Proposals to update the asset information collected from defined benefit pension schemes

April 2021

Contents

1. Executive summary

1.1. Introduction

1.1.1. This consultation sets out proposed changes to the asset class information TPR collects annually from defined benefit (DB) schemes via the scheme return. TPR uses this information to help measure investment risk, and the PPF uses it to help calculate the PPF levy.

1.1.2. We welcome comments from all stakeholders and, in particular, would invite views from trustees and their professional advisers on how our proposals can be implemented in a proportionate way. We recognise there is a balance to be struck between the benefits of more granular asset information and simplicity of reporting for schemes.

1.2. Why we are proposing changes

1.2.1. Schemes' allocation to bonds has increased steadily over the last 10 years and now represents over two-thirds of the assets held by DB pension plans. As a result, it is increasingly important to be able to assess the investment risks within schemes' bond allocations by maturity, credit quality and currency – rather than simply to distinguish them from growth (return-seeking) assets, such as equities. Within growth assets we have also seen a change, with schemes diversifying away from traditional equities and the increasing use of diversified growth funds (DGFs), particularly among smaller schemes.

1.2.2. Given these changes to the pensions investment landscape and with a focus on being "clearer, quicker and tougher", TPR will be seeking to improve the scheme information it holds. A key component of TPR's approach to best practice in scheme management is that the degree of investment risk taken should be appropriate in the context of the maturity of the scheme's obligations and the strength of the employer covenant. The new requirements introduced in the Pension Schemes Act 2021 set out the expectation that trustees should have a long-term plan and say how they intend to manage the risks around their plan. In the first consultation on a revised DB code, TPR consulted on proposals for how trustees could comply with the new legislative requirements, including through an assessment of a stressed investment scenario. There was strong support for the use of a PPF stress test to measure investment risk, which is currently being considered. This will help trustees to determine the appropriateness of the risks being taken, in the context of their scheme's maturity and covenant.

1.2.3. The PPF also has an interest in a better assessment of investment risk for the purposes of charging a risk-reflective levy.

1.2.4. In addition, TPR believes scheme trustees will benefit from reporting their asset data in a more granular way, resulting in a clearer picture of their investment risk as part of the information required to meet the standards expected under the new regime.

1.3. Summary of our proposals

1.3.1. We want to take a proportionate approach to the data we collect – reflecting that smaller schemes may have more limited resources and simpler investment strategies.

1.3.2. Accordingly, we are proposing a tiered approach, basing the information we ask for on scheme size. Smaller schemes (Tier 1) will see only minor changes – with larger schemes (Tier 2) being asked to provide more granular data. We are proposing the largest schemes (Tier 3) will also continue to carry out the bespoke stress calculation, as required under the PPF levy rules. Schemes will be able to "trade up" tiers and voluntarily provide more information if they wish.

1.3.3. Our proposals are largely derived from the more granular set of asset categories used in the bespoke stress calculation for the PPF levy. Therefore, this will be familiar to the one in seven schemes that currently submit this information for levy purposes – and the advisers and investment managers who support them.

1.3.4. We believe this more detailed asset breakdown should be relatively straightforward for most schemes to provide and, in many cases, will already be included in regular reporting from investment managers. The bespoke stress calculation also requires information on the sensitivity of the portfolio to changes in interest rates and inflation and calculating the impact of our specified risk-factor stresses, although this will continue to be required for only the largest schemes.

1.4. Main changes to asset class information

1.4.1. The main changes to the asset class information we are proposing to collect from schemes are as follows:

Bonds

- Introducing a specific UK Government fixed interest bond category to replace the more general Government bond category that currently exists for all Tiers.
- Introducing a specific UK Government inflation-linked bond category to replace the more general inflation-linked category that currently exists for all Tiers.
- For bond investments, introducing additional categories to identify differences in maturity, credit quality and currency for Tiers 2 and 3.
- Adding a sub-investment grade bond category for all Tiers.
- Adding a private debt bond category for Tiers 2 and 3.

Equities and other assets

- Further breaking down overseas equities into developed and emerging markets for Tiers 2 and 3.
- Removing the hedge fund category for all Tiers.
- Adding a DGF category for all Tiers.
- Adding an absolute return fund category for Tiers 2 and 3.
- Removing the commodities category for all Tiers.
- Removing the insurance fund category for all Tiers.

1.5. Where to set the tier thresholds

1.5.1. Ideally, we would like to collect more detailed information – critically on bond maturity and credit quality – from all schemes, since this is likely to be material to the level of investment risk the scheme is running. We expect that for many schemes this will be straightforward – requiring, at most contact with investment managers to provide the required information.

1.5.2. We recognise, however, that smaller schemes may find it more difficult to collect this additional information efficiently. Therefore, we are proposing a 3-tiered approach, basing the information we ask for on scheme size, allowing the smallest schemes to continue to provide a similar level of asset information as they do now.

1.5.3. Our proposals on the tier thresholds are as follows:

- We propose setting the boundary between Tier 1 and Tier 2 at £20m (based on s179 liabilities at the most recent valuation). By way of context, this would mean that a majority of schemes would fall in Tiers 2 and 3 and, therefore have their investment risk assessed against more detailed information, while offering a simplified approach for around two-fifths of schemes.

- To the extent that, in the short term, this would be challenging for schemes at the lower end of the Tier 2 bracket, there could be justification for setting a higher threshold initially, whilst provision of more granular information becomes routine. We ask for views about the need for a higher interim Tier 1 to 2 boundary and where that might be set.

- We propose setting the boundary between Tier 2 and Tier 3 at £1.5bn. That is consistent with the current threshold for provision of the bespoke stress calculation for the PPF levy and, we believe, remains appropriate going forward. This means that approximately 200 of the UK's largest schemes would continue to be required to submit the additional Tier 3 information.

1.6. PPF roll-forward indices

1.6.1. The PPF uses indices to roll forward submitted asset information and ensure broad consistency of this data between schemes when calculating risk-based levies in any year. As the proposals include collecting new asset class data, we have carefully considered whether additional roll-forward indices should be introduced to represent the new asset categories. However, we are mindful that the roll-forward calculation is, by necessity, an approximation. There is a balance to be struck between the accuracy that additional indices bring and the simplicity and cost-effectiveness of maintaining the existing roll-forward framework.

1.6.2. To date, the PPF has not used separate indices for each of the existing asset classes. For example, all bonds are rolled forward using a single generic index, rather than using separate indices to distinguish between government and corporate or fixed interest and inflation-linked bonds.

1.6.3. Our view is that the benefits of moving to a more granular approach will be relatively marginal and likely to be outweighed by the costs and disruption of introducing a new set of indices (including additional licensing fees for schemes or their advisers seeking to replicate the roll-forward calculation). We are therefore proposing to retain the current roll-forward system. However, we would welcome views from stakeholders on this conclusion and on our assessment of the relative costs and benefits of changing the indices.

