XPS Pensions Group

The future of defined benefit pension schemes in a better funded world

Part 1: Would a public sector DB consolidator serve the public good?

Introduction

On 23 February the Government published its consultation on setting up a public sector consolidator. The Pension Protection Fund, expected to run such a consolidator, has since set out its views on how this could be designed and operated.

This now has the industry asking the questions: do we need a public sector consolidator, and would this serve a public good?

The success of the PPF - and continuing this positive contribution

Since it was established in 2005, the PPF has made an enormous and valuable contribution to the UK pensions landscape. Before it was established, corporate insolvencies frequently led to disastrous outcomes for members of defined benefit schemes. The PPF, although not providing full benefits to members in such outcomes, has cushioned the blow and provided protection to just under 300,000 people who may otherwise have been left financially vulnerable.

Funding levels have now improved materially for most defined benefit schemes in the UK, and the majority are now funded to "above PPF" levels. As such, the number of schemes and members that benefit from the protection of the PPF (as it currently operates) has greatly reduced. In simple terms, the PPF now has a lot less to do.

However, there is a real opportunity for the PPF to continue to add a lot of value. The primary risk to a defined benefit scheme today remains the insolvency of the corporate sponsor, as although most schemes are funded to "above PPF" levels, most are not funded to the level of a full buyout. In these outcomes, members do not receive full benefits.

We think there is a real opportunity for the PPF to have a role here. We think the PPF could be very effective in providing stewardship of those schemes, overseeing the trustees to reach 100% of members' benefits over the medium term. We think this would lead to demonstrably better outcomes for members than the status quo of those schemes either entering the PPF with reductions to members' benefits or securing a "PPF plus" buyout with an insurer with a level of benefits that is above the PPF minimum but below full benefits.

The consultation is about a wider role than this, with the PPF as a public consolidator of a wider range of schemes including where the sponsor remains solvent. We have some grave reservations about this, which we set out below.

Government's aims for a public sector consolidator

Government's two central aims are to improve outcomes for pension scheme members and enable pension schemes to invest more in productive assets, for the good of the wider economy.

The case put forward for a public sector consolidator is twofold:

- that this would introduce another option for trustees of DB schemes to secure members' benefits, particularly those schemes that cannot do so in the commercial market because they are unattractive to providers (because of their size or the complexity of benefit structures); and
- it would also lead to the pooling of many small schemes into a much larger scheme which would have the scale to invest in productive assets.

In terms of the financing of the public sector consolidator, schemes would be able to enter if fully funded on a "gilts + 75 basis points" basis, or if there is a deficit on this measure, schemes could enter with the employer paying a fixed schedule of payments to make good this deficit over a period of time.

Ultimately, the new public consolidator would be underwritten by UK taxpayers.

Does this case stack up?

Access to consolidators for small/complex schemes

Looking first at the availability of consolidator options for schemes, we have not seen any evidence that schemes "cannot get a quote" from existing consolidators. It is suggested that small schemes and/or schemes with complex benefits may be in such a situation, but across our large client base, which has the full range of schemes in terms of size and complexity, we simply have not encountered this, perhaps with the exception of very small schemes for senior executives, which may be difficult to insure through a bulk annuity - but even then, individually underwritten annuities are available.

In terms of benefit complexity being a barrier, the PPF has suggested that where this is the case, a harmonisation of benefits to a simpler structure on entry to the consolidator could enable even the most complex schemes to have access. As above, we have not seen evidence that complexity is a barrier, but if benefit harmonisation is needed then why should its application be restricted to only a public consolidator - surely it should apply to all?

There are wider challenges around the harmonisation of complex benefits. A decision has to be made - do we harmonise complex benefits to simple structures that we expect have a good chance of being of equal value (but might not be), which might be called an "averaging" approach, or do we "level up" all benefits? An example of where a decision would be needed is where a scheme provides pension increases that are inflation linked but capped and collared. A fixed increase could be applied - but if this is lower than the cap, then benefits could be lower than they would have been; if it is set at the level of the cap, then benefits will likely be higher than they would have been in many future years.

This is of course a whole topic in itself. The two key points that are relevant here though are:

- If the "levelling up" route is taken to harmonisation, benefits will be materially more expensive to provide, and the consolidator will look less attractive and/or be less accessible; but
- If the "averaging" approach is taken, there is a very real risk of future legal action by members left worse off in the future.

On this latter point, additional costs arising from a successful case would likely be large (both in terms of additional liabilities and the cost of rectification) and these costs would fall to the UK taxpayer if there wasn't a large surplus in the consolidator to cover the bill.

Finally on the topic of "attractiveness of schemes" to existing consolidators, this is of course also a question of time. Some schemes still need to become materially better funded. Others need to prepare their data and documentation for a transaction. All the time the market is innovating to create capacity for small schemes. The huge increase in funding levels and insurance transactions over the last decade is evidence of the market adapting to demand and this is an accelerating trend.

Investment in productive assets

We consider that it is not the responsibility of private sector DB pension schemes to ensure growth of the UK economy; it is their role to provide their members with their pension promise. The case put forward for a public sector consolidator appears to conflate some big differences between DB and DC schemes. For DB schemes, members' benefits are not directly dependent on returns in the same way that they are in DC schemes; the main risk in DB schemes is insolvency of the sponsoring employer before members' benefits have been secured in full. The design of any non-insurance consolidator has the potential to reduce security if it enables companies to discharge their schemes at lower costs than the insurance market.

In the case of the public sector consolidator specifically, the protection that members would have to mitigate this risk is that the UK taxpayer would underwrite the fund. We find this extraordinary, for two reasons:

- First, is this a risk to taxpayers' money that should be taken at a time when the tax burden is high, and the UK needs a wide range of public investment in key areas? How would it be fair if in future the taxpayer is called on to fund private sector DB pensions for a generation fortunate enough to have had them, while the next generation of taxpayers meeting the cost typically has much lower value DC provision?
- The second key issue is about the functioning of the market. When assessing benefit security, a taxpayer-underwritten consolidator will always be more attractive to a pension trustee choosing an end destination for a scheme than a commercial consolidator. How could a commercial provider ever compete with something government-guaranteed? This runs against the principles of free enterprise, and of course if it led to the commercial consolidator becoming very large, then the level of risk being underwritten by the UK taxpayer would also be very large.

Closing remarks - is there a better role for a public sector consolidator?

We at XPS are hugely supportive of the development of a thriving market of consolidators. There is a need for a strong, competitive market for schemes of all sizes and complexity. Different consolidators will be suitable for different needs. We warmly welcome both the emergence of "superfunds" and the rapid expansion of the bulk annuity market, and we are engaged with our clients about all the options that are available to them now and in the future.

The PPF has done a brilliant job protecting members from disastrous outcomes over the last 20 years. We think it could continue to play an extended and very valuable role, supporting schemes with the aim of providing full benefits even where there is a corporate insolvency and a scheme not yet fully funded on buyout.

We do not however think that there is a case for the creation of a taxpayer underwritten public consolidator.

For more information or to discuss further, please contact events@xpsgroup.com or your usual XPS Pensions Group contact.