Written evidence from Adam Saron DBP0069

Definitions

The following defined terms and abbreviations have been used throughout my Response to the Guidance Review.

Term	Definition
"Clara" or the "Clara Group"	means the group of companies of which Clara-Pensions Group Limited is the holding company, with Clara-Pensions Limited and Clara Trustees Limited among its wholly owned subsidiaries.
"DB"	means defined benefit.
"DWP"	means the Depart for Work & Pensions.
"Guidance"	means the Pension Regulator's *Superfunds Guidance* dated 18 June 2020.
"PRA"	means the Prudential Regulatory Authority.
"Response"	means this response dated 26 April 2023 prepared by Adam Saron in reply to the Work and Pensions Select Committee Call for Evidence on Defined Benefit Pension Schemes.
"Superfund"	has the meaning ascribed to it in the Guidance.
"TPR" or the "Regulator"	means The Pensions Regulator.
"Trustee Guidance"	means the *Superfund guidance for prospective ceding trustees and employers* published by TPR on 21 October 2021.
"White Paper"	Means the *Protecting Defined Benefit Pensions Schemes* white paper presented to Parliament by the Secretary of State for Work and Pensions on 19 March 2018.
"WPSC" or the "Select Committee"	means the Work and Pensions Select Committee.

Background

I am the founder and former CEO of the Clara Group. Together with my co-founder and former colleagues I am responsible for conceiving and building Clara's member-first model. I led Clara through the completion of TPR's Superfunds assessment process on 30 November 2021.

I first became involved with Superfunds in October 2016 and began working full time on the project that became Clara in April 2017. Clara-Pensions Limited was incorporated on 21 August 2017. Following the DWP's White Paper in March 2018, Clara publicly launched as one of the prospective commercial consolidators or Superfunds in September 2018.

I was CEO of the Clara Group until 31 March 2022. I have no executive or non-executive involvement with Clara although I retain an economic interest in the Clara Group.

I remain active in the UK pensions sector and remain strongly supportive of a safe and vibrant Superfunds market as a real end game alternative for UK DB schemes. The consolidation of UK pension assets and liabilities may not be the solution to all the weaknesses in our system, but I strongly believe that consolidation makes the solutions much easier.

I would welcome the opportunity to discuss my thoughts with the Select Committee.

Regulatory Framework

WPSC Question 1
Is the right regulatory framework in place to enable open DB schemes to thrive?

Response to Question 1

In 2012 there were 908 open DB pension schemes, which represented 14% of the DB schemes in the PPF's Purple Book data set. By 2022 the number of open DB schemes had declined to 488 (a 46% reduction) and these open schemes now only represented 10% of total DB schemes. Over the same period the number of DB schemes closed to future accrual increased from 1,667 to 2,604 (a 56% increase). More telling, 2022 was the first year when schemes closed to future accrual represented more than 50% of the universe of DB schemes.

I do not believe that either of these two trends will be halted or reversed. While the existing regulatory framework works well to protect open DB schemes; open schemes as a class have not "thrived".

The status of the remaining open schemes will be driven more by the industrial relations between the sponsors and employees than by the regulatory framework. The better question is therefore whether the existing regulatory framework will allow those schemes that choose to remain open to thrive?

Buy-out Market

WPSC Question 2
Is there sufficient capacity in the buy-out market to meet demand from DB schemes? If not, what are the alternatives?

Response to Question 2

Demand vs Supply

The short answer to the Select Committee's question is no. There is and will be a higher demand for bulk annuity transactions than the insurance market will supply.

It is unambiguously positive that scheme funding has improved for DB schemes. It is equally positive that more schemes can afford buy-out[1] today and expect to be able to do so in the foreseeable future. There is, however, a significant difference between being able to afford a bulk annuity transaction and being able to execute one *"now"*.

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[1] I have used "buy-out" generically in my Response. Almost all bulk annuity transactions are executed as one or as a series of buy-ins, which are later converted into individual policies and bought-out.

