C-Suite Pension Strategies' Response
Options for Defined Benefit Pension Schemes
Public Consultation February 2024

Government is highlighting the option to "Run On 4 Good" creating sustainable improved outcomes for all stakeholders.

Exercising Discretion Over Surpluses Collapses The Case For Bulk Transfers Now

Government has made important, positive policy changes to its approach to the funding of pension schemes over the last year. This Consultation builds on progress achieved and reflects a readiness for Defined Benefit (DB) schemes to have a significant, continuing economic role. **They can, if enabled to Run on 4 Good, invest in "productive assets", provide well secured benefits for members and support current employment.** *(See further information in document included with the response: Run On 4 Good – Pension Funding Strategy for 2024)*

C-Suite Pension Strategies' premise has long been that corporate sponsors should seek to take a more involved role in pension funding. Limiting engagement - seeing schemes as legacy problems - has not worked to corporate and often members' best advantage. **Now all stakeholders should input to a new risk-benefit analysis.** Working within the frameworks available and with some of the possibilities set out in the Consultation, there is scope to produce materially better outcomes. Data needs reconsideration. C-Suiteps Analytics can support the process *(Refer to document included with the response: C-Suiteps Analytics - Run On Upside vs PPF Downside Risk-Benefit Analytics)*

The C-Suite theme centres on "Run On 4 Good" – ensuring schemes have the time to work to benefit all stakeholders. **Good outcomes can be achieved with a focus on UK employees – past and present** – with use of surplus funds primarily directed to UK pension provision. Over time corporates can expect to provide pensions for today's employees at no cash cost. DB pension surpluses can come to fund company and employee contributions. Improved DC or CDC pensions link in.

Direct cash returns to sponsors can be a further feature. A rush to make large, potentially risk creating, cash returns to sponsors quickly from emerging surpluses need not be the consequence of proposed policy changes. But it is a risk. We propose a limit on the value of assets which can be returned directly to a Group in any one year – the limit increasing if it has not been used. Pensions benefit from gradualism.

A well-prepared risk analysis will balance differing interests. A new plan can emerge from working through:

- Integrated Risk Management exercises as established by TPR in 2016.
- Technical Actuarial Standard 300 version 2.0 requiring actuaries from April 2024 to test the bulk transfer option against a viable run on plan.
- DWP's Funding and Investment Regulations requiring from August 2024 clarity on investment plans.

This work and new risk-benefit assessment can cover:

- A base case financial model for the scheme running on with sensitivities and stress tests.
- The scheme being a working example of sponsor and trustees ESG ethos in practice.

- The extent to which the sponsor is ready to help address remaining trustee concerns about covenant strength – notably through arranging a level of surety guarantee.
- The scheme rules, as amended if necessary, to support discretion being used where surpluses are known to have arisen.
- The investment strategy and actuarial assumptions to be incorporated in Statements of Investment Principles and Statements of Funding Principles.

The risk-benefit study must examine carefully the downside risk to pensions given the financial position of the sponsor and PPF coverage in place. It can then also consider the availability of discretionary powers to trustees to improve benefits and how such powers can best be used. An overall package is required, showing awareness of the constraints on all parties.

C-Suite's view is that there is sufficient flexibility within the existing structure to take initiatives ahead of more regulatory or statutory changes. There is no need to wait for legislation. Regulatory guidance can achieve much of what is appropriate to re-energise pension provision. A new direction of travel can be established.

That means when statutory changes are made there will be less concern and speculation about their impacts. The risk of unexpected consequences reduces because the knowledge base established about how trustees and sponsor are responding to an altered regulatory approach will be clearer.

In our comments to the specific questions the theme is:

- **Look in detail at the risk-benefits available. The conclusion is all stakeholders can benefit where there is agreement to "Run On 4 Good".**

When trustees and sponsors have Run On as a viable option, it can take the overheating out of the risk transfer / life insurance market. Indeed it can galvanise life insurers into offering more attractive proposals to the pension industry because their go to "Gold Standard" status has been given perspective. **At present a small group of life insurers are unhealthily dominant. Exercise discretion in the use of surpluses and the case for bulk transfers as currently practised collapses.**

The risk-benefit study resets boundaries and looks to the future of UK employment by the sponsor.

Better pensions for past and present employees at reduced cost to the sponsor underlies Run On 4 Good.

