Six changes to seize the pension surplus opportunity

WTW white paper, July 2023

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Foreword

Just over a year ago, we started a debate in various forums: should we be more open-minded about the range of opportunities presented by increasingly well-funded DB plans sitting on £1.5 trillion of assets?

Should some pension schemes reverse the default practice of improving funding positions triggering ever more de-risking, with a view to buying-out benefits with an insurer at the earliest opportunity? Our question at these forums: could, and should, some pension schemes consider retaining some risk, with appropriate controls in place, with a view to generating better economic outcomes for stakeholders?

The prize of going down this path? The potential to work the £1.5 trillion capital base sitting in these schemes a little harder, in a risk-managed way, and generate surpluses which, in aggregate, could amount to many tens of billions of pounds of economic value. Surpluses which might be put to use to benefit sponsoring companies, their employees and pension scheme members. Surpluses which could help address the inadequacy of retirement savings being made by the majority of today's workforce in DC pension plans.

When we first started these conversations, at roundtables with independent trustees and pensions lawyers, and at WTW conferences, we had to be a little cautious as, at the time, our ideas were considered bold.

Going down this path would mean doing things differently, but only in the right circumstances, with appropriate checks and balances. It would mean a shift in mindsets in our industry.

For many schemes, continuing the de-risking journey or moving to buyout will still be the right thing. But it need not be inevitable – under the right circumstances, the alternative could be very attractive for some schemes and employers.

Last month, I was delighted to be invited to make the case at Law Debenture's high-profile debate on the topic, and am pleased that the views of the pensions industry have evolved over the past year. It is clear that mindsets have shifted.

Now, we would like to move the debate further. We would like to see changes in the pensions regulatory framework that make this alternative approach more viable and more attractive for schemes and employers. Real, meaningful changes, that will lead to different behaviours from trustees and employers. Changes that will deliver benefits for employers, members of DB schemes, and those saving for pensions in DC.

In this White Paper, we set out the six changes we would propose to the pensions regulatory framework. We have already shared our ideas with HM Treasury and the Department for Work and Pensions. We now look forward to engaging further with the whole pensions industry on our latest ideas.

It is our conviction that these changes will help improve retirement incomes for millions, and at the same time lead to asset strategies that help fuel growth in the UK economy, which will benefit us all.

Rash Bhabra
GB Head of Retirement, WTW

Six changes to seize the pension surplus opportunity

UK private sector defined benefit (DB) pension schemes hold around £1.5 trillion in assets, and these schemes are better funded than ever. Many are on a path towards a very substantially de-risked asset portfolio, as part of their journey plan towards buying out with an insurer.

There are two major consequences of this direction of travel. First, neither employers nor their current or past employees stand to benefit fully from the opportunity presented by well-funded DB pension schemes. Second, the aggregate effect is contrary to the Government's desire for UK pension savings to support economic growth by investing more in productive finance.

Some fundamental changes are needed to the pensions regulatory regime; otherwise the opportunity presented by well-funded DB plans will be missed. Making it easier for employers, DB members, and employees saving through defined contribution (DC) schemes to benefit from surpluses, albeit with appropriate checks and balances in place, would encourage more employers and trustees to retain growth assets in their pension portfolios with the aim of making the surpluses more persistent. This would also benefit the wider UK economy.

We estimate that most pension schemes are already in surplus on the Pensions Regulator's proposed 'Fast Track' low dependency basis; this is a conservative funding basis, which assumes very low future investment returns. Many more are close. The opportunity for the UK to take advantage is therefore one that exists today; equally, unless the pensions regulatory regime changes in the very near future, the opportunity will be missed.

The key to realising this opportunity is unlocking 'trapped surplus': with appropriate checks and balances, it should be easier to access surpluses when they arise. This would give employers and trustees a reason to invest in assets with higher expected returns. By extending schemes' time horizons and delaying the journey to buyout, it would also facilitate investment in less liquid assets such as UK infrastructure projects.

In this paper we propose six changes the Government should make:

1. **Create a legislative mechanism by which a DB scheme's surplus can be used to finance contributions to benefit DC members in a different scheme.**
2. **Reduce the tax rate on refunds of surpluses to an employer, ideally to align with the corporation tax rate.**
3. **Amend legislation to more readily allow refunds of surplus while a scheme is ongoing.**
4. **Remove some tax barriers to sharing surpluses with DB members.**
5. **Ensure that the final funding and investment strategy regulations do not funnel schemes into excessive de-risking, and that they allow open DB schemes to thrive.**
6. **Revisit the Pensions Regulator's statutory objectives to encourage an approach to regulating DB pension schemes that considers members' broader interests beyond solely protecting accrued pensions.**

These changes could reasonably be expected to result in DB schemes directing tens of billions of pounds into higher return seeking assets.

Beyond DB, the expansion of Collective DC (CDC) via multi-employer, master trust and decumulation-only arrangements should provide further opportunities for boosting retirement savings and for them to be invested in higher returning assets. This will become increasingly important as nearly all private sector DB schemes have a finite investment time horizon. We have played a leading role in bringing CDC to the UK market, working with Royal Mail, and we support the Government's plan to bring forward draft legislation later this year to make all forms of CDC a reality so that as many people as possible can benefit. It is our view that decumulation-only CDC arrangements will have the broadest reach.

About WTW

WTW has a particular strength in the area of UK pensions; our colleagues are Scheme Actuary to more of the largest 500 private sector DB pension schemes than any other organisation; we have over £50bn of assets under management across our UK delegated investmentmanagement mandates; and LifeSight, WTW's DC master trust, looks after the pensions of 325,000 members with approximately £14.5bn of assets secured under management.

Section 1 : Why is change needed?

Context

UK private sector DB pension schemes collectively hold c. £1.5 trillion in assets[1] and these schemes are better funded than ever. We estimate that most schemes are already in surplus on the Pension Regulator's (TPR's) proposed 'Fast Track' low dependency basis[2].

DB pension schemes have also significantly de-risked: the proportion of assets invested in equities fell from 61% in 2006 to 20% in 2022[3] and many are looking to de-risk further. Most are on a path towards buying out with an insurer.

Schemes' strong funding positions present an opportunity to use the capital more productively for the benefit of employers, DB members, employees saving through DC schemes, and the wider UK economy. Further, that opportunity to benefit exists today, although it is at risk of being missed if changes to the regulatory regime are not made soon.

However, investment decisions will ultimately be driven by what schemes are trying to achieve.

Provided the employer remains solvent, it will suffer the downside from investment risk if a scheme moves into deficit (because it can be called on to make cash contributions to repair these deficits). So, for a well-funded scheme, the employer will also want some of the upside if it is to support an asset strategy which targets returns above those required to simply preserve the current funding position. Equally, trustees will need to believe that members stand to gain if they take some investment risk, and that the risks can be appropriately managed without necessarily being reduced to nil.

The current regulatory framework

The decisions trustees and employers make are within the current framework summarised in Box 1. From the employer's perspective, this can make funding the scheme look like a one-way valve; from a trustee's perspective the onus is on securing pensions that have already been promised rather than enhancing pension provision either for DB members or employees in DC schemes.

