ICAEW
REPRESENTATION 37/24

OPTIONS FOR DEFINED BENEFIT PENSIONS

Issued 19 April 2024

ICAEW welcomes the opportunity to comment on the Options for Defined Benefit Schemes published by Department for Work and Pensions on 23 February 2024, a copy of which is available from this link.

> The distribution of surpluses should be made easier, but this should not undermine the independence of pension schemes or member security. Government needs to clarify its intentions on key aspects of the proposals for treatment of surpluses, including on whether employers will be subject to any constraints in using surpluses paid to them and, what, if any, ongoing role pension scheme trustees may have to play if there are constraints. It will also need to consider a number of potential pitfalls regarding the proposed public sector consolidator model and we believe that the market for the services of such a consolidator will then be considerably smaller than government appears to be contemplating.

This ICAEW response of 19 April 2024 reflects consultation 2024 reflects consultation with ICAEW's pensions sub-committee. This is a sub-committee of the Business Law Committee and includes representatives from professional trustee organisations and auditors of pension schemes.

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Key Points

1. We are answering only selected questions on surpluses and public consolidator.

SURPLUSES

2. The starting point must be for government to make clear which surpluses are under consideration. Is it a one-off surplus that may have arisen through “serendipity”/market movement or is it a longer-term strategy? The risks and, therefore, considerations for both trustees and employers may be different depending on the answer.
3. There is also an underlying principle to consider as to whether employer money is theirs to use as they see fit. Trustees can decide whether a surplus is directed to the members or the employer, but it is not for trustees or regulators to stipulate how it should be used by an employer unless the trustees retain some recourse. Recourse would, however, probably be unattractive to a sponsor and there are better approaches to trustees protecting value if that is the objective.
4. For context, this is consistent with the current position – once contributions have been paid over to be controlled by trustees, it is not for the employer to impose conditions. There is an obligation to consult on the Statement of Investment Principles, but decisions remain with the trustees.
5. Any undermining of this principle is arguably a step back to before the Pensions Act 1995 which was brought in post the Maxwell scandal. The fundamental point is that there is a legal separation of pension scheme assets from company assets for good reason. Generation of a surplus for distribution may become a key part of an employer’s business model/support for commercial activities and start to drive business decisions. This could result in an employer wanting more influence on the level of and approach to generation of a surplus.
6. Any change in the regulatory environment that weakens that separation should, therefore, be given careful consideration to avoid unintended consequences.
7. A final general point is that paragraph 43 of the consultation provides a very important statement – “the position of schemes can change significantly in a short period of time”. Whilst this is in the second part of the consultation on a public consolidator, it must surely be equally relevant to any debate on surpluses.

PUBLIC SECTOR CONSOLIDATOR (PSC)

8. In principle, we welcome an ‘end game’ solution for those schemes which are unattractive to commercial consolidation providers. We recognise the benefits that this option could provide to:
   - smaller schemes in terms of risk management and governance standards;
   - enable efficiencies and economies of scale to be maximised; and
   - those which are less well-funded/with weaker covenants.
9. However, we perceive the stated objectives could be seen as being ‘at odds’ with each other. For example, in order to achieve some of the stated objectives (specifically ringfencing it to schemes ‘unattractive to commercial consolidation’ and to enable greater investment in UK high growth assets), the PSC risks distorting the current commercial consolidation marketplace, breaking one of its other objectives.
10. In considering end game options, sponsors and trustees will clearly consider a variety of issues, including pricing/affordability, structure of benefits, level of member security, timescales etc. We recognise that, generally, larger, well-funded schemes will probably continue to prefer current commercial consolidation options given these provide the ability to

secure attractive pricing and timeframes and can secure benefit structures to match existing scheme benefits. The latter would not likely be available to those entering the PSC.

11. However, if the objective around investment in UK high growth assets is to be met, the PSC will need to achieve significant scale, which must mean there is a risk to distorting the current commercial consolidation market, as scale will unlikely be achieved without focusing solely on schemes which are ‘unattractive’ to commercial providers. There also remains the issue of how schemes/sponsors would evidence how they are unable to secure an alternative from a commercial provider, bringing the risk of ‘gaming’ the system if the PSC offering is deemed more widely attractive.

ANSWERS TO SPECIFIC QUESTIONS (WHERE APPLICABLE)

QUESTIONS ON SURPLUSES

Question 1: Would a statutory override encourage sharing of scheme surplus?

