C-Suite Pension Strategies – Written evidence (SCG0063)

The Committee's work is timely. The onus placed by the current Government on investment and growth is clear. The introduction to FCA and PRA of their secondary objective in August 2023 on competitiveness and growth has had time to become established. The questions set and the oral evidence to the Committee has received, reference the important but at times conflicting requirements set.

Sam Wood's response for PRA to the request for "Concrete Proposals" talks on growth of "looking for potential overlaps between PRA's governance and disclosure requirements and those of legislation and other relevant regulators". This is an area we should like to consider in particular in our response.

We concentrate on Defined Benefit (DB) Pension Schemes to provide specific examples. The reasons for highlighting it are:

- The value involved (£1.3 trillion of assets and £50 billion in pensions in payment) is material to the overall economy, growth and investment as well as specific sponsors and members.
- The tensions between protection / derisking and long-term investment/growth are demonstrable. The focus on the primary objective has had serious – and often detrimental – effects on UK companies; UK Capital Markets and overall growth. Regulatory caution and enthusiasm for life insurers has shaped the market. The Pensions Schemes Act 2021 was a high water in risk aversion.
- The roles of relevant regulators are siloed. Closer coordination is much needed. Yet the frameworks of the individual regulators are now well developed and provide flexibility with fall back on statutory instruments available. Complex, time consuming changes to regulation and legislation are not required ahead of substantive progress being achieved to support the growth agenda. In this, the Pensions Minister having a HMT role was a good idea.

- DB pensions can become quickly a case study of what is achievable when regulators collaborate beyond their specific remits. The primary and secondary objectives can be aligned in all stakeholders' interests.

Within the remit of this inquiry, our recommendations are:

- Work on "Credible Alternatives" to buyout and the comparison of outcomes with bulk transfers as required by Technical Actuarial Standard 300 Version 2 and should be monitored in detail. Actuaries and their clients should expect their work to be called in and questions to be asked.
- The PRA and TPR work to ensure "Credible Alternatives" to buyout are coming to market and they are not using their processes as costly blocking mechanisms.
- A cross-departmental / regulatory team (HMT/PRA: DWP/TPR: BT/CMA) is established to look at the practical policy impacts of DB practices on investment strategies and member security and growth. Many problems will self-correct as soon as trustees and their advisors realise it exists. Accounts disclosures of risk transfer deals and their continuing impact should be materially upgraded.
- In the legislative process, the Audit, Reporting and Governance Authority (ARGA) can be clear on requirements on disclosure and on pro growth strategies. Transparency is much needed and should be boosted.
- Studies of how to reduce the level of compliance work an ongoing task. Freeing up SME resource by ensuring the benefits of regulation are sufficient is important. It is, however, the real trigger for growth.
- The pension industry is under the spell of the pension risk transfer industry. PRA should consider whether the life insurance industry is too influential and is an impediment to growth.

Too much influence: Historical context

The power of life insurers in the DB market is an obvious problem. It can be addressed. It has happened before with pensions.

"The influence of the Crown has increased, is increasing and ought to be diminished. It is competent to this House to examine into and correct abuses". In a motion addressing the King's pensions so moved John Dunning, 1st Lord Ashburton in 1780. Life insurers now play the role of royalty in the pension sector.

Much regulation and many "have regards" can be rationalised, but taking back control is the first step in the DB subsector. Weak regulatory coordination has allowed an overheated £50 billion risk transfer market to emerge. Its requirements are poorly aligned with UK growth. But as in 1780, the necessary adjustments are straight forward and should be "expedient to the wisdom of this House" – or its Select Committee.

Enforce TAS300V2 and many issues self correct in all stakeholders' interests. Then Government can add well engineered incentives for the long term and gear up for growth.

Question 1: What opportunities or changes should be prioritised in order for the regulators to meet their secondary growth and competitiveness objectives effectively?

The opportunity is for the regulators to look beyond their specific remits and consider the overall impact at their actions and policies on, the wider economy. The DB market provides an excellent worked example of the policy / regulation interface. Since the LDI crisis, public policy has shifted led by HMT / DWP. FRC's Technical Actuarial Standard 300 Version 2 should be transformative. It calls for bulk transfer and run-on comparisons. Policy decisions are pending following consultations. The 2021 Pension Schemes Act gave rise to new DWP regulations on Funding Strategy and Investment now in force, which provide scope for schemes to reset.

Regulatory features and sector background:

- DB pensions are a DWP area of responsibility. Its regulators are The Pensions Regulator and Pension Protection Fund.