Within this context, schemes are increasingly de-risking and targeting buyout.

[1] £1.385 trillion at the end of May 2023, according to the PPF's 7800 Index
[2] Based on the low dependency basis described in TPR's proposed Fast Track parameters (currently subject to consultation). TPR uses a discount rate of gilts + 0.5% for this purpose. In practice, some schemes will adopt a different low dependency basis.
[3] The Purple Book 2022, PPF, Figure 7.2

Box 1: The framework surrounding funding, investment, and access to surplus

- Trustees are solely responsible for choosing investments[4], though they must consult the employer before preparing or revising a statement of investment principles[5].
- New long-term funding and investment strategies, which specify "the investments the trustees intend to hold" once the scheme is significantly mature must be agreed with the employer once the proposed funding and investment strategy regulations come into effect[6].
- Surpluses can be used to benefit the employer within a scheme, typically subject to trustee agreement and if permitted by scheme rules, but these options are not universally available:
  - Surpluses can fund the cost of further benefit accruals, but most DB schemes are now frozen.
  - They can pay for future scheme expenses, but these might be small relative to the surplus.
  - They can sometimes pay for DC contributions, but this might not be straightforward where DC provision is not in the same trust as DB.
- Beyond this, broadly speaking, only a surplus above the amount required to buy out the scheme's liabilities with an insurer can be paid to the employer, with legislation overriding scheme rules where these are more permissive and where they place the power to distribute surplus in the hands of someone other than the trustees (typically the employer)[7]. There are also schemes where the scheme rules are a lot less permissive, and the legislation does not provide an override in these circumstances. For schemes planning to run off, the level of funding required before a surplus can be paid to the employer may be meaningfully above a prudent estimate of how much they will need. In practice, a surplus refund usually only occurs once a scheme is winding up, so for a scheme that is running on there may be no mechanism for the employer to access surplus for decades into the future. Moreover, trustees must also be satisfied that it is in their members' interests to use the surplus in this way, as they will often have some level of control over surplus distribution.
- As well as only being possible where the scheme is fully funded on a buyout basis, refunds paid directly to the employer attract a 35% tax charge[8]. This will typically exceed the corporation tax relief the employer received in respect of the contributions that helped produce the surplus.
- A recovery plan must be prepared to repair any deficit against a statutory funding objective. Under the proposed regime to apply from April 2024, this funding target would converge on a low dependency basis over time. Deficits would also be cleared as quickly as the employer could reasonably afford.
- In most schemes, any augmentation of benefits will require the employer's agreement.

[4] s35(5) of the Pensions Act 1995 says that the consent of the employer cannot be required
[5] Regulation 2 of the The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378)
[6] S229(1)(za) of the Pensions Act 2004, as inserted by Schedule 10 of the Pension Schemes Act 2021.
[7] s37 of the Pensions Act 1995 and Regulation 4 of The Occupational Pension Schemes (Payments to Employer) Regulations 2006. The requirement is for the scheme to be in surplus on the solvency basis used by the scheme actuary. This will not always exactly match the market buyout cost. Trustees were required to pass a resolution to retain any surplus refund power by April 2016 – failure to do so resulted in such powers being lost.
[8] s207 of Finance Act 2004

Risk appetite

One key reason for schemes increasingly de-risking and targeting buyout is that employers seldom support investment strategies that aim to generate higher returns which they cannot be confident they can benefit from within a reasonable timeframe. Although investment strategy is the remit of trustees, absent employer appetite for some risk to be retained, most trustees will seek to de-risk as far as they can once funding positions approach full funding on a low dependency basis.

This contrasts with the position for schemes further from buyout, where employers generally support investment risk doing some of the heavy lifting to hold contributions below the level otherwise required. Improved funding levels could therefore see schemes de-risk further and faster than they would have been expecting to do at this time. As TPR recently told the House of Commons Work and Pensions Committee: "...recent funding improvements mean that many schemes are ahead of where they expected to be in their funding position and long-term journey planning and will be considering how they can lock in these gains..."[9]

For individual schemes and employers, the present choice is about whether to prioritise reducing risk above all else, ultimately seeking to transfer all risk to a third party and get pension liabilities off the sponsor's balance sheet as soon as possible, or to view actual and potential pension surpluses against a low-risk liability measure as an opportunity. Different schemes will, reasonably, reach different conclusions based on a wide range of considerations, such as the strength of their covenant, the profile of their membership and the entitlements of their members.

Buyout as the ultimate destination?

To date, buyout has, rightly in our view, been seen as the destination of choice for most schemes. This is likely to remain the case. However, for a significant number of schemes, the alternative of 'running on' the scheme could be attractive, particularly if tax and regulatory changes made future surpluses more accessible to employers and members.

The UK insurance regime is robust. It has an excellent global reputation for being prudent, with proactive regulation from the Prudential Regulation Authority (PRA). In particular, the levels of reserving and capital required are onerous, supported by a strong risk management framework which is currently being refined as part of the implementation of Solvency UK. The PRA also performs regular reviews of the risks and insurers' ability to meet their policyholder obligations and withstand extreme events.

Nevertheless, given the continuing growth in the bulk annuity market and demand to transfer pension liabilities into the insurance regime, policymakers will need to consider the macroeconomic consequences of these transfers accelerating. The risks associated with this acceleration are understood by the PRA. Policymakers will need to form a view on the appropriate balance of support of the c. £1.5 trillion of pension liabilities, between the insurance regime and UK private sector.

[9] TPR's written evidence to the Work and Pensions Committee's inquiry into defined benefit pension schemes

Asset allocation in the run up to buyout

Well-funded schemes on the path to buyout are typically running lower risk investment strategies than those which intend to run on for longer (see Figure 1). For example, a scheme close to being fully funded on a very low risk "gilts flat" funding measure may choose to run an investment strategy which targets only a modest level of outperformance above that measure, in order to maintain their funding position with minimal risk, typically through a small allocation to investment grade credit.

Schemes on the path to buyout also look to sell illiquid investments that an insurer might not accept as part of the premium (at least under the current solvency regime; the Pensions and Lifetime Savings Associated has proposed changing this[10]) and resist new investments in such assets. In doing so, schemes hope to make their portfolios "buyout-friendly" to a wide range of insurers, each of which may pursue slightly different investment strategies.

This disinvestment from illiquid assets is over and above that which is already occurring in the wake of collateral calls during the LDI crisis of September – October 2022 as schemes rebalance their portfolios, and risks reducing the financing available for new illiquid investment opportunities.

This difference in investment strategy typically only arises in the period before buyout. Post-buyout, insurers often invest similarly to schemes which are running on. Therefore, as a scheme's journey to buyout progresses, illiquid assets initially feature in the portfolio of assets backing the members' benefits, then disappear, and then come back again after the transaction completes. After buyout, the main difference is that insurers will hold a larger capital buffer, whereas a scheme running on would have recourse to the sponsoring employer.

