Consolidation of defined benefit pension schemes
IFoA response to the Department for Work and Pensions

1 February 2019
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Dear Sir/Madam,

RE: IFoA response to DWP consultation on the consolidation of defined benefit pension schemes

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to comment on the Department for Work and Pensions’ (DWP) proposals for the consolidation of defined benefit (DB) pension schemes.

Executive summary

This response has been developed by the IFoA’s Self-Sufficiency, Buyout and Consolidation Working Party and overseen by the Pensions Board. Before moving on to our detailed responses, we would like to highlight the following:

- We would note that there is a difficult balance to be found between creating a new viable option that could be valuable to some schemes in certain circumstances, and creating an option that sponsors could use to facilitate a cheaper outcome with more risk to their members than would otherwise be the case. It is therefore essential that the appropriate controls are put in place and that there is a recognition among policymakers, trustees and members that the level of security provided will be different under this model.
- Superfunds could be a viable development provided they are operated and regulated to a level consistent with the risk of failure that they actually have. The regulatory approach in the consultation may not achieve this, meaning an appropriate ‘balance’ may be difficult to achieve.
- Some of our responses depend on the overall policy objective. We believe it is important for DWP to satisfy itself on this point before moving on. For example, is the objective to maximise consolidation in order to improve governance and consolidate Pension Protection Fund (PPF) risk for smaller, riskier and less well run schemes? Or is it to facilitate the separation of UK sponsors from their pension liabilities in a more cost-effective manner than an insurance solution?
- Without a clear policy objective, it is difficult to comment in detail on the range of measures without fully understanding the purpose and rationale behind the thinking of some of the proposals, particularly when there are outstanding questions on related matters of policy and regulation. This is a particular issue given the high level of
prescription in financial tests and lists of issues to be considered, many of which could be better served by having strong principles and a regulator well-versed in the relevant issues.

- The IFoA is very conscious that the two current arrangements – an ongoing DB scheme and a bought out insurance policy – sit at the extremes of the spectrum, with very different aims, methods of regulation and risk profiles. Given that a new consolidator arrangement will need to sit somewhere in the middle, its regulation, aims and risk profile may each have some features of both existing arrangements. There is therefore much to ‘play for’ and the IFoA cautions against too much emphasis on the detail before the policy intent and basic principles have been established. Clarity of thought as a first step will more likely result in a successful outcome.

- The Pensions Regulator’s (TPR’s) readiness in terms of expertise and funding has not been addressed in the consultation and neither has the potential for a different institution to regulate the proposed regime. For example, there is a case to consider for the Prudential Regulation Authority (PRA) to play a role, as it is already equipped to regulate the financial modelling envisaged for superfunds, or the Financial Conduct Authority (FCA), given a superfund might be viewed as an investment vehicle paying dividends to investors. Notwithstanding this comment, we have referred to the eventual regulator of superfunds as TPR throughout our response.

- There are areas of the consultation where further input would be useful once more detail is available and the IFoA would be happy to assist, drawing on the expertise of its Self Sufficiency, Buyout and Consolidation Working Party as appropriate.

**IFoA Response to consultation questions**

**Defining superfunds**

**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 believe that the definition needs to capture a commercial business that sets up multiple schemes (one per transfer) and also one that replaces the sponsors of schemes (rather than transfers to a superfund), as these variations may otherwise not be classed as superfunds.

We assume legislation will be drafted so that arrangements that “look like” the superfunds envisaged by the stated characteristics will be in scope even if technically they do not have all those characteristics, so as to avoid arrangements being established that unintentionally or intentionally fall outside of the requirement for authorisation.

We would therefore expect that if TPR is equipped with the necessary powers, it will be able to intervene and prevent unsuitable institutions from being established as superfunds.

With reference to specific points of the proposed definition, we would also add the following comments:

- In respect of the third characteristic in the consultation paper, we would highlight that the capital buffer might be partially provided by the transferring scheme’s sponsoring employer (i.e. the link with the employer may remain in place in some (potentially capped) manner).
In respect of the fourth characteristic in the consultation paper, we would highlight that there may be no returns to investors from the scheme – the returns may only be derived via the buffer.

