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Government Pushes on with Legislation to Facilitate Defined Benefit Superfunds

The British government has announced its intention to forge ahead with legislation that paves the way for commercial Superfunds. The Chancellor's recent Mansion House Address unveiled this development, underscoring the government's efforts to consolidate defined benefit pension schemes into Superfunds.

Initially proposed in March 2018 (Defined benefit pension scheme consolidation - GOV.UK (www.gov.uk)), the Pensions Regulator established an interim regime to oversee these entities which has, to-date, delivered a limited degree of success. The latest initiative is in response to this four-year-old government consultation.

A CONSOLIDATION STRATEGY

The aim of this consolidation strategy is to provide a safety net for schemes, which despite their inability to fully finance insurance buyouts, have buyout funding levels between 70% and 90%. By targeting schemes with this level of funding the aim is to shield the consolidator regime from excessive risk.

It is worth noting that there is already an approved Superfund – Clara. Clara is open to business and is designed to aid schemes in reaching buyouts. The proposed changes from the interim regime seem however to favour other non-buyout routes, which aligns with the model The Pension Superfund was developing. This should facilitate the emergence of additional Superfunds.

On the subject of applicability to schemes, it's important to note that this isn't a cheaper buyout alternative. If a scheme can 'reasonably' afford a buyout, this route isn't viable: these schemes would not meet the potentially expensive gateway test. As such the superfunds would only be applicable to schemes unlikely to afford buyouts within a reasonable timescale. Our research at Cartwright suggests that 25% of schemes are currently in surplus to buyout, with another 25% that are close enough to buyout that they wouldn't pass the gateway test. However, this leaves 50% of schemes that might consider this route a more beneficial path to enhancing member security.

UNDERSTANDING SUPERFUNDS

As the industry gears up for more detailed future consultations, a Superfund is currently defined by the following characteristics:

1. The consolidation of DB pension scheme liabilities into a single occupational pension scheme.

2. The alteration or severance of the relationship with the ceding employer post-transfer to the Superfund.

3. The substitution of the employer's 'covenant' with a capital buffer, provided by investors behind the Superfund.

4. The capacity to distribute returns to parties other than members or service providers.

The design of Superfunds raises significant questions around whether to segregate individual schemes into self-contained sections with their own capital requirements, or to consolidate all incoming schemes. The Department for Work and Pensions (DWP) has said that they lean towards the coexistence of both models. This is due to the risk mitigation of segregated structures for scheme members and the Pension Protection Fund (PPF), as well as the economies of scale offered by co-mingled Superfunds.

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There are ongoing questions about how much cheaper Superfunds will be than insurers (noting that only Schemes that pass the gateway test will be eligible anyway). While projections range from 5% to 10% cheaper, there isn't any solid evidence to back this up yet. The replacement of Solvency II with UK solvency for UK insurers could also enable bulk annuity insurers to price more competitively, creating another potential headwind for consolidators.

However, with 50% of schemes likely to want to access a buyout within the next couple of years and the insurance market unlikely to meet that demand that quickly, Superfunds could become a viable alternative. It's a situation that's constantly evolving and we at Cartwright are watching closely.

THE SUPERFUND BLUEPRINT

The blueprint for these Superfunds involves their regulation and authorisation by the Pensions Regulator. Superfunds have been functioning under an interim regime since June 2020, a regime currently under review. The authorisation criteria will be applied to the entire Superfund in a segregated model, whereas each section will be expected to adhere to individual capital adequacy requirements.

Other elements of interest include:

1. Regulatory technical provisions for Superfunds should be based on the best estimate of future cash flows, with specific reserves allocated to cover member expenses and protect against adverse longevity trends.

2. The DWP sees a 2% risk of scheme failure within a Superfund as an acceptable level, up from the 1% deemed reasonable in 2018.

3. Superfunds will not be compelled to pursue buyouts with insurers, as deemed by the DWP.

4. Primary legislation will be introduced to establish a compulsory framework for Superfunds, with details fleshed out in secondary legislation, allowing flexibility in changing market conditions and facilitating extensive industry consultation.

Industry insiders are optimistic about the DWP's response to its 2018 consultation, recognising the potential benefits for schemes faced with challenging circumstances. Despite the complexity of these processes, there is confidence that robust industry engagement can catalyse a shift in the DB pension's landscape. It remains to be seen if the Pensions Regulator will update its interim guidance in line with the DWP's vision.

Working with our specialist bulk annuity and superfund broking partner K3 Advisory, we continue to work hard to deliver the advice trustees and sponsors need. In some cases, this might mean assessing the Superfund option against the range of alternatives in order to provide more secure futures for members.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

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