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Work and Pensions Committee Call for Evidence: Defined benefit pension schemes

Insight Investment response
April 2023



Executive summary

UK defined benefit (DB) pension scheme assets represent over £1.8trn of capital¹ invested in the provision of equity and debt-based financing for the UK and global economies.

Over 2022 many schemes have shifted into a surplus, meaning they have more assets than needed to meet projected future liability payments, even under a prudent set of assumptions for the future. As a result, many are now among the best funded pension schemes in the world, requiring investment returns of only a small margin above gilt yields to be able to pay future pensions in full – in other words, the security of their members' pension payments is largely well established.

Given this recent and significant improvement in funding levels, attention is now turning to how these surpluses may be best projected and deployed. As well as fulfilling their primary goal of providing pensions to their members, DB pension schemes now have the potential to deliver enhanced benefits to the people who helped to create this prudent funding position – members and sponsors – and society more broadly.

Specifically, they have the scope to potentially:

- offer enhanced benefits for members who have worked for many years to build up their pension savings,
- reimburse some of the capital that sponsors have historically contributed to enhance the security of pension benefits,
- improve the intergenerational equity and security of pension provision through support for defined contribution (DC) schemes of their sponsor, and
- provide finance to support the UK and global economies.

Importantly, given the improved funding position of most schemes and the enhanced investment solutions that are now available, all of these benefits can potentially be achieved without compromising the security of the benefits that need to be delivered.

However, under the current legislative and regulatory framework, there is little incentive for a DB pension scheme to keep these assets working once it reaches fully funded status.

We believe this is a once-in-a-generation opportunity to ensure this large pool of capital can fulfil its potential. A more conducive environment for DB pension schemes will be key to allow, or even encourage, schemes to run on and deliver the benefits outlined above.

Insight Investment is one of the UK's largest investment managers, managing £671bn in assets, primarily for UK DB pension funds, as well as insurers, sovereign wealth funds and financial institutions². Most of Insight's assets under management are in risk management (including liability-driven investment, or LDI) solutions and fixed income.

Insight Investment

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¹ Source: [Annual report on UK defined benefit and hybrid schemes 2022](#), 8 December 2022, The Pensions Regulator.

² As at 31 March 2023. Assets under management (AUM) are represented by the value of cash securities and other economic exposure managed for clients. Figures shown in GBP. Reflects the AUM of Insight, the corporate brand for certain companies operated by Insight Investment Management Limited (IIML). Insight includes, among others, Insight Investment Management (Global) Limited (IIMG), Insight Investment International Limited (IIL), Insight Investment Management (Europe) Limited (IIMEL) and Insight North America LLC (INA), each of which provides asset management services.

Questions and answers

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

We are broadly supportive of the current regulatory framework: it has led to pension schemes today establishing a strong funding position and largely securing their members' future retirement income. However, we believe there are some improvements that could help open (and closed) pension schemes to thrive.

There is a perception that there is no upside for trustees, members or sponsors to fund improvements beyond a 100% funding level on a buy-out basis (i.e., a funding level required to conduct an insurance buy-out). In our experience, some trustees feel they lack the freedom to opt for alternatives to buy-out: even if they believe it is in the best interests of a scheme's members, opting against a buy-out could leave them open to legal challenge.

We believe it would be beneficial for the legislative and regulatory framework for DB pension schemes to evolve so that other options can be considered alongside insurance buy-out. Without adjustments to the current legal and regulatory framework, recent improvements to pension schemes' funding levels could lead to the accelerated demise of UK DB pension schemes – representing an unparalleled missed opportunity for members, corporate sponsors, and society as a whole.

With regard to open schemes, although DB schemes typically provide the greatest pension security for their members, less than 10% of corporate DB schemes are now open to new members³. Increasing life expectancy, low yields and investment strategies that historically did not reflect liabilities, which led to liabilities growing faster than assets, made DB schemes more expensive and their liabilities became a growing burden for corporate sponsors. As a result, most corporates have switched to a DC structure. This was not a result of the regulatory framework, but a cost and risk issue; DB schemes are unable to compete with DC schemes on a cost and risk basis considering the future uncertainty of DB pension scheme liabilities.

The result is worsening intergenerational equity with regard to pensions: future generations of pensioners who rely on income from DC schemes may have to live with reduced benefits and less certainty than their predecessors who benefit from their DB schemes.

Despite this shift towards DC structures, UK DB pension assets represent over £1.8trn of capital invested in the provision of equity and debt-based financing for the UK and global economies, and thriving DB schemes could bring material benefits, as outlined in the executive summary.

