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By email pensions.consultations@dwp.gov.uk

Department for Work and Pensions

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Dear Sirs

Options for Defined Benefit Pension Schemes: Consultation Response

Squire Patton Boggs is a leading full-service commercial law firm operating globally, with a significant UK pensions practice. With some 40 pension specialists in four UK offices, we advise more than 400 trustee, corporate and public body clients with scheme assets of between £5 million and £50 billion. We act for circa 45 schemes with assets over £1 billion. We also operate a professional trustee company, which looks after 26 schemes with over 260,000 members and manages assets in the region of £42 billion.

In this response we have offered some general comments on the consultation as well as answers to specific questions where indicated.

As noted in our response to the July 2023 call for evidence, we share the government's desire for increased growth in the UK economy and can readily understand why harnessing the estimated £1.4 trillion of DB scheme assets to that goal is an attractive prospect. However, pension scheme trustees and sponsoring employers have no duty or obligation to generate such growth. The focus must remain on securing members' promised benefits and we are pleased to note that the consultation document acknowledges the importance of this goal. We believe that this requires a balanced, global investment strategy and – in line with consistent guidance over many years from The Pensions Regulator (TPR) – for the closed DB schemes that make up the majority, reducing reliance on the sponsoring employer's contributions so that schemes can meet their liabilities on a low dependency basis. If the UK economy offers attractive investment opportunities then schemes will embrace them, but should not be tasked with an obligation to create them.

In its February 2024 overview of the DB landscape, TPR has noted that 68% of DB schemes are fully funded on their technical provisions basis. This is a significant achievement and aligns with the focus TPR has placed over a prolonged period on trustees of closed DB schemes reducing (and eventually eliminating) reliance on ongoing employer covenant.

In our experience, most sponsors of DB schemes share the trustees' long-term aims of removing funding volatility and reliance on employer contributions, with the ultimate goal of moving the pension scheme off the employer's balance sheet (typically through buy-out with an insurance company). Employers who do not want to pay an insurance premium for full divestment are nonetheless looking for schemes to be self-sufficient, with a de-risked investment strategy that will prevent the employer from having to pay contributions in the future.

"Productive assets" are normally considered to involve a higher degree of risk than is desirable for a significant (or any) role in a low dependency or de-risked investment strategy. In keeping with TPR's guidance many DB schemes (particularly those closed to future benefit accrual with a maturing membership) have shifted their investment strategies towards gilts and corporate bonds that offer a closer match for their liabilities and lower volatility. We made this point in our response to the July 2023 call for evidence and we do not see any change in position in this regard.

Treatment of Scheme Surplus

Statutory Override

1. Given the more recent regulatory focus on de-risking, in our experience it is rare for trustees to consider a scheme sufficiently well-funded for a refund of surplus to apply before winding-up is completed. We think that, generally, this would continue, even if a statutory override were to be introduced. Pensions trustees are likely to remain cautious when considering scheme surplus. Neither trustees nor sponsoring employers have a legal obligation (or, in the case of trustees, a fiduciary duty) to target funding levels that exceed those required to provide the promised benefits. Indeed, trustees who chose to adopt a riskier investment strategy to target a surplus that did not materialise and left the scheme with insufficient assets to meet its core liabilities would expose themselves to breach of trust claims and potential personal liability if the employer failed and the scheme entered the Pension Protection Fund (PPF).

   One trustee client (of a closed scheme with asset value of less than £10 million and in deficit) told us, however, that they would be interested in a statutory override to refund surplus to the employer. However, the prospect of such an override would not encourage them to change their investment strategy to target surplus generation.

   (**Question 1**)

2. If a statutory override were to be introduced, our preference would be for it to be a statutory power to make payments, rather than to amend scheme rules. Amendments to scheme rules could prove costly, and might have unintended consequences.

   We think a statutory override should be operable by trustees in agreement with the employer, unless the scheme rules give the trustees sole power in relation to funding decisions, in which case payments should be possible by trustees unilaterally, although prior consultation with the employer should be required.

