DEFINED BENEFIT PENSION SCHEME CONSOLIDATION

Consultation Response

The Pension SuperFund

Taking care of pension promises

Contents

Introduction

Members can expect to be better off under the Pension SuperFund. And UK businesses will be freed up to concentrate on what they do best, to the benefit of this country and its citizens.

We welcome the opportunity to respond to the consultation. We strongly support the objective of a robust framework of regulation to underpin high standards and ensure that the considerable benefits that superfunds can offer are fairly distributed between members, sponsors and providers of additional capital. **We congratulate the Department of Work and Pensions on the production of an extremely comprehensive set of proposals and acknowledge the significant challenges inherent in balancing diverse views**. We would like to express our gratitude for the depth of research conducted into emerging superfund models including our own, the Pension SuperFund, right from the inception of our concept over two years' ago.

In our response, we have sought to balance the objectives of mitigating new risks (actual or perceived) introduced by business models such as the Pension SuperFund, versus the opportunities for scheme-specific and wider public benefit we create.

Our response is underpinned by our belief that every scheme's circumstances are unique. Any comparison between two covenants, especially when their nature is different, involves some level of subjectivity. **The right and obligation of trustees to exercise that judgement is essential and should not be undermined or reassigned by regulation**.

This response sets out the background and rationale behind our views and proposals, followed by the key issues raised by the consultation for our business in particular, followed by responses to the questions posed by the consultation document.

The Pension SuperFund consolidation proposition is designed to be **complementary, rather than detrimental to the existing pension insurance market**. We fully acknowledge the appropriateness of insurance "buy out" for schemes which can achieve it - we aim to help those schemes and sponsors which current providers cannot reach. We are sure it would not be an intended consequence of policy to reduce the number of schemes and members which can be so helped, by requiring unnecessary replication of insurance features. Indeed, the challenge we were posed at the outset by the Pensions Minister was to design an more affordable, yet still robust pension consolidation model, and that is what we have striven to achieve. On the evidence of recent public and private statements by prominent members of the insurance industry, we believe many of their supposed concerns, whilst they could be seen as protecting vested self-interests, stem from **incomplete or incorrect understanding of our and similar proposals**. We seek to address this directly and rebut some emerging adverse narratives.

The financial cost of recruiting and maintaining a well-resourced, resilient and expert board of trustees, supported by a suitably structured executive team, is greatly diluted in larger schemes. Bluntly put, it is impossible for smaller schemes to support such governance at a reasonable relative cost, yet the task of running such schemes is certainly no easier. We argue that aligned and focussed trustee and in-house resources lead to **better decision making** and hence **better expected member outcomes**. This is the **primary benefit of consolidation**.

Further, the relative impact of a wide range of other costs relating to administering the scheme and managing its assets can be significantly reduced through scale, either because they are (or become) fixed in nature or as a result of increased buying power.

Turning to asset and liability management processes, scale permits **disintermediated access** to asset classes such as infrastructure, avoiding costly fund of fund arrangements and ultimately achieving **better matching of assets to liabilities**. The ability to build well-qualified and specialist internal investment teams can provide very significant net savings against external fees; moreover, in mixed models of internal and external asset management, as adopted by many large international funds, symmetry of resources with external asset managers allows in house teams to exchange **best practice**, work in partnership and **hold external managers better to account**.

While some of the advantages above can be achieved through shared services and other routes, we believe the simplest, **most economical and most effective solution lies in the full merger of schemes**, creating a single pool of liabilities. This allows the resulting diversification of idiosyncratic risks, which have a disproportionate impact on smaller schemes, to simplify the tasks of hedging and matching the aggregate cashflows required to pay benefits.

The Pension SuperFund brings all of these advantages to a wider set of pension schemes than the insurance market currently serves. We start those schemes' new journey at a higher level of funding and so overall improved security for members, by attracting one off cash injections from their current sponsor in exchange for closure of their DB liability; and backstop capital from investors, in exchange for a fair return on that capital. Additionally, as **members share in any outperformance** of our scheme's assets though enhancements to their benefits, we ensure that **all parties interests are fully aligned**.

Background to our response I: The case for superfunds

The UK's existing framework for corporate defined benefit occupational pension schemes ("DB schemes") neither promises nor delivers certainty of benefits except, where relevant, at a level underpinned by the PPF. Further, both statute and case law unambiguously acknowledge the need to **balance the interests of members with the interests of the sponsor**. This results in the both members and sponsor being exposed to risk and uncertainty that are a complex mix of the portfolio risks arising from assets and liability movements and the fortunes of a single operating business or group. We focus our attention on schemes that to a lesser or greater extent are relying on their sponsor to underwrite their asset and liability management (ALM) risks through a series of recovery payments or other means; or, alternatively put, those schemes with disproportionate exposure to a single corporate credit risk.

Arrangements such as the Pension SuperFund seek in the first instance to **apportion the existing risks more efficiently, fairly and transparently.**

The result is that members' exposure is transformed to be predominantly the risk that their scheme's diversified portfolio of assets will be unable to match the promised level of benefits, whereas the sponsor and its owners are left with the uncertainty surrounding the fate of the operating business rather than being co-mingled with pension assets and liabilities. In general, the sponsor benefits from the removal of ALM risk and an ultimately open-ended liability, so we intend that this redistribution of risk is recognised by a significant transfer of resources from the sponsor to the scheme entering the Pension SuperFund.

In the second instance, **propositions such as the Pension SuperFund seek to significantly reduce the *overall* level of risk by introducing new, external capital to the DB system**.

Such capital itself provides a buffer against loss and also creates a further level of surplus of assets above liabilities, enabling the resulting whole to be managed with a lower target level of ALM risk. It is important to note that providers of such capital will need to be fairly compensated for deploying their capital, so proposals such as ours will always seek to achieve some outperformance of assets relative to liabilities. Regulation has a role to play in ensuring this is targeted appropriately.

It is this second feature, **introducing new, external capital** 'today' explicitly to stand behind existing legacy pensions promises, that is **a distinguishing feature of superfunds**.

Beyond that, there is little to distinguish superfunds from the many existing pension schemes. Seeking the benefits of scale, using capital buffers or seeking commercial return from the securing of pension promises are no longer new. Severance of links to the previous employer is also not necessarily a universal feature of the new consolidators; there are a range of options for ongoing links involving limited or contingent liability which we are already exploring

Since superfund arrangements can only be successful at scale, they bring the well-rehearsed and considerable benefits of consolidation in general, as set out in our Introduction.

We believe that the above is wholly positive from a public finance perspective. Provided that the redistribution of risk is done fairly, and in particular, that there is no detriment to members' likelihood of receiving full benefits, **regulation should seek to provide a supportive framework for the growth of superfund arrangements**. Excessive restrictions including attempts to replicate the constraints applying to insurers are likely to strangle innovation, denying many **benefits of consolidation** to all but the best funded schemes and squandering the very real opportunity to **bring more capital into the pensions system**.

In addition to improvements to the situation of pension funds, there are wider benefits to the economy superfunds can offer that should not be overlooked:

- **Businesses can attract long term investment more easily** without the uncertainty introduced by DB obligations; therefore wider access to de-risking is likely to stimulate business growth, jobs and prosperity;
- **Creation of large pools of patient capital**, free to take appropriate levels of risk, will greatly increase the capacity for **UK investment in UK infrastructure**, including housing, since such assets can provide cash flows that are a natural match for the liabilities in question.
- Investors with **long term perspectives** and the **scale to own assets directly or exercise significant influence** over investee companies have both the incentive and the means to advance **impact and sustainability**.

Background to our response II: Contrasts with insurance

We believe that a range of misconceptions have entered the debate around DB consolidation as a result of incomplete understanding of the business models proposed by the Pension SuperFund and others and an erroneous perception of potential competition, together with a concern that unsupervised development of stand-alone consolidators could contaminate the reputation of pensions consolidation, whether under the occupational pension scheme regime or that of insurance.

We are neither offering insurance nor purporting to replicate the same outcomes. Instead, we offer a transparent, but typically **lower level of certainty**, for a **more affordable price** and most importantly an **improvement to members' expected outcomes** relative to their status quo.

