Department
for Work &
Pensions

Consolidation of Defined Benefit Pension Schemes

Public consultation

December 2018

Contents

Introduction

1. This consultation seeks views on a number of measures to support the consolidation of Defined Benefit (DB) pension schemes. In particular, we are seeking views on a new legislative framework for authorising and regulating DB "superfund" consolidation vehicles of the type envisaged by the white paper Protecting defined benefit pension schemes, published in March 2018.

2. Many in the pensions industry believe that superfund consolidation represents a potentially more efficient way of managing legacy DB pensions for some closed schemes. While we welcome innovation, we recognise that these vehicles have a different risk profile to that seen in traditional DB pension schemes and therefore pose their own set of challenges .There is broad consensus around the need for a new legislative and regulatory regime to ensure superfunds operate as intended, including a requirement for all superfunds to be authorised. The aims of the superfund authorisation and regulatory regime will be that:

    - members of superfunds benefit from equally effective protections to members of other DB pension schemes;
    - the risks specific to superfunds are proactively regulated - risks include the replacement of the employer covenant by external capital, potential commercial interests within the superfund, and other factors that influence their financial resilience and viability; and
    - the Pensions Regulator (TPR) has the right tools and powers to intervene when necessary.

3. These proposals have been developed in close consultation with TPR, the Pension Protection Fund (PPF) and other stakeholders.

4. This document also includes an update on work to introduce an accreditation regime for new and existing DB Master Trusts and changes to guaranteed minimum pensions (GMP) conversion legislation.

About this consultation

Who this consultation is aimed at

We expect this consultation to be primarily of interest to:

- Employers who sponsor a DB pension scheme(s)
- Trustees

- Those seeking to establish a superfund
- Members of a DB pension scheme(s)
- Pension professionals
- Life insurers

Purpose of the consultation

This consultation sets out our proposals for how a future legislative framework for authorising and regulating superfunds might work. The consultation document contains a number of questions about specific aspects of the policy. In developing our proposals we have looked to other authorisation and regulatory regimes such as those for DC Master Trusts and Prudential Regulation Authority (PRA) authorised firms.

We would particularly welcome views on whether our proposals offer sufficient protections for members, including views on our proposals around the financial sustainability and governance arrangements of superfunds discussed in Chapter 3, and the introduction of a regulatory gateway for schemes looking to enter a superfund, discussed in Chapter 5.

Scope of consultation

This consultation applies to England, Wales and Scotland. It is envisaged that Northern Ireland will make corresponding regulations.

Duration of the consultation

The consultation period begins on 7 December 2018 and runs until 1 February 2019.

How to respond to this consultation

Please send your consultation responses to:

Defined Benefit Team
Private Pensions and Arm's Length Bodies
1st Floor, Caxton House
Tothill Street
London
SW1H 9NA

Email: DB.CONSOLIDATION@DWP.GSI.GOV.UK

Government response

We will aim to publish the government response to the consultation on GOV.UK. Where consultation is linked to a statutory instrument responses should be published before or at the same time as the instrument is laid.

The report will summarise the responses and outline our next steps.

How we consult

Consultation principles

This consultation is being conducted in line with the revised Cabinet Office consultation principles published in March 2018. These principles give clear guidance to government departments on conducting consultations.

Feedback on the consultation process

We value your feedback on how well we consult. If you have any comments about the consultation process (as opposed to the issues which are the subject of the consultation), or if you feel that the consultation does not adhere to the values expressed in the consultation principles or that the process could be improved, please write to:

DWP Consultation Coordinator
Legislative Strategy Team
4th Floor, Caxton House
Tothill Street
London
SW1H 9NA

Email: caxtonhouse.legislation@dwp.gsi.gov.uk

Freedom of information

The information you send us may need to be passed to colleagues within the Department for Work and Pensions, published in a summary of responses received and referred to in the published consultation report.

All information contained in your response, including personal information, may be subject to publication or disclosure if requested under the Freedom of Information Act 2000. By providing personal information for the purposes of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit or remove any personal information. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this.

To find out more about the general principles of Freedom of Information and how it is applied within DWP, please contact the Central Freedom of Information Team:
Email: freedom-of-information-request@dwp.gsi.gov.uk

The Central FoI team cannot advise on specific consultation exercises, only on Freedom of Information issues. Read more information about the Freedom of Information Act.

1. Background

1. As we set out in the white paper: *Protecting Defined Benefit Pension Schemes*, the available evidence shows that the Defined Benefit (DB) sector is working well and that the vast majority of members are likely to get their benefits paid in full. However, we also identified areas where the system could be improved and made more efficient, including through the consolidation of individual pension schemes.

2. Consolidation already happens across the pensions market to varying degrees, from sharing and outsourcing administrative services, to pooling assets and liabilities through common vehicles such as DB Master Trusts, to insurance buyins and buyouts. Whether and how schemes choose existing consolidation options will depend on their own specific circumstances.

3. A significant proportion of schemes remain in deficit, and have done over the last decade, despite £120 billion being paid in special contributions, the majority of which were deficit reduction contributions. While the outlook for the vast majority of schemes is positive, in that members can expect to receive the pensions they have been promised, there are some schemes where the outlook is much more uncertain. In some cases, a closed DB pension scheme can be a significant burden for the sponsoring employer, limiting their ability to focus on their core business, including investment for the future and the pay and pensions of current employees. In these circumstances pension scheme members can be exposed to a significant insolvency risk of the sponsoring employer.

4. Encouraging a well regulated superfund sector may offer a more effective way of managing liabilities for some schemes. It would provide an incentive for employers to inject significant sums into their schemes to bring them up to being sufficiently well funded on a prudent basis, so that they can enter a superfund. This potentially significant up-front investment would allow the employer to discharge their legacy liabilities, and concentrate on their core business, while being reassured that the members of their pension scheme are likely to be better protected in the long term.

5. For suitable DB schemes, factors which should improve the probability of benefits being paid in full in a superfund include:

- the injection of additional funds from the employer or its parent group,
- the capital buffer provided by a superfund's investors,
- the efficiencies of scale offered by a consolidation vehicle;
- and the absence of potential future sponsoring employer insolvency.

6. Superfunds will have the benefits of scale. They are likely to be able to access a wider and potentially more innovative mix of investment opportunities. Provided the right regulatory regime is in place to deter excessive risk taking, the interests of members and investors are likely to be more evenly balanced. Both stand to benefit from a well regulated regime. In addition, the ability of superfunds to deploy significant capital in the investment markets is also likely to be of benefit to the wider economy as trustees will look to have a well-diversified portfolio which might include investment in later-stage venture capital, or growth-capital for small-medium enterprises (SMEs). This is also discussed in more detail in the recent HMT policy paper *Financing Growth in Innovative Firms: one year on*[1].

7. Trustees will decide whether to transfer a scheme into a superfund, subject to the eligibility conditions which may be imposed by regulation. Before agreeing to the transfer they will need to see evidence that members' benefits are better protected in the superfund than they would be remaining in the sponsoring employer's scheme. Trustees will also be required to notify TPR at the earliest opportunity of the intention to transfer to a superfund. The extent of the role of TPR in the transfer of a scheme to a superfund is an issue raised in this consultation. This subject is discussed in detail in Chapter 5.

8. We envisage that superfunds will be classed as a type of DB occupational pension scheme, with the employer covenant replaced by a capital buffer provided by investors. However, we accept that the risk profile of superfunds differs from that of traditional DB occupational pension schemes with a sponsoring employer. As such, as well as the existing DB occupational pensions legislative and regulatory framework, additional safeguards will be needed. These should ensure that members' benefits and the PPF are properly protected and a sensible and sustainable balance is struck between the interests of members, the sponsoring employer, and the superfund investors.

9. This consultation seeks views on an appropriate legislative framework for the authorisation and regulation of superfunds looking to enter the market.

10. Many of our proposals would require primary legislation and we will seek to legislate in due course when Parliamentary time allows. In the meantime, we would expect any superfund considering entering the market to engage with TPR and the PPF before doing so. We would also expect employers considering a transfer of their DB scheme into a superfund to seek voluntary clearance from TPR before any transfer takes place.

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752193/Financing_growth_in_innovative_firms_one-year_on_PDF.pdf

2. Regulating superfunds

11. In the UK, the idea of superfunds started to enter wider public discourse in 2017. Since publication of the white paper, we have seen a number of different superfund models preparing to enter the DB market. The Pensions and Lifetime Saving Association (PLSA) has supported enabling superfund consolidation, and the PLSA DB Taskforce published a number of reports between March 2016 and September 2017 which included their view of the required regulatory regime and the potential benefits that could be gained from superfund consolidation.

12. We consider that the current legislative framework does not prevent a superfund setting up and attempting to attract other funds to consolidate. However, there are clear risks in doing so without a suitable regulatory framework to ensure member protection. Government therefore has three options:

- Do nothing and rely on TPR to manage the emerging superfunds with their current powers.
- Legislate to prevent superfund consolidation.
- Legislate for an effective regulatory regime so that members, employers, regulators and the wider economy benefit from the potential offered by superfund consolidation.

13. This government has chosen the third option to embrace innovation, and to proceed with what is a difficult but potentially worthwhile program to enable a properly regulated superfund consolidation sector.

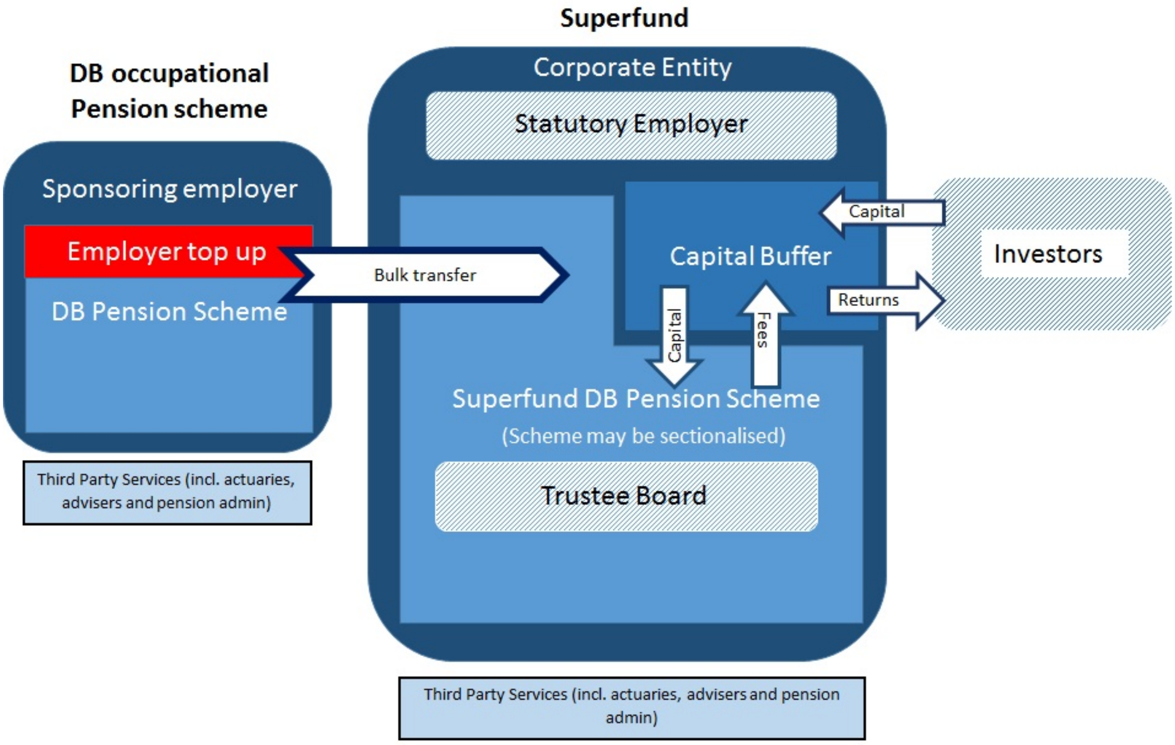
14. Diagram 1 sets out a very simplified structure of a potential superfund and should be viewed in this context. There will of course be variations between the complexities of superfund structures depending on their business models.