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?

TPR may need to ensure that when a scheme transfers into a superfund, there is an appropriate balance between scheme assets and the capital buffer to ensure that the superfund corporate entity does not have excessive influence or negotiating power over the superfund trustees. This point is connected to management control over the capital buffer which we comment upon later.

Additional challenges for TPR may arise around the ability of capital to be withdrawn: how the quality and sustainability of capital is measured will need to be fully understood. TPR will also need to fully understand the business model of each superfund (and how investors get returns) as the models will vary.

Authorisation Criteria

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

We feel others are better placed to comment here.

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?

Potentially, where the terms are materially different from those which were previously envisaged at authorisation. For example, the business plans, capital support mechanisms or the profile of schemes may change or be different for new segments, so the business model approved may not cover the new circumstances.

Supervisability

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?

We believe these are suitable restrictions.

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?

We expect TPR would find it more practical and straightforward to regulate UK companies.

Fit and Proper Persons

Question 7: Should TPR have a discretionary power to require evidence that individuals outside the superfund structure meet the fit and proper persons requirement?
No comment.

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

No comment.

Question 9: Should TPR have the power to interview individuals for the purposes of the fit and proper persons test?
Others may be better placed to answer this.

Roles within the superfund subject to a mandatory fit and proper persons requirement

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

We note that although the statutory scheme actuary to a superfund is a key advisory role, scheme actuaries are required to possess a practising certificate issued by the IFoA, so we do not expect scheme actuaries to be subject to separate specific ‘fit and proper persons’ requirements for superfund purposes. In saying this, we anticipate that the superfund scheme actuary role will be very tightly defined by the superfund.

We would, however, expect those in other key roles who happen to be actuaries to be subject to the same ‘fit and proper persons’ requirements as anyone else.

The Fit and Proper Persons Test

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

Yes, in theory, this may be a worthwhile consideration. However we would question how this would be monitored and/or enforced in practice, to ensure that it is not reduced to a ‘tick-box’ exercise.

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

No comment.

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

No comment.

Governance

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?
Yes, we agree that there is a role for NEDs, for example in making key appointments, and therefore there should be some form of minimum requirement. However we will leave it to others to comment on how this may be achieved.

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

There is an argument for having at least one superfund nominated trustee on boards to ensure investors’ views are appropriately taken into account when exercising trustee duties and making decisions, although we would not expect such a trustee to chair the board. We also believe there is merit in having independence over who appoints trustees to the superfund.

We do not, however, necessarily agree that all the trustees should be independent and would argue that the quality of trustees, and even more so, the quality of the board as a whole, its diversity and the sum of its knowledge, experience and other qualities, can be more important than each trustee’s independence.

It will also be important that the corporate entity cannot fetter the trustees’ actions. We would expect TPR to check this as part of the authorisation process.

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

Yes. ‘Non-affiliation’ is a better term than ‘independence’ and may be a more suitable for this type of structure, particularly as it would assist trustees in complying with the fundamental duties of the scheme if they are not affected by any relationship with the scheme funder.

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

Overall, we would expect most existing governance arrangements to be applied to superfunds given the desire to consider them as occupational schemes, including MNT/MND requirements.

We see some value in achieving member representation and there is a range of views on how to obtain their involvement, but we note that this will be a contentious area.

**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?**

Yes (and see our response to question 17).

**Systems and Processes**

**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?**

No comment.

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

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?

At a high level, the insurance based approach using a Solvency II type balance sheet is simply one way of delivering a probability of success.

We believe a pensions based funding approach with an added test for probability of success would be appropriate and, on the basis that superfunds are intended to fall under the occupational pension regime, we do not believe that probability of success should be measured by reference to a Solvency II type methodology.

Also, we do not believe it is appropriate to require a common long term funding objective, with or without minimum standards but, instead, we would expect that the superfund’s long term funding objective would be one of the matters TPR considers for authorisation purposes.

