LCP powering possibility

LCP's response to the Department for Work and Pensions consultation on options for defined benefit schemes

17 April 2024

This document sets out LCP's response to the DWP's consultation document on Options for Defined Benefit Schemes published on 23 February 2024 (the "Consultation").

Who we are

LCP is a firm of financial, actuarial, and business consultants, specialising in pensions, investment, insurance, energy, health and business analytics. We have over 1,100 people in the UK, including 160 partners and over 300 qualified actuaries.

The provision of actuarial, investment, covenant, governance, pensions administration, benefits advice, and directly related services, is our core business. About 80% of our work is advising trustees and employers on all aspects of their pension arrangements, including investment strategy. The remaining 20% relates to insurance consulting, energy, health and business analytics. LCP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.

Executive summary of our views

We very much welcome the proposals and discussion around the role DB schemes can play in materially contributing to productive finance investment in a way that in turn improves outcomes for scheme members and for sponsoring employers, while managing the potential impact on the UK gilts market and the UK insurer and commercial superfund markets. We believe the overall potential prize for the members, UK business and the UK economy can be measured in £100bns, but that meaningful changes to the pensions legal framework will be needed to achieve this.

Chapter One

Our view is that introducing a **statutory override** in respect of surplus extraction would, in isolation, have limited impact as it would be unlikely to shift the dial on trustee decision making around investing more productively and running on to generate surplus to be shared between members and sponsors.

If the government wishes to encourage more schemes to run on for longer, and encourage meaningful investment in productive finance, in a way that would in turn lead to greater surplus sharing with sponsors and members (whilst also protecting the gilt markets), our view is that strong additional member protection is required. In our view, this could be most effectively achieved by an appropriately costed option to participate in a 100% PPF underpin.

Chapter Two

We support the establishment of a **public sector consolidator (PSC)** run by the PPF and which is set up to meet the government's objectives as stated in the consultation. We believe the PSC could act as a helpful market stabiliser given the potential for pension scheme demand to outpace the supply of commercial insurance and consolidation solutions in future, particularly at the smaller end of the market.

We agree with the PPF (see its publication dated 1 March 2024) that it is not straightforward to meet all of the government's objectives for the PSC, as they are somewhat conflicting. In particular, achieving scale, so that there is meaningful investment in UK productive finance assets through the PSC, can be expected to impact the superfund and insurance buy-out markets.

That said, in our view the following principles in relation to **eligibility** and **PSC pricing** would be a good compromise to ensure the PSC has a market stabilising effect, and meets the government's productive finance objective.

1) Eligibility: We propose a simple size criteria for eligibility – with the PSC open automatically only to schemes with liabilities of less than £10m (size to be consulted on and kept under review, and to be assessed using an objective measure).

For schemes that are bigger than the size threshold, we propose eligibility for the PSC could be linked to the existing superfund gateway test – this would help larger schemes for which the PSC is genuinely the only option.

Taking such an approach would allow schemes currently unattractive to commercial providers to access consolidation. Whether consolidation would currently be attractive to the trustees of such schemes would then depend on other detail, particularly the approach taken to benefit standardisation and the pricing offered to schemes.

2) PSC pricing: Setting PSC pricing in line with a PSC technical provisions basis of Gilts+0.5% pa to Gilts+0.75% pa (as suggested in the consultation) can be expected to be materially more favourable for schemes than insurer pricing. Therefore, in order to meet the government's objective of minimising the potential distortion of commercial markets, in our view, entry pricing would need to be set broadly in line with insurance pricing (as per the current PPF). We note that there is no need for entry pricing to be set in line with technical provisions and pricing more prudently would give the PSC greater flexibility to invest in productive finance as it generates more surplus in the future.

We recognise **benefit standardisation** will be necessary to support simplified ongoing administration and communication to all PSC members. Whether or not trustees and employers will find the PSC benefit standardisation approach attractive will depend on the exact requirements of benefit standardisation, the possible extent of 'winners and losers' for their scheme, the protections offered through any new laws and statutory discharges in this area, and also on the attractiveness of the PSC in other key areas (price, security, dealing with deficits, illiquid assets etc).

Provided the eligibility rules and PSC pricing are set appropriately we do not think that benefit standardisation specifically will have a disproportionate impact on the existing commercial market. However, the government may wish to consider whether any new flexibilities to achieve benefit standardisation should also be made available to commercial providers in the right circumstances.

Our comments on your proposals

We have set out below our answers to the specific questions that you have set, other than Questions 41 to 49 which are directed at individual schemes. We have been able to make all our key points within our answers to the questions you have set.

We are happy for LCP to be named as a respondent to the consultation and happy for our response to be in the public domain. We are happy for you to reference our comments in any response.

Jonathan Camfield
Partner

Michelle Wright
Partner

Steve Hodder
Partner

Laura Amin
Partner

About Lane Clark & Peacock LLP

We are a limited liability partnership registered in England and Wales with registered number OC301436. LCP is a registered trademark in the UK and in the EU. All partners are members of Lane Clark & Peacock LLP. A list of members' names is available for inspection at 95 Wigmore Street, London, W1U 1DQ, the firm's principal place of business and registered office.

Lane Clark & Peacock LLP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries for a range of investment business activities. Locations in Cambridge, Edinburgh, London, Paris, Winchester and Ireland.

© Lane Clark & Peacock LLP 2024

https://www.lcp.uk.com/emails-important-information contains important information about this communication from LCP, including limitations as to its use. We accept no liability to any party in relation to this communication.

LCP powering possibility

LCP's response to the questions in the Consultation

Chapter 1 – Treatment of scheme surplus

Statutory override

1. **Would a statutory override encourage sharing of scheme surplus?**

Our view is that changing the legislation on surplus extraction in isolation, with no additional protections for members, will have limited impact. In order to effect meaningful change, stronger member protection is essential (for example the 100% PPF Underpin).

We note that the government's third aim is to "Remove behavioural barriers by bringing surplus extraction in line with trustee duties" – we see nothing in the consultation that will achieve this, as the government is not proposing to change the legal definition of trustee duties, which will remain the same and remain focussed on the provision of promised pensions rather than being required to consider and/or implement surplus distribution.

It is not clear to us whether the government is proposing to create a statutory override that will enable "surplus distribution to both sponsors and members" or "surplus distribution to sponsors only" – the distinction is important. For example, if it is the latter, and if trustees currently have powers to distribute surplus to members, they are unlikely to choose to avail themselves of the override, as this would reduce the protection for members.

Many scheme rules already give the trustees a power to pay out surpluses (above an estimated buy-out level) but these powers are rarely used other than at the point of buy-out and wind-up (ie the end of the scheme). The reasons for this are:

- the detailed due process required, including the member representation process;
- uncertainty and risk associated with the cost of providing the benefits in the future, with the primary duty of trustees remaining to ensure members' promised benefits are paid; and
- usually surplus is difficult to measure accurately and a "true" surplus only crystallises at the same time as the scheme is considering full insurance, so the trustees understandably consider that they should await that point before considering the application of any surplus.

The only time we see trustees regularly using surplus is for the minority of schemes that have DC in the same unsegregated trust. Trustees of such schemes do sometimes make decisions to allocate surplus to be used for DC contributions, but such distributions are invariably subject to different scheme rules and don't have to follow the surplus distribution rules and processes that are being consulted on by the government here.

A statutory override in the way that is being consulted on would extend the option of surplus distribution powers to all trustees – this is clearly positive in that it would offer trustees the possibility of introducing new powers (if they so wished) which would somewhat address the scheme rule lottery that we currently have.

However, to answer the specific question, we do not think that a statutory override, in isolation, would "encourage" sharing of scheme surplus – it would just remove a legal barrier for some schemes and open up the possibility of trustees considering surplus sharing in more cases (but very likely continuing to conclude that surplus sharing should not happen until the end of the scheme's life).

If the government wished to encourage surplus sharing with sponsors, in a way that encouraged more schemes to run on, and therefore better protect the gilt markets and encourage investment in productive finance, our view is that some or all of the following would be necessary:

- Strong additional protection for members outside of the scheme (see our comments on 100% PPF underpin);
- As part of the statutory override, a requirement for trustees to regularly consider distributing surplus, perhaps with explicit reference to a new statutory code of practice from the Pensions Regulator;
- Statutory override power available to all trustees to pay out surpluses (without needing a rule change) along with a change in trustee duties, explicitly set out in legislation, to require them eg to distribute surpluses once a scheme is securely funded.

