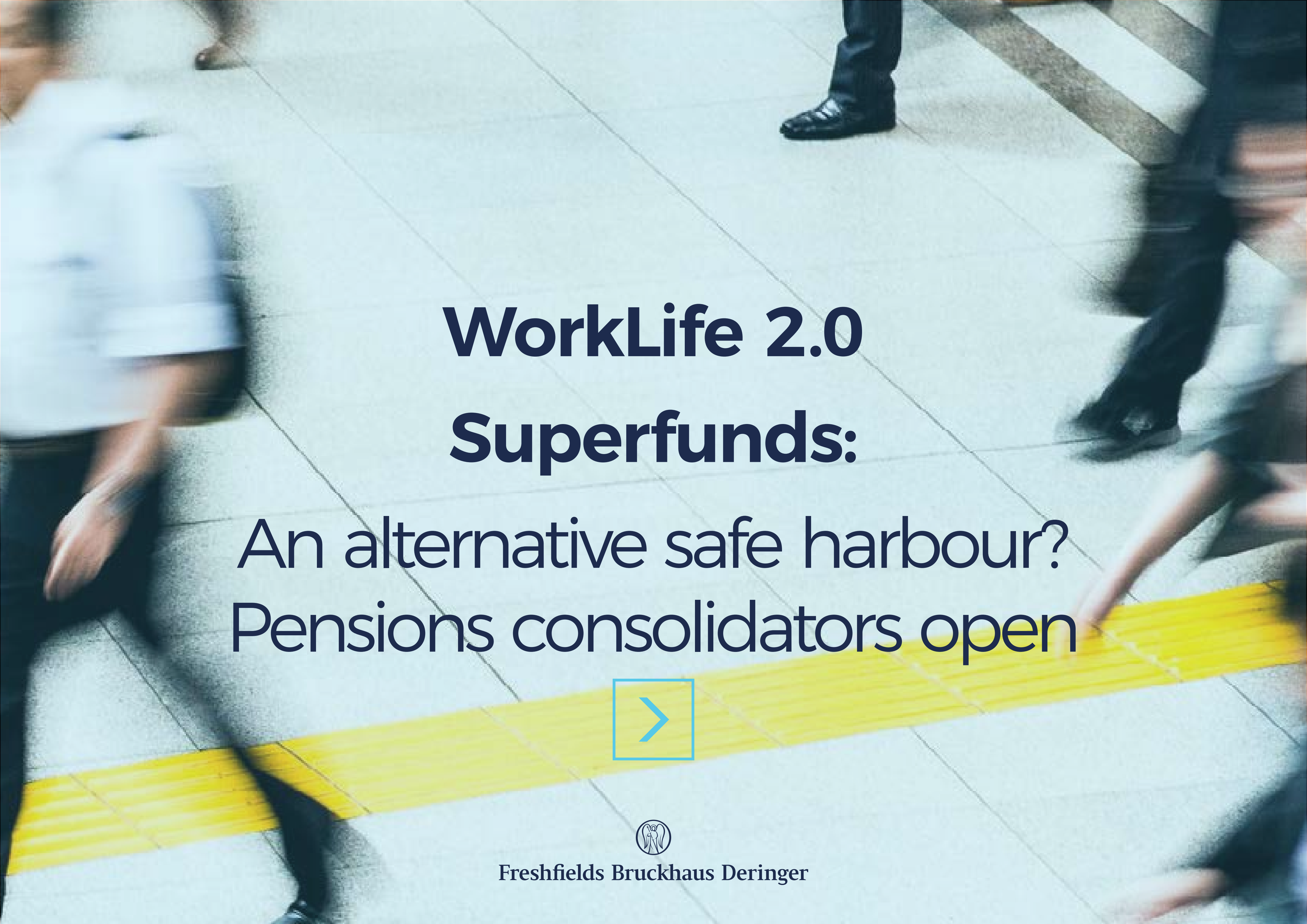


WorkLife 2.0 Superfunds:

An alternative safe harbour? Pensions consolidators open

Freshfields Bruckhaus Deringer

Introduction

The Pensions Regulator (TPR) has recently published interim guidance (the Guidance) on the regulatory framework it will apply to pension superfunds (also known as 'DB consolidators').

