

Work and Pensions Committee

Oral evidence: Defined benefit pension schemes, HC 1218

Wednesday 6 September 2023

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Members present: Stephen Timms (Chair); Siobhan Baillie; Neil Coyle; David Linden; Steve McCabe; Nigel Mills; Selaine Saxby; Sir Desmond Swayne.

Questions 33-90

Witnesses

I: Yvonne Braun, Director of Policy, Long-Term Savings and Protection, ABI; Serkan Bektas, Head of Client Solutions Group, Insight Investment; Tracy Blackwell, CEO, Pension Insurance Corporation; Brian Denyer, Senior Solutions Director (Pensions), Abrdn.

II: Luke Webster, CEO, Pension Superfund; Adam Saron, Co-founder and former CEO, Clara-Pensions; Simon True, Chief Executive, Clara-Pensions.

Written evidence from witnesses:

[Association of British Insurers](#) (DBP0059)

[Pensions Insurance Corporation](#) (DBP0073)

[Insight Investment](#) (DBP0044)

[Abrdn](#) (DBP0047)

[Clara-Pensions](#) (DBP0051)

[Adam Saron](#) (DBP0069)

Examination of witnesses

Witnesses: Yvonne Braun, Serkan Bektas, Tracy Blackwell, and Brian Denyer.

Q33 **Chair:** Welcome, everybody, to this meeting of the Work and Pensions Select Committee and our inquiry on defined benefit pension schemes. A warm welcome to each of the witnesses joining us for panel one, and if each would please tell us very briefly who you are, starting with Brian Denyer.

Brian Denyer: Good morning, and thank you for having me here today. My name is Brian Denyer. I am a senior solutions director at Abrdn.

Serkan Bektas: Good morning, I am the head of client solutions group at Insight Investment. Insight is a UK-headquartered global asset manager, and we are among the largest asset managers in the UK defined benefit pension space.

Tracy Blackwell: I am the CEO of Pension Insurance Corporation. We are one of the largest providers of bulk annuity insurance for defined benefit pension schemes.

Yvonne Braun: I am director of policy for long-term savings at the ABI. I represent insurers and long-term savings providers to Government and regulators.

Q34 **Chair:** Thank you for joining us. First, do you think the Chancellor's Mansion House speech is going to change the investment role of defined benefit pension funds? Is their investment role different to life insurers? How do you think investment might be secured in the UK rather than going overseas, if there is to be an increase in productive investment? And should the former focus on addressing the risks of climate change, do you think, be maintained? That is four questions, but I would be very interested to hear the answers of each of you to those. Starting with Brian Denyer.

Brian Denyer: To the first question, yes, I do think the Mansion House announcements will change the way that schemes can invest. It has fuelled debate within the industry about offering pension schemes a choice around what their long-term funding target is.

At the moment within the DB pension industry we have most schemes moving on a pathway to insurance buy-out as soon as possible. This means they have been de-risking through time into an investment strategy, which at the point of buy-out will largely be gilts and investment-created credit. This means they have been reducing equity allocation and, to date, most pension schemes invest their equity allocation globally passively, which means even if it is a small equity allocation it is a much smaller investment in UK equities.

Because funding levels are much improved after the events of the last 18 months or so, given what has happened in gilt markets, we have



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schemes that are much closer to insurance buy-out than they were previously, which means that we are seeing much less investment in liquid assets, the assets that we need to be investing in for that transition into a net zero economy. That is where we are today.

I think Mansion House opens the debate around whether we can give schemes more choice. That choice might be, "Let's delay buy-out for a period of time, or maybe we run off indefinitely." I am sure we will come on to the reasons why that might be an appropriate thing to do. We even have superfunds potentially on the table, and they will have a different investment strategy within there.

However, if we have delayed insurance buy-out or if we have schemes running on for longer and potentially re-risking, we could increase that equity investment and we also lengthen investment time horizons, which means that liquidity requirements are less short term, and it could potentially fuel greater investment in the liquid assets.

Serkan Bektas: UK defined benefit pension schemes already play a key role in the investment economy and in productive finance, but we believe this role can be enhanced further. Pension scheme investments in gilts supported the UK through a period of heavy gilt issuance and pension schemes investments in bonds and other fixed income assets provide essential funding for corporates and the economy overall.

Having said that, we now have a once-in-a-generation opportunity to enhance this role. We support the three golden rules of the Mansion House speech and believe defined benefit pension schemes are extremely well placed to support those golden rules, subject to the establishment of the right framework.

Pension schemes now have surpluses and can pursue growth of those surpluses without putting the security of pension plan members at risk. That is the key to unlocking some of the opportunity that I would like to touch on.

First, it is important that as pension funds evolve they do not return to deficits. This requires them to continue to match liabilities and ensure member security is preserved. Then excess surpluses can be deployed to those growth investments and due to the size of the defined benefit pension industry these surpluses can be very material and have a very positive impact on the UK economy overall.

You asked about differences between pension funds and insurers. I am sure the panel will touch on this more broadly, but I would like to make a pro-defined benefit pension fund case because I believe pension funds have some unique advantages. First, they can access a broad investment universe beyond what is efficient in the insurance space and through that construct portfolios that diffuse their liabilities, cheaper than cost of buy-out. The resultant savings are of tangible value to members and corporate sponsors.



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Secondly, pension funds are uniquely placed to pursue surpluses for the benefit of their members. Buy-out transactions and other solutions tend to focus on contractual liabilities with limited scope to make payments beyond those contractual liabilities. If pension funds are able to successfully pursue surpluses, they can benefit defined benefit pension plan members, and they can benefit corporate sponsors, subject to the establishment of the right framework.

This framework, in our view, requires pension funds to be encouraged to revisit the benefits of running on. When timeframes are short the ability to invest for the long-term take risk will be adversely impacted. Pension funds that are running on will be able to support the Mansion House golden rules better than any other type of entity.

The DB funding codes should evolve to enable the co-existence of liability matching and the deployment of surpluses to growth assets. Pension plan members and corporate sponsors should have efficient access to the surpluses. There is a range of regulatory tax and other enhancements that we believe would unlock that potential.

Finally, I believe PPF has a role if PPF benefits can be increased and the PPF lifeboat role can become more relevant to the broad defined benefit pension industry.

Tracy Blackwell: In Mansion House, a lot of different types of pension schemes were talked about, and I think what we are talking about today are private sector DB schemes, in particular. Public sector DB schemes have a different role. But on the private sector side, I do not think it will encourage any other different types of investment in the DB space. It is different when it gets into the insurance space.

There is a completely logical reason for that. Ninety per cent of schemes are closed to new members and closed to future accruals. That means they have a fixed liability, which means it is entirely logical for them to match that fixed liability with fixed investments. That is what insurance companies have to do as well because that is in the best interests of the members and is for the safety and security of the members.

There are about 9.6 million DB scheme members. Of those, only about 786,000 are in open schemes. Those open schemes, of which 40% are USS and Railpen, already invest in these productive assets. So you can see that if this scheme is still open, they do invest in higher risk assets; it makes complete logical sense. But the closed schemes invest as they do because their liabilities are fixed. That is the right thing to do. That is how you safeguard member benefits.

When those fixed liabilities are passed to insurers through a buy-out process, that means we have the same types of needs to invest and match our long-dated liabilities that we know we need to pay to our pensioners but when it comes into insurance it does not mean it is not invested in productive assets. We, as PIC, and through our competitors who have done more, have invested over £11 billion in productive assets



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over the past 10 years, and throughout the industry even more. We funded things such as £3.6 billion in social housing, £3 billion in the UK's education sector and £1.5 billion invested in urban regeneration. For every £100 billion of liabilities that we take on, about 30% goes into productive assets.

Some examples. We funded housing for the London Borough of Newham, lending to the council where they are investing in the construction of 161 homes. We have supported the UK's Government Property Agency by investing £268 million in the Croydon hub, and that follows our £105 million investment in the GPA's Manchester hub. So there is productive investment going on. It is just not in the very high risk/high return end of productive investment. It is a different type of investment.

Your second question was about DB investment versus insurance investment. It is very similar, and it is similar because of the nature of the liabilities. That is exactly the right thing to do. Those incentives that were being talked about to invest and reopen schemes—schemes are never going to reopen. They are closed and many of them have been closed for quite a long time.

The corporate sponsors who should be talked to in all of this will have no desire to reopen the schemes and take that risk because they have had to pay over £200 billion into their schemes over the last 10 years. That is about 20% of their overall dividends. There is no incentive, surplus or not, for them to take more risk in that pension scheme. What they should be getting on to do is running their business and have insurers or pension funds run their schemes to completion.

Yvonne Braun: I want to build on that and bring the employer perspective in, so the perspective of the corporate sponsor. Quite a good example is the ABI's own defined benefit pension scheme, which is closed. It was set up in the 1980s, it was closed to new members in 1987. It was closed to new accruals in 2010. A month ago, we were delighted to be able to buy it out because it means, first, that we have security for all the members of that scheme and the buy-out rule is universally acknowledged as the gold standard and, secondly, it removes uncertainty from our own finances. Our business is not to run a pension scheme. We do very different things.

The same picture is repeated all across the country with employers who make engineering products or the service business or run supermarkets, or whatever. It is not in their interest, if they are in a position to now buy out that scheme, to re-risk it and run it for longer. Some may want to do that, absolutely. That is absolutely fine but broadly speaking it does not make a lot of sense.

As Tracy has already pointed out, the numbers speak for themselves because out of the almost 10 million people in private sector DB schemes only 800,000 are still accruing benefits and, of those, most are in Railpen and the USS.



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It is quite a different picture. We have to make a distinction between closed schemes, people largely retired, very close to retirement, and open schemes like USS and Railpen and LGPS. We constantly have new people joining the workforce where it makes a lot more sense to invest in that way, and you can see that in the investment profiles of those companies.

If I can briefly turn to the question about investment in the UK and how to make that more attractive, ultimately, the UK is in a global competition. There are many other jurisdictions who want investment. It is not the case that the UK is somehow an outlier in terms of not investing in the UK. The same trend can be observed in Australia, the Netherlands and many other countries.

Ultimately, if we want investment in the UK to be more attractive, we need to make the environment more attractive, and you can see that the Government have already tackled that, for example with the Edinburgh reforms, which also have a bearing on insurers, in particular around what insurers themselves can invest in, which will again free up proactive investment, but also in recent announcements around UK foreign direct investment. All of that will help make the UK a more attractive place for investment because we are competing with, for example, the US with the Inflation Reduction Act, and the EU on the Green Deal.

Tracy Blackwell: If I could just come on about the UK point, if you look at the open schemes that do invest in equities or high-risk assets and you look at the proportion that is invested in the UK it is very small, there is no guarantee that if suddenly schemes were to reopen and start investing they would invest in the UK because they currently do not.

Q35 **Nigel Mills:** Have we, maybe by the freak timing of the move away from DB, got ourselves into a nasty notspot, because if we have all our pension schemes still open, then the money that we are talking about would be being invested in long-term productive assets to try to get the return open schemes are doing? If we had managed to get them all to buy out so they did not exist, as you say, the insurance industry would be doing something similar with the money. I think, Tracy, you talked us through that.