Gradualism replaces the Endgame. It is not the End and it is not a Game.

Specific policy proposals included in the C-Suite response to the consultation questions are:

- Trust deed and rules be revised by trustee/sponsor agreement to include power to make payments directly to sponsors.
- A statutory override should support the use of surpluses. A statutory maximum be set on the proportion of a scheme's assets to be paid directly to the sponsor in a year. The proportion can increase over time if not utilised.
- Sustainable low dependency be set at gilts plus 50 basis points plus a 5% asset buffer. Assets to include third party solvency guarantees. Schemes funded to low dependency can accrue and when at sustainable low dependency can pay money to the sponsor.
- Exercising discretion to be encouraged. Existing rules do provide flexibilities as seen in proposals for Discretionary Step Ups. Add to the list of authorised Payments. This could include discretionary payments made to cover inflation up to general RPI increase in a year. This adds flexibility to help those receiving no increases on pre 1997 pensions.
- Funds provided to a sponsor's current DC scheme by the DB scheme not to be a taxable return of surplus. The amount to be a tax allowable cost to the sponsor.
- The capital value of third- party guarantees provided to a scheme to be tax allowable over 4 years.
- Increase PPF coverage to phase out/eliminate the pre-retirement 10% reduction. Start to add to cover for pre 1997 service. Inflation increase levels being below scheme maxima address remaining moral hazard concerns. These adjustments mean a new top tier for PPF is not required.

Notes:

C-Suite Pension Strategies works with partners to provide long term asset management strategies and insurance back up to enable trustees to work to adopt Run On 4 Good. C-Suite has developed with Van Lanschot Kempen, the fiduciary manager, a run on package called FM+ involving a 10 year asset management contract linked by a return target to a third party solvency guarantee.

C-Suite was founded in 2016 by William McGrath who had 25 years executive Board experience with groups sponsoring large pension schemes. Latterly he was CEO of Aga Rangemaster which put in place a long-term funding plan with a new US based parent – which has worked highly effectively in practice.

He first became involved with pension funding in 1986 as part of a Lloyds Bank advisory team to Norwest Holst, the UK civil engineering group, now part of the French group Vinci. Norwest Holst Pension Scheme invested surplus pension funds in the Group as part of a Court endorsed refinancing package. A result was that within 3 years all employees received cash sums for their shares and loans provided by the scheme were fully repaid.

Responses to the Consultation Questions

Chapter 1: Treatment of Scheme Surplus

Question 1: Would a statutory override encourage sharing of scheme surplus?

A statutory override to restrictive current scheme rules will be relevant and helpful in some scheme cases. The significance may be more in putting pension surpluses on the agenda as part of a risk-benefit appraisal. The recognition that Government supports a run on approach and the positive use of surpluses is very important. That Regulators are not just looking to see accrued benefits covered by a FSCS covered insurer but are interested in a wider perspective of what serves the best interests of all stakeholders. That changes the tone of discussions.

Trustees and sponsors should look hard at the framework already in place through their Trust Deed and Rules. Most schemes have discretionary powers (but they are now rarely used). These can be directed to improve benefits for members where there is sponsor consent to do so. An objective is to establish what those circumstances are. Schemes at sponsor initiative can (re)open schemes on new bases to which surpluses can be directed. This is well established legally (Barclays Bank versus Holmes) – but again there are few examples in recent years. Collective Defined Contribution is a clear further option.

Encouraging trustees and sponsors to look at those areas can be a feature of TPR Guidance on the uses of surpluses.

Question 2: What is the appropriate balance of powers between trustees and employers? Should a statutory override allow trustees to amend scheme rules around surplus at their sole discretion, or should such amendments be contingent on an agreement between trustees and the sponsoring employer?

A new strategic consensus is needed on what can be achieved. How to use surpluses should emerge from risk-benefit analyses by trustees and sponsor. The work can reflect on the current economics of the scheme. Interest, inflation and life expectancy assumptions will have changed the position appreciably. Integrated Risk Management (IRM), TAS300 version 2 and DWP 2024 Funding and Investment Regulations are all important part of the processes and analyses needed. Bringing in a new party can ensure some fresh thinking, as the cosy consensus of life insurers and many actuarial consultants needs some challenge.

For the statutory override to allow trustees to amend rules at their sole discretion is not a good idea.