The pension surplus opportunity

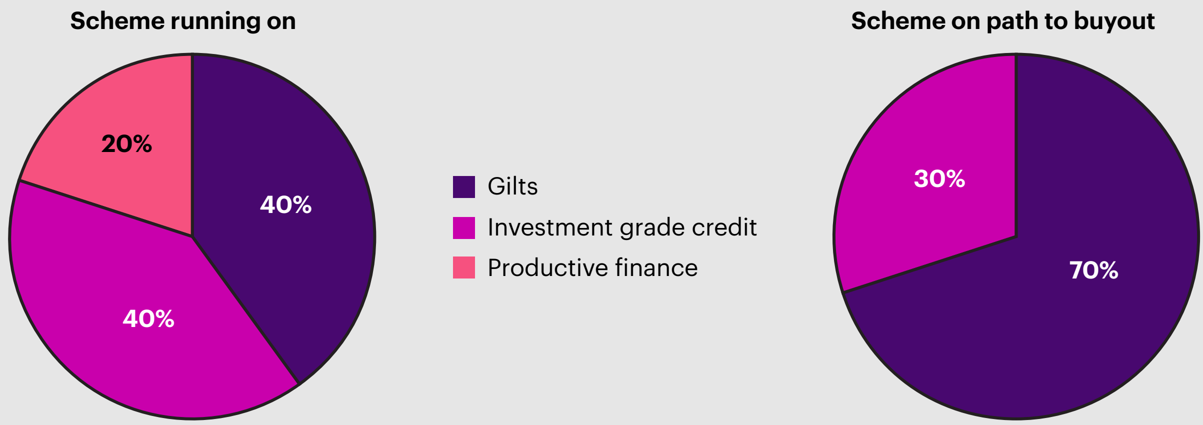
Well-funded pension schemes can provide material support to the UK economy by retaining a greater exposure to growth assets than their current direction of travel. The key to changing the current trajectory is unlocking access to 'trapped surplus' for employers and members. This would give employers and trustees a reason to invest in assets with higher expected returns and would facilitate investment in less liquid assets by extending schemes' time horizons.

This does not mean going back to the days when DB schemes were principally invested in growth assets; most schemes are more mature, and the focus in these cases is rightly on paying the benefits promised. It's also important that the sponsoring employer covenant can support the associated risks. But the scale of DB assets means that even a small change in asset allocation to target upside for some schemes would have meaningful effects.

For example, if just 10% of schemes were to change their approach and direct just 20% of their assets into higher returning asset classes, such as equities or productive finance assets, that would translate into around £30bn of additional investment in these asset classes. This in turn would be expected to generate hundreds of millions, or even billions, of pounds of additional returns each year that could benefit employers and members of these schemes.

Moreover, unlocking access to trapped surpluses would directly benefit sponsoring employers, members of DB schemes and, potentially, other employees who are accruing DC pensions.

Figure 1: **Illustrative investment strategy for a very well-funded DB pension scheme 'running on' vs on a path to buyout**



[10] Pensions and Growth, PLSA, June 2023, p13

Section 2 : WTW's proposed changes

The Government should make surpluses easier to access and encourage a longer timeframe for investing assets.

In our view, surplus should in general, and where possible, be used for pension purposes. This could be either for financing existing pension contribution commitments (DC or DB, and for employers or employees) or for improving pension adequacy, e.g., through discretionary awards to members with DB pensions or making extra DC contributions.

We propose the Government takes six steps:

1. **Create a legislative mechanism by which a DB scheme's surplus can be used to finance contributions to benefit DC members in a different scheme** used by the same employer group, without incurring tax penalties that arise under current rules (although we are also proposing to change these; see below), subject to appropriate conditions.
   - Currently, this is very difficult and has happened only in isolated cases via convoluted bulk transfers.
   - We would expect the legislative mechanism to include conditions to ensure that DB benefits remain funded to an appropriate level of benefit security – for example, that the scheme remains fully funded on its low dependency basis.
   - The wording of automatic enrolment legislation could also be reviewed to avoid any legal interpretation that this is not permissible (i.e., to put beyond doubt that financing DC contributions with the proceeds of DB surpluses meets automatic enrolment requirements to "pay contributions").
   - How surpluses are shared should be left for employers and trustees to agree, depending on scheme rules and scheme-specific circumstances.
2. **Reduce the tax rate on refunds of surpluses to an employer, ideally to align with the corporation tax rate** so that, in circumstances where using the surplus to pay for future pension provision is not achievable, employers are not penalised for funding their scheme well and remain incentivised to invest in a manner that should generate surpluses without the fear of penal tax treatment where a refund ultimately arises.
3. **Amend legislation to more readily allow refunds of surplus while a scheme is ongoing.** Legislation requires a scheme to be fully funded on a buyout basis before a refund of surplus is permitted, and many trustees are comfortable with allowing refunds only once a scheme has actually bought out and removed any possibility of the buyout position deteriorating. We propose a lower legislative threshold for allowing refunds, set by reference to a scheme's low dependency basis, so that accessing a surplus and continuing to invest in a manner that aims to make surpluses more persistent are not mutually exclusive. We do not, however, propose a legislative override to existing scheme rule provisions, where these are less permissive.
4. **Remove tax barriers to sharing DB surpluses with members.** Surpluses can be used to increase annual pensions, but this carries an uncertain eventual cost for employers and drip-feeds the benefit to members. One-off lump sums, similar to Uncrystallised Funds Pension Lump Sums (UFPLSs) from DC arrangements, would be more attractive to many employers, but trigger penal tax charges for members and the scheme because they are not 'authorised payments'. This should change.
5. **Ensure that the final funding and investment strategy regulations do not funnel schemes into excessive de-risking, and that they allow open DB schemes to thrive.** In particular, proposed requirements around "highly resilient" asset allocations at the point of low dependency may threaten schemes' ability to target returns expected to generate a surplus. Further, genuinely long-term open DB schemes, with strong employers to support them, should be exempt from the requirement to fund for low dependency.
6. **Revisit the Pensions Regulator's statutory objectives to encourage an approach to regulating DB pension schemes that considers members' broader interests beyond solely protecting accrued pensions** – for example, by exploring whether it should be tasked with looking after members' interests or, say, "supporting adequate retirement incomes for members of workplace pension schemes" rather than just protecting accrued benefits, or by giving it a new objective modelled on the proposed "competitiveness" objective for the FCA.

Section 3 : Helping employers and current employees to benefit

Surpluses exist largely because employers have paid more into their schemes than now appears to have been necessary[11], in part because of the legislative requirement to fund prudently. Allowing employers to benefit from surplus would reduce the fear of contributions leading to a trapped surplus, which can be a barrier to repairing benefit security in adverse situations. It would also facilitate continued exposure to growth assets for the longer term that would be expected to lead to ongoing generation of surplus.

In 2013, HM Treasury argued that pension costs such as deficit contributions and high costs of accrual had been holding down wage growth[12]. By that logic, allowing employers to benefit from surpluses should also benefit employees (whether in the form of wages or higher pension contributions).

Covering employer pension costs for current employees

1. Create a legislative mechanism by which a DB scheme's surplus can be used to finance contributions to benefit DC members in a different scheme.

Policy could facilitate using surpluses to provide pensions to current employees, and without the frictional tax effects from taking a refund and making a contribution separately.