Do we accidentally have nightmare scenarios where we have lots of closed schemes trying to get to buy-out but not quite there? They are just being incredibly cautious with their investment for understandable reasons. Do we need a policy response to say that is not a great position to have got ourselves into and we just need to get ourselves through this notspot quickly.

Yvonne Braun: May I rephrase that? It is a very good opportunity for UK plc because employers are now able to focus on what their core business is. The predictions for this decade are that by the end of it, 5 million members will have been bought out. That is very significant and that is a very good outcome for the people in those schemes.



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I would see it more as quite a positive confluence of factors. Five years ago we were worried about unfunded schemes and deficits. Now we are in this positive situation, and we are able to provide all of these people with security and can concentrate on the people who have the financial resilience problems, which are DC savers.

Q36 Nigel Mills: That was where I was going next because it is great that these 10 million people in DB schemes are now all going to be fine and they are generally going to get pretty good pensions, but we are going to have twice that many people currently at work not in the DB pension scheme who now—and I think one of our previous witnesses told us that what you used to have was like a transfer between the generations. For people who had already retired, their pension schemes are very healthy, and they effectively subsidise those who are now earning and that surplus got moved through the generations. Now that cannot happen, can it, because the surplus is locked in a closed DB scheme and effectively current employees are going to get a far worse pension?

It feels like we are investing it very cautiously, that it is not helping the economy and we are stuck. We cannot help people who are going to get a much worse pension in later generations. It feels we need to get out of this, doesn't it?

Tracy Blackwell: Over 20 or 30 years, legislation has moved us to a place where DB schemes are closed. I think we are right in the middle. You are right: we are right in the middle of this generational change where the system that has been built up over DB is now changing and moving to DC, where DC is the future, then LGPS, and so on; we should not forget about all of that as well.

A survey from Abrdn last year shows that 73% of pension funds are looking to go to buy out, so it is time and we are in this period of change. That is okay but it is bumpy along the way. The future is DC. You are right though, that the problem with DC is that contributions are not nearly what they were in the DB world, and that is a different question that needs to be addressed and fairly urgently.

Yvonne Braun: To illustrate that, the numbers in 2019 were that DB contributions from employers was 22%, and DC contributions from employers 3%.

Serkan Bektas: I believe that even closed defined benefit pension schemes have a key role to play and a better role to play going forward to address the points you rightly raised. While open pension schemes will have a longer time horizon to the extent they have memberships still accruing benefits, the key driver of investment strategy is time horizon and return requirements. Even closed pension schemes with surpluses will have plenty of scope to support their members and their corporate sponsors. They have the ability to support DC provision, in a way I will briefly touch on, and the economy overall.

You ask whether we should we be doing things to enable this. The answer is wholeheartedly yes. Investing in growth requires a reason to invest



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and take risk, and a time horizon to bear the potential volatility of those investments and ability to withstand downside. Defined benefit pension schemes, even closed defined benefit pension schemes, have all three in spades, but there are reasons why they are unable to fully leverage that.

They need to be given a good reason to pursue surpluses without endangering pension benefits. That is achievable because of the surpluses we have. They can lock the promises they made through secure portfolios. They can deploy their surpluses towards growth assets. They need a way to channel further surpluses to define benefit plan members through discretionary increases and to corporate sponsors. The corporate sponsors would use that funding partially or entirely to support their DC schemes. It would better enable corporate sponsors to back DC schemes.

Time horizon is a key issue though. Defined benefit pension schemes have liabilities spanning decades, but with an eye on buy-out, their time horizons are shorter because the moment they decide buy-out is what they need to pursue, they need to stabilise their funding position to make that possible. So a pension scheme with 40, 50, 60 years of liabilities would need to keep an eye on the one, two, three-year performance of their portfolios. That is why a key change that is needed is that trustees should be asked to revisit the benefits of running on for the long term so they can have the right time horizon to invest to support the objectives that you have outlined.

Brian Denyer: I agree that open schemes are definitely, by their nature and their longer time horizon, able to take more risk than closed schemes. Having said that, we should definitely look to see whether we can provide these closed schemes with a choice. Most of them, even given that choice, will probably still want to go to buy-out. We definitely acknowledge that. It will be the right thing to do from the employer and the trustees' perspective for many of those schemes.

Quite often we speak to our clients and sometimes while we think the motivation for insurance buy out is, "I just want to get this pension scheme off my balance sheet," an equal motivation is, "I am sick and tired of the hassle of dealing with this pension scheme. I am investing lots of time and money and resource in terms of managing it and this is disproportionate and it is taking me away from running my business."

Having said that, there will still be some schemes that we believe would be interested in having this choice. If we give them that choice, then the right incentives need to be there. Who ultimately will decide whether it is the right thing to do? It will be the trustees and the employer. Why would the trustees want to do this? Serkan mentioned discretionary increases.

Over the last two years, accumulative increase in CPI has been 17.6%. Many increases to DB pensions and payment will have been linked to CPI but capped at 2.5%. Some will have nil increases, some will have 5% caps. Let's pick the middle. Those particular members will have had a 12% reduction in the real value of their pension over the last two years. If a trustee is given the option to run that scheme on for slightly longer,



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grow a surplus with an objective to use some of that surplus to reinstate part of the real value of the pension that that member has lost, then it is worthy of serious consideration.

- Q37 **Nigel Mills:** Finally, you are all happy that this present benign funding position is real because for some people—you think a year ago we had a massive shock, pension schemes in crisis, inflation shooting up, but all of a sudden pension schemes have come out of it smelling of roses and the problem we have been worrying about for 20 years has all magically gone away. Let us all go down to the casino and spend our bonus.

Are we not slightly worried that maybe we have seen some quirky actuarial sweet spot and perhaps we should not give all this money away because it might all reverse a bit in a couple of years, and we will wish we had not been quite so radical?

Serkan Bektas: You are absolutely right that if we observe where we are and allow that to encourage us to be imprudent, there is every risk of going back to deficits and the issues that created for trustees, plan members and corporate sponsors. Having said that, the improvements are not illusory because UK pension schemes manage risk very well. Risk management discipline and governance around risk management improved appreciably over the last two decades and a lot of the improvements, as a result, are locked in. They should be locked into a greater extent.

We should not look at pension schemes that are 120% funded and expect them to go into equities with the majority of that portfolio. That would introduce risk. But if those pension funds back their liabilities using high and maximum grade assets, gilts and other types of assets that match their liabilities to the tune of 100%, then I can look you in the eye and say, "Pension schemes are secure going forward" because the risk-taking is with the surplus, with governance, separate governance and controls around that, such that risk taking with a surplus, excess surplus, cannot impair their ability to back their pensions. That is essential to this debate. We should not allow pension funds' funding positions to decline to where they were but that is achievable. The tools are available to pension funds.

- Q38 **Sir Desmond Swayne:** Does the proposed DB funding code sit entirely comfortably with Mansion House? If we were to revise the code in the light of experience over recent years, what would you change?

Yvonne Braun: How the funding code has been generally interpreted is that trustees should seek to secure the benefits of the members with a hint towards buy-out. We certainly think that it makes sense to distinguish in the funding code between closed schemes and open schemes for the reasons we were talking about earlier, because the time horizons are a completely different affair, and because indeed in these schemes the time horizon is finite and it makes a lot more sense to look at it in a different way. But for open schemes, if you have constantly new people coming into the scheme, it should look very different.



Serkan Bektas: The funding code is no longer the ideal structure for the circumstances of the pension funds as they are, but I understand why we are where we are. It is because for the last two decades our eye has been on deficits, protecting members and protecting corporate sponsors from unexpected calls.

What has changed is that rather than focusing on deficits, we now have a regime where pension schemes are very comfortably funded. There are lots of measures. For example, if you look at the data from PPF, on a PPF basis they estimate pension schemes are funded to 146%. On stronger bases, we will again see surpluses.

The key area where the funding code needs to evolve is where it needs to permit the co-existence of liability matching and pursuit of growth. Currently, the funding code looks at low dependency portfolios and solutions where the emphasis is on matching liabilities. That made sense in the circumstances or deficits. It now needs to be a broader universe.

Another factor, by virtue of the points I made earlier, is that buy-out being the sole objective or the main objective should be debated. Buy-out is a very valuable tool and should be pursued, but even for pension funds that want to pursue it, it will take some time for the industry to digest. Pension schemes need longer time horizons and, as a result, running on should be emphasised further in the guidance that is provided to pension schemes.

Brian Denyer: It is perhaps not surprising that Mansion House and the funding code are pulling schemes in different directions. Mansion House is looking to re-risk investment strategies. The funding code is looking to lock down investment risk, secure member benefits—benefits on that pathway to buy-out.

I do think they can co-exist though. As Serkan said, I believe that the funding code needs extending again. It is about your objective. If you are on a pathway to buy-out or low dependency, the funding code works. Some slight tweaks need to be made around giving schemes some more flexibility in terms of what they invest in and perhaps that looks to be up to the draft regulations. However, the key development would be that if we have a minority of schemes that want to look to run on for longer and maybe grow a surplus, there absolutely needs to be some guidance provided by the regulator to trustees to give them the factors that they need to consider when they would accept such a proposal.

Q39 **Steve McCabe:** I want to ask a bit more about buy-out. LCP said recently that 2023 was going to be a record year for buy-out, yet at the same time we are told that there is not enough capacity in the market to meet the increased demand. How much of a problem do you think the supply and demand issue is at the moment. I see Tracy nodding, so I will start with Tracy.

Tracy Blackwell: There are no capacity issues in the buy-out market. There may be quite a lot of people talking about it for very different



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reasons but there are no capacity issues, nor do we expect there to be. Our employee base has doubled over the last three years, we have no shortage of staff to be able to deal with it and we are not aware of any pension scheme that has not been able to get a quote for a bulk annuity scheme in the recent past.

One insurer recently reported completing 35 transactions for schemes of less than £500 million in the first half of the year, of which 22 had liabilities of less than £10 million, so there is a completely orderly transaction going on from DB pensions into buy-out and we do not foresee any difficulties at all.

Q40 Steve McCabe: When you say that, are you talking from the perspective of your company or do you think that that is widespread? Because certainly a different impression has been conveyed, that there is a problem in the market about supply and demand.

Yvonne Braun: I am very happy to talk to that. At the moment, eight insurers are active in this market and a ninth one has announced that it will enter into the market this year. The biggest transaction this year was for £6.5 billion, the smallest for £600,000, so schemes of all sizes can transaction. Therefore, we do not think that there is a capacity issue. Of course, it is an ecosystem that also involves advisers and there is quite a lot of work involved, often, to do data cleansing and so on, but that is the case in any form of endgame.

Q41 Steve McCabe: Some folks suggest that there is a shortage of people and that it is now quite a labour-intensive exercise to provide quotes and to provide viable quotes, but you are not aware that there is any shortage of people to work in the industry at the moment?