The parties can be expected to reach a new strategy together. Once the best interests of members and those of the sponsor are understood, both have an upside as well as downsides to consider. They will want risk-reward managed differently in these changed circumstances. Agreements should emerge.

Question 3: If the government were to introduce a statutory override aimed at allowing schemes to share surplus with sponsoring employers, should it do so by introducing a statutory power to amend scheme rules or by introducing a statutory power to make payments?

The new statutory power should be to make amendments to the Scheme Rules rather than be a power to make payments. The specific scheme rules may have been put in place for good reason. There is no need for the new "override" to circumvent established processes in the Trust Deed and Rules to change specific rules. A new Framework Agreement can be attached to it.

Question 4: Should the government introduce a statutory power for trustees to amend rules to enable one-off payments to be made to scheme members, or do schemes already have sufficient powers to make one-off payments?

There is a strong case to introduce a statutory power to make payments. Exercise of the power should be within a clear public policy framework to support a long term agenda.

A major constraint on the use of discretion to improve pensions is that increases have long term actuarial consequences that impact on funding levels and levels of contributions. £100 increase is seen in actuarial terms as added liabilities of say £2,500. That liability will need to be dealt with under say a 5 year recovery plan. This is immediately not attractive to a sponsor.

Making one-off payments has attractions to members. There are, however, general tax consideration for pre and post retirement groups which make large one-off payment problematic and perhaps undesirable.

The ethos of the reforms should be for schemes to "run on" over time to benefit past and present employees. "One-off" payments are better seen as part of a series of discretionary amounts and as part of a bigger pension picture.

"One-off" payments may need limits placed on the amounts paid to individuals, groups of members and against the asset level and funding position of the scheme. Large one-off payments may cause distortions and introduce wider funding risks. Timing and fairness and eligibility for receipt of the payment would be factors. Balance between the interests of past and present employees and the sponsor may vary depending on the scale and membership composition.

An approach avoiding causing major shifts in policy could be to state that "one-off" payments can be authorised payments – but within the context that they are made to all pensioners/members. The principle that once increased a pension cannot got down can be retained for such circumstances.

C-Suite has developed the idea of a **Discretionary Step Up (DSU).** This involves a pension being increased and remaining at that level until the inflationary increases to the pension currently in place reach the increased level set by the DSU. DSU supports the idea the discretionary benefits are spread over time and are designed to reflect a steady improvement in the financial position.

DSU's work within the existing tax and legal rules. They are already Authorised Payments and so no new tax legislation is needed. Allen and Overy, the leading law firm, have provided C-Suite a confirmatory legal opinion.

The payments would have limits on the costs to the scheme and sponsor and provide them with flexibility to exercise discretion with confidence. A DSU modelling example is available on request.

Some greater flexibility in structuring benefit enhancements is desirable, but not essential to the use of discretion. C-Suite propose, for example the idea of 'One Less One More'. Where life expectancy is recognised as overstated by say a year and is reduced, a one-off sum equating to one year's worth of pension payments cost could be funded because actuarial liabilities have fallen. Such payments could be made Authorised Payments without major adjustments to tax frameworks. They could also work as DSU payments.

Question 5: What impact, if any, would additional flexibilities around sharing of surplus have on the insurance buyout market?

The insurance buyout market has achieved a level of growth and a dominant market position which means it has become itself an issue. The extremely high profitability being achieved by a small cadre of life insurers brings a concentration risk for regulators to address. Working closely with a similarly small number of actuarial consultants with significant market share they have a terrifically strong business model to defend. They trade off their cosy relationships. With the great improvement in funding levels, demand is well ahead of supply. They can dictate terms. Many deals are on an exclusive basis. Business practices in overheated markets need monitoring – as Bank of England has acknowledged.

That "Run On 4 Good" can provide a sound regulator endorsed alternative to buyout would be very healthy for the market. The added flexibility provided by making surpluses available for use creates an upside for members and sponsors. The standard case for buyouts collapses with discretionary payments being possible. The probability of added benefits now is far greater than the probability of the scheme falling into PPF. A weighting should be given to the possible failure of a sponsor in any one year, given the sponsor's financial status.

Life insurers will in turn need to respond with better and potentially more flexible deals.

The Risk Transfer industry should also be clear on how the unfunded FSCS would work in practice. It should highlight that the security of the life insurer really is better than having the sponsor remain. The Prudential case on the transfer to Rothesay in the UK and AT&T case in USA on the transfer to Athene do show some scheme members are questioning what is a good trade-off. The loss of discretion for no added value would be an additional factor to be recognised by trustees.

