# EVIDENCE FROM THE ASSOCIATION OF CONSULTING ACTUARIES

26 April 2023

Online Submission
UK Parliament
Work and Pensions Select Committee

## Subject: Call for Evidence: Defined Benefit pensions schemes

I'm writing on behalf of the **Association of Consulting Actuaries (ACA)** in response to the above call for evidence issued by the Work and Pensions Select Committee. Our members work for a wide range of pension and investment consultancy firms and advise sponsors and trustees of defined benefit and defined contribution schemes. In preparing our response, we have taken into account the typical perspectives of our client base.

Our key points are:

- New scheme funding regulations need to be put in place carefully to make sure current open schemes continue to thrive. To help achieve this, we believe it would be helpful for genuinely open schemes to be appropriately "carved out" from new requirements imposing an obligation to set and fund for a journey plan (that in practice for these schemes may not be expected to materialise). We have responded separately to DWP's and TPR's recent consultations in this area.

- Given sponsors' historical experiences with DB schemes, we believe it is unlikely employers will reopen DB schemes or that a significant number of new schemes will be put in place without significant additional incentives from Government. A key driver of this has been decisions by previous governments that have significantly increased the costs and risks to sponsors of providing pensions in this form.

- However, we believe the emergence of CDC schemes which, similar to DB, also provides members with an income in retirement will offer a strong middle ground between expected member outcomes from DB and DC schemes. We believe these schemes will be well placed to thrive in coming years provided regulations emerge as currently planned.

- We expect to see an acceleration of DB schemes approaching insurance markets over the next decade. However, given recent funding level trends, we expect market financial capacity to be resilient to these requirements. For schemes not seeking insurance, a run-off approach is likely to be a reasonable alternative. In some cases (for example where sponsor covenant is poor) we believe use of consolidators might further improve outcomes if an appropriate full regime can be put in place.

- As trustee boards continue to evolve in the direction of professionalisation, TPR can help to improve quality by monitoring the range of activities provided by professional trustees and ensuring appropriate oversight. We also continue to believe there is role for lay Trustees to ensure diversity of thinking and that member perspectives are fully taken into account in decision making.

- The use of surplus is often closely prescribed in schemes' rules, with potentially large variations in trustee/sponsor powers for different schemes. In some cases, this could mean there is rationale for sponsors and trustees to agree to target future surpluses (e.g. by continuing to take more risk than would otherwise be the case) as part of run-off approach (e.g. to pay DC contributions set up in the same scheme). However, these cases are likely to be based on individual circumstances and we expect many sponsors will prefer to simply proceed to insurance buy-out as soon as this can be carried out efficiently. We do not believe it would be appropriate for legislation to be introduced which overrides the existing provisions in scheme rules.

We hope you find the contents of the letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me at steven.taylor@lcp.uk.com (or on 07785 907425)

Yours sincerely

**Steve Taylor**

Chair of the Association

## Answers to Select Committee questions:

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

Information in PPF's 2022 "Purple Book" indicates a continuation of the trend of long-term decline in employee membership of private sector defined benefit schemes (currently c0.9m people). More than half of schemes are stated to be closed to all accrual but in practice many other schemes are also likely to be closed for all but a small number of current employees (often with special or legacy contractual employment terms). Only 10% of schemes remain technically open to new members.

These trends have been relatively consistent for the past few decades, driven by a combination of factors such as falls to long term interest rates and improved life expectancies that have increased the cost of building up new benefits, and contributed to persistent deficits.

However, over the last 40 years, governments have also regularly layered additional inflation protection and other measures, that have fundamentally changed the nature of DB schemes to employers from a commercial best endeavour to a guarantee (and led to ever wider DC provision for current employees augmented by the AE 'revolution'). In view of this, we believe it would be very difficult for Government to regain the trust of business to re-engage in DB on the current terms. However, if there were minded to do so, potential steps Government could take include:

- providing additional tax incentives for DB contributions (such as reversing the removal of the ACT credit on equity dividends) and DB investment. For example, this could be linked to the government's desire to stimulate pension investment in UK industries and infrastructure,
- facilitating business friendly treatments of pension surpluses, including eliminating penal taxation on refunds of surplus or surplus that are used to invest in business or pensions for current workers (although we note in question 6 the potential limitation of restrictions in scheme rules),
- a slashing of the mountain of red tape that pensions have accumulated, to reduce the running costs.
- providing assurances and guarantees that future governments will not fundamentally change the regulatory standing of DB schemes; and
- carving out open DB schemes from the proposed new funding regulations.