1.6.4. To support this, we have set out below the wider indices we could use to roll forward the new sub-classes in Tiers 2 and 3, should this consultation indicate broad support for a more sophisticated approach:

- Maturity-specific FTSE UK gilts indices for the new UK Government fixed interest bond sub-classes.
- Maturity-specific FTSE UK index-linked gilts indices for the new UK inflation-linked gilts sub-classes.
- Markit iBoxx indices for the new sub-classes in respect of non-UK Government fixed interest bonds (including sub-investment grade and private debt).
- MSCI equity indices for the new overseas equity sub-classes of developed and emerging markets.

1.7. Next steps

1.7.1. Our proposals on the changes to asset classes fit within a wider programme of change – in particular TPR's implementation of the new funding code and changes to TPR systems for future scheme returns. TPR plans to update its IT systems to enable the collection of new asset class data in time to support the introduction of the new code. TPR will ensure schemes have sufficient notice before implementation. The PPF would then expect to make associated changes to the PPF levy rules.

1.8. The consultation

1.8.1. This consultation is open for six weeks and will close on 10 June 2021.

1.8.2. There are two versions of online submission available to you on the PPF's website: 'quick' and 'full':

- The 'quick' submission allows respondents to review a summary of key proposals set out under consultation and is designed to take only 10 to 15 minutes to complete.
- The 'full' version sets out all the questions we are asking in this consultation, allowing complete responses, along with free format text fields for additional views to be submitted. An offline template, which can be downloaded and completed offline and then uploaded via the PPF website, is also available to aid collaborative submissions where input is needed across an organisation or range of stakeholders.

1.8.3. Both organisations will consider the responses. Information included in responses will be shared between the PPF and TPR – i.e. both organisations will have access to the detailed information. A summary of responses and our conclusions will be available on the PPF and TPR's website.

1.8.4. We are not expecting to run a further consultation and, accordingly, would invite responders to respond fully on all aspects of the proposal at this stage.

2. Rationale for change

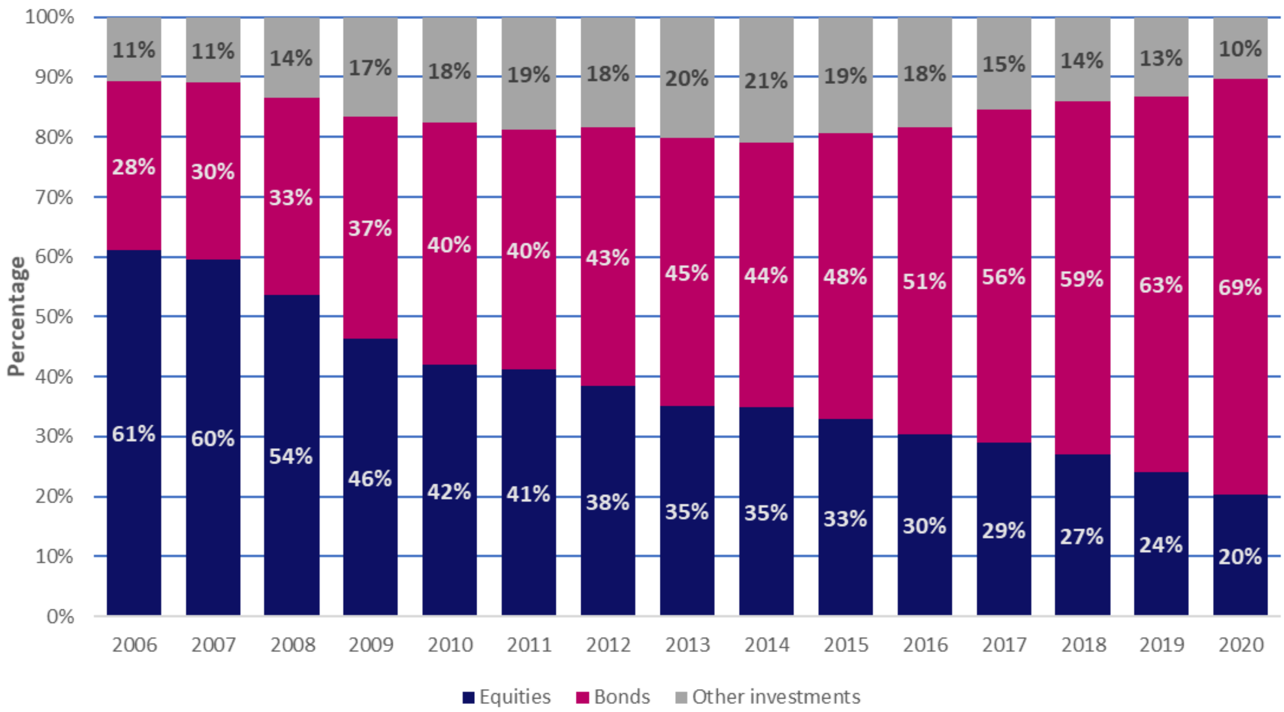
2.1. Introduction

2.1.1. This section sets out our rationale for change. It includes wider regulatory context and changes to how schemes invest their assets.

2.2. Responding to the changing asset allocation of pension schemes

2.2.1. Schemes are asked to submit asset class information via the scheme return. The information collected around asset classes has changed little since it was introduced in 2005, but since 2005 scheme asset class allocations have changed significantly (Figure 1). For example, in 2006 61% of scheme assets by value were in equities and this had decreased to 20% by 2020. Over the same time period, the proportion of assets allocated to bonds has increased from 28% to 69%.

Figure 1: How schemes' asset allocation has changed between 2006 and 2020 by value