If there is no constraint on surpluses and how they are used, the risk transfer industry will see major new opportunities arising. There will be more whole scheme buy-ins with capital returns to sponsors being structured in. The approach could be very attractive to sponsors not wishing to re-engage with legacy questions. It is a good example of where Government's public policy decisions can have a direct and immediate impact.

Question 6: What changes to the tax regime would support schemes in delivering surpluses to distribute as enhanced benefits?

(i) Authorised Payments

Making more categories discretionary payments to members "authorised" payments would be a benefit. Discretionary Step Ups (DSUs) do work within the existing framework as the payments are made in a way which ensures the pension never goes down.

Some greater latitude would assist. Authorised payments could, for example, also include discretionary payments made to scheme members receiving less than RPI in the year to bring them up to the RPI

increase level. This could be a mechanism to make discretionary payment to those not receiving increases on pre 1997 service. If discretion was exercised there would be an acceptance that year on year the pension would fall without the payments made being unauthorised. These payments would not distort the overall economics of the scheme. Inflation caps introduced with Goode Committee were designed to limit risk to sponsors. Some averaging up for members receiving relatively harsh treatment is a worth-while priority.

(ii) Third party surety bonds

For trustees to be confident in making payments from surpluses, the strength of the sponsor is significant. Sound sponsors can provide a surety bond to the scheme. Willingness to do so is a good lead indicator of their attitude to pension provision. They could be encouraged by a tax initiative.

The sponsor could provide a third-party risk diversifying guarantee. A proportion of the capital value of the bond could be deductible for tax purposes. EG: a contingent surety bond of £10m is provided. Interest (of say 1% per annum) is deductible by the sponsor. In addition, a given proportion of the capital value could also be tax deductible (over say 4 years): 25% x £10m = £2.5m x corporation tax rate at 25%.

NB. Actual cash recovery plan payments into a scheme are tax deductible over time.

Question 7: Are there any other alternative options or issues the government should consider around the treatment of scheme surplus?

C-Suite thinks there is a strong case for Government to see a key use of surpluses as being to fund and improve current pension provision. Schemes were set up to support employees on a continuing basis. A combination of tax changes; changed accounting treatments; legal shift from best endeavours to statutory requirements and growing risk aversion all resulted in poorer pensions and the overall ethos being lost. In this context sponsors and trustees should reflect on the way first closure to new entrants and then to future accrual worked to worsen pension provision.

Now, with funding improved by high sponsor contributions and actuarial methodologies making schemes appear sharply better funded in a higher interest rate environment, sponsors should work with trustees to improve pension provision for current employees. A new tier within the DB scheme can be opened. New rules can be introduced. It can be a supplement to the DC provision in place. The tier can be funded with DB surpluses. Pensions then aligns with corporate ESG commitments and provides an HR led competitive advantage. A CDC tier could be introduced.

Such initiatives are possible now.

Funding DC contributions outside the scheme

Where a new approach could be introduced as part of current reforms is for surplus payments to be made to DC funds which are not part of the DB scheme. If these are made on the basis that there is no tax on the payment of the surplus, but the payment is still tax allowable in the books of the employer there is a real attraction in making the payment.

The sponsor can then reset the level of payment to make to the DC fund so that the employee and the sponsor benefit. The individual member may also consider what contribution to make taking of the sponsor and the scheme's contributions.

So if current DC contributions are 10% - 6% from the sponsor and 4% from the individual – with the added DB contribution a further 10% of salaries could be paid in. Company paid contributions could fall to say 3% and employees could contribute just 2% - but with the 10% contribution from DB scheme, the result would still be a total DC contribution rise from 10% to 15% - but with the employers and employees paying less.

Question 8: Under what combination of these criteria should surplus extraction be permitted? If you feel alternative criteria should apply, what are they?

Where a sponsor would like to consider extracting surplus, there should be a recognition that members and trustees would want their concerns over continuing support for the scheme addressed.

To use surpluses schemes need to be funded to a low dependency level of gilts plus 50bp. A further buffer of say 5% of assets can be added to create a Sustainable Low Dependency level (SLD). The asset value can include on demand third party guarantees. Post the payments the scheme must still be at SLD. The guarantees provide a basis to give sponsors more flexibility in seeking cash from the scheme or pay discretionary increases.

