

Work and Pensions Committee

Oral evidence: Defined benefit pension schemes, HC 1218

Wednesday 21 June 2023

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Members present: Sir Stephen Timms (Chair); Debbie Abrahams; David Linden; Steve McCabe; Nigel Mills; Sir Desmond Swayne.

Questions 1 to 32

Witnesses

I: Professor Iain Clacher, Professor of Pensions and Finance and Director, Centre for Financial Technology and Innovation, University of Leeds; Dr Con Keating; Sir Steve Webb, Partner, Lane Clark & Peacock; and Joe Dabrowski, Deputy Director of Policy, Pensions and Lifetime Savings Association.

II: Leah Evans, Chair of Pensions Board, Institute and Faculty of Actuaries; Martin Hunter, Head of Integrated Funding, Railpen; Derek Benstead, Senior Consultant, First Actuarial LLP; and John Ralfe, John Ralfe Consulting.

Written evidence from witnesses:

[DBP0054 Pension and Lifetime Savings Association](#)

[DBP0032 Professor Iain Clacher and Dr Con Keating](#)

[DBP0056 LCP](#)

[DBP0063 Railways Pension Trustee Company Limited \(RPTCL\)](#)

[DBP0065 John Ralfe](#)

[DBP0060 First Actuarial](#)

Examination of witnesses

Witnesses: Professor Iain Clacher, Dr Con Keating, Sir Steve Webb and Joe Dabrowski.

Chair: Welcome, everybody, to this evidence session of the Work and Pensions Select Committee for our inquiry into defined benefit pension schemes. We are very grateful to the four members of our first panel for joining us this morning. Could I ask each of you very briefly to tell us who you are?

Dr Keating: I am Con Keating. I am a retired financial analyst, and I still chair the bond commission of the European Federation of Financial Analysts Societies. I spent my professional career working in the capital markets, in particular the bond markets, across the world. In the course of that career, I visited 173 countries. My interest in pensions is that for quite a bit of my career, I was managing pension scheme assets.

Professor Clacher: I am Iain Clacher. I am a professor of pensions and finance at the University of Leeds.

Sir Steve Webb: I am Steve Webb. I am a partner at actuarial consultants LCP and was Pensions Minister from 2010 to 2015.

Joe Dabrowski: I am Joe Dabrowski. I am the deputy director of policy of the Pensions and Lifetimes Savings Association, a trade association for pension funds that represents 1,300 schemes that look after 30 million members and manage over £1 trillion-worth of assets.

Q1 **Chair:** Thank you all very much for being with us. Can I put the first question to each of you?

For a long time, we got used to defined benefit pension schemes being largely in deficit, and policies were set accordingly. However, for the last couple of years, most defined benefit pension schemes have been in surplus. What do you think the policy implications of this change are? What role do you think defined benefit pension schemes should play in future?

Dr Keating: I will begin by challenging the premise, at least with respect to the supposed outperformance over the last year or so—in fact, for the year 2022. On the improvement in scheme funding that is being widely claimed as 15% or 20%-plus—the PPF claim is that scheme funding improved by 26%—the work that we have done suggests that the number is nearer to nothing or perhaps 5%.

We started off by looking at samples of schemes. When we saw the first set of results from the very first sample, we thought we were low-biased. Everything that has come in since has suggested that, overall, scheme performance is nowhere near as strong as we have been led to believe. Some schemes have done very well; some schemes have done extremely badly. The schemes that have done extremely well are the schemes that



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did not do liability-driven investment in any meaningful way. There is a distribution, and for the last year it is a wider distribution of results than ever before.

Q2 **Chair:** Can I put to you the point that the claim that schemes are in surplus was being made before the events of last September? Would you accept that most are now in surplus, or are you not sure about that?

Dr Keating: As at the beginning of the year, our analysis suggests that about half the schemes were actually in surplus and about half were in deficit. In the first sample of 350 schemes that we looked at, the median funding ratio was 95.4%. As it happens, tomorrow morning we get the ONS end-of-December survey results, which will give us a clear indication—given that these schemes are asked exactly what assets they have, and that is a pretty undeniable fact—and we will know exactly how much funding there was and where the funding regimes come out.

Iain and I did send a paper to Djuna Thurley expressing our concerns over this stuff; unfortunately, we got it here too late for circulation to you. There will be a postscript when we see tomorrow's numbers.

Chair: Professor Clacher?

Professor Clacher: I think Con has covered everything that we would normally say, so I think we can pass on.

Sir Steve Webb: I think what has happened in the last six or seven years to DB funding is absolutely staggering. While there is a lot of detail to talk about on whether the current numbers are exactly right or whether we need to adjust them a bit, it is vital on the first day of the Committee's inquiry to get the foundations right—and the foundations are utterly staggering.

Rather unhelpfully, there are four ways you can measure the financial strength of a pension scheme—it would be nice if there were one, but there are four—but they all tell the same story. This morning, I circulated a chart, which is in front of members of the Committee. I will not go through it in any great detail, but I will just flag two numbers on it.

This is the Pension Protection Fund. It has no reason to overstate or understate funding. It is simply trying to measure what is going on, and this is the net position of 5,000 to 6,000 schemes over the last seven or eight years. In my time as Minister, just at the start of this chart, I would be told that the PPF was saying that, collectively, schemes were nearly £400 billion in deficit.

I would get a monthly sub on these figures. They went all over the place, but the worst one I saw was nearly £400 billion down. The latest one, on the right-hand side of the chart, shows that these schemes are £400 billion up, in surplus. That is massive. Among the nit-picking on the detail and the definitions, you cannot lose that story.



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My central proposition for the Committee, which you have hinted at, Chair, is that policy was forged in the crucible of 2016-17 with BHS and Sir Philip Green being dragged before the Committee. The Pensions Regulator—I am sure some members of the Committee were in the room at the time—became hugely cautious, worrying about deficits, but six or seven years on, things have changed. But I do not want you just to accept that piece of evidence, so here are just a couple of others.

Companies have to put the state of their pension schemes in their annual accounts. We have looked at the FTSE 100. Just the FTSE 100 schemes are £70 billion collectively in surplus. These numbers move around, and that data is a little bit old because company accounts take time to come through, but that is £10 billion better than it was a year earlier, so the accounts say surplus.

The regulator has published the most recent, up-to-date figures, well past last September, and the regulator says that 75% of schemes are in surplus on what is called “technical provisions”, a boring technical word for “a prudent basis”. The regulator says that three quarters of schemes are in surplus.

Finally, there is buy-out, which is like the gold standard of funding—to have so much money in the scheme that you could write a cheque to an insurer, shut up shop and the pensions would be paid forever. That is the absolute gold standard of funding. Buy-out business is booming. LCP, the firm I work for, is the biggest single provider of advice on buy-out. We are recruiting; we are expanding the team. We cannot keep up with demand.

Whatever conclusions we might come to about the nitty-gritty of the fine detail, a point here or a point there, there has been a massive swing in funding. If all these things were not happening, the Pension Protection Fund would not have slashed its levy nearly in half last year. It did that because it does not need the levy, because the number of claims coming in is low and the deficits when they do come are low. I hope the Committee will keep that big picture in mind, because it is just staggering

On your point, policy has to be made in a world of surpluses for most schemes—of course there are exceptions—and not the world of 2016. The Pension Schemes Act 2021 and all the headlines from the previous-but-one Minister for Pensions were about jailing bad bosses. That was the mindset of 2016. It is not the right policy for 2023.

Joe Dabrowski: I would agree with a lot of what Steve said. Just anchoring things to start with, I think it is always worth recognising that DB schemes continue to play a critical part in the pension system. With 10 million members, £1.5 trillion—although we might haggle over the number and where it is post-LDI—and 5,000 employers in the system, it is an essential part of our retirement framework. From all the data that we have looked at, we know that people with a DB pension tend to have a more adequate outcome in retirement. Those with DC pensions have poorer outcomes. It is important for that kind of context.



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We have seen a big change, even in the last couple of years when the Pensions Regulator initially put out its consultation—very unluckily timed, just before the pandemic—and in the couple of years that have just passed. The funding position of schemes has moved on rapidly. Some of that has been driven by the rise in gilt yields and interest rates, which we would expect to continue and be maintained for some while. That means that schemes will continue to be robustly funded. That will have a wider impact on funding and surpluses.

That leads us to ask where we are now at this juncture. Given this surplus position, what choices could we make around the funding regime, what choices that gives for the overall system in terms of the throughput into insurer capacity but, also, how can we introduce some more flexibility in particular for open schemes because we want those to thrive in future? It also leads to other questions.

The number of claims on the PPF has been dropping year on year on year. If scheme funding remains strong, that will continue, so that does raise a question about what the calls on the PPF might be. Clearly there are questions floating around about whether there are other things that the PPF could be doing.

We are in a really nice position now, given the funding position of schemes. We can make some choices around policy interventions. We should also recognise that not everything in the wider garden is rosy. While scheme funding is strong, we are facing recessionary forces, which will have a call on employers in future. That may be coming sooner rather than later. However, the funding position of schemes is really strong. Members' benefits have probably not been as secure for 10 to 20 years, so we need to be pleased about where we are and think about the flexibility we can introduce.

Q3 Debbie Abrahams: There certainly seems to be a bit of a difference between members of the panel. I would be grateful if we could try to unpick some of the cause.

Con and Iain, you are really saying that the picture is not as rosy as Steve and Joe are saying. Can you explain why? Why is there this difference? In particular, Con, you said that half of the schemes were in surplus and half were not. Could you say which ones are in surplus and are well-funded, and what we should be looking out for? Then perhaps we can explore that with Steve and Joe.

Professor Clacher: The problem with pensions is that it is all so terribly technical and tedious. *[Laughter.]* We are all massively into the detail, and it is really hard when you then get these debates and discussions.

There are challenges around the different methodologies that are applied. The PPF 7800 index is based on what is called the roll-forward methodology. It is not capturing everything that would be going on at any one point in time; it is a modelled value of assets. That modelling does not capture things like derivatives, portfolio rebalancing and the use of borrowing.