The Guidance is intended to govern the operation of superfunds pending the introduction by the UK government of a comprehensive legislative framework for authorisation and supervision later this year, which will build on the results of the Department for Work and Pension's (DWP's) consultation on the use of consolidators in 2018-19. This Guidance is expected to give superfunds the green light to seek 'clearance' from TPR to implement their first transactions.

As other market commentary has noted, one of the more unexpected pensions outcomes of the COVID-19 crisis has been TPR's ability to overcome the political hurdles that have held up this framework for the last year.

The COVID-19 outbreak has also exacerbated some existing issues and inefficiencies in the UK pensions industry. We have recently seen a sharp increase in pension plan deficits and substantial weakening of the employer covenant supporting many plans. Faced with these challenges, pension scheme trustees and sponsors may well consider superfunds as a viable solution, helping them to save costs and secure member benefits within a foreseeable timeframe.

In summary, a superfund is a pension scheme set up under trust by the superfund provider. Essentially a transaction would involve transferring the assets and liabilities of a particular employer's pension plan to the superfund thereby removing the employer covenant of the plan and releasing the employer from further liabilities. The employer covenant is replaced with the security of third-party capital (typically provided by institutional investors such specialist private equity funds) which backs the superfund. In most cases this process will also involve a material improvement in funding provided by the departing employer sponsor as a lump sum contribution to the superfund.

Why superfunds? Why now?

Government believes that the UK pensions industry — particularly for smaller pension plans — is inefficient, and that consolidation can be used to achieve economies of scale to reduce costs per member, enable more effective investment strategies and improve governance. These concerns have been building up in the system for a long time, and one response to them has been the development of master trusts, which can provide most of the above advantages to at least some extent but leave the sponsoring employer responsible for funding the benefits. However, those concerns have now been amplified by the COVID-19 crisis which has sharply increased pension plan deficits and weakened the employer covenant supporting many plans, particularly in those industries which have been badly affected by the shutdown. This has focused attention on the extent to which many members' benefits are exposed to the risk that the employer's business could fail. The government has indicated that now is the time to act.

The promise of superfunds is a safe and secure environment for members' benefits that is within reach for a much larger number of pension plans, but which is not dependent on continued employer support. However, superfunds are not suitable for every pension plan - they are intended to fill a gap within the defined-benefit pensions market where an insurance buy-out solution (which for most pension plans would require the employer to pay the insurer a very large cash sum to take the liability for plan benefits off the employer's balance sheet) is not affordable for the plan today or in the foreseeable future.

By way of illustration, we understand from analysis carried out by the pensions consulting industry that the current providers in the market, The Pension SuperFund (the PSF) and ClaraPensions (Clara), aim to undercut insurance pricing by up to 10 to 15%, depending on the profile of the plan in question. If this pricing model can be achieved in practice, we would expect many employer sponsors (and trustees) to be willing to investigate whether superfunds should be factored into the long-term journey plan of the scheme. Early indications are that up to 11% of UK defined benefit pension plans have already discussed superfunds as an option for their target end-game, while a further 9% are planning to do so shortly, according to a survey conducted by consultants Willis Towers Watson following TPR's announcement on how it will regulate the superfunds regime.

How do superfunds work?

Broadly, the current superfunds work like any other defined benefit pension plan, albeit they will be subject to greater scrutiny from TPR going forward (see section on regulatory approach below). The key difference is that post-transfer to the superfund there is no ongoing employer covenant supporting the plan, instead the plan will be fully funded on a prudent basis, run a low risk investment strategy (appropriately hedged against unrewarded risks) and be supported by an external pool of capital provided by a third-party capital provider. In other words, a transferring plan will be giving up the current employer covenant supporting the plan for the financial covenant of the superfund.

To secure benefits with a superfund, the existing pension trustees and the employer will execute a bulk transfer of (usually) all members, agreed benefit liabilities and assets into the superfund, plus any lump sum top-up payment from the employer. This will be similar to a scheme merger, but in practice all of the considerations that typically arise in an insurance buyout transaction will also arise in a transfer to a superfund because it is a crystallising event. In addition, there will be some considerations that will be more specific to superfunds due to their legal structure and the role of TPR.

