Private & Confidential

ABI RESPONSE TO DWP CONSULTATION ON SECURITY & SUSTAINABILITY IN DEFINED BENEFIT PENSION SCHEMES

About the ABI

The Association of British Insurers (ABI) is the leading trade association for insurers and providers of long term savings. Our 250 members include most household names and specialist providers who contribute £12.0 billion in taxes and manage investments of £1.8 trillion.

Executive Summary

- The ABI welcomes the publication of the green paper and the Government's focus on forging a new consensus on how to balance between protections, sustainability and affordability in defined benefit pension schemes. This is important both to avoid situations like British Home Stores (BHS) and British Steel – but also to rebuild trust in pensions as a whole.

- The majority of UK defined benefit (DB) schemes are well-run and well-funded, but reforms are needed to improve the system for employers, schemes and members alike. We welcome the green paper's measured tone, which resists the suggestion of a sector in crisis whilst seeking opportunities to address some pressing issues.

- There are a number of costs inherent in providing a guaranteed income for life; comprising of administration, investment management and governance costs, as well risks associated with longevity and investment returns. These are real costs and risks faced by both DB schemes (and their sponsoring employers) and insurers alike.

- Insurers are well placed to manage these costs and risks, given both their scale and technical expertise. They also have the ability to be significant investors in infrastructure, as the long-term nature of insurance liabilities can be well-suited to the often long-term nature of infrastructure investment, up to 30 or more years. Such investment provides significant benefits for the wider economy.

- Insurers already play a critical role in the DB pensions sector, with seven firms[1] currently competing in a competitive UK risk-transfer market which has appetite for schemes and transactions of all sizes. Since 2007 £70 billion of pension liabilities have been insured or consolidated, accounting for over 1,200 pension funds and one million members. In addition, insurers provide longevity swaps, administration and investment services to a number of DB schemes.

- The ABI does not recognise the assertions made in the green paper regarding "a market failure" in the buy-out market for smaller schemes: we see no supply-side barriers to small, well-funded schemes accessing the market. For example, since 2012 there have been more than 670 transactions for under £100m, with an average transaction size of £14m. Around 400 of those transactions were small scheme buy-outs with an average size of c. £11m (Source LCP analysis[2]).

- As the proportion of deferred members of schemes decreases, and the proportion of pensioner members increases, the cost of buy-outs will fall as the longevity risk becomes more predictable. In addition, there are opportunities to minimise some of the inherent costs outlined above, to make risk transfers more affordable:

  - The consolidation of schemes could help to achieve administration and investment efficiencies within the system and reduce costs for schemes. However, any such changes should account for the transfer of longevity or investment risk to third parties: be they the PPF (and its levy-payers), members or the government.

  - The cost of buy-outs for regulated insurers is largely driven in part by the reserving requirements and capital requirements under the EU Solvency II Directive. Reform at both European and domestic level to aspects of Solvency II regulations, particularly the Risk Margin, could reduce the costs of buy-outs for insurers and thus improve the attractiveness to pension schemes.

  - The simplification of expected benefits for individual scheme members, to enable insurers to more accurately assess their exposure and therefore more quickly and more accurately quote for DB schemes and minimise costs.

- A key component that is missing from the current valuation measures is a comprehensive evaluation of the covenant strength, including both its current status and how it may change in the future. TPR (The Pensions Regulator) guidance for assessing and monitoring employer covenants provides a sensible framework and should be followed more widely.

[1] As of April 2017 the following firms are active in the UK buy-out market: Aviva, Canada Life, JRP Group, Legal & General, Pension Insurance Corporation (PIC), Rothesay Life & Scottish Widows.

[2] Source: LCP - https://insight.lcp.uk.com/acton/attachment/20628/f-04d8/1/-/-/-/-/LCP%20Pensions%20Derisking%20report%202016.pdf

- Additionally, we believe improvements could be made to the timeliness and accessibility of communications to scheme members regarding the financial strength of their DB scheme.

Introduction

1. The ABI welcomes the publication of the green paper and the importance placed by the Government on building a consensus on how to balance member protection, sustainability and affordability in defined benefit pension schemes. We are grateful for the opportunity to comment.