For schemes that remain open, a key question is whether they are still accumulating assets (meaning pension payments are outweighed by growth in assets from investment returns and sponsor contributions), or have moved into the 'decumulation' stage (meaning pension payments now exceed growth in assets). If an open scheme is in heavy decumulation then it is effectively no different to a closed scheme from an investment strategy perspective. Therefore, while the rest of this response focuses on closed schemes, the same principles apply to open schemes in the decumulation phase. In general, most private sector DB pension schemes are in the decumulation phase, with public sector schemes (for example, the Local Government Pension Scheme) in the accumulation phase.

Going forward, whether UK DB pension schemes thrive will be influenced by the legislative and regulatory framework in which schemes and sponsors operate. If the legislative environment is conducive to allowing key stakeholders to benefit from a pension scheme surplus, and the regulatory framework ensures schemes do so while maintaining a high degree of security for their members, it is foreseeable that UK DB schemes will sustain these assets for longer, meaning they can be reinvested in the economy and deliver the benefits outlined in the executive summary. If the pensions framework is not conducive for this, DB pension schemes will likely cease to exist at some stage diminishing any future role they could play in the capital markets.

Separately, there have been discussions around the role that pension schemes should play in supporting the UK capital markets, particularly the equity market. It is natural for DB pension schemes in decumulation to invest more heavily in bonds, as these provide a legally binding (contractual) return; such returns are therefore typically more predictable and

³ Source: [Annual report on UK defined benefit and hybrid schemes 2022](#), 8 December 2022, The Pensions Regulator.

secure than equities, and more suitable for schemes seeking to secure pension payments for their members. By comparison, investing in equity markets may be more suited to DC pension schemes, DB pension schemes in the accumulation phase, and the surplus assets of DB schemes in decumulation. We believe it is important that pension scheme trustees have the freedom to choose the assets that best suit their goals, rather than be mandated to invest in certain asset classes.

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

Given the recent improvements in UK DB schemes' funding levels, an insurance buy-out will transfer significant value from pension schemes and their potential beneficiaries – members and corporate sponsors – just when schemes have become most valuable. The current regulatory environment strongly encourages trustees to conduct a buy-out for their scheme when this becomes affordable.

Given this regulatory environment, and the significant profit potential for insurers by taking on DB pension scheme assets and liabilities, it is very likely that even if capacity in the buy-out market cannot meet demand from DB schemes today, it will expand to meet demand over time.

However, we believe it would be beneficial for pension schemes to have different options available to them rather than relying on buy-out as the only goal.

A wide-scale transfer of DB scheme assets and liabilities to the global insurance sector could lead to:

- increased systemic risk to the UK financial system through concentrated exposure to the insurance sector – as the pension benefits of millions of people move from being paid by over 4,000 DB pension schemes (backed by a similar number of diversified sponsors), to being paid by a small group of insurance companies; and
- increased reliance on the UK's Financial Services Compensation Scheme (FSCS), which offers protection for pension payments backed by insurers in the event of an insurer default – potentially leading to a greater burden on the taxpayer.

For some pension schemes and sponsors, buy-out might be the most suitable goal; and for others, alternative approaches may be more suitable. We believe it would be beneficial if the legislative and regulatory framework for DB pension schemes evolves so that other options can be considered alongside insurance buy-out.

Given the strong funding position of many schemes, they can now invest to secure their members' benefits using a diversified portfolio of high-quality bonds. Schemes should be encouraged to allow their bond portfolios to mature over time to generate the cashflows needed to pay members' pensions, rather than invest in the hope that asset values will rise in time for pensions to be paid.

Alongside this, pension schemes can retain three valuable lines of defence, outlined below.

1. Over-collateralisation using the assets of the scheme: When a pension scheme is well funded on a buy-out basis, its assets are generally able to support pension payments with a level of return that is typically close to that offered by gilts. However, the returns available from high-quality bonds are typically higher, meaning that as pension schemes' bond holdings mature they can support pension payments while also funding increased surpluses over time – enabling both improved security for members' benefits, and the potential wider benefits outlined in our executive summary.
2. Sponsor covenant: If funding shortfalls arise over time, and a scheme's assets are not sufficient to pay pensions, corporate sponsors act as the next line of defence. Having said this, current high funding levels, a prudent regulatory regime and sensible investments will likely limit the need for sponsors to offer such support.
3. Pension Protection Fund: This is the ultimate lifeboat, although for a well-funded scheme that could afford an insurance buy-out, the factors outlined above will likely limit the need for the PPF to offer support.

