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PRA response to DWP consultation paper: Defined benefit pension scheme consolidation

1. Introduction

The PRA welcomes the opportunity to respond to this consultation paper. We have a close interest in the regulatory framework for defined benefit (DB) pension scheme consolidation because it offers economically similar financial services to annuities yet may have different standards of authorisation and prudential supervision. DB pension scheme consolidators could compete with PRA-regulated insurers providing annuities, and it is possible that insurance groups will operate in the consolidation market and we become the consolidated group prudential supervisor.

2. Executive summary

We agree a regulatory regime is needed for defined benefit pension (DB) consolidators. The pension promises made by DB schemes are very similar to annuity products. And profit-seeking DB consolidators are very similar to insurance companies, which provide annuities and are regulated. Regulation helps to solve the tension between pension scheme members' security and investors seeking to make profit.

Regulation of DB consolidators will need to include a robust framework for authorisation and supervision. It is important that a regime to support vital long-term services is well thought-through. We would therefore encourage a measured pace for policy, although we recognise the challenges of investors seeking to enter the market with no regime in place. Our response considers further analysis that could help develop a regulatory regime.

Our response focuses on five key areas:

a) financial sustainability;
b) future transfer of DB schemes from consolidators to insurers;
c) authorisation;
d) supervision; and
e) reporting and disclosure.

Our response discusses these in detail. Here are our main points.

- The risks faced by DB consolidators are similar to those managed by insurance companies providing annuities. And insurance companies may want to enter the DB consolidation market. There may be unintended consequences if the two types of business are regulated differently.

- The new framework could require consolidators to calculate prudential requirements using the same methods as insurers. We have found the insurance framework to be effective in mitigating similar risks.
- The insurance regime gives the regulator robust powers of rule-making and supervisory intervention. We suggest the proposed framework create similar powers.
- It is very challenging to minimise the risk of arbitrage between regulatory regimes. In this case, there is a risk that more pensioners may not have the chance of greater security enjoyed by those with annuities, backed by insurance regulation. The consultation paper includes an option that consolidators act as a bridge, until schemes are strong enough to buy annuities from insurers. Of the options proposed, we think this would be the most effective in mitigating the risk of regulatory arbitrage.

In conclusion, we note and support the development of a robust authorisation and supervision regime for DB consolidators. We would argue that the insurance framework provides an appropriate model for scheme member protection. We would encourage further analysis of how to meet the desired policy objectives and keep pensions secure.

3. Detailed responses to matter raised in the consultation paper

3.1. Financial sustainability

Given the nature of the risks being taken by consolidated schemes, we posit that the methodology for determining the financial adequacy of DB pension scheme consolidators should be made as close and comparable to that of insurance companies as possible. In particular it should:

a) use a current and projected balance sheet approach to solvency assessment;

b) specify a method for the calculation of technical provisions using best estimate cash flows at the time of solvency evaluation;

c) use a risk based capital requirement in addition to the technical provisions to deal with adverse experience;

d) use an own funds regime that specifies the quality and loss absorbency of capital resources; and

e) where DB pension scheme consolidators own modelling is permitted, use an internal model approval framework to ensure adequate capital and provisions are being held.

In Annex 1 'Further detail on financial sustainability regime' we include more technical detail on these points.

We consider there are clear advantages in adopting a financial sustainability framework that closely follows insurance business given how similar DB pension scheme consolidation will be to annuity business in the UK.

In our judgement, adopting a similar financial sustainability framework will enable decision makers (eg trustees) to make informed decisions about the relative security of member benefits in different

DB pension scheme consolidators and compared to an insurance company. It should also act to give the Government and regulators appropriate comfort on the safety and soundness of DB pension scheme consolidator entities receiving transferring benefits.

A balance sheet approach introduces market disciplines and transparency to the valuation of assets and liabilities. This reduces the risks associated with lower than predicted (and therefore required) forecasts of cash flows that would potentially reduce the security of members' benefits and increase the likelihood of calls on the Pension Protection Fund (PPF).

In addition a balance sheet approach is required in order to test whether a scheme is sufficiently funded to buy-out insurance contracts.

We understand that in order for the policy initiative to be successful in assisting schemes that cannot currently afford buy-out, the calibration of the requirements may need to be lower than the Solvency II regime for insurance companies.

The exact calibration of the regime depends on the Government's risk appetite for the failure of a DB pension scheme consolidator. That risk appetite needs to assess the increased risks of a lower calibration against the policy objective of potentially enabling employers in the real economy who cannot afford insurance buy-out in the near future, to increase their productivity once freed of their DB pension scheme liabilities.

