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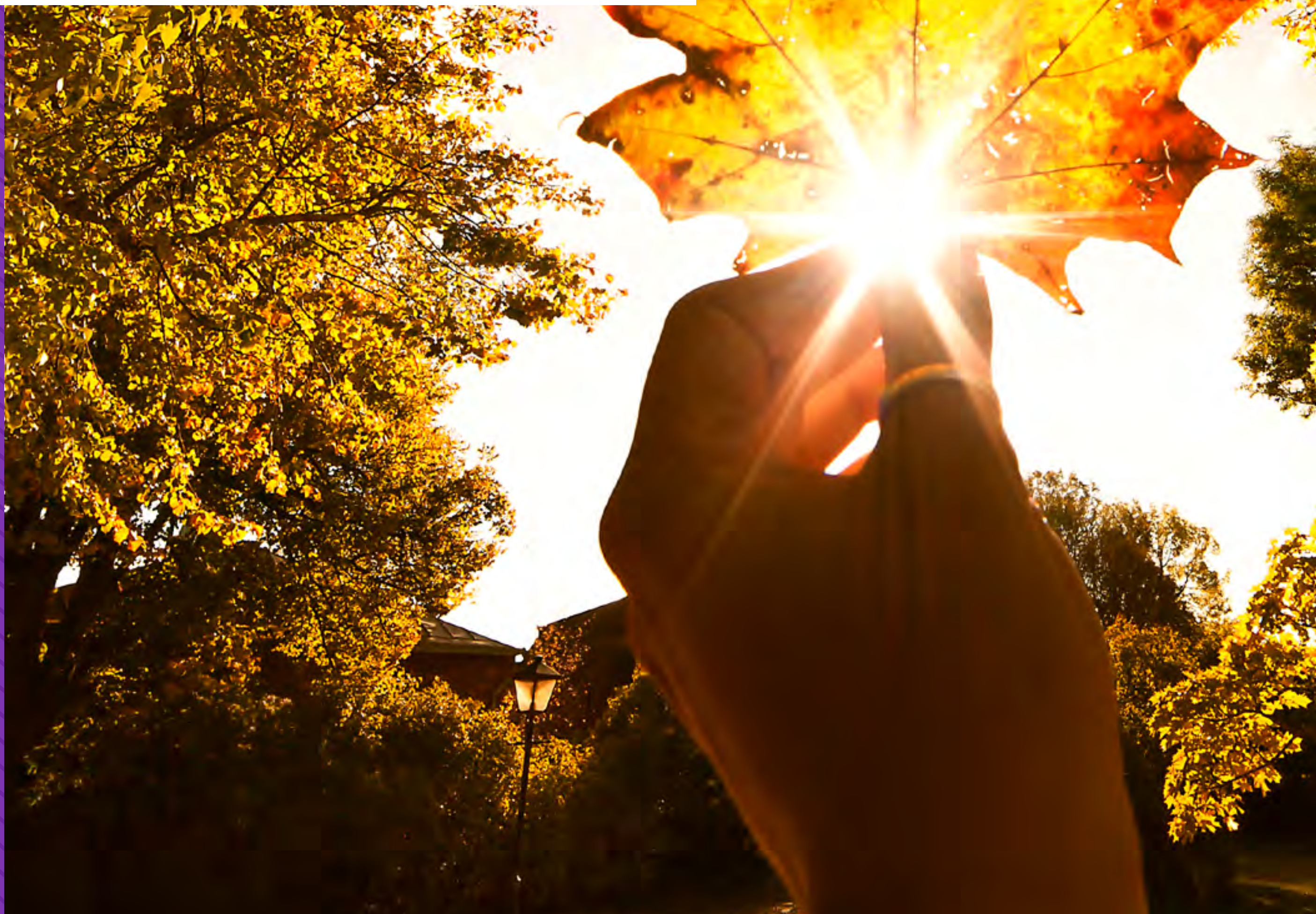
A golden opportunity to improve outcomes for pension savers

WTW's perspective on policy reforms following the Chancellor's Mansion House speech



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Foreword

There is appetite in Whitehall for far-reaching reforms to pensions policy. The Chancellor set the ball rolling in his speech at Mansion House on 10 July.

The DWP then issued a wave of responses to existing consultations, new consultations and calls for evidence, with two key themes:

- Better returns and member outcomes are to be expected if pension schemes invest more in "productive finance" assets
- This would be more likely with fewer, larger schemes — both defined benefit (DB) and defined contribution (DC)

The Chancellor laid out three golden rules that he says will guide policy decisions:

- Improve member outcomes
- Maintain resilience of the gilt market
- Strengthen UK competitiveness in financial services

This presents the opportunity for fresh, bold thinking on pensions. At WTW, we are fully vested in leading the way with innovative, creative and well thought through ideas that could improve outcomes for pension savers. In July, ahead of the Chancellor's Mansion House speech, we released a white paper, Six changes to seize the DB surplus opportunity, in which we suggested policy changes that would facilitate access, with the right checks and balances, to 'trapped surplus' within DB pension schemes — unlocking an opportunity to use the capital more productively for the benefit of employers, members, employees, and the UK economy.

In this paper, we set out and explain our perspective on the key points that should underpin policy reform, across DB and DC pensions.

What is productive finance?*

Equity capital and finance for businesses in the UK including start-ups, infrastructure, and private equity, as well as longer-term investments, typically in illiquid assets.

* Source: DB options call for evidence

Documents published by Government immediately after the Chancellor's Mansion House speech:

Calls for Evidence (CfE)	Consultation responses	New Consultations*	Other documents (not covered in this paper)
Options for Defined Benefit schemes Pension trustee skills, capability and culture	Defined benefit pension scheme consolidation Value for Money: A framework on metrics, standards, and disclosures Extending opportunities for collective defined contribution pension schemes	Helping savers understand their pension choices: supporting individuals at the point of access Ending the proliferation of deferred small pension pots **These also include responses to previous calls for evidence*	Analysis: Analysing the impact of private pension measures on member outcomes Consultation: Local Government Pension Scheme (England and Wales): Next steps on investments Collection of documents on: A Smarter Regulatory Framework for financial services

The WTW perspective

Pension reforms are looming large: In his speech at Mansion House on 10 July, the Chancellor said he had set the direction of travel and that final decisions would be taken ahead of the Autumn Statement. What this means in practice, time will tell.

In this paper, we set out our perspective on the key points that should underpin policy reform. In summary, these are:

1. Across DB and DC, member outcomes will improve in a regulatory environment that encourages greater investment in growth assets such as equities, corporate bonds, property, private equity and infrastructure.

2. In turn, being able to remain invested in growth assets over a longer time horizon will make it more viable for DB and DC schemes to invest in productive finance assets.

3. In DB, policies that lead to more investment in growth assets will be those that make the risk/reward trade-off more symmetrical than is currently the case. Our white paper[1] set out six changes that we believe are needed to reduce the current asymmetry. Absent these changes, schemes are incentivised to de-risk beyond what is economically desirable at a macro level for the Government's productive finance agenda.