2. As we noted in our evidence to the Work & Pensions Committee[3] last year, insurers have an important part to play in helping manage the risks to DB schemes and their sponsoring employers, offering a range of solutions including 'buy-outs', 'buy-ins' and longevity swaps.

3. Whilst the scale of UK DB deficits is concerning, this is an area where the need for measured consideration is particularly relevant. The graphic on page 4 of the green paper demonstrates the extreme volatility of this measure - £459bn in August 2016, £197bn in January 2017 but 'only' £28bn in December 2013.

4. Whilst there is certainly no room for complacency, the paper's measured tone should not disguise the real problems which exist for particular categories of individual schemes; problems which need to be addressed, with one solution being the transfer of liabilities to insurers via bulk annuity transfers.

The UK Risk Transfer Market

5. 'Risk transfer' is used in this submission as a broad term covering situations where the liabilities of a pension scheme are matched or taken over by an insurance company. This can be a useful tool in sponsors' and trustees' armoury to manage long-term investment and longevity risk, in order to safeguard outcomes for members, and enable sponsors to undertake corporate transactions or focus on their primary business.

6. There are three mechanisms via which risk transfers can take place, which are described below:

    - With a buy-out, the scheme's liabilities are transferred to the insurer and the sponsor's obligation to the members is extinguished. The terms of the insurance policy are required to precisely match the form of the members' benefits under the scheme.

[3] ABI response to Work & Pensions Committee inquiry into the TPR and PPF http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/pension-protection-fund-and-the-pensions-regulator/written/38841.html

- Under a buy-in, the policy is held by the trustees and is effectively a scheme asset which pays the members' benefits. In other words, the ultimate obligation to pay the members still remains with the scheme.

- Longevity reinsurance/longevity swaps describe the transfer of risk through an exchange of cash flows. The trustees agree to pay a fixed series of payments, representing the expected benefits payable under the pension scheme plus a fee, in return for the swap provider paying the benefits that in fact fall due, based on actual scheme mortality.[4]

7. Insurers can provide tailored and innovative solutions, based on one or a combination of the mechanisms described above, to suit the risk-appetite, benefit structure and budget of individual schemes and sponsors.

8. Importantly, these are not solutions of last resort. In many cases they have become the preferred way to manage the costs and risks of a DB pension scheme. In some instances, a buy-out is considered as the ‘end step’ in a phased de-risking solution, which could also include liability management exercises (enhanced transfer values or ETV, pensions increase exchanges or PIE, and enhanced early retirement) designed to provide members with more choice and improve the funding situation for remaining members.

9. Seven insurance companies currently compete for bulk annuity business following Prudential’s recent withdrawal from the market, the merger of Partnership & Just Retirement and new offerings from Canada Life and Scottish Widows. These firms are: Aviva; Canada Life; JRP Group; Legal & General; Pension Insurance Corporation; Rothesay Life and Scottish Widows.

10. In addition, RGA, SCOR, Swiss Re, Pacific Life Re, Hannover Re, Challenger and Munich Re also operate in the UK longevity reinsurance market.

11. Recent changes to the primary annuity market following freedom and choice, in combination with record low interest rates, have increased supply-side competition in the risk transfer market. This means that there are good existing opportunities for DB pension schemes to de-risk - especially those who are well prepared and have the appropriate governance in place.

12. According to analysis from LCP, £70 billion of pension liabilities have been insured or consolidated over the past 10 years covering over 1,200 pension funds and one million members[5].

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[4] This tool is also used by enhanced annuity providers, bulk annuity providers and large DB schemes to manage the risk of people living too long.

[5] Source: LCP - https://insight.lcp.uk.com/acton/attachment/20628/f-04d8/1/-/-/-/-/LCP%20Pensions%20Derisking%20report%202016.pdf

13. These opportunities are not limited to ‘large schemes’, and the ABI does not recognise the assertions made in the green paper regarding “a market failure” in the buy-out market for smaller schemes.