Yvonne Braun: No.

Q42 Steve McCabe: Okay, that is fine. In terms of the kind of expansion that we are expecting, Charlotte Gerken said that she wanted to see moderation in the growth. Is that likely to happen? Are we in for a bit of a free for all now or is there going to be some more smoothing out and a more moderate pace of development?

Yvonne Braun: This is a very, very heavily regulated sector. The industry will take very careful note of what the PRA says. To pick up specifically on the funded reinsurance issue, the PRA has looked at that and said that that is of very limited concern to them if it is used in a diversified portfolio. It has also said that it will look at risk management practices in buy-out insurers this year. Obviously our sector will work very closely with the PRA on that and whatever recommendations come out of it, it will of course implement. It is worth saying that some of the other variations of endgame would be far less well regulated, so I am not worried about this part of the market.

Q43 Steve McCabe: Eight or nine companies does sound to me like they have quite a stranglehold on an emerging market.



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Yvonne Braun: Very briefly, on this point about do we want eight or nine, the Government also want scale and consolidation.

Tracy Blackwell: On scale and consolidation, the PRA is a very robust regulator. It wants to make sure that we as insurers have enough capital but also have the right people and resources. We and our competitors have taken the best part of a decade in building up the teams, the systems, the resources to be able to invest in productive assets. You need scale and time to be able to do that. We have all spent a lot of time, effort and resources on being able to do that. We have robust risk management systems and processes to make sure that it is not a free for all and that we are not investing in things we should not be investing in, to safeguard the members' benefits.

Q44 **Steve McCabe:** Brian, it is quite a rosy picture that I am hearing here, but it was your company that said that the market was not functioning well for small and medium-sized funds and that some of them were not getting a very good deal at all. Do you stand by that? If that is the case, what do you think they have to do to get a better deal?

Brian Denyer: We definitely have anecdotal evidence from speaking to our clients and others in the industry that there is a supply and demand imbalance in the buy-out market and that capacity constraint is being more keenly felt by the smaller schemes. While those smaller schemes may receive a quote, generally speaking—we are not talking tiny schemes here; this could be schemes of up to £100,000, potentially, of assets, or greater than that—in order to receive a quote, quite often the way that the insurance market is working at the moment is that they will have to go on an exclusive basis with one provider. They will receive one quote and then they need to decide whether that is good value. Is it good value because you can afford it, or is it good value because it is competitive? Again, that is up to the employer and the trustees to decide that.

To your second point, is there a solution to that if that issue is being more keen felt by smaller schemes—the reason that it is smaller schemes that may need to go exclusive is because it is a lot of work for an insurer to provide an insurance quote so it takes a finite amount of resource. It is proportionate, but it is not that twice as many assets means twice as much work. Therefore, consolidation solutions, where we bring those small schemes together before buy-out, can help reduce the amount of work on the insurer's side and reduce that frictional cost of insurance.

Tracy Blackwell: If I may, because I am the one who runs a company that does this sort of thing, there is no difference in the process between a very small scheme and the very large scheme. The very large schemes might be more time-intensive just because they are more complex. There is no difference in how we treat a small scheme versus a large scheme.

I should also note that a lot of people in the industry, including us, are working on solutions where we can streamline the process for small schemes, so it does not have to be quite as intensive, time intensive and



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cost intensive for them, because they have to be able to pay advisers and everything else to do this, so it makes it much easier for them. Therefore, I would let the private sector work out solutions before implementing something like a public sector consolidator, because it is happening and so far it has been very efficient.

Q45 Steve McCabe: When I read that some of the smaller schemes can only find an insurer on the condition of exclusivity at an early stage, what do you understand that to mean?

Brian Denyer: Can I just clarify an earlier point because it has been slightly misinterpreted? When I talked about consolidation being able to provide that solution, I was not talking about public sector consolidation; I was talking about private sector consolidation that does not break covenant prior to the transition into insurance buy-out.

Q46 Steve McCabe: I was trying to understand the issue about smaller schemes only being made an offer if they engage in exclusivity at an early stage. I presume that means that they have to give all the business and opportunities to a particular company. Is that what you are referring to?

Tracy Blackwell: No, it is not all the business. What tends to happen is that because some of these things are complex, we will work with a scheme for some time to see if we can reach an agreement. If we cannot, the scheme is free to go to the rest of the market to get quotes. Sometimes that does happen.

Q47 Steve McCabe: Serkan, I have not come to you yet, but I hope you realise that I was trying to tease out my understanding of what is going on. Is this a good thing that we are witnessing? I am not saying that it is all bad, but are there warning signals about this booming market?

Serkan Bektas: The good thing about where we are is that we are approaching all of these issues from a position of strength. I defer to Tracy and Yvonne's expertise but in a market economy, any capacity constraints will get sorted. I think that there is a strong rationale for insurers to invest in their resources and infrastructure and address capacity issues. Fundamentally the problem we have is that we have a £1.4 trillion industry trying to walk through a door called buy-out. That door might be narrow, and it might be wide. It might change depending on the circumstances of different pension schemes. The key is that the industry believes that it needs to walk through that door and that should be its focus.

If a pension scheme can construct backing for their liabilities of 10% or 15%—we can debate the number but at a meaningfully different price point—should they disregard that? To us, pension schemes should pursue buy-out if their circumstances warrant it, but they should explicitly, deliberately consider the implications, cost implications, member-benefit implications and corporate sponsor benefits that might arise when we are looking at these problems from a position of surplus. That surplus can be deployed in a multitude of ways. It can be to pay a buy-out premium.



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There are some very valid reasons for it, but that surplus can be used differently towards broader aims as well, and we think that that is the real opportunity.

- Q48 **David Linden:** This week marks a year since Liz Truss became Prime Minister and we all remember the LDI episode, so I want to probe down a little bit further and probe on the potential for financial stability risks if too many schemes target buy-out at the same time. Mr Bektas, in your evidence—I refer you to page 3—you said, “A wide-scale transfer of DB scheme assets and liabilities to the global insurance sector could lead to: increased systemic risk to the UK financial system through concentrated exposure to the insurance sector”. You go on to say that “increased reliance on the UK’s Financial Services Compensation Scheme...potentially” leads to “a greater burden on the taxpayer.” Can you expand on that a bit further for me, please?

Serkan Bektas: We talked about upside; let’s talk about downside. When things go wrong, what layers of protection are available? For a defined benefit pension scheme, the layers of protection are as follows. First is their surplus. They should invest so that surplus does not erode but it is there in case it is necessary. Second is their corporate sponsor. Their corporate sponsor backs the pension scheme, has done so for decades, and helps pension schemes reach the healthy funding position they are in. Third is PPF, and the protection that PPF offers in its capacity as the lifeboat.

We believe that the surpluses alone will be very valuable and that the diversified backing of the UK corporates, thousands of them, is very robust protection. PPF is already there and we think that PPF can play a better role. If we compare that to the insurance industry, there are a smaller number of providers. As a result, an event impacting an insurance provider can be material. There is a high degree of prudence, robust regulation and those events are not very likely, but should they happen, they will be larger events. Quite simply the maths is that one insurer will be a larger proportion of the bulk annuity market than a pension fund will ever be in the pension industry.

Looking at the Financial Services Compensation Scheme, there is a misconception that it translates to a guarantee. It is a scheme that is funded by the industry overall. It can very ably deal with lots of issues, but a systemic issue across portfolios that might be similar might well be beyond the ability of the Financial Services Compensation Scheme. I do not wish to scaremonger—I think pension schemes and pension funds are well managed and they are very aware of these downside risks—but there is a difference, and that difference should be expressed explicitly. In my view pension schemes have a very robust structure around risk management and that can continue to be relied on for the benefit of members and the economy overall.

- Q49 **David Linden:** I take your point and I would agree. To the wider panel, when it comes to managing that systemic risk, do you feel that the UK has learnt the lessons of the LDI episode?



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Brian Denyer: The systemic risk that crystallised during the LDI episode was caused by leveraged gilt holdings. Due to the fall in price of gilts there were collateral calls on that leverage and schemes that invested primarily in pooled LDI funds were unable to provide that collateral, which resulted in forced selling of gilts.

Since then we have had a reduction in the level or leverage across the board of LDI funds, and we have increased stressed capacity, so gilt markets need to move by a much greater amount than they did previously before any collateral would be called. That has reduced the likelihood and the impact of that risk again. I do not think that it has gone completely. As long as we retain leverage within LDI funds, that risk will always exist.

In the context of the transition from 5,000 schemes to insurers, clearly there is a concentration from 5,000 to eight or nine insurers, but we will also have a deleveraging of investments from leveraged gilts into the types of investments that insurers hold. There is a mix, and maybe my fellow panellists can talk more about the insurance side of things, but you are looking at a large gilt and investment-created credit holding, primarily investment-created credit more than gilt. Therefore, we have that deleveraging piece. That does bring into play another risk, which is further default risk on the underlying credit. However, you have that balance. If you think about diversification, then that transition into the insurance industry brings a level of diversification until the balance tips too far the other way.

Tracy Blackwell: I think of it as two different issues. There is a question of concentration in the insurance sector and that being under the purview of the PRA, which is responsible for financial stability. Insurers have to hold a large amount of capital; we are very robustly regulated. I talked about 100% FCS protection for policyholders. It is a very, very robust regime that is admired around the world.

The LDI issue is slightly different. That was a problem of different actors in the financial sector being regulated by different regulators and perhaps not as much co-ordination going on there as one might expect. We as insurers have exactly the same exposures as the pension funds. We have to hedge our long-term interest rate exposure and we were of course affected and had to post collateral for that risk. However, we are very well regulated on that; we perform stress tests on liquidity all the time. It is something that we are required to do, and we would do it anyway, but there were no problems in the insurance sector.

The bigger problem with the LDI issue is that with different regulators looking at different bits of the market it was very hard to co-ordinate and see what the problems were, whereas as we move more pension funds into insurance it is very clear for the PRA to understand from a financial stability perspective what is going on.

Serkan Bektas: The pension industry, asset management industry and the regulatory framework have evolved significantly since the crisis. I



would like to touch on the point that Tracy made about the need for greater co-ordination, which has happened very rapidly and is happening. We received very clear guidance and coherent guidance from different regulators shortly after the financial crisis. Over the last year that guidance became even more streamlined. Currently, for example, we report the profile of the portfolios that we manage. The FCA and the pensions regulator and in the context of our funds the Central Bank of Ireland receive the same information and that co-ordination and co-operation we think is very, very important. Indeed, about two weeks ago market levels were not far from what we observed about a year ago. The resilience of the industry is such that that was not a stress event at all. It was managed without any concern, with significant residual buffers even from that point. Tail risk cannot be eliminated, cannot be ignored and needs to be managed but leverage levels are lower, portfolios have been calibrated for far greater stress and the regulators are engaging very effectively with the industry.

Q50 David Linden: To confirm that, the view of the panel that I am getting is that there is evidence to suggest that the regulators are working more closely together to identify those emerging risks so we will not be back to saying, "Oh, the regulators could have done more," in a couple of years' time. Is that right?