However, within the set of open DB schemes remain some of the UK's largest, including those sponsored by large employers with strong cultural and paternalistic drive to continue providing DB pensions in the future. It is in the context of sustaining these arrangements that we believe open DB schemes can potentially thrive under the emerging regulatory regime if this is set up appropriately.

We have recently responded to both DWP's and TPR's consultations on the draft Funding Regulations and the draft Funding Code and won't repeat those in detail here. However, in a recent ACA survey two-thirds of respondents indicated they believed that, as drafted, the proposed new regime would have a negative impact on schemes open to future accrual. To mitigate this and help such schemes to thrive, we believe that for 'genuinely open' schemes (that are not moving at pace towards significant maturity), it would be helpful to

include a “carve out” from new requirements imposing an obligation to set and fund for a journey plan that in practice is not expected to materialise, but that would be potentially very onerous to reserve for.

In time, we also believe that the emerging regulatory framework around new Collective Defined Contribution schemes (which, similar to DB, offer an “income in retirement”) could help to find some middle ground for these employers and employees. A key driver of this will be demonstrating that CDC schemes are affordable to employers and produce stable and better outcomes than traditional DC arrangements. Confidence will also need to be maintained that there will not be regulatory creep – which occurred with DB arrangements – that undermines the rationale for such schemes being offered by employers.

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

Research indicates that recent improvements in DB funding levels could accelerate the number of schemes approaching insurers in coming years. For example, at 30 September 2022, a typical scheme was estimated to be c.88% funded on a buy-out measure, an improvement by around 15% from a year earlier. Based on this, the average projected time for a typical scheme to reach buy-out is currently around 5 years less than it was 12 months ago.

Recent years have seen buy-out volumes of around £30-50bn p.a. Based on current funding levels, buy-out volumes over the next decade are projected to be c£600bn, which, whilst a step up, we believe is likely to be within tolerance for existing market financial capacity.

A key reason for this resilience is that recent improvements in buy-out funding levels have been correlated with a significant fall in the overall scale of buy-out liabilities across the DB pensions universe (from around £2.3bn in March 2021 to £1.4bn in September 2022). We expect this to mean that current levels of insurance capital can now be more efficiently deployed across a larger volume of schemes.

Based on the above analysis, more than half of DB liabilities will not be insured over the next decade and these schemes will instead use a “run-off” approach and seek to pay benefits as they fall due over coming decades. For well-funded schemes this is a viable alternative and could for example be consistent with an approach where emerging surplus in the scheme is used for a pre-planned purpose, such as paying discretionary pension increases, or making contributions to defined contribution pensions (that are operated within the same trust).

For less well funded schemes or those with weaker sponsors, a run-off approach could be a necessity rather than a choice (and members might ultimately need to rely on the backstop of the Pensions Protection Fund). For these schemes, we believe that consolidation is also a viable approach (see Q4 below), provided the long-awaited regulatory regime for these schemes emerges.

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

In recent years, there has been a growing trend towards professionalisation among pension scheme trustee boards, with most larger schemes now including at least one professional trustee, often in the role of Chair.

Increasingly, as schemes approach their “endgame”, many are also adopting a “sole” trustee model in which a small group of trustees, often within the same professional trustee organisation work closely with the sponsor. This can be especially useful if time critical decision making is needed. However, it also reflects

difficulties in recent years recruiting "lay" trustees, especially where schemes are closed and no longer have close ties to the existing company employees.

We would expect, and encourage, these trends to continue. However, as professionalisation continues, some challenges are likely to emerge. For example, at present, professional trustees typically obtain accreditation. However, these requirements are not mandatory and are less rigorous than for other professional roles. This means there is potentially a wide range of experience among market participants. In many cases professional trustees are also experienced wider industry professionals (e.g. actuaries, lawyers, investment advisors or administrators) and these skills provide valuable experience to trustee boards. However, schemes need to be confident that, across their trustee board they are sufficiently competent across all relevant areas and seek advice appropriately where gaps are identified.

We also continue to believe there is role for lay Trustees to ensure that member perspectives are fully taken into account in decision making. This will also help to ensure schemes also encourage appropriate diversity among their boards, which can help bring wider perspective to decision making (and for example help manage risks around "groupthink").

