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Pensions Committee

DWP
Caxton House
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5 September 2023

Dear Sir/Madam

Our response to the DWP consultation on Options for Defined Benefit Schemes: a call for evidence

I am writing on behalf of the Pensions Committee of the 100 Group of Finance Directors with regard to the above-named consultation.

About the 100 Group

The 100 Group represents the finance directors of the FTSE 100, several large UK private companies and some UK operations of multinational groups. Our member companies represent the vast majority of the market capitalisation of the FTSE 100, collectively employing 6% of the UK workforce, and pay (or generate) taxes equivalent to around 12% of total UK government receipts.

Our overall aim is to promote the competitiveness of the UK for UK businesses, particularly in the areas of tax, reporting, pensions, regulation, capital markets and corporate governance.

The 100 Group represents companies sponsoring Defined Benefit (DB) pension schemes with assets of approximately £600bn and membership of 3.5m (around a third of the overall DB universe).

Overall comments on the Consultation

Before addressing any of the specific points in the consultation, we would like to emphasise our support for the intention behind the proposals, backing the Government's drive to deliver economic growth. We would welcome any steps to allow well-run DB Schemes to invest in productive assets and give their employers the ability to invest in the sustainable growth of their own businesses. We do have particular concerns about the use of the PPF as a consolidator which we outline below. In addition, given the plethora of activity around pensions legislation, we would highlight that any changes, particularly regarding new consolidation vehicles, consider the capacity constraints in the operational support in the industry.

We have summarised our view of the key points in relation to this consultation within this letter and attach an annex with responses to the detailed questions.

1. Pension savings in scope

The 100 Group welcomes the consultation but wonders if the desire to encourage more investment in productive finance is necessarily solely relevant for private sector DB schemes; many of whom have commenced on de-risking journeys and are looking to secure liabilities with insurance companies over a relatively short time horizon.

We understand that there is also focus on assets in Defined Contribution (DC) schemes, and note that the Government is considering whether assets in funded public sector schemes, which have longer time horizons and are already pooling assets in some cases, could also be encouraged to invest in productive assets. We believe it is right to focus on these schemes rather than just private sector DB schemes.

2. Use of productive assets within DB schemes

There is a need for a joined-up approach by the Government in relation to investments in DB schemes. We have previously written to both HMT and DWP outlining our concerns over the recent consultations issued by DWP and TPR on funding and investment regulations. (A copy of our consultation responses are attached).

There are two key areas which are relevant for this call for evidence:

> ***Investment flexibility***
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> The draft funding and investment regulations push DB Schemes to largely invest in gilts and other LDI assets, removing their ability to invest in a broad range of return seeking assets, including productive finance. Adopting the draft regulations as they stand would divert risk capital away from such growth assets to the detriment of UK economic growth, at odds with the Chancellor's Mansion House speech encouraging more investment in productive finance.
>
> ***Appropriate use of cash by sponsors***
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> We recognise that the DWP and TPR understandably have a narrower view regarding appropriate use of corporate sponsors' cash to provide funding of defined benefit pension schemes (whilst noting that TPR does have a statutory objective of minimising any impact on the sustainable growth of employers in relation to the exercise of its funding powers). However, the asymmetric and inflexible nature of the draft funding and investment regulations, which requires companies to prioritise pension scheme funding above other legitimate uses of cash by corporate sponsors, is at odds with the part of this consultation that propose to give companies a greater ability to extract surplus.

As previously commented, we believe the funding and investment regulations can be amended in a way that allows standards to be raised where needed, but without reducing both the ability of well-run DB Schemes to invest in productive assets and their employers' ability to invest in the sustainable growth of their own businesses. This should be taken into account before the draft regulations and guidance are finalised and may then allow more schemes to invest differently than would otherwise have been the case.

3. The importance of Liquidity

The LDI crisis from late 2022 highlighted the importance of liquidity to all pension schemes. We agree that DB pension schemes are natural investors in productive finance but also recognise that these assets are long term investments that are generally highly illiquid.

In our informal feedback to the Bank of England at the time of the LDI crisis we highlighted that the issue for pension schemes was access to liquidity rather than a concern over their capital solvency. Indeed the capital solvency of many schemes improved through this period provided they had adequate liquidity to maintain their risk management. In response the Bank of England did allow access to liquidity through a temporary relaxation to their repo facilities. While many schemes did not use the facility, it did give confidence that support would be there if needed (which would have reduced some of the market turbulence).

We believe that having appropriate access to such a liquidity facility, direct with the Bank of England, would be an important enabler for schemes to consider investment in productive finance.

4. Pension protection Fund as a consolidator

We do not believe it would be appropriate for the PPF to act as a consolidator.

It was set up to provide significant protection for members of schemes with weak sponsors with the industry paying for it by way of levies. We caution any changes to the remit of the PPF, which may lead to more schemes entering the PPF and higher levies. The design of the levy is that is typically the larger schemes who are less likely to enter the PPF (such as those sponsored by the 100 Group) who end up paying the bulk of the levy.