Yvonne Braun: Yes, and to amplify that, the Bank of England is also doing an exploratory scenario of financial stress tests right across the piece. It is going to be looking at not just DB schemes and insurers and DC schemes, but it is also going to be looking at banks and asset managers. It will be very, very useful because it will show how in a stress situation or in various different stress situations different actions of different actors in the system might influence problems. That should be published in 2024.

Q51 Selaine Saxby: Do you expect to see a significant number of well-funded schemes run on rather than enter buy-out? What would be driving that and what issues does that raise for policymakers?

Tracy Blackwell: A number of schemes have said that they would like to run on, and that is absolutely fine. They still have the issue of having a fixed liability, and at some point we tend to see that as corporate sponsors change and it is no longer an employment benefit, the appetite of the corporate sponsor to have the scheme keep running on diminishes over time, especially if there is a corporate event—M&A or something—where they need to do something with the pension fund. However, absolutely a number of schemes want to run on and that is fine. However, it is not the just about the trustees; there is also the pension sponsor in this and sometimes that gets forgotten.

Serkan Bektas: A significant number of pension funds have to run on if for no reason other than the capacity reason that we talked about, as they go through this process and the insurance industry takes it on. However, we believe that run-on is a more attractive solution for a larger proportion of the pension schemes, and the framework needs to evolve to



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make that achievable. Currently trustees and corporate sponsors are used to pension schemes being an issue for them—a burden, a restriction. Pension schemes have surpluses; they are now an asset. If pension scheme trustees are given the ability to efficiently channel surpluses to enhance member benefits, if corporate sponsors that back these schemes for decades can efficiently receive excess surpluses, subject to guidelines, so that they can fund DC, or take surpluses that they contributed to in the first place, there will be a far better framework for pension schemes to run on and benefit from those surpluses. It will benefit members, corporates and the economy overall. We think that it requires greater emphasis.

Brian Denyer: There need to be incentives on both sides. We have talked about trustees and Serkan outlined some of the incentives that might be there for the employer. That does need to be backed by new regulatory guidance to give trustees the comfort that they are doing the right thing. We need to tread carefully.

Yvonne Braun: Treading carefully is important here because it will all depend on how you define the level at which trustees can be comfortable doing something with a surplus or employers can do something with a surplus. If that is below buy-out level, the trustees will need to have a lot of confidence in the ability of the employer and the willingness of the employer to continue to sponsor the scheme. A lot of it will be about how exactly you define it.

Serkan Bektas: We agree. There need to be safeguards, portfolios need to be resilient and only the excess surplus should be available. Otherwise we go back to problem days of deficits potentially arising. It requires careful guidance, but we think that it is eminently possible to arrive there because of where we are.

Q52 **Selaine Saxby:** If it was easy to extract a surplus, do you think that that would result in more investment into productive finance?

Serkan Bektas: Certainly. Right now, pension schemes are focused on protecting member benefits, rightly, but they do not have as much of an incentive to grow surpluses, because the ability to benefit from those surpluses is less certain and there are obstacles on the way. Those obstacles should be addressed.

Tracy Blackwell: I just do not agree. Pension schemes for the employer are a benefit when they are an employee incentive. Because these schemes are closed, they are no longer employee incentives. Once they are no longer employee incentives, there is no incentive, surplus or not, for the corporate to do anything. The corporate can borrow on its balance sheet if it wants to do something like that, it does not necessarily need to take the surplus out of the pension fund and everything that goes around that to be able to do it.

Q53 **Selaine Saxby:** Might a different and simpler approach be to change the DB funding code to enable trustees to take more investment risk?



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Serkan Bektas: We think that that is a factor. The funding code should evolve to enable the coexistence of liability matching portfolios for security and growth portfolios where there are surpluses so that those surpluses can be invested. I agree entirely with you. An evolution for the funding code is a necessity.

Brian Denyer: I do not think that changing the funding code in isolation will be enough, because there still needs to be a reason for the employer to agree to it. A funding code might give a reason for why the trustees might want to run on for longer, perhaps, grow on a surplus, award discretionary increases but the employer is not going to agree to that unless there is a reason for them to. Then we come back to the question of can they extract prior to buy-out and what use is that surplus put to.

Q54 **Siobhan Baillie:** Before I go to my question on the excess surplus, Serkan, you did not argue for a change in the tax rate. It is about 35% for a return. Do you argue for a reduction in that as part of incentivisation to change the current approach?

Serkan Bektas: Thank you, I do. I referenced obstacles around the surpluses being put to use to enhance member benefits or for corporates to be able to benefit from them and taxation is a factor. Corporates get tax deductions when they contribute into the pension schemes. As a result we are not suggesting that there should not be taxation, but there should not be punitive taxation as long as safeguards are met and the amount of surplus being extracted to put towards defined contribution or to put towards the corporate's own use is calibrated correctly.

Siobhan Baillie: You were nodding, Yvonne.

Yvonne Braun: The divergence between the tax rate on contributions is essentially 25% and extracting surplus at 35% seems probably no longer right.

Q55 **Siobhan Baillie:** Sorry, I was straying into my colleague's questions. Thinking about the Pension Protection Fund—PPF—there have been arguments about allowing well-funded schemes to pay an increased levy to have a 100% protection rather than the current 90% to 95%. Do you think that that would be effective in increasing the investment for productive finances? I am also interested in your views on the potential and intended consequences of such a change because I noted in our preparation that a gentleman called Joe Dabrowski of the PLSA said that that the proposal raised more questions than answers.

Yvonne Braun: Funnily enough, that is exactly what I had written down for myself, that it raises a lot of questions, and more questions than it provides answers for. You would need to think quite carefully about what that increased levy should be to compensate the PPF for taking on this additional risk and how you deal with a situation where the scheme is already in deficit. If a scheme is in deficit, then by definition the PPF will not receive the assets that are sufficient to pay out the benefits of the scheme members. Of course they could invest that more aggressively but that might go well or it might not. If it does not, who bears that



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additional risk? Is that the original PPF scheme or do the Government want to underwrite that? The Tony Blair Institute proposal of just sweeping the smallest 4,500 schemes into the PPF seems to suggest that there are quite a lot of them that are not funded to pay out all of their liabilities, that somehow somebody somewhere will accept that risk and write the cheque when it comes to it. It is not clear to us who that is going to be.

Tracy Blackwell: And it should not be the taxpayer, I think. The link that everyone is making, which I do not quite understand, is that if you do this with the PPF, it will invest more in productive assets. The PPF, because the nature of those liabilities are fixed, does not invest that much in productive assets—about 6% in equity and about 6% in private equity, so even now it does not invest an enormous amount.

It comes back to this: it is because of the nature of the liabilities and the fixed nature of those liabilities rather than any other incentives along the way that channels the investment behaviour. I cannot see why it would change from where it is now. The PPF does a great job of doing what it is supposed to do, which is being the backstop for these pension schemes where the employer has failed, but from a productive investment standpoint I cannot see why that would change the nature of their investment.

Q56 **Chair:** Can I come in there? The argument is not that the PPF would do more investment in productive finance; I think it is that the scheme would be liberated by this reassurance for 100% of benefits for members and it felt that it would be able to investment more.

Siobhan Baillie: That was my understanding. There is obviously a cost and there is a very real life impact, but it is almost a symbolic change to change the mental comfort zone for the trustees, to give them a behaviour change.

Tracy Blackwell: It comes back to what we talked about before. The way that they invest is not about behaviour; it is about the logical conclusion of the fact that their pension schemes are closed, have been closed for some time, are not an employer incentive and there is no reason for them to do it.

Serkan Bektas: I will slightly disagree, in the interests of supporting our discussion. There is a discussion about a potential PPF role as a consolidator. I will put that to one side and I will come to your question relating to PPF's role as a lifeboat. If we look at data published by PPF, the PPF 7800 index, in March 2006, around the time of PPF's creation, the aggregate pension scheme industry was in deficit relevant to the PPF basis. When we look at data as at the end of July, the pension industry is 146% funded, according to PPF's data. PPF had a safety net right around where the pension schemes were. Right now the safety net is well below the asset value.



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There are technical differences. I can be challenged on the details of this but fundamentally pension schemes' funding raced ahead and the protection that PPF offers has not. As a result, 90% of pension funds are overfunded on the basis that I am describing. That creates a real possibility that if a pension scheme's corporate sponsor is in difficulty, the pension scheme will likely to be better outside PPF than in PPF. To me that makes a very clear case that PPF's role as a lifeboat needs to be strengthened. Should it 100%? Should it be a different number? These are all very helpful discussions. We think that even 100% should be affordable, because if you look at the risk that PPF took at the time of its creation to underwrite pension schemes relative to asset values, we can get a lot closer to asset values without finding ourselves in a situation where PPF is exposed to greater risk.

This is helpful in pension schemes thinking of their investment strategy. Going to Tracy's clarification, what this does, as pension schemes think about how to invest—we talked about unlocking the benefits, or the upside. There is a similar point about giving them peace of mind about downside. They do not need a lot of peace of mind because they have surpluses, they have corporate sponsors, but PPF's lifeboat role being stronger will support their ability to take greater investment risk with their surpluses.

The way that I marry this argument with the points that Tracy made earlier is that we are not suggesting that pension schemes should go and invest in growth assets in a way that endangers their ability to back their benefits. They should back their benefits and then focus on the surpluses. PPF's lifeboat's role being strengthened role will support that.

Brian Denyer: The latest annual report of the PPF says that it is 156% funded, with a £12 billion surplus. If the PPF is to provide protection against full-member benefits, that is the tick in the box for why a should trustee agree to this. They have done their job to some extent, and they have managed to secure the benefits. There are a lot of operational issues that would need to be thought through because it is a whole new benefit scale times the number of schemes that ultimately would go into the PPF that the PPF would then need to operate.

The other thing is that the PPF has worked because it is an insurance fund. Its insurance is all about the law of large numbers and there are 5,000 schemes currently in the UK. What has been proposed is that this solution will be available only to the largest, best-funded schemes in the country, so you are concentrating risk on an insolvency event of one of the employers of those schemes. If this solution were to work, I would like to see a solution that extended the idea to all schemes not just the largest, most well-funded.

Q57 **Siobhan Baillie:** Would that require an increased levy for all schemes?

Brian Denyer: You would have to make it opt in or opt out.



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Serkan Bektas: The point you made earlier about Joe Dabrowski's comments and the need essentially for moral hazard to be understood and managed is very important. In arguing for PPF benefits to be strengthened, I would like to also clarify that that should be subject to a number of tests, including resilience of the portfolios being managed. PPF should not underwrite any risk. Pension schemes should demonstrate that they have resilient portfolios to back their liabilities, that their potential need for reliance on PPF is likely to be minimal in that scenario and that they should be held to that standard. PPF should be protected while this enhancement is considered as well.

Q58 **Siobhan Baillie:** The LDI question I was going to ask was addressed earlier, but I can ask it anyway. In our LDI inquiry we heard that accounting rules made sponsoring employers want to get LDI off the books. To what extent is that still the experience and issue on the ground or has "brand LDI" recovered?

