

Briefing

# Navigating your endgame: the DB superfunds junction

RISK | **PENSIONS** | INVESTMENT | INSURANCE



With The Pensions Regulator's (TPR) assessment of the Pension SuperFund and Clara-Pensions entering what are hopefully the final stages, thoughts within the industry are turning towards what the first defined benefit (DB) superfund transactions will look like.

Transactions will still be subject to a formal clearance process as noted in last year's guidance and, whilst TPR have emphasised that this will be a robust review, we would expect the early transactions to be reasonably clear cut and obviously beneficial to scheme members. These cases may typically be those where external capital is available (e.g. via a corporate transaction or overseas parent), or where there is a weak employer covenant.

The superfund market has developed significantly since TPR announced the interim regulatory regime in summer 2020 followed by separate guidance for trustees and employers in the autumn. This has led to more interest from trustees and employers, who now feel more confident in considering this as a genuine option.

But how feasible is this for "ongoing" schemes that don't fall into the group of clear cut cases?

## The funding sweet spot

Sponsors of even well-funded schemes that are looking to settle liabilities may well still be a little short of being able to afford to secure benefits with an insurer. Superfund premiums are expected to be lower than the cost of insuring benefits (reflecting the lower level of security), so such a transaction could be a feasible alternative where buyout is out of reach.

However, it has been clear from the outset that superfunds are not to be used by schemes that would be able to afford to buyout; this was recognised in DWP's consultation in early 2019 and the 'gateway principles' have been carried through to TPR's interim regime announced in the summer. This means that schemes that can afford to buyout, or expect to be able to afford buyout within the foreseeable future, will not be cleared to transact with a superfund.

The "foreseeable future" was originally envisaged as being a five year period, and although we still await DWP's response to the consultation, this is slightly softened in TPR's more recent guidance which notes that it may be possible to justify other periods based on covenant visibility.

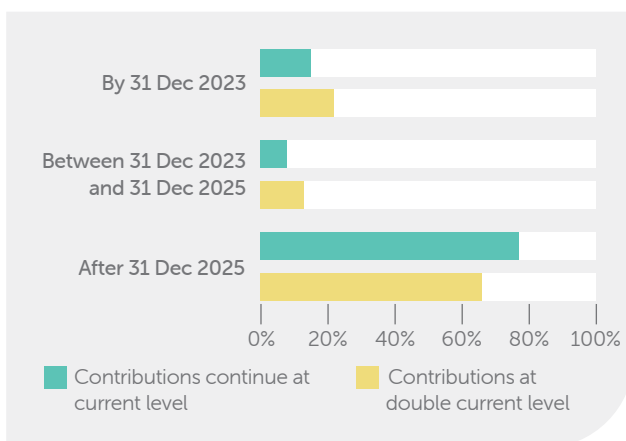
This can vary significantly between employers, but typically might be expected to be around three years.

So, very broadly, we can put schemes into three groups depending on when they expect to be able to afford buyout:



In practice, employers that are looking to carry out a superfund transaction should engage fully with the trustees to ensure that the gateway principles are evidenced (including the third principle around member outcomes) in the clearance application.

Based on our analysis of the accounts of FTSE350 companies with a DB pension scheme, and assuming that deficit contributions continue at their current level, the chart below shows how these companies will fall into the groups set out above.



This shows that only 15% of sponsors would be able to buyout their pension liabilities at present or within the next three years without further contributions from the sponsor in addition to those that are currently assumed.

Whilst there are a small number in the 3-5 year period, over 75% of schemes would not be expected to buyout within five years. Even if deficit contributions were to increase to double their current rate, this picture does not look significantly different and 65% of schemes would still fall into this final group.

But before we focus on those further from buyout, are schemes in the first group out of scope of superfunds?