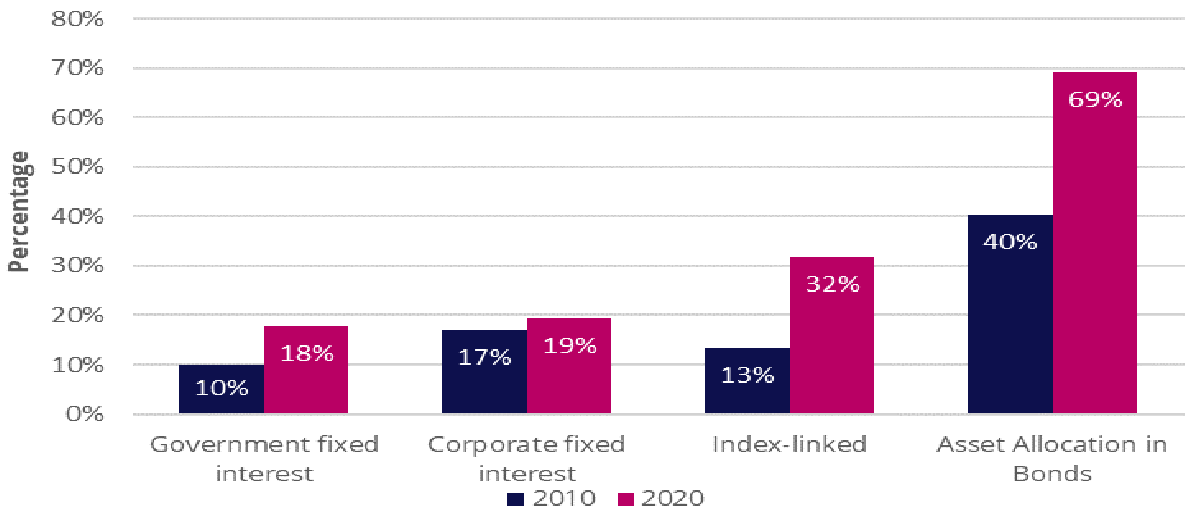


Source: *PPF Purple book 2020*

2.3. Current and future trends in asset allocation

2.3.1. Our informal discussions with scheme advisers and investment managers reinforce the focus of pension funds on bonds, as well as diversifying their growth assets. Many pension funds are looking for additional yield enhancement opportunities in fixed income (given, in part, the historically low level of Government bond yields at the time of writing).

Figure 2: How sub-classes of bonds as proportion of total asset allocation have changed between 2010 and 2020



Source: *PPF Purple Book March 2020*

2.3.2. The overall allocation to bonds has clearly increased significantly over the last 10 years. The composition of the bond allocation (Figure 2) has also changed. For example, schemes are now more likely to invest in index-linked bonds compared to 10 years ago. In addition, schemes are making greater use of corporate bonds as well as other sub-asset classes such as high yield and private debt.

2.3.3. Pension schemes now use bond investments for a variety of reasons. For example, schemes use high quality long maturity government bonds to help match assets and liabilities, while many schemes consider sub-investment grade bonds as return-seeking. Currently, the data we collect does not allow us to easily distinguish between these sub-asset classes.

2.3.4. The use and composition of equities in schemes' asset allocation has also changed in the last 10 years. Schemes are now more likely to invest in overseas quoted equities and private equities. For example, in 2010, 55% of equity assets by value were in overseas quoted equities, compared to 69% now.[1] The data we collect does not allow us easily to distinguish between developed and emerging markets.

Consultation questions

- **Do you agree that bonds will continue to be a focus for pension plans?**
- **Are there other market developments we need to consider?**

2.4. Updating the scheme return

2.4.1. Due to the changes in how schemes allocate their assets, the information collected from DB schemes annually via the scheme return needs to be updated.

2.4.2. The PPF and TPR have worked together to identify a set of asset class categories that can be used by both organisations for our respective purposes. We have sought to strike a balance between measuring investment risk accurately and minimising the burden, particularly for smaller schemes. The sections below set out how this fits into wider regulatory change within TPR, and how the PPF aims to use new data on asset classes.

2.5. Use of the information by TPR

2.5.1. TPR acknowledges:

- In relation to the imminent changes in relation to the DB funding code - whilst still under development, these are likely to affect/change the way trustees make decisions and report on those decisions;
- the limits of the data we have; and
- that, even though reporting requirements will change with the Statement of Strategy introduced by the Pension Schemes Act 2021, funding reporting is on a triennial basis only.

2.5.2. TPR wants to be able to better-understand the investment landscape to provide more guidance and scrutinise trends and changes in the market. Therefore, TPR requires more granular investment data to be submitted annually via the

[1] PPF, Purple Book 2020.

scheme return.

2.5.3. TPR envisages using asset information in three main ways:

- Understanding schemes' investment risk.
- Engaging with schemes to help identify what actions may be needed for schemes to comply with the legislation.
- Improving the understanding of the DB universe, and to better-identify trends in investment.

2.6. Use of asset information in the PPF levy

2.6.1. In 2012, the PPF started to use investment risk as part of the risk-based levy. This is calculated for the majority of schemes using the asset breakdown information collected by TPR in the scheme return. Whilst schemes' investment strategies have changed, the information used has not. This means that some elements of a scheme's investment risk are not captured in the levy calculation, for instance, information on the maturity and quality of bond investments.

2.6.2. Updating the asset categories to reflect the changes in scheme asset allocation (e.g. the greater use of bonds) will allow the PPF to make an improved assessment of investment risk in the levy for a larger number of schemes. Prior to seeing the more granular data from schemes for the first time, it isn't possible to be certain of the overall effect on the levy. However, our expectation is that the impact is unlikely to be significant by comparison with other factors that change from year to year[2]. These proposals are, however, likely to result in some redistribution of the levy, reflecting the more accurate measurement of investment risk.

2.6.3. Information on schemes' investments is also used by the PPF in assessing the risks they face, including to the PPF's long-term funding strategy. More detailed information on asset classes will help improve this understanding.

[2] The levy varies naturally with changes in the insolvency risk of sponsors and changes in scheme funding or asset allocation. The PPF also has levers to ensure the levy remains at an appropriate level through changing calculation methodology.

3. Detailed proposals on asset class information

3.1. Introduction

3.1.1. This section sets out our proposals for the asset class information that will be collected. The information required will vary depending on the size of the scheme under a three-tier approach (see section 4). An overview of the proposals is set out in Figure 3.

Figure 3: The tiered approach and asset class categories

Existing

Bonds

Fixed interest
- Govt.
- Non-Govt.

Inflation linked
- Govt. & non-Govt.

Equities
- Overseas quoted
- UK quoted
- Unquoted / private

Other
- Cash
- Annuities
- ABCs**
- Property
- Hedge funds
- Other

Tier 1 (basic)

Bonds

Fixed interest
- UK Govt.
- Investment grade (exc. UK govt.)
- Sub-investment grade

Inflation linked
- UK Govt.

Equities
- UK quoted
- Overseas quoted
- Unquoted / private

Other
- Cash
- Annuities
- ABCs**
- Property
- Diversified Growth Funds
- Other

Tier 2 (mid-range)

Bonds

Fixed interest

- UK Govt.
  - Short (<5yrs) / medium (5-15yrs) / long (>15yrs)
- UK Investment grade (exc. UK Govt.)
  - Short & medium (<10yrs) / long (10+ yrs)
- Non-UK investment grade (inc. overseas Govt.*)
  - Short & medium (<10yrs) / long (10+ yrs)
- Sub-investment grade
- Private debt

Inflation linked

- UK Govt.
  - Short <5yrs / medium (5-15yrs) / long (>15yrs)

Equities

- UK quoted
- Overseas quoted
  - Split Developed / Emerging markets
- Unquoted / private

Other

- Cash
- Annuities
- ABCs**
- Other
- Property
- Diversified Growth Funds
- Absolute Return Funds

Tier 3 (large)

Tier 2 plus risk factor stresses

- Equities (UK, non-UK developed markets and emerging markets)
- Interest rate
- Inflation
- Credit

*Under the proposals, UK Govt. inflation linked bonds will be categorised separately, with other inflation linked bonds being allocated to their corresponding fixed interest sub-class.