In particular, we would expect that a superfund would not normally agree to assume all potential liabilities that may reside in the existing plan, but (as with most insurance buyout transactions) would only assume clearly defined benefit obligations in respect of an identifiable set of members and beneficiaries. Therefore, the transferring plan trustee will need to have carried out due diligence on its benefit administration practices and member data in order to be able to define which benefits and members the superfund will assume responsibility for. As with most pension bulk annuity insurers, the superfund would normally expect a high level of preparation and due diligence to have been carried out before it would be willing to transact.

With the price for the transaction being set on the basis of the agreed position, the premium would be constituted by the assets in the existing plan, plus any top-up amount from the employer. The superfund may require the transfer of an agreed portfolio of assets and the existing trustee would then need to ensure that it can transition its existing investments within the agreed timescale in order to match those requirements.

TPR's moral hazard powers would in theory in some circumstances allow TPR to have recourse to the former employer in respect of the transferred benefits for up to 6 years from the transfer, if the superfund were to fail. Because of this, we would expect the ceding employer to want to seek formal clearance from TPR in respect of the transaction, so that this potential exposure to liability is closed off. This ties in with TPR's own guidance that it expects clearance to be sought in respect of each transfer to a superfund, as discussed below.

In order to achieve a "clean break" we expect that ceding employers and trustees will want to fully end their liability by winding up the plan afterwards. However, employers and trustees will need to consider how to deal with any residual liabilities that the superfund is unwilling to assume as part of the transaction. This may involve the employer indemnifying the trustees and the trustees putting in place suitable D&O run-off insurance in respect of such liabilities.

Legal issues and TPR engagement

Superfunds are unchartered territory and employers and trustees will need to take independent actuarial, covenant and legal advice on whether the superfund comprises an appropriate solution for their particular plan. Some of the legal issues that will need to be carefully considered include the following matters:

- whether the superfund route is an appropriate end-game for the plan from a trustee duty and employer duty of good faith perspective;
- the legal integrity of the overall structure of the arrangement including matters such as the segregated status of the superfund (if applicable), the details of the investor contribution commitment and model for return of capital and profits to shareholders;
- the implications of transferring the plan to the superfund from the perspective of TPR's moral hazard powers and other residual risks for the employer;
- the impact of the transaction on member benefits (including the reliability of the due diligence process undertaken for the purposes of preparing the benefit specification for the plan); and
- whether the member communications and any member consultation process carried out in connection with the transaction creates any legal risk in relation to the transaction (and how to manage that risk).

From a process perspective, we would anticipate that the legal documentation required to implement the transaction (such as a memorandum of understanding, bulk transfer deed and various other technical documents) will be subject to negotiation between the ceding employer, the transferring trustees and the superfund and their respective professional advisers which will take some time. The transaction timeframe will also likely need to accommodate an engagement process with TPR and a clearance application to be submitted to TPR to manage any moral hazard risk and to comply with TPR's guidance. The extent to which TPR is prepared to use the transaction as an opportunity to look-back at the ceding employer's prior conduct in relation to the plan for the purposes of its moral hazard powers (or to seek a top-up to the ceding employer's contribution to the plan) is an open question, but seems a real possibility given statements made by TPR in the Guidance.

Different types of superfunds

There is no "one size fits all" model for superfunds. Rather, superfunds are expected to take differing approaches. For example, the two models that have emerged so far, the PSF and Clara, are quite different. The key differences derive from the structure of each model.

The Clara model is a legally segregated model. This means that the benefits of each plan that transfer into Clara will continue as a distinct arrangement that is funded by a ringfenced pool of assets, which will not be co-mingled with assets from any other plans that transfer. The capital buffer provided by investors is also kept separate in respect of each such benefit arrangement.

This is in sharp contrast to the PSF model, where there is co-mingling of assets and liabilities received from the different transferring plans, and the capital buffer is there to provide support for the entire PSF.

