Pensions: **Corporate Agenda**

SUMMER | 2019

DB commercial consolidators

This “new” option has a similar effect to a buy-out in that scheme assets are transferred (to another occupational scheme) and the transferring scheme has no further liabilities. However, there are some key differences.

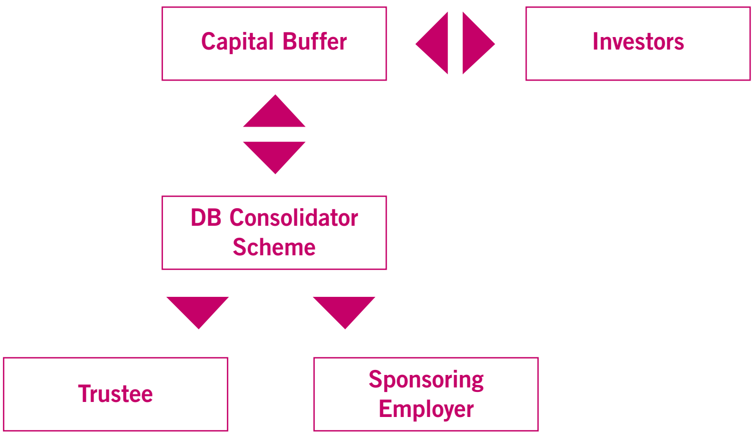
In a nutshell

DB commercial consolidators are occupational pension schemes that are set up “for profit”. A DB commercial consolidator will take on the assets and liabilities of other defined benefit pension schemes. It is a single employer scheme with no link to the transferring pension scheme (or its sponsoring employers). No benefits are built up whilst in the consolidator’s scheme. The transferring scheme usually has no further liabilities and will wind up.

In this respect it differs from some existing industry-wide DB consolidators (sometimes referred to as DB master trusts) which take on the liabilities of other defined benefit schemes in order to leverage economies of scale but also retain a link to the sponsoring employers, and may provide for ongoing accrual. These other consolidators could be described as an alternative to or even a stage before the kind of DB commercial consolidators discussed in the rest of this article.

How are these different to a “normal” pension scheme?

Whilst they are occupational pension schemes, current commercial consolidator models include a capital buffer which sits outside the scheme.



“Sectionalised means that a section’s assets may only be used for a particular section of the scheme.”

DB commercial consolidator schemes can be non-sectionalised or sectionalised.

Sectionalised means that a section’s assets may only be used for a particular section of the scheme, relating to a single transferred-in scheme (like a pension scheme within a pension scheme). Non-sectionalised means there are no separate sections and there is cross-subsidy between the different schemes which have transferred in to the DB consolidator.

How do you transfer to a DB commercial consolidator?

There is a bulk transfer from the existing scheme to the DB consolidator’s scheme using existing legislation which allows this subject to certain conditions.

As part of the transfer, the sponsoring employer of the transferring scheme will pay a fee. Some of this fee will go into the DB consolidator’s scheme to ensure a certain funding level is met and any remaining amount is paid into the capital buffer.

How are the assets invested?

Like any other pension scheme, the trustee of the DB consolidator scheme controls the investment of the assets. They are currently subject to the same restrictions which apply to other occupational pension schemes and the trustee can delegate its investment decisions like other trustees. The capital buffer does not currently have the same restrictions on investment as it sits outside the scheme.

The government is proposing that a new regime applies to DB commercial consolidators

The Government has published a consultation on a new legislative framework for the regulation of defined benefit “superfund” consolidator schemes. It closed at the start of February and legislation is expected when parliamentary time allows.

The consultation covered three areas:

> **Authorisation:** Similar to the regime for defined contribution master trusts, commercial consolidators (referred to as “superfunds”) will be required to seek authorisation from the Pensions Regulator. In order to be authorised, the Pensions Regulator will have to be satisfied 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.

> **Supervision:** Superfunds will also be subject to ongoing supervision by the Pensions Regulator.

> **Superfund transactions:** The Government is proposing to introduce a “Pensions Regulatory gateway” that must be satisfied before a transfer to a superfund can be made. This will be based on the following principles:
  - schemes that are assessed by the trustees as having the ability to buy out at the point of transfer would be excluded (buy out would be assessed “on a basis used by a typical scheme when assessing its ability to buy out”);
  - schemes assessed by the trustees as being able to afford buy-out in the “foreseeable future” would be excluded (“foreseeable future” is defined 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 that it enhances the likelihood of members receiving full benefits.

> The Pensions Regulator will be given 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.

Trustees will be required 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.

Schemes will be required to:

- notify the Pensions Regulator at the earliest available opportunity of their intention to join a superfund;
- make a declaration to the Pensions Regulator outlining the rationale and evidence that the scheme's transfer to a superfund enhances member security; and
- if professional covenant advice has not been taken, explain to the Pensions Regulator why it is not appropriate in their particular circumstances.

