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RE: Options for Defined Benefit schemes: a call for evidence

BlackRock[1] is pleased to have the opportunity to respond to the consultation on options for Defined Benefit (DB) schemes, issued by the Department of Work and Pensions (the 'DWP').

BlackRock manages the pension savings of over 12 million people in the UK. Our investment approach is rooted in our fiduciary duty: we start with our client's objectives, we seek the best risk adjusted returns, and we underpin our work with research, data, and analytics.

We welcome the opportunity to comment on the issues raised by this consultation paper and will continue to contribute to the thinking of the DWP on this and other topics.

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BlackRock welcomes the work that DWP has been undertaking to drive better outcomes for pension savers. As a fiduciary, this is central to everything that we do.

UK DB schemes make a significant contribution to supporting the UK economy and public services, with just over £1.4 trillion in assets. We are proud to work with DB schemes across the country.

The starting point for any conversation on the future of DB schemes must be member outcomes. The primary and most important responsibility of pension funds is ensuring that member benefits are paid – trustees need to find the best investments to meet their liabilities and make investment decisions which meet their members' needs and time horizons.

It is crucial that any changes to the system do not threaten this responsibility. While we are supportive of efforts to ensure that pension scheme money is working as effectively as it can for members, in the context of DB schemes' current funding position, we believe caution must be exercised when thinking about wholesale change of the system.

International comparisons

The consultation notes that UK DB schemes are "underinvested" in productive assets compared to international comparators, however, it is important to examine the picture holistically when thinking about this question, and ensure we are comparing like with like.

[1] BlackRock is a leading provider of investment, advisory and risk management solutions, and has been active in the UK for over 50 years. Our purpose is to help more and more people experience financial well-being.

Of the 5,131 DB schemes in the UK, 90% are closed to new members.[2] Scheme funding has also improved significantly since interest rates started rising at the beginning of 2021. These factors are crucial when thinking about appropriate asset allocation.[3]

The primary and most important responsibility of pension funds is ensuring that member benefits are paid – trustees need to find the best investments to meet their liabilities and it is prudent for these schemes to make investment decisions which meet their members' needs and time horizons.

In predominantly closed private DB systems like the UK, 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. Given this dynamic, while investment in illiquid assets may be appropriate under certain circumstances for certain schemes, to incentivise this type of investment more broadly would require a radical re-orientation of the system. It is not clear how this would benefit members.

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 for illiquid investment. Indeed, BlackRock has been highly supportive of the Government's work to get further DC investment into productive assets where consistent with the investment objectives of the relevant scheme.

Finally, we would highlight that UK private sector DB funds own an estimated 80% of the long-dated index-linked gilt market. As the majority holders and purchasers of UK index-linked gilts, pension funds give vital support to the UK economy by providing a stable and long-term source of funding for government borrowing. This helps to fund government spending on infrastructure, social programmes, and other initiatives that support economic growth.

Building surplus

When thinking about building further surplus, it is worth noting the journey that schemes have been on since the beginning of 2021. We now have 4,673 schemes in surplus and only 458 schemes in deficit. For these well-funded schemes and their trustees, there is very little incentive or appetite to take any additional investment risk in order to build a larger surplus.

The consultation document suggests that ability to extract some of this surplus for other purposes may make this more attractive. 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 for subsiding any DC contributions they make under their auto enrolment obligations. This may act as an incentive for some sponsoring companies.

However, while this may be true for plan sponsors, without some form of uprating of member benefits alongside this, this type of risk would still not necessarily be in the interest of trustees, whose responsibilities are to scheme members, not the sponsoring company. It is also worth noting that, even if conditions were to be changed, for those schemes on a credible path to buy out, this is still likely to remain unattractive and resource intensive option.

