Summary
• The industry has come a long way in the journey towards pension superfund approval.
• The process has been steady and slow, but TPR's measured approach has been welcomed.
• Interest is coming from different types of scheme and 2021 should see the consolidation market thrive, with new players entering the space and deals being done.

Superfunds under the spotlight

Francesca Fabrizi looks at how far we have come in the superfund journey to date

Superfunds have certainly had their fair share of the spotlight in 2020. Aside from enjoying multiple column inches in the pensions press, and being the subject of many a virtual conference session, they have, more importantly, been under the scrutiny of The Pensions Regulator (TPR), keen to get on the front foot to ensure the superfund regime is fit for purpose.

In February, TPR committed to assessing how savers transferring into defined benefit (DB) superfunds would be protected, while in June, after consultation with the industry, the regulator launched its much anticipated interim regime for superfunds and other new models, which set the bar high for the standards it expects in this area.

More recently, in October, TPR published new guidance for trustees and sponsoring employers of DB schemes considering transferring to a superfund; while, in the background, it is in the process of assessing existing superfunds against the expectations set out in its interim regime, and, if approved, will add those names to an online list of providers.

Suffice to say, progress has been detailed and slow but, in general, the industry has welcomed this measured approach and particularly the most recent guidance, which the PLSA stated, provides a clear set of expectations about what 'good looks like'.

But whilst the rest of the industry may be happy with the progress, how are some of the superfunds feeling about the progress to date?

"Positive", says Clara-Pensions director of policy and communications, Richard Williams. "A measured approach with TPR being rigorous in its assessment of consolidators and clear in its guidance to trustees and sponsors is absolutely the right one. The greater scrutiny that consolidation faces, as against other 'end-game' options, will give huge confidence to those schemes where consolidation is the right answer for them. For us, our priority has always been getting things done right rather than done quickly."

Similarly, The Pension SuperFund welcomes the slow but steady progress, as the firm's managing director, Peter Cazalet, puts it: "We are building something that needs to last many decades. TPR is taking a robust and rigorous approach to its assessment of superfunds; and members, trustees and sponsors should be reassured by that."

Legislation is due in a few years but TPR, he adds, has set the bar high for its interim regime. "We welcome the recent further guidance for trustees that sets out how they can rely on the TPR's work which is vital for making The Pension SuperFund applicable to schemes of all sizes and complexity," says Cazalet.

Scheme interest

But while there may have been a lot of noise on the topic, and the regulator has made superfund scrutiny one its key priorities in 2020, how much actual scheme interest has there been to date?

"Interest has been strong from both trustees and sponsors", says Williams, who states that Clara-Pensions has a "very healthy pipeline", even stronger than previously anticipated. "We feel we are on track to meet our ambition of consolidating at least £5 billion of pension liabilities over the next five years," he says.

The Pension SuperFund's pipeline is also looking strong, argues Cazalet, "with a number of scheme trustees contacting us direct to enquire about consolidation as a potential solution to funding members' benefits and removing the liabilities from the balance sheet given the prevailing economic uncertainty".

But, while the superfunds themselves might be seeing interest, this may be less obvious from a professional trustee perspective, particularly if their client base is a financially-sound one.

BESTrustees trustee executive, Mike Smaje, comments: "I personally haven't had any enquiries from clients on the superfund option, but it could be the circumstances of the clients I am working with – generally, I would associate the option of superfunds with weak employers and all the schemes I work with are strong enough where either a runoff or a targeted buyout is realistic."

Across the firm, however, Smaje says there are clients who are considering this and other possible options – such as capital-backed journey plans.

"Corporate advisers may also be talking to some of our clients about this as a potential option; but among typical trustees, this is not something that has been brought to the top of the agenda. People have also, to some extent, been waiting for the guidance and the regulation to emerge," he adds.

BESTrustees director, Huw Evans, agrees that clients do not seem to be raising the topic of superfunds much "although we, as professional trustees, are thinking about it. In general, I am looking for sponsors to take the initiative on this. The exception to that would be in a distress situation", he says.

Evans adds that, for anyone who thinks they can get to buyout within five years, they are probably not going to talk about this: "It would take an initiative from the sponsor; and it would be quite difficult for the trustees to agree to go down this route rather than to an insurer; so for the schemes that are well placed, it's not something we are going to spend very long on."

Saying that, he adds, the way TPR's guidance seems to leave the door open for a scheme that does not expect to buy out in five years – to start targeting a consolidation vehicle rather than buyout – is interesting. "For those schemes that might take a while to get to buyout, superfunds could be the way forward."

Of course, in the future, the types of schemes that will look at this as a possible option will vary, and the players in the space will offer differing solutions to meet varying needs. But where is the real interest coming from now?

"Clara is seeing enquiries from all types and sizes of scheme – from parent companies rethinking the shape of their UK business, to sponsors wanting to focus on their business, to trustees worried about the future of their covenant", says Williams.

"Covid-19 has certainly driven many to look again at the future of their DB schemes, while the recent TPR guidance has given greater clarity and confidence in moving to a consolidator, which has started many new conversations with schemes," he adds.