However, we recognise that this would be a significant shift in powers and in some cases would override existing rule powers that enable trustees to distribute surplus to members (perhaps where there is no current power to distribute to the employer). So whilst we think these are the only types of changes that will have a material impact on surplus distribution, government would need to think very carefully about the appropriateness of making such bold changes.

2. **What is the appropriate balance of powers between trustees and employers? Should a statutory override allow trustees to amend scheme rules around surplus at their sole discretion, or should such amendments be contingent on an agreement between trustees and the sponsoring employer?**

A key question is whether the statutory override relates to distribution of surpluses to sponsoring employers only, or also to members. We assume the latter given the government aim to make it easier to share scheme surplus with employers and scheme members – if this is the case, then employers are likely to be concerned about a new power to distribute surplus to members, and therefore employer agreement should be needed. If the former, then trustees may be concerned and may well resist the rule change in any event, particularly if they currently have powers (perhaps via other discretionary benefit rules) to distribute surplus to members.

Scheme rules constrain who can make changes to the rules, and with whose agreement. Generally, trustee and employer agreement would be needed for rule changes, and we think that generally makes sense.

3. **If the government were to introduce a statutory override aimed at allowing schemes to share surplus with sponsoring employers, should it do so by introducing a statutory power to amend scheme rules or by introducing a statutory power to make payments?**

If the intention is to encourage more surplus distributions, then a statutory power to make payments is a better approach, as it removes a barrier (agreeing a rule between trustees and employers). A "statutory power to make payments" approach also enables the government to clearly define the process that needs to be followed to distribute a surplus. However, we would still expect trustee duties to be paramount, and therefore we would expect only a limited number of trustees to choose to follow the process prior to the end of a scheme's life, in the absence of further changes to the pensions regulatory framework.

4. **Should the government introduce a statutory power for trustees to amend rules to enable one-off payments to be made to scheme members, or do schemes already have sufficient powers to make one-off payments?**

One-off payments are difficult to achieve currently within pensions and tax law. We are aware of some clients having considered ways to do this, but they are convoluted.

The most commonly preferred additional benefits provided or insured by trustees for members at the point of surplus distribution are:

- a one-off discretionary pension increase;
- a one-off increase in benefit for all members;
- increasing or removing any cap on future pension increases in payment.

This is because trustees and members rightly think of their pension scheme as being there to provide regular retirement income rather than one-off "bonuses". This has always been the approach of pensions and tax law as well, with the only significant "lump sum" payment currently permitted being the tax-free cash lump sum at retirement.

In the light of the above, whilst some schemes may have a theoretical power to make one-off payments currently, there are practical and tax challenges. We are not against additional flexibility being introduced, but in isolation we cannot see it would make a difference to the government's productive finance objectives.

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

As set out to our response to question 1, in isolation we cannot see additional flexibilities having a material impact, including on the insurance market. In the current regime, most schemes look to ultimately settle their benefits with an insurance company. Whilst changing rules around surplus extraction may impact the timing of these transactions (if more schemes choose to run on), we think ultimately the practice of eventual settlement would likely continue even if there were statutory overrides for surplus distribution.

Some schemes are already looking to "run on" for the longer term. Such schemes are doing this for a variety of reasons, of which potential use of surplus can be one. It is therefore possible that additional flexibilities around sharing of surplus could tip the balance for some schemes so they are more likely to run on. There may also be some schemes that choose to defer an insurance endgame for a period beyond initial affordability to generate some surplus if this can be accessed more flexibly. On balance, though, we expect the impact on the insurance market to be small.

Taxation

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

If trustees have the power to (and decide to) distribute surpluses to members, benefits are usually provided as additional pension. This fits the current tax regime. There can be constraints on benefits arising from unauthorised payments and tax consequences for members (Annual Allowance), depending on what level of benefits are being granted and how they are being given. Removing unintended tax consequences would provide more flexibility to trustees in how they deliver surplus to their members. However, the decision as to whether (rather than how) to distribute surplus is not usually driven by tax constraints.

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

A further option that government should consider is to make it possible for DB schemes to pay surplus directly into DC pension arrangements that are not in the same trust, with a simplified process and no tax consequence. This would include occupational DC schemes (including Master Trusts) and contract-based arrangements.

Safeguards for member benefits

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

Surplus extraction is currently permitted where a) the rules of the scheme permit; b) the scheme is funded above a buy-out basis; c) trustees follow due process including member consultation; and d) trustees believe it to be in in line with their fiduciary duties.

As we have explained in our response to question 1, in practice hardly any schemes distribute surplus to the sponsor before the end of the life of the scheme.

As well as the legal funding threshold and practical challenges for allowing surpluses to be released to the sponsor, there are key related issues of a) what is the statutory process and b) whether trustee fiduciary duties are being changed.

In our view, where the funding threshold is set may be of secondary importance, because trustees won't pay out surplus unless they are comfortable doing so, and many trustees will want to purchase full insurance (and so then their surplus is a known number, with very little risk) before considering use of surplus.

We can see arguments for reducing the threshold below full buy-out funding. We note that this could be risky in the context of a weak covenant (if the trustees did not follow their fiduciary duties properly or came under pressure from the employer). However, a covenant test would be complex and challenging to implement. Therefore, on balance, we are of the view that surplus extraction should be permitted above a low dependency basis plus an appropriately set risk buffer. Consideration will need to be given to how bases can be set appropriately and objectively by different schemes.

For these reasons, in our view, the provision of stronger member protection, eg the PPF 100% underpin, is necessary to support meaningful changes to surplus extraction and in turn to investment in productive assets.

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

In our view, guidance (eg from TPR) will be helpful, but may still not go far enough to meaningfully change scheme behaviour. This is because underlying fiduciary duties are proposed to remain the same, and the law will trump any guidance.

In the current pension regime, trustees' primary duty is to deliver the members' promised benefits. Extracting surplus may therefore be viewed as inconsistent with this duty given it would necessarily reduce the security of those benefits. As we have explained elsewhere, this is why most trustees don't consider the distribution of surplus until the end of the life of the scheme. We do not see that guidance will make a significant difference to those taking this view, especially as we expect that guidance will in itself need to be heavily caveated given trustee duties.

For those schemes that are already considering running on for longer and how surpluses might be used, having some published guidance should help trustees become more comfortable.

LCP powering possibility

10. What might remain to prevent trustees from sharing surplus?

We have explained our view on this elsewhere in our response. There are many reasons currently why trustees do not share surplus, and many of these will remain following a statutory override to provide trustees with additional powers. These include:

- Risks associated with the employers' future covenant, future scheme experience/longevity risk and investment risk, and future buy-out pricing;
- Conflicts with fiduciary duty – by definition any distribution of surplus weakens member benefit security (even if this is from 99% to 98%);
- Regret risk – there are scenarios where this action will result in members losing out;
- Trustees don't have a duty to maximise investment returns or produce surplus – they have a duty to pay promised benefits;
- Inertia, established mindset, accepted practice, and concern about being an exception;
- Member challenge and reputational risks.

Alternative safeguard: 100% PPF underpin

11. Would the introduction of a 100% underpin have a material impact on trustees' and sponsors' willingness to extract surplus? If so, why and to what extent?

Yes. This would help reduce trustee concerns about surplus release and therefore mean the Government is much more likely to achieve its aims.

Our proposal is the introduction of a new option for well-funded schemes that has two features (and both are needed together to make this work):

- Payment of a super-levy for 100% PPF underpin if the sponsor ever goes bust; and
- Easier access to surpluses once funding is super-secure.

This would give trustees and sponsors a reason to run-on and invest more productively to generate further surpluses, rather than needing to buy-out and wind-up in order to release surplus.