***ABCs are deducted from asset allocations before rollforward and therefore do not have a rollforward index or a stress factor.*

3.1.2. The proposals have built upon the PPF's existing asset categories captured through the scheme return and the breakdown used in the PPF's bespoke stress calculation. For Tier 1, we would request information at the current level of detail, with only minor refinements proposed, including the introduction of a diversified growth fund (DGF) category. For Tier 2, the proposal is to seek more granular information, based on the asset categories used in the PPF's existing bespoke stress calculation. Schemes in Tier 3 are also asked to provide information on the sensitivity of the portfolio to changes in interest rates and inflation and to calculate the impact of the specified risk-factor stresses.

3.1.3. Following this consultation, the PPF will review the stress factors[3] applying to the updated set of asset classes, as well as the risk factor stresses required to be calculated for Tier 3 schemes. These stress factors will then be used in the risk-based levy calculation and details will be included in the relevant levy consultation. TPR proposes to use the same stresses to assess investment risk.

[3] The current asset stress factors can be found on the PPF website, under the Investment Risk Appendix 2021/22 and the Transformation Appendix 2021/22

3.2. Proposals for bonds

3.2.1. The key area of change proposed in this consultation is around bond investment categorisation. TPR currently collects information on schemes' allocations to fixed interest Government bonds, fixed interest non-Government bonds, and inflation-linked bonds.

3.2.2. For Tier 1, we would like to refine the bond categories to reflect the bond categories small schemes most commonly invest in. This includes having a dedicated category for UK Government fixed interest bonds. We are also proposing to have dedicated categories for other fixed interest bonds, split by investment quality.

3.2.3. For Tier 2 and Tier 3, we would like to collect more information on the maturity, quality and currency of these schemes' bond investments. The detailed proposals are set out below.

3.3. Fixed interest Government bonds (UK and non-UK)

3.3.1. The current category for fixed interest Government bonds covers a mixture of predominantly UK Government bonds with some non-UK Government bonds. We think there is a clear case for distinguishing UK Government bonds from overseas Government bonds. Firstly, UK bonds are likely to be a better match for liabilities of UK pension schemes. Additionally, the current approach does not allow us to take account of the currency risk or credit quality of overseas Government bonds.

3.3.2. We are concerned that the current system allows emerging market debt to be allocated in the same category as UK Government bonds and benefit from the same asset stress factor. This is not appropriate in our view, as the credit risk is quite different. We believe that the credit rating of an emerging market bond (or, indeed, any bond) is the best way of capturing the credit risk and our proposals address this.

3.4. UK Government fixed interest bonds (gilts)

3.4.1. We propose to have a dedicated category for UK Government fixed interest bonds (gilts). Within this category, the key determinant of risk is maturity. For

Tier 1, we are proposing a single category for UK Government fixed interest bonds. Under Tier 2, we propose asking for a breakdown by short, medium and long maturity. We outline our proposals in Table 1.

3.4.2. Overseas Government fixed interest bonds provide a lower degree of liability matching compared to gilts and would be grouped with corporate bonds - either investment grade or high-yield (sub-investment grade), depending on credit quality.

Table 1: Proposal for UK Government fixed interest bonds

Current	Proposal for Tier 1	Proposal for Tier 2 and Tier 3
Fixed interest Government bonds	UK Government fixed	UK Government fixed – short (less than 5 yrs.)
		UK Government fixed – medium (5 to 15 yrs.)
		UK Government fixed – long (over 15 yrs.)

3.5. Other fixed interest bonds (excluding UK government bonds)

3.5.1. The vast majority of corporate bond allocation is likely to made up of UK investment grade corporate bonds[4]. However, there will also be some allocations to the following sub-classes:

- Overseas Government bonds (investment grade)
- Overseas corporate bonds (investment grade)
- Sub-investment grade bonds (also referred to as high-yield bonds)
- Private debt

3.5.2. Risk is determined in this category by several factors:

- Credit quality
- Maturity

[4] We define investment grade as rated between AAA and BBB- by Standard & Poor's or Fitch or, between Aaa and Baa3 by Moody's.

- Currency
- Liquidity

3.5.3. Tier 1 proposals focus purely on distinguishing bonds by credit quality. For Tier 2 and 3, we will also want to take account of maturity and currency risks. Table 2 outlines our proposals.

3.5.4. Sub-Investment grade bonds will combine holdings of high-yield corporate bonds and Government bonds rated below investment grade. As credit risk dominates here, we don't believe there is merit in splitting out by country or by maturity. This new category will apply to all tiers.

Table 2: Proposals to split fixed interest non-UK Government bonds by investment grade

Current	**Proposal for Tier 1**	**Proposal for Tiers 2 and 3**
Investment grade (excluding UK Government)		
Fixed interest non-Government bonds	Investment grade (excluding UK Government bonds) (NB will include non-UK Government bonds including inflation-linked)	Investment grade UK (excluding UK Government) – short and medium
		Investment grade UK (excluding UK Government) - long
		Investment grade overseas (corporate or Government) – short and medium
		Investment grade overseas (corporate or Government) – long
Sub-investment grade		
Fixed interest non-Government bonds	Global – sub investment grade	Global – sub investment grade
Private Debt		
	Private debt	Private debt

3.5.5. Private debt is a sub-asset class of fixed income, which has become more popular in recent years, although allocations in most schemes are low. The average allocation is difficult to assess given the data currently held but is likely to be less than 5%. Nevertheless, the holdings within individual pension plans vary, with larger schemes, in particular, sometimes allocating over 5% to private debt. This asset class exhibits different risk characteristics from rated corporate bonds. In particular, it typically has a lower level of liquidity. Assuming this asset class continues to grow in popularity, we consider it to be sensible to include this category for Tiers 2 and 3. We believe creating a separate category encompassing all types of private debt investment is sufficient, i.e. without the need to split this category further by currency and maturity.

