Pension Risk Transfer Insights

Green light for DB commercial consolidators

More than two years after the Government signalled support for superfunds, the Pensions Regulator ("TPR") has released detailed guidance for superfunds, setting out an "interim regime" that should enable initial transactions to occur ahead of a longer-term authorisation regime coming into force.

A brief history

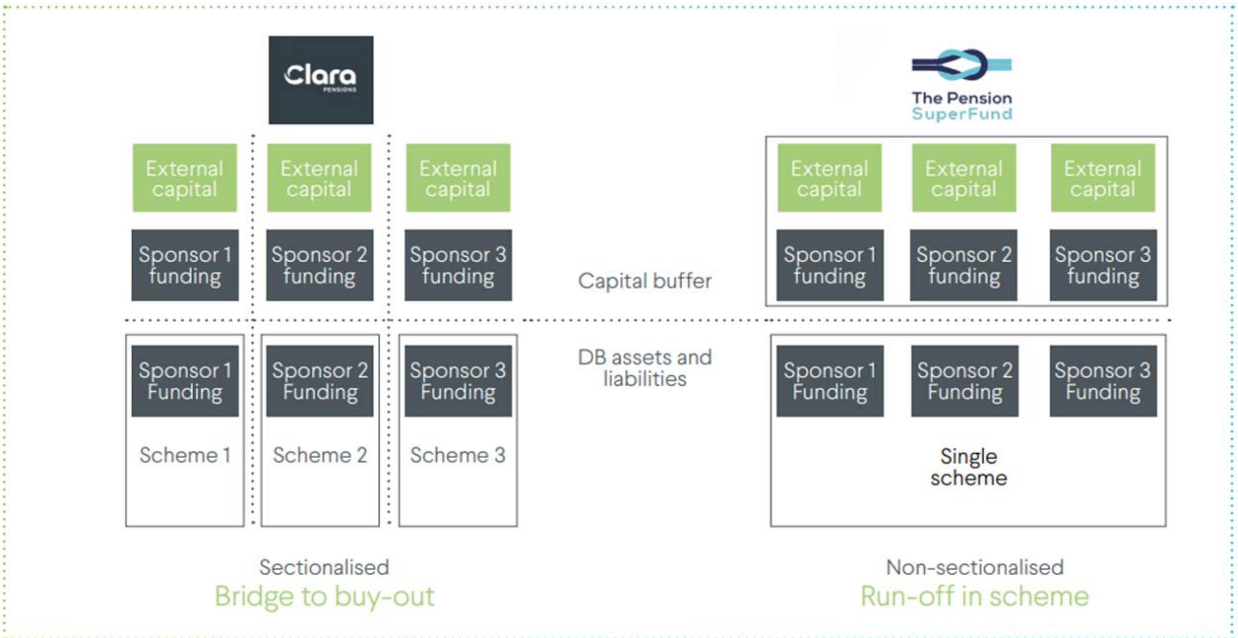
A highly anticipated Government White Paper in March 2018 signposted the future development of a regime to facilitate commercial consolidation via vehicles known as 'superfunds'. Superfunds are designed to accept pension scheme liabilities for less than the cost of buy-out, but with a corresponding lower 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 Pensions 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 Pensions Superfund.

Following the White Paper, in December 2018 the Department for Work and Pensions issued a consultation on the legislative framework for commercial consolidation. At the same time, TPR issued initial guidance for trustees and sponsors considering consolidation, and for superfunds themselves.



At a glance: the interim regime for consolidators

On 18 June 2020, TPR issued its updated guidance for superfunds setting out details of its interim regime under which transactions can occur ahead of legislation and a longer term authorisation regime. TPR also ran a closed consultation with 8 interested parties ahead of issuing the guidance, and has released its response to the consultation at the same time. The guidance covers governance and service requirements of superfunds, but of primary interest are the details on the required financial security of superfunds. Below we give a high-level outline.

Capital and funding requirements

Two important funding and capital levels have been established:

- **Technical Provisions**: A funding basis with a discount rate of gilts + 0.5% p.a. and other prescribed assumptions.
- **Risk-based capital requirement**: Sufficient capital to give a 99% probability that scheme/section assets plus capital will be greater than the Technical Provisions liabilities in 5 years, allowing for key risks including investment and longevity. TPR estimates this will lead to capital requirements of 18-28% of Technical Provisions.

New schemes can only be accepted if the Technical Provisions and capital requirements are fully met by the accepting scheme/section overall. For non-segregated vehicles, individual transactions must also be capitalised to this level, so it is not possible to use existing surplus in the vehicle to fund new transactions.

