Consultation on Options for DB Pension Schemes

The government recently published a consultation paper entitled "Options for Defined Benefit Pension Schemes", following an earlier consultation in 2023. The paper outlines some proposals centred on making it easier to extract surpluses from DB pension schemes. As well as the potential for the Pension Protection Fund (PPF) to become a consolidator of schemes. The industry has until 19 April to provide feedback as part of the consultation.

At Cartwright, we welcome the government's focus on the pension industry but are keen to ensure proposals are well thought through and ultimately lead to better outcomes. Trustees and sponsors of schemes on the cusp of insurance buy-out – which normally remains the gold standard for smaller schemes – may not wish to wait on the chance that these proposals ever actually come through. However, for schemes still a few years or more from buy-out it will be worth monitoring how, and if, these proposals develop. Our initial thoughts on some of the key areas in the proposals are outlined below.

Surplus Extraction

The proposals outline ways to make it easier to extract surplus from well-funded defined-benefit pension schemes. This will be done through changes to statutory powers and an incentive in the form of a lower tax rate to be paid on any such distribution.

We believe that security of member benefits is paramount and welcome the emphasis on safeguards and regulatory oversight of any such proposals. It is critical that the framework manages the competing interests of investment growth and benefit security.

The difficulty, from a Trustee point of view, is of course that any distribution of surplus, as the report concedes "will reduce security for members". Trustees will be mindful that recent surpluses appeared very rapidly following unprecedented market movements and could disappear quickly too; to the extent those gains have not yet been locked in. Crucially, it would seem very hard to reconcile any surplus extraction being consistent with Trustees fulfilling their fiduciary duty; in the absence of any additional security for members such as a full benefit underpin.

100% PPF Underpin

The proposal also suggests the potential to offer a 100% PPF underpin. This would appear to make surplus extraction an easier choice for Trustees when purchased at the same time. The proposal is that in return for a higher PPF-levy, full member benefits can be insured at the PPF rather than the 90% level; currently provided as a backstop.

The 100% underpin could give Trustees the confidence to adopt higher risk investment strategies and resulting improved returns could be welcomed by Trustees, sponsor and members alike. This could however, lead to an investment strategy that is imprudent. And, the proposals do not deal with the potential moral hazard and conflict of interests that are created by such a guarantee.

We feel it is important that any proposed underpin is designed with the members best interest in mind. The underpin, should it ultimately prove successful, would have a side effect of allowing more schemes to continue running-on with traditional investment strategies. This is instead of insuring and thereby supporting the continued demand for gilts and providing a larger pool of assets for UK productive finance. Pricing the underpin correctly is also challenging and could lead to cross-subsidy of schemes within the PPF.

PPF as a Consolidator

The consultation also proposes an option of a public consolidator, in the form of the PPF, as an alternative to the private market. It is important to note that we believe the current insurance market is working well, even for smaller schemes. We are seeing an increasing number of insurers entering the market, competitive pricing and innovation in structures that can assist schemes in unusual positions.

Unlike the report, we have stronger confidence that practical solutions can be found for most schemes in the existing private market. We would encourage the government to let that relatively new market continue to grow and innovate before assessing if any public intervention is required at a later date. With the growing insurance market and with consolidation and capital-backed journey planning available privately too, it is hard to see the current need for additional public sector involvement; aside from the existing PPF backstop.

If it went ahead, a public consolidator would provide a pool of assets which could be used to support UK productive finance; and this appears to be a stated goal. Trustees would need to weigh the perceived advantages of such a solution versus the disadvantages, including the loss of control over the investment strategy.

There would also be additional complexities in making such a consolidator work, particularly around the proposed use of standard benefit structures and the work required to transact schemes into the consolidator on that basis. A further challenge is that the simplification of benefits inevitably would create winners and losers among scheme members. The security of member benefits would also need to be considered against the backdrop of the strong PPF solvency versus a PRA-regulated and FSCS-protected insurance product.

Should I Worry About Any of this Now?

The proposals put forward in the consultation are at very early stage and will take some time to develop. To complicate things further, the general election later this year may well result in a Labour government, which could lead to further adjustments to proposed policy and more delays in final implementation.

It is important for Trustees and sponsors to know that these proposals are being consulted on and may become a viable option in the future. It is a more difficult call whether to make any changes to current journey-planning based on potential future legislation. Uncertainty is rarely helpful.

Our view is that buyout remains the gold-standard for Trustees of smaller schemes in most situations. And, those schemes that are close to securing buyout are unlikely to be affected by any of the potential changes outlined. For schemes that have strong covenant but still a while to get to wind-up it will be worth monitoring how, and if, these proposals develop.

Open dialogue with sponsor is (as usual) important and something we can help facilitate at any stage. Cartwright are experts in journey-planning for small and medium sized pension schemes. Utilising our strong industry relationships and innovative structures we have 100% success rate at securing buyout for over 30 schemes.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

March 2024

250 Fowler Avenue
Farnborough Business Park
Farnborough
Hampshire GU14 7JP

T: 01252 894883

E: enquiries@cartwright.co.uk

Marlborough House
Victoria Road South
Chelmsford
Essex CM1 1LN

T: 01245 293300

E: enquiries@cartwright.co.uk