Options for Defined Benefit schemes: a call for evidence
IGG Response
September 2023

About IGG

Independent Governance Group (IGG) specialises in, and is one of the leading providers of, professional pension trusteeship, scheme governance and pensions managerial services in the UK. We were created in 2023 following the merger of two long-standing professional pension trustee firms, Independent Trustee Services and Ross Trustees and have 140 members of staff. Our multi-disciplinary team includes wide-ranging expertise in all areas. Investment specialists, actuaries, analysts, covenant and restructuring experts, pensions managers, project managers and scheme secretaries deliver value through collective excellence and a fully integrated, team-based approach.

IGG holds a variety of appointments with occupational defined benefit (DB) and defined contribution (DC) schemes and master trusts. Including DC Master Trusts, the total value of all schemes we support, across 460 appointments, is more than £350bn.

Mansion House reforms

IGG welcomes the core principles set out in the Chancellor's Mansion House speech and his ambition to promote economic growth in the UK through innovation and competition in the financial services and pensions sectors. We broadly support the attempt to address some of the difficult economic issues present in the UK through more innovative use of pension scheme assets; we want to work with the Government on the practical application of these reforms in the short and medium terms.

We believe there should be further consideration as to how the proposed reforms can be practically implemented to deliver the change the Chancellor is hoping for. In our response below, we detail practical suggestions for reforms to the pensions landscape and highlight what we believe are the outstanding issues that the Government must take into account when considering next steps.

Executive Summary

IGG does not accept the premise that the system is broken. While there is always room for innovation and new thinking, the system ensures that schemes meet their fiduciary duties to beneficiaries. This obligation will always remain at the heart of the decision-making process.

We recognise the wider economic impact of pension schemes investing in a range of asset classes as envisaged by the Chancellor. Indeed, we would like to make investment decisions that support continued and sustained economic growth in the UK economy and create an attractive business environment. Not only does this provide macro benefits nationwide, but economic growth also positively impacts our clients and scheme members.

Already, trustees can invest in productive assets, in line with their usual fiduciary duty where it is the right thing at that time for that scheme. However, the reforms need to address why this is not happening at the scale Government wants: a lack of incentive and impetus, and too much risk. What is really missing is the impetus to invest in productive assets as opposed to staying in low-risk assets to protect the funding level or other more traditional global growth assets. We must also address concerns about the risk of what is "under the bonnet" with these productive assets and their likelihood of failure. Addressing these issues will be key in enabling trustees of DB schemes to invest in productive assets within the current regime.

Achieving the proposed reforms set out in the Mansion House speech is not dependent on further consolidation in the DB universe, either in the superfund space or by means of the PPF. IGG believe it would be better for Government to focus its efforts on addressing the two main barriers to increased investment in productive assets in the UK: incentive and risk. We do not believe a new government consolidator would address a lack of investment in productive assets within the Government's anticipated timeframe. Whilst we are supportive of the principle of consolidation for both DB and DC schemes more generally to provide increased options for additional covenant support (for DB schemes) and / or improved governance (both DB and DC schemes), our view is it will not deliver Government's desired outcomes in a timely fashion and does not address the two main barriers outlined above: incentive and risk. The private sector as currently structured can provide sufficient efficiency of scale to do so, and we expect to see more innovation so that it does so.

As detailed in our response, we believe reform of surplus rules could give way to greater investment in productive assets. Allowing the use of a surplus for a wider range of benefits within an appropriate framework with clear and proportionate regulatory supervision could create a "win, win" for employers and trustees, as well as the UK economy. For example, Government could incentivise the making of different investment decisions by providing for the taking out of a surplus before winding up in potentially a more tax efficient way. At the very least, it could be used for DC benefits elsewhere.

