THE SOCIETY OF PENSION PROFESSIONALS
making pensions work

Work and Pensions Committee
House of Commons
London
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Dear Work and Pensions Committee

SPP Response to the Call for Evidence on Defined Benefit pension schemes

We welcome the opportunity to respond to this Call for Evidence. We would be happy to discuss our response with the Committee and expand on any of the points raised if helpful.

Opening comments

Occupational pension schemes, including Defined Benefit (DB) pension schemes, are long term arrangements. Given this, we strongly suggest that cross-party political consensus is sought on any proposed changes to the DB pensions regulatory framework.

Responses to individual questions

1. Is the right regulatory framework in place to enable open DB schemes to thrive?

Our view is that the current regulatory framework makes it very difficult for open DB schemes in the private sector to thrive. This is evident from the decline in the number of private sector employees who are still accruing new DB benefits, as already noted by the Committee. Most private sector employers have already taken the decision to close their DB schemes to future accrual and provide employees access to DC schemes instead. Whilst some schemes remain open, these tend to be concentrated in sectors or industries that are heavily unionised, may have been nationalised in the past (and now subject to Protected Persons legislation) or could be considered as "quasi-public sector".

Some of this change was inevitable due to costs being driven up by changes in financial markets and increasing life expectancy over the past few decades. However, these changes illustrated the risks to employers of offering DB within the existing regulatory framework, and without significant change to that framework our view is it is highly unlikely that the trend of open DB schemes declining could be reversed.

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What could be done?

If the Committee's goal is for open DB pension schemes to thrive, a lot would need to change in our view, and ultimately the risk to sponsors would need to significantly reduce. This could be, for example, by having members carry some risk instead (for example, as envisaged by the proposals on Defined Ambition in the November 2013 DWP consultation on Reshaping workplace pensions for future generations), or indeed have the State carry some of the risk.

Also, some way of allowing schemes to take a much more long-term view would also help. For example, not requiring schemes to buy-out on insolvency but instead allowing them to run on indefinitely with a meaningful proportion of return seeking assets.

It would also be helpful for employers if they could benefit from the upside of the risk they are taking more easily. For example, an easier way for employers to share in scheme surpluses which are expected to materialise over time due to the requirements to fund prudently.

That all said, given the experience of the past few decades and most employers have already switched to a DC arrangement, it is difficult to envisage a new wave of DB pension schemes being set up in the foreseeable future even with some of these changes. CDC schemes may be a more likely vehicle for future benefit provision as an alternative to "pure" DC, though these of course do not offer the same protection for members as DB schemes. Importantly, CDC might be viewed as an alternative to traditional DC only because, in law, CDC is still money purchase and therefore not subject to the same risks to employers as DB.

Case study - USS

It is interesting to consider the position of the Universities Superannuation Scheme (USS), as the largest private sector scheme in the UK. USS remains open to both future accrual and new members.

The size of USS means it benefits from significant economies of scale, for example in accessing investment opportunities which smaller schemes are not able to. In addition, USS benefits from the collective covenant of the university sector which may be considered to have a longevity that other sectors do not.

The benefits available from USS to active members for future service have been reduced over time, and further reductions were made in April 2022 in light of the significant deficit revealed at USS's 31 March 2020 actuarial valuation. These reductions to benefits led to significant industrial action from members and disruption for students.

USS's funding position has now recovered significantly (and recent quarterly funding assessments have shown a substantial surplus). USS is now working with the relevant stakeholders towards an objective of restoring future service benefits for active members to pre-April 2022 levels from April 2024.

Whilst this would be a good outcome for active members, it begs the question of whether the current regulatory regime allows private sector DB schemes to take a sufficiently long-term view when considering future benefit provision.

The position of USS can be contrasted with the Local Government Pension Scheme (LGPS), which falls outside of the regulatory framework for private sector schemes. The regulatory framework for public sector schemes allows the LGPS to take a very long-term view, which helps to avoid having to make significant changes as a reaction to the outcome of a single actuarial valuation (as USS did). Whilst other factors will be relevant, this long-term approach is perhaps one reason why benefits from the LGPS have remained broadly unchanged since 2014 when the last set of changes were made.

