DWP DB Call for Evidence Policy Team
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Dear Sir/Madam

RE: Investment Association Response to 'Options for Defined Benefit schemes: a call for evidence'

The Investment Association (IA) welcomes the opportunity to respond to the DWP call for evidence on options for Defined Benefit (DB) pension schemes. With just over £1.4 trillion in assets[1], including a significant exposure to the UK, primarily through the gilt market, UK DB schemes make a significant contribution to the funding of the UK economy and public services.

The call for evidence is timely, since with scheme funding having improved significantly since interest rates began rising at the start of 2021, there is an opportunity, under certain conditions, to change trustee incentives around DB investment strategies in order to encourage greater allocation to riskier assets, including those associated with UK 'productive finance'.

Our responses to the call for evidence questions are set out in the attached response, and we also include a number of observations about the history of DB funding to set the context.

In line with the three focus areas of the consultation (asset allocation and incentives; rules around surplus; scope for consolidation), our key messages are as follows:

1. The evolution of DB schemes towards de-risking suggests that wholesale reform will be difficult

Since the late 1990s, a combination of changing actuarial and regulatory orthodoxy around the valuation of pension liabilities, rising longevity, lower interest rates and lower equity

[1] PPF 7800 Index, August 2023

market returns has driven a profound shift in the way in which the private sector UK DB pension system operates.

Re-orienting the system towards taking more risk would require a radical change in the regulatory structure and the incentives for trustees and corporate sponsors of well-funded schemes. Whatever the merits might be of broadening the supply of risk capital in this part of the market, it is not clear that the appetite for such a change exists. This is an important starting point for the current debate, particularly as the maturity profile and current asset allocation in the DC market suggests that this is a much more obvious place to start.

Once comparisons are made on a like-for-like basis - i.e. comparing the UK to other countries where mature DB systems are responsible for a similar proportion of assets - the UK is broadly in line with respect to allocations to equities and bonds. It is, however, an outlier when it comes to alternative asset classes, where the UK allocates a smaller proportion of assets than other DB systems.

This reflects an important point about mature DB systems internationally: the funding context ultimately drives the investment strategy. Once DB promises are sufficiently funded, there is an inherent incentive to de-risk since no party benefits from investment returns above the level of the guarantee. Additionally, in predominantly closed private sector corporate DB systems like the UK's, cashflow generation becomes more important as benefit payments draw closer. Fixed income assets are natural matching investments for such needs since they provide fixed and predictable cashflows.

Thus, even allowing for differences in regulation across jurisdictions, mature DB systems will have a significant level of de-risking built in as funding levels improve and pension obligations move closer into the payout phase. These characteristics work against any wholesale 're-risking' of the system.

2. Some limited 're-risking' of DB may be possible through reforming the rules around surplus

Despite these structural obstacles, the significant improvement in scheme funding since 2021 does offer an opportunity to change trustee and employer incentives around investment risk to a limited extent. Such a reform would involve changes to the treatment of funding surpluses, the excess of assets over liabilities.

Current rules on DB surplus make it hard to extract this additional money and would mean that, for those schemes already in significant surplus, any additional investment risk taken with a view to seeking to further build a surplus would be unrewarded.

In principle these incentives could be changed by making it easier for sponsors, under certain conditions, to extract a surplus, either for investment in their own business, or, where relevant, for subsiding any DC contributions they make under their auto enrolment obligations. The ability to extract this money would provide an incentive to take investment risk above a certain funding threshold.

3. DB consolidation is not a panacea and will be unlikely to be a significant driver of changes in asset allocation

Much of the debate around consolidation in DB pensions is driven by the assumption that larger pension schemes will invest in a more diversified manner than smaller schemes. The implication in this consultation seems to be that larger schemes would take more risk.

While some larger schemes do in practise invest differently, with a greater likelihood of allocations to specialist and niche areas for specific reasons e.g. diversification, return, impact or liquidity for example, the major drivers of DB investment strategy are the funding level/required returns and scheme maturity. These are factors which are invariant to scheme size. Therefore, we would not expect to see significant impacts on DB asset allocation from consolidation.