We strongly support measures to **ensure the highest standards of governance** in how our and similar arrangements are run. However, as we will discuss when considering a precise **definition of a pension superfund**, there are **more similarities than differences with existing pension funds**., Some of the criticisms being levelled by insurers have the characteristics of a 'slippery slope', likely to apply to all DB schemes unless superfunds are to be irrationally targeted for disadvantageous treatment. UK business would clearly be crippled for a generation at significant cost to jobs and prosperity and the capacity of the insurance market sorely challenged by a requirement for all schemes to insure to full benefits. Indeed the cost has been estimated at some £1 trillion, a sum that would represent an enormous inter-generational transfer to gold-plate the limited downside risks of those with pensions provisions now unavailable to most. Therefore, if the regulations are to be fair and consistent, these arguments must be swiftly addressed and any red herrings mercifully dispatched.

Myth 1: Superfunds are financial institutions using the pensions regime to escape regulation

We do not accept this in relation to our model or any other we have seen.

Firstly, there is **no intent to escape regulation**: we gladly accept the same fit and proper criteria and requirements for systems and controls as any other financial institution might, the only difference being that it is not feasible for the same capital adequacy requirements to apply to pension fund arrangements as do to insurers (something that HMG and the PLSA strongly resisted when considering IORP II).

As with many other large pension schemes with a sophisticated in-house team, where parts of our business engage in regulated activity such as **asset management** or **provision of investment advice**, they will be **regulated by the FCA**. Similarly, the FCA will regulate any partnership of capital providers where such partnerships constitute an alternative investment fund.

We are of course also subject to **regulation by tPR** and a **risk-based levy from the PPF**.

An insurer is a corporate entity under the sole direction of its board with duties under the Companies Acts to maximise value to shareholders. Regulation serves, amongst other ends, to prevent rapacious behaviour at the expense of policy holders. A fundamental difference common to any pension fund is the existence of a trustee board that oversees all operations relating to the scheme and exercises significant control over buffer assets, protecting members' interests. Unless their powers are fettered, they are not independent or they are insufficiently resourced to provide adequate challenge to superfund management or capital providers, **the trustees provide an equivalent, albeit different, tier of oversight and assurance**. TPR's existing powers would allow rectification of any of those caveating circumstances.

In the case of the Pension SuperFund there is **no corporate entity with a profit motive analogous to an insurer**. There is a partnership between Trustees and Capital Providers with an agreed **common objective to secure long term outperformance of assets over liabilities for the benefit of members as well as capital providers**. The partnership establishes a range of companies **exclusively to serve the needs of the pension scheme** and manage the partnership's assets **on a cost recovery basis**. Provided a pre-agreed threshold is exceeded and maintained, distributions can be made to the trust (to enhance members' benefits) and to capital providers as an investment return. The trust is additionally entitled to priority distributions should it fall into deficit. Unlike insurance, where outperformance accrues only to the corporate and never to the members, the Pension SuperFund structure **aligns interests** and **disincentivises excessive risk taking**.

We believe any concerns can be mitigated by a suitable system of regulation to ensure that only those models displaying suitable checks and balances between trustees, investors and management of the relevant entities can become authorised.

Myth 2: Members and trustees will not understand the difference between superfunds and insurers, especially if the superfund is "Authorised"

Putting aside the immensely patronising sentiment, this is easily addressed by an appropriate communication strategy from DWP and TPR and could be supplemented by a requirement of superfunds to ensure they do not hold themselves out as offering insurance as a condition of authorisation.

Myth 3: Superfunds will undercut and damage the insurance market

Whilst we would argue that it should never be the intent of regulation to suppress competition, we believe this is an unfounded fear.

We assume *a priori* that most DB schemes with the resources to buy-out now, or those with a strong conviction that they will be in such a position within a period the trustees deem reasonable, will do so. We do not think it plausible that trustees would take decisions that are, in their assessment, detrimental to members relative to other available options. Although we understand that trust law[1] does not require trustees to adopt the most "risk free" option, we do not think it is likely that trustees would consent to a transfer of liabilities to a consolidator in preference to a buyout solely to reduce the cost to the sponsor, and would never do so unless satisfied that the consolidator provides adequate security for the members and an improvement on members' current position.

The Pension SuperFund is already working with some insurers to consider joint transactions where we expect a joint bid may produce an overall more affordable solution for certain schemes and improve members' expected outcomes. We are aware that at least one other consolidator, Clara Pensions, explicitly targets buyout for sections of its scheme. Although our objective of long term self-sufficiency at scale is different, we have already mooted proposals where a partial buy outs or buy ins are an attractive risk management option, as would be the case with any standard DB pension scheme. Additionally, we have already encountered instances where trustees have considered consolidation only to conclude that they can in fact afford insurance buyout in part or in whole. In summary, we believe **the emergence of models such as ours will on a net basis be positive for those pensions insurers** that embrace the opportunity to work with emerging superfunds.

The involvement of the insurance market in pensions as buy-out providers for self-administered occupational pension schemes is relatively recent, having expanded very materially over the last 10 to 15 years in light of regulatory changes and the closure of defined benefit occupational pension schemes. While the insurance market has provided an excellent solution for maturing, closed occupational pension schemes, we do not think there is any reason of principle to restrict the development alternatives or treat occupational pension scheme liabilities as "reserved" for the insurance market. It should be noted furthermore, that many DB pension funds continue to accrue liabilities, and it would be perverse to deny such funds the opportunity to enjoy the benefits of consolidation should they not wish to shut off their members from their pension benefits.

Myth 4: "Insurance-lite"

No pensions are guaranteed to total certainty. Whilst the prospect of individuals suffering reductions in their expected benefits is appalling, it is a risk common to all such promises. The object of pension fund consolidation is to **improve member outcomes** including **reducing, but not eliminating this risk**.

Insurance, as its name suggests, promises something close to certainty and insurers hold considerable amounts of capital in support of this. However, insurers can and do fail – an inevitable consequence of taking ALM and operational risks over the long term. In such instances, the insurance industry through the FSCS and the auspices of the PRA, stands ready to meets the obligation in order to maintain consumer confidence in the integrity of the insurance promise, though in

[1] As confirmed in *MNRPF v Stena Line* [2015]

some countries such mechanisms have proven inadequate in the recent past and governments have had to step in.

Returning to the balance between member and sponsor interests, moving pensions towards a similar arrangement to support full benefits through some sort of cross guarantee between all employers with DB schemes would hardly balance interests; indeed, it would be extremely unfair to the shareholders and current employees of surviving sponsors. The PPF and its industry-wide levy provide a different type of backstop. **Since superfunds are firmly intended to be pension fund solutions, it does not seem reasonable that they should be subject to additional constraints modelled on insurance which do not apply to other pension schemes**. In fact, this increases the blurring of lines and risks creating confusion.

Key Issues for the Pension SuperFund

Partnerships

A requirement for entities providing services or key decision making to be UK-based and a limited company is workable. The outright preclusion of UK-based partnerships within the overall financial structures is problematic and in our view is **likely to increase the risk of superfunds' arrangements constituting contracts of insurance.** Moreover, it would be perverse to **jeopardise the protection of capital providers** from liability in excess of their initial commitment, something that has proven **essential to raise new risk capital** for the pensions system, whether in the insurance or pensions regimes.

This is a key issue for structuring the ownership and control of buffer assets: partnerships are a natural vehicle for shared risk and control; moreover, the conceptual heart of our proposition is a partnership between the scheme's trustees and providers of capital to hold buffer capital and create and own a set of companies that will efficiently deliver first class administration and ALM, with the proceeds of any outperformance above a prudent threshold being shared by both members and capital providers.

- The **use of Scottish Limited Partnerships is well established within UK occupational pensions** as a means of structuring Asset Backed Contributions. We see **no justification for superfunds to be subject to less flexibility** in structuring.
- New regulation or clarification of the TPR's existing powers can impose the desired and appropriate high standards of transparency and governance on all structures connected with a superfund's operation, without specifying the legal form of entities and risking **unforeseen complications or barriers to innovation**.

Gateway

We believe the **fundamental question** is whether a transfer to a consolidator will result in an **improvement to members' current position**. Linking the "gateway" to uncertain prospects of buyout may give the appearance of a state carve-up, **legislating in favour of one economic interest group** (insurers) and contradicting the existing body of UK case law by imposing a new duty for trustees to seek a minimum risk solution rather than the much more nuanced range of options available to them.

