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Response from The Pensions Regulator to DWP's consultation on Consolidation of defined benefit (DB) pension schemes

1. The DWP's consultation sets out a number of measures to support consolidation of DB schemes. The pensions landscape is continually changing and so are the risks and challenges we face as a regulator in pursuing the objectives given to us by Parliament. It is important that we have a regulatory framework that can adapt to these risks and challenges, and support our regulatory approach, which includes regulating emerging 'superfund' consolidation vehicles.

2. While we do not intend to offer responses on the detailed questions posed in the consultation paper, we do wish to comment on a number of key points and possible changes, which we feel would support our regulation of superfunds. We particularly focus on protecting member benefits, promoting good administration of funds, and reducing risks of calls on the PPF. Our comments concentrate on the areas of regulation, financial sustainability, funding triggers and the transaction gateway.

3. We think consolidation within the DB sector could be beneficial, particularly if consolidation took place amongst smaller schemes, which tend to be less well-governed and could benefit from economies of scale and better investment opportunities. Members of these schemes could also benefit from improvements in administration - another key focus for us. We think consolidation of these schemes could provide better outcomes for members and improve funding of DB pensions.

4. We see a number of benefits to the proposed superfund consolidation. The addition of upfront contributions and investor capital should improve the funding of DB pension schemes in the UK. At the same time, authorisation and supervision of these schemes with strong requirements around governance, administration, investment and funding, backed by adequate powers for us, will provide stronger oversight and protection for members and the PPF than remaining in existing DB schemes.

5. However, there are some risks that concern us. Any new framework for consolidation needs to be flexible enough to allow innovation without exposing members and the PPF to unacceptable risks.

6. To mitigate the risks, we agree that superfunds should be actively regulated; there should be an onus on the superfund to demonstrate to us their arrangements are appropriate before they can begin to operate. They also must continue to satisfy us that the superfund meets threshold conditions on an ongoing basis. We are therefore in favour of an authorisation and supervision regime for DB superfunds as set out in the consultation document.

Regulating superfunds

7. We support the consultation proposals and agree a high level of governance is needed, as payment of member benefits relies on the superfund operating effectively and there will be no further recourse to ceding employers for additional contributions. We also agree there is a need for independent minds with non-affiliated trustees and directors, as commercial entities have different conflicts compared to traditional single-employer sponsored pension schemes.

8. Regulation of superfunds needs to ensure member needs are considered and benefits protected, along with protecting the PPF. We agree that an authorisation and supervision regime building on that for DC master trusts is needed, recognising the different risks between superfunds and DC master trusts.

Financial sustainability

9. The government has been clear that superfunds will not be required to meet the same funding standards as insurers. If the funding requirements were the same as insurers then the price of entry would also be the same. As such, any scheme that could afford to enter a superfund would also be able to buy out. This would go against the premise that superfunds provide an option for schemes unable to afford to buy out but still offer an increased level of security for members.

10. It is critical that superfunds are financially robust; to protect members and ensure that trustees considering transferring to a superfund are confident it is in the best interest of beneficiaries. We therefore support DWP in putting in place a ‘strong’ regime that aims to balance member security with facilitating a functioning market, which could offer some trustees and employers a credible and efficient option for delivering members’ benefits. We support the need for capital requirements for superfunds.

11. The consultation sets out a number of options for this, and the 99% principle as envisaged under option 1 is likely to set a high bar for superfunds and provide a strong financial adequacy regime. We recognise there will be a judgement decision as to where the ideal level sits and this will be informed by further analysis. We agree superfunds need to have a high probability of paying benefits.

12. While the high level principle under option 1 has significant merits, we would agree that superfunds should be required to demonstrate their ability over the long term under different economic scenarios to continue to meet this principle. However, there are significant challenges in ensuring that such modelling is robust and consistently applied across the market. We therefore see merit in the additional tests, standards and safeguards of options 2 and 3. The calibration of these should be consistent with the principle of a high probability of paying members’ benefits and include risk-based capital requirements, although we think it is important for transparency that the regime should be kept as simple as possible.

13. We also need powers to monitor and challenge such modelling, and we support a strong requirement that the modelling is able to be clearly tested and demonstrated, including the assumptions and inputs used in the model.

Funding triggers

14. It is important to the protection of members' benefits that when a superfund's financial position deteriorates, some action is taken. The consultation proposes a series of 'trigger points' that prescribe what would happen if the funding level in a superfund falls below certain limits. We examine each of these triggers below.

General comments in relation to funding triggers

15. We believe funding triggers will be important to protect member benefits in weakening scenarios. However, they could trigger irreversible action. We therefore think it is appropriate to consider whether a trigger is breached over a period of time, perhaps of the order of three to six months, before action is taken. This could be supported with more frequent and rigorous reporting to us during such a period, to include assumptions, and financial and investment strategy changes.

16. There may also be circumstances where immediate action is required. Therefore, we propose that we are given the flexibility to intervene immediately if appropriate.

17. In general, triggers should be set at a level which is easy to measure and verify. Superfunds should be required to monitor whether they are approaching a trigger, or have breached a trigger and are required to notify us. Early notification of events will be critical to our effective supervision of superfunds. We therefore propose that the 'significant events' regime includes reporting where a scheme is approaching a relevant trigger.

Tier 3: a restriction on the extraction of profit from the capital buffer

18. We think such a trigger would support our objective to protect members' benefits by ensuring funds remain within the superfund until it is clear that they can be extracted without impacting members' benefits over the short to medium term. Setting a trigger at a level higher than required for authorisation should also reduce the effect of short-term market volatility on the adequacy of the superfund. This will reduce the possibility of a superfund oscillating between meeting and not meeting the capital adequacy requirements for authorisation over a relatively short period of time.