Given the ability of well-funded DB pension schemes to achieve and maintain security for their members' benefits, in order to fulfil their potential and offer wider benefits from their surpluses to their members, sponsors and wider economy, we believe that the legislative and regulatory framework should evolve so that other options can be considered alongside insurance buy-out.

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

We observe that many trustee boards are highly experienced, well resourced, and seek professional advice when making investment decisions. This was clearly demonstrated during the recent period of market volatility when the overwhelming majority of our clients were able to convene ad-hoc meetings at short notice, enabling swift decisions to sell assets to source collateral for their LDI portfolios.

There should be minimum standards set for all pension schemes when it comes to trustee experience, access and affordability of advice, and access to appropriate investment options.

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

As per our response to Question 3, there should be minimum standards set for all pension schemes when it comes to trustee experience, access and affordability of advice, and access to appropriate investment options. In clearly setting out such standards, and with appropriate enforcement, schemes that cannot meet the standards may be encouraged to consolidate in order to achieve the necessary requirements through economies of scale.

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

We believe it is important that pension schemes have the freedom to operate and invest in pursuit of their specific goals, rather than be mandated to consolidate in pursuit of political or other motivations.

As we explain in our response to Question 4, setting out minimum standards may encourage schemes that cannot meet the standards to consolidate, and thereby ensure the prudent ongoing management of such schemes. The arguments for consolidation may be different for private versus public pension schemes.

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

Yes. The improvement in funding levels has significantly strengthened the ability of UK DB schemes to secure future pension payments to their members, and this has revealed the potential for these schemes to support UK pension provision beyond their assumed remit.

With many schemes now in surplus and the primary objective of securing members' benefits being largely met, discussions can take place regarding the best use of UK DB pension scheme assets. As outlined in our executive summary, these may include enhancing the benefits for existing scheme members and contributing to DC schemes to benefit current employees. We share greater background below to this thinking below.

Background

Historically, with many pension schemes underfunded, it has been natural for trustees and sponsors to view schemes as a burden. The long downward trend in yields increased liability valuations, many pension schemes were underfunded, the reliance on sponsor contributions left pension schemes exposed to the risk that their sponsor might be unable to support them in future, and it was uncertain whether their investments would generate sufficient returns to match future liabilities. Against this backdrop, many corporate sponsors provided material contributions to close their schemes' funding gaps.

However, this changed significantly in 2022. The sharp rise in gilt yields shifted many pension schemes into surplus, and some substantially so. Over a relatively short period of time, pension schemes could be viewed as an asset, rather than a burden.

This shift should be recognised by adjustments to the legislative and regulatory framework so that schemes can continue to build on their current strength, realising potential benefits for all, as we outline below. The current framework may not encourage the full potential of this large pool of capital to be realised and may result in the decline of UK DB pensions in the long run.

As noted in our response to Question 2, investment solutions already exist that provide security for members' benefits, allow further surpluses to accumulate with a high degree of certainty, and deliver benefits to relevant stakeholders.

What are the potential benefits?

As described above, many schemes are now in a position whereby they have the assets required to secure the payment of all pension benefits in full, along with additional assets – a surplus). Efficient deployment of this surplus could result in a number of significant benefits:

- offer enhanced benefits for members who have worked for many years to build up their pension savings,
- reimburse some of the capital that sponsors have historically contributed to enhance the security of pension benefits,
- improve the intergenerational equity and security of pension provision through support for DC schemes of their sponsor, and
- provide finance to support the UK and global economies.

We note however, that the current regulatory environment does not encourage the deployment of surplus in this way.

What can be done?

Establishing a DB pensions framework that enables key stakeholders (both members and corporate sponsors) to benefit from a pension scheme's surplus, above a prudent level of funding, could provide the appropriate incentives for this capital to be utilised appropriately. This would require a change in the regulatory framework such that key stakeholders can share and access surplus more easily.

In addition to enabling access to surpluses, there may also be significant benefits to keeping assets within a DB scheme, but providing the flexibility to invest surpluses more freely. They could be invested in capital markets, supporting the UK and global economies.

They could also be used to finance green and other ESG-related initiatives that are important to the UK. However, we believe greater clarity around the interpretation of fiduciary duty for pension schemes would be beneficial as there can be differences in interpretation relating to the balance between financial and non-financial factors in investment decision-making.

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?

For the purposes of this question, it may be useful to define “surplus” as any excess above a prudent level of funding (e.g., 105% funded using a conservative discount rate to measure the value of liabilities). For schemes with assets in excess of this prudent level of funding, it might be argued that the surplus could be put to use without compromising the fundamental aim of the pension scheme to provide member benefit security.

