Transferring to a superfund: A road map for ceding trustees and employers

TPR has released its updated guidance for ceding trustees and employers who are considering a transfer into a commercial defined benefit consolidator - a superfund.

November 2020 – Updated December 2021

Introduction

TPR has issued its highly anticipated guidance for ceding trustees and employers who are considering a transfer to a superfund, under the *interim* regime. We take a closer look at the primary responsibilities of the trustees and the employer, and set out a comprehensive roadmap for how to take these important decisions.

TPR has already signalled that this guidance will evolve as the market develops. If you are considering a transfer to a superfund, please do get in touch.

As expected, this October 2020 guidance dovetails closely with TPR's earlier light touch guidance to trustees and employers, and the more comprehensive guidance directed to those running a superfund (issued in June 2020). This version of the guidance is extremely thorough, but with a helpful degree of tractability to reflect the fact that schemes may be coming to this decision from very different circumstances.

The wide appeal of superfunds reflects our experience so far: we have discussed the possibility of a superfund transfer with schemes currently undergoing PPF assessment, through to robust employer sponsors who are interested in exploring the potential to reduce management time and improve the ongoing governance of their schemes.

Taking a decision to transfer to a superfund is the last big decision for the trustees of a defined benefit pension scheme. Any scheme therefore, but particularly a larger scheme, will need to undertake a detailed, rigorous analysis of the advantages and disadvantages to the scheme, in accordance with the requirements set out in full in the guidance. The employer will have a significant role to play, particularly through the clearance process but ultimately to reach the destination of a superfund the decision rests with the ceding trustees, and the questions they have to answer in the positive are:

1. Is the transfer in the best interests of members?
2. Does this transfer satisfy the "gateway principles"?

TPR's guidance gives the gateway principles prominence throughout, perhaps because it is a less familiar test to trustees than the "best interests" concept, but almost certainly because it is within the gateway principles that the trustees will have to weigh a number of factors that will be difficult to compare.

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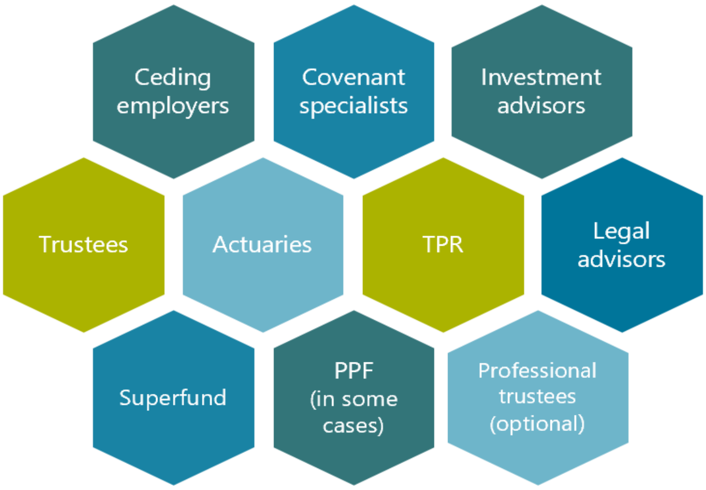
Step 1: Trustees should line up their support

TPR is clear that this is not a decision trustees and employers should take in isolation. TPR is also clear that advice and expertise should be sought at each point in the process.



Step 2: Engage with TPR at the beginning of, and throughout, your journey

TPR expects early engagement

At the very beginning of the journey, TPR expects the superfund and the ceding trustees and employer to flag the possibility of the transaction to them. The first sign-post to TPR should take place after the point at which the trustees' and employer's initial analysis shows a superfund could be the right option for the scheme. At the same time, the superfund is expected to engage with TPR about any potential clients and future transactions.

Trustees will need to ensure any confidentiality agreements signed with superfunds permit appropriate engagement with TPR.

The Trustees' Role

The decision is a matter for trustees, with input from their advisors to make a judgement on.

The ceding trustees will be expected to demonstrate appropriate due diligence, but it will be for the ceding employer to apply for clearance (if appropriate).