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Most of the time, there is not much difference between these different models and methods, but last year they were all huge factors because of the LDI cases. The roll-forward methodologies of, say, the PPF have not captured that yet. Adjustments have been made, but the number that we put more faith in is the ONS number, which is the financial survey of pension schemes. That is a direct survey that is broadly representative of the distribution of schemes that you would see from very large to small, and it is their returns to the ONS. That number differs quite considerably between the roll-forward you see at the PPF versus the actual scheme results. A major source of that difference is that it does capture portfolio rebalance, leverage and derivatives. That is the source of difference. We put more emphasis on the numbers that are reported directly by schemes as opposed to a methodology, which is fairly sound most of the time but in times of stress these things can often get odd results. It takes time for the modelling to catch up with what is going on.

Dr Keating: Let's deal with the problem of liabilities. On the asset side of the equation, the amount of assets held by pension schemes has declined markedly: £545 billion of decline to the end of September, according to the ONS, starting from £1.8 trillion. That is pretty huge. We think it will be down another £50 billion or so, perhaps a little more.

The problem with the liabilities is that, yes, the interest rates have risen, and we have seen schemes in all sorts of difficulty with their asset allocations. The crown jewels have largely been sold by most of the schemes that were employing LDI. The asset allocation in those schemes that we have looked at—and these are quite major schemes—can only be described as being in a state of disarray.

The point about the discount rate is that it is the rate of return that you have to earn on your assets to justify the valuation of those liabilities. Now, when I look at the assets, these are assets that a year ago we were saying were going to earn us 2.8%. Now we are saying that these assets are going to earn us 6.8%. When you look at the assets and say, "Is it likely that this particular group of assets will generate that return?", the answer is no.

The Pensions Regulator has reduced its liabilities. Its annual decline in liabilities, due to changes in the interest rate, was 38.8%. When we look at the sample—and we are now approaching 600 schemes that we have looked at—our median is just a little over 32%. That does not sound like a lot, but it is a hell of a lot in terms of funding ratios. That would account for a 10% to 15% difference in funding ratios on its own.

In aggregate, the PPF thinks that funding ratios improved in the course of 2022 by 26%, from 107 to 136.5. At best, we think that number is around 110 to 115, not 136. We are a good 20 percentage points lower than PPF's numbers.

Q4 **Debbie Abrahams:** Can I try to understand the real difference between the academics and the industry? Steve, what do you make of what Iain and Con are saying?



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Sir Steve Webb: If I were a member of the Committee and had not immersed myself in all this, I would want to look at a range of sources. Any one number, as we have heard, has particular properties and you can argue it either way. When you have four separate sources of information all telling the same story, that is compelling to me. The PPF data has been going on a consistent basis for a decade. The Pensions Regulator—unlike the ONS figure that Iain is referring to, which is a sample survey—gets information from every single scheme. So why wouldn't we use that? The company accounts for all the big companies tell a story.

When I go back to the office today, I will not be able to talk to my people who are doing buy-out deals because they are so busy doing buy-out deals. Something real must be going on, because companies have so much money in their pension schemes that they are writing cheques to insurers to get them off their books, and that activity is accelerating.

We can debate the exact numbers, but in the real world, in the markets, schemes have got so much money that they can get the schemes off the books, write a cheque to an insurer and be done with it. That is not funny money. These are serious people who want to make a profit out of business. They believe these pension schemes have got enough money to pay for the insurance company to do a buy-out.

I particularly put that chart in front of you today because, even if we think the last 12 months have been a bit wild and wacky and that the numbers are all over the place and nobody really knows, the 10-year story is inarguable.

Lastly, I asked my colleagues to look at today's valuations relative to a year ago, for all the schemes where we are the scheme actuary or we advise. They said that 75% of the schemes that we have member-level data for, and work with every day, are better funded today than they were a year ago. That is literally the PPF saying, "We haven't got the very, very latest data"—I take that—but we have, because we work with these schemes every day.

When all the witnesses say one thing and all the evidence says one thing, arguing about an individual stat or source misses the big picture.

Debbie Abrahams: Can I get Joe to comment? I will give you the right to reply, Con.

Joe Dabrowski: I agree with Steve. All the data we see from members indicates that improvement. That general feeling that things have improved is in the private sector, and it is in the funded public sector schemes that we represent, too. We also see some of those changes in current DC valuations.

I worked at the PPF for nine years, so I have a slightly vested interest, but it is probably worth just thinking about the robustness of that data. The data that comes through is provided by scheme returns that the PPF



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gathers for the purposes of monitoring and charging for the levy. There is obviously a degree of lag, but it takes from the scheme returns all the investment information from schemes and feeds that in, in order to make its decisions about levy charging and the risks it faces. It also feeds that information through to the Purple Book, which is an official national statistic about the level of funding within the DB sector, which has been published, as Steve said, consistently for about 15 years, and you can see that traction of improved funding. It is a PPF measure, not a buy-out measure or any of the other measures that are out there, but I think we can see that big improvement has occurred. There will be nuances. There are always arguments within the industry about approaches and measures but I think that, on the whole, the consensus feeling is largely that we have seen big improvements.

Q5 Debbie Abrahams: Can, do you want to come in? Looking at the chart, it does not really recognise the seriousness of the LDI episode last year for some schemes, does it?

Dr Keating: First things first: let me begin by saying this. Steve said that schemes have more money than ever. This is a mis-statement. Schemes apparently have better funding ratios than ever before, but the actual amount of money in those schemes today is about what it was a decade ago. That is how much has been lost.

The second thing is that TPR and PPF do produce broadly similar numbers. There are some inexplicable differences between them—at least as far as we are concerned—which are in the note that we sent over, unfortunately on Monday. They are a common source; they are not different sources.

If you want to look to completely different sources independent of us, Willis Towers Watson did a study of the 89 schemes—or 84, I cannot remember exactly which—in the FTSE 350 that reported year returns on an IAS 19 basis. The improvement there was from 107% to 111%, a 3.75% improvement over the year. This is not the 26% or even the 17% that TPR is suggesting.

On LDI, there is a very, very good study of fiduciary fund managers with respect to performance last year, which looks in great detail at performance relative to liabilities. There are sub-groupings of levels of hedging in LDI in various forms, and the results are quite surprising. The median is negative. Schemes did not do better. In fact, none reached their attempted targets.

Just 20% of schemes outperformed their liability changes and, of those, five did that so marginally as to be hardly worth considering—we are talking about numbers that are less than 1%. Five produced numbers of 10% or 15% or perhaps even more—16%, I think, in one case—above the level of liabilities. That is 10% of schemes that were not using liability-driven investment.



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One thing that comes across very strongly from that report is that the level of liability-driven investment in schemes that were using fiduciary management appears to have been very high indeed: in excess of 90%, perhaps.

Chair: Thank you very much. We are a bit under the cosh on time this morning.

Dr Keating: I do apologise.

Chair: If we could have some succinctness in answers, and indeed in questions, that would be very helpful.

Q6 **Sir Desmond Swayne:** I think we have covered what I was going to ask: given the divestment of assets—the assets that have been sold off after LDI—do we need to worry, given that the costs of providing the benefits are going to be so much lower? I think you have pretty well addressed that, Dr Keating, unless there is a comeback from the others.

Sir Steve Webb: I was not quite sure what Con was saying but, in response to your question, two things happened. Asset values went down, as we know, because interest rates have gone up. We spent a decade saying, “Oh, my goodness, these deficits are huge because interest rates are so terribly low; everything is terrible.” Now that interest rates have gone up, we say, “Oh, well, we can’t score that because it is funny money.”

One of those two things has to be false. Essentially, if I sit in bonds—bear in mind that most of these schemes are de-risking, selling equities, buying Government bonds—the return on my assets is going up when interest rates go up. That is a real thing. For most schemes, yes, it was bumpy. To respond to Debbie’s question, yes, last September was bumpy. By the way, I should say that this is a PPF chart. It is not my funny data; it is the PPF’s data.

The key point is the net effect of all of that, which is that figure I cited: of the schemes we work with, 75% are up on the year, taking everything in the round, with the asset fall but the interest rate change. That is the net effect.

Q7 **Sir Desmond Swayne:** Con, why will those assets not generate the returns?

Dr Keating: It is very simple, Sir Desmond. If you hold a bond, you are expecting to earn the return on the bond when you buy it. That is what determines what the yield will be. If interest rates go up, the price of that bond goes down. Your income doesn’t improve.

Sir Steve Webb: It does not go down either, though.

Dr Keating: True, assuming you are not fool enough to be invested in corporates.



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Basically, the assumption is that we are now going to be able to earn rates of return that are twice—perhaps more than twice—those that we were expecting a year ago. Quite apart from what has happened to the asset allocation in schemes, I look at the economy and say, “Has the economy improved sufficiently, either locally or globally, to warrant such an increase in the expected return on my assets?” I do not see any justification for a doubling of the expected return on my assets.

Q8 David Linden: Can I direct these questions to Professor Clacher and Mr Dabrowski, to begin with? Gilt yields have been rising again recently; I think the two-year gilt yield is now well above what it was in the Liz Truss era. Do you think there is reason for concern, given the events of last September?

Professor Clacher: Where we are today is a very different position from where we were last September. What we have seen with liability-driven investment, for example, is much higher capital buffers being held. We have also seen quite significant de-leveraging. For LDI positions currently in the market, I do not think—and that is “think”, because you never know—that we would see a repeat of what we saw last year.

We are now in a position where the factors that really caused all the problems—it was not just about the Truss Budget; it was going from late 2021 onwards as interest rates went up, with lots of leverage and lots of derivatives—have all been unwound and there are much higher capital buffers. I do not think, going forward, as interest rates rise, that you will see a repeat of what happened.

Joe Dabrowski: I would agree with a lot of what Iain says. All things being equal, rising gilt yields are good for defined benefit schemes. A lot of the problem in the autumn was to do with the very rapid change over a very short period. It was also partly driven by loss of confidence in the markets at that time, following the mini-Budget, which led to wider uncertainty.

Since then, as Iain said, collateral buffers have improved, and leverage has dropped, but also the increases have been steady. They have been largely signalled, and schemes’ managers and advisers will have been able to price that in, as they were for some of the rises that were happening in the early part of last year. It was that four-day period—a very short period where everything changed much more than it had in 20 years—that caused the problem. I do not think we are in the same scenario now.

We very much welcome the guidance that has come out from the FCA and TPR in recent weeks and months about managing some of those risks in the new circumstances. I think we do need to be mindful that there are still risks, but I think the risks are different.