Consequently Government risk appetite for DB pension scheme consolidator failure may be higher than the Government risk appetite for insurance firm failure. We propose careful examination, by government departments, financial regulators and other specialists, of the level and nature of risk appetite that would be socially optimal. We have included more technical detail on a potential framework in section f) of Annex 1 'Further detail on financial sustainability regime'.

3.2. Superfund gateway

We welcome the consideration of the approach that should be taken when consolidated schemes reach buy-out funding. We also welcome the intention to minimise the risk of arbitrage with the insurance market. To that end we consider the most appropriate approach would be to view DB pension scheme consolidation as bridge to buy-out with an insurance company.

An objective to reach buy-out using insurance contracts would be an effective way to mitigate the risk of DB pension scheme consolidation scheme sponsors taking unnecessary investment risk or reducing contributions in an attempt to arbitrage the insurance regime. A prudentially sound framework would effectively prohibit transfer to a DB pension scheme consolidator where buy-out is feasible and where buy-out is required once the consolidation vehicle reaches buy-out level.

Further we consider limits on profit extraction should be put in place. DB pension scheme consolidators would be constrained until the scheme has been safely bought out with insurance contracts.

In order that the gateway is able to operate effectively, a legislative framework will be required that enables relevant regulators to co-ordinate and share commercial information, and make objective judgements about the financial position of the scheme compared to an insurance buy-out contract.

3.3. Authorisations

The new regime that could be established appears to hang somewhere between the existing DB pension scheme regulations and insurance company rules, and would create a new set of risks and challenges that policymakers and regulators should consider. The current regime is clearly defined and offers little by way of opportunity for arbitrage. Any new regime creating a halfway house will potentially change behaviours and create different incentives in the market.

The consultation paper proposes the development of a principles-based code of practice. This proposal needs close examination to ensure the supervisory approach would be suitably effective at addressing any potential shortcomings in the risk management and financial sustainability of DB pension scheme consolidators.

To that end, careful consideration should be given to the requirements placed on entities seeking to establish and operate a superfund, and to establishing a framework for the individual accountability of directors and senior managers of DB pension scheme consolidators. This framework should be to the same standard as that established through the Bank of England and Financial Services Act 2016 for all other financial services firms.

The high level criteria proposed in the consultation paper include a number of hurdles to enable the operation of a DB pension scheme consolidator to be carried out effectively, and by suitably fit and proper persons in a financially sustainable and supervisable manner. Such operation is a central plank in ensuring members receive appropriate protection, and that the market functions with a level playing field. The requirements would need to be maintained in all circumstances in order to be effective.

We note the DWP's proposal to include a mandatory fit and proper persons requirement and a set of conduct standards for the superfund's corporate board. We suggest that the DWP mirrors more closely the full PRA and Financial Conduct Authority (FCA) requirements under the Senior Managers and Certification Regime, and have set out more detail in Annex 2. This would prevent regulatory arbitrage, ensure greater enforceability, and raise the standard of governance within DB pension scheme consolidators to the level required of other financial institutions, including in particular those that provide retirement products.

3.4. Supervision

It is important that the regulator has the necessary powers to prevent a poorly funded DB pension scheme consolidator taking on more schemes, and placing a further strain on the investor resources and capital buffers of the existing schemes. The regulator must similarly have powers to prevent the DB pension scheme consolidator managers taking a disproportionate amount of investment risk or changing the liability valuation method in an effort to restore the scheme's funding level.

There are risks to effective supervision posed by the possibility for DB pension scheme consolidators to be part of a larger group, and consideration should be given to an appropriate group supervision framework including group solvency. It appears possible for a DB pension scheme consolidator to be established as a subsidiary of a financial services group and this could create a need for appropriate

rules for consolidating balance sheets. This might mean consequential changes to other financial services regulation. Provision for supervisory colleges may also be needed where there are different prudential supervisors of the group and DB pension scheme consolidator entity.

3.5. Reporting and disclosure

Our view is that DB pension scheme consolidators should be required to publish an annual balance sheet using market valuations and including liabilities valued on a buy-out basis, together with a buffer fund based on the Solvency II approach. We consider this type of disclosure to the market as a key element of maintaining transparency and market discipline.

DB pension scheme consolidators should also be required to submit returns to the regulator that report on the current and projected financial position, and include more detail on the balance sheet and risks. Consideration should also be given to DB pension scheme consolidators producing an Own Risk and Solvency Assessment to aid the trustees in their decision making.

