Is a Superfund right for your DB pension scheme?

LCP's specialist support for DB schemes considering a transfer to a Superfund

December 2021

Introduction

Could pension scheme members be better off in a Superfund? How can companies and trustees decide? We have developed a sophisticated model which can provide the analysis you need to make a clear and informed decision.

Gordon Watchorn
Partner

Superfunds offer an opportunity for trustees to fulfil their duties by transferring their scheme to a third party, removing it from the employer's balance sheet in the process. This will only be appropriate if all parties are comfortable that the position of members is improved by the transfer, and that the alternative of buy-out with an insurer is unlikely to be viable for the foreseeable future.

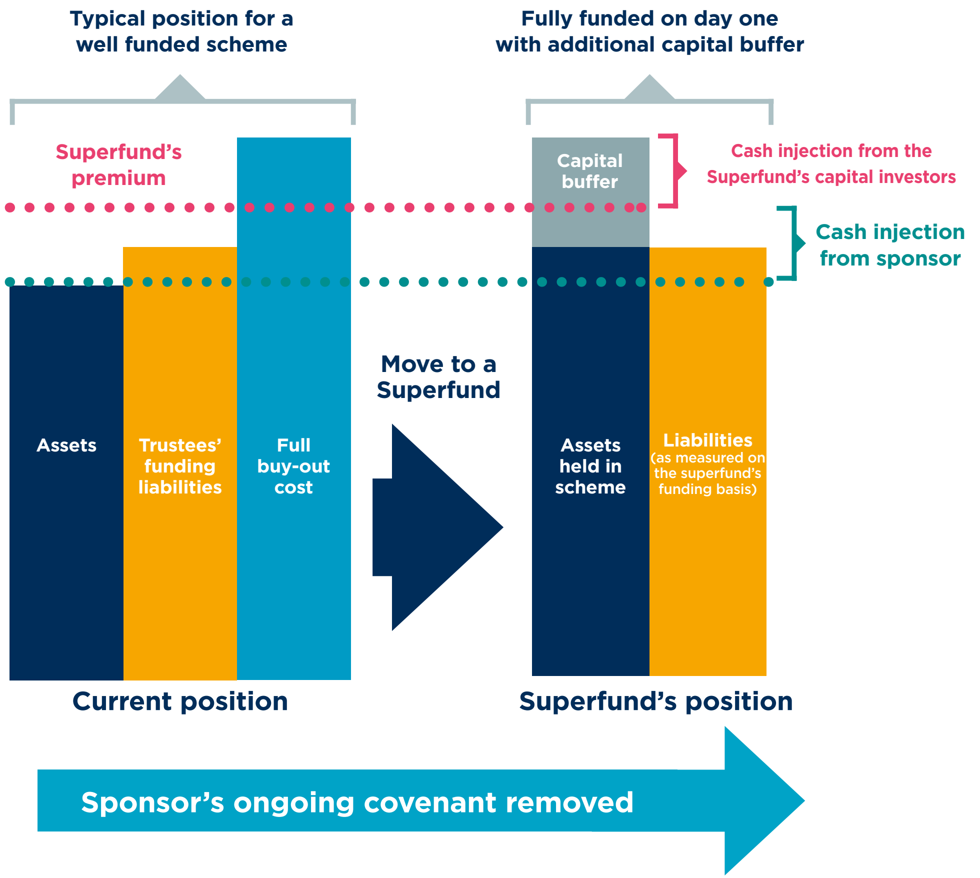
Here we introduce the nuts and bolts of how trustees and employers can go about assessing whether or not their scheme is suitable for a transfer to a Superfund. This will typically require a detailed analysis of future investment, funding and covenant scenarios.

Contents:

We are pleased to introduce LCP's Covenant Comparator modelling tool on page 6 of this report

What is a Superfund?

- A Superfund is a defined benefit pension scheme into which other pension schemes can transfer their liabilities. The premium for the transfer is set by the Superfund.
- Superfunds operate within the UK pensions regime and are therefore regulated by The Pensions Regulator (TPR). An interim framework is now in place to enable the first Superfund transfer to happen.
- The chart below illustrates how the position of a scheme typically changes following a move to a Superfund.