Further, we believe the probability of success should be determined primarily by reference to member outcomes and we comment on that further in our answer to Question 23.

The consultation paper proposes an internal model regime, governing the stochastic model to be used for authorisation and regular reporting. We highlight that over the long term and in the tail distributions that are being considered here, stochastic models can produce very wide-ranging results, so a strong regime is essential to ensure that the models are robust, credible and comparable.

The experience of the insurance industry internal model regime may provide some learnings for the superfund regime. There will need to be full consideration of the standards of statistical quality, data and calibration, governance, model validation, documentation, future model changes and the extent of reliance on expert judgement. The application and approval process also needs to be set out clearly.

However, it should be noted that the experience of the life and general insurance industry is that the process has been extremely difficult and expensive, and significant costs were expended to meet the standards that the PRA considered necessary to satisfy themselves that the models were appropriate. TPR should therefore consider carefully the standards it wishes to set and the process that it wishes to enforce for internal model approval. It would therefore be useful for TPR to specify what it expects to see in an internal model and it might be appropriate to base some of the key methodologies and parameters on the PPF’s model given the investment made in that, with superfunds having the freedom to depart from that baseline with justification.

It should also be noted that for superfunds setting up after the requirements are in force, the costs of obtaining internal model approval will need to be incurred before any business is actually written. The investors will therefore need to absorb the sunk cost, at least initially, which may prove a deterrent for new investors.
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?

See answer to Question 21.

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?

We are in favour of the principle of operating the consolidators in line with a broad level of member security.

The target probability is a policy decision but we note that the higher the probability the higher the required funding (i.e. the combination of scheme assets, employer top-up and investor buffer capital) of a scheme on entry into a superfund and hence the smaller the potential market for superfunds. If the target probability is too high then the required funding will be too close to buyout which will mean trustees and/or employers will not find the superfund option attractive.

99% appears too high a level of security and too high a level of precision. One of the drawbacks of the probability of paying pensions is that it is heavily model dependent and cannot be relied upon to the nearest % given it is bringing together a number of very uncertain variables and projecting out over years or decades.

For example, if this probability is to include longevity risk (the chance of the mortality basis being revised over a period of many years) then it would be relatively difficult to ever achieve a probability of 99% without an explicit hedge in place against this risk, unless the buffer capital was excessive. Longevity is important as it is likely to be one of the largest risks in these vehicles. While investment risk is subject to large estimation errors, there are at least established frameworks to quantify this, whereas modelling a combination of longevity and investment risk over periods of many years will result in numbers that cannot be relied upon to a high degree of precision.

We would also note that the definition of “99% probability of members being paid” is not altogether clear and within a stochastic model, can be interpreted in a number of ways. For example, one measure could be to determine that all the members have a 99% chance of receiving all their benefits ultimately, but there may be points in the interim where the fund fails to be able to pay on time or doesn't meet the 99% expectation. Alternatively, it could be interpreted as being required to ensure that level of security at every point. The latter is a significantly higher bar to meet than the former. In fact, depending on interpretation this requirement might be far stronger than the Solvency II balance sheet test.

We think the level of security is a key consideration and further work and thought ought to be invested in finding the “right” level or at least the right balance of risk and return. On this last point, we can also envisage an outcome where different consolidators operate different models, with a different probability of meeting members’ benefits over the long term.

Question 24: Should a superfund have a long term objective to secure benefits with an insurance company?
This should not be a necessity but a superfund must have a clearly defined strategy for its liabilities over the long term which may or may not include securing benefits with an insurer.

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

We do not think it is appropriate to set out the authorisation basis at this stage, until a decision is made about who will regulate superfunds and how. An over-formulated test, as suggested in the consultation, may lead to inappropriate decision-making where individuals make decisions in order to comply with the test, rather than to meet the underlying objective. A set of underlying principles would be of much more use until the approach by the eventual regulator is known. Once known, the regulator may well want to operate a different set of formulae/tests in different circumstances and for different structures of providers.