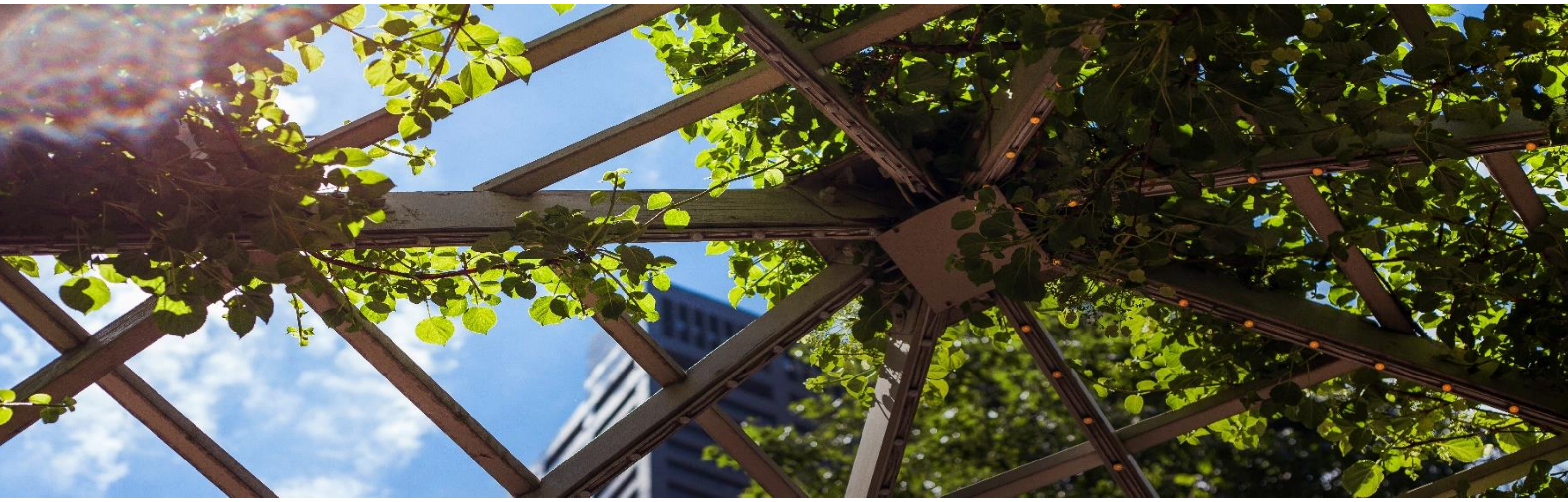
Step 3: Check your potential superfund destination has been assessed

Whilst there is no authorisation regime in place at this time, a superfund will need to have successfully completed its assessment under TPR's interim regime before TPR will issue any clearance statements, and trustees can "take some comfort" from TPR's assessment when carrying out their own due diligence. Their focus should be on the transaction rather than a reassessment of the superfund.

TPR includes a list of superfunds they have already assessed – as at the date of publication, Clara is the only DB superfund assessed.

The focus for ceding trustees should therefore be on their decision to transfer. Helpfully TPR recognises that such a decision is a matter for the trustees, having taken advice, to judge. But the judgement must be made by appropriate, experienced individuals. Trustees are encouraged to reflect on their own expertise and to seek the appointment of an independent trustee if necessary. They will also be expected to take appropriate advice as referenced above. TPR's expectation is that the cost of this will generally be passed back to the employer.

The guidance recognises the importance of proportionality in approach, taking into account the scheme's available resources (including their covenant) and potential benefit to members.



