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Thoughts on the Mansion House Package of Pensions Reforms

July 2023

Matthew Giles – Introduction

Chancellor Jeremy Hunt's Mansion House speech on 10 July 2023 (and the vast quantity of accompanying documents) launched a wide-ranging review of pension policy on a disparate range of topics. It was self-proclaimed as "a series of measures to boost outcomes for savers and increase funding liquidity for high-growth companies through reforms to the UK's pension market." In truth, it goes far beyond this, with an eclectic mix of semi-formed pension policy ideas by way of consultation responses, alongside the launch of new consultations and calls for evidence. It is a mixed bag of new ideas and older topics revisited. Taken together, they constitute a fairly radical reform agenda. However, time will tell how far implementing the programme can progress before the next general election and whether they attract cross-party support such that they will remain on the agenda whatever the outcome of the election.

The arguments in favour of further consolidation in both public and private sector pensions are strong, while expanding the exciting new collective defined contribution (CDC) model makes total sense. Ensuring defined contribution (DC) pension plans are delivering value for money and offering attractive decumulation options will gain widespread support. Government and industry need to work together closely to iron out the details of how to deal with small deferred DC pension pots now that a preferred solution has been identified – we are pleased to see that this is gaining momentum. Meanwhile, we are sceptical about giving an expanded role to the Pension Protection Fund (PPF) – it will be interesting to see how this develops. However, the biggest challenge to the package of measures may well be around its centrepiece. The aim of encouraging the investment of pension assets to support the wider economy is not a neat fit in either the defined benefit (DB) or DC pension environment, and re-examining the duties of pension trustees to help drive the government's growth agenda could have uncertain implications for savers and their employers.

Our pension partner group has analysed the detail of the reforms and summarised the key takeaways for you.

Matthew Giles

Pension Trustee Skills, Capability and Culture: A Call for Evidence

What Does it Say?

- The UK economy would benefit from a greater proportion of the £2 trillion of total pension assets being invested in high-growth businesses, startups and infrastructure projects. Investing in assets of this kind can generate better returns, which will improve outcomes for DC savers and provide additional security for members of DB pension schemes.
- In order to seize this opportunity, trustees need to enhance their effectiveness through building their knowledge and skills, challenging their advisers and considering consolidation into larger, better governed schemes.
- This may involve re-examining trustee fiduciary duties, expanding the trustee accreditation regime, improving the quality of advice given and adopting a more "constructively tough" approach to regulatory oversight.

Key Takeaways and Comment

DB pension schemes are typically seeing an improving funding position and so are gradually de-risking to lock in those gains. Trustees are making fully informed and well-advised decisions to de-risk, normally with the support of their sponsoring employers. DB trustees are also minimising their investment in illiquid assets, to enable them to transact with insurers. In that context, the premise of this consultation is open to challenge and could be said to buck the de-risking trend. Meanwhile, the increased portability and focus on investment charges that come with DC have made illiquid investment classes less attractive. DC trustees can make available a range of options and must select default investment funds that are appropriate for their members. While DC members may make specific decisions around investments of DC assets, most generally do not dictate how the assets are invested. Improving trustee knowledge and skills is likely to reinforce requirements for a balanced and appropriate investment approach that provides good value for members, which could lead to an outcome that is the polar opposite to the government's ambition to encourage assets to be invested in "productive finance". (This is considered further by Kirsty McLean below.)

David Griffiths

Defined Benefit Pension Scheme Consolidation – Consultation Outcome

What Does it Say?

- The government has consulted on consolidation of DB pension schemes and, in its response to consultation, is supportive of consolidation superfunds.
- A superfund in this sense will most likely mean an occupational pension scheme for unrelated employers that have severed their legal obligation to contribute to their own pension schemes, on paying an entry price for entering the superfund. The employer covenant so lost will be replaced with a capital buffer provided through external investment.
- The government supports targeting pension schemes that are currently unable to buy out and unlikely to be able to do so in the foreseeable future. Schemes that can do so within, say, five years will be excluded from entry to a superfund. Government does not wish to give employers with well-funded schemes a cheaper exit route than full buyout.
- Superfunds could mobilise additional investment opportunities, plus capital from investors, which may make member benefits more secure, and could afford employers the chance to sever their link with their own pension scheme, by paying an entry price to the superfund.
- The government recognises that, in legislation, it will have to strike the right balance between member security, affordability of employer entry price and reasonable opportunities for a profit motive for investors in the superfund.
- The government objective is also to see consolidated pension assets being used "to contribute to greater investment in assets that support the UK as a whole".
- In terms of security, the superfund should offer a 2% or less chance of not paying member benefits in full, and this is likely to translate into an employer entry price some 10% lower than the price of insurance buyout.
- The legislative regulatory regime for superfunds will lie within the pension system (but applying some aspects of the insurance buyout regime), including intervention triggers, restrictions on profit-taking by investors and a monitored risk of failure of superfunds.
- There will also be legislative requirements for a full advisory process where pension scheme trustees intend to transact and transfer their assets and liabilities into a superfund.

