PENSIONS AND LIFETIME SAVINGS ASSOCIATION

18 May 2018

WORK AND PENSION SELECT COMMITTEE INQUIRY ON THE FUTURE OF DEFINED BENEFIT PENSIONS: WRITTEN EVIDENCE FROM THE PENSION AND LIFETIME SAVINGS ASSOCIATION (PLSA)

The Pensions and Lifetime Savings Association is the national association with a ninety year history of helping pension professionals run better pension schemes. With the support of over 1,300 pension schemes and around 400 supporting businesses, we are the voice for pensions and lifetime savings in Westminster, Whitehall and Brussels. Our purpose is simple: to help everyone to achieve a better income in retirement. Our pension fund members own over £1 trillion of assets and are responsible for the pensions of 20 million people.

INTRODUCTION

We welcome the broad range of measures to strengthen the Defined Benefit (DB) sector set out in the government's White Paper. We are also pleased to have the opportunity to feed into the Committee's inquiry to inform the forthcoming consultations on some of the White Paper's proposals. Our response seeks both to answer the Committee's specific questions, as well as highlight what we believe are some further worthwhile areas for consideration.

Our response has been informed by the work of the PLSA DB Taskforce and also by conversations with PLSA members which include large and small pension schemes, member-nominated, lay and professional trustees, scheme investment managers and other service providers. We will continue to consult with members over the course of the White Paper consultations and would be happy to elaborate further on any of the issues below at the Committee's request.

THE CURRENT DB LANDSCAPE

The DB landscape today is much more complex than it was 20 years ago. In part driven by the growth of the size of the assets under management, but many other factors too, including: significant changes in the regulation (both domestic and international), increased scheme maturity[1], changes in longevity, and fundamental shifts in the macro-economy.

Defined Benefit pensions matter. They are a 'social good' and today 11 million people in private sector schemes rely on the benefits from DB schemes for a secure pension in retirement. However, of these 5800 schemes, 3600 are in deficit[2] and the majority of schemes have been in deficit for close to a decade.

[1] *Building Resilience to Risk,* Hymans Robertson (June 2016) and *Trouble Beneath the Surface*, Goldman Sachs (September 2016)
[2] PPF 7800

These deficits have remained stubbornly high despite the significant levels of employer contributions including £120 billion over the last 10 years in special contributions, and close to £400 billion in overall contributions.

Today's DB schemes face many other difficulties: the threat to the employer covenant as many industries face significant headwinds owing to globalisation, demographic shifts and increasing automation. These trends are particularly prevalent in the more 'traditional' industries such as bricks and mortar retail, or manufacturing, where many DB scheme sponsors reside.

Given the significant levels of underfunding in the sector and the myriad other challenges DB schemes are facing in the current climate, we therefore welcome the commitment of government and Parliamentary policymakers to undertake serious consideration of the variety of challenges facing the DB system and the range of measures that might be taken forward to address them.

The current regulatory approach

The UK DB system is characterised by a high degree of fragmentation and a large number of schemes -the Pension Protection Fund (PPF) reports 5794 schemes in its universe with £1.5 trillion under management. By comparison the Netherlands has a similar amount of assets and has, after a period of consolidation, c.300 schemes.

The diverse nature of the DB sector, has informed its regulatory structure. The DB system today is too large, complicated and diffuse for The Pensions Regulator (TPR) to apply a fully supervisory approach. Instead the regulatory framework is set up to work on a 'risk-based' approach, whilst simultaneously seeking to ensure standards of trusteeship are maintained or strengthened and funding commitments are met through the scheme funding regime.

TPR EFFECTIVENESS

1) **To what extent is improving TPR's effectiveness a matter of greater powers, better use of resources or cultural change in the organisation?**
2) **Will a criminal offence provide a meaningful deterrent?**

We welcome TPR's shift towards a clearer, quicker and tougher approach to driving up standards in the pensions sector; we believe this has been a positive step and one which our members have indicated is already being felt 'on the ground'. We also believe that those areas of focus outlined in TPR's recently published corporate plan for 2018 – 2021 are appropriate and look forward to continuing to engage with TPR on these and other issues.