The benefits of further consolidation are likely instead come in the areas of governance and administration rather than investment. The investment management industry already provides the benefits of scale in investments to DB pension schemes via pooled funds and services such as Fiduciary Management.

Further consolidation options for schemes also exist via the insurance risk transfer market. Once DWP legislates for a permanent 'Superfunds' regime, DB schemes will have an additional consolidation option to add to the existing range of choices on offer. In light of this, and the lack of evidence of a market failure that would warrant such an intervention, we do not believe there is currently a case for a public consolidator.

We support ongoing efforts within the insurance industry to reform Solvency II requirements such that greater investment in assets associated with productive finance will be possible, in line with wider allocation strategies from buyout and bulk annuity vehicles.

I hope this response is helpful and I would be happy to discuss further.

Yours Sincerely,
Imran Razvi
Senior Policy Adviser, Pensions & Institutional Market

Response to selected questions and broader comments

Options for Defined Benefit schemes: a call for evidence

About the Investment Association

The IA champions UK investment management, supporting British savers, investors, and businesses. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base and manage £10.0 trillion of assets. The investment management industry supports 122,000 jobs across the UK. Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs. The UK is the second largest investment management centre in the world, after the US and manages over a third (37%) of all assets managed in Europe.

A brief history of DB funding and investment – and why 20 years of investment behaviour will be hard to reverse

In the early noughties, two major changes took place in the UK financial and pension system that were connected but ultimately should be seen as distinct from one and other. The first was that the 'golden age' of equities that had seen annualised UK real returns of 14% between 1980 and 1999 (mirroring similar returns in other international markets) came to an abrupt end with the dot com crash. The second was that a combination of changing actuarial and regulatory orthodoxy around the valuation of pension liabilities, rising longevity, lower interest rates and lower equity market returns drove a profound shift in the way in which the private sector UK DB pension system operated.

Pension scheme deficits began to be viewed as a form of debt to pension scheme members, with accounting regulations in 2002 requiring surpluses and deficits in pension schemes to be reported on corporate sponsors' balance sheets. DB pension scheme funding therefore attracted greater focus from corporate plan sponsors.

This was accompanied by DWP's creation of the modern UK DB funding regime in 2004, which established a framework for improving funding levels, requiring that all schemes must meet a statutory funding objective, determined using a prudently chosen approach.

Schemes were also required to undertake a triennial valuation to establish the level of their assets and liabilities.

The collective impact of these changes was to place a greater emphasis on funding and closing deficits, in turn leading to a view of DB funding through the lens of risk management. DB schemes' subsequent investment behaviour, with a greater focus on liability matching investments and the hedging of inflation and interest rate risks stems directly from these changes in markets and regulation.

In investment terms, the consequence was a dramatic disinvestment from UK equities as part of an overall de-equitisation of investment strategies in corporate DB schemes. From a peak of 57% UK equity exposure in 1993, this had fallen to 17% two decades later[2] before falling further over the next decade to below 2% in 2022, but with 13% in overseas listed equities[3], reflecting increasing global diversification. However, comparative UK equity market performance was not obviously adversely affected for most of this period. UK annualised equity real returns between 2000 and 2015 were 1.7% compared to 1.6% in global markets, 1.6% in Europe and 2.3% in the US[4]. Since 2016, the gap between the UK and US has widened significantly[5] for a range of reasons, including index composition and sentiment.

At the same time, DB schemes have come much more significant buyers of UK government debt, contributing indirectly to the financing of the UK economy. They have also become much more diversified in their exposure to private markets, including infrastructure. A major contrast with earlier decades is that real estate has played a much smaller part in these allocations than would have been seen through the 1970s and 1980s.