David Linden: Dr Keating, do you have anything to add to that?

Dr Keating: No, I think that pretty much covers it. It looks pretty good to me. Should they be able to withstand, without generating another



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spiral? Yes. It probably takes another 150 basis points to have a similar order of magnitude of shock.

- Q9 **David Linden:** Sir Steve, you were the Minister for Pensions during the independence referendum campaign. I remember that you said that, as part of the UK, "People have greater certainty and security when it comes to retirement." Do you still stand by that?

Sir Steve Webb: As this is an inquiry on DB pensions: as we transitioned from DB to DC, the uncertainty for individuals has gone up. Members of the Committee, and I as an ex-MP, have a guaranteed pension regardless of the markets, longevity and all the rest of it, which is a very good thing. I also have a DC pension, and I don't know whether its pot value will go up or down. It is certainly true that individuals in the DC world face greater uncertainty. I am sensing that might not be quite where you are coming from, but that would be my answer.

- Q10 **David Linden:** In relation to the hundreds of millions of pounds that the DWP has been underpaying pensioners, last June you said, "It beggars belief to hear that a government department could simply decide that it was acceptable to pay the wrong rate of pension for decades, but feel under no duty to tell Parliament or the public. If the DWP has sat on this secret for decades, it makes you wonder how many other things simply get brushed under the carpet."

Nearly a year later, you said that these problems persist. You said, "I fear the state pension is so riddled with errors that recipients should not automatically trust that the income they receive is correct. Essentially, you should always start from the assumption that the sum of money you get may be incorrect—that's how bad it is." Does that sound like security and certainty to you?

Sir Steve Webb: Well, no. I think the latest DWP figures are that it thinks one in six claims is in error, which is astonishing. I am working very hard to try to understand exactly what that means. I had an FOI request back from it quite recently, listing all the errors that persist in state pensions. Much more work needs to be done. Following the work that I did with This is Money, they have appointed 1,000 civil servants to check hundreds of thousands of records: they go in every day and all they do is check for errors. There is a long way to go before people can be confident, in my view.

David Linden: Perhaps we don't have that certainty and security that you spoke about so confidently when you were Minister for Pensions during the 2014 referendum campaign.

Sir Steve Webb: I will leave it at that.

- Q11 **Nigel Mills:** This panel seems like an Ashes match. We have the über-aggressive optimists on one side and the cautious Australians on the other, so, Sir Steve Stokes—

Sir Steve Webb: I will take that.



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Nigel Mills: Let's move on before we get too bowled over—oh dear.

It seems like we are in a situation where we have had a forever rollercoaster for 20 years on this and we are finally coming to a nice, flat levelling-out. You can probably understand scheme sponsors and trustees thinking, "Phew, we've survived. Let's just do the most cautious thing and lock in where we have got to." I think you are advocating something slightly more aggressive than that. How do you square that with the natural reaction of, "We are in an actuarial sweet spot—let's lock it in and not risk it"?

Sir Steve Webb: That is a really good question. For many companies, I think that is exactly what they will do. I referred to my colleagues doing all these buy-out deals. That is what you describe. The company has been planning to get enough money to pay to an insurance company; they have got enough money; then they breathe a sigh of relief and get on with making widgets or whatever they do.

That is fine—that will happen, and it is not going to stop—but once you have a well-funded pension scheme, is it an asset to the company rather than a millstone? If you were sitting on a pension scheme that had more money than it needed to pay all the pensions, you might think that was a good thing, but what you would be frustrated by was that you could not get a decent return on that money. With anything else you do in business, you are looking for a rate of return, but for the money in the pension scheme, you are getting something like a cash ISA or something like that. It is ridiculous.

What we are suggesting is that everybody in this room wants those DB pensions paid. We want member security. At the moment, the way we do it is by de-risking. Companies sell equities. They buy bonds. They get low returns, low risk, and we can all relax. What if there were another way of underpinning those member benefits?

We have been talking about the PPF—how well-run it is, how full of cash it is. We are arguing that for the best schemes, the cream—this is not the Tony Blair thing, which is the small schemes at the bottom; this is the big, well-funded cream of the pensions world—they could pay a PPF super-levy, an extra PPF levy, to finance that last bit of benefits that the PPF does not cover. PPF is great—it covers 80% to 90%, depending on the scheme of benefits—but it does not cover the last slice.

What if the really well-funded schemes that, frankly, are not going to make a call on the PPF anyway, opt in to pay an extra levy to cover that last bit? The trustees can then sleep at night because the member benefits are 100% underpinned by the £40 billion Pension Protection Fund, which is why the trustees are there: to make sure the pensions are paid. You can then look at the money in the scheme and invest it for long-term growth—not put it all on the 2.30 at Haydock, but just invest for slightly more long-term growth and the things the Government want, like infrastructure and transition to net zero. You can create more surplus in the schemes, and that can benefit the members of the scheme.



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For the DC generation—because we all know the next generation is under-saving—why not get some surplus in the DB by investing for better growth and use some of that for, for example, the workers of the firm who are in DC? The firm can benefit and get some money invested in the firm, and the Government can benefit. It feels as if there is a massive wasted opportunity. If we were simply investing this money a bit more for long-term growth, like we used to, with member benefits underpinned by 100% PPF cover, this would be a game changer. That is our central proposition.

Q12 Nigel Mills: It sounds like having your cake and eating it, doesn't it? I can lock in everything I have and I can do more with the money as well. Mr Dabrowski—I have put you on the England side here—are you in agreement with this?

Joe Dabrowski: I won't pick a player to be. We have had some discussions with members about the proposal that Steve and colleagues at LCP have been thinking about. At this stage, we probably have more questions than answers, but I think it is worth broadly thinking about options for the future of the DB sector and the changes that we could make to enhance and support it. It is worth doing that, and we should probably look to the Government to consult on some of the options and get feedback from the industry.

There are a couple of things that I would flag about the proposals that, at a high level, we would want to see a little bit more information on, to see how they would work, such as how the proposals would alter the role and the functions of the PPF and what impact that would have on levy payers. Levy payers have contributed to that £9 billion, £10 billion or £12 billion surplus that the PPF has currently.

I think the PPF's own evidence to the Committee was that paying increased levels of benefits would be very expensive in relation to inflation and revaluation changes. Therefore, whether it is economic to do that on a scheme by scheme basis for individual schemes to transfer at 100% is a little unclear until we have seen the numbers. Also, how would the change fit in with the broader landscape, with the question of buy-outs being very buoyant at the moment? Would we have a super-fund regime too?

Other proposals have been bandied around for extending the PPF's remit. With some of the proposals, there is also a question, to a degree, about moral hazard. That may be captured by the levy that is paid, which leads you into affordability questions about the moral hazard of handing over to the PPF at an extra cost and whether that creates competition issues for employers and trustees. What are the benefits that would be paid at the other side?

PPF pays very standardised benefits at particular levels. It does not have experience of paying individual scheme levies. It would need to change its systems. It would need to be able to accommodate those changes. We saw a very big High Court case yesterday, which is going to cause us all



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lots of problems, with contracting out. How would it deal with things like that?

Then come structural considerations. What PPF has now has been paid for by admin levy payers, protection levy payers, in terms of building up those systems, that expertise, those operational functions. Will that cross-subsidise a new role? How does that work? Is it done separately? Questions like those would need to be worked through, and a consultation that explores the issues is probably the best way to do it.¹

Nigel Mills: Con?

Dr Keating: I have done work on the difference between PPF benefits and full benefits. Seventeen years ago, I proposed to the then Pensions Minister that we be allowed to create a private competitor to the PPF. I have been following this for a very long time.

In the note that I sent to the Committee, I compare the funding levels of TPR—that is, full benefits—with those of the PPF benefits. Last year, that required you to pay somewhere between 9% and 25% more from PPF levels to the full benefits.

This is not in the note that we sent, but I also looked at the cost of augmenting the existing stock to full benefits. That comes in between £4 billion and £5.5 billion, depending on the precise levels of benefits and the precise mixture of maturities of the schemes in the stock. That is about half the level of the current PPF surplus. In other words, they could do it at the cost of halving their surplus. I think that when they are crying extra costs to paying increased benefits, they are crying wolf.

Finally, I will just say that there is no moral hazard associated with paying full benefits. It has never existed.

Professor Clacher: When you look at what happened last year, a lot of it came from a very homogeneous approach to pensions. The regulator had a regime that pushed all schemes in a similar direction. Everybody ends up de-risking. A lot of schemes then closed much earlier than they potentially would have done, so you had this forced de-risking and pushed all the schemes together that would essentially have unwound at different points in time into a very similar position. Where we are today, we have to look very seriously at what that gets us. It gets us a low-growth economy, and if you are putting in low-risk investments you are, almost with certainty, going to get a bad outcome if you are a member or a sponsor.

What we have to look at—I think Steve said it very well—is whether there is less difference between people who have DB benefits and people who have DC. We need a more systemic look at this, because we need different business models, for want of a better description, as to how we

¹ Joe Dabrowski provided this clarification – [DBP0083](#).



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deliver benefits. What has been proposed by Sir Steve and his colleagues at LCP is interesting. As Joe said, we need the detail.

We also had the Tony Blair Institute paper, which was looking at consolidation at the smaller end. I think we have to have a much better understanding of different business models and different approaches, caveated with the fact that they might not all work. But just now it is not working and we are all in the same place. With buy-out, the market is not big enough for the £1 trillion or so of DB liabilities. I think PPF statistics show full buy-out at about £70 billion since 2012—I can get the precise number to the Committee—so the capacity in that market is not there.

When you look at buy-ins, the capacity in that market is not there. This year is going to be a bumper year. We might see about £70 billion of buy-in. That does not fix all those other liabilities. All those other liabilities are going to run on as normal and pay pensions, so we have to look very carefully at where those assets sit and where they are invested. The crucial thing for me is that we start to think across the piece about different models, whether that is consolidation, buy-out or buy-in, and so on.

If the solution was to transfer the world of DB pensions to the world of insurance, we would essentially double the size of the insurance sector. I don't think the capacity is there in the market; I don't think the demand for that is there in the market either.

