Pension Risk Transfer Insights

The bar has been set for superfund transfers

Following guidance for superfunds, The Pensions Regulator (“TPR”) has set out detailed guidance for trustees and sponsors considering transferring to superfunds, ahead of a longer-term authorisation regime.

A brief history

A highly anticipated Government White Paper in March 2018 signposted the future development of a regime to facilitate commercial consolidation via vehicles known as ‘superfunds’. Superfunds are designed to accept pension scheme liabilities for less than the cost of buy-out but with a corresponding lower level of member security. With superfunds, the covenant of the sponsoring employer is replaced with a capital buffer.

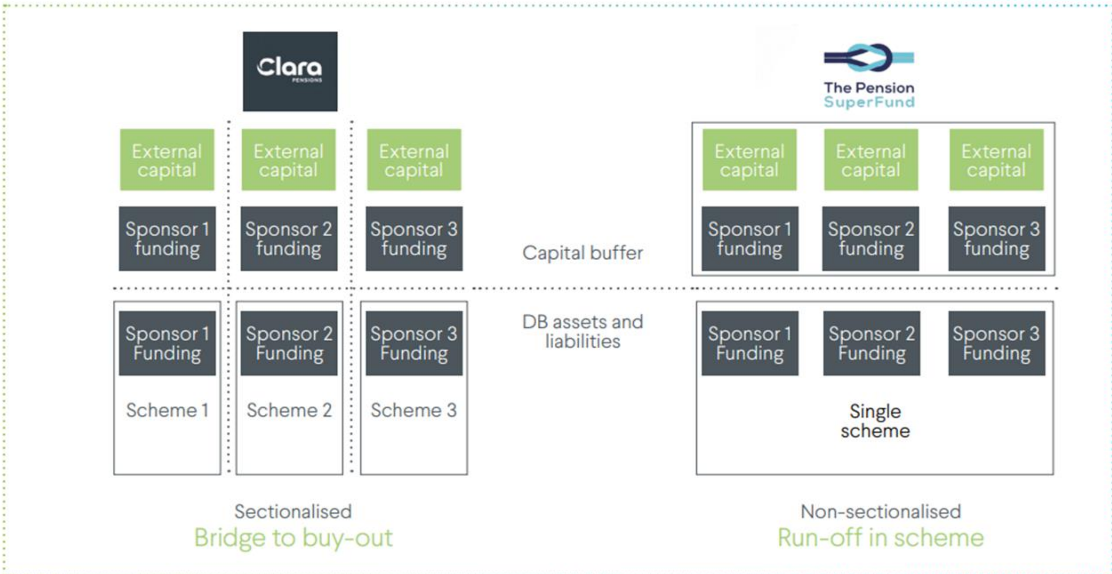
Following the White Paper, two vehicles quickly emerged:

- Clara-Pensions – which aims to buy-out schemes it takes on in the medium-term.
- The Pension SuperFund – which plans to run-off liabilities it takes on indefinitely.

For more on each consolidator, see our previous deep dives on Clara and The Pension SuperFund.

Following the White Paper, in December 2018 the Department for Work and Pensions issued a consultation on the legislative framework for commercial consolidation.

In June 2020, TPR issued its detailed guidance for superfunds, setting out details of its interim regime under which transactions can occur ahead of legislation and a longer-term authorisation regime. For more on the superfund guidance, see our previous Insight publication. TPR has now published updated guidance for trustees and sponsors.



At a glance: guidance for trustees and sponsors considering superfunds

On 21 October 2020, TPR issued detailed guidance setting out its expectations of trustees and sponsors considering transferring their scheme to a superfund. Below we summarise the key points from the guidance:

The gateway test

Central to the guidance is the requirement for the trustees of the ceding scheme, with support of the sponsor, to be satisfied that three 'gateway principles' are met:

Gateway principle 1:	Gateway principle 2:	Gateway principle 3:
The Scheme cannot afford to buy-out now	The scheme has no reasonable prospect of buying-out in the foreseeable future (up to 5 years)	The transfer improves the likelihood of members receiving full benefits

The process

All transfers should be 'cleared' by TPR. Clearance gives assurance that TPR doesn't expect to use their anti-avoidance powers to issue a contribution notice or financial support direction in relation to the transfer.