The other crucial difference is that the PSF is primarily designed as a run-off vehicle whereas the Clara model is designed to operate as a bridge to an insurance buyout for each segregated arrangement over roughly 7 to 10 years. However, both models ultimately provide third-party capital instead of the employer covenant as security for members' benefits over a period of time.

The key differences between the two models can be summarised as follows[1] :

Feature	PSF	Clara
Legal structure	Legally non-segregated model	Legally segregated model.
Impact on member benefits	Potential upside – transferred members receive the same benefits but with the potential to share in investment upsides.	Neutral - transferred members receive the same benefits but with no potential to share in investment upsides.
Endgame	Run-off of benefit obligations.	Buy-out of benefit obligations (5-10 years).
Target market	Pension plans with £200m-£10bn in liabilities and all but the weakest covenants.	Whole of market solution.
How much will it cost?	Transferring plan assets plus ceding employer contribution equal to 105% of PSF 'self-sufficient' liabilities.	Transferring plan assets plus ceding employer contribution equal to 90% of buy-out liabilities.
Amount of initial investor capital?	Amount equal to 10% of PSF 'self-sufficient' liabilities.	Amount equal to 10% of buy-out liabilities.
Any ongoing investor obligations?	Employer covenant of ceding employer replaced by financial security, equal to 115% of PSF 'self-sufficient' liabilities on day one. No requirement for additional injections of capital by investors.	Employer covenant of ceding employer replaced by financial security, with initial capital supporting each segregated section equal to 100% of buy-out cost on day one. No requirement for additional injections of capital by investors for a given pension plan.
When can investors get their returns?	A funding test is carried out annually to test whether the PSF pension plan funding level exceeds 115% of PSF 'self-sufficient' liabilities. Excess assets over 115% are distributed with one-third of each distribution paid to a separate trust for the benefit of scheme members and two-thirds to PSF investors. The member trust funds can be held as future member security or distributed as a bonus to members.	No return of capital until each transferred pension plan is fully bought out with an insurer.

[1] See further "Superfunds: New solutions for DB pension plans", Isio, March 2020.

Benefits and risks of the superfund model

Whilst the use of pension superfunds as DB consolidation vehicles is currently untested in practice, we set out below the key advantages and disadvantages, from the perspective of both employers and trustees, that will need to be weighed up by sponsors or trustees considering the prospect of consolidation.

Employer perspective	
Advantages	**Disadvantages**
Cheaper than insurance buy-out (by up to 10 to 15%).	Cost of upfront cash lump sum required to fully fund the transferring plan on a very prudent basis.
Employer achieves a "clean break" by transferring entire pension plan to superfund.	Employer technically remains within scope of TPR's moral hazard powers for up to 6 years from date of transfer of plan (but clearance will from TPR in respect of the transfer expected to mitigate this risk). Employer may remain "on the hook" for any residual liabilities not assumed by superfund.
Significant ongoing administration and governance savings.	Significant HR and reputational risk if superfund fails to provide promised member benefits.
New players expected to enter market which will drive competition and lower prices.	Consolidation currently not an option if the plan is able to buy-out in the foreseeable future.

Trustee perspective	
Advantages	**Disadvantages**
Consolidator may offer stronger covenant and greater security relative to current sponsor.	Superfunds will not operate a revenue-generating business to support the plan going forward. Transferring plan will need to rely on initial cash lump sum contribution, capital buffer and investment strategy to support member benefits.
Economies of scale expected to reduce costs per member, enable more effective investment strategies and improve governance.	Trustees will need to understand and scrutinise the amount of risk capital available and the model for return of capital and profits to shareholders.
Members retain eligibility for Pension Protection Fund (PPF) protection. Legal trigger for winding-up and PPF entry if the superfund drops below a threshold funding level which will be above the level needed for full PPF benefits.	Not as secure as buy-out – solvency requirements for insurers are stricter, and PPF eligibility provides less protection than Financial Services Compensation Scheme (FSCS) cover for annuities in the event of a superfund failure.
Segregated models effectively ring-fence each plan from cross-contamination risk within the superfund.	For unsegregated models, there is a risk of cross-subsidisation of liabilities received from other plans in the event of poor investment performance or flawed pricing.
Full trustee discharge after transferring plan has wound-up (as with buy-out).	Superfund will not accept hidden liabilities from transferring scheme, so trustees will need to use protections normally available for winding-up and run-off. Trustee also faced reputational risk if consolidator fails.
No change required to member's accrued benefits. Trustee structure of superfund is familiar to members.	Member communications will be challenging given the complexity of the superfund structure and the perception the plan is being transferred to a profit-making third party with less security than an insurer.