Key Takeaways and Comment

The legislation governing superfunds, and the transfer of pension assets to such funds, will be necessarily complex in order to balance the competing interests. The government is seeking to balance factors, only one of which – benefit security – is relevant to target pension scheme members themselves. Pension scheme members have no direct interest in the commercial opportunity superfunds may provide to investors, and no direct interest in the use to which government might see pension assets being co-opted, "to support the UK as a whole". If, however, the government is correct that superfunds can mobilise greater inward investment, as well as greater investment options within the superfund once invested, then provided this results in greater benefit security, target pension scheme members and their trustees could give careful and cautious consideration to a superfund. The proposed legislative requirement to ensure that trustees take legal, actuarial, investment and covenant advice before determining their scheme's suitability for entry into a superfund will give trustees useful guidance and possibly support a legal discharge from future liability on following the requirements.

Kirsty McLean

Options for DB Schemes: A Call for Evidence

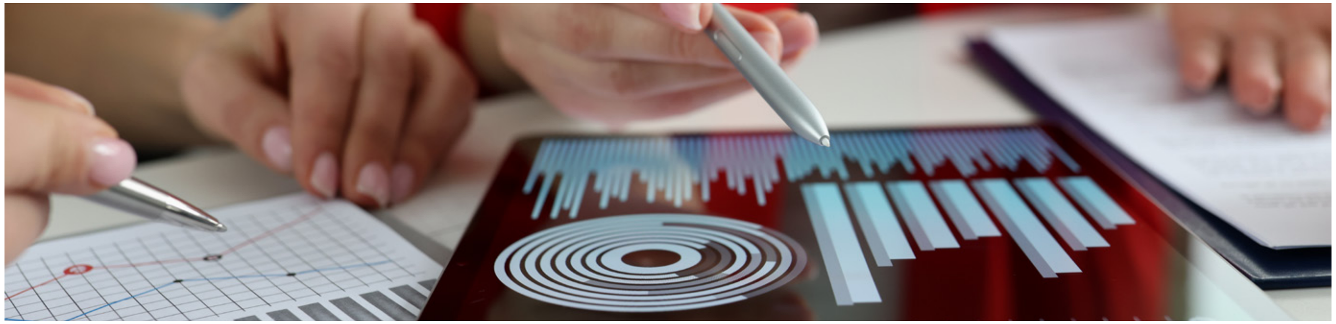
What Does it Say?

- The Department for Work and Pensions (DWP) wants to build an evidence base around how DB schemes could use their assets more flexibly to help promote economic growth. Essentially, the DWP wants to facilitate ways of increasing the investment of DB scheme assets in "productive finance", providing equity capital and finance for UK businesses, including startups, infrastructure and private equity, and investing in illiquid assets for the long term.
- The key potential levers that the DWP is keen to explore are encouraging schemes to build up surplus assets (taking more investment risk than present strategies in return for the carrot of employer refunds or supporting DC contributions elsewhere) and consolidation, perhaps using the PPF.
- Any future policy development will be guided by the principles of fairness for DB scheme members, prioritising a strong and well diversified gilt market, and strengthening the UK's competitive position as a leading financial centre.

Key Takeaways and Comment

With around £1.7 trillion of DB scheme assets and a stagnating economy, it is not surprising that the government wants pension funds to actively contribute to UK financial growth. The Pensions Regulator (TPR) estimates in its recent annual funding statement that a quarter of DB schemes are fully funded on a buyout basis, so this might appear to be a golden opportunity. However, with TPR having consistently encouraged trustees for many years to focus on de-risking, many trustees (and employers) will not welcome a change in approach that reintroduces investment risk and prolongs the cost and management time of running schemes on.