Investing in productive assets is likely to result in the employer and trustees taking more risk. A second reform is needed to allow them to get more comfortable with that risk. Firstly, a clear definition of productive assets and what the Government wants to see pension funds invest in is needed. Investment in different categories of productive assets will naturally attract different risk profiles, for example, investing in a technology-driven start up versus investing in a piece of critical infrastructure such as a new road. Secondly, reform is needed to protect pension scheme investors, so they feel able to invest. For high-net-worth investors, tax breaks are the carrot used to incentivise investment in some productive asset classes and negate the risk borne by the investor. Government must recognise this and work with industry to provide an equivalent, or a form of protection such as a guarantee, for pension schemes (which don't pay tax) to manage the risk so trustees are able to invest without worrying about what happens should a large deficit appear.

As such, IGG believes there should be consideration given to what type of guarantee might be appropriate, including a guarantee of full benefits by the PPF from its current, more limited benefits. There may be certain types of investments at the riskiest end of the spectrum where trustees would need to be able to rely on the PPF in order to feel comfortable making those investment decisions, which they are currently unable to do. Pension schemes should be offered an underlying guarantee because without it, and given the high failure rate of start-ups, many are likely to anticipate losing money and will therefore not to want to take the risk.

If the Government is not aligned with incentivising employers in these proposed ways, a consequence will be that the main aim for most employers will be to buy out as soon as possible. On buy out, the pension scheme will sell its gilts; however, insurers are not in the market and there are no other buyers of inflation-linked gilts, meaning increased costs of borrowing for Government. Government may come to the view that incentivising schemes to remain invested is a necessary policy to protect its own borrowing.

Whilst we are supportive of consolidation more generally, we do not believe there is a need for further consolidation in the DB universe, either in the superfund space or by means of the PPF to achieve the Mansion House goals. New DB consolidators and DB master trusts will take too long to set up and scale, compared to incentivising trustees to create surpluses. Either way, if nothing is done Government will not realise the desired outcome as schemes will continue to decide to buy out in short order. What is really missing is the impetus to invest in productive assets as opposed to staying in low-risk assets to protect the funding level or other more traditional global growth assets.

The way in which liabilities are valued, and regulatory interpretation of this, has driven the way in which schemes invest. To enable schemes to invest in other assets it would also be helpful to bring into the mix an adjustment to how liabilities are valued and paid for. We see that TPR's amendments to the superfund guidance recently recognise that a change is needed.

There is a barrier in terms of how to create funds of productive assets that are well managed and risk assessed, and which represent a genuine investment opportunity. Given the experience of the recent gilts crisis, there needs to ideally be a way to make these funds liquid. An outstanding question remains whether the expertise and/or capacity exists in the UK to manage these funds.

Finally, we question what the Government's aim is, in terms of what it would like to achieve with these assets. Trustees will need to know more clearly what effect it hopes is achieved. For example, is the aim GDP growth or employment growth? Do the underlying companies need to be start-ups or listed in the UK? There needs to be a clear prioritisation from Government of its aims and ambitions. In prioritising, the Government must consider the necessity of a mechanism to incentivise pension schemes to avoid buy out for the next 10-15 years, which is the time horizon of any likely investment.

IGG's substantive response to the questions follows below.

Investing in productive assets

IGG's response to Questions 1 and 2

The substantive question about whether DB schemes are underinvesting in productive assets is challenging to answer for two reasons. Firstly, it is not clear what productive assets international comparators are investing in, and secondly, it is not clear what the Government means by productive assets for the purposes of this consultation. IGG believes there is scope for increased investment in what are generally understood to be productive assets; however, to realise this potential, Government must address two fundamental challenges as set out above: incentives and risk point.

A trustee's primary responsibility is to ensure that members' benefits are paid as and when expected and to the value which is promised. To realise the Chancellor's ambitions, the Government must consider the framework in which trustees make decisions. They must have regard for the various aspects and stakeholders which make an investment strategy successful. Effectively this has been condensed to the consideration of risk in terms of a balance sheet approach where assets and liabilities are valued on an infrequent basis that ultimately considers the (1) sponsor's ability to underpin the investment risk and (2) guidance designed to ensure schemes target a low risk / low dependency basis. The intention of this approach is to effectively increase the probability that a trustee (on behalf of the Scheme) can fulfil its primary responsibility to members. This general guidance has meant that schemes target a long-term objective of gilts + 0.25% (this can go up to gilts + 0.75% where the covenant is weak).