For schemes that have not completely closed, the costs of new DB accrual can be met, in full or in part, from surplus. The Courts have also upheld use of surplus to meet some of the employer's contribution costs in relation to a DC section of the same scheme[13], though that very much depends on how the scheme rules are worded.

It is harder to achieve this, at least without a convoluted bulk transfer, where the employer has set up a separate DC scheme or outsourced its DC provision (because the DC members are not beneficiaries of the trust with the surplus), or where it wishes to provide DB or CDC pensions through a separate vehicle.

It could therefore be useful if a statutory override to scheme rules allowed trustees to transfer surplus funds to another pension scheme used by that employer, subject to relevant criteria being met. The amounts transferred could be credited to members' DC accounts or used to fund their DB or CDC accrual.

The principal requirement could be that a DB scheme's benefits would have to be fully funded on a low dependency basis after the transfer. This would typically be more conservative than using surplus measured on a "technical provisions" basis (which trustees may agree to do in the limited cases where surplus can already be used to finance pension provision for current employees within the same trust), but the gap between these two liability measures would usually shrink over time (for closed schemes at least). Alternatives could be considered; for example, requiring a buffer above the cost of buying out benefits at Pension Protection Fund (PPF) levels would more directly protect the PPF from future claims, but funding levels on this basis can be more volatile as they are not what schemes target.

As transfers of surplus would be permitted, rather than required, trustees could apply additional tests before allowing the employer to access surplus, such as assessing the employer's ability to repair any deficit that might re-emerge and the impact on existing benefit security, and the Government could also stipulate such further safeguards. TPR guidance could also be issued to support trustees in considering the issues.

Employers wishing to utilise surplus to pay for DC contributions – in whatever vehicle – may also need legal advice in connection with the wording of automatic enrolment legislation: a DC scheme can be a qualifying scheme in relation to a jobholder only if, under the scheme, the employer "must pay contributions in

[11] Estimates published in successive editions of the PPF's Purple Book indicate that employers have paid almost £200bn deficit contributions since the current regime was introduced in 2005
[12] Autumn Statement 2013, pages 16-18
[13] Barclays Bank plc vs Holmes & Ors, [2000] EWHC Ch 457

respect of the jobholder"[14]. Employers would need to be reassured that using a surplus (typically derived from money they paid) to credit DC accounts would satisfy this requirement; the Government could helpfully clarify the policy intention and, if necessary, amend the legislation.

It might also help encourage use of DB surplus to meet DC costs (or DB accrual) if this were not treated as an employer pension cost for the purpose of a company's Profit & Loss account. However, accounting standards are not the responsibility of the Government.

Refunds to the employer

2. Reduce the tax rate on refunds of surpluses to an employer, ideally to align with the corporation tax rate.

3. Amend legislation to more readily allow refunds of surplus while a scheme is ongoing.

For many employers, allowing DB surplus to cover pension costs as they arise should be sufficient, but there may be times when a straightforward refund would be more valuable – for example, where the employer wants to fund an investment project quickly and it would take a long time for a surplus to offset DC contributions.

To encourage sponsors to support investment choices that are more likely to generate surpluses, it is therefore worth revisiting the circumstances in which surpluses can be refunded directly to the employer, along with the tax treatment of such payments.

The legislative requirement for schemes to be fully funded on the actuary's estimate of a buyout basis could be replaced with a requirement for the scheme to be remain fully funded on a low dependency basis (less demanding but still cautious) after a refund had been paid, perhaps supplemented with an assessment of the employer's ability to repair future deficits. Any additional requirements imposed for a surplus to be transferred to another pension scheme could be mirrored here and we would not propose to interfere with any further restrictions or conditions within individual scheme rules.

The tax on refunds was originally set at 40% when the main rate of corporation tax was 35% and was reduced to 35% when the main rate was 30%. The original justification, from 1987, for setting the rate five percentage points above the corporation tax rate was to provide a "safeguard against employers seeking to withdraw scheme funds without proper regard to the interests of their members"[15]. That can be better achieved by setting conditions around when refunds are appropriate, especially now that schemes typically have much shorter time horizons and are less able to benefit from surpluses through contribution holidays.

The main rate of corporation tax is currently 25%. If tax on surplus refunds were charged at the same rate, this would still be above the rates applicable since 2012 – a period over which employers paid substantial deficit contributions, which would have attracted corporation tax relief at the rates prevailing at the time. It would also exceed the income tax rate that might typically apply where surplus is instead used to augment DB benefits. Aligning the tax rate on surplus refunds with the main rate of corporation tax therefore appears reasonable.

Even if policymakers conclude that the tax on refunds ought to be above the main corporation tax rate (for example, to avoid sheltering profits from tax in anticipation of cuts in the main rate, or because investment returns are taxed less heavily inside a pension fund), the current 10% differential looks too high – especially when contributions need to be determined in accordance with funding regulations.

[14] s20 of the Pensions Act 2008 (for employers complying on complying on a qualifying earnings basis) and Regulation 32E of the principal automatic enrolment regulations (SI2020/772) for employers certifying against an alternative quality test. In our experience, employers with legacy DB schemes are more likely to use the alternative DC quality tests prescribed in regulations. So, although primary legislation should ultimately be amended if it is felt to be an obstacle, changes to regulation could make a difference more quickly.
[15] Norman Lamont set out this view on behalf of the Government in the relevant House of Commons debate on 20 July 1987.

Section 4 : Helping DB members to benefit

Amending the tax treatment of certain payments to individuals

4. Remove some tax barriers to sharing surpluses with DB members.

Trustees' fiduciary duties require them to act prudently, but also in the best interests of scheme beneficiaries. They are therefore more likely to take investment risk where their DB members can benefit from the upside. Typically, this would be through discretionary pension increases. Some trustees will be particularly eager to provide such increases now that inflation has eroded the real value of members' benefits in a way that would not have been anticipated a few years ago: while pension increase rules vary scheme by scheme, it is common for increases in private sector DB schemes to be capped at 5%, and sometimes at 2.5%, or even not to increase at all for benefits accrued before 1997; meanwhile, 12-month RPI inflation was 12.6% in September 2022 (September being a common reference month for pension increases).

However, such increases can have tax consequences for individuals and the full impact of the benefit is spread over many years. Employers may also be reluctant to agree to the uncertain costs of increasing pensions due to be paid out not only in the current year but also decades into the future.

Making one-off lump sums 'authorised payments'

One way around this would be to permit DB schemes to make one-off discretionary lump sum payments. However, this is not normally possible under current HMRC rules, whereby any payment that is not an authorised payment attracts penal tax charges (minimum 40% for member and 15% for the scheme[16]). Broadly, in a DB scheme, the authorised benefits payable are a tax-free pension commencement lump sum (PCLS) and a DB scheme pension payable for life[17]. The scheme pension must not reduce from one year to the next and hence it is not possible to increase a pension just for one year.

Within a money purchase arrangement (which for tax purposes includes cash balance designs, as well as DC), there is already a facility for delivering one off payments – the ability to pay an Uncrystallised Funds Pension Lump Sum (UFPLS) has existed since the introduction of 'pension freedom'. This is a single payment, 25% of which is tax-free, with the balance taxable at the individual's marginal rate.