12. Yes, but not much. Those that want to as part of a long-term strategy will have taken the necessary action (probably in 2016). If one off, an override is more helpful. We do not however think it would be a key driver in any change in decision-making, given the ultimate responsibility for managing scheme funding levels (and any risks associated therewith) remains with the trustees.

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

13. A distribution of surplus must be by mutual agreement; however, in line with the core proposition that “trustees would retain responsibility for managing scheme funding levels”, it is critical that scheme trustees have executive power. The main concern from a trustee perspective would be if a surplus can be distributed without due assessment of all factors. From an employer perspective, the concern would be an unreasonable position being taken by trustees, given the employer will ultimately need to meet any future funding shortfall that might arise. Security of members should, however, be the overarching objective and the existing balance of powers should not be changed to reduce member security (although other security could be provided if it is agreed to change the balance of powers).

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

14. A statutory override would be more likely to result in surpluses being shared, but this must be in the context of the previous responses and must not be seen as placing an onus on trustees to consider sharing surpluses.

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

15. An override may be necessary due to the construct of some Deeds and Rules, but see previous responses. It is a matter for agreement between employers and trustees, but there

must be recognition that discretionary increases for DB members can be perceived as giving further benefit to older generations and cohorts who already have better benefits.

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

16. It has the potential to reduce the number of transactions, but the buy-out market already has resource constraints. For one-off surpluses, it potentially helps with the management of the flow of schemes into the insurance market i.e schemes run on for a reason whilst in a queue for buy-in/out. For longer-term strategies, which are most suited to larger schemes, it would probably help capacity in the insurance market place as settlement may not be the priority.

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

17. Tax disadvantages on the distribution of surpluses/unauthorised payments when there are surpluses should be eliminated. However, more generally, should the tax regime be amended as a result of the issues raised in this consultation, it will be important to ensure that any amendments do not work to prejudice the security of members' benefits; for example whilst we acknowledge the core proposition set out at paragraph 22 that "extracting surplus will not be conditional on use of funds for particular purposes", we do not consider that this prevents the use of incentives - including tax incentives – to encourage re-investment of any surplus extracted back into operations of the sponsoring employer which would be covenant enhancing, as opposed to facilitating dividends to shareholders.

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

18. One alternative is that investment in a sponsor may be a better option – this would require a change in the self-investment regulations. This potentially allows the trustees to retain access to value. As explained in our response to Q6, as a general principle there should be incentives for any surplus being distributed to an employer to be seen to improve the value of the employer, but ultimately the decisions must be one for the directors.

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

19. A fixed margin above a prudent funding measure (which could be buy-out) seems the simplest. 5% feels low (for PPF+ the rule of thumb is 10%). There must also be a scheme specific allowance for costs and all data projects must have been completed and rectification undertaken.
20. However, it is key that there is a high level of security whatever the funding measure there should be robust security in place from potentially buy-ins of part of the liabilities and employer guarantees/contingent assets. We comment further on this is subsequent responses.
21. The timing of the measurement of the surplus also needs to be considered. Given the risk of changed circumstances it should be either annual or at the point of the agreement to distribute. This timing may provide some consistency with the corporate reporting, but any suggestion of the use of the corporate measure of liabilities for this purpose should be rejected. Whilst it provides a consistent measure across different entities, it rarely provides an accurate measure of the scheme specific funding level.

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

22. The guidance should focus on the risks to member security, the risk of pressure being placed on trustees from sponsors and the need to achieve fairness between all cohorts of members.
23. Trustees could also be supported by introducing a regulatory framework.
24. The requirement for trustees to consider the employer covenant impact (ability to meet any future scheme funding requirements that might arise) could be be part of a new gateway test or form of regulatory 'clearance', under which any scheme considering the potential extraction and distribution of a surplus is required to notify the Pensions Regulator of their intentions and outline its decision against stipulated tests.
25. In addition, we believe that it would be beneficial to the decision-making process if the trustees were to have an understanding of (but not control of) the proposed use of the surplus by the sponsor, for example investment into its UK operations, with a corresponding expected benefit to covenant.
26. Where a scheme is open to accrual, such safeguards become of even more critical importance given that, optically, it could be difficult for trustees to agree to return a surplus to an employer, whilst members continue to pay contributions.
27. Alternatively, there could be a notification process involving the Pensions Regulator. This could address some of the risks of undue pressure and unfairness. It would also provide an opportunity for the Pensions Regulator to intervene.
28. Such processes should ensure that trustees can evidence their due consideration of the many issues relevant to the distribution of a surplus and potentially provide parameters. This should not, however, be overly formulaic or create an overly arduous regulatory burden.