14. Since 2012 there have been more than 670 transactions for under £100million, with an average transaction size of £14million. Around 400 of those transactions were small scheme buy-outs with an average size of c. £11million[6].

15. Furthermore, consulting firms have developed specific tailored services to allow small schemes to transact buy-outs and buy-ins; assisting schemes to navigate the process and promoting competition.

16. The annual Hyman Robertson Risk Transfer report provides an overview of the UK risk transfer market. The table below, taken from their August 2016 report[7], provides a summary of the state of the DB Bulk Annuity Market.

Figure 2: DB bulk annuity size appetite for each insurer

	Business written over 12 month period ending 31 Dec 2015[1]			Appetite by transaction size			
	Number of deals	Total size	Average size	<£50m	£50m - £100m	£100m - £500m	>£500m
Aviva	34	£984m	£29m	Target market	Target market	Target market	More selective
Canada Life	3	£65m	£22m	Target market	Target market	More selective	Unlikely to quote
JRP Group[2]	51	£1,234m	£24m	Target market	Target market	More selective	Unlikely to quote
L&G	64	£1,977m	£31m	Target market	Target market	Target market	Target market
PIC	13	£3,868m	£298m	More selective	Target market	Target market	Target market
Prudential	6	£1,508m	£251m	Unlikely to quote	Unlikely to quote	Unlikely to quote	Unlikely to quote
Rothesay Life	5	£2,420m	£484m	Unlikely to quote	Unlikely to quote	Target market	Target market
Scottish Widows	4	£1,300m	£325m	Unlikely to quote	Target market	Target market	More selective

Key: Target market; More selective; Unlikely to quote

[1] Except for the new entrants Canada Life and Scottish Widows where the figures cover the period to 30 June 2016.
[2] We have combined Just Retirement’s and Partnership’s figures under JRP Group, following their merger in April 2016.

17. This report highlights the positive impact on pricing of the recent new entrants to the market for schemes of all size. Hymans Robertson expect up to three further insurers to enter the bulk annuity market over the next five years, further improving the choice and pricing available to pension schemes.

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[6] LCP - https://insight.lcp.uk.com/acton/attachment/20628/f-04d8/1/-/-/-/-/LCP%20Pensions%20Derisking%20report%202016.pdf

[7] Hymans Robertson – Risk Transfer Report 2016 https://www.hymans.co.uk/media/uploads/Risk_Transfer_Report_2016.pdf

18. However, we recognise that for some schemes, funding shortfalls will act as an immediate barrier to accessing risk transfer solutions. That said, we believe there are ways that the cost of buy-outs could potentially be reduced, namely through changes to Solvency II regulations, which currently prevent insurers from offering more attractive pricing and block simple deferred premiums structures that would enable sponsors to manage the cash flow requirements of funding a buy-out deficit. We elaborate on this issue under our response to question 6.

Responses to Questions

Question 1

Are the current valuation measures the right ones for the purposes for which they are used?

19. At present, a comprehensive evaluation of the strength of the covenant (or the employer's present and future financial ability to meet its legal obligations to pay the promised benefits - the liabilities - and to manage the risks to which it is exposed) is missing from the current valuation measures.

20. For strong sponsors investment and longevity risk does not impact the members, but for weaker sponsors, the risks becomes critical. It is our view that risk exposure should therefore relate to the sponsor first and the assets second.

21. TPR has issued guidance[8] for trustees on how to assess the employer covenant of a scheme as part of an integrated approach to managing scheme risks, how to monitor the covenant and how to take action to improve scheme security. The guidance provides a sensible framework and TPR should signpost trustees to this or instead, consider mandating its use.

22. More widely, the discrepancy between occupational pension schemes and regulated annuity providers in terms of how risk is calculated should be noted. The fact that pension funds are not required to calculate and report their risk exposure is inconsistent to insurers or similar counterparts.

23. Techniques for quantifying risk are well developed in the insurance and banking sectors, and are used as a primary tool by insurance regulation to ensure that insurance companies are well capitalised and secure. The techniques used are indeed applied by many pension funds on a voluntary basis and are often incorporated into the investment advice that is provided to trustees and scheme sponsors.

