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

15 September 2023

Dear Sir Stephen,

Re: Additional evidence on defined benefit (DB) pension schemes

Thank you for your letter following my panel attendance at the Work and Pensions Committee on 6 September. I am grateful for the opportunity to provide more information. I would like to summarise the key points I wished to convey as follows.

UK DB schemes are in excellent health and we have a once-in-a-generation opportunity for c.£1.4 trillion of DB pension assets, across both open and closed schemes, to better serve pension scheme members and the UK economy for decades to come, but urgent changes are needed to enable this potential. This letter summarises the key facts behind this assertion and the required policy evolution.

DB schemes' funding levels are at a record high. At the end of August, the PwC Buyout Index was at a funding level of 120%[1], and PPF data indicates a funding level of 146%[2] on a Section 179 basis. Regardless of the measure chosen, UK DB pension schemes are now able to back their pension promises with high quality investments and have scope to deploy their surpluses for growth.

Pension schemes possess unique advantages in the way they invest and these advantages should be preserved in the interest of serving pension scheme beneficiaries and the UK economy overall. We believe that, if DB pension schemes are maintained and managed for the long term, the three golden rules set out alongside the recent Mansion House reforms would be far more likely to be achieved.

- **The best outcome for pension savers:** Pension schemes can construct liability-matching portfolios at a significantly lower cost than the cost of conducting an insurance buy-out. We estimate this difference can be in the region of 10% to 15%, and the savings can directly benefit pension scheme members. Furthermore, pension schemes are able to offer discretionary benefit increases to their members, and potentially return a share of excess surpluses to corporates (which could be used to fund contributions to a defined contribution pension scheme), whereas insurers aim to deliver only contractual benefits. These observations apply to both open and closed DB schemes and there are strong cost and benefit advantages to both types of pension schemes running on.

- **A strong and diversified gilt market:** Pension schemes invest more in gilts than portfolios used by insurers to back pension liabilities. The transfer of pension portfolios to insurers will likely have a negative impact on demand for gilts.

- **Strengthen the UK's position as a financial centre:** Pension schemes can access a broad universe of investments whereas buy-out insurers focus on a restricted universe of Solvency II Matching Adjustment eligible assets. This flexibility enables pension schemes to target an improved balance of risk and return while supporting the UK economy through investments in growth assets such as debt financing, equities, private assets, business start-ups and infrastructure.

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[1] UK DB schemes reach new record collective funding level, but schemes have more to do before an insurance transaction, 4 September 2023, PwC.
[2] PPF 7800 index September 2023 update (PDF), PPF.

The current framework, and misperceptions about buy-outs, could lead this once-in-a-generation opportunity to be missed.

Despite the significant potential benefits of running on, a recent LCP survey found that 67% of UK defined benefit pension schemes surveyed expect to undertake a final insurance transaction in the next five years[3]. While insurance buy-outs are appropriate for some pension schemes, we believe a better balance should be struck, and trustees should be guided to carry out a comprehensive assessment of the alternatives available to them. In our view, this should include assessments of:

- the cost differentials between running on a scheme and an insurance buy-out;
- the potential benefits of being able to offer discretionary benefit increases to pension scheme members and, possibly, return part of an excess surplus to corporate sponsors; and
- the downside risk profile of running on a scheme relative to a buy-out, which would compare the layers of protection available in the two regimes (illustrated below).

Downside risk mitigants available to pension schemes	Downside risk mitigants available to buy-out policyholders
• Resilience of pension scheme liability-matching portfolio • Pension scheme surplus • Covenant quality of the corporate sponsor • PPF protection	• Resilience of the insurer's liability-matching portfolio • Capital position and credit quality of the insurer • FSCS protection

Additionally, we believe the overwhelming push towards buy-out, even when the considerations above highlight the relative advantages of running on, is influenced by a number of factors where greater clarity should be offered to pension trustees and corporate sponsors. Examples include:

- the misperception that insurance is risk-free, and/or that the FSCS is equivalent to a government guarantee – the Prudential Regulation Authority and the Bank of England have already pointed to significant risks[4];
- the belief that pension surpluses are not valuable to members or corporate sponsors because of the difficulty of benefiting from them; and
- some trustees, corporate sponsors and their legal advisers believing that not pursuing a buy-out as soon as it is affordable might expose stakeholders to complaints or legal claims.

