LCP response to Work and Pensions Committee call for evidence on Defined Benefit pension schemes

26 April 2023

This document sets out LCP's response to the Work and Pensions Committee's call for evidence on Defined Benefit ("DB") pension schemes published on 16 March 2023.

Executive summary

The decision of the Work and Pensions Committee to investigate the future of the Defined Benefit system is extremely welcome. Current regulations have been developed by successive governments with the best intentions, focussed on protection the benefits of DB pensioners. However, we believe that current regulations have now led to a situation where many DB schemes are forced into excessively low-risk / low-return investment strategies. This leads to around £1.5 trillion of assets in private sector DB schemes being under-utilised.

In this submission, rather than answering your specific questions, we instead focus on our proposal for an innovative new opt-in system which could:

- Help to ensure DB member benefits are paid in full.
- Allow pension scheme investments to achieve a greater rate of return, generating pension scheme surpluses.
- Free up pension scheme assets to invest in priority areas, including UK infrastructure, funding the transition to 'net zero' and investing for long-term growth of UK companies.
- Provide additional funds to improve DB member benefits, for example by paying discretionary increases in periods of high inflation.
- Enable employers to make higher contributions to the DC savings of their current workers, where it has been well-documented that savings rates are likely to be inadequate for a significant proportion of the UK population.

We recognise that this is a complex proposal with wide-reaching implications that we are not able to fully-address in this submission. Would welcome the opportunity to discuss our proposal with the Committee and provide further information, if helpful.

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Our argument is as follows:

- UK DB pension schemes are generally extremely well-funded, and typically now invest in very low-returning assets.
- Policy and regulatory focus has become exceptionally risk-averse, aiming to ensure that benefits are delivered with certainty. This is likely to mean even more de-risking.
- As a consequence, the £1.5tn of private sector DB assets are unlikely to significantly invest in long-term growth assets, including those supporting the UK economy.
- In our view, this is an inefficient solution to delivering member security, meaning DB schemes are forgoing long-term investment returns that could otherwise be spent on supporting UK plc, the economy, investing in UK infrastructure and improving DC savings rates for future generations.
- We think two changes to the DB system could free the £1.5tn of UK DB assets to invest for long-term growth:
    1) An increase to PPF coverage to 100% of benefits, supported by additional PPF levies. This would provide additional security to members and their Trustees as benefits would be under-pinned in full and in turn enable them to consider taking more reward seeking investment strategies.
    2) A mechanism to allow growing scheme surpluses to be extracted (within appropriate limits and for appropriate purposes), to provide an incentive for sponsoring employers and trustees of schemes to invest for long-term growth.
- We suggest such a system could be implemented through a “opt-in” basis, with schemes having to meet minimum funding levels to qualify. This, and other protections, would significantly mitigate the additional risk placed on the PPF providing 100% coverage.

Current status of UK pension provision

UK private sector DB Pension Schemes have c£1.5tn in assets in aggregate and are now generally extraordinarily well-funded. The schemes of the FTSE 100 alone in aggregate have over £100bn more in assets than the pension scheme liabilities stated in their accounts. LCP estimates that in aggregate all UK DB schemes are now c90% funded on the cost of fully-insuring their liabilities with an insurance company (a very high bar) – as recently as 2016 that figure was less than 60%.

With schemes now so well-funded, encouraged by regulations , they are increasingly investing in very low risk / low return investment strategies. Typical schemes plan to deliver investment returns of only 0.5% pa higher than gilt / cash rates. For context, endowment funds often target returns of 4-6% higher than cash rates. Applied to the full £1.5tn of total UK DB Scheme assets, even a 2% pa higher return represents £30bn pa of forgone return.

By contrast, current savings rates in DC pensions are widely projected to lead to inadequate retirements for many. The Pensions and Lifetime Savings Association’s recent report “Five Steps to Better Pensions” concluded that only 8% of households with active DC savings are expected to reach a comfortable retirement. The current total assets invested in DC pensions is only around £200bn, placing into context the c£30bn pa that DB schemes may be forgoing in achievable returns.