- We argue that **these provisions are unnecessary** in the context of trustees' existing powers and responsibilities and constitute an **unjustified restriction on trustee and sponsor discretions** about how to give effect to the employer's pension promises, ensure the benefits get paid or are consensually varied. Trustees are already bound to seek the best outcome for members, balanced against their duties to the sponsor as required by the relevant Trust Deed and Rules and general trust law, having regard to all the circumstances. Repeating an earlier point, we do not think it plausible that trustees would consent to a transfer of liabilities to a consolidator in favour of buyout solely to reduce the cost to the sponsor, unless satisfied that the consolidator provides adequate security for the members, nor would trustees take decisions that are, in their assessment and having regard to all relevant matters in accordance with their trust law duties, detrimental to members on a risk-adjusted basis relative to other available options. Trustees cannot be fettered in their duty to seek the best outcome for their members rather than the least risky option.

- We believe the object of regulation should be to ensure that
  - **trustees' decisions are taken properly** and with regard to appropriate advice where required;
  - **superfunds adhere to the highest standards of transparency** so that trustees and their advisors cannot be misled in respect of the risks inherent in each superfund's model; and
  - **there are sufficiently robust checks** on a consolidator to prevent those risks being materially altered post transfer.

- **5 years is far too long a window** for any such assessment, pushing the prospect of buyout firmly into the hypothetical. Inevitably, there will be sponsors that collapse within such a timescale, leaving members contemplating a haircut to benefits when they might have been transferred earlier to a successful superfund. We do not think such periods should be defined by regulation.

- Thought must be given to the interaction of the any gateway provisions on PPF+ cases, where consolidator-based solutions may offer higher benefits (albeit at lower certainty) than insurance solutions. In these circumstances, that balance is certainly something **trustees and their members may legitimately wish to consider**. A gateway should not preclude this.

Capital Adequacy

Capital adequacy constraints are a legitimate area for intervention given the risk that failing superfunds may result in a significant transfer of assets and liabilities to the PPF alongside potential cuts in member benefits. However, we believe any such limits **need to be significantly below the capital requirements for insurers** to enable a range of materially more affordable solutions to be made available to the greatest range of schemes. As above, we believe **ensuring transparency around risk with is a greater priority than imposing specific limits**.

- Subject to a fundamental policy decision on **a "floor" set on a common valuation basis**, we believe that the other triggers should be **a matter for each**

consolidator to set, subject to review by TPR during the processes of authorisation and supervision, and that these parameters should be **clearly communicated** and made available to trustees contemplating a transfer into that consolidator.

- Any assessment of capital adequacy or a system of limits must take account of investment risk, or more precisely, the expected **tracking-error of assets relative to liabilities**, to be meaningful. We note that the PPF has already created a framework for assessing these risks in the course of developing the Levy framework for superfunds; and we would urge convergence of approaches.
- If a balance sheet / ALM stress test approach is adopted, this should not simply be a watered-down version of Solvency II as this will lead to yet **more investors chasing the same limited pool of assets**, to the detriment of all except the issuers of such rated debt instruments. **Penalising illiquid asset holdings is inappropriate** and places superfunds at a disadvantage to other pension schemes in self-sufficiency run-off, as well as ultimately limiting availability of capital for UK infrastructure.

Responses to Questions

Question 1: Are these characteristics wide enough to define a superfund? If not, how could superfunds be defined for the purposes of a future regulatory regime?

We agree the characteristics are likely to apply to many superfunds though as previously discussed, severance of an employer link may not be essential. For instance, sectionalised models are foreseeable, where an employer link is maintained until funding has improved to a level where the section can prudently be transferred to the buffer-supported superfund section with no link to the previous employer.

The characteristics also apply in various combinations to many pension schemes, especially DB master trusts, schemes with significant dependence on escrow or ABC arrangements, and well capitalised schemes and/or sponsors where the sponsors current turnover is negligible. As noted, there is nothing about proposals such as the Pension SuperFund that are inconsistent with current legislation therefore the envisaged schemes are essentially standard in nature. The key distinguishing feature is the introduction of external capital on a rewarded basis (although of course there are already pension funds with borrowings).

We would prefer the wider definition of "DB Consolidator" for any arrangement meeting the first definition (so capturing both arrangements like ours and DB master trusts) with the subcategory of "Authorised DB Consolidator" (ADBC), being DB consolidators that have applied for and obtained authorisation. Authorisation could be required to accept transfers where such a transfer results in a replacement of a link to the ceding employer link with a capital buffer only, although we see no robust reason why the origin of that buffer should matter.

Light touch regulation of transfers to "Authorised" DB consolidators could then be permitted. **This will be crucial to keeping the cost of decision making down, since overly onerous requirements will price smaller schemes, i.e. those with the most to gain from consolidation, out of the opportunity.**

As occupational pension schemes and as registered pension schemes, such schemes will be bound by existing pension scheme regulation in addition to the new regulatory requirements.

Question 2: Given the differences of superfunds and traditional DB occupational pension schemes, what are the additional risks and challenges associated with TPR regulating superfunds?

The key difference is that employer support and risks relating to trading employer are removed (or reduced) and that instead the scheme has access to a capital buffer and may attract further capital based on its ability to provide a return directly or indirectly to the providers of that capital. Therefore, <u>additional risks and challenges</u> arise from this difference just as <u>others are removed</u>: employer insolvency risk is removed, leaving only funding risk.

The scheme may have access to new capital but there is a risk that access to new capital will not be available if returns or the expectation of returns are restricted.

Returns are linked to funding risk, scheme management and regulatory requirements.

The key additional challenge is ensuring returns to capital do not increase funding risks above acceptable levels and that funding strategy and scheme management and administration do not restrict returns or expose committed capital to unacceptable risks or limit ability to attract further capital to ensure success of consolidation.

The risk of conflicts between capital providers and members is similar to the risk of conflicts between employers and members in "conventional" occupational pension schemes. It can be **managed by shared powers between the scheme operator or sponsor, the capital providers and trustees** and by **pre-defining acceptable levels of funding and investment risk and conditions for increasing scheme liabilities and paying returns to capital providers**.

Although the Pension SuperFund and other new ADBCs may have unique features that TPR will need to understand in the course of authorisation, these are likely to be no more complex than existing ABCs, escrow arrangements or contingent assets. We ultimately believe that the ongoing supervisory task will be very similar to any other large scheme, and the reduction in the number of schemes as a result of transfers into ADBCs will be positive from a regulatory burden perspective.

Question 3: Are the proposed authorisation criteria the right ones for the superfund regulatory regime?

Yes. We enthusiastically support these.

Question 4: Are there any circumstances in which it would be advantageous, or necessary, that the authorisation criteria are not applied to the whole superfund but instead to individual segregated sections when the superfund scheme is sectionalised?

Yes. We have already discussed the possible scenario of sections retaining a sponsor link and hybrid DB master trusts. Another is a section for liabilities fully covered by "buy in" contracts. These should clearly not be subject to capital adequacy requirements in the same form as those applying to sections relying on buffer capital only.

Our inclination is that governance and systems and control requirements should be assessed across the whole operation, however this does beg the question as to why these enhanced governance provisions proposed for superfunds/ADBCs ought not apply to all DB schemes and certainly other DBCs.

Question 5: Are these restrictions the right ones to ensure that superfund corporate structures are transparent and compatible with regulatory supervision? Are there any other measures that would aid TPR's ability to supervise superfunds?

While paragraph 32 of the consultation's assertion than superfund structures have the potential to be complex, we think in most cases this will be no more so than the arrangements surrounding existing ABCs or private asset holdings of existing pension schemes. Nevertheless, we agree that TPR must have the ability to demand any and all structures and documentation relating to the governance or operation of ADBCs, therefore relevant entities, or at least the assets of these must reside in jurisdictions where such powers are enforceable.

We are unclear what the rationale would be not to allow Scottish limited partnerships within the governance or support structure of a defined benefit consolidator and view this with very considerable alarm. These are used for asset-backed contribution structures for "conventional" occupational pension schemes. We view the fact that insurers cannot be partnerships as irrelevant since ADBC are not insurers.