In the new DB paradigm, liability-driven investment (LDI) strategies worked well for clients for 20 years, bringing stability to schemes' funding ratios. An estimate[6] from last year put the benefits of LDI for FTSE 100 schemes at £100bn-£200bn over the period 2016-21 – that is, the amount by which scheme funding would have been lower in the absence of LDI. This is some 20-40% of the value of these companies' schemes. In an era when interest rates had fallen to historic lows, increasing the present value of DB liabilities, this protected schemes from worse funding outcomes as their matching assets increased in value as their liabilities had risen.

The rise in interest rates since 2021 has led to material improvements in DB funding, albeit with some significant liquidity challenges for schemes along the way, following the rapid and large rise in long-dated gilt yields in September 2022. In aggregate, UK DB schemes are currently funded at 118% on a buyout basis, meaning the system is in good health and members' benefits are secure.

In this context, regardless of one's view of the UK's current DB funding and investment regime, a change in DB investment behaviour to re-orient the system towards taking more risk would require a radical change in the regulatory structure and the incentives for trustees and corporate sponsors of well-funded schemes. Whatever the merits might be of broadening the supply of risk capital in this part of the market, it is not clear that the appetite for such a change exists. This is an important starting point for the current debate,

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[2] UBS Pension Fund Indicators, 2016.
[3] Weighted average equity allocations for 2022 derived from PPF Purple Book, 2022.
[4] Credit Suisse Global Investment Returns Yearbook 2016.
[5] Credit Suisse Global Investment Returns Yearbook 2023.
[6] Lane Clark and Peacock, November 2022.

particularly as the maturity profile and current asset allocation in the DC market suggests that this is a much more obvious place to start.

The importance of DB schemes in financing the UK government's borrowing requirements

The recent debate around DB investment has focused on DB schemes' role as providers of risk capital to the UK economy, with the general tone being one of concern at DB schemes being heavily invested in 'unproductive' assets. While the ability to provide risk capital is important for the economy, DB schemes are not the only source of such funding. DC schemes, with their less mature demographic profile and absence of guaranteed benefits, are in general better placed to provide significant amounts of long-term risk capital. Other institutional and retail investors also have a role to play.

Moreover, the debate ignores the positive role played by DB schemes in the gilt market. The UK government has benefitted from a steady and robust demand for its long-term and index-linked debt from pension schemes and insurance companies. Data from the DMO shows that pension funds and insurance companies owned 27% of the stock of gilts by market value at the end of September 2022[7]. More recent data from the ONS shows that by the end of 2022, corporate DB schemes had total gilt holdings of £368bn, of which £310bn consisted of long-dated (25+ years) and index-linked gilt holdings[8]. The influence of the DB and insurance sectors can be further seen when comparing the average maturity of the total UK debt stock to other countries: for the UK, this is 15.1 years, compared to just over 8 years for France and Japan and around 6 years for the US[9]. A long average maturity of debt significantly reduces the UK government's exposure to refinancing risk, by enabling gilt issuance to be spread along the maturity spectrum.

These gilt holdings constitute a significant investment in the UK, allowing the government to invest in the UK's public services and meet its other spending commitments. Any reforms that seek to alter DB investment behaviour should be mindful of the important role that DB schemes play in the gilt market. In that regard we are encouraged by the Chancellor's three golden rules guiding the Mansion House Reforms, in particular the promise to prioritise a strong and diversified gilt market.

Q1: Do you agree with the assessment of the position [that there is some evidence that UK DB schemes are underinvested in productive assets compared to international comparators]? Is there evidence to the contrary?

Comparing the UK with other major pension systems around the world, it would appear, on the face of it, that the UK pension system does have lower exposure to risk assets. In particular, looking at the seven largest pensions markets in the world ("P7")[10], the UK allocates 33% of pension assets to equities compared 42% across all seven markets. UK allocations to fixed income[11], meanwhile, are at 56% compared to 32% across all seven markets[12].