The way that trustees have used "covenant" assessments to incorporate in funding policies and actuarial discount rates has not worked as well as it should. The impact has been modest. It may now be far better for the sponsor to provide third party corroboration of its financial status from banks and insurers whose business it is to make credit risk assessments. That should make a material difference to trustee policy.

C-Suite has for many years urged corporates to "get stuck in" and support trustees in assessing risk by providing contingent back up. That the approach is rarely used – Aga Rangemaster being a successful exception – has not helped sponsors. High contributions levels have been seen and the lack of spread in actuarial discount rates used in triennial models remains.

In reverting to the subject as part of a new risk-benefit exercise, sponsors should be prepared to provide a surety bond (and related insurance products covering guaranteed investment returns and future contributions) as part of the package to agree on the use of surpluses.

Sums in the scheme should be considered surplus when the scheme is in "sustainable low dependency" – which means that it has assets above a low dependency level and a buffer provided by actual assets. These assets which could be called on in the event of the failure of the sponsor.

The scale of the surety bonds provided can take account of the investment return assumption level above the low dependency level and the scale of any return of surplus to be made. Just how the balance is struck should be for the parties to consider within a standard triennial reassessment.

TPR could indicate the back-up it would expect to see linked to levels of investment risk and surplus return. The form of the surety back up is important. It should be in place when surpluses are to be used. It needs to remain available irrespective of the evolving credit status of the sponsor and be on demand. Banks and insurers are ready to provide the products needed. Quite why demand has not developed is a reflection of an introverted sector.

A Heads of Terms is contained in the response to question 14.

Question 9: What form of guidance for trustees around surplus extraction would be most appropriate and provide the greatest confidence?

Trustees in agreeing a new framework should emphasise “discretion”. Confidence in a new settlement can best emerge over time. Trustees should be comfortable with a long term, stable, investment return and asset allocation which aligns with a corporate’s ESG plans. They should also be keen on use of surplus in a controlled way and address the interests of past and present employees and the sponsor. Large one-off payments and abrupt policy changes should be treated with scepticism and caution.

C-Suite has developed a set of Risk-Benefit modules to support sponsors and trustees in assessing the strategies which are in all stakeholders’ best interests given the constraints on individual parties. *(Refer to document included with response – C-Suiteps Analytics - Run On Upside vs PPF Downside Risk-Benefit Analytics).*

The proposal is for the scheme to have a long-term asset strategy set at over gilts plus 150 basis points and held at that level. The trustees should then also watch as demographic prudence benefits surplus numbers. An overall out performance of the actuarial model set at low dependency at gilts plus 50bp can be achieved.

C-Suite considers that an outperformance of the model by 2% a year can be expected in many cases. 2% then provides a quantum in a year or a multiple taken cumulatively that the parties can consider as available for distribution as discretionary payments. With flexibility they can adjust as circumstances and performance allow.

The theme should be that having reached a satisfactory position, the residual downside for members should be addressed but now as part of a wider agreement. It can also mean better pensions than are currently expected. There are new boundaries set by corporate policy and by Government legal and tax adjustments.

When schemes are considering risk-benefit assessments, TPR could provide a help desk to highlight what it sees as good emerging practice.

Question 10: What might remain to prevent trustees from sharing surplus?

There may be a mindset consideration in not pursuing the assumption that the early transfer to a life insurer is achieving the Gold Standard. Willingness now to consider use of surpluses may be seen by trustees as calling into question the line they have accepted on derisking for so long.

Trustees should look again at their remit. The best interests of members are not served by the presumption the formal contractual rights are good enough. Even major consultants are reluctant to suggest improving benefits for members, still less improving pensions for current employees. They fear standing on what has become a tenet of the beliefs of major clients. Further a change of course might suggest deals already undertaken had not been in the best interests of members.

The reluctance of consultants to provide and of trustees to request data on the track record of risk transfer deals is a good indicator that they already know opportunity costs have been massive.

They should be mindful of Work and Pensions Select Committee suggestion that TPR’s remit should be forward not just backward looking. Having seen the impact of inflation and interest rates and seeing the over-estimates of life expectancy, they should see there is a sound, longer term justification for “taking

time". The idea that a transfer to a life insurer brings "peace of mind" to members and reaches a Gold Standard is complacent thinking.