**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 think that combining the probability of paying all benefits, and the probability of being funded at a certain future level is overly complex and potentially confusing as a framework. Combining the probability of paying benefits with the current funding level is a more understandable framework.

As mentioned in our answer to Question 25, further work would need to be done on the proposals in paragraph 105 if the authorisation basis proposal was to be taken forward. Also, as mentioned in our answer to Question 23, the precise definition of 99% (or whatever percentage is set) needs to be articulated.

For example, Question 23 states “Does a 99% probability of paying or securing members’ benefits over the lifetime of the scheme …” whereas this Question 26 states “… a 99% probability of paying or securing members’ benefits at all times” – these are each very different measures to each other.

**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?

Both of these dates are relatively far in the future and we think that there is a case that superfunds should be run in a way that meets demonstrable security and funding targets on shorter time horizons (e.g. 5 years) with projections and qualitative analysis of how the position could develop and be managed after that (so long as it is backed up by further stochastic analysis for longer-term). A false sense of security can be propagated by allowing management to look forward over such long time periods.

**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?
As per our answer to Question 21, we do not believe it is appropriate to prescribe additional minimum standards. We would expect that target annual funding volatility would be assessed by TPR as part of the authorisation process.

Assuming the superfund can ensure benefits are guaranteed to be payable over 5 years; that longer term analysis to suggest all is on course for paying benefits in the future is undertaken; and trustees have management control over the buffer with a sensible pace of releases to investors, then the tests outlined in our answers to questions 23 and 27 would suffice.

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?

We believe that superfunds should be required to annually publish information that confirms their financial status against the key financial metrics that are eventually implemented following this consultation.

Schemes reaching buyout funding

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, it should not be compulsory for superfund to buyout as soon as practicable, with the exception of circumstances where those were the terms on which the superfund sold itself to the trustees (or the terms on which it was authorised). The superfund’s trustee board would need to act in members’ interests and therefore it would need to rationalise why benefits are not being bought out. Members can in some circumstances be worse off under a buyout (for example, where an exact benefit match is not possible), so there might be a good reason not to do so.

Another aspect for TPR to consider is the choice of insurer if trustees do proceed to buyout (and the trustees’ freedom to make such a choice). Investors will likely prefer the lowest cost option so as to maximise their return, but the lowest cost option may not be the most appropriate (for example, according to whether there is a good match of benefits, whether residual risks are covered, insurer security, administrative capabilities etc.)

It might be more efficient or in members’ interests to run on after being fully funded on buyout, especially if members benefit from additional funding. Some margin above the buy-out funding level would also provide more flexibility and confidence that buy-out could ultimately be achieved.

We would suggest that DWP or TPR issue guidance on this issue to clarify any grey areas.

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?

We do not believe there should be a separate minimum level of funding for the reasons described in our answers to the previous questions.
Proposed test for failure

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

We would encourage a flexible approach in these circumstances and recommend avoiding using tests that depend on very long-term projections. For example it might be better to look at the next 5 years (rather than 1% over the lifetime), with some qualitative analysis on the longer-term scenarios, thus pursuing an approach that is less model dependent. If there is a desire to obtain a greater sense of likelihood of failure, then stochastic modelling could be used.

Funding level triggers and responses (superfund triggering events)

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

The Solvency II regime includes a set of different intervention points where the PRA will intervene behind the scenes if a funding issue is identified. A similar system could be introduced for this regime. If so, it would be helpful to understand where the intervention points might lie and what the necessary steps might be when TPR does intervene. We would suggest that this is looked at in more detail as it should not be assumed that existing measures in the occupational regime are sufficient for superfunds.

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

We would note that the S179 basis or any prescribed basis will never accurately reflect actual market bulk annuity rates. The issue here is not just whether the S179 level of funding is sufficiently accurate, but also the difficulty superfunds will have in managing their funding risks if one of their targets (S179) cannot in fact reflect how bulk annuity pricing moves on a day to day basis. This is less of an issue for other ongoing occupational pension schemes as there are no prescribed triggers for formal intervention based on S179 funding.