1 February 2019

Annex 1 Further detail on financial sustainability regime

We suggest the requirements of a prudential supervisory framework would include the following elements at a minimum:

a) A current and projected balance sheet approach to solvency assessment

This approach, which is based on an ability to secure benefits rather than paying benefits, allows an assessment of whether the firm has sufficient assets to secure the liabilities by purchasing assets of a certain quality in the market. This approach is widely used in financial services regulation: insurance, banking, and pensions.

With regard to assets, we note the consultation paper proposes to use market values which provide a reasonable basis for assessing the contribution of assets to solvency. It also means that the regime can place reliance on market values and (where not traded) audited fair values of assets.

However, should the DWP depart from a balance sheet approach, the assurance of using market and/or fair values will be lost. In such a case solvency will need to be assessed based on estimates of long-term cash flows from assets. We are of the view that such estimates are highly subjective and notoriously challenging, especially for variable interest assets.

b) A method of calculation of technical provisions using best estimate cash flows at the time of solvency evaluation

We consider solvency as measured at a particular point in time should be based on the cash flows expected to emerge at the time solvency is assessed, as this best represents the current state of solvency of the firm.

The consultation paper suggests that the liability cash flows should be measured as at a point when most members have retired. This approach increases the risk of unrealistically dampening volatility in the long-term liabilities and sees scope for excessive subjectivity in the assessment. It would impair comparability of solvency standards between DB pension scheme consolidators and insurers, and between DB pension scheme consolidators, as the expected cash flows would be for different points in time for different firms.

We also consider that there will be a disconnection between the assets (which will be measured as at the date of the solvency assessment) and the expected cash flows (which the consultation paper suggests will be calculated at a future time point). There is a significant risk this will lead to incoherent solvency measurement, and result in false assurance that there are sufficient assets to secure liabilities.

The consultation paper also proposes a metric, which suggests that the PPF cash flows should be used. Our view is that beneficiaries should be assured that a fund is solvent based on the full contractual cash flow obligations at the time of the solvency assessment, rather than the reduced amount recoverable from the PPF (eg the 10% reduction in pensions and the cap in benefits).

c) A risk-based capital requirement in addition to the technical provisions to deal with adverse experience

We have found that where annuity-type business is backed by limited capital resources without further recourse to capital providers, a risk based capital requirement is an important protection for annuitants.

Our experience has been that annuity-type business can suffer material adverse experience. This could be as a result of demographic risk, market risk, credit risk, or operational risk. In our experience the risk profile of annuity businesses can vary materially. Consequently we have found a risk sensitive capital requirement desirable to ensure adequate policyholder protection while admitting business models that seek different levels of risk.

The DWP indicates it welcomes a range of business models which are likely to have quite different risk profiles. However the DWP consults on one option for a capital requirement as a fixed percentage of technical provisions.

We are of the view that this would not be sufficiently risk sensitive to provide an appropriate level of protection for beneficiaries when the DWP is open to a range of business models that could have materially different risk profiles.

d) An own funds regime that specifies the quality and loss absorbency of capital resources backing capital requirements

A key plank of any prudential regime is the quality of the capital resources backing the capital requirements. By capital resources we are generally referring to equity and subordinated liabilities. These can absorb losses and thus provide some protection to beneficiaries. By capital requirement we are referring to an amount of capital resources required to withstand a set level of adverse experience discussed in c) above.

In insurance regulation capital resources are referred to as own funds. An insurer must have own funds that absorb losses in a going-concern situation (eg equity) equal to at least 50% of their capital requirement. Insurers usually have considerably more than 50% of their capital resources as equity.

Equity is the highest quality capital resource as it fully absorbs loss. The holder of equity in an insurer would be paid last and would therefore always rank behind policyholders in the creditor hierarchy. In the event of the capital resources being eroded (eg through adverse asset or demographic experience) the equity interest in reserves will fall, so losses are absorbed and the insurer remains a going-concern.

If the capital resources backing the capital requirement are of low quality (for example if most of them only absorb losses in a gone-concern situation) then there is an increased risk that the insurer will not be able to survive a stress and still remain a going concern, although it may still be able to be wound-up in a manner that avoids policyholder loss.

At the point of non-viability the policyholder would rank ahead of sub-ordinated liabilities. Investors in sub-debt of an insurer may therefore lose some of their investment. This is how such sub-debt instruments provide gone-concern loss absorbency.