Early engagement is encouraged, with trustees and sponsors asked to get in touch with TPR once a transfer looks like a viable option. The clearance application will need to be supported with clear evidence of appropriate due diligence and consideration of the gateway principles.

TPR has signposted a need of at least 3 months to consider a clearance application, and that it expects a transfer to happen within 3 months of clearance being provided.

The role of trustees and sponsors

TPR expects trustees and sponsors to work together to assess the potential superfund transfer. Below we highlight the key expectations of trustees and sponsors when considering a transfer to a superfund:

Trustees

- Ultimately sign-off the transfer.
- Engage with TPR early on once a transfer looks viable.
- Review expertise and consider appointing a professional independent trustee.
- Perform due diligence on the superfund, proportionate to the transfer being considered.
- Appropriate advice to support assessment against the gateway principles, consideration of alternatives options and legal considerations (conflicts, powers, responsibilities).

Sponsors

- Co-ordinate and submit the clearance application to TPR.
- Provide trustees with all the information they need and pay for the trustees' advice.
- Take their own advice in relation to the transfer.

The gateway test in more detail

The backbone of TPR's guidance is the gateway test. By design, the 3 gateway principles ramp up quickly in complexity. Below, we give some further detail on each of the principles.

Principle 1: Can you buy-out now?

This one is *relatively* straightforward. While real buy-out pricing can only be determined by approaching the market, advisers can provide a sufficient estimate of the price achievable through a competitive broking process.

Generally, we wouldn't suggest approaching the market for a quote unless there's a real potential for a transaction. Indeed, if the estimated position is that close, you probably shouldn't be considering transfer to a superfund!

Principle 2: Do you have a realistic prospect of reaching buy-out in the foreseeable future?

This gets a bit trickier. Projecting funding positions, allowing for a scheme's investment strategy, maturing of liabilities and sponsor contributions is a well-trodden path. However, even if buy-out looks achievable in the medium-term, (say, 3-5 years) this may crucially hinge on some committed sponsor contributions and, importantly, the sponsor surviving long enough. If the sponsor goes insolvent before the scheme reaches buy-out, trustees are forced to wind-up the scheme triggering early annuitisation and a risk of a haircut to members' benefits.

Covenant advisers therefore become crucial, as does openness and transparency from sponsors to give trustees the information they need to assess covenant in the medium-term.

Principle 3: Does the transfer improve the likelihood of members receiving full benefits?

The final principle is the most nuanced and challenging to address. Trustees and sponsors need to compare:

- **The status quo**. How secure are members' benefits now, considering current funding and sponsor support? Long-term covenant is very uncertain and difficult to assess. Therefore, potential sponsor insolvency is a key risk even for schemes expecting to reach buy-out without any further sponsor contributions.

- **Outcome following transfer**. How secure are members' benefits in a superfund, where benefits are fully funded on the superfund's funding basis on day 1 and supported by an external capital buffer? With no covenant to consider, this side of the equation is less subjective, and standard modelling should be available from superfunds, based on the modelling they've done for TPR's assessment.

We have developed tools and modelling to answer this in a simple-to-understand way in our [Closer look at Clara] publication. A snippet of the output is below.

Charts showing (broadly) the probability at any point in time that:

- benefits are secured with a buy-out;
- the scheme or superfund is still running; or
- things have gone wrong and members have less than 100% of benefits secured.

Our thoughts

We are pleased to see the revised guidance for trustees and employers providing further clarity on TPR’s expectations of trustees and sponsors when assessing transactions. The groundwork has been laid for the first transfers to occur ahead of a formal legislative regime, and perhaps just-in-time given the potential wave of corporate insolvencies in 2021. We feel superfunds should be able to play an important role in securing more DB benefits and reducing the risk on the PPF, and should therefore be encouraged.

We outline some of our observations on the new guidance:

Buy-out remains the gold standard

While superfunds can provide a safe home for DB liabilities, it is still generally accepted that buy-out is the best outcome for members, given high capital requirements and the stringent insurance regulatory regime. This is the driver of the first two gateway principles, which aim to weed out schemes which are already sufficiently close to buy-out.

