Summary
• Insurers have expressed concerns over the emergence of superfunds.
• There are debates as to whether superfunds should be regulated akin to insurers or pension funds.
• The DB de-risking market should be large enough for both insurers and commercial consolidators to co-exist.
• There are opportunities for superfunds and insurers to work together.

Friend or foe?

Superfunds, the new DB consolidation options available to schemes looking to de-risk, have been compared and contrasted against insurance buyouts. Laura Blows looks at the relationship between insurers and commercial consolidators

There are always concerns when you get a new neighbour. Will you get on, will they leave you be, will they be intrusive? Will you end up having fights over land boundaries?

The latter seems to be the case for pension scheme insurers. The arrival of commercial consolidators, also known as superfunds, has caused some concern that these new entrants may have pitched up uncomfortably close to insurers' bulk annuity offerings.

When a buyout is purchased for a pension scheme, the insurer takes on the assets and liabilities of that scheme, including the responsibility of paying the members' pensions, from the employer. A commercial consolidator also takes over the running of the scheme, and also frees the employer from any further responsibility, but at a cheaper cost and with lower member benefit security than the pretty-much-guaranteed security a buyout brings.

So far, two commercial consolidators have entered the market – Clara Pensions, which sectionalises the assets and liabilities of each scheme entered and aims to bring each to buyout, and The Pension SuperFund, which blends all together in a 'run off' model and plans to use a proportion of the profits to increase member benefits.

Insurer concerns

Insurers have expressed concerns about their arrival.

According to Pension Insurance Corporation chief origination officer Jay Shah, many – including insurers' regulatory body, the Prudential Regulatory Authority (PRA) – are seriously questioning whether superfunds "should be allowed to offer the same product as insurers but based on lighter regulation and less capital".

"Clearly, there has been a lot of, shall we say, concern expressed *[by insurers]*," Clara Pensions CEO Adam Saron tells *Pensions Age*. "If we are a quarter as successful as the insurers appear to be worried, I'm a happy guy."

The Pension SuperFund has stated that insurers' concerns "stem from incomplete or incorrect understanding of our and similar proposals".

Working together

Indeed, The Pension SuperFund managing director, asset and liability management and solutions, Antony Barker, says that the insurance companies it has engaged with have seen the advent of consolidation as "primarily a good thing".

The fund claims to have already encountered instances where trustees have considered consolidation, only to conclude that they can afford buyout.

