ICAEW
REPRESENTATION 19/19

CONSOLIDATION OF DEFINED BENEFIT PENSION SCHEMES

Issued 1 February 2019

ICAEW welcomes the opportunity to comment on the Consolidation of Defined Benefit Pension Schemes published by DWP on 7 December 2019 (the '**Consultation**'), a copy of which is available from this link.

We welcome initiatives that help trustees and employers manage the challenges of funding DB pension schemes. However, we believe the approach of treating DB superfunds as occupational pension schemes from a regulatory perspective may not be appropriate as the emerging business models have many characteristics of an insurance arrangement and are more complex and carry different risks to traditional DB occupational pension schemes.

In particular, the severance of the employer covenant and establishing a finite capital buffer would appear to potentially expose pension scheme members transferred into such arrangements to risks akin to those of a with-profits insurance business. Therefore, of the three options set out in paragraph 12 of the Consultation, we would suggest a fourth option is added and explored along the lines that DB superfunds could be treated as insurance operations for regulatory purposes under the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA). This would have the benefit of providing member protection through a well-established regulatory framework and remove the need to create a new regulatory framework via the Pensions Regulator which in effect seeks to regulate the same risks that exist in the insurance industry.

Superfunds (or consolidators or defined benefit master trusts) are not inherently wrong or a bad idea, but the balance between member protection and investor returns must be carefully managed. Specifically any differences in regulation between (1) superfunds and traditional employer-supported occupational schemes or (2) superfunds and insurers, need to be deliberate and easy to explain to members. It is of particular interest to the Institute and its members for DWP to set out its expectations around audit of superfunds and whether that would be based on the current framework for insurers, for occupational schemes, for master trusts or whether it would require a bespoke audit process to be created. In each of first three cases some special treatment will be required (for instance occupational schemes have a statement as to employer contributions which will not apply for a superfund) and, for all, legislative amendment and guidance-drafting time will be required.

The transactions by which members are transferred (and our understanding is that it would be without consent in the business models of superfunds) need to meet the statutory tests and Pensions Regulator's guidance on its moral hazard powers. For example, any payment of an additional employer contribution at the time of such a transfer that is less than the full section 75 debt payable on winding up (by law) or on buyout (in practice) can only be justified if there is an increase in security for members caused by the amount of, and rules of access to, the superfund's capital buffer.

This is a wide ranging and complex consultation, which the DWP has issued for a period of 8 weeks over the Christmas period, and is concurrent with two further lengthy DWP consultations (10 week consultation on CDC schemes and 8 week consultation on the dashboard). The Consultation is very through and extends to over 240 paragraphs with over 70 questions for response. Representative professional bodies find it difficult to go through due process within short consultation periods, and therefore this response contains mainly high level comments, and we query the DWP's ability to draw valid conclusions as bodies trying to respond to all three of these consultations may not have had sufficient time to give them proper consideration, which will reduce the quality of responses.

The ICAEW is aware of concerns raised by other industry professional bodies in response to the Consultation and echoes those. Rather than repeat those in detail and taking into account our available resources, this ICAEW response contains some high level comments and answers some of the specific questions, but not all the questions raised.

This ICAEW response of 1 February 2019 reflects consultation with the Business Law Committee which includes representatives from public practice and the business community. The Committee is responsible for ICAEW policy on business law issues and related submissions to legislators, regulators and other external bodies.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 150,000 chartered accountant members in over 160 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

ANSWERS TO SPECIFIC QUESTIONS

Q1 and Q2: Defining superfunds

The defined criteria appear to cover the two known possible superfunds that have received publicity within the pensions industry in 2017-8. However, it is not clear why a direct profit motive is mandatory if superfund backers are prepared to consider other structures (such as dividend paying shares in the former employer of a transferred scheme) or operate a not-for-profit model.

We would expect any definition to contain flexibility outside of primary legislation to allow developments. In addition, it is not clear why the criteria should exclude an employer-supported occupational scheme converting to a superfund if the perceived benefits of a transfer to a superfund can be obtained.

Under Q2 (*Given the differences of superfunds and traditional DB occupational pension schemes, what are the additional risks and challenges associated with TPR regulating superfunds?*), as mentioned in our general comments above, we believe the approach of treating DB superfunds as occupational pension schemes from a regulatory perspective may not be appropriate as the emerging business models have many characteristics of an insurance arrangement and are more complex and carry different risks to traditional DB occupational pension schemes. In particular, the severance of the employer covenant and establishing a finite capital buffer would appear to potentially expose pension scheme members transferred into such arrangements to risks akin to those of a with-profits insurance business. Therefore, we would suggest DWP explores the option that DB superfunds are treated as insurance operations for regulatory purposes under the PRA and FCA. This would have the benefit of providing member protection through a well-established regulatory framework and remove the need to create a new regulatory framework via the Pensions Regulator which in effect seeks to regulate the same risks that exist in the insurance industry. It is also important for any differences in regulation between (1) superfunds and traditional employer-supported occupational schemes or (2) superfunds and insurers to be deliberate, and easy to explain to members.