4. In DC, recent Government policies have sought to reduce the number of small schemes, by consolidating them into larger arrangements that can be governed more effectively. Policies should further encourage this trend. Larger DC schemes are typically able to deliver better member outcomes through a wider choice of decumulation options, lower costs, better investment solutions and better member communication and engagement.

5. The big untapped opportunity in DC is to enable investment in growth assets for longer through CDC decumulation options. Currently, the only income options available are annuities or drawdown and both have drawbacks. Annuities require conservative investment strategies, and most individuals are not well-equipped to make complex decisions on investing and how much to draw down to avoid running out of money. CDC decumulation provides a middle ground that would benefit millions of people already saving in conventional DC plans rather than just the small group that may get access to whole-of-life CDC.

6. Consolidation in DB would not help with the Government's growth agenda. A small percentage of DB schemes hold the vast majority of assets. These largest schemes are already very well equipped to invest, either directly or through fiduciary mandates, in sophisticated and/or illiquid growth assets. Their challenge is the asymmetry in the risk/reward trade off, which leads trustees and employers to de-risk excessively (see 3. above).

7. There is, however, a case for consolidation of small DB schemes, where around 1,800 schemes have fewer than 100 members, which don't have the scale to improve member outcomes through effective and efficient governance. However, this one-third of private sector DB schemes by number represents just 1% (£15bn) of the £1.5 trillion private sector DB asset base and so their consolidation would be insignificant for the Government's growth agenda.

8. The PPF (or any other public consolidator) does not have a role to play where employer support is voluntarily severed. Some proposals are impractical, such as the Tony Blair Institute for Global Change's suggestion to consolidate 4,500 schemes into the PPF on the basis that this would take 18 years even if onboarding schemes at a rate of one per working day (which is completely infeasible for the PPF). Having a single entity onboarding thousands of schemes on multiple and complex benefits structures has prohibitive operational challenges that is better addressed through commercial consolidation solutions.

9. In our experience, low allocations in the UK to productive finance assets are not because of deficiencies in trustee knowledge and understanding. The trustee model works well and there is a risk that changes in support of the narrow productive finance agenda could be more damaging than helpful. Furthermore, board effectiveness practices and the ability to engage with high quality advice from a range of specialists are significantly more important in driving good member outcomes than deep subject matter expertise of individual trustees.

We set out further commentary supporting these views in the remainder of this document.

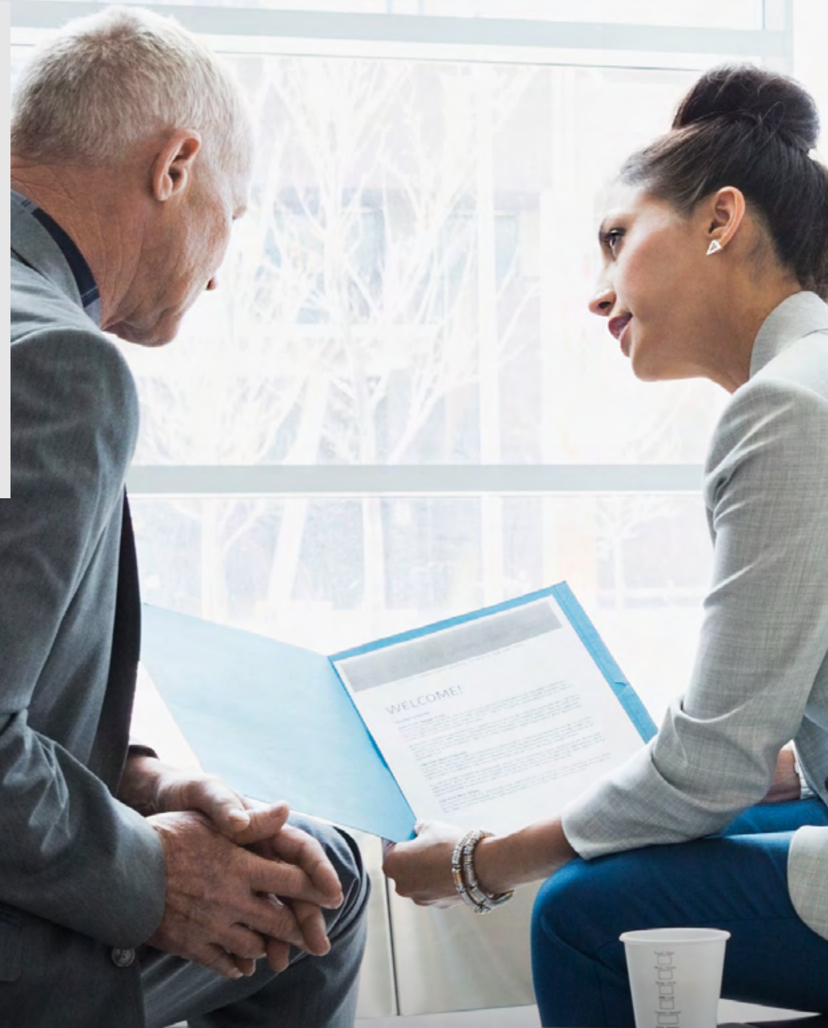
[1] Six changes to seize the DB pension surplus opportunity, WTW, July 2023

Six changes to seize the pension surplus opportunity, WTW, July 2023

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.

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 investment management mandates; and LifeSight, WTW's DC master trust, looks after the pensions of 325,000 members with approximately £14.5bn of assets under management.



DB schemes

Improving outcomes and consolidation

Key policy questions

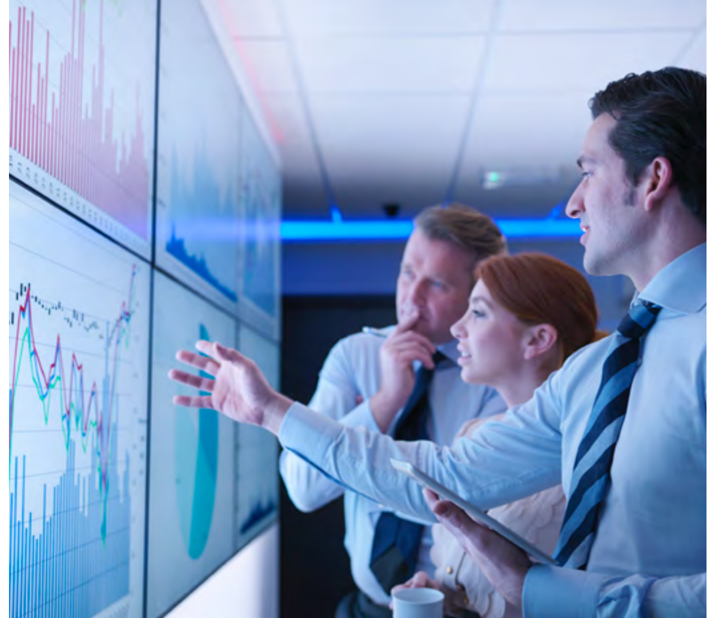
- Could the c. £1.5 trillion of DB assets be used to invest in productive finance assets?
- What are the opportunities relating to DB scheme surpluses?
- Would consolidation help? What role could the PPF play, as a public consolidator?