Consultation questions

- **Do you agree with our proposals for new bond categories under Tier 1?**
- **Do you agree with our proposals for more granular detail under Tier 2?**
- **Do you agree that private debt should be included for Tiers 2 and 3?**
- **If so, do you agree that a single sub-asset class is appropriate?**

3.6. Inflation-linked bonds

3.6.1. We expect the vast majority of inflation-linked bonds held by UK pension plans to be UK government inflation-linked bonds. The key characteristic that determines the risk associated with UK inflation-linked bonds is maturity.

3.6.2. At present, the scheme return groups all inflation-linked bonds together. This includes both UK gilts and overseas Government bonds and inflation / index-linked corporate bonds. We are proposing to refine our approach.

3.7. Dedicated category for UK inflation-linked gilts

3.7.1. For all tiers, we are proposing a dedicated category for UK inflation-linked gilts, as we expect most inflation-linked bonds held by UK pension plans are UK Government inflation-linked bonds. We also propose a more detailed breakdown by maturity, as this is the key characteristic. The proposal is to split maturity by short, medium and long UK Government inflation-linked bonds (table 3). All overseas investment grade inflation-linked bonds would be included in investment-grade non-Government bonds.

Table 3: Dedicated category for UK inflation-linked bonds

Current	Proposal for Tier 1	Proposal for Tier 2
All inflation-linked bonds	**UK** Government inflation-linked bonds	**UK** Government inflation-linked – short (less than 5 years)
		UK Government inflation-linked – medium (5 to 15 years)
		UK Government inflation-linked – long (over 15 years)

3.7.2. Note that under this proposal US TIPS will be classed as overseas non-Government fixed interest Bonds. Whilst we recognise that this allocation is not ideal, we prefer it to including these in the same category as UK inflation-linked bonds because these assets have returns linked to a different rate of inflation as well as currency risk (if unhedged) and we think these risks should not be understated in a stress test.

Consultation question

- **Do you agree with our proposal for having a dedicated category for UK Government inflation-linked bonds given the implications for US TIPS?**

3.8. Equities

3.8.1. We are proposing very limited changes to the information that schemes provide on equity investments, as the use of these assets is decreasing among schemes. The scheme return breaks down equities into three sub-categories: UK quoted equities, overseas quoted equities and unquoted/private equities. For Tier 1, reporting will remain as it is currently.

3.8.2. We are proposing a change to the equities category for Tiers 2 and 3. This will involve reporting the overseas equity allocation to developed and emerging markets separately (consistent with the categories for the PPF bespoke asset calculation). Investors typically allocate to emerging markets in the pursuit of higher expected returns, acknowledging the higher level of volatility. Therefore, we believe such a split is appropriate.

Consultation questions

- **Do you agree with our proposals for leaving the equity split unchanged for Tier 1?**
- **Do you agree with the proposal for Tier 2 to split overseas equities into developed and emerging markets?**

3.9. Other asset class categories: changes

Commodities

3.9.1. Commodities have historically been used to provide some diversification to the equity allocation within growth assets. As the allocation to equities has almost halved over the last 10 years (20% currently vs 42% 10 years ago) and schemes have used other asset classes to diversify growth assets, the current use of commodities is very low among schemes. The PPF Purple Book does not explicitly show the current commodities allocation; however, the miscellaneous category, to which the commodities are expected to be allocated, represents only 0.8% of assets. Therefore, we propose to remove this category. Schemes will be directed instead to use the 'Other' category.

Hedge funds, diversified growth funds and absolute return funds

3.9.2. The current average allocation to hedge funds is 7%. The results of a sampling analysis by TPR has revealed that the vast majority of this asset class is made up of DGF's, which have quite different characteristics from what are traditionally thought of as hedge funds. The remainder (non-DGFs), in TPR's experience, is made up of a range of different strategies that can be thought of as closer to what is traditionally thought of as hedge funds. These include, but are not limited to, absolute return funds.

3.9.3. To remove this potential confusion, we are proposing to remove the hedge fund category and introduce a replacement category of DGF's for all tiers.

3.9.4. Introducing DGFs also removes the need to allocate these assets to the underlying asset classes (which is how they currently should be allocated, rather than being included with hedge funds), thus having the advantage of simplifying returns.

3.9.5. Absolute return funds have become more popular in recent years and are a sub-set of hedge funds. These funds typically have a 'cash-plus' benchmark and often target a high proportion of their return from the alpha (returns generated by manager skill), rather than returns of the intrinsic asset class. We propose a separate category for such strategies for Tier 2 and Tier 3.

3.9.6. If schemes do hold hedge fund assets (not DGFs) other than absolute return funds, then they should allocate these holdings to "Other".

Insurance Fund Investments

3.9.7. This category has caused some confusion and currently has a very low allocation (0.1% in 2020 PPF Purple Book). Insurance fund investments exclude insured immediate and deferred annuities, which are included elsewhere, i.e. these are investments rather than insurance contracts. They may include pooled funds, deposit administration contracts and with-profits contracts. TPR's guidance5 has encouraged the splitting out of these into their constituent investments and otherwise allocating them to the "Other" category.

3.9.8. We propose to remove this insurance fund investments. Schemes are still directed to use instead the" Other" category where they don't split them into their constituent parts. We do not think that this should be an issue for schemes because:

- The amounts allocated are very low and we do not expect this to be a growing asset class; and
- The stress on this asset class is currently the same as that for the "Other" category.

Consultation questions

- **Do you agree with including a category for DGFs for all tiers?**
- **Do you agree with our proposals to add absolute return strategies for Tier 2 and above?**
- **Given our proposals for DGFs and absolute return strategies, do you agree that the hedge fund category can be removed?**
- **Do you agree with our proposals to remove the commodities and insurance categories?**

[5] Help for submitting asset breakdown

3.10. Multi-asset credit funds

3.10.1. From our industry engagement, we are aware there is growing use of multi-asset credit funds. These funds can include a number of different assets. This makes it difficult to identify appropriate roll-forward indices and stress factors for PPF levy purposes. As such, we believe these investments should be broken down into their constituent parts. We would welcome industry views on whether this is the best approach, or whether there is merit in having a dedicated category.

Consultation questions

- **Do you agree with our proposal for multi-asset credit funds to be broken down into the constituent parts for the scheme return?**
- **Are there any other changes we should consider for asset class categories?**

4. Proposals on tier boundaries

4.1 Introduction

4.1.1 This section sets out the proposals for a tiered approach to collecting asset allocation information and our accompanying rationale.

4.1.2 We want to get the balance right between getting more granular data to help regulate schemes, protecting members, and limiting the burden on schemes. To take account of differing needs and approaches across the DB universe, we are proposing a tiered approach, basing the information we ask for on scheme size. For Tier 1, we are proposing that small schemes provide similar information to that currently required in the scheme return, with schemes in Tier 2 to provide more granular data on their asset allocation. Schemes that meet the criteria for Tier 3 would also undertake the bespoke stress calculation. Schemes will be able to "trade up" tiers and voluntarily provide more information if they wanted to.