In all cases, payments should be subject to the same regime as presently applies when making payments of surplus to the employer when a scheme is terminated, with two prior notices to scheme members and an opportunity for members to make representations to the trustees and (if they are concerned that they have not received their full benefit entitlement) The Pensions Regulator.
(**Questions 2 and 3)**

3. Trustees will sometimes have the power to make one-off payments to members under the rules of older schemes but, from a tax perspective, these would constitute unauthorised payments and are therefore undesirable because of heavy tax consequences. Therefore, legislation would be required in order to make one-off payments an attractive proposition from a tax perspective. (**Questions 4 and 6)**

Taxation

4. We understand that the SPP has put forward a suggestion in their response that the Finance Act 2004 could be amended to allow for a lump sum surplus distribution payment to members with a flat tax rate of say 25%, with no annual allowance charges or reporting requirements. That would be consistent with the tax treatment that employer surplus payments receive. Alternatively, the tax could be at an individual's marginal rate. We support those proposals if the government does proceed with one-off lump sum payments to members. We also agree with the SPP that there should be no negative impact for members in receipt of means tested state benefits. (**Question 6)**

5. The reduction in tax rate on a refund of surplus to employers from 35% to 25%, which came into force on 6 April, might incentivise some employers, but we expect that many schemes will continue to use escrow accounts and other arrangements to provide protected funding sources outside the scheme that can be called upon if required, but returned to the employer free of tax if the scheme's funding proves adequate. Reducing the tax rate on a refund of surplus (rather than removing it completely) is unlikely to make the escrow account option less attractive.
(Question 7)

Safeguards for Member Benefits

6. Our preference would be that only surplus funds over and above full funding on the buy-out basis could be extracted, so that full benefits could still be secured in the event of a scheme's wind-up being triggered. We understand many actuarial advisers suggest their internal insurer price tracking has a margin of error of ±5%, so a threshold of 105% of estimated buy-out would be prudent. Failing that, our second preference (out of the options suggested in the consultation document), would be funding above the low dependency funding basis at 105% because, although less prudent than buy-out, this would represent the simplest criteria from those options to determine whether trustees could (but not necessarily should) make a refund of surplus. We would recommend that TPR's DB funding code includes a section on extraction of surplus and would expect trustees to be required by TPR to take covenant, actuarial and legal advice before determining whether or not a refund would be in line with the purposes of the scheme and members' best interests.

It would also be useful for there to be DWP statutory guidance on extraction of surplus.

(**Questions 8 and 9)**

7. It is difficult to see generally that trustees of well-funded schemes that have already significantly de-risked would consider it appropriate to re-risk their investment strategy with a view to building up surplus assets. Whilst some schemes may choose to do so, we anticipate they will be in a small minority. (**Question 10**)

Alternative Safeguard – 100% PPF Underpin

8. The views that we have received from trustee clients have been that a PPF underpin would not encourage them to invest in a different manner (i.e. to increase investment in productive finance) or to refund surplus to members or employers. They also felt that a levy of 0.6% of scheme liabilities was too high.

   There may be some trustees who would consider the PPF underpin to be an attractive option, but government should bear in mind that other factors would need to be addressed if there were to be a PPF underpin. Current case law (*Independent Trustee Services Limited (ITS) v Hope and Others*) sets out that trustees have a legal obligation not to rely upon the protection of the PPF when setting their funding and investment strategy. Additionally, trustees would not wish to fall foul of the new offence of “conduct risking accrued schemes benefits”, introduced by the Pension Schemes Act 2021, which carries criminal penalties of up to seven years in prison or an unlimited fine. **(Question 11)**

Model for a Public Sector Consolidator

Approach to Eligibility

9. We think the proposed approach would be attractive to schemes that are unable to use a commercial consolidator (and also other schemes, if the buffer is provided by the government.) **(Question 15)**

Proposed Model

10. We agree that the public consolidator should be run as a single pooled fund, otherwise the benefit of economies of scale would be lost. We also agree that if the scheme is to be operated on a run-on basis then it is likely to be more attractive to trustees than a commercial consolidator operating on a run-on basis would be, if the government provides the financial buffer. **(Question 21).**