Serkan Bektas: We believe that the fundamental profile of pension liabilities draw how pension funds manage their portfolios. Accounting rules were a factor but in our view not a primary factor. If you have a defined liability profile and if you wanted to manage risk around it, you would do the kinds of things that pension schemes did. We do not believe that accounting was a driver of the behaviour, at least not a primary driver; it could have been a factor.

As we speak to corporate sponsors now, we see some of them—I believe a minority but still some of them—take the view that they want to keep their pension funds and they want to run on because of their view around how they want to look after members, because of the view that a pension scheme with a surplus can be an asset and it is an asset that they have funded. Over the last two decades, all the funding pressures that they felt resulted in these surpluses. I think that it is right that they want to benefit from the surpluses and protect—

Siobhan Baillie: The spotlight being placed on it has allowed another look at what is happening.

Serkan Bektas: Correct.

Q59 **Nigel Mills:** If we were sat here a couple of years ago, we would probably have been talking about whether pension consolidators were a solution to try to clear up the long tail of thousands of very small pension schemes, what we could do with ones with small deficits and what on earth we did with ones with much larger deficits. It feels as if that discussion as gone away because perhaps the problem is not quite the same. Do we still see a role for consolidators now that things are in a far better place? Is this a good time for trustees to look at exiting via a consolidator rather than via an insurance buy-out?

Brian Denyer: I will go first because I am going to answer that question in a wider form of consolidation. When we talk about consolidation, we naturally go to superfunds. It is an alternative to insurance buy-out and it



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severs the employer covenant. Maybe they will look to buy out at a later point, maybe they will not.

However, we also have other forms of consolidation. I am involved with a defined benefit pensions master trust, for example. They still have a very real and valuable role to play in the sense that they take the hassle factor away from the employers, and they can be comfortable—for the small to medium-sized pension schemes where that form of consolidation would be appropriate—that they provide an increase, on average, in the standard of governance. That includes investment governance and that was a key aspect of what led to the LDI crisis last year. Consolidation is definitely something that is still on the table.

It also potentially provides a solution for those types of schemes to some of the things that we have talked about today. It should make accessing the insurance market easier for some of those types of schemes. Potentially you could look at commoditising some investment pathways within those types of structures that look at maybe growing a surplus that look at investing in the types of productive finance that we have talked about, or move towards buy-out.

Nigel Mills: I thought you might be in favour.

Serkan Bektas: We are in favour of efficiency improvements and governance improvements, and we think consolidation has a role to play in the broad sense of consolidation that Brian touched on. If that enables pension schemes to reduce their costs, run themselves better, and access a broader range of investments where scale might be a factor, then those are all positive and we would support it. However, we believe that pension schemes should have choice. Private market solutions should be made available to them, they should assess their circumstances and decide whether they should run on as they are. These are private assets; members are private individuals. Corporate sponsors have funded these schemes, and they should not be compelled down one route or another; they should have the choice to assess what they need to do themselves.

There should also be safeguards. For some of the consolidation solutions I am aware there are comparisons to insurance, and it needs to be secure. These need to be long-term vehicles where there should be no doubt about their viability in the long run, and the necessary safeguards should be there.

Q60 **Nigel Mills:** It must be five or six years since consolidation came around. As a Committee we looked at it and there was that concern about whether this was, "Let's have all the advantages of buy-out without playing that pesky price, and we could play some kind of regulatory arbitrage and it would all be fine. What could possibly go wrong?" We are in the habit of finding out what could possibly go wrong. Have we managed to resolve that problem now so we cannot let a bit of actuarial gymnastics get us in a mess in the future?



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Yvonne Braun: I do not think that it has been resolved. First, given all the funding improvements that we talked about earlier, it is questionable whether superfunds are still needed. The Government have said that they want to go ahead with it. It is very, very important that the Government, if they indeed do that, make sure that there is a very, very clear distinction between what superfunds can offer and what buy-out insurers can offer. A lot of that is to do with how you construct the so-called gateway—the gateway to how schemes can access a superfund. That is key because the Chancellor's No. 1 golden rule about protection for the saver will not be met otherwise.

We have already talked about how the regulatory regime for insurers is very robust. It is also a great deal more robust than what we have seen so far for superfunds. Of course, that has been an interim regime, but what we need is a legislative regime for that, and we need to answer all the unanswered questions that we still have. For example, what are the powers for the Pensions Regulator in terms of enforcement for superfunds? What is the legislative definition of a superfund? What is the tax regime that applies to them and how do you go about the gateway? There is still a lot—even at this point where we have a response from the Government to the 2018 White Paper—that is unresolved.

Returning to the question of productive investment, it is also not clear what superfunds will invest in. We do not know that at this point.

Q61 **Nigel Mills:** We had a debate a couple of questions ago on the role of the PPF and whether it could be a consolidator. There is a long tail of schemes that still have a deficit. Presumably if you have one now, you wonder what is going to change in the future. Is there a role at some point to have a proactive sweep-up of schemes that are never going to be able to pay their full benefits? At some point they will drop into the PPF, and it is just a question of when they finally drop and whether we could get better outcomes for their members by dealing with that up front and trying to do it in a managed way to get them the advantages of better investment. There is probably no commercial solution there—it is PPF or nothing. Is there a role there that we should be looking at, at this time?

Tracy Blackwell: We have long advocated for a PPF-type solution. PPF has the scale, the resources and the knowledge to be able to sweep up some of those small, underfunded schemes where the corporate sponsor is in danger. If the corporate sponsor is not in danger, then it can go on for a very long time and nothing needs to happen. However, where the corporate sponsor is stressed, there is a question of whether something should be done about that.

The crucial bit about all of this is that the link to the corporate sponsor should not be severed, because that raises all the moral hazard questions. If you do that, somebody needs to back it, as Yvonne was saying. With any consolidation of the PPF, somebody will need to back their promises and there is a question of whether other schemes would want to pay for schemes that maybe have not managed their affairs as well as the better-funded ones. There is a lot of devil in the detail, but



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there is a question about whether that is a potential solution for these small, underfunded schemes. The link to the corporate sponsor is the key.

- Q62 **Chair:** Thank you. Mr Denyer, finally, you mentioned your involvement in a master trust. How much interest is there in the market at the moment in joining in with master trusts as a solution?

Brian Denyer: There is interest when there is awareness is probably how I would phrase it. What we have at the moment is a lack of awareness from particularly corporate sponsors of these types of schemes and of the answers or the benefits that a master trust can provide. That is where we would see the role of Government policy or the regulator providing more encouragement or guidance to employers and trustees when it would be appropriate for them to at least consider if moving into a master trust is the right thing.

Chair: Thank you all very much indeed. That has been a very helpful and useful session. We are grateful to all of you. If you would now step down, we will welcome the second panel.

Examination of witnesses

Witnesses: Luke Webster, Adam Saron, and Simon True.

- Q63 **Chair:** I ask each of you to tell us very briefly who you are.

Adam Saron: Thank you very much for having me. I am the founder of Clara-Pensions, and its former chief executive. I have worked in financial services my whole career, for more than 25 years. I started as in investment banker and then an asset manager for more than a decade. Now I am one of the founding partners of Greycross consulting, where we are looking to bring some innovative thought to complex strategic financial problems.

Simon True: Good morning and thank you for the opportunity to speak today. I am the chief executive of Clara-Pensions. Clara is the member-first, defined-benefit consolidator. We completed TPR's assessment in November 2021, and we are currently engaged with 10 opportunities that cover around 50,000 members who are investigating whether a transfer to Clara would demonstrably improve member outcomes.

Luke Webster: I am one of the co-founders of the Pension Superfund and still a non-executive director of the investment fund that owns that entity. I am also the chief investment officer of the Greater London Authority and the managing director of the GLA's regulated asset manager, London Treasury Limited, in which capacity I work quite extensively with the local government pension scheme.

- Q64 **Chair:** Thank you all very much for joining us. Can each of you tell us whether you think that recent scheme funding improvements should change how defined benefit schemes invest? Do you think defined benefit



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schemes should now be switching from bonds to productive investment in equities?

Adam Saron: Looking at the funding levels themselves, it is probably an insufficient question. You have to take a step back from that and think about what, as a system, we are trying to achieve. The previous panel explained quite eloquently that the path that DB schemes have been on, for better or worse, is broadly towards scheme closure, with some noted exceptions, and within those closed schemes there is a very strong trend towards buy-out. That has knock-on effects to what is a sensible investment strategy.

To answer your question, the level of funding should not change what you invest in. If your objectives or your targets stay the same, if you are still targeting buy-out, no, you are not going to change anything. No doubt we will debate this so I will not get into it now, but if there is an alternative objective that might be sought by some schemes—I think Serkan said it well—should schemes follow another path to run on for longer? In that case it is almost inevitable that those schemes will consider their investment strategies. Without a doubt, having a higher allocation to riskier or higher-rewarding assets, productive investments, whatever term you want to give them, is also a natural progress from that. What will remain interesting is what the composition of those productive investments will be.

My one gripe with Mansion House and all the consultations that followed it is that no one seems to have been quite clear about what they mean by “productive investments”. Some people use the same language that you used, Chair, and say, “Unlisted equities”. That is one version. Tracy spoke about public housing and infrastructure. That is another version. They have different risk profiles and I think that they all have a role to play in a well-balanced portfolio. It is not just about venture capital or just about private equity; it is private debt structures, infrastructure and greening of the economy. A lot fits into that bucket.

Simon True: The first thing to note is that there is no one-size-fits-all solution. There are over 5,000 UK pension schemes. The circumstances that have led to improvements in funding will differ enormously as will their objectives. I believe that the primary objective is in line with the funding code, which is to give absolute security to member benefits, to make good the promises that were made in the past. Clara operates a bridge to buy-out. We believe that the insurance market is the most secure end destination for members and their benefits. We think that the regulatory regime around that is extremely strong, as are the controls. Clara is a bridge to that ultimate destination.

When we look at the vast improvement in funding levels, unprecedented over the last 18 months—the previous panel was very articulate about that—there is an opportunity for schemes to lock into that. Some of the members of the panel rightly said, “Is this a temporary situation? Don’t we want to lock into this situation?” I firmly believe that we should lock into that situation, and we can do that by moving into the insurance



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market where achievable. Where not achievable, maybe moving through an interim step like the Clara model.

To echo one point that Adam has just made, within the definition of productive finance is a broader one, which is that if we allow UK sponsors to be freed up from the burden of managing and paying for and overseeing their pension schemes, that is a form of productive finance. It allows those UK employees to focus on their core business and be more productive in their own field of expertise.

Luke Webster: The pace with which the improvements have emerged should indicate the lesson that it is a very fragile situation, so we should not be over-complacent just because actuarial valuations appear favourable at the moment. That said, I agree that it is an opportunity to have a rethink about the way that the system is organised and potentially accelerate some endgame solutions for individual schemes.