Productive finance assets are described by the Government as "equity capital and finance for businesses in the UK including start-ups, infrastructure and private equity, as well as other longer term illiquid assets".

WTW viewpoint in a nutshell

Making the risk/reward trade-off more symmetrical would lead to DB schemes investing more in growth assets. In turn, this would make it more viable for them to invest in productive finance assets, but the main advantages would be higher retirement incomes for many members and savers and access to capital for employers to grow their businesses.

Addressing the current asymmetry would be a more effective and faster acting lever for policymakers to pull than pursuing the rapid consolidation of schemes. We see no place for consolidation of larger schemes. However, there is room for governance of smaller schemes to be improved through a range of commercial consolidation models, although doing so would be of no significance to the Government's productive finance agenda.



In more detail

Closed DB plans are on a journey towards heavily de-risked asset portfolios. This is driven by the simple fact that once there is sufficient funding to deliver benefits promised to members, there is usually limited upside for either party (that is, for the employer or for the trustee, acting on behalf of their members) in taking additional investment risk, but the downside risk remains.

This asymmetry creates an incentive for all parties to reduce risk as soon as scheme funding levels permit. It also leads to some employers being reluctant to provide additional funding to schemes in deficit for fear of it being a one-way valve, with no prospect of reciprocation when deficits turn into surpluses.

Improved funding levels are allowing many schemes to de-risk more quickly than they had anticipated. Moreover, many "productive finance" assets are not considered sufficiently liquid for schemes looking to be "buyout ready". Many schemes are therefore moving in the opposite direction to the Government's productive finance agenda.

The alternative, at least for large schemes, would be to retain ***some*** exposure to growth assets. Not anywhere near the exposure to such assets that has been seen historically — we are talking here of assets invested with similar risk and return characteristics to portfolios run by insurers.

For this to happen, the risk/reward trade-off would have to be more symmetrical, so that members and employers can participate in upside. Policies would need to make it easier for DB members, employees saving through DC schemes and employers to benefit from DB surpluses, with appropriate checks and balances in place, but without providing any automatic rights to surplus to employers that could conflict with maintaining adequate benefit security. This would encourage more employers and trustees to retain growth assets (a subset of which could include productive finance assets) in their pension portfolios with the aim of making surplus generation more persistent. This would also benefit the wider UK economy.

Six specific policy changes advocated by WTW

Our July 2023 white paper, Six changes to seize the pension opportunity, proposed the following changes in pensions regulation:

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

Details of the rationale behind our proposals can be found in our white paper.

Is enhanced PPF cover part of the solution?

One idea receiving considerable focus is to address the potential downside that could arise from not fully de-risking when the funding position allows, by having the PPF cover full benefits for schemes, either universally or on an 'opt-in' basis where schemes/employers agree to pay higher levies.

This idea has merits in that it makes it easier for trustees to justify not de-risking as much as they might do otherwise (subject to trustees being allowed to take account of the PPF when taking investment decisions). There are, however, significant challenges, such as:

- How would employers and policymakers become comfortable that trustees will not take excessive investment risk given the fall back of full benefits being covered (replacing the existing risk asymmetry with a new one)?
- What would happen if the levies became unaffordable at the point cover is most needed?
- How would existing PPF reserves be apportioned between existing claims, new "core compensation" claims and "enhanced compensation" claims? Indeed is it appropriate to use any of these reserves for enhanced claims?

There would, in addition, also be significant practical challenges in the PPF administering different benefit scales for different schemes, of which it currently has no experience; the compensation the PPF currently pays is standardised but that would not be consistent with covering full benefits and any harmonisation would create "winners and losers" amongst scheme members.

If these challenges could be overcome, the idea would merit further consideration. That said, we believe creating the right upside incentives would, alone, result in larger changes in behaviour.

Would DB consolidation help the productive finance agenda?

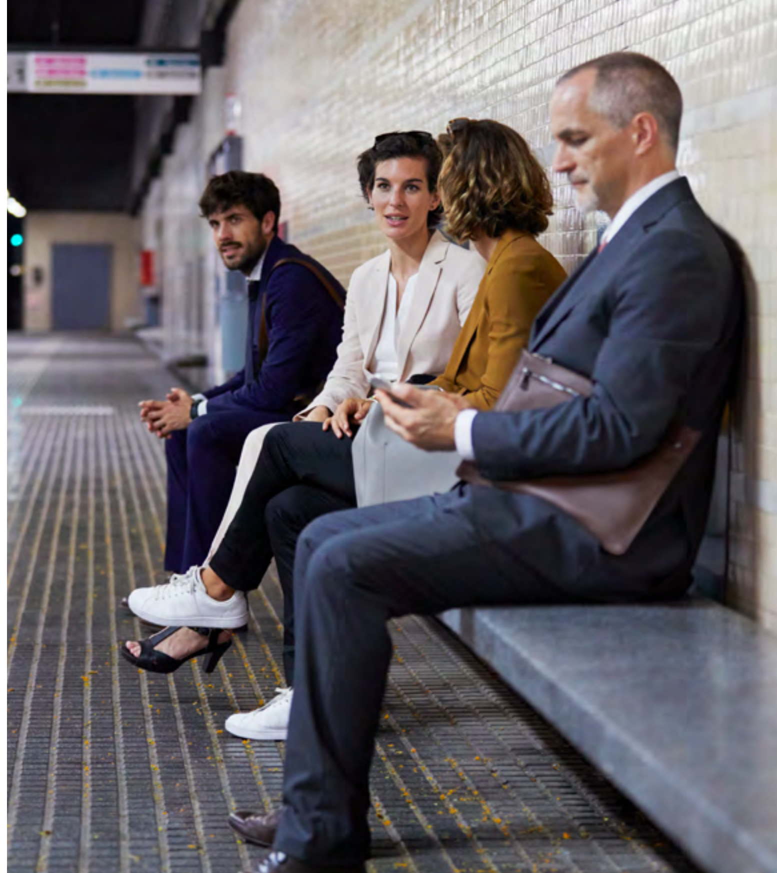
The short answer: No.

Fundamentally, the vast majority of the c. £1.5 trillion of DB assets are held by a minority of the largest schemes. For example, the largest 3% of schemes hold over 60% of total DB assets, and the largest 7% hold around 75% of total DB assets. On the whole, larger schemes can already access a diverse range of investment possibilities, including productive finance assets, either through direct investment or via fiduciary mandates. The barrier is the asymmetry in the risk/reward trade-off, which incentivises investment in lower risk, liquid investments; it is not a lack of knowhow or capability.

The three pathways available to DB schemes as they mature are to 'run the scheme on', undertake a buyout with an insurer, or transfer to a superfund. Each has a role to play, and between them they offer schemes a comprehensive set of pathways:

- **Continue to run the scheme on:** For some schemes, this will be their strategy for the foreseeable future. Many others will run on until they get to a point where they can buyout, which will be driven in part by funding levels and in part by capacity in the insurer market. Addressing the asymmetry in the risk and reward trade-off will enable these schemes to run-on for longer and to provide incentives not to excessively de-risk (from a macro-economic perspective)
- **Buyout with an insurer:** This is the current direction of travel for most schemes, and will effectively lead to consolidation of a sizeable number of DB schemes into a handful of insurers over time. There are limits on annual market capacity, with this capacity likely to grow only on an incremental basis (noting that the PRA has expressed concerns about the risks of aggressive growth in this market).
- **Transfer to a superfund:** For those schemes that can't afford buyout (now or in the foreseeable future) and that have limited and uncertain covenant to support strategies that run-off, superfunds provide an alternative consolidation option.