This consensus target has resulted in schemes' liabilities being valued on such a basis and has historically led to funding gaps arising though the triennial valuation cycle which need to be closed. This is generally due to either (1) realised experience being different to assumptions or (2) a strengthening of basis to achieve the 'long-term' discount target.

It is the responsibility of trustees to agree a strategy to close the funding gap which (void of liability management exercises) is limited to investment returns or contributions from the sponsoring employer. The valuation of liabilities is undertaken, at least, on a triennial cycle meaning trustees need to consider the sustainability of investment returns vs the contributions payable by the employer. In effect, it provides an incentive for trustees to tilt their strategy to close the shortfall with sponsor contributions versus investment returns as this gives them a more certain return stream.

The result of this approach has created a conundrum in scheme management. Trustees are faced with attempting to be considered as long-term investors able to accommodate investment volatility, while having shorter three-year time horizon valuations in which schemes need to measure performance against their long-term target. Underperformance falls to a discussion on investment strategy or contributions. This cycle of decision making creates a short termism in investment horizons which acts as a counter to making decisions to allocate to illiquid assets.

To realise the potential benefits of DB scheme investment in productive assets, IGG recommend the Government reconsider the valuation basis and move away from the sole reliance on mark-to-market valuations. This method encourages a short-term perspective, leading to conservative asset allocations. By introducing alternative valuation methods that balance short-term fluctuations with long-term objectives, trustees might be more willing to invest in higher-yielding productive assets. Complementing this should be a rethinking of the approach taken in a three-year triennial valuation cycle. This cycle promotes a short-term view due to the fixed date valuation. By potentially extending the period, providing a more flexible approach or considering a more larger window for valuations to occur, sponsors and trustees may feel less pressure to maintain stable positions and may consider more long-term investments.

While trustees hold the ultimate responsibility for managing schemes, they aren't the sole decision-makers. They must weigh the perspectives and capabilities of sponsors to support the investment risks they're taking. Under current accounting standards, especially those that influence how large schemes are managed, corporates must frequently value liabilities on a basis which is more akin to risk free plus a variable risk premium. This method can be at odds with the statutory funding obligations. There's a notable discrepancy: sponsors are penalised for supporting trustees' low-risk investment strategies via contributions. Yet, these same strategies introduce asset liability volatility onto corporate balance sheets.

This misalignment makes the costs of Defined Benefit (DB) pension schemes appear disproportionately high from a reporting standpoint compared to the actual scenario. Consequently, there's an increased motivation for scheme sponsors to transfer DB pension scheme liabilities away from their balance sheets. This shift has given rise to buyout-style contracts in the market.

Given that companies generally prefer consistent expense patterns, sponsors often advocate trustees' desires to aim for a low-risk liability framework. The goal is to manage contributions and investment returns over time so that they can meet liabilities without excessive cash outflows, albeit potentially incurring a P&L loss.

We see this in practice especially among sponsors in the insurance or banking sectors. Theoretically, they should be in a position to manage pension risks more adequately; however, they are faced with strict solvency rules stemming (generally) from account practices.

For them, transferring schemes to alternative balance sheets has become a common strategy, freeing up solvency capital for company investments or dividends enhancements. This approach, driven by accounting standards, has pushed sponsors to manage scheme risks to optimise their cost structures, which is largely an outcome of the liability basis and accounting practices.

In examining how statutory obligations of pension schemes are managed, we can draw insights from international comparisons. Consider the Irish market where there remains an ongoing debate surrounding the retention of the minimum funding standards as an example. This approach has led to a baseline position of liabilities that is considerably lower than that of the UK. Consequently, the Irish market tends to have a more substantial equity allocation compared to its UK counterparts. This preference for equity can be considered as the volatility inherent in equity markets can be better absorbed due to the greater 'margin' available between the statutory funding obligations and the asset base.

