April 2024

DWP Options for DB schemes Consultation

Cardano Group response

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The Department for Work and Pensions Consultation on Options for Defined Benefit schemes – April 2024

This response is provided on behalf of an organisation (the Cardano Group) rather than an individual. We confirm that we are happy for our response to be made publicly available.

In the consultation response that follows, we have only answered questions on which we have a view, and have left the others unanswered.

Introduction

Overview on the overall ambition

We welcome the measures that are being considered as Options for Defined Benefit (DB) schemes.

The measures that Department for Work & Pensions (DWP) and the Government are proposing would “open up” the DB market and make other options more achievable. These more flexible options should be thought of as:

1. Within the current DB operating environment
2. Under a commercial consolidator
3. Under a public sector consolidator

This consultation seeks to address the first and third on the list (with the second arguably already addressed as part of previous reviews of consolidator operating parameters).

The DWP’s proposals could improve scheme member outcomes as well as have a positive impact on the UK economy. However, we remain to be convinced that they will achieve the main stated objective of ensuring DB scheme assets work harder for the UK economy.

DB schemes need viable alternatives to buyout

Many DB schemes are well on their way to achieving full funding on a buyout basis, an option which has long been seen as the ‘gold standard’ destination for mature DB schemes. Whilst this route is well established and is often the right, prudent choice for many trustees, the options for DB schemes that the DWP is consulting on provide challenge to the notion that a bulk annuity purchase should be the ‘default’ endgame solution for all schemes.

The insurance option is expensive and insurers operate with far tighter solvency requirements than DB schemes and as a result are limited in the extent of productive investments they can make in the UK economy. In addition, with the huge scale of DB pensions (market predictions of c. £350 billion) estimated to transfer to the insurance market over the next five years or so, there could be unintended systemic risks – further making the case for viable alternative endgame options.

We believe it can be possible to deliver a safe outcome for members outside the insurance regime that also delivers a good outcome for corporates and the economy as a whole.

DB schemes’ surpluses unlocked

The consultation focuses primarily on whether certain changes would make it easier to extract surplus from DB schemes, and whether such changes would achieve the consultation's objectives.

Sponsors of DB schemes have generally provided significant funding to DB schemes, which are now in surplus. It would therefore seem reasonable to allow surplus funds to be returned and used by sponsors to invest in their own growth, which would benefit the UK economy. This should rebalance risk and potential rewards between sponsors and trustees, fostering sponsor commitment to continue running their schemes, thus extending the schemes' time horizon and opening up longer-term investment opportunities. Indeed, we have seen amongst our clients some sponsors who are already changing their perspective to support modest re-risking –more detailed thoughts on which we share in the main document.

With the right safeguards, members could also benefit – through sponsors being willing to keep schemes open and / or surplus sharing arrangements allowing provision of discretionary benefits.

However, trustees of DB schemes have fiduciary duties relating to the security of members' accrued benefits, so will need to carefully consider the extent to which release of surplus is consistent with their duties. Without material changes to trustees' underlying fiduciary duties, it seems unlikely that rule changes to facilitate return of surplus will have a material impact on the industry.

100% underpin at too high a cost

In our view, a 100% PPF underpin does not appear a practical solution to underpin the security of members' accrued benefits given the high cost and limitations of the proposed approach. Accordingly, while we are supportive of the intent to facilitate surplus distribution (with the right safeguards), we do not believe it will achieve the objectives of the consultation (increasing investment in UK productive assets).

A public sector consolidator for small DB schemes

We can see how a public sector consolidator (PSC) could be useful for very small schemes (<£20m of assets) that are currently not able to access the commercial consolidator or the insurance markets. In a recent Cardano survey of UK Chief Financial Officers (CFOs) on this topic, 30% of CFOs thought that the PPF can act as a consolidator for small schemes.[1]

A government-backed entity would provide improved security and remove the governance and regulatory burden for these schemes and their sponsors. However, the scale of activity for a PSC is unlikely to be that significant in the context of the £1.3 trillion DB pension fund market. By our estimates, around £30bn (just over 2% of the existing DB market assets) could reasonably be candidates for PSC activity. Even if the PSC made a meaningful allocation to UK productive assets, that's unlikely to have a material impact on the British economy.

To minimise potential distortion of the superfund and insurance buyout market, we strongly believe that a PSC should be subject to similar regulatory parameters as the commercial consolidators. In particular, a PSC should be subject to similar Gateway Tests as those that apply to commercial consolidators. The Gateway tests are an important protection in the superfund regulatory regime that ensures both insurance and commercial consolidator solutions remain competitive.

