Dear Mr Field

Work and Pensions Committee oral evidence session, Wednesday 2 May 2018

Thank you for giving me the opportunity to give evidence to the Work and Pensions Committee as part of your inquiry into the DB White Paper.

The Committee asked for clarification and further written information about the number of employers that would support the concept of a Superfund. The PLSA DB Taskforce commissioned IFF Research to survey 100 financial directors, who worked for employers with DB schemes about their attitude toward the consolidation of their DB schemes, between 17 July and 11 August 2017. This found that 39% of respondents would be interested in transferring their scheme into a Superfund.

I thought it helpful to clarify certain recommendations that the DB Taskforce made regarding the Superfund authorisation regime and also to address certain concerns around Superfunds apparent in the discussion last Wednesday, in particular which schemes could benefit, Superfund economics compared to buy-out and concerns expressed regarding Superfund ownership.

The regulatory regime for Superfunds

Any Superfund regime must have a strong regulatory structure to support it. We believe this could be similar, and potentially tougher, than the regime being introduced for DC Mastertrusts in the Pensions Schemes Act 2017.

We recommended both the sponsor and trustees operating a Superfund would need specific authorisation from the Pensions Regulator (TPR), and would need to show that:

- The people involved with the Superfund are fit and proper;
- It is financially sustainable, i.e. the Sponsor has sufficient assets to support the operation of the Superfund; and
- It has adequate skills, systems and processes to ensure it is managed effectively.
Superfunds would need to submit a business plan to the TPR, covering areas such as strategy, investment policy, profit levels and other aspects of operation. TPR would need to approve the business plan which would provide the basis upon which the ongoing operation of the Superfund would be supervised. Crucially, although changes could be made to the business plan, these would need to be decided by agreement between the sponsor and trustees and would also be subject to approval by the TPR.

Entry of a scheme to a Superfund would require approval of the transferring Trustees, the sponsoring employer and the Superfund sponsor and Trustees. Transferring Trustees would only be able to approve such a transfer if, having taken expert advice, the transfer was deemed in the interests of members and, in practice, beneficial.

We also envisage that any ultimate change of ownership of the Superfund would require a new business plan and approval from the TPR, who would have the power to remove its licence to operate. These safeguards are fundamental to protect member benefits.

**Sector segmentation**

The table below indicates the make-up of the DB sector schemes in deficit (representing approximately 78% of all Tranche 10 schemes), broken down by covenant group based on the latest analyses produced by TPR. It focuses only on schemes in deficit and adopts the TPR’s definitions of covenant strength and scheme categorisation.

<table>
<thead>
<tr>
<th>Employer Covenant Group</th>
<th>Proportion of schemes</th>
<th>Average Funding level based on Technical Provisions</th>
<th>Average length of recovery plan (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CG1 - Strong</td>
<td>13%</td>
<td>91%</td>
<td>5.4</td>
</tr>
<tr>
<td>CG2 – Tending to Strong</td>
<td>46%</td>
<td>85%</td>
<td>6.7</td>
</tr>
<tr>
<td>CG3 – Tending to Weak</td>
<td>28%</td>
<td>84%</td>
<td>8.3</td>
</tr>
<tr>
<td>CG4 - Weak</td>
<td>14%</td>
<td>81%</td>
<td>9.6</td>
</tr>
</tbody>
</table>

TPR: Scheme Funding Statistics 2017.

We consider it unlikely that Trustees of well-funded schemes with CG1 sponsors, which are mostly heading for insured buy-out, would be able to deem transfer to a Superfund to be in their members’ interests. Schemes with CG2 employers will either seek to run-on, achieve insured buy-out or Superfund buy-out depending on the sponsor and scheme fortunes. Given pressures facing scheme sponsors we consider covenants more likely to weaken than strengthen.