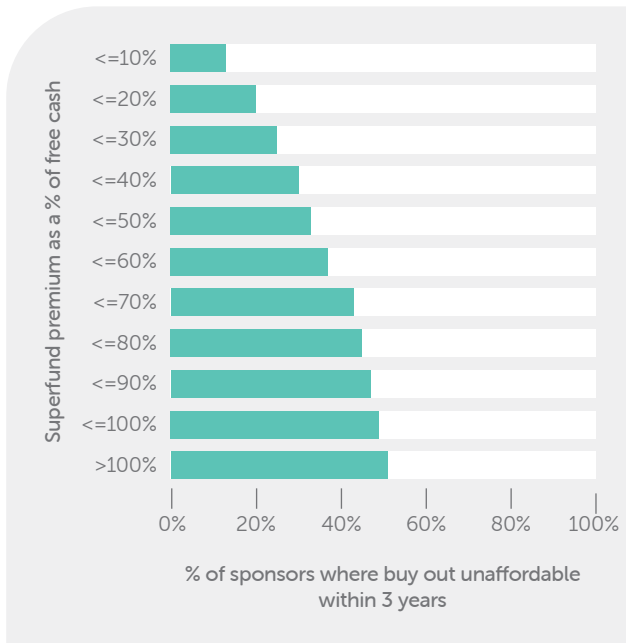
Given the strong funding positions, the only feasible way to meet the gateway criteria will be in cases of a particularly weak sponsor. For example, a scheme may be able to buyout in two years' time provided the employer is around to pay contributions during that period. In the current environment this is not necessarily a given, particularly in certain sectors (as noted below).

## A not so niche market?

The chart to the left shows that around 85% of schemes would not be expected to buyout within three years and therefore fall into the final two groups. So, in theory, if they were so minded and had funds available, sponsors could put up the cash required for a superfund transaction and, subject to meeting the other criteria, be reasonably confident of this going ahead.

Based on the position shown by 2019 accounts, we estimate that around 50% of these companies would have sufficient free cash to cover a superfund premium. However, the Covid-19 pandemic during 2020 is likely to have had an impact on this, particularly in certain sectors such as retail, travel and hospitality.

We will update this analysis in a future paper. The chart below sets out how much free cash would be used.



This shows that, within the group of sponsors where buyout is not affordable within three years, just under 15% of companies could cover a superfund premium with less than 10% of their free cash, and just under 25% of companies could do this with less than 30% of free cash.

This potentially points to a wider potential market for “ongoing” schemes than has previously been considered, although it does raise some interesting points:

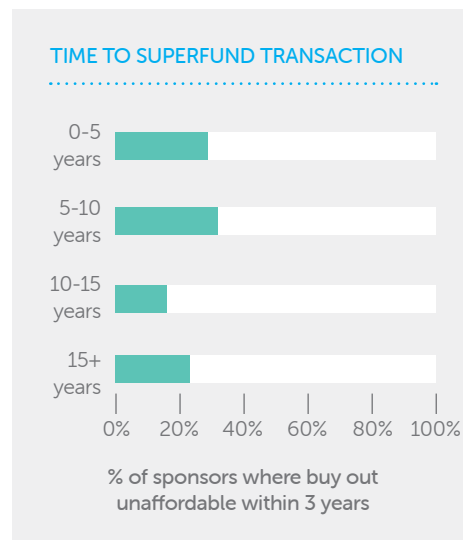
- Just because a transaction is affordable does not mean it is desirable – sponsors will need to decide whether settling the pension risk is worth the investment relative to the other uses it could be put to within the business
- Whilst in theory the gateway principles would be met, there could be a challenge that if the sponsor is prepared to commit some of its free cash to a superfund transaction, why will it not commit what might be a relatively small amount more to pursue full buyout? Sponsors will therefore need to make sure they have a robust justification for this course of action.

## Looking to the long term

2020 was obviously a challenging year and, as noted above, the majority of companies are likely to have seen a strain on cashflow as they deal with the impact of the pandemic. As such, transactions that may have been feasible pre-Covid may no longer be attractive.