15. A basic superfund structure includes:

- a corporate entity,
- a statutory employer
- a DB pension scheme,
- a capital buffer, and
- can potentially include in-house service providers (for example, pension administrators)

16. The capital buffer is furnished by capital provided by external investors (who expect a return) and/or the fee paid by ceding employers for entry to the superfund. The capital buffer may be managed entirely separately to the superfund pension scheme's assets. The structure for the buffer will be subject to approval as part of the authorisation process. The corporate entity is responsible for the overall management of the superfund, with trustees responsible for the management of the superfund's pension scheme. The corporate entity would also be the statutory employer in respect of the DB occupational pension scheme. The pension liabilities from the ceding scheme will be transferred to the superfund through the existing bulk transfer process.

Diagram 1



17. We envisage that a scheme within a superfund will continue to be classed as an occupational pension scheme, with the employer covenant replaced by a capital buffer provided by investors as well as potentially the ceding employers, and will be subject to the legislation and regulation appropriate to occupational pension schemes.

18. Superfunds have some similarities to insurance, given that the traditional employer link is broken, and the protection for members' benefits in the long term is provided by a capital buffer. The corporate entity will become the statutory

employer in the superfund; however, the ‘employer covenant’ will only extend to the limit of the capital buffer. Superfunds will not be required to provide the same level of confidence that benefits will be paid in full as an insurer following a buyout of the scheme liabilities. We envisage that schemes within the superfund will be trust based occupational pension schemes, with trustees expected to act in the best interests of all the members to minimise the risk that members will not receive their pensions in full. The superfunds’ governance arrangements should ensure trustees’ freedom to act in this manner is not impinged upon.

19. A strong regulatory framework for superfunds will be needed to ensure that there are appropriate protections for members and that the risk of regulatory arbitrage with the insurance buyout market is minimised. Without an effective gateway (discussed in Chapter 5) superfunds would enjoy a considerable competitive advantage in the price of acquiring DB schemes compared to insurers given the lower capital requirements in the occupational pension space.

20. In addition, it is important that the regulatory framework for superfunds operates in such a way as to preserve the integrity of the current regulatory framework for insurers. Insurers are regulated under Solvency II which is a comparatively stringent regulatory regime compared to the regime for DB pension schemes. There may be a need to guard against incentives for insurance companies to establish a vehicle outside the current regulatory structures to acquire, or conduct, business that would otherwise have been acquired by the insurance company itself which could weaken the current regulatory framework for insurers.

21. A consequence of regulating superfunds in respect of DB occupational pension schemes rather than as an insurance arrangement is the minimum compensation that would be available to members on the failure of the superfund. As a DB occupational pension scheme, members would be eligible for PPF protection and not compensation under the Financial Services Compensation Scheme (FSCS). The latter provides different benefits from the PPF.

22. We entirely accept that superfunds are not exactly the same as traditional DB occupational pension schemes with sponsoring employers and that they pose different risks. These include:

- the fact there is no enforceable recourse to the former employer, corporate entity, or investors for the trustees to get further financial support once the capital buffer has been exhausted
- the commercial element of the emerging superfund propositions and the expectation of investors to make reasonable profits from the capital which they put at risk alongside the assets of the scheme; and

- the concentration risk which arises from consolidating the variety of employer covenant and investment strategy risks from multiple schemes into the risk of a single investment strategy failing. Given the potential size of superfunds, the consequences of their investment strategy failing could have significant impacts for scheme members and the PPF levy payers.

23. We are therefore consulting on a more robust bespoke regulatory framework for these consolidation vehicles.

Defining superfunds

24. Superfunds differ from more traditional ways of managing DB liabilities in some respects. We think that these differences would be an appropriate place to start in defining superfunds for the purposes of any future regulatory regime. Based on extensive and ongoing consultation with the industry and those designing the emerging models we have seen, our initial view is that the main characteristics of a superfund are that:

- a superfund is, or contains, an occupational pension scheme set up for the purposes of effecting consolidation of DB pension schemes' liabilities;
- A transferring scheme's link to a ceding employer is severed on transfer to the superfund;
- The 'covenant' is a capital buffer provided through external investment that sits within the superfund structure; and
- There is a mechanism to enable returns to be payable to persons other than members or service providers.

25. We want to ensure that the definition captures current and future vehicles that are appropriate to the new targeted regime, and excludes any arrangements that are not intended to be superfunds or are already effectively regulated within the existing regime. In addition we want to avoid unintended consequences, such as inappropriately constraining the scope of the industry to innovate in designing new consolidation vehicles. We would welcome views on whether these characteristics are the right ones to define the types of arrangement to which the new regime will apply and whether there are any other characteristics which could help in 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?

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?

3. Authorisation

26. Given both the range of emerging business models and the potential scale of superfunds, there is broad consensus for the need for an authorisation regime. The authorisation regime we are proposing, 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.

27. We propose that a superfund will be required to seek authorisation from TPR in order to operate and will be prohibited from operating as a superfund unless it is authorised. To cover TPR authorisation costs, we propose introducing an application fee. We consider on-going levies in Chapter 4. From the outset, the onus will firmly be on the corporate entity and trustees of the pension scheme of a superfund to demonstrate and evidence how the superfund meets and continues to meet the authorisation criteria.

28. Under the proposal, TPR would be required to either grant or refuse authorisation within a set period of time. Should authorisation be refused, TPR will be required to set out the reasons for its decision and the corporate entity of the superfund will have the right to appeal to the Upper Tribunal.

Authorisation Criteria

29. In order to be authorised, TPR will have to be satisfied that the superfund meets certain criteria. The criteria we propose are that the superfund:

- can be effectively supervised;
- is run by fit and proper persons;
- has effective administration, governance and investment arrangements;
- is financially sustainable; and
- has contingency plans in place to protect members.

30. We believe that these criteria meet the aims of the authorisation regime set out at the beginning of this chapter and are consistent with other authorisation regimes, in pensions and broader financial services such as that for DC Master Trusts and PRA regulated firms.

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

31. The authorisation regime will cover the entire superfund structure, i.e. both the corporate entity and the scheme. We are aware that some superfunds may wish to establish their scheme on a sectionalised basis. Where this is the case, we do not propose that each section be treated as a separate scheme for the purposes of authorisation. While the funding for these schemes may be sectionalised, the authorisation criteria go wider than this and require a view across the entity as a whole. Sectionalised schemes are discussed further at paragraphs 143 and 144.

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?

Supervisability

32. The structure of superfunds have the potential to be extremely complex. It will be important that TPR can effectively supervise superfunds to protect members and the PPF. To ensure that superfunds can be effectively supervised, we think it will be necessary to set some clear limits on the types of corporate structures that are appropriate.

33. We propose that the corporate entity of a superfund should be established as a body corporate incorporated in the United Kingdom (UK) with their head office and their registered office maintained in the UK. Any companies controlled by the superfund would also be required to be incorporated in the UK. We note that it has been suggested that some superfunds intend to use the Scottish Limited Partnership structure. UK insurance companies are not allowed to be partnerships and we would welcome views on whether there should be a similar restriction placed on superfunds.

34. In order to grant authorisation, TPR would also need to be satisfied that it can effectively supervise a superfund. In particular we would expect TPR to take into account the way the superfund is organised, consider close links with other persons and assess whether membership of a corporate group could hinder supervision.

35. Taken together, we believe that these requirements will promote transparency and ensure that superfunds are established with corporate structures which are compatible with close regulatory supervision, while still maintaining the market's ability to innovate.

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?

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?

Fit and Proper Persons

36. A number of authorisation regimes include a fit and proper persons requirement to assess whether individuals are suitable to conduct regulated activities. In general, this test seeks to ensure that individuals act with honesty, integrity and propriety and that they are competent (either on an individual or collective basis) to carry out their responsibilities. We propose that a similar requirement be applied to superfunds.

37. The fit and proper persons requirement for superfunds will need to capture those whose actions have the potential to impact member outcomes. This includes not only those within the superfund (both the corporate entity and the scheme), but also those who are in a position to exert influence over entities within the superfund.

38. Identifying individuals who are subject to the fit and proper persons requirement will be based on the nature of their responsibilities within and in relation to the superfund. This is consistent with other authorisation regimes and provides more flexibility than basing the requirement on job titles or roles.

39. We have set out some suggested responsibilities that could be subject to a mandatory fit and proper persons requirement. In addition, we propose that TPR should have discretion to request evidence that other specified individuals meet this requirement where they could exert influence and/or can impact member outcomes. This would not necessarily be restricted to individuals within the superfund structure. For example, TPR might reasonably want to assess whether individuals within a superfund's parent group or those providing a significant amount of external investment are 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?

40. It will be important for TPR to be able to properly identify those individuals who should be subject to the fit and proper persons requirement. We therefore propose that both the corporate entity and the pension scheme be required to clearly set out their governance arrangements on application, including the role of any committees and sub-committees. We propose that this would be supported by a statement of responsibilities, completed by those subject to the fit and proper persons requirement, which would outline their responsibilities and how their role fits within the wider superfund structure. The intention behind this statement would be to provide TPR with a clear picture of how the superfund is governed and enable them to identify gaps within the governance structure.

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

41. We would also welcome views on whether it would be appropriate for TPR to have the ability to interview individuals as part of the fit and proper process. Both the Financial Conduct Authority (FCA) and PRA have a similar power as part of Senior Managers/Insurance Managers Regime. The purpose of the interview would be to gather additional information to complete the assessment of an applicant's fitness and propriety to perform their role. The interview could cover any aspect of the fit and proper requirements but we would expect most to focus on whether individuals understand and are able to explain their roles and regulatory responsibilities within the superfund. Interviews could also explore how an individual's knowledge or experience equips them to carry out the role. The decision to interview would be at TPR's discretion; however we would expect them to adopt a risk based approach based on, for example, the size, complexity and risk profile of the superfund.

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

42. The fit and proper persons test will be an ongoing requirement supported by the significant events framework discussed in Chapter 4. Under this framework, superfunds would be required to inform TPR prior to changing personnel subject to the mandatory fit and proper persons requirement.

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

43. We list below the areas which in our view should be subject to a mandatory fit and proper persons requirement. We believe that these areas are key to the effective operation of the superfund, in particular that:

- it is adequately funded and financially sustainable;
- it is well governed;
- compliance, investment and operational risks are well managed
- it is well resourced; and that
- members' interests are protected.

44. We would expect superfunds to have arrangements in place to cover the responsibilities listed below. Note that a 'person' could mean an individual or a corporate entity. Where a person is a corporate entity, the same standards would apply and we propose that all relevant directors and senior managers would be subject to the fit and proper persons requirement. We propose that the mandatory fit and proper persons requirements are applied to:

- a person who establishes a superfund
- a person responsible for the overall management and conduct of the superfund (for example, CEO)
- a person responsible for the overall management and conduct of the superfund's Non-Executive Board
- a person responsible for the overall management of financial resources (for example, CFO)
- a person responsible for the overall management of risk (for example, CRO)
- a person responsible for investment decisions and/or implementation for the pension fund or capital buffer (for example, CIO)
- a person responsible for overall management of internal audit and compliance
- a person who can appoint trustees
- a person who can alter trust deeds
- a person who is a trustee

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

The Fit and Proper Persons Test

45. The authorisation regime for DC Master Trusts introduced a fit and proper persons requirement as a criteria for authorisation, which will be monitored through ongoing supervision and the significant events detailed in Chapter 4, which consists of three tests. These are:

- The integrity test
- The conduct requirement; and
- The competency test.

46. These tests are consistent with other fit and proper persons regimes, including FCA rules for financial institutions and financial advisers. We do not propose introducing any additional tests for superfunds as we believe these tests would meet the aim of the fit and proper persons requirement in assessing whether a person acts with honesty, integrity and propriety and that they are competent to carry out their responsibilities. In addition, we believe using similar tests to DC Master Trusts would provide consistency and reaffirm our expectations to industry. We therefore propose to introduce these tests for the purposes of superfund regulation.

The Integrity Test

47. An integrity test is generally used to assess a person's tendency to be honest, trustworthy, and dependable. We propose to set out a number of matters which TPR must take into account when assessing honesty and integrity. These could include, but are not limited to, bankruptcy, unspent criminal records and any previous contravention of TPR rules or rules of any other regulatory authority.

The Conduct Requirement

48. We propose that the conduct requirement would allow TPR to take into account the actions and behaviour of those subject to the fit and proper persons requirement when assessing whether they act with honesty, integrity and propriety. It could cover past behaviour as well as being an ongoing requirement as part of supervision. The conduct requirement could take into account, for example, whether a person is under investigation or disciplinary action by a regulator, government agency or professional body, whether they have been dismissed or forced to resign in a related area and how open and honest they have been in providing TPR with information.

