Pension superfunds: another option for achieving a successful end-game?

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Sponsoring corporates and trustees of UK defined benefit (DB) pension schemes face an increasing number of options to achieve their 'end-game' objectives of:

- fully meeting DB promises to pension scheme members, while
- enabling corporates to remove obligations from the balance sheet in an affordable, timely and reputationally sound manner, agile to overall business circumstances.

Pension superfunds are now firmly on the menu, with The Pensions Regulator (TPR) issuing its interim guidance for superfund operations and approvals.

Rapidly changing business conditions, and worsening pension deficits, mean many sponsors and trustees now need to review and update how best to meet their obligations both to pension scheme members and other stakeholders of the business.

Making the right decision is not easy: while innovative opportunities do exist to achieve end-game goals, many risks remain. Decisions need to be made and implemented based on full information.

As always, a critical factor in decision-making is whether the security (or 'covenant') offered to members' benefit promises is being enhanced by the actions proposed. Sponsors and trustees must be able to evidence and justify their decisions on this basis: covenant-led decision making is key.

Now is the time to update end-game goals and strategies

Things have changed	More options available

Many sponsoring corporates are in a fundamentally different place to where they were six months ago, with changes in business conditions, outlook and focus. At the same time, the funding position of many pension schemes has worsened.

Never before have trustees and companies had such a wide range of options. These choices give trustees and companies more power than before to choose the approach that is right for their particular business and pension scheme members, including (but not limited to):

- Superfunds
- Insurance transactions such as buy-ins, buy-outs and longevity hedging
- Hedging risks using e.g. an investment bank as a counterparty
- Mastertrusts, fiduciary managers, and bundled or unbundled operational consolidators
- Other new structures and products such as 'insured self-sufficiency' and 'capital- backed' journey plans
- Captive insurance approaches

What sponsors and trustees now need to do

1. Sponsors should review their long term objective for meeting and discharging their DB obligations consistent with aspirations for the wider business, and engage with their trustees appropriately.
2. Understand the broad range of options available to enable sponsors and trustees to most affordably and sustainably meet their obligations while enhancing the likelihood of being able to pay full benefits to members.
3. Review the strategies available for achieving that long-term objective. It is helpful to have agreed criteria for testing and selecting particular asset, liability, risk and operational strategies, counterparties and providers.
4. Ensure that protocols are fit-for-purpose between sponsor and trustees for information sharing, decision-making and decision–implementation.
5. Ensure that all decisions and actions regarding pensions management do not just help the sponsor's business strength and sustainability, but are also evidenced as being in members' interests – including that the covenant attaching to pension promises has been sustained and, preferably, enhanced.

More about superfunds ...

What is a superfund?

Pension superfunds (or 'commercial consolidators') are consolidating pension schemes that absorb and combine defined benefit obligations and assets from separate pension schemes into one large fund, generating value through optimised investments, reduced risks and costs, and improved governance.

The value generated through consolidation is used to enhance security and benefits for members and to reward the providers of capital underwriting the benefit promises and security offered by the superfund.

Superfunds enable sponsors to transfer defined benefit obligations off their balance sheet at lower cost than buying out the benefits with an insurance company. They are attractive to sponsors who wish to fully discharge and exit DB benefit provision, but who cannot afford or justify the cost of an insurance buy-out in the foreseeable future.

A transfer to a superfund can take place only if the 'covenant' offered to members is being enhanced. Trustees of a ceding scheme must be confident this is the case in order to give their approval to a transfer.

Superfunds will be attractive to trustees of some pension schemes whose employer is in stress or distress, as they may enable members to receive higher benefits than would be the case should the pension scheme enter the Pension Protection Fund (PPF).

How are superfunds regulated?

Superfunds are occupational pension schemes and are regulated as such by TPR.

The key distinction between a superfund and a mastertrust is that superfunds introduce external capital to replace the pension scheme sponsor who underwrites the benefit promises. The involvement of external capital and the separation of the scheme from the employer have raised questions about how superfunds should best be regulated.

TPR has now released interim guidance on how it intends to regulate superfunds, pending legislation from the DWP.

What superfund options exist?

