SUPERFUNDS

Superfundamentals: how Clara's clearance could affect the sector

The UK's first commercial consolidator has at last secured regulatory approval. How will the superfund market work – and what effect might it have on the provision of defined benefit pensions?

Alex Wright

Superfunds looked set to shake up the UK pensions sector when they arrived on the scene four years ago, but their impact has been less than seismic – so far. Of the two main providers that have emerged to date, only one, Clara Pensions, has secured approval from the Pensions Regulator. The other, the Pension SuperFund, is still awaiting clearance.

What are the main differences between the two? What are their chances of commercial success? What risks, if any, do they pose for members and trustees? And will 2022 be the year when superfunds truly make their presence felt?

Also known as a commercial consolidator, a superfund is designed to take on several final salary corporate pension schemes and use its economies of scale to run them more cost-effectively than the firms that established them could on their own. Clara and the Pension SuperFund are approaching this task in different ways.

Clara's model is known as a 'bridge to buy-out'. It's designed to run a scheme for a relatively short period – probably between three and eight years – before this is bought out by an insurance company. Until that time, the scheme's assets and liabilities will be kept in an allocated section of the Clara master trust scheme, where they will be treated separately from any other funds.

Clara's investors will put up the necessary capital against a given scheme to ensure that it reaches the buy-out stage, satisfying the regulator's requirement that the fund be protected against a one-in-100-year adverse event. This money will then be returned to the investors once the buy-out is completed.

> **Superfunds are likely to be attractive if the sponsoring company is struggling**

By contrast, the Pension SuperFund is proposing to use the 'long-term run-off' method. This is designed to administer a scheme's benefits in perpetuity and run off its liabilities over several years. Each scheme it takes over will also be pooled rather than sectionalised, with any surplus being shared among the members.

Its investors will also need to put up capital to protect each scheme, but this money will be drip-fed back to them once it's no longer required. Investors in Clara, by contrast, will get their money back in one go.

Having been given the regulatory green light in November 2021, Clara is expected to take over numerous schemes by the end of this year. Pension Protection Fund buy-outs are likely to be among the first in its sights.

The Pensions Regulator has established three so-called gateway principles that any proposed transfer into a superfund must satisfy, based on the watchdog's position that superfunds cannot match the level of security provided by insurance companies. The first is that the scheme under consideration can't afford a normal insurer-backed buy-out. The second is that there is no realistic prospect of such a buy-out in the foreseeable future. And the third is that the transfer would make the scheme members more likely to receive the full benefits due to them on retirement than they otherwise would be.

With these restrictions in mind, uptake is widely predicted to be slow and steady in 2022 before accelerating next year.

"In the short term, the focus will be on ensuring that the first of these new and complex transactions happen smoothly, rather than to push for volume," predicts Harry Harper, head of risk transfer at XPS Pensions Group. Once these have been completed, the key for Clara will then be to grow quickly, "with efficient processes, so that schemes and their providers can benefit from economies of scale, delivering members' benefit promises into the future".

Tom Hargreaves, principal and senior consultant at Barnett Waddingham, believes that any superfund would "need a minimum of £5bn in assets taken on from other pension schemes to achieve scale. This may take time, even with a strong first year. But there is sufficient demand from pension schemes to enable superfunds to reach this point. Insured solutions are likely to remain the gold standard, but that will be out of reach for some schemes."

One of the biggest concerns for scheme members about a potential transfer to a superfund is that they'll be moved out of a good corporate plan that's focused on giving them a healthy return to a larger fund whose main priority is to make profits for its investors. The fear is that they might not receive the full pension they were expecting as a result.

But the bottom line is that the regulator will allow a scheme to be transferred only if the employer in question and its pension trustees can show that this transaction will improve members' chances of receiving all the benefits due to them – as set out in its third gateway principle. When deciding the best course of action, they must therefore weigh up the company's ongoing ability to support the scheme against the likelihood that the superfund will meet its objectives.

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Moreover, trustees need a valid reason for resorting to a superfund rather than an insurer. They must exercise due diligence and take appropriate advice when choosing one. They should also communicate clearly to members how their pensions will be provided under the superfund model if that is the chosen option.

"One of the biggest challenges is assessing employer covenants over the longer term. For many companies, it is hard to predict how they will fare over anything but a relatively short period," notes Claire van Rees, a partner specialising in pensions at law firm Sackers.

Trustees and their advisers might genuinely believe that the third gateway principle is met, "based on their assessment of the sponsoring employer's strength at the time", she adds. "But their decision could come under heavy scrutiny if things don't play out as expected and the chosen superfund fails or exits the market, say, while a weak employer does better than expected."

While it's true that the focus of a superfund will be on remaining profitable for its investors, first and foremost it is a pension scheme that's managed by trustees who need to deliver for members. The regulator will also be keeping a close eye on superfunds' activities to ensure that members aren't getting ripped off.

Final salary schemes are "increasingly finding that they need time as much as they need money. In some cases, the contributions are no longer their focus. Corporate longevity is the real issue," observes Jane Kola, partner at Arc Pensions Law. "For these schemes, superfunds are likely to be attractive as an option if the sponsoring company is struggling. It would be a shame if those schemes did not explore this option."

600
defined benefit pension schemes could satisfy the regulator's three gateway principles and be sufficiently funded to transfer to a superfund in the next decade

£170bn
The combined value of those 600 schemes

5,400
The total number of defined benefit pension schemes remaining in the UK

£5bn
The amount of pensions liabilities that Clara expects to assume over the next five years

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