



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.

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

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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.

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."



Having your pensions cake and eating it

Innovation in the defined benefit pensions market is enabling employers to reduce the costs of their pension schemes through consolidation—but without losing control

The pensions industry has long grappled with a cost problem: the smaller a pension scheme is, the higher the per member costs of running the scheme.

"There's a whole range of costs across a pension scheme, although investment management charges were probably the lightbulb moment for us," says Mark McClintock, a partner in Deloitte's pensions consulting business. "Why should a pension scheme with £10m of assets pay a higher annual management charge than a pension scheme with £100m of assets with the same fund manager in the same fund?"

That uneven backdrop is driving consolidation across the pensions industry in an effort to level the playing field for small and medium-sized pension schemes. The aim is to reduce their costs and enable them to benefit from the same economies of scale that larger pension schemes enjoy.

"One potential snag is that consolidation has traditionally meant employers and trustees have been forced to relinquish control of their schemes in order to merge their assets with a consolidated fund."

"To access a vehicle that allows you to consolidate, you typically have to give up something—and that, if you're an employer, is essentially loss of control," says McClintock. "That matters because employers will have a trustee board that oversees their pension fund and they will know them and understand how they act: there are no surprises."

Under that relationship, employers maintain influence over the scheme's investment and funding strategy – and therefore have more control over how fast the scheme progresses to a fully-funded status.

50%

3,000

Typical reduction in investment costs for schemes joining the Deloitte Pensions Master Plan
Deloitte, 2021

The potential number of defined benefit pension schemes in the UK that could benefit from Deloitte Pensions Master Plan savings
Deloitte, 2021

"If you go into a consolidation vehicle, you don't control who the trustee is and you lose the ability to have your own autonomous plan," says McClintock.

That structural impediment, which has traditionally deterred smaller schemes from consolidating, was the catalyst for Deloitte creating the Deloitte Pensions Master Plan (DPM). This is a pension plan that allows defined benefit (DB) schemes to pool their assets without ceding control.

"The key design feature we came up with was allowing pension funds to lift and drop into our plan with a scheme's existing trustee in place," says McClintock. "That means there is no loss of control, which is a unique proposition in the market. We believe no other DB master trust has this feature – you get the trustee that attaches to that consolidation vehicle. That's a big barrier for a lot of small and mid-size pension schemes."

DPM solves this by having each scheme that "drops" into the fund remaining as a separate entity with its own trustee board. That means trustees maintain their existing powers, including investment discretion. There is also a central professional trustee sitting at the core of the Master Plan who is responsible for oversight of the fund as a whole and can be called on if needed, for instance if a scheme's trustee is facing a particularly difficult decision and they want a second opinion from an experienced practitioner," says McClintock.

Aside from maintaining control, the other main benefit of this structure is that it can drive down costs for small and medium-sized pension schemes by pooling all of the schemes' assets without breaking the segregation of each individual scheme section. Deloitte kick-started the plan by pooling the assets of its own defined benefit scheme, giving the Master Plan sufficient scale to immediately help member schemes reduce their costs. Initially, typical reductions in investment costs were around 30% but that has since risen to more than 50%, McClintock says.

"As the Master Plan gets bigger, the ability to drive down those costs continues to grow, so it becomes a club where the people who are already in it benefit as others join," he says. "And, of course, the more you reduce the cost, the more money stays in the fund and so that drives better funding over time and better outcomes for members."

Robert Hughes, chairman of Hughes Electrical and one of the DPM's members, says the cost savings of a DB master trust and the ability to reduce their own investment strategy were the chief motivations for joining the plan. Other companies have also

signed up to diversify their workplace pension schemes.

"Working with Deloitte, we developed and launched the BT Hybrid Scheme, a blended defined benefit and defined contribution scheme, based on the DPM. We're delighted with the scheme: for members, it provides greater income certainty and is easy to use; and for BT it's cost effective and reduces risk," says Kerry Shiels, pensions director at BT Group.

The DPM will typically benefit all small and mid-sized DB schemes. That could be anything up to £500m of assets, especially if those assets are split across several investment managers where the scheme would quickly lose the benefit of scale. The size of the potential market in the UK for DB schemes that fall under this umbrella is around 3,000.

"We're finding that even getting to several hundred million of assets, the cost savings are really quite significant, particularly on the investment side," says McClintock.

The drive for more innovation in the pensions industry comes as the Department for Work and Pensions (DWP) seeks to encourage the consolidation of DB pension schemes where it can benefit the schemes by reducing costs, enabling more effective investment strategies and improving growth. The introduction of the DB master trust self-certification regime, for instance, enables employers that are considering consolidation to compare schemes through self-certificates hosted on the Pensions and Lifetime Savings Association website.

"The pensions industry has had relatively little innovation in the past, so when something new comes along that seems to move the goalposts quite substantially people are naturally sceptical. But one of the benefits of the self-certificates is to have more information available and make this feel a bit more real for employers," McClintock says.

DWP's support for the creation of self-certificates, and the information they provide to employers and trustees, will be critical in helping build trust when companies are weighing up new ways of managing their pension schemes and maximising the benefits of consolidation.

For more information about the Deloitte Pensions Master Plan please visit dpmc.co.uk

