In Touch technical update

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Consolidation of defined benefit pension schemes

- Consultation outlines a new regime to encourage consolidation of schemes

A consultation has been released on measures to support the consolidation of defined benefit (DB) pension schemes, one of the topics discussed in the Government's March White Paper. Views are sought on a legislative framework for authorising and regulating DB "superfund" schemes. The aim would be to protect superfund scheme members in a similar way to those in other DB schemes and ensure that the risks specific to superfunds can be appropriately regulated, with the Pensions Regulator having suitable powers to intervene.

The Government feels that the current legislative framework does not prevent a superfund being set up and used to consolidate other funds. However, it acknowledges the risks if there is no suitable regulatory framework to ensure member protection when necessary.

Basic structure

A basic superfund structure comprises a corporate entity, which is the statutory employer to a DB pension scheme, the scheme itself and a capital buffer.

The capital buffer is furnished by capital provided by external investors and/or a fee paid by ceding employers on entry to the superfund. The buffer may be managed separately to the pension scheme's assets; its structure will be subject to regulatory approval. Trustees will be responsible for the management of the DB pension scheme, but the corporate entity is responsible for the overall management of the superfund. The pension liabilities from the ceding scheme will be transferred to the superfund through the existing bulk transfer process and the link to the ceding employer is severed.

The consultation proposes strengthening the current transfer process by introducing a regulatory gateway to ensure that the decision to enter a superfund is in the best interests of scheme members. The consultation notes that for those schemes and sponsors where there is a realistic prospect of buying out in the insurance market, entry into a consolidator would not be in the interests of the members and should not be available merely as an alternative with lower costs.

It is envisaged that the underlying DB scheme will be classed as an occupational pension scheme and will be subject to the legislation and regulation appropriate to occupational schemes. However, the employer covenant will be replaced by the capital buffer. Members would be eligible for PPF protection. However, a more robust bespoke regulatory framework will be needed to guard against the risks such as the loss of financial support if the capital buffer is exhausted, concentration risk (due to the possibility of a single large scheme failing) and the commercial element (those investing in setting up new superfunds will expect to make reasonable profits).

Authorisation criteria

The authorisation regime will be run by the Regulator and there will be an application fee. The criteria proposed are that the superfund:

- can be effectively supervised: the consultation anticipates that the corporate entity (and any subsidiaries) should be established and administered as a UK corporate body.
- is run by fit and proper persons: this requirement will need to capture all those whose actions have the potential to impact member outcomes, including not only individuals within the superfund, but also those in a position to influence entities within the superfund. The consultation sets out suggested responsibilities that would all be subject to the fit and proper persons requirement, and proposes similar tests to those that apply to DC master trusts, in relation to integrity, conduct and competency.
- has effective administration, governance and investment arrangements: the Regulator will need to assess the governance of the corporate board and trustee body, and member panels should be set up; a 'systems and processes' requirement will be drawn from the master trust

- authorisation regime, and the requirements will be underpinned by a code of practice.
- is financially sustainable: this will be assessed at commencement, and thereafter superfunds will need to continue to show that they meet the requirements and to notify the Regulator if certain events happen. The consultation proposes a framework based on a 99% probability of paying benefits in full, and considers three options for demonstrating this level of confidence: stochastic modelling; a standard long-term objective valuing the liabilities on a basis equivalent to buy-out; and expanding the standard long-term objective by imposing additional minimum standards. A further option is considered based on an insurance-like regime – requiring an annual balance sheet test.
- has contingency plans in place to protect members: there will be a series of underpinning trigger points where funding levels fall below certain prescribed limits, as well as superfund triggering events together with the proposed consequences should funding levels reach the specified levels. The consultation proposes three escalating tiers: a trigger to restrict when profit can be taken either by investors or members; a trigger to prevent new business being written and a trigger to pay any remaining capital buffer into the superfund scheme which will then transfer to another superfund or wind up.

Supervision and enforcement

Adequate supervision is needed to ensure that the Regulator has the information it needs, can identify any emerging risks and can respond to those risks. The consultation suggests setting an enforceable superfund code of practice.

Superfunds will be expected to submit annual valuations and produce quarterly funding updates (notifying the Regulator if the quarterly funding position is likely to have triggered any of the tiered responses referred to above). Additional reporting requirements will be placed on the superfund's corporate entity. There will also be a significant events framework for superfunds to sit alongside the existing notifiable events framework.

Buy-out or run-off?

The consultation asks whether schemes in a superfund should be required to secure benefits with an insurance company at the earliest possible opportunity when funding levels allow, or whether it is acceptable for them to continue to run-off benefits when funding levels would allow buyout to be considered.

Next steps

The consultation runs until 1 February 2019. Many of the proposals would require primary legislation and the Government will seek to legislate when Parliamentary time allows. It acknowledges that superfunds may want to enter the market in the meantime but expects any such schemes to engage with the Regulator and the PPF before doing so, and employers considering a transfer into such a scheme should seek voluntary clearance.

The Regulator has issued guidance for superfunds, and for trustees and employers considering transferring to a superfund, for the period before the authorisation regime is in legislation.

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