Fiduciary management provides small schemes with an existing and efficient route to improve investment governance. Indeed, small funds are just as capable of accessing fiduciary management as large ones and, as sole trusteeship gains ground, this is rapidly becoming the norm. That said, we do believe that

[1] Cardano report 'New World, New Decisions', October 2023.

small funds could benefit from a PSC providing an alternative viable option for risk transfer.

Unlocked surpluses and a PSC unlikely catalysts for a material increase in UK venture capital

We continue to stress the importance of looking abroad to the Canadian, Nordic and Dutch pension systems for examples, and that a more obvious route, in our view, would be to consider the partial funding of public sector pension funds or the state pension. Funded public or state pension assets would likely adopt similar investment strategies followed by their global peers. Measures to encourage the bulk annuity market to invest further in private debt and ways to use the PPFs unowned surplus for the benefit of the UK economy should also be considered.

Our response to the Consultation

Chapter 1: Treatment of scheme surplus

Aims
21. The government's aims with respect to scheme surplus are to:
- Support schemes to invest for surplus in productive asset allocations by making it easier to share scheme surplus with employers and scheme members
- Remove practical barriers to surplus extraction such as those relating to scheme rules
- Remove behavioural barriers by bringing surplus extraction in line with trustee duties

Core propositions
22. The government's core propositions with respect to scheme surplus are as follows:
- Surplus should only be extracted where safe to do so from a member benefit perspective
- In all cases, trustees would retain responsibility for managing scheme funding levels
- Extracting surplus will not be conditional on use of funds for particular purposes

Statutory override

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

- A statutory override enabling a more straightforward route to make surplus refund payments to sponsors would encourage sharing scheme surplus.
- We also observe that the statutory override would need to set out a framework for deciding how the surplus is shared between the sponsoring employer(s) and scheme members as without this accompanying framework, trustees and sponsors may not be incentivised to use this provision. One approach that could be used to determine how the surplus is split could be based on total historical contributions paid into the scheme (allowing for growth in the scheme's assets over time).
- The framework will also need to provide guidance as to whether it is appropriate for trustees to return surplus in the context of their fiduciary duties – there is a difference between whether trustees *can* return surplus, and whether they *should* do so.

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?

We observe that:
- Trustees' agreement to the amendment of scheme rules to enable sharing of scheme surplus is important as they hold the fiduciary duty to prioritise scheme members' security.
- The benefit of it being a sole trustee discretion is that it would likely be a straightforward process, to the extent that a trustee is satisfied making the change is consistent with their fiduciary duties.
- The benefit of it being a joint agreement is that it gives corporates a seat at the table, engages them on the topic, and incentivises sponsors to keep their DB schemes running.
  - There is however a risk that this opens the door to corporates applying pressure on trustees to agree to the rule amendment where the trustee's decision may have been on the margin, which is not uncommon when considering long-term pension obligations.
- DWP may consider whether the balance of powers in this regard should reflect the overall existing balance of powers for a scheme. For example, if the employer has the wind-up power for buyout, then it might be reasonable for any changes to the scheme that would delay wind-up (e.g., around

surplus sharing to run on the scheme) to require employer agreement. Following this rationale, trustees are likely to at least need to consult with the employer in many cases.

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?

N/A

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?

N/A

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

- Greater flexibility to share surplus should encourage more sponsors to run-on their schemes rather than move to buyout, at least in the short-to-medium term.
- All else being equal, this should reduce scheme demand for insurance buyouts and potentially impact buyout pricing. As insurers appreciate that schemes have the option to run-on rather than buyout, they could offer more competitive pricing or require schemes to firmly commit to transacting a buyout in order to engage with them.
- It may also reduce the number of buyouts above core scheme benefits, in particular where there is no framework to share surpluses between the sponsor and scheme members.
- However, in practice, we observe that greater flexibility to allow return of surplus without any changes to trustee fiduciary duties may have little overall impact on the market.