Looking to the US market, their valuation approach closely mirrors accounting standards. Additionally, US corporates have a distinct perspective on the ramifications of discharging liabilities on their P&L. The relative increased cost on an accounting basis, when juxtaposed with the UK market, means that schemes are more likely to stay on a sponsor's balance sheet. As a result, US sponsors often perceive themselves more formally as long-term investors who can consider more volatile investments. This outlook doesn't strictly adhere to a short-term, three-year cycle prevalent elsewhere. Ultimately, this leads to a pronounced tilt towards equities, with schemes less inclined to see a low-risk portfolio as being primarily constituted of treasuries or corporate bonds.

IGG recommends the evaluation of accounting standards. Sponsors play a crucial role in trustees' investment decisions. Realigning accounting standards with trustees' methodologies might encourage schemes to remain on corporate balance sheets, which could, in turn, influence the asset allocation strategy. In our response, we've identified the evaluation basis as a key factor influencing trustee and sponsor decisions. A secondary effect of this basis stems from the aim to stabilise funding levels or deficits.

This emphasis has led to a notable shift towards risk-mitigating strategies, as an example UK defined pension schemes heavily favour liability-driven investments as a way of reducing risk. In essence, trustees tend to prioritise reducing risk, gauged by the volatility of funding levels or deficits over instantaneous or short (sub 3 year) time horizons, and subsequently focus on bridging the funding gap.

This approach results in schemes maintaining high hedge ratios, especially concerning inflation and interest rate hedges—a strategy that has been endorsed by the Pensions Regulator. The considerable portion of schemes' asset portfolios dedicated to these strategies is amplified by newer regulations.

Consequently, after accounting for risk mitigation, schemes possess limited capital for investments beyond core assets like corporate or government bonds. This limitation is further exacerbated as the comparatively smaller capital pool must align with performance expectations, compelling schemes to diversify risk to stabilise returns. This has led to a drift away from UK equities towards international markets, aiming for diversification across various macro environments. However, this trend isn't universally observed. Larger international markets, like the US, offer inherent diversification due to their sheer size, so they don't always value diversification in the same way as UK pension schemes. As a result, the UK market has a reduced capital allocation to domestic assets compared to its international counterparts.

As part of its next steps following this call for evidence, IGG recommends Government evaluates the incentives which drive trustees to stabilise funding levels. The mark to market valuation of schemes assets and liabilities drive to a risk mitigation approach whereby the cost of such mitigation encompassing both the management fee and liquidity budget limit the ability of trustees to consider alternative asset classes.

In essence, we believe that the modifications and assessments recommended would facilitate the retention of schemes on sponsors' balance sheets and encourage trustees to venture beyond the confines of low-risk, low-volatility assets. Such a shift might lead them to explore alternative assets, which, although possibly characterised by increased volatility, could yield higher returns, thereby diversifying the investment landscape. However, a nuanced perspective is required when it comes to understanding how such capital can be deployed in productive assets, and a clear delineation of what constitutes these assets is paramount.

Several pertinent challenges emerge in this context:

- **Start-up Engagement**: Is the intent to foster and support budding start-ups? If so, determining effective management strategies for this asset pool is crucial and ability to pool resources becomes a consideration.
- **Market Capacity**: We need to scrutinise whether the market possesses the requisite capacity to absorb large inflows of capital into alternative asset classes as well as outflows form the more traditional asset classes and do so without undue disruptions.
- **Return Suppression Concerns**: Past trends have demonstrated that when there's a pronounced push to divert assets into a particular asset class, it can inadvertently depress the return profile of that class. This poses a dilemma for trustees and allocators, including investment consultants and asset managers, as they must gauge the relative benefits against other asset classes.
- **Valuation and Retention Basis**: By revisiting how schemes are valued, retained, and how surpluses are employed, we can better position schemes to capitalise on return potentials more vigorously.

