our remit to run a separate consolidator vehicle.

There are of course risks for the PPF and our stakeholders if we were to act as a public consolidator. We have already identified some of these and where appropriate addressed them in this response. For example, in relation to any use of the PPF as an underwriter or source of funding, the impact for our existing stakeholders (see our response to question 15) needs to be considered.

We acknowledge there would be operational risks involved in both the set up and running phases. We have a proven track record of setting up and running new and significant operations, for example, insourcing both our member services and asset management capabilities. We also have a Risk Management Framework which we would use to identify, manage, and monitor these risks.

Anecdotal evidence from our SME Forum demonstrated general support for the PPF as a public consolidator, even among those members who wouldn't expect to avail themselves of it.

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?

Eligibility criteria would need to be designed for any public sector consolidator, not only a PPF-run consolidator. A public sector consolidator could be designed to focus on schemes which have not proved to be attractive to the private market due to scale, or to the unintended consequences of their earlier attempts to de-risk by buying annuities for part of their membership. However, the greater the limitation on the consolidator, the less impact it can make towards the government's productive finance objectives.

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

While design elements would need to be worked through in more detail, we would envisage a PPF-run public consolidator operating with prudent technical provisions and running standardised benefit structures (but with an actuarial value equal to full scheme benefits). It would operate an Assessment Period and cleanse data before transfer in much the same way as the PPF does now. Overfunded schemes would transfer at the 'price' the consolidator charges, with any excess disposed of in accordance with scheme rules. Design choices would be needed around any eligibility restrictions, risk underwriting (see above), standardised benefit structures (likely to require a statutory process for establishing that the benefits offered are of equal actuarial value) and indexation.

The administrative burden and challenge of onboarding schemes – for transferring schemes and the consolidator itself - should not be underestimated. This is likely to be a particular issue if a public sector consolidator is focussed on a potentially large number of small schemes. It is therefore essential that the design of any public consolidator aims to make the onboarding process as straightforward as possible. Legislation will be needed, including to provide a defined route for transfer including for the standardised benefit structures. This would then offer a secure end-game solution for schemes that can't access other market solutions, increased and continued asset investment in productive finance (with a PPF-like investment strategy), and options around long-term use of returns generated.

- *are there options that could allow schemes in deficit to join the consolidator?*

Yes (and bring potential advantages for struggling schemes). For example imposing on the employer a contractual schedule of contributions to the consolidator, to address funding deficits, alongside the severing of the employer covenant. If employers became insolvent before that schedule of contributions was complete, benefit reductions could be imposed (always ensuring members received at least the level of benefits that would be provided through PPF compensation). This would ensure equal outcomes with members of schemes outside the public consolidator. These options would need careful consideration at the design phase.

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

This would depend on the design of the consolidator, but we would envisage a solution not unlike the relationship between the PPF and FCF, whereby the Board is responsible for both, but they are run independently.

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

Both are viable options, the decision will depend on the objectives of the consolidator. While concentrating on the schemes at the smaller end of the market would have less impact on the commercial consolidation and bulk annuity markets, the more the size of scheme is restricted the less the consolidator's investment strategy will be able to have an impact on the government's productive finance goals.

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

As previously mentioned, the PPF's current investment strategy allocates c. 30% of total assets to productive finance assets (Equity, Alternative Credit, Infrastructure, Real Estate and Timberland/ Agriculture) and c. 35% to gilts. Our investment strategy can be scaled to accommodate a significant increase in assets under management ('AUM'). We have considered the practicalities of increasing AUM up to £300bn, and do not see this impacting our ability to scale up allocations if we were to adopt the same investment strategy. That said, mandate design would be integral to the discussion when setting investment objectives, and any desire from the government to set minimum allocations above our current target would require careful consideration of any associated change in risk profile.

We would caution against too prescriptive an approach, and believe it will be essential to retain the Board's independence in setting the investment strategy (and asset allocation) to achieve the government's objectives.

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

Liability Driven Investment is a risk management strategy that would continue to be a fundamental part of our investment strategy, leading to us continuing to hold gilts more than would be seen under a pathway to buy-out, or if schemes moved to a commercial consolidator.