News Alert 2020/05

18 June 2020

Framework for regulating superfunds launched by the Pensions Regulator

At a glance

The Pensions Regulator (TPR) has today published interim guidance on the regulatory framework it will apply to superfunds (also referred to as DB consolidators) before the full legislative framework is in place. This guidance is expected to allow superfunds to seek "approval" from TPR and to move forward with their first transactions.

The detail

Superfunds are defined benefit pension plans specifically set up to consolidate other pension plans by transferring them into the superfund. Crucially, on transfer, the ceding employer is released of its obligations to fund the liabilities and its covenant is replaced with a "capital buffer" which is available to support the liabilities if there is adverse experience.

Following the Department of Work and Pensions' (DWP's) consultation which closed in February 2019 (see our News Alert), significant work has been taking place behind closed doors to design a framework for regulating superfunds. TPR has today published guidance in relation to this framework, which sets out the standards it expects superfunds to meet if they wish to operate. This is a framework which will operate in the "interim period" before new legislation is in place governing superfunds. TPR has stated that it will be updating its existing equivalent guidance for employers and trustees "in due course".

The interim framework details TPR's expectations for the minimum standards a superfund is required to meet, including in relation to its capital levels, triggers to protect member benefits, investment strategy restrictions, limits on "value extraction" and standards of governance. Any superfund looking to undertake a transaction will first be expected to obtain approval from TPR to confirm it meets these minimum standards. TPR expects each transaction to go through its "Clearance" process, giving it a key supervisory role in any transfer.

1. Capital requirements

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

- New transactions trigger – when the liabilities of a pension scheme transfer 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. To transfer new liabilities to the superfund, the scheme and capital buffer must be funded to at least the level of the liabilities calculated on a prescribed "technical provisions" basis plus a minimum amount of additional risk-based capital.

  During the interim period the technical provisions basis is based on returns of 0.5% pa above the yield available on gilts. The minimum additional risk-based capital is the amount that, when added to the pension scheme assets, gives a 99% chance of being funded at or above the technical provisions in five years plus an additional c.3% for longevity risk. It is calculated allowing for the appropriate risks present and mitigations in place. The superfund will have to demonstrate its approach satisfies the Regulator's requirements.

- Low risk funding trigger – if the scheme assets plus capital buffer fall below 100% of the liabilities calculated on the "technical provisions" basis, the capital buffer becomes available to the scheme trustees.

- Wind-up trigger – if the assets fall below 105% of the value of the PPF liabilities valued on a Section 179 basis, the superfund scheme would have to wind up.

Our view

The Pensions Regulator describes the guidance as a "stringent set of standards". It treads a fine line between adequate member protection and a commercially viable framework that can attract the significant external investment necessary for the fledgling superfund model to take-off.

2. The "gateway" test

One of the key planks of the DWP consultation in December 2018 was a "gateway test" that schemes which could afford to buy-out within a foreseeable timeframe should not be permitted to transfer to a superfund. It proposed to define this timeframe as 5 years.

The gateway test is only mentioned briefly in the final guidance saying that the Regulator does not expect a superfund to accept the transfer from a ceding scheme that has the ability to buy-out or is on course to do so within the foreseeable future (for example, in the next five years).

Our view

The proposed gateway test was a crude tool which took little account of the specifics of the scheme such as the strength of the covenant. Whilst the test has not disappeared completely, we hope the Regulator will consider the specifics of each scheme when granting clearance rather than applying blanket rules.

3. Value extraction

The superfunds will be privately-funded enterprises, with investors expecting to achieve a return on the significant amounts of money they will be putting at risk in the capital buffer.

The guidance does not permit any capital to be withdrawn during the interim period unless the scheme benefits are bought out in full with an insurer. Indeed even if the assets do well any excess capital cannot even be used towards the "risk-based capital" required to support new liabilities transferring into the superfund.

In response to concerns that superfunds might try to extract capital in other ways, such as through higher than standard fees or charges on the superfund scheme, the Regulator has also included a requirement for any fees, costs or charges to be justifiable.

Our view

The Regulator is clearly concerned about the possibility of investors taking "profits" and the superfund subsequently running into difficulties. In this regard the guidance is coming down firmly on the side of the members, with investors having to wait until the full legislation is in place to access any return on their investments in the absence of a full buy-out.

4. Investment arrangements and governance

The guidance requires that the superfund's investments comply with eight principles, including maximum allocations to the total issuance of a security and to single securities and issuers. There are also limits on the levels of illiquid assets that can be held. 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.

The governance requirements are intended to provide assurance that the key people running the superfund are fit and proper, as well as ensuring adequate systems and processes are in place for the superfund to run effectively.

Our view

The Regulator is keen for supporting funds kept outside of the superfund scheme to be subject to similar requirements as the funds inside the superfund scheme, and demands thorough consideration of the investment risks faced.

5. Conclusion

Whilst we await full legislation covering superfunds, the Regulator has outlined how it intends to use its existing powers to regulate these new structures. It has intentionally taken a safety-first approach to that regulation to minimise the risk of a superfund failing during the interim period.

Our view

This announcement paves the way for the first pension scheme transfers to a superfund. It provides long-awaited clarity on the shape of the regulatory framework. One of the perhaps more unexpected pensions outcomes of the Covid-19 crisis has been its ability to cut-through the political log-jam that has held up this framework for the last year.

This News Alert does not constitute advice, nor should it be taken as an authoritative statement of the law. If you would like any assistance or further information on the contents of this News Alert, please contact the partner who normally advises you at LCP on +44 (0)20 7439 2266 or by email enquiries@lcp.uk.com

www.lcp.uk.com

At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in pensions, investment, insurance, energy and employee benefits.

Lane Clark & Peacock LLP
London, UK
Tel: +44 (0)20 7439 2266
enquiries@lcp.uk.com

Lane Clark & Peacock LLP
Winchester, UK
Tel: +44 (0)1962 870060
enquiries@lcp.uk.com

Lane Clark & Peacock Ireland Limited
Dublin, Ireland
Tel: +353 (0)1 614 43 93
enquiries@lcpireland.com

Lane Clark & Peacock Netherlands B.V. (operating under licence)
Utrecht, Netherlands
Tel: +31 (0)30 256 76 30
info@lcpnl.com