On the whole, we do not see the need for further commercial or public consolidation for these larger schemes. In particular, we cannot see schemes that do not fall into the superfund cohort, and so for whom buyout is an affordable option, being willing to otherwise consider options less secure than buyout, without there being potential upside for them or their members.



Can the superfund regime be improved?

Whilst we welcome a regulatory framework to support the DB superfund market and the changes noted in the Government's consultation response, we believe the regime proposed is still too onerous, and could inhibit the development of a thriving superfund market.

To change this, we would encourage statutory requirements, including timescales, being introduced on how TPR reviews and approves new DB superfund applications, as well as timescales for approving any individual transactions — this would add certainty for those investors looking to provide capital to DB superfunds. Furthermore, a risk-based approach could be undertaken by TPR in approving individual transactions if it has already been through an extensive authorisation process for the superfund.

The Government's response also identifies that schemes in PPF assessment might be able to achieve better member outcomes by transferring to a superfund. We agree with this. However, we believe many member outcomes can also be severely impacted given the current multi-year process for PPF assessment, which could see a change in the position of a scheme from being able to transact with a superfund, to no longer being able to do so. In addition, throughout this process a member would be receiving (lower) PPF compensation when full benefits may have been affordable. We would encourage legislative changes so that schemes of insolvent employers can have a time-limited period of grace to consider and execute a superfund transfer (or buyout with an insurer) before PPF assessment starts — this creates an opportunity to maximise member outcomes but also not excessively defer PPF assessment.

Consolidation for the smallest schemes?

Small schemes typically lack resources to ensure a high standard of operational governance, or the scale to invest efficiently in a broad range of asset classes.

Consolidation might lead to more of these schemes' assets being invested in productive finance, but the size of their assets — around £15bn for the 1,800 schemes with fewer than 100 members — makes this scarcely relevant to the Government's productive finance agenda.

Consolidating these schemes' governance arrangements can be achieved through various routes. DB master trusts are one solution (see below) and need not require ending the sponsor's obligations to the scheme. Another is consolidation of governance (e.g. through bundled advisory services or sole trustees). Additionally, as the superfunds market develops scale, we would expect smaller schemes also to have an option to sever the employer link via transfer to a commercial consolidator under the tests proposed by the Government.

Could DB master trusts play a bigger role?

Yes, although changes in legislation would help DB master trusts to gain traction and scale in the market.

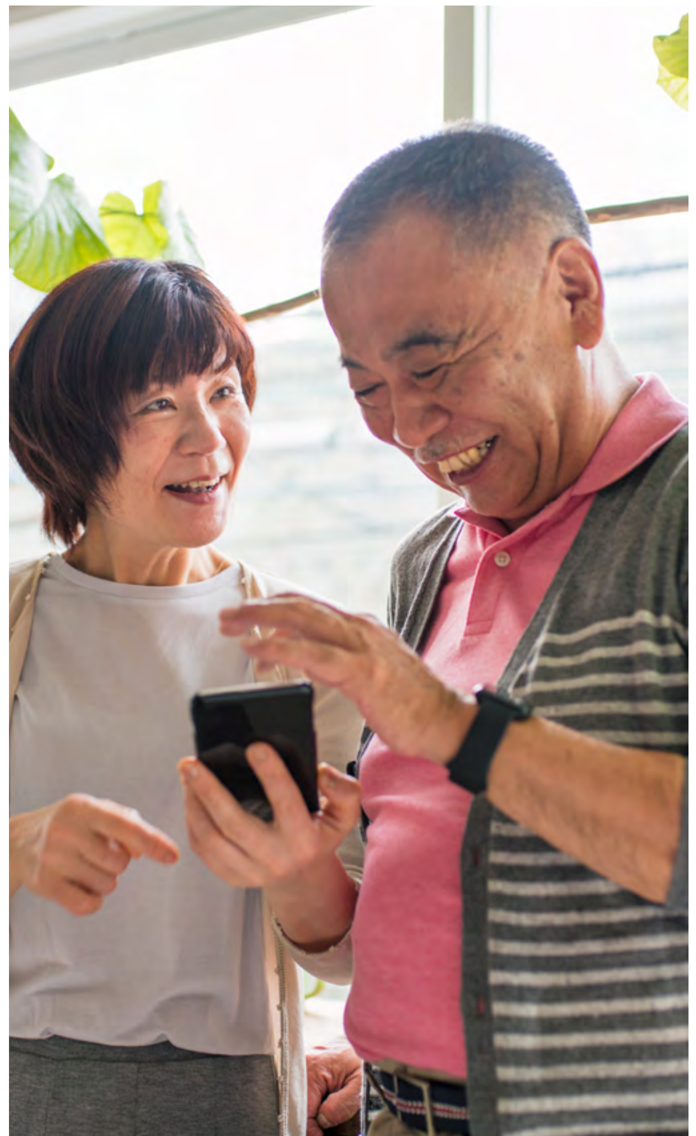
We have seen many forms for consolidation that drive improved investment and/or governance in a way that does not need to change the employer's obligations to a scheme — for example through fiduciary management of investments, consolidating advisors (i.e. bundled actuarial, investment and administration services) and the use of sole trustees — with all aspects being able to be delivered through the use of DB master trusts. However, the DB master trust market has struggled to gain scale with barriers for entry — it can be both expensive and difficult to achieve in practice as a result of needing to gain agreement from trustees.

As such, to support this market, we believe there should be legislative change that requires schemes below a certain threshold to consolidate to a DB master trust, if a request to do so is made by the sponsor (provided that the scheme's rules already permit the sponsor to appoint a sole trustee). This would still be subject to a requirement that members' benefits are not adversely affected although there might be room to simplify the way this is validated where an authorised master trust is used.

We would envisage the DB master trust should operate on a sectionalised basis for this purpose, and, as with DC master trusts, to have a more formal authorisation requirement managed by TPR.

Additionally, we would envisage that there should be appropriate guidance from TPR to make it easier for DB master trusts to change funding approaches, member options and operational considerations from how these were addressed by the ceding scheme to work within the master trust's framework, but ensure that each section still retains the ceding scheme's own rules, so that members' benefits and the employer-trustee balance of powers are unchanged. We would expect the commercial market to develop several DB master trust offerings, each being able to create improved scale across this smaller end of the DB landscape.

In addition, we believe consolidation in this way will be better for schemes who wish to undertake insurance transactions, for example through combined market deals that take advantage of larger scale than would otherwise be achievable for a stand-alone smaller scheme. Whilst we do not believe small schemes are unable to buyout, it can be challenging and there is no reason to believe this will become easier over the years given the significant number of smaller schemes in the UK DB universe where buyout is now becoming more financially feasible.



The PPF as a consolidator?