The pensions industry looks to the Regulator to set standards while acting as a preventative lever and a defence against malpractice, it is vital therefore that TPR has the appropriate range of tools to be able to do its job effectively. The White Paper proposals to strengthen TPR's powers to act against 'reckless' behaviours that put pension funds and savers at risk are therefore welcome. Furthermore, changes to ensure schemes and sponsors have a clear understanding of their funding obligations and long-term aims, and requirements to set out how any actions, such as mergers, affect the schemes, should enable greater scrutiny of the sector.

We look forward to working with DWP and the Regulator to examine the detail of these issues further.

TPR powers

We support the changes The Pensions Regulator (TPR) has set out in its TPR Future Programme to be tougher and faster – and our members have indicated that the strengthening of approach is transferring into changes in day-to-day interactions with the Regulator. We expect TPR to continue to drive these reforms forward at pace, and work with industry to ensure that changes in practice and how they utilise their powers are clearly understood and communicated.

We welcome specific changes in the White Paper to enable TPR to impose significant fines and undertake more in-depth information-gathering exercises. These powers should act as deterrent to reckless behaviour, enable more timely intervention in cases where regulatory action is needed and play a role in safeguarding people's pensions.

However, while there is support for ensuring that TPR has the power to undertake its role, we also need to ensure that we guard against unintended consequences that place extra requirements on all schemes, rather than those where enforcement action is genuinely needed.

Deterrents

We believe that making "wilful or grossly reckless behaviour" a criminal offence would prove to be deterrent to company directors, and would fit alongside the suite of possible punishments, including superfines. We anticipate, however, that it may prove difficult to clearly define the range of what 'good' and 'bad' behaviour would look like and therefore it will be necessary to give careful thought to whether such a power would be implementable in practice. It would also be helpful to consider whether overlaps in the regulatory regime would lead to a position where different regulators had similar or duplicative duties to act against poor practice.

CONSOLIDATION

We are pleased to see that the White Paper takes forward the work on consolidation developed by the PLSA's DB Taskforce over the past two years. There is a growing body of evidence that consolidation in its many guises could provide the benefits of scale for those schemes that choose to consolidate.

3) How can consolidation of the fragmented DB landscape be best achieved?

In addition to making it easier for TPR to oversee the fragmented DB sector, we believe that consolidation could be a key part of the solution to the challenges facing DB schemes, helping to bring about economies of scale and improved governance.

Whilst consolidation by itself is not a panacea to the challenges facing the sector and many small schemes are exemplars of good practice, the PLSA DB Taskforce reports, the White

Paper, as well as evidence from the FCA Asset Management Market Study, have referenced a growing body of research[3] which demonstrates that the larger the scheme, the easier it is to:

- Achieve economies of scale and value for money through exerting pressure on consultants and managers, with larger schemes better able to hold service providers to account and achieve lower costs (see Figure 1 below)
- Invest in and acquire skills to make it easier to pick and scrutinise investments; and
- Improve governance and oversight of the scheme

For example, on key measures of pensions efficiency – governance, adequacy, sustainability and integrity– Denmark, Australia and the Netherlands are ranked as the top three in the 2017 Melbourne Mercer Global Pension Index partly in recognition of the value for money their large scale pension provision provides.

	ADMINISTRATION (£ PER MEMBER)				ADVICE (£ PER MEMBER)			
	PERCENTAGE OF TOTAL COSTS	AVERAGE COST	LOWEST COST	HIGHEST COST	PERCENTAGE OF TOTAL COSTS	AVERAGE COST	LOWEST COST	HIGHEST COST
Very large schemes (5,000+ members)	35%	£64	£21	£139	13%	£23	£8	£52
Large schemes (1,000-4,999 members)	31%	£87	£25	£214	23%	£65	£18	£158
Medium schemes (100-999 members)	36%	£182	£50	£368	29%	£146	£40	£296
Small schemes (12-99 members)	41%	£432	£108	£1,125	21%	£221	£55	£576

*costs have been rounded.

Figure 1: DB scheme running costs (*Source: DB Taskforce Third Report*)

Another outcome is that larger schemes are often better able to take a long-term investment approach as they have access to the expertise and resources necessary to invest in illiquid asset classes (which can provide both an illiquidity premium and diversification) such as infrastructure. Such schemes are also better able to integrate environmental, social and governance factors into their investment approaches which can have a positive impact on long-term investment returns.

Consolidation can take a number of different forms and there is no one-size-fits-all approach that will work for every scheme. We believe consolidation should only be considered part of the solution to the challenges facing the DB scheme system, alongside some of the other proposals in the White Paper such as TPR powers.