There is a clear and consistent message from insurance market participants (schemes, advisers and insurers) that the demand for buy-out transactions is at an historic high. There is a fundamental mismatch between pension schemes seeking buy-out and the insurers providing it. The insurers are focused on the £ value of capital deployed (and there is no sense of a lack of available capital). The pensions schemes, however, are focused on the number of transactions (and whether they can be one of them) and there is a limited supply of the number of transactions that can be executed. The factors driving this supply-demand imbalance will not change in the short to medium-term:

- ***Pricing Capacity*** – people are a key constraint and insurer pricing teams have a limit on the number of transactions they can price.
- ***Shift to Full Buy-ins*** – historically the "buy-out" market has primarily been a market of partial pensioner only buy-ins. An effect of last year's LDI crisis is that partial buy-ins are less attractive to schemes in an environment where there is less leverage available. Full buy-ins that include all deferred members are more complex to price adding further pressure on limited pricing capacity.

  As more schemes seek full buy-ins, ceding trustees are increasingly seeking "all risks" pricing from the insurers, which in turn adds further complexity to the pricing process.
- ***Large Transactions*** – are more attractive to insurers as they can deploy more capital without using more scarce pricing resources. Large transactions absorb more pricing capacity across the market and the winning insurer often steps back from new transactions while they process/digest a large transaction.
- ***Administration Capacity*** –administrators have a growing backlog of post transaction transitions to process. This is a growing issue that is not sufficiently discussed.
- ***Scheme Readiness*** – even though bulk annuity affordability has improved dramatically and quickly, scheme readiness has not kept pace. Many schemes may now be able to afford buy-out but are not ready to approach the market as they have data and benefit issues that need to be rectified. This work is pressurising the same administration resource that processes bulk annuity transitions.
- ***Absence of New Entrants***- despite the supply-demand imbalance in the bulk annuity market there has not been a new entrant since 2017[2]. The capital, regulatory and marketing barriers are high and have dissuaded new entrants.

Alternatives

There is a narrative in the DB industry that buy-out affordability equates to a buy-out imperative. The first alternative to buy-out it is to consider the alternatives.

Any sensible trustee or sponsor governance process should consider three questions:

1. ***Alternatives*** - begin with a balanced consideration of the alternatives available to the scheme and sponsor;
2. ***Timing*** – buy-out is a fantastic outcome and will be the right answer for many schemes. For most closed schemes buy-out will be an inevitable step at some point, but not enough

[2] Phoenix Life entered the bulk annuity market in 2017 and rebranded as Standard Life in 2021.

consideration is given of when that point should be. Immediately is often not the right answer; and

3. ***Next Steps*** – what do the scheme and sponsor do next. Market conditions can and will change over time. Buy-out may become less affordable or the risk of sponsor failure may increase. How do you manage risk now?

It is no surprise that I see Superfunds as a viable alternative path to buy-out. Superfunds that target a specified objective and align themselves with their members by delaying profit extraction until that objective is met can deliver better outcomes with lower risk. Clara's objective is clear – provide better outcomes for members by creating a safer, better capitalised journey to buy-out.

This is not the only way.

The last 18 months have seen significant improvements in DB scheme funding. Though buy-out pricing has also improved, it remains an expensive solution, particularly when compared to most sponsors own targeted returns on equity. Sponsor can and should consider whether accumulated surplus can be deployed to improve circumstances for their employees inside and outside the DB scheme. This is particularly relevant against the prevailing economic backdrop of high inflation and cost-of-living pressures.

Trustee Boards

WPSC Question 3

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

Response to Question 3

Trustees perform a non-executive governance function. Without access to their own executive support, trustees can become overly reliant on advisers. TPR should consider requiring trustee boards to be supported by an executive function separate from the scheme's advisers.