In such a new world, we expect the following:

- Trustees would be interested in their schemes having a 100% PPF underpin because it offers full protection for members following employer insolvency.
- The 100% PPF underpin would give the trustees an incentive to accommodate rule changes (or agree to a statutory override) that permit surplus distribution, and would be considerably more inclined to actually distribute surplus.
- Trustees of schemes that join would have considerably more investment freedom as they would no longer be concerned about downside risk in the same way and, subject to covenant, should be more able to take a longer-term view. Note this is subject to trustees being able to take account of the 100% PPF underpin in making decisions.
- Investment freedom would mainly be constrained by a risk-based super-levy – which should be affordable when funding is strong and risks are sensible (see question 13).
- Employers could therefore see a path to benefit from investing productively and would be willing to support the trustees by opting into the 100% PPF underpin.
- Once in the 100% PPF underpin, schemes would therefore invest with more freedom, which would have a material impact on the level of investment in productive assets from the £1.5 trillion of assets held by DB schemes.
- Schemes in the 100% PPF underpin would likely continue to invest material amounts in the gilt markets and this would slow up the significant disinvestments in gilts by UK schemes that are currently anticipated over the coming years as schemes are currently expected to move to full insurance (insurers generally invest considerably less in gilts).
- These freer investments would be expected to create surpluses in schemes and trustees would be far more relaxed about distributing surpluses (to sponsors and members) given the 100% PPF underpin.

In our view, this proposal is the only proposal being considered by government that is likely to have material benefits for the UK economy.

This view is supported by a poll carried out on a recent LCP webinar attended by c200 people representing a cross-section of the industry. The audience were asked: "What changes would be needed for DB schemes to invest more for growth?". Of the respondents that thought changes were needed, c.85% thought that "meaningful new protections for member benefits" were required for this aim to be delivered in practice, rather than simply more flexibility and guidance.

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

Yes. Let's assume for the purposes of this response that the government has made changes to allow a statutory override re surplus distribution. Our argument in our response to previous questions is that statutory overrides relating to surplus extraction in themselves (without further strong member protection) will make little difference to:

- Scheme strategies (it is possible that a few more schemes will choose to run on for longer)
- Investment in productive finance or growth assets (will remain low)
- Investment in gilts (will continue to fall quickly as schemes move to insurance)
- Amounts of surpluses generated or shared (there may be a little more of this)

In contrast, if the 100% PPF underpin option is introduced in a way that is attractive to schemes and employers (see question 13 below) we see this making the following differences, which we think are significant to government:

- Scheme strategies would change for those schemes that opted into the 100% PPF underpin – they would likely be big schemes, that would run on for much longer, and delay moving to insurance
- By virtue of running on, and by virtue of being able to take on more risk, considerably more investment in productive finance and growth assets
- In addition, maintaining higher investment in gilts for longer (because of the delay to move to insurance)
- Considerably higher amounts of surpluses generated and shared – resulting in direct benefits to the UK economy.

We would expect that all the above would have material direct benefits to the UK economy.

13. If you consider a 100% underpin could deliver valuable benefits, what does the government need to prioritise to ensure an effective design? For example, does the way the "super levy" is calculated need to ensure that the "super levy" is expected to be below a certain level? How high a level of confidence does there need to be that the PPF will be able to pay a 100% level of benefits?

An effective design is a design that would make the option attractive to schemes (assuming it is an option) and would also make the schemes attractive (not harmful) to the PPF. Key issues that would need to be considered are:

- A 0.6% pa "super-levy" would make the option unattractive. In our view, this estimate is too prudent and this can be demonstrated by simple scenario testing: see the end of our response to this question. If the super-levy were set at this level, very few schemes would join the 100% PPF underpin regime, and it wouldn't be viable.

  In making this observation, we note that a 0.6% pa super-levy also appears to be expensive relative to the pricing basis that the PPF is proposing for the Public Sector Consolidator (eg around Gilts+0.5% to 0.75%). That is, it appears inconsistent to us that the PPF would be willing to consolidate schemes at this pricing level (with a suitable reserve buffer) and thereby take on the **whole** of the scheme's risk with no further insurance costs, but also considers it reasonable to charge a premium of 0.6% pa to cover the risk of a **similarly funded** pension scheme which bites only in the unlikely event that a sponsoring employer fails and the scheme proves to be underfunded. Put another way, at first order, if the PPF is willing to take on a whole scheme priced at Gilts+0.5%, then if a 100% PPF underpin scheme is funded to a Gilts+0.5% level then the PPF should not need to charge a levy to that scheme for the risk of sponsor failure.

  Our own calculations suggest that a super-levy of 0.1% to 0.2% would be adequate in the long term. Contrary to what is stated in the consultation document, our calculations are not predicated on integration with the existing PPF lifeboat in coming up with this figure. We recognise that there is a risk that short-term events could lead to a need for short-term additional capital for this section of the PPF (eg two large sponsors go bust in year 1) in order to demonstrate there is a suitable reserve buffer. But in our view this risk could be managed through the same means that the government proposes to provide a buffer to the PPF as a Public Sector Consolidator – that is, provision of temporary buffer finance from government (or from the existing PPF). The expectation is that this would purely be a funding facility and would be paid back over time via

future levies from the 100% PPF underpin pool. (We note that the government intends to consult on the use of the PPF's existing reserves and we think that that consultation should be completed before the government discounts the idea of using the PPF's reserves to support the smooth operation of the PPF 100% underpin.)

We also note that there would not be a short or medium cashflow issue if eg two large sponsors go bust in year 1, because the assets in their schemes would cover payments to pensioners for many years to come even if they were unexpectedly in deficit.

- As we have set out in detail in our FAQ document there would be further design considerations around:
    - Entry funding level and requirements (we argue for a secure funding level (based on Gilts+0.5% discount rate) and targeted at the largest of schemes)
    - Any constraints on risk taking (our preference is to achieve this via the design of the super-levy, to discourage inappropriate risk – ie schemes that took considerably more risk would be charged a considerably higher super-levy)
    - The ability of 100% PPF underpin schemes to rely on the PPF when setting investment strategy
    - Accessing surplus (we are suggesting employers should be able to access surplus once member pensions are protected in this way)
    - Any constraints on sharing surplus (sponsors vs members – we are suggesting this would be agreed between sponsors and trustees)
    - Knock-on impacts on the funding regime (we believe these would be minor)
    - Treatment of open schemes (we think open schemes would be able to participate and this would support more open schemes)
    - Moral hazard (we think these risks can be managed)

We note that the 100% PPF underpin could potentially be introduced for **all** schemes. This would reduce the super-levy risks/costs considerably given the pooling of risks across a larger population.

Note on prudence of 0.6% pa:

We recognise that a risk of operating the 100% PPF underpin independently to the current PPF risk pool is the risk of a lack of scale. We also note that if the 100% PPF underpin in introduced with an expensive levy, then it will not be attractive to many schemes and lack of scale will be self-fulfilling. However, one way of illustrating the prudence of the 0.6% pa potential levy is to consider a scenario where just 20 strong schemes opt-in to the 100% PPF underpin:

Imagine if just twenty of the strongest schemes, with an average of £5bn of assets each, opted in to the 100% PPF underpin regime with a 0.6% pa super-levy. This would mean the PPF would collect £0.6bn of levy in year one. By year four the PPF would have c£2.5bn in a ringfenced pot for an emergency.

The covenant and funding strength of these schemes would necessarily be strong (in fact, they would be funded at the level of prudence at which we understand the PPF is willing to price consolidation). There is clearly a risk that the funding strength changes over time, but rules could be introduced to constrain risk in such schemes and/or to penalise risk-taking with higher PPF levies. And over time the full expectation is that surpluses would grow in these funds at least to the even safer level of funding required for surplus extraction (after all, that's the reason why schemes would opt in to the 100% PPF underpin).

Therefore, even if an occasional sponsor went bust (which would be expected to be rare), it is unlikely that there would be much deficit (if any) for the PPF to make up at all. For example, a 5% deficit in a single scheme would be a cost of £250m, and this would be an unlikely situation. This is only 10% of the ringfenced pot after four years. And even if two of the twenty schemes went bust in the first four years, both with a 10% deficit (surely extremely unlikely!) this would only use up £1bn of the ringfenced pot.

It therefore seems to us that a 0.6% super-levy will prove to be too prudent over time, and this would therefore lead to further surpluses emerging at the PPF.