Step 4: Start the trustees' due diligence

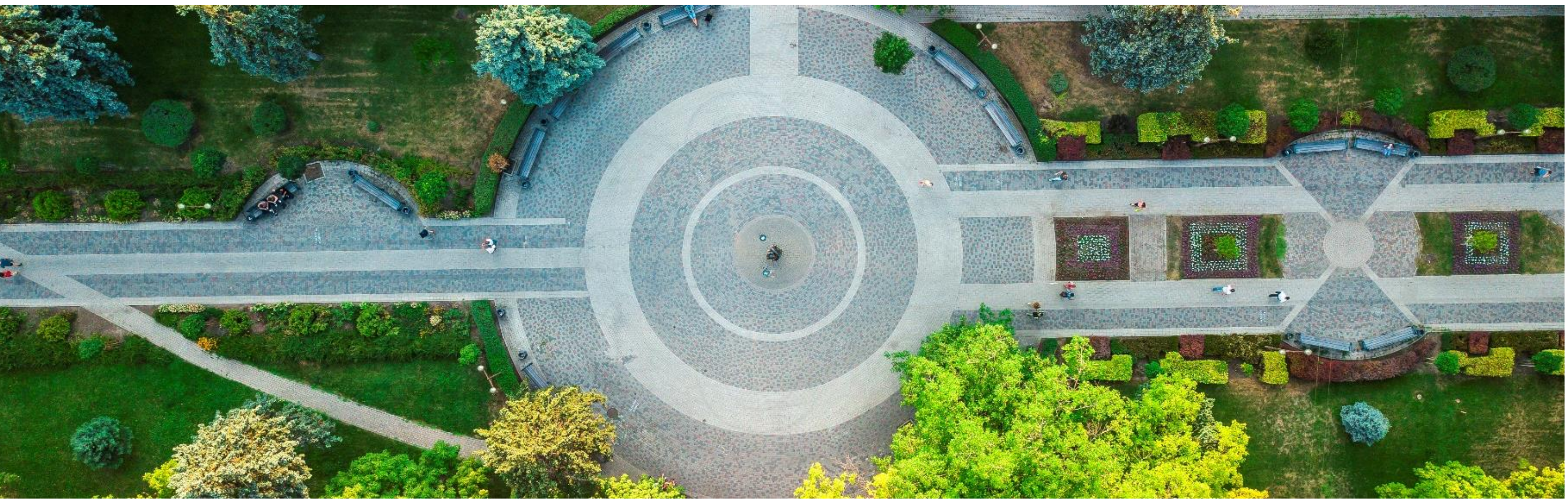
Areas that trustees should consider in their investigations (taking a proportionate approach) include:

- Their alternative options, such as support from the wider employer group;
- The interim assessment by TPR of the superfund, and any changes made to the superfund since;
- The scheme's current circumstances and the members' experience;
- due diligence on how the superfund will run post transfer, including funding and investment objectives, and their methods for achieving the same and the associated risks, superfund fees and conflicts of interest;
- Any member enhancements to be offered;
- Modelling outcomes provided by the superfunds, specific to the ceding scheme;
- Prior corporate activity and value extraction from the employer's group or shareholders and the broader context of the proposed transfer to the superfund;
- The risks of any residual liabilities not passed across to the superfund; and
- The "best interests" test and satisfaction of the gateway principles.

Assessing all options

Trustees will already be aware of an expectation of them to assess the likelihood of a buy-out with an insurer in the foreseeable future, but there is an expectation in this guidance that trustees should consider all possible options available to the ceding scheme as part of their due diligence. This includes DB master trusts, other capital-backed arrangements, and staying with their existing employer, but looking for further security elsewhere. The assessment should take into account cost, security, and the suitability and appropriateness of the arrangement for members.

Any meaningful consideration of all these options is likely to bring significant cost and time implications, so trustees will need to rely on the recognition of a proportionate approach and look to filter their options down (depending on their drivers) early in the process.



Step 5: Engage with members

Member engagement

The guidance also outlines the importance of communication with members in advance of the transfer and reiterates the trustees' obligation to follow best practice standards if any member option exercises are intended to be run in connection with the transfer.

It will be important to get the timing of member communications correct.

Step 6: Understand and test the gateway principles

The gateway principles

Passing the gateway test requires satisfaction of three gateway principles. A transfer

(i) should only be considered if the scheme cannot afford to buy out now;

(ii) should only be considered if a scheme has no realistic prospect of buy-out in the foreseeable future, given the employer cash contributions and the insolvency risk of the employer;