4.1.3 This section sets out our proposals for the tier boundaries by size of scheme. As part of the consultation, we are seeking views on where to set these thresholds.

4.2 Definition of scheme size

4.2.1 As set out in TPR's DB funding consultation, scheme size can be measured by size of the scheme assets, size of the liabilities or the number of members. The following measures are already used:

- Number of members - for schemes with fewer than 100 members, more limited disclosures are required.
- Liabilities - s179 liabilities are used for levy purposes to define small schemes with s179 liabilities below £20 million are charged a 50 per cent lower levy. While schemes with liabilities greater than £1.5bn are required to undertake a bespoke stress calculation.

4.2.2 We recognise there is an argument for using an asset-based measure when gathering information on investments. However, we are reluctant to introduce more complexity through having an additional basis used to assess scheme size. A 100-member limit would mean that a large proportion of schemes move immediately to providing more information, but it could also mean some schemes with relatively large investment portfolios would fall below the Tier 2 threshold.

4.2.3 We are therefore proposing to measure scheme size for tiers using liabilities as measured by the latest submitted s179 liabilities. This is consistent with the current approach for determining which schemes provide additional information on their investments through the bespoke stress calculation.

Consultation question

- **Do you agree with our proposals to measure scheme size by submitted s179 liabilities?**

4.3 Tier 1/2 boundary

4.3.1 Ideally, TPR wants to collect more detailed information – critically on bond maturity and credit quality - from all schemes – since this is likely to be material to the level of investment risk the scheme is running.

4.3.2 In addition, TPR believes that the information provided through Tier 2 will help schemes to have a clearer understanding of the investment risks that they are taking, including the degree to which assets provide a match to liabilities. For this reason, it would be appropriate to include as large a proportion of schemes in Tier 2 (or 3) as can reasonably provide the information.

4.3.3 Furthermore, TPR believes it is likely to be easier for schemes to demonstrate they meet the requirements for "Fast Track" if they have better information on investment risk in line with the Tier 2 requirements. If the threshold for Tier 1 is too high, schemes may be less likely to obtain sufficiently detailed information on investment risk. If TPR is to protect members across the range of schemes, that points to setting a low threshold.

4.3.4 It is expected that, for many schemes, providing Tier 2 information will be straightforward – requiring at most contact with investment managers to provide the required information.

4.3.5 It is appreciated this may initially be more challenging for some, especially smaller, schemes. Some schemes may be concerned about the potential cost of needing to obtain more detailed information due to requiring professional advice to obtain the necessary information for their annual reporting exercise and scheme return.

4.3.6 While understanding investment risk is equally important for smaller schemes, TPR and the PPF recognises that administrative costs are higher for small schemes, and they may be less able to access professional advice. Again, this points towards the need for having a lower tier to limit the burden on small schemes.

4.3.7 We recognise, however, that there may be some benefit in having a phased approach as it may more difficult initially for smaller schemes to efficiently gather the information until new reporting tools become standard.

4.4 Number of schemes impacted by Tier 1/2 boundary options

4.4.1 To understand the implications from a regulatory perspective of different potential thresholds, we looked at the proportion of schemes that have s179 liabilities at £20m, £30m, £40m and £50m[6].

4.4.2 Setting the Tier 2 threshold at £20 million means two in five schemes would provide only basic information, rising to more than three in five schemes at £50 million of liabilities (table 4).

Table 4: Number of schemes in each tier

	Number of schemes in Tier 1[7]	**Proportion of all schemes in Tier 1**	**Number of schemes in Tier 2 and above**	**Proportion of all schemes in Tier 2 and above**
Less than £20m	2315	43%	3015	57%
Less than £30m	2765	52%	2565	48%
Less than £40m	3070	58%	2265	42%
Less than £50m	3290	62%	2040	38%

[6] Using data collected in March 2020

[7] These figures are based on invoiceable schemes at 1 April 2020 and rounded to the nearest 5 or 10.

4.4.3 Additionally, the £20m liability figure relates closely to the minimum 100 members condition for the requirement to have a Statement of Investment Principles (SIP). If the Tier 1 boundary was £20m liabilities or less, it would mean 94% of schemes with fewer than 100 members would be in Tier 1. It would, however, also include in Tier 1 around 565 schemes that have more than 100 members.

4.5 Proposals for Tier 1/2 boundary

4.5.1 We think setting the maximum level for Tier 1 at £20m would strike a reasonable balance. It would mean that a majority of schemes have their investment risk assessed against detailed information, while offering recognition of the potential burden on smaller schemes. And it would set that at a level consistent with the PPF's view on where administration burdens are substantially greater[8].

4.5.2 To the extent that, in the short term, this would be challenging for schemes at the lower end of the Tier 2 bracket, there could be justification for setting a higher threshold initially, while provision of more granular information becomes routine. We welcome views whether there is a need for a higher interim Tier 1 to 2 boundary and where that might be set.

4.5.3 Schemes that want to provide more detailed asset data can do so by voluntarily trading up to a higher tier.

Consultation questions

- **Do you agree with the proposal to set the tier at £20m?**
- **Do you believe there is a case for a higher initial threshold for Tier 1? If so where should this be set?**
- **Do you support our proposal to allow schemes to voluntarily provide more asset information?**
- **Could it become more difficult for schemes in Tier 1 to complete the standard asset return, if industry reporting moves to provide more granular information in Tier 2?**

[8] For more information on the Small Scheme Adjustment and supporting evidence see, PPF, Changes to Levy Methodology for 2021/22 levy year, Consultation document,

4.6 Tier 2/3 boundary

4.6.1 For Tier 3, schemes will calculate the impact of our specified risk factor stresses in addition to the more granular asset class data. Risk factor stresses are particularly useful if the scheme employs derivative-based strategies. This is because a stress measure focused on physical assets may not adequately capture how derivatives alter the risk exposure of the pension fund.

4.6.2 In 2012, the PPF mandated that schemes with more than £1.5 billion in liabilities undertake a bespoke stress calculation, which included calculation of the impact of our specified risk factor stresses. There are now 190 schemes with £1.5 billion in liabilities. In addition, a further 570 schemes voluntarily submit bespoke stress calculations. These voluntary submissions may point to the increased use of derivatives to manage risk. Accordingly, we have reviewed whether there is merit in setting a lower or different threshold for Tier 3.

4.6.3 We are aware that use of derivatives and leverage is increasingly common among schemes. In many cases this is used to better match liabilities, though derivatives are also used to provide returns – for example using synthetic equity. We have considered the merits of different options to better reflect derivative positions held by schemes.