Key features of a transfer to a Superfund

- Once a pension scheme has transferred to a Superfund, it can be wound up and removed from the sponsor's balance sheet. All current scheme obligations pass to the Superfund at this point, e.g. managing the scheme, paying operational expenses, communicating to members, paying benefits etc.
- To support the transfer, a Superfund has investors who provide capital on day one to provide a buffer of support (i.e. contingent security) for the liabilities being transferred.
- Schemes moving to a Superfund are exchanging their sponsor covenant for the financial covenant offered by the Superfund (i.e. the capital / contingent security provided by its investors) as well as (typically) an upfront cash injection from the sponsor.
- Therefore, the key question when assessing whether a Superfund is appropriate is whether the exchange of the sponsor covenant for the financial covenant of the Superfund is expected to improve member outcomes.

This is the key question that the LCP Covenant Comparator model has been designed to answer

- see page 6 for further details.

Sam Jenkins
Partner

Is a Superfund appropriate for my schemes?

Superfunds may be expected to improve member outcomes where pension schemes have most of the following features:

Insurance buyout not affordable in short term (e.g. 3-5 years)

Trustees should only consider a Superfund transfer if insured buyout is not expected to be affordable in the short term.

Weak or uncertain future covenant

Concerns over the ability of the sponsor to support the scheme over the medium to long term make a Superfund transaction more attractive.

Well funded and/or cash available

Scheme is well funded and/or cash is available to meet a Superfund premium.

Immature population

A reasonable proportion of non-pensioners, which makes Superfund pricing attractive compared to an insured solution.

Examples of schemes with a strong case for considering a transfer to a Superfund:

- Well-funded schemes with sponsors that are vulnerable to a potential reduction in covenant strength
- A well-funded "zombie" scheme (i.e. one with negligible covenant support)
- Schemes attached to a weak subsidiary of a stronger parent company with deeper pockets
- As part of a corporate transaction, where a payment to remove the pension scheme from the target's balance sheet may facilitate a deal
- "PPF plus" cases, i.e. where a sponsor becomes insolvent, but the scheme has assets to provide benefits above PPF levels but below full scheme benefits.

What are the key differences between the two current commercial Superfunds?

There are currently two Superfunds active in the market: Clara Pensions and the Pension SuperFund. At a high level, the key structural difference between the two Superfunds is that the Pension SuperFund (PSF) looks to run off liabilities and shares any upside through an increase to member benefits, whilst Clara targets insurance buy-out and shares any upside by moving to buy-out sooner. Schemes may find either of these approaches more attractive than the other, and there will be other important factors to consider (not least the superfund's "premium" for the transfer, and the assessed level of security for members' benefits). Further entrants to the market are expected.

	Clara Pensions	The Pension SuperFund
Long term target	Buy-out	Run-off liabilities until all benefits are paid
When is capital returned to investors?	Following buy-out	Investors share in outperformance as liabilities run-off
Impact if Superfund's assets outperform	Move to buy-out earlier	1/3rd of outperformance is passed to PSF Trustees to be used for the benefit of members
Is each transferring scheme kept in its own section?	Yes	No
Capital providers	TPG Sixth Street Partners (TSSP), Wilton Re	Disruptive Capital
Key individuals at the Superfund	Founder and CEO: Adam Saron Co-founder and COO: Kim Toker. Chairman: Lawrence Churchill (ex-chairman of the PPF).	Edi Truell (founder of Disruptive Capital) Chairman: Chris Hitchen (ex-CEO of Railpen) CEO: Luke Webster (CIO of the Greater London Authority)
Trustee board	Alan Pickering (Chairman, BESTrustees), Michael Chatterton (LawDeb) and Frank Oldham (ITS)	Richard Wohanka (Chairman), Antony Miller (2020 Trustees), Caroline Rookes, Michelle Hirons-Wood and Margaret Snowdon (Independent Trustees)

