LCP powering possibility

Powering Possibility in Pensions - FAQs

July 2023

Our ***Defined Benefit ("DB") pensions*** *policy proposal is outlined in our recent submission to the Work and Pensions Select Committee. In summary, we propose creating a new "opt in" system for well-funded DB schemes, with two key changes:*

- Pension Protection Fund ("PPF") cover increased to 100% of member benefits; and
- The ability to use DB surpluses on an ongoing basis (with suitable protections).

We believe that these two changes would fundamentally change the incentive structure for those running UK DB pension schemes, delivering:

- Full protection to DB members' benefits in a more efficient way than continued investment de-risking;
- Incentives for schemes to invest for growth, deploying the DB asset base to support the UK economy; and
- Opportunity to generate hundreds of £bns of surpluses to share between DB members, Defined Contribution ("DC") savers and investing in the economy.

Our proposal is designed to balance the needs of new opportunities for economic growth with security of pensions and fairness between generations. For the purposes of these FAQs, we have summarised all this in the name "Protection Supporting Prosperity" (or "PSP").

This FAQ document answers detailed questions we have been asked about our idea from a wide range of interested parties, including addressing a number of technical points, sometimes in technical language.

The questions are grouped as follows:

- **Question 1:** Why has LCP developed the PSP policy proposal?
- **Questions 2 to 13:** How does the PSP proposal work in practice?
- **Questions 14 to 20:** What might the PSP proposal mean for DB scheme investment strategies?
- **Questions 21 to 28:** What about TPR and PPF perspectives?
- **Questions 29 to 33:** Other questions

Note: These FAQs set out considerable detail in key areas. In some areas, we have deliberately not taken a view on detailed points as we think it more productive to get alignment and consensus on the principles before details are debated. However, we are happy to share our analysis on key aspects further in collaboration with The Pensions Regulator ("TPR"), PPF and government as the discussion evolves, and we are confident that our proposal can be made to work whilst balancing the needs of all key stakeholders.

1. Why has LCP developed the PSP proposal?

The current DB pensions regulatory framework and funding regime has been in place for nearly 20 years. During that time, the emphasis has been on protecting member benefits through increased employer contributions to pension schemes, and a continued trend to safer investments. Owing to a combination of these measures and substantial changes in financial markets, our DB schemes are collectively now much better funded than ever before, but most are now closed to future benefit accrual.

Most employees in the UK are now members of DC pension schemes. Whilst auto-enrolment has been very successful in extending coverage of membership in recent years, the level of employer and employee contributions to DC schemes generally remains below the levels that are expected to be necessary to support reasonable retirement incomes. This is a savings time bomb for the UK.

This led us to ask ourselves the following question in early 2022: "How could the DB pension regulatory regime be adjusted to …

- Maintain (or even improve) DB member security, whilst …
- Freeing up DB pension schemes to invest for more growth, and thereby …
- Create opportunities to share the upside with DC members, also leading to …
- Greater investment by DB schemes in UK productive finance to help boost the UK economy."

Having brainstormed many ideas, our favoured idea became the PSP proposal, which is explored in more detail in these FAQs.

Questions 2 to 13: How does the PSP proposal work in practice?

2. How does LCP envisage entry into the PSP regulatory regime would work?

We envisage that entry into the PSP regime would be voluntary at any time (once the law made the option available) for all 5,000+ UK private sector DB schemes, as long as they satisfied the following requirements:

- company agreement to enter the PSP regime;
- trustee agreement to enter the PSP regime; and
- actuarial certification of a secure level of funding.

From that point on, the sponsor would be committed to making contributions to cover any future deficits measured against this secure level of funding.

Those schemes who do not enter the PSP regime would remain in the current DB regulatory regime. Subject to meeting the conditions, they could enter the PSP regime at any time in the future.

We have not taken a firm view on the exact nature of the required level of secured funding to enter the PSP regime at this stage, noting that this would be for TPR, PPF and the Government to decide. But we might expect this to be either the expected "Fast Track" basis proposed by TPR in its recent draft funding code, or a low dependency funding level based on a discount rate of "Gilts + 0.5% pa", with appropriately prudent demographic and other assumptions.

Trustees and employers may wish to negotiate additional agreed entry constraints between them. We envisage this would be up to each scheme. For example, this could be agreements on the future use of powers to wind-up the scheme and the future use of discretionary benefit increase rules. This might include agreements or a stated intent that surpluses arising may be split between members and the company in different ways. Companies may also wish to explore introducing a DC section into the DB scheme, or linking an agreement to

another DC scheme, and agreeing with the trustees that surpluses could be used for both regular and bonus DC contributions – see question 8 on this.

3. What PSP scheme member benefits would be protected by the PPF?

Following sponsoring employer insolvency, 100% of PSP scheme pensions would be protected by the PPF, including pension increases set out in the scheme rules.

4. Once a scheme has entered the PSP regime, could it ever exit the PSP regime?

No. This is because, if an exit possibility existed, trustees would not have sufficient confidence that the full PPF protection would apply in the future. We believe this confidence is necessary if trustees are to consider entering a regime where surpluses may be more readily shared outside of the scheme, alongside increasing their long-term investment risk.

5. How would the surplus in a PSP scheme be accessed?

We envisage that a surplus would be permitted to be used outside of the scheme (or for additional benefits in the scheme, including DC benefits) if a high security threshold for surplus was attained (a 'super-surplus').

This threshold could be linked to the investment stress factors under TPR's current draft Fast Track regime (which in turn are based on PPF's own stress factors, presenting high degrees of alignment), or linked to a simple fixed percentage, eg funding at the level of 105% of the secure entry requirements to the PSP regime.

In practice, we would envisage an employer having the power (subject to any remaining overriding rule provisions, or other agreements reached with the trustees) at least at each triennial valuation, to remove super-surplus from the scheme if they wished. This could be to support business growth and/or spend the surplus on existing or new DC contributions and/or agree to spend any surplus on new benefits for existing DB members – see question 7 on how this might be shared.

Note that we would also encourage government to review the tax regime for return of surpluses to ensure that it remains fit for purpose with the current regime and the PSP regime – see later question on this.