What is needed is a high-quality risk assessment. It needs to look at the drivers of demography in the scheme and look to replace broad brush assumptions with empirical data. What risks the investment strategy still has; the back up to the sponsor offered by third parties and the superiority of FSCS to PPF should be examined - not taken as read - in the context of the long term run on of the scheme.

Schemes should also consider consulting with the members in the light of their risk-benefit assessments and explaining their reasoning on bulk transfers and run on options.

What should not be allowed to happen is for scheme to drift. Trustee bodies should set themselves clear timeframes to move to long term structures with which all can be satisfied.

Question 11: Would the introduction of a 100% underpin have a material impact on trustees' and sponsors' willingness to extract surplus? If so, why and to what extent?

Question 12: Are there other benefits to a 100% underpin that the government should consider?

The discussion about the impact of 100% underpin for PPF is remarkable – most notably because there is so little examination of the value to members of what it currently covers. Questions 11 and 12 highlight there is work needing to be done to establish how the PPF fits into an overall risk-benefit assessment before its role is changed.

The belief was astutely created by TPR and PPF that trustees could act in the best interest of members and not treat the PPF's existence as relevant in a risk analysis. Not considering there to be a safety net at all bolstered the view that coverage by FSCS and a regulated insurer was the Gold Standard to which all schemes should aspire. The basis for the view is thin, selective and dated.

Two relevant Court cases there have been rightly highlight circumstances in which it would not be appropriate to factor PPF into a strategy. Judges in both cases, however, say that they are not commenting on the circumstances in which PPF could be a relevant consideration. Ignoring insurance which covers most liabilities; has been paid for over many years; and which may soon provide better benefits reducing downside risks further does not stand scrutiny. Trustees who exclude PPF from stress tests of their strategies should explain to members why they have done so.

In a risk assessment for a DB scheme, part of its "stress test" for the investment strategy and for the corporate should be the gap between the level of PPF cover and full payment of existing benefit rights. The thinking in current circumstances needs resetting. What the risk-benefit assessment should now include is an appraisal of the upside available for surpluses and the exercise of discretion and the probability of them happening.

C-Suite has – in the absence of work by the major actuarial consultants – developed its own models to highlight the balance of downside risks and upside potential from member and sponsor perspectives.

In summary this shows:

- Inflation increases is the major difference between the PPF and FSCS coverage. For pensioners with post '97 service this means there is no difference in cover for inflation of nil to 2.5% between the two safety nets. There is a reduction when inflation is between 2.5% and 5%. When inflation is over 5% there is a possibility of discretionary increases but rarely from an insurer.

- For older pensioners with pre ’97 service the 2.5% maxima on increases falls to nil if all their service is pre ’97.
- As schemes mature an ever- higher percentage of pensions are covered by PPF. This is the mirror to PPF drift.
- For deferred members there is a 10% reduction on the pension to which they are entitled on entering PPF. Around half of the cut to deferred will have gone within 10 years as more members retire.
- Of note is that the “tall poppy” provisions to limit higher pensions were found to be illegal in European and UK Courts.
- Age discrimination was a major factor in Court decisions. It is quite plausible, given the very substantial surplus in the scheme, that the reduction for deferred members will need to be subject to careful review in any reconsideration of the position of PPF in the consultation expected later in 2024.

C-Suite considers that the “folk lore” surrounding PPF should be addressed. An objective reassessment can be made. This fits well with the Work and Pensions Select Committee’s questioning of TPR’s role in protecting the PPF.

While a 100% underpin has attractions, the first step should be to establish clearly what PPF offers now and how that can be modified.

The case to create an expensive, completely new tier to address the position of scheme members of those least likely to fall into PPF is not easily made. It is entirely possible for sponsor of schemes eligible for the new tier to provide more cheaply surety bonds payable on demand if they fail. This is considered further under Question 14.

The benefit of a 100% underpin is that the downside risk which trustees have used as their primary policy consideration is addressed. The pressure to sell to a life insurer diminishes.

Just how much more risk they will be willing to take to adjust the investment policy could prove a concern both for sponsors and for regulators. The onus should be on steady policy evolution rather than a major shift in strategy to which the trustees may be ill suited. The clear funding and investment stipulations and nearly 20 years of TPR monitoring should limit the concerns. Retaining some reduction to 100% coverage retains a moral hazard feature to PPF provision - long a TPR consideration.