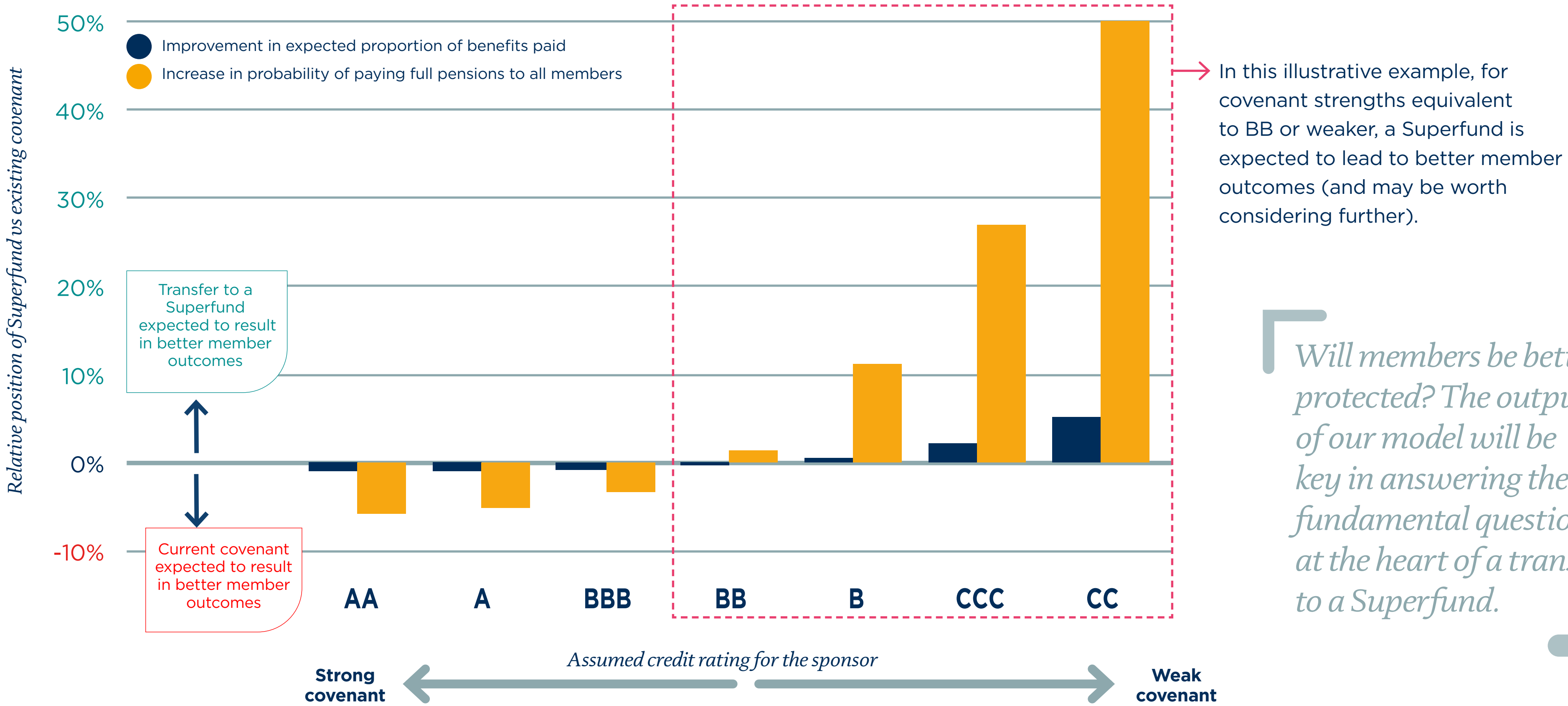
Note: We meet with the existing superfunds and regulators to discuss developments in this market on a regular basis. We are also advising a number of schemes on potential Superfund transfers. This gives us a deep understanding of the current market, and ensures that LCP is well positioned to help you evaluate the Superfund option. We also note that ring-fenced LCP teams provide advice to superfunds (and potential superfunds) and have advised them on their development.

How can LCP's Covenant Comparator tool help assess the suitability of a Superfund?

Key question: Would a Superfund transfer lead to an improvement in expected member outcomes compared to the current sponsor covenant?

To answer this question the LCP Covenant Comparator tool allows us to build a detailed model of the covenant offered by the current sponsoring company, and also a model of the covenant provided by a Superfund. The tool can then be run to produce projections under both these options: the likelihood of members being paid their benefits in full, and the expected proportion of members' benefits that will be paid. The results can then be compared: an improvement in likelihood demonstrates that the Superfund option is expected to result in improved member outcomes; a reduction in likelihood demonstrates that the scheme is expected to be better staying with its current sponsor.

We have illustrated the output of this model for an example pension scheme below, and shown the results assuming it is currently sponsored by a company with a variety of credit ratings (in practice, only one or two credit ratings are likely to be appropriate to consider in a real life situation). As expected, the analysis confirms that the weaker the current covenant, the more likely it is that a Superfund is expected to be better. The powerful aspect of the model is to enable trustees and other parties to quantify the difference. Whilst trustees will need to consider several factors to assess a Superfund, this tool enables trustees to readily analyse the range of covenant scenarios under which a transfer to a Superfund may be appropriate.