We agree scheme, trustee, capital buffer and all entities involved in governance of the scheme should be UK resident or possibly resident in jurisdictions with clear links to the UK such as the Crown Dependencies.

Question 6: Should the corporate entities of superfunds be permitted to be established as partnerships or should they be required to be set up as a UK limited company?

This is critical to the commercial feasibility of ADBCs, or at least those following a model similar the Pension SuperFund. If the capital buffer is in a UK limited company, there may be no solution to ensure both limited liability for investors and to ensure the arrangement is not insurance business.

The reasons for any restrictions should be clear. Regulatory restrictions limiting innovation should not be added without a clear rationale (it would be contrary to Red Tape Challenge and risk-based and principles-based regulation).

It is important to be clear about what is referred to as "the corporate entities of superfunds":

- The defined benefit consolidator itself will be a **trust** and will therefore have a trustee which will need to be UK resident, but which may not need to be a limited company. As such, the consolidator itself will not be a partnership or a UK limited company or other corporate entity (because it will be a trust).
- Most defined benefit consolidators are likely to have a **statutory employer** which will need to be a UK limited company to ensure straightforward access to the PPF (ensuring there can always be a clear qualifying insolvency event), albeit this is not necessary and limited partnerships in particular are clearly provided for.
- They will also have a **scheme operator** who may be separate from the statutory employer. Provided it is a UK entity or person that can be regulated by the Pensions Regulator, there is no particular reason for the scheme operator or strategist to be a UK limited company rather than a partnership or limited liability partnership or trust or indeed an individual. The individuals forming part of the governing body should be identifiable to ensure they can be assessed on "fit and proper" terms. This is no different to a DB master trust.
- There may be separate or external service providers. This is no different to a DB master trust or other occupational pension schemes.
- The capital buffer will be held separately from the defined benefit consolidator itself and may be separate from the statutory employer and/or scheme operator. Provided the trustees have sufficient access when required, there is no requirement for the capital buffer to be held by a UK limited company. It may not be possible to provide a capital buffer providing appropriate funding protection and an appropriate returns mechanism for external investors without a Scottish limited partnership. The reasons for prohibiting the use of a Scottish limited partnership should be clear as this may be critical at least to some models (including the Pension SuperFund). They are used by

conventional schemes for capital buffers and there should be no difference in treatment.

- It could be efficient for defined benefit consolidators to participate in investment partnerships investment trusts or other investment structures with other occupational pension schemes, including master trusts and other consolidators. There is no particular reason for additional restrictions on the form of any such investment vehicle over and beyond existing pensions and investment regulation. This is no different to conventional schemes and DB master trusts.

The Pensions Regulator would not need to supervise such investment vehicles or indeed capital providers to the consolidator provided it can supervise:

- the trustee;
- any other persons directly involved in the governance of the consolidator (e.g. in the role of a principal employer including the right to exercise powers under the trust); and
- the capital buffer. It is difficult to see why the buffer fund could not be held within a trust or a partnership (e.g. Scottish limited partnership) provided it is UK based.
- We note that any such trust would need to be approved by HMRC and that the buffer fund, if combining the interests of several capital providers and possibly the pension trust of the ADBC, is likely to constitute an investment fund and so be subject to FCA supervision and authorisation.

Question 7: Should TPR have a discretionary power to require evidence that individuals outside the superfund structure meet the fit and proper persons requirement?

Clarity over the "superfund structure" is required: the trust, the trustee, the statutory employer, the scheme operator or strategist (if separate), the capital buffer.

Persons involved in the governance of the ADBC should be fully accountable for its governance and therefore other persons who are not involved in such governance should not need to be regulated and therefore do not need to be fit and proper. There should be clear delineation of who is or is not involved in the governance of the ADBC.

The key difference with conventional schemes and DB master trusts is the form of covenant/capital support. There is no reason to extend the fit and proper requirements for defined benefit consolidators as compared to any other occupational pension schemes.

Question 8: Would these requirements be sufficient to allow TPR to identify those subject to a mandatory fit and proper persons requirement?

Yes.

Question 9: Should TPR have the power to interview individuals for the purposes of the fit and proper persons test?

Yes

Question 10: Are there other areas that should be included as part of the mandatory fit and proper persons requirement?

No

Question 11: Would introducing a set of standards of conduct for the superfund's corporate board be proportionate?

Any proposed standards of conduct should be consistent with applicable trust law or corporate law and directed at fitness and propriety for the role assumed by each individual (i.e. whether involved in the trustee body or commercial operation of the consolidator or of any buffer fund or investment vehicle).

Question 12: What in your view should form the basis of any standards of conduct?

It is important not to confuse the role of the commercial operator of a consolidator or its sponsor with the role of the trustee. There is a body of law defining the roles and how each should act and what is relevant to their decisions. This should be used as the basis of any standards of conduct and, to ensure proper checks and balances, roles should not be confused. In particular, the holder of the capital buffer may have duties to investors as well as to the trustee and may have no duties to members. Treatment of members should not be a relevant criterion for such person (as it will have no dealings with members) but integrity and competence should be fundamental.

Question 13: In your view, are there any other elements that should form part of a potential integrity test, conduct requirement or competency test?

Any test of "fit and proper" should be relevant to the role.

Any integrity, conduct or competency test should be relevant to the role assumed. There should be no irrelevant criteria. Subjective criteria should be avoided. All supervisory processes, including the rationale for any criteria used and the evidence required, should be transparent and TPR's assessment should be subject to review through the courts.

Question 14: Should there be a minimum requirement on the proportion of independent NEDs on the superfund's corporate board or should this be left to TPR discretion? If so, what would be a suitable proportion?

The Pension SuperFund intends to appoint NEDs to most of its key corporate entities, but it is not clear why NEDs are required for the board of either the scheme operator or sponsor or the capital buffer. They are not a requirement for DB master trusts or conventional schemes even of similar size. A NED requirement could be added for bodies involved in the governance or administration or capital buffer of an occupational scheme above a £ size by assets, but otherwise there is a very significant risk of overburdening the scheme with costs. We feel it would be inconsistent with other areas of corporate law to prescribe a particular proportion.

Question 15: Should superfund trustee boards consist entirely of independent trustees?

Not necessarily, although the Pension SuperFund has adopted this model. There are several concepts of independent trustee in pensions legislation, however, we believe no trustees should have a financial interest in the scheme, its sponsor or buffer capital, beyond their agreed remuneration.

Some flexibility may be desirable as schemes may accidentally fall within the definition of a DB consolidator (as the definition is proposed) and this could result in the forced removal of trustees or breach if the trustees are entrenched, e.g. as MNTs or under existing scheme rules.

We see no reason for difference with DB master trusts in this regard.

Question 16: Should there be a non-affiliation requirement for the appointment of trustees to a superfund's trustee board?

Not necessarily. Trustee independence is likely to be sufficient.

Trustee accountability and adequate provision for the removal and replacement of trustees who are or may be failing in their duties or fail/cease to meet fit and proper requirements should be included will be essential, as for DB master trusts.

Question 17: Should superfund trustee boards be subject to the MNT/MND requirement?

Not necessarily (the Pension SuperFund adopts a fully independent trustee board), so there is no reason for MNT/MNDs to be proscribed. In models where they are present, we believe they should meet the same fitness, qualification and propriety standards as other trustees.

Question 18: Should superfunds be required to establish member panels? Would such panels be an effective and proportionate way of ensuring that members' views are represented?

The Pension SuperFund favours this approach but sees no reason for requirement. Issues are no different to DB master trusts and industry-wide schemes or other large schemes without MNT/MNDs.

Question 19: In your view, would the areas outlined in this section enable TPR to assess the effectiveness of a superfund's systems and processes? If not, what alternatives would you propose?

Yes.

Question 20: Are there other areas that should be included as part of the systems and processes requirement for superfunds?

The proposals are comprehensive.

Question 21: Should superfund financial adequacy be regulated through a pensions-based funding requirement approach with an added test of probability of success or an insurance based approach using a Solvency II type balance sheet?

Our preference is for a pensions-based approach, ADBCs being pension schemes. We see little justification for applying Solvency II type balance sheet to an occupational pension scheme. The purpose is to enable consolidation of pension schemes as pension schemes within the current regulatory framework that has been designed for that purpose.