Extending standards to the corporate board

49. Trustees have a fiduciary duty to act prudently, responsibly, honestly, and impartially in the best interests of members. Given that superfunds will not have a historic link to members transferring into the fund, we would welcome views on whether similar requirements should be placed on individuals on the board of superfund's corporate entity. In particular, we would welcome views on whether we should introduce standards of conduct, with which such individuals would have to comply. The purpose of such standards would be to ensure high standards of corporate behaviour and to increase the accountability of the corporate board. In particular, we would envisage the standards covering:

- the culture of the corporate board;
- interaction with TPR and other regulators; and
- treatment of members.

50. Any future standards could be included as part of a Code of Practice for superfunds discussed in Chapter 4.

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

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

The Competency Test

51. We propose that the competency test would aim to assess whether a person identified as being subject to the mandatory fit and proper persons requirement has the right skills, knowledge and experience to carry out their role. In assessing competence, TPR could take into account for example relevant professional experience, membership of professional bodies as well as professional qualifications.

52. In addition, the test would also aim to assess the collective competence of both the superfund's corporate and trustee boards to ensure that they each have the appropriate range of skills, knowledge and experience to run the superfund and its pension scheme, based on the complexity of the business model. For the trustee board, this could also involve an assessment of the board's ability to provide effective challenge to the corporate board. For both boards we would expect to see an appropriate balance of pensions, financial and investment experience.

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

Governance

53. Good governance will be important to the successful operation of superfunds. This includes not only the governance of the superfund structure as a whole, but also the governance of the superfund's corporate and trustee boards. The key to promoting good governance will be to ensure that the appropriate checks and balances are in place and that potential conflicts of interests are well managed.

The Corporate Board

54. Decisions made by the corporate board will have a direct impact on member outcomes.

55. We therefore propose that the corporate board would need to demonstrate that it has an appropriate number of independent non-executive directors (NEDs) to effectively hold management to account. In assessing independence, TPR could, for example, take into account provisions within the UK Corporate Governance Code[2], such as a NED's relationship with the corporate body or wider corporate group and whether they have been appointed in an open and transparent manner.

56. We also propose that the corporate board would need to demonstrate that it has plans to monitor and manage any conflicts of interest and that these are regularly reviewed. The 'appropriate' number of independent NEDs could be prescribed or left to the discretion of TPR.

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

The Trustee Board

57. The superfund's trustee board will play a crucial role in representing the best interests of all members transferring into the superfund's pension scheme. It will also act as an important counterweight to the corporate board through providing effective challenge where necessary. As a result, it will be important that the trustee board:

- is made up of persons independent of other entities within the superfund;

[2] https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code

- can make objective decisions; and
- has the right level of skills, knowledge and experience to manage a complex scheme with potentially multiple benefit structures.

58. To meet these aims, it has been suggested that the trustee board should consist entirely of independent trustees. Independent trustees still have a fiduciary duty to act in the best interests of members and they would likely have a level of knowledge and experience to effectively and objectively run a superfund pension scheme. While independent trustees are often professional trustees, they can also be lay trustees.

59. To guard against potential conflicts of interest and further protect the independence of the trustee board, it has also been suggested that we apply a non-affiliation requirement, similar to that used for multi-employer DC pension plans. This could require trustees to be independent of anyone who provides services to the superfund (such as advisory, administration or investment services) as well as requiring trustees to be recruited through an open and transparent appointment process.

Member representation

60. There is a current requirement that at least one third of the membership of the trustee board of a pension scheme are member nominated, subject to certain exemptions (the Member Nominated Trustee (MNT) and Member Nominated Director (MND) requirement).

61. There are compelling arguments that this requirement is inappropriate for superfunds. They could comprise very different constituencies of members with varied benefit structures as well as distinct historical, social and demographic backgrounds. In addition, if the trustee board were required to consist entirely of independent trustees, they would be exempt from an MNT/MND requirement. We do not therefore propose to apply the MNT/MND requirement to superfunds.

62. However, we recognise that there must be other channels through which members' views are represented should there be no requirement for member nominated trustees (or directors).

63. One option could be to add the provision of 'adequate systems and processes to ensure members' views are represented' as a condition of authorisation. Although this would allow for a degree of flexibility, we believe that it could risk members of different superfunds experiencing different levels of service. It might also be difficult to define what "adequate" looks like in this context.

64. A more prescriptive option would be to require superfunds to establish member panels. The purpose of such panels would be to ensure that members' views are brought to the attention of trustees and to facilitate members' engagement with the scheme.

65. The panels could be established on a purely consultative basis, where the trustee board would be required to consult the member panel on certain decisions. Alternatively, the panels could have a stronger role provided it does not impede the board's ability to carry out its legal duties.

66. The panels could also be required to publish annual reports on their activities and on member issues, which could be made publically available. We believe that doing so would enhance transparency and comparability for employers and pension scheme trustees considering transfers to a superfund.

67. On balance we think that members' interests are best served by a requirement for superfunds to establish member panels, and propose to proceed on this basis. We would welcome views on whether this would be effective and proportionate.

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

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

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

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?

Agreements between the corporate and trustee boards

68. Some superfund models suggest that the rights and responsibilities of the corporate and trustee boards are set out in legal agreements. We want to be clear that such agreements should not impede trustees in carrying out their legal duties. We do however see how they could be useful in providing clarity. We therefore propose that any such agreements should be submitted to TPR on application for authorisation and that the superfund would need to explain these arrangements if TPR felt that trustees' discretion was being fettered.

Systems and Processes

69. In order for a superfund to be run effectively, it will need robust administrative systems and governance processes. Therefore, as part of authorisation, the corporate entity of the superfund will need to satisfy TPR that it has the right systems and processes in place to support the business model being proposed. In this chapter, we discuss how a potential 'systems and processes' requirement, drawn extensively from the DC Master Trust authorisation regime, could work. We envisage that the requirement will be underpinned by a future TPR Code of Practice.

Risk Management

70. Both the corporate and trustee board of a superfund would need to demonstrate that they have processes in place to assess and control risk. These processes should enable each board to identify, document and manage operational, financial, and compliance risks; both internal and external. Both frameworks would need to enable their respective board to maintain effective oversight of their respective entities. TPR could, for example, ask to see evidence of how each board reviews and updates their risk registers, how this is supported by accurate and timely management information, as well as plans to review the overall effectiveness of the framework on an ongoing basis.

Investments

71. Both the corporate and trustee boards would need to demonstrate that their investment governance is appropriate for the complexity of their investment arrangements, so that risks are properly managed. This could, for example, include documented evidence on how they set their investment objectives, risk appetite and investment strategy and how risks are identified, monitored and, where appropriate, mitigated on an ongoing basis.

Continuity Strategy

72. We define certain funding level triggers and the responses that would be required to protect the best interests of members in Chapter 3. We therefore propose that superfunds would need a continuity strategy in place to assess and address the potential issues that might arise as a result of a trigger being breached. We also propose that the continuity strategy should set out the response required should certain other events occur. Events would for example include:

- TPR withdrawing authorisation,

- an insolvency of the corporate entity,
- the corporate entity being unlikely to continue as a going concern, or
- the investors wishing to end the relationship with the superfund.

I.T. Requirements

73. Both the corporate and trustee boards would need to demonstrate that their I.T. systems are capable of supporting the business model being proposed. This could cover areas such as data security, functionality, ongoing maintenance and disaster recovery.

Member records

74. The trustee board would need to demonstrate that they have processes in place to ensure member records are kept accurate and regularly reviewed.

Security

75. Both the corporate and trustee boards would need to demonstrate that they have processes in place to protect personal data and sensitive information as well as protocols for managing data breaches. It will be the responsibility of the pension scheme to ensure that the member data is appropriately protected. As part of authorisation it should be evidenced that there are procedures and protocols in respect of member data, identifying the risks and any breaches, including outsourcing to third parties, and the plans in place to respond to incidents.

Member Complaints

76. Superfunds would need to demonstrate that they have an adequate complaints procedure in place. This could include evidence that they have processes in place to enable the resolution of complaints and that members are informed of their rights.

Third Party Providers

77. We recognise that the corporate board and/or the trustee board may want to engage third party providers. Although both boards will be able to delegate certain tasks and decisions, they will ultimately remain accountable. We therefore propose that they should be required to submit any Service Level Agreements (SLA) and demonstrate how they will monitor delivery against these on an ongoing basis as part of authorisation, or before engaging the third party provider.

A change in person(s) responsible for delivering key services would form part of the significant events framework discussed in Chapter 4.

Conditional authorisation

78. There may be cases where a superfund does not have all systems and processes in place prior to becoming operational. In such instances we propose that TPR could grant conditional authorisation subject to certain conditions being met, for example, the scheme appointing a minimum number of trustees within a certain timeframe.

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?

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

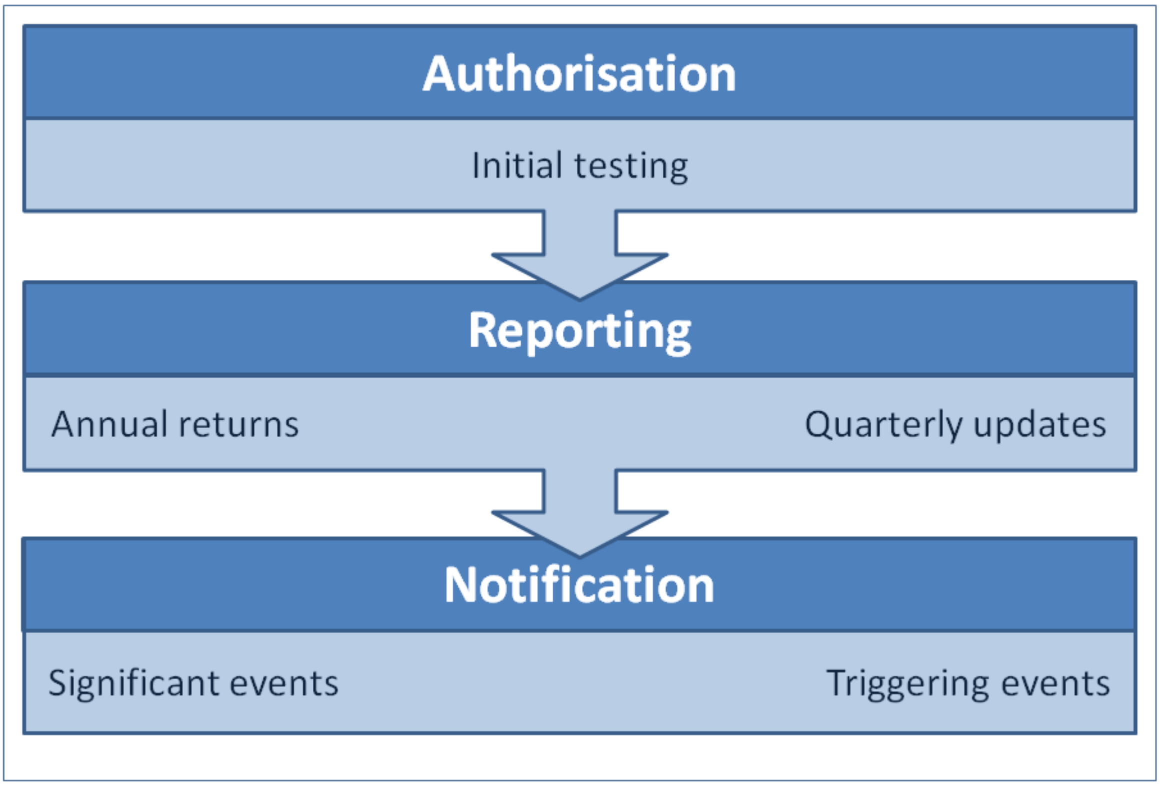
Financial Sustainability

79. The financial sustainability and adequacy of a superfund is arguably the most critical and difficult area for the new legislative framework. It needs to deliver improved protection to members moving into superfunds, while balancing the need to maintain reasonable affordability for employers, and sufficient potential profitability to attract investment capital.