Finally, as set out above, we are calling on Government to provide a precise definition of 'productive assets'. When doing so, Government must consider the viability of supporting start-ups, assess the market's assimilation capacity and seek to understand the risk of return suppression when overly concentrating on a specific asset class. This will ensure a holistic approach when considering incentives and other strategies to counter risk levels, such as a guarantee of some form.

Building and managing surpluses

IGG's response to questions 3 through 9

As set out above, we recognise the wider economic imperative and impact of pension funds investing in productive assets; however, there needs to be an incentive to do so. As a business, we are at the forefront of innovative approaches and new thinking to deliver for our clients and members. As part of this, we are keen to take action that contributes to the growth of the UK economy and help create an attractive business environment, within an appropriate framework with clear and proportionate regulatory supervision. Not only is this good for the UK economy, but it will directly and indirectly benefit our clients.

We believe Government should incentivise the building of surpluses for schemes where the sponsor covenant is assessed as strong or tending to strong to promote investment in productive assets, while factoring in risk. We remain open minded and optimistic about the wider economic benefits; however, we are concerned about the lack of detail regarding what productive assets the Government wants pension schemes to prioritise investment in.

While commercially driven, we believe fresh-thinking and new ideas is key to realising the Chancellor's ambition. Our proposed surplus reforms will give trustees the green light to show employers how schemes can invest in productive assets with acceptable levels of risk, and deliver for schemes, keeping members' interests at the forefront. This is a win-win for employers, the Government and the UK economy.

For the purposes of what can be considered a surplus, we envisage a self-sufficiency funding level above which the slice would be counted as a "surplus" and to which new rules could apply, allowing this surplus to be paid within a framework that includes consideration of scheme members' claims on that surplus. To realise the benefits of building a surplus and so that a tranche of that surplus is invested in productive assets, IGG believes employers should be offered the chance to extract the surplus, or a proportion of it, pre-wind up, at the very least to use for DC contributions in separate arrangements (and of course, this will resolve the growing issues of intergenerational unfairness between DB and DC scheme members too). IGG do not think that mandating investment in certain productive assets would be helpful as all schemes and employers are different; however, we do think extraction of surplus pre-wind up, with potential taxation efficiencies, would provide an incentive. If trustees need to consent to the extraction of surplus by an employer (which currently depends on individual scheme rules), the presence of an independent professional trustee on the Board will mitigate the risk of misuse of funds by ensuring that the trustee board acts prudently and in accordance with its fiduciary duties.

We are supportive of innovation around the use of surplus. We recommend that use of surplus is determined within an appropriate governance framework with clear parameters and checks and balances, together with proportionate regulatory guidance.

Investing in productive assets is likely to result in the employer and trustees taking more risk. A second reform is needed to allow them to get more comfortable with the risk. For high-net-worth investors, tax breaks are the carrot used to incentivise investment in some productive asset classes and negate the risk borne by the investor. Government must recognise this and work with industry to provide an equivalent or a form of protection such as a guarantee for pension schemes (which don't pay tax) to manage the risk so trustees are able to invest. We believe the PPF would be an appropriate vehicle to provide a guarantee of all benefits. Doing so will expand the pool of schemes that are able to play in this space and give trustees and sponsors, who might otherwise not invest without the guarantee, greater confidence when making active decisions. It goes to incentive and impetus and management of risk.

Consolidation and the role of the PPF

IGG's response to questions 10 through 20

Whilst we are supportive of the principle of consolidation for both DB and DC schemes to provide increased options for additional covenant support (for DB schemes) and / or improved governance (both DB and DC schemes), it is important to recognise they will not be the right solution for all schemes. Using the PPF as a consolidator may not deliver material investment in productive assets in a timely fashion. This is particularly the case if it is intended to remove the employer covenant on entry. Competition from buy out providers who have benefited from excellent pricing reflects the challenge current superfunds have experienced in scaling to date.