As we have highlighted earlier, it is desirable to draw sharp distinctions between ADBCs and Insurers. A Solvency II based approach may incentivise further competition for the same types of asset, driving up prices and reducing risk-adjusted returns for all.

Question 22: Which of the suggested models would best ensure appropriate financial adequacy, and balance the interests of the various parties? Are there elements of other options that you think should be combined with your preferred option?

We believe each ADBC should set its own capital adequacy basis supported by appropriate financial modelling to support an assessment of funding level outcomes over a period of time in the range of 10-20 years, since further extrapolation is likely to be of very limited value. Triggers should then be set with reference to this basis, and in the case of minimum funding, linked to valuation of PPF benefits for the scheme.

- We believe the method should meet the following requirements:
    - Be simple and cost-effective to apply
    - Be simple and easy to understand (e.g. for lay trustees considering a transfer to a consolidator)
    - Strike a balance between member protection and commercial viability of the consolidator
    - Reflect the level of risk being run by the consolidator (particularly investment risk relative to liabilities)
- Any model should be considered in the context of the actions that would follow if the financial adequacy level was breached (and not corrected). These are as follows:
    1. Prevent distributions of capital from the buffer fund to investors
    2. Prevent new schemes being taken on
    3. Transferring control of buffer assets entirely to scheme trustees
    4. Wind-up the scheme

We would suggest that regular intra year monitoring with annual review based on independently certified valuations and review of ALM assumptions would justify a 12month forward look approach to setting limits.

A generalised version of the Pension SuperFund's approach would be as follows:

A capital adequacy basis (CAB) is set pre-authorisation, being a prudent self-sufficiency estimate, e.g. G+0.25%

A maximum ALM outperformance objective should also be set – for example outperformance of assets over liabilities by 2% together with the expected tracking error commensurate with achieving this. The modelling and assumptions would be reviewed by TPR pre-authorisation, ideally linked to the PPF levy assessment.

Define the desired confidence interval for limits to be sufficient – for example 99%

The limits will follow sequentially

- Limit 4 is the regulatory minimum funding expressed in the CAB e.g. 90%
- Limit 3 is the higher of 100% on the ADBCs TPs (if different from the CAB) or the level of funding providing confidence that Limit 4 will not be hit in 99% of circumstances
- Limit 2 must be at least the level of funding providing confidence that Limit 3 will not be hit in 99% of circumstances (in practice, the market is likely to impose a higher threshold, based on what is attractive to trustees)
- Limit 1 will have been set to ensure Limit 2 will not be hit in 99% of circumstances, with regard to the maximum ALM outperformance objective.

The analysis would look something like the following table:

Minimum funding levels in 12month at 99% confidence

	Target Return	0.4%	0.8%	1.2%	1.6%	2.0%
	Tracking Error	1%	2%	3%	4%	5%
Initial Funding (CAB)	120%	118.0%	116.0%	114.1%	112.1%	110.1%
	115%	113.1%	111.2%	109.3%	107.4%	105.5%
	110%	108.2%	106.4%	104.6%	102.7%	100.9%
	105%	103.3%	101.5%	99.8%	98.1%	96.3%
	100%	98.4%	96.7%	95.1%	93.4%	91.7%
	95%	93.4%	91.9%	90.3%	88.7%	87.1%
	90%	88.5%	87.0%	85.5%	84.1%	82.6%

- Limit 4 is the regulatory minimum funding expressed in the CAB e.g. 90%
- Limit 3 is c. 100%
- Limit 2 is c. 110%
- Limit 1 is c. 120%

This approach allows for dynamic adjustment of risk and corresponding limits as funding levels fall.

NB – table data are illustrative.

Question 23: Does a 99% probability of paying or securing members' benefits over the lifetime of the scheme adequately protect members' benefits, and effectively balance the competing priorities of employer affordability and member security? If not, what would an appropriate probability be, and why?

The 99% lifetime measure is not practical, technically being a much higher hurdle than current insurance capital adequacy. We note it is possible to construct long term models that provide this level of confidence over 20-30 years, if success is defined as reaching the end of the period without hitting a wind up trigger set close to a §179 valuation. However, the value of the insight provided by such models is deeply questionable, given the potential impact of unquantifiable risk and/or model idiosyncrasies over such long periods. However, suspending such reservations, the necessary level of capital and therefore required price is in any case very close to buyout estimates, so there is insufficient 'clear water' to create a vibrant and stratified consolidator market able to bring consolidation to the widest audience.

We return to the view that the important thing at the point of a potential transfer is for trustees to decide **whether the ADBC offers an improved probability of paying full benefits than the current sponsor**. Stochastic modelling has a valuable role to play in this assessment but is a matter for trustees and their advisors rather than for regulation. The binary nature of employer failure and the fact that this is not a probabilistic event, but rather a business decision driven by a range of complex exogenous and uncertain factors means that a fully like for like comparison of consolidator risk versus the status quo can never be achieved. We return to the element of subjective judgement, which is trustees proper right and duty under trust law.

However, if a limit were to be set in this way, a wider margin for uncertainty would be desirable, with regard to the probability of a typical scheme being able to deliver full benefits, which the PLSA's DB Taskforce estimated as follows:

FIGURE 13: ESTIMATED MEMBER BENEFIT LOSSES ON DEFAULT

	ESTIMATED BENEFIT LOSSES ON DEFAULT	PROBABILITY OF DEFAULT	PROBABILITY WEIGHTED BENEFIT LOSSES
CG1 Strong	11%	6%	1%
CG2 Tending to strong	14%	20%	3%
CG3 Tending to weak	16%	40%	7%
CG4 Weak	19%	65%	12%

Question 24: Should a superfund have a long-term objective to secure benefits with an insurance company?

No.

It is inappropriate for legislation to mandate a commercial transaction which transfers trust-based pension assets to corporate profit (through the insurer's premium). It is also impractical as the pricing and capacity of the (still relatively new) pensions insurance market has already been seen to be volatile. Moreover, it would place a fundamental restriction on ADBCs that does not apply to other DBCs or pension schemes with similar characteristics.

Finally, it is invidious to proscribe members' opportunity to enjoy higher benefits in order to favour the insurer's profits, let alone sacrifice the wider societal benefits of the ability of the Pension SuperFunds to invest into real assets and real businesses to move to the constraints of Solvency II and the potentially illusory safety of the crowded trade of rated debt.

The trustees of the ADBC would be free to consider this option in whole or part as circumstances allow, and the Pension SuperFund would expect to make use of such transactions where prudent to do so. In particular, should run-off reduce assets and liabilities to a level where the Pension SuperFund was uneconomical to run, we would expect to investigate insurance or transfer to another consolidator, as the future of the market then allowed.

Question 25: Is the proposed authorisation basis suitable for this purpose? If not, what basis, if any, would you propose for this purpose?

Our work suggests the proposed authorisation basis exceeds current buyout cost. If an authorisation basis is to used, we think that it should be calibrated with regard to prudent self-sufficiency rather than a theoretical cost of insurance. Gilts + 75 basis points may be more suitable as a floor, although this suggestion is made with regard to current market conditions. For maximum flexibility we argue that, subject to a floor, each ADBC should propose its capital adequacy basis with triggers set out per Diagram 4 of the consultation expressed, with limits expressed in that basis. TPR should assess the reasonableness of these as a condition of authorisation and could further insist that the individual fund's basis and triggers can only be altered with regulatory approval.

With such assurance that an individual ADBC's triggers are not subject to manipulation, trustees and their advisors can properly assess the risk profile and make the crucial assessment of whether this represent and improvement for scheme members.

We would always favour wider limits to broaden the scope of schemes able to afford ADBC entry.

Question 26: Is a 97.5% probability of being 100% funded on an authorisation basis by the earlier of 2040 and the date the scheme reaches its estimated peak cash outflows consistent with the principle of a superfund having a 99% probability of paying or securing members' benefits at all times?

We do not think this is a suitable approach and is at odds with the treatment of all other schemes. The question illustrates the difficulty of comparing different assessments and care must be taken to avoid creating tiers of overlapping restrictions resulting in a narrow or non-existent feasible region of operation.

Question 27: Is the earlier of 2040 and the independently assessed point at which the superfund's membership reaches peak maturity a reasonable target date?