Currently there are two superfund providers in the market:

- The Pension Superfund, which is looking to manage a consolidated "run-off" pool as an alternative to insurance buy-out; and
- Clara Pensions, which offers a "bridge to buy-out" structure that warehouses pension liabilities for a period of years before buying them out with an insurance company

Others are considering market entry.

What does the guidance mean? What are our predictions?

Pension superfunds will become a viable and attractive option (among others) available in the market to enable employers and trustees to discharge their obligations to pension members while securing better deals for those members.

They represent a better option for members where the security offered by the superfund is greater than that offered by the employer and where that employer cannot afford or justify finding the resources to finance a buy-out to an insurance company in the foreseeable future.

Expect to see an immediate uptake in interest from corporates looking to more affordably remove pension obligations from their balance sheet, and from trustees who are very concerned about the covenant weakness of their sponsoring employer and who view superfunds as a better option than entering the Pension Protection Fund.

The new interim regime provides greater clarity than before on the context within which superfunds are required to operate, specifically covering capital adequacy and profit extraction – and ensuring that people, operations and governance are robust and 'fit and proper'.

Capital providers are now better informed to make decisions as to whether or not to enter the market. The interim requirements, while sensible to protect members' security, will in the shorter-term reduce the extent to which capital is attracted to support superfunds.

So what?

The interim guidance provides much needed clarity to superfund providers, employers and trustees. However, we do not expect a rush of transactions to happen quickly:

- Superfunds and their capital providers must consider how they need to change their business model to reflect the new rules.
- TPR needs to authorise each superfund before it can transact.
- Sponsors and trustees will seek TPR's clearance before agreeing to proceed with a transaction.

In any event, the onus is on ceding trustees to ensure covenant is being improved for their members – this is a non-trivial exercise reliant on a specialist and wide-ranging covenant assessment covering a number of important areas.

Sponsors and trustees should definitely consider the use of superfunds as part of the range of options for achieving end-game objectives in an affordable, reputationally-sound way – and in members' best interests. However, the decisions are not easy and need to be fully-informed, evidenced and justified. The benefits of using a superfund could be considerable but only where the criteria line up.

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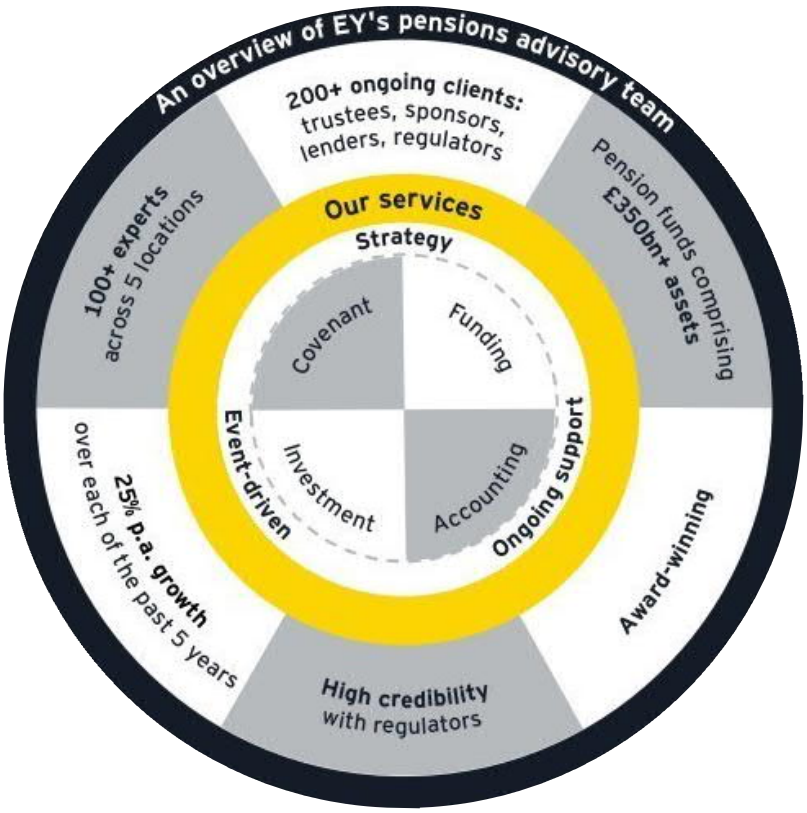

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