Will members be better protected? The output of our model will be key in answering the fundamental question at the heart of a transfer to a Superfund.

How would you achieve a transaction with a Superfund?

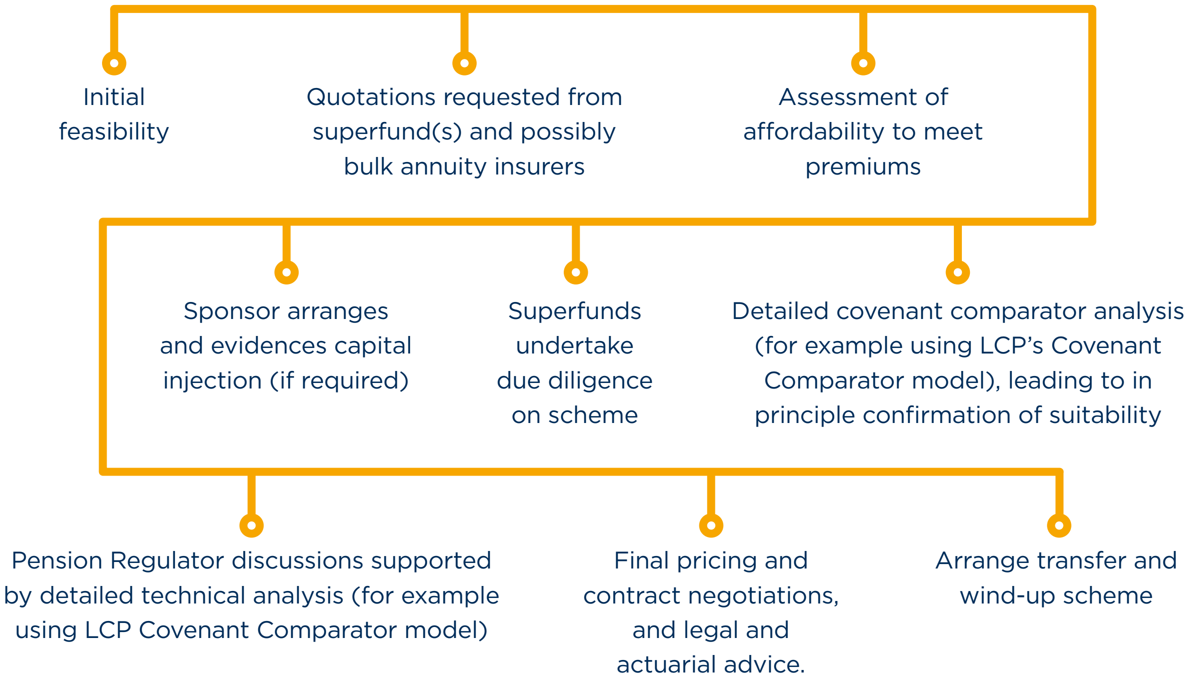
What are the next steps?

An initial feasibility should be undertaken if you believe a Superfund could be appropriate for your scheme. This would involve obtaining indicative pricing estimates, for both the superfunds and insurance solutions, to understand the feasibility of a transfer. As a transfer to a Superfund requires the support of both the scheme's sponsor and trustees, it is important at the outset to understand the views of both parties.

If, following the receipt of pricing from the superfunds, it is deemed appropriate to proceed, a detailed covenant analysis should be undertaken (for example using LCP's Covenant Comparator model).

An insured buy-out with a specialist insurer is a tried and tested route, and typically seen as the gold standard for trustees. The appropriateness of a Superfund will depend on the circumstances of your scheme, and the analysis needed to assess this is complex. In particular, trustees, employers and the Pensions Regulator will need to be satisfied that a transfer to a Superfund will improve the position of members (taking into account funding, investment and covenant considerations). Our Covenant Comparator model is key in helping all parties assess whether the Superfund option is appropriate.

LCP takes you through the typical steps schemes will need to take as part of a transaction:



LCP has led the market in insurance de-risking solutions for many years. We have helped schemes assess superfunds and have ringfenced teams that advise the superfunds themselves. With our Covenant Comparator model, we are well placed to support schemes that are considering a transfer to a Superfund.

You can find the contact details of key members of LCP's DB Superfund team overleaf.

LCP INSIGHT CLARITY ADVICE

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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.

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