It is possible in theory for DB schemes to route a one-off discretionary payment through an UFPLS, but it would not be straightforward (because that is not what it was designed for). If there were a separate DC or cash balance scheme, or a DC/cash balance section within the DB scheme, surplus could potentially be used to pay a lump sum of the desired amount to that DC scheme/section with pensioners taking that amount as an UFPLS – though legal advice would be needed. Accessing pension savings via an UFPLS also makes individuals subject to the Money Purchase Annual Allowance (MPAA) going forward; currently, this means that an Annual Allowance charge would be triggered if more than £10,000 was paid into their DC pensions in any future tax year, with this amount subject to change. Trustees may worry about making their pensioners under age 75, some of whom may still be working, subject to the MPAA.

We therefore propose that the Government creates an equivalent to UFPLSs for DB schemes, by adding one-off discretionary lump sums as a new category of authorised payment.

If one-off DB payments are permitted, 25% should be tax-free (subject to the individual not having used up the full extent of their maximum tax-free lump sum amount) and 75% taxed at the member's marginal rate. This would be consistent with the policy intention behind not allowing pensions to decrease (in nominal terms) once in payment: tax-free lump sums would not be artificially inflated. (The tax-free component should be 25% of the one-off payment, not 25% of 20x the one-off payment.)

Abolishing the Lifetime Allowance creates an opportunity to permit these payments without worrying about BCE3 tests (under which pension increases above a permitted level trigger a Lifetime Allowance assessment).

Permitting such payments direct from a DB scheme could be conditional on all pensioners (or at least a sizeable subset of pensioners, for example all pensioners within the same benefit category) receiving either the same pound amount or the same percentage of their pension.

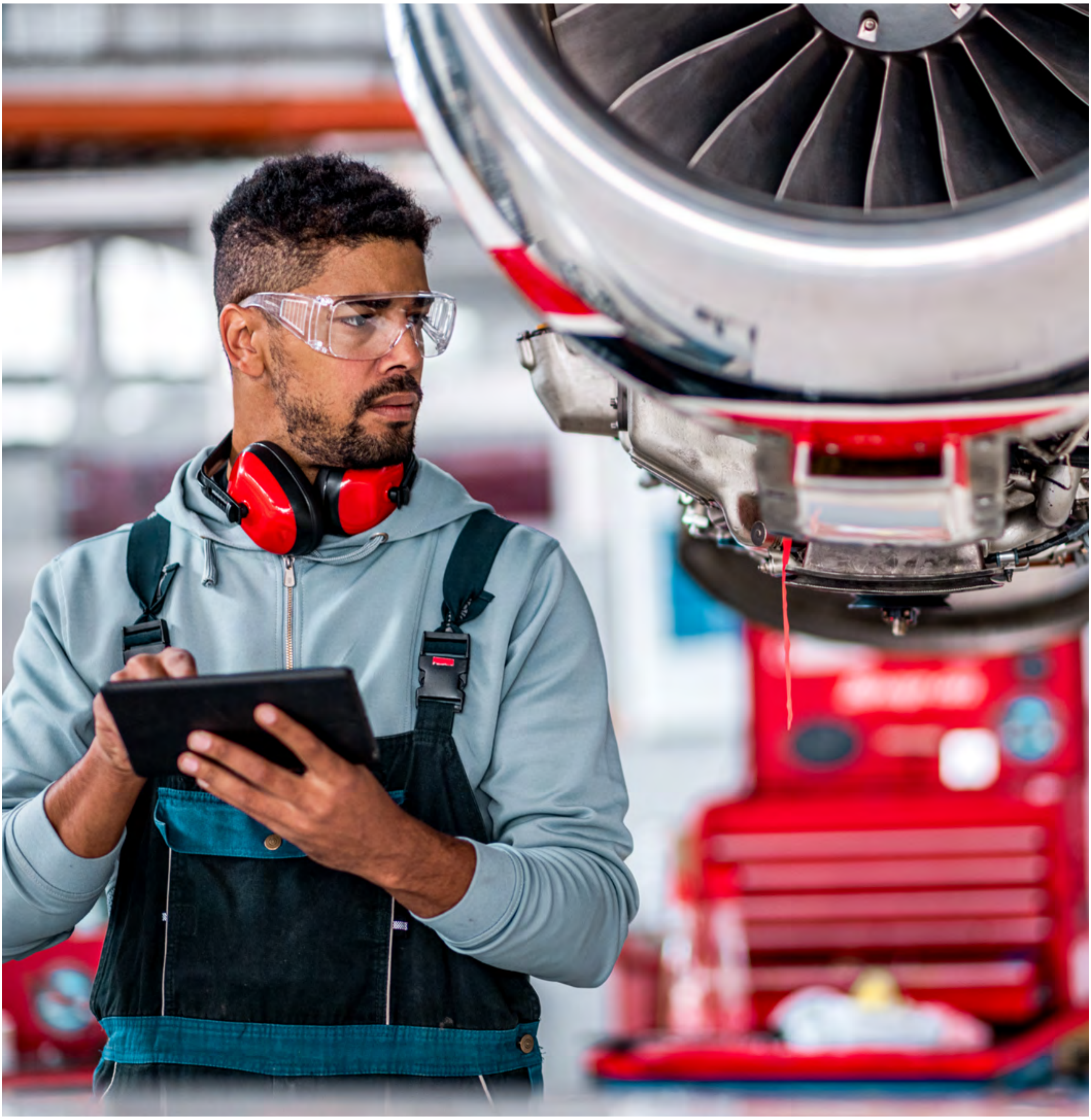
Similar to the points made in the previous section, although accounting standards are not the responsibility of the Government, it might also help encourage use of DB surplus to fund benefit enhancements if this did not increase the employer's pension costs for the purposes of its Profit & Loss account, or if this increase could be spread over time as allowed under US accounting standards.

[16] Sections 208 and 209 of Finance Act 2004
[17] Schedule 28 of Finance Act 2004, Paragraph 2

Linking employer gains to member gains?

Negotiations between trustees and employers may typically result in both parties gaining something from a surplus distribution. While we can see a presentational appeal of saying that, for example, members must get half of the benefit, this may be best left to individual circumstances: the appropriate split might be affected by scheme-specific factors such as the wording of scheme rules, the extent to which contributions previously made by the employer or members have led to the surplus, an offer of contingent security in exchange for a use of surplus that benefits the employer, or a historical practice of providing discretionary increases.

It also seems hard to prescribe that some of the money used to fund employer DC contributions must increase contributions above what the employer would otherwise have paid – e.g., this effectively penalises employers for having provided higher contribution rates to begin with, and it can be hard to prove what changes to pension plan design the employer would anyway have made for recruitment and retention reasons. But the Government could say that only employer contributions above the minimum values required to satisfy automatic enrolment quality requirements could be financed in this way.



Section 5 : Removing regulatory barriers

Supporting run-off strategies by revising the draft funding and investment strategy regulations

5. Ensure that the final funding and investment strategy regulations do not funnel schemes into excessive de-risking, and that they allow open DB schemes to thrive.