Fundamentally, we do not believe the PPF (or any other entity) as a public consolidator, whereby a scheme cedes employer support and ultimately becomes pseudo-Government backed or supported by other schemes, is a fair or optimal solution.

If the Government were to pursue this, small schemes (such as the 1,800 schemes with fewer than 100 members) would be the obvious place to start, from the perspective of delivering improved member outcomes through scale. However, consolidating very large numbers of small pensions schemes into a single entity would present huge operational and resourcing challenges, with no meaningful benefits for the Government's growth agenda, as the aggregate assets would still lack scale to make a meaningful difference to the UK economy.

The operational challenges of consolidating large numbers of DB schemes should not be underestimated. To date, the PPF has administered only a standardised compensation structure without many of the complexities inherent in numerous DB schemes' designs. Unless members' benefits were simplified at the point of consolidation, the PPF would have to administer scheme-specific benefit structures. This would be fraught with difficulties for a single consolidator of (potentially) thousands of schemes. Conversely, any attempts to standardise benefit structures has the potential to create winners and losers, leading to worse outcomes for some members, which would be equally challenging (and breach one of the Chancellor's golden rules). Homogenisation of benefits — with the associated winners and losers — is acceptable in the case of an underfunded scheme being admitted following sponsor insolvency as the 'alternative' (as in pre-PPF scheme failures) could be considerably worse. Where the sponsor is solvent, it is difficult to see that such homogenisation is justifiable.

Beyond administration, there would be many other significant areas to consider, such as:

- **who** underwrites the risk and supports the ongoing funding?
- **what** would be the entry price and the level of security offered?
- **how** would entry valuation assumptions and guidance be set and reviewed to ensure ongoing fairness?
- **who** would support any capital buffers required against risk?
- **what** happens to benefits if the consolidator is underfunded, especially if the ceding employers are still in existence?
- **how** would funding differentials at the point of entry be addressed?
- **what** is the justification for (and fairness of) employers being able to access the public consolidator support simply due to smaller scheme size?

These are significant issues that could impact the pensions market at a macro level, and stifle commercial and competitive offerings, as well as innovation in the buyout, superfund and DB master trust areas. If, however, the commercial market fails to respond to solutions for the smaller schemes over time (alongside the legislative changes noted), then a public consolidator may present an opportunity as a last resort. In this case, we see the PPF as an obvious candidate for this rather than setting up a discrete entity. However, this should be pursued only after the commercial market has been given the opportunity to develop first — by removing some of the barriers to DB master trusts we note above.

In any event, we consider that it would be necessary to segregate any new PPF consolidator section from the existing section that already provides compensation for members of underfunded, failed schemes; not least to protect the funding of the PPF that has been met by levy payers — which we would not expect to be used to subsidise any new PPF consolidation section.

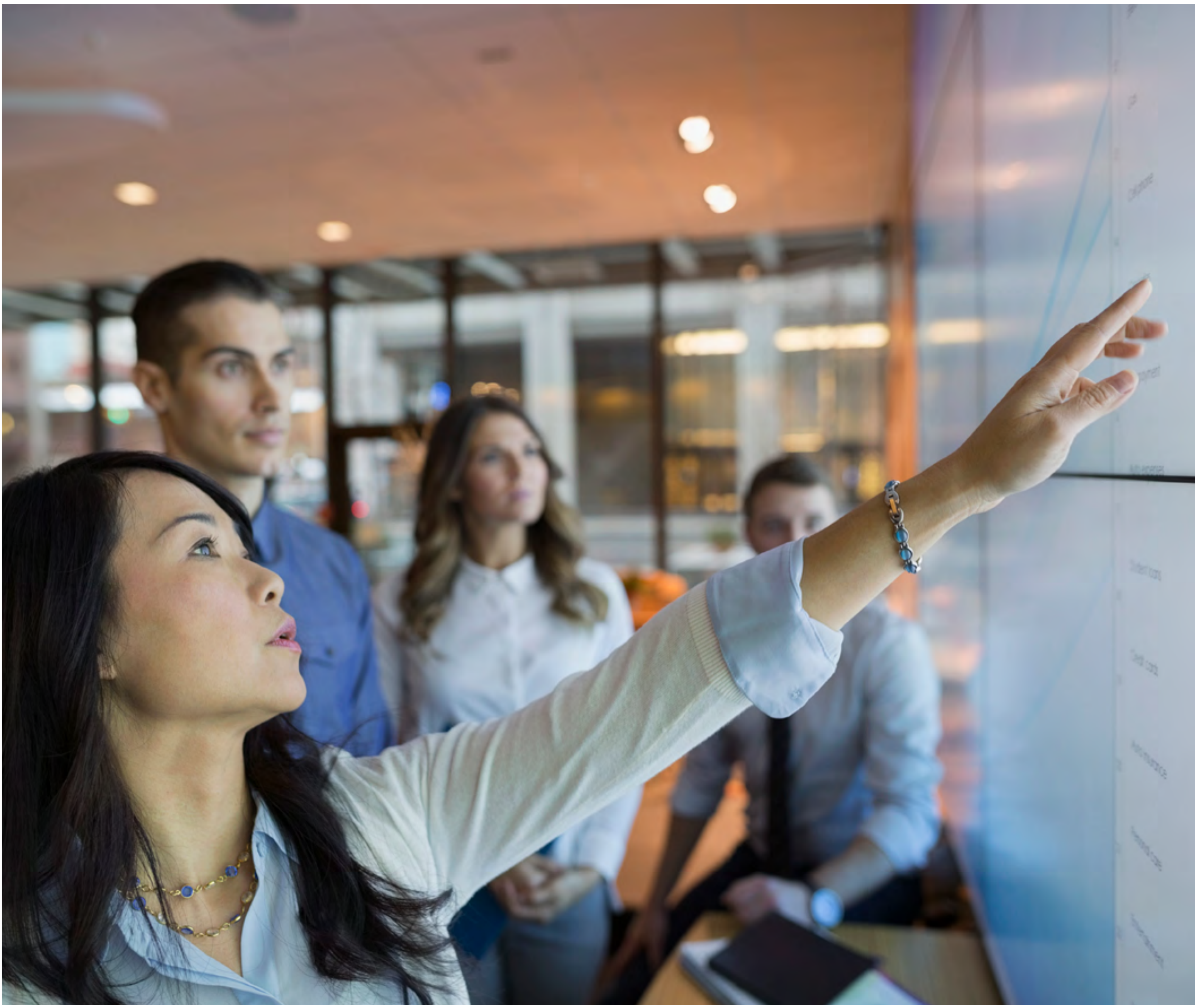
A radical solution has been put forward by the Tony Blair Institute for Global Change, involving the consolidation of all DB pension schemes into a series of c£400bn schemes. The proposal assumes the smallest 4,500 DB schemes would be consolidated to form one of these large funds in the region of £400bn. This is highly impractical as even if these schemes were fully onboarded at a rate of one per working day (which is completely infeasible), this would take 18 years to achieve. Moreover, funds of this scale could cause gilt market distortions, breaching one of the Chancellor's golden rules.