Taxation

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

N/A

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

We have the following observations around alternative options for making extracting surplus attractive to trustees:

- Lift limits on self-investment for surplus scheme funds – this option would enable schemes to still “keep” ownership of their surplus funds by way of security over employer assets. Employers would still get to use their schemes’ surplus funds to invest in the business and the arrangement would direct means of investing in the real economy for those companies who have felt the greatest drain from pensions contributions.
- Introduce tax efficient routes for trustees and employers to extract surplus funds to enhance Defined Contribution (DC) benefits held in separate trusts. DC members are more likely to be under-pensioned, and DC schemes have longer investment horizons and are therefore more likely to allocate a higher proportion of scheme funds to UK productive finance assets.

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Safeguards for member benefits

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

- We agree that the level of investment risk and covenant risk should be taken into consideration when determining the threshold above which it is reasonable to consider sharing scheme surpluses.
- A key aim should be ensuring that the surplus is relatively “robust” with limited risk that the position could reverse through market movements / changes in asset values.
- Referencing the low dependency funding basis as the threshold above which surpluses can be extracted still leaves the scheme exposed to covenant risk if the funding position reverses, and more cash or time is needed to remedy that position. Also, a scheme generally needs a solvent sponsor to run-on (if a sponsor fails when a scheme is fully funded on a low dependency basis, the trustees would not be able to afford to buyout the scheme in full, and members would likely suffer a shortfall). From our perspective, a buyout funding basis threshold, plus an appropriate buffer, would minimise the risk of a scheme needing further support from its sponsor should its funding position weaken after surplus extraction.
- If the threshold is set lower than this, covenant would clearly be a key consideration. A variable 100% + y% model, where y depends on **both** the level of investment risk (e.g. by reference to a VAR or target return above gilts / swaps) and covenant risk would work well.
- We acknowledge that covenant can be challenging to quantify and can change over time. On the whole, changes in covenant strength tend to take place gradually over a period of time but even a very strong covenant can suffer a sudden and material deterioration, so any formulaic approach to returning surplus should be approached with care.
- A simple formulaic approach could be used to set the legislative framework as to whether a surplus *can* be returned, with the legislation highlighting the need to consider key factors such as funding levels, investment risk, covenant, liquidity and data risk when trustees are considering whether they *should* return surplus. Clarity around “can” and “should” is vital.
- The factors will be very scheme specific but can be material when downside scenarios are considered (e.g. risk of haircuts on illiquid assets, or scope for increased liabilities where data has not been subject to due diligence) – this is another reason to be wary of a formulaic approach for assessing whether surplus *should* be returned.
- Guidance will be needed to help trustees assess the above factors in the context of their fiduciary duties (i.e. the risk of members not receiving their accrued benefits as a result of a decision to return surplus). This should include consideration of downside scenarios and contingency plans to help trustees achieve an appropriate balance of prudence and pragmatism.

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

- Prescriptive guidance may be more likely to encourage surplus extraction where prescribed thresholds have been met as trustees will more likely view returns of surplus as being ratified by the Pensions Regulator (TPR).
- However, given the scheme specific factors that should be considered, it is unlikely that a set of prescriptive parameters will be appropriate for all circumstances (meaning members’ accrued benefits could be put at risk, or surplus extraction is blocked unnecessarily).
- A principles-based framework would allow trustees flexibility to factor in all relevant considerations in a manner appropriate to their specific circumstances. As part of such a framework, we would

expect trustees to be encouraged to stress-test the covenant / sponsor performance (as well as investment and funding position), and/or do contingency planning to support their decision-making.

- Principles-based guidance is easier for TPR to formulate, but more difficult for trustees and sponsors to follow and more difficult for TPR to monitor / police.
- The risks associated with a principles-based framework involving judgement are:
  - trustees allow release of surplus which inappropriately reduces the security of members' accrued benefits, or
  - trustees block return of surplus through excessive prudence.
- Ultimately trustees should have the flexibility to meet their fiduciary duties as best they can, recognising that judgement (supported by regulatory guidance and engagement) is part of their role.
- Additionally, this is an emerging issue and the flexibility of principles-based guidance with regulatory oversight should help fine tune a more formulaic approach if that is TPR's desire in the future.

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

We think that the following reasons may dissuade or prevent trustees from sharing surplus:

- Fiduciary duties
- Desire to use surplus for discretionary increases in member benefits
- Regret risk
- First mover hesitancy
- Ambition to buyout eventually (although could share surplus at that point)
- Complex / difficult to implement regulations around surplus extraction
- Disagreements between sponsors and trustees around how the surplus should be split between the various stakeholders (e.g., sponsoring corporate, scheme members, employees in other pension arrangements etc)
- Contingency against tail risk and protection against future deterioration of covenant strength

Alternative safeguard: 100% PPF underpin

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?