[8] TPR – Assessing and monitoring the employer covenant: http://www.thepensionsregulator.gov.uk/guidance/guidance-assessing-monitoring-employer-covenant.aspx#s19597

24. With regards to shorter valuation cycles for high risk schemes, whilst it might help to provide earlier warning of critical deterioration in a scheme, it would also impose greater compliance burdens on weaker schemes – which are inevitably in a worse position to carry out the work more frequent valuations would require.

25. A balance therefore needs to be struck between the desirability of timely information and the imposition of extra compliance burdens. However, reducing the frequency might be desirable as the position of a scheme could deteriorate significantly during the period taken to compile the report, meaning that potentially time is lost during which useful remedial action might have been possible.

Question 2

Do members need to understand the funding position of their scheme, and if so what information would be helpful?

26. In our response to the Committee last year, we commented that enabling trustees to act earlier and be more open with members about the reality of their position could better enable potential opportunities to be taken for de-risking.

27. This is particularly relevant where there is a real prospect of member benefits being reduced, i.e. if the sponsor is weak and the scheme is drifting towards the PPF.

28. In its simplest form, a communication could come in the form of a basic annual benefit statement or signposting to a website which could give a summary of the following information to all scheme members:
    - full expected benefits;
    - a standardised, high level comment about the solvency of the employer, possibly based on Experian ratings and the adequacy of the funds on insolvency; and
    - benefits the member would receive if the scheme were to cede into PPF and a description on the difference in value from full benefits.

29. This would enable members to consider whether there is a need to change their behaviour (keep working/save more/spend less), seek further advice or take some other form of action.

30. More widely, any requirement to provide communications should also aim to influence the behaviour of trustees acting in the interests of members, rather than the behaviour of members themselves. Additionally, we would argue that these communications should be proactively distributed by trustees, particularly in the case of weak schemes.

Question 3

Is there any evidence to support the view that current investment choices may be sub-optimal? If yes, what are the main drivers of these behaviours and how could they be changed?

31. The green paper highlights concerns that the current regulatory environment is causing overly cautious investment on aggregate. For schemes with a strong covenant, this is likely to present more of an issue for sponsors than for trustees or members.

32. Decisions on investment strategies, including asset allocation, are complex. In practice, most trustees are heavily reliant on the advice provided by investment consultancies, a sector of the market which is currently unregulated. The interim report of the Asset Management Market Review highlights some of the competition and conflict of interest issues inherent in this market. It is possible that these issues could incentivise investment consultants to overstate the case for remaining invested to trustees and sponsors (as opposed to undertaking a buy-out) in order to protect future revenues. We welcome the FCA's scrutiny of this sector, and encourage DWP to be mindful of the findings of this work when considering the relative value of consolidation.

33. In addition, where schemes have a weak covenant, trustees may also be incentivised to pursue overly risky investment strategies in order to reach 'full benefits'. Although this may pay off, it could lead to rising deficits and, therefore, a greater unsecured debt from the sponsoring employer. In such an event, outcomes for members may be further compromised and/or the costs borne by the PPF (and PPF levy-payers) increased.

34. The transfers of risk from individual occupational pension schemes to insurers can also facilitate greater investment in infrastructure, as insurers are better able to collect both the illiquidity premium and use swaps to manage rate risks. Since 2012, insurers operating exclusively in the UK buy-in and buy-out markets have invested over £11 billion back into UK infrastructure projects.[9]

35. However, it should be there is a discrepancy between investors' interest in long-term investment grade opportunities and the supply of infrastructure projects available.

Question 4

Is there a case for making special arrangements for schemes and sponsors in certain circumstances such as a different regime for employers who can afford to pay more, and/or new or enhanced flexibilities for stressed sponsors and schemes?

36. Members of stressed schemes experience considerable uncertainty about what they will achieve and younger members are disadvantaged by PPF drift. Therefore where trustees have the opportunity to provide their members certainty of PPF + benefits then it should be easier for companies and funds to agree a separation in return for a final contribution.

