Bank of England PRA

Rt Hon Sir Stephen Timms MP
Chair, Work and Pensions Committee
House of Commons
London
SW1A 0AA

Sam Woods
Deputy Governor, Prudential Regulation
CEO, Prudential Regulation Authority

Dear Stephen,

29 September 2023

DB pension scheme consolidation

Thank you for your letter of 13 September.

Has DWP's response addressed the concerns you raised in 2019?

The PRA has taken an interest in the regulatory regime for pension superfunds because of the potential impact that a superfund established within an existing, PRA-regulated insurance group could have on the safety and soundness of the insurers within that group and the protection of their policyholders. There is a risk that a superfund, held to a lower financial standard than insurers within the group, would in effect dilute policyholder protection if the group found itself needing to support its superfund. This risk directly impinges on the PRA's statutory objectives. DWP's response that you refer to notes the risk to insurance policyholders which I described above, and the need for insurance regulators to assess and if necessary mitigate risks to insurance policyholders – I cover below what this might entail in response to your question about what PRA would need to do differently.

The PRA's response to DWP's 2018 consultation also discussed the risk of regulatory arbitrage. We understand that in order to attain the government's policy goals, the financial standards applied to superfunds will need to be somewhat lower than those that the government has set for annuity business in life insurers. But this creates the potential for regulatory arbitrage: that schemes that could have achieved the higher standard of financial security offered by transfer to an insurer are instead transferred to a superfund. This risk might be mitigated by requiring superfunds to adopt a 'bridge to (insurer) buyout' model, or by a robust gateway governing which schemes may transfer to a superfund, or some combination of the two. The DWP has opted for a gateway approach.

The DWP response references the smaller expected size of the market than had been anticipated in 2019, thanks to changes in DB scheme funding positions. This reduces potential risks to financial stability.

<u>Have any new risks emerged since the initial consultation and your response to it?</u>

New risks are always emerging in the financial system but none have emerged since the initial consultation that would change our response to it.

<u>What will the Pensions Regulator need to be alert to in regulating pension superfunds?</u>

Economically, superfunds would be similar to life insurers that write annuities. The liabilities are fixed and long term, and financial resilience is provided by capital (rather than by a covenant from a substantive sponsoring employer). So TPR will need to be alert to the same key areas that the PRA considers in its regulation of life insurers: capital, liquidity, governance and risk management, reporting and disclosure (to facilitate market discipline), and resolvability.

<u>Could and should regulation of pension funds be given to the PRA?</u>

We see no strong reason to disturb existing institutional arrangements. The PRA has expertise and experience in insurance companies and not pension schemes. There are structural and legislative differences between pension schemes and insurers and we see limited synergies from combining their oversight in a single institution.

<u>What will you need to do differently if PRA-regulated entities set up pension superfunds?</u>

As noted above, the prudential regime for superfunds will be calibrated to a lower level of resilience than insurers undertaking annuity business. The presence of both within the same group could effectively dilute the protection that policyholders currently enjoy. PRA would need to develop an approach to group regulation and supervision of groups in this position that would preserve the level of protection that government and Parliament have decided is appropriate for insurance policyholders.

The PRA would also need to establish supervisory colleges with the Pensions Regulator and ensure the communication and information-sharing systems and protocols facilitate effective regulation and supervision by each regulator.

Has the PRA continued to be part of the discussions with the Government on how to proceed in this area?

The PRA has contributed its expertise in the regulation of long-term annuity liabilities in support of the development of policy by Government, through membership of working groups convened by DWP, and has continued to provide advice to HMT on request.

Has pension scheme consolidation been discussed in the Prudential Regulation Committee or the Financial Policy Committee?

PRC has discussed risks from possible designs of prudential regulation of superfunds on several occasions since 2019.

Pension scheme consolidation has not been substantively discussed at FPC, though the issue did arise in the context of discussion around LDI in March this year. "The FPC noted wider work to change the regulation of pension schemes. For example, the Government was in the process of implementing a broader strategy to ensure that DB schemes in the UK were sustainable, well-governed and that scheme members achieved better outcomes. As part of this, actions had already been taken to strengthen the regulatory framework for DB pension schemes, support consolidation and enhance scheme governance and member protection. The Government was also in the process of ensuring that DB funds in the UK were appropriately funded as they became significantly mature, which would help them to be sustainable, and of encouraging DB scheme trustee boards to more actively detect and respond to risks. The FPC considered this work essential given potential risks to financial stability."[1]

I hope these answers will assist your current inquiry.

[1] **Record of the Financial Policy Committee meeting - 23 March 2023 (bankofengland.co.uk)**

Yours sincerely

Sam Woods
Deputy Governor and CEO, Prudential Regulation Authority

Work and Pensions Committee

13 September 2023

Sam Woods
CEO
Prudential Regulation Authority
(By e-mail only)

Dear Sam,

DB Pension Scheme consolidation

As part of our current inquiry on the future of Defined Benefit pension schemes, the Committee took oral evidence on 6 September on the role consolidators (pension superfunds) might play in future. We have seen the PRA's 2019 response to DWP's 2018 consultation on consolidation, which raised concern about some of the Government's proposals in this area. However, we are unclear of the extent to which elements of DWP's response to its consultation published in July 2023 (for example, in relation to financial adequacy requirements, the requirement to act as a 'bridge to buyout' and profit extraction) diverge from the views set out by the PRA in 2019.

We would therefore be grateful for your answers to the following questions:

- has DWP's response addressed the concerns you raised in 2019;
- have any new risks emerged since the initial consultation and your response to it;
- what will the Pensions Regulator need to be alert to in regulating pension superfunds;
- could and should regulation of pension funds be given to the PRA;
- what will you need to do differently if PRA-regulated entities set up pension superfunds;
- has the PRA continued to be part of the discussions with the Government on how to proceed in this area; and
- has pension scheme consolidation been discussed in the Prudential Regulation Committee or the Financial Policy Committee?

I would be grateful for your response to these questions by Wednesday 4 October. As is usual practice with the Committee's correspondence, I will be publishing this letter and your response on the Committee's website.

Yours sincerely,

Stephen Timms

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Chair, Work and Pensions Committee

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