[7] Source: Debt Management Report 2023-24, HM Treasury, 2023.
[8] Source: Financial Survey of Pension Schemes October – December 2022, ONS, 2023.
[9] Source: Debt Management Report 2023-24, HM Treasury, 2023.
[10] Australia, Canada, Japan, Netherlands, Switzerland, UK, US.
[11] One important point to note from this data is that the asset class categories are broad and will encompass a range of sub-asset classes that vary in their risk-return profiles. For example, bonds will include high quality, low risk, sovereign issuers at one end of the spectrum, all the way down to higher-yielding, riskier corporate issuance. Therefore, it is important not to over-interpret the data and assume that bonds equate purely to low-risk investments.
[12] Global Pension Assets Study 2023, Thinking Ahead Institute, 2023.

However, once this data is compared to the proportion of assets in each system that are DB or DC, the UK looks closer to other comparable systems, although some differences remain, as shown in Figure 1:

Figure 1: P7 Asset allocation and DB/DC split, 2022

Source: Global Pensions Asset Survey 2023, Thinking Ahead Institute

Comparing the UK with other countries where private sector, funded DB systems are responsible for a similar proportion of assets i.e. the Netherlands and Japan, it can be observed that the relative allocations to equities and fixed income are broadly similar, but where the UK really is an outlier is in the significantly lower allocations to alternatives.

Asset allocation decisions are intended to deliver a chosen investment strategy, and the important point about DB systems is that the funding context is what ultimately drives the investment strategy. Once DB promises are sufficiently funded, in line with local regulatory requirements, there is an inherent incentive to de-risk, since no party benefits from investment returns above the level needed to ensure that assets are sufficient to meet liabilities. While on the downside, if investment risk is realised, this may contribute to a deterioration in funding status, leading to reduced security for members and an additional funding requirement on the sponsor.

The other important point about mature DB systems is that pensions are closer to being paid out, meaning the investment objective moves towards generating cashflows in order to meet benefit payments. Fixed income assets are natural matching investments for such needs since they provide fixed and predictable cashflows. While equities can also generate income in the form of dividends, these are more volatile and less predictable than interest payments on bonds.

Thus, even allowing for differences in regulation across jurisdictions, these points means that mature, closed DB systems will have a significant level of de-risking built in as funding levels improve and pension obligations move closer into the payout phase.

Q2: What changes might incentivise more trustees and sponsors of DB schemes to consider investing in productive assets while maintaining appropriate security of the benefits promised and meeting their other duties?

In general, DB pension systems' capacity to provide risk capital is greater when funding levels are lower (the corollary of which is a need for higher investment returns) and/or schemes are open and new benefits are still being accrued. The greater returns associated

with taking investment risk have the potential to lead to greater improvements in funding, with associated lower ongoing funding costs for sponsors. The need for income is also less of a dominant factor in open schemes, meaning that the cashflows associated with bonds are relatively less attractive.

Neither of these conditions are true of the UK corporate DB system in aggregate: only 9% of schemes are fully open[13] to new members and new accruals by existing members, while in terms of funding, the aggregate system-wide position is an estimated 118% on a buyout basis[14] as of July 2023. In light of these facts, it is not obvious that there are incentives within the current DB funding framework to encourage trustees and their sponsors to take more investment risk. Current rules on DB surplus make it hard to extract this additional money and would mean that, for those schemes already in significant surplus, any additional investment risk taken with a view to seeking to further build a surplus would be unrewarded.

In principle these incentives could be changed by making it easier for sponsors, under certain conditions, to extract a surplus, either for investment in their own business, or, where relevant, for subsiding any DC contributions they make under their auto enrolment obligations.

The ability to extract this money would in theory provide an incentive to trustees and sponsors to take additional investment risk, since the money extracted either goes to support the sponsor's business (further strengthening the scheme's employer covenant[15]) or to employees via additional DC pension contributions[16]. Whether this incentive would translate to actual behaviour is something that government should look to test with sponsors and trustees prior to any proposed changes.

Q3: How many DB schemes' rules permit a return of surplus other than at wind up?

This question is best answered by DB pension schemes and their advisers.

Q4: What should be the conditions, including level of surplus that a scheme should have, be before extended criteria for extracting surplus might apply?