New regulatory approach

The Guidance issued by TPR sets out the minimum standards that it expects superfunds to meet before commencing business. Their initial approach appears to be cautious but positive, focusing on protecting members' benefits and monitoring the risk of superfunds failing in this interim period. Crucially, TPR is clear that nothing in its guidance will affect the ability of TPR to use its moral hazard powers. This means that adhering to the guidance will not in itself rule out TPR later being able to exercise those powers, which makes formal TPR clearance for each transaction critical to address this risk.

TPR views the capital buffer described above as a proxy for the employer covenant and as key for securing member outcomes. TPR considers it essential that the assets in this capital buffer are appropriately invested to provide long-term support for the benefits in the superfund, and expects robust provisions to be in place to prevent value leakage.

TPR reserves the ability to use all its existing legislative powers to ensure that the management and governance of superfunds meet their expectations. Before the launch of a new superfund, TPR will need to be satisfied that the superfund is capable of being supervised by the trustees of the superfund, is run by fit and proper persons with effective governance arrangements in place, is financially stable and has adequate contingency plans, and has sufficient administrative systems in place for effective operation.

TPR's ability to force the appointment of a new trustee (under section 7 of the Pensions Act 1995) and to require changes to scheme funding arrangements (under section 231 of the Pensions Act 2004) are central to its ability to impose standards on and regulate the operation of superfunds. TPR has set out its considerable expectations for the fitness and suitability of individuals who will be carrying out key roles in the superfund, particularly those responsible for investment decisions and risk management. TPR expects such individuals to be clearly identified and accountability structures to be clearly explained, and the named individuals must undergo assessment and disclosure processes with TPR. Superfunds must also demonstrate the collective competence of their corporate and trustee boards, for instance through a skills matrix, and show an assessment of any skills / knowledge gaps. TPR has some experience in monitoring and supervising the application of these standards which are not dissimilar to the corresponding regime governing Master Trusts.

Superfunds are expected to have robust risk-management practices in place, and a key area of governance will be the oversight of investments. All investments should comply with the principles set out by TPR in the guidance, which can be summarised as follows:

- Assets in the capital buffer should be invested as though the requirements of the Occupational Pension Schemes (Investment) Regulations 2005 apply, with the superfund having to follow a 'comply or explain' process.
- Scheme assets should be managed in line with asset scale.
- Maximum allocations of any issuance or security are stipulated, including any underlying holdings, to avoid concentration risks within investments.
- Limits on illiquid assets are prescribed to ensure that assets are readily available in the event of a transfer to another provider.
- Recognisable in-house pooled funds must only be used for quoted assets that can be freely traded and transferred in specie without penalty.
- Investments in transferring employer investments or asset-backed funding vehicles (whether directly or indirectly) should be consistent with investments the trustees would otherwise choose.
- Assets transferring to the pension scheme or capital buffer must be subject to a transition plan for re-alignment of those assets as quickly as possible (expected to be complete within 12 months of receipt).

New regulatory approach

Superfunds are also expected to have a detailed and robust 'integrated risk management' framework, including a liquidity risk management plan and a climate risk management plan. TPR intends to provide further detailed guidance in coming months on monitoring and reporting requirements, but expects monitoring to include factors such as the probability of the plan being fully funded above intervention triggers, exposure to revisions in law and the possible impact of any shock events.