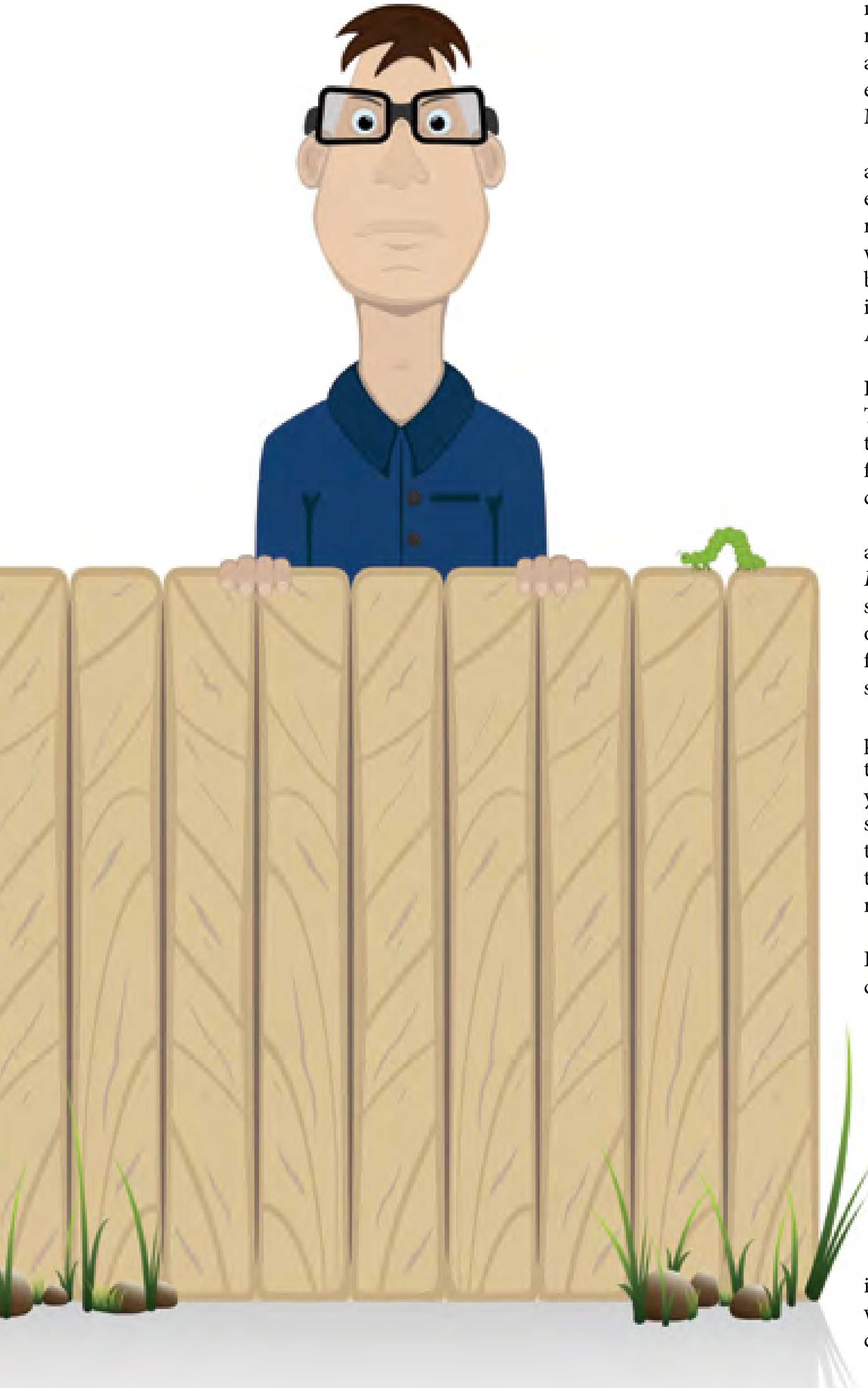
Insurers and consolidators can also work together, Barker states. For instance, The Pension SuperFund has quoted on a joint basis with some insurers or offered deferred-only quotes. It can also partner with an insurance company, with The Pension Superfund absorbing the more illiquid assets as part of the deal. The superfund itself may also seek partial buyouts or buy-ins from insurers.

Clara also highlights its own positive dialogues with insurers. "Clearly, in our model, the future health of the insured market is crucial for us, because our model will only work if there is a future healthy insurance market for us to ultimately deliver our members to," Saron explains.

Pensions Management Institute (PMI) president Lesley Carline suggests this could also be beneficial for insurers, as for those whose resources for new buyouts are constrained "will see some consolidators as a helpful screen, effectively acting as a funnel for the right type of scheme and giving them breathing space".

There is also the possibility of insurers effectively cutting out the middle man and creating these precursors to buyouts themselves.

While still at a preliminary stage, Legal & General is the first insurer to announce its intention to offer its own insured self-sufficiency product. In this, the scheme's assets, along with any employer contribution required to reach the initial funding requirement, are passed to Legal & General and invested to reach buyout over time. An insurance wrapper is also included, whereby the insurer covers a fall in funding in all but the worst 1-in-



200 year event.

This was conceived "as an innovative means by which pension schemes can reduce their long-term risks, while allowing the sponsor to remain fully engaged", Legal & General head of DB Mark Johnson says.

However, for insurers to create a superfund model that breaks the employer link would be tricky. The regulatory regime that insurers operate within is incredibly stringent, so it would be down to the PRA to decide whether insurers could operate a superfund, the ABI warns.

Regulation and authorisation