Similarly, Cazalet says The Pensions SuperFund has received enquiries from a broad range of schemes, including those where the sponsor covenant has deteriorated on the back of the pandemic; where the sponsor is the subject of M&A activity; or where sponsors wish to simply remove the pension liabilities once and for all.

"The Pension Schemes Bill before parliament has encouraged many companies to look again at the best way to manage their pension liabilities. Sadly, at the moment a particularly busy area is working with the large schemes in Pension Protection Fund (PPF) assessment, which has required us to develop new legal routes to bringing schemes out of assessment and in a position to secure full benefits with the superfund," he adds.

At the end of the day, if a superfund can put certain schemes in a better situation than they are in now, that has to be good news for some trustees. As Evans puts it, "if this route increases the chances of getting members the benefits they have been promised in full, then it gets a big tick from a trustee".

Smaje agrees: "I like the idea that a superfund possibly offers a better outcome for members than potential PPF entry and I can see it being very attractive in a distress situation. Potentially other areas where it could get some appeal would be on a corporate takeover, possibly a private equity transaction, where the deal is potentially contingent on the trustees agreeing to transfer to a superfund. If it's, for example, the scheme of a distressed employer and there is a white knight that comes to the rescue, that could be good."

Evans concurs that, where you have a white knight, like a private equity house, the decision could be pretty clear cut: "If the trustees are given a one-off opportunity to take some cash and go to a consolidator, that's going to be a relatively easy decision; you just need to do the arithmetic to know that's a deal worth having."

Superfunds might also work for a scheme where there are doubts about the long-term covenant of the employer – employers, for example, in potentially dying industries, argues Smaje: "If there is doubt about the long-term ability of the sponsor to support the scheme, the idea of a strong covenant support from a consolidator could begin to become more attractive."

Evans adds that, if you have a sponsor with a very big contract with a clear end date, if you cannot buy out, or it looks as if you are not going to be able to buy out before that contract expires, then that huge uncertainty at a known point in time might be motivation enough for you to look at this alternative route.

So, while the benefits for different schemes are there, what are the potential concerns? "The obvious security question is front and centre – is this a safe thing to do for the members?" says Smaje. "Are members going to be better off in this vehicle, not significantly worse off?"

Cazalet agrees that, typically schemes and their advisers are interested to understand the robust financial covenant that The Pension SuperFund offers and compare it with the sponsor's own covenant; while many of the questions Clara receives from trustees focus on "our giving greater security and certainty than their status quo that pension promises will be delivered", says Williams.

But once those concerns have been addressed, and the concept proven, will 2021 see dramatic developments in this area? Cazalet argues yes. "We believe that, following passing Phase 1 of TPR's assessment process, we will rapidly help a number of schemes apply for Phase 2 assessment and/or clearance with TPR. Our initial deals will allow us to prove the concept behind The Pension SuperFund and achieve scale before end 2021."

Williams agrees that the next 12 months will see the market thrive. "We know that our model will not be right for every scheme so we're looking forward to seeing how the market develops to meet a range of sponsor, trustee and member needs. Ultimately, we want as many members as possible to have access to safer pensions."

Written by Francesca Fabrizi

Summary
- It may be wise for trustees to stay in close contact with employers' management teams due to the rapidly-shifting economic environment that the pandemic has precipitated.
- Drawing up a protocol for the information shared between trustees and management teams can forewarn the former of potential upcoming covenant breaches.
- Being prepared for employer distress with contingency can help to improve member outcomes.

The Covid covenant conundrum

Duncan Ferris explores how the pandemic and the economic difficulties it has catalysed may affect the way trustees monitor employer covenants, looking into communication with sponsors and planning for the worst

A number of high-profile companies have fallen into financial difficulties in recent months as the pandemic drags on and businesses continue to feel the heat. Travel and retail companies have been particularly in the spotlight due to restrictions on travel and opening restrictions, with big hitters such as Arcadia and Flybe collapsing, but businesses from all manner of industries could be feeling the pinch from the effects of Covid-19. As such, this is a key time for trustees to consider their sponsors' ability to adhere to covenant arrangements.

After Mercer's *Pensions Risk Survey* found that the accounting deficit of FTSE 350 companies' DB schemes had climbed from £73 billion at the end of September 2020 to £75 billion on 30 October, Mercer chief actuary, Charles Cowling, warned that covenants were facing "big pressure" and urged trustees to "monitor their situation wisely". But how should trustees monitor the covenant and how has this changed under the influence of coronavirus?

Covid changes

It's important to establish that the fundamentals of covenant assessment remain unchanged but, in some cases, trustees may need to adapt to take steps such as increasing the regularity of their monitoring.

Grant Thornton partner and head of pensions advisory, Paul Brice, states that the pandemic and its impact on sponsor trading has "led to many trustee boards needing to assess and monitor covenant very dynamically – staying close to management teams and receiving regular financial updates".

He continues: "Trustees have often needed to respond very quickly to measures taken by sponsors and other stakeholders such as lenders, managing the tension between helping sponsors survive and ensuring a sustainable funding position for schemes."

