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# UK Pensions Briefing: Pensions Regulator publishes interim guidance on DB superfunds

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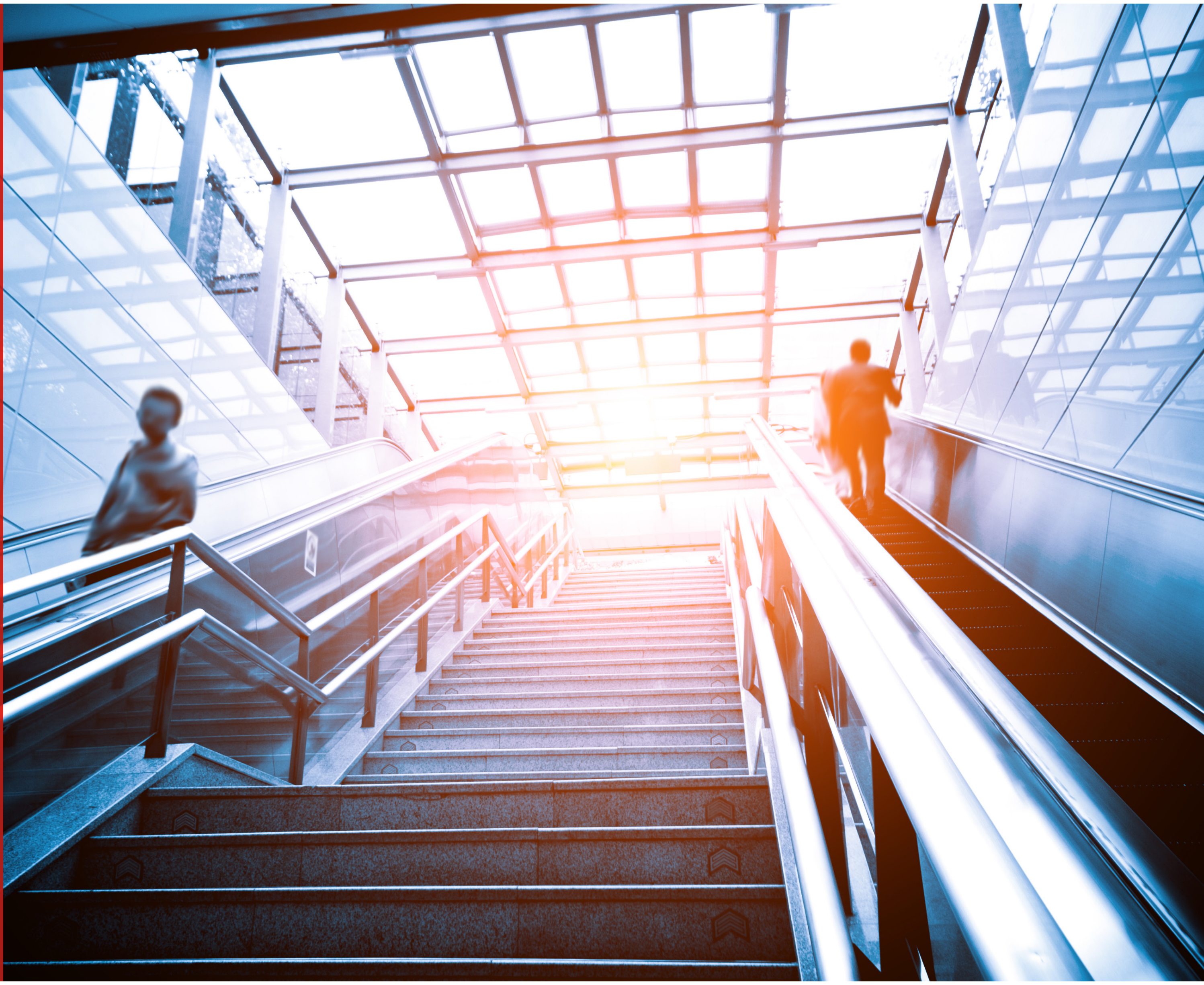

# Introduction

On June 18, 2020, the Pensions Regulator published some new interim guidance for those setting up and running a DB superfund. The guidance sets out the standards the Regulator expects to be met in the period before the legislative framework is in place. Superfunds must clear a high bar before they can transact but, as the interim regulatory regime comes into force immediately, superfunds will now be able to seek the Regulator's approval and embark on their first transactions. As the superfunds market is evolving, the Regulator envisages developing this guidance accordingly, and providing further detail in certain areas over the coming months.