CG3 schemes are highly unlikely ever to be able to reach insured buy-out and are the part of sector that Superfunds can benefit most. Schemes with weak funding and with CG4
employers are highly likely to eventually fall into the Pension Protection Fund (PPF) and members will suffer benefit reductions, on average around 25%.

Whilst Superfunds might be able to accept such schemes under some form of risk-sharing arrangement, or amendments to benefits (as has happened in the British Steel Pension Scheme), without greater understanding and transparency about the risk currently borne by members of such schemes, we consider this option unviable currently.

**Superfunds economics**

The Committee also asked about the value of Superfunds taking on schemes that are 100% funded on a self-sufficiency basis, when it is the schemes that are underfunded that need greater support. The Taskforce recognised this and concluded that for schemes that are already well funded (typically CG1), Trustees should continue to target buy-out or self-sufficiency. However, the majority of schemes are not in this position and have not been for over a decade. As such, we concluded (amongst other measures to improve the funding regime) that for schemes with weaker funding and weaker covenants the Superfund model could create the right incentive to accelerate payments into underfunded schemes, and this remains one of its key potential benefits.

The transfer of a scheme to Superfunds would operate along similar principles to buy-out by an insurer. Under both the recipient entity will require the scheme deficit to be eliminated or substantially eliminated. The insurer or Superfund provides 'first-loss' capital, which is used to make good any benefit damage in adverse scenarios. Both reward the providers of such capital through investing scheme assets and through earning any 'excess' return on such assets.

Because the layer of capital protection provided by a Superfund is lower than for insured buy-out, we calculate the price of a Superfund buy-out for an employer to be 80–85% of insured buy-out for an average CG3 scheme (insurance buy-out is typically 120% of Technical Provisions). Superfund protection is accordingly lower at around 90–95%, compared to the 99.5% plus protection provided by insurers.

Our analysis indicates that these entry criteria would enable Superfunds to be affordable for a large proportion of employers, and provide 100% of benefits at levels of security similar to the PPF. Data from the PPF Purple book shows that to provide the levels of protection under Solvency 2 would cost £780 billion for the sector as a whole. While it is desirable to achieve the highest standard of protection for members, the reality is that this level of cost is unaffordable for many employers and leaves a large proportion of members' benefits at risk. The DB Taskforce analysis indicated that 3 million members currently have only a 50/50 chance of receiving their benefits in full.
Ownership considerations

As the Committee has found in recent inquiries, acquisition and merger activity has the potential to pose risk to members’ benefits. Alongside other measures proposed in the White Paper, I believe that consolidation, combined with a tough supervisory regime, would help bring such activity under the control of the Regulator and ensure that protection of members’ benefits is given utmost priority.

In the life insurance sector, there have been no instances of policyholder detriment and clear evidence that many millions of policyholders have benefitted from the activity of consolidators. Indeed customers in consolidators typically receive higher service levels, because consolidators’ sole focus is the management of legacy books and failure to provide high quality customer service undermines their ability to attract additional schemes.

Superfunds provide a new option for underfunded schemes that doesn’t currently exist under the current regime. It creates an incentive and achievable goal for employers to make a one-off payment to reach self-sufficiency funding levels, without having to pay for the more expensive - and in many cases unachievable - insured buy-out option. In return, where Trustees agree it is in the interest of the members to move to a Superfund, members get greater assurance their benefits will be paid and, in the case of the one Superfund already set up, a share of any extra gain made from the investments of the new Superfund. Under our proposals, Superfunds will also act as a ‘first line of defense’ and help to protect the PPF.

The structural problems faced by the sector require a solution which addresses the issues of scale, cost inefficiencies and lack of access to high quality investment, risk management and governance skills currently faced by many, especially smaller, schemes. The proposals contained in the White Paper, backed up by an appropriate regulatory framework, are necessary and can over time address these structural issues significantly improving outcomes for members.

I hope these further points are helpful. If you or other members of the Committee require any further information or clarification, please do not hesitate to get in touch.

Yours sincerely

Ashok Gupta
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