Written evidence from the Pension Insurance Corporation plc DBP DBP0073

Executive Summary

1. PIC is pleased to respond to DWP Select Committee's Inquiry into defined benefit pension schemes.

2. There has been much debate in the media and elsewhere over recent months about the benefits of consolidating, and potentially re-opening, private sector defined benefit pension schemes. The main driver of this line of argument seems to be that the City, especially the stock market, is losing out to other major financial centres and that because DB schemes have reduced their investment in equities over the past 15 years, the decline of the City can be reversed by forcing DB schemes to invest in equities once again.

3. This line of thinking conflates two separate issues. The first is how we support the stock market and "save the City". In our view, "saving the City" is not the job of DB trustees or their scheme members, although in time DC pension investors will be more invested in UK equities. Rather, it requires real acknowledgment by policymakers and regulators that attracting capital is competitive. We need to make the City competitive compared to other financial centres, which means proportionate regulation, a supportive tax policy, a better balance between investment for growth and the requirement for dividends, and a culture that celebrates success.

4. By contrast, the proponents of private sector DB consolidation in order to "save the City" have noticeably failed to either explain how and why their proposals benefit scheme members and other stakeholders, including corporate sponsors, mitigate risk with appropriate capital and governance (which should be at insurance levels), or address the logical flaws in their analysis.

5. The first flaw is the failure to address the demographic reality of DB schemes. With c.90% of DB schemes being closed to new members and / or future accrual for many years, and with no incentive to reopen at any point, most members are close to retirement or already retired. This means that most schemes only have a limited duration, making equities an entirely unsuitable investment to provide the steady cashflows needed to fund their members' retirements, as is recognised by TPR in their consultation on the new Funding Code.

6. The second flaw is that any significant change in investment strategy for DB schemes – forcing them to invest in equities at scale when they are currently c.70% invested in fixed income assets[1] - would be useless as an answer to current policy issues because

[1] The Purple Book 2022 (ppf.co.uk)

it would take years to complete. It would also significantly push up the cost of borrowing for the UK Government, due to a consequent collapse in demand for gilts.

7. The third flaw is the failure to account for the resistance this plan is likely to generate amongst corporate sponsors, the very people who closed these schemes in the first place because of the risks they posed to corporate balance sheets. The historically low gilt yields we have seen over the past decade were partly responsible for persistently underfunded DB schemes, which forced their sponsors to contribute an additional £200 billion in deficit reduction contributions – or more than 20% of total dividend payments[2]. This fact alone might be more pertinent for the "saving the City" argument.

8. Sponsors - and their shareholders - would not agree to having the risk they have paid to mitigate back on their balance sheets in full force, exposing a final logical flaw - that any solution along these lines would require primary legislation and a change in regulation and safety net so that the Government rather than other employers stand behind the consolidated schemes - and the Government is very unlikely to want to guarantee these pensions and have them on its own balance sheet.

9. Following last year's rise in gilt yields, we estimate that about 20% of schemes can now afford to complete a pension insurance buyout without recourse to additional funding from the sponsor. This is at least double the number at the end of 2021.

10. With estimated volumes already this year of about £10 billion, trustees are driving the private sector DB consolidation process through the life insurance industry, achieving security for their members' benefits and driving economies of scale in liability management with appropriate levels of capital, governance and regulatory oversight.

11. By contrast, and despite much publicity, no DB schemes have chosen to pursue the pension superfund route, in our view because these models were designed to primarily benefit the corporate sponsor, with member security a second order consideration.

12. However, there is one area of the DB pension sector in which further additional consolidation would be beneficial - the 100+ schemes within the Local Government Pension Scheme ("LGPS"). Despite the recent efforts at pooling, the LGPS costs at least £1 billion a year more to run than a direct comparator, the Canada Pension Plan Investment Board ("CPPIB"), which has c.£330 billion of assets, compared to the LGPS with £364 billion. Furthermore, LGPS costs since pooling have actually risen by more than £1 billion. And the CPPIB has a more sophisticated investment strategy, mainly focussed on productive assets, undertaken by professional investment managers and achieving better outcomes.

[2] https://www.linkgroup.eu/media/1610/july-2021-dividend-monitor-report.pdf

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

13. Open DB schemes are increasingly hard to find. This isn't just driven by changes in demographics and regulation but by changes in employment patterns. It is very rare to find employees working all their lives for one employer. So employers are looking at other methods to recruit and retain talent – such as portable DC schemes with high employer contributions.