Moreover, it is worth bearing in mind that surpluses can act as a buffer for market volatility. There is a danger that if surpluses are extracted and there is a sudden downturn, sponsors

[2] PPF The Purple Book 2022
[3] The aggregate surplus of the 5,131 schemes in the PPF 7800 Index is estimated to have increased to £446.1 billion at the end of July 2023, with a funding ratio of 146.4%.

may put themselves in a precarious position. Endgames may also change - schemes that have thought of themselves as going to buy out may be hindered by capacity constraints, given the level of well-funded schemes, or other issues and instead pivot to self-sufficiency. In that scenario, again the surplus may be helpful in terms of cash flow for member benefits while a scheme pivots its portfolio.

Finally, if DWP is to go ahead with a change in this area it will be important to consider the tax treatment of any surplus. The possibility of allowing companies to use the surplus to invest back into the business raises the prospect that companies may treat the pension scheme as a tax efficient profit centre.

Consolidation

At BlackRock, we have been supportive of the UK government's work to date on consolidating the UK pensions market.

However, we would note that while there are many benefits to consolidation, scale is an imperfect proxy for quality and there are many smaller, well-run, well-funded schemes who invest heavily in the UK. Schemes of all sizes can deliver excellent member outcomes, and consolidation should above all serve this purpose. In line with this, any decision around scaling up should squarely focus on the benefits to members.

The fundamental question is what consolidation is trying to achieve – deficit recovery, economies of scale, lower fees, improved governance, or other improvements. Given schemes funding position there is less of a case now than if the majority of schemes were in deficit and member outcomes were at risk of being compromised.

We would also note that there is not necessarily a straight line between larger schemes and an appetite to take more investment risk in this context. The factors, discussed above, which impact DB investment strategy are likely to persist no matter the size of the scheme.

However, under certain consolidation conditions, you may see further investment in productive assets. Consolidation can take a number of forms, and in our Outsourced Chief Investment Officer (OCIO), sometimes referred to as fiduciary management, business we have successfully invested DB assets into illiquids.

Beyond this, there are already several consolidation options for schemes, including the insurance risk transfer market, which under Solvency II reform may in the future allow greater investment in assets associated with productive finance. Superfunds will also offer DB schemes an additional consolidation option to add to the existing range of choices on offer once the regime is up and running.

With this in mind, we believe there are already a number of options for well-funded schemes, with the deepest pools of capital, where conversations on consolidation have traditionally focused. However, there could perhaps be more of a case for consolidation at the less well funded end of the market, where schemes could benefit from the improvements in governance and administration that consolidation offers.

In our 2023 paper *UK defined benefit pension schemes – After the storm*, we categorised DB schemes into three groups:

- **Stay the course:** Schemes which are well funded and who intend to operate on a self-sufficiency / low dependency basis.
- **Credible path to risk transfer:** Schemes which are well funded but who are seeking a path to buy-in or eventual buy-out.

- **Difficult path ahead:** Schemes who have a significant deficit and who are a long way from self-sufficiency or to buy-in, and who may have covenant or governance challenges as well.[4]

Schemes in the difficult path ahead category will have the challenge of recovering the scheme deficit with reduced options for their endgame. This will require generating returns from the return seeking portion of their portfolio whilst also managing risk in their liabilities.[5] However, these schemes may have a weaker governance budget and less in-house investment expertise to help make these types of decisions. Hence, there may be an opportunity to think about how consolidation could be used as a tool to help these schemes and protect their members' benefits.

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Conclusion

We are supportive of the work that DWP is doing to drive better outcomes for pensions savers. However, in the context of DB schemes' current funding position, we believe any changes must be balanced against further member benefits.

We welcome the opportunity to comment on the issues raised by this consultation paper and will continue to contribute to the thinking of the DWP on any issues that may assist in the final outcome. We welcome further discussion on any of the points that we have raised.

Yours faithfully,

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[4] BlackRock, *UK defined benefit pension schemes – After the Storm,* Joanna Matthews & Gavin Lewis
[5] Return seeking or growth assets can encompass equities, credit, liquid alternatives or private market assets.