Whilst of course the status of DC savers is not directly relevant to those managing DB pension schemes, we think taking a more holistic view highlights an inequality between the “have” and “have nots” of the UK pensions landscape. We think a different approach to managing DB schemes could unlock substantial additional money for companies to invest in their current workforces DC savings, whilst still protecting DB members.

Current regulatory focus

Over the past two decades, successive government policy and regulatory focus has been on reducing investment risk to very low levels. The ultimate objective, accelerated by various high profile company insolvencies (BHS, Carillion), is that even if a scheme's sponsoring employer becomes insolvent the scheme members will receive their benefits in full.

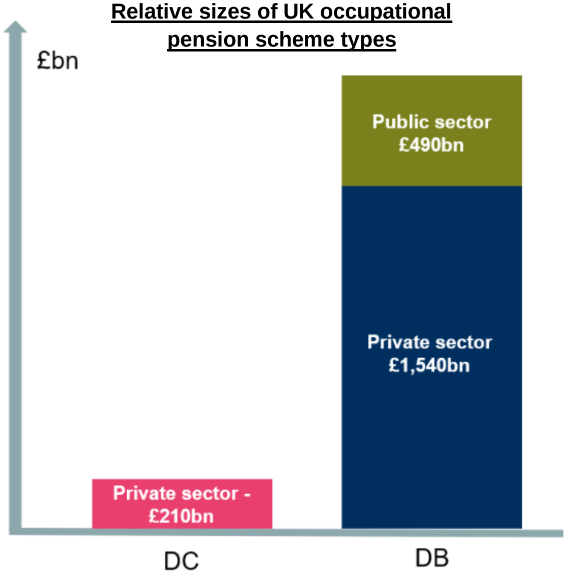
Whilst of course this is good for scheme members, it does come at a cost:

- lower investment returns mean corporate Britain has to pay more to schemes, reducing the ability to contribute to DC pensions of current workers, invest in their business, pay down debt, pay better wages or make payments to shareholders.
- if scheme assets have to be low risk (eg bonds) this reduces the potential for investment in productive finance, long-term infrastructure projects, start-up businesses etc (all potentially harming the UK economy).

Related to the second point, much has been written recently about whether DC pension schemes should do more to invest to support the UK economy. We think those arguments are missing the bigger picture – the chart places in context the relative sizes of current UK DC and DB assets.

We note that the Government has committed to leveraging £90bn of private investment in Net Zero alone by 2030 – clearly this is a very high proportion of DC assets (even given those assets are expected to grow), but a much more realistic proportion of DB assets.

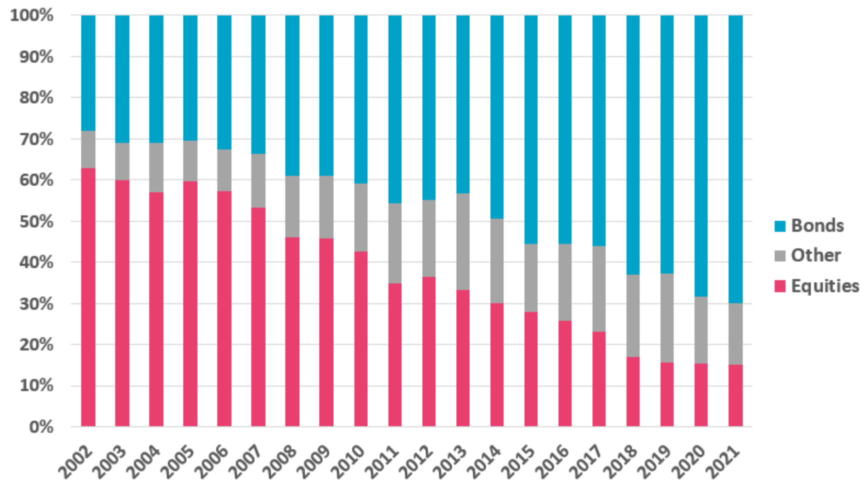
Relative sizes of UK occupational pension scheme types



Source: ONS "Funded occupational pension schemes in the UK – September 2022".