Increasingly, as professional trustee firms have built scale, they have begun to provide additional services, which might traditionally have been carried out by employee benefit consultancies. This is natural, reflects the wealth of valuable experience of the trustee directors involved and we believe improves the quality of Trustee boards. However, as this trend evolves, we would expect TPR to take steps to understand the range of activities undertaken by professional trustee companies and to ensure appropriate levels of oversight.

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

We believe there are potentially significant benefits to member outcomes that could be gained from consolidation. For example:

- for very small schemes, these benefits might come from economies of scale, enabling day to day services to be provided more cheaply; and

- for larger schemes supported by a very poor sponsor covenant (and that might have historically needed to invest very conservatively), the fresh capital provided by a consolidator might enable a more growth focussed investment approach that could in turn promote better member. In some models, emerging surplus might also be explicitly shared with members.

In June 2020, TPR issued interim guidance on principles it would use when assessing models that could be used to consolidate DB schemes (which it referred to as "superfunds"). However, to date only one such model, Clara, has sufficiently satisfied TPR around its approach to be listed on its website and to date no transactions have been carried out.

In part we believe this reflects extreme regulatory caution around how superfunds should operate, as well as volatile market conditions, rather than the underlying rationale.

In particular:

- a key rationale for consolidators and other third-party capital models was that external capital would provide additional contingent support for schemes. This would benefit the schemes in downside situations, and, in exchange, the capital provider would make profit on its capital injection in upside

scenarios. However, by stipulating in its guidance that no excess capital could be returned until after a scheme had been bought out with an insurer (a process that itself can take several years once buyout funding levels are reached), TPR severely limited the attractiveness of the investment proposition, by in effect making models more capital intensive than traditional insurance. If TPR instead allowed models with a buy-out surplus to return some capital to providers over time (e.g. when funding levels reach certain hurdle levels) we believe this could significantly improve the potential for innovation, and fresh capital, in this area.

- TPR's "gateway test" stipulates that for schemes where an insurance buy-out is expected to be possible in future, they could not enter a superfund. This means that in practice there is a very narrow "sweet-spot" for schemes that are sufficiently well funded to be attractive to capital providers and those that are too well funded to obtain TPR approval. Significant swings in market movement in recent years have meant that in practice, for many trustee boards that have begun to think seriously about consolidation, funding levels have soon improved too quickly for them to remain viable. In other cases, this has arguably led trustees into inaction due to concerns about the "regret risk" of entering into a transaction that later proved not to have been necessary.

To mitigate these risks we suggest, we suggest making updates to the interim TPR regime that would more appropriately balance downside protections with attractiveness for capital providers. We would also suggest more detailed guidance for trustees around appropriate situations for Trustees to agree to progress with superfund transactions.

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

We do not believe consolidation should ever be mandatory (except for entry into the PPF, which we note is already effectively a form of consolidation for schemes adversely affected by sponsor insolvency).

We note TPR already has the power, which it has used in the past, to replace scheme Trustees where there are governance rather than financial issues within schemes.

However, the draft Funding Regulations do envisage that for some schemes (e.g. where covenant is poor), entry into a superfund could be an appropriate long term funding objective. We believe that trustees should be given clear guidance about the situations when this might be appropriate, so as to help avoid situations where schemes are later forced to enter the PPF with some benefits being cut, when a far superior outcome for members might have been achieved by entering into a superfund at an earlier stage.

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

For most of the past decade, pressures on DB scheme funding levels have led sponsors to make tens of billions of pounds of contributions to meet emerging deficit requirements. In many cases these payments will have been unexpected and will had a significant opportunity cost for their wider business. Despite recent funding level improvements, the PPF Purple Book notes that over £12bn of deficit payments were expected to be made during 2022 and average recovery plans remained around 6 years in length.

Further, the cost of pensions continuing to build up remains high by historical standards at around 30% of salaries according to ACA's most recent survey, which is significantly higher than the c10% typical contribution level into Defined Contribution schemes. New Collective Defined Contribution schemes are

expected to cost somewhere between these levels (for accrual comparable to a DB scheme costing 30% of salary).

