Written evidence from Abrdn DBP0047

About us

abrdn plc is a leading global investment company. We have offices in over 50 locations worldwide and employ around 6,000 people. Our strategy is to enable our clients to be better investors and through that to deliver client-led growth in revenues and operating profits.

Operating across three vectors – Investments, Adviser and Personal – that reflect how our clients interact with us, abrdn has the full ecosystem of capabilities that enable our clients to be better investors. Our expertise and resources gives us a holistic view of retail customers through participation in provision of our platforms, financial advice business, discretionary services and investment management. abrdn offers a wide range of investment solutions and services designed to meet our clients' needs today, tomorrow and for the longer term. We manage and administer £500 billion of assets worldwide (as at 31 December 2022).

Wherever we are in the world we strive to make a positive long-term impact. This means delivering world-class investment solutions. It also means operating ethically, encouraging and where necessary mandating good practices among companies we invest in, and providing support and expertise for the benefit of the communities in which we operate.

abrdn plc is headquartered in Scotland. It has over 1 million shareholders and is listed on the London Stock Exchange.

Executive Summary

abrdn has a long history of managing assets on behalf of our defined benefit (DB) pension clients as well as for our insurance clients, including managing assets backing annuity portfolios. We manage assets on behalf of around 350 DB pension schemes and remain committed to providing solutions for our pension clients. We provide fiduciary management services to DB pension scheme trustees and have recently launched a DB consolidation vehicle, the “abrdn pensions master trust” which is designed to target improvements to the way in which small to medium sized pension schemes are run.

A common trend in recent years has been DB schemes de-risking and transferring their liabilities to an insurer through a buyout. Transaction activity was particularly strong in 2022 and is expected to continue due to improved funding positions, in part as a result of a rise in gilt yields.

While there are many benefits to a buyout, we see an unchallenged wisdom that “buy-out as soon as possible” is the best solution for small to medium DB schemes. This perception - together with a sharp and unexpected improvement in funding levels - has resulted in many schemes looking to engage with capacity constrained insurers and accelerate plans to become “buyout ready”.

Additionally, many schemes are reviewing their investment approach to be more in line with that adopted by insurers, with gilts and UK investment grade credit being attractive asset classes. Schemes which have invested in illiquid assets in the anticipation that holding them for a longer period would provide a stable yield enroute to buyout, are now looking at how they can offload them at a fair price. As a result, we have a situation that risks herding schemes into common investment strategies and creating systemic risk.

While we willingly acknowledge that a buyout will be the best course of action for many schemes, we are concerned this is driving irrational investment behaviour for others, causing corporate DB pension scheme sponsors to lose material amounts of economic value from their balance sheet that could otherwise be realised into cash for reinvestment / distribution at some point in the future.

Our response to this call for evidence provides recommendations on how regulation and government intervention could mitigate some of the detrimental risks we see developing and lead to better outcomes for DB schemes, their corporate sponsors, trustees and ultimately scheme members. In making these recommendations we see four key objectives:

- greater investment diversification between DB schemes;
- a manageable pace of risk transfer to the insurance industry;
- improvement in governance levels (particularly within small schemes); and
- continued innovation across the pensions market, thus protecting member benefits.

We hope our response is helpful to the committee. We would of course be delighted to provide further detail on the points we make below.

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

In our view the buyout market for small to medium sized pension schemes is no longer functioning well or truly competitive. The significant improvement in average funding levels over the past 18 months has resulted in an increase in demand unmatched by bulk purchase annuity ("BPA") providers' capacity. Inevitably, it is smaller schemes that are losing out with many sub £100m pension schemes struggling to find an insurer willing to quote and some only finding a willing insurer on the condition of exclusivity at an early stage.

We do not see any improvement in market conditions in the short to medium term, although we expect insurance industry capacity to become more aligned to demand in the long term. A key constraint on capacity is the number of skilled people to process transactions. This is likely to be overcome through technology adoption as insurers amend their processes to become more automated, thus reducing the workload per transaction. In the interim those schemes struggling to find a willing insurer to transact with (at what they perceive to be a fair price) may simply need to join the queue and plan to transact at a later date.