Dalriada Trustees professional trustee, Sarah Ballantyne, argues that the economic environment that has been catalysed by the pandemic has left employer covenants "more susceptible to rapid change, and unfortunately the likelihood is that this will be adverse".

She continues: "Many trustee boards have used the uncertainties caused by Covid-19 to request further and more regular financial information from their sponsor."

Ballantyne adds: "Whilst for some schemes monitoring on an annual basis may have been appropriate before Covid, circumstances may now mean that more frequent monitoring is appropriate.

"For example, on some schemes we are monitoring on a monthly basis and receiving information on short-term cashflow forecasts. Frequency and depth of monitoring is therefore very much scheme specific."

Communication

It seems clear that increased communication is key in these financially unstable times, but what is the best way to conduct this dialogue?

BESTrustees trustee executive, Ann Rigby, recommends that trustees "involve the employer right from the start so they understand the assessment process, timescales and potential impact of that assessment on funding".

She continues: "Also bear in mind that any requests for information need to fit in with the employer's own work schedules. Finally, redacted reports should be shared with the employer to agree all factual information before the report is presented to the trustees."

Ballantyne agrees and adds that

discussions should be held with the employer "on its financial outlook, trading and liquidity position" so that the trustee board can fully understand "what issues may be on the horizon".

To improve trustee monitoring on sponsors' trading and financial position, Ballantyne also recommends drawing up an "information sharing protocol".

She explains that this could give trustees warning of future corporate events such as "a breach or anticipated breach of banking covenants, refinancing or material increase in debt of sponsor, provision of security or negative pledges".

Lincoln Pensions managing director, Dan Mindel, agrees and sees the possibility of more information sharing as a potential learning experience, stating: "Management teams of employers have many competing demands, and trustees should be sensitive to this in their interactions.

"Ideally, information requests should leverage management information that is used in the normal course of business, or that provided to other creditors such as lenders. Increased sharing of information and interaction can be mutually beneficial, in providing trustees with more visibility and understanding, which in itself can reduce risk over the longer term."

This all sounds like it could be a good opportunity for trustees to get to know sponsors' management teams, but Brice points out that there will be occasions where "trustees will need to be assertive if there is any risk that a scheme's position will be unduly compromised relative to other stakeholders".

Regulation and legislation

The issue of monitoring employer covenants has also been affected by advice from regulators and new legislation from Westminster.

For example, The Pensions Regulator (TPR) released guidance for covenant monitoring, in which the regulator recommended trustees "enhance the level of covenant monitoring over the short to medium term" and released a series of questions to help with the monitoring process.

In cases where there is only short-term visibility, TPR recommends that trustees only agree to short-term concessions from the sponsor, make reductions or suspensions shorter if they are not confident of receiving relevant financial information in the near future and carefully consider how appropriate substantial contribution suspensions might be.

Looking at the legislation side of the coin, Mindel says: "The expedited introduction of the Corporate Insolvency and Governance Act has created additional complexity for trustees to navigate as they and their advisers try to understand how the new moratorium and arrangement might impact their scheme (positively or detrimentally)."

The legislation referenced by Mindel came into force in June and was designed to improve the likelihood of business' survival by adding new procedures by which companies that have fallen into financial distress might be rescued. The act introduced a new moratorium to give companies breathing space from their creditors while they seek a rescue, as well as a new restructuring plan sanctioned by the court that will bind creditors to the plan.

Mindel adds: "With the impending changes to regulatory legislation through the Pension Schemes Bill, many trustees will need to be more considerate of insolvency outcomes in their covenant assessments for the foreseeable future."

Contingency planning

The other key facet of covenant monitoring is planning for different scenarios, as Mindel comments that mere monitoring "can only help so much and must be coupled with robust contingency plans".

He explains: "Not all events can be easily anticipated, with Covid-19 being an example, but a robust contingency planning process should consider the appropriate actions in response to broad down-side scenarios, alongside specific events that can be reasonably foreseen.

"Contingency planning should also consider how investment, funding and covenant down-side scenarios interact, noting that Covid-19 has impacted all three areas."

Ballantyne comments that "preparation, quality advice and trustee experience of stressed financial covenants can all improve member outcomes", but warns that if this is not done before "stress turns into distress" then there is the risk of "being placed last in the queue of creditors to take protective action".

Brice notes that there are a number of scenarios that trustees could consider depending on the scheme sponsor in question, with these including key downside scenarios such as "a breach of lending covenant; a liquidity crisis; asset disposals or acquisitions; or, at worse, insolvency".

On a more positive note, she says that trustees can establish some more upbeat contingency plans, depending on the state of their sponsor, by considering upsides and recovery options, which might result in plans such as "contingent contribution plans driven off agreed performance metrics to get cash into a scheme as the sponsor recovers".

Good news or bad, it seems sensible that trustees prepare themselves for any eventuality as the unpredictability of 2020 looks set to bleed into 2021. But with good news about scientists developing vaccines hitting the front pages in November, we can hope that the new year will bring a dose of economic recovery to our shores and sponsors.

Written by Duncan Ferris