Sackers

Consultation on options for DB schemes

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Introduction

On 23 February 2024, the DWP published a consultation seeking views on proposals to make it easier to make payments from DB scheme surplus to sponsors and scheme members and a model for a public sector DB consolidator run by the PPF.

Key points

- The consultation builds on the "package of pension reform" in the Autumn Statement 2023, which has the aim of providing better outcomes for savers, driving a more consolidated market, and enabling pension funds to invest in a diverse portfolio (including productive finance).
- The Government is considering introducing a statutory override to enable all DB schemes to share surplus, subject to appropriate funding levels.
- By 2026, it plans to establish a public sector DB consolidator run by the PPF which will be aimed at schemes unattractive to commercial endgame providers.
- The consolidator would offer standardised benefit structures and be legally separate from the existing PPF compensation fund.
- The Government will "press ahead" with creating a permanent legislative regime for superfund consolidators.
- As well as asking for views on the proposals, the consultation also includes a short survey for DB schemes, aimed at gathering information on the level of interest in these new policies.

Background

The proposed measures in the consultation are intended to "balance enhanced options for trustees with prioritising the security of member benefits". They are intended to build on the principles of the forthcoming revised funding and investment regime, as well as the proposals in the Autumn Statement 2023.

In the Autumn Statement, which built on July 2023's Mansion House reforms, the Government announced plans to "overhaul" the pensions landscape, with the aim of providing better outcomes for savers, driving a more consolidated market, and enabling pension funds to invest in a diverse portfolio (including productive finance).

As part of these reforms, the Government explored the use of surplus in DB schemes and whether there was a role for a public sector DB consolidator for schemes that are unattractive to commercial providers. While it acknowledged the “lack of consensus” as to the path forward in the response to its call for evidence on DB options, the Government confirmed it would issue a further consultation to address these points in more detail.

Treatment of scheme surplus

The Government aims to:

- support DB schemes to invest surplus in productive finance, 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.

Its core propositions are:

- surplus should only be extracted where “safe to do so” from a member benefit perspective
- trustees would retain responsibility for managing scheme funding levels
- extracting surplus will not be conditional on use of funds for particular purposes.

The Government also proposes to introduce additional guidance for trustees around the considerations required when considering extraction of surplus.

Proposed changes

Statutory override

As many scheme rules prohibit (or heavily restrict) extraction of surplus, a statutory override may be introduced to ensure that all schemes can choose to share surplus, subject to appropriate funding levels. The consultation calls for input on the appropriate balance of powers between trustees and employers, and whether any statutory override should take the form of a power to amend scheme rules to allow for payments, or a statutory power to make surplus payments.

Taxation

To complement the reduction to the rate of tax payable by employers on surplus repayments from 35% to 25% from 6 April 2024, the Government plans to simplify the process under which trustees can make **one-off payments** to members. As part of this, it is asking for views on what changes to the tax regime would support schemes in distributing surpluses to members as enhanced benefits.

Safeguards for member benefits

Recognising that any extraction of surplus will reduce security for members, the consultation seeks views on enabling greater sharing of surplus while ensuring “there remains a very high probability that member benefits will be paid in full". It sets out various possible eligibility criteria for surplus extraction, which are based on factors including funding levels and covenant strength.

The Government is also interested in understanding whether giving employers the option of paying a higher "**super levy**" to the PPF in exchange for the PPF offering a 100% level of compensation in the event of the employer's insolvency (described as a "100% PPF underpin") would be "valued and necessary" to enable increased surplus extraction.

Model for a public sector consolidator

Building on its ambition to consolidate the DB landscape and enable greater investment in UK productive finance assets, the Government intends to establish a public sector consolidator administered by the PPF by 2026. It proposes that:

- the consolidator would be set up as a statutory fund administered by the Board of the PPF, which would be subject to a range of legislative requirements, likely to align with the authorisation criteria for superfunds
- the consolidator fund would be legally separate from the PPF's existing compensation fund
- the link between the employer and pension scheme would be severed when the scheme transfers to the consolidator, apart from underfunded schemes, where the employer would enter into an obligation to pay off the deficit over time
- it would operate as an unsegregated fund on a run-on basis, rather than targeting buy-out.

Other considerations

Eligibility

The consolidator's statutory objectives would require it to offer an option specifically for schemes unattractive to commercial consolidation providers. Broad eligibility criteria could be set alongside this objective, ie a scheme demonstrating an inability to join a commercial consolidator or secure buy-out with an insurer. The Government is also exploring whether to set an explicit limit on the size of the consolidator, either overall or by annual growth, to avoid concerns about overexpansion.

Member benefits

The consolidator would offer a small number of standardised benefit structures and so would pay the actuarial equivalent of full existing benefits to members. This is intended to help smaller schemes, where the fixed cost of directly replicating scheme benefits could prevent them from transferring into the consolidator. The options would be designed to ensure that there would be no need to reduce the "headline level of benefits".

Treatment of deficit or surplus on entry

Where an underfunded scheme transfers to the consolidator, the employer would enter into a contract to pay off the deficit by instalments over a specified time period. If the employer becomes insolvent while the deficit remains, the standard PPF assessment would apply. Members would receive at least PPF compensation if their scheme assets did not support higher pension payments.

In contrast, if the transferring scheme has a surplus, employers and trustees could use the proposed new surplus flexibilities to share the surplus alongside entering the consolidator and/or to "purchase" a higher level of benefits from the consolidator for their members.

Funding and investment

To minimise the risk of unfair competition and with the aim of ensuring a high level of security for members, the consolidator could be required to meet the same funding standards as commercial consolidators, which will need to comply with the "forthcoming" superfund legislation.

The consolidator would maintain an investment strategy that supports a "prudent funding basis as well as increasing productive asset allocation", with the aim of benefiting members as well as the broader economy. There would be an expectation, subject to achieving sufficient scale, that the consolidator would invest part of its funds in UK productive finance assets – though the Government acknowledges that the extent of this may depend on the nature of the underwriting in place.

Underwriting

Commercial consolidators use third-party capital to provide a limited "buffer fund" that the consolidator could draw on should funding drop below certain pre-defined levels. A key question for the design of the public sector consolidator is how to enable the consolidator to provide a similar level of security. The Government is concerned that operating a very prudent funding basis could make the "entry price" unaffordable. Given this, it suggests that a form of underwriting will be needed, and it would "welcome views" on the different options available, including Government underwriting or use of existing PPF reserves.

It is envisaged that any underwriting would be finite in nature. As with commercial consolidators, this means that in a failure scenario, the members would need to have recourse to the existing PPF compensation. This means the consolidator would be expected to pay the PPF levy, again ensuring a "level playing field" with commercial consolidators.

Next steps

The consultation closes on **19 April 2024**.

No timing has been suggested for the reforms to the surplus framework but with a general election looming later this year, it will be interesting to see how this affects these proposals.

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