We also note that PPF has a healthy surplus, and we believe that this should be used to reduce levies and even return to those who have made the largest contributions, before being used for any other purpose.

There may be a role for a separate government supported consolidation vehicle (maybe a Pensions Consolidation Fund, a 'PCF') but this should be separate to the PPF with no obligations or levies created for Schemes that didn't use it. It is important that we don't create a moral hazard with levies for a PCF style solution being cross subsidised by either the existing surplus of the PPF or the covenant of the sponsoring companies paying into the PPF.

Should you wish to discuss any aspect of our consultation response further, we would welcome the opportunity to do so.

Yours faithfully,

Philip Aspin

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Chair
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Annex – Response to specific questions

<u>Call for evidence</u>

Question 1

Do you agree with the assessment of the position? Is there evidence to the contrary?

We agree that UK DB schemes are underinvested in productive assets relative to international comparators, but that for any comparison to be meaningful it should also consider the risk/return balance on the corporate sponsors from the different legislative environments internationally.

The risk/return balance on corporate sponsors from the UK's pension's legislative framework has progressively tightened over the last 20 years or so, such that today it is one of the most cautious internationally.

This has ultimately led to sponsors taking progressively lower risk approaches to their pension schemes with a switch from productive assets towards gilts and corporate bonds.

Question 2

What changes might incentivise more trustees and sponsors of DB schemes to consider investing in productive assets while maintaining appropriate security of the benefits promised and meeting their other duties?

We mentioned in our introductory comments that offering flexibility under funding and investment regulations will enable trustees and sponsoring employers to consider investing more in productive assets. Currently, the draft regulations prescribe that DB Schemes must target a highly resilient, cashflow matched (and therefore very low return) investment strategy.

Our feedback on the previous consultation was that we do not consider that it is appropriate to prescribe that DB Schemes, especially those with a strong employer covenant, must target a highly resilient, cashflow matched (and therefore very low return) investment strategy. However, where there are justifiable scheme specific reasons, DB Schemes in this situation should continue to be free to invest as they are currently, as long as its trustees are comfortable that the level of risk is supportable (including where the employer covenant and any contingent arrangements can support the investment strategy). In particular, amending the draft funding and investment regulations would allow these DB Schemes to continue investing in assets such as productive finance.

Under the productive finance group of assets are many that are illiquid, which we agree would normally be appropriate assets for DB pension schemes to consider investing in, given their lengthy duration and the reduced need for earmarked assets. However, in times of economic stress, such as those faced last September when gilt yields rose over a short space of time, the lack of liquidity was an existential issue for many schemes. In our feedback to the Bank of England, we asked whether it would consider introducing a repo facility for corporate bonds to provide liquidity to schemes. While many schemes would not use the facility, it would give confidence that support would be there if needed (which would likely have reduced some of the market turbulence). Having appropriate access to such a liquidity facility, direct with the Bank of England, would be an important enabler for schemes to consider investment in productive finance.

<u>Building surplus</u>

Question 3

How many DB schemes' rules permit a return of surplus other than at wind up?

We believe that a very small minority of our members' DB scheme rules may permit a return of surplus while the scheme is ongoing but this will be in limited circumstances.

For example, there are stringent legislative restrictions around the return of surplus in an ongoing scheme. Section 37 of the Pensions Act 1995 and the Occupational Pension Schemes (Payment to Employers) Regulations 2006 set out when refunds may be made in an ongoing scheme, if permitted by scheme rules. This includes, among other things, that the trustees must be satisfied it is in the interests of members - a difficult thing for trustees to conclude, requiring consideration of things like the likely future funding strength of the scheme and the employer covenant.

In addition, section 251 of the Pensions Act 2004 says that trustees had to pass a resolution by 6 April 2016 to confirm that they could continue to exercise such surplus refund provisions – if this was not done, the power in the rules will not be exercisable.

Question 4:

What should be the conditions, including level of surplus that a scheme should have, be before extended criteria for extracting surplus might apply?

From a corporate sponsor perspective, it would be better to have more flexibility about the circumstances in which surplus could be returned, rather than only at wind-up of a scheme. The sponsor is the ultimate underwriter of the pension scheme, and the asymmetrical approach to funding currently contained in legislation is that while more funding is sought at times of stress, it is very difficult for the sponsor to extract any funds before wind-up if the position is better than expected. This also encourages the sponsor to take a more cautious approach to funding the pension scheme.

One possible approach that could be taken would be that once the scheme is funded on a "low-dependency" basis, (as set out in the latest funding and investment regulations and guidance) that there should be a mechanism for return of surplus before wind-up and/or allow the sponsor to support other employees (via DC contributions).

Question 5

Would enabling trustees and employers to extract surplus at a point before wind-up encourage more risk to be taken in DB investment strategies and enable greater investment in UK assets, including productive finance assets? What would the risks be?