In our view, ideas need to be grounded in the practical reality of pensions and avoid the country embarking upon projects with epic risk of creating unnecessary pension turmoil.

A PPF-managed UK Productive Finance Fund

The PPF has established a track record of success in managing its portfolio of assets. Similarly, NEST has quickly achieved significant scale and is helping achieve good member outcomes from its diversified portfolio. Both non-departmental bodies have the scale and expertise to successfully manage a portfolio of productive assets.

As such, an alternative that could be considered instead of setting up a public consolidator to take over the complex administration of multiple scheme benefit structures, would be to use either or both the PPF and/or NEST's expertise in establishing and managing a 'UK Productive Finance Fund' that could be unitised and made available to all schemes to incorporate as part of their wider investment strategy. This could be attractive to many pension schemes — both DB and DC and across the spectrum of size — and would likely achieve the Government's objective of directing much needed investment into productive assets more quickly and without the complications and difficulties arising from other proposals. This would also avoid any potential conflict with commercial consolidators (whether insured buyouts, 'Superfunds', Master Trust or other structures). Indeed, over time, the fund need not be limited only to pension fund investors. However, we recognise that this would raise other 'market' considerations (with regards to the potential impact on other fund managers and whether there is some undue competitive advantage). We also acknowledge that running an investment portfolio for their own members is a different proposition from establishing and operating a fund for third parties and neither NEST nor the PPF currently have the resource and knowledge necessary to operate as a fund manager for third parties.



DC and CDC

Improving outcomes and consolidation

Key policy questions

- Do DC schemes offer access to the full range of asset classes, including infrastructure and private equity?
- Do they have the scale and expertise to deliver Value For Money (VFM) and better member outcomes?
- Do they offer access to drawdown at the point of decumulation? Should the options available be extended to include decumulation Collective Defined Contribution (CDC)?
- How should small pots be consolidated?

WTW viewpoint in a nutshell

Scale and expertise are important in DC. We welcome the revised VFM framework and expect it to deliver better member outcomes and to encourage further consolidation in DC.

Requiring DC schemes to offer access to and communicate the full suite of retirement options, including drawdown, will be a step forward (bearing in mind most members prefer drawdown to buying an annuity).

Legislation to enable decumulation only CDC should be brought in as soon as possible. This has huge potential to reach many more savers than whole of life CDC and to substantially improve their expected retirement incomes.

We welcome the extension of auto-enrolment and proposals to consolidate small pots into a consolidator vehicle.

Mansion House Compact

One of the big announcements by the Chancellor in his Mansion House speech was that nine large DC pension providers have pledged to allocate five per cent of assets in their default funds to unlisted equities by 2030, as part of the 'Mansion House Compact' — a new, non-legally binding agreement. This is expected to channel £50bn of DC assets to productive finance assets. The Chancellor believes that this, in combination with the other measures being announced, will have the dual benefit of boosting investment in UK industries while also potentially increasing a saver's retirement outcomes.

The effect of this is to gain commitment from the pensions industry to enable DC savers to invest in a broader range of assets. This should help create an impetus and lead to innovation, which can only be good for savers.

Will the new VFM framework encourage further consolidation?

Unlike the DB market, significant consolidation is already happening in the DC landscape through an increasing move from single-employer DC trusts towards multi-employer commercial master trusts.

We support this direction of travel, which we expect to continue. This is on the basis that with the master trust model, when compared with both contract and single employer trust-based schemes, we see:

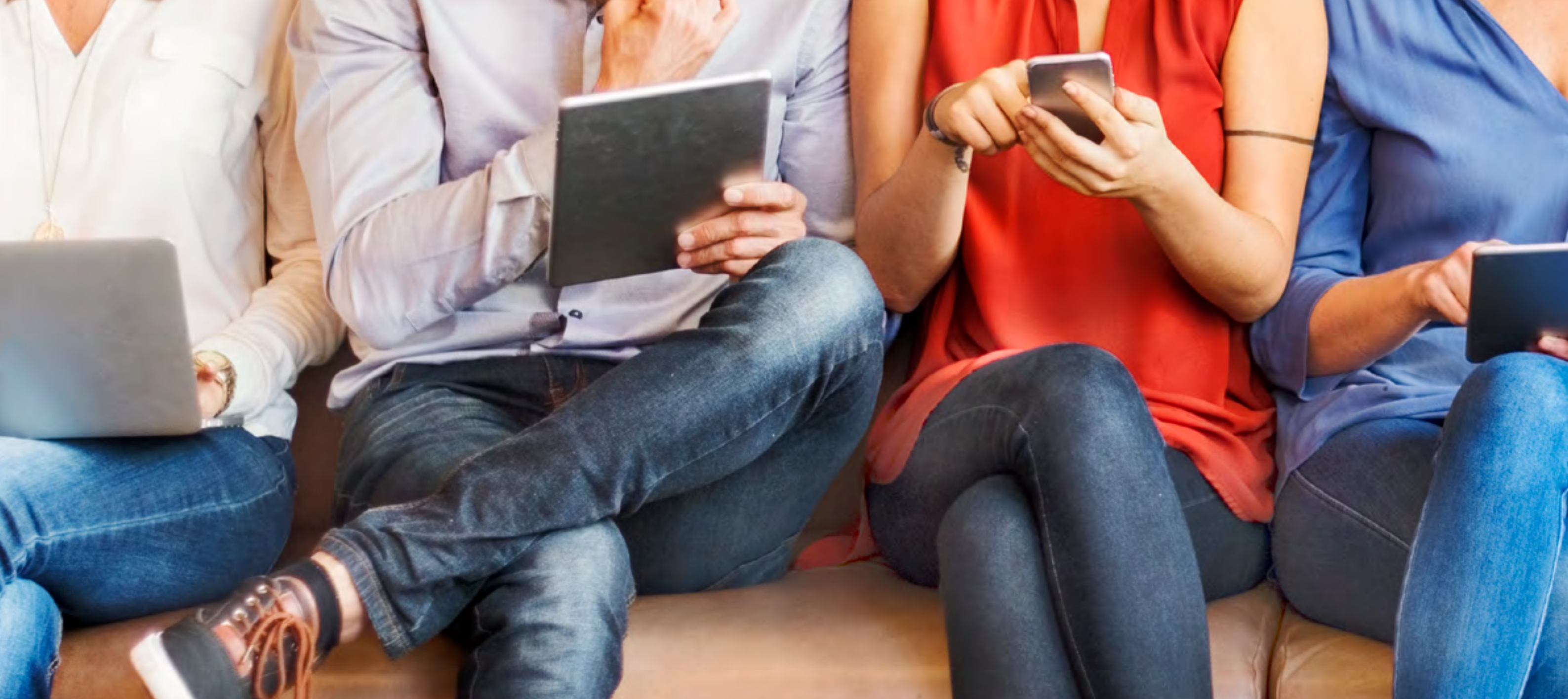
- Significantly better member communication and access to a fuller suite of retirement options, which should lead to better outcomes for members
- Fees that may be lower, sometimes by multiple tens of basis points.