37. The current regulations that allow this – Regulated Apportionment Arrangements (RAAs) - require that a number of strict conditions are met in addition to approval from both TPR and PPF. These conditions include:

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[9] This is a conservative estimate, as it does not include infrastructure investment from insurers that operate in the UK buy-out market alongside other regulated insurance activities.

a) that the scheme will be significantly better off than in an insolvency;
b) that the scheme is treated fairly alongside other stakeholders; and
c) that a better outcome cannot otherwise be achieved for the scheme by recovering assets from a related business or party (including through the use of the Regulator's powers where relevant).

38. In addition, the process is very costly and the lengthy test period means that any action is left until the last moment, when the ability to act is undermined by imminent insolvency.

39. Consideration should be given to how this process could be made more efficient and less stringent. The role of trustees should also be reconsidered so that they are able to take a decision in the interest of their members in these scenarios.

Question 5

Do members need further protection, and should this be delivered by a stronger and more proactive Regulator, and/or trustees with enhanced powers?

40. We believe that, on the whole, the existing powers of TPR are appropriate. Our observation is that the resources and capacity of TPR are likely to be more of a constraint on the quality of regulatory outcomes than existing legal powers. These issues may be further exacerbated by the new responsibilities for TPR in relation to Master trusts.

41. On a similar note, we believe that existing fiduciary duties acting on trustees are adequate, and that the Government should not enhance trustees' powers in the absence of minimum qualification requirements for trustees. However, trustees would benefit from improved access to information they need to make the necessary judgements, including TPR's assessments of the strength of their covenants, and forward notification of planned corporate actions which might impact their ability to fund deficits.

42. Should the Government consider consolidation options that enable the transfer of longevity and investment risk from DB schemes (and sponsors) and/or PPF levy payers, to a third party, we would urge the Government to ensure that the third party is required to adhere with the stringent solvency standards applied to insurers by the PRA (Prudential Regulation Authority).

Question 6

Should Government act to encourage, incentivise, or in some circumstances mandate the consolidation of smaller schemes into vehicles with greater scale and better governance in order to reduce the risk to members in future from the running down of closed, especially smaller, DB schemes?

43. As noted in our introduction, the risk transfer market is operating effectively: existing methods for consolidation, including bulk annuity insurance, have and continue to operate effectively across all sizes of pension funds, from full (buy-outs) or gradual (buy-ins), with a zero failure rate. The market is competitive and the scale and efficiency of bulk annuity insurers is reflected in pricing.

44. That said, one considerable barrier greater affordability are aspects of Solvency II regulations. The main driver of the cost of buy-outs for regulated insurers is the reserving requirements and capital requirements they must meet under the EU Solvency II Directive – which make it particularly hard to insure deferred members. In the UK, the PRA is the National Competent Authority responsible for its implementation.

45. Under Solvency II, when valuing their liabilities insurance firms are required to form a best estimate view of all future obligations they owe to policyholders and claimants. To reflect the uncertainties implicit in this estimation, firms are required to hold a capital buffer – the Solvency Capital Requirement (SCR) – over and above the best estimate of their liabilities.

46. Another component of Solvency II that contributes to the cost of buy-outs is the Risk Margin. This is an addition to the best estimate of liabilities and the SCR that firms need to hold. It is intended to reflect the risk premia of transferring the liabilities to a third party, hence making the liabilities side of the regulatory balance sheet more market consistent – a key principle of Solvency II.

47. The design of the Risk Margin is deeply flawed – as has been acknowledged by both the PRA CEO Sam Woods at a recent Treasury Select Committee appearance and HM Treasury too. Its size is too high and it is too sensitive to interest rates. This acts as a strong disincentive for insurers to write the long-term business which offers protection against longevity risk, such as annuities and other long-term guarantee-based products.

48. Reviewing the Risk Margin could lead to a reduced cost for insurers, whilst still maintaining a very high level of policyholder and claimant protection. Whilst there is some scope to review the PRA's local implementation of Solvency II in these areas, a more materially and mutually beneficial outcome will require change at the European level (or, post-Brexit, change to UK legislation and regulation).