6. Will company sponsors wish to enter the PSP regime and continue to take some investment risk for decades to come?

We believe that most sponsors will consider it, and that a good number of larger schemes would choose to enter the PSP regime. We note that the option to purchase bulk annuities would remain available to all PSP schemes at any time in the future, so that entering the PSP regime does not close down that route as a future option.

We recognise that some companies will continue to be keen to remove pension scheme risk from their balance sheet sooner rather than later, via bulk annuity insurance, and may therefore not see benefits from the PSP regime and its accompanying PPF super-levy in the meantime.

However, our experience of UK board room discussions for some years is that many directors are frustrated about the perceived ever-increasing prudence and security that is built into the current pension regulatory regime. They are also acutely aware of the regulatory asymmetry of being required to fund pension schemes to prudent levels (ie higher than expected to be necessary), but having very limited means to remove any surplus funds.

We believe that sponsors of DB schemes will therefore welcome the opportunity to explore alternatives that will allow the company to benefit from expected long-term investment returns being earned by the scheme (which the company's contributions have provided). We also expect for there to be increasing pressure on companies (rightly so) in the longer term to increase DC contributions for current employees, and the PSP regime provides a way in which funds can be made available to support this, with limited additional risk to employers.

Our early discussions with many of our clients have indicated strong interest in exploring the PSP regime. If you are a UK employer with a DB pension scheme, we would be pleased to discuss our idea in more detail with you – please do get in touch.

7. How should the surplus of a PSP scheme be spent and shared between the various stakeholders?

This would be for the sponsoring employers and trustees to decide, within any constraints set by Government. We would welcome debate across the industry and Government as to whether any particular restrictions should be in place. Our own view is that we would like to see incentives to be in place for more contributions to be paid to DC schemes – see question 8 below – whilst protecting DB members.

In our experience, pension "surpluses" are too often currently seen as something to be avoided, because of the complications and tax charges that can result. However, we believe it is preferable for employers and trustees to be faced with the challenge of how to share large surplus funds generated through higher investment returns, rather than have no surplus at all.

Our sense is that many employers and trustees will decide that some element of sharing is preferable, perhaps with some better inflation protection for DB members, more money going to DC schemes, and all with less cost to sponsors so that more money can be spent on business investment (whether that be CAPX or people).

8. How might the PSP regime support better DC contributions for current employees?

Like many in the pensions industry, we have deep concerns that contributions to many DC schemes (especially those at auto-enrolment minimums) are currently not adequate to provide reasonable retirement outcomes for members.

We recognise that not all employers with DC schemes have a DB scheme, and vice versa. However, one of the challenges faced by employers over recent decades is that DB pension schemes have been costly to maintain, and amongst other things this has put pressure on budgets for DC contributions.

Our ambition is that the PSP regime will result in improved contributions to DC schemes. This could happen voluntarily, or via additional incentives / requirements from future Governments, perhaps encouraging or requiring companies who have PSP schemes to do one or more of the following:

- Include a DC section in a PSP scheme, to allow surplus to be used to fund (ideally additional) DC contributions
- Allow DB surplus in a PSP scheme to be transferred to another DC scheme and incur little or ideally no tax charge – this would be a new legal option and would be our preference as it will be the most efficient way forward
- Increase auto-enrolment minimum contributions across the board (as DB pensions become less expensive and are better protected through the PSP regime)
- Require PSP schemes to use some of any surplus that is taken out of the scheme to support additional DC contributions for existing employees

Note that where we refer to DC schemes, we also include Collective Defined Contribution "CDC" schemes – which are being developed by Government as a new pension option that we fully support – more on this in a later question.

9. Once a scheme has entered the PSP regime, does the covenant of the employer still matter?

Very much so. The PPF super-protection would only be available if the sponsoring employer became insolvent. Whilst the business and pension scheme are healthy, and continue on an ongoing basis, it is the company that will need to contribute towards any deficits.

Therefore the covenant strength of the company, including the availability of free cashflow to fill any deficits if required, will remain very important. We envisage that this will be a natural constraint on the level of investment risk that is appropriate for trustees to take, and therefore PSP schemes with weaker company covenants would take less risk than those with stronger covenants.

10. Does the PSP proposal have any implications for open schemes?

We envisage that schemes that are open to new members and future accrual would be able to enter the PSP regime. This would mean that open schemes could exist in either the existing regime or the PSP regime.

In the existing regime, we anticipate that some open schemes will wish to continue running investment risk in order to reduce the expected long term cash cost of newly accruing pensions, although this strategy is not without risk. Such schemes may choose to operate at funding levels below the secure level of the PSP regime, and may look to agree "Bespoke" funding agreements with TPR.

To enter the PSP regime, open schemes would first need to ensure they satisfy the PSP secure funding condition, and this may take additional financial support from their sponsoring employer to achieve this. Having then achieved that level of funding, the open scheme could enter the PSP regime, thereby considerably improve member security through PPF super-protection. The scheme could then more freely run a higher risk investment strategy (assuming this was supportable by the sponsor covenant), seeking to ensure that the ongoing expected cost of accruing benefits remains low, in line with its current objectives.

Therefore, we anticipate that the PSP regime would enable the effective continuation of open schemes with more regulatory freedom, as long as they first top up funding to an appropriate secure level. This seems to be a beneficial regulatory option to us for all interested parties.

11. How will differing DB scheme stakeholders see the PSP regime?

Members of DB schemes should be delighted if their trustees and sponsoring company agree the scheme should enter the PSP regime – they gain full protection of all benefits on the company's insolvency, along with the potential to benefit from higher levels of surplus through the granting of additional benefits.

Trustees should also be keen to explore entering the PSP regime given the extra protection for members and potential for members to share in future upside. We envisage they would need to get comfortable with any knock-on impacts on the scheme's rules, potentially including changing or constraining rules on wind-up powers or the granting of discretionary increases.

We envisage that **sponsoring employers** will wish to explore entering the regime. In particular, the PSP regime addresses the regulatory asymmetry of the current regime, that employers generally have very little access to any upside from DB schemes but must stand behind any downside.

