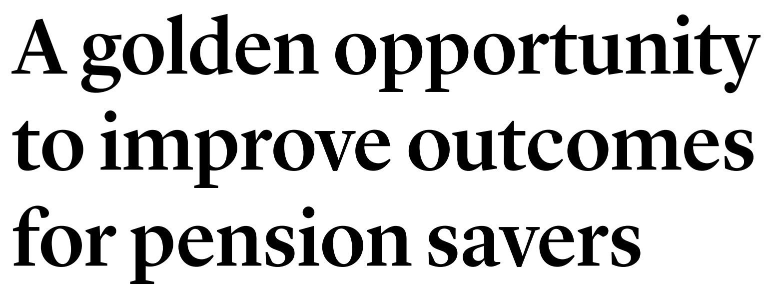
wtw



A golden opportunity to improve outcomes for pension savers

DB schemes — Improving outcomes and consolidation

wtwco.com

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?

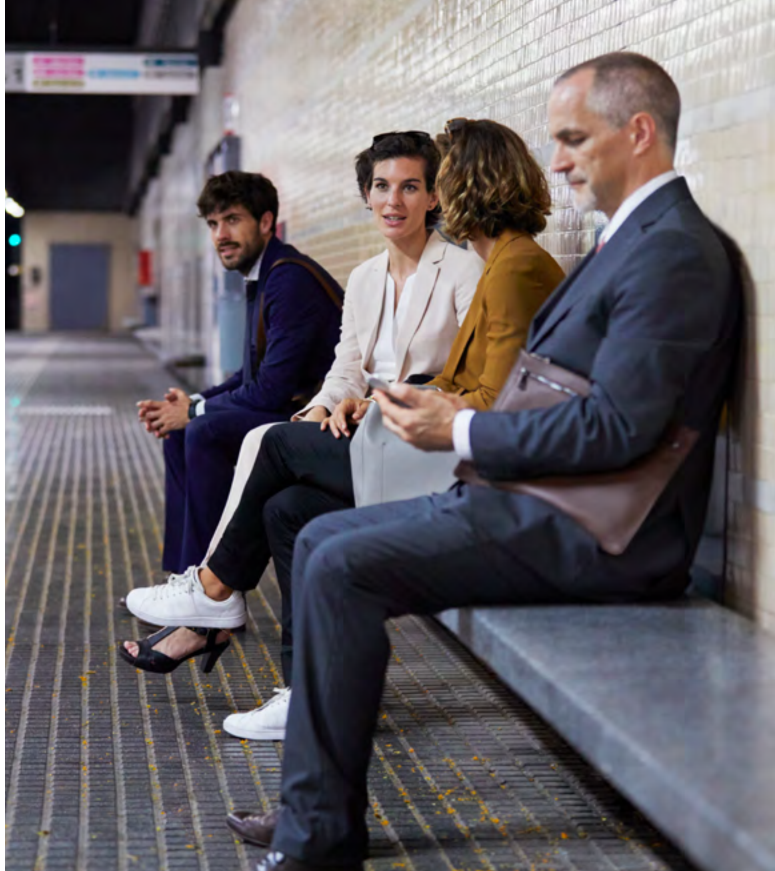
The short answer: No.

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.

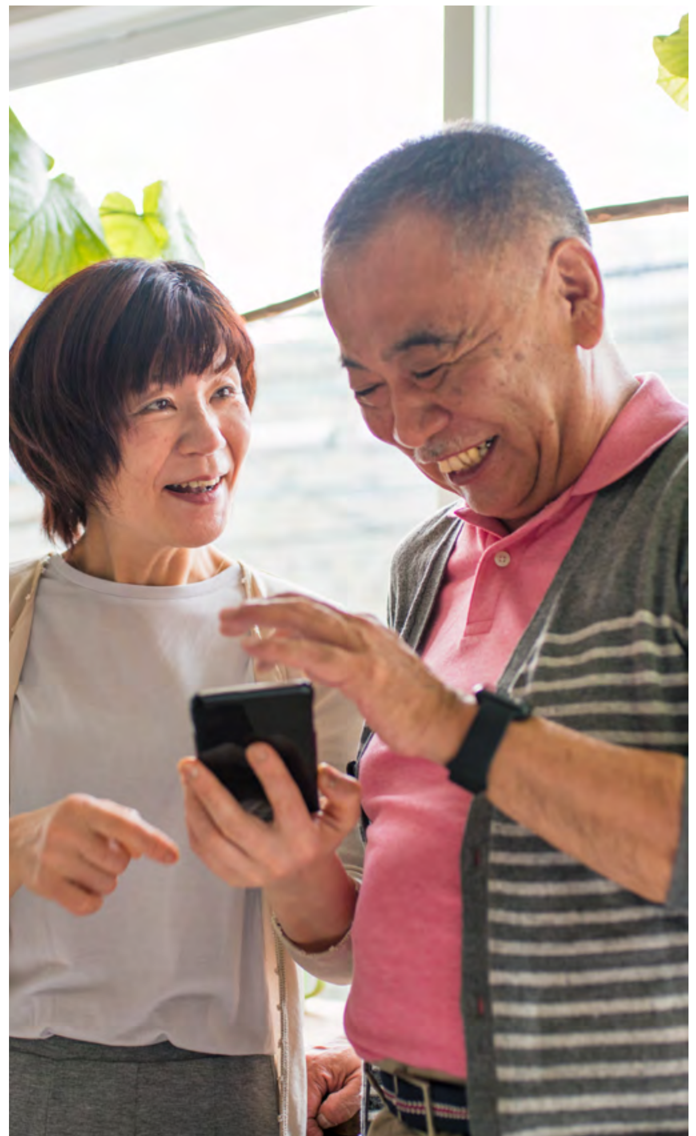
We have seen many forms for consolidation that drive improved investment and/or governance in a way that does not need to change the employer's obligations to a scheme — for example through fiduciary management of investments, consolidating advisors (i.e. bundled actuarial, investment and administration 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.