Q13 Nigel Mills: Some of this is down to decisions that trustees and sponsors can already make if they wish, but what should the regulator be changing? Has it been too cautious? Should we be changing its objectives? Does the PPF still need to be protected, or could that objective drop away? Should we be erring more towards supporting the sponsors and encouraging growth? What should the change of policy response be to drive the behaviour that you want?

Dr Keating: Should the PPF's objective to protect the PPF be abolished? Yes. No other pension protection fund anywhere in the world needs a guardian angel, and many of them take on far more risk than the PPF. In Germany, there are 90,000 completely unfunded schemes insured: there is no protector for the Pensions-Sicherungs-Verein. In Sweden, there is the pre-pensions guarantee: another 20 billion or 30 billion of funds, 1,400 schemes, insured, all unfunded.

One of the problems we have is with the Pensions Regulator having regard to protecting the PPF. It has done so consistently at the cost of schemes. If you take it away, you take away that incentive, and you give the PPF an alternate objective, which is to provide retirement income—not to protect funds, but to generate good retirement income schemes.

Sir Steve Webb: I think everybody has behaved rationally, given the framework that they have been given, but what we are now saying is that the framework needs to change.



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If you are a regulator, almost all your objectives are defensive. No regulator ever got sacked for under-regulating. *[Laughter.]* Let me try that one again: no regulator ever got sacked for over-regulating.

If you were the chief executive of TPR and you got dragged into this room and harangued over Philip Green, what are you going to go back to Brighton and do? You are not going to say, "Oh, let's give them all an easy ride." You are going to hammer down on risk. The trustees have no incentive to allow the schemes to take more risk, because they are only interested in member benefits. The corporate has no incentive to sweat the assets, because they cannot get the money out.

All the incentives point to this de-risking, low-return world, as long as you are depending on the company standing behind the promise. The beauty of what we are proposing is that the PPF stands behind the promise and then the regulator can come along—in answer to your question—and say, "Hang on: we know these pensions are going to be paid, so we have done our job." As long as we make sure that the company that has opted into this regime is still behaving itself, is still following our funding code and so on, TPR can be confident that it has achieved its goals without hammering down on risk and return. That is the fundamental change: TPR would be able to change its stance once it knew that member benefits were secured 100% by the PPF for these schemes. It would be transformative.

Joe Dabrowski: We are supportive of the current framework. We think the current framework has worked pretty well overall. I think there are adjustments that could be made to improve and enhance it, certainly for the world that we are in.

It is also probably worth bearing in mind that we have a scheme-specific funding regime. There are cultural and other nudges have probably led to some degrees of convergence of various views. Also, post the great financial crisis, the regulator was given objectives to think about employer growth too, so some of that protection of the PPF has already been tempered through changes to its objectives and how it operates.

The regulator itself—I am not here to speak for it—would always say, "We have applied flexibility; we all look at things through that lens." Going forward, if we were to think about where the regulator's objectives might change, I think that that would be very much focused on ensuring high-quality outcomes for people in future. That would mean focusing not only on accrued benefits, but on how you might encourage future benefits to be paid, and to be paid well. I think that that would also have a massive impact on the DC space, where we see pretty inadequate outcomes for many people because of the low levels of savings.

Overall, I think the regime has worked pretty well. The counterfactual would be that the regulator ignored some of the risks for the PPF, which would be a little bit odd. It is probably also worth saying that we do have case law that requires trustees by and large to forget about the existence of the PPF as a vehicle to support member benefits in order to carry on



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doing their job properly. There are lots of counterbalances in the system already, and I think it has worked pretty well.

- Q14 Nigel Mills:** A final question from me: is it fair to say that what we have seen for quite a while now is current employees with a very low pension promise basically working to pay for a much higher pension promise for their predecessors, which now looks to be pretty well funded? Is there a way we can make that intergenerationally fairer, and use some of these surpluses to top up what will be inadequate pensions for a lot of current workers at the same employer that now has a scheme in surplus?

Sir Steve Webb: I thought your question to the Pensions Minister on Monday was spot on, because you do have this huge generational difference. In the last three years, corporate Britain has put 84 billion quid into DB. Part of the reason for the improvements that we have seen in funding is not just market movements and funny numbers; it is real businesses putting real money into DB, often to cover past promises. That is money that was not available. If you think of a company as having a kind of pensions budget, the bigger the DB costs, the less they have for the DC generation. The challenge is "Can you honour the DB promise and free up cash for the DC?" Well, you have to make the cake bigger—and it is about making the cake bigger.

What we have suggested is that once a scheme was not just 100% funded but had a buffer on top of that so it was at 105%—super well-funded—companies getting above that could take the top slice. You could, if you wanted, have a rule that you could only take that super-surplus out if you were an employer that was funding DC payments at a good level, for example. If they were not, they could bump up the DC pensions, so you can how this could benefit the DC generation as well.

Dr Keating: If your overall scheme, which has DB and DC sections, is suitably structured and correctly put together, the surplus associated with the DB section can be applied to the DC.

Sir Steve Webb: Yes, if you've got a DC section already.

Dr Keating: The detail is one for the lawyers.

Joe Dabrowski: I agree that it is structurally possible. I would probably add, although this is a little more anecdotal than quantitative, that my general experience is that those schemes that still offer DB or have offered DB tend to offer better DC currently than those that might just have joined the automatic enrolment system at the beginning of that and paid the minimum contributions.

I think I would prefer to take the Occam's razor approach and just legislate to improve DC contributions over an appropriate time, rather than relying on slightly more arcane ways of recirculating the money. I think there are ways of doing it and ways of looking at some of the legislation around surpluses that might make that a little bit easier. There is scope to do more.



Q15 Steve McCabe: I want to ask about the funding regime that has been proposed. By way of an opener, what are the major differences in the way the schemes operate, apart from the obvious one that open schemes include new members and closed schemes do not?

Sir Steve Webb: Shall I kick off? I think one of the worries about the new regime is that it treats open schemes a bit too much like closed schemes. When the Pension Schemes Act was going through the House of Lords, assurances were given that open schemes would be appropriately treated, and I am not convinced that we have seen that yet.

The final version of the DB funding code has not even come in yet. It is for 2024 and, as I said earlier, that is still, in many ways, from a bygone era. It was legislation for a world that had big surpluses but, by and large, we do not now. What I think we need for open schemes is recognition of the long time horizon.

Chair: A world where we had big deficits.

Sir Steve Webb: Sorry, did I say “surpluses”? I apologise for that—I got carried away. Thank you for correcting the record there.

It seems to me that with open schemes there is still too much in the new regulations that says, “Well, your employer might not be around for very long, so you’ve got to take risk off the table.” The universities scheme is a controversial scheme, but the University of Oxford has been around for a while. The assumption is that six years hence, you will need to start thinking twice, but it seems to me that for open schemes, we want open schemes. We want employers who are willing to run these things on, and the regime has to encourage them, not penalise them. I am not convinced that that balance is right.

Joe Dabrowski: I agree with that. Part of your question was what the characteristics are. It is probably worth saying that if you are running an open DB scheme now, you will have chosen to do that quite actively over the last 15 to 20 years as an employer, for various reasons. What we tend to see is highly profitable companies, those that need to recruit and retain highly skilled staff, and those where you have a labour force with strong trade unions or perhaps formerly nationalised industries. That is largely where you see the 10% of DB schemes today that are open to new accrual.

I agree with Steve that they have longer time horizons. Some of them that I engage with often have quite young workforces. A funding code that says, “Think about yourself in five years’ time with lowering unemployment”, is a little bit draconian in that sense. We would therefore like to see an additional level of flexibility built into the funding code and how the regulator goes about approaching things, because they can carry risk for longer in different ways, and that should be reflected in the regime.

Steve McCabe: Does anyone want to add anything?



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Professor Clacher: What is currently on the table is more money today every time, so what you are looking at, regardless of whether a scheme is open or closed, is pushing more and more onus on company sponsors to put more and more money in the DB scheme, regardless of debates about current funding positions and everything else. For me, that is economically not the most sensible thing to do because, essentially, you have to invest in your employees. You have a DC scheme that you are not really paying anything into, so with more and more money today you are not really taking risk off the table in the same way.

If we go back to a world of huge deficits and say, "We are going to have all these deficit repair contributions going in," that is de-risking that DB scheme and it is securing member benefits in some way, shape or form. We have seen this shift where the regulatory regime has kept ratcheting that up. If we keep on ratcheting it, there is less money in the company, there is less money for projects, for anything you want to grow the economy, plus everybody else. For me, it is economically at a point where it goes far too far.

Q16 Steve McCabe: If the economic environment has shifted and TPR is far too cautious, what is the answer? Should we scrap this financial code and regime altogether, or should there be a separate one for open defined benefit schemes?

Sir Steve Webb: I think an explicitly separate regime for open schemes is the answer. At the moment, it is too much like the closed scheme regime with a nod and a wink to open schemes. That is not enough. It comes back to the point that TPR is a creature of Parliament. It has done what Parliament has told it to do. All the emphasis was on crises, scandals and pensions not being paid, and now that is far less of a risk. The risk, actually, is not enough money going into pensions and not getting a good enough return. That is why we need a regime fit for today, not for a bygone era.

Joe Dabrowski: TPR has moved to try to combine most of its codes into one place. There are different ways you can cut it but, by and large, I agree with Steve that there should be a separate chapter, module or set of expectations for open DB schemes—largely so that it is also very clear, from the regulator's perspective and from the scheme's perspective, what is expected. In the current code and in past codes, a lot of expectations have been intermingled. That is fair enough, but it does mean that when it comes to supervision or interaction, there can be interpretations and differences of opinion. If it were very clear, in black and white—"This is what we are going to do for open DB schemes, and this is how it is different or not different"—that would make things a lot more straightforward.

Q17 Steve McCabe: Dr Keating, you talked about the PPF and the approach in other countries. The PPF seems to be very concerned about large open defined benefit schemes, which it feels are rather less well funded than closed schemes. That seems to be a major anxiety.



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Dr Keating: They should be less well-funded than closed schemes. You can argue that the greatest asset of an open scheme is, in fact, the flow of new members each year and the contributions of existing members coming in. This makes those genuinely long-term institutions.

If you look at the arrangements for the two biggest groups of schemes, Railpen and the USS, to a large extent they are shared cost schemes between members and sponsors, certainly in the rail area: 60:40 seems to be the arrangement for most of those.