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

There are a number of methods already used within the industry to provide additional security. However, they can be complex, involve costs, and are not easily available to small and medium schemes. Whilst they will also help to increase member security, they would rarely offer as much protection as the proposed 100% PPF underpin and hence would not help with the challenge of trustee duties. These include:

- Contingent assets: Asset-Backed Funding, escrow etc – depending on the structure, can be complex to set up, and often employers do not have the free assets or do not want to offer them
- Surety bonds and letters of credit: these can be helpful but are complex to put in place, are not available for all schemes/sponsors, and are generally short term and risk not being available (or are very expensive) at the time when they are most needed (as a sponsor's covenant weakens)
- Additional guarantees: group guarantee (but only as strong as the group) or external guarantees from banks or insurers (not always available, particularly at the point a scheme needs them, and can be very expensive)
- Simply overfunding a pension scheme (above buy-out): some schemes are choosing to do this, but risks remain until the point of full insurance and it is not clear why sponsors should support this arrangement unless they can be sure of benefiting from any surplus that arises. Even then, any surplus is generally not expected to be received for many decades, which is longer than most corporate timeframes for assessing value.

LCP powering possibility

Chapter 2 – Model for a public sector consolidator

Approach to eligibility

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

First, as one of the UK's leading brokers of bulk annuities for pension schemes, we haven't seen significant evidence of smaller or more complex schemes being unable to access insurance on acceptable commercial terms; recent and shortly anticipated new entrants to the bulk annuity market should improve this access further. However, we are aware that other consultants have reported a different experience and that there remain thousands of schemes that will at some point in the future look to insurance or consolidation as an end game, by which point the position may look different.

We therefore support the establishment of a public sector consolidator (PSC) that is set up to meet the government's objectives as stated in the consultation, and believe, if implemented in the right way, this could act as a helpful market stabiliser given the potential for pension scheme demand to outpace the supply of commercial insurance and consolidation solutions in future.

We agree with the PPF (see its publication dated 1 March 2024) that it is not straightforward to meet all of these objectives, as they are somewhat conflicting. In particular, achieving scale so that there is meaningful investment in UK productive finance assets through a PSC, can be expected to impact the superfund and insurance buy-out markets.

It is for government to balance these objectives by defining appropriate eligibility criteria for the PSC and other anti-competitive constraints (eg on pricing) as may be appropriate to meet its objectives.

Although we don't yet see evidence of this ourselves, in our view schemes that are potentially unattractive to commercial providers either now or in the future could include the following:

- Schemes that are complex (this can most easily be remedied by ensuring good preparation work and clear quotation requests for insurers, recognising that it may be necessary to choose an exclusive insurer early in the process and that pricing may be more expensive than in other cases, but this may still be deemed to offer value)
- Schemes that have poor data and/or where there are uncertainties about detailed benefits (such a scheme would also likely find it difficult to enter a PSC)
- Schemes that are small (note: we have had good success in broking smaller schemes including those as small as £10m, and we also note that insurance companies are willing to arrange individual annuities for very small amounts of money - £10,000s)
- Schemes in deficit (note: the unattractiveness of such schemes is generally only by virtue of the scheme not yet being well funded – once such a scheme reaches full funding we would expect such a scheme to then be attractive to commercial providers – we recognise this could take 10 years or more in many cases)
- Schemes that don't meet the "gateway tests" for commercial superfunds are clearly unattractive to commercial superfunds (this is a design feature set by regulators)
- Schemes with illiquid or other complex assets that insurers cannot hold under Solvency UK (note: this is usually resolved by schemes either selling assets at a discount before moving to the insurer/superfund, awaiting run-off of the assets before approaching the insurer/superfund and/or using financing arrangements – from the insurer, the sponsor or a bank – to borrow part of the premium until the asset has run off or is sold).

We note that the government is not at this stage making firm proposals as to how such schemes would be identified as eligible for the PSC.

Until firm proposals are made on the eligibility criteria, it is difficult to comment on the impact on "unattractive schemes" (from the list above).

However, noting the stated desire for a principles-based approach to eligibility and the government's stated aims, we see that there could be five possible approaches to eligibility as follows:

- There could be no eligibility criteria, other than the employer must be able to afford to pay off a loan that would replace the scheme's deficit (this is our understanding of what has been proposed by the PPF) – our view is that without further anti-competitive constraints (eg on pricing) this would be likely to lead to disruption of the current superfund and insurance markets.
- There could be criteria based on size of scheme – eg schemes of size less than £10m could be eligible. The detail of such a criterion would need to be thought through – does the £10m apply to asset or liability values, and what happens as these change over time with market conditions? Would there need to be some protection against schemes manipulating their size (eg by encouraging transfers-out, choosing poor assets, or splitting into two)? But we could see how this form of size-based eligibility could help to meet the objective of minimising the potential impact on the current commercial consolidation markets.
- Eligibility could be based on inability to access insurance (or a commercial superfund) – whilst seemingly attractive in principle, this is difficult to prove and there would need to be some objective criteria. There is a potential precedent for this within PPF rules (for potential PPF+ schemes that in some circumstances can present a "Protected Benefit Quotation" to the PPF as evidence of an unaffordable insurer quotation) but this would be a subjective and time-consuming process for schemes, insurers and the PSC. Also, in our experience, the ability to obtain quotes depends on a good understanding of the market – which insurers to approach for which schemes, and how to present the proposal to the insurers. Therefore, such eligibility criteria could "reward" poorly managed schemes or inexperienced brokers and/or be manipulated by schemes – particularly if there is a material price difference between insurers and the PSC. The test of the "unattractiveness" to insurance and commercial superfunds would need to be reviewed regularly by government / regulators, noting this might change with variability in supply and demand and thereby market capacity.
- There could be a constraint on the size of the PSC, or on how much it could grow (as referenced in the consultation document). However, this would appear to be in conflict with a proposed PSC duty (which we understand and agree with) to be available for all eligible schemes. It also opens up challenges for the PSC in prioritising schemes. However, we note that such constraints may inevitably arise due to capital limits (eg if set at a proportion of PPF reserves or at a finite amount from government) or from resourcing constraints.
- There are existing gateway tests within commercial superfund guidance, which is that schemes are eligible if "a scheme has no realistic prospect of buy-out in the foreseeable future, given potential employer cash contributions and the insolvency risk of the employer", and the transfer "must improve the likelihood of members receiving full benefits". It would be relatively straightforward to have consistent gateway tests for the PSC putting the PSC on a level playing field with commercial superfunds (noting it is proposed the PSC would also be capitalised to a consistent level to commercial superfund). The gateway tests have the advantage of having already been proven in another context.

We note that any combination of the 2nd to 5th bullets above would also be possible.

Our suggested pragmatic approach to eligibility

Taking the government's objectives as a whole, in our view the most pragmatic approach to eligibility would be a simple size criteria – eg open only to schemes of less than £10m (size to be consulted on and kept under review by ministers but with a statutory requirement for the minister to consider the impact on the insurer and superfund markets, and minimise disruption, when setting the level from time to time). This would also seem to be a fairer way of ensuring PSC resource is appropriately allocated to the smaller schemes it is primarily intended to serve, rather than its capacity potentially being disproportionately used up on larger, more complex cases that might also find the PSC attractive (depending on the final design features).

We think the size should be the value of the liabilities on an objective basis reflecting the PSC's pricing basis from time to time, and there should be powers to restrict entry if it is believed that eligibility has been manipulated.

For schemes that are bigger than the size threshold (eg £11m), eligibility for the PSC could potentially be linked to the superfund gateway test – this would help larger schemes for which the PSC is genuinely the only option.

Taking such an approach would allow schemes currently unattractive to commercial providers to access consolidation. Whether consolidation would currently be attractive to the trustees of such schemes would then depend on the other detail, particularly the approach taken to benefit standardisation and the pricing offered to schemes.

We note that supply and demand in the commercial markets will evolve over time and that further market innovation could also impact these dynamics. The eligibility criteria (and specifically how the relative “attractiveness” of schemes to the commercial providers) would therefore need to be reviewed regularly by regulators/government to ensure that the PSC continues to meet the government’s objectives over time.