We are concerned that whilst the funding levels and investment strategies of DB pension schemes have changed so drastically over the past 20 years, the regulatory march towards "ever more de-risking" remains. In fact, we think the drive towards ultra-low investment risk is if anything accelerating, when most schemes have already adopted very low-risk investment strategies (see chart).

Asset allocation history of UK DB FTSE 100 pension schemes



We think now is a good time to take stock and reassess whether the inertia of a "de-risking mindset" now needs to be challenged. Is investing in such low-returning investment strategies really the most efficient way to ensure members receive their benefits in full? Or does it come at too great a cost to corporate Britain, future generations and starve the UK of much-needed long-term investment in infrastructure and our economy? Might the UK look back at the opportunity to have better-invested £1.5tn of DB pension fund assets with regret?

If DB pension security is to remain paramount, and there is no full protection provided outside of pension schemes, then the current regulatory regime does make some sense – pushing well-funded schemes to safer and safer assets. However, if stronger protection for pensions can be provided from another source, this would free up schemes to invest for longer term growth.

The role of the Pension Protection Fund ("PPF")

The PPF acts as an "insurance policy" for UK DB schemes, providing members with partial coverage of their scheme benefits should the scheme's sponsoring employer become insolvent *and* the scheme not be fully funded. The PPF charges annual levies on schemes (in effect an insurance premium), which are calculated based on the assessed risk of each scheme on the PPF (based on size, funding position, investment strategy and sponsor strength).

The PPF applies two main reductions to members benefits: 1) any member that is below their "Normal Pension Age" has pensions reduced by 10%, 2) any member with service accrued before April 1997 loses any promised inflationary increase to those benefits. Broadly, on average, these reductions means that the PPF covers around 90%-95% of the value of DB scheme benefits (albeit of course this varies by scheme-to-scheme and member-to-member).

One important point to note is that as time passes the PPF's coverage is drifting upwards as members age (and therefore the proportions receiving a 10% reduction / those with pre-1997 benefits reduce).

We note that the PPF is currently very well-funded, with £11.7bn of its £39bn of assets at 31 March 2022 deemed surplus "reserves" – a funding level of 143%. This healthy financial situation suggests that centrally supporting DB members' benefits is an effective approach to managing downside risk. Indeed, this is the (successful) model adopted by the wider insurance industry.

The success of the PPF to date suggests that marginally extending the PPF to cover 100% of benefits would be a viable course of action. Of course, one key consideration would be to ensure that this "full coverage" does not incentivise adverse behaviours from those running DB pension schemes (eg chasing very risky investment returns).

Given the presence of the PPF successfully covering c90-95% of members benefits, it seems to us that striving for certainty over the final (and diminishing) c5-10% of benefits by investing in ultra-low risk investments comes at a very high and disproportionate cost to the UK.

A new "opt in" system for DB pensions

To address this inefficiency, we propose creating a new "opt in" system for managing DB pension schemes, with two key changes:

1) An increase to PPF coverage to 100% of benefits, supported by additional PPF levies. This would provide additional security to members and their Trustees as benefits would be under-pinned in full and in turn enable them to consider taking more reward seeking investment strategies.
2) A mechanism to allow growing scheme surpluses to be extracted (within appropriate limits and for appropriate purposes), to provide an incentive for sponsoring employers and trustees of schemes to invest for long-term growth.

We believe that these two changes would fundamentally change the incentive structure for those running UK DB pension schemes. They would provide the necessary protection and create an incentive for schemes to invest for longer-term growth (including in critical areas for the UK).

The surpluses generated, which may amount to over £100bn over the coming decade, can be shared appropriately between DB members, increased DC saving for current workers and higher investment in the UK economy.