In discussions about entering the PSP regime, it will be important for employers to agree with the trustees an understanding of key expectations on future investment strategy, and the use of certain rule powers. The employer will need to be comfortable with the level of investment risk being taken. This is because, in a downside scenario, a higher level of risk could mean cash contributions are needed over a short period (eg 3 years) and/or a fast escalating PPF super-levy. If the employer is comfortable with these risks, entering the PSP regime can be expected to reduce the long-term cost of pensions to the employer. In many cases, the financial impact is expected to be materially positive to UK companies in the long term, and this is expected to be positive for shareholders and for UK growth generally.

Current employees of sponsoring employers, who are likely to be in DC schemes, should also benefit from the PSP regime. This is because the company would be expecting to have more money to invest in its business. This should mean a healthier employer generally, and employees may also benefit from higher DC contributions if entering the PSP regime provided the means to fund them at a higher level – see question 8 on this.

TPR and the PPF are primarily concerned with the protection of member benefits and the protection of the PPF. Member benefits are better protected under the PSP regime. Whilst the PSP regime results in the PPF taking on more risk, we are of the view that these risks are very much manageable in the way we have described elsewhere in this FAQ document.

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12. How would the PSP regime work in practice for an example scheme?

Summary:

- £1bn pension scheme enters the PSP regime;
- The investment strategy is amended to target a broader range of growth investments, including in productive finance;
- An additional £10m pa is generated by the scheme's assets;
- Depending on agreement between sponsor and trustees, and the extent incentives or limits are put in place by the Government, these additional funds can be spent on higher DC contributions, higher DB pension increases and/or investment in the business; and
- Members' pensions are safer than before.

In more detail, consider an example of a DB scheme with the following characteristics (which we see as being typical):

- The scheme has £1bn in assets, with a reasonably strong covenant supporting it;
- It is currently 100% funded on a secure "Gilts+0.5% pa" discount rate, and is over 90% funded when assessed on a buyout basis (ie the cost of buying bulk annuities);
- The sponsor has historically paid significant contributions into the scheme, but currently is not doing so given the strong funding position;
- It is a scheme that is closed to new members, with 5,000 deferred and pensioner members (split c.50:50 between deferred and pensioners);
- The scheme's inflation-linked pension increases are capped at various caps ranging from 2.5% pa to 5% pa;
- The sponsoring employer also pays into a DC scheme for all its 3,000 employees (payroll £150m pa) - it makes contributions of 8% of salary to the DC scheme (ie above minimum auto-enrolment standards) – with a total DC spend of £12m pa;
- The Scheme currently has a journey plan to aim for a full insurance transaction by 2030 (trustee intention, not yet formally agreed with the employer); and
- It has already significantly de-risked its investment strategy (70% bonds), and expects to continue further on this path (to 90% bonds) over the period to 2030.

Under the status quo of the current DB pension regime:

- The DB scheme is currently predominantly invested in gilts and other low-risk bonds, in line with its medium-term intention to transact with an insurer;
- It also holds some illiquid infrastructure investments and these will have to be sold over time, potentially with loss of value;
- The benefits that are ultimately insured can be expected to incorporate the fixed pension increase caps, meaning any future possibility of higher discretionary increases would be lost post buyout;
- Once the insurer takes on the scheme's assets it can be expected to sell most of the scheme's gilts;
- Once the insurer takes on the scheme, the company will have effectively crystallised the costs of all the contributions it has made, and thereafter the insurer will benefit from any future upside in return for assuming the risk; and
- Based on the PLSA's Retirement Living Standards work, members of the DC scheme are not projected to have a moderate standard of living in retirement.

Under the PSP regime:

- The scheme's funding position is expected to be adequate enough for it to enter the PSP regime;
- The sponsoring employer and trustees would consider the attractiveness of this – we would expect the trustees to be keen (to gain full protection for members) and the company to be keen as long as it was confident the trustees would invest appropriately (at least to be expected to cover the additional PPF super-levy);
- We envisage that both the company and trustees would also be keen to reach a mutual understanding about the use of wind-up and discretionary

benefit powers (ie to ensure future company involvement in those powers), and the use of any future surplus that may arise (to agree a suitable sharing mechanism). Any recognised unions may also have a view on these points.

- Let's assume that these points are agreed through negotiation (noting the considerable alignment of interests) and, following actuarial certification, the scheme then enters the PSP regime:
- From then on, rather than further de-risking the investments and risking haircuts on illiquid assets, the scheme will be able to hold a well-diversified, efficient portfolio that generates expected returns of, for example, gilts +2% pa, and this can be done for the long term foreseeable future, leading to long-term expected *additional* returns (net of PPF super-levies) of at least £10m pa;
- We believe this can be done through use of a well-diversified, risk-controlled investment strategy;
- We also note that the trustees could choose to invest, if they wish, in assets that contribute to productive finance, including investment in UK businesses and supporting the UK's transition to net zero; or indeed Government may choose to incentivise such investments;
- The trustees would need to be comfortable that any losses that may arise in the future could be funded over a relatively short time frame by the strength of the company's covenant and cashflow; and the company would also wish to be comfortable with the level of risk being taken, and the resultant expected PPF super-levy;
- Over time, the scheme would be expected to grow a potentially significant surplus; once this surplus reached the super-surplus level set in the PSP regime, surplus could be released;
- There are lots of options for how this surplus can be used that would benefit various stakeholders – this could be left open to be decided at the time, or pre-agreed, subject to any incentives / constraints set by Government:
    - Some of the surplus could be used to provide DB members with higher benefits, eg better inflation protection (an extra 1% may cost £5m);
    - Some could be used to improve the DC contributions that the employer makes to its DC scheme, eg from 8% to 10% pa (cost of £3m pa), to improve the projected pension outcomes for its DC members, and help the employer attract and retain talent;
    - Some could be reinvested in the company itself, perhaps for R&D, training, other employee benefits or workplace wellbeing programmes, which will ultimately contribute to the productivity and profitability of the company and also help benefit the real economy of the UK.

13. Wouldn't it be better for a scheme to "buyout" (ie buy bulk annuities with insurers) rather than enter the PSP regime?

We recognise that for some schemes, buyout will be a better option, for example due to a weak sponsor covenant or simply a lack of risk appetite to continue to support a DB scheme.

However, whilst the purchase of bulk annuities nearly always enhances DB member security (compared to the status quo), this comes at a cost.

Firstly, there is the high financial cost of the bulk annuity premium due to the high level of security that insurers provide.

