In Touch technical update

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TPR issues DB commercial consolidator guidance

- TPR issues guidance on the standards it expects from DB commercial consolidators (or "superfunds")
- This guidance is an interim measure until longer term legislation is implemented
- The guidance aims to ensure member benefits are protected against funding, personnel and governance risks

In December 2018, the DWP published a consultation in relation to consolidation of defined benefit pension schemes. While there has been no formal response to this consultation, the Pensions Regulator (TPR) has now taken the step of issuing its own guidance for how it will regulate such solutions until future legislation is put in place.

Superfunds

TPR defines a superfund as a model that allows a sponsor to sever their liability towards a defined benefit scheme, with:

- A bulk transfer of all liabilities to a consolidator scheme, with its own trustees, governance and administration; and
- The employer is replaced by a new employer (which may be a special purpose vehicle) providing a capital injection to support member benefits.

Capital backed investment

Some business models offer capital support even though there are no changes to the trustees or their responsibilities. There is no change to the existing trust or the legal sponsor of the scheme.

TPR has confirmed that the capital adequacy tests equally apply to these models.

TPR assessment

Superfunds

In the absence of legislation, superfunds will need to explain to TPR how they will meet the expectations set out in the guidance before any transactions take place.

Transfers to a superfund

Existing sponsors of pensions schemes are expected to apply for clearance before any transfer to a superfund takes place. In line with the "Gateway test" in the DWP consultation, TPR do not expect Superfunds to accept transfers from schemes who have the ability to buy-out in the "foreseeable future" (with an example of 5 years given).

Capital adequacy

An important aspect of a superfund model is that it will give a very high degree of certainty that member benefits will be paid in full, even if the superfund were to exit the market. To achieve this, superfund will need to:

1. Have Technical Provisions at least as prudent as a reference basis, including a discount rate of Gilts + 0.5% p.a.
2. Have a "market risk" capital buffer which, when added to scheme assets, gives at 99% chance of being fully funded on a Technical Provisions basis in five years' time. The superfund must disclose the assumptions underlying this assessment to TPR.
3. Have a further "longevity risk" capital buffer based on a long-term rate of improvement of 2.0% p.a.

Distress scenarios

TPR can intervene in the following two scenarios:

(a) Total assets (including capital provided by the superfund) fall below the Technical Provisions. In this scenario, all assets are tipped into the scheme and investors will receive no return.

(b) The superfund will wind-up if the funding position falls below 105% of s179 funding.

Superfund profit extraction

At least initially, while different models emerge, no superfund investor will be able to extract a return until all member benefits are secured with an insurance company.

This policy will be reviewed within three years.

To avoid returns being extracted in alternative ways, there are reasonably prescriptive restrictions on the level and type of fees that can be paid by the superfund.

Financing strategy

Investment strategy

The investment strategy of a superfund should comply with 7 principles, as follows:

1. Any capital buffer should be invested in line with the Occupational Pension Schemes (Investment) Regulations 2005.
2. Investments should reflect the scale of the assets.
3. There shall be limits on allocation to any individual security.
4. There shall be a limit on the overall allocation to illiquid assets.
5. If in-house pooled assets are used, they must be freely traded in an active market and transferrable in specie without penalty.
6. Any investment decisions taken by an employer must be consistent with those that the trustees would ordinarily have taken.
7. There must be a transition plan for any assets taken as part of a transaction, with the expectation that they will move to the superfund strategy within 12 months.

Integrated risk management (IRM)

Each superfund will need a detailed and robust IRM framework. This will include risk management plans for liquidity, climate change and overall resilience.

TPR plans to issue further guidance on this in coming months, including minimum guidance for how trustees should monitor the progress of their scheme.

Financial sustainability

Different consolidation models will have different intentions for the long-term goal – this could vary from ongoing self-sufficiency to buy-out. Either way, these long-term objectives need to be documented, alongside a detailed business plan and corporate structure.

Superfunds should have costed plans for wind-up in all scenarios, including costs. This may involve ring-fencing of resources within the superfund sponsor.

Operational requirements

Fit and proper personnel

TPR will carry out a "fit and proper persons" test for all key stakeholders in a superfund, based on high-level information on their background, experience, qualifications and (any) criminal records.

This will apply to a wide range of individuals, including trustees, senior management, CIOs and risk managers.

Governance

As for any well-run pension scheme, superfunds will be expected to have robust and clearly documented governance processes, to include:

- Conflict of interest protocols;
- Transparency (including of appointments and responsibilities);
- Investment risk management; and
- Effective administration processes and systems.

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