14. There are 9.6 million DB scheme members, down from 9.7 million in 2021. 43% of these are pensioners, 47% are deferred members, and just 10% are active members[3]. This means that 90% of members of these schemes have no ongoing defined benefit relationship with the sponsor responsible for making good any deficit. A closer look at the data also shows that of the c.900,000 people accruing benefits in open schemes, more than 200,000 are actually in the USS[4]. According to the PPF, it is large pension schemes which are more likely to be open[5].

15. It seems incongruous therefore to reshape DB scheme regulation to address a tiny minority of schemes and members, potentially increasing risk for millions of other people.

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

16. We believe that there is sufficient capacity within the buyout market to meet demand over the next decade.

17. The rise in yields over 2022 had a momentous effect on funding. At year end, DB schemes were on average c.20% better funded than they were at the start of 2022, with aggregate funding levels approaching 90% of buyout. Many schemes were much better funded than this, with about 20% of schemes able to complete a pension insurance buyout without recourse to additional funding from the sponsor, at least double the number at the end of 2021. This lays the foundation for what is expected to be a significant increase in the size of the pension risk transfer market over the coming years.

18. This economically important process will, as a consequence of the desire from trustees for higher levels of security for their members' benefits, remove pension risk from corporate balance sheets and significantly increase investment into sectors including renewable energy, social housing, urban regeneration and the UK's

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[3] https://www.ppf.co.uk/sites/default/files/2022-11/PPF_PurpleBook_2022.pdf

[4] https://www.uss.co.uk/news-and-views/latest-news/2022/07/07252022_uss-publishes-202122-report-and-accounts#:~:text=USS's%20membership%20grew%20by%20almost,of%20the%20scheme's%20DB%20section

[5] The Purple Book 2022 (ppf.co.uk)

universities by the insurance companies – and allow the employers to flourish without a DB scheme.

19. However, the opportunity for a greater number of transactions brings with it capacity challenges, in particular around asset availability, human resource, reinsurance, and capital. Whilst each of these is not insignificant, the pension risk transfer market is dynamic and has been working for some time to address these capacity challenges.

20. In terms of human resource for example, PIC's employee base has approximately doubled over the past three years, and now stands at almost 500 employees, to enable us to meet increased demand from trustees.

21. On the asset side, the pension risk transfer providers have significantly increased their asset sourcing capabilities and sophistication. We have a proven track record of investing in new asset classes that provide secure, long-term cashflows to match our pension obligation over coming decades. This includes private rental sector, urban regeneration projects, retirement living, and electrified rolling stock. We are also expanding our work with local councils to develop their urban regeneration expertise, and help them bring forward more investable assets, benefitting local people and economies.

22. In terms of capital, given the size and number of institutional investors seeking to invest in the PRT market, such as sovereign wealth funds and private equity partners, it would be difficult to argue there is a lack of capital to support a significantly larger buyout flows.

23. Reportedly, there are currently several companies considering entering the PRT market, albeit to varying degrees. If demand continues to increase from pension schemes, the industry expects that further insurers will continue to join.

24. It is also worth noting that the industry continues to innovate to find ways to address the demand, including facilitating smaller schemes completing buyouts alongside increased demand from very large schemes. This would involve streamlined de-risking processes for small schemes.

25. Finally, marginal price increases as the demand / supply dynamic shifts will also materially increase the capacity of the market.

Question 3 - Do the recent improvements in funding levels change the future role of DB schemes in UK pension provision?

26. For the reasons outlined above, we think the future role of corporate DB schemes in UK pension provision is largely limited to securing the historic liabilities they oversee.

27. However, should complete consolidation of the LGPS be achieved, there is a significant, leading role for that entity to play within the pension sector, including helping drive up standards of governance across the board.

Question 4 - What should the Pensions Regulator (TPR) do to improve the quality of trustee boards?

28. We do not believe that there is one single answer as the understanding and experience of trustees can vary significantly between schemes. Rather than focussing on policy levers, we believe that schemes should focus on how they can deliver what's important – good governance, clear objectives, and mechanisms to manage their data in order to make informed decisions.

29. The trustees we have engaged with have all been thorough and diligent in exercising their duties and excellent consumers of the professional advice they receive from actuaries, investment advisors, and lawyers. Diversity is known to be important on boards and we have found a range of perspectives is crucial in achieving outcomes that can differ significantly, depending on the status of the scheme.

30. We are also wary of once again increasing regulatory requirements for trustees, given the ongoing challenge of recruitment. At least one recent trustee survey[6] suggests that TPR's trustee requirements require "substantial time and resource", without obvious benefits for scheme governance.