80. Superfunds can potentially already operate within the existing occupational pension framework. However, the current framework is not optimised to deal with the new risk profile posed by superfunds (as outlined in Chapter 2). It is important that a bespoke framework is designed to manage these risks and maximise the benefit superfunds can bring to the delivery of DB pensions, and to the wider economy.

81. We set out in Diagram 2 the process for assessing and monitoring financial sustainability. Financial sustainability will be assessed at commencement and superfunds will need to demonstrate they meet the criteria for authorisation. Thereafter, they will need to continue to demonstrate that they meet the requirements and to notify TPR if certain events happen in relation to the funding of the superfund and take any required or relevant action as a result.

Diagram 2



82. Our priority is to ensure that member benefits are adequately protected and that the risk of regulatory arbitrage of the insurance buyout market is minimised. However, we welcome innovation in the pension industry and therefore aim to provide a framework which enables new models to develop and flourish, with as many schemes as possible able to afford entry into a superfund if it gives them a greater chance of paying or securing member benefits in full.

83. Our intention is not to duplicate a less costly version of the insurance buy-out model; doing so would be a form of regulatory arbitrage that would hurt the

growing insurance buyout market that provides a high level of security to DB pension scheme members. Nor do we wish for superfunds to be a way for employers to offload underfunded schemes where it would be in members' best interests to remain in the employer's scheme and benefit from deficit repair contributions.

84. Our 'gateway' proposals discussed in Chapter 5 will help guard against schemes which are able to buyout, or have a realistic prospect with sponsor support of achieving buyout in the foreseeable future, from entering a superfund. And our minimum standards proposals, which would require schemes to be well funded on a prudent basis at outset, would guard against the inappropriate consolidation of under-funded schemes.

Options for ensuring financial adequacy

85. There are a number of approaches to ensuring financial adequacy and sustainability. There are important questions both about the structure of the regulatory approach, and whether it is appropriate to the nature and profile of risks presented by superfunds. There are also questions about where the various funding and other metrics should be pitched to deliver an appropriate level of member protection, while balancing the competing calls of employer affordability and investor profitability.

86. The fit of the financial adequacy regime to the emerging superfund models will partially depend on whether they are seen (and therefore regulated) as predominantly insurance-like vehicles, or as occupational pension schemes. Superfund proposals have some similarities to insurance, given that the employer link is broken, and the security of members' benefits in the long term is provided by a capital buffer. We have therefore set out options for defining the financial adequacy required both within a DB pension framework and also in an insurance like framework. We have set out four options in total – three options based on progressively greater transparency of funding and capital requirements to increase the levels of confidence within the occupational pensions framework (options (i) – (iii)) and a further option based on an insurance-like regime (option (iv)).

DB Pensions Framework

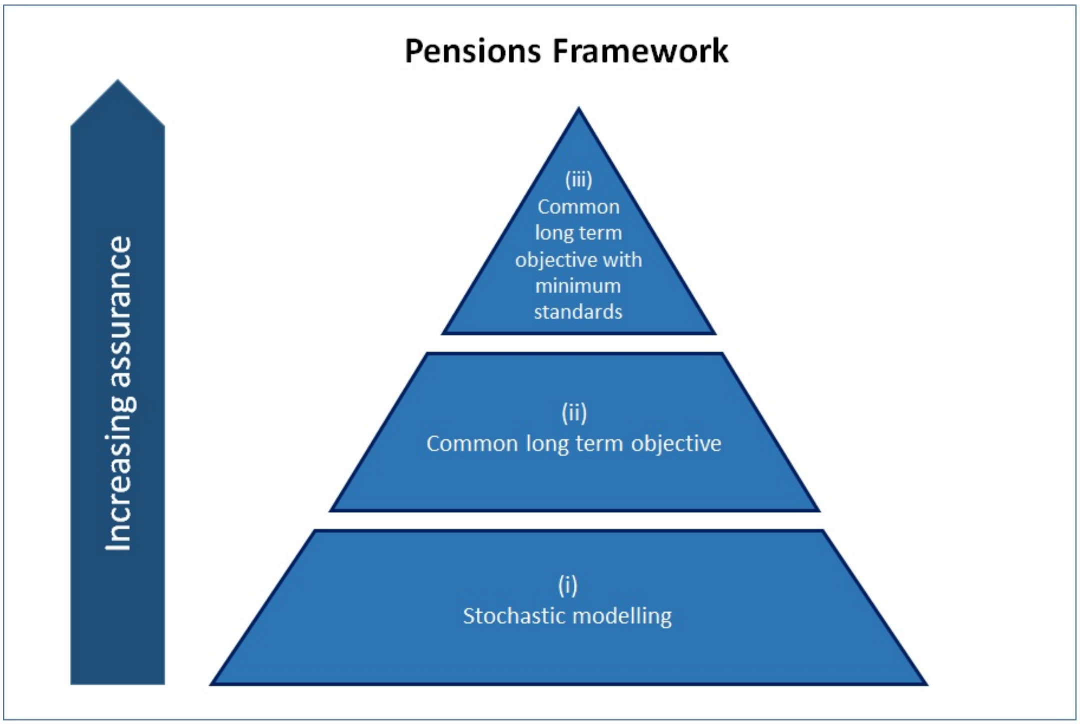
87. Current DB occupational pension legislation provides a framework within which risk can be effectively managed in order to balance the competing priorities of member protection, and employer affordability. In the main, as evinced in our green and white papers, the system has been largely successful in delivering this balance.

88. The existing DB occupational pension framework was not set up to deal with the particular risks posed by superfunds. We therefore propose to add a further stochastic modelling requirement for authorisation and on-going supervision which will more robustly assess the purpose, objectives, and risks of superfunds: we are seeking views on the possible approaches and parameters for those requirements.

89. We propose to set up a framework based on a high probability of success. In our consultations with the industry, we have been told that a 99% probability of paying benefits in full is achievable. This seems like a reasonable starting point for the debate - we might therefore require superfunds to demonstrate at least a 99% probability of paying or securing all members' benefits in full.

90. We have considered three options for demonstrating this level of confidence within the DB occupational pensions framework as demonstrated in Diagram 3. The parameters in the three options below are all intended to be consistent with the principle of the superfund demonstrating at least a 99% probability of paying or securing all members' benefits in full. Supporting each of these approaches, we would expect TPR to issue guidance setting out how a superfund would be expected to evidence this high probability of success. With all approaches, TPR would continue to regulate the superfund as an occupational pension scheme, with, for example, powers in relation to technical provisions and recovery plans.

Diagram 3



(i) Stochastic modelling approach.

91. In this approach we would add a stochastic modelling requirement to the existing DB framework. We would require the superfund to undertake their own stochastic modelling. This would need to demonstrate that there was at least a 99% probability of members benefits being paid or secured over the lifetime of the superfund, both at authorisation and then annually with the annual valuation.

92. While this approach gives flexibility to superfunds to develop new models of provision, the requirement to demonstrate a continued high probability of paying benefits in full should in itself constrain the amount of investment risk and profit taking, and help to determine the level of the capital buffer required.

93. If this option were taken forward, it could be argued that we would be creating an internal model regime where the capital buffer is set by the regulated entity in a manner approved by TPR. The aggregate level of funding and capital would have to meet the overall probability of success and TPR would retain its role in relation to scheme funding etc. History suggests that this approach requires a strong regulator with the power to reject a model it considers to be inappropriate, otherwise this may result in a weak regulatory regime. We would therefore aim to ensure that TPR had the necessary powers.

94. Stochastic modelling is likely to be a feature of most potential options for determining financial adequacy, and there is further discussion of parameters and supervision in the section on modelling at paragraph 161 below.

95. It is important to note that the pension scheme within the superfund will also be subject to the same requirements as any other occupational DB pension scheme with respect to scheme funding and investments.

(ii) Common long term objective approach.

96. We are concerned that simply adding a scheme based stochastic modelling requirement onto the existing framework may not provide adequate safeguards. Therefore, in line with the white paper proposal for all DB pension schemes to set their Statutory Funding Objective in the context of a long term objective, we will require all superfunds to be authorised using a standard long term objective. This approach therefore adds a more specific objective with a clear time by which the objective should be achieved, against which the superfund proposal will be assessed. It is again underpinned by the principle of demonstrating a high probability of success, but here, all superfunds would be authorised based on their probability – to be demonstrated by stochastic modelling - of meeting the standard long term objective, within a clear time-frame.

97. It is worth noting that option (i) will include a similar sort of framework, but in that case set by TPR as part of its regular supervisory role as a result of proposed changes in the new DB Scheme Funding Code of Practice.

98. The timeframe to achieve the long term objective is intended to coincide with a point in time when the majority of members have retired and the superfund scheme has reached or even passed peak cash-flow. The timeframe also needs to reflect the fact that transferring schemes will be closed and maturing even as superfunds are growing in size and consolidating new schemes. This could be a fixed target date, such as 2040, but on balance we think this needs to be scheme specific, as more mature schemes should need less time to reach their peak cash-flow or even be in run-off.

99. We might expect the superfund, both pension scheme and capital buffer, to be funded on a basis such that over the timeframe it will be able to maintain or achieve a level of funding that would allow trustees to either secure the benefits through a buyout or to continue paying benefits as they fall due on a very low risk basis.

100. Another option might be to set a specific long term objective of securing benefits with an insurance company. But as there is no requirement on traditional DB occupational pension schemes to have a long term objective to buyout, an objective based on on-going funding against an 'authorisation basis' may be more appropriate rather than require any specific action to be taken.

101. Regardless of the above, we think that the authorisation basis should reflect a prudent estimate of the cost of winding up a scheme and buying out all the benefits. This would be for a scheme that has matured to the point most of its members have retired and at a level which should otherwise allow it to continue to run on with very low investment and funding risk.

102. We propose that the authorisation basis is set valuing the liabilities on a basis equivalent to the cost of buying out the liabilities with an insurer by using assumptions broadly consistent with a typical pension scheme's Technical Provisions, which includes a prudent allowance for scheme specific mortality assumptions, but based on the following:

- a gilts flat discount rate i.e. no allowance for any expected out-performance above gilts in the discount rate or illiquidity premiums.
- a further margin of 7.5% of liabilities in respect of a reserve for expenses, adverse longevity and other demographic experience as well as other margins for prudence; and
- an allowance for other factors specific to superfunds which could be set out in a TPR Code of Practice or legislation for this purpose, for example, the treatment of options which we would expect to be calculated on broadly 'cost-neutral' terms regardless of how factors were determined in the ceding scheme.

103. An alternative would be to set the authorisation basis considering scheme specific circumstances, for example, adjusting the 7.5% margin to allow for scheme specific factors. For example if the superfund has hedged all mortality risk then an additional margin of 7.5% may not be appropriate although we would expect the cost of hedging to be included the superfund scheme's Technical Provisions.

104. We propose that the superfund, both pension scheme and capital buffer, is then required to demonstrate that it will be able to be fully funded on an authorisation basis to a very high probability of, for example, 97.5% by the earlier of 2040 and the date the scheme reaches peak cash-flow. On and after that date the objective would be to retain sufficient capital to ensure there is at least a 97.5% probability of being 100% funded on the authorisation basis in one year's time which would be broadly consistent with the approach as set out below under option (iv) from this date onwards if a risk-based approach is to be used for that option.

(iii) Common long term-objective and minimum standards approach

105. It could be argued that an approach that relies on assessing the probability of success using stochastic modelling still gives insufficient assurance that

members' benefits will be adequately protected, even in the context of a clearly defined objective and broadly consistent approach and assumptions.

106. Clearly the outputs of the modelling supporting any of the options will be highly dependent on the internal working of the model, and on the underlying assumptions used. These will have to be carefully assessed when superfunds are authorised as well as monitored when superfunds are supervised on an ongoing basis. But this may not be enough. The uncertainty inherent in modelling approaches suggests that some additional safeguards relating to some key parameters may still be needed to guard against excessive risk taking, profit taking, or under-funding

107. This approach therefore builds on the common long term objective approach, but adds on a number of specific minimum standards. These might include requirements for taking on new business and ongoing authorisation such as:

- the superfund scheme on its own without any capital buffer should be at least 87.5% funded on the 'authorisation basis' or something broadly equivalent. An alternative might be to set the scheme a separate long term objective – perhaps a two thirds probability of reaching 100% funding on an authorisation basis within the standard timeframe;
- the capital buffer should be sufficient for the scheme assets plus the capital buffer to equal at least 100% of the 'authorisation basis' or something broadly equivalent;
- any remaining capital buffer should be paid into the superfund scheme if the scheme assets plus capital buffer is less than 90% of the 'authorisation basis' or something broadly equivalent; and/or
- the risk taken in the investment strategy should be constrained, perhaps to limit annual funding volatility to less than 5% pa, for example, by employing a test based on the PPF's methodology for assessing stressed values of assets for PPF levy calculations.