Question 10: What might remain to prevent trustees from sharing surplus?

29. Whilst our previous responses provide some protection to trustees, there is a risk of legal challenge from either members or sponsors on how surpluses are being distributed. Members may consider some groups of beneficiaries as being treated unfairly and there will always be a tension between the employer and members as recipients of surpluses. However, such decisions are a part of trusteeship and trustees must have the appropriate advice in making such decisions. As with corporate transactions, there should be a clear indication that employers are expected to meet the costs of advice when any surplus is being distributed to an employer.

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

30. It almost certainly would as, in principle, it is easy to see how the approach might be effective. By guaranteeing full member benefits (on a buy-out basis) even in a worst-case scenario, trustees could put a significant proportion of their asset portfolio on-risk, safe in the knowledge that if the strategy fails there is no loss to members. If the strategy works, however, a large surplus could be generated for the benefit of the employer and members alike.
31. However, it undermines the principle of not relying on the PPF in making decisions (see para 335 of the draft funding code, which although considering distress, makes the point on not relying on the PPF very clear) and is unlikely to be that straightforward, for a variety of reasons. For example, it is hard to envisage circumstances where the PPF would not look to control the 'moral hazard' risk associated with 100% protection, for example by creating barriers to entry (e.g. a strong covenant requirement) and controls on investment risk to limit

the potential downside. The PPF may also require consultation in the event of surplus extraction.

32. Ultimately a 100% underpin system is likely to attract those schemes that stand to benefit from it the most; in general, these would likely be the schemes that are most willing to take risk at the potential expense of the PPF and therefore least likely to be attractive to the PPF, necessitating strict controls that would limit the effectiveness of the approach.
33. A better model may be to have a maximum value of assets that can be utilised to generate a surplus and maintain the current PPF regime.

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

34. There are downsides. If PPF was called upon, the need to manage different benefit structures may be problematic to its established business model. The PPF is successful in part because it manages a single benefit structure for PPF compensation. The operation of scheme specific benefits is very different and will probably require significant change to the structure of PPF operations.

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

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

35. In response to 13 and 14, the commercial market is better placed to insure this risk. There are also Capital Backed Journey Plans that may work. Strong guarantees/contingent asset structures may also be a better solution. Of course, a combination of solutions may be appropriate.

QUESTIONS ON PUBLIC SECTOR CONSOLIDATOR (PSC)

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

36. The eligibility should be restricted to where there is no commercial offering due to market constraints or, more importantly, particular funding features. Otherwise, the commercial market will cherry pick only the most attractive and least risk business.
37. Question 16: Is setting the consolidator a duty to accept transfers from schemes unattractive to commercial providers and mandating certain design features (for example, benefit standardisation) and ensuring no unfair advantage sufficient to limit impacts on commercial alternatives? If not, what alternative approaches would you recommend?
38. Benefit standardisation will limit attractiveness and could disadvantage some groups of members that may challenge the decision to consolidate on such a basis.
39. If there is standardisation, it would need to provide statutory discharge to the trustees.

Question 17: Would a limit on the size of the consolidator be needed? If so, how might a limit on the size of the consolidator be set? Would limits on capital and a requirement to

meet the same capital adequacy requirements as commercial consolidators suffice, or are there alternatives?

40. The size does not need to be limited, but there needs to the appropriate level of capital backing.

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

41. Clear evidence that the scheme is either below the industry accepted commercial criteria or evidence that commercial providers have declined to quote with a robust justification for that commercial decision having been reached.

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

42. We would suggest that the PSC should carry out the same level of due diligence as that carried out by commercial consolidators in relation to data, benefit specifications and risk. As noted above, whilst we recognise the importance of the PSC accepting transfers from schemes with a deficit on the PSC's pricing basis (as part of the objective to support to schemes which are unattractive to commercial providers), there needs to be a rigorous entry process for those schemes to avoid potential moral hazard issues.