The draft funding and investment strategy regulations[18] would require assets for significantly mature DB schemes to be "invested in such a way that the value of the assets relative to the value of the scheme's liabilities is highly resilient to short-term adverse changes in market conditions".

This encourages further de-risking, potentially beyond the point of diminishing marginal risk reduction, which becomes more like "de-returning" than "de-risking"; uncertainty about which risks will materialise means it can be better to hold a broader range of asset classes and a prudent reserve. Moreover, as currently drafted, the regulations seemingly require schemes in surplus (on this 'low dependency' basis) to seek to maintain their current funding position rather than just remain fully funded; this will make it harder to use surpluses to benefit either members or sponsors – and therefore make it less likely that schemes will invest in a way likely to generate surpluses in the first place.

The Pensions Regulator has said it believes that holding "around 20% to 30%" in growth assets "could be consistent with the DWP's draft regulations"[19]. While this is a welcome intervention, trustees' legal advisers may not interpret the regulations in this way, so the regulations should ideally be changed.

[18] The draft Occupational Pension Scheme (Funding and Investment Strategy) Regulations 2023; DWP's consultation on these draft regulations closed in July 2022; current policy intention is that these regulations and an accompanying Code of Practice from the Pensions Regulator should come into force in April 2024

[19] Defined Benefit funding Code consultation document, TPR, December 2022

We envisage two mechanisms by which schemes could target a surplus against this sort of low dependency target:

a. The assumptions underpinning the low dependency target would be chosen prudently. The actual returns from holding a given percentage of growth assets should then be higher than the returns assumed in the discount rate, at least on average.
b. It should be possible to target more than 100% funding on a low dependency basis, with the aim of generating a surplus to share between members and the employer.

In finalising the regulations, the Government should aim to ensure that the wording does not preclude either approach.

The draft regulations also do not allow the Trustee to directly take into account for funding and investment purposes the potential value of contingent funding arrangements beyond the point of significant maturity. Changing this would also allow trustees to be more comfortable with taking some investment risk and releasing surpluses.

To continue to allow genuinely long-term, open DB schemes to operate successfully, including being able to invest substantially in growth assets and take a long-term view, they should be exempt from the requirement to fund for a low dependency target which they never expect to need. Contingency planning for closure could instead be required to ensure that such schemes are able to adapt if their circumstances change and they do, in fact, begin to mature.

Refreshing the Pensions Regulator's objectives

6. Revisit the Pensions Regulator's statutory objectives to encourage an approach to regulating DB pension schemes that considers members' broader interests beyond solely protecting accrued pensions.

The Regulator's statutory objectives are tilted towards reducing risk in the system and so tend to push it, and by extension the industry, in that direction.

The Regulator has objectives to "protect the benefits of members" (rather than, for example, to "look after the interests of members"), and to "reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund".

In 2014, the Government sought to rebalance the Regulator's work by giving it a new objective in relation to scheme funding: "to minimise any adverse impact on the sustainable growth of an employer". While this is strongly worded ("minimise"; "any"), it considers only direct effects on the sponsor – in contrast with the new "competitiveness and growth objective" which the Financial Services and Markets Bill currently before Parliament would give to the Financial Conduct Authority[20]. Moreover, perhaps the most visible consequence of giving the Regulator this objective is now being reversed: in 2014, the Regulator deleted the suggestion that deficits should be cleared as quickly as the employer could reasonably afford from its Code of Practice, but a similar requirement is now being inserted directly into law by the draft regulations[21]. If this requirement survives in the final regulations, it will be even more important to take steps to persuade employers that funding is not a one-way valve.

The precise objectives given to the Regulator should reflect policymakers' priorities. Options could include:

- Defending the interests of scheme members (rather than just protecting accrued benefits);
- Promotion of workplace pension schemes that are more likely to produce acceptable retirement incomes; or
- An objective to promote wider UK prosperity (potentially modelled on the proposed new FCA objective).

[20] Clause 24 in the version of the Bill as amended by the Lords Grand Committee
[21] Regulation 20(8) of the draft funding regulations

Section 6 : How can trustees get comfortable with this approach?

Trustees who have been on a de-risking journey for many years may rightly be concerned with the suggestion they should now slow the pace of de-risking – or in some cases increase risk above current levels. How might a trustee justify such a course of action given their duties to act prudently and in the best interest of beneficiaries?

Most importantly, as outlined above, trustees are more likely to take investment risk if their DB members could benefit from the upside. However, even putting that to one side, we believe there are circumstances in which trustees can get comfortable with returning surpluses to employers and continuing to take a manageable level of investment risk.

Ultimately, schemes need sufficient money to pay benefits as they fall due, and trustees will want a high level of confidence that this will be the case. Further, as schemes mature it is appropriate for them to reduce risks and move towards a 'low dependency' funding and investment strategy. However, low risk does not mean no risk, and we think the clarification from the Pensions Regulator that such strategies could have 20% to 30% in growth assets is helpful.

There also comes a point where the benefits from de-risking are outweighed by the reduction in expected returns such that de-risking perversely leads to lower returns in many downside scenarios. This typically occurs when target returns are less than around 1% pa above the yield available on gilts, at which point schemes are "de-returning" more than "de-risking". We therefore believe that, in conjunction with the proposals set out in this paper, it would be reasonable, and often sensible, for schemes to continue to run a modest amount of investment risk and for the surpluses generated to be used for the benefit of members and employers, rather than being retained indefinitely within the scheme. This is typically how insurers operate, usually investing up to 40% of their assets in productive finance, both in the UK and overseas, ultimately for the benefit of their shareholders. As noted earlier, it seems counter-intuitive for schemes to be de-risking significantly beyond this level, especially if they are on a path to buyout.

In other contexts, trustees have already been comfortable with running on pension liabilities and returning value to the employer. For example, under the Section 75 debt legislation employers ceasing to participate in a multi-employer DB pension scheme must pay a statutory debt equal to their share of the scheme's solvency deficit, which would in theory allow that proportion of the liabilities to be bought out with an insurer. However, under Flexible or Scheme Apportionment Arrangements, trustees can waive the requirement for the employer to pay some or all of the debt due at the time they cease participating in the scheme. The conditions that must be met to use a Flexible or Scheme Apportionment Arrangement at that time include a 'funding test' requiring the trustee to be comfortable that the remaining employers can continue to fund the scheme as required and that there is no materially adverse impact on the security of members' benefits. By satisfying these conditions, in some cases with contingent arrangements outside the scheme agreed as further mitigation, and taking into account the employer's interests as a relevant consideration, trustees have been able to get comfortable making use of these arrangements.

We believe that trustees could adopt similar principles in determining whether use of surplus for the benefit of members and / or employers is appropriate, potentially also seeking similar protections in relation to "regret risk" if things subsequently go wrong. This could also be supported by relevant TPR guidance, as is the currently the case for the alternatives to Section 75 debt.

Section 7 : Further opportunities with Collective DC (CDC)

Although not directly related to the opportunity that exists within existing DB schemes, the expansion of Collective DC (CDC) via multi-employer, master trust and decumulation-only arrangements should provide further opportunities for UK pension schemes to invest in higher returning assets for the longer term. This will become increasingly important as nearly all UK DB pension schemes in the private sector have a finite investment time horizon.