We welcome the new VFM framework, which will broaden the current limited focus on costs to a more holistic and informed assessment of value for members. By focusing on value, the proposals also seek to encourage schemes to consider factors critical to improving longer term member outcomes, including those in relation to investment. We expect that the new VFM requirements will increase the pace of DC consolidation.

Equally, those remaining single-employer trust-based schemes that are well run and have sufficient scale and resources available to them, could fare well under the new assessment approach and will continue to be the vehicle of choice for some employers.

The DWP has said it will work with the FCA to consider allowing the bulk transfer without consent of contract-based arrangements. This is something that WTW has been advocating. If successful, it will broaden the focus on value for members and DC account consolidations to a much wider audience.

However, fundamental to consolidation being catalysed will be the effectiveness of regulators in compelling poorly performing schemes to take the necessary action.



Decumulation only CDC — the missing piece of the jigsaw?

Laura Trott MBE, the Minister for Pensions, has stated that CDC in decumulation is a key policy aim and we are pleased to see the Government's intention to develop a decumulation-only framework.

CDC decumulation offers a middle ground between annuities and drawdown options. We strongly believe it will have a very significant beneficial impact on member outcomes and the ability to benefit the broadest subset of current pension savers. It has the potential to:

- materially increase, by around 50%, members' expected annual incomes compared with traditional annuities; and
- enable a generation of millions of existing DC savers to remain invested in growth assets into retirement without the risks presented by drawdown of drawing too much or too little of their savings each year.

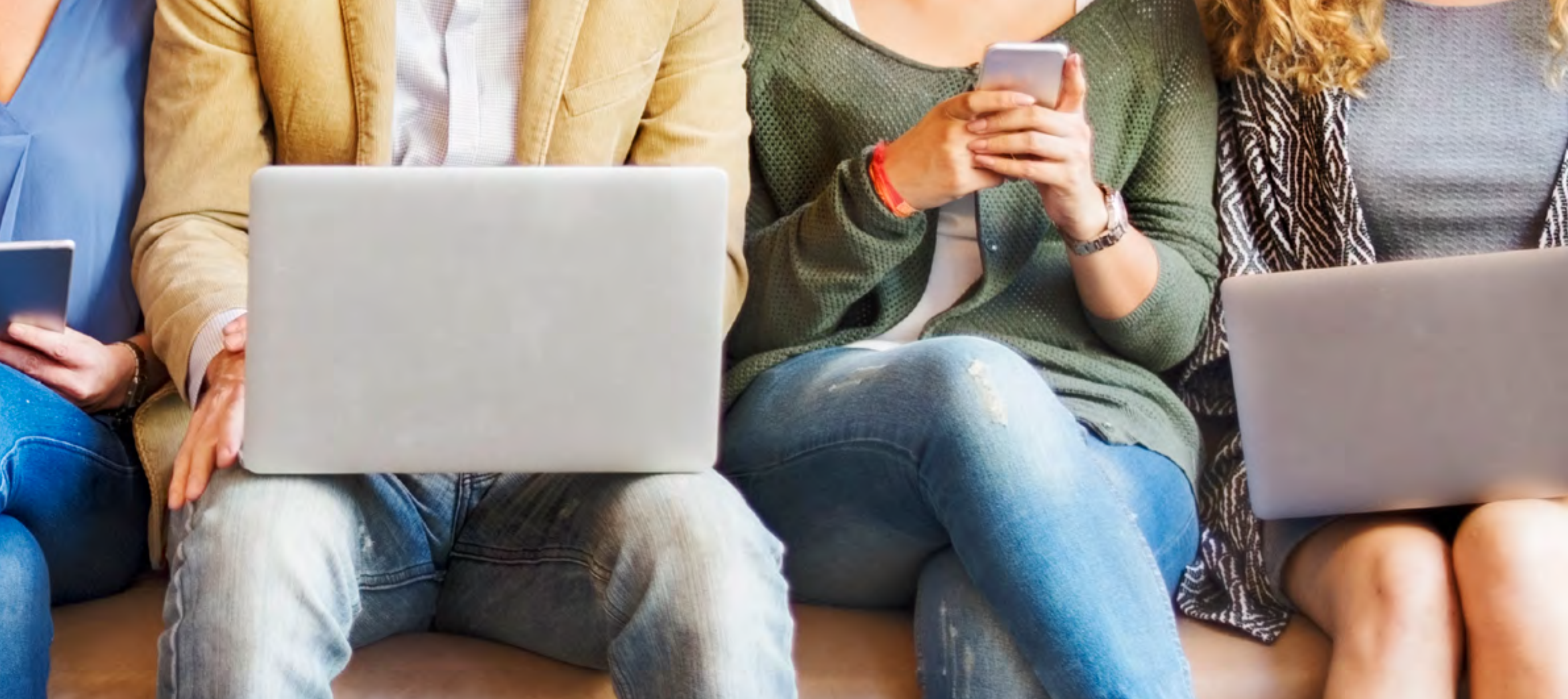
A market for CDC decumulation could mean around £5bn over the next 10 years being invested in productive finance assets, depending on how popular CDC becomes as an option.

Moreover:

- 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.
- Growth assets will be held for a longer period of time as there is no need to "lifestyle" out of them as individual members approach retirement.
- Unlike with DC (including drawdown options), 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 traditional DC vehicle.
- Unlike with annuities, there are no capital or regulatory constraints when it comes to investing in certain return-seeking asset classes.

Despite strong support from Government for decumulation only CDC, it is disappointing that there is no clear timetable as to when the Government will bring forward legislation in this area. We urge the Government to do so to help provide clarity and certainty to providers who would be crucial in ensuring that this market evolves.

However, we are pleased to see draft regulations permitting a wider range of whole-of-life CDC vehicles (through an extension to multi-employer and master trust arrangements) and designs (which will also benefit single employer schemes). In practice these will take longer to have a meaningful impact on member outcomes than focusing on the needs of the many DC savers who could benefit from CDC decumulation more rapidly and in respect of a much greater proportion of their retirement savings.



Enhancing DC decumulation options further

In our view, it is important that the minimum level of retirement support offered by trust-based schemes is improved. In particular, we believe that:

- Trustees should ordinarily be required to facilitate a full suite of retirement solutions which includes access to a drawdown facility (either within the scheme or via an external arrangement).
- Where they do not, trustees should be able to clearly articulate why access to these solutions is not appropriate for their membership.
- Whilst there are likely to be some set-up costs with these proposals, we do not see this as a significant barrier to the objective of helping members access solutions at retirement.
- Trustees should facilitate access to guidance and advice, even if this is paid for by members.

Over time, we see merit in having minimum quality standards for retirement support and facilitated options including an assessment approach similar to the VFM assessment.

Automatic enrolment (AE)

We support requiring that automatic enrolment contributions commence from the first pound of earnings and bringing forward the enrolment age to 18 from 22. The pensions minister has said she hopes to consult on the implementation of these changes in the autumn, and we hope changes will begin as soon as possible after elevated short-term cost of living pressures ease. Whereas most of the initiatives under consideration aim to improve outcomes by making the money that is saved for retirement work harder, increasing the amount paid into DC pensions in the first place is also necessary to improve adequacy.