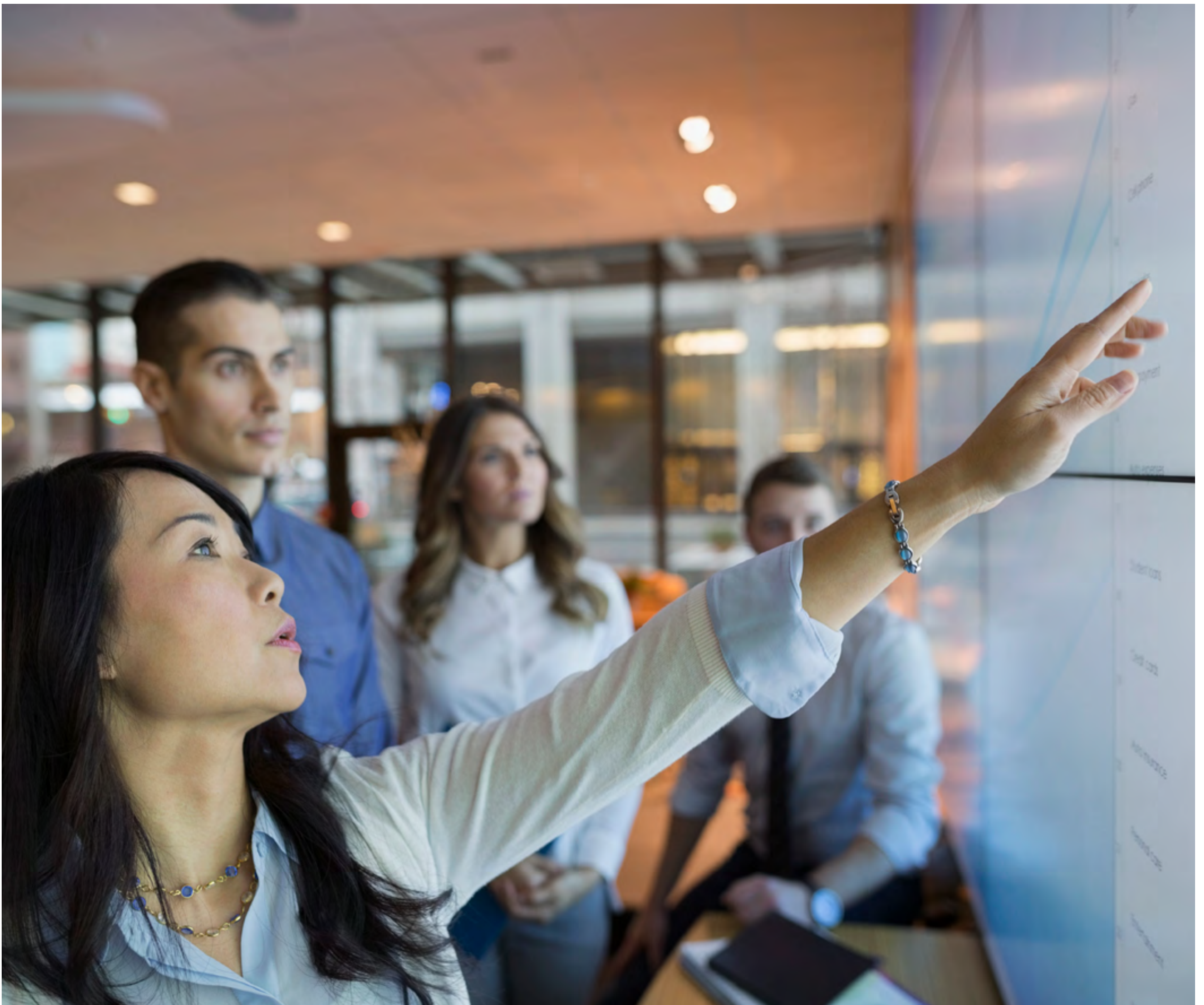
A radical solution has been put forward by the Tony Blair Institute for Global Change, involving the consolidation of all DB pension schemes into a series of c£400bn schemes. The proposal assumes the smallest 4,500 DB schemes would be consolidated to form one of these large funds in the region of £400bn. 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.



About WTW

At WTW (NASDAQ: WTW), we provide data-driven, insight-led solutions in the areas of people, risk and capital. Leveraging the global view and local expertise of our colleagues serving 140 countries and markets, we help you sharpen your strategy, enhance organisational resilience, motivate your workforce and maximise performance. Working shoulder to shoulder with you, we uncover opportunities for sustainable success — and provide perspective that moves you. Learn more at wtwco.com.

wtwco.com/social-media

Copyright © 2023 WTW. All rights reserved.

WTW_120400_Aug23

wtwco.com

wtw