They were set up under Pensions Act 2004. TPR's primary remit is to ensure pensions are paid. It has had an objective not to impact on the "sustainable growth" of the sponsor for a decade. This requirement was never a demonstrable policy feature and has been de- emphasised in recent years. Return targets for investments fell as journey plans of derisking to head to the "Gold Standard" of buyout accelerated schemes towards a cash based portfolio. Corporate contributions escalated to around £20billion a year. Poorly understood LDI mechanisms became a standard product to use in 'endgames' involving PRA regulated life insurers. Annual sponsor contributions were remarkably high to close actuarial deficits caused by low interest rates. The impact of such derisking was to damage the UK Capital Markets as growth assets were sold and create an overheated life insurance market.

LDI – notably in the leveraged form – demonstrated many DB scheme trustees and their advisors had little grasp of collateral requirements. Bank of England intervention was required to maintain stability in markets in autumn 2022. As interest rates rose the costs of "hedging the measure" of actuarial liabilities became clearer.

- Life insurers are a HMT / PRA responsibility. The move from Solvency II to Solvency UK has been the key recent development. What that has underscored is that returns targets set by TPR for UK DB schemes and the return available to life insurers have moved in different directions. A consequence is remarkably profitable business for life insurers with a captive market of "forced sellers" has been created. "Gluttony" was a well stated PRA concern in relation to life insurers. The funded reinsurance of longevity risk undertaken to free up capital to accelerate taking on DB business was a good indicator of why PRA's concerns with "overeating" and related business practices.
- Pension Protection Fund was introduced to reduce risk to members of failure of a sponsor. Indeed, the PPF to FSCS gap in value of their respective safety nets is the rationale for risk transfers. PPF is a considerable success, and it has substantial surplus funds. The gap on a probabilistic basis now is small and it is open to question whether the gap should be a strategy driver – particularly when there are

scheme surpluses which could be used to provide more to pensioners or fund current pensions.

- FRC regulates accountants and actuaries. It reports to Business and Trade. Its lack of resource and clout has been recognised. It is to be replaced by ARGA. Meanwhile, its weakness is reflected in the nonchalant practitioner attitude towards it. Technical Actuarial Standards compliance levels and accounting disclosures on pension risk transfers are dire. This matters. Hence our DB pension proposals contain a key recommendation that Technical Actuarial Standard 300 Version 2 workings by actuaries on bulk transfer v run-on and the availability of Credible Alternatives are looked at seriously – even if this requires a temporary review group.

  On disclosures, the financial rationale of risk transfers can be readily obscured. Transparency is needed. We cite the cases of Aviva (sale of pension liabilities to itself) and NatWest (£11 billion risk transfer transaction being buried). That a strong regulatory team is looking at the position would have suitably salutary effect on relevant professionals. Many concerns would self-correct.

- DB pensions as the worked example of what is achievable should be given a high profile. The lessons taken can be translated into other initiatives being undertaken. Companies - long too distanced from the subject of quality, long-term pension provision - should be encouraged to re-engage. Something that becomes more likely if it is a high profile project with clear links to S172 / ESG and wider economic and reputational and considerations.

The consequences of implementing TAS300V2 are:

- TAS300V2 requires risk-benefit comparison of bulk transfers and run-on. The work will highlight the key and falling gap between the unfunded and untested FSCS and the overfunded PPF. When there is a discretionary upside available, or discretionary benefits which might have to be given up to obtain a risk transfer in the form a life insurer wants, the case for a buyout collapses.

- Trustees have legally to ask relevant questions and obtain answers. The TAS300V2 questions are relevant. Their fiduciary duty will be to ask for the exercise results.
- Corporate sponsors will re-examine the upside to those of running-on as part of an overall package with a stable, long-term investment strategy.
- Government could provide incentives so that the structure of deals is long-termist; adds to investment in productive UK assets; adds to pensions and helps fund pensions of current employees.
- What makes DB pensions a powerful example is the £1.3 trillion of existing investment and £50 billion of current pensions paid to members. Enforcement of existing regulations has ramifications which at 10% asset reallocation added to UK productives is £130 billion and 10% increase in pension in payment is £5 billion in taxable income for pensioners.
- Competition can be increased. Having a solid option to run-on takes away the presumption that a buyout is just a matter of time. The concentration and overheating risks in a small group of life insurers - with a wide range of scale - are addressed. (NB. The recent history of the risk transfer industry is remarkable. CMA should consider it a segment to keep monitoring. The close links with intermediaries, the relentless advocacy of pricing available as being attractive, the actual profits achieved, the lack of transparency (added to by accounting standard changes to IFRS17) all should be kept under review by PRA and the incoming ARGA. PRA should consider how such a large business streams have arisen so rapidly and whether it is actually creating concentration and systemic risks. These may be best addressed by ensuring run-on is a well understood alternative.
- A further consequence of well developed run-on options is a strengthening of UK capital markets. The relentless sale of equities and illiquid fixed income assets ends because there is immediately an expectation of more money coming into the sector. Further, that will be enhanced as DB monies are recycled in DC funds which can by their nature have a

longer-term perspective.