They are also the last men standing in most cases. The idea that the 190-odd universities could collectively go down the pan—well, if they do, the rest of the country's gone down the pan anyway, so I wouldn't worry about it. That is beyond Armageddon. Is the concern with those schemes justified? No.

Q18 **Steve McCabe:** Is that the view of all of you? Is that an unrealistic anxiety about large open schemes?

Sir Steve Webb: It comes back to the point about—let me try to get this right—never being fired for over-regulating. If you are the PPF, you only have one job: it is to worry about deficits. In a rare moment of consensus I am going to entirely agree with Con. You would expect open schemes to run bigger deficits because they have a longer time horizon. That is what you would expect.

Joe Dabrowski: I agree with the consensus. I am not 100% sure that they are more in deficit than others any more, either. Also, we should bear in mind that PPF has the means to worry about that itself through the levy if it is concerned about that.

Q19 **Steve McCabe:** And put up the levy, if need be?

Joe Dabrowski: Yes.

Q20 **Chair:** Can I put a final quick point to you? If we are going to see a big increase in buy-out in the next few years, is there potentially a systemic risk there to the economy? The Finance Policy Committee has suggested the Pensions Regulator should be required to take account of financial stability. Are there risks around a big surge in buy-out?

Sir Steve Webb: It is certainly right for the prudential regulators to look at not just the initial transaction but where the money then goes—the reinsurance market. You obviously do not want massive concentration; we are talking about huge amounts of money. It is a growing market, so it is absolutely right for prudential regulators not to say on each individual deal, "Are you causing a systemic problem?", which is all the LDI stuff; it is for the prudential regulators to look at the whole system. I do not think it is at sufficient scale to be of concern yet but if we had mass buy-out over a long period of time and all the money was reinsured in a narrow number of places, you might be concerned. It is a legitimate thing, and they have asked to be notified of these major transactions, which is entirely proper. So my view would be "Not yet, but it does need to be monitored."



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Dr Keating: There are serious technical issues associated with bulk annuity insurance. The first principal one is their use of capital, or their definition of capital, which is the matching adjustment. In essence, what they do is buy a set of investments, which are yielding them 6%, or some percentage. The margin between what is being promised on those and, for example, the gilt rate is claimed as profit and capitalised today. In other words, they are claiming, under matching adjustment, future profits as capital today. There is the obvious problem that they may never materialise and there is the second problem, which is that if they do not materialise you are up the Swanee with no hope of redemption.

Joe Dabrowski: I agree with Steve that that there is not necessarily a problem now. We would probably expect to see new entrants come to the market and it will need to grow, or we would expect it to grow, in order to reflect the demand. There is also the UK solvency regime to come. The Bank, the PRA and the other regulators will need to be mindful of the interaction of all of those things. It is reassuring that in the last few days they have said that they are going to do a systemic review of bank and non-bank risks, and I would imagine that that would continue. They will have to be alive to this issue as it goes on, but the scale of transactions at the moment is doable within the market.

Chair: Thank you for a very interesting session. We are grateful to you all.

Examination of witnesses

Witnesses: Leah Evans, Martin Hunter, Derek Benstead and John Ralfe.

Chair: Welcome, all of you. Can I ask each of you to tell us very briefly who you are?

Leah Evans: Good morning and thank you for having me. I am Leah Evans. I am here in my capacity as chair of the Pensions Board of the Institute and Faculty of Actuaries; in my day job, I am a consultant working with companies and trustees on managing their DB pension schemes, with a focus on risk management and investment, including buy-outs.

Derek Benstead: I am Derek Benstead. I work for First Actuarial LLP; I am a pensions actuary with 35 years in the business. The two things you might be most interested in are that I am the pensions consultant for the Communication Workers Union in its pension negotiations with Royal Mail, and that I am the pensions consultant for the University and College Union in its negotiations about the universities superannuation scheme.

Martin Hunter: Good morning. I am Martin Hunter. I am the head of integrated funding at Railpen, and an actuary by background. I work and support the trustee of the railways pension schemes, the corporate trustee looking after the principal pension schemes in the UK rail industry. Broadly, that is 110 different pension schemes, with 350,000



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members, 100,000 of whom are active members, with about £35 billion in assets. As an actuary, I got quite excited when I saw the first question that the Committee was asking on open schemes, which are a key area of interest for me.

John Ralfe: I am an independent pension consultant. I have been advising companies and schemes for the last 20 years.

Q21 **Chair:** Thank you all very much for joining us. Can I put to you the same first question that I put to the earlier panel? For a long time, most defined benefit schemes were in deficit and policies were set accordingly, but for the last couple of years it seems the majority have been in surplus. What do you think the policy implications of this change are, and what role should defined benefit pension schemes play in the future?

John Ralfe: I don't think there should be any changes. The idea, for example, of changing the objective of the Pensions Regulator, so that it is not to protect the Pension Protection Fund, is nonsense. Chair, you were around 20-odd years ago when the Pension Protection Fund was started; I do not know how directly involved you were with it.

Chair: When Con Keating said he wrote to the Pensions Minister 17 years ago, I wondered whether that was me.

John Ralfe: I wondered as well. We have to be very, very clear that what the Pensions Regulator is about, and what the Pension Protection Fund is about, is protecting the several million people who have defined benefit pension promises. It is not that long ago, if you are as old as me, that you will have seen people marching up and down Whitehall because they had put money into their pension scheme for however many years, and then the company had gone bust and they had lost 80% or 90%.

Although funding has improved—and I am much more sanguine today in 2023 than I ever thought I would be—I don't think that there are any changes needed. I think Joe talked about little tweaks here and there; I don't want to sound too Panglossian about it but I think that we are in the best of all possible worlds.

What should the Pensions Regulator be doing? Broadly speaking, it should be doing what it is doing. There is a scheme-specific funding standard. What that means in practice—and over the years I have dealt with a number of schemes that are closed and a number of schemes that are open—is that the way in which the Pensions Regulator regulates them and what is required in practice can and do vary quite a lot. I think that there is enough flexibility built into the existing system.

As for the idea that the Pensions Regulator should not have the job of protecting the Pension Protection Fund—well, you might as well tear it up. Even if you think it a good idea and take it for granted that pension funds should be investing in slightly riskier assets, the mechanism that has been suggested—I will not expand on it now, but you might like to ask the question later—is straining at gnats. There is a much, much simpler commercial way of doing it.



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There is a market failure, if you like, that set up the Pension Protection Fund: you could not get banks and insurance companies to insure the whole of the pensions industry, for obvious reasons. There is no market failure when it comes to—as Steve Webb said—the super-funded schemes. Broadly speaking, I am very comfortable about where we are and where we will be going over the next few years.

Leah Evans: I certainly agree that we are in much better shape than we have been in the past. By most measures and most estimates, funding levels have broadly, on average, increased. Where that is positive is that it is allowing sponsors and trustees a little bit of breathing space to really think about what they want to do with their pension schemes, whereas in the past it has been firefighting, if you like, and deficits have been increasing. The focus has been on what you can afford. Now companies and trustees can work together and take stock of what the is the right thing for them.

I also agree that, broadly speaking, the current regime works well. I think it strikes an appropriate balance. The big strength of the current regime is the scheme-specific nature. Retaining that as part of the new funding code and the new regulations is key. We might get on to open schemes in more detail; again, being able to do something specific but appropriate for open schemes and providing the Pensions Regulator with the flexibility to agree something specific with those schemes is important.

On some level, there is broader opportunity there in the sector. We are talking about huge amounts of money here that could be put to use, and there is a policy decision about whether you try to access this. Under the current regime the opportunities for doing something significant are probably limited. That is because if you are investing the assets into different types of assets that provide greater return, there is some risk that comes with that, and ultimately somebody has to pick up the risk. It might be the PPF—there is a proposal there, and there are practicalities to be considered. Unless you come up with some way of separating the schemes from the sponsors, the sponsors will still be taking some risk.

The question is whether they would want to. You were referring to the rollercoaster ride earlier. Most of them want to get off, to be honest, rather than have another round. There is potential there for opportunities, and it is positive that there is so much debate and different ideas being put forward, but it is not an easy change around the edges. If you want to harness that, something bigger needs to happen.

Finally, it is worth noting that we are talking about overall schemes being in a better place. Obviously the improvements in funding levels have not been universal. There are still schemes that are underfunded, with weaker employers. It is quite right that the focus continues to be on protecting the members in those schemes and their benefits.

Derek Benstead: The question arises largely because of the events of 2022, where yields and government bonds have risen so much. We need



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to distinguish carefully between the task of having sufficient assets in a pension scheme to pay benefits as they fall due—that is the real-world activity of a pension scheme with a long-term future—and the modelling world that compares assets with an actuarial value of liabilities.

We need to distinguish managing the model, which is what we spend a lot of time doing in the industry, from the actual task of paying benefits as they fall due. Lots of pension schemes value their pensions using a discount rate based on gilt yields. If gilt yields fall, the value that they place on the liabilities falls, but the benefits that they are paying every month have not fallen. They are not affected by interest rates; those are promises in the scheme rules.

The events of 2022 have affected pension schemes differently, depending on how they are invested. A pension scheme with a large amount of LDI-type investments may have seen its assets fall as fast as the value they place on the liabilities has fallen, but their benefit cash flows have not changed by a penny. On the contrary, they are likely to be inflating quite a lot at the moment. Those pension schemes are no better placed—probably worse placed—to pay their benefits as they fall due because of the losses that they have made on their assets.

On the other hand, schemes that did not have LDI, but nevertheless valued their liabilities using a gilt-based discount rate, will have put a much smaller value on the liabilities in their pension scheme, while on the assets side they did not have LDI, they did not make those big losses and their funding levels look a lot better. However, that appearance is just a result of poor modelling: on the one hand you have a liability value that you have constructed to follow the gilt market, while on the other hand you have investments largely not in gilts. That is just poor modelling, rather than anything real.

We create perceptions of pension schemes based on modelling that may be more or less helpful. If you do have a pension scheme where you have based your discount rate on gilt yields, while you have invested not in gilts and created a volatile answer, you can choose as trustees or scheme actuaries to look past that volatility and nevertheless set a stable contribution rate—or you can be obsessed with the volatility in the numbers, which are just modelled numbers and do not necessarily help you in the overall task of paying benefits as they fall due.

