Supervision regime for commercial consolidators

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The Department for Work and Pensions' (DWP) recent consultation on defined benefit (DB) commercial consolidators (CCs) set out the framework that it expects to use in supervising CCs. It contained requirements around fit and proper persons, systems and processes, and monitoring and reporting. But the heart of it is the financial regime that the CCs will need to comply with.

What is a commercial consolidator?

It is a pension scheme that takes on the responsibility to provide members' benefits and removes the link to the prior trustees and sponsoring employer in situations where buying out is unaffordable. Over time, multiple schemes will transfer into the consolidator and so they will potentially benefit from economies of scale. Entry to the consolidator swaps the existing covenant for a known monetary amount, with this capital coming partially from investors and the rest from the prior sponsoring employer via a one-off premium. CCs remain regulated by the Pensions Regulator and subject to the PPF. The premium is expected to be lower than for a buy-out.

They are also known as superfunds.

Impact of a high financial target

The tougher the financial target, the more secure members' benefits will be in the CC, but also the higher the premium for entry to the CC. This is critical because those three elements (financial target, security and premium) will define what the CC proposition actually is. It seems tempting to say that the financial hurdle for CCs ought to be high because this will deliver the best security to members.

That is true, but the consequence is that the premium for CC entry will also be high, meaning only a small gap between the costs of CC entry and buy-out. As a result, the target market for CCs would be small; CCs are only appropriate where the employer cannot afford buy-out. Consequently, the amount of CC business will be relatively small if the financial target is high.

Impact of a low financial target

The lower the financial target is set, the greater the market size and also the wider the range of possible business models, but member security moves further away from that provided by insurance companies. Consequently, deciding if the CC covenant is better than the existing covenant becomes more difficult. Modelling can help with this comparison, but there will be things that the modelling cannot take into account, so the judgement of the transferring trustees will be paramount in deciding whether consolidation is in members' interests. And the potential for regret risk becomes greater if, with the benefit of hindsight, it turns out the members would have been better off in the original scheme.

In a Nutshell

The difficulty of the decision on where to set the CC financial security test is underscored by the fact that the consultation puts forward four different models. But one thing that is very clear; you cannot have the security provided by an insurance company for a lower price.