- We expect that a 100% PPF underpin would make trustees and sponsors more willing to extract surplus.
- It would also offer a genuine alternative to buyout in the medium-to-long term (as there would effectively be a buyout safety net), assuming that schemes are "locked-in" to the arrangement and therefore that the PPF is responsible for any claims that arose in the future.
- However, under the proposal, the 100% underpin option is only open to the best funded schemes with the strongest sponsors. This criterion narrows the subset of in-scope schemes (for example, there are 1,930 schemes with £700 billion assets that have a CG1 or CG2 covenant and are over 100% funded on a buyout basis) and raises the risk that the structure does not gain scale and meet the 100% underpin option.
- Yet the biggest question seems to be around the feasibility of the levy. Some high-level analysis suggests that, for a scheme with a well matched, low-dependency investment strategy, the cost of the annual super levy would likely outstrip investment outperformance. This means that the extent to which surplus can reasonably be extracted would be limited, as a buffer would need to be held to meet the substantial super levy payments over time.

- Further, to the extent that the 100% safety net is subject to limitations (i.e. benefits are not covered and/or there is scope for this to be rescinded) it would be unlikely to achieve its objectives.

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

- We believe there are two further drawbacks of a 100% underpin that should be considered.
  - At the extreme, if the 100% underpin is provided and trustees were allowed to take account of this in choosing their investment policy, then that would allow trustees to effectively ignore the sponsor covenant and adopt any investment strategy. However, we assume this would be an untenable stance to adopt, as it would result in extreme moral hazard to the 100% underpin provided by the PPF. Regulatory guidance is clear that trustees may not take an investment decision based on the PPF underpin, and they need to justify their investment risk with reference to the sponsor covenant. We assume that this aspect of policy is not under discussion. However, this could be very resource intensive to administrate (potentially lots of pensions actuaries and administrators needed to price and monitor scheme-specific rather than generic PPF benefits).
  - Very well-funded, insured schemes may choose to pay the super levy for double protection (insurance and pensions regime) and not move to buyout, although the funding level would need to be very high for this to be viable given the proposed cost for the 100% PPF underpin.

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?

- If the super levy for the 100% PPF underpin is separate to the normal levy currently paid by schemes to the PPF and this ‘super levy’ fund will be separate from the PPF lifeboat, the following aspects would need to be taken into consideration in the design of the fund:
  - If the 100% underpin option is only open to the best funded schemes with the strongest sponsors, implications for a scheme’s eligibility (or implications for its 100% underpin levy) in the event of deteriorated sponsor strength and / or scheme funding need to be made clear. Loss of 100% cover when covenant weakens would make this an ineffective underpin.
  - The process that a super levy paying scheme would follow in the event of its sponsor’s failure. Clarity around whether it goes through PPF assessment, and to the extent that it is funded below the PPF level of benefits, how it claims recovery from the PPF lifeboat and a top-up recovery from the super levy PPF and then potentially seeks insurer buyout.
- The 100% underpin PPF must provide a level of confidence commensurate to an insurer (or at a minimum a superfund) with respect to being able to deliver the 100% level of benefits. Without such a commitment, we do not think trustees and sponsors would seriously consider it a legitimate option for securing scheme members’ benefits.

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

- There are already various alternative solutions in the market that provide schemes choosing to run-on with the downside protection that a 100% underpin PPF would provide. These include investment strategies / approaches in the market that underwrite scheme’s downside risk e.g., Capital backed arrangements, Fiduciary Management + solutions with attaching insurer underwrite, etc.
- There are also commercial instruments, such as letters of credits and surety bonds, that could be used to achieve the outcome of underwriting a sponsor’s obligations to its scheme in the event of sponsor failure for a regular premium.

- For listed sponsors, credit default swaps / short credit positions on sponsors at the quantum needed to plug solvency shortfall might be a more cost-effective way of "topping up" downside protection.