4.6.4 One option would be to require schemes that use derivatives linked to return-seeking assets to provide information under Tier 3. This would mean that the risk characteristics of the derivatives are captured, albeit requiring a gateway question to test whether the scheme did indeed use derivatives that would not otherwise be reflected under the Tier 2 requirements. While this is simple in concept, our concern is that many schemes might spend time deciding how to answer the question, to identify the few that actually had strategies that would warrant enhanced disclosure.

4.6.5 Another approach we considered was to gather more information about a scheme's exposure within the information provided for Tier 2. So, a scheme holding equity futures – which in risk terms are the same as equities – would report them as if they were equities. However, this would mean breaking the link with reporting information that feeds in to the annual accounts.

4.6.6 A third option, particularly if concern centres on larger schemes, would be to significantly lower the threshold for Tier 3. This would, however, impose an unnecessary cost on schemes not using derivatives of this nature.

4.6.7 Based on analysis of the alternatives and our understanding that synthetic investment in growth assets is not widespread for mid-range and smaller schemes, we believe at present the best option is to maintain the current approach. However, we welcome stakeholder views and we may also revisit this if concerns arose in the future about strategies being designed to mask the underlying risk characteristics.

4.6.8 We propose that Tier 3 is mandatory for all schemes with liabilities over £1.5 billion to undertake the bespoke stress calculation.

Consultation questions

- **Do you believe that there is a need for TPR to collect more detailed information on derivatives for a larger proportion of schemes?**
- **Do you agree that the boundary for Tier 3 should be £1.5 billion of s179 liabilities?**

5. PPF proposals for indices

5.1. Introduction

5.1.1. This section sets out the PPF proposals on indices used to roll forward assets and ensure broad consistency of this data between schemes when calculating risk-based levies in any year.

5.1.2. The introduction of new asset classes requires the PPF to consider appropriate corresponding roll-forward indices, as well as providing an opportunity to review the indices in use for the classes which are being retained.

5.1.3. To date, we have not used separate indices for each of the existing asset classes. For example, all bonds are rolled forward using a single generic index, rather than using separate indices to distinguish between government and corporate or fixed interest and inflation-linked bonds.

5.1.4. We propose to continue the practice of using a limited range of indices, but welcome views on whether we should instead move to having separate indices for some or all of the new asset classes. This latter approach would offer a more accurate roll-forward calculation (potentially avoiding some of the drivers to perform out-of-cycle s179 valuations), but with increased complexity for schemes in the estimation and checking of their levy bills, as well as potential cost/licensing implications where commercial indices are involved.

5.1.5. We also note that the roll-forward calculation is, by necessity, an approximation and should, in any event, apply over a relatively short time period if schemes are submitting asset information on a regular basis. This implies that any differences in outcome in using a more detailed or granular range of indices are likely to be marginal.

5.2. Core proposal

5.2.1. Our core proposal does not differentiate between tiers and represents only modest changes to our current approach as set out in the table below (table 5). The asset classes shown do not include the new equity and bond sub-classes for schemes in Tiers 2 or 3, as these holdings would be rolled forward using the corresponding index for the 'parent' class.

5.2.2. From our review of the current indices, we believe there is merit in refining our approach to 'Other' holdings– i.e. assets which cannot be allocated to any of the specified classes and where the risk profile is therefore unknown to us. These allocations are currently rolled forward using a composite index comprising 50 per cent bonds, 12.5 per cent UK quoted equities, 12.5 per cent overseas quoted equities and 25 per cent cash.

5.2.3. Our proposal is to treat 'Other' holdings as 100 per cent cash and to roll them forward using our internally-generated index which replicates returns in line with Bank of England base rate. This will allow for a likely modest positive return and reduce the probability of an unduly favourable roll-forward for holdings where we cannot quantify the risk.

5.2.4. We have also considered how to roll forward the new asset class representing DGF holdings (applicable to all tiers).

5.2.5. Industry analysis indicates that DGFs have historically achieved a comparable return to a composite index comprising 60 per cent global equities and 40 per cent gilts. Actual equity allocations in DGFs are generally lower than 60 per cent, but the benefits of diversification permit a higher return than a face reading of the asset allocations would suggest, without increasing volatility or investment risk.

5.2.6. To avoid undue granularity, we would propose a composite roll-forward index for all tiers comprising 60 per cent quoted equities (represented by the FTSE All-World TRI) and 40 per cent gilts (represented by the FTSE UK Gilts All Stocks TRI).

5.2.7. Absolute return funds are a new asset class in Tiers 2 and 3. The majority of these funds typically use a benchmark return of 3 to 5 per cent above cash (LIBOR). Taking the mid-point of this range, replacing LIBOR (which is due to be retired) with SONIA and assuming SONIA to be broadly in line with LIBOR, would give SONIA + 4 per cent. However, a target defined in relation to Bank of England base rate (which we already source and use to calculate our cash roll-forward index) would offer improved operational simplicity for the PPF and for schemes.

5.2.8. Analysis over the period since 2010 shows that SONIA lags Bank of England base rate by around 0.5 per cent on average, so we would propose to calculate and use a new cash-based roll-forward index, representing Bank of England base rate + 3.5 per cent.

5.2.9. Where an index change is proposed, each new index would be applied with full retrospection over the rollforward period.

Table 5: Roll-forward indices – core proposal for all tiers

<table>
<tr><th>Asset class</th><th>Current index</th><th>Proposed index</th></tr>
<tr><td>Fixed interest – UK Government</td><td colspan="2">FTSE UK Gilts All Stocks TRI</td></tr>
<tr><td>Fixed interest – investment grade (excluding UK government)</td><td colspan="2">FTSE UK Gilts All Stocks TRI</td></tr>
<tr><td>Fixed interest – sub-investment grade</td><td colspan="2">FTSE UK Gilts All Stocks TRI</td></tr>
<tr><td>Inflation-linked – UK Government</td><td>FTSE UK Gilts All Stocks TRI</td><td>FTSE UK Index-Linked Gilts All Stocks TRI</td></tr>
<tr><td>UK quoted equities</td><td colspan="2">FTSE All-Share TRI</td></tr>
<tr><td>Overseas quoted equities</td><td colspan="2">FTSE All-World ex UK TRI</td></tr>
<tr><td>Unquoted/private equities</td><td colspan="2">FTSE All-Share TRI</td></tr>
<tr><td>Cash</td><td colspan="2">PPF-generated index reflecting Bank of England base rate</td></tr>
<tr><td>Property</td><td colspan="2">MSCI UK Monthly Property TRI (rebased to FTSE All UK Property Gross TRI from 31 December 2014)</td></tr>
<tr><td>Annuities</td><td colspan="2">FTSE UK Gilts All Stocks TRI</td></tr>
<tr><td>Diversified growth fund</td><td></td><td>Composite index comprising 60% FTSE All-World TRI and 40% FTSE UK Gilts All Stocks TRI</td></tr>
<tr><td>Absolute Return Fund</td><td></td><td>New PPF-generated index reflecting 3.5% over Bank of England base rate</td></tr>
<tr><td>Other</td><td>Composite index comprising 50% bonds, 12.5% UK quoted equities, 12.5% overseas quoted equities and 25% cash</td><td>PPF-generated index reflecting Bank of England base rate</td></tr>
</table>

Consultation questions

- **Do you agree that maintaining a simplified roll-forward approach is appropriate given the relative costs and benefits (rather than establishing a**

more sophisticated approach using a wider range of indices as described below)?