Established "alternatives" to insurance buyout may therefore be an interim solution. We believe the Pensions Regulator (TPR) in conjunction with government policy could do more to encourage take up of such options.

In our view DB consolidators can provide an efficient stepping-stone to an insurance transaction (see below for further explanation). We would also challenge the herd mentality within the DB pensions industry of ushering schemes towards buyout as soon as possible. In certain circumstances this can be inefficient, placing unnecessary demand on sponsor

cash or even foregoing a return of surplus to sponsors (sponsors that have already contributed significant sums of money to fund assessed deficits over many years before).

Changing the timeframe to buyout – either due to insurer capacity or a desire to develop a funding surplus – also opens up investment opportunities in suitable illiquid assets, such as real estate, infrastructure debt or other forms of private debt. These assets typically provide an attractive risk / return profile and a good match for scheme liabilities. However, they are currently less in demand by UK pension schemes due to the desire to hold a fully liquid portfolio ahead of an imminent buy-out transaction.

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

We see a strong need for the 'professionalisation' of all trustee boards. However, there are two areas to address before this is practical:

1. There is insufficient capacity in the professional trustee market.
2. There is currently no required qualification to become a professional trustee.

Greater consolidation of small schemes would go a long way to solving the issue of too few professional trustees since one trustee board could look after numerous schemes under one umbrella rather than have separate trustee boards performing the same role.

In relation to the professional trustee qualification, it would seem sensible to move the voluntary accreditation process to a mandatory requirement.

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

DB consolidation means different things to different people but for the purposes of this submission we consider two forms of consolidation vehicle: financial consolidators and master trusts.

<u>Financial Consolidators</u>

Financial Consolidators are similar to DB mastertrusts but the main difference is the break in employer covenant. The existing principal and participating employers are replaced with a new entity that provides financial strength in the form of capital.

To encourage consolidation through financial consolidators, there needs to be a clear regulatory regime which goes beyond the "interim guidance" currently in force. It is also worth highlighting the practicalities of this interim guidance and in particular the expectation that a financial consolidator transaction should only be considered if the scheme in question is not expected to be able to buy-out in the "foreseeable future".

Scheme suitability for buyout is often considered in the context of the scheme's funding level, i.e. does the scheme have sufficient assets to wholly fund the bulk purchase annuity single premium? Given the current capacity constraint, it would seem appropriate to consider insurance capacity alongside funding level when assessing timeframe to buyout.

Mastertrusts

Mastertrusts are multi-employer DB schemes for non-associated employers. Master trusts normally offer segregated sections for each new scheme and have common advisers, trustees, investment approach etc across each section. Under this vehicle the employer covenant is unchanged, i.e. each section normally retains the same principal / participating employer that existed outside of the master trust.

Why encourage DB consolidation?

DB pension scheme consolidation can provide significant benefits to scheme members, sponsors, regulators, and the wider economy.

Through delivering governance improvements, reduced running expenses; efficient and integrated investment and funding strategies; stable routes to insurance buyout; and a focus on positive member experience, they can offer an efficient runway to buyout for small to medium sized pension schemes.

Despite these clear benefits, their take up to date has been limited. We estimate that less than £20bn of assets are in DB consolidation vehicles. This compares with around £400bn of assets across small to medium sized pension schemes that could benefit from such solutions. There may be various reasons for this. In some instances, it may be due to conflicting interests between the various parties involved in running the scheme which results in a status quo. Or it may be because scheme sponsors and lay trustees may be unaware that a more efficient solution to managing their legacy DB pension scheme exists

TPR has been instrumental in the rise of DC master trusts through its "govern or consolidate" initiative which required small schemes to demonstrate why it was in their members' best interest to remain outside of a consolidation vehicle. A similar initiative (considering both members and sponsoring employers) would be helpful to ensure members' benefit security is protected whilst at the same time helping more scheme sponsor resource to be directed towards funding members' benefits rather than ongoing running expenses.

What steps can TPR take?

An authorisation regime / regulatory kitemark for DB master trusts would give TPR comfort that encouraging consolidation is not concentrating exposure to a model that is sub-standard.