Chapter 2: Model for a public sector consolidator

Aims

40. The government intends to establish a public sector consolidator administered by the Pension Protection Fund (the "consolidator") by 2026. The aims of the consolidator will be to:

- Maintain the security of members' benefits by ensuring that members' interests are protected
- Provide an alternative endgame solution for DB schemes unattractive to commercial consolidation providers
- Enable greater investment in high-growth UK assets than would be achievable by eligible schemes in the absence of a public sector consolidator
- Minimise the potential distortion of the superfund and insurance buyout markets

Approach to eligibility

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

- The proposed approach of setting a predominantly principles-based approach to eligibility, as opposed to specific eligibility criteria, should allow schemes 'unattractive to commercial providers' to access consolidation. However, it would leave the door open to other schemes who may not face similar challenges and it does not appear to us that there would be sufficient mitigants under the proposed PSC structure to avoid creating a consolidator that has an explicit advantage over commercial consolidators and insurers.
- As an example, schemes looking to access commercial consolidators need to meet Gateway Principles that preclude all but well-funded schemes with weak sponsors. If schemes looking to transfer to the PSC are not subject to the same requirements, under the proposed structure there would be a clear arbitrage for the PSC above commercial consolidators.
- We therefore strongly believe that a PSC should be subject to similar regulatory parameters as the commercial consolidators (to preserve an equal market footing). In particular, a PSC should be subject to similar Gateway Tests as apply to commercial consolidators. The Gateway Tests are an important protection in the superfunds regulatory regime that ensures both insurance and commercial consolidator solutions remain competitive.
- A clearer eligibility criterion could be applied to manage the above dynamic. Recognising the challenges that come with a more prescriptive criteria, we make the following observations:
  - A requirement for schemes to demonstrate an inability to access a commercial consolidators or buyout with an insurer (e.g., they would need to go to market and source quotations that evidence uncompetitive pricing terms, evidence insurers indicating their inability to provide quotations for the scheme etc.).
  - Alternatively, a scheme could demonstrate an inability to get competitive pricing from insurers through a high level cashflow pricing exercise, rather than doing a full quotation exercise:
    - There could be a prescribed basis to generate these cashflows set by the PSC and this process could be relatively automated.

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?

- From our perspective, the above duties and design features would not provide sufficient limits to ensure that the PSC will have no unfair advantage over commercial alternatives.
- Please see our response to question 15 on our observations around the criteria for the PSC only accepting transfers from schemes unattractive to commercial providers.
- We also observe that the proposal to allow the PSC to offer benefit standardisation will 'undercut' insurers and commercial consolidators, who do not have this flexibility in their toolbox. We note that if this design feature can be implemented for the PSC, the same concessions could be allowed for commercial consolidators (and potentially insurers) to improve their provisions for smaller schemes and those with complicated benefit structures.

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?

- Yes. A limit on the size of the PSC would be consistent with the stated aim that it is 'designed for small and less funded schemes'. The limit would serve as a check for the PSC to stick to its mandated objective, as opposed to just targeting 'bigger' schemes in order to achieve scale.
- The limit on the size of the consolidator could:
  - Reflect the total size of all DB schemes that fall into the 'small' size bracket based on whole of market DB scheme data held by TPR, updated annually to reflect changes with market conditions.
  - Be relative to the capital buffer available to the PSC that ensures it provides the schemes it takes on with the same level of security as commercial consolidators.
  - Reflect the PSC resource capacity to transact, for example, from a governance, advisory costs and benefit administration capacity.
- We expect that any limits set at the outset would likely need to be reviewed once actual take-up for the PSC option is known.

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

- Please refer to our response to Question 15.
- An alternative approach that schemes could use to demonstrate being commercially unviable may be by comparing the scheme's running costs with its sponsor's cash generation. Trustees and sponsors are constantly examining the opportunity cost of cash directed to a scheme rather than towards the sponsor's business operations. The PSC could be a potential solution where that opportunity cost would be the commercial viability of a sponsor's business.

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

- We set out below example criteria upon which the PSC could use as the basis for reject entry to a scheme:
  - Data quality – Data or benefit information that is not of good quality could prolong the process of transacting with a scheme (and resultant implications on transacting costs) and at worst, open the PSC up to reputational damage if members feel the reciprocal benefits they are receiving from the PSC are not of the same value as their promised benefits.
  - Funding level / sponsor covenant – Where the funding level of an applicant scheme is below the

PSC entry price, the PSC would need to take a view as to the creditworthiness of the sponsor before it can get comfortable with accepting a contract to make good the deficit by instalments over time (i.e., a deferred premium). In the scenario where a sponsor is viewed as unlikely to meet the deferred premium, the PSC should be able to reject a scheme's application.