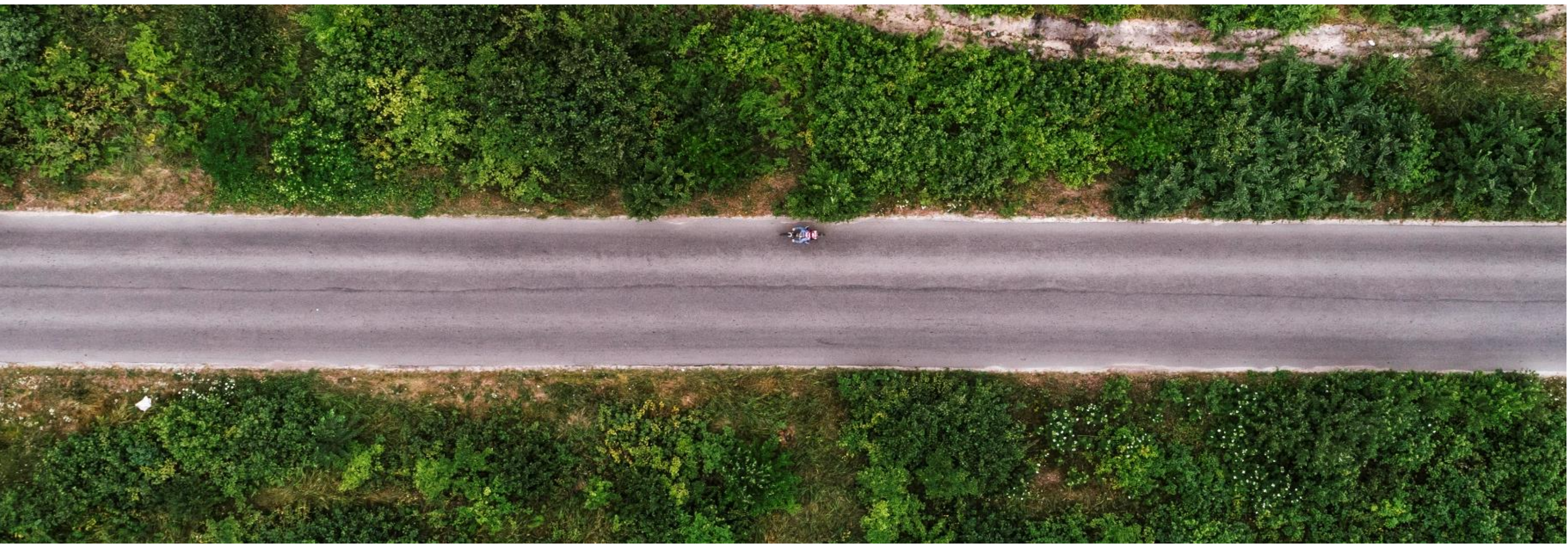
(iii) must improve the likelihood of members receiving full benefits.

The gateway principles are a key focus for trustees. The industry (including superfunds, the ABI and regulators alike) has already accepted that if trustees can access buy-out with an insurer, they should drive down that route, rather than turn to a superfund.

The guidance provides some helpful detail on how to draw that conclusion. For example, the buyout level of funding should be tested no more than one month before the date of the clearance application.

TPR expects a granular assessment of the likelihood of reaching buy out. An actuarial report should be prepared setting out the buy-out funding level and a detailed breakdown of the asset valuation, the pensioner/deferred split, actuarial assumptions and details of any buy-out prices sought, if applicable.

The second limb of the gateway test is more challenging to assess.



A particularly difficult situation for trustees is where the employer covenant is weak and the superfund offers an attractive degree of security. How is that factored into the trustees' assessment of the gateway test? Where deficit repair contributions, or indeed expected recovery on an insolvency provides enough value to secure buy-out in the foreseeable future, the threshold test for transfer to a superfund will not be met. However, this must include an assessment of how confident the trustees are that the expected amount will be received. This could require the trustees to commission a further report on insolvency outcomes.

This assessment includes estimating the funding level progression as a result of asset returns and receipt of an appropriate level of employer contributions, an improvement in buy-out pricing as the scheme matures and any improvement that could be expected due to the improvement of scheme data quality. Again, the assessment must include reflection on the employer's ability and willingness to make those anticipated payments and/or improve security. Helpfully, TPR emphasises the need for proportionality here once again.

The "foreseeable future" is further finessed as an expectation of "up to 5 years", but will be specific to the employer's circumstances. TPR notes that the shorter the period e.g. 3 years, the greater the level of certainty that exists, and that longer periods are unlikely to give sufficient clarity to support the trustees' assessment. In any event, trustees can judge the appropriate timeframe but must provide a rationale for their selected timeframe.

