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Superfunds

APL and ACA Joint Event 2019

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Superfunds

What are they?

Key features

- OPS set up to effect consolidation of DB pension liabilities
- Link to ceding employer is severed on transfer
- Supported by capital buffer provided by external investors (expecting reward for risk capital rather than as service providers)
- Segregated or non-segregated?

Other models for DB consolidation

- NL – reduced number of schemes by 75% in 20 years
- Canada models – CPP: C$300bn (£203bn); diversified respected investors
- Asset and admin pooling – no change to employer link
- DB master trusts – OPS; commercial operator; TPR regulated; employer link
- Insurers – Solvency II; FSCS; commercial; own capital
- PPF – statutory; capital from levy-payers and transferring schemes

Superfunds

Why consolidate defined benefit schemes?

DWP

- £120bn paid into schemes in last decade but still in deficit
- Significant burden to employers and real economy
- Scheme members exposed to significant insolvency risk of employer

PLSA's findings

- Challenges: underfunding, weak employer covenants, lack of scale
- Gazelle modelling: gilts flat exit premium + PPF asset strategy + 5% capital buffer enhances security to CG1 Levels and secures benefits faster than unconsolidated schemes (20 years rather than 30 years) at materially lower cost than buy-out

Superfunds

Why consolidate defined benefit schemes

DWP – factors expected to improve probability of benefits being paid in full

- Injection of additional funds from employer or parent on entry
- Capital buffer from superfund investors
- Efficiencies of scale offered by a consolidation vehicle
- Absence of potential future sponsoring employer insolvency
- Benefits of scale
  - Cost efficiencies
  - Investment risk spreading and opportunities
  - Pooling and dilution of risks
- Strengthened governance
- Interests of investors and members more evenly balanced, provided the right regulatory regime to deter excessive risk taking

Superfunds

How to transfer to a superfund

Transfer process

- Transfer under trust provisions
- Transfer without consent - reg. 12 – CET and broadly no less favourable
- FAAs?
- Winding-up – transfer to an OPS, personal pension plan or buy-out
- Exit from PPF?
- Reducing and changing benefits – PIEs or hard-coding

Trustee considerations

- Scope of powers
- Best interests of members and beneficiaries – proper purpose principle
- Legitimate interests of employers (MNRPF v Stena Line)
- No duty to adopt most risk free approach

Superfunds

New regulatory regime

Proposals

- PPF levy-proposal
- DWP consultation – December 2018
- Legislation – 2020?
- TPR guidance – pre-authorisation and clearance

TPR guidance

- For superfunds – based on DWP consultation and expected regulation
- For trustees
- For employers – Type A event; apply for clearance

Superfunds

New regulatory regime

The need for new law?

- DWP: current legislative framework does not prevent a superfund setting up and seeking other OPS to consolidate
- Superfunds will be subject to trust law and all regulatory and tax law applicable to other defined benefit OPS including funding and investment regulation
- TPR powers – covers very large associated and non-associated schemes

Different risks

- Expected size
- Rewarded capital and commercial operator creates different conflicts
- Employer covenant replaced by limited capital buffer (no unlimited liability)
- Reliance on modelling and systems (one-off pricing)
- Risk to PPF: risk of irreparable damage re. size and assuming enters PPF when funded below cost to PPF of providing PPF compensation

Superfunds

Guidance for trustees

DWP

- Trustee decision
- Factors for trustees: solvency funding and relative funding and covenant position
- Gateway – exclude schemes within up to 5 years of buy-out and require evidence transaction enhances likelihood of members receiving full benefits

TPR guidance

- Why transfer is best option in interests of beneficiaries vs employer or buy-out
- Rationale and assumptions
- Guidance on covenant advice and actuarial and investment modelling

Superfunds

Guidance for superfunds

Authorisation

- Can be effectively supervised
  - “Corporate entity” (operator) is UK body corporate – UK governance code
- Run by fit and proper persons
  - Trustees and persons responsible for overall management and conduct, NEDs, CFO, CIO, CRO, internal audit and compliance, alteration of trust deeds and appointment trustees
  - Integrity, conduct, competency
- Governance
  - Trustees independent and majority non-affiliated; member representation but no MNTs
- Effective administration:
  - Systems and processes, records, IT, third party providers, risk management processes
  - Continuity strategy re. funding level triggers, withdrawal of authorisation, corporate entity insolvency, investors terminating relationship

Superfunds

Guidance for superfunds

Authorisation - Financially sustainable

- Stochastic modelling demonstrating 99% probability of benefits being paid or secured over lifetime of superfund (at authorisation and annually)
- Note additional options in DWP consultation inc.:

  - common long term objective (97.5% of reaching gilts flat + 7.5% margin by earlier of 2040 or peak cash flow)

  - minimum standards additions (e.g. scheme assets without buffer > 87.5% of authorisation basis, buffer paid to scheme if scheme assets and buffer < 90% of authorisation, annual funding volatility < 5%)

  - balance sheet basis
- Buffer terms: restricted release, risks cannot be increased without TPR reassessment, asset allocation changes require trustee consultation, transfer to scheme on trigger event
- Projections with justified assumptions
- Investment strategy and governance inc. risk budgets, ESG, monitoring and controls
- Comparative modelling re funding, stochastic modelling, risk monitoring, asset valuations

Superfunds

Guidance for superfunds

Authorisation (cont.)

- Trigger funding levels and winding-up
  - Wind-up superfund
  - Buffer transfers to scheme
  - No new business (i.e. no new transfers) – no less than 99% probability of paying benefits
  - Restrict profit (i.e. no distributions/dividends to capital buffer providers) – higher than 99% probability of paying benefits or following buy-out
  - Legally enforceable, appropriate, automatic, suitably defined and permanent, monitored
- Protecting full member benefits
  - Escrow for buy-out
  - Wind-up trigger to transfer to another superfund
- PPF levy proposal
  - Winding-up trigger at 105% of s.179

Superfunds

TPR response to DWP consultation

Beneficial

- Economies of scale and better investment opportunities, esp. for smaller schemes
- Better outcomes for members and improved funding
- With strong requirements, superfunds will provide better protection for members and PPF than remaining in existing DB schemes
- Flexibility to allow innovation without unacceptable risks to members and PPF

Financial sustainability

- Not same standards as insurers as intended for schemes that cannot afford buy-out
- Capital requirements and new powers to monitor:
  - 99% principle - a high bar (further analysis?)
  - Long term objective, minimum standards and safeguards - subject to calibration and simple

Superfunds

TPR response to DWP consultation

Funding triggers

- Minimum periods and intervention powers
- Tier 3 (extraction of profit) – level must balance protecting buffer and need to attract investment capital
- Tier 2 (restriction on new business) – level required for authorisation; query application to segregated superfunds?
- Tier 1 (protecting full benefits)
  - May be very strongly funded and still able to pay full benefits
  - Continuing superfund may provide better outcome than buy-out or PPF
- Wind-up
  - Level to be considered
  - Above level required to meet PPF compensation levels (cost to PPF?)

Superfunds

TPR response to DWP consultation

Authorisation and supervision

- Viable business model, financially sustainable, well governed and high probability of being able to pay members' benefits as they fall due;
- Run by fit and proper persons, with effective administration, governance and investment arrangements and contingency plans to protect members
- Work with DWP to develop regime inc. appropriate reporting requirements

Transactions

- Demonstrate more secure than remaining with employer
- Acknowledge in some cases can be better than buy-out if evidenced
- Gateway:
  - Trustee decision-making should have primacy
  - 5 years is too long – much shorter period for certainty

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