A more robust approach might be to also require superfunds to retain a minimum level of current funding and medium term (e.g. 5 years) projected funding above the PPF’s technical provisions assumptions (including asset outperformance over the discount rate) assuming PPF Compensation is paid. This would be consistent with the policy that superfunds should not be a burden on PPF levy payers. This avoids focusing on the S179 basis, or on setting another basis that tries to anticipate pricing in the bulk annuity market which in practice is opaque and depends on various supply and demand factors.

If the PPF is comfortable that its technical provisions basis (including asset outperformance over the discount rate) reflects its cost of liabilities, then that should be a robust trigger measure, a suitable measure for monitoring likely evolution of funding against that trigger and for a superfund to manage its risks against.

A 5% buffer retains a lot of “gap risk” to actual buyout cost given the length of time it takes to obtain insurer quotations and uncertainty as to what the pricing would be. Our suggestion of a trigger based on the PPF’s technical funding methodology perhaps avoids this (provided the PPF...
is comfortable taking on a scheme with a funding level that is at least equal to its technical provisions basis), albeit we would suggest that each superfund is required to agree with TPR what the buffer should be in light of its actual investment strategy and year on year evolution of PPF drift.

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

Breaching the PPF-type trigger should be a very uncommon event. We would suggest that, rather than debating a suitable grace period, wind up should commence within a short period (e.g. one month) unless the superfund submits a management plan for rectification to the satisfaction of TPR. We would expect that as a superfund’s funding level gets closer to the trigger, TPR will expect frequent (for example, monthly) reporting of the funding level against the trigger.

**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?

TPR should also have the ability to waive application of the trigger based on bulk annuity pricing in the event of a “dislocation” in the bulk annuity market which results in supply drying up and/or pricing increasing significantly.

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

We see value in having some triggers as they would enhance security, protect the PPF and would provide a trigger for capital to pass to the scheme (i.e. the level at which some profits should not be taken). However, we do not believe that the Tier 1 funding level is necessary. Both TPR and the trustees should be alert to the superfund’s deterioration and the presence of the minimum funding trigger should be sufficient enough to protect members’ benefits.

In general, there should be nothing preventing those establishing a superfund introducing rules within the superfund that permit transfer to another superfund whether that is trigger-based or not (or indeed transfers to insurance buyout). That might be a feature attractive to trustees considering a transfer to a superfund and also to investors who may see it as a way of taking advantage of a transfer of their superfund’s liabilities to a more efficient superfund. However, we do think that there will need to be a higher bar for transfers between superfunds than for trustees transferring liabilities from a traditional occupational scheme to a superfund.

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

See answer to Question 37.

**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?

See answer to Question 37.
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?

See answer to Question 37.

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?

For reasons highlighted in our answer to earlier questions we think this introduces yet another funding test that needs to be regularly calculated, managed, reported and overseen by the trustees, superfund management and TPR and hence more complexity. It might be easier if the decision is left to the trustees given that TPR will be able to reject new business due to the clearance process.

Again, a reiteration of guidance from TPR will be important for trustees in this position and could help to self-police this area.

Also, as already mentioned, the independence of the trustees, or at least robust governance and understanding of their duties, will be important given they may come under commercial pressure from the superfund sponsor to accept new business.

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?

The ability for investors to take a profit should be consistent with the supervisory regime implemented following this consultation and also the business plan/approach submitted by that superfund for authorisation purposes. There may be various approaches to payment of profit to investors and so there should be sufficient flexibility to accommodate those provided they are consistent with the supervisory regime.

Additional protections from excessive or inappropriate profit taking

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?

We agree with the general thrust of what is proposed. The objective should be that distributions back to investors should be progressive and sustainable.

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

We believe this will largely be a policy decision for DWP to make and it is connected to how much member security will be expected from superfunds, balanced against the need for investors to make reasonable returns (compared with other opportunities). The question can perhaps be reframed as to whether DWP is comfortable that a secure superfund market can be created in which good member outcomes are delivered by superfunds that can, if they choose, operate on a long term run-off basis with regular returns back to investors (much like an insurer but without as high a solvency level). If the buyout funding requirement is excluded then the long
term run-off funding plan needs to be prudent with sufficiently high likelihood of delivery before profit can be distributed.