Insurance type framework

(iv) Annual balance-sheet approach

108. This approach would require a superfund to annually demonstrate its probability of success by meeting a required level of solvency based on a prudent estimate of buying out benefits with an insurance company, comparing liabilities and assets, including any capital buffer.

109. The superfund, in terms of its pension scheme and capital buffer could simply be required to be fully funded for buyout at all times. However, a superfund will be exposed to adverse experience over time. This could be a longevity extension, increasing buyout costs, or adverse investment experience. There is therefore a case for a superfund to have excess funds above 100% of buyout as a buffer against adverse experience.

110. A capital buffer against adverse experience could be fixed or dependent on the risks that the individual superfund faces. For example, the superfund could always be required to be at least 105% funded compared to buyout.

111. Alternatively, there could be a variable funding level above 100% that is reflective of the risk being run and the specific likelihood that the superfund will remain 100% funded over the next year. This would allow for all the factors that might impact on the assessment over the next year (for example, a 97.5% probability of still being 100% funded on a buyout basis in one year's time).

112. This approach seeks to protect member benefits by carefully defining a level of funding a superfund is required to maintain and demonstrate at all times in terms of its pension scheme and capital buffer. Some may argue that it leaves less room for innovation within the sector and may ultimately be more suited to an insurance type proposal that seeks to reduce risk to very low levels, despite the fact that the various parameters can be flexed to reflect the risk appetite of a long term occupational pension scheme. In addition the associated costs could significantly undermine the ability of superfund vehicles to attract adequate investment.

113. However, others may argue that this approach provides for a more objective way of assessing solvency because it directly tests the cost of securing benefits in the buyout market. Others would also argue that a balance sheet approach can provide for a wide range of risk appetite. For example, a nil capital requirement would only require assets to be equal to buyout liabilities with no buffer against adverse experience, whereas a 1 in 200 capital requirement would provide protection approaching that of a life insurance company. It could be argued that. since a superfund is economically very similar to an insurer (even if the legal structure is different) because there is no recourse to a corporate sponsor the balance sheet approach to solvency is a more suitable approach.

114. Although this treats the superfund more like an insurance vehicle, it will still have at its heart an occupational pension scheme. This option could therefore be combined with some elements of the minimum requirements discussed in paragraph 104 particularly relating to the authorisation level of funding for the superfund scheme, payment of any remaining capital into the superfund scheme,

as well as the conditions, if any, we might wish to place on the investment strategy.

115. The options presented above are not an exhaustive list of the potential mechanisms to assess and control the financial sustainability of a superfund. There may be elements of each option that could be combined with overall preferred options. For example, calculating a risk based capital buffer could be included in any of the above options. In addition to the requirements of any of the options above, a balance sheet valued at market values could be prepared, and published.

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?

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?

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?

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

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

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?

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?

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?

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?

Schemes reaching buyout funding

116. There is a question about whether schemes in a superfund should be required to secure benefits with an insurance company at the earliest possible opportunity when funding levels allow, or whether it is acceptable for them to continue to run-off benefits when funding levels would allow buyout to be considered.

117. Allowing a superfund to continue to operate once the scheme is fully funded to buyout level could be seen as regulatory arbitrage between the superfund sector and the life insurance sector. The justification for allowing superfunds to operate without the employer link but with a lower level of protection than an insurer is to provide a better way of managing some DB schemes where there is no realistic prospect of buyout. This serves the interests of both employers and members. Consequently it can be argued that once funding has risen to a level where it could be bought out, the rationale for remaining in a regime without a sponsoring employer, but with lower protection than an insurer could provide, falls away and the scheme should be obliged to leave the superfund regime by buying out benefits with an insurer. We envision TPR would be involved in this process and additional powers required. We would welcome views.

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?

118. Superfunds could intentionally be set up to maintain a level of funding within the superfund scheme so that the scheme will never have a realistic chance of buying out benefits at some future date. Even if there is no specific requirement for superfunds or their scheme to buyout at the earliest opportunity, we might seek to mitigate any underfunding risk within the superfund scheme through the minimum requirements on scheme funding levels as set out in paragraph 104 above. This could also include a separate long term objective for the superfund scheme to reach a buyout level of funding at some future date regardless of approach to financial adequacy or requirements to buyout.

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?

Proposed test for failure

119. As well as being authorised based on a suitably high probability of paying or securing members' benefits, we propose that superfunds should also be authorised based on demonstrating a very low probability of failure. We suggest that an appropriate metric would be a less than 1% chance of them triggering a wind up in extremis (described in the winding-up triggering event below) over the duration of the superfund. We should not underestimate the difficulty and potential subjectivity of this assessment, in particular the assumptions that will need to be made about the type of scheme entering the superfund and the extent to which benefits provided by the PPF will converge with superfund scheme benefits over the lifetime of the superfund.

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

Funding level triggers and responses (superfund triggering events)

120. In addition to the main financial adequacy regime we think that for members and PPF levy payers to be adequately protected there will need to be a series of underpinning trigger points that describe what must happen if funding levels fall below certain prescribed limits.

121. We therefore propose to define a series of superfund triggering events together with the proposed consequences of these events, should funding levels reach the specified levels. For authorisation, the superfund governing documentation should set out the superfund triggering funding levels and the required responses. We also propose to require the trustees to notify TPR and to take the relevant actions should the funding level fall to below these trigger levels. TPR will have the power to intervene if the triggering level is not acted upon. We welcome views on what additional powers, if any, TPR would need to intervene should a trigger be breached.

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

122. As Diagram 4 illustrates, we propose that there should be a hierarchy of superfund triggering events at different funding levels. The four required responses to superfund triggering events being proposed are:

Minimum funding: to force wind up of the superfund scheme in extremis and to pay any remaining capital buffer into the scheme in respect of the wind up.;

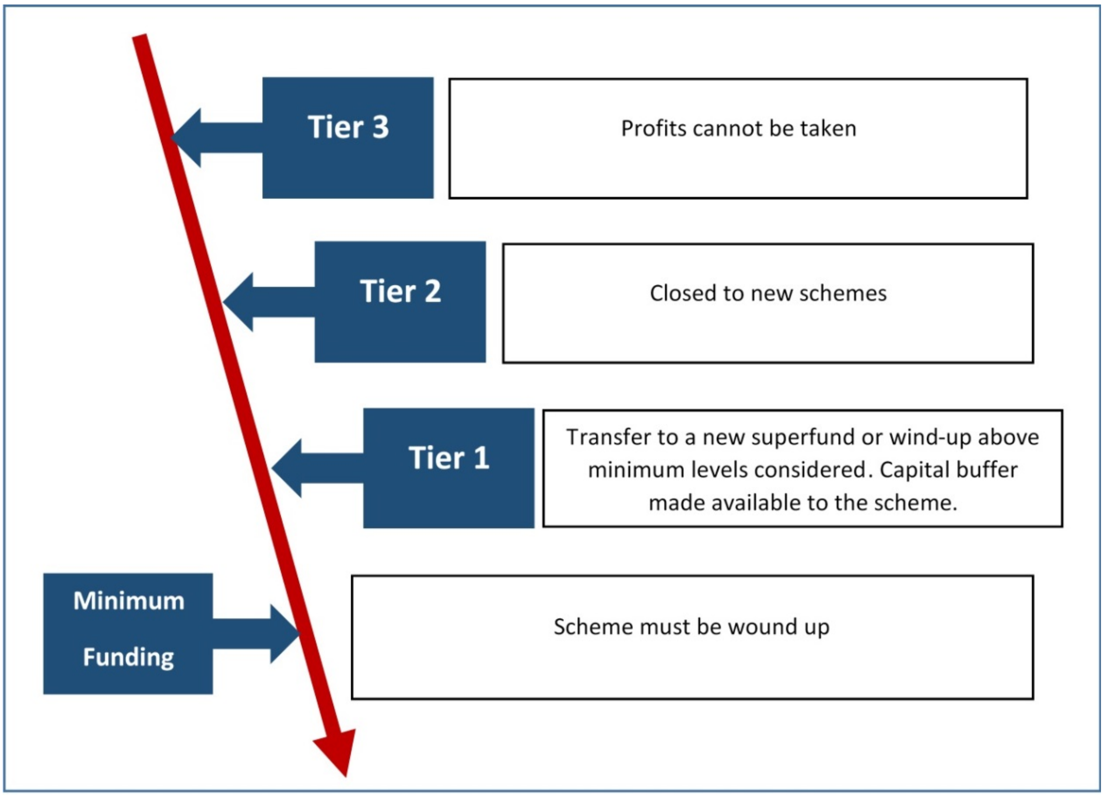
Tier 1: to pay any remaining capital buffer into the superfund scheme and to enable either a transfer of the superfund business to another superfund or to wind up above PPF levels but potentially less than 100% of full benefits;

Tier 2: to prevent new business being written; and

Tier 3: to restrict when profit can be extracted.

123. We discuss these triggers and responses in further detail below,

Diagram 4



Minimum funding: winding up the superfund in extremis

124. As the schemes within a superfund may be classed as DB occupational pension schemes, we believe that they should be protected by the PPF, so that members continue to be protected from significant losses. But the PPF and its levy payers also need to be protected from the risk posed by a superfund failure. A minimum funding level trigger could therefore be defined as the superfund's

scheme assets and capital buffer falling below that required to buyout PPF level benefits.

125. However, there could be a significant period of time between the decision that a superfund should be wound up and the liabilities being transferred out of the scheme. We therefore propose that a margin above that required to buyout PPF level benefits should be allowed for, in order to provide some protection against further deterioration in the funding level during the time taken to wind up the scheme.

126. We propose that the trigger for automatically winding up a superfund should be on a consistent basis for all superfunds, depending on the definition of failure, (for example, 105% of that required to buyout PPF level benefits on a prescribed basis). Reaching the minimum trigger point should require the superfund to automatically start a wind-up process and allow trustees of the superfund scheme to have full access to the assets in the capital buffer. This trigger will protect the PPF and PPF levy payers, ensuring that members of a superfund will still be eligible for PPF compensation if that proved necessary.

127. The winding up process should be triggered automatically as the difficulty of exercising discretionary powers in such scenarios could lead to long delays in wind up. There may be an incentive in such cases for the superfund to delay the wind up in the hope the scheme may recover on its own. By this point the capital buffer will have been injected into the scheme, investors will be unable to lose more money but may have a chance of taking future profit if the scheme's position improves. However, this will come at an unacceptable level of risk of member benefits deteriorating further and therefore become a greater cost for the PPF.

128. We propose a statutory wind up trigger as soon as the risk of a claim on the PPF is too high. The PPF recently published the 2019/20 Pension Protection Fund Levy Consultation[3]. In this consultation the PPF state a preference for the new regulatory framework for superfunds to include a statutory wind up trigger in order to protect the PPF. In the period before the legislative framework for superfunds is in place (or if a statutory wind up trigger is not implemented) the PPF propose that the levy calculation for superfunds reflects the risk that the funding level in a scheme within a superfund may deteriorate to a level significantly below that required to fund PPF level benefits. This should provide a strong incentive for the superfund to put its own wind up trigger in place at a funding level above that required to buyout PPF benefits.

129. This minimum funding level trigger would force the start of a wind up. Rather than a single one-off assessment, however, we propose that the assessment of

[3] https://www.ppf.co.uk/sites/default/files/file-2018-11/levy-consultation-document-2019-2020.pdf

whether the minimum funding level has been reached should be judged over a timescale, (for example, over three months) over which the triggers described above are breached before the wind up process needs to begin. This is to allow for the volatility in funding due to market movements. A single assessment that the minimum funding level has been breached should still result in an agreed recovery period being put in place to allow the scheme the chance to recover or investors to put more money into the superfund.

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

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

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?

Tier 1: a trigger to pay any remaining capital buffer into the superfund scheme and to enable a transfer of superfund business to another superfund or to wind up the superfund scheme above minimum PPF levels

130. A minimum funding level trigger to wind-up in extremis serves to protect the PPF and to ensure that members of a superfund will still be eligible for PPF compensation if that proved necessary. However, having been transferred to a superfund, members still might reasonably expect to get full benefits even in the case of a superfund which is deemed to be failing but is not an immediate risk to the PPF.