Secondly, and importantly, there is an opportunity cost. This is because taking the insurance route prevents scheme stakeholders (eg members, sponsoring employers and current workforce) from benefiting from the potential upside that can be achieved from a well-diversified and well-funded DB scheme.

There is also the growing challenge of the potential supply / demand imbalance of the insurance market over the coming years, as the volume of schemes now reaching funding levels able to achieve buyout is considerably higher than historical levels of buyout market volume. In our view, adding the PSP as an alternative option for some well-funded schemes would be helpful to ensure buyout remains a sustainable and cost-effective solution for those schemes that wish to continue to target it.

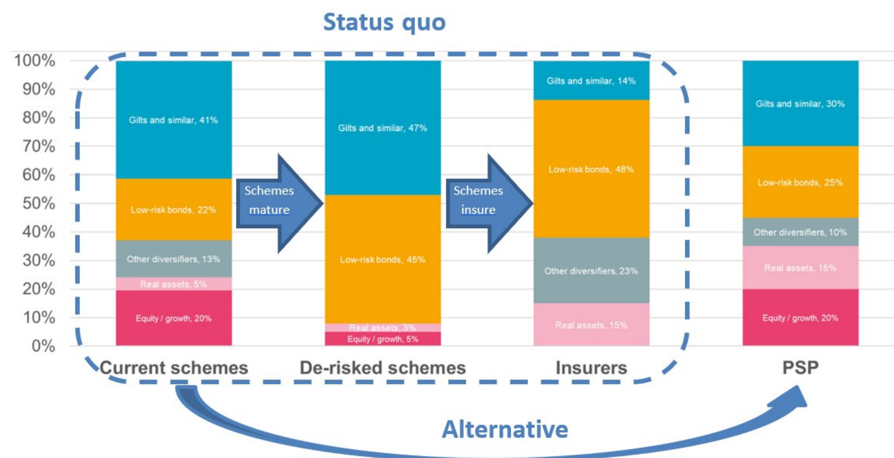
Having said that, the buyout route would remain open to PSP schemes, who could choose to take that route at any time in the future. In fact, for some

schemes, we note that entering the PSP regime will also make it more likely that they will eventually reach a level of funding that can support buyout. This is because of the additional investment returns that would then be expected. If circumstances change (eg the sponsor covenant deteriorated) then the scheme may choose to buyout in the future.

Questions 14 to 20: What might the PSP proposal mean for DB scheme investment strategies?

14. How might schemes invest under the PSP regime, compared to the status quo?

We have undertaken some modelling to show the expected direction of travel for underlying current c£1.5tr of pension scheme investments under the status quo, and the alternative of the PSP regime. The chart below summarises this:



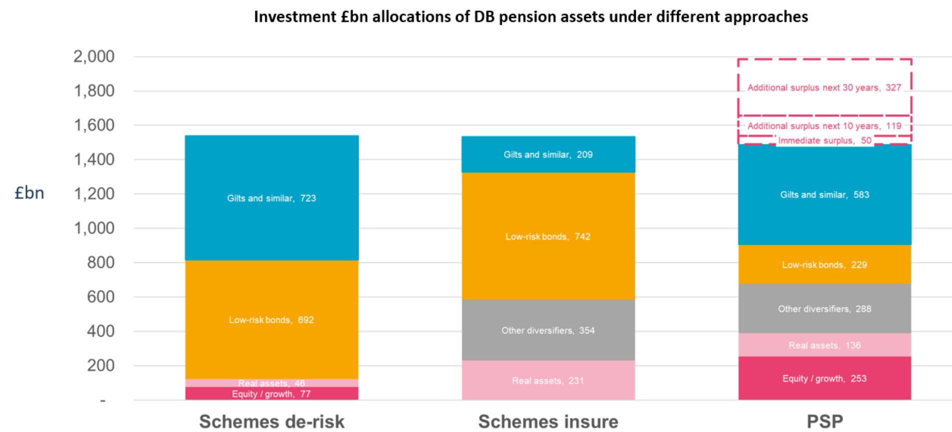
Source: Current DB: Pension Protection Fund "Purple Book" 2022; Anticipated DB under status quo: LCP expectations for a typical "low-dependency" strategic portfolio; Insurers: insurer asset allocations reflect the aggregate of insurer annuity funds; PSP: long term strategy which we believe to be a reasonably balanced, sensibly risked portfolio that may target Gilts+2% pa in the long term, which may be adopted by schemes that choose to enter the PSP regime.

Key points:

- DB allocations are currently expected to de-risk as schemes mature, both under the current regulatory regime, and even more so under the currently anticipated new funding code.
- Therefore, under the "status quo", most schemes will de-risk further (allocation 2), and many will move to insurers over time (allocation 3).
- Insurers do not proportionately own as many gilts as DB pension schemes, and invest little in equity (eg supporting UK growth companies). Whilst schemes are not insured, they are expected to retain gilts, but most schemes are expected to largely sell their equity holdings as they mature. Schemes targeting buyout are also increasingly unlikely to invest in illiquid opportunities such as UK infrastructure.
- Under the PSP proposal, if schemes chose to enter the PSP regime, we believe it likely that equity allocations would be preserved at least at current levels, with longer time frames for larger amounts of overall assets remaining in DB schemes, improving the potential for investment in productive finance. Other "real asset" investments such as UK infrastructure to support the energy transition could also increase. There would also be scope for governments to encourage any particularly desired investments through incentives if they wished.
- We also believe it is likely that more stable and potentially higher gilt holdings would be preserved under the PSP regime, particularly when compared to large-scale moves to insurers (where schemes often build up large gilt holdings, that are sold on transition to an insurer). This may be seen as positive by Government / the UK taxpayer.

15. What might be the £bns financial benefit of the PSP proposal?

We have extended our modelling to project the potential allocation of assets over time, under both the status quo, and the PSP proposal. This highlights the additional funds that could be available for various stakeholders. This is summarised in the chart below.



Source: total private sector DB assets assumed to be £1.5tr (both ONS and PPF recent sources), allocation %'s as per previous question; Assumes surplus can be released above 105% funding on gilts + 0.5% pa, with LCP data suggesting current aggregate surplus on gilts + 0.5% funding basis is around £100bn, of which half (that above a 105% threshold) could be immediately released under the PSP proposal; LCP modelling of expected surplus over next 10-30 years; insurer asset allocations reflect the aggregate of insurer annuity funds.