Financial services regulation places strict minima on the amount of loss absorbency of the capital resources (setting both overall minima and minima for going concern loss absorbing capital) and gives powers to supervisors to approve or reject certain capital instruments if they do not have the required loss-absorbing features. Instruments that are not suitably subordinated do not protect the policyholder. Such instruments should not be recognised as regulatory capital resources.

We promote an approach that recognises the inherently different challenges facing the regulator of DB pension scheme consolidators and the PPF compared to a DB pension scheme that has a sponsoring employer. A balance must be struck between short-term volatility (in both liabilities and assets), and ensuring appropriate action is taken to safeguard members' benefits and where appropriate calls on the PPF.

Firms managing DB pension scheme consolidators should also have the opportunity to raise and inject more capital resources in stress events should they have the appetite to without necessarily being obliged to.

The consultation paper does not address the quality of the capital resources. We suggest the approach described above is replicated in the DB pension scheme consolidation regime.

e) Where DB pension scheme consolidators own modelling is permitted, an internal model approval framework to ensure adequate capital and provisions are being held

The consultation paper proposes to allow DB pension scheme consolidators to undertake their own modelling. Insurance and banking regimes also allow financial institutions to undertake their own modelling using the internal model regime (insurance), or internal ratings based regime (banks).

We have found that it is very important to have a robust approval regime in place to thoroughly review proposed models. This ensures that firms are maintaining the policy intention of the statutory capital standards and mitigates the inevitable conflict of interest when a firm is able to calculate its own capital requirement or technical provisions. It was not evident to us that such an approval regime was envisaged by the consultation paper. We consider that such a robust approval regime should be put in place.

f) Where DB pension scheme consolidators are part of a group there should be a solvency requirement at both solo and group level

In the insurance regime, risks to policyholder security can arise from other group entities and we can foresee similar risks arising for consolidated schemes. For example, a solo entity may rely on group support and a supervisor will need to be able to assess the financial strength of the group to ensure the policyholders of the solo entity are adequately protected. Conversely the policyholders of one solo entity in the group may be at risk from a different solo entity in the group if the group is adversely affected by the troubled solo entity.

Consequently we consider that the DB pension scheme consolidation regime should capture the financial sustainability of both group and solo entities – and should therefore contain a group and solo solvency requirement.

Annex 2 Further detail on Senior Managers and Certification Regime (SM&CR)

Under the provisions of Part V of the Financial Services and Markets Act 2000 (FSMA), there is a mandatory 'approvals' regime for the individual directors and senior managers of financial services firms, under which each such individual has to be approved by the appropriate regulator. Following the Financial Services (Banking Reform) Act 2013 which introduced a number of new features to the regime for banks and large investment firms, this regime has become termed the Senior Managers and Certification Regime (SM&CR), and the scope of this SM&CR is now being extended progressively through the commencement of the Bank of England and Financial Services Act 2016 to all financial services firms.[1]

A key objective of this regime is to ensure the individual accountability of senior managers and directors of these firms.

To that end we consider that the proposed conduct standards should be extended to all people who could cause significant harm to the scheme members and beneficiaries of a DB pension scheme consolidator. We believe it is essential for conduct standards to be enforceable, through appropriate disciplinary powers that are given to the regulator to apply relevant sanctions. We recommend that DB pension scheme consolidators be required to seek (and to provide) 'regulatory references' for their senior managers and directors from the institutions at which they have worked previously. This would be consistent with the recommendations in the 'Fair and Effective Markets Review'[2] that have been applied to all other financial services firms. In addition, there should be a criminal records check.

We also suggest that the actuarial function should be included under the fit and proper regime. An actuarial function is defined in the Solvency II Directive, and deemed to be a key function for pension schemes under the terms of that Directive, which then says that the competent authorities should be able to assess whether the persons carrying out the actuarial function meet the fit and proper requirements. We understand that there are similar provisions for pension schemes in the second directive on the activities and supervision of institutions for occupational retirement provision (IORP II). We believe that the actuarial function is a key role for undertakings that have long-term liabilities of uncertain amount or duration, and we have successfully implemented fit and proper requirements, together with an approval process, for the individual who is responsible for an insurance firm's actuarial function. We recommend a similar approach is applied for DB pension scheme consolidators, which would also provide regulatory consistency.

[1] Information and materials to support our implementation of the SM&CR is available on the Bank of England website at https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/strengthening-accountability.

[2] June 2015: https://www.bankofengland.co.uk/report/2015/fair-and-effective-markets-review---final-report.