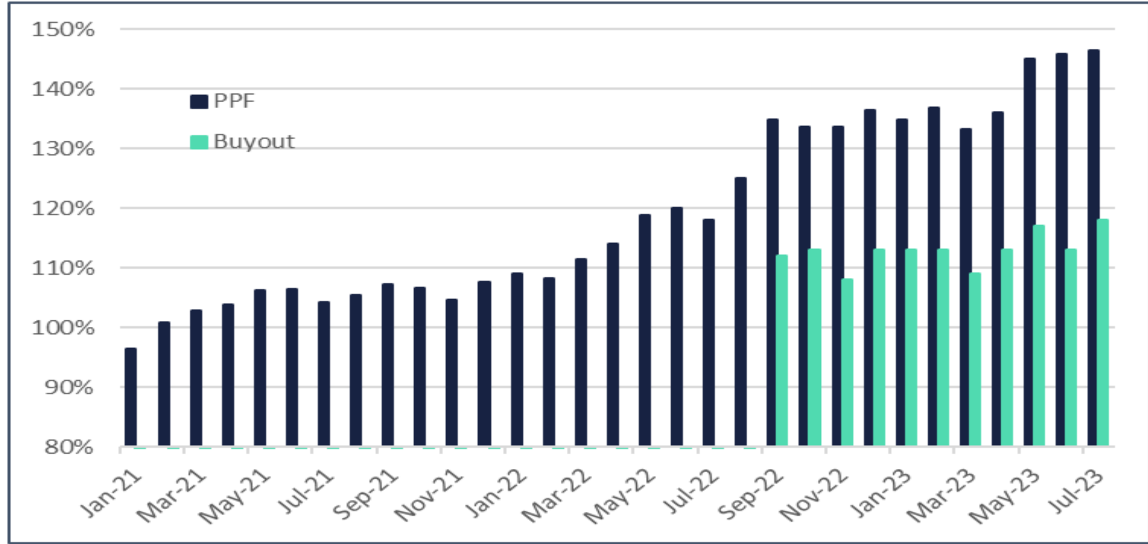
The starting point should be that any changes do not undermine the security of DB scheme members' benefits, nor increase the funding obligation for the employer. Any approach to releasing surplus should therefore have significant guardrails in place. Our view is that at a minimum, benefits should funded somewhere moderately above full buyout basis[17] before any additional surplus can be extracted e.g. 105-110%. This provides a margin to absorb any losses incurred when taking additional risk. This would both ensure the security of member benefits and give sponsors the incentive to take this risk, since the presence of the

[13] Annual report on UK defined benefit and hybrid schemes 2022, TPR, 2022.
[14] PwC Buyout Index, July 2023.
[15] Though it should be noted that for a scheme that is close to or fully funded on a buyout basis the sponsor covenant is a secondary consideration, so the incentive for trustees to take risk may not be especially strong.
[16] This assumes the same Trustee body is responsible for an employer's DB and DC schemes, which will only be the case for some schemes. In these situations, trustees will need to be sure that the use of any DB surplus to pay additional DC contributions does not represent a conflict of interest between the fiduciary duties owed to each scheme.
[17] Our proposed approach is more prescriptive since it effectively results in schemes locking in funding levels greater than full buyout and using a "surplus capital bucket" above the threshold to invest for capital gains that can then be released. An alternative, and less prescriptive, approach would give trustees more flexibility to re-risk at a broader scheme level, by simply allowing surplus to be extracted without conditionality around the funding level. However, we would not favour such an approach as the risks to members' benefits could be greater in such a scenario.

buffer will help reduce the risk of further employer contributions being needed if the additional investment risk taken is realised.

While this level is necessarily high, it is more achievable today than at any point in recent years, given the improvement in UK DB funding levels since the start of 2021 (Figure 2).

Figure 2: Evolution of the UK DB funding ratio since 2021



Source: PPF 7800 Index, PwC Buyout Index

Q5: Would enabling trustees and employers to extract surplus at a point before wind-up encourage more risk to be taken in DB investment strategies and enable greater investment in UK assets, including productive finance assets? What would the risks be?