19. We are supportive of this proposal, but the level at which it is set will need to balance protecting the capital buffer with the need for the superfund to attract investment capital in the first place.

Tier 2: a restriction on writing new business

20. The rationale behind the superfund regime is that superfunds should meet a high threshold of financial adequacy and sustainability in order to operate in the market. This reduces the risk to members and the PPF by ensuring superfunds are capitalised to an adequate level to operate. It is therefore logical that where a superfund falls below the level required for authorisation, there should be a prohibition of extracting profit and a restriction on writing new business.

21. This will reduce the possibility of any additional risk to current superfund members, while also stopping any new members entering the superfund while it is undercapitalised.

22. Further thought will need to be given to how this trigger functions for a segregated superfund. This superfund model arguably already minimises the risk of sections of the superfund being undercapitalised for current and future members because segregation avoids cross-funding of the different schemes that enter the superfund. Such a trigger

being in place for schemes that already protect members from cross-funding would represent a high hurdle, and one that may deter the investors needed for additional capital to be brought into the superfund.

23. We support the proposal that this trigger point be set at the level required for authorisation.

Tier 1: protecting full member benefits

24. The strong level of funding required of superfunds, compared to individual funds, means they are more likely to be able to continue to pay members' full benefits even if adverse experience suggests the superfund can no longer take on new business. Continuing the superfund may provide a better outcome for members than crystallising a wind-up and passing the superfund to the PPF.

25. As the superfund market is in its infancy, it is difficult to predict how the market will develop, in particular how superfund entry prices will change in future. A superfund that breaches this trigger may be capable of being transferred to another superfund, although this is not without difficulty. Similarly, there will be other practical issues such as differences in asset bases and the extent to which any receiving superfund could make a profit.

26. Where no superfund transfer is available, a superfund scheme could be in a position where it is effectively a scheme without a substantive sponsor (SWOSS) and would need to operate in line with any requirements set out for these schemes. Given the scheme is likely to be very strongly funded, it may still be able to pay full benefits. We would need to consider this as part of the resolution of this triggering event.

27. In order to meet our objective to protect full member benefits, we need sufficient oversight of trustees' decision-making in these circumstances. The consultation proposes that we have the power to wind up a superfund scheme if it is in the best interests of the members. However, this will crystallise member benefits and rule out the possibility that the funding level of the scheme may recover. Therefore, we believe the certainty achieved by requiring trustees to take specific actions, supported by our ability to approve and supervise the trustees' plans, is more appropriate.

28. Given this trigger assumes the superfund has failed but that it still has options (recapitalise, transfer, run as a SWOSS or wind up), it is important that such a trigger point is set at such a level to allow the trustees options other than winding up, and to avoid entry to the PPF.

Scheme wind up

29. Given the potential size of a superfund, there is a clear risk to the PPF if a superfund initiates a claim. We therefore agree with the consultation proposal for a wind-up trigger set above that required to meet PPF levels of compensation. This would limit the extent of any claim on the PPF and address the concern that the collapse of a single large superfund or series of superfund failures would irreparably damage the PPF.

30. When taken in the context of the current proposed requirement that there should be a 99% chance of a superfund paying member benefits in full, it ought to be unlikely that a superfund would initiate a claim on the PPF. However, the funding level needs to be right for commercial consolidators and will need to be considered carefully. It should clearly be set at a level based on the balance between the risks to members and risk to the PPF.

31. This trigger needs to be initiated within an acceptable period, as funding levels will be below that required to protect full member benefits. There could also be significant risk of a sudden collapse in funding, which would have a substantial impact on the scheme's ability to pay benefits.

Authorisation and supervision

32. The consultation proposes that the authorisation regime will assess whether a superfund:

    - has a viable business model
    - is financially sustainable
    - is well governed, and
    - has a high probability of being able to pay members' benefits as they fall due.

    Those involved in running the superfund should be fit and proper persons, the superfund should have effective administration, governance and investment arrangements in place, and there should be contingency plans to protect members.

33. We believe the consultation proposals for fit and proper persons, systems and processes and governance are suitable. We will be working closely with DWP to develop an authorisation and supervision regime that allows us to effectively assess and supervise these areas. In developing the proposals in these areas, consideration will need to be given to appropriate reporting requirements and we will work with DWP further on this area.

Superfund transactions

34. The decision to transfer members to a superfund will require careful consideration from a scheme's trustees and employer. We support the consultation's position that trustees must act in the best interest of beneficiaries and so will need to be convinced members' benefits will be more secure in a superfund than remaining with the employer and the current funding arrangements. Our view is that a decision to move members to a superfund should remain a trustee decision.

35. There could be a small number of circumstances where transfer to a superfund might represent a better outcome for members than an insurance company buy-out. Our preference would therefore be for trustees to be given the responsibility for identifying whether transferring to a superfund or an insurance company buy-out is in the best interests of beneficiaries. They should be prepared to evidence this to us.

36. If a gateway is introduced, we believe that trustee primacy in decision-making must be retained. We should have the option to intervene using risk-based approaches. Guidance for trustees on what to consider when making the decision to transfer is likely to be a helpful approach.

37. We believe that five years is too long and potentially open to significant model risk and lack of clarity for trustees and TPR. The 'foreseeable future' should therefore be defined as a much shorter period so it is clear for trustees and TPR in assessing whether the scheme can afford to buy out. Over longer timeframes, the level of uncertainty in modelling and performance of investments increases. We agree trustees need to get appropriate advice and this should also be proportionate.

We very much appreciate the opportunity to respond to this important and wide-ranging consultation and we remain committed to working closely with you as we seek to preserve and enhance the security and sustainability of DB pension schemes. We will continue to engage actively with DWP and industry to develop a robust regulatory framework for superfunds in the UK pensions market.

Yours sincerely

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