- **Do you agree that the index proposals set out above are appropriate, in particular the approach to roll forward 'Other' holdings, diversified growth funds and absolute return funds?**

5.3. Alternative approach

5.3.1. To help support an informed consultation, we have considered which indices we might adopt to roll forward the individual equity and bond sub-classes in Tiers 2 and 3 (table 6), should stakeholder responses suggest a clear preference for this more granular approach. In doing so, we have had regard to the market coverage of commercial indices available, how well they match their corresponding sub-class of scheme assets, and whether they are available in sterling-denominated form.

5.3.2. Respondents favouring the simplified approach under our core proposal may disregard the following proposals and the associated consultation questions (but are of course welcome to comment).

5.3.3. We could roll forward the new UK Government fixed interest bond sub-classes using maturity-specific FTSE UK gilts indices.

5.3.4. One option would be to use appropriate Markit iBoxx indices as set out below for the new sub-classes in respect of non-UK Government fixed interest bonds:

- UK investment grade bond holdings (excluding UK government): We consider the Markit iBoxx £ Non-Gilts Index to be appropriate as each constituent must have an investment grade rating on average. This index could be used for both the short and medium/long sub-classes, to avoid unnecessary complexity and granularity in the roll-forward calculation.

- Non-UK investment grade bond holdings: We consider the Markit iBoxx $ Liquid Investment Grade Index to be appropriate as it excludes emerging markets and represents the more liquid part of the market. This index would be used for both the short and medium/long sub-classes, to avoid unnecessary complexity and granularity in the roll-forward calculation.

- Sub-investment grade bond holdings: We consider the Markit iBoxx Global Developed Markets High Yield Index in GBP is likely to be an appropriate match for the majority of schemes' sub-investment grade bond holdings.

- Private debt: There are inherent difficulties in sourcing a representative index, but we could use the Markit iBoxx £ Non-Gilts Index for simplicity, acknowledging this might not reflect the credit profile or take account of the likely liquidity mismatch.

5.3.5. In addition, we could roll forward the new sub-classes for UK inflation-linked gilts using maturity-specific FTSE UK index-linked gilts indices.

5.3.6. Overseas quoted equities are divided into Developed Markets and Emerging Markets. One option would be to roll forward these new sub-classes using the MSCI World ex-UK Index (Sterling-denominated) and the MSCI Emerging Markets Index (Sterling-denominated) respectively, as together they provide consistent and appropriate coverage without overlaps.

Table 6: Options for roll-forward indices under alternative approach– Tier 2 and Tier 3

Asset Class Grouping	Detailed grouping	Potential Index
Bonds		
Fixed interest - UK Government	Short (less than 5 years)	FTSE UK Gilts up to 5 years TRI
	Medium (5 to 15 years)	FTSE UK Gilts 5 to15 years TRI
	Long (over 15 years)	FTSE UK Gilts over 15 years TRI
Fixed interest – excluding UK Government		
Investment Grade	UK (all durations)	Markit iBoxx £ Non-Gilts Index
	Non-UK (all durations)	Markit iBoxx $ Liquid Investment Grade Index
Sub-Investment Grade	UK and non-UK (all durations)	Market iBoxx Global Developed Markets High Yield Index in GBP
Inflation-linked - UK Government		
	Short (less than five years)	FTSE UK Index-Linked Gilts up to 5 years TRI
	Medium (5 to 15 years)	FTSE UK Index-Linked Gilts 5 to

		15 years TRI
	Long (over 15 years)	FTSE UK Index-Linked Gilts over 15 years TRI
Equities		
Overseas quoted equities	Developed markets	MSCI World ex UK Index (Sterling denominated)
	Emerging markets	MSCI Emerging Markets Index (Sterling-denominated)

Consultation questions

- **Do you agree that if a more sophisticated set of indices is applied then those set out above would be appropriate?**
- **If you favour an intermediate approach between the two approaches we have outlined, for which of the proposed asset classes would separate indices be beneficial?**

6. Responding to the consultation

6.1. How and when to respond to the consultation

6.1.1. The consultation runs from 29 April 2021 until 5pm on 10 June 2021. Please ensure your response reaches us by the deadline.

6.1.2. The PPF is hosting the consultation response forms. There are two ways to submit your response online - 'quick' and 'full':

- The 'quick' submission allows you to review a summary of key proposals set out in our consultation, and the opportunity to give your views. It is designed to take only 10 to 15 minutes to complete. This version is designed for those who may not have time to respond to our consultation in full.
- The 'full' version sets out all the questions we are asking in this consultation, allowing complete responses, along with free format text fields for additional views to be submitted. This version can either be completed online, or via an offline template, which can be downloaded and completed offline and then uploaded via the PPF website. The offline submission is designed to help with collaborative submissions where input is needed across an organisation or range of stakeholders.

6.1.3. Please ensure you state whether you are responding as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

6.1.4. Information included in responses will be shared between the PPF and TPR – i.e. both organisations will have access to the detailed information. A summary of responses and our conclusions will be available on the PPF and TPR's website.

6.2. How we treat your personal data

6.2.1. Under the Freedom of Information Act 2000 (FoIA), all information contained in the response, including personal information, may be subject to publication or disclosure. By providing personal data for the purpose of the public consultation exercise, it is understood that a respondent consents to its disclosure and publication.

6.2.2. If this is not the case, the respondent should limit any personal information provided, or remove it completely. If a respondent requests that the information given in response to the consultation be kept confidential, this will only be possible if it is consistent with FoIA obligations and general law on this issue. Further information can be found on the GOV.uk website:

https://www.gov.uk/make-a-freedom-of-information-request

6.3. Feedback on the consultation process

6.3.1. The consultation is being conducted in line with the Cabinet Office's Consultation Principles:

https://www.gov.uk/government/publications/consultation-principles-guidance

6.3.2. We hope this process has been clear and useful. However, we welcome suggestions and feedback on the consultation process. If you have any comments, please contact:

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