Question 5 - What, if any, further steps should be taken to encourage DB scheme consolidation?

31. The reality of DB consolidation comes in many flavours, including pooled funds, master trusts, multi-employer funds, and buyouts / buy-ins. For the purposes of this response, however, we focus on recent proposals to consolidate DB schemes through other means, including pension superfunds.

32. The recent push for non-insurance consolidation of DB schemes through superfunds has rightly foundered on two main issues. The first was whether superfunds would increase the chances of defined benefit pension scheme members receiving their full benefits. The clear danger to members receiving their full benefits through increased risk taking by for-profit superfunds operating within the not-for-profit trustee framework, combined with the second issue of the potential systemic risk posed by these entities (as highlighted by the Bank of England[7]), seems to have outweighed any benefit to sponsors of transferring DB schemes to a superfund.

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[6] https://www.icaew.com/insights/viewpoints-on-the-news/2022/jun-2022/pension-schemes-worry-over-new-governance-code

33. Proponents of DB scheme consolidation in an effort to "save the City" also have the same issues. They have not explained how their plans will increase, or at the very least maintain, levels of benefit security for members, nor how their ideas address issues of systemic risk, governance, capital, or regulatory oversight.

34. It is also noticeable that these proposals also contain several logical flaws.

35. The first flaw is the failure to address the demographic reality of DB schemes. With c.90% of DB schemes being closed to new members and / or future accrual for many years, and with no incentive to reopen at any point, most members are close to retirement or already retired. This means that most schemes only have a limited duration, making equities an entirely unsuitable investment to provide the steady cashflows needed to fund their members' retirements.

36. The second flaw is that any significant change in investment strategy for DB schemes – forcing them to invest in equities at scale when they are currently c.70% invested in fixed income assets - would be useless as an answer to current policy issues because it would take years to complete. It would also significantly push up the cost of borrowing for the UK Government, due to a consequent collapse in demand for gilts.

37. The third flaw is the failure to account for the resistance this plan is likely to generate amongst corporate sponsors, the very people who closed these schemes in the first place because of the risks they posed to corporate balance sheets. Trustees would only have very limited timeframes to close any deficit caused by adverse equity market movements. This would force them to call, once again, on their sponsors. These are the same sponsors who have contributed about £200 billion in deficit reduction contributions over the past decade.

38. Sponsors - and their shareholders - would not agree to having the risk they have paid to mitigate back on their balance sheets in full force, exposing a final logical flaw - that any solution along these lines would require primary legislation and a change in regulation and safety net so that the Government rather than other employers stand behind the consolidated schemes - and the Government is very unlikely to want to guarantee these pensions and have them on its own balance sheet.

Question 6 - Are there any circumstances in which consolidation should be mandatory?

39. In our view there is one clear case where consolidation should be mandatory: the LGPS.

<u>The benefits of LGPS consolidation</u>

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[7] https://news.sky.com/story/boe-governor-bailey-blows-hole-in-pension-superfunds-regime-12013423

40. As recently as the 1980s, many Canadian public pensions were invested largely or entirely in domestic Government bonds, funded primarily on a pay-as-you-go basis, lacked independent governance and were administered in an outdated and error-prone fashion. Over the past three decades a model of public pension has emerged combining independent governance, professional in-house investment management, scale and extensive geographic and asset-class diversification in order to effectively consolidate funds.

41. There are some parallels with the current LGPS arrangements, and indeed with the ultimate prize following LGPS consolidation – a true UK sovereign wealth fund.

42. Despite moves to pool assets, the LGPS remains fragmented and has significantly lower levels of investments in productive assets compared to large taxpayer-backed schemes of similar size and purpose around the world.

43. In terms of assets, the LGPS is directly comparable in size to the CPPIB, which has c.£330 billion[8] of assets, whilst the LGPS has £364 billion[9]. Yet the CPPIB has a much more sophisticated investment strategy, mainly focussed on productive assets.

44. Most significantly, however, from a taxpayer perspective, is that the CPPIB costs £1 billion a year less to run than the LGPS. This £1 billion represents a direct transfer from local taxpayers struggling with a cost of living crisis to the myriad advisers and service providers employed by each of the 100+ LGPS trustee boards.

45. Further, as has been well documented, the LGPS has seen some degree of asset consolidation (pooling) over recent years and the Government is due to consult on further consolidation along these lines. However, on at least two of the original goals of pooling, "reduced costs" and "improved capacity to invest in infrastructure"[10], the merger so far has not been successful.