- Our view is that the PSC should open to schemes that don't evidently meet consolidator or insurer affordability metrics in the short or medium term, and that meet the PSC's pricing requirement. The entry requirements should be robust enough to ensure that the PSC is not a route for sponsors to shirk their obligations to their DB schemes.

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

N/A

Proposed model

Structure

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?

- We agree that for the PSC to be viable and achieve the Government's aim of investing a proportion of its assets in UK productive finance, it would need to run as a single pooled fund and operate on a run-on basis, in order to have the longer-term investment horizon.
- We observe that a pooled fund structure, and here we assume a non-sectionalised model, introduces the risk of a binary outcome for all members in the event that the PSC fails resulting in benefit haircuts for all members.

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

- We agree that it would make sense to segregate the underfunded schemes while their sponsoring employers pay the deferred payments required to get the schemes to full funding on the PSC entry price basis. On achieving full funding, they could then be pooled with other schemes.
- Such an operating model for the PSC would clearly have legal and operational complexities that would need to be worked through.

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

- A PSC structure that includes some form of government backing would certainly prove attractive for both trustees and sponsors of in-scope schemes.
- However, we observe that it may be more straightforward to lower the barriers of entry for smaller schemes looking to access commercial solutions that already exist (e.g., benefit standardisation, setting aside the gateway tests for 'smaller' schemes) than setting up a PSC.
- The main barriers to commercial consolidators gaining scale stemmed from execution risk and first mover hesitancy. With two transactions now completed, those impediments may dissipate and encourage more take-up in this space.

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

- Allowing open schemes entry into the PSC would add great complexity to the governance of the consolidator, in particular around the structure and level of future service rights provision. Even assuming the standardised benefit structure would apply to future accrued rights, there would still be complications around salary linkage and how any funding deficits relating to future accrued rights are dealt with. Such a structure would also result in an extended link between the PSC and employers, adding to the governance burden for the consolidator.
- From our experience most smaller schemes tend to be closed to future accrual and given they would make up majority of the PSC's target market, our view is that the consolidator should focus on these schemes initially.

Member benefits

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?

- Standardising benefit structures would manage transacting costs and complications, and likely be an attractive incentive for trustees to transact with the PSC.
- However, we note that the same flexibilities could be extended to commercial consolidators (and insurers) and achieve the same outcome for the same schemes that the PSC would be targeting.
- Please see our response to question 26 in respect of key elements of benefit structures that should be retained.

Question 26: If standardised benefit structures are applied, what should these benefit structures be?

- From our experience, the following key aspects should be reflected in the standardised benefit structures considered for the PSC:
  - Adequate or reciprocal Inflation protection
  - Normal retirement age protection with flexibility to retire earlier or later (subject to actuarial reduction / increase)
  - Option to take lump sum benefits at retirement
  - Ability to transfer benefits out of the scheme
  - Flexibility to take benefits early in cases of ill health
  - Provision of dependant benefits
  - Provision of life assurance benefit before retirement

Question 27: What effect will this have on the existing market of commercial consolidators?

- The additional flexibilities proposed for the PSC (relative to current commercial consolidators) will likely negatively impact the market for commercial consolidators given the overlap in their target schemes. We observe that, under the current proposal, the PSC might enjoy the following key flexibilities which its commercial peers would not:
  - No Gateway Tests
  - Ability to standardise benefits easily (e.g. without consultation, significant scheme rule amendments)
  - Likely lower entry cost, as no allowance for a profit premium
  - Greater deferred premium flexibility
  - Cleaner severance for corporate sponsors
  - Potential Government underpin, assuming this is the adopted source of capital buffer for the PSC

- We therefore strongly believe that a PSC should be subject to similar regulatory parameters as the commercial consolidators (to preserve an equal market footing). In particular, a PSC should be subject to similar Gateway Tests as apply to commercial consolidators. The Gateway Tests are an important protection in the superfunds regulatory regime that ensures both insurance and commercial consolidator solutions remain competitive.

Governance

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

- We agree with the proposal to separate the PSC from the PPF lifeboat fund.
- We also observe that if both the 100% super levy and public consolidator proposals go ahead, then there will be three separate PPF funds (one for each of these as well as the main PPF). The PPF Board would need to consider their ability to manage all these three distinct funds, in particular any related conflicts and how these would be managed.

Question 29: What alternative governance structures should be considered?

N/A

Funding

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?

- We agree with the principle of aligning the funding and capital buffer requirements of the public and commercial consolidators.
- To the extent that the PSC's capital buffer is provided by Government, it could be viewed as being more 'secure' by schemes, given the perceived greater ability of Government to fund any additional capital requirements relative to the investors that currently back commercial consolidators.