16. Is setting the consolidator a duty to accept transfers from schemes unattractive to commercial providers and mandating certain design features (for example, benefit standardisation) and ensuring no unfair advantage sufficient to limit impacts on commercial alternatives? If not, what alternative approaches would you recommend?

Yes. But the detail of the design of the PSC really matters given the risk of unintended consequences.

In the rest of this response we assume that that the overriding objective is to limit the impact on commercial providers (which is what this question is about). We recognise that government may choose to compromise this objective in order to more fully meet other objectives (eg productive finance, member security).

In our response to question 15 above we have discussed eligibility criteria. If eligibility can be defined to clearly include only those schemes that are “unattractive to commercial consolidators”, then there should be limited impact on commercial providers.

However, if eligibility is wider than this, for example open to all schemes, then there would need to be other anti-competitive constraints to limit the impact on the commercial alternatives in order to meet the government’s objective of not disrupting these markets. In such a case, the key levers that would need to be controlled to avoid market disruption would be:

- price (if pricing is consistently and materially more attractive than insurer pricing, then trustees and sponsors are likely to prefer the PSC to insurers);
- security (if security/funding/underwriting of the PSC is perceived to be stronger than an insurer, then trustees may prefer the PSC to insurers);
- benefit standardisation (depending on the design, this could be seen as attractive or unattractive by the trustees – although trustees may be more relaxed on this if pricing is such that it enables an additional uplift to benefits to be secured compared with alternative solutions);
- deficit solution (the offer of an affordable loan to replace an uncertain pension deficit could be very attractive to sponsors and trustees – this is generally not available in commercial solutions);
- treatment of assets, particularly illiquid assets or poor quality assets (if the PPF has a favourable approach compared to commercial providers, this would favour the PSC).

A key item from the list above is price, and this is discussed further below in our response to question 31.

Note that if there are no eligibility criteria, so the PSC is open to all, and if PSC pricing is based on the pricing terms outlined in para 60, then we are of the view that many schemes would wish to move to the PSC over a short time frame. Whilst this would achieve scale and support the government’s productive finance objectives, we believe this would be highly disruptive to existing markets and potentially contrary to the objective of the PSC targeting schemes unattractive to commercial consolidation providers. This could lead to reduced innovation in the private sector (eg fewer new commercial private providers). If commercial providers are consistently undercut by the PSC’s pricing, some may even consider exiting the market.

17. Would a limit on the size of the consolidator be needed? If so, how might a limit on the size of the consolidator be set? Would limits on capital and a requirement to meet the same capital adequacy requirements as commercial consolidators suffice, or are there alternatives?

As commented in our response to question 15 above, we do not think that a limit on the size of the consolidator is an effective way to constrain eligibility.

We also note that a limit on size could be counter to the government’s aim for achieving scale to support productive finance, depending on where the limit was set. It could also undermine the proposed statutory objective to provide a route for schemes unable to access commercial markets, depending on the approach taken by the PSC in triaging schemes.

The size of the PSC would in any case ultimately be constrained by its access to supporting capital, either from the existing PPF reserves or from government. The security requirements on the PSC (eg in line with the superfund regime) would also impact its potential size.

Further constraints should be considered by government and regulators (including the Bank of England) in relation to operational risk (and the need for the PSC not to grow too quickly), the availability of suitable assets for the PSC and systemic risks to the UK economy.

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

Principles-based criteria which can be applied consistently across schemes and across time periods to assess a scheme's inability to access insurance (or a commercial superfund) will be challenging to define in practice.

Options include:

- The PPF seeking confirmation from the Scheme Actuary that the funding in the scheme is not at commercial pricing levels (perhaps on a standard set of assumptions akin to S143), and from the covenant adviser that the sponsor is unable to bridge the gap to fund a commercial transaction.
- The PPF monitoring the market and having regular discussions with insurers to identify schemes that are unlikely to get commercial quotations, and on that basis accepting / rejecting schemes.
- The PPF seeking and assessing hard evidence from schemes that they have been unable to get commercial quotations despite fair attempts to do so (this could be similar to the current Projected Benefits Quotation process used by the PPF for potential PPF+ schemes that are struggling to get competitive quotations). This could include confirmatory statements from existing advisors (or PPF Panel Advisers) that this is the case.

Note that in our experience, the ability to obtain commercial quotes depends closely on a good understanding of the market – which insurers to approach for which schemes, and how to present the proposal to the insurers. We also note that the "answer" to this question will vary through time, not only because a scheme's funding position changes but also because the commercial markets change, including capacity variations from month to month.

In practice, we think there are challenges with each of the above approaches, which is why in our response to question 15 we concluded that a simple sized-based criteria would be preferable, with a further gateway test for schemes in excess of the size-based criterion.

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

As a key government aim of the PSC would be to address any market failings, the PSC should be able to reject eligible schemes only in extreme cases (provided such eligibility criteria are suitably defined).

In this regard, the PSC may wish to add a further level of protection against moral hazard/the risk of schemes misrepresenting themselves to the PSC in order to meet the eligibility criteria (eg splitting a scheme to meet a size criterion). And potentially set minimum data quality requirements for schemes looking to transfer into the PSC.

The latter point could be addressed by requiring trustees to obtain insurance of a suitable quality on the remaining data and benefit risks post transaction, but this insurance may not be easily available at an appropriate price for smaller schemes. Another approach could be to require actuarial and legal confirmations from the existing advisers (or appointed panel advisors) in a standard form addressed to the trustees confirming that eg "we are not aware of any material remaining inaccuracies or omissions in the data or benefits …".

From a practical standpoint, there may be a need for prioritisation of schemes transferring into the PSC which may involve the need for a process to effectively triage schemes and defer those which are lower priority (rather than rejecting any schemes).

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

Other considerations which will need to be addressed include:

Impacts on scheme funding and future expected progression of schemes to commercial providers

We are sure that government will also consider the impacts on, and interactions with, other aspects of the pension funding environment and requirements on sponsors. For example, there may be moral hazard risk in allowing sponsors to pass their pension schemes to a PSC with pricing at eg Gilts+0.75% pa which may be less prudent than many schemes' current Technical Provisions' and long-term funding bases. Sponsors may ask why they should fund a scheme to a level that is more prudent than the PSC pricing basis and may therefore never reach a funding level that would enable insurance. This would risk further future longer-term disruption in the commercial markets.

Impacts on scheme investment strategies

If the PSC is open to a wide range of schemes, its pricing basis may become a target for both funding and investment strategies. This in turn could lead to impacts on investment markets, which should be considered.

Interactions with the PPF for schemes with weak/distressed sponsors

There will also be interactions with the existing PPF regime to consider, and to check for moral hazard / oddities. In particular, if the PSC prices transactions at eg Gilts+0.5%, and if this is cheaper than Section 143 PPF entry pricing, then this could open up potential arbitrage risks and opportunities, in terms of whether for example poorly funded schemes might look to PSC entry.

There are a number of such scenarios for different schemes, with different funding levels and different covenants that would need to be thought through to manage this potential for moral hazard and ensure that perverse behaviours are not incentivised.

There will also be a need to think through if schemes in PPF assessment (or stressed schemes with sponsors potentially facing insolvency) might be offered the route of securing PPF+ benefits within the PSC (instead of with an insurer or superfund) and what legal steps and processes might be needed to support that.

Impact on shareholder value

The impact of PSC eligibility and pricing rules for UK business valuation should also be considered. Currently, in many M&A transaction scenarios, the pension scheme is valued on a very low risk or insurance basis, with an assumption that very low dependency or insurance should be targeted over a relatively short timeframe, and trustees may also be granted protections/security with reference to these funding approaches and risks. However, if pension schemes can instead in the future be passed to the PSC for a price that is 10% cheaper than insurance (which may move many schemes from deficit to surplus) then this could be a windfall for shareholders.

Subsidy Control and anti-competitive constraints

No doubt the government will also be considering the implications of the Subsidy Control Act 2022 and wider anti-competitive regulations, which may act to constrain the structure of the PSC. For example, there may be additional legal due process to work through if PSC pricing is materially lower than insurance pricing and if the government underwrites the PSC capital buffer.