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

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

43. There may be a case for it being both as with continued support from an employer some schemes may be able to achieve buy-out. These schemes must be sectionalised. Others that are not going to achieve buy-out due either to funding or complexity could probably be pooled. That does presume that commercial parameters do not change.
44. This does, of course, introduce a level of complexity. To address this, the eligibility criteria could be set to only include schemes that are suitable for pooling.

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

45. See previous response – if the purpose of the PSC is to "settle" schemes that will never achieve buy-out and provide a standard benefit, then as with PPF there is cross-subsidy. However, unlike the PPF, this is not funded by the broader population of schemes.

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

46. Potentially, but if there are standardised benefits trustees may be uncomfortable with any reductions in the benefits (real or perceived). Sponsors with weak covenants and under-funded schemes would find it an attractive option.

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

47. Schemes must be closed.

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

48. Early retirement and increases probably need to be retained in line with the Rules to avoid member complaint as these continue unrestricted regardless of the funding position. It is also necessary to understand what a small number of structures means given that one of the possible reasons for being unattractive to a commercial provider is complexity. If simplification of benefits is the issue, could these be changed within the scheme and so become attractive to a commercial consolidator?

Question 26: If standardised benefit structures are applied, what should these benefit structures be?Question 27: What effect will this have on the existing market of commercial consolidators?

49. If it is structured correctly, it should have no effect as it is focussing on those schemes that cannot be settled commercially.

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

50. Yes as a demonstrably successful structure, but there will need to be the right level of resources and recognition that the circumstances are not the same as for the PPF as a lifeboat.

Question 29: What alternative governance structures should be considered?

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

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

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

51. If it was to go to members, that would be different to commercial providers and could disrupt the market. It should, therefore, go to the providers of capital/off-set the amounts underwritten.

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

52. In response to para 61a – if there is to be a continuation of contributions, how would the level and time period be established? Logically this should be a continuation of the triennial valuation, but the parameters giving rise to the entry requirement may prevent an affordable contribution. The extent to which a sponsor can negotiate needs to be ascertained
53. On para 61b – if the process is akin to a buy-in, then one presumes there will be the same management of the funding position and a final contribution from the employer
54. On para 63 – A full PPF process should follow an insolvency with an underfunded scheme. As part of the entry requirements, would a substantial part of the PPF validation/assessment process be complete. If above PPF funding does the scheme remain in the consolidator with cut-back benefits?
55. Questions 21 and 22 are also relevant

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

56. As a part of the objective is productive finance, this is a move away from the commercial market which takes a low risk approach to investment. How would the potential for investment in productive finance impact pricing and the economic justification required of the provider of capital?

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

57. It could struggle to achieve scale if a consolidator of last resort.

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

58. If the objective is to safeguard pensioner's interests and provide certainty, Government funding is likely to be the better route, but if the overall objective is productive finance, this seems to be the wrong approach as government should reduce other barriers to productive finance rather than effectively take control of a particular source of capital.

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

Question 38: Should government underwrite the consolidator and set the investment strategy?

59. The strategy should, be set independently by those responsible for the governance. As with the current investment regulations for pension schemes, consultation with the underwriter/provider of capital could take place.

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

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

60. If the PPF reserves are to be used in a different way to currently and if the overall objective is productive finance, then PPF could make direct investment in UK entities/productive finance and not become part of a more complex structure involving a PSC.

Question 41: Can you provide an overview of the size of your scheme (assets, liabilities (preferably on a buy-out basis), and number of members)?

Question 42: Has your scheme previously had a surplus extracted? Was this accessed for a specific purpose?

Question 43: To what extent do you think your scheme would extract a surplus under the changes discussed in this consultation?

Question 44: Would your scheme be likely to change investment strategies as a result of being able to access a surplus easier? To what extent would this be dependent on the PPF 100% underpin?

Question 45: As outlined in the consultation, the PPF previously conducted analysis suggesting a super levy of 0.6% of liabilities would be required to support a 100% PPF underpin. Do you consider this an appropriate cost? Is there a particular point which would make this more or less attractive to your scheme?

Question 46: To what extent would your scheme be interested in entering a public sector consolidator as outlined in the consultation?

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Question 47: Has your scheme faced any challenges in trying to buy-out with an insurer?

Question 48: Were you to take part in the public sector consolidator, what would be the estimated savings of entering a public sector consolidator? Do you envisage any costs and if so, can you provide an estimate of what the costs are likely to be?

Question 49: Do you have any wider concerns about the impact a public sector consolidator could have on the insurance or superfund market?