It is important to note that the decision to pursue a buy-out leads to a reduction in the investment flexibility of a pension scheme, as a scheme then focuses its portfolio on maximising the certainty of achieving that outcome. Therefore, even before pension funds transfer their liabilities to insurers, the mere decision to target buy-out often results in significantly shorter investment time horizons, in line with the timeline for implementing a buy-out, rather than investing to take advantage of the long time horizons in line with the long-dated liability cashflows of pension schemes. This limits pension schemes' interest in and ability to invest for longer-term growth, meaning there is a real loss of economic and investment efficiency for pension schemes and for the UK economy as a whole. These consequences could be avoided by pension schemes being encouraged to fully consider the benefits of running on.

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[4] For example, see: BOE Issues Fresh Warning Over Risks in Pension Transfers, 15 June 2023, Bloomberg; Bank of England tells insurers to moderate their push into pensions, 27 April 2023, Reuters; Bank of England says shake-up of insurance rules increases risks, 16 January 2023, Financial Times; Moderation in all things – speech by Charlotte Gerken, Prudential Regulation Authority Executive Director for Insurance Supervision: given at Westminster and City's 20th Annual Conference on Bulk Annuities, 27 April 2023, Bank of England; Letter from Andrew Bailey, Governor of the Bank of England, to Harriett Baldwin MP, Chair of the Treasury Committee (PDF), 22 February 2023.

Revised policy guidance, regulations and tax rules are needed to unlock the full potential of both open and closed DB pension scheme portfolios. We advocate several changes.

To better incentivise trustees and corporate sponsors to maintain and manage DB pension schemes for the long term, several changes could be made.

- **Encourage pension schemes in surplus to secure their members' pension benefits and then invest their surpluses for long term growth.**
  - Amend the DB funding code to enable liability-matching and growth portfolios to co-exist.
  - Encourage high-quality investment grade liability-matching portfolios, designed to closely meet liability cashflows and the risk characteristics of pension liabilities, with additional appropriate buffers for risk.
  - Allow for the excess surplus to be deployed towards growth portfolios to generate further surpluses without putting member security at risk.

- **Provide a clear rationale to pension scheme members, trustees and sponsor to pursue growth and enable them to benefit from surpluses.**
  - Guidance to ensure an appropriate division of excess surpluses between members and corporate sponsors, without putting the security of members' retirement income at risk.
  - Introduction of portfolio resilience and funding tests before excess surpluses may be distributed towards discretionary benefit increases and/or refunds to corporate sponsors.
  - Removal of punitive taxation consequences that might arise if members are provided discretionary increases and/or if corporates receive partial refunds of excess surpluses.
  - Incentives for deployment of any distributed surpluses towards the sponsor's defined contribution pension schemes, where appropriate.

- **Provide guidance to trustees to fully assess the cost, risk and benefits of running on versus buying out, as described above.**

- **Consider strengthening the lifeboat role of PPF to provide pension schemes additional support and peace of mind.**
  - Few pension schemes would currently enter the PPF even if their sponsor was no longer able to support them, as most schemes would be better off outside the PPF. Pension schemes' current circumstances are significantly better than the safety net PPF provides. The PPF's lifeboat role should become relevant to the DB pension industry again and any enhancements to the safety net PPF offers would further support pension schemes' ability to invest for the long term.
  - The improved funding levels of pension schemes provide the opportunity for the PPF to offer improved protection, without increasing the associated risk above what the PPF has historically assumed, when pension funds' actual funding position was less healthy relative to the PPF basis.
  - Any changes should be implemented in a manner that protects the PPF and the possibility of an actual call on PPF's resources should be remote. For example, the enhanced protection should be contingent on portfolio resilience tests to ensure the downside risk to PPF is significantly mitigated by the pension scheme through prudent matching of liabilities, and the maintenance of an additional buffer beyond the level sufficient to cover liabilities.

Finally, on the topic of consolidation and the proposal relating to the establishment of a public consolidator, DB schemes have only recently moved to a healthy surplus and the new rules for consolidation have only just been proposed. We believe more time is needed to fully explore private market solutions before a public-sector consolidator is introduced. We believe that, if a public-sector consolidator is considered, it is necessary to establish who would bear the downside risk of such a consolidator if a deficit were to develop and who would benefit from any surpluses before the merits and the governance structure of such a consolidator can be fully debated. The evolution of PPF's role as a lifeboat through the enhancement of the safety net it offers is directly relevant to the future potential of £1.4 trillion of DB pension scheme capital: we believe the near-term priority should be to address this matter in the interest of pension scheme members and the UK economy.

We have expanded on the points above in our response to the call for evidence by the Department for Work and Pensions on the options for defined benefit schemes. Our response is available here.

I hope these comments are helpful to you and the Committee as you consider the circumstances of UK DB schemes. In our view, we have a once-in-a-generation opportunity to achieve long-term benefits for individuals and corporates, and the UK economy, but significant change is necessary to unlock this potential.

Yours sincerely,

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