Pensions Superfund - an answer to the rundown of the defined benefit sector

DENTONS

April 30, 2018

As some readers may be aware pension schemes offering a guaranteed income in retirement are not a popular sell and haven't been for fifteen years or more. In fact a fair proportion of the collective intelligence of the pensions industry is devoted to the conundrum of how to deal with the run down of our formerly world leading defined benefit sector.

One option getting a lot of thought at the moment is consolidation. Small funds, the argument goes, have less resources to devote to regulatory compliance, they have little negotiating power with their providers and they do not have the bulk that the most interesting investment options offer.

A big fund (one made up of dozens of these smaller, less efficient funds) would be able to leverage its size into greater efficiency. Greater efficiency would mean lower costs per member, meaning less money is required to get to those end-result guaranteed benefits. That should be an easy sell to employers struggling with deficit contributions into defined benefit schemes that disappear into a black hole over the funding cycle so that more are always needed.

There is also the sheer amount of effort and risk associated with legacy defined benefit schemes. No one likes a visit to meet Frank Field if something goes wrong.

The government finds the idea attractive. Its white paper on the future of defined benefits in the UK included a future consultation on proposed regulatory framework consolidator schemes this year.

So all is well? Not entirely. Although there are a few consolidator style schemes already out there, the proposed launch of a new superfund and the government consultation appear to have engaged the interest of the insurance industry.

A word on funding here. Occupational pension schemes are regulated by the UK Pensions Regulator, and are generally funded on a "scheme-specific" basis. This requires employers to pay in enough money to make sure that funds are available to pay benefits as they fall due. Funding takes into account things like investment returns over time which means less money is needed upfront.

Of course, if an OPS terminates or the employer decides they have had enough of their scheme and wants to get rid of it (legally), you move over to a far more expensive "buy-out" basis, which is based on the cost to buy benefits with an insurer right now.

And insurers do not fund benefits they are required to pay under the scheme-specific funding regime. They have to fund under the more stringent Solvency II capital rules.

Two things appear to concern the insurers.

First, if, rather than 5,600 potentially fragile schemes, there are 100 or 200 superfunds, each with the expected efficiency savings and investment options, buy-outs would become much less frequent, or disappear entirely.

Secondly, why would anyone choose to close down their scheme and pay an insurer a big upfront cost to buy out the benefits when they can hand over the keys to a cheap as chips consolidator that will just send them a bill once in a while?

So we are getting into regulatory arbitrage arguments and competition issues. The press war has already begun. This issue has history too. The IORP II Directive took forever to negotiate due to fundamental disagreements between those member states with big occupational pension sectors and those with insurance-based schemes under the Solvency II regime as to how OPS benefits should be funded.

In our view this is not an open-and-shut case. Funding is central to everything defined benefit. The UK's current scheme funding regime was not set up with this form of big consolidator scheme in mind (hence the DWP's consultation), but there are clear theoretical benefits that are hard to ignore to the bigger is better approach.

But there are also big risks. The Pension Protection Fund acts as a lifeboat for the defined benefit sector – if your employer goes under, the PPF gets the assets of your scheme and provides you with compensation.

Your average defined benefit pension scheme is not a huge strain to the PPF – although some of the bigger schemes would be hard to digest. If something went wrong with a superfund, the PPF would face a nightmare with either bigger industry levies or a cutback of PPF compensation until it was back on an even keel.

If the superfunds funded like insurers, this would be a very minor risk. It would also kill the superfund idea stone dead, as the point of the product is to combine the less stringent ongoing funding basis applicable to occupational pension schemes with administration, governance and investment quality available to an insurer-sized operation.

After some more thought, we will be commenting on the DWP's consultation when it is released.

Your Key Contacts

Sarah Beeby
Partner, Milton Keynes
D +44 20 7320 4096
M +44 7584 204819
sarah.beeby@dentons.com

Mark Hamilton
Partner, Edinburgh
D +44 141 271 5721
M +44 7880 787 838
mark.hamilton@dentons.com