It is interesting that this timescale for gateway principle 2 (Do you have a realistic prospect of reaching buy-out in the foreseeable future?) has been shortened to an upper limit of 5 years, while acknowledging that it may be appropriate to consider shorter timescales in situations where covenant support is uncertain or fragile. This could now bring more schemes in scope of superfund transactions than had previously been envisaged.

Qualitative, rather than quantitative

The guidance is largely principles-based, without giving clear direction on metrics or how exactly trustees and sponsors should set about addressing various points in the guidance. This can be helpful and provide flexibility to tailor approach to circumstances, but it also makes it tougher to map out a clear route to clearance.

Wide-ranging considerations for clearance

The clearance application outlined in the guidance is very wide-ranging, risking making the process more onerous than it might have otherwise been. It not only covers the more obvious points around member security, but also additional ones like demonstrating why a superfund transfer is better than other forms of consolidation and support from the employer that might be possible. The application also needs to consider the impact of any historic corporate activity, including any detriment caused to the scheme.

Flexibility to be proportionate

We were glad to see some leeway for pragmatism and proportionality to avoid costs and effort being a blocker to transactions. Indeed, it is important that disproportionate costs are not a blocker to smaller schemes, and that unnecessary costs are not incurred where a transfer is obviously the right thing to do.

Ability to take comfort from TPR assessment

In the spirit of managing costs and complexity, it is helpful that TPR has confirmed trustees and sponsors can take comfort from TPR’s own assessment of the superfund, and the superfund will provide ceding trustees with a summary of TPR’s assessment. However, they still expect trustees and sponsors to consider what due diligence they carry out on top of this.

Door opened for partial transfers

The guidance suggests trustees and sponsors could consider the merits of partial transfers, for example where a scheme insures pensioners and transfers its deferreds to a superfund. This may improve affordability for sponsors, as the capital requirements for superfunds mean their pricing will be more favourable than insurance for deferreds but may be more expensive than insurance for pensioners.

Providing members with different outcomes may be less comfortable for trustees. TPR points out that this may be acceptable if benefit security is improved for each group. Trustees may be surprised to see that the relative improvement in security for deferred members from moving to a superfund may be much greater than for pensioners who have their benefits insured (this is because deferred members are exposed to covenant risk and underfunding risk for a longer period of time, and they have a bigger haircut to benefits in the PPF than pensioners).

PPF+ cases remain challenging

The guidance confirms that PPF+ cases should only consider transferring to a superfund without member consent if the superfund can provide 100% of benefits. However, the gateway test continues to apply, so if the scheme can buy-out in full it is expected to do so, even if >100% of benefits are being offered by a superfund.

This leaves a relatively small pool of schemes that might be eligible for superfunds after an employer insolvency event, as the scheme needs to be pretty close to fully funded on a buy-out basis to cover 100% of benefits in a superfund, but not so close that it doesn’t pass the gateway test.

There are some recognised issues with paying less than 100% of benefits in a bulk transfer but, if these could be overcome, it would open up superfunds to a broader range of more poorly funded schemes suffering employer insolvency events.

What comes next?

Superfunds are working hard to pass TPR's assessment process, which confirms they comply with TPR's guidance for the interim regime. Only then will TPR begin considering clearance applications for individual transactions. The superfunds that have completed TPR's assessment process will be listed here as the assessments are completed:

https://www.thepensionsregulator.gov.uk/en/trustees/managing-db-benefits/db-superfunds/db-superfunds-list-and-assessment

While there are a number of schemes in advanced discussions with the superfunds, the need for providers to be assessed, and for individual transactions to obtain clearance, means it may be some time before the first transactions occur.

Only time will tell what these first transactions will look like but, in our view, early transactions need a "burning platform" making it in members' best interests to transact now rather than wait for the longer-term authorisation regime expected with new legislation, which may still be some years away. This burning platform could take several forms but, given the current economic climate as a result of COVID-19, it is likely that struggling sponsors and corporate insolvencies may be the primary drivers for consolidation activity.

Get in touch

If you have any questions about anything covered, please don't hesitate to get in touch.

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