There is enough flexibility in the guidance that trustees can look to transfer to superfunds where they are confident that it is clearly in the interests of their members to do so, even if meeting the gateway test is not straightforward.

Step 7: Consider taking covenant advice

Covenant advice will be a critical piece for the trustees in analysing this part of the test. Any such advice should consider:

— the employer's market and strategic position, prospects and profitability;

— the insolvency risk of the employer;

— the estimated return to the scheme on an insolvency;

— the employer's ability to make payments; and

— the employer's capacity to pay additional contributions (and critically what trustees can reasonably expect to receive).

The third element of the gateway test is whether the transfer will improve the likelihood of members receiving full benefits. To properly analyse this test, TPR wants to see a comparison between the respective likelihoods of reaching full scheme benefits (a) with the existing sponsor; or (b) in the superfund.

This could be fairly straightforward where the employer covenant is weak and the funding level is poor, but TPR accepts there will be circumstances where it is a finely balanced decision, especially where the employer sponsor is robust.

Once again, the trustees must undertake a fairly detailed consideration, comparing the funding and investment strategies of the superfund and the scheme, and how these are expected to change over time. The impact of investments progressing unexpectedly, assessing how the employer might respond in such a circumstance and any opportunities that could arise if experience is more favourable than anticipated, should all be considered.

In assessing the likelihood of members receiving full benefits the comparison between the scheme and the superfund should look at both the status quo and the future.

Helpfully, TPR sets out some factors that should be considered when trying to determine the future security of members' benefits, including

— the current view of the short to medium term covenant;

— the employer's sector and emerging trends within the relevant markets;

— horizon scanning for risks relevant to the employer's business;

— the impact of downsides on the superfund, versus the employer.

TPR acknowledges that the capital requirements on superfunds will likely mean they are better funded than many pension schemes.

In terms of future security and capital funding, the information to be provided by the superfunds themselves will be of assistance in assessing this limb.

Finally, if the decision on where the members' benefits will be most secure in the future is a difficult one, consideration of the general benefits of consolidation should also be taken into account, for example improvements due to economies of scale, or different consolidation options that might need to be reconsidered.

Step 8: The Employer needs to ensure access to the relevant company sources

Employer's role

The employer may not be the sole determiner of whether the transaction proceeds, but it is expected to play a 'key role' in providing and co-ordinating information for clearance applications and to provide relevant information to the trustee. This includes:

(a) arranging access to senior management and key post-holders
(b) providing forecasts and accounts for the scheme's current sponsor and wider group as appropriate
(c) providing evidence of the current capital structure, terms of lending and key refinancing materials
(d) facilitating an understanding of the key business strategy plans for the group

> Employers are generally expected to pay the trustees' costs through this process, including the cost of advice for trustees, any report(s) required to assess the employer's market position and of course to pay for their own advice.

Step 9: Finalise your clearance application

Clearance

A transfer to a superfund will be a new category of Type A event.

> Clearance assesses whether the removal of the ceding sponsoring employer's covenant caused by the transfer has been adequately mitigated.

Ceding employers are expected to seek clearance, where appropriate. Indications from the guidance are that it is only in circumstances of schemes leaving PPF assessment (that is, where no sponsoring employer remains) where it would not be appropriate to seek clearance. However, as the market develops, the concept is proven and transactions become more frequent, the necessity of clearance may start to be questioned in certain cases, and we would expect TPR to grant it more quickly . We can already identify circumstances where it would be very clear that a transfer to a superfund would not involve "material detriment".

However, this approach is some way down the track yet. Even in PPF+ cases the expectation is that some notification of the transaction will be given to TPR and engagement with the trustees and superfund is still expected (see 'Schemes in Assessment' below).

Trustees have an active role to play in the clearance application. They will be listed as a 'directly affected party' to the application by the ceding employer and their evidence will be critical to any application granted. TPR flags its intention to pay close attention to trustees' evidence on satisfaction of the gateway principles, and in particular on the assessment of any mitigation provided.

Superfunds will also have a key role to play. They too will be listed as a 'directly affected party' and will be responsible for providing relevant information to be contained in the clearance process, including information on their position post-transfer.

Any clearance application must consider the context of the transfer to the superfund. In particular, if there is simultaneous corporate activity in relation to the transferring scheme's employer group this will be relevant to TPR's consideration of any application.