Summary: Question 1

The DB sector highlights the risks in siloed thinking and fragmented control. TPR is proud to be a "tough regulator" but its policies have become anti-growth and were exploited by the well-funded, astute life insurance industry. In contrast FRC has been underpowered. Meanwhile PRA had other major items on their agenda and is remarkably supportive of life insurers. A determined effort to coordinate between regulators and raise awareness of all relevant policy drivers is appropriate. The introduction and role taken by ARGA could provide a notable opportunity.

Question 2: To what extent are the regulators focused on the objective to promote international competitiveness and growth? Are there areas where the ability of the regulators to fulfil their secondary objectives might be constrained by having to fulfil their primary objectives?

The primary protection objective can be balanced with the secondary objective through good risk-benefit analyses. The requirements are not for protection as indemnification, but to establish a satisfactory, achievable balance.

The DB sector can be informative. Regulatory changes altered the nature of pension risk. Over time the "best endeavours" commitments of sponsors became more of an underwriting of pension payments by sponsors. And pensions were calculated and funded in a new way which increased the liabilities as actuaries completely changed their valuation technique. Further, accountants alighted on a different methodology. This made sponsors' Boards confused and anxious to limit exposures and "get rid ASAP" of the scheme itself. Such was the occupation of moral high ground by fixed income sales teams and risk averse trustees (convinced by their view that their fiduciary duty was to deliver the base pension), that the primacy of derisking took hold. Badged as "derisking", even obviously questionable decisions on investments seemed reasonable. The primary derisking objective allowed negative returning assets to be acquired (the reasonable LDI concept became high risk leveraged LDI without proper control). Illiquid assets to be sold at a loss as

soon as the possibility of reaching a position to sell to a life insurer emerged.

The need for a rounded view of risk is reflected in the push of risk from DWP / PPF / Sponsor axis to PRA / FSCS axis. With the finances of both FSCS and PRA under review there is a reasonable consideration as to whether reducing one risk is simply not having the effect of creating another.

Summary Question 2:

There is a perfectly reasonable balance to be established between primary and secondary objectives if the objective is not to have absolute back up. This requires silo cultures to go and there to be more collaborative and holistic management.

Question 3: What are some of the barriers in the current regulatory framework (including the role and responsibilities of other regulators and bodies such as the Payment Systems Regulator, The Pensions Regulator and the Financial Ombudsman Service) that could hinder efforts to drive economic growth and international competitiveness in (a) the UK economy and (b) the financial services sector?

The current regulatory frameworks have been established with care over a long time. They are not a primary issue – other than with the underpowered FRC – which is already being addressed. Coordination between the FCA / PRA and other regulators to ensure all relevant factors are grasped and mutually compatible objectives set is a central point. With the DB pensions sector and PRA's impact on it taken as the example, topics to consider are:

- Why did the (leveraged) LDI led crisis catch it by surprise?
- Is the "Gold Standard" buyout solution concentrating residual, well-diversified risk currently covered by the well funded PPF in an exposure to the untested, unfunded FSCS really what's wanted?
- Is the risk transfer market's growth creating an "overheating / overeating" issue and raising business practice questions which are avoidable if "Credible Alternatives" to buyout were emerging and receiving public policy and regulator support?

- Are the life insurers and their advocates so well organised and persuasive that their ability to deflect new entrants is a competition problem? N.B The "Gateway Test" – if you are close to buyout funding you can't go with a superfund. It was a masterstroke to protect life insurers' business growth because it so limited the superfunds' target market. Collective Defined Contribution models similarly were allowed to be limited by particularly zealous reporting requirements. Consolidation models are still in the foothills of the mountains of opposition. Delay is a powerful weapon against ideas such as Superhaven and Gibraltar insurance cells currently awaiting clearance. Are such delays necessary?
- PRA processes have delayed clearance and TPR caution has made the cost of market entry extremely high. The call for "Credible Alternatives" makes a reset timely.
- PRA has looked at control of the rapid growth of (funded) reinsurance of longevity risk outside Solvency UK. Has that work involved questioned why the business is so attractive? Has it looked at the blatant conflicts of interest on the committees of the Continuous Mortality Investigation which provide key longevity tables used in risk transfer transactions?