DB scheme assets do contribute to the UK economy when invested in UK gilts, as do many insurers with the capital reserves that back annuity policies. Trustees do not owe fiduciary duties to the broader economy or society – as the law currently stands, their primary duty is to provide members with their promised benefits (taking into account the employer's interests where appropriate). While the pensions industry might also welcome a slowdown in the transfer of DB schemes to insurers (from a capacity and longevity of work perspective), it is imperative that the security of members' benefits is not compromised, and employers are not forced to take unwelcome and unnecessary risks. There might be wider economic benefits from greater investment in the UK, but extreme care is required to avoid undoing all the good work by trustees and employers over the last decades to secure DB liabilities.



Catherine McKenna

Government and Regulator Response to "Value for Money – A Framework on Metrics, Standards and Disclosures"

What Does it Say?

- This is the joint response from TPR, the Financial Conduct Authority (FCA) and DWP to their consultation that proposed to extend the value for money (VfM) framework to require workplace personal pensions and occupational DC pension schemes to achieve a consistent and more objective way to assess and evidence VfM outcomes and the actions they are taking to improve the value they provide to savers to enable better retirement outcomes.
- Initially, the new VfM framework will only apply to workplace "default" arrangements, i.e., broadly, those arrangements not actively chosen by members (although the "default" definition will change too), so that most DC pension savers can be protected from remaining in underperforming schemes for long periods, with a view to the framework being extended over time to cover pensions in decumulation, CDC schemes, non-workplace pensions and self-select options.
- TPR, FCA and the DWP are keeping the VfM framework broadly similar to that proposed in consultation, but have listened to feedback and intend to simplify the number of data points to be assessed. A key metric for VfM will be gross investment performance over various periods, rather than net of all costs and charges, which will significantly reduce the number of data points required from multi-employer schemes with differing cost structures, while still providing meaningful backward-looking data for assessment purposes. Other metrics, many still to be evolved, will also support assessment based on value, not just cost, including communication, standardised member satisfaction surveys, complaints and administration service standards.

Key Takeaways and Comment

The response is notable as the revised VfM framework will impact (with some exceptions) all workplace pension providers, whether they are regulated by TPR or the FCA, and the joint response is a step forward in "joined up thinking". The aim to achieve greater consistency measures across a complex market is laudable, to better enable direct comparisons, and the emphasis being placed on investment performance and quality of service is a good starting point. Many of the themes coming out of the response dovetail with others across the Mansion House proposals, which support ongoing improvements in the regulatory framework to enable savers to make good decisions about their retirement, to enable providers to be assessed against higher standards to benefit savers, and consistently poor performers to be identified for improvement or consolidation.

There are complexities in setting the right metrics to enable a realistic comparison of a multitude of differing investment arrangements with different underlying costs, structures and performance objectives. Care will need to be taken to avoid a new set of DC compliance requirements that confuse the position for members or do not, in practice, lead to improved retirement savings. We welcome a planned evolution of the requirements of the annual chair's statement, which has mainly become a compliance exercise and is not a useful tool for pension savers. There is as yet no timetable for implementation, which will be done in stages, will involve further consultation and will require primary and secondary legislation. Evolution of the VfM framework is likely to take several years.

Victoria Jeacock

Ending the Proliferation of Deferred Small Pots – Consultation and Response to Call for Evidence

What Does it Say?

- The DWP's call for evidence has revealed that the number of small deferred pension pots (that have mainly arisen since the introduction of auto-enrolment) is higher than previously estimated. There are thought to be approximately 20 million pension pots worth less than £10,000 across the DC market, representing an estimated £30 billion in assets. This is a particular problem for master trusts. An automated consolidation solution for small pots has been under discussion for a number of years and is now gaining momentum.
- The challenge of reducing the number of small deferred pots is twofold – addressing existing deferred small pots and addressing the creation of more deferred small pots.
- The government wants to achieve increased member engagement and better value for money for members alongside its overarching aim of achieving more pensions investment in the UK economy to boost economic growth (mainly through illiquid assets, such as unlisted infrastructure, private equity and property). The proliferation of small deferred pension pots frustrates the government's investment aims, as a level of scale is needed before illiquid asset investment is viable.
- Consolidation should achieve economies of scale and help to generate higher investment returns with more options for members – this dovetails with the VfM aims (addressed by Catherine McKenna above).
- After considering responses to the call for evidence, the government's preferred option is a multiple default consolidator approach rather than a single default consolidator or a "pot follows member" approach. A pot will be identified as "small" if it is less than £1,000 and it will be identified as "deferred" (for this purpose) if there has been no contribution to it for at least 12 months. Consolidation will be supported by a centralised approach, delivered through a clearing house to identify where a member's deferred pot should be transferred. Schemes will require authorisation in order to operate as a consolidator vehicle.
- Continued member engagement should be encouraged, and the government proposes that members will be given the option to choose their designated consolidator, together with an option to opt out of consolidation. However, lack of member engagement will not be a barrier: the government is seeking views on the preferred approach to allocating a pension pot to a consolidator where members do not engage.