It is possible that it might encourage more investment risk to be taken. However, as mentioned above in our answer to question 2, the direction of travel for UK DB schemes has been to de-risk. This means that any shift in investment is likely to be small for private sector DB schemes.

From a sponsor perspective, the risk would be that if there was deterioration in funding level due to an increase in investment risk, the sponsor would have to make more contributions over a short time frame. This would particularly be the case under the current drafting of the funding and investment regulations, which do not encourage investments in more risky assets.

Question 6

Would having greater PPF guarantees of benefits result in greater investment in productive finance? What would the risks be

We caution against making any changes to the remit and benefits provided by the PPF, which may lead to more schemes entering the PPF and consequent higher levies on continuing schemes. The design of the levy means that it is typically the larger schemes who are less likely to enter the PPF (such as those sponsored by the 100 Group) who end up paying the bulk of the levy.

We also note that PPF has a healthy surplus, and we believe that this should be used to reduce levies and even return to those who have made the largest contributions, before being used for any other purpose, such as increasing the cover available. The fact that the PPF's levy assumptions have proved to be overly cautious in practice does not entitle it to retrospectively change the terms under which it operated. Doing so would be akin to an insurance company unilaterally changing the cover provided under a policy and charging policyholders increased premiums to reflect the increased benefits granted to previous policyholders.

Question 7

What tax changes might be needed to make paying a surplus to the sponsoring employer attractive to employers and scheme trustees, whilst ensuring returned surpluses are taxed appropriately?

Any significant reduction in the tax rate below the current punitive 35% level would make it more attractive for employers to extract any surplus, for example to the corporation tax rate.

Question 8

In cases where an employer sponsors a DB scheme and contributes to a DC pensions scheme, would it be appropriate for additional surplus generated by the DB scheme to be used to provide additional contributions over and above statutory minimum contributions for auto enrolment for DC members?

Yes and we would suggest that this should go further in that surplus could be used to pay for any DC contributions. We appreciate that employers are under a statutory obligation to pay minimum contributions to AE schemes, but being permitted to utilise excess surplus to do so might ensure the survival of an employer in temporarily-straitened financial circumstances.

Consideration should be given to make it easier to use the surplus to pay DC contributions, even if DC provision is not part of the same trust.,.

Question 9:

Could options to allow easier access to scheme surpluses lead to misuse of scheme funds?

We do not believe this would be the case as we would expect that appropriate safeguards and guidelines to be put in place, such as our recommendation under question 4 as to when access to surplus is permitted.

Consolidators

This set of questions are more relevant for smaller schemes, which are different to the ones sponsored the 100 Group and so we have not answered these.

Pension Protection Fund as a consolidator

Question 17

What are the potential risks and benefits of the PPF acting as a consolidator for some schemes?

We believe it would be inappropriate for the PPF to act as a consolidator.

It was set up by the government as its obligation under the EU Insolvency Directive to provide significant protection for members for schemes with weak sponsors and the industry has been paying for it by way of levies on DB Schemes. We caution any changes to the remit of the PPF, which may lead to more schemes entering the PPF and higher levies. The design of the levy means that it is typically the larger schemes who are less likely to enter the PPF (such as those sponsored by the 100 Group) who end up paying the bulk of the levy.

We also note that PPF has a healthy surplus, and we believe that this should be used to reduce levies and even return to those who have made the largest contributions, before being used for any other purpose. As per our answer to q6, the fact that the PPF's levy assumptions have proved to be overly cautious in practice does not entitle it to retrospectively change the terms under which it operated. Doing so would be akin to an insurance company unilaterally changing the cover provided under a policy and charging policyholders increased premiums to reflect the increased benefits granted to previous policyholders

There may be a role for a separate government supported consolidation vehicle (maybe a Pensions Consolidation Fund, a 'PCF') but this should be separate to the PPF with no obligations or levies created for Schemes that didn't use it. It is important that we don't create a moral hazard with levies for a PCF style solution being cross subsidised by either the existing surplus of the PPF or the covenant of the sponsoring companies paying into the PPF.

Question 18

Would the Board of the PPF be an appropriate choice to operate a public consolidator?

We do not believe this would be appropriate as it would create an inherent conflict of interest with the current objectives of the PPF and more broadly pose a moral hazard.

Question 19

How could a PPF consolidator be designed so as to complement and not compete with other consolidation models, including the existing bulk purchase annuity market?

As we do not believe the PPF should operate like a consolidator we have not answered this question.

Question 20

What options might be considered for the structure and entry requirements of a PPF-run public consolidator, for example:

- *are there options that could allow schemes in deficit to join the consolidator?*
- *what principles should there be to govern the relationship between the consolidator and the Pension Protection Fund?*
- *should entry be limited to schemes of particular size and / or should the overall size of the consolidator be capped?*
- *how could the fund be structured and run to ensure wider investment in UK productive finance?*
- *how to support continued effective functioning of the gilt market?*

As we do not believe the PPF should operate like a consolidator we have not answered this question.