We should also draw attention to our early comments around buyout funding levels being difficult to determine given buyout pricing is not transparent.

We would highlight that insurers’ Solvency II profit margins on buyout are typically several per cent of the overall buyout premium. Therefore if the profit distribution restriction was drafted along the lines of a buyout policy having to be purchased before a distribution is made (rather than, as stated in the question above, buyout funding exceeded but with no insurance policy purchased) this then means investors would be unable to receive profit distributions until the superfund can deliver a significant profit to an insurer via buyout. Again, we would see that as a policy decision.

Finally, we would also add that there is little commentary in the consultation paper about how and whether investors should be obliged to supply additional capital during difficult financial periods. In their current form, the proposals focus on the regulations around the profits that investors can extract during well-performing periods but not on their obligations during challenging times. Further consideration on this point is necessary.

**Sectionalised schemes**

**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?

From an actuarial perspective this is reasonable if the buffer capital is also sectionalised, as for all intents and purposes they are separate superfunds. The master trust overlay is a means of creating economies of scale.

**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?

The overriding principle should be that if they are genuinely separate segregated sections with segregated buffers then each should be considered separately. If the master trust allows the amalgamation of surplus and deficits at scheme and/or buffer level, then it needs to be considered on a combined basis. We feel it would be better to be principles-led here as it would be difficult to anticipate in advance all future superfund structures and arrangements.
Question 47: Does this approach provide adequate protection for members, while effectively balancing the interests of the investors?

The capital buffer is a key part of the superfund structure, therefore trustees should have strong controls over how it is invested, its operation (eg 3rd party providers) and surplus distributions. Where that buffer is made of contingent capital the trustees will need to ensure they have genuine value.

It does not appear a necessity for amounts to be paid from the buffer into the scheme to make up deficits as long as the trustees have strong controls. Indeed requiring capital buffer to be paid into a scheme to make up deficits as a matter of routine risks damaging the sustainability of superfund models as, once capital is paid into the superfund, it cannot be returned without the payment of a substantial free-standing tax charge even when it is clearly not needed.

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?

See answer to Question 47. We expect that the superfund trustees will need to take covenant advice on an ongoing basis about the quality of the capital, with the liquidity/availability of the capital becoming more important in situations where the funding level deteriorates. The trustees have some control in how they approach the investment strategy for the Scheme assets – if the capital moves to “less reliable” assets, the trustees could choose to take a much more prudent approach with their own investment strategy.

We note that the ceding scheme trustees will also want to take covenant advice on the quality of capital (among other issues) before agreeing to the move to a superfund.

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

The buffer could perhaps be notionally split into two parts for these purposes. Firstly the amount required so as to meet the various funding requirements for superfunds (which may be the whole buffer). Secondly, a distribution reserve which is buffer surplus for distribution back to investors, albeit that distribution might be phased over time as per our answer to Question 43. It would make sense for the investors to have a strong say in how the distribution reserve is invested.

We expect that the superfund trustees will take covenant advice on the quality of the capital on an ongoing basis, and the ceding scheme trustees should also have taken advice on the proposals for capital before agreeing to the original transfer.

Evidence required to demonstrate that financial sustainability requirements are satisfied for authorisation

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

We would expect superfunds to provide information to TPR both routinely and on request, as per the existing occupational regime requirements, to ensure they are regulated to the same
standard. The existing model of regulation is a good default position to revert to. Superfunds should also be required to provide details of their strategy outlining how they envisage other risks, such as demographic risks, will be managed.

**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?**

If within the statutory framework, the trustees and scheme actuary are to take responsibility for scheme funding, then the control of the funding (including modelling) should sit with the trustees who should act after taking the advice of their scheme actuary. The scheme actuary should take responsibility for the advice provided. Whist there is no problem in having a suitable regulator reviewing a model, we would argue against the use of a standard model produced by the Regulator.