Small pots

The Government has been grappling with the issue of small pots (i.e. small DC pots left behind across multiple arrangements as individuals move jobs) for some years. Our high-level views on its proposals are:

- We broadly welcome the concept of small pots being aggregated with a consolidator vehicle, which means ruling out other proposals such as "pot follows member".
- However, we believe there are strong merits in having a single consolidator rather than a panel of multiple consolidators (which we expect are likely to be master trusts).
- We believe the regime should allow refunds for micro-pots (of, say, less than £100) rather than forcing consolidation of these.
- It would be sensible if the timing for when small pots are considered to be dormant is aligned to AE re-enrolment timescales.
- Suggestions that employees, rather than employers, should select the pension provider risk much higher marketing costs being passed on to savers through higher charges.

Pension trustee skills, capability and culture

Key policy questions

Whilst the Government is currently consulting on a broad range of issues related to the skills, capability and culture of pension trustees, the following are the most pertinent themes being explored in relation to its growth agenda:

- What role do and should trustees play in relation to investment decisions?
- How do trustees balance investment return decisions with other factors? Are they overly risk averse, particularly in relation to alternative asset classes?
- Are there barriers that restrict their ability to invest in productive assets?

WTW viewpoint in a nutshell

We do not believe that under-investment in productive finance assets is caused by a lack of knowledge and understanding amongst trustee boards. Based on our experience with our own clients, trusteeship is working well — albeit we have limited exposure to the large number of the very smallest schemes. We would be concerned that too narrow a focus on trustee understanding and knowledge of investment matters leads to unnecessary disruption of what is a strong and effective governance model.

Additional prompts to improve trustee board effectiveness more generally, such as those provided by TPR's General Code, are welcome and together with access to high quality advice, are a stronger determinant of good member outcomes than deep investment subject matter expertise.

The more likely and direct causes of under-investment in productive finance assets, in DB and DC schemes of different sizes, are addressed earlier in this paper.

Trusteeship is working well

WTW works with several hundred DB and DC trust-based schemes. The majority of these have trustee boards, whilst a number have sole trustees in place. Our experience across the spectrum is that the governance of these schemes is good. Too narrow a focus on investment expertise within trustee boards risks disrupting this well-functioning system.

A key to effective governance is clear dividing lines between advisers, who advise, and trustees, who crucially make decisions in the best interests of members, taking into account the advice they have received. The existence of and clarity over these dividing lines must be maintained even if increased investment expertise is added to trustee boards.

We recognise that there are some concerns about trustee skills and capability for the smallest schemes, and our experience of working with such schemes is relatively limited. As noted earlier, there are approximately 1,800 DB schemes with fewer than 100 members, and less than 1% of these are WTW clients. Consolidation of these smallest schemes is desirable from a governance perspective, but has real practical challenges, as discussed earlier and will not make any significant contribution to increasing investment in productive finance assets.

Where the scheme is governed by a trustee board, we find that the effectiveness of the board is down to the mix of skillsets amongst the board combined with an inclusive culture. Trustee boards are stronger where the set of skills is diverse. It is not necessary or desirable for every trustee to be an investment expert.

More broadly, we consider that the skills and experience of trustees are more important to their effectiveness as trustees, rather than knowledge and understanding of particular subject matter. Indeed, there are examples of individuals in decision-making roles who have strong and dominant views based on their narrow field of expertise, which lead to decisions which are sub-optimal in the round. There is so much more to trustee effectiveness and member outcomes than investment capability.

There is a risk that the changes being considered, for example through an accreditation regime that is too onerous or too wide, could disrupt the current trustee model from working effectively by reducing the diversity of skills and experiences. Trustees who may not have deep subject matter expertise in some fields bring a perspective that supports important decisions on a wide range of governance issues across communication, funding and administration.

DB: low-risk asset portfolios are not driven by trustee deficiencies

Investment returns targeted by schemes and their trustees are primarily driven by their funding objectives. Because funding levels are much improved, schemes typically need to target relatively low returns to meet their objectives. Absent an incentive to target surpluses, this has led them to de-risk, moving out of growth assets (including productive finance assets).

Indeed, many schemes are reducing their investments in illiquid assets as preparation for buyout, which is in sharp contrast to the Government's objectives.

In our experience, it is these factors, and not deficiencies in trustee knowledge and capabilities, that lead to what may be regarded as lower risk asset portfolios than might be seen in other jurisdictions. Taking into account their growth and liquidity targets, and a desire for diversification within their growth portfolios, trustees make sensible allocations to alternative asset classes.

Looking at the different segments of the market, the very largest schemes hold the majority of UK DB pension assets, and are therefore the most relevant to the Government's productive finance ambitions. These schemes, in our experience, have very strong trustee boards as well as best in class advisory support. They are therefore very well-governed, and have the sophistication to access alternative asset classes in a variety of ways.

The mid-market is also well-governed, through a mix of trustee boards or sole trusteeships. It also has the means to access alternative asset classes, typically through fiduciary mandates and pooled funds.

The small end is very fragmented and could benefit from some degree of consolidation, in order to improve scheme governance. As discussed earlier, multiple commercial consolidation providers and solutions should be encouraged, in order for the pension system to be able to cope with the operational burden of consolidating these schemes.

DC has different challenges with investing in unlisted equities, but it's still not a lack of trustee knowledge and understanding

The quality of trusteeship and governance effectiveness for large DC schemes and for master trusts is, in our experience, very high, and neither board effectiveness nor specific investment knowledge and understanding present a barrier to DC schemes investing in productive finance assets.

As discussed earlier, the biggest challenges with DC schemes investing in illiquid assets is the need for daily dealing and the higher associated costs, in an environment where currently value for money is looked at through the lens of costs. Overcoming both challenges requires scale, and historically the very fragmented nature of DC schemes has meant that the scale has not existed.

Pension policy is helping address both of these challenges. It has encouraged DC schemes to consolidate, leading to fewer and larger schemes. Moreover, the value for money framework is being changed to focus on value, rather than cost.

The emergence of a smaller number of larger DC schemes and master trusts is then enabling innovation and investment in technology which will allow them to make a wider range of assets, including unlisted equities, available to members.

WTW's view is that there is huge scope for further innovation in this area. On our part, we are committed to leading the industry in developing new solutions.

What next?

The outcomes of the Mansion House package could mark a historic moment in pension policy reforms. The potential benefits to employers, members, employees and the UK economy means the issues raised and proposals made should not be overlooked as they present a golden opportunity.

Timing is also key — if the Government delays moving forward on policy changes, positive outcomes for members will be missed and possibly for some schemes, change might just be too late.

Regarding the proposals made, the Chancellor said in his Mansion House speech: *"Tonight I lay out the direction of travel. Sometimes consultations will be necessary, but all final decisions will be made ahead of the Autumn Statement later this year."* The issues raised are hugely important to the future of UK pensions, but to make changes a reality requires momentum and cross-party support to avoid the risk of further uncertainty and policy reversals. Time will tell where this all lands, and WTW will continue to advocate for positive regulatory change based on the views we have set out here.

Contact us

Thank you for reading. If you would like to discuss any of the topics raised, please contact your WTW consultant or one of our area specialists below.

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About WTW

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