A client case study

We have considered this idea with a number of our clients (some of the UK's largest pension schemes). For one example DB Scheme with £2.5bn of assets, we estimate that continuing to target a modest investment return (around 1.5%-2.0% pa higher than cash rates) would generate an additional £25m-£40m pa of surplus each year, compared with the cost of fully insuring the Scheme. We also estimate that the Scheme's surplus will also grow a further £10m-£25m pa as its membership matures (insurance pricing tends to be cheaper for pensioners than non-pensioners, and prudent assumptions about future experience are replaced by actual outcomes). Combined, this £35-65m pa improvement is of similar order to this company's £50m pa contributions to its current workforce's DC savings.

Continuing to run this Scheme in a balanced risk controlled-way gives a number of options on how to spend the additional expected surpluses: the DC saving rates current employees could be broadly doubled (at no additional cost), the company could invest additional surpluses in growing its business (and the UK economy), or part of the increased surpluses could be used to improve DB members' benefits (eg discretionary pension increases in times of high inflation).

Current DB scheme regulations present two key challenges to this strategy:

1) the Trustees are asked to ensure that members' benefits are secured with as near to 100% certainty as reasonably possible – investing for even modest investment growth can be viewed by Trustees as conflicting to this objective.
2) in practice the Company has no mechanism to extract surpluses to invest in its own business on an ongoing basis, and only a minority of Companies would be able to use surpluses to increase DC savings and/or take DC contribution holidays.

What could this mean if applied across the pensions industry?

To illustrate the potential scale of the benefits of our proposal, let's assume that 25% of DB scheme assets "opt-in" to the new system. Note this wouldn't mean 25% of all schemes by number opt in, as we would expect it to make more sense for larger-than-average schemes to pursue this approach. This would give around £385bn of assets in the new system.

Simply applying the figures in our single case study, which we believe to be a reasonable representative example, these assets may generate an additional £5.4bn-£10bn of value *each and every year* when compared with fully de-risking those pension schemes. Depending on how this additional return is used, the additional benefits could compound to c£100bn or more over the next decade. Note that this figure is broadly half of all DC assets saved in the occupational pension schemes in the UK to date.

But this cannot happen within the current regulatory environment – member protection must be extended via the PPF to support and enable modest investment growth to be targeted, and a mechanism must be introduced to allow generated surpluses to be accessed in a sensible way.

What are the risks?

The primary risk of this new system would be that schemes opt-in for 100% PPF coverage and subsequently fall into the PPF in deficit. We proposed the key protections against this would be:

- Schemes opting into this system would still be subject to all existing laws and regulations for managing DB schemes, including the need for regular prudent actuarial valuations and recovery plans if deficits were to emerge. In our experience, we believe this means scheme sponsoring employers would not look to adopt excessively risky strategies.
- Schemes would be required to have a sufficiently strong funding level to opt-in (eg 100% funded on TPR's new fast-track basis). Well-funded schemes are far less likely to create financial pressure should they fall into the PPF. Indeed the PPF may expect to make a profit from such schemes and further grow its reserves.
- Schemes opting-in to this system would pay additional PPF levies to fund their additional coverage. These would be calculated reflecting the risk each scheme presents, so would provide disincentive for excessively-risky strategies (and provide the PPF with additional funding where those strategies are adopted).
- More direct protections (eg maximum equity allocations) could be put in place to govern strategies of "opt-in" schemes and help protect against "moral hazard risk" on the PPF.

Overall, we expect this system would lead to schemes adopting "low to medium-risk" investment strategies from very well-funded starting positions. This is a very different picture to when much of the current regulatory framework was developed, when under-funded schemes were running much riskier investment strategies.

To the extent a key objective is to drive DB assets towards high-priority investment areas, there is also a policy risk that schemes opt into the new regime but then not invest in the way intended. It would be open to governments to develop "carrot and stick" policies to support appropriate investments, perhaps through the creation of central funds or favourable tax treatments.