Whilst an authorisation regime might seem an additional burden on an already resource-stretched regulator, we believe it could actually free up resource and assist TPR to achieve its responsibilities as they relate to small to medium sized pension schemes, namely:

- Improve the way workplace schemes are run (through setting a high bar for authorisation);
- Reduce the risk of schemes ending up in the Pension Protection Fund (though appropriate funding and investment strategies); and

- Making sure employers balance the needs of their DB pension scheme with growing their business (more on this below).

In relation to the last point, we consider the new (but delayed) funding code and its implications for small schemes.

Most industry participants acknowledge that a "fast-track" compliant strategy is one which targets a low-risk funding position. However, it can also be inefficient as there are low risk investment strategies that can justifiably support funding targets that would not meet the fast-track threshold. For example, it is appropriate for a small scheme to adopt a predominantly fixed income-based investment strategy – across private as well as public assets - that is expected to return a (contractual) yield in excess of 1% p.a. over the prevailing yield on gilts.

DB consolidation vehicles can standardise such strategies and offer efficient implementation to tens, if not hundreds, of sections. A regulator kite mark could enable swift certification of such approaches and free up additional sponsor resource without detriment to member benefit security.

Are there any circumstances in which consolidation should be mandatory?

Although there will be exceptions, it is the smallest schemes that have the most difficulty ensuring proper governance at a reasonable cost.

Due to the number of very small schemes in the UK, it is near impossible to monitor the governance arrangements of all these schemes. A potential solution, to ensure proper governance of small schemes, is to introduce an 'opt-out' regime for DB consolidation for schemes with less than a specified level of assets.

We believe such a threshold to be £10m to £20m but it could be set higher. All schemes below this size would be required to consider transferring to an authorised DB mastertrust or other consolidation solution. Those who decide not to transfer would need to document the rationale for the decision and explain how their governance arrangements are sufficient. This would be reviewed by the regulator.

This together with mandating certain governance requirements such as the appointment of a professional trustee is likely to improve the attractiveness of DB mastertrusts for small schemes due to cost differential.

Although the buyout market is constrained and schemes of this size may struggle to find competitive quotes, we believe there is good capacity in DB consolidation vehicles such as mastertrusts, which could accommodate the expected demand from introducing this opt-out regime for very small schemes.

Introducing this regime would also help DB mastertrusts achieve scale, reducing per scheme costs and ultimately improving the security of members benefits.

In the case of impending corporate sponsor insolvency, there is a case for mandatory consolidation into one of the financial consolidation vehicles (where the covenant is replaced by a capital backed entity). This may be appropriate if it enables a higher proportion of member benefit to be secured than if member benefits were provided from the PPF or via

insurance company. This would be the case where the scheme is fully funded on the PPF basis, less than fully funded on an insurance basis and consolidation pricing is less than the equivalent bulk purchase annuity.

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

We do not envisage a reversal in the well-established trend towards Defined Contribution workplace schemes. Even with improvements in funding levels we do not see a return to large scale DB provision. Furthermore, members' benefits from DB schemes (whether open or closed to new members) will remain unchanged because of funding level improvements (other than potentially discretionary benefit awards which may have become more likely).

How should scheme surpluses be treated? For example, should they remain in the scheme or shared between employers and scheme members? Are the issues different for open and closed schemes?

Ownership of surplus is a legal question and will vary from scheme to scheme depending on the underlying governing documentation. In principle, subject to the legal position in the governing documentation, we think it is appropriate for scheme sponsors to expect some refund of surplus after all guaranteed benefits are secured.

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

Improved funding levels are likely to lead to a lower levy collection but also a lower level of exposure to risk for the PPF. It is more likely that schemes which suffer a corporate sponsor insolvency will have sufficient assets to secure greater than PPF level benefits with an insurance company and thus not fall into the PPF.

Should changes be made to the Pension Protection Fund (PPF), Financial Assistance Scheme (FAS) or Fraud Compensation Fund (FCF) to improve outcomes for members?

The PPF does not currently compensate the full level of member benefits. The financial cost of increasing the level of benefits protected could be reviewed as it may help trustees delay buyout transaction and deliver a wider economic benefit without risking the security of their members' benefit promise.

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