The way that we look at pensions risk has entirely the wrong focus in the UK at the moment. It is predominantly driven by current accounting standards but there is far too much focus on the valuation of assets rather than liquidity. What matters, in my view, when constructing a pensions portfolio is generating enough cash to pay the pensions when they fall due without having to liquidate assets in an unplanned way. If you can be sure of that, that you are not going to be a forced seller, you can have a much higher tolerance for short-term fluctuations in asset valuations.

That is one of the reasons why the local government pension scheme, which is free of those accounting restrictions and is able to take a genuinely a long-term view, is generally in much better health than the corporate DB sector, notwithstanding the fact that it is still open, which comes with some advantages. I think that the risk focus is wrong and that drives levels of behaviour that strongly disincentivise investment in productive assets. That is not good for society at large and it is not good for individual savers' value.

Q65 **Nigel Mills:** Towards the end of the previous panel, you all heard that we had a few exchanges around consolidation of superfunds and what role they have. Simon, could you start us by explaining how your model would work and what the advantage would be?

Simon True: I am very happy to. The way that we work is that Clara is a pension scheme, but it is sectionalised. When schemes transfer to us, their members and the assets of that scheme transfer into a sectionalised section of our scheme. That is then backed by additional capital that secures member benefits. On day one there is a demonstrable improvement in the security of member benefits. All of that capital is then ringfenced and is not released until all of those members' benefits have been secured in full in the insurance market. It is fully sectionalised and backed by patient, long-term capital.



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In terms of the benefits that we bring across the piece, we are able to invest very heavily in our systems, our risk systems, our investment systems, and are able to access areas of investment that some of the smaller schemes would not be able to do because of the disproportionate amount of time and effort that it would take to investigate them. Thinking for instance about things in the productive finance space like infrastructure debt, it is a highly complex area and needs a lot of technical knowledge to understand the risks involved, which is not accessible to individual schemes. We bring that benefit of scale; we bring new capital to it and we hope that in a lot of cases we bring improved governance. We have an independent board of trustees who have a deep level of industry knowledge and that gives you economy of scale because you are looking over a wider range of members, which the members effectively benefit from.

- Q66 **Nigel Mills:** What is the minimum funding level of a scheme that you would be interested in? Do you only take schemes that are 99% funded or do you go down a bit further than that?

Simon True: The rule of thumb at the moment is that schemes that are 99% funded should probably hang on for the 10 minutes that it is going to take them to get buy-out. At around 95% and below it gets a bit more interesting. When you get to below about 85% of buy-out funding, it is going to probably require a sponsor contribution on top of the existing assets to move to Clara. There is a wide range of situations where the Clara solution works.

Nigel Mills: Are you saying that is 85% to 95% funding?

Simon True: That is a broad rule of thumb, yes.

- Q67 **Nigel Mills:** Thank you. The people who put the patient capital in, your investors—what return are they expecting from this?

Simon True: Prior to coming to Clara I worked at the Phoenix Group. I have been in the life and pensions industry for 30-odd years. I was previous group chief actuary there and set up their bulk-purchase annuity business. The returns that are being looked at on this business are pretty much the same as those within the life insurance industry. That is proprietary and rule of thumb but they are very, very similar baseline returns.

- Q68 **Nigel Mills:** I was trying to work out what the magic is. Part of this is that you can invest better and be more efficient, but is a large part of this basically a time play—the nearer you get to the end the lower the risk is and the numbers unravel a bit and by marking time you effectively get from 85% to buy-out level without having to do anything else?

Simon True: That is one of the aspects, that the schemes tend to mature. However, they are able to mature because they have new capital that is coming in to support them, which is invested in a way that will support that profile of liabilities. There are economies of scale. Schemes have a fixed cost of administration and governance that we will have a



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lower cost of by achieving scale as well. It is a combination of factors that lead to it, but time is definitely one of them.

- Q69 **Nigel Mills:** Give me a rough split. If I come into you at 85% funding and your plan is to get me to buy-out after whatever the time period is, how much of that gap closing is because you invest better, how much is because you cost less than previous trustees and how much is time play?

Simon True: We have not disaggregated that impact, but to one of your questions, the timeframe is typically five to 10 years. That is what we look at. Some are at the lower end of that, and some are beyond 10 years. That is the sort of timeframe. Bear in mind that we are looking after that scheme until it is ready for buy-out, and it is not just the funding position. It is around the quality of the data, the quality of the member experience and the assets. Our asset philosophy, ironically, is very similar to the long-term position of the insurers. What we want to do is pre-package a set of schemes that have high-quality data, maybe bucketing two or three together to make them more attractive and to get insurers' attention, and pre-funded with the long-term assets that the insurers are going to find attractive in their regime as well. It is a combination of factors and I have not disaggregated those to work out which one is driving which.

- Q70 **Nigel Mills:** I just want to work out what you are offering trustees. If I am going to be releasing the sponsor, and okay, I accept you have some equity there that effectively replaces the sponsor, but what do you do that I cannot do? The answer seems to be you can package these things up and make them a bit cheaper to buy out. Is that part of it?

Simon True: That is definitely part of it. I think that we can achieve potentially buy-out terms that individual schemes cannot achieve, so that is one direct benefit. New capital is quite important. There are certain situations, especially when there is no sponsor covenant—no sponsor there at all—when new capital demonstrably improves it. There is a bit of a grey area when there is an existing employer, but it is a catalyst for change. It is a catalyst which in a lot of cases although the employer is there, they are not making any contributions at all anyway, so this is an opportunity for the trustees to crystallise the recent gains that they have had, bring in new capital and effectively share in the economies of scale that we expect to generate over time.

- Q71 **Nigel Mills:** Luke, is your model different?

Luke Webster: Yes, our model is significantly different, in that the aim was to establish a large and long-running pension scheme, so a scheme that would operate under the occupational pensions regime for the foreseeable future, so not a bridged buy-out. Essentially the construct was that the schemes would transfer in. You would have a structure whereby there was a conventional pension fund with its own trustees, supported by a buffer pool of capital, so structured as a partnership. The deal was that the trustees would invest the surplus of the scheme into that partnership. The capital providers would top that up to a level that ensured that we met the security objectives of the fund, which is very



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high, and very close to the standard of insurance, in fact. Essentially the system would be that if the scheme became underfunded at any point, assets would flow down from that buffer to bring it back up to full funding, but if the overall level—let us call it 120%—was maintained and improved, then money would be released from the buffer simultaneously to members in the form of improved pensions and to capital providers to compensate them for their investment. That was the structure, and the idea was to run on whenever the benefits of scale emerged.

A very important difference is that we are thinking about the long-run returns of our assets, rather than a potential transfer in future to another marketplace, and secondly that we are not sectionalised. The drivers of benefit from a superfund structure are the economies of scale that have been discussed, and access to different asset classes. If you want to invest in infrastructure projects, it is very difficult to do that as a small investor. You need to be able to bring big chunks of money to the table and have high-level negotiations with the project sponsors and owners.

There is all that stuff, but then the free lunch in this arrangement is the raw maths of dealing with unpredictable behaviour. If everybody in this room decided to set up our own pension arrangement that would be a very difficult thing to achieve, because the amount that we would need in total and when we would need it, crucially, would be massively affected by an individual's decision of when to retire and then bluntly when they exit the mortal coil.

It is very hard to run a small pension scheme on a defined benefit basis. However, if you have hundreds of thousands of members, then the law of large numbers comes to your aid and the behaviour of human beings in aggregate is really quite predictable, so the cash-flow matching exercise becomes much easier if you do it at scale in an unsectionalised way. That was the key driver of our value proposition.

Q72 Nigel Mills: What range of funding percentages do you take?

Luke Webster: For similar reasons they would be very similar to Clara's, so we would be looking for schemes that were in a position together with their sponsor contribution to be fully funded on arrival and that would translate again to that 85%-plus funding on a buy-out basis. There is no magic solution from the private sector for underfunded schemes without reduction in benefits, bluntly. That was not what we were in the space of providing.

Q73 Nigel Mills: What return do your investors expect they can get on this?

Luke Webster: Again the natural comparator when investors were looking at it was the insurance market, so there were returns in the teens, which is normal for these kinds of investments.

Q74 Sir Desmond Swayne: Luke, can you tell us about your experience of the authorisation process for superfunds?

Luke Webster: I have less of a dog in the fight than I did the last time I came to this Committee, so I will be as frank with you as I can.



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Overall, the experience was pretty vintage public-sector value-destruction and that is regrettable. The reasons for that are that ultimately there was a lack of clarity in leadership from Government. There was a consultation exercise that you will be well familiar with, launched by DWP, reflecting really excellent work and thinking by the officials there. That was not responded to, and one can speculate as to why that was the case, but I think it is fairly clear that there was no uniformity of opinion between all the Departments involved in this. That led to a situation where the regulator probably did not have a clear direction to go in and the marketplace trying to participate had to get involved in a lot of guesswork as well. The exam question I think was not clear. The process was opaque in the absence of regulation in the legal sense. You effectively had a situation where the regulator used their guidance powers to tell trustees, "Do not deal with people unless they are on our list," and then they invented a process to construct that list. That is very different from the situation of regulated industries generally where there is a set of standards defined in law that a regulator holds people against, and there is absolute clarity and transparency of how that is done, particularly if there is no right to appeal coming back to the regulation route that is in place currently.

Overall, I think it was very unsatisfactory. There were lots of well-intentioned and able people involved on both the public sector side and the private sector side trying to do the right thing, but without that clarity it ended up being a process that consumed a lot of private capital, cost people some jobs and has really not resulted in any substantive change to the pensions landscape to date.

Q75 Sir Desmond Swayne: Simon, you have had your authorisation for two years.

Simon True: We received it in November 2021.

Q76 Sir Desmond Swayne: So nearly two years. Why no subtraction subsequently?

Simon True: The reality is if you take the previous point that we were looking at schemes that were in the 85% to 95% funding, last year saw a massive jump in funding levels so the short answer is that we were fishing in the wrong pool, or the pool moved. There were six schemes that we were looking at around Q2 last year, all of which at that time believed they were in the range of five to 10 years away from buy-out. By the end of the year all six had bought out. That was a great result for members, but it is a terrible result if you are a bridge to buy-out. The economic volatility and the volatility of funding levels was hugely difficult for us to transact in that space.

What it highlighted were some deficiencies and some shortcomings in the TPR's interim regime, and in Q1 we were able to consolidate our learnings from 2022 and engage constructively with TPR on those shortcomings. To their credit they have updated their guidance in recent weeks, which has addressed some of those shortcomings. We are a lot more confident now



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that the regulatory regime or this interim regime is more supportive to us and if we saw that same volatility again, we would be not quite immunised but certainly cushioned against some of the extreme differences that we saw last year.

Q77 Sir Desmond Swayne: Are you satisfied with the changes to the guidance in that respect?

Simon True: It was very helpful. It allows us to transact today, which is great. It gives us confidence in the long-term future. It is that, coupled with the direction of travel that DWP have put out for the ultimate legislation, which also gives us comfort that that is on the right track.