## 1. Why has the Regulator released this guidance now?

The development of DB consolidators in the market generated considerable diversion of views, including between government departments. These models have attracted some criticism and contention over the last few years but one unforeseen consequence of the COVID-19 pandemic appears to be its ability to expedite long awaited guidance and legislation.

The DWP's consultation on superfunds closed on February 1, 2019, and the Regulator published its response (and its guidance) over a year later on June 18, 2020. The consultation looked at the potential issues surrounding the consolidation of DB schemes into superfunds, in order for them to benefit from improved funding, better security for members, economies of scale and better governance. DWP has not yet issued a response to their consultation and it is not clear when a legislative framework dealing with DB consolidators will be introduced. The Pensions Bill 2019-2021 does not currently deal with this topic and whilst the Regulator acknowledges that the existing legislation does not specifically cater for DB consolidators, it considers that superfund models can exist within the current legislative framework. The Regulator is supportive of the DWP's intentions to ultimately legislate for an authorisation and supervisory regime but in the short to medium-term, the Regulator wants to clearly set out in the guidance its own expectations for any consolidation transactions intending to proceed in the interim period. During this interim period, the Regulator wants a high degree of certainty that a superfund will be able to pay 100 per cent of member benefits so expects to be involved in any transactions via its clearance procedure.

## 2. What is a superfund?

The guidance describes a superfund as a consolidation of DB schemes, run on a commercial basis. They will be privately-funded enterprises, and investors will expect to achieve a return on funds they put at risk in the capital buffer. This can be achieved by replacing the scheme employer with a special purpose vehicle (usually to preserve the scheme's PPF eligibility) or it may involve replacing the scheme employer's liabilities with a new employer, backed up by the introduction of investor capital (alongside a contribution or premium paid by the employer of the scheme).

Consolidator schemes are typically formed by a bulk transfer of the transferring scheme's liabilities, members and assets to the consolidator (usually from various unconnected transferring employers). The consolidator will usually have its own governance and administration processes and normally there is one trustee board.

## 3. What type of schemes are likely to consider transferring to a superfund?

DWP's consultation set out a "gateway" test requiring that schemes which could afford a full buy-out within the foreseeable future (i.e. three to five years) should not be considering consolidation. The Regulator's guidance is consistent in that it suggests that schemes with the ability to buy out within the relatively near future ("for example, in the next five years"), should not be accepted by a superfund.

Considering a transfer to the superfund might be particularly appropriate for schemes which are relatively well-funded (in that they can afford to transfer into a superfund) but have relatively weak employer covenants. The addition of upfront contributions and investor capital could improve the funding of these schemes and remove the risk of the employer covenant deteriorating.

The current economic uncertainty resulting from COVID-19 might increase the number of schemes for which superfunds might be viewed as an attractive option. For example, employers facing a possible insolvency event where it can afford to secure benefits that exceed PPF compensation but cannot afford to buy out benefits in full.

A transfer to a superfund (and consolidation more broadly) could also be beneficial for smaller schemes, which tend to be less well-governed and could benefit from economies of scale and access to a wider range of investment opportunities.

## 4. What requirements must be met by the superfund during the interim period (before any transactions will obtain clearance)?

To achieve a sufficient level of member protection, superfunds are expected to comply with a range of requirements:

| Capital requirements, based on: | Extraction of value requirements, based on: | Investment and governance, based on: |
|---|---|---|
| • The scheme's technical provisions.<br>• The amount of additional risk-based capital the superfund is required to hold in the capital buffer.<br>• The legally enforceable triggers a superfund should put in place. | • Limiting the extraction of profit from the superfund (initially no surplus value should be extracted for three years).<br>• Monitoring and reporting on the fees and expenses of the superfund. | • The guidance sets out eight investment principles, including investing (on a comply or explain basis) the capital buffer in line with the principles underlying the pensions investment regulations, maximum allocations to the total issuance of a security and to single securities and issuers.<br>• Limits apply on the levels of illiquid assets that can be held.<br>• Assets transferring to the superfund scheme or capital buffer need a transition plan in place to meet these limits usually within a 12-month period.<br>• Governance requirements intended to provide assurance that those running the superfund are fit and proper, as well as ensuring adequate systems and processes are in place for the superfund to run effectively. |

## 5. What conditions must be satisfied for an individual transfer to obtain clearance?

Under the new regime, transferring employers will sever their liabilities to the DB pension scheme. This severance will be a new Type A event and employers proposing to transfer will need to obtain clearance by showing that the arrangement is:

- Capable of being supervised by the trustees.
- Run by fit and proper persons with effective governance arrangements in place.
- Financially sustainable and with adequate contingency plans in place to manage funding level triggers as well as to ensure an orderly exit from the market.
- Run effectively, with sufficient administrative systems and processes in place.