49. With regards to other modes of consolidation, the ABI notes with interest the PLSA DB Taskforce paper: *The Case for Consolidation*[10]. We also note their analysis that consolidating scheme elements could reduce the proportion of members exposed to the risk of not seeing their benefits paid in full by only 1 or 2%, and that only the creation of a new type of authorised 'superfund' has the potential to transform the sector.

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[10] http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/0622-The-Case-for-Consolidation.aspx

50. However, the creation of a superfund would be immensely complex and raises a range of potentially intractable issues. Our view is that the sector should capitalise on the more modest benefits which might be obtained from consolidating scheme elements, outlined in the Taskforce's report, such as shared back office services, asset pooling and governance. These are discussed further in the sections below:

Asset Pooling

51. The DB taskforce describe the key benefits from asset pooling as:
    - improved bargaining power when purchasing fund management services;
    - access to higher quality advice and;
    - access to a wider range of investment opportunities that are not available to, or cost effective for the smaller investor.

52. However, they also cite a number of barriers to take up, one of which is the difficulty of ensuring interests are aligned with unconnected schemes. One of the main concerns raised by the ABI in its evidence to the Committee was the difficulty faced by of trustees, especially those of small schemes in making sound investment decisions. So, to the extent that asset pooling has the potential for making the role of trustees more straightforward, it is worth pursuing.

Governance

53. The taskforce also suggest that overlaying a common governance framework, thereby raising governance standards, could deliver real benefits. They cite research which suggests that good governance can raise fund value by up to 1% a year. But, subjectively, if this affords an opportunity for improving the position of trustees, then it is worth exploring.

Superfunds

54. Both the green paper and the DB Taskforce describe the option of creating private or public superfunds which consolidate the assets and liabilities of participating pension schemes and discharging solvent employers from their pension obligations.

55. In our view, superfunds could become significant institutions – given the aim is to create scale – and should therefore be regulated appropriately. If the intention is for insurers (among other PRA-regulated firms) to set up and run superfunds, there is an important question regarding how the PRA would apply Solvency II rules, (assuming the superfund is set up as an occupational pension scheme). We would suggest that a clear view from the PRA is sought on whether they intend to run two capital regimes for pensions.

56. In terms of governance, the majority of financial institutions (banks and insurers, rather than pension funds) operate a "three lines of defence" model with a Board (with independent members) to provide oversight and governance, an executive and management team to run the business and risk/internal audit/compliance functions to provide assurance and risk controls.

57. The majority of pension funds operate with the trustees undertaking the oversight and governance role, with the executive and management layer role typically filled by a third party such as consultants and/or advisors.

58. Given the potential size and systemic importance of pension consolidation vehicles a corporate type model based on the three lines of defence approach would appear to be more appropriate.

59. Further issues which have been raised in relation to the proposal include:
    - the appropriate asset allocation employed by superfunds in their investment strategies;
    - the acceptable risk of failure of a superfund: the PLSA report superfunds suggests that funding criteria might be a funding level consistent with a 90 per cent minimum probability of being able to pay superfund member benefits in full, on an ongoing basis;
    - the challenge of aligning the huge diversity of existing DB schemes – it is worth noting that pension fund assets and liabilities are managed by insurers on a consolidated basis with scale and efficiency, but without needing to harmonise benefits;
    - the implications of breaking links with employers – it has been suggested that allowing employers to walk away from their DB schemes creates a moral hazard and could weaken the position of members who would be without the back-up of the sponsoring employer;
    - the lack of clarity about: how a superfund would stand in relation to the PPF and who would pay the levy; risk management principles; and equality between schemes entering the fund at different times, should reserving calculation methodology change in the meantime.

60. The ABI believes the ‘superfund’ proposal deserves further consideration. However the inherent complexities and the challenges it raises should not be underestimated. The Government should be very wary of committing to such an idea in principle in the absence of greater detail on the role, structure and regulation of superfunds.

61. We welcome the opportunity to further engage with Government and the relevant stakeholders on these issues.