There are **two key intervention triggers** related to the level of assets and capital, illustrated on the right:

Low risk funding trigger:
All remaining capital flows into the scheme if assets plus capital falls below 100% of Technical Provisions

Wind-up trigger:
Wind-up triggered if funding falls below 105% of PPF funding

Surplus extraction

A key consideration in assessing the security of superfunds is the mechanism for profit extraction, which reduces the pool of assets and capital supporting members' benefits.

While the market develops, superfunds attain scale, and given uncertainty regarding future legislation, the interim guidance states that **profit cannot be extracted from superfunds for the next three years, unless members' benefits are bought out**. TPR also signposts that this will be reviewed within three years.

Restrictions have also been placed on costs and expenses to ensure these are not used to extract value.

Investment principles

Highlights of the guidance regarding the investment strategies of superfunds include:

- **Capital buffer**: Must be invested in line with pension scheme investment regulations.
- **Investing in ceding employers**: Superfunds can invest in the employers of ceding schemes to part-fund a transfer provided this is consistent with investments the trustees would ordinarily have chosen.
- **Concentration and diversification**: Limits are outlined on counterparty and issuance exposure, though certain asset classes such as buy-ins are exempt.
- **Illiquid assets**: Restrictions have been placed on allocations to illiquid assets to avoid issues if the superfunds were forced to wind-up.

Risk-based capital requirements and trustee control over the superfund scheme's assets also provide indirect checks and controls over the superfunds' investments. Other assets can be taken as part of a transaction, but should be transitioned to the above principles within 12 months.

Our thoughts

Generally, we welcome the guidance. It appears to align with a longer-term legislation and authorisation regime, which suggests TPR and DWP are joined up on the direction of travel, and therefore gives the market far more confidence on the long-term viability of consolidators. In our view consolidators 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.

Below we outline some of our observations on the implications of the new guidance:

Trustee and sponsors still need to look 'under the bonnet'

While the guidance should provide significant comfort to ceding scheme trustees and sponsors, the guidance is largely 'principles-based', giving flexibility to superfunds in how they choose to operate. It therefore remains important that trustees and sponsors do their homework on the superfunds ahead of any transaction to understand their models. Importantly any clearance application to TPR for a transaction needs to include the due diligence carried out by the ceding trustees.

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Pricing may only support transactions for immature schemes

TPR has reiterated that it does not expect superfunds to accept a scheme which can buy-out, or is on track to do so in the next five years. This means the cost of consolidation must be materially lower than the cost of buy-out for a transaction to be viable.

Capital requirements for superfunds might mean that pensioner liabilities are more expensive to settle than with an insurer, although non-pensioners will be materially less expensive. Therefore, the required gap between buy-out and consolidation may only materialise for immature schemes.

Unintended consequences of a fixed "gilts +" discount rate

Both the 'low-risk funding trigger' and the 'wind up trigger' are linked to funding discount rates based on a margin above gilts. This could lead to unintended consequences, such as triggering when credit spreads widen for what might be a temporary period. It is therefore welcome that the margin above gilts is kept under review.

Surplus extraction restrictions may hamper some models

The guidance shifts the long-term objective for superfunds from potentially having to target buy-out (one of the options in the DWP consultation) to supporting run-off, which will enable different types of superfund models to operate. However, the surplus extraction is still pegged to achieving buy-out, which may be problematic for the run-off models, unless TPR changes this with the review it has committed to carry out within 3 years.

Uncertainty remains ahead of formal legislation

While the guidance is helpful and goes a long way to providing comfort for those considering consolidation, and we certainly expect to see some transactions under the new guidance and interim regime, uncertainty remains regarding the ultimate framework in future legislation.

Given the apparent alignment of TPR and DWP, many aspects of the guidance can be seen as indicative of the future regime. However, there is no guarantee things won't change, and TPR's guidance has deferred some aspects of detail (such as profit extraction ahead of buy-out) for what appears to be a concern with being inconsistent with subsequent legislation.

What comes next?

Superfunds are working hard with TPR to gain ‘pre-authorisation’, confirming they comply with the guidance for the interim regime. Only then will TPR begin considering clearance applications for individual transactions. TPR has also signposted further guidance to come for trustees and sponsors considering consolidation.

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

Only time will tell what these first transactions look like, but in our view, it remains the case that early transactions need a “burning platform” meaning it is in members’ best interests to transact now rather than waiting for an authorisation regime. This could take a number of 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 driver of consolidation activity. Particularly interesting are PPF+ cases, where trustees may be faced with a tough decision, weighing up lower security but higher benefit coverage (e.g. 95p in the £) from superfunds against higher security but lower benefit coverage (e.g. 90p in the £) from insurance buy-out.

Interestingly the guidance also covers capital backed solutions that do not initially sever the link to the employer covenant at the point that capital is provided, but which could result in the employer covenant being severed at some future point. This may well impact the structure of new capital backed solutions coming to market. Indeed, TPR appear to have issued this guidance now in part to capture these new capital backed solutions.

Get in touch

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

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