As part of the clearance process, the Regulator will assess whether any detriment to the scheme has been adequately mitigated and consider whether the scheme could achieve a better outcome through other means. A transfer will only proceed where any top-up payment or other mitigation agreed as part of the transfer into the superfund will mitigate this detriment fully.

## 6. What is the capital buffer and why is it required?

The scheme employer is to be replaced by either an employer which is a special purpose vehicle (preserving the scheme's PPF eligibility), or by an employer backed with a capital injection to a capital buffer (generally created by investor capital and contributions from the original employers).

The capital buffer replaces the transferring employer's covenant and, while it is not an asset of the pension scheme, it forms part of the longer-term security of the scheme and can be called upon by the trustees of the scheme in specified circumstances.

Trustees of some superfund models will only gain control of the investment strategy of and/or the assets in the capital buffer (or the share of the capital buffer appropriate to their section) in the event that funding level falls below certain funding level thresholds (see question 7 below).

The Regulator regards the superfund's capital buffer as a proxy for the employer covenant. One of its key aims for the interim period is to ensure a high degree of certainty that members' benefits will be paid, thus the overall level of funding and capital required is fundamental.

## 7. What are the capital adequacy triggers?

The superfund will include the following triggers if capital falls below certain levels.

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New transfers trigger – when a scheme transfers to a superfund, the superfund supports the assets of the scheme with a separate "capital buffer" that is made available to the trustees of the scheme if funding deteriorates.

The transferring scheme and capital buffer must be funded to at least the level of the liabilities calculated on: a prescribed "technical provisions" basis of 0.5 per cent pa above the gilt yield, plus a minimum amount of additional risk-based capital of the amount that, when added to the pension scheme assets, gives a 99 per cent chance of being funded at or above the technical provisions in five years (plus approximately 3 per cent for longevity risk). The superfund will have to demonstrate that its approach satisfies the Regulator's requirements.

Low risk funding trigger – this is set at total assets (i.e. scheme assets plus risk-based capital buffer assets) being equal to 100 per cent of the Regulator's minimum technical provisions level. At this point, in the absence of an additional capital injection, all funds in the capital buffer will flow into the pension scheme and come under the control of the trustees.

All capital provided at the outset and any additional capital injections will be lost to investors at this stage.

Wind-up trigger – this is set at 105 per cent of the value of the PPF liabilities valued on a s179 basis. At this point, the scheme must begin winding up and members transferred out.

Superfunds should also identify any other events that may trigger (a) the commencement of the wind-up of the pension scheme superfund; or (b) it being left to run-on without the support of the corporate entity and/or capital buffer.

## 8. What are the rules in relation to value extraction during the interim period?

The Regulator recognises that the "management for profit" motive is outside the normal DB scheme concept. During this initial period, as different models and structures emerge, the Regulator believes that superfunds should not extract funds from the scheme or the capital buffer unless members' benefits are bought out in full.

This will help to ensure that the incentives for those running superfunds are aligned with members and to limit the potential for excessive risk-taking.

A review of this profit extraction position is to be conducted within three years of this framework being published. The review will be informed by both the experience to date of the operation of the superfund regime and by any DWP policy developments.

Surplus value in the scheme or capital buffer should not be used as capital to support new transfers into a superfund, and all transfers should be able to meet the capital adequacy test on a "standalone" basis.

In response to concerns that superfunds might try to extract capital by the back door (for example, by charging higher than standard fees), the Regulator has also included a requirement for any fees, costs or charges to be justifiable. There are no prescriptive limits on fees but the guidance sets out key principles to follow (including that these charges should be no higher than equivalent "market prices" and all success or transaction fees should be disclosed to all parties prior to transfer).