Exact nature of underwriting from eg government

If the government funds the buffer and provides underwriting, then this may take a number of forms. This could be "equity" or "debt" style funding, or simply an unfunded commitment. The exact nature of this buffer/underwriting, and how it can change over time, will be important and will need to be set out in detail for trustees and sponsors with firm legal commitments so they can assess the security of the PSC compared to available alternative strategic options.

Approach to pricing longevity risk

The PPF currently has a single standard "longevity pricing" model, set out in Section 179 and Section 143 bases. Insurers and commercial superfunds price different schemes differently, depending on socio-economic characteristics, given the wide range of longevity expectations for different pensioner groups around the UK. The PSC will need to consider if it adopts a similar approach to insurers (along with

resourcing specialist expertise) or continues with a single longevity pricing model. If the latter, this could create arbitrage opportunities for schemes that have members who have an expectation of longer life expectancies and may make the PSC pricing prohibitive for schemes with members who have an expectation of shorter life expectancies.

The interaction of PSC pricing, the funding code and superfund reserving requirements

The interaction of PSC pricing, PSC technical provisions, the funding code and superfund reserving requirements will need to be carefully considered. This is to manage the risk of potential inconsistencies, unintended consequences and arbitrage opportunities being required to fund.

Proposed model

21. Do you agree that the consolidator should run as a single pooled fund and operate on a "run on" basis rather than target insurance buyout? If not, what alternative structure or operating basis would you propose?

We agree that operating as a pooled scheme in run-on would be a sensible approach to meet the government's objectives (eg investment in productive assets).

As proposed in the consultation document, we agree that underfunded schemes should be ringfenced on entry until their deficit loan is paid off, in order to manage cross-subsidy risk and enable scaling back of member benefits on employer insolvency if required.

We can think of two related policy decisions that will be needed at some point:

- Would it be possible for a commercial superfund to target the PSC rather than insurance as an end game?
- Might it be possible for the PSC to choose to invest in bulk annuity insurance contracts and/or longevity swaps as part of a balanced portfolio of risk? It is an approach that we understand Clara (and other potential superfunds) intend to explore. This could potentially be one way of helping to mitigate market distortion risk, depending on eligibility criteria.

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

Yes – this would be a critical consideration for trustees in terms of managing the risk of dilution of member security. Such dilution would arise if underfunded schemes join the PSC and their associated sponsors then default on the deficit loan. By operating some form of segregation or separate accounting of schemes until the deficit loan is repaid, member benefits could be scaled back in a fair way if the sponsor defaults on the loan to the PSC eg in the event of insolvency.

The way in which benefits are scaled back in this scenario will need to be carefully considered. The existing PPF can provide only PPF-style benefits, and the PSC will be able to provide only PSC standard benefits. This leads to questions like:

- On employer failure, will the PSC benefits revert to the original scheme benefits before members' benefits being provided with PPF haircuts?
- Or will the new PSC standard benefits be scaled back with reduced PSC benefits being provided to members within the PSC?
- Will it be possible to game the benefit standardisation approach, by a scheme with a weak employer entering the PSC and deliberately choosing to standardise benefits with nil pension increases (and therefore achieving significant immediate uplifts on member pensions), only to then immediately become insolvent, and thereby significantly increase members' PPF entitlements?
- What about members who are winners / losers through the various approach?

There will need to be a clear process for the PSC to follow to ensure appropriate benefits are provided by an appropriate provider whilst managing internal conflicts of interest.

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

Our understanding of the key features of the proposed structure is:

- Link between employer and scheme severed (other than any deficit loan)
- Unsegregated pooled fund on a run-on basis (with ringfencing of schemes underfunded on a PSC pricing basis on entry)
- Similar in operation to a superfund (without private capital backing)
- Capital buffer (limited to superfund levels) provided by government or existing PPF reserves
- Voluntary entry

Yes, we do think that schemes unattractive to commercial consolidators would be attracted to a PSC based on this model.

We also note that more schemes than this could be attracted to the PSC, potentially materially more, depending on the eligibility criteria and the attractiveness of the design detail on the key points listed in our response to question 16 above.

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

No. We don't consider the proposed PSC would be a suitable home for schemes with active members that have a salary-link and/or ongoing accrual. It is not clear how future salary and service accruals would work. And there would need to be a retained link to the employer (as a sponsoring employer in pensions law rather than someone who simply owes a loan). It is also not clear how open schemes would fit with benefit standardisation.

Member benefits

25. Will this achieve the right balance between limiting the cost of transactions whilst remaining reasonably attractive to scheme trustees and their members? Are there certain elements of schemes' benefits that should always be retained?

We agree that if the PSC is going to be successful as a consolidator of smaller schemes, some degree of benefit standardisation will be necessary to support simplified ongoing administration and communication to all PSC members.

However, noting the specific focus of the question on the cost of transactions, we don't agree that benefit standardisation will necessarily reduce the cost of PSC transactions, given the complexity and amount of additional work that will be required to be carried out by the scheme in respect of the actuarial equivalence calculations and certifications – such costs may also be disproportionately higher for smaller schemes.

We note that the requirement for benefit standardisation is also likely to accelerate the volume of work that needs to be carried out upfront, ahead of undertaking the conversion calculations. This includes data cleansing, GMP rectification/equalisation, benefit due diligence, and potentially actuarial systems development. This additional work could cause delays in the timescales to entering the PSC vs an insurance solution, as such work can often be completed at a later stage of an insurance process – we note that the PPF has included some thoughts as to how this could be managed through process design in its document.

Having said this, we do think benefit standardisation is the way forward for the PSC. This is because the PSC then has no need to understand the detail of each scheme's benefits, which will help manage PSC's costs and operational constraints. As set out in the PPF's design document, we note that the team at the PPF are experienced in setting up streamlined processes which may help to manage the initial additional costs of benefit standardisation.

Whether or not trustees and employers will find the PSC benefit standardisation approach attractive will depend on the exact requirements of benefit standardisation, the complexity of their specific scheme rules, and the attractiveness of the PSC in other key areas (price, security, dealing with deficits, illiquid assets etc). Trustees and

sponsors will need to weigh up all the advantages and disadvantages for members across all areas and make a decision.

The most significant aspect which may impact on the relative attractiveness of benefit standardisation under the PSC to scheme trustees will be the inevitable creation of "winners and losers" amongst members, both initially and over time. There are various sources of the potential for "winners" and "losers", including:

- The detailed elements of a scheme's benefit structure (including spouse and dependant definitions), which will need to be valued for the purpose of actuarial equivalence, but which may not be relevant for every member depending on their individual circumstances;
- The need to place a value on member options, the terms of which can vary significantly by scheme and which will not be taken up by every member;
- How to allow for more bespoke member options, which may be taken up by some but not all, and may not be easily replicated under a standardised structure;
- The fact that assumptions made about the future in relation to eg longevity and inflation will almost necessarily not play out accurately for any given individual, who will therefore end up a winner or loser compared to their original benefits, over time;
- The complexities of allowing for GMPs, GMP equalisation, anti-franking and GMP conversion, which should not be underestimated.

We note that each individual will, in theory, be able to track what their benefits would have been and able to therefore assess their personal gain/loss.

In the remainder of the response to this question we set out some further reflections relating to benefit standardisation, before answering the question about retaining elements of schemes' benefits.

Mechanisms for achieving benefit standardisation

We do not believe that the current mechanisms in law (Section 67 and GMP Conversion) would be suited to convert benefits into PSC standard benefits. Reasons include:

- Section 67 being based on individual scheme Cash Equivalent assumptions (rather than standard PSC pricing assumptions, which would be suitable here);
- The requirement to consult with members on the implications, and explain the implications adequately (a separate policy decision should be made in relation to consultation on entering the PSC);
- Other constraints around member and spouse pensions, and employer agreement.
- Pension tax rules (around the AA and potentially the LTA if it were to be re-introduced) are also constraining for actuarial equivalence projects.

Given this, we would strongly recommend a new actuarial equivalence approach is designed in law for the purpose of PSC benefit standardisation. This should be designed to enable as simple an approach to be taken as possible, based on appropriate consent and consultation requirements, and appropriate assumptions. It would address the tax issues associated with standardisation and the flaws in the current legislation. We would also strongly recommend that it includes a statutory discharge for the key parties involved (trustees, employer, actuary, lawyer, PSC) to prevent inappropriate liabilities and risks arising through complaints about minor differences in benefits.