131. We therefore propose a higher funding level (Tier 1) trigger that would be breached should the scheme plus the capital buffer funding level fall to less than 90% on the authorisation basis (or something broadly equivalent). If this trigger is breached there should be a requirement for the trustees of a superfund to transfer the members to a new superfund, while the trustees of the superfund scheme would require full access to the remaining capital buffer in order to facilitate the transfer to a new superfund. We propose that the assessment of whether the triggering funding level has been reached should not be made on the basis of a single assessment but that there should be a timescale (for example, three months) over which the trigger is repeatedly breached. A single assessment that the triggering funding level has been reached should however result in a recovery period being agreed.

132. Although the Tier 1 trigger is intended to require a transfer to another superfund there may not be another superfund willing to take on the business, particularly if no additional employer capital or sufficient funding is available, or if all superfunds are struggling in challenging economic conditions. In this circumstance, trustees might consider it still to be in the best interests of members to allow the scheme to continue rather than to wind up the superfund. However, we would not expect the superfund to be allowed to continue indefinitely without adequate capital backing or without a firm expectation of being able to secure full benefits within a relatively short period of time.

133. We would welcome views on whether TPR should have the power to intervene at this point and require the fund to be wound up at perhaps less than 100% of full benefits, or members transferred, if they believe that the trigger has not been acted on in the best interests of members.

134. An alternative trigger intended to achieve the same outcome would be for the funding level to be assessed against a certain probability, for example, two-thirds of the scheme assets plus the capital buffer still being sufficient to provide benefits in full.

135. Over time we might expect to see the Tier 1 trigger moving closer to the minimum funding trigger and it could even become lower because of the value of the PPF benefits converging with the cost of buying out full benefits as the scheme matures. This is something we may need to address at a future point but is unlikely to be an immediate issue for superfunds.

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

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

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?

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?

Tier 2: a trigger to prevent new business being written

136. We propose that a Tier 2 funding level trigger be introduced to prevent a superfund from acquiring new schemes if it no longer meets the funding level requirements for authorisation. In these circumstances the superfund would

remain authorised to run-off existing schemes subject to the minimum and Tier 1 funding level triggers not also being breached.

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?

Tier 3: a trigger to restrict when profit can be taken either by investors or members

137. Superfunds will be authorised on the basis that profit can only be extracted if member benefits remain sufficiently protected – paying member benefits must be the primary aim of superfunds. These rules will apply whether profit is extracted for the benefit of the investors, or profit sharing arrangements are in place, from which members benefit (for example, through bonuses or enhanced benefits). As a minimum, the superfund would need to demonstrate that it continues to meet the conditions for authorisation. However, this leaves members exposed to the risk that profits are generated through market volatility alone rather than genuine outperformance.

138. Therefore we propose a Tier 3 funding level trigger so that superfunds are only authorised to take profits when they are able to demonstrate that funding levels exceed the requirements for authorisation. We have considered three options that could be used to broadly meet the same objectives:

- require that superfunds meet similar tests for authorisation but to a higher level of probability, for example, consistent with a general principle of paying or securing full benefits but with an overall probability of 99.5%;
- require superfunds to hold an additional risk based capital buffer based more around a one year value-at-risk, for example, an equivalent probability of being 100% funded on the required basis for authorisation over the next year; or
- only allow profits to be taken if the funding level of the superfund (scheme assets plus capital buffer) is at a margin above that required for authorisation depending on the option taken forward for authorisation, for example, 105% of that required for authorisation.

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?

139. The parameters for setting the framework for financial sustainability are based on initial views following engagement with stakeholders. We will undertake further work throughout the consultation period to refine the framework. We welcome

views on the framework and parameters for financial sustainability and whether it achieves the objectives set out.

Additional protections from excessive or inappropriate profit taking

140. Member benefits could be put at risk if profits are taken inappropriately, or if excessive profits are taken. This risk is not present in traditional DB, and it could be argued that additional specific protections against this risk are needed.

141. One way of mitigating the risk that profits are taken from gains generated by market volatility rather than genuine outperformance could be to retain profits for a certain period so that they are only paid out if the superfund continues to demonstrate it meets the requirements to take profit. For example, we might require that profits are retained in a separate contingency reserve for a certain period (for example, 6-18 months).

142. Another option to ensure that members are protected from the risks of excessive profit taking would be to prevent superfunds from taking any profits until all benefits in the scheme have been bought out. This approach has the benefit of aligning the commercial interests of superfunds with the interests of the members. Although this approach aligns interests and provides members with a very high level of protection it could mean that many superfund models become commercially unviable as investors may be unwilling to invest in a vehicle over these longer timescales.

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?

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

Sectionalised schemes

143. One issue to be considered in these options is how these criteria might apply in superfunds with sectionalised schemes. As long as the individual section (including any allocated capital buffer) meets the requirements for authorisation, it can be argued that the funding position of the other sections within the scheme is irrelevant because the assets for that section (including any allocated capital buffer) are ring fenced. Therefore it could be argued that the triggers should apply to each section individually. However, as we have previously proposed that the authorisation criteria view the sectionalised schemes as a whole, the aggregate funding position of the superfund could be used to determine whether it continues

to meet the requirements for authorisation as well as any additional requirements we might impose through the proposed tiered trigger arrangements.

144. Treating each section (including allocated capital) totally separate would mean individual sections could fail or even transfer to the PPF, while other members might still expect to be able to receive full benefits, and profits taken. This could put members in underperforming sections at greater risk of not receiving benefits in full while members of better performing sections receive full benefits.

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?

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**

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?

Control of assets and access to the capital buffer

145. To be authorised, we propose that a superfund would have to set out clearly who is in control of the assets, and in particular, who has access to the capital buffer in various circumstances. We would expect these arrangements to be set out in scheme rules and binding agreements between the various parties. In order to protect members, we think that TPR should be satisfied that these arrangements provide robust protection for members. Two options to achieve this are set out below, and we would welcome views.

146. The assets in the pension scheme fund will be owned and controlled by the trustees of the scheme. However, the capital buffer is provided by the ceding

employer and investors, and owned and controlled by the superfund corporate entity on behalf of the investors. Assets within the scheme and the capital buffer will be measured by audited values, which are bid market values.

147. The purpose of the buffer is to protect the scheme against adverse experience and to prevent the funding level of the scheme falling to a level which threatens the security of members' benefits. The authorisation regime will need to set minimum standards in relation to the capital buffer (for example, in relation to form held in, legal protections, restrictions in terms of nature of assets) to ensure that they can be relied upon to be available to the scheme when needed to meet a fall in the value of scheme assets. However, the investors will be expecting a return and to maintain some control over their investment, specifically in regards to the investment strategy. Investors may be willing to take more risk within the investment strategy in order to generate profits compared to the level of risk that the trustees of the scheme are willing to take with the assets of the scheme.

148. If a deficit emerges in the scheme it may not be reasonable to require the assets from the capital buffer to be paid into the scheme straightaway, due to the difficulties and potential costs involved in transferring the assets and in removing the assets from the scheme if the funding position within the scheme was to improve. However, it is vital that trustees have both sufficient powers with regards to the investment strategy, and access to the assets within the capital buffer when the scheme needs them. We propose two possible options:

Option 1: require the deficits within the scheme to be made good as they emerge by transferring the assets from the capital buffer into the scheme

149. This approach would ensure that the trustees had sufficient control and ownership of the assets as and when they need them. However, the investors may want to be able to reclaim assets back into the capital buffer if the funding position of the scheme improves. If the assets are transferred into the scheme it will be difficult for the investors to reclaim the assets or to have any control over how they are invested.

Option 2: ring fence the assets in the capital buffer

150. This approach would lead to assets within the capital buffer being assigned and ring fenced in respect of deficits within the scheme. The trustees would be entitled to direct how the ring fenced assets are invested and if the deficit becomes too large, i.e. approaching or exceeding the size of the capital buffer, then the assets in the capital buffer will transferred into the scheme. However, if the funding level within the scheme improves then the assets within the capital buffer will no longer be ring fenced for trustee control and the investors regain control over the investment strategy for these assets.

151. Of course, any options we consider for access to the capital buffer will be subject to any minimum requirements or funding level triggers we might impose, for the payment of capital buffer funds into the superfund scheme.

152. We envisage that the assets of the pension scheme will be subject to current DB occupational pension scheme requirements regarding how the assets of a pension scheme can be invested, for example, a restriction on the amount of assets that can be invested in the sponsor of the pension scheme (self investment). As the purpose of the capital buffer is to provide support to the pension scheme should the funding within the scheme deteriorate, we propose that the capital buffer is subject to similar requirements.

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

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?

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

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

153. It is up to the trustees and the corporate entity of the superfund to demonstrate that together they can meet the financial sustainability requirements, in terms of both scheme funding and financial resources. Superfunds will need to provide TPR with satisfactory evidence that they meet the financial sustainability requirements at authorisation. It will then be the responsibility of the superfund to demonstrate that they continue to meet the requirements and must notify TPR of any of the triggering events discussed above, or significant events discussed in Chapter 4.

Scheme funding

At authorisation, we envisage that superfunds will need to get approval from TPR for the following:

- the legal structure of the superfund;
- the assumptions used in their funding calculations;
- the investment strategy; and
- modelling.

The legal structure of the superfund

154. The legal structure of a superfund will be documented in:

- a detailed business plan,
- contracts with third parties, and
- the trust deed and rules.

155. The policy intention is that members will be entitled to the same benefits under the superfund trust deed and rules as under the scheme from which they are transferring. The explanation of the legal structure should clearly specify the circumstances in which money is moved into and out of the scheme, as well as the circumstances in which trustees have control over the capital buffer and when profit can be extracted.

The assumptions underlying the funding calculations

156. The assumptions used to calculate the Technical Provisions, or liabilities used to determine (amongst other things) the basis on which profits will be distributed will be documented in the Statement of Funding Principles and any documentation explaining the modelling provided by superfunds to TPR.

The investment strategy.

157. The investment strategies of both the scheme assets and the capital buffer are crucial in determining the success of a superfund and ensuring that members' benefits have adequate protection. The commercial nature of a superfund may mean that investors will be willing to adopt riskier investment strategies in order to generate the profits they require. However the capital buffer is the only protection members have against emerging deficits. Therefore, in order to protect members' benefits it is important to fully understand and allow for the risks in proposed investment strategies when assessing the probability of a superfund meeting the requirements for authorisation.

158. As a starting point, we have considered the Statement of Investment Principles (SIP) already required for DB pension schemes. However, the SIP does not require a scheme to provide the level of detail necessary to fully understand the risks within individual strategies and fairly significant changes could be made to the investment strategy without a requirement for TPR to be notified. The capital buffer would also fall outside the current requirements for a SIP. Therefore at authorisation we propose that the superfunds provide more detailed evidence of the investment strategies for both the scheme assets and the capital buffer. There are options over whether this is:

i. a line by line report of all the investments; or

ii. the detailed fund management guidelines provided to asset managers, which detail the objectives of the strategy, the asset class and risk factor, asset allocation frameworks, benchmarks, the discretion allowed to the asset managers and a full suite of risk dashboards and monitoring tools.

159. In the case of either of these options we propose that there would need to be a disclosure regime for ongoing supervision, so that TPR are made aware of any changes to the investment strategy.

160. We propose that the detailed fund management guidelines provide the right balance of information for TPR to be able to understand the risk held within the investment strategy to a reasonable level. However given the importance of the investment strategies to a superfund's success we propose that TPR have the power to request further information in relation to the investment strategy at any time.

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

Modelling

161. If we require superfunds to provide their own modelling which demonstrates that they meet the requirements for authorisation in respect of financial adequacy and funding, we think there would be a need for an acceptable range of assumptions used in the modelling to be set out either in a Code of Practice issued by TPR, or in legislation. This would lead to a common basis on which all superfunds are modelled, increasing the consistency within the authorisation regime.

162. Sufficient detail should be provided to TPR to enable them to understand the assumptions and approach used in the modelling, and how the risks (especially investment risk) within the scheme have been allowed for. TPR will have the authority to reject a model if it does not adequately reflect the superfund proposal, or if they do not agree with the assumptions or rationale for the assumptions used in the model.