If Government wants pension schemes, including DB schemes, to invest in productive assets for a substantial enough period to produce results and returns, then its energies are best spent looking at incentives and risk management. When you consider the lifespan (to potential buyout) of most pension schemes is much reduced post the gilts crisis, incentives as described above will increase the likelihood of DB schemes investing in productive assets in a much timelier fashion.

We also believe that it would not be straightforward to use the PPF as a consolidator, which will add substantial time to the set-up period. The PPF has been in operation for 20 years and is in surplus, which on the face of it suggests it would be a good vehicle for consolidation of other schemes. However, it should be recognised just how varied the benefit structure and governing trust documentation can be for each scheme. This makes consolidation cumbersome and dampens efficiency gains. The PPF is a good example of a successful consolidator, but one of the reasons it works well is that it has a very simple benefit structure. This may be because it is a product of last resort that provides compensation rather than the original scheme benefits and, prior to entry into the PPF, the benefits and governing documents have gone through a thorough audit. This simple structure and cleansed starting basis offer a strong base for operational efficiency. It is hard to see how trustees of schemes where the employer is not in insolvency would be able easily to agree to a change to the benefit structure that we think would be needed for efficient running of the PPF as a broader consolidator

We also consider that professional corporate sole trusteeship, with the right risk reduction controls and incentives as set out above, can be an effective management option and route to consolidation which overcomes the various barriers associated with superfunds. This will help realise the Government's ambitions of promoting economic growth more quickly. As trustees of billions of pounds of assets under management across numerous trusts, it is possible to leverage the aggregate scale of these pension schemes, to create equivalent economies of scale that superfunds are able to achieve in the area of investments. That scale could also drive investment in assets that support the UK economy, where appropriate, to the needs of the scheme.

Due to improvements in DB funding positions a large number of schemes and employers in a perfectly functioning bulk annuity market would have already transacted. However, market inefficiencies such as capacity restrictions (staffing, capital and operational) are causing delays for the schemes that are least attractive to insurers. Increasing the number of consolidators will not solve all of these inefficiencies, for example the staffing constraint. Insurers, consolidators and superfunds are all seeking to employ the same experienced individuals with at least two years in the industry, adding to the existing burden.

PPF+ consolidation

However, there are some rather niche areas of the buy-out market where a PPF consolidator would be useful. When a scheme enters a PPF assessment period it will either transfer to the PPF if funded above PPF levels or exit PPF because it is funded above PPF levels (PPF+). When funded above PPF levels (but below full scheme levels) the expectation is that the scheme will be able to secure benefits in the bulk annuity market. A mismatch in the way assets have been invested or allocated from when a scheme was targeting a scheme benefit basis, compared to a valuation of liabilities on a PPF basis, can mean the scheme does not have enough unencumbered assets to achieve a PPF+ transaction in the private market. We have several examples of these schemes.

- Value in the assets is coming from pensioner annuities secured on a scheme basis. The annuities are in the scheme's name and cannot be surrendered or restructured to allow a transaction with a bulk annuity provider. The PPF can take on the annuity policies and redirect the income to other members to provide the valued level of PPF benefits.
- Value in the assets comes from an old insurance style contract and again only by taking on this contract and redirecting the income would a PPF+ transaction be viable.

For these schemes we believe a PPF+ consolidator would be a good outcome for members. The current alternative is that schemes are being held in 'Closed scheme status' and with no employer available to fund the ongoing costs of the scheme, the outcome for members will inevitably be a return to PPF once scheme expenses have drained the assets to an extent that the scheme once again becomes funded below PPF levels. The other scenarios where a PPF+ consolidator would be a good outcome:

- PPF+ schemes that are not immediately attractive to a bulk annuity provider because there is no employer to fund ongoing expenses and so the scheme doesn't have time for the bulk annuity market to naturally correct itself to increase capacity or for the scheme to 'wait its turn'

- PPF+ scheme where the scheme is waiting for a dividend payment from the employer insolvency event. Sometime an insurer will still be interested but not always.

As the Government finalises its response to this call for evidence, we would welcome the opportunity to discuss our response in detail with officials.

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