Q78 Sir Desmond Swayne: How has Mansion House changed your prospects?

Simon True: When the Chancellor delivered his speech, the following day DWP set out their response to their consultation that they had done in 2018 and within that they set out their road map for the ultimate legislation. That was extremely helpful. It was along the lines that we were hoping for. Obviously in an ideal world it would be enacted today. That would take away all the doubt and we would all know exactly where we were in terms of legislation. All the trustees would have confidence in that.

There is a lot of detail to be worked through, which gives a bit of uncertainty, and that is difficult in attracting long-term capital if there is some doubt over future legislation. At the moment there is enough there that we are confident that we can proceed and that we have the backing of our investors to do so.

Q79 Sir Desmond Swayne: Will it change your Clara model?

Simon True: Fundamentally no. However, there are certain aspects of it, for instance what is called profit extraction, which TPR is going to consult on later in this year and DWP has set out a very broad framework for that. When we look at that, it is very interesting. Is there a potential for us? When there is demonstrably excess capital above that required secured member benefit is there a way in which some of that could be returned and therefore being used to support new members coming into our platform? That is something that is of interest to us, but as I say there is very little detail around that, at the moment.

Luke Webster: Unfortunately the updates to the guidance would fall in the camp of too little too late, from our perspective. The lack of clarity about being able to make distributions renders the proposal uninvestable at this stage. It is completely unreasonable I think for us to expect people to put their capital at risk without having any line of sight to how they might achieve a return on that.

The pejorative language of profit extraction is enormously unhelpful too. We do not use that language in any other business context. The extraordinary double-think whereby we view the transfer of wealth that happens on day one when a scheme transfers to buy-out—and I am not saying that buy-out is a bad thing because it fulfils a very useful purpose,



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but it is high security but low choice for members. It is not the only option in my view. There is always profit in these kinds of things and that is not bad. That is how you pull capital into the system to create security. That is a serious shortcoming.

There are still issues which make fulfilling the Mansion House reforms, which I would be generally supportive of, difficult. For instance, not owning more than 2.5% of a given entity makes it very hard to invest in private markets, so there are still a number of investment restrictions in there that are not helpful. They will be much less problematic for Simon's model where the aim is to get to insurance, but for somebody who wants to operate in the pensions world and achieve those kinds of returns from private assets it is still very problematic.

I think there has been a bit of paranoia about the extraction of profits through indirect means, so inability to use surpluses to bring new schemes on, which again from a public policy point of view is massively attractive. That is exactly what we want, to have some smoothing of ups and downs between schemes and generations. That is still difficult under the current model and despite the fact for the reasons that I outlined previously the clear drivers of the benefits here come from scale, there are still issues with using structural surpluses to fund business development and that is clearly in the interests of everyone.

It is still very problematic and without more clarity we probably will not be proceeding with our proposition for the foreseeable future. That probably covers our views. The gateway test also remains a hugely anticompetitive feature.

Q80 Sir Desmond Swayne: Would that need for clarity involve legislation? Is there a role for legislation?

Luke Webster: Yes, most definitely. The direction of travel in DWP's response is very helpful and having that properly defined in regulation would give a lot more confidence to investors and those involved in delivering these proposals.

Q81 Sir Desmond Swayne: Adam, is there anything you would like to add?

Adam Saron: A few things. It may be for the Committee's benefit just to add some perspective. Clara was my baby, and it was very strange and pleasing to hear Simon present it, but I will try to give a slightly broader perspective. Luke was very polite when he said there were differences in Government following the 2018 White Paper; I will be direct. The ABI—I would say this to Yvonne's face if she was still sitting here—were very resistant to the idea of superfunds, and that was reflected in the Treasury's view. That was incredibly unhelpful, and Luke described what we had. We then had a regulator who was asked to produce guidance without the confidence of knowing where it was going. The absence of a response to the consultation from 2018 to 2019 was a huge source of delay, and probably cost us three years in time.

Simon True: And millions of pounds, I might add.



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Adam Saron: If we put a number on it, probably accurate. I think Mansion House from our perspective was hugely significant for two reasons. The Chancellor's first golden rule about putting the interests of members first resonated incredibly strongly with me and would have done with everybody at Clara. It is the founding principle that the solution is built on and I think is essential, but probably even more important than that it was the voice of the person who was giving the speech. It was highly relevant that it was the Chancellor who announced the final publication of the consultation response and not the Minister for Work and Pensions. I think we can now be confident that there is a cohesive thought in Government that the option of superfunds is a benefit. It is something that would help schemes. It is not a compulsion, it is not a replacement for insurance, but it is just another option to help that journey towards de-risking. This clear direction of travel is very helpful.

Despite all the delays I think it has been helpful and will continue to be helpful that we have been operating in an interim regime, rather than trying to draft legislation in 2019, even if we could have done. Even if everybody's views were aligned, we would have made mistakes, without a shadow of a doubt. You can see this in the shift in the regulator's guidance and having lived through the assessment process myself I know where those shifts have come from. They have come from learning. I had always been a strong proponent of having this interim period to learn, so that when we do get to that much-wanted permanent legislation that seems to be a direction of travel, it will be right and we will not be collectively back here at the House's door saying, "Could you please amend sections 28 through 37 because of the following three or 40 things we did not think about?"

The outcome has definitely been slower than we wanted. It has all happened the way we thought it would, but slowly. I am greatly encouraged—maybe just a final thought to the question Mr Mills started with—about the need for consolidation and how this ties in to Mansion House, is that what has not been emphasised enough is encouraging trustees and sponsors to think about more adventurous investments is well and good, but then there is the massive question around the governance to do it.

I guess the magic in superfunds, or any form of consolidation for that matter that is very hard to put a figure on, is that governance value, and more particularly the executive function supporting the trustees—the ability to really do the work independently of the advisers and have your own mind to understand what is going on. When you start thinking about these alternative asset classes it is crucial, because the barrier is not just the funding code, it is not just what the objective is. It then becomes, "Okay, what are we trying to do?" and as a trustee board do you have the experience and information to invest in your asset class? Probably not. Do you have the decision-making skills if you are a medium sized scheme where it is not everybody's day job? There is the agency risk of then relying on your consultants to pick manager X rather than manager



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Y, and the implementation cost. All these things are dramatically enabled through consolidation, so it has an important role to play. It is not the panacea, and it is not the policy itself, but I see it as a great unlock and a massive enabler. Bigger is better for all these things. It is just going to be easier.

Q82 Siobhan Baillie: I was thinking about trustees and decision making and they are hugely guided by security and forward planning. I notice Brian in the previous panel said that where there is awareness about superfunds, there is interest. My question was going to be about whether DWP needs to take more steps to raise awareness about the superfund option, but I am going to add to that and ask, having listened to you, whether you think that just raising awareness without the legislation or the clarity back-up is just not going to do the job with trustees who are inherently cautious. I will address this to Luke.

Luke Webster: Sure. I think we collectively were pretty successful in communicating the message and the option to trustees at large very ably supported by the employee benefit consultants in the UK market. I think awareness is very high. I do not think there is a need for Government intervention on that front.

Again, there is a wider problem in the pensions system at the moment, in that we have increasing demands placed on trustees and their sponsors and that has led to a somewhat adversarial relationship developing, which relies on massive amounts of legal and other technical advice on both sides, all of which is ultimately paid for by the members, of course. That means that there is great inertia and reluctance to act and do things differently if there is any risk of criticism or comeback. I think clear legislation will help that immensely, because it will remove some of the uncertainty and remove the barriers to action.

Noting Adam's point about the learning process, it would very much be my hope that any such legislation is very clearly principles-based rather than prescriptive, so that there is some scope for flexibility and confidence moving forward.

Simon True: If we had legislation today, it would be helpful. It would take some of the doubt away in trustees' minds. The vast majority of trustees that we engage with are, first, rightly focused on securing member benefits and, secondly, they tend to be well educated on the option, and they welcome an additional option because the options at the moment are the status quo or buy-out. If buy-out is not achievable for whatever reason, that leaves you with only the status quo.

We have had a lot of good quality traction with trustees, but they tend to be at the more professional end—they tend to be people who live in the pensions industry all the time. I do think there is a swathe of trustees who are looking at superfunds with interest and will have more interest once the first transaction is announced and they will have more comfort that they are not the first. It is a very risk-averse industry, as you know, and there will be a set of trustees who will not transact because they



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want to see that legislation in place. They want to know that the long-term position is absolutely locked down. Yes, it would help, but it is not a barrier to today's progress.

- Q83 **Siobhan Baillie:** I know Luke has a different model, but have the trustees you have spoken to, professional or otherwise, made the case that the sectionalised nature of your superfund is an important part to them, or is that something that is up for discussion?

Simon True: Luke's model will be applicable if he chooses to put it back to different schemes, and I am not disparaging that model. Our model is attractive to a number of people, mainly because the security of their members is not dependent on our future success. In a sectionalised model with dedicated capital, it does not matter whether we do another transaction or not. Their members are secure, and they are on a journey too, to buy-out. Their security is not diluted or improved by any subsequent sections coming in, and that is quite attractive to a number of trustees. I said at the start it is not one size fits all in this industry.

- Q84 **Siobhan Baillie:** Do you want to come back on the sectionalised point?

Luke Webster: It is an entirely valid intellectual choice for trustees to take for the reasons Simon has just outlined, but our model is offering an alternative for those who want to exploit the benefits of collaboration and collective action to take a different path. I think both are valid but unquestionably an unsectionalised model is easier to manage from a cash flow perspective.

- Q85 **Siobhan Baillie:** Okay. Adam, awareness, sectionalised—all of it?

Adam Saron: Yes. A couple of interesting things. Simon should comment on the more recent interactions with trustees, and transactions more generally, but when we started the journey, it was in our mind that this would be a wonderful sell to corporates: "Here is another way for you to resolve your pension obligations at a point that is earlier than you would otherwise have done on a buy-out journey." We thought CFOs would love it, and they do. What absolutely floored us is that the vast majority of transactional interest came from trustees. They were the originators.

I think awareness is very high and in fairness to the point that Brian was making, he was talking much more about DB master trusts. It is important because, on the face of it, DB master trusts really look like they should be the consolidation solution. You get scale, professionalism, lower costs, but awareness is low, and take-up is low. I think the simple reason for that is that as things stand maybe some of the things that have been spoken about around the DB call for evidence is that the master trust does not offer a lot to the trustees and the sponsors.

For the seeding trustees it is okay—"Maybe these people are better at doing it, and that is great"—but the probability of paying benefits is exactly the same. The funding levels are not changing, and the sponsor is not changing, because the sponsor link is not broken. For the sponsor they may be getting a more professional trustee, which is good, and



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lower costs, which is good, but not that much, and they are giving up some control, because they lose the ability to hire and fire the trustees. There is not a strong rationale for it, whereas in the superfund scenario you are getting those benefits and the additional security and that is key.