Fees, costs and charges will need to be monitored on an ongoing basis and the superfund trustees need to regularly demonstrate to the Regulator that they are getting value for money for the services they commission.

Robust provisions are also required to ensure the capital buffer is not subject to value leakage and will be available to the pension scheme if it is needed.

## 9. What information is required by the Regulator?

Companies considering a transfer to a superfund can expect the Regulator to request information about four key areas to ensure a smooth transition:

| Supervision | Governance | Capital requirements | Administration |
|---|---|---|---|
| Evidence will be required to show that the superfund is capable of being supervised. Funds themselves will need to be registered with HMRC and be able to explain why the fund is eligible for the PPF. Superfunds will be expected to provide prospective transferring employers and trustees with full and transparent details of their offering, their associated fees, their funding and investment objectives, and their methods for achieving their objectives. | The superfund must be run by fit and proper persons and have effective governance arrangements in place. The Regulator expects those carrying out certain key functions to be able to demonstrate that they have the right level of knowledge, skills and experience to carry out their role as well as "an appropriate level of propriety". | The superfund must be financially sustainable and have adequate contingency plans in place to manage funding-level triggers as well as to ensure an orderly exit from the market. It will be required to be funded on a prudent basis and have a capital buffer. | The superfund must have sufficient administrative systems and processes in place to ensure that it is run effectively |

## 10. What areas are we expecting the Regulator to issue further guidance on?

Further guidance is expected on capital buffers, enforceability provisions, administration, transfers out, reporting requirements and data security issues. More detailed guidance is also expected specifically for trustees and employers that may be considering a transfer to a superfund.

## 11. How does the guidance differ from the proposal in DWP's consultation?

The transferring scheme and capital buffer must be funded to at least the level of the liabilities calculated on the prescribed "technical provisions" basis described in question 7 above (new transfers trigger). This has changed from the 2018 consultation proposal which suggested that the scheme assets plus capital buffer combined should at least be equal to an estimate of the buy-out price (producing a 1-in-100 Value at Risk (VaR) over a one-year period).

The Regulator's response to the consultation outlines various reasons for moving away from this basis, including:

- Concerns that the level of capital required may be set too high for a superfund market to develop.
- That aligning the proposals to a buy-out figure (and setting intervention triggers on that basis) could mean superfunds would be investing in the same limited pool of assets as insurance companies, affecting availability and price.
- It might be difficult to obtain an accurate assessment of the buy-out price on an ongoing basis in practice (as insurance companies have no obligation to disclose their pricing bases).

A key safeguard introduced by the guidance is that no capital will be permitted to be withdrawn during the interim period unless the scheme benefits are bought out in full with an insurer. This will be reviewed within three years. Various other changes to the original consultation proposal have been made, particularly in relation to the investment principles.

## 12. What has the reaction been from the industry in general?

The guidance has generally received a positive reaction from the industry in that it aims to provide an opportunity for a viable market in DB consolidators during a period when many businesses are attempting to deal with the economic consequences resulting from COVID-19. Superfunds are widely seen as having the potential to strengthen the security of millions of DB savers whose sponsoring employers face an uncertain future. The pandemic may create a new category of schemes for which a transfer to a superfund might be a prudent option to consider.

The guidance appears to be seen as a real step forward for superfunds and innovation in the sector. Indeed, Clara-Pensions and The Pension Superfund have both welcomed the guidance. However, the Regulator needs to tread carefully between ensuring sufficient member protection whilst allowing enough flexibility for a commercially viable superfund framework.

The guidance has received some criticism, particularly in relation to the rule against profit extraction in the interim period which has been branded as too cautious. In contrast, the severing of the employer link without the security for members of a regulated insurance company has been criticised (particularly by some unions and insurers).

Whether the guidance will have the intended effect of giving trustees and sponsors the confidence to embark on the first superfund transactions remains to be seen, but it re-emphasises that the Regulator clearly sees a role for the superfund model as part of pension scheme 'endgame' planning. In particular, it may be of interest to schemes who find themselves stuck between their current position and a seemingly unattainable insurance solution and it is anticipated that the guidance may also lead to greater consideration of other types of DB consolidation (for example through new insurance products entering the market or other forms of capital backed journey plans).

If you require any further information or assistance with any of the above, your Norton Rose Fulbright pensions adviser is always happy to help.

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