Such a standard would inevitably be viewed as providing the only “right answer” and would undermine the scope for any individual actuary to make professional judgements and take responsibility for them. A Regulator model might be devised with the interests of the Regulator in mind rather than the interests of the scheme trustees or their members. A centralised model would also be at significant risk of being infected by group think and could also be slow to react to market changes. A scheme actuary responsible to the trustees and with a public interest duty is well placed to advise on appropriate modelling.

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

No. TPR should avoid developing a model which could inadvertently become the default or that allows potential for “modelling arbitrage”.

**Reporting**

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

No comment other than to say that those aspects that were important to authorisation should be reported, depending on type, regularly or on an exception basis (i.e. where there is a change).

**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?**

Superfunds should have to disclose their asset allocations and investment risk limits, however we would not expect TPR to get involved in the investment strategy, except in exceptional cases where there may be concern over the sustainability or governance of that superfund.

**Public disclosure**

**Question 55: Should superfunds be required to regularly publish publicly available material on their financial position and operations?**
We do not support mandatory requirements for superfunds to disclose specified information regarding their financial position and operations (including any submissions made to Companies House), however we expect many superfunds will do so anyway and those that do not will come under competitive pressure to do so.

**Significant events**

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

We would expect to comment on this aspect of the consultation with specific reference to superfunds once more is known about the outcome of the consultation on TPR’s powers and the notifiable events framework.

More widely, clarity on what TPR will do when notifiable events are reported to it would also be welcome and may impact on what needs to be reported.

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

We believe this needs to be agreed between TPR and the superfund based on the specific circumstances of the superfund. This would likely be agreed at outset based on the authorisation submission and then reviewed periodically.

**Skilled persons reports**

**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, although we might expect TPR to be required to justify its actions.

**Responding to market risk**

**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?

In our experience, we have not found codes of practice to be particularly nimble in reacting to emerging risks. More broadly, we are concerned that an enforceable Code of Practice, which appears to us to be a contradiction in terms, would effectively allow TPR to create law without the oversight of parliamentary process.

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

See above.

**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?

No comment.
Covering the costs of supervision

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

In principle this seems fair, although we would suggest that the answer to this is considered in the context of the overall policy aim of consolidation.

Superfund gateway

Question 63: Do these principles achieve the policy aim?

Trustees should act in the best interests of members. Hence, we believe it is a Government policy decision as to whether a formal set of gateway rules should be put in place. If a formal set of gateway rules is adopted then we believe those proposed broadly achieve the policy aims as we have understood them.

We would suggest that the rule “excluding schemes assessed by the trustees as being able to afford buyout in the foreseeable future …” could be more carefully drafted, as the current wording may place trustees in a difficult position should they not proceed with a superfund transfer following such an assessment and then, say 6 years in, the employer becomes insolvent and there is a large buyout deficit.

In relation to the rule “… enhances the likelihood of members receiving full benefits …” we would suggest this be qualified to refer to a material enhancement.

We would expect to comment in more detail once the proposed wording of the gateway rules is available.

The actual wording will be critical in ensuring properly informed decisions can be made and trustees are not forced into inappropriate decision-making or unintended consequences.

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

It would generally appear reasonable, but should remain subject to the overriding requirement that trustees should act in the best interests of members. For example, a scheme with a very high likelihood of achieving buyout in 10 years with contingent capital in place to cover any gap in the meantime should probably not be transferring to a superfund if that worsened the position for members.

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

Trustees should be required to ensure that they have carried out sufficient due diligence on their own scheme to ensure that they can accurately represent their liabilities to the superfunds. In particular, trustees should be expected to be able to demonstrate that they understand the actual legal entitlements to benefits in respect of all of their members as required under the terms of the scheme rules and pensions law. Trustees have a legal duty to pay the correct benefits and
therefore, when representing what those are to a third party when the obligations of the trustees and the employer are to be severed, it would be reasonable to expect that the legal and administrative work necessary to fairly represent the scheme to the consolidator should be a duty of the trustees.