11. We think that the majority of schemes that would be interested in the PPF consolidator are likely to be underfunded with no expectation of being able to reach full funding within a reasonable timescale, otherwise it is hard to see why trustees would not ultimately target securing benefits with an insurer. We note and agree the proposal that scheme employers pay the equivalent of the section 75 debt by way of a fixed repayment schedule. Assuming the PPF is comfortable with the ability of the

employer to meet the payments, it might be possible to pool all funds without segregation, provided that in the event of an employer subsequently becoming insolvent before the repayment schedule has been satisfied, there is some type of mechanism in the rules of the consolidator that triggers automatic sectionalisation of assets and liabilities relating to the insolvent former employer. The Pension Protection Fund (Multi-employer Schemes) (Modification) Regulations 2005 could be amended to ensure they apply to the public consolidator, meaning that the part of the consolidator scheme that has become segregated would be treated as a separate scheme and would enter a PPF assessment period. **(Question 22**)

12. We think employers of schemes unattractive to commercial consolidators would be happy with the proposed approach, especially if the link with the employer is severed once any deficit is paid off on a 'once and for all' basis. Trustees would still need to weigh up the benefits and disadvantages and for some trustees the benefit of a public sector consolidator, provided by a known quantity, with a government backed-buffer, might be preferable to continued reliance on a struggling employer. However, if the target market for the public consolidator is schemes with employers that can meet their section 75 debt, query if this is a broad enough group of schemes to enable scale. It also leaves no option other than the PPF for schemes with employers judged unable to meet their section 75 debt. (**Question 23)**

13. We think the focus should be on closed DB schemes. It is hard to see how it could feasibly work for open DB schemes, where a link with the employer is a requirement for ongoing contributions**.** This could be reviewed at a future date, depending on the success of the model for closed DB schemes. **(Question 24)**

Member Benefits

14. The PPF is used to working with standardised benefits in the form of PPF compensation. We think that in order for this project to work, and for the reasons set out in the PPF's paper of 1 March 2024, it would be necessary for the public consolidator to provide standardised benefits. However, the cost of ensuring actuarial equivalence would need to be factored in, and would be a consideration for pension trustees on the viability of transferring to a public consolidator. Also, there should be a statutory discharge available for trustees who use a public sector consolidator that provides standardised benefits (because the risk of members bringing a complaint would be much greater where benefits have been changed, even if they are of an actuarially equivalent value). **(Question 25**)

Governance

15. If there is a public consolidator, we think that the PPF would be well placed to provide this via a statutory fund that is separate from the PPF's existing fund. We think this would generate public confidence. (**Question 28**)

Funding

16. We agree that the same funding basis used for commercial consolidators should apply to the public sector consolidator. **(Question 30)**

Treatment of Entering Scheme Deficits and Surplus

17. We agree with the proposals for dealing with a scheme deficit or surplus on entry to the public consolidator. We suggest that the rules of the consolidator provide for automatic segregation of assets and liabilities relating to a former employer that becomes insolvent before a repayment schedule is satisfied, and that the existing PPF Multi-employer Scheme Regulations (mentioned above) are amended so that they would apply to the public consolidator. However, where a segregated section is too well funded to enter the PPF, we suggest that any surplus in the public consolidator is used to “top-up” that segregated section so that the segregated section is reintegrated back into the pooled fund of the consolidator and members receive full benefits, rather than benefits being scaled back or there being a PPF + buy-out scenario, such as happened with the Debenhams pension scheme. **(Question 33)**

Underwriting

18. We agree with the comments made by the PPF (in its March paper) that the financial buffer should be provided by the government and not by existing PPF reserves. Ultimately, if there is sufficient surplus within the public consolidator, the government buffer should be repaid (provided there is an obligation to re-buffer if the funding position should deteriorate in the future). **(Question 36)**

19. We think the PPF should retain control of the investment strategy, in consultation with the government (if the government provides the buffer). **(Question 38)**

20. The existing PPF resources should not be considered as a source of underwriting. **(Question 40)**

Yours faithfully

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