Key points:

- For simplicity, we have shown "what if?" the current c£1.5tn of DB assets are *all* invested in line with one of the three options. Clearly in practice it is likely a combination of options would be pursued by different schemes.
- For schemes entering the PSP regime, significant surpluses are expected to be released both in the near term and over the decades ahead. These could be used to increase member pensions, fund higher DC spend, or re-invest in the sponsor's business – all of which can be expected to directly support the UK economy.
- Under the PSP proposal, we would expect more stable and potentially higher gilt holdings to be preserved (above those expected to be held by insurers), and schemes would be expected to invest for further growth, including supporting productive finance, including UK equity investments.
- Under the insurance option, whilst investments in gilts and UK growth equity is likely to be lower, some capital is also expected to support the UK economy through eg debt investments in UK infrastructure and as capital reserves are released over time.

16. From a productive finance perspective, wouldn't it be better for schemes just to "buyout" (ie buy bulk annuities with insurers)?

From a productive finance point of view, we believe there would be benefits in assets remaining in some large DB schemes rather than transferring them to an insurance company (albeit we believe that there would continue to be a significant flow of assets into the insurance regime even if the PSP regime was introduced – see next question).

Following a bulk annuity transaction, insurers currently invest the pension scheme assets they receive somewhat differently to DB pension schemes. We would expect this to continue in the future. Our research set out above suggests insurers typically invest predominantly in bonds and other relatively low-risk / low-return debt-like assets. They generally do not invest in equity growth investments. This is because Solvency II rules incentivise them to hold lower risk bond-like assets, backed with high levels of capital, to match the long-term pension promises they are taking on, and to ensure there is very low risk of pensions not being paid.

Our modelling suggests that a large productive asset allocation can be achieved (and more quickly) if funds remain within large DB schemes, outside of the Solvency II regime, which can be achieved via the PSP proposal.

We note that Solvency II rules may evolve over time and may introduce more flexibility in the way insurance companies may invest. However, we do not expect the impact to be material compared to the big picture set out in charts in earlier questions.

Furthermore, we note that insurers tend to hold a lower allocation to gilts than a typical pension scheme (as Solvency II rules are pegged to swap rates rather than gilt rates). Therefore, an increase in insurer bulk annuity investments might be expected to reduce demand for gilts, potentially reversing the current long-term trend of DB pension schemes being net buyers of gilts. We note that this will

be at a time when Government needs to issue significant amounts of gilts on behalf of the taxpayer, alongside the expected unwind of Quantitative Easing. A reduction in the demand for gilts may therefore be negative for the taxpayer.

17. What might the PSP regime mean for the bulk annuity insurance market?

Currently, the vast majority of the UK's £1.5tr of DB pension scheme assets are expected to be headed for the bulk annuity insurance regime in due course. Many schemes have become much better funded over the last few years and are now much closer to being able to afford full insurance.

We remain of the view that the insurance market will continue to expand to take on growing amounts of pension liabilities, and that backing capital is expected to be available to do so. However, there are currently limiting factors relating to the operational resource needed to process the volume of schemes headed in this direction, and we expect this to continue.

We do not envisage that all schemes would choose to enter the PSP regime. For many, it will continue to make sense for them to move towards insurance in the short and medium term. For those who do enter the PSP regime, we would envisage many of them running on their pension scheme for some decades, and then transferring to an insurer at a later date, once the scheme has only older pensioner members and is much smaller in size.

Therefore, we do not believe that the PSP regime would stifle the insurance regime, but rather it would enable a more orderly transition into the insurance regime over the coming decades. It would also provide a viable alternative for larger schemes to consider, potentially reducing concentration risk within the insurance regime.

18. Why don't schemes invest for more growth already?

Without full protection from an outside source, the status quo regulatory regime understandably requires schemes to invest safely to protect members' pensions. Trustees have little incentive to take more investment risk if they think this would increase the risk of member benefits not being paid in full, and sponsoring employers have little incentive to take more investment risk because they cannot readily access any resulting surplus. Our proposals to change the rules of the PPF (to provide full member security) and on accessing surplus (to give the employer an upside) deal with these two incentive issues.

19. Would a PSP scheme be able to rely on the existence of PPF super-protection when setting an investment strategy?

We recognise that case law currently points to schemes not being able to rely on the PPF when making key strategic decisions in an ongoing situation. We envisage that the law changes that would be necessary to implement the PSP proposal would also make it clear (to the extent needed to enable functioning of the regime) that a PSP scheme could make appropriate reliance on PPF super-protection in considering its investment options. In our view this does not create new material moral hazard risk for PSP schemes – see later question on this.

20. How could the approach specifically support greater investment into UK (rather than solely overseas) growth?

The PSP proposal can be expected to have a positive impact on investment in (specifically) UK growth through a number of routes:

- By encouraging more of the assets held by the pension scheme to be invested in growth assets generally, this naturally brings up the allocation to UK growth assets;
- The opt-in regime could potentially include incentives to have minimum allocations to eg UK growth assets and/or certain investment areas, eg sustainable funds and investing in assets the support the transition to net zero;
- Through the release of surplus funds which could be used by companies to invest in their own UK business and/or pay to their UK employees to be spent in the domestic economy;
- Through the release of surplus funds into DC arrangements which in turn can be invested more in UK growth, which may then require DC members

themselves to save less (with money to spend in the UK economy) and/or provide higher longer-term DC benefits, to be spent in the UK economy in the long term; and
- Through an expected more stable and potentially higher long-term holding of UK gilts compared to a swift mass migration of UK DB schemes to insurers.

Questions 21 to 28: What about TPR and PPF perspectives?

21. What happens if things turn out badly?

All parties, particularly TPR and the PPF will want to carefully consider what may happen in poor outcomes under the PSP regime, including systemic risks.

It is clearly always possible that scheme assets underperform and/or a pension scheme sponsor becomes insolvent – these are risks that pension schemes have always been exposed to.