We do not favour this approach but would suggest peak cashflows is logical. There is no strong rationale for a 2040 'long stop'.

Question 28: Are the additional minimum standards in (iii) needed, in order to ensure a high level of protection for member benefits? In particular, are the additional minimum standards (that the superfund scheme itself is funded to 87.5% on the authorisation basis) required for every scheme entering a superfund?

We see no relevance in any restriction on the schemes transferring in, *per se*. The trustees of the ADBC will need to ensure that overall impact of any incoming scheme does not lead to dilution of the overall existing ADBC funding level (including the buffer), but they are likely to be ambivalent to the proportion of assets coming from the transferring scheme versus the capital provided in investors: only the total matters.

The significance of whether assets sit in the scheme or in the buffer will vary from model to model; we do not think new conditions are required in regard and could lead to unnecessary consequences. In all cases, the ADBC scheme will need to remain fully funded on its technical provisions (TPs) or else a recovery plan will need to be agreed – in a closed system (we assume the ADBC sponsor has no business unrelated to the ADBC) this can only be resolved by some transfer from the buffer or increase in ownership of the buffer by the scheme. TPR has existing powers to intervene in matters of recovery plans and setting of TPs.

Question 29: Should superfunds be required to publish an annual balance sheet using market valuations and including liabilities valued on a buyout basis together with a buffer fund based on the Solvency II approach?

ADBCs will need to maintain regularly updated records of assets and liabilities on a range of bases in order to facilitate the assessment of their financial strength by trustees of incoming schemes and their advisers.

Transparency will therefore be a business necessity as much as a desirable regulatory outcome.

We would contend that the relevant measures of funding are the ADBC's capital adequacy basis, scheme TPs (if different), authorisation basis and the basis used to determine the minimum funding trigger.

Current insurance pricing (which is subject to volatility and hard to measure as price discovery is only truly possible through transacting) and a Solvency II approach should not be considered, let alone mandatory. It was reported that the cost to the UK insurance industry of adopting Solvency II was of the order of £3 billion, in terms of models and processes, so we can see why the insurance industry would like to amortise that cost and create a high barrier to entry into an essentially closed shop.

It is important in our view to bear in mind that ADBCs will mainly be 'closed systems' – without employer links, there is no source of income other than return on scheme and buffer assets. All costs borne therefore reduce members security and should be minimised. Only absolutely necessary information should be mandated.

Question 30: Should superfunds be required to secure benefits with an insurance company as soon as practicable, once the scheme assets reach the buyout level of liabilities?

No.

ADBC trustees should not unreasonably be prevented from so doing but nor should their discretion be fettered. In such a condition of surplus, they would have other choices available, such as enhancing members' benefits.

Repeating an earlier point: It is inappropriate for legislation to mandate a commercial transaction which transfers pension assets to corporate profits (through the insurer's premium). It is also impractical as the pricing and capacity of the (still relatively new) pensions insurance market has already been seen to be volatile. Moreover, it would place a fundamental restriction on ADBCs that does not apply to other DBCs or pension schemes with similar characteristics.

Please see also Question 63.

Question 31: Should superfunds be required to maintain a minimum level of scheme funding regardless of approach to financial adequacy? This could include a separate long term objective for the superfund scheme itself to reach a buyout level of funding but to a lower level of probability than the superfund as a whole?

No. This is unnecessary complexity and could legitimately vary between ADBCs, depending on their structure.

In the Pension SuperFund's case, scheme assets will be capped at the higher of 100% of liabilities on scheme TPs or 100% on our capital adequacy basis (a contractual obligation used to set thresholds for transfers to and from the buffer and eventual release of capital to investors and members), so any other long term objective would not make sense.

In practice, we cannot see how any model could sustain a scheme deficit on scheme TPs so this is likely to be a de facto minimum funding. We would expect any proposed minimum TPs applied to schemes in general to apply equally to ADBCs.

Question 32: Is the failure test in relation to the PPF funding level proportionate and what probability of failure is acceptable?

We do not agree with such a test and view it as unnecessary assuming there is a wind-up trigger set with reference to PPF funding in order to **mitigate against the risk of loss to the PPF**, as opposed to risk of entry into the PPF, since the risks of the latter are already accounted for through the PPF's risk based levy for consolidators.

The wind-up trigger could be set on a basis with reference to prevailing PPF TPs rather than §179.

The probability of failure is a function of investment risk and current funding, so is already addressed by the PPF's consolidator levy.

Question 33: What powers should TPR have to intervene should a funding level trigger be breached?

In the first place TPR could remove or suspend authorisation to prevent new schemes transferring in. Existing intervention powers are likely to be sufficient for any further action.

Question 34: At what level above fully funded on the S179 basis should the winding up trigger be set?

We think that 102-105% of the reference basis should allow sufficient margin for wind up costs.

Question 35: Is three months an appropriate period of grace to allow for any volatility in investments to recover before triggering a wind up?

The grace period should be a function of the margin above PPF funding and the current level of investment risk. For 105% we think a longer grace period is appropriate, such as six to twelve months. It is worth noting that in the last financial crisis certain insurers were granted a significant grace period to execute a recovery plan.

Question 36: Is this minimum funding level trigger sufficient to provide adequate protection for the PPF while mitigating the risk that short-term volatility might force

a superfund into the PPF when it still might have a very good chance of meeting the long term objective?

Volatility in this valuation certainly poses a risk of perverse outcomes. We think it is appropriate for TPR to have discretion to allow exceptions in relevant circumstances, where this is the wish of ADBC trustees.

Question 37: Do you agree that there should be a Tier 1 funding level trigger to protect members' benefits at this level?

We note there is significant risk of confusion with the minimum funding level. We think the effect of the trigger should be to transfer full control of the buffer assets to the trustees (whether they stay there or are transferred to the scheme would be a matter of trustee discretion). At this point, the ABDC trustees will have to make decisions about the future of the scheme, which will look very like a SWOSS and should not be treated differently.

If capital providers believe the scheme might recover, they will be incentivised to inject additional capital to remedy the breach of the trigger, thus restoring their former level of control over buffer assets.

This trigger should be model specific and proposed and agreed during authorisation.

Question 38: What would be the best way of expressing this trigger?

The Pension SuperFund sets this trigger at scheme + buffer assets at 100% on our capital adequacy basis. I.e. when the scheme deficit reaches the full value of the buffer.

Question 39: Is three months an appropriate period of grace to allow for any volatility in investments to recover before allowing trustees access to the capital buffer?

A grace period is sensible but will depend on the specific model. It should be considered during the authorisation process.

Question 40: should TPR have the power to intervene and require wind up or transfer if they believe the trigger has not been acted on in the best interests of members?

Provided TPR would need to act in the best interests of members in exercising such power and its decision would be subject to appeal or review via the courts.

Question 41: is this a reasonable basis on which to prevent new business being written, or should this be left to the discretion of the superfund trustees on the basis they should not be accepting new business if it would have a detrimental effect on existing superfund members?

This should be left to the discretion of (independent and fit and proper) trustees.

Question 42: Is it reasonable to only allow investors to take a profit after they exceed the requirements for authorisation and if so on what basis?

'Profit extraction' and 'taking profit' are emotive and potentially inappropriate terms: a profit only emerges when investors have received more than they committed. A better term is release of capital. This term also captures other relevant reductions in total ADBC assets, such as additional payments to members.

We propose that each ADBC sets its trigger for permissible release of capital on authorisation with reference to its own capital adequacy basis.

Question 43: Is it reasonable to retain investor profits for a period to mitigate against profits being taken from market volatility rather than genuine outperformance?

Some models may wish to do this, but it may be redundant, if there has been sufficiently robust stochastic modelling assuming release of capital at a certain trigger, this risk will have been captured and understood.

Question 44: Should superfunds be restricted from taking profit until the funding level is above that required to secure a buyout?

No. This would be wholly inappropriate. Capital should be released at the triggers on which the ADBC was authorised, not with reference to the vagaries of insurance pricing, especially as insurance buyout pricing usually includes a 'new business' profit margin.

Question 45: Is it reasonable to allow a sectionalised superfund to take profit or write new business if one or more sections are inadequately funded?