In both versions of the model the big difference is you are replacing the covenant with funded capital. Now, funded capital is finite—it may run out, highly unlikely, but it might—but the big difference is it is funded up front. You would always rather have the money in the trustees' pockets for members, as Simon was describing, than sitting on the sponsors' balance sheet, which is all fine while the sponsor is solvent and disastrous when it is not. The big offering is that the downside scenarios are far fewer and the potential loss to members is far lower.

Trying to circle back to where you started your question about trustee decision making, Luke raised this and Yvonne Braun did as well, although she has a very different view on it: the gateway tests. I have consistently been against them, because they are not a protection for members—that is not true. They are a protection for insurers, and I do not think the insurers need protection. They are going to do enough business this year and will have plenty left over for the next decade to come. The real issue that subverts the trustee decision making is effectively it says to trustees, "You cannot even think about this option and even if you are thinking about it, it is not really your decision. It is a regulatory decision." I think that is wrong. The real gateway for pension schemes is the trustees. It is their job to decide what is the best way of delivering the benefits under the scheme.

Q86 Siobhan Baillie: Before I bring Luke in, I just want to put it on record that I apologise for misquoting Brian. My apologies to Brian for that. I was obsessing about superfunds. Luke, do you want to come in? I have one more question.

Luke Webster: Adam raised a very important point. In the funding code and frankly the behaviour of the regulator, there is a lot of subtext and indirect policymaking, essentially mandating this transfer from the occupational pension world to the insurance world. Now, Parliament is sovereign, and that is an entirely valid path to take, but if that is Government policy, it should be explicit. As a taxpayer, I would suggest that if you are mandating a transfer of wealth from companies and individuals to a small subset of the financial services industry you should tax that appropriately. It is indirect at the moment and that is an unsatisfactory circumstance. The gateway test is anti-competitive and anti-choice as it currently stands.

Adam Saron: One of the few things that Luke and I agree on.

Q87 Siobhan Baillie: Finally and briefly from me, the basis of the question was whether the DWP's decision to allow profit extraction before buy-out makes the big difference to trustees. To Luke, how would you rename it? How would you talk about profit extraction?



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Luke Webster: Return on capital is a perfectly sensible term. We have always presented our model to trustees operating in the way we see it doing in the long run: surplus being shared between members, improving their pensions and compensating capital.

Simon True: Can I just extend on that, and be pedantic because I am still an actuary, I would call it the return of excess capital? It is the capital above and beyond that which is required to support members' benefits. When you have straightened the point that you have so much capital that members' benefits, to all intents and purposes, are secure, surely that capital could be recycled for the benefit of an incoming set of members.

Luke makes a very good point about the pools of capital who will not invest if their time horizon is too long or if there is no prospect of return on capital. One of the key features we are looking to do is of course bring new capital into this industry to secure member benefits, so if this helps and allows us to tap into new pools of capital, it may even reduce our costs of capital and therefore make the offering more broadly applicable.

Adam Saron: Trying to be pedantic and correct, the DWP consultation response does not specifically allow the extraction of excess profit, but it says they would like to. Although I disagree with this, I understand their philosophy behind it, which is that they want a principles-based environment where the best ideas can flourish and that is perfectly fine. The updated guidance, as Luke rightly pointed out, has not yet said the extraction of extra surplus is allowed. It is saying, "We are all thinking about it." They are minded to go in that direction, but as things stand now if you want to be assessed as a new superfund that cannot be part of your model, because your transactions will not get cleared.

I will personally make a prediction, but it is going to be a decision for this House, not for me: I do not think profit extraction will make it into the final legislation. I think there will be a lot of resistance from the ABI, I suspect. It is a hard thing to sell. One of the reasons that the Clara model has received such good take-up from trustees is that it is easy to understand. It is a clear deal. They do not get their profit until their members have their benefits fully secure. It is a clear order of events, but I may be proven wrong.

Q88 **Chair:** A few final points from me. Adam, you made the point that the Treasury delayed their response on superfunds. That was prompted by ABI's worries, and the ABI's worry was that the superfunds were buy-out on the cheap and it was therefore risky. What do you think it was that swung the Treasury in the end to favour the model?

Adam Saron: Luke and I have been in a lot of meetings with the Treasury, and I would like to think they brought out their notes and were swayed by our eloquent argument. I do not think that is right. I think the truth is that when you look at the wider Government finances the UK balance sheet is not in a great position. National debt is very high. Public spending is very high. There is not a lot of flexibility left. Where you can



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get some flexibility is through growth—things that stimulate the economy in other ways. Consolidation, broadly put, as I have said before, could be one of those really big unlocks. It is a way of putting capital to productive use, and superfunds do that. They already do that, and the provision of additional risk capital bringing in external capital and creating a new form of financial model, a superfund, is very consistent with I think the third golden rule—I am probably misremembering the order—and this idea of supporting a dynamic financial services industry in the UK, which is one of the things we are very strong in. I think of those bigger pictures. The Treasury desire for growth, broadly put, is trumping some of the technical concerns, which I think are very different when you think about the two models we have spoken of. This bridge to buy-out does not in any way endanger the bulk annuity market. In fact, it would be a great enabler. As Simon described, it will bring together smaller schemes and ultimately deliver them to the insured market in time in a more digestible package. I think it is all these things taken together.

Q89 Chair: Simon, you have told us that you are talking to 10 schemes at the moment, but last year you were talking to six and all of those have gone. As for the 10 that you are talking to now, are they schemes that because of the recent changes have reached the 85% to 95% window and were not there before?

Simon True: That is exactly right. A year ago they would have been way below being able to be affordable. It would have required a significant sponsor contribution and in some situations that sponsor contribution has reduced materially and now it is of interest to them. I think there is a difference between situations where it is trustee-driven, so the funding has improved, they want to lock it in, they want security of member benefits. The clear day-one improvement in position where you have new capital coming in to support that is attractive. You also have situations where sponsors for a long time have wanted to settle this historic liability. They would like to tidy up their balance sheet. The pension scheme may be a distraction, it may be costly, and they would like to focus on their core business, and they have just seen the cost of that reduce enormously as the funding position has improved. There are definitely different dynamics at play.

What we rely very heavily on though is on the employee benefit consultants. This is a very heavily intermediated and supported market. They have invested very heavily in understanding all the superfund models and all the alternatives available to trustees, and they are doing a great job of educating those trustees and making sure that they are aware of the range of options that are available to them and helping them on that journey. It is a difficult journey, and the insurance industry took a long time to take off as that became an option for them through longevity swaps, buy-ins and buy-outs. I expect to see the same happen with the superfund regime. We will build up momentum, people will get more comfortable with the concept, they will see the demonstrable benefit for their members, and sponsors will see the benefit of cleaning up their balance sheet and focusing on their day jobs.



Q90 Chair: Lastly, what do you think about the suggestion of a wider role for the Pension Protection Fund as a consolidator for small or stressed schemes?

Simon True: The first point I would make is that I do not think that is a great idea. If there is any sniff of a public-funded vehicle being involved in a market it will deter capital. That is my No. 1 concern, because as a public entity it is not clear what their criteria are for assessing risk. It is not clear what returns they are seeking and therefore that might dissuade capital. Anything that does that I would be opposed to.

I have engaged with PPF on this topic. We clearly want member outcomes improved whether that is through us, Luke's vehicle or other vehicles. If there is a way that PPF could engage with schemes that have literally no prospect of ever reaching either the consolidation market or ultimately buy-out then there may be a role for them to do some of the heavy lifting on that and, if you like, become a bridge to consolidation. Of the 5,000 schemes in the UK, the 2,000 smallest only make up £15 billion of assets under management. It is a tiny percentage and a very skewed distribution. If there is work that PPF could do, because there is a lot of heavy lifting to do around cleaning up administration, and sorting this out, demonstrably improving governance and as a precursor to consolidation, then I would welcome that, but it would have to be very tightly controlled so as not to scare the providers of capital who would really not want to see a public figure in that way.

Luke Webster: The PPF has submitted some evidence to this inquiry this month, which is extremely interesting and contains a great deal that I agree with on general policy grounds. In particular the way the PPF invests is much closer to how I think would be beneficial than the way the DB landscape is structured at large, but there are quite serious moral hazard issues to be considered if there is a role going beyond its lifeboat provision. I can see why they are very attractive, and it should be investigated further, but probably the way I see it operating best would be for there to be a dynamic marketplace of endgame options, including consolidators and insurance. Then in those instances of market failure, because there will be schemes that are too small to justify the due diligence involved in taking them on—I think Tracy made the point very accurately that the amount of work involved between a large scheme and a small one is not dissimilar so there will be a certain level at which it is not commercially feasible to interact with those schemes.

I think that should be established through the market and then the state can become involved in addressing that failure. If PPF has an unconstrained commercial mandate there are issues of competition, but potentially more seriously from a public policy point of view PPF's risk currently is underwritten through its levy in large part, so there would be a risk of indirect transfer of wealth from savers in other schemes to savers who had been consolidated under that model and that would need to be thought through very carefully. It definitely merits more investigation.



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I think something that should be considered is the role of PPF and consolidators potentially providing an annuity alternative as well for savers with DC pots. The ability to exchange a sum of money at any stage of your working life for well-capitalised or state-backed retirement income is something that we should not be closed to considering as a society. It is overly pessimistic to consider defined benefits dead on a funded basis. There is no reason that it cannot be run sustainably and the LGPS proves that.

Adam Saron: It is interesting. I like ideas, and I am interested by them, but I think the proposal of PPF as a consolidator is an answer looking for a question. The cynic in me says that PPF looks like it has a large current surplus, and people are very attracted to saying, "Well, there is money there. We must do something with it." Maybe that is right but having built one consolidator, I feel like they have skipped the hard work. There are probably seven or eight a priori questions that they need to answer first before you conclude that the PPF as a consolidator is the answer, but I will maybe try to end on a constructive note, and this is an idea that just came to me, to tie some of the things we have spoken about.

Simon is right. There are 2,000 smaller schemes with only about £15 billion to £17 billion of assets. They represent a tiny amount of value, a bunch of work and a lot of effort, but for the members in those individual schemes they do not know that. This is their retirement savings, and it is incredibly important to them. There is that administration question, that effort question, and whether that work is commercially viable to do—it is probably not. Is there a role for the PPF possibly in sponsoring a form of a DB master trust rather than a capital-backed consolidator to bring all those schemes on to a single platform as a stage one? It will bring scale, help them invest, lower their costs and massively reduce their adviser costs, which are a real burden.

That is a big help on its own, but it then creates options for the future. Is there a way of reaching a deal with the sponsors for compromised benefits against further contributions? That is a difficult area and hard to decide who gets the benefit, but there is that kind of thinking. They could even be created on a much more usable admin platform, so that if some of these schemes could reach a funding level where a superfund or buy-out is attractive, that transitional work is already done. If the worst happens—if it is on PPF's Civica system and they have to fall into the PPF—the transition into PPF assessment and then the PPF fund itself is much easier. They carry that risk anyway. They are ultimately insuring those schemes.

Chair: Thank you all very much indeed. That is another very interesting session you have given us. That concludes our meeting.