We note the PPF's proposal that the actuarial equivalence calculations would be completed by the Scheme Actuary (or perhaps a PSC appointed panel actuary) and we agree this is a sensible approach. The PSC should not have to understand scheme benefits – that would defeat the object.

We think the PSC should also publish guidance on the expected process, expected investigations to be completed, and the level of detail required to be dug into by the various advisers.

The PSC may also wish to consider whether any independent review of the calculations would be required as part of the process and what warranties / comfort statements would need to be provided by trustees and their advisers.

Other potential complications arising from benefit standardisation

Finally, there are a number of other complications that will need to be addressed to make benefit standardisation effective. Some we thought worth highlighting are:

- Schemes that have purchased bulk annuity contracts as an asset backing specific scheme benefits;
- Schemes/members with split retirement ages (and interaction with GMPs);
- Members with enhanced benefits that apply whilst they remain in employment with the sponsor (but are no longer accruing benefits);
- Bridging pensions and other pension step-ups/downs.

Elements of scheme benefits that should be retained through benefit standardisation

We think that the following key elements of benefit structures should be offered as a minimum:

- Different retirement ages
- Different pension increase types and revaluation (to ensure inflation protection of members' benefits where the existing benefit structure provides for this)
- Different spouse pension levels

In addition, key member options (transfers, commutation, trivial commutation and early/late retirement plus in respect of ill health) should also be available within the PSC, but these would likely need to be on standard PSC terms, rather than scheme-specific terms.

26. **If standardised benefit structures are applied, what should these benefit structures be?**

We are broadly supportive of the PPF's proposed approach, subject to our response to question 25.

27. **What effect will this have on the existing market of commercial consolidators?**

The impact on the existing market will depend on whether insurers and superfunds will be able to make use of a new statutory route to standardise benefits in the same way as the PSC. If not, this would be a key differentiator for the PSC. We note that technically trustees could use existing Section 67 and GMP Conversion processes to achieve a form of benefit standardisation ahead of insurance, but this has key disadvantages outlined in our response to question 25.

Because of the winners and losers necessarily created by benefit standardisation, trustees have historically been highly cautious about simplifying benefits using the existing routes to do so. When seeking insurance currently there is little incentive to simplify benefits because most insurers price most scheme-specific benefit structures competitively.

Whether or not trustees and employers will find the PSC benefit standardisation approach attractive will depend on the exact requirements of benefit standardisation, the protections offered through any new laws and statutory discharges in this area, and also on the attractiveness of the PSC in other key areas (price, security, dealing with deficits, illiquid assets etc).

Provided the eligibility rules and other design features of the PSC are set appropriately (as described elsewhere in our response) we do not think that benefit standardisation specifically will have a disproportionate impact on the existing market. However, the government may wish to consider whether any new flexibilities should also be made available to commercial providers in the right circumstances.

Governance

28. **Will this proposed governance structure achieve effective administration and public confidence in the public sector consolidator?**

Yes. In our view the legal ringfencing of the PPF's existing funds and the PSC consolidator funds is necessary for market confidence in the statutory role of both the PPF as the lifeboat and the PSC as a consolidator.

29. What alternative governance structures should be considered?

We note that there is the potential for conflicts between the existing PPF and the PSC. These could arise in the following circumstances:

- The setting of a PPF levy to be paid by the PSC
- The treatment of a PSC scheme whose employer has failed before paying off its deficit loan
- The treatment of a scheme in PPF assessment which may be able to pay higher benefits to members if it were able to exit PPF assessment and enter the PSC rather than the PPF

There will need to be clear governance arrangements to ensure these potential conflicts are addressed. It is possible that on reflection government or the PPF may conclude that a different Board should oversee the PSC. (We note that such conflicts do not currently exist with the Fraud Compensation Scheme.)

The government will also need to consider whether the PPF should be under the regulatory watch of the Bank of England, PRA, FCA and/or TPR.

Funding

30. Is the proposed funding basis appropriate to achieve the consolidator's aims and in particular its aim to maintain the security of member benefits?

We can see why it is attractive for the PSC to be funded in a way that aligns with superfund requirements. We note that this could give the PSC a competitive advantage over insurers who are constrained by Solvency UK.

We are comfortable that funding at this level should be appropriate to achieve the member security aims in current conditions, with the available capital buffer to underwrite downside experience (eg on investments or through member experience). We also agree that, if the PSC is not subject to Solvency UK, it should be eligible for the PPF.

We suggest that once the detailed funding arrangements are known, the PSC should publish regular third party reports on its website on the strength of the security offered by the PSC and how this is expected to evolve in future, and any risks. This will enable trustees to take informed decisions on the relative security of the PSC as compared to other market options and their existing covenant.

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

Setting PSC pricing in line with technical provisions of Gilts+0.5% pa to Gilts+0.75% pa can be expected to be materially more favourable for schemes than insurer pricing (particularly for less mature schemes). This level of pricing could therefore disrupt the market, potentially significantly so depending where the PSC eligibility criteria are set.

Pricing at Gilts+0.5% pa to Gilts+0.75% pa could be eg 10% cheaper (ie £100m for a £1billion scheme) than insurance. This difference is at such a level that, in our view, all schemes would need to actively consider the PSC as an alternative to insurance, if they were eligible.

If insurers and superfunds are consistently undercut by the PSC's pricing, some may stop quoting on PSC-eligible schemes, and even consider exiting the market. This could make even more schemes unattractive to insurers and superfunds.

If the objective is to not distort existing markets (whilst still providing a viable alternative endgame solution that minimises the price penalty that small schemes can pay for consolidation) pricing around the existing Section 179 and Section 143 assumption sets may better achieve this. We note that existing PPF entry pricing (Section 179 and Section 143) is broadly based on pseudo insurance pricing, and this has worked well for considering PPF schemes and the possibility of them purchasing PPF+ benefits with an insurer.

We also note that there is not necessarily a need for the PSC's pricing basis to be in line with its technical provisions basis.

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

Our view is that long-term treatment of PSC surpluses should be transparent up front.

LCP powering possibility

The normal economic approach under the superfund regime and for insurance companies is for surpluses/profits to return to the provider of capital. If this was the government/taxpayer then we can see an argument for surpluses to be returned to the taxpayer. If the provider of capital was the existing PPF, it would make little sense to return surpluses to the PPF without a wider consultation and agreement on the use of the PPF's existing reserves.

The government could decide that surpluses should be shared with members. This would be a further differentiator for the PSC as compared to the insurance and superfund regimes, and provide a route for future discretionary increases to/augmentations of member benefits in the PSC.

Treatment of entering scheme deficits and surplus

33. **Are these arrangements for schemes transferring into the consolidator sufficient to achieve the consolidator aims outlined above? If not, what alternative arrangements would you propose?**

We note that it is proposed that a key role for the PSC would be to take on poorly funded schemes. We note that government policy over many decades has been that poorly funded schemes should be fully funded by the employers over affordable periods and that the imminent new funding regime will ensure that all schemes reach a low dependency position (likely to be similar to the proposed PSC pricing basis) once they are significantly mature. Therefore there is already a framework for addressing poorly funded schemes over time, and there doesn't seem to us to be a need for the PSC to take on schemes in deficit.

Having said that, we can see the attractiveness of the PSC proposals for sponsors and trustees in relation to the treatment of deficits and surplus.

Schemes in deficit vs PSC pricing:

The potential to transfer to the PSC with a deficit (as assessed on the PSC pricing basis) and to agree a fixed repayment schedule would be a key differentiator for the PSC vs commercial providers. The details around the terms of the deficit repayment schedule will be critical to understand the extent to which this will cause disruption to the private markets for which taking on this level credit risk is generally not a viable option (insurers will generally be willing to defer some element of the premium for a given period and subject to interest, but typically not for facilitating a transaction for poorly funded schemes or schemes with weak sponsors).