However, as we have described in earlier questions, the ability to enter the PSP regime is restricted to schemes funded to a secure level, which we believe will reduce the risk of negative outcomes. In addition, surplus cannot be taken from a PSP scheme until it is funded on an even more secure level (a ‘super surplus’), providing an additional ‘buffer’ against poor investment performance and/or sponsor weakness.

Furthermore, we envisage that the DB funding regime would continue to apply with minor adjustments to ensure appropriate levels of funding for PSP schemes. Therefore, if the funding position of a PSP scheme worsens, the sponsoring employer would be required to contribute to the scheme to get it back to the full level of required secure funding over a suitably short timeframe.

Under the PSP regime, members are further protected by their benefits being 100% covered by the PPF in the event the sponsor goes bust.

Therefore, from a member protection perspective, the PSP proposal significantly reduces the adverse consequences of things turning out badly.

22. Does the PSP proposal put the PPF at undue risk?

In our view, no. There are several reasons for this:

- We anticipate that the PPF would set the PSP regime’s PPF ‘super-levy’ on a risk-based basis designed to meet the expected cost of claims (broadly consistent with the current PPF levy approach – see a later question on this). Therefore, a PSP scheme which takes a higher level of investment risk (or which has an employer at higher risk of insolvency) will have to put more money into the PPF to reflect these additional risks.
- PSP schemes would remain under the current funding regime (with appropriate adjustments), with sponsoring employers responsible for repairing any emerging deficits.
- PPF claims would only arise if the sponsoring employer went out of business, not if investment performance was simply disappointing.
- The PPF is currently in a strong position notwithstanding taking on less well funded schemes historically and has very strong reserves.
- Only the best funded schemes would be permitted entry to the PSP regime – this high hurdle for entry means that any exposure of the PPF on employer insolvency would likely be relatively small (or possibly even nil), and in some cases could be expected to be readily made up over time with future PPF investment returns.
- When a scheme goes into the PPF, the whole of the assets transfer across, but the liabilities are spread over decades into the future, so there would be plenty of time for PPF to adjust levies etc as required to recover any funding shortfall.
- Assuming many schemes enter the PSP regime, this would be expected to enable the PPF to collect higher levies from more schemes for a longer period – reducing long term systemic risks to the PPF.

23. Will the PPF levies for PSP schemes be reasonable and affordable?

We believe so.

LCP powering possibility

It will of course be up to the PPF to model this and to decide what levies it will charge to PSP schemes.

We have done some modelling of PPF risk-based levies using the key assumptions detailed below. In effect, we have assumed that the PPF treats this new risk similarly to the way it has treated risks to-date.

Our modelling suggests that even if the PPF increase their current scaling factor back up to "1" for PSP schemes (more than a doubling of the current levy for each £ of risk) we think the PSP super-levy would typically be equivalent to less than a 0.1% pa "drag" on the additional investment returns that may be targeted by a PSP scheme (eg an additional 1%-2% pa).

This super-levy drag would be a little higher for poorer covenants and could potentially be expected to increase to no more than 0.2% pa following a downside investment shock. The expected super-levy quickly reduces as the funding position of a PSP scheme improves.

Whilst these amounts are of course more than the risk-based levy being paid by such well-funded schemes at the moment (many of which are paying no risk-based levy at all), they are small in the context of the overall assets of schemes and the potential investment return of a PSP scheme.

Key assumptions:

- *PPF risk-based levies continue to be calculated in line with the structure of the PPF's final 2023/24 levy rules dated December 2022, subject to a possible increase in the scaling factor to 1, noted above.*
- *Assumptions used for scheme funding are broadly comparable to those used for Section 179 valuations, other than adopting a discount rate of Gilts+0.5% pa.*
- *Modelling has been carried out on schemes of varying assumed maturity (between 50% and 100% current pensioners), covenant strength (D&B scores of between 1 and 10), three investment strategies (typical current, de-risked, and a typical anticipated PSP scheme broadly corresponding to a diversified mix of 50% growth assets, of which half are equity based), and an investment shock of up to 10% of assets.*

24. Would the calculation of PPF levies be more difficult?

We don't think so. In fact, we would expect the calculations to be simpler in many cases.

Currently, a Scheme Actuary must sign off a "Section 179 valuation" for each UK pension scheme based on benefits that are different to the scheme's benefits, on which the levy is assessed. Under the PSP regime, this valuation would be based on scheme benefits, which the Scheme Actuary is already valuing in detail for triennial valuations and other purposes. We envisage that the calculation of the super-levy would be directly linked to the funding level, investment strategy and covenant strength of each PSP scheme, which is a simple extension of the current regime.

25. Would the PPF need a different "PSP section"?

Our current thinking is that this wouldn't be appropriate, as it would be against the principle of pooling insurance risk, but it would be for the PPF to come to a view working with Government, to ensure fair treatment of PSP schemes relative to non-PSP schemes.

In particular, we envisage that very few PSP schemes would actually end up in the PPF, and that even those who do would end up costing other levy payers very little (or even make a profit for the PPF), given their secure funding levels and given the level of investment return that the PPF typically makes on its own assets.

However, we would envisage that the PPF may wish to consider approaches to ensure reasonable fairness for all levy payers. One way in which this could be achieved would be to allow differing scaling factors for PSP schemes and non-PSP schemes over time. The PPF could then monitor the risks associated with each group and be mindful of broad "fairness" when setting the scaling factors from time-to-time.

We are also of the view that the PSP proposal can be expected to improve the overall long-term security of the PPF. This is because, currently, a risk that the PPF is exposed to is that all the “healthy” schemes transfer to the insurance regime in the coming years, leaving the “unhealthy” schemes at risk of entering the PPF. These “unhealthy” schemes could then increasingly be required to pay higher levies that may be unaffordable for them and their sponsoring businesses. In the absence of a significant surplus in the PPF, this could lead to risk of a downward spiral for the PPF in some circumstances. In contrast, under the PSP proposal, the lifetime of some of the largest and safest UK pension schemes is expected to be prolonged. In turn, this would extend the pool of assets and timeframe over which the PPF can charge levies if required.

If the PSP proposal was pursued, we would expect the PPF to undertake detailed modelling and consider whether or not a separate PSP section is preferable.

26. PPF provides standardised benefits but the PSP regime protects 100% of *scheme* benefits – isn’t this much more complicated for the PPF?