In line with our responses to questions 2 and 4, we believe it is possible to create an incentive for trustees and sponsors to take greater investment risk in attempts to build up surplus that can subsequently be extracted. Whether that is likely to translate to actual behaviour is something the government should seek to test with DB trustees and sponsors.

We are less sure that the ability to extract surplus would automatically result in greater allocations to UK risk assets, including productive finance, as defined by the DWP[18]. Trustees' fiduciary duty should lead them to consider investments on a global basis. While this may lead to additional UK allocations, it is not a given.

Regarding types of asset class, while it is reasonable to suppose that increased allocations to listed UK equities could easily arise, it is less clear that illiquid assets held over the longer term would see additional investment: the key factor in determining whether this happens is the time period over which the accumulated surplus is intended to be extracted. If the aim is to extract a surplus in the short term, this creates an incentive to hold liquid assets that can be easily sold. Where the expectation is to extract surplus a number of years into the future, such a timeframe will be more consistent with illiquid investment. In such cases the presence of an illiquidity premium that contributes to the surplus generated is likely to be part of the investment case.

[18] Equity capital and finance for businesses in the UK including start-ups, infrastructure, and private equity, as well as longer-term investments, typically in illiquid assets. As defined on page 3 of the consultation document.

The risks of enabling surplus to be extracted prior to wind-up are as follows:

- Any additional risky investments made to build a surplus resulting in losses that led to a fall in the funding ratio to below the level needed to buy out with an insurer. This would mean reduced security for members and potentially additional funding costs for the sponsor

- Surpluses can also act as a buffer against market volatility, so there is a risk arising from the buffer being reduced as surplus is extracted, and then a scheme seeing its assets fall in value in the event of a large downturn

- Scheme endgames may also change over time and the role of any surplus may change accordingly e.g. some schemes may choose to operate on a low dependency/self-sufficiency basis instead of buying out, and in this case the surplus may be better utilised for cash flow purposes rather than being extracted

These risks can be reduced by requiring any extraction of surplus to be conditional on the maintenance of a minimum buffer above buyout, as set out in our answer to Q4.

Q6: Would having greater PPF guarantees of benefits result in greater investment in productive finance? What would the risks be?

Increasing the level of guaranteed benefit provided by the PPF would improve the outcomes for members of those schemes entering the PPF whose assets are either insufficient or just sufficient to meet the current level of PPF benefits. For such schemes, taking more investment risk would become more attractive if the PPF guarantee were raised and this could very well lead to greater investment in productive finance.

However, at the time of writing, this is a relatively small number of schemes and assets: 458 schemes with assets of £23.1bn and a PPF deficit of £2.2bn[19]. Thus, any additional investment in productive assets from this group is likely to be relatively small at UK economy-wide level.

For schemes in this position that do take on greater investment risk, the impact of this risk being realised would be a further deterioration in funding, and a greater call on the PPF. This in turn could have implications for the size of the PPF levy as well as the PPF's own asset portfolio.

For schemes that are funded sufficiently in excess of the PPF guarantee level, the incentive to take more investment risk due to an increase in the PPF guarantee is generally much weaker. We would not expect to see any significant changes to their investment strategies as a result.

Q7: What tax changes might be needed to make paying a surplus to the sponsoring employer attractive to employers and scheme trustees, whilst ensuring returned surpluses are taxed appropriately?

This is best answered by scheme sponsors, trustees, and their advisers.

[19] PPF7800 Index, August 2023. Note that this number understates the potential size of this group of schemes, because it does not include those who are currently funded above the existing level of PPF benefits, but below any increased level in future. As the new level of guarantee increases, so will this underestimate.

Q8: In cases where an employer sponsors a DB scheme and contributes to a defined contribution (DC) pensions scheme, would it be appropriate for additional surplus generated by the DB scheme to be used to provide additional contributions over and above statutory minimum contributions for auto enrolment for DC members?

