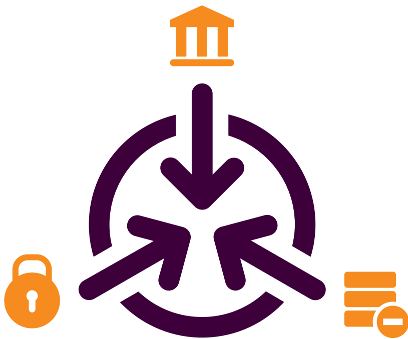
Sackers

# Hot topic

July 2020

## DB superfunds – what trustees need to know

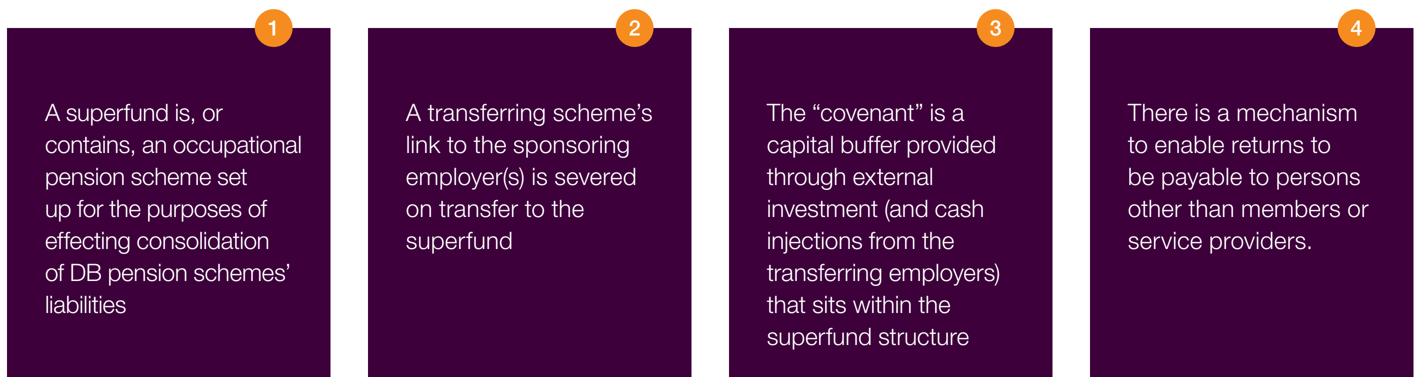


In recent years there has been a lot of discussion about consolidation of DB pension schemes. Drivers for consolidation include improving security of member benefits, reducing the cost of running DB schemes, and managing governance and risk more effectively.

This hot topic highlights some key considerations for trustees who are asked to transfer their scheme to a DB superfund.

### What is a DB superfund?

While individual models may differ, the main characteristics of a DB superfund are as follows:




The superfund might be set up on a sectionalised basis (where each transferring scheme has its own individual section within the superfund) or it might be set up without individual sections (where all assets are effectively pooled).

### When might a transfer to a DB superfund be considered?

TPR acknowledges that DB consolidation could be particularly beneficial for smaller schemes which may not be well-governed and could benefit from economies of scale and access to a wider range of investment opportunities. It is recognised that members of these smaller schemes could also benefit from improvements in administration and stewardship.

However, there are a number of scenarios in which a transfer to a DB superfund might be considered, including:

- Corporate transactions where there is a commercial driver for paying cash in return for a clean break from DB scheme liabilities.

# DB superfunds – what trustees need to know cont.

- Sponsor or trustee desire to improve the security of member benefits and scheme governance, but the scheme is not able to afford full insurance buy-out for the foreseeable future.
- Trustee desire to "protect" members from sponsor covenant risk where this is a concern. In corporate distress situations, where a scheme is better funded than PPF levels but not fully buy-out funded, a transfer to a DB superfund might be a way to secure a higher level of member benefits than would be possible to provide with insurance. The addition of upfront contributions and investor capital would immediately improve the funding of DB pension schemes entering a superfund.
- Sponsor desire to sever ties with a closed legacy pension scheme so that it can focus more effectively on its core day-to-day business.

## What are the key risks?

A key concern for transferring trustees will be the loss of covenant support from the sponsoring employer. Given the absence of an ongoing employer covenant, the scheme would become wholly reliant on its funding position and/or any capital provided to the superfund.

To mitigate this risk, a cash injection is usually required from the sponsoring employer upon transfer to a DB superfund. This results in an improvement in the scheme's funding level and should enable a lower risk investment strategy, with less reliance on the superfund "covenant" going forward.

## What other options are there?

The main "alternatives" to the DB superfund structure are:

- transfer to a DB master trust
- buy-out the scheme with an insurer.

A master trust structure would not generally sever the transferring scheme's link to the sponsoring employer. Instead, the sponsoring employer would participate in a segregated section of the master trust. It is expected that a master trust structure can achieve economies of scale and better governance than small schemes may be able to provide for their members.

Buy-outs are often viewed as the most "secure" option for members and, as with a transfer to a DB superfund, they enable the sponsoring employer to sever their link to the scheme and any future liabilities. Although full buy-out with an insurer is generally the most costly option, some trustees may feel that buy-out is a realistic prospect (and a better option) for the scheme in the foreseeable future.

## What is TPR's role?

On 18 June 2020, TPR launched a new interim regulatory regime for DB superfunds, pending the establishment of a full statutory framework which is expected in due course.

Whilst TPR believes DB superfunds have the potential to offer benefits for both members and sponsoring employers, such as economies of scale and good governance, it also acknowledges possible funding, personnel and governance risks inherent in the model. The guidance establishes the "high bar" TPR expects new superfunds to meet to ensure both savers and the PPF are adequately protected.

To help manage these risks, TPR wants to ensure that the following elements are in place.

- The superfund scheme and its capital buffer meet certain requirements. Capital adequacy is one of the most important areas of TPR's interim regime, and the "overarching objective" of TPR's capital requirements is for there to be a very high probability of members' benefits being paid in full.
- Key individuals who exert financial control, influence the superfund's strategies, or have control over the assets, should be "fit and proper" (including being financially sound, and possessing the right level of knowledge, skills and experience to carry out their roles).
- The governance, systems and processes associated with the capital buffer and the scheme are appropriate and robust. For example, superfunds must ensure careful risk management and focus on their investment governance.

# DB superfunds – what trustees need to know cont.

## Key trustee considerations

A transfer to a DB superfund would require the consent of the transferring scheme trustees, who would need to take legal, actuarial and covenant advice and need to assess, in detail, the impact of a transfer on member benefits and security.

TPR's view is that trustees will need to be certain that a transfer to a superfund is in their members' best interests, compared with maintaining the link with the employer, transferring to any other consolidator, or an insurance buy-out. It considers a transfer to a superfund should not go ahead if buy-out is a "realistic prospect" in the foreseeable future (which TPR seems to regard as five years).

Trustees should only consider using a superfund (or similar new business model) once it has been assessed by TPR.

Employers are expected to apply for clearance from TPR in relation to a transfer from their scheme to a superfund, and TPR expects to see evidence of the trustees' due diligence as part of the clearance application.

TPR's June 2020 guidance includes links to its current guides for employers and trustees who are considering transfers to DB superfunds. These guides will be updated in due course to provide more detail. For now, they cover the requirement to obtain TPR clearance, evidencing the rationale that a transaction is in members' interests (and that any detriment to the scheme is mitigated), and the importance of obtaining legal, actuarial and independent covenant advice.

*For further information, please speak to Claire van Rees, Sonya Fraser or your usual Sackers contact. You can also visit www.sackers.com/expertise/schemes/defined-benefit/.*

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