Key Takeaways and Comment

The government is focused on tackling the existing stock of small pots and views this as a "win-win" opportunity for members, providers and the UK economy. A solution is essential for master trusts and pension providers that are currently operating small deferred pension pots at a loss.

The introduction of a multiple default consolidator model, delivered through a clearing house, should reduce the administrative complexities for trustees and employers in comparison to the "pot follows member" approach, while ensuring market competitivity amongst the consolidators.

There is still a lot of fine tuning to do by government, regulators and the pensions industry before automated small pot consolidation becomes a reality. Will the £1,000 maximum pot limit still be suitable by the time that automated consolidation comes into fruition?

Wendy Hunter

Extending Opportunities for CDC Pension Schemes – Consultation Outcome

What Does it Say?

- The government remains of the view that CDC has huge potential, reducing and mitigating risks to savers at fixed costs to employers; it is committed to taking the concept forward to multi-employer schemes.
- Respondents to the consultation largely agreed with the key principles proposed by government, including regulation as occupational pension schemes similar to that for master trusts. Appropriate adaptations will include emphasis on scheme design requirements and marketing and promotion, plus the introduction of the concept of a "scheme proprietor", a role which must be distinct from that of trustee.
- The government plans to publish draft legislation in the autumn that will cover whole-life multi-employer CDC schemes and address some points on multi-annual adjustments and scheme winding up that are also relevant to single employer schemes.
- The draft legislation in the autumn will not extend to decumulation only arrangements even though the government has confirmed that it is "committed to moving forward with creating provision for CDC decumulation-only products". It states that work on this initiative will progress alongside the production of the legislative framework for whole-life multi-employer CDC schemes. This ties in with the DWP's response to the "Helping savers understand their pension choices" call for evidence, which proposes the introduction of duties on relevant pension schemes to offer decumulation solutions for their members and envisages that CDC decumulation-only arrangements could be one of the options on offer in the future. (Kate Bailey comments on this in more detail below.)

Key Takeaways and Comment

CDC remains a work in progress but one to which the government has shown strong commitment by choosing to press ahead and legislate for whole-life multi-employer schemes swiftly. That it has chosen to do so while leaving decumulation-only schemes to be considered and addressed separately reflects, as it said, that "no clear-cut, simple answers have emerged and further work needs to be done" when it comes to identifying a regulatory framework that encourages the development of sustainable, good quality, decumulation-only schemes.

Kate Bailey

Helping Savers Understand Their Pension Choices: Supporting Individuals at the Point of Access – Response to Call for Evidence and Further Consultation

What Does it Say?

This document focuses on the extent to which occupational pension schemes should support individuals in making choices about how to access their pension savings. It covers two broad areas:

- It responds to feedback the DWP received following its earlier call for evidence on "Helping savers understand their pension choices".
- It consults on the proposed introduction of a new decumulation framework and examines the support and decumulation solutions that should be made available to members.

Feedback to the DWP's call for evidence included comments that:

- Smaller schemes tend to provide fewer retirement products and services and would struggle to provide a full range of decumulation options.
- The popularity of annuities remains low.
- The current investment pathway options (introduced by the FCA) do not prevent members over- or under-drawing from their pension, and the options could be expanded.
- Partnering with master trusts and CDC arrangements could help expand member choices.

The DWP asks 22 consultation questions focused on what decumulation products/options schemes should offer and how the proposed decumulation framework should be structured. The questions also seek views on:

- The extension of the VfM framework to decumulation
- The development of a CDC-in-decumulation market
- The ability of schemes to partner with other schemes
- The role of the National Employment Savings Trust (Nest) in decumulation