Yes, subject to the security of DB members' benefits being maintained, this could be an appropriate use of any extracted additional surplus. It helps close the disparity in contribution rates between DB and DC schemes and will improve the outcomes of DC scheme members. However, if this is the only use permitted for an extracted surplus, it may weaken the sponsor's incentive to see additional surplus built in the first place.

Giving the option to the sponsor of choosing between investing the released surplus in their business or paying additional DC contributions would be a better way of ensuring there is a good incentive for the sponsor to want the trustees to take additional investment risk to build the surplus.

Q9: Could options to allow easier access to scheme surpluses lead to misuse of scheme funds?

If the conditions under which the extraction of surplus is permitted are sufficiently controlled, we do not think there is a significant risk of scheme funds being misused. Requiring the maintenance of a margin above the buyout level of funding before any surplus can be extracted, as described in our response to Q4, should provide sufficient protection for scheme members. Before seeking to extract surplus, trustees should stress-test their portfolios appropriately, in order to satisfy themselves that any investment risk that is realised as a result of the decision to invest in productive finance assets is capable of being absorbed by the risk margin above the buyout level of funding.

When it comes to the investment of scheme assets to generate additional surplus, the existing legal and governance framework - trustees' fiduciary duty, the prudent person principle and the requirement to seek investment advice under s36 of the 1995 Pension Act – continues to apply and will provide sufficient protection against the risk of any misuse of scheme assets.

Q10: What impact would higher levels of consolidation in the DB market have on scheme asset allocations? What forms of consolidation should Government consider?

While smaller schemes are likely to gain some benefit of expertise and scale from consolidation, it is not obvious at a macro level that there would be a significant impact of greater scale in the DB market on asset allocation. Experience both in the UK and abroad suggests that large pension schemes, who account for almost 75% of total assets[20], tend to be heavily diversified in their portfolios, both across asset classes and geographies. However, this tends to be a function of the greater governance resources and in-house investment expertise that large pension schemes have, rather than scale per se. These features can already be seen in many UK DB schemes.

As we have discussed above, the biggest drivers of DB investment strategy are funding level/required returns and scheme maturity, factors which are invariant to scheme size. Given the largely closed nature of UK corporate DB schemes and their increasingly healthy

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[20] Large DB schemes with over 5000 members make up almost 75% of assets, liabilities, and members. Source: PPF Purple Book 2022

funding levels (see Figure 2), there is going to be an inherent focus on de-risking and cashflow-driven investing within the system. Further consolidation in the market will not change this and so we would not expect to see significant impacts on aggregate DB aggregate asset allocation as a result.

The PPF itself is a good illustration here, as can be seen in its asset allocation in Table 1:

Table 1: PPF Asset Allocation

Asset Class	Strategic Allocation
Liability hedging instruments - Gilts (nominal and ILG) - Swaps (interest rate and inflation) - Gilt repos - Exchange Traded Derivatives - Sterling corporate bonds from govt backed institutions and systemically important institutions with very high financial and/or operational linkage to govt	**40%**
Return-seeking assets - Global govt bonds - Global aggregate bonds (govt, govt-related, corporate, and securitised debt from developed and emerging market issuers if investment grade category) - Sub-investment grade debt - Public equity - Alternatives (inc. property, private equity, alt credit, farmland and timberland, absolute return strategies)	**41.5%**
Hybrid assets (assets with return-seeking and liability hedging characteristics)	**12.5%**
Cash	**6%**

Source: PPF

The PPF has significant scale and in-house expertise, but its asset allocation is driven by the increasingly mature nature of its liabilities. It is noteworthy that its return-seeking portfolio contains significant allocations to bonds (albeit higher yielding, riskier instruments) alongside ‘true’ risk assets such as public and private equity.

More generally, we see the benefits of further consolidation coming in the areas of governance and administration rather than investment. The investment management industry already provides the benefits of scale in investments to DB pension schemes and other investors. This is often done through pooled funds, where DB schemes invest alongside other investors, benefitting from economies of scale and professional fund management.