Broadly speaking, schemes in surplus have the scope to potentially:

- offer enhanced benefits for members who have worked for many years to build up their pension savings,
- reimburse some of the capital that sponsors have historically contributed to enhance the security of pension benefits,
- improve the intergenerational equity and security of pension provision through support for DC schemes of their sponsor, and
- provide finance to support the UK and global economies.

Specifically, under the current DB pensions framework, we understand that a pension scheme surplus could be used in several different ways:

- **From the member perspective: discretionary benefit increases**
 1. Removal or increase of caps on inflation-linked pension increases
 2. Uplifts to benefits (e.g., cash lump sum, additional voluntary contributions)
- **From the sponsor perspective: a range of potential uses**

1. Repayment of surplus to the scheme sponsor (with a corresponding tax liability)
2. Reopen the scheme to other employees, without putting existing members' pension security at risk or triggering additional sponsor contributions
3. Use surplus assets to pay contributions to a DC scheme of the sponsor
4. Pay the scheme's expenses
5. Merge an underfunded DB scheme into the overfunded scheme, while ensuring the merged scheme remains fully funded (on a prudent basis for liability valuations)

However, under current legislation, it is challenging for pension schemes to use a surplus aside from the specific purpose of securing members' benefits. What is permitted varies across pension schemes, and for many, it is likely to be decided by negotiation between trustees and sponsors.

For trustees, there is often the view that there is no incentive to run pension schemes once full funding is achieved, given the perceived risk of falling short of the promised benefits. For sponsors, the current regulatory environment makes accessing the surplus burdensome, and the historical burden of supporting a DB scheme makes removing them from the balance sheet – through an insurance buy-out – an attractive option.

As explained in our executive summary and through this response, we believe such perceptions undermine the potential for DB schemes to offer a wide range of possible benefits. Therefore, for clarity, we believe it would be helpful for legislation to allow for the use of a surplus in a manner that is acceptable to key stakeholders, and which does not undermine the security of members' benefits.

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

With many pension schemes now in surplus, the PPF has become significantly safer as there is less risk that pension schemes will need assistance in future. As a result, there are a number of potential implications which could support DB pension schemes to unlock the value which has now been established:

- **The PPF could finance benefits for the UK and global economies:** To the extent that the PPF also has a surplus (i.e., assets in excess of those required to safely secure the benefits promised), this could be deployed in a similar way to surpluses of DB pension schemes, as described throughout this document.
- **The PPF is in a better position to support the schemes that need it:** With many pension schemes now in surplus, fewer are likely to fail and prompt support from the PPF. Also, the PPF itself is also in a better funding position, enabling it to play its role more effectively when pension schemes do fail.
- **The PPF could uplift benefits for both current and future members:** When a scheme falls into the PPF, the benefits provided are lower than those promised under the original pension scheme obligations. An improvement in the PPF's funding level could mean that benefits are uplifted for pensioners already being supported by the PPF, to a level closer to that originally promised.

Additionally, the PPF could uplift benefits for future members who fall into the PPF, at or close to the original promised pension payments. This would mean the difference for pensioners between a buy-out, and PPF protection, is narrower – allowing for trustees to freely consider all options available, given the ultimate benefit provisions to members would remain similar, or the same, under different scenarios. Any potential moral hazard concerns of the PPF uplifting its benefits would be mitigated by the proposed DB funding code, which requires pension schemes to manage their risks prudently.

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?

As the risks facing the PPF decline, as outlined in our response Question 8, we believe it can play a significant role in helping pension schemes to unlock the value that has been established. We note that in order to achieve this, however, it would require a fundamental rethink of the current regulatory environment.

Insurers are well capitalised and regulated, but in the unlikely event a major insurer defaults, the funds within the FSCS are unlikely to be sufficient to maintain pension payments. We believe this is a growing concern given the ongoing transfer of pension scheme assets to insurers. Policymakers should assess whether the FSCS is able to meet any potential calls for compensation in the unlikely event of an insurer defaulting, to ensure that DB pension liabilities can be met. This may include an assessment of some reasonable stress tests which require calls on the FSCS, and to ensure that the FSCS has arrangements in place (pre-funding and other pre-defined support mechanisms) to be able to cope with such demands.

Unlike the FSCS, the PPF is funded, and enhancing benefits offered by the PPF (as described in our response to Question 8) could help DB pension schemes consider other mechanisms to secure members' benefits, other than relying only on insurance buy-outs. As mentioned in our response to Question 2, this could serve to enhance UK financial stability by reducing the concentration of exposure to a small number of insurers.

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