The Pensions Regulator will be given 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.

There may also be a requirement that any scheme joining a superfund should be funded to a minimum level upon entry (e.g. 80% of the full buy-out liabilities could be required in order to transfer).

What do schemes need to think about before transferring to a commercial consolidator?

The issues to think about are not new. They are the same issues as for a scheme merger, but here with a different type of receiving scheme to consider.

On any bulk transfer, the trustee will need to ask itself two key questions:

- Do they have the power to transfer?
- Should they transfer?

The first question is usually quite easy to answer. This is done by checking the rules to see if they allow the bulk transfer, and if they do, who makes the decision. There usually is a power and it is usually a trustee decision. If there isn't a power, normally it is relatively straightforward to amend the rules to allow this.

The second is a harder, and a much bigger, question to answer.

For practical purposes, the second question for the trustee can generally be considered as: "Is there any reason why the trustee should not agree to the transfer?". This question should be considered in conjunction with professional advice.

Technical legal requirements for the bulk transfer

The transfer needs to satisfy the "employment relationship" condition. This condition is, broadly, that the two schemes relate to employment with the same employer or there is a financial transaction between the employers.

The scheme actuary will also need to provide a certificate that benefits provided after the transfer are "broadly no less favourable" and any established discretionary benefits are maintained in the receiving scheme.

Factors for transferring trustees

Comparison of funding levels

The first factor trustees will look at is how the funding levels compare between the two schemes.

Commonly, comparisons will be done of the two schemes' funding positions on an agreed date and using the common bases: PPF (s.179), technical provisions, and buy-out.

The commercial consolidators may also have their own funding measure that will need to be taken into account.

There can be difficulties if there is a difference in funding levels. For commercial consolidators, the proposal is that the employer tops-up the funding level in the transferring scheme as it transfers to the DB consolidator. This top-up payment may be held in or outside the receiving scheme.

This mechanism may make funding level comparisons redundant, but trustees will need to understand how much the funding level in the scheme is being improved by this payment.

Trustees will also need to consider whether the consolidator is set up on a sectionalised or unsectionalised basis. This is because this impacts on:

- what will happen to the funding of the transferring scheme once it is in the receiving scheme;
- how the funding level (or nature of the scheme) could change in future; and
- how future transfers-in will impact on the funding.

Covenant supporting the scheme

Covenant is a key element to consider when deciding whether or not to agree to a transfer out, as it affects the ongoing security offered to members.

When considering a normal bulk transfer, the transferring trustee will assess the employer covenant supporting the receiving scheme (i.e. the strength of the employer with direct responsibility for funding that scheme).

When moving to a DB consolidator, there will not be a traditional employer covenant supporting the receiving scheme. The statutory employer for the purposes of the scheme is likely to be a shell company. The covenant offered here, rather than being by virtue of an employer, will be derived from the initial capital funding of the scheme and any capital that sits behind this.

Trustees will also need to understand how the commercial consolidator's structure works and how it compares to the support currently offered to the scheme.

Benefits

The transferring scheme will be concerned to understand the benefits to be provided under the receiving scheme. The DB consolidator will be concerned to ensure that they understand the benefits to be provided.

Benefits do not have to be identical but ideally benefits will be replicated in the receiving scheme: at the moment no commercial consolidator is proposing otherwise.

Balance of power

Transferring schemes will want to understand the balance of power between the trustee and the employer in the scheme consolidator (i.e. who has the power to make which decisions). Key powers include employer contributions, rule amendments, winding up and surplus.

Whilst powers do not have to be identical, the transferring scheme will want to ensure that members are not materially "worse off" because the powers in the new scheme are less favourable. This is just one consideration when looking at the transfer as a whole.

Governance and administration

The transferring scheme will also want to make sure that there are appropriate arrangements in place in the receiving scheme for the ongoing governance and administration of the receiving scheme, and may want to perform some due diligence here.

Other considerations

End game – what is the DB consolidator intending to do in the long run? Will the scheme run on until the last member dies, or is the intention to target buy-out? This varies and could be something that influences any decisions.

If funding worsens – what is the consolidator's policy to protect members if funding begins to worsen.

Profit – when and how is profit taken out by the DB consolidator? At what point does this happen? Is it on an annual basis, and what is the measure used to decide whether profit can be taken out? Again, this is something that varies between DB consolidators and will need to be understood.

Regulatory regime – what applies to the scheme? Currently a DB consolidator's scheme is just treated like any other occupational pension scheme, and it is eligible for the Pension Protection Fund, but regulatory change is on the horizon.

What can be expected in the future?

There has been a mixed reaction to the Government's consultation for superfunds and we are still waiting for the first transaction with one of the new commercial consolidators. More consolidators are expected to enter the market; but these may be structured differently, so schemes will have to consider different issues.

8697_Stage02/07.19