CDC schemes provide clear advantages over existing pension arrangements in delivering this opportunity:

- There is a clear benefit for CDC scheme members from the scheme adopting an investment strategy that targets higher returns – this results in higher incomes. At the same time, because employers are not underwriting the risk of assets underperforming, there is no employer resistance to such strategies. This makes alignment of all stakeholders' interests easier.
- Within a CDC arrangement, investment decisions are taken by trustees on behalf of individuals, rather than by individuals directly. This should support investment in a broader range of return seeking assets, which are held for longer.
- Unlike with DC (including drawdown), there is no need for daily pricing of assets, given that assets are held collectively rather than each member having their own 'pot'. This facilitates investment in illiquid assets, which are more difficult to incorporate into a DC vehicle.
- Unlike with annuities, there are no capital or regulatory constraints when it comes to investing in certain return-seeking asset classes. If an individual with DC savings is going to invest in CDC post-retirement, there is no need for them to 'lifestyle' their investments in the period before retirement into lower risk investments. This extends their time horizon for holding higher return-seeking assets, enabling investment in a broader range of asset classes and ultimately delivering higher expected returns.
- The ability to pool investments across a large number of individuals, and without individuals having the flexibility to withdraw large one-off amounts, provides greater certainty over future scheme benefit payments than may be the case for an individual's own drawdown pot. This more certain payment profile better lends itself to investing in long-term illiquid cashflow-generating investments.

Inevitably, there is a lot of uncertainty around how many DC savers might choose to convert all or part of their pot into a CDC income, rather than entering drawdown, buying an annuity or cashing out via one of more UFPLSs. This level of take-up may also increase over time, as an increasing proportion of future DC retirees will have no DB pensions at all. But there is an obvious gap in the market for a product that allows investment returns to be pursued in retirement whilst also providing a lifetime income that protects people against outliving their money. Indeed, the Pensions Minister has commented that CDC can "play a key role in allowing DC savers to turn their pension pot into an income"[22].

This highly uncertain level of take-up would determine the resources available for productive finance; around £5bn over the next 10 years seems a reasonable illustration, but much higher figures would be possible if CDC quickly proved a very popular retirement income choice.[23]

We therefore continue to support the Government's plan to bring forward draft legislation later this year to make all forms of CDC, including multi-employer, master trust, and decumulation-only vehicles, a reality so that everyone can benefit. Permitting decumulation-only CDC is perhaps particularly pressing: more and more people approaching retirement will have less and less in the way of DB pension income, so interventions to improve the adequacy of DC retirement savings are needed.

[22] Speech by Laura Trott at the Conservative Home pensions and savings conference on 22 May
[23] This assessment is premised on:
- It is projected that over the next 10 years UK workplace DC savers (excluding contract-based) will access c£200bn of pots for the first time (Source: Broadridge 2022 Navigator report)
- If all DC savers had access to CDC at retirement, perhaps 20% of savers' funds would purchase it rather than be taken as cash/drawdown (Source: WTW 2021 employee survey data suggests 57% of individuals want an income for life in retirement but FCA retirement income market data suggests only around 10% buy an annuity, implying an unmet demand)
- CDC investments in UK illiquid growth assets could be c15%, similar to that in annuities, whereas drawdown/cash holdings usually feature no illiquids.
- Combining the above, 20% of 15% of £200bn gives around £5bn (rounding down).

Section 8 : What about other suggestions?

Numerous suggestions have been made as to how to redirect DB assets towards investments that are more beneficial for the UK economy. These are typically aimed at altering one (or more) of the key factors that drive UK DB investment strategies, which in broad order of importance are:

1. Economics, e.g. benefits, funding levels
2. Incentive structure
3. Governance

No one (to our knowledge) is suggesting changes under 1 above. Our focus has been on proposing changes under 2 above. We propose that supporting schemes to change what they are trying to achieve is the main lever the Government should pull if it wants a larger, but still modest, proportion of DB portfolios to be invested in growth assets. Put simply, there is a risk/return trade-off at play and the current framework for DB is biased towards de-risking as there is insufficient upside for stakeholders.

The most common suggestions that aren't proposed in this paper are consolidation and changes to the PPF. Changes to the PPF are a variant of 2 above, but we are unconvinced that the effect on behaviour would be strong. Consolidation falls under 3 above, but in our view this is the least important factor influencing investment strategy.

Consolidation is not a panacea

While scale through consolidation undoubtedly confers advantages – such as the governance needed to invest in more complicated asset classes that might offer more diversification or better risk-adjusted returns, and a larger pool of assets to absorb fixed running costs – it is not a panacea. Further, there are already many actions being taken within the industry to pursue a bottom-up route to consolidation, such as through scheme mergers, outsourcing and sole trusteeship.

One difference between some of the large North American pension schemes, which are often held up as exemplars of a consolidated model, and a typical UK scheme, is that the former have much younger member profiles. For example, the Ontario Teachers' Pension Plan has six active members for every five pensioners and its active members have an average age of 44[24]. In PPF-eligible UK schemes, there are more than four times as many pensioners as employees accruing new benefits, and many schemes have no active members at all. Consolidating lots of mature DB plans into a single scheme with a comparable asset value would not give them the same time horizon as these overseas schemes when committing to investments.

More broadly, consolidating lots of DB schemes into a small number of "superfunds" would also introduce potential systemic risk. There may also be diseconomies of scale once these funds were to reach a certain size.

A change in schemes' objectives, so that fewer are targeting buyout and more are looking to generate surpluses for the benefit of members and employers, can influence investment decisions without having to grapple with some of the thornier issues around proposals to consolidate DB schemes – for example, the "entry price" for consolidators that sever the employer link; benefit reductions where schemes/sponsors cannot meet this; or managing member demands in scenarios where a consolidator has to cut benefits but the original sponsor remains profitable.

The PPF backstop

Some changes to legislation are necessary in response to the PPF's improved funding position (for example, allowing it to offer a levy holiday without losing the ability ever to charge a levy again), and the 2004 Act does not prescribe how resources held by the PPF should be used if they ultimately are not needed to pay compensation at current levels. We believe this is something the PPF and policymakers should look to address in consultation with the levy payers that have funded it to this point, as we have consistently argued, including in our 2016 submission to the Work and Pensions Committee[25]. The PPF has said it will be working with Government between now and 2025 "to develop an approach for utilising any excess reserves when the level of risk we face has sufficiently reduced"[26].

How PPF reserves should be used is linked to the question of how DB schemes invest. If policy changes lead to schemes taking more risk than they otherwise would do, this will increase risks of future claims on the PPF (at least initially, and from a low level) and, all else equal, make it appropriate that the PPF holds onto these reserves for longer.