What emerges as a weakness in the regulatory framework is that FRC has given actuaries and accountants far too much latitude in the pension space. The "turf war" in early years of the century which led to conflicting valuation techniques for accounts and actuarial purposes was a disaster. Key consequences were confusion and a readiness for corporate Boards to adopt the "get rid ASAP" mindset. As ARGA warms up there is real scope for a higher quality regulatory recipe. Ahead of that, a straight, deliberative focus on compliance with Technical Actuarial Standard 300 Version 2 can have a real, galvanising impact on the pension sector. Here is the small, regulatory gear which can have a major gearing impact into the wider economy.

As soon as quality explanatory data on risk transfers is available with a major push back from shareholders, CMA will take an interest. Putting DB pensions into "special measures" in supervision levels ahead of ARGA reaching temperature would be straightforward and impactful. It would change attitudes amongst scheme members and sponsors – groups

which have been too accepting of orthodoxies in the sector.

There are many situations where the combination of regulation and poor disclosure of results are clearly unsatisfactory. Examples include:

- **BT Group Plc:** It has a pension scheme of over £30 billion. There is a State Guarantee of the pensions. It is derisking its investments to a very low return level. It operates its Openreach business (under DCMS and Ofcom supervision) as a state within a state because the pension trustees made the "spin-off" of the business impractical. It is paying still large sums into the pension scheme which could be redirected immediately to "productive assets".
- **NatWest Group Plc:** "Announced" on page 30 of a third quarter set of results by NatWest (and not picked up by the pensions sector for over a week), its pension scheme undertook one of the largest buy-ins of pension liabilities ever. The lack of transparency was remarkable. Its large surplus is not relevant in accounts terms because of the powers of the trustees. This means costs of buy-ins can be buried. Given the State shareholding and the surplus in the scheme, here is a simple example of where there is scope to produce far better outcomes for the economy and for scheme members than transferring large sums to life insurers with their investment constraints and with shareholders based abroad.

The lack of transparency in the sector makes it difficult for members, trustees and sponsor to appreciate what the solutions offered to them are worth. In 2022 we produced a paper "Buy-ins, longevity swaps and other unforced errors". What it highlighted was just how little information is available on risk transfer transaction. This clearly suits the risk transfer industry. FRC and TPR should simply not allow it to continue. That Aviva was able to book a pre tax profit of £1 billion on sales of its pension liabilities to itself should be a "red flag" for all related regulators. The paper is being revised to include examples arising since TAS300V2 came into force.

Summary Question 3:

The barriers created come from siloed thinking. Clear cooperation and understanding would help considerably. A specific "knotty problem" team could be in place. The impact and flexibilities within individual sets of rules can be applied to produce better outcomes. It could support "Credible Alternatives" reaching market and stop absurd sub-optimal funding strategies arising.

Question 6: In delivering their secondary objective on growth and competitiveness, what opportunities are there for the regulators to help to promote and support innovation in the financial services sector? How effective has the FCA's regulatory sandbox been for supporting greater innovation in the financial services industry?

Innovation to introduce "Credible Alternatives" to risk transfers is astutely deflected by the life insurance industry. Long lead times, complex drafting and cost and pricing power all serve to hobble competition without needing to kill it off completely. Here, PRA might reflect on whether it could be more positive in its approach to superfunds and Collective Defined Contribution schemes and the current generation of Credible Alternatives like Superhaven and insurance protected cell structures.

PRA in relation to DB schemes seems too convinced that buyout is a Gold Standard. For a highly profitable £50 billion a year business largely controlled outside UK to emerge so quickly with so many supporters amongst Employment and Benefit Consultants (EBC) should raise questions. A CMA investigation covering related subjects was readily deflected into second tier issues. Perhaps it too needs to look harder at the actual risk-benefit numbers. It should be more sceptical of the benefits of life insurers' strategies. In the 1920s and in 2020s "Gold Standards" benefited the few not the many.

A coordinated PRA / TPR revision to its approach to innovation can follow a new risk-benefit analysis to help align the primary and secondary objectives.

C-Suite Pension Strategies was founded in 2016 by William McGrath to urge corporate boards to “get stuck in with their DB pension schemes”.

Since 2018 the core idea was to Run On 4 Good - not to derisk too much but ensure stable returns protect corporate resources and can be channelled to improve pensions of former employees and improve current pension provision. Initially counter to nearly all mainstream thinking, it has become seen as a possibility in the industry. It aligns well with Government’s recent requests for “Concrete Proposals for Growth”.

William McGrath was CEO of Aga Rangemaster for 14 years and an executive director of other groups with large pension schemes. He first came across DB pension issues in the mid 1980s while working in corporate finance in the city.

NB. Aga Rangemaster was sold to an American group in 2015 because of the pension scheme funding outlook. The structure set out to protect all stakeholders worked well. Without large company contributions and with stable long term investments the scheme is now well funded.

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