However, even if a transaction is not on the cards in the short term, sponsors should bear in mind that it may become a realistic option again in the future. So what happens to journey plans if schemes target a superfund transaction rather than a buyout transaction?

The chart below shows the expected time until a superfund transaction is affordable for sponsors of schemes where buyout is currently more than three years away.



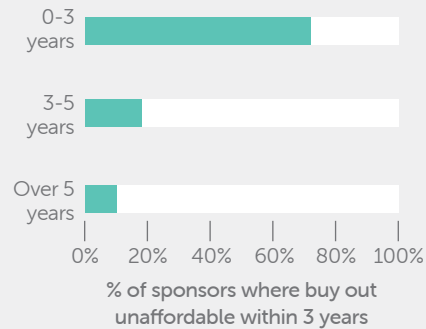
This shows that over half of sponsors with schemes that would not be able to buyout within three years would be able to afford a superfund transaction within ten years. Taken in aggregate, this means that two-thirds of sponsors would be able to afford a superfund transaction for their scheme within the next ten years, albeit not all of them would meet the gateway principles.

But this doesn't tell the full story. As a scheme progresses closer to the superfund transaction over time, it also moves closer to being able to buyout, both in terms of the scheme progressing along its journey plan and the differential between superfund and buyout pricing reducing as the scheme matures. They therefore risk not being able to pass the gateway criteria once a superfund transaction becomes affordable naturally.

Again, focusing on the group of sponsors with schemes that would not be able to buyout within three years, the chart to the right sets out the expected time to buyout for these schemes at the point that a superfund transaction becomes affordable.

This shows that, if contributions are assumed to continue up to the point of buyout, over 70% of schemes are likely to be within 3 years of buyout at the point that a superfund transaction becomes affordable. This means that they are unlikely to be able to meet the gateway principles at that point, and may well have lost the option to transact with a superfund despite that being the original objective.

#### TIME TO BUYOUT AT POINT OF SUPERFUND TRANSACTION



#### BEING PROACTIVE

Employers and trustees looking to pursue a superfund transaction in future should therefore be looking to identify that "point of no return" in setting their long-term objective, and this could mean targeting an "affordable" level of deficit to a superfund transaction so that the gateway principles have a better chance of being met when required.

As transactions do start to happen in due course, we will start to see how the gateway principles are applied in practice rather than just in theory, so it will also be important to maintain flexibility in these journey plans to be able to react to what remains a developing market.

In fact, even if your ultimate target is buyout or something else, this still highlights how important it is to be aware of all of your options as you navigate towards your scheme's endgame, as some of them may disappear without you even realising it.

#### NOTES ON INFORMATION USED

The data used for this analysis has been collected from the accounts of FTSE350 companies for their 2019 year ends (i.e. up to and including the year ending 31 December 2019). Liability values on a buyout and superfund basis have been estimated as at 30 November 2020 by approximately updating these results and using Barnett Waddingham's view of current buyout and superfund pricing. Asset values have been estimated as at 30 November 2020 using index returns and the asset split disclosed in the pension disclosures. The current level of deficit contributions have been estimated based on information set out in the pension disclosures and for the purpose of this analysis these are assumed to continue until buyout funding is reached.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

✉ [info@barnett-waddingham.co.uk](mailto:info@barnett-waddingham.co.uk)

☎ 0333 11 11 222

[www.barnett-waddingham.co.uk](http://www.barnett-waddingham.co.uk)

Barnett Waddingham LLP is a body corporate with members to whom we refer as "partners". A list of members can be inspected at the registered office. Barnett Waddingham LLP (OC307678), BW SIPP LLP (OC322417), and Barnett Waddingham Actuaries and Consultants Limited (06498431) are registered in England and Wales with their registered office at 2 London Wall Place, London, EC2Y 5AU. Barnett Waddingham LLP is authorised and regulated by the Financial Conduct Authority. BW SIPP LLP is authorised and regulated by the Financial Conduct Authority.