Eliminating downside risks and providing too much scope to extract surpluses has obvious risks. The section below looks at PPF’s position in more detail.

Taking Account of Pension Protection Fund : Time for Realism in Exercising Fiduciary Duties

The Pension Protection Fund is an insurance body funded by pension schemes, providing a safety net covering much of a scheme's liabilities payable in the event of a sponsor's failure. Introduced in 2006 and protected by TPR, it has never been clarified what difference it makes in trustee risk assessments.

The existence of the PPF was first considered in Court in Independent Trustee Services v Hope, 2009.

ITS and Hope is quite explicit in that it is not ruling on when trustees can take into account the PPF. It only precludes the kind of scheme that is the subject of the case. The pensions industry, however, use the case as meaning trustees do not take it into account at all.

https://www.bailii.org/ew/cases/EWHC/Ch/2009/2810.html

From para 106

> Mr Giffin submitted, and I would agree, that there is no single all-purpose answer to the question whether the PPF is a relevant consideration for trustees to take into account. It all depends on the context and purpose of the particular power which the trustees are proposing to exercise, and the particular way in which they wish to take the PPF into account.

From para 119

> Adopting that approach, I would hold, as a matter of law, that the prospective availability of compensation under the PPF, if and when the Scheme enters the PPF, is not a relevant factor for the Trustee to take into account in the exercise of the rule 12.3(b) power, or any power of a similar nature, because to take it into account would be contrary to the clear legislative policy of the Pensions Act 2004, and would thus be contrary to public policy. **Further than that I would not, at present, go, bearing in mind that the existence of the PPF is in certain contexts a legitimate matter for trustees to take into account, and the dangers of invoking public policy in relation to a situation which is not before the court.**

BRASS v Goldstone

https://www.bailii.org/ew/cases/EWHC/Ch/2023/1978.html

The recent Brass case reiterates Hope v ITS because it is a comparable situation. It specifically states that it is not making a general ruling.

From para 65

> **It is not necessary for me to make general observations as to the relevance or otherwise of the PPF**. The Trustee has already concluded that, whether or not regard is had to the PPF, the Decision was the same. I simply add that I agree that the Trustee could not have sought in this case to take advantage of the existence of the PPF to justify failing to take steps to prevent the Scheme deficit (and drift) increasing further. In my view, that would be a situation of the sort in which Henderson J would rightly expect the court here to take a "similar approach" to that he took in ITS.

Hughes and others v PPF is interesting in relation to the principle of proportionality and when moral hazard is relevant. In paragraph 145 the judge concludes that

> "where the justification for the policy is so weak, or the line has been drawn in such an arbitrary position, that even with the broad margin of appreciation accorded to the state, the court will conclude that the policy is unjustifiable"

https://www.judiciary.uk/wp-content/uploads/2020/06/hughes-v-ppf-judgment-220620.pdf

The judge then strikes down "tall poppy syndrome" on age discrimination grounds. This was a clear defeat for the PPF and the Secretary of State. It did not appeal the ruling.

In taking into account the PPF, trustees need to differentiate proposals from the circumstances covered in the ITS and BRASS cases. The exercise of discretion to provide an upside can be a trigger for situations where the PPF can be taken into account as part of a stress test.

In its response to the Call for Evidence PPF appears to focus on what it would like the position to be, rather than what it is. It wrote,

> "In its ITS v Hope judgement, it was decided the PPF protection was not a relevant consideration for trustees to take into account **when making some decisions**. The principle was confirmed by the High Court in August this year in the BRASS Trustees v Goldstone judgement. **A change in the law would, therefore, be required for trustees to have regard to PPF protection when setting their investment strategy.**" This does not follow.

The line taken was understandable in the early years of PPF. Now it is time to update the approach. There is even a "moral hazard" for TPR / PPF in urging trustees to ignore relevant information and completely overstate the risk to members' benefits. Trustees may consequently be "gaming" the members on behalf of regulators/insurers and be failing in their fiduciary duty to act in the best interests of members – notably when sustaining an investment strategy would generate surpluses from which members could benefit.

PPF is not the primary factor in setting investment policy. Trustees, as they have through out the life of the trust, rely on support of the sponsor. The loss to members if it were to fail is stress tested against what the PPF insurance coverage provides. The relative value and quality of FSCS coverage can also then be assessed if a journey plan to buyout is adopted.