Key Takeaways and Comment

- There is a big focus on CDC. In her ministerial foreword, Laura Trott, the pensions minister, states that her objective "is to help savers achieve better outcomes through the provision of CDC", and stimulating CDC in decumulation is later identified as a policy aim. The consultation also asks what the government can do to help a CDC-in-decumulation market emerge.
- The need for broad alignment across schemes regulated by the FCA and TPR is supported by DWP, FCA and TPR, to ensure members receive sufficient support regardless of scheme type.
- The extension of the VfM framework to decumulation is being explored.
- Ensuring a level of fairness and good outcomes for members is a key policy objective, and levelling up the options that small schemes offer is being explored through the idea of partnering with other schemes/CDC.
- The DWP intends for Nest to provide decumulation services in the same way as would be required for other occupational pension schemes.
- Although the DWP intends to legislate "when parliamentary time allows", in the meantime they intend to work with TPR to issue guidance promoting the need for schemes to offer decumulation products.
- There is more to come from the DWP on this topic. In this paper, the DWP has only responded to the feedback received following the call for evidence regarding member support through the provision of products and services. The DWP's response to the elements of the call for evidence covering information, guidance and communications will apparently follow "in due course".

Kirsty McLean

Local Government Pension Scheme (LGPS) England and Wales: Next Steps on Investments – Consultation

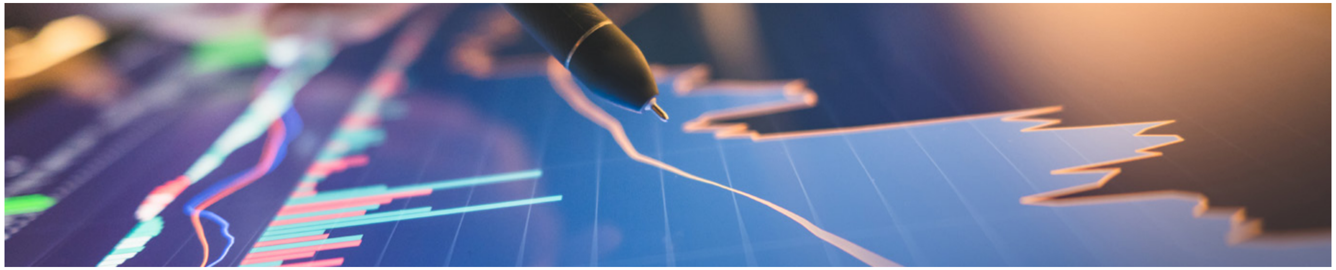
What Does it Say?

- The pace of asset transfers into pools (where the 85 LGPS funds in England and Wales combine their assets) should accelerate, with a deadline of 31 March 2025 for both completing the transfer of liquid assets and considering the transfer of illiquid assets.
- Going forward, the government proposes consolidation of the current eight pools into a smaller number (perhaps five), each with assets of at least £50 billion (double the previous threshold), with greater collaboration between pools and the development of specialisms in areas such as infrastructure and private equity.
- A requirement for 5% of assets to support levelling up in the UK and an obligation to consider how to meet the government's ambition for 10% investment in private equity.

Key Takeaways and Comment

Much of the detail on these proposals will be contained in revised statutory guidance, although it appears the levelling up obligation could be included directly into the LGPS regulations. Mandating particular asset classes feels like a backward step and raises similar matters of principle about the government dictating investment strategy to the boycotts/sanctions issue (where in 2020 the Supreme Court overturned a government ban on LGPS funds making investment decisions that go against UK defence or foreign policy – although the government is currently legislating to reverse that ruling). While pooling has already achieved significant cost benefits and improved governance, the proposals will materially shift the goalposts before the full benefits of the current pooling guidelines have been realised.

There is a warning that the government will use its existing power to direct the investment of LGPS funds if the deadline for asset transfers is not met. The LGPS has a strong track record in governance, transparency, and sharing and building upon best practice. Local accountability is an important principle and pooling has been successful so far because funds have come together to build structures and governance models that suit their collective circumstances. The key messages for the LGPS are unsurprising in the wider context of the Mansion House proposals, although balancing funds' fiduciary investment duties – which the consultation acknowledges – and contractual obligations to existing pools with the proposed evolution will present significant challenges.



Chris Harper

A Smarter Regulatory Framework for Financial Services

What Does it Say?