This step 9 is about finalising the clearance application, in recognition of the fact that Employers should produce a draft clearance application to be submitted to TPR, allowing it to flag issues that may arise at an earlier stage.

Evidence to be appended to a clearance application includes:

— analysis of other forms of support or consolidation options available to the pension scheme, for example a transfer to a DB master trust, or seeking further support from the wider employer group;

— the consideration of the gateway principles and a clear rationale for the conclusion that the gateway test is met;

— evidence of any employer top-up payments as a result of the transfer;

— demonstrating adequate mitigation for any detriment caused by the transfer;

— superfund evidence that it will continue to meet the capital adequacy requirements post transfer.

Once all evidence has been submitted TPR advises applicants to allow at least 3 months for a decision to be made. The transaction should then take place within a further 3 months of any granted clearance.

Factor the clearance timescale of at least 3 months into any project plan.

The spectrum widens

The guidance trails some atypical circumstances where transfers to superfunds may be contemplated including:

(a) in PPF assessment cases;

(b) where the employer sponsor is not initially divorced from the ceding scheme (but might be replaced in the future); and

(c) partial scheme transfers.

It's helpful to have a steer from TPR that these circumstances are not, in their view, a bar to transacting.

Schemes in PPF Assessment

If trustees can secure an immediate buy-out for full benefits with an insurer after exiting PPF assessment, this should be their preferred option. However, if (as is likely) trustees are not able to secure an immediate full benefit buy-out with an insurer, they will need to decide whether to:

— transfer to a superfund offering a high probability of full benefits, or

— buy-out with an insurer at a lower level of benefits.

TPR is clear that trustees may not go ahead with a transfer to a superfund without member consent for lower than full benefits. Therefore, any solution involving a transfer to a superfund absent member consent will need to bridge the gap between the funding level of the scheme and full benefits.

A clearance application may not be appropriate or possible for schemes in PPF assessment, although each insolvency situation is different. However, TPR will still require trustees to evidence the rationale for transferring to a superfund rather than securing a PPF+ buy-out with an insurer, including demonstrating how the gateway principles are satisfied. Trustees should also engage early with both TPR and the PPF.

A further distinction for schemes in assessment relates to costs. There may be no employer to pay for the trustees' professional advice required for a transfer to a superfund. TPR is clear that the costs of considering 'new and innovative structures and methodologies' for transferring to a superfund should not be met by the scheme. This appears to be a nod to early movers in this area as the superfunds develop their offering to PPF+ schemes; the insinuation being that those costs are met by the superfund. The trustees' costs of the transfer itself, including addressing the gateway principles and due diligence, can be met from scheme assets.

Transfers with no immediate severance from the employer

Transfers to some arrangements do not initially divorce the scheme from the sponsoring employer. The gateway principles still apply to such transactions, in particular ceding trustees need to be satisfied that the transfer will improve the position for members, by providing additional support to that of the existing employer, or provide access to greater economies of scale than could be achieved by other means. Other considerations for such arrangements will include whether TPR's capital requirements in the interim regime apply to the arrangement and the impact on member benefits if an insolvency arises.

Partial transfers

The guidance includes a short reference at the end to the possibility of a partial transfer to a superfund if a full buy-out or a transfer of all members to a superfund is not possible. The closest analogy would be to a partial buy-out with an insurer of e.g. pensioners or a tranche of pensioner liabilities. The gateway principles would still apply to any such transfer and trustees will be required to demonstrate how such a transfer would improve the likelihood of all members receiving full benefits – and why a partial transfer to a superfund is the best option in the circumstances of their scheme.

Partial transfers are the most challenging type of transfer – and specialised legal advice should be taken in all circumstances.

A final thought

This guidance will give Trustees comfort that the proposition of transferring to a superfund is credible and worth consideration. It's a clear stamp of legitimacy for the assessed superfunds. The real question for trustees going forward is can they afford not to take into account a superfund transfer option? Are there circumstances where members will question why a trustee didn't consider providing the security and/or increased funding for their schemes that a superfund could have provided? This is particularly relevant in a time of economic turmoil, and staring at an even more uncertain future. This comment applies equally to schemes coming out of PPF assessment, and to those ongoing.