In other areas of financial services, regulators require firms to have internal (or outsourced) resources to cover certain functions (for example, Chief Actuary and Money Laundering Reporting Officer). This is also not unfamiliar in UK DB as the large DB schemes already have their own internal resources. There are variations on how these resources are structured. In some cases, the executive resource is provided by or shared with the employer and in others a pension management company is a subsidiary of the trustee. BT Pension Scheme Management has even rebranded itself as Brightwell and is offering its services externally to other pension schemes.

This is another clear example of the benefits of scale.

Consolidation

WPSC Question 4
What, if any, further steps should be taken to encourage DB scheme consolidation?

Response to Question 4

DB scheme consolidation can be encouraged by either or both of (i) incentivising the schemes to consolidate; and (ii) making consolidation more attractive.

Incentivising Schemes

Actions by TPR to improve governance, administration and reporting standards will increase the costs of operating a DB pension scheme and will disproportionately impact smaller schemes.

The economy of scale benefit offered by consolidators like DB master trusts should be attractive, but since scheme costs are borne by the employer (often directly) it is not a strong motivating factor for trustees. Sponsors should be incentivised to consider consolidation but are usually focused on non-pension issues.

Deliberately targeting smaller schemes' cost bases through special levies or other levels measures does not feel appropriate. It will likely be more effective to focus on making consolidation vehicles more attractive.

Enhancing Consolidation

Clarifying PPF+ Cases
It is accepted that Superfunds are a viable alternative to PPF+ buy-out if the Superfund can reinstate full pre-insolvency benefits. The current bulk transfer regulations, however, do not allow a PPF+ transaction with a Superfund that will deliver benefits higher than can be achieved through a bulk-annuity transaction but below 100%. Members in this situation are being denied the best economic outcome available.

This is a small change to secondary legislation that I believe would find support at the DWP, TPR and the PPF.

Superfund Gateway Tests
The first two Gateway Test set out in TPR's Trustee Guidance for Superfund transactions are unnecessarily restrictive.

Gateway Test 1 is focused on the affordability of buy-out for a ceding scheme. As described in the response to Question 2 above buy-out affordability is not the same as being able to execute a buy-out transaction.

There are now schemes trapped between the Gateway Tests and the reality of the bulk annuity market. It does not make sense that they cannot consider other options that could improve member outcomes. **Smaller schemes** are particularly vulnerable to this "trap". Insurers are focused on deploying capital rather than executing a particular number of transactions. With scare pricing and administrative resources, they are incentivised to (and do) target ever larger transactions.

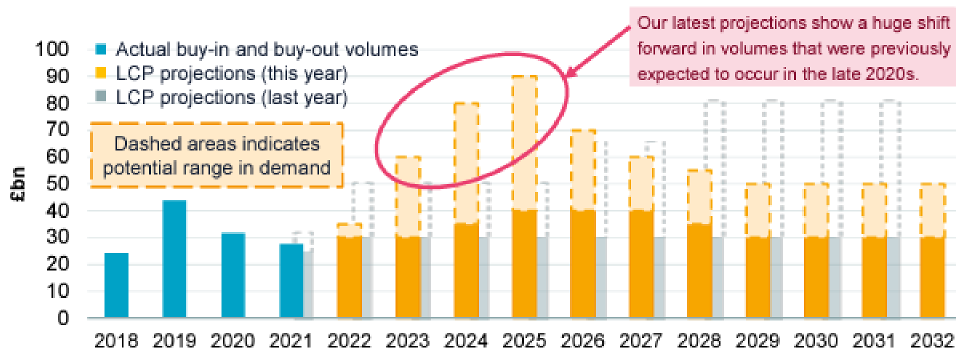
I would propose amending Gateway Test 1 as follows:

"A transfer to a superfund should only be considered if the scheme cannot ~~afford to~~ buy out now."