As part of its work, the DB Taskforce looked at four different models of consolidation:

- shared services;
- asset pooling;
- single governance, and
- the superfund model.

[3] Examples include: *Pension Fund Efficiency: The impact of scale, governance and plan design* (Bikker and De Dreu, 2006); *A Fine Balance, Report of the Expert Commission on Pensions* (Ontario Pensions, 2008); and *Is Bigger Better? Size and Performance in Pension Plan Management* (Dyck and Pomorski, 2011).

Its analysis found that sharing services, having a single governance structure and pooling assets could produce economies of scale and also deliver a governance premium. It also found that the total annual cost savings for schemes merging all three aspects would be in the region of at least £1.2bn per year.

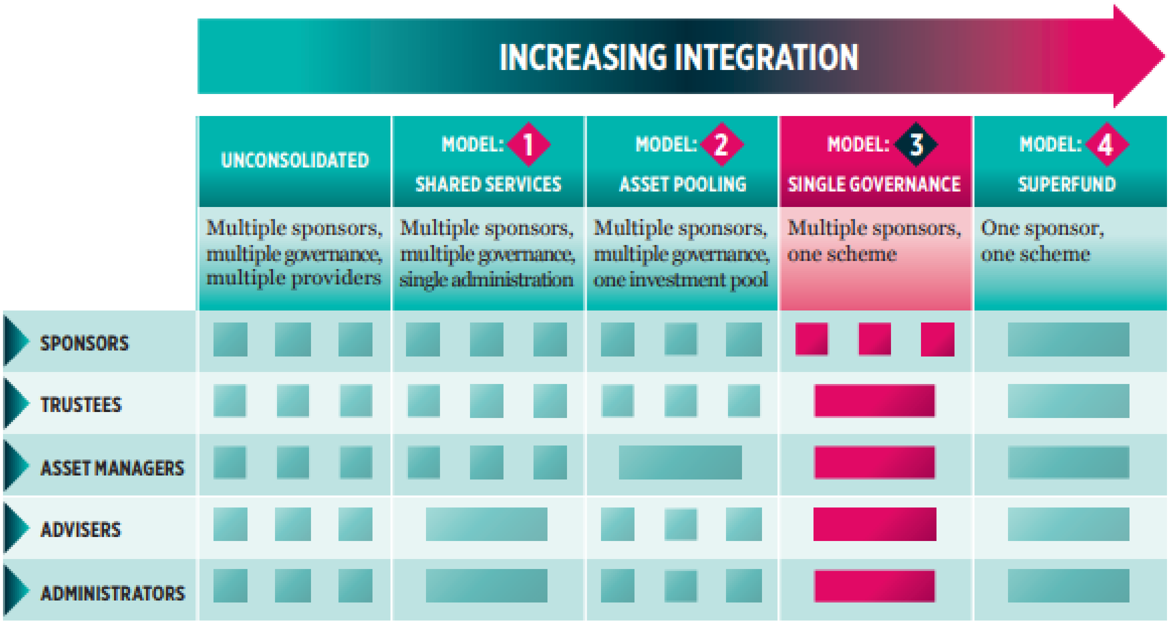

Figure 2: Integration models *(Source: DB Taskforce Third Report)*

The Superfund concept

Finding a route to provide greater security for the 3 million members, who its analysis showed were at risk at not receiving full benefits led the DB Taskforce to propose a new model for consolidation - through the creation of superfunds – vehicles designed specifically to consolidate both the assets and the liabilities of participating pension schemes.

Modelling commissioned by the Taskforce found that a Superfund could:

- Significantly reduce risk to members' benefits;
- Offer a new, affordable option for employers to secure their legacy DB obligations, allowing them to invest more in jobs, wages and growth;
- Reduce the burden on the PPF; and
- Boost investment returns (and economic growth) through provision of better access to investment expertise and greater investment in illiquid assets such as infrastructure

We address a few of the key aspects to the Superfund model below. Further details are outlined in the third report of the DB Taskforce *Opportunities for Change* and we have also attached a more detailed explanation in Annex 1.

Affordability

The PLSA DB Taskforce recognised that for the strongest schemes which are typically well-funded, the best course of action is still likely to be either running on or seeking to buy-out.

It is also the case that for an employer to transfer their ongoing liability for their pension scheme to a Superfund, they would need to improve the funding level in the scheme. A transfer would also not be permitted without the approval of the trustees, who would be required to ensure that the members would not be detrimentally impacted by proceeding.