2. Is there sufficient capacity in the buy-out market to meet demand from DB schemes? If not, what are the alternatives?

The number of schemes who are seeking to secure their liabilities has increased significantly in the past 12 months. However, there are several constraints that may mean that schemes who wish to buy-out are not able to do so in their desired timescale, including:

- **Insurer capacity:** there are limits on the amount of business that can be written by the eight insurers in the bulk annuity market. This is mainly driven by the people resources needed within insurers to facilitate buy-out transactions, though there are other issues such as the ability to source sufficient capital and the availability of assets to support competitive pricing, both of which can cause problems if there are short-term peaks in demand.
- **Trustee advisor resources:** equally there are also significant constraints on pension schemes' advisors, in particular administrators, to help schemes prepare to approach the buy-out market. For example, the work associated with cleansing membership data for buy-out transactions is significant, which limits the number of schemes able to transact. This comes at a time when the administration market is already very busy with work on GMP projects (reconciliation, rectification and equalisation).
- **Illiquid investments:** some DB schemes hold illiquid investments that cannot be easily sold as part of carrying out a bulk annuity transaction. As insurers are not willing to accept these types of assets as part of a bulk annuity transaction, DB schemes holding illiquid investments must either wait until these assets run off over time or dispose of these assets at a material discount before they are able to access the buy-out market.

All of these issues create short-term challenges for schemes wishing to buy-out. However, over the longer term we would expect the market to be able to adapt to the increased demand.

We see two alternatives to buying out liabilities with an insurance company:

1) Financial consolidators

Financial consolidators (or "superfunds") could be an alternative route for sponsors seeking to discharge their obligations to their DB schemes. These could provide additional sources of capital, which may allow more transactions to take place, and may also be able to address the issue of illiquid investments mentioned above. However, our view is that the current interim regulatory regime in place for superfunds is preventing this market from progressing and discouraging capital providers from entering this market. Please see our response to question 4 for further commentary in relation to superfunds.

That said, regardless of the regulatory regime for superfunds, we expect that buying out liabilities with an insurer is likely to continue as the main vehicle for the financial consolidation of DB pension schemes.

2) Run-off

There are circumstances in which it is appropriate for schemes to run-off over time, for example, a scheme could continue building up surplus to fund discretionary benefits for members.

3. What should the Pensions Regulator (TPR) do to improve the quality of trustee boards?

We note that there are many trustee boards, including those made up of purely lay trustees, which are well run and carry out their duties to a high standard. We have highlighted below three areas which in our view are features of high-quality trustee boards. TPR could consider what actions it could take to encourage trustee boards to consider these areas, but we appreciate that this is not straightforward and there is a balance to strike between taking actions that will have a meaningful impact and mandating certain things that could lead to disproportionate requirements and costs for some schemes (particularly small schemes).

1) Professional trustees

In our experience, professional trustees usually add significant value to the trustee boards on which they sit, as a result of:

- having experience in the pensions / wider financial services industry and expertise in particular areas
- being a trustee on a portfolio of schemes, which allows them to see a range of views from advisors on key issues, rather than from just a single set of advisors.

TPR could encourage more schemes to appoint professional trustees, but we would caution against making this a mandatory requirement as we do not believe a professional trustee is always necessary, there are likely not enough professional trustees to service all schemes and there would be significant cost implications for smaller schemes.

2) Equality, diversity and inclusion (EDI)

We share TPR's view that improving equality, diversity and inclusion (EDI) across trustee boards should improve the quality of those boards. Trustee boards should be encouraged to give this proper consideration. The guidance that TPR published on EDI in March is a welcome step to address this.

3) Trustee training

Operating a DB pension scheme is now more complex than ever, particularly as a result of new legislation / regulation (e.g. the draft Funding and Investment Strategy Amendment Regulations published in 2022) and at times challenging market conditions (e.g. the gilts/LDI crisis of September/October 2022). Trustees must have the skills necessary to make the decisions being asked of them, occasionally under significant time pressure.

It is therefore critical that all trustees of DB schemes take their training requirements seriously.

TPR could consider whether there are steps that could be taken to:

- Ensure that more training that is available to trustees of DB schemes (ideally at no cost to individual trustees)
- increase the minimum level of training that trustees of DB schemes must receive each year
- better enforce the compliance regime relating to Trustee Knowledge and Understanding.

4. What, if any, further steps should be taken to encourage DB scheme consolidation?

There is a range for what DB scheme consolidation could mean in this context.

Under "operational" consolidation, multiple schemes are overseen by a single trustee board and a common set of advisors. This could be through a master-trust or a pension platform. The link to the sponsoring employer is maintained and there is no pooling of employer covenant. This approach allows schemes to potentially improve governance, resolve conflicts of interest and benefit from significant economies of scale from both an investment perspective and in terms of the procurement of services. For schemes considering this form of consolidation, there is a range of potential solutions available, and we do not see any need for further steps to be taken to encourage this.

"Financial" consolidation is similar to operational consolidation but allows an employer to walk away from any future financial responsibility, in return for the payment of a covenant premium (which can be significant, depending on the scheme's initial funding position). The DB "superfunds" fall into the category of financial consolidators.