In the expected rare instance that the PPF took on a PSP scheme, the PPF would need to work with the administrators of the scheme to ensure continuity of payment of member benefits in line with scheme rules. The administrators will know the fine detail of scheme rules and could support transfer of the administration to a PPF selected administrator (this is in line with the process that is undertaken when a scheme buys bulk annuities with an insurer). The expected administration costs could be reflected in the PPF ‘super levy’.

Alternatively, the current administrators could have a role in the post-transfer payment of ongoing scheme-specific benefits to members if there are capacity concerns for the PPF.

We note that our approach would be expected to result in very few such claims on the PPF, and hence very few schemes that would need to be administered with their full scheme benefits. This is in contrast to some other proposals for the future of DB pensions, which involve mass consolidation to the PPF on full scheme benefits.

27. What other regulatory angles has LCP considered?

We recognise that any amendments to the status quo need to be very carefully considered for regulatory risk, moral hazard risk, and the protection of member benefits. Our thoughts on PPF aspects are covered in earlier questions. Our thoughts on other key regulatory aspects are:

- We believe the existing and new funding regimes should work well with the PSP proposal. In our view it would be reasonable for the funding regimes to continue for all schemes, including those who enter the PSP regime. We envisage that TPR may wish to consider some small additional amendments to the new funding regime for PSP schemes, eg additional regulatory constraints could be explored that impose recovery plan length / covenant leakage constraints if a PSP scheme falls into deficit on the selected secure basis.
- We envisage that TPR will wish to consider whether commercial superfunds/consolidators should be permitted to enter the PSP regime.
- There is the possibility that eg new shareholders may look to buy up businesses with larger pension schemes in order to fund the schemes to the level at which they can enter the PSP regime. However, we don't think this is a material new regulatory risk because the new owner would have improved the security of the pension scheme and of pensions. We note that the covenant of the sponsoring business would continue to support the PSP scheme.
- More generally, TPR would continue to have available its existing moral hazard powers to use if appropriate, including the Pensions Schemes Act 2021 Contribution Notice powers.

28. Under the PSP proposal, what is to stop schemes (driven by either trustees or employers) investing in a very risky way, knowing they have the back up of the PPF if ever needed? Is this a moral hazard risk?

In summary, we think that the additional moral hazard risk of the PSP regime is small. This is because only well-funded schemes would be permitted to enter the PSP regime, so the PSP regime does not allow a route for a poorly funded scheme to be 'dumped' on the PPF with 100% super-protection. In addition, under the PSP regime a scheme would remain subject to the key protections provided by the current DB funding regime, including the requirement to top-up the scheme to a secure level of funding if funding falls below a specified level, and we envisage that PPF 'super-levies' would be set with reference to a PSP scheme's investment strategy, disincentivising excessive risk taking.

We recognise that, once within the PSP regime, sponsoring employers would, by design, be incentivised to invest for greater investment growth. Further, trustees may also have an incentive to invest for growth because they may reach agreement with sponsoring employers (or they may have the unilateral power to do so under scheme rules) that members may share in the expected future growth through granting of discretionary benefits. In theory, these incentives could lead to increased moral hazard risks, with significant investment risk being taken by schemes whilst "relying" on the full protection of the PPF.

We think these risks are small for a number of reasons including:

- From a trustee perspective, the PPF super-protection is only relevant if a business becomes insolvent. In the absence of insolvency, the supporting business must continue to fund a PSP scheme to a secure level, including any additional discretionary benefits granted, and including being able to cope with any downside risks. Trustees will therefore wish to be sure that they have acted sensibly in the risks they are taking, including ensuring the covenant of the business continues to support those risks. We find it difficult to imagine trustees wishing to act in such a perverse way that would threaten the very existence of the business (which is a risk with the status quo in any event).
- If discretionary benefits are indeed granted by trustees and/or employers, this might a) move the scheme funding level down closer (but not below) the threshold at which PSP schemes are considered to have a surplus that can be released (we would envisage such constraints as being part of the PSP regime) and b) increase the risk based PPF super-levy. Clearly employers will want to manage both risks.
- There are clearly some potential moral hazard issues around the granting of discretionary benefits if these were to be immediately fully protected by the PPF. But these are akin to risks that the PPF already has, and the existing "3 year lookback strikeout" rule on such benefits would continue to apply.
- If trustees of a PSP scheme mutually agree with the sponsoring company to take large investment risks because the company can afford to fill any downside deficit if necessary over a short time frame, we don't think this should be of significant concern to TPR or the PPF. The additional risk to the PPF should be small in such cases.
- Further protections could of course be built into the PSP regulatory framework if felt helpful by policymakers. For example, it could be possible to constrain (or penalise through PPF levies) the level of investment risk that could be taken by trustees of a PSP scheme, or to give sponsors of PSP schemes greater investment powers under the PSP regime to give them confidence that trustees won't take too much risk. In any event, some natural constraint on investment risk would be expected to arise through the normal calculation of the PPF super-levy.

That said, we expect PSP schemes to invest for more growth than under the status quo. In turn we believe this will lead to significant benefits to stakeholders and the wider UK economy as set out elsewhere in this FAQ. The above points do not diminish from this goal, but act to safeguard against overly-aggressive risk taking and moral hazard within the regulatory regime.

Finally, we recognise that a very weak company on the verge of bankruptcy, with a reasonably well funded pension scheme, could choose to enter the PSP regime. We would welcome debate as to whether such a scheme should in fact

be permitted to be immediately fully covered by the PPF or whether there should be additional protections for the PPF in such circumstances, for example a short vesting period.

Questions 29 to 33: Other questions

29. How does the PSP proposal fit with DB superfunds / consolidators?

We are of the view that our idea works well alongside the policy intent for DB superfunds / consolidators.

In particular, we envisage key target markets for DB superfunds being:

- DB schemes that are expected to find it difficult to afford full insurance in the foreseeable future; where
- the supporting business is "just about" able to find the capital to be able to afford the required "DB superfund premium" and / or additional capital becomes available, perhaps from a group parent or another external source (eg in the context of M&A) to top-up the DB scheme to a "DB superfund premium" level, but not to a bulk annuity insurance level; and
- the company and/or the external capital provider are keen to remove the DB scheme from the company's balance sheet.