We believe that a Superfund vehicle could create the right incentive for weaker employers to accelerate payments into underfunded schemes in return for detaching themselves from their liabilities and eliminating uncertainty about their ongoing liabilities.

Superfunds would operate in a similar way to an insured buy-out, as for both approaches the recipient entity requires the scheme deficit to be either completely or substantially eliminated. Both the insurer and a Superfund would provide 'first-loss' capital to act as a buffer. However, because the layer of capital protection provided by a Superfund would be lower than for an insured buy-out, our Taskforce modelling calculated the price of a buy-out for an employer to be 80-85% of insured buy-out.

At this entry price point, Superfunds could be affordable for a larger proportion of schemes and sponsors, providing 100% of benefits at a level of security similar to that of the PPF.

A strong authorisation regime

It is our view that the regulatory regime for Superfunds must be extremely robust, in line with – or possibly more stringent than – the recent authorisation regime introduced for DC master trusts. This would ensure that member benefits are protected as far as possible.

Our PLSA Taskforce work explored this issue in greater depth. One key recommendation was that both the sponsor and trustees operating a Superfund would need explicit authorisation from TPR. The Superfund would need to satisfy TPR that:

- The people involved with the Superfund are fit and proper;
- It is financially sustainable, with the Sponsor having sufficient assets to support the operation of the Superfund
- It has adequate skill, systems and processes to ensure it is managed effectively; and
- It has an adequate continuity strategy and sufficient capital.

Superfunds would need to submit a business plan to the Regulator, covering areas such as strategy, investment policy, profit levels and other aspects of operation. TPR would need to approve the business plan which would provide the basis upon which the ongoing operation of the Superfund would be supervised. Although changes could be made to the business plan, these would need to be decided by agreement between the sponsor and trustees and would also be subject to approval by the Regulator.

We also envisage that any ultimate change of ownership of the Superfund would require a new business plan and approval from TPR, who would have the power to remove its licence to operate. These safeguards are fundamental to protect member benefits.

Entry of a scheme to a Superfund would require approval of the transferring Trustees, the sponsoring employer and the Superfund sponsor and Trustees. Transferring Trustees would only be able to approve such a transfer if, having taken expert advice, the transfer was deemed in the interests of members and, in practice, beneficial.

Further details on the potential nature of, and regime surrounding, a Superfund are outlined on pp.23-37 in our final DB Taskforce report *Opportunities for Change*, a copy of which we have provided to the Committee alongside this response.

Industry appetite

There is growing consensus in the industry and from regulators about the benefits of consolidation, though there is still significant debate about what form that should take, for which types of scheme, and how to overcome the associated behavioural, regulatory or practical barriers, Many forms, such as asset pooling or DB master trusts, are also reasonably established in parts of the sector already.

More broadly, we are pleased at the positive reception that the work of the DB Taskforce has received. One of the key principles of the work was to be open and collaborative and we welcome the positive signs of significant industry consideration and innovation around the future provision of consolidation vehicles – particularly if they can provide options to schemes 'in the middle' i.e. those schemes with weaker employer covenants which would not be able to afford buy-out but are too well-funded to enter into the PPF. We anticipate the industry will engage further following the publication of the White Paper.

4) What can be done to strengthen the regime for clearing corporate transactions (e.g. dividend payouts, selloffs, takeovers) that might weaken a pension scheme?

It is clear that pension funds need to be protected from the effects of poor corporate governance and their interests are not disregarded during company re-structures. The proposals in the White Paper should help protect schemes, as will proposals in the Department for Business, Energy and Industrial Strategy's (BEIS) paper on Insolvency and Corporate Governance to strengthen Directors' duties and support schemes in their stewardship role.

5) Given the difficulties facing DB schemes, is a faster legislative timetable warranted?

We welcome the Committee's recognition of the fundamental issues facing the DB pensions system and the need for reform. Considering the complexity of the issues being examined we believe the current government timetable as outlined is sensible, and will allow for in-depth discussion and consultation with the industry.

However we would urge policymakers not to lengthen timescales unnecessarily – issues such as new enforcement powers for the Regulator are important and need to be progressed with that in mind. We would welcome further details from Government on the timetable.

We hope that the above is helpful. We would welcome the opportunity to provide evidence to the Committee at a later date.