These details include:

- the PSC pricing basis and the potential for the deficit calculated on that basis to be lower than some schemes' technical provisions and IAS19 deficits, and therefore be attractive to schemes in deficit
- how the period for repayment is to be evidenced and determined and what constraints on this there would be
- the level of interest on the repayments and whether these would reflect default risk (on behalf of the members)
- recourse to the sponsor on failure to make repayments, how the PSC would rank versus other creditors of the sponsor, and whether the debt to PSC would be secured?
- interaction with the existing pensions moral hazard regime: ie the treatment of these deficit payments following any corporate event materially impacting the ability of the sponsor to make these payments (eg refinancing / introduction of prior ranking debt / material distributions)

While ringfencing of schemes underfunded relative to the PSC basis on entry is a helpful mitigation vs risk of sponsor failure, the detail of the benefits which would be payable to members in the event of insolvency will be important, to understand the potential for moral hazard / risks to PSC members. The PPF's document suggests that benefit reductions could be applied within the consolidator (benefits paid would reflect the value of PSC benefits that the asset share equates to using the PSC pricing basis). This could result in members receiving higher/lower benefits than the PPF compensation level benefits which they would have otherwise received had the scheme not transferred into the PSC. For this reason, a preferred approach in this scenario may be entry to PPF assessment with the relevant asset share. But a decision will also need to be taken about whether a PPF+ case (either directly or via the PSC) can re-enter the PSC if this would provide higher benefits than an insurer.

Schemes in surplus vs PSC pricing:

The potential for any surplus relative to PSC pricing to be used to enhance members' benefits in the PSC and/or be shared with the employer will make this option attractive to both trustees and sponsors. Member benefit enhancements could also help to address the challenge of winners vs losers under benefit standardisation (as set out in our response to question 25).

Note that the outcome of the consultation on the statutory override (and the legislation which might be required to facilitate this use of surplus on entry to the PSC) could affect the extent to which this differentiates the PSC from the commercial superfunds and insurers.

Investment strategy

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

Broadly yes.

As it would not be constrained by Solvency UK requirements, the PSC would have greater investment flexibility compared to insurers – thereby being freer to invest to a greater extent in UK productive finance and to accept and hold a broader range of illiquid assets.

The investment strategy would still be required to support a prudent funding basis and not create too much risk for the buffer. With a proposed funding basis broadly linked to gilts, this would suggest that the PSC could also be a significant holder of gilts for the long term (which could help to support the continued effective functioning of the gilt market – another key aim of government).

The consultation is silent on the approach to asset valuation and asset transfer from schemes to the PSC. This is usually a key part any insurance /superfund transaction. In particular, would the PSC accept illiquid assets, poorly performing assets, and any other asset, or would it require presale of assets into liquid markets such a gilts, equities and cash? If the PSC is to accept all assets, how would these be valued and who would verify the value? The detail here would be important to understand to enable comparison the position of insurers and superfunds – where material holdings of illiquid assets can be a barrier to a transaction.

As outlined in our response to question 25, thought will also need to be given as to whether the PSC would accept schemes with an existing bulk annuity contract (a "buy-in") that has been purchased on the basis of unstandardised scheme benefits. We are of the view that such schemes should not be prohibited from entering the PSC on the basis of decisions previously taken to sensibly manage scheme risks.

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

In our view, the proposed approaches explored in the consultation document can enable to the PSC to reach scale. As discussed elsewhere in our response, it will be important to balance the following in order to ensure an appropriate scale is reached and the government's other objectives are met, including to minimise disruption to the existing commercial markets:

- Eligibility rules
- Pricing attractiveness
- Funding, underwriting and security levels
- Terms of any deficit loans
- Valuation and acceptability of scheme assets
- Benefit standardisation process and protections

Underwriting

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

The expected capital requirements will ultimately be dependent on the demand for the PSC which will in turn depend on the eligibility criteria, pricing etc (see our response to question 35), and so it is difficult to comment on the method and extent of required underwriting in isolation.

The proposal for any underwriting to be finite in nature reflects the position for commercial superfunds and insurers where underwriting is also finite and controlled

by commercial pressures, so this would be consistent with the government's aim of minimising the potential distortion to the superfund and buy-out markets.

As the PSC is not proposed to be an insurer, we also agree that, as with commercial superfunds, members should have recourse to the existing PPF in a failure scenario. Therefore, the PSC should pay a PPF levy – albeit careful thought will be needed about the appropriate level of the levy and who sets that levy (mitigating potential conflicts of interest within the PPF Board).

The consultation document notes that care would need to be taken to ensure government underwriting would not create unfair competition. Government underwriting of the PSC's capital requirements (even if with limits) is likely to give the PSC a material actual and/ or perceived advantage compared to insurers and superfunds, particularly if it allows the PSC to price at the levels suggested. There is also the question of whether the government would need to fund this capital upfront, or whether the requirements would be unfunded (noting that this unfunded approach is not a route available for commercial providers).

The alternative is that PPF reserves could be used for underwriting (with a limit). We agree the challenges of this approach in reaching scale as use of a (proportion of) PPF reserves will naturally ultimately limit size. We think broader consultation on the use of the existing PPF reserves would be appropriate before a decision to use those reserves to support the PSC buffer.

In either case, an appropriate assumed "cost of capital" may need to be allowed for to ensure the PSC is not provided with an unfair pricing advantage. This would also provide clarity on the expected return on the capital deployed by either the PPF (if PPF reserves underwrite the buffer) or by the government (if the government underwrites the PSC capital).

We note that the PPF has a successful track record of generating surplus assets compared to a prudent pricing model. Therefore, if this can be replicated in the PSC it is quite possible that the PSC could become "self-funding" over time, returning buffers to the government or the existing PPF, and no longer requiring underwriting.

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

If the consolidator is to be public sector, we cannot think of any. Clearly it would be possible for private money, including private equity firms, to be involved in providing capital, but this would then become akin to a commercial consolidator and we do not think it makes sense to introduce a further type of commercial superfund.

38. Should government underwrite the consolidator and set the investment strategy?

We can see how if the government were to underwrite the capital buffer of the PSC, then this could give the government a role in influencing the PSC's investment strategy and how this could potentially support the government's aims in relation to increasing investment in productive finance (albeit the extent of this would be dependent on the scale achieved by the PSC).

For good governance purposes we do not believe that the government should set the investment strategy unless the underwriting is unlimited. Investment strategy should be set by a board that is independent of government (eg the PPF Board) who would be required to consult with government. This is similar to the way in which trustees currently consult with sponsoring employers of pension schemes.

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

Risks to the UK taxpayer could be limited by:

- Constraining the amount of business the PSC could write (through explicit limits or restricting eligibility) – however, this may restrict the PSC reaching scale.
- Ensuring a more cautious, tightly hedged, investment strategy and a diversified pool of longevity hedges – however, if this is taken too far then it would limit the scope of investment in productive finance.
- Restricting the extent of government underwriting (limiting the capital buffer) – we note this could have an impact on pricing and may also lead to trustees being concerned about the security of the PSC.
- Assuming a higher implicit "cost of capital" when setting pricing (eg in line with the cost of capital used by commercial providers), arguably reflecting the nature of the risk being assumed by the taxpayer.

However, a question that will be in everyone's minds is the same question that is asked about the existing PPF: would any government in practice limit the availability of capital in a downside scenario and allow the PSC to fail/call upon the PPF, with 100,000s of members then in receipt of PPF compensation levels / lower benefits?

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

We note that a wider consultation on the use of the current PPF reserves is planned, and we think this should be completed before further policy decisions on this topic are made, including consideration of the options of enhancing member benefits and/or returning money to levy payers.

We can see how a proportion of the PPF's reserves could be used to underwrite the capital buffer if the scale of the PSC is to be limited in some way (eg through eligibility for small schemes only). However, there is circularity and conflicts of interest in using the PPF's reserves in this way as if the PPF/Government decides to not provide further underwriting this could cause the PSC to fail, with PSC schemes then falling into the PPF. Therefore, we think the PSC should be managed by a different Board if PPF reserves are to be used, and the government should also consider providing a further overriding "stop loss" type underwrite to the PSC which can be used to prevent a downwards spiral in the case of systemic risk playing out.

If the PPF reserves are to be used for underwriting the capital buffer for the PSC, then the PPF should benefit from upside from the PSC, and it should be clear how that upside is to be used within the PPF.