163. Alternatively, TPR would have the power to impose additional capital requirements or conditions regarding the retention of profits if it is of the view that the proposed capital structures do not adequately reflect the underlying risks of the superfund.

164. Superfunds should also demonstrate to TPR that the model has been through a rigorous quality assurance process. Superfunds will have a very strong incentive to ensure their modelling accurately reflects their proposal and the relevant assumptions given that the corporate entity and investors have capital at risk within the superfund. However these are likely to be very sophisticated models so TPR should require assurance that the model has been through an adequate quality assurance process, possibly with an external adviser.

165. Consideration would need to be given in the Code of Practice or legislation to the types of schemes entering a superfund and the nature and duration of the liability cash-flows. Prudence should be incorporated into key demographic assumptions, including mortality. The modelling should demonstrate the sensitivities of the results and include some examples of what would happen in stressed scenarios, especially with respect to liquidity longevity, inflation and investment risks. TPR should have the power to request further information on the modelling if required.

166. The requirement for superfunds to demonstrate through risk based modelling that they have a high probability of paying or securing benefits should adequately allow for the risks within the structure of the superfund (in particular the investment strategy). The modelling will allow for the interaction between the funding level of the scheme, the structure of the superfund (including the mechanism for taking profits) and the risk within the investment strategy. Any changes to the above will be significant events, which will have to be reported to TPR. The superfund would have to demonstrate that it continues to meet the requirements for authorisation after the significant events have occurred.

167. The alternative is for TPR to create their own 'standard' model used to assess superfund proposals. This could provide a default model for superfunds without the resources or the desire to create their own model. However, given the differences in the structures of proposed superfunds and their differing objectives, any standardisation could be lost and the model may require a great deal of adjustment. We consider that this would not be an efficient use of TPR resources, therefore we propose that superfunds submit their own models, which TPR would then review.

168. Although TPR may not have a standard model to assess every proposal they could have a default model for superfunds whose internal model was rejected or to use as a benchmark against which to assess the fitness of internal models.

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?

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

Financial resources of the superfund

169. As a minimum we expect superfunds to provide a comprehensive business plan, with accounts from the superfund corporate board and the pension scheme within a superfund where available. Superfunds should provide TPR with the information needed to assess their financial strength. This could include the running costs of the superfund, its financial reserves, costs for resolving a triggering and/or significant event, and a 'cost, assets, and liquidity plan' (CALP). In particular, the CALP should demonstrate that the superfund has the financial support needed to discharge benefits without cost to members.

4. Supervision

170. Previous chapters have discussed the evidence that superfunds will be expected to provide to demonstrate that they are well run and financially sustainable. This chapter discusses some of the mechanics of supervision that are needed to ensure that:

- TPR has the information it needs;
- emerging risks can be identified; and
- TPR has the ability to respond to those risks.

171. The regulatory regime we introduce will be supported by a TPR Code of Practice which would apply to both the corporate body and the pension scheme.

Reporting

172. DB pension schemes are already required to submit information to TPR under existing legislation. This includes an annual scheme return and a full actuarial valuation at least every three years.

173. For superfunds we think it is important that TPR has adequate information so that it has early warning of any emerging problems. We therefore propose that superfunds should be required to submit annual valuations to TPR, produce quarterly updates on the funding position, and notify TPR if the quarterly funding position is likely to have triggered any of the responses referred to in Chapter 3.

174. We also propose placing additional reporting requirements on the superfund's corporate entity in order to ensure that TPR is able to develop an accurate picture of the overall position of the superfund. These requirements would sit alongside the pension scheme's annual valuation and be supported by accompanying stress tests and sensitivity analysis. The scenarios to be included in the stress tests and sensitivity analysis could be included in the Code of Practice issued by TPR.

175. Taken together, both returns would seek to provide TPR with the information it needs to build an overall picture of the superfund's financial position and to identify emerging risks within the superfund.

176. As part of this, we propose that the corporate entity be required to submit its:

- business plan;
- latest set of accounts; and
- latest risk assessment

177. The risk assessment would cover financial, operational and compliance risks across the superfund over the short, medium and long term. The assessment would also need to clearly outline what steps have been taken to mitigate identified risks, particularly in relation to ongoing financial sustainability and financial adequacy.

178. We would also welcome views on whether, both the corporate entity and pension scheme should also be required to disclose their strategic asset allocation and investment risk limits as part of the annual return, so that TPR can effectively supervise the investment strategy.

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

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?

Public disclosure

179. We would also welcome views on whether superfunds should be required to make regular (for example, annual or quarterly) public disclosures on their:

- solvency and financial condition;,
- governance;
- business and performance; and
- risk management.

180. We believe that this would enhance transparency and comparability for employers and pension scheme trustees considering transfers to a superfund, and encourage market discipline.

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

Significant events

181. In addition to regular reporting, it will be important for TPR to have early warning of risks as they arise. We therefore propose requiring superfunds to report certain events to TPR under a 'significant events' framework.

182. The significant events framework would seek to:

- ensure that the superfund continues to meet the authorisation criteria;
- provide an early indication of potential issues within the superfund; and
- minimise impacts on member outcomes where necessary.

183. Table 1 sets out the events we think would meet these aims. It draws on the DC Master Trusts framework.

184. The significant events framework for superfunds would sit alongside the existing notifiable events framework, under which employers and trustees are

required to report certain events to TPR to provide early warning of a possible call on the PPF.

Table 1

Event	Description	Applies to
A change to an area subject to the fit and proper persons requirement	The appointment of a person to an area assessed under the fit and proper persons requirement at the point of authorisation, or A change in the circumstances of a person subject to the fit and proper persons requirement.	Corporate entity/pension scheme
An investigation by another regulator or competent authority	Where an investigation is launched into any part of the superfund, or a person involved in the superfund, including by those outside the UK.	Corporate entity/pension scheme
A change in, or failure of, systems or processes	A change in systems or processes agreed at authorisation, including a change in third party providers, as well as a failure in systems and processes which results in a significant adverse impact on service delivery and/or members.	Corporate entity/pension scheme
A change to the business plan	Any changes that require a revision to the business plan.	Corporate entity
A change in the investment strategy	Any departures from the investment strategy, (outside of ranges agreed at authorisation)	Corporate entity/pension scheme
A deterioration in investment performance	A significant deterioration in investment performance over a set time period, for example, [10]% over a quarter	Corporate entity/pension scheme
A change to the statement of funding principles	Any changes to the approach used to derive assumptions for calculating liabilities.	Corporate entity/pension scheme
A deterioration in the funding level	A significant deterioration in the funding level over a set time period, for example, [5]% over a quarter	Pension scheme

The corporate entity is unable or unlikely to meet agreed levels of assets or liquidity	A deterioration in the cover provided by the financial reserves within the business.	Corporate entity
The superfund pension scheme and/or corporate entity is unable or unlikely to meet its liabilities on demand	The superfund pension scheme and/or corporate entity is unlikely or unable to meet its liabilities on demand as they fall due or its costs (either expected or unexpected)	Corporate entity/pension scheme

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

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

Skilled persons reports

185. The PRA has the power to gather information on financial services firms by means of 'skilled persons reviews' (also known as S.166). TPR also has a power to require a skilled person's report (under s. 71 of the Pensions Act 2004), although this power is different in a material way from the PRA's power and is exercisable by TPR's determinations panel. We would be interested in views as to whether TPR's power in relation to skilled persons reports for superfunds should be brought more in line with the PRA.

186. In particular, we would welcome views on whether TPR's executive arm should have the power to commission a skilled persons report in relation to superfunds, including appointing the skilled person. This would be different from TPR's current s.71 power in that it is TPR's determinations panel that exercises the power to commission a skilled persons report.

187. The main aim would be to ensure that the superfund is operating as intended, meeting its regulatory obligations and that TPR can act more quickly where they have significant concerns over the management of the vehicle. This could arise, for example, where they had concerns that conflicts of interest were not being managed or that excessive investment risks were being run so as to generate surplus for investors

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?

Responding to market risk

188. The superfund market is still developing. Since publishing the white paper we have a seen a variety of different business models looking to enter it.

189. Currently, TPR can issue practical guidance through Codes of Practice ('Codes'). These are not enforceable but are admissible as evidence in any legal proceedings. TPR will be producing guidance for superfunds for the period before the authorisation regime is in legislation. TPR will provide guidance on the governance and financial security in respect of superfunds planning to onboard schemes before the legislative framework is in place.

190. Given that it will be important for TPR to be able to respond quickly and proactively to emerging risks as the market develops, we believe that they will need the ability to directly intervene in the superfund market if it identifies a significant risk to members.

191. Other regulators, such as the PRA, have a general rule making power with which firms must comply and which can be used to further their organisational objectives. Although granting TPR such a power would enable them to respond quickly and proactively, we believe it may not be proportionate given the comparatively small number of superfunds likely to enter the market. We may also come under pressure to introduce a similar power to other areas of pension regulation, where it may not be appropriate.

192. Another option would be to make a specific enforceable Code of Practice, a 'Superfund Code' to be issued by TPR, so that superfunds must comply with key areas set out in the Code with an appropriate penalty for non-compliance. This would be consistent with our white paper committment to deliver clearer enforceable funding standards.

193. The enforceable Superfund Code would not operate in isolation and superfunds will be expected to comply with other oversight activity, for example, relevant pensions legislation and company law.

194. On balance, we think that an enforceable Superfund Code would be more proportionate, while still allowing TPR to respond quickly and proactively.

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?

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

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?

Covering the costs of supervision

195. TPR is funded by a general levy on eligible pension schemes. Regulating superfunds will be a new function of TPR, which will carry additional costs. The costs that TPR incurs will largely depend on the regulatory regime introduced.

196. We do not believe that it is right for ordinary pension schemes to subsidise the regulation of commercially run vehicles. We therefore propose that superfunds be subject to a bespoke levy to cover on going supervision, which would be ring-fenced for the sole purpose of regulating superfunds.

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

5. Superfund transactions

197. A key objective for trustees of DB pension schemes is paying the promised benefits as they fall due. The protection of members' benefits should therefore be the key focus when considering whether to move to a superfund. This decision will require careful consideration from the scheme trustees and the sponsoring employer, as well the superfund. Trustees must act in the best interest of beneficiaries; they will need to be convinced that members' benefits will be more secure in a superfund than remaining with the sponsoring employer and the current funding arrangements.

198. Since the publication of the white paper we have continued to engage with stakeholders and a range of interested parties from across the pensions industry

in order to understand more fully the issues that may arise in legislating to enable superfunds.

199. The key issues that we are focussed on are:

- ensuring that superfund consolidation offers a clear and viable option for a segment of pension schemes to improve security for members.
- ensuring that superfund consolidation is not seen as, and cannot be used as, an alternative to insurance buyout.

200. We therefore propose strengthening the current pension scheme transfer process by introducing a regulatory gateway to ensure that the decision to enter into in a superfund is in the best interests of scheme members. It is clear that for those scheme and sponsors where there is a realistic prospect of buying out in the insurance market, entry into a consolidator would not be in the interests of the members as it would provide less certainty of benefits being paid. It should not be available as an alternative with lower costs.

201. The government wants superfunds to be able to offer an alternative for those schemes and sponsors who do not have a realistic prospect of being able to fund an insurance buyout either now or in the foreseeable future. For these purposes, the foreseeable future is probably around 5 years, as it is very challenging to assess the future covenant strength of an employer with any degree of certainty beyond that horizon.

202. The regulatory gateway should therefore prevent schemes from entering a superfund if buyout is a realistic prospect. Furthermore, a well-functioning superfund market offers the potential to provide another source of business for the bulk purchase annuity market as superfunds themselves look to de risk through insurance buyins and buyouts over time.

203. The majority of UK employers run their business responsibly and fulfil their responsibilities to their employees and their pension funds. Trustees are also required under trust law to act in the best interest of their beneficiaries and, where a scheme has individual trustees, can be personally liable if they are found to have breached their fiduciary duties. As insurance buyout provides the greatest certainty of benefits being paid when they fall due, trustees should not agree to move to a superfund where buyout is a realistic prospect. To help build confidence in the new regime we propose putting in place additional protections for members to prevent entry into a superfund for any employers who may be tempted to seek to discharge their responsibilities through a superfund, when buyout is a realistic prospect.