Q3 – Q52: Authorisation

This is clearly an important area and we welcome the detailed and careful analysis shown in the Consultation.

Subject to our point made at Q2 above (that we believe DWP should consider whether DB superfunds should be treated as insurance operations for regulatory purposes under the PRA and FCA), at a high level we think the proposed balance is right – funding should be tested and regulated by reference to the funding of occupational pension schemes as that reflects the history of the benefit promise which members have; governance should be based on the standards expected of regulated insurers as that reflects the role which superfunds expect to have.

On points of detail we think further work is required perhaps with specific input from existing/proposed superfunds. For instance, segregation will make the decision to transfer to a superfund easier for scheme trustees to agree to, but it increases administration costs for the fund and, provided the funding rules protect members adequately, makes it less likely that investors will receive returns. Further, in a segregated fund, it is not clear that members get the risk-reduction benefits of transfer to a superfund.

Some of the proposals regarding supervision by reference to individuals' duties (such as powers to interview as part of the fit and proper test) would constitute a major increase in the regulation of pension arrangements. The industry would expect a clear rationale for the proposed rules (as suggested, by reference to insurers) and a commitment that no extension of such duties to employer-supported occupational schemes is planned to be satisfied that these were not the thin end of the wedge for such intrusive regulation into pension schemes in general.

We agree that members are entitled to protection against investors taking profits before benefits are secure (paragraphs 140-142).

Q53 to Q62 Supervision

Whilst we recognise that tPR is a mature regulator with experience of regulating a wide range of entities governed by the same core legislation, as explained above we believe DWP should consider whether superfunds should be regulated by the PRA/FCA, and we note that paragraph 191 of the consultation acknowledges the PRA already has a general rule making power with which firms must comply and which can be used to further their organisational objectives**.** If DWP decides that tPR is the appropriate regulator, we see merit in a Code of Practice approach. The use of a Code of Practice regime allows for more rapid reaction to market developments, promotion of best practice, not just bare compliance and can create a working relationship between regulator and the regulated.

In our view superfunds should produce public information regularly and should be subject to annual audit. Where audit results are published, appropriate information as to the nature and role of the audit should accompany those results. As mentioned in our general comments above, we believe DWP should set out its expectations around audit of superfunds and whether that would be based on the current framework for insurers, for occupational schemes, for master trusts or whether it would require a bespoke audit process to be created. In each of first three cases some special treatment will be required (for instance occupational schemes have a statement as to employer contributions which will not apply for a superfund) and, for all, legislative amendment and guidance-drafting time will be required. The statements made by superfunds to their potential investors should be available to trustees and employers looking to transfer members to them and vice versa.

We would query whether tPR has adequate resources to monitor investment strategy and, further, whether tPR having such a role impinges on the long-established principle that the trustees and only the trustees are responsible for investment strategy.

Q63 to Q73 Superfund Transactions

We agree that the gateway to a superfund should be carefully regulated. There will be a category of case where transfer to a superfund is an improvement to an existing employer covenant and where an insurance buyout is not feasible. The legislation and regulatory system should not unreasonably block such transactions.

In our view a requirement to involve tPR combined with a Code of Practice approach allows appropriate flexibility to take each case on its merits. This will, in practice, almost always involve the commission of appropriate covenant advice. Such a regime would not require a statutory test for the bulk transfer that would apply only to a superfund transfer and not to other transfers without consent.

In response to your specific question at Q69 *(Should it be a requirement for those providing covenant advice to be regulated by either the Financial Conduct Authority or the Financial Reporting Council?*), the regulation of covenant advice may be an issue for DWP to consider but, in our view, it is not an intrinsic material aspect of the regulation of superfunds – it is an independent issue in its own right.

At Q70 (*Do you agree that the current legislation regarding bulk transfers should apply to transfers to a superfund? Please give an explanation for any changes you recommend to the legislation.*), as mentioned in our general comments above, the transactions by which members are transferred (and our understanding is that it would be without consent in the business models of superfunds) need to meet the statutory tests and Pensions Regulator's guidance on its moral hazard powers. For example, any payment of an additional employer contribution at the time of such a transfer that is less than the full section 75 debt payable on winding up (by law) or on buyout (in practice) can only be justified if there is an increase in security for members caused by the amount of, and rules of access to, the superfund's capital buffer.