The ABI's response to the Department for Work and Pensions consultation on *Consolidation of Defined Benefit pension schemes*

February 2019

Executive Summary

1. The ABI is the voice of the UK's world leading insurance and long-term savings industry. A productive, inclusive and thriving sector, we are an industry that provides peace of mind to households and businesses across the UK and powers the growth of local and regional economies by enabling trade, risk taking, investment and innovation. The UK insurance and long-term savings industry is the largest in Europe and the fourth largest in the world. We welcome the opportunity to respond to this consultation paper.

2. Insurers are the original consolidators. They offer bulk annuity insurance ("buy-out") which allows employers to sever their relationship with their defined benefit (DB) pension schemes, while providing scheme members with virtually guaranteed benefits which fully reflect the promises made by the employer.

3. This response represents the views of 7 active buy-out insurers responsible for £127.1 billion of assets and 1.5 million DB pension scheme members. Last year alone, our members insured c£30 billion of DB pension scheme liabilities, including the BHS pension scheme and its 9,000 members. Insurers are regulated by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), and their insured customers benefit from guaranteed pension pay-outs, backed up by stringent capital requirements, and rigorous regulatory oversight.

4. The Department for Work and Pensions (DWP) originally set out to tackle the right problem: how to fill the gap between the Pension Protection Fund (PPF), and insurance buy-out. In particular, how consolidation could help small, underfunded DB pension schemes achieve better outcomes for their members, by using the benefits of scale, higher standards of governance and lower administration costs.

5. But the policy development process lost its way. The present proposals have ignored the real problem, and instead focus only on helping employers with better funded schemes. The proposals would create an untested, light-touch regulatory regime which incentivises employers with well-funded pension schemes to offload their liabilities to profit-seeking financial institutions because it would be considerably cheaper than buying them out with insurers. Not only would this create very significant risks for scheme members' benefits, the proposed system would privatise profits (with the private equity backers of consolidators) and socialise liabilities, as failing consolidators would fall into the PPF. More concerning still, this could significantly undermine the reputation of the UK's pension system and with it, the enormous progress made with reviving pension saving through the automatic enrolment programme.

6. As a result, our members are gravely concerned about the proposals and believe they need an urgent and fundamental rethink so that an appropriate regulatory regime can be developed. The DWP should also return to the wider problem, and work with the sector on how to help small and underfunded schemes access the benefits of consolidation so that their members have better prospects.

7. If this is not the case, and Ministers decide to forge ahead with the plans at this point, it is vital that the following five points are addressed to attempt to avert the very worst outcomes.

8. **Use the right regulators**. It is proposed that The Pensions Regulator (TPR) should regulate commercial consolidators, as the legal form of consolidators is a trust-based arrangement. However, this overlooks the fundamentals: commercial consolidators will be profit-seeking institutions, similar to investment banks, hedge funds and insurers, rather than DB pension schemes which are not-for profit and run under trust law. Financial institutions are regulated by the FCA and the PRA for purposes of conduct and capital. These regulatory regimes give the PRA and the FCA robust authorisation, rule-making and supervisory powers. Such powers will be necessary for the regulator of commercial consolidators. A principles-based code of practice as proposed is not a suitable regulatory tool for profit-seeking institutions responsible for potentially hundreds of billions of pounds of savers' pension entitlements. It is obvious that the appropriate regulators for commercial consolidators are the PRA and the FCA.

9. **Strengthen the "Gateway"**. It is right that schemes which can afford buy-out are prevented from using a commercial consolidator. However, the proposed assessment criteria in the Gateway can be easily gamed and must be strengthened:

    a. Schemes should not enter a consolidator if they can achieve buy-out in the foreseeable future, rather than in five years as proposed. This is because DB pension schemes' ability to buy-out is entirely scheme-specific, and highly reliant on the ability and willingness of the employer to fund the scheme to buy-out.
    b. Related to this, the Gateway principles must include an assessment of all the employer's sources of finance, based on professional advice.
    c. More widely, the regulator must guard against employers paying less into their scheme to be able to enter the "Gateway" and so be able to sever their links with the scheme at a lower price.

10. **Require appropriate and comparable levels of capital, and the use of a standard model**. The consultation proposes that commercial consolidators need to hold financial resources to have a 99% probability of paying or securing full benefits over the lifetime of the scheme. This is a measure that may sound reassuring to a layperson but is impossible to compare with the capital strength required of insurers under Solvency II. This prevents trustees from assessing the security on offer to their beneficiaries from commercial consolidators, and to arrive at an informed conclusion. Worse still, we estimate that the level of capitalisation proposed for commercial consolidators would be between 15% and 45% lower than what is required of

insurers***; insurers would be deemed insolvent with the level of capital proposed***. In addition, commercial consolidators should be required to use a standard model as this will give much more clarity and less subjectivity about the level of capital required relative to the risks.

11. **Set appropriate governance, risk management and disclosure standards**. We are very concerned that the consultation proposes to set up a new regulatory regime from scratch even though there are tried and tested standards for financial institutions. There is no reason not to utilise these even if commercial consolidators have to meet lower capital standards than insurers:

    - A robust senior managers regime is already in place for financial institutions: the Senior Managers and Certification Regime (SM&CR), adopted after the global financial crisis and championed by HMT, the PRA and the FCA. It makes much more sense for this regime to be used for commercial consolidators.
    - We are also very concerned that the consultation does not include any concrete requirements for a risk management framework for commercial consolidators. But a risk management framework is vital so that commercial consolidators can demonstrate how the level of risk they are taking is proportionate, how risk taking might be limited to protect scheme members, and what action is taken when set risk limits are breached.
    - Under Solvency II, insurers have to conduct a significant level of public disclosure, as well as private reporting to the PRA. There is at least as much public interest in the activities of commercial consolidators, one of which has stated a target of £500bn assets under management. Commercial consolidators should therefore meet the same standards.
    - Commercial consolidators should also be subject to close and continuous supervision, in the same way that large banks and insurers are supervised by the PRA and FCA.

12. **Address the macroprudential risks posed by commercial consolidators**. In the absence of an employer covenant, the security of members is entirely dependent on the investment performance of the fund. Unlike in the current system, where risk is diversified across individual schemes with their own investment strategy, consolidators would bring schemes together with all risk focused on one investment strategy. If this strategy were to fail, this could potentially lead to large claims on the PPF. The investors backing the consolidator could also take funds out in years of good investment returns, preventing a greater level of reserves to build up. This could mean investors make significant returns in the early years with the consolidator failing in the long-term. This would have adverse consequences for intergenerational fairness. It is not clear what consideration has been given to the risk to financial stability that these entities could pose, and how this would be monitored.

13. In conclusion, we urge Government to put the current proposals on hold, and consider the regulatory requirements in much greater detail. The proposed policy creates vastly more risks than the consultation suggests. We urge Government to engage on solutions for under-funded schemes, including how to secure benefits at a compromised level above that of the PPF for underfunded schemes.