[24] Annual Report 2022, Ontario Teachers' Pension Plan, page 47
[25] WTW's written evidence to the Work & Pensions Committee's 2016 inquiry into the Pension Protection Fund and Pensions Regulator, page 5
[26] The PPF's written evidence to the Work & Pensions Committee's inquiry into defined benefit pension schemes

Higher PPF compensation could reduce the potential losses to members in adverse scenarios and therefore make extra investment risk within DB schemes appear more justifiable. This should be considered, but it is not without problems:

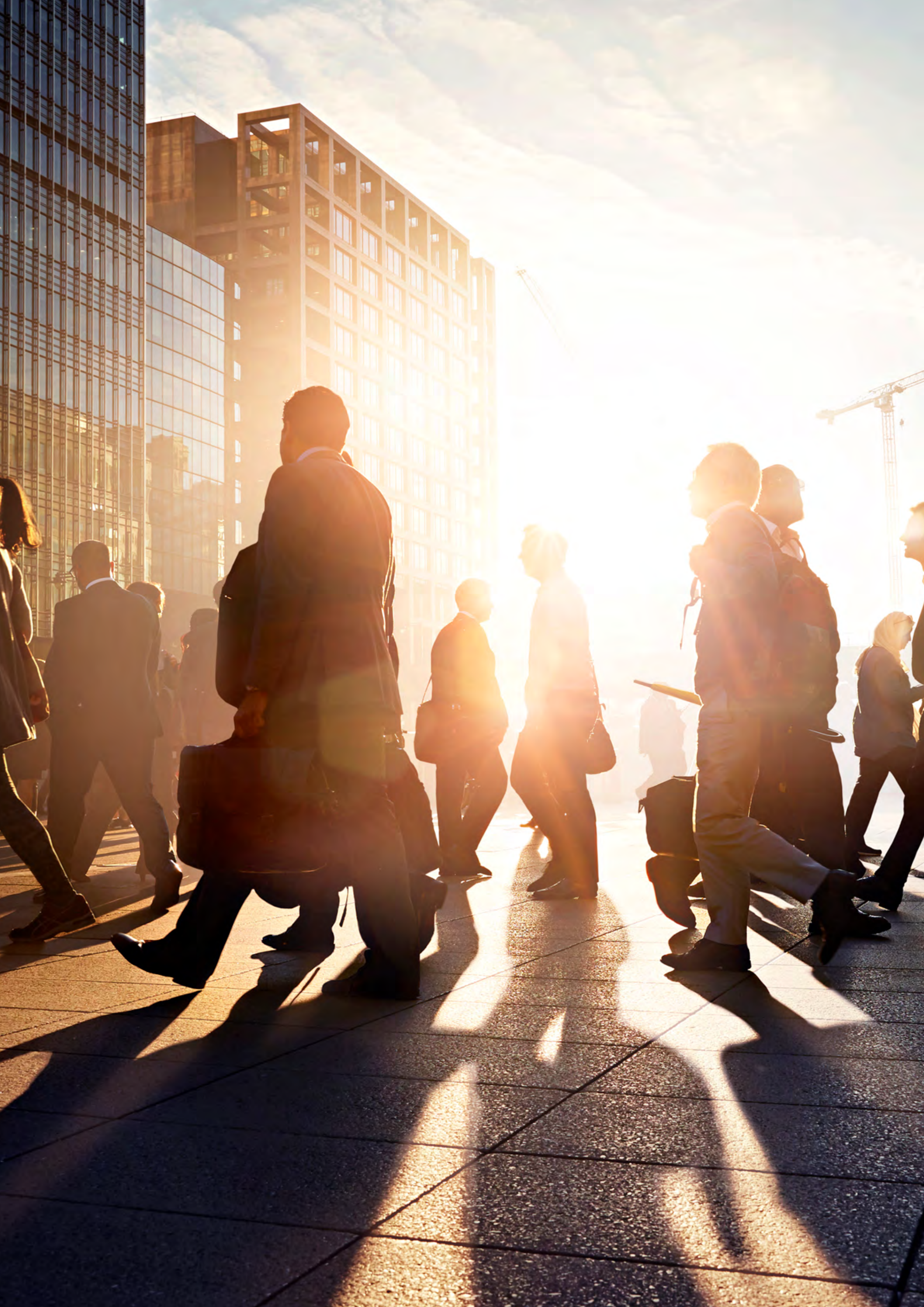
- If extended to existing PPF beneficiaries, while this would give back something to those whose benefits have perhaps been cut in real terms by more than was originally envisaged given recent high inflation, this would come at a substantial cost without any effect on the behaviour of existing DB pension schemes; indeed, by increasing the PPF's liabilities overnight, and reducing its reserves, it would weaken the PPF's ability to absorb risk arising from the actions of eligible schemes.
- If existing beneficiaries gain, some members whose schemes bought out a higher level of benefits outside the PPF following employer insolvency would have done better if their scheme had been less well funded.
- Pressure to extend similar treatment to the Financial Assistance Scheme could create costs for the taxpayer.
- On the other hand, elected politicians may understandably be reluctant to tell over 300,000 people[27] who already receive PPF compensation, or expect to, that an improvement will not apply to them.
- If a higher level of compensation were provided for future claims only, there would be questions around how the PPF's reserves would be apportioned.
- If schemes were allowed to "opt in" to a higher level of compensation, there would be questions around who should take this decision, whether it would be a one-off choice, how to manage selection risk, and how existing PPF reserves were apportioned between existing claims, new "core compensation" claims, and "enhanced compensation claims".
- PPF compensation can be cut; unless the taxpayer stood behind the PPF (which might not command public support when some people would be getting very large pensions), trustees could not rely on this as a copper-bottomed insurance policy.
- With the potential (eventual) use of PPF excess reserves currently under discussion (and the compensation paid to around 300,000 people a live political question in any case), it is not clear what level of core protection an opt-in policy would augment.
- Opting in to 100% compensation would leave the PPF to administer a different benefit scale for every scheme.
- Finally, the Pensions Regulator's Code of Practice on DB funding says: "trustees should not take into account the potential for the PPF to provide compensation to members of the scheme"[28]. The rationale is to avoid moral hazard, which is reasonable. However, if changes to PPF coverage are to make trustees more comfortable pursuing higher risk strategies, they are likely to need to be able to take some account of the PPF's backstop role in coming to that view. The moral hazard risk arising from such a change would be less now that most schemes are in surplus on a PPF basis[29].

Clearly, the Government would have its own preferences regarding how any increase in compensation would be delivered and would want to study the distributional effects – for example, removing the 10% "haircut" for members below normal pension age (which is anyway becoming less significant as more members pass normal pension age), or offering increases in a high-inflation environment (whether by giving some increases on benefits accrued before 1997 or by increasing the 2.5% cap on post-1997 pension increases).

We are not convinced that opting in to 100% coverage is feasible in practice, but it might merit further consideration if the points above could be resolved satisfactorily.

More broadly, however, amendments to PPF coverage may not trigger much of a change in investment behaviour in their own right. While they could be considered, we believe the six changes we have outlined in this paper will ultimately be more effective.

[27] The PPF had 294,847 members as at 31 March 2022, with a further 71,550 in schemes undergoing PPF assessment following an insolvency event; not all of the second group will ultimately enter the PPF
[28] Paragraph 35 of the existing Code. The same language features in the draft Code on which TPR is consulting paragraph 335).
[29] In its 7800 Index, the PPF estimates that, by 31 May 2023, those schemes in deficit of this basis had combined deficits of just £2.4 billion; this number had been £263 billion three years earlier.



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