If we look at the universities superannuation scheme—to choose a public, pertinent example—we have an open pension scheme where the income from contributions and the income from the assets, which are reported annually in the USS accounts, will exceed the annual spend on benefits, out of the USS. Projections show that that will remain the case, as long as the USS remains open to new entrants, for decades to come. You do not need an actuarial valuation to tell you that the USS has more than enough resource to pay its benefits as they fall due.

Nevertheless, the way the USS has been managed in the last few years has been very obsessed with the funding targets that follow gilt yields.



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That has resulted in benefit cuts for members a year ago, which now, after the events of 2022, the parties to the USS are looking at reversing. We have not managed, in the context of the USS, to look past the instability of modelled numbers to the reality of the long-term future of the pension scheme.

When we talk about surpluses, let's distinguish between the ups and downs of modelling, which may have been better or worse constructed, depending on how the assumptions have been set, to the reality of a pension scheme. The reality of a pension scheme having enough resources to pay benefits as they fall due might be rather better than the appearances of modelled numbers.

Martin Hunter: There are a few points to cover; quite a few have been made by some of my fellow panellists. One of the things that struck me from the first evidence session was a major focus on managed decline of the DB industry. As somebody representing an open pension scheme, I think it is critical to think about where that decline has come from and what opportunities there might be for the future.

I agree with the comments that Sir Steve Webb made that we are in a fundamentally different position now from 2016-17, the time period that he was looking at. There are some incredible opportunities that we have now as an industry and that the Government have, through policy, to use the DB pensions industry as a power for good, both to help members and savers and to help the UK economy more widely.

There has been a lot of focus on improvements in funding levels. It is also critical to consider what the cost is today of providing DB pensions to current active members. That has fallen materially in the last few years as well. To put some numbers around that, we have about 40 open schemes that we look after through the railways pension scheme. The cost of benefits being built up by current actives was maybe 20% to 25% of salaries a few years ago; that has fallen by about five percentage points to perhaps 15% to 20% now. That is a great improvement and very valuable, particularly for employers and any active members who are paying their contributions into those schemes.

We do now have a few employers where they have a bit of a quandary, because they have a DC scheme and a DB, and the cost of accrual in the DB scheme is potentially lower than DC, so they are reconsidering whether the DC is actually the right way to go for their employees or whether they should be looking to put some back into DB again. It is a great opportunity to look at some of these things.

The other point, which a few other panellists have made, is that there is a huge pot of money within DB schemes: more than £1 trillion. Given where Government policy is and the risk aversion that comes through that, the regulator's statutory objectives are likely to look to transfer that across the insurance market over the years to come. That seems to me to be in contradiction to Government policy, particularly the Treasury's.



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I see a major difference of opinion between the Treasury and the DWP. The DWP is pushing taking less risk, moving money out of equities into bonds, and taking as little risk as possible. That seems to contradict the Treasury's desire to have pension schemes invest in productive finance and other assets that will benefit the UK economy. To me, that is a particular concern, because open schemes are a great vehicle for that kind of investment. We do a lot of that ourselves, which I think is valuable not just to our members, but to society.

Chair: Thank you very much. Can I just make the point that I made earlier? We are a bit under the cosh on time, so if we could be as succinct as possible, that would be helpful.

Q22 David Linden: Most of you have spoken in your opening remarks about how funding has changed in recent years, so we will not go over that ground again. Can you talk a bit more about the impact of the LDI episode last year? Secondly, what impact are the schemes you work with seeing from rising gilt yields?

John Ralfe: I will try not to repeat what we said last year. The LDI debacle was not in LDI, which is matching assets and liabilities; it was to do with leverage. You will not be surprised to hear that none of the people I work with had leverage.

You can see from certain things that have been published that British Telecom, the granddaddy of all UK pension schemes, has de-geared. You can see that in its accounts. It de-geared because it had to post quite large amounts of collateral: £5 billion or £6 billion. What did it do? It sold overseas equities. There has been a de-gearing.

I am not privy to what goes on, for example, with BlackRock or LDI leveraged funds. You will remember that it was those funds that were not masters of their own destiny, because they were pooled funds. The information is a bit patchy, but my guess is that if Legal & General was running an average of five or six to one, it is now running an average of three or four to one.

Also, of course, we have had the Pensions Regulator waving a big stick. I know that the Committee is publishing a report on LDI shortly. The thing I would like to see is better accounting. Both at the pension scheme level and at the company level, you cannot see what is going on.

Q23 David Linden: You have talked about the Pensions Regulator waving a big stick. Is it waving it enough?

John Ralfe: Yes. It is a bit like the Bank of England used to be—the Bank of England in the good old days would raise an eyebrow. Pension schemes, particularly small pension schemes, do not like to be asked awkward questions by the Pensions Regulator. The short answer is yes, I don't think it needs to do any more, but let's see.

David Linden: Interesting. Ms Evans?



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Leah Evans: A couple of points. First, as someone on the earlier panel said, the big challenge that we had in September was the speed at which rates rose, which was completely unprecedented. For example, gilts rising now is causing much less of a strain on the system because schemes have time to provide additional collateral and so on.

The other big thing is that schemes and asset managers have changed their approach. Some of that was already happening when we discussed this here last October. At the time we were saying that, anecdotally, asset managers have increased their collateral buffers, and there were extra requirements on schemes to have plans for making collateral available and so on. There is now guidance from the regulators as well that requires it.

Overall, industry best practice has shifted quite significantly to put schemes into a better place. They are in much better shape. I would be less concerned about a repeat of last September. It would have to be significantly more severe this time around to cause anywhere near the same sort of level. I would never rule it out, but schemes are in a much, much better place than they were.

David Linden: I think the Conservative party has learned its lesson on that.

Derek Benstead: Rising gilt yields generally potentially provide an investment opportunity, an increasing role for bonds and a diversified portfolio. You mentioned LDI specifically; the role of LDI depends on the time horizon of the pension scheme. If the trustees and/or the employer have already decided for whatever reason that they wish to wind the scheme up within, say, five years, LDI has a role to stabilise the buy-out funding level, to turn what would be a gilt-based deficit for the employer into a cash deficit to stabilise the employer's remaining deficit contributions. That makes a lot of sense.

If you have a scheme whose time horizon is much longer, either because it is open to new members or continuing accrual, even if closed to new members, or because it is a weakly funded scheme with a weak employer that, even though it is closed, cannot conceivably buy out for 20 or 30 years, the case for LDI falls away. LDI is a short-term balance sheet management vehicle that, if your horizon is long, becomes irrelevant.

In the case of the weakly funded scheme with a weak employer that can only pay benefits as they fall due because that is all that can be afforded, to invest in LDI creates a big risk that otherwise would not be there: that the bond market falls, that cash calls are made, and that assets are taken out of equities and thrown into a falling bond market to lose even more money.

That does not help the task of having sufficient money to pay benefits in full as they fall due over the 10, 20 or 30 years. LDI needs to be used carefully. It is not a universal solution; it is a solution appropriate in particular circumstances of short time horizons. With long time horizons,



it is an additional risk that does not need to be taken, and should not be taken where it is not appropriate.

Martin Hunter: Some of this links to what Derek said. Our pension schemes do not hold leveraged LDI, so we did not quite have the level of commitment that many of the other schemes did last autumn. A key reason for that—to some of Derek's points—is that for an open pension scheme with a very long time horizon and very strong employers standing behind it, a key focus is the expected return that you are going to achieve on your assets. Particularly between 2008 and last autumn, the yields available on government bonds were not particularly attractive to provide that return, so we had lower allocations than many other schemes would have done. We are reconsidering that now, given that yields are at more like normal long-term levels.

Q24 **Sir Desmond Swayne:** I was going to ask about the difference in the characteristics between open and closed schemes, but we have pretty well covered that, unless there is anything that you want to add.

On a more detailed question, what proportion do the railway scheme and the USS scheme together represent of the total open schemes?

Martin Hunter: I will take that second question first. We have 100,000 active members across our railway pension schemes. From the stats available, I think USS is about double that, with about 200,000 or a little more. So that makes about 300,000. The total active members across private sector DB schemes are about 900,000 nowadays, so those two schemes make up about a third—a very substantial proportion.

It has been a real battle for many open schemes to survive over the last 20 years. We have been operating within an industry that is primarily designed for closed pension schemes to run off accrued liabilities in a way that is low-risk. The regulator's statutory objectives mean that there is a big focus on protecting benefits that have been accrued in the past and protecting the PPF. That means that the regulator is, at best, agnostic about the future accrual of benefits in pension schemes.

Against that backdrop, it is not surprising that a lot of schemes have been trying to fight that tide, but have not managed it and have given up. Trustees and sponsors have been closing those schemes over the last 20 years. To put it mildly, that is a great shame for society. The vast majority of members who have come out of DB schemes have gone into DC, and various studies show that they are likely to have real struggles with poverty in retirement. We are particularly seeing that now, with the cost of living affecting a lot of members. It is critical to think fundamentally about the members of these schemes. These are not just financial assets that are being run off; there are members here facing fundamental issues.

There are often myths about DB schemes being gold-plated. Our average pension that we pay out to our 140,000 pensioners is about £7,800 a year, or £150 a week. With the cost of living nowadays, that is not gold-



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plated; that is not people living in luxury. That is a fundamental, critical part of somebody's retirement income.

Most of our members have spent most of their career in the railways industry, so that is hard-earned retirement income alongside a state pension and maybe a wee bit of DC from a few years outside railways. These are fundamental benefits for people, so it is critical that we have a regulatory framework that allows open DB schemes to survive, first and foremost. To thrive would be a wonderful ambition too, but a lot of change is required to get there, particularly looking at the statutory objectives that have been given to the regulator, which lead to a very, very big focus on past service benefits at the expense of considering future accrual for active members, particularly in open pension schemes.

Q25 Debbie Abrahams: We have had different contributions about how the role of the regulator should change. Do you think that it has the balance in its approach to scheme funding about right?

John Ralfe: I do. I am not going to repeat what I have already said.