Another existing investment consolidation option available to DB schemes is Fiduciary Management, where schemes delegate day-to-day investment decision-making to a Fiduciary Manager, while retaining control over the overall strategic funding and investment objectives. The Fiduciary Manager brings the benefits of scale and professional

portfolio management to the scheme. This includes allocating to a broad range of asset classes within the mandate set by trustees.

Q11: To what extent are existing private sector buy-out/consolidator markets providing sufficient access to schemes that are below scale but fully funded?

This is best answered by DB trustees and their advisers, but we note again that the investment consolidation options described in our answer to the previous question are already available to such schemes. Fiduciary Management in particular may be more beneficial for smaller schemes precisely because it is primarily a governance solution to the challenges of running a scheme's investment portfolio.

Q12: What are the potential risks and benefits of establishing a public consolidator to operate alongside commercial consolidators?

We do not see that a case has been made for a public consolidator to operate alongside commercial providers. The DWP has indicated that it will legislate to introduce a permanent 'superfunds' regime to encourage the development of new commercial consolidators. This should be done, and the market given time to grow before any decision is made to introduce a public consolidator. A public option would only be appropriate in the event of a market failure – in this instance lack of a private consolidation option to serve DB schemes. This test has yet to be met given that the DB consolidation market is only in its nascent stages.

Q13: Would the inception of a public consolidator adversely affect the existing bulk purchase annuity market to the overall detriment of the pension provision landscape?

This is best answered by insurers providing bulk annuities to the DB market.

Question 14: Could a public consolidator result in wider investment in "UK productive finance" and benefit the UK economy?

As set out in our answer to Q10, greater scale alone is unlikely to shift DB asset allocation in aggregate, since current allocations are not a function of scale but rather existing funding levels/required returns and scheme maturity. Unless a public consolidator was to seek greater returns by adopting a riskier portfolio, we would not expect to see significant changes in asset allocation towards UK productive finance assets. It is not clear either that there is a market failure that would warrant such an intervention.

We note that the private consolidation market has been constrained by aspects of regulation that limit asset allocation, notably Solvency II requirements that are now subject to review. With the ability to allocate in a more economically efficient manner, the insurance market should be in a better position to invest in UK productive finance alongside other investment opportunities to help deliver effectively for pension scheme members whom they serve.

Q15: What are the options for underwriting the risk of a public consolidator?
We are answering Q15-20 in a combined response below.

Q16: To what extent can we learn from international experience of consolidation and how risk is underwritten?

Q17: What are the potential risks and benefits of the PPF acting as a consolidator for some schemes?
Q18: Would the Board of the PPF be an appropriate choice to operate a public consolidator?
Q19: How could a PPF consolidator be designed so as to complement and not compete with other consolidation models, including the existing bulk purchase annuity market?
Q20: What options might be considered for the structure and entry requirements of a PPF-run public consolidator for example:

- **Are there options that could allow schemes in deficit to join the consolidator?**
- **What principles should there be to govern the relationship between the consolidator and the Pension Protection Fund?**
- **Should entry be limited to schemes of particular size and / or should the overall size of the consolidator be capped?**
- **How could the fund be structured and run to ensure wider investment in UK productive finance?**
- **How to support continued effective functioning of the gilt market?**

Combined answer to Qs15-20
We reiterate the point made in our answer to Q12 that the case for a public consolidator – whether that is the PPF or some other entity – has not yet been demonstrated. Such a significant intervention would only be justified by a major market failure, such as a segment of DB schemes being unattractive to commercial consolidators, leading to a situation where these schemes have no other consolidation option outside of insurance.

The superfunds regime needs to be legislated for first and then given sufficient time to develop, with an appropriate number of transactions taking place.

With regards to the PPF specifically, it serves an important function in the UK DB system by acting as a type of insurance against employer insolvency for badly underfunded schemes, ensuring that members in such schemes receive at least some of their promised benefit. This core focus should not be diluted without good reason, which we do not think has been demonstrated as yet.