Superfund gateway

204. Following the publication of the white paper we have engaged with stakeholders and other interested parties across the industry and sought views on this issue and we are grateful for their informed contributions. Having carefully considered this feedback we have reached the conclusion that the complexity of the issues are sufficiently complex and the possible scenarios so varied that any type of formulaic gateway (when comparing against buyout) could potentially create perverse outcomes. On balance we believe a principles-based gateway, considering the specific circumstances of each case, and relying on professional assessments such as actuarial and covenant advice, would best support our overall aims.

205. We therefore propose introducing a regulatory gateway based on the following principles:

- excluding schemes that are assessed by the trustees as having the ability to buyout at the point of transfer (buyout would be assessed on a basis used by a typical scheme when assessing its ability to buyout);
- excluding schemes assessed by the trustees as being able to afford buyout in the 'foreseeable future' (in this context we define 'foreseeable future' as a period up to five years); and
- for any other scheme looking to transfer, a move to a superfund would need to be based on evidence it enhances the likelihood of members receiving full benefits.

206. When considering a move to a superfund we would require trustees to take the following factors into consideration:

- the scheme's current funding position on a solvency basis,
- any deficit reduction contributions,
- professional covenant advice with a clear conclusion on the employer's ability to support the scheme for the foreseeable future,
- actuarial advice regarding the future funding of the scheme; and
- the funding position and the long term objective of the superfund.

207. These will all be important factors for trustees when weighing up the pros and cons of moving to a superfund.

Question 63: Do these principles achieve the policy aim?

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

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

208. A potentially significant injection of additional funds from the employer (or another group company) will be required to enable a scheme to transfer to a superfund. By moving to a superfund and breaking the link with the original sponsoring employer, the trustees are replacing protections provided by the original sponsoring employer with a capital buffer, which sits outside the scheme assets but within the superfund structure. It is important therefore that there are safeguards in place to protect both the transferring scheme members and superfund scheme members during the transfer process. This is to prevent a poorly funded scheme joining a superfund and weakening the overall funding position of the superfund scheme.

209. The superfund entry price will be driven by the financial framework put in place and only those able to meet that entry price will be able to transfer. The authorisation regime and significant events framework discussed earlier will help guard against superfund funding levels being weakened by a transfer. Superfund trustees will also have a fiduciary duty to reject a transfer into the superfund scheme if it is not in the best interests of all members

210. However, without a minimum funding level for the transferring scheme itself at the point of entry, there is potentially a risk that the transferring scheme reduces the funding level in the superfund pension scheme and erodes the security of members' benefits.

211. There could also be a requirement that any scheme joining a superfund should be funded to a minimum level upon entry, for example at least 87.5% funded on the 'authorisation basis' discussed in Chapter 3. An alternative would be for the minimum funding level to be set in relation to a buyout basis, as buyout is already understood and regularly reviewed at actuarial valuations. For example, based on our findings in the white paper, a minimum funding level of 80% of the full buy out liabilities could be required in order to transfer. Achieving this minimum funding level might require an injection of additional funds from the employer or another group company.

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?

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?

Covenant Advice

212. An important part of any assessment will be the trustees' ability to form an objective view on the likelihood of the employer (or its parent group if legally liable) to be able to fund the scheme now and in the future.

213. Trustees continually assess the strength of the employer covenant of their DB pension scheme as part of an integrated approach to managing scheme risks. Detailed guidance on how trustees should assess and monitor the employer covenant is already available from TPR[4].

214. The decision to move to a superfund will be a challenging one and trustees will need to assess the risk that their sponsor will not be there to support the scheme in the future. Given the significant nature of this transaction we would expect an external covenant assessment by a regulated provider to be an essential component for trustees when considering this complex issue. We would expect this advice to set out clearly the conclusion of the analysis and the matters considered such as the sponsor's ability to pay additional contributions and an assessment of the contributions that the trustee could otherwise reasonably be expect to obtain.

215. We think professional covenant advice should be the norm, and we would expect trustees to take such advice, on a comply or explain basis. In some cases covenant advice may not be necessary for example where trustees have undertaken a covenant assessment following a recent valuation or where trustees form the view that it is disproportionately expensive. In such cases we would expect the trustees to explain to TPR why they have judged covenant advice to be inappropriate in their particular circumstances.

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

[4] http://www.thepensionsregulator.gov.uk/guidance/guidance-assessing-monitoring-employer-covenant.aspx#s19596

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?

Transfers to a superfund

216. Under current legislation, a bulk transfer without member consent which includes deferred members must satisfy several criteria set out in regulation 12 of the Occupational Pension Schemes (Preservation of Benefit) Regulations 1991 (and for contracted-out rights, regulations 4 and 9 of the Contracting Out (Transfer and Transfer Payment) Regulations 1996). This includes gaining a certification from the scheme actuary which certifies, among other things, that the transfer credits to be acquired for each member in the superfund for the categories of member covered by the certificate are, broadly, no less favourable than the rights to be transferred.

217. We propose that the corporate entity of the superfund will become the statutory employer for the transferring scheme and will therefore be able to receive the bulk transfer from the ceding employer. We envisage that the benefits payable under the superfund trust deed and rules will be the same as the benefits payable in the transferring scheme.

218. Following this consultation, the government will consider whether further legislation is needed for tax purposes to fit superfunds into the current Finance Act 2004 framework.

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.

TPR’s role

219. We think that the decision to move to a superfund will predominately be a trustee decision taken in conjunction with the sponsor and the superfund provider, with notification and evidence supporting the decision provided to TPR. We do not think it will be an effective use of resources for TPR to be the decision maker in each and every transaction. However, it is important that TPR as a risk-based regulator is aware of schemes considering a move into a superfund, and has tools at its disposal to take action if it has reason to believe that the members’ best interests are not being served.

220. As part of the gateway, we therefore propose to introduce a new notifiable event arising in advance of any transfer requiring trustees to:

- notify TPR at the earliest available opportunity (for example at least 3 months) of its intention to join a superfund;
- make a declaration to TPR outlining the trustees' rationale and evidence that the scheme's transfer to a superfund enhances member security; and
- if professional covenant advice has not been taken, to explain to TPR why it is not appropriate in their particular circumstances.

221. We would expect TPR to undertake a basic triage check, and to identify those transactions where there are significant risks, and where a more detailed assessment is warranted. We would expect TPR to notify those schemes within a reasonable period where it feels further investigation is appropriate. This will be to ensure any potential transfer is in the best interests of the members.

222. Given the move to a superfund is an irreversible decision it is important that TPR has powers both to intervene where it identifies that a move to a superfund is not in the members' best interests, and to prevent the transaction from taking place.

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.

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?

223. As part of the gateway we will continue to work with TPR to introduce a new Code of Practice to give trustees practical guidance on all the matters that will need to be taken into account to give them confidence in deciding whether or not to transfer into a superfund.

224. We accept that a decision to move to a superfund will be a challenging one and trustees will need to be convinced that the transfer will provide the best available outcome for members. We believe the principles set out in this chapter will help trustees with their decision making process whilst also providing sufficient protection for members.

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.

Changes to the DB Funding Regime

225. The gateway will form part of the wider changes we are making to deliver clearer funding standards, including ensuring trustees set their scheme funding objective in the context of their long term objective. One example of a suitable long term objective would be to specify a date by which a scheme may be able to secure buyout, or to set a time frame for transferring into a superfund. As we continue to develop changes to the scheme funding regime we will also consider how the Chair's Statement could be used to alert TPR to the risks involved where a proposed superfund transfer is a clear deviation from a scheme's previously stated objective. TPR will be consulting on these changes in due course.

6. Section 75 employer debt

226. When an employer's relationship with a DB pension scheme ends, legislation sets out requirements for what is known as a 'Section 75 employer debt'. This is the amount the employer must pay into the pension scheme if it is underfunded in order exit the scheme. The amount of 'employer debt' is based on the cost of securing members' benefits with an insurance company.

227. Employer debt is common to all DB occupational pension schemes and is an important part of member protection. Section 75 employer debt legislation will also apply to superfunds if they decide to end their relationship with the scheme. We will therefore consider what changes are needed to ensure that superfunds

including any capital buffer are captured within the definition of an employer in primary legislation for the purposes of an employer debt.

7. PPF Levy

228. In September 2018 the PPF published the 2019/20 Pension Protection Fund Levy Consultation Document[5], which discusses the risks posed to the PPF from superfunds. The consultation describes the similarities between superfunds and schemes without a substantive sponsor (SWOSS). The PPF have determined a calculation method for a bespoke risk based levy for SWOSS and are proposing to adjust the existing methodology for superfunds allowing for the different risks posed. The PPF's proposals for 2019/20 have been developed within the current legislative framework. However we consider it desirable to amend the legislative requirements for the levy to provide more flexibility. This is because we need to reflect that the risks posed specifically by superfunds may be different to those of other schemes, and ensure that the amount superfunds and other schemes pay

[5] https://www.ppf.co.uk/sites/default/files/file-2018-11/levy-consultation-document-2019-2020.pdf

can be considered separately.

8. Other live issues

DB Master Trust Accreditation

229. As set out in the white paper, there are already a number of options open to pension schemes to consolidate, which can help them to reduce scheme costs per member, improve governance and lead to more effective investment strategies through economies of scale. These options are:

- sole trusteeship: an individual or company replace the existing board
- investment platforms: schemes access pooled funds run by different asset managers
- mergers and simplification: schemes merge or share functions
- Master Trusts: schemes can transfer all of their assets and liabilities into a section of a larger DB trust
- Insurance buyouts: pension liabilities transferred to an insurer in exchange for a fee

230. Respondents to the Green Paper thought more should be done to raise awareness and encourage take up of these existing consolidators.

231. Defined Benefit Master Trusts (DB MT) are already operational within the pension market. Many pension schemes benefit from using a DB MT to run all aspects of their scheme such as administration, investment and governance.

232. The white paper sets out that government wants to do more to help encourage existing forms of consolidation as it recognises the benefits it can bring in reducing scheme costs per member, enabling more effective investment strategies and improving governance.

233. The white paper also committed to consult on proposals for a new accreditation regime for DB MTs to give trustees confidence that the scheme is being well managed and meeting clearly defined standards.

234. We do not feel that DB MTs require authorisation or specific legislation as they are already bound by pension scheme regulation. On balance, after discussions with interested parties across the pensions industry, we favour an industry led accreditation scheme, setting standards which would raise awareness and promote the use of DB MTs, and which DB MTs would be able to sign up to on a voluntary basis.

235. DWP has approached representatives of the existing DB MTs with a view to establishing an industry working group to explore how an accreditation scheme might operate.

236. This would be supported by wider guidance on when and how DB schemes consolidate and the issues that trustees should consider.

Terminology for Defined Benefit

237. Following the introduction of the DC master trust authorisation regime in October 2018 the term “Master Trust Scheme” has now been defined in legislation as meaning an occupational pension scheme which “*provides money purchase benefits (whether alone or in conjunction with other benefits)*” (section 1(1)(a) Pension Schemes Act 2017).

238. As part of our wider work to raise awareness of existing consolidators we are interested in seeking views as to whether the term “Defined Benefit Master Trust” is still an appropriate term to describe this type of DB consolidation vehicle. In conjunction with developing an accreditation regime for DB Master Trusts we therefore propose exploring if a more suitable name would be helpful in providing more clarity between the different services DC and DB Master Trusts currently

provide.

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?

Guaranteed Minimum Pensions (GMPs)

239. In the white paper we explained how we are working with the Pensions Industry working group to assist benefit simplification around GMPs. The group was set up to address inequalities caused by GMPs and consider some minor changes to the GMP conversion legislation. That work is ongoing and we are confident of finalising it in the near future.

240. The outcome of the High Court case brought by the Lloyds Banking Group pensions trustees in October 2018 endorsed our long held position that pensions must be equalised for the effect of inequalities caused by GMPs and that the methodology we consulted on in November 2016 is a viable method of achieving equal pensions. Following that judgement, and building on our November 2016 consultation, we are hoping to be able to provide schemes with some guidance on how they can equalise pensions for the effect of inequalities caused by GMPs.

241. We continue to work with HM Revenue and Customs to investigate whether changes might be necessary to tax legislation for those potentially negatively affected by GMP conversion as a result of benefit changes and corresponding Lifetime Tax Allowance and/or Annual Allowance requirements.

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