I am sorry to be a bit rude, but I am going to slightly jog back and talk about the railways pension scheme and the USS. I would not draw any conclusions whatsoever from those two schemes. They are technically, legally, private sector, and they are regulated and they pay a Pension Protection Fund levy, but they are both public sector. Given that they are both public sector, implicitly or explicitly guaranteed by the taxpayer—you can have lawyers telling you whether it is implicit or explicit—I would not draw any conclusions whatsoever.

In the work that I did—when I say “work that I did”, this was doing a bit of googling, let's not exaggerate—I was astonished at how few private sector schemes there were that were still open. Rolls-Royce, which happens to be a company close to my heart—it may be close to Mr Mills's heart, too—closed its scheme quite recently. It was one of the ones that were saying a few years ago that it was there for the long term.

There are very, very few genuine private sector pension schemes that are still open in any shape or form. The ones that are have much less of an incentive to close now, but the ones that have closed have no incentive whatsoever. I know there is a process of self-selection. In 25 years I have not met any finance director who says that what they are about is trying to reopen the defined benefit pension scheme. They are all very glad to be shot of it.

Q26 Debbie Abrahams: Shall we move on to TPR?

Leah Evans: As someone previously said, everyone is acting rationally within their own framework. TPR is following the objectives that it has been given by Government. It is completely appropriate to review its objectives from time to time; as someone else pointed out, there has already been a tweak in relation to considering the company as a stakeholder. Things have changed since TPR was set up, and I see no harm in reviewing its objectives.



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It feeds into the broader policy question for the Government of what the future view is on how pensions are provided in this country. It is fairly clear that in future the majority of pension provision will not come from private sector DB schemes, one way or another. I think we should try to keep open those that are still open, but there is a shift away to DC. We all know that there is big issue around adequacy. It is appropriate to consider that broad picture and, in the light of that review, whether the objectives for TPR need to be changed.

Derek Benstead: Explicitly on TPR objectives, it has one to protect the benefits of members of occupational pension schemes, which the regulator interprets to mean benefits for past service to the exclusion of future service. It would be very helpful if Parliament were to clarify that objective as including benefits for future service, which perhaps is what Parliament intended all along, albeit that that is not the way the regulator and the industry have interpreted it.

There are some important misunderstandings in the industry that could usefully be addressed or discussed. One of them is that new benefits accrual undermines the security of benefits already accrued. I do not believe that that is true. The benefits of continuing benefit accrual are to extend the available investment time horizon to make it more possible to invest rewardingly, to grow the funding level and to make the scheme more affordable.

I have a scheme on my own portfolio, a weakly funded scheme with a weak employer, still open to accrual, where we studied the probability of paying benefits in full if we carried on as we were; if we closed to accrual, which would be the first thing the regulator case manager would recommend but which would greatly increase the likelihood of being unable to pay benefits in full, because we would have shortened the investment time horizon; or if we invested more aggressively, which reduced the probability of being unable to pay the benefits in full because the higher return expected on more aggressive investment helped the funding of the scheme.

We have a common misunderstanding in the industry that the best thing to do with investment risk is to reduce it. We call it de-risking—a horrible, virtue-signalling term. The risk that we should be reducing is the risk that we cannot afford to pay benefits in full. As I have said, in a weakly funded scheme, earning more on the investments might reduce the risk that you cannot afford benefits in full.

In the industry, we commonly use value at risk as a risk criterion, meaning how the pension scheme funding level might vary on a one-year or three-year timescale. That is important if you are buying out in five years or in a shorter period of time; it is not important in a scheme with a long-term future, either because it has active members or because it is weakly funded and cannot afford to be insured.

We need to get away from misunderstandings and poor choice of risk criteria to the understanding that the best thing that you can do to



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reduce somebody's risk of poor income in retirement is to provide them with a pension. Even if that pension has some risk attached, it is better to have a pension than to have no pension. That is what the pensions industry and the regulator have been missing for the last 20 years. It has positively discouraged benefit accrual rather than encouraging it.

Martin Hunter: We are in a fundamentally different position now from when the Government gave the regulator its objectives. One of the ones that they were calling for to be looked at again is that protection of the PPF. I understand why the regulator had to have an objective to protect the PPF in its infancy and its early days, when there was a quite substantial risk because of where funding levels were and what might happen to the economy. Indeed, we had a recession just a few years after the PPF was established in 2005.

But the PPF is in a fundamentally different place now. Its last reported numbers showed a reserve or a surplus of £12 billion. It is very, very well-funded and it is very large. It is expecting far fewer claims in future than it has had in the past, particularly because of the improvements in funding levels in schemes. In the past, it might have had 100 or so a year; now, perhaps, it might be single figures or perhaps 10 a year. It is in a fundamentally different position, so I do not think it needs the protection of a big brother, the regulator—particularly because that objective, combined with the one that Derek mentioned about protecting member benefits, leads to a focus on past service benefits at the expense of considering the future. Derek made the point quite eloquently: from a member perspective, it is the pension that savers get at the end of the day that is important to them.

Q27 **Steve McCabe:** We were talking about whether or not to change TPR's objectives. The other argument that is often used about constraining open defined benefit schemes is about the accountancy rules and the kind of restrictions that they may place on trustees, or even on the psychology of trustees at times. Would it be possible to change TPR's objectives with any meaningful effect unless we changed the accounting rules as well?

John Ralfe: Accounting and regulation, as a matter of history, go hand in hand. The accounting changed at about the same time as the regulation. I think they do go hand in hand: if you were starting from scratch you could have a system that had no meaningful accounting and no meaningful regulation, but what you would be doing is going back to the situation that we had 20 years ago, with people marching up and down Whitehall.

I worked with quite a lot of investors. When the accounting was opaque, they used to pay me quite a lot of money to work out what the accounting was—to work out what the real economic position was. It is the same with the credit rating agencies, Standard & Poor's and Moody's. This Committee does not have the power to tear up FRS 17, FRS 102, FAS 87 in the US, or IAS19. If you did, all you would be doing is creating a cottage industry for people who say, "We have these numbers. What



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are the numbers that we are interested in? We, as shareholders, are interested in the risk that the pension scheme poses to the viability of the company and the annual cost, if the scheme is open, of providing those pensions.” If there are deficits, I think the shareholders—and I am a shareholder in some companies—would want to know what the financial risks are that the company is running. Because I am interested in pensions, that would include the pension.

It is one of those things where even if you could do it, it would not achieve anything.

Steve McCabe: Fair enough. Does anybody take a contrary view?

Leah Evans: No. Perhaps I would just add that there has been an evolution of the international accounting standards. There are some specifics, both under IAS 19 and under the US GAAP, that sometimes stop companies doing what they would otherwise want to do with their pension scheme—more so with the US accounting standards than the international accounting standards. But on the whole, companies and trustees have got a lot better at looking through that, focusing on what the best thing to do for the pension scheme is, and then explaining to the market how that feeds through the accounting. Sometimes, to be quite honest, that does not make complete sense, but it is something that, if you can explain it, companies are getting more comfortable with.

The accounting is important. As John said, it is really important that investors, analysts and credit rating agencies have a picture of what the pension scheme can do to the company, but the accounting should not be a barrier to doing the right thing for the pension scheme.

Steve McCabe: Really the constraining factor, some might suggest—no, maybe I should just leave it there. I know we are tight for time.

Chair: Thank you very much. Nigel Mills?

Q28 **Nigel Mills:** There is quite a lot that we can have a go at here, isn't there? I sense that as a panel you have not quite got the optimistic, aggressive edge that some of the previous panellists had, and you are a bit more cautious about where we are and what we should do. What are your views on what we should do with the surpluses that now seem to be in the system? Should we have a change of approach and try to use them better, or should we just breathe a sigh of relief, get off the rollercoaster for a bit and just bank them?

Leah Evans: It depends on whose perspective you take. Companies and trustees probably, for the most part, want to get off the rollercoaster. The trustees' job is to protect the members' benefits. They don't have any remit or objective to generate more money than they need to pay members' benefits. That is what Derek has been talking about; that is the fundamental purpose of the pension scheme. Whether that is done within the scheme or through an insurer, that is their focus. Trustees would always be happy to provide additional benefits to members, but that is not their fundamental job.



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At the moment, companies have very, very little incentive to do anything other than try to make the pension scheme as little a problem as it can be. Assuming that they do not have ongoing accrual any more, for them the main focus is on reducing the risk on the cash, and the uncertainty over having suddenly to pay more money at the next valuation, having paid billions over the last decades, as well as the accounting implications. For them, if there is an opportunity to move it to an insurance company, say, without paying more money, that is often their preferred approach.

If we wanted to use surplus differently, some of the options include using it to pay DC contributions, for example. If that is an option, that is a great way of using surplus. There is also a consideration about whether you can use discretionary benefits or high inflation increases. Those are all good things, but it all comes with a risk. As I have said, there is a question about who picks up the risk, and there is very little appetite from companies to do that. If there is a desire to do something big with the surplus, we need to carefully think about who underwrites that risk.

John Ralfe: It is also fair to say—and I know that you can get lawyers to tell you what you want to hear—that there is only a surplus as far the trustees are concerned if there is an amount beyond buy-out. If there is enough to buy out, you buy out; if there is something left, it goes back to the company and the company does with it what it wants. That might be putting money into DC, it might be paying a dividend or it might be investing in the business.

There are a number of different ways of looking at it, but you only have a surplus once the fat lady has stopped singing: when you have actually bought out. Who does that surplus belong to? In terms of law and economics, it belongs to the company, because it has put the deficit contributions in. In some trust deeds, although I do not think I have ever come across one, there is a sharing with the members, and member benefits can be enhanced.

Mr Mills, you mentioned slightly more aggressive investment allocation. I said right at the beginning that if you want to encourage schemes that are in very significant surplus—not enough for buy-out but a lot better than IAS 19 or PPF—you do not have to change the PPF. If your goal is to get those trustees to invest more adventurously, aggressively or however you want to describe it, it is very, very simple.

This is not a theoretical thing; this is something that I did with a scheme a long time ago. In the end, they did not do it, for various reasons, but they were quite close to doing it. The idea was that you would obtain a bank guarantee from the bank to the company, which was taking all sorts of different credit risk—making loans, providing letters of credit and dealing in guarantees—and that would be a guarantee in favour of the defined benefit pension scheme. The numbers in that case were that the guarantee would be for £500 million; the buy-out deficit was about £400 million, as I recall, so there was a bit of a cushion.