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?

- The approach to use the same technical provisions basis that commercial consolidators adhere to is feasible and at first glance, equitable.
- However, the PSC by virtue of not being a commercial vehicle will not have any profit making aims thus its entry price, all other things being equal, could be lower than that of commercial consolidators who need to pay a return to their investors.
- Given our observation above, unless there are clear entry parameters that preclude schemes that could access commercial consolidators entering the PSC, the introduction of a PSC will impinge on the commercial consolidators target market.

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

- The surplus generated by the PSC could be deployed in a number of ways, such as:
  - Enable release of 'excess' capital buffer back to the capital providers
  - Enhance member benefits, likely easier to do as one-off increases
  - Build up a fund for self-insuring the PSC

Treatment of entering scheme deficits and surplus

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?

- The proposed arrangements for schemes transferring into the PSC appear to us broadly sufficient for achieving the PSC's aims as outlined in paragraphs 61 to 63.
- Please see our response to questions 21 and 22 for our observations around allowing entry to schemes that are in deficit relative to the PSC's entry price.

Investment strategy

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

- Assuming that the PSC would be subject to an annual funding and capital test, like current commercial providers, there would be an established governance process for TPR to engage with the Board to ensure its investment approach supports the prudent funding basis.
- Whether this investment approach would increase investment in productive UK assets is unclear. If the intention is to run-on, then we assume the investment strategy will target a return equal to the funding basis but with a margin for prudence. That suggests an investment strategy of c. Gilts +0.75% to Gilts +1.0% after costs. This is relatively low, meaning the majority of the assets, probably at least 80%, could be held in safe, high quality bonds such as UK government bonds and investment grade credit.
- That leaves only a small part of the portfolio for investment in "productive assets". Moreover, the low return requirement means the sorts of assets that would be suitable would not be high return assets like private equity or venture capital, but lower returning assets like private debt.

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

- The PSC's scale and operational efficiency will be determined by its ability to attract its target schemes (entry will be voluntary). The investment strategy will play a part in this, with the primary need that it is prudent and well risk-managed, such that trustees are comfortable transferring members to the PSC.
- The Gateway Tests in current superfund regulatory requirements limit the market opportunity for commercial consolidation to a specialised subset of the DB pension fund universe; these are reasonably well funded schemes that have *very poor sponsor covenants*. The table in s. 76 of the paper suggests c. 740 schemes with assets of c. £100bn have weak or tending to weak covenants and funding levels in the range 70% - 100%. The analysis in the consultation doesn't break these figures down by size of scheme. However, if we assume that the size distribution of schemes with weak or tending to weak covenants is the same as the universe as a whole, then around 700 schemes with assets of c. £30bn could fit within a PSC target universe.[2]
- Therefore, we think the scope for a PSC is quite small in the context of the market and this will impact the likely scale that the PSC could achieve if it is subject to the same requirements as commercial consolidators.

Underwriting

[2] Approximate number and size of schemes funded between 70% and 100% on a buyout basis, with a CG3 and CG4 covenant, and less than 5,000 members. Cardano estimate based on the DB schemes data set out in paragraphs 73 and 76.

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

- Government underwriting would be the most likely to enable the PSC to achieve its proposed aims. We agree that the level of Government underpin would have to be finite to avoid unfair competition with commercial consolidators.
- However, we observe that the statement that 'Government underwriting would give more authority to allow the government to set the direction of the consolidator and the level of investment risk' does not necessarily align with DB scheme trustees' duties. Therefore a framework for how the Government's influence on the PSC's investment approach would align with the PPF's Board's fiduciary duties to PSC members would need to be put in place.

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

N/A

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

Please refer to our response to question 36.

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

N/A

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

N/A

Chapter 3: Potential take-up and impacts

Survey for DB schemes

General scheme information:

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)?

N/A

Scheme interest (treatment of scheme surplus and 100% PPF underpin):

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

N/A

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

N/A

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?

N/A

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?

N/A

Scheme interest (public sector consolidator model)

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

N/A

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

N/A

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?

N/A

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

Please refer to our response to questions 15, 16 and 27.

cardano

Cardano | 9th Floor, 6 Bevis Marks, London EC3A 7BA
T: +44 (0)20 3170 5916 | E: info@cardano.com | W: cardano.com