In such cases, we are of the view that it would be unlikely to be desirable for the scheme to enter the PSP regime, as this would retain the risk on the company's balance sheet. And in such a case there would be a material risk that the investment risks in the PSP scheme could become unsupportable by the company's covenant over time. Therefore, such a scheme should continue to explore a superfund solution.

30. How does the PSP proposal fit with CDC schemes?

The Government and TPR are developing a regulatory regime to permit the wider use of new type of pension scheme – Collective DC, or "CDC" schemes. These are currently available for single employers and, over time, we expect regulations to be extended to multi-employer and decumulation only arrangements. We support this development and can see significant attractions for certain employer groups and for decumulation for DC schemes.

The PSP proposal is for DB schemes, and therefore has no direct bearing on CDC schemes. Having said that, the PSP proposal can be expected to have a number of features which we think will work well alongside an expected future growth of CDC schemes.

First, PSP schemes can be expected to develop surplus-sharing mechanisms that result in cross generational benefits, which has similarities with the principles of a CDC scheme.

Second, PSP schemes can be expected to extend the lifetime of DB schemes, so that there could be a more natural overlap of financial institutions who expect to in due course sell growth assets (PSP schemes in a decade or so) and those who wish to buy growth assets (e.g. CDC schemes as they naturally build scale). This is because CDC schemes are expected to be generally freer to invest in growth assets, and for longer, compared to DC schemes.

31. What might the PSP proposal mean for tax on pension surplus?

Currently, once a scheme is fully transferred to an insurer, any surplus remaining may (subject to the scheme's rules and consultation with members) be transferred back to the sponsor, subject to a 35% tax charge. Under the existing tax regime, tax receipts from this source are currently expected to be low, and take many years to emerge.

Under the PSP proposal, long term investment returns can be expected to lead to better funded pension schemes, and sponsors would be able to draw down on surplus sooner, triggering the potential for earlier (and larger) tax payments.

In our view, if the PSP proposal is explored further by Government, the pension surplus tax regime should be reviewed and the tax rate made less penal. One approach we would like to be considered is for tax incentives in the case where DB surplus is spent on DC contributions, similar to what may currently be possible where DB and DC benefits are provided through the same trust.

32. How does the PSP proposal fit with the idea of consolidating smaller schemes into the PPF, on full benefits?

We are aware that it has been proposed that another potential use of the PPF would be to consolidate 1,000s of smaller, less well funded, pension schemes into the PPF.

We have a number of questions and concerns about this proposal, which we will be considering separately.

However, we note that if such a proposal were to go ahead, there is no reason why it could not sit alongside the PSP regime. If both options were available, smaller less-funded schemes might be expected to enter the PPF over time, whilst larger and more well-funded schemes would have the option of bulk annuity insurance or the PSP regime.

In our view, the PSP proposal has a number of benefits compared to consolidating well-funded larger schemes into the PPF:

- The surplus generated can be shared with the stakeholders associated with the scheme, either the members, sponsoring employer or other employees, including for additional DC savings. (There is no ability for these stakeholders to benefit once a scheme has been consolidated into the PPF.)
- The PSP regime facilitates associated productive finance benefits without a need to transfer any schemes into the PPF, which is a lengthy process, and would involve the PPF administering many 1,000s of different benefits structures.
- In any event, the PPF is not incentivised to invest for growth. The fact that it now holds higher growth allocations than many individual DB schemes is an artefact of the issues with the current regulatory regime that the PSP proposal is intended to address.

33. Can something equivalent to the PSP regime already be done commercially?

For a small group of pensions schemes, where DB and DC is already within the same trust, and subject to the rules of the scheme, sponsors can use surpluses from DB to fund DC contributions (and/or an increase in DC contributions). In some other cases, schemes are able to target higher growth perhaps to support increases to members' benefits and/or share a surplus with the sponsor. In all cases, trustees would typically need strong confidence in the long term covenant of the sponsoring business to support such strategies.

It is therefore possible for some schemes to be able to invest for growth and access the value created by surpluses for the benefit of key scheme stakeholders and to support productive finance.

However, implementing this under the current regulatory regime has a number of challenges, including:

- Members' benefits are not fully underwritten by the PPF and so trustees are taking on additional risk (even if small) if they invest for growth
- Trustees therefore often conclude that it is more appropriate to target bulk annuity insurance, rather than to invest for growth in the long term
- Some sponsoring employers conclude that shareholders are best served by targeting bulk annuity insurance, and the removal of pension risk from the balance sheet, especially as routes to accessing any upside from DB schemes are currently complicated and uncertain, and generally significantly deferred and subject to penal tax
- DC benefit provision is generally not provided through the same trust. Moving DC arrangements into the DB trust is often not practical, may be resisted by DB trustees in some cases given their wider responsibilities and may be contrary to DWP/TPR's policy intent to move towards consolidation of DC schemes that may not offer good value for money.

Furthermore, some have suggested that there is no need to change the law to achieve what we are proposing through the PSP regime. This is because

schemes and sponsors can, it is said, already put into effect this "solution" using commercially available bank guarantees. That is, sponsors could pay a premium to a bank or insurer to guarantee the pension scheme liabilities (rather than the additional protection being provided by the PPF), thereby providing trustees with the investment flexibility envisaged by the PSP proposal.

However, this is not viable as a global policy solution for the following reasons:

- Not all schemes / sponsors are able to access such insurance at reasonable prices (and this is likely to be less cost effective for the pension schemes than the PPF providing the protection)
- The insurance protection would be needed over the lifetime of the scheme, with such insurance generally either not available or not economically viable
- Most importantly, such insurance becomes highly expensive and/or not available as a sponsor / scheme approaches the point at which the insurance is most needed (ie a strongly weakening covenant strength) – therefore, we envisage that no company would ever legally commit to maintaining such insurance "forever"
- Finally, sponsors can only benefit from scheme surpluses under limited circumstances, with significant deferral (on scheme wind-up) and subject to penal tax

In our view, in order to give trustees and companies the comfort they need to be genuinely comfortable taking long-term additional investment risk, a permanent, sensibly priced "guaranteed" insurance solution is required, and this can only be provided by the PPF, via a change in the law. Hence the PSP proposal.

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