Given these dynamics, it seems very unlikely that there will be a renaissance towards employers setting up new DB schemes. However, given the lower cost of CDC, and a key design feature that sponsor deficits cannot emerge in CDC schemes, it is possible that the lower costs of these arrangements could help provide impetus to these schemes in coming years for employers seeking better member outcomes than can be produced by standard DC schemes.

In recent years we have also seen significant de-risking of DB scheme assets, which today are made up of around 25% growth allocations, compared to well in excess of 65% in 2006 when the PPF first started collecting data. This reflects a trend over time for schemes to de-risk as funding levels improve and has also helped to mitigate volatile funding requirements for employers.

It is possible that some sponsors might see funding improvements as an opportunity to generate future surpluses that could benefit members or the sponsors themselves, for example taking more risk than would otherwise be the case (and for example it is possible that US GAAP accounting standards might already incentivise this behaviour in some cases).

However, for most DB Scheme sponsors, given their historical experiences with DB schemes, we expect the opportunity to further financially insulate the sponsor by seeking an insurance buy-out, will be a financial priority (and for example there are presumably other non-pensions ways that sponsors could seek to exposure to growth assets if they wished). In some cases, explicit rules in the schemes governing documents around use of surplus (see Q7 below) could be a further driver of behaviours here, especially if employers have no way to benefit from emerging surpluses.

### 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?

Private Sector DB schemes are set up under trust and typically have a clear set of rules around what to if there are deficits or surpluses as a result of regular valuations. This will include setting out who should benefit from any emerging surplus.

As for many other major technical areas (such as rules around whether inflation definitions can be changed) there are a very wide variety of different procedures set out by schemes for how surplus is used, and for example rules may also be closely linked to relative trustee and sponsor powers around ability to wind up the scheme, to augment benefits and to set contributions. These rules are often very complex and, even now, often require detailed legal advice when schemes are bought out and then wound up.

For example, in some cases, rules will state clearly that surplus can be used by trustees to benefit members (e.g. by augmenting their benefits). In other cases, sponsor consent may be required, which means that in practice companies and trustees will need to come to an agreement on use of surplus. As an illustration of this, in many cases sponsors will historically have paid material contributions to fund deficits in the scheme and so might reasonably expect to benefit if those contributions proved unnecessary.

It is therefore very difficult to generalise around the impact on schemes of recent significant improvements to funding levels that may have generated surpluses. Given the wide variety of scheme rules and situations, and

the various ways in which stakeholders have managed the schemes in accordance with those rules to date, we also do not believe it would be appropriate for any legislation to be introduced which overrides the existing provisions in scheme rules.

We have seen some suggestions that, given recent funding improvements, some schemes might choose to rebalance their investment holdings (for example by holding additional growth assets) in order to specifically target additional surpluses that could potentially be shared between sponsors and members. In some cases, we believe, this could be reasonable, such as if the rules allowed such sharing. For example, we have already seen some cases where surplus emerging in the DB section of a scheme is used to pay future contributions into a DC section that is set up within the same trust and we would support an extension of these principles.

We do not see any specific reason why treatment of surpluses should differ between open and closed schemes. However, one further observation is that there is potentially a direct read across between debate around use of DB surpluses and features of potential consolidator models which to date have not been supported by regulations. For example, the ability to regularly extract surplus from a DB scheme for other purposes is similar to concepts around regular return of capital in consolidator models (where schemes already have a buy-out surplus) and we would encourage ensuring consistent regulatory principles in each area.

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

We do not see strong rationale for fundamental changes to the PPF's investment approach to reflect improved funding levels. However, we do believe that, given large surpluses, there may be less need for significant levies in the near term. This could be facilitated by removing the current restrictions on the extent to which the PPF can vary levies from year to year, so that the levy can be significantly reduced if the PPF's funding position supports it.

## 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?

Historically there have been powerful calls for improvements in particular to the FAS, which involved many cases of very significant benefit reductions to groups of members affected by insolvencies prior to the formation of the PPF. If surpluses are to be used to improve member outcomes (e.g. to uplift to regular PPF levels) we would suggest they are a good initial focus.

However, we would also suggest being mindful that historically (such as in the 1980s) when surpluses have emerged in DB schemes, governments have responded by mandating benefit improvements that later proved unaffordable. Given this we would guard against making significant uplifts to PPF, FCF or FAS members if there is a risk that future levy payers might suffer as a result.

**Produced by**:
Association of Consulting Actuaries
26 April 2023