Where loss is improbable and modest and benefit material and likely, these factors are relevant to the management of the scheme.

Question 14: Are there other methods outside of the PPF that could provide additional security to schemes choosing to run on?

C-Suite strongly believe that banks and insurers are able and should be encouraged to provide products to cover remaining risks within pension schemes. They should be providing a fixed sum cover if the sponsor fails or fails to maintain the guarantee. A pension sufficiency guarantee is a form of Stand-by letter of Credit. It is an on-demand instrument held by the trustees. This should be sufficient to ensure the scheme is funded to a level that the risk of falling into PPF is negligible.

The guarantee can be a new line or can be a 'permitted use' under existing revolving credit lines of the sponsor. It is an undrawn committed line. Pricing will follow the margin on the sponsors other lines. It is a risk diversifying third party line. The insurers and banks providing it are highlighting the credit status of the sponsor. It is a major positive for trustees and covenant assessors.

It is ‘new money’. It is a trigger for the change from a short-termist to a run-on approach. It is not given in isolation. By being ready to provide it, Boards of sponsors can ask for a wider Framework Agreement. This can cover the investment strategy and the allocation of surpluses between the sponsor and the membership of the scheme.

Following is a Term Sheet showing how the Pension Sufficiency Guarantee of low dependency can work in practice.

C-Suite
Pension Strategies

Final Salary Pension Scheme (the Scheme)
Low Dependency Guarantee (LDG)
Indicative Term Sheet

Purpose and Amount	To provide the Scheme with insurance to cover the difference between the value of assets held at completion and the value required for the Scheme to be at low dependency on the agreed basis after taking account of any recovery plan payments (the Difference)
Issued by	Banks / insurers with A- credit ratings or above on behalf of the Sponsor or the Scheme
Guarantor	Where relevant the parent or financing subsidiary company of the Sponsor guaranteeing the obligations of the Sponsor to the Issuer
Beneficiary	The Scheme
Initial term	5 years
Pricing	[1%] per annum
Arrangement fee on signing	XX basis points
Extension	Option for Issuer and Sponsor to extend at end of year 5 for 5 years. Quantum to be adjusted down but not to be increased above the level of the Difference Extension fee to be xx basis points
Payable	
(i)	If 6 months before the end date, LDG has not been extended, the Issuer shall notify the Scheme. If 3 months before end date LDG has not been replaced by an equivalent line from a comparably rated source, the LDG amount becomes payable on demand to the Scheme until the end date.
(ii)	If an event of default arises under a financing facility of the Sponsor and is notified and has not been remedied within 90 days by the Sponsor. This does not apply if confirmed by the Guarantor that the guarantee is in place and it does not have a continuing event of default.
Recourse	The Issuer has recourse to the Sponsor if LDG is drawn. The amount then ranks pari passu with other lenders to the Sponsor. If the Guarantor meets the obligation to the Scheme, it has recourse to the Sponsor.

Chapter 2: Model for a public sector consolidator

A public sector consolidator is an enterprising initiative. As the time taken to establish the remit for superfunds shows there is scope for demarcation disputes.

Question 25: Will this achieve the right balance between limiting the cost of transactions whilst remaining reasonably attractive to scheme trustees and their members? Are there certain elements of schemes' benefits that should always be retained?

Question 26: If standardised benefit structures are applied, what should these benefit structures be?

On member benefits there is a surprising readiness to replace member benefits with the actuarial equivalent for administrative reasons. Further, for discretionary benefits and currently available options ahead of retirement to be lost in the process of making risk transfers easier needs clear justifications.

How appropriate it is to use standardise benefit structures should be carefully considered.

Question 36: What method of underwriting would be most appropriate to achieve the aims of the consolidator, given the expected capital requirements and timescales?

How appropriate it is for PPF to access funds for underwriting purposes generated from money made by it running insurance for a membership group is debateable. It can be seen as a reasonable additional service provided to a subgroup.

In the first instance, however, the surplus in PPF should be seen as enabling it to provide greater coverage to the membership in the event of schemes entering the PPF. The consultation on what reductions are made to a scheme's liabilities is important. The insurance levels provided need to be reset.

Members and trustees can then see what risks they are running and how that changes over time. They should also be interested in how they could benefit from any surpluses being generated by the consolidator over time.

That aligns Chapter 2 of the consultation with Chapter 1 on how to use surpluses arising from schemes running on long term.