There is currently an interim regulatory regime for DB superfunds, as set out in the June 2020 guidance for prospective superfund providers and the October 2020 guidance for trustees and sponsors contemplating a superfund transaction. The interim regime has set a very high bar to be cleared before superfunds and trustees/sponsors can start progressing transactions, which is understandable given the novelty of these structures. However, the inflexibility of the interim regime has, in our view, been counterproductive if the ambition is to establish a functioning market for non-insurance consolidation solutions.

In particular, our understanding is that both Clara and The Pension SuperFund found the process of applying for initial regulatory assessment by TPR to be onerous and opaque, with thus far only Clara having completed the assessment. The difficulties that these organisations have experienced during the assessment process will have no doubt deterred other potential entrants into the consolidation market.

Further, no superfund deals have yet been completed, despite over a year having passed since Clara gained their assessed status. We believe that this is in part due to the inflexible nature of the 'gateway' tests schemes need to pass in order to move to a superfund, and the difficulty of applying these during volatile market conditions, together with the lack of clarity about the process required to obtain 'clearance' from TPR for a superfund transaction and the approach that TPR will take to assessing any clearance applications.

Superfunds also have a potential positive application in the case of distressed employers, or insolvent employers where the scheme can afford to buy-out more than PPF benefits, but less than those promised under the scheme rules. For these schemes superfunds could result in better benefits for members than the alternative. However, the existing regime makes this very difficult to achieve in practice.

Whilst we understand the government/TPR's concerns with protecting members, if consolidation of DB schemes is a serious policy goal of the government the existing regime would need to change or be formalised in primary legislation. The triennial review of the existing interim regime, which we understand is due this year, would seem to be a good opportunity to reflect further on this.

5. Are there any circumstances in which consolidation should be mandatory?

We do not think there are any such circumstances (aside from where a scheme enters the Pension Protection Fund because of the insolvency of its sponsoring employer(s)).

6. Do the recent improvements in funding levels change the future role of DB schemes in UK pension provision?

We do not think these improvements change the future role of DB schemes, for the reasons set out in our response to question 1 above. These improvements do however improve the likelihood of members of these schemes receiving benefits in full, as well as reducing the strain on sponsoring employers, and potentially accelerating demand for insurer capacity (see our response to question 2).

7. How should scheme surpluses be treated? For example, should they remain in the scheme or be shared between employers and scheme members? Are the issues different for open and closed schemes?

In practice the use of surplus for a particular DB scheme will be driven by the provisions of its governing legal documentation (i.e. the trust deed and rules). Absent any specific requirements from this documentation, there are a range of potential uses for any surplus that emerges:

- enhancing benefits for existing members
- subsidising future contributions from the employer and/or scheme members
- securing members' benefits with an insurer via a buy-out
- being refunded to the employer

Employers bear the vast majority of both the cost and risk associated with DB pension schemes and so there is an argument that they should benefit from some, or even all, of any surplus that emerges once members' benefits have been secured. If employers are not able to benefit from a surplus, they will be more reluctant to trap money in schemes which could reduce security for members.

We would caution against introducing new legislation / regulation that directs how surpluses should be used and suggest that this is left up to the trustees and employers of individual schemes to determine, particularly given that the circumstances of how a surplus may emerge could differ materially between schemes.

We do however note that the current regime makes it very difficult for sponsors to share in the upside of the risks they underwrite in providing DB schemes. Allowing sponsors easier and perhaps sooner access to surplus in certain cases could have positive impacts, though would need to be considered carefully.

8. What are the implications of improved funding levels for the Pension Protection Fund?

Pension schemes becoming better funded means it is less likely that schemes with insolvent employers will enter the Pension Protection Fund (PPF), and instead be able to secure above PPF benefits with an insurer. This means lower PPF levies should be needed in future. Further, the Pension Protection Fund (PPF) is itself becoming extremely well-funded, meaning there are key decisions to be made about the best use of that surplus.

To address these issues we suggest:

1) The PPF should have greater flexibility to change its levy in future – in particular, the flexibility to reduce the annual levy on DB schemes to zero, but with the ability to increase the levy in future should the need arise.
2) Consideration should be given to how any future surplus in the PPF should be used, and under what circumstances. For example, should benefits paid by the PPF to members be improved, and if so when and how? We note that there is little inflation protection provided by PPF benefits and so this might be viewed as a priority if any surplus were to be distributed. In the same way as for any scheme with a surplus, the different perspectives of all stakeholders would need to be considered when doing this.

One option would be for the PPF to grow its role and enter the consolidator space in some form, expanding its coverage to a greater breadth of schemes – though there would be many considerations to work through here.

9. Should changes be made to the Pension Protection Fund (PPF), Financial Assistance Scheme (FAS) or Fraud Compensation Fund (FCF) to improve outcomes for members?

Please see our response to question 8.

Yours faithfully,

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