TPR may ask superfunds for further details in relation to investment governance and the way decisions are made, including any incentive structures or performance-related fees. In particular, TPR sees the possibility of a 'management for profit' motivation as a unique risk for superfund structures. As a result, TPR has taken a cautious approach to this issue, requiring that no surplus value should be extracted from the capital buffer or the plan unless plan benefits have been bought out in full. This is intended to align the incentives of those running the superfund with those of the members, and limit excessive risk-taking behaviours. This position will be reviewed by TPR within three years As noted below, it is not clear to us whether the early distribution of assets to PSF investors in certain circumstances under the PSF model (as described in the "when can investors get their returns?" column of the table on page [5]) can be squared with this aspect of the Guidance or whether the PSF model may need to be adapted in this respect to comply with the Guidance.

TPR will pay particular attention to transfers both in and out of the superfund. Employers are expected to apply for clearance for any transfer from their plan to a superfund. As noted above, employers are expected to want clearance in any event, in order to deal with their residual exposure to the transferred benefit liabilities under TPR's moral hazard powers. However, a clearance process will give TPR considerable ongoing power over and oversight of superfunds, as it can normally withhold clearance if its conditions are not met.

To formalise this approach, a transfer to a superfund will be considered a new category of Type A event for the purpose of TPR's clearance guidance, and clearance applications must be able to demonstrate trustee due diligence on the suitability of the superfund as method of securing the benefits. Superfunds are encouraged to engage with TPR as early as possible and co-operate with any information requests ahead of proposed transfers.

Superfunds will be expected to provide full and transparent details of their offering, funding and investment objectives to prospective ceding employers and trustees, and to engage with the TPR as soon as possible. They must also have robust business plans and strategies for dealing with intervention or winding up, and sufficient financial reserves to pay any costs incurred as a result of these events. Superfunds should not accept transfers from schemes that have the ability to buy-out (or are on a course to do so within the foreseeable future, such as the next five years), meaning they are not an alternative option for plans already close to buy-out funding.

Superfunds are also expected to have a baseline level of legal protection, in that triggers should be included in their legal arrangements for reports to be made to TPR when the superfund assets fall below either:

- 100% of minimum technical provisions, in which case the superfund trustee will gain complete control over the scheme unless additional capital is injected into the superfund; or
- 105% of the PPF funding level under section 179 of the Pensions Act 2004, in which case it must wind-up, unless exceptional circumstances apply.

Conclusion and further information

We expect that superfunds will continue to face challenges as they begin to do business in earnest. For trustees, deciding to enter a superfund would mean a balance between a typically long-standing and well-understood employer relationship and covenant and a superfund which promises higher security but which will be largely unproven for a considerable time to come. Unlike insurers, they are untested and the regulatory environment for them will inevitably evolve, initially with legislation for a formal authorisation and supervision framework expected from the DWP, and also with greater scrutiny from TPR over time as experience in the pensions industry is taken into account.

The close attention being paid to superfunds by TPR and the Government will give significant comfort to many trustees and employers. Despite the risks of going into uncharted territory, these developments open up a wider range of opportunities for many plan trustees and sponsors to secure member benefits within a foreseeable timeframe. While it remains to be seen whether the PSF and/or Clara will need to adapt their models to meet the new requirements under the Guidance before they can start to transact (e.g. whether the early distribution feature under the PSF model can be squared with the requirement under the Guidance not to distribute profits to investors prior to the benefit obligations being bought out), this should soon become apparent now that the light has turned green.

Andrew Murphy
Partner
T +44 20 7785 2708
E andrew.murphy@freshfields.com

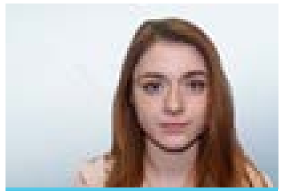
Dawn Heath
Partner
T +44 20 7427 3220
E dawn.heath@freshfields.com

Charles Magoffin
Partner
T +44 20 7785 5468
E charles.magoffin@freshfields.com

Lauren Jackson
Senior Associate
T +44 20 7427 3644
E lauren.jackson@freshfields.com

Tharusha Rajapakse
Senior Associate
T +44 20 7785 2445
E tharusha.rajapakse@freshfields.com

Gareth Davies
Associate
T +44 20 7427 3410
E gareth.davies@freshfields.com



Rose Pollard
Associate
T +44 20 7785 2835
E rose.pollard@freshfields.com

freshfields.com