46. Since pooling was brought in, LGPS costs have actually risen by more than £1 billion. The LGPS pays 56bps per annum in fees[11], up from 45bps in 2017/18. This compares to 27bps per annum for the CPPIB[12].

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[8] https://www.cppinvestments.com/public-media/headlines/2022/cpp-investments-net-assets-total-539-billion-at-2022-fiscal-year-end/

[9] Local government pension scheme funds for England and Wales: 2021 to 2022 - GOV.UK (www.gov.uk)

[10] https://democracy.durham.gov.uk/documents/s57106/LGPS%20Investment%20Reform.pdf

[11] Local government pension scheme funds for England and Wales: 2021 to 2022 - GOV.UK (www.gov.uk)

[12] https://www.cppinvestments.com/public-media/headlines/2022/cpp-investments-net-assets-total-539-billion-at-2022-fiscal-year-end/

47. In terms of infrastructure investment, as the table below shows, the LGPS has remained significantly invested in listed equities, rather than the productive assets, including infrastructure, which is the focus of CPPIB investments.

	LGPS	CPPIB
Public Equity	57%	27%
Private Equity	3.3%	32%
Gilts	9%	
Infrastructure		9%

48. This should not be a surprise when considering relevant data on necessary size requirements for significant infrastructure investments, and it seems the original target of £25 billion of assets for each pool is simply not big enough to provide the necessary economies of scale. "Bringing private equity assets inhouse is an activity limited to the largest funds – the smallest investor in the CEM database that reported having substantial internal private equity investments in 2020 had $18 billion (USD) in total assets, while the average investor with internal private equity investments in 2020 has total fund AUM of $152 billion (USD). This is the real win for scale, the ability to deliver cost-effective and diversified private asset management by leveraging scale to implement these assets internally."[13]

49. Furthermore, as highlighted by the Government Actuary's Department, there are concerns over the ability of the local taxpayer to support the system as it stands: "We are concerned that employer contribution rates are decreasing (reducing the burden on current taxpayers) at the same time as the deficit recovery end point is being extended further into the future (increasing the burden on future taxpayers)."[14]

50. It has been estimated that c.20% of council tax is used to support the LGPS[15].

51. This then, suggests a clear case for compulsory consolidation into one scheme in order to lower overall costs, reducing the current and future burden on local taxpayers, and increase the LGPS's ability to invest in productive assets.

52. From a member perspective, the local taxpayer guarantee would remain in place, so there would be no increase in risk to their benefits.

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?

[13] https://www.imcoinvest.com/pdf/research/CEM-Benchmarking-Report_A-Case-For-Scale-February-2022.pdf

[14] https://www.lgcplus.com/finance/government-actuary-warns-of-pensions-strain-on-council-budgets-16-12-2021/

[15] https://www.professionalpensions.com/news/2141263/gbp1-gbp5-council-tax-goes-lgps

53. We believe that where possible the scheme surplus should be treated as a buffer against future adverse experience as a result of financial or demographic changes that could worsen the scheme's funding position until all benefits have been secured.

54. The way in which the surplus will be attributed will be a matter for the sponsor and the trustees and any prior agreements made in the Trust deed. The cleanest way to access the surplus is to buyout the scheme, as there unlikely to be further recourse to these funds in future, which may not be in the case on any other surplus measure. Once the buyout has been undertaken, benefits could be uplifted, or funds refunded back to the employer depending on the agreements made.

55. In practice, after allowing for the cost of buyout, ongoing costs such as winding up the scheme, potentially purchasing residual risk coverage, and additional exercises such as GMP equalisation, there is a significant overall uptick required for the average scheme to be truly in surplus and for funds to be released back to members or sponsor.

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

56. Improved funding levels reduce the risk on the PPF, however increased scheme investment in equities would increase the risk to the PPF of scheme being underfunded.

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?

57. No response.

About PIC

58. PIC is a specialist insurer providing pension insurance buyouts and buy-ins to the trustees and sponsors of UK DB pension schemes. At year-end 2022, PIC had £41 billion in assets and had insured 302,200 pension scheme members. We have a clearly articulated purpose, which is to pay the pensions of our current and future policyholders. We have paid almost £11 billion of pensions so far, with a 99% customer satisfaction rate.

59. Our investment strategy prioritises the management of key risks, including environmental, social and governance, as integral to paying the pensions of our policyholders over the coming decades.

60. PIC has more than £11 billion invested in areas with a lasting impact on current and future generations, including renewable energy (c.£1.5 billion), social housing (£3.6 billion), urban regeneration (£1.5 billion), and the UK's education sector (£3 billion).

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