**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?

As long as scheme plus the buffer is enough and the trustees have sufficient control over it, we would question why a minimum would be set for the scheme in isolation, as it would create a further hurdle for the scheme.

Not having a minimum funding level requirement at entry might also increase the numbers of schemes that would be eligible (including those less well funded schemes that arguably stand to gain more from consolidation) and also increase the scope for innovation in how superfunds are developed.

**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 our answer to Question 66. However, if there were a minimum scheme funding level, we believe it would best be based on the authorisation basis. ‘Buy-out’ is a well understood concept but the assessment of the buyout position in scheme valuations is often just a broad estimate and not necessarily closely aligned to actual market pricing.

**Covenant Advice**

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

Yes, we expect ceding scheme trustees will need to properly understand the covenant available to their members before and after a transaction in order to make a decision that is in members’ interests. However, we would highlight the cost to small schemes of obtaining this 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?

We would expect that such individuals would need to be sufficiently competent and independent (i.e. do not and have not provided services to the employer), and that they are answerable to the necessary regulatory regime.

**Transfers to a superfund**

**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.
The consultation is clear that a transfer needs to be in members' interests (not least in order to satisfy the trustees’ fiduciary duties), but it is less clear whether trustees will only be required to be satisfied that a transfer will result in good outcomes, or whether they will need to be satisfied that members will benefit from better than existing outcomes. In other words, how high will the bar be and exactly what will trustees need to take into account?

Bulk transfers on a no consent basis with actuarial certification are typically done on the basis that the benefits will remain identical in the transfer process. However, the law is more flexible than this and allows some reshaping of benefits using transfer credits, provided the transfer credits in the receiving scheme are “broadly no less favourable” than the rights being transferred for each member.

Importantly, although an actuarial certification that transfer credits are “broadly no less favourable” is a requirement for a bulk transfer without consent, it is not sufficient and does not give the trustees authority to make the transfer. Rather, the trustees must make their own decision about whether the transfer is in members’ interests and whether to allow it to proceed. The IFoA believes a bulk transfer without member consent to a superfund should work in the way we have described and it would not be appropriate for a transfer to proceed solely on the basis of a stronger actuarial certification. We would therefore reiterate that this is a decision for trustees, who already have a large number of legal obligations in how they carry out this process. These are the protections that should be focused on.

We also note that there are existing technical and legal uncertainties relating to the actuarial certification of a bulk transfer without consent, such as whether the actuary is required to consider changes in security or the strength of covenant before and after the transfer. While these uncertainties exist, they will reduce the potential for transfers to a superfund.

Trustees are likely to need further guidance or legal reassurance in relation to bulk transfers without consent if the Government wants to encourage transfers to superfunds, since the alternative is to seek individual member consents to such transfers, which is expensive,cumbersome and generally problematic, particularly for larger schemes.

Finally, we also note that there is a significant difference between “members’ interests” and “members’ best interests”. “Best interests” is used in the consultation questions, but DWP needs to make it clear whether this is intentional.

**TPR’s role**

**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.

TPR should be granted the necessary powers in order to prevent a scheme from entering a superfund, as the gateway will be unable to foresee all eventualities, although we would expect TPR to have to justify such a prevention.

**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?
TPR should have the power to obtain the advice that it needs to satisfy itself, such as expert “skilled persons” reports, although to the extent that TPR will provide clearance for all transfers, we might expect that provision of the requisite information simply becomes part of the clearance process.

**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.

See our introductory remarks about the need for an effective and well-equipped regulator of superfunds. Other existing regulators may be more suitably prepared to regulate superfunds, particularly from the perspective of funding, resource and skill-set.

**Terminology**

**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?

DWP might want to consider differentiating between insurance company “incubator” superfund models and DB master trusts, where the latter might have a preference for running off the assets for the whole life of the scheme.

Should you wish to discuss any of the points raised in further detail please contact Henry Thompson, Policy Manager (henry.thompson@actuaries.org.uk / 0207 632 2135) in the first instance.

Yours sincerely,

John Taylor
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