- This plan marks the start of a phased programme to bring retained EU law governing the financial services sector into the UK's domestic system. It is much more than a technical legal drafting exercise. HM Treasury has identified the UK's exit from the EU as an opportunity to develop the attractiveness of the UK as a financial centre and, with the Financial Services and Markets Act 2023 now enacted, attention has turned to the detail.
- A key theme of the chancellor's Mansion House speech was growth of UK capital markets. The proposals for a "smarter" financial services framework are front and centre of the government's plan for creating innovation and seeking competitive advantages for the UK. This is reflected in the new secondary objectives given to the FCA and Prudential Regulation Authority (PRA) to facilitate the international competitiveness and growth of the UK economy. The statutory reforms include:
  - Revisions to the prospectus rules governing new public listings
  - Development of a "consolidated tape" of continuous live market data
  - Reform of information disclosures to retail investors
- There is also to be a new regime for UK insurers and reinsurers, Solvency UK, replacing the requirements introduced by Solvency II. The proposals include a move to provide insurers with more flexibility over asset allocation, permitting "highly predictable" rather than fixed cashflows. The hope is stated to be that the changes will unlock £100+ billion of private investment, including in UK infrastructure. The UK will also pursue its own approach to a "green taxonomy" governing sustainable investment products regulated in the UK.

Key Takeaways and Comment

There is a comprehensive set of reforms with an ambitious timetable (the government wants to see "significant progress by the end of the year"). HM Treasury's plan of action sets out its plan to ensure the PRA and FCA have the necessary powers to implement and enforce the new regime.

While technical in detail, this set of reforms plays into a number of bigger-picture themes:

- The creation of opportunities for investment in UK markets and projects, given the government's drive for investment by pension schemes (in particular occupational DC schemes and the LGPS funds and pools) in the UK.
- Increased flexibility in the range of asset classes available to insurers and reinsurers, which may relieve some aspects of the pressures building up in a heated bulk annuities market for private sector occupational DB schemes.
- The creation of a green taxonomy in the UK, together with a new sustainability disclosures regime and government's wider roadmap to sustainable investing, which should assist UK pension schemes seeking to act upon their ESG and responsible investment policies.

Clifford Sims

Analysing the Impact of Private Pension Measures on Member Outcomes – Research and Analysis

What Does it Say?

- Unlike the other Mansion House pension proposals, this paper is not a consultation document. It brings together some details of the economic assumptions that underpin the government's DC proposals and gives some sometimes heroic projections for improving member outcomes in retirement. It is helpful to see the projected impact on median and lower earners both pre- and post-retirement.
- The assumptions rest very heavily on the 2017 automatic enrolment (AE) review proposals being adopted, i.e. to abolish the lower earnings limit (currently £6,240) from qualifying earnings and move the age at which AE starts to 18 from 22, which are said to increase retirement pots by 33.4% for a median earner. Another 10.6% increase is expected to come from the VfM framework improvements to investment performance (considered by Catherine McKenna above).
- Next comes the investment improvement from introducing a 5% allocation to private equity, which is a backbone of the Mansion House proposals to pump money into UK growth assets. The paper contains some dubious maths in this respect; the general assumption is a 3% uplift in investment returns over a model portfolio over 30 years, but one key table translates this into a 4.3% uplift.
- Small pot consolidation and increased competition in the decumulation market are assumed to reduce charges by trivial amounts.
- The paper then takes the projected increased retirement pots and assesses how these would translate into increased retirement incomes, measured against current annuity rates and the potential to improve on those rates provided by using CDC for decumulation. No allowance is evident for earners taking tax free lump sums.

Key Takeaways and Comment

Although no one will argue with the policy aim of increasing outcomes for savers in retirement, this paper places enormous weight on a lot of assumptions that are uncorrelated (regardless of the untested political ambition to push them all through). The risks inherent in this modelling will be examined in detail by economists and the actuarial and investment community, but here are some to ponder:

- There is no account of behavioural factors that might counteract the effect of the proposals. Increased AE opt-out rates, poor investment choices and a reversion to lower interest rates at some point in the future would all impact on the base assumptions that there are significant prizes to be won in increasing the capital value of retirement pots.
- The cost structure of private equity funds is assumed to be capable of moving from the classic 2% per annum plus 20% for performance over 8% investment return, to 1% per annum plus 10% for performance over 8% investment return. There is no discussion of the scale needed to engineer such a change in the private equity market, but we doubt that fund providers would wish to reduce their fees to that extent.
- The CDC industry is in its infancy, and decumulation is untested. To deliver increased value for money will require a considerable mind-shift.

Conclusion

We hope that this publication has given you some food for thought on the Mansion House package of pension reforms. Our pensions team will be responding to the consultation package over the summer, and we look forward to sharing our further thoughts on these important developments. If you would like more details on how any of these issues may impact your scheme, please get in touch with your usual contact in the pensions team.

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