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If the company goes bust, the guarantee is triggered. The bank then pays the section 75 buy-out deficit straight into the pension scheme and then makes a counterclaim under its counter-indemnity against the company, obviously paying a guarantee fee, so the pension scheme trustees can be entirely comfortable that whatever happens, they are covered.

You can do that, as a matter of fact. What does that do? It means that the trustees can then invest as adventurously as they like, and you are not messing around with the Pension Protection Fund. The idea of changing the Pension Protection Fund's remit so that you have two classes of pension schemes is completely unworkable, particularly because—as we heard in the first panel—we are only talking about a relatively small number of schemes: not 5,000 but, by the sound of it, a few dozen.

The clearing banks—the commercial banks, the American banks—would be absolutely delighted to provide those guarantees, so you can do it very easily without changing the Pension Protection Fund. There is a market solution, and you always choose the market solution if you can.

Martin Hunter: I have a couple of perspectives, thinking quite differently about closed pension schemes and open pension schemes. If you are looking at one individual closed pension scheme, I can absolutely understand why, based on the current regulations and the framework that you are operating within, a lot of those schemes are moving towards buy-out and transferring across to an insurance company. But we should recognise that from a broader, systemic perspective, there is very substantial risk associated with that. More than £1 trillion of assets, all moving towards six or eight insurance companies, a pretty limited number of reinsurance companies too, and all of those assets then being invested in a low-risk way—is that aligned with Government policy? Is that a good use of those funds? Are there better ways for those funds to be invested?

From a member perspective, is just getting absolute security of benefits the right thing to do or, for members with small pensions, are there alternative uses of that money? When the money is in the pension fund, it is effectively the member's money. It is deferred pay. Are there better outcomes there for the members of those closed schemes than just moving across to the insurance industry?

For open schemes, I come back to the point about whether it is a rollercoaster. Well, it should not be a rollercoaster for an open pension scheme. You should be taking a long time horizon. When you do a valuation every three years, it should be a planning exercise with relatively small adjustments because you are taking a long-term view. One of my major concerns about trying to shoehorn open schemes into a framework developed by the regulator principally to manage risk in closed schemes is that it creates short-term volatility and other issues, because there is an overriding assumption that even an open scheme would have to de-risk and get to a very cautious position over time, which is not what is expected to happen for an open pension scheme.



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Derek Benstead: It might be completely unrealistic to suggest that schemes that are very well funded could reopen to new members, admit more people and have more benefit accrual, but they perfectly reasonably could do so. If a scheme is very prudently funded, it is relatively easy to maintain that prudent funding while accruing new benefits.

You have to remember that, if we think of the best-estimate cost of pension benefits plus the prudent funding margin on top, when you pay out a pension you are paying the actual cost and you are leaving behind the prudent funding margin. You can add a new benefit accrual at the best-estimate cost, because as you pay out pensioners you are leaving behind the prudent funding margin, which becomes a prudent funding margin for new benefit accrual. It can and should be very affordable for a scheme that is very well funded already for past service to be open and accruing benefits for new members. It might be very unlikely that employers would make that decision in the current environment but, actuarially, in principle it is entirely possible.

Here at the Committee, surely the concern needs to be that there used to be 6 million people in private sector collective pension schemes, but there are now fewer than 1 million. That is a serious problem that the industry should be addressing. As lawmakers, so long as you are facilitating benefit accrual of pensions as opposed to investment pots in the private sector, that is your task.

Q29 **Nigel Mills:** We do have a very large amount of money in DB schemes that is not being invested particularly well in terms of growing the economy or generating half-decent returns. Should we change anything, or should we just let that sit in gilt and keep funding Government spending, which is very generous of them but may not be quite the right thing to do? What do we need to change now, that it looks like we are in a slightly healthier position, to try to get that investment allocation a little better used?

Martin Hunter: It is an excellent point, and it almost sounds to me like a rhetorical question. Absolutely: we should look at that and consider whether that is the best use of funds. As a previous panellist mentioned, the LCP proposal that Sir Steve Webb talked through is very interesting. It is really positive to see some attempt at innovation within the pensions industry—we don't get that very much. Now is an excellent time to be looking at those kinds of thing. As a few other panellists said, there is a bit of detail I would like to better understand with that kind of proposal, but that is an excellent thing to be looking at. Can we do something that protects the benefits that the members have, while also being of benefit to the UK economy?

It did not feel like the kind of proposal that would be looking at open schemes. It was very much thinking about the crème de la crème, as I think Sir Steve Webb described them: the larger closed pension schemes. But I absolutely think that a Government policy that facilitates and perhaps encourages that kind of innovation would be very, very valuable.



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Otherwise, we will just sleepwalk into this transfer of assets from the pensions industry into the insurance industry. I do not think that that is necessarily good for the UK economy or savers in pension schemes.

John Ralfe: It is worth saying that there was a very interesting letter from the chief executive of PIC in the *Financial Times* on Monday, pointing out that it has a lot of pension scheme assets that have been transferred. A big proportion of its portfolio—it did not say what percentage it was—is invested in infrastructure, in green technology and in local housing, for example.

There is this idea that money is going out of the real economy and somehow disappearing down a rathole, never to be seen, and at best you get it in gilts. The money is not disappearing down a rathole. It is being invested in gilts, so it is funding whatever it is that the Government want to spend money on. If that is no longer around, that itself has an impact. This idea that you just have this pot of money sitting there doing nothing, and that if you put it somewhere else we would have a much better world—I really do question that.

Leah Evans: It is worth looking at. As I said at the start, the great thing about funding levels having improved is that it gives us the opportunity to look at this. We do not have to worry quite so much about people losing their retirement income. We can take a step back and say, "Funding is okay and we have reached a stable level, but is this what we want to do?" It should be a conscious decision. Doing what we are doing now is a perfectly reasonable thing, but it should be a conscious decision.

If there is a Government desire to do more with pension assets, it is worth looking at how to do it. As John pointed out, transferring it to insurers is a way of doing it, because in some ways insurers are more able to take advantage of certain investment opportunities. Similarly, looking at the consolidation spectrum, whether that is super-funds or something else, and having a proper look at what innovative options are available is the right thing to do.

Within the fragmented market of schemes linked to specific sponsors, you would need to look at what is in it for the sponsor taking the risk. That might be around changing the tax rates or making it easier to access the surplus, which brings with it the question of what it means for member security. If you want to properly harness the opportunity of this money, it probably requires something bigger than just telling everyone to invest a bit more in infrastructure.

Q30 **Nigel Mills:** We are running out of time, but can I quickly ask you about TPR's new funding regime? Is it a good thing? Should we have a different regime for open schemes and closed regimes? Should it go ahead or be delayed?

Derek Benstead: If we wind the clock back to 2005, the introduction of the Pension Protection Fund made sure that DB schemes were no longer islands, but supported each other. The issue of member risk was



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fundamentally solved and dealt with by the introduction of the PPF. It therefore does not need solving and dealing with again with the long-term funding target regime, for example, or with all the risk-averse measures promoted by TPR or professional trustees or investment consultants everywhere.

If anybody has misgivings about the quality of protection and about the PPF, let's improve the PPF for everybody, not just for members who worked for better-off employers. Pre-1997 pension increases would be a case in point. I would say: rely on the PPF for member protection, and moderately and prudently fund schemes—within the statutory funding regime of 2005 we have the option to use discount rates that are not driven by gilt yields and that help trustees and actuaries plan schemes in a smooth, flexible way. We should make good use of that. I would amend the regulator's objectives, as already discussed, to introduce an explicit commitment to protecting future service, not just past service.

To come to your question about the long-term funding target, that feels like a mis-step to me. Although it is obviously true that most schemes are closed and most schemes are migrating towards the day that they wind up and ensure benefits, that does not mean that as lawmakers you should set up the framework that assumes schemes are in run-off and closure if the actual objective is to provide people working in the private sector with pensions. Either we provide them with defined benefit pensions that are fully guaranteed if an employer can manage it, or we provide them with a flexible defined benefit pension where we have some discretionary benefits on top of a defined benefit to make it easier for an employer to manage, or we can provide—as Royal Mail will hopefully show soon—a collectively invested DC pension that provides a pension out of a collective pool of assets. Those three things together need to grow.

Leah Evans: I have one specific point on the new funding code. I think direction of travel is fine. There are some specific points that we have raised in our consultation responses, including around open schemes.

From a practical perspective, one of the challenges we have had is the way this has come out, because of the timing. We had draft regulations from DWP. Then we had the draft code from TPR, based on the draft regulations, which we understand will still change based on changes in market conditions and consultation responses. What is really important for the industry is that the regulations and the code work together, and that there is an opportunity for the industry to see the combined draft regs and draft code and be able to comment on them, so that we do not run into an issue where TPR is forced to implement something that is not quite clear in the regs, even though the intention was something different. It is about the practical sequencing of making sure that the regulations and the code are right, so that TPR can then exercise appropriate flexibility in doing the right things for specific schemes.

Martin Hunter: To try to briefly answer your question, it is absolutely critical that we have a separate regime for open pension schemes that



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recognises the fundamental difference. John said earlier that he was surprised by how few open schemes there are left. I am not surprised. I have seen at first hand how incredibly difficult it has been for open schemes to survive for the last 20 years. This would go even further and make it very difficult for schemes to continue to survive, let alone thrive. That is a critical thing. It is a great time, with where the codes are and the regs are, for the Committee to look at this critical issue.

Q31 **Chair:** Our time is up, but there is one final point I want to raise. Martin, you raised concerns a few minutes ago about the prospect of lots of schemes ending up in a limited number of insurance companies. Do you think there is a potential systemic risk to the economy in that happening? Do any of you have concerns about that? Are there things that you think ought to be done to avoid systemic risk?

Leah Evans: I do not have concerns, as such—certainly not now—but it is certainly something that Government should be aware of and monitor. It is important that the PRA reflects that in its supervision of those life insurers, if we end up in a situation where a substantial part of the population's retirement income flows through a relatively small number of insurers.

Q32 **Chair:** Is that your general view?

The witnesses indicated assent.

Chair: That is extremely helpful. I am sorry we have been a little bit rushed to get through it all, but we are very grateful to you all for the information and the responses that you have given us this morning.