Gateway Test 2 should be abolished. The concept of "foreseeable future" has proven to be complex and difficult to quantify. Furthermore, Gateway 2 is:

- ***Unnecessary*** – bulk annuity insurance is a market that does not need protection. Since the White Paper in 2018, the bulk annuity market has only become stronger. 2019 was a record year for volumes, which have remained consistently high and are widely predicted to rise even further in coming years.

Chart 4: Projected buy-in and buy-out volumes over the next decade



Source: *LCP report on future demand and supply in the buy-in and buy-out market* October 2022

- ***Subversive*** – another unintended consequence of Gateway Test 2 has been to subvert trustees' judgement and decision making. Prior to the politicisation of the Superfunds debate, the White Paper[3] saw the difficult decisions between end game options as being for the trustees supported by appropriate advice. Trustees are the true gateway for every DB pension scheme. Working with their sponsoring employer, they are best positioned to select the right end game for their scheme and more importantly what it the optimal path and timeline.

Surplus on Wind-up

Surplus paid to the sponsoring employer on wind-up of a DB scheme is subject to penal taxation. By contrast, bulk annuity insurers can receive surpluses (above technical provisions) as premium. This tax treatment imposes a structuring and pricing cost on Superfunds, particularly in the case of PPF+ transactions, which represent the most vulnerable members from the perspective of their outcomes.

The attraction of consolidation solutions (both Superfunds and DB master trusts[4]) would be enhanced if surplus on wind-up of a DB scheme through an assessed or authorised consolidation vehicle was tax free, or at the very least taxed at the corporate tax rate.

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[3] See paragraph 157 of the White Paper.

[4] This would require a formal authorisation or assessment process for DB master trusts analogous to that for Superfunds or DC master trusts.

WPSC Question 5
Are there any circumstances in which consolidation should be mandatory?

Response to Question 5

No. It is difficult to envisage what would be a clear trigger for mandatory consolidation.

Entry into the PPF (or more strictly, entry into PFF assessment) is the only form of mandatory consolidation that exists in the current DB framework. This is distinguishable as the tiggering event (insolvency of the sponsoring employer) is clear, unambiguous and not vulnerable to manipulation.

Scheme Funding

WPSC Question 6
Do the recent improvements in funding levels change the future role of DB schemes in UK pension provision?

Response to Question 6

Improved funding and surpluses are a useful reminder that DB pension schemes are not just liabilities on corporate balance sheets but can be valuable assets as well.

While recent improvements in funding levels are to be welcome, they should not be assumed to be permanent when considering the future of DB schemes and wider pension provision. Pension promises are long-lived and market conditions will change.

We also should not just ignore the policy focus of the very recent past. The 2018 White Paper was not just about consolidation and Superfunds, its real focus was on making DB schemes safer. These aspects were realised in the Pensions Act 2021 and the criminal sanctions for the avoidance of employer debt.

Strong funding and surpluses are not spread uniformly across the DB universe and there remain weak schemes with weak sponsors.

There are many ideas of what to do with the assets of DB schemes, but their primary purpose is to provide the benefits under the DB schemes they support.

WPSC Question 7
How should scheme surpluses be treated? For example, should they remain in the scheme or be shared between employers and scheme members? Are the issues different for open and closed schemes?

Response to Question 7

Scheme surpluses are not permanent until the scheme has wound-up and should remain in the scheme until then. Early extraction of surpluses from DB schemes is as inappropriate as profit extraction from Superfunds.

The sharing of surplus between members and the sponsoring employer is a matter for the trust deed and rules of each scheme.

Pension Protection Fund

WPSC Question 8
What are the implications of improved funding levels for the Pension Protection Fund?

Response to Question 8

I have no response to Question 8.

WPSC Question 9
Should changes be made to the Pension Protection Fund (PPF), Financial Assistance Scheme (FAS) or Fraud Compensation Fund (FCF) to improve outcomes for members?

Response to Question 9

I have no response to Question 9.

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