Depending on the model, yes. The key test would be whether the proposed transaction is dilutive to the security of one or more other sections.

Question 46: In relation to the criteria for financial adequacy and funding level triggers discussed above, should each segregated section within a sectionalised scheme:

(a) be considered separately for financial adequacy purposes and also considered separately for the funding level triggers;

(b) be aggregated together (along with the capital buffer) for assessing financial adequacy but each section is considered separately in relation to funding level triggers;

(c) be considered separately for assessing financial adequacy but be considered together as a whole when assessing whether the collective scheme funding position meets any of the funding level triggers; or

(d) be aggregated together (along with the capital buffer) for assessing financial adequacy and considered together as a whole when assessing whether the collective scheme funding position meets any of the funding level triggers?

If the assets are segregated – i.e. assets of one section are not permitted to be used for any other section, (a) applies best. Where transfers between sections are permitted, aggregation may be appropriate.

Question 47: Does this approach provide adequate protection for members, while effectively balancing the interests of the investors?

Option 1 may lead to excessive leakage of assets through transaction costs and taxation to the detriment of overall security.

While the Pension SuperFund uses a version of option 2, and in any case, our Trustees have significant control of buffer assets though our Joint Investment Committee, this may not be suitable for all models.

We propose an approach where a condition of authorisation is that an integrated ALM strategy is produced and maintained in agreement between trustees and capital providers for the management of both scheme and buffer assets with responsibilities and investment 'guiderails' for both asset pools clearly defined.

The authorisation process should therefore ensure that buffer assets can be quickly and effectively transferred to the scheme at the relevant trigger point and that the schemes' claim to the assets is robust and cannot be weakened (meeting PPF contingent asset conditions should suffice, although there may be alternative arrangements). With this assurance, the scheme and the buffer can be regarded as one pool for overall risk assessment purposes.

Question 48: What are the minimum requirements on a buffer fund in order for the scheme to be able to rely upon the assets being available in the event they are needed?

Given the potential variety of buffer arrangements, we think the same standards that apply to DB scheme assets generally should apply to buffer assets, including the preparation of a SIP (possibly combined with the scheme SIP)

We note such buffers will almost invariably meet PPF contingent asset conditions in order to minimise Levy costs.

Question 49: Should there be minimum standards on the capital buffer to ensure it can be relied upon in stressed situations?

Previous two answers apply. In the context of the scheme and buffer assets being considered as a whole, the question is superseded by an overall appropriate asset structure.

Question 50: Is it reasonable and proportionate to require superfunds to provide detailed fund guidelines, and does this provide the regulator with sufficient information?

It may be reasonable and proportionate in certain circumstances, noting the commercial importance of confidentiality, in the context of assisting TPR to understand potential risk.

TPR involvement should not undermine trustees' ultimate responsibility for ALM decisions.

Question 51: Should superfunds be required to submit their modelling for TPR to review, or should TPR develop a model against which they can assess all superfund proposals?

TPR should be responsible for review, with access to external resources if required. A single model able to cope with all ADBC structures is a likely unachievable goal and, if a poor fit, such modelling could be a barrier to innovation and competition; and even in the best case, such an approach could involve duplication of work and cost already being borne by ADBCs.

Question 52: Should TPR have a 'fall back' model for cases when the modelling provided by superfunds is not adequate?

No. adequate modelling should be a condition of authorisation. However, care should be taken not to incur the costs of for example, the Solvency II internal model regime, which daunted even some of the biggest insurers and gave little if any net benefit to the system as a whole.

Question 53: Should there be any other reporting requirements of either the corporate entity or pension scheme to ensure effective supervision?

No, however as discussed in Question 6, "corporate entity" may be ill-defined as most ADBCs will have a range of entities. As part of the Authorisation process, TPR should identify the elements of the structure relevant to scheme security and agree appropriate levels of consolidated reporting to minimise cost.

Question 54: Should the corporate entity and pension scheme have to disclose their strategic asset allocation and investment risk limits so that TPR can effectively supervise the investment strategy?

Yes.

Question 55: Should superfunds be required to regularly publish publicly available material on their financial position and operations?

No. The purpose of TPR supervision is that independent public scrutiny is not required. Information will need to be provided to trustees considering transferring in and to investors and other affected persons, especially members, but should not be mandatorily public.

The Pension SuperFund would include such information in its annual reports. There is no business incentive for lack of transparency, quite the reverse, but there is no benefit in public dissemination of the short-term movements in the position of what are extremely long term propositions.

Question 56: Would the proposed events outlined in Table 1 meet the aims of the significant events framework?

Yes, with the addition of any change to corporate structure as this will be a key area to understand when assessing any ADBC model and possible removal of 'change to business plan' as this is hard to define. See also comments on investment in Question 57.

TPR should be able to grant exemptions if justified by individual circumstances in order to limit excessive reporting burdens.

Well defined materiality thresholds and an exception reporting based approach are desirable.

Question 57: How could we define 'significant deterioration' in relation to investment performance and funding level?

Investment performance is likely to be irrelevant in isolation, since pension schemes are concerned with the value of assets relative to liabilities. We would suggest such triggers are proposed by ADBCs and agreed with TPR as part of the authorisation process, since different models may justify different approaches. This should be subject to regular review.

Question 58: Should TPR's executive arm have the power to unilaterally commission a skilled persons report in relation to superfunds with TPR acting as the end user?

Yes, provided adequate processes for oversight of TPR by the courts.

Question 59: Would an enforceable Code of Practice be sufficient to allow TPR to respond quickly and proactively to emerging market risks and supervise effectively?

TPR should not be both a regulator and a legislator. TPR and rules laid down by TPR should be subject to adequate oversight by government and the courts.

Question 60: In your view, what areas of a future code should be enforceable?

We think an appropriately drafted code could be fully enforceable provided there is scope for TPR to adjudge exceptions, noting that there are potentially many different models that will be captured by the ADBC definition.

Question 61: Would the proposals outlined in Chapter 4 allow for the effective regulation of superfunds? Are there any other powers needed for TPR to intervene where necessary to effectively regulate superfunds?

We believe the proposals are comprehensive, though as set out above we do not agree with all of them.

Question 62: Should superfunds be subject to a bespoke levy to fund their ongoing regulation?

The cost, fairly and transparently calculated, of ADBC authorisation should be met from the resources of the applicant, but we do not support different treatment for ADBCs on an ongoing levy basis. The success of ADBCs should lead to a reduction in TPR's supervisory burden as schemes are merged into the new arrangements, which will be able to provide enhanced and timely information.

We contest para 196 since there is little difference between ADBCs and normal pension funds unless surplus thresholds are reached and an additional levy would be an unjustified erosion of scheme security. If a levy must be imposed is better addressed though the normal system of taxation of gains on investors and on pension benefits in the hands of members.

Any charges or levy should not be disproportionately borne by the first ADBCs which are likely to be limited in number.

Question 63: Do these principles achieve the policy aim?

The purpose of encouraging new forms of defined benefit consolidation including "commercial" consolidators and other innovation, as referred to in the White Paper, appeared to be to consolidate defined benefit liabilities within an occupational pension scheme framework and to enhance the likelihood of member benefits being paid at an affordable cost. This purpose does not appear to be served by the introduction of formulaic gateways or even "principles-based" gateways that are intended to override the discretions and powers of the trustees and sponsors of such occupational pension schemes, to the benefit of commercial insurers and the disbenefit of members, especially the members of less well funded schemes. It appears to treat defined benefit liabilities and assets as a market to be carved-up between insurers, service providers and defined benefit consolidators. It is inappropriate market intervention. Any 'gateway' is in any event open to manipulation as it is itself a manipulation of the market.

The gateway proposals penalise strong sponsors or corporate groups that have provided strong support or funding for their schemes by excluding them from defined benefit consolidators. This is perverse.

Such gateways will be a barrier to innovation and may prevent trustees and sponsors taking appropriate decisions for their schemes having regard to all relevant matters and not irrelevant matters; and for proper purposes in accordance with the relevant trust provisions. For instance, there may be a choice between:

- a buy-out after liability management exercises such as enhanced transfer values and pension increase exchanges;
- buying out tranches of benefits at different dates;
- enhancing benefits within the scheme (e.g. by hard-coding discretionary benefits such as increases on pre-1997) and then transferring it to a defined benefit consolidator at a cost below buy-out;
- enhancing other benefits or remuneration for members or other employees; strengthening the business;
- a combination of any of the above.

Trustees are required to take decisions according to trust principles and the provisions of their scheme. A "principles-based" gateway or indeed a formulaic gateway is an inappropriate restriction of their trust powers and the rights of the scheme sponsors.

If defined benefit consolidators are being regulated, there is no reason to restrict access to them.

Case-law is clear (reconfirmed as recently as 2015[2]) that trustees are under no duty to seek the "most risk free" option provided they are choosing an adequate option to ensure members' benefits are paid as they fall due. Case-law is equally clear that trustees can take account of employer interests (and indirectly the interests of their employees).

---

[2] see MNRPF v Stena Line [2015]. https://www.macfarlanes.com/media/1682/two-key-cases-on-the-duties-of-trustees-and-employers-ibm-v-dalgleish-and-mnrpf-v-stena-line.pdf

Were a new best interest duty to be imposed, this should not just be a 'least risk' interpretation. Funds open to continuing accrual – the majority of schemes in the UK – or PPF+ cases would be an obvious example of this, where level of benefits would be key consideration.

Question 64: Is five years a reasonable timeframe to assess a scheme's potential to reach buyout in the foreseeable future?

No. We do not support the gateway provisions linked to buyout for the reasons in our introduction and the previous answer.

Five years is a long time to be taking a risk on a trading sponsor. Gateway proposals must not prevent trustees acting if in their judgement there is benefit in doing so, for instance protecting against the risk of employer failure. We have seen ample evidence of rapid deterioration of sponsor covenants in recent years.

Question 65: Are there any other important factors that trustees should take into consideration as part of the transfer to a superfund?

Yes.

Trust law requires them to consider all relevant matters and not irrelevant matters, including the interests of the employer (and indirectly its employees). What is relevant can only be determined by the trustees and their advisers in the factual circumstances arising at the time they take their decisions and it is inappropriate to seek to fetter their decision or override it.

The enhanced benefits offered by the Pension SuperFund to members, sharing in ALM outperformance, are but one example of a factor some trustees may deem relevant.

The task of government and the Pensions Regulator is to provide a sound and transparent regulatory regime for ADBCs so as to limit the due diligence that trustees would otherwise have to undertake to assess an ADBC when comparing it to other options that may be available for their scheme.

Question 66: Should a scheme looking to join a superfund be required to meet a specific minimum funding level at the point of transfer, for example 87.5% funded on the authorisation basis?

See also answer to Question 28.

If the defined benefit consolidator is being regulated and needs to demonstrate financial sustainability to maintain "authorised" status, there is no need for schemes looking to join it to meet additional hurdles.

Question 67: If you think there should be a minimum scheme funding level for entry to a superfund, should it be based on the authorisation basis or a buyout basis? What percentage minimum funding threshold do you think would be appropriate?

See also answer to Question 28.

Any access rule based on insurance buy-out is wholly inappropriate for vehicles that are designed to enhance the deliverability of pension promises in an occupational pension scheme framework which is not based on insurance market pricing.

There is a risk of creating unnecessary and conflicting tests: through the new Levy rules, the PPF effectively require a termination trigger based on buy-out cost of PPF level benefits for defined benefit consolidators; this is not aligned to the proposed entry requirement based on buy-out cost of full benefits. Full benefits and PPF level benefits are not aligned because PPF compensation rules favour certain categories of benefits over others (e.g. increases on pre-1997 accrual). Defined benefit consolidators may become unavailable except to schemes weighted to deferred members with capped (high value) pensions and material increases on pre-1997 service: an option for a minority of well-funded schemes with "rich" benefits.

Defined benefit consolidation will become a missed opportunity in this circumstance.

Question 68: Should external covenant advice be a mandatory requirement of the superfund transaction process? In what circumstances would covenant advice not be required?

Leaving aside the vested interests inherent in the question, this should be a matter for the trustees and the Pensions Regulator under any clearance or approval processes. There may be cases where the merits of the decision are so clear, covenant advice is not required or where covenant advice would not change the decision or cannot provide meaningful guidance. Care should be taken not to substitute a decision by covenant advisers on narrow criteria for the decision of duly advised trustees taking account of all relevant matters and acting for proper purposes.

On the basis that an authorised defined benefit consolidator will need to meet financial sustainability tests, detailed financial due diligence of the consolidator would seem unnecessary.

Given that trustees are under no obligation to seek the "most risk free option" for their members under trust law and there is no rationale for introducing such a duty solely in connection with transfers to defined benefit consolidators, which are intended to provide more affordable options for ensuring scheme benefits can be paid, and given that most employers represent some risk of insolvency and therefore early termination for their schemes, trustees may in some cases consider that they do not need to take detailed covenant advice on their sponsor in the context of a transfer to a defined benefit consolidator in addition to any legal and actuarial advice.

Question 69: Should it be a requirement for those providing covenant advice to be regulated by either the Financial Conduct Authority or the Financial Reporting Council?

This should be no different to covenant advice sought for any other purpose by trustees, so is in our view a wider question about the regulation of this sector. The trustees should consider whether their advisers are suitably qualified.

Question 70: Do you agree that the current legislation regarding bulk transfers should apply to transfers to a superfund? Please give an explanation for any changes you recommend to the legislation.

Yes, however we believe the process could be improved by removal of the requirement for a transfer without member consent to be a connected employer transfer if it is a transfer to an ADBC.

Question 71: Should TPR decide whether each scheme transfer to a superfund can proceed or only have the power to prevent a scheme entering a superfund if they judge that the principles set out in the gateways are not being met.

If the transfer is to an ADBC (that has not hit any triggers requiring it to cease accepting transfers) and if the transfer complies with current legislation regarding bulk transfers, other than the requirement for a connected employer transfer, there should be no requirement for further scrutiny of the trustee decision.

We expect most transfers will be accompanied by clearance applications in the early stages of market development.

We support the introduction of a new notifiable event and a 'comply or explain' approach to professional advice.

Question 72: What checks should TPR do on a proportionate and objective basis to satisfy itself a transfer to a superfund is likely to be in the best interests of members?

The courts have been clear that trustees of occupational pension schemes:

- have no separate duty to act in the best interests of members as distinct from their duty to exercise their powers for proper purposes and having regard to all relevant matters and not irrelevant matters, which may include the interests of employers (and indirectly their employees); and
- are under no duty to seek the "most risk free" option provided they are choosing an adequate option to ensure members' benefits are paid as they fall due.

The DWP should consider whether it is appropriate to introduce a new duty to act in the best interests of members solely in relation to transfers to ADBCs or whether to focus instead on ensuring ADBCs provide an adequate (and affordable) option to ensure benefits are paid as and when they fall due.

TPR should not be expected to opine on the merits of each transaction but should focus on how trustees have taken decisions. We expect TPR would seek to satisfy itself that trustees have considered:

- the full range of options available to them;
- the model of the relevant ADBC and the level of risk members will be exposed to post transfer
- have compared this risk to the status quo for members, including sponsor willingness to make contributions and over what time period

- any increase in benefits members may expect from the ADBC in comparison to other options (particularly relevant to "PPF+" cases)
- relevant advice

In respect of professional advice, care needs to be taken not to impose a prohibitive barrier of cost to the smallest schemes (which stand to gain most from consolidation). We believe the Authorisation process should result in information that could be made available to trustees contemplating such transactions to avoid duplication of effort by advisers. For instance, we would not expect it to be possible for ADBCs to significantly alter their structure or triggers without reauthorisation.

DWP may wish to work with ADBCs, the covenant advice, legal and actuarial professions to develop a low cost 'safe harbour' pathway to consolidation for small schemes.

Question 73: What further powers should TPR be given to allow it to regulate effectively both superfunds and transfers to superfunds? Please provide reasons for any additional powers suggested.

We see no need for additional powers beyond those current and proposed within the consultation.

Question 74: Should these schemes continue to be known as "defined benefit master trusts" or is there a more suitable name that can be used to distinguish them from DC master trusts?

We think the term is reasonable. In the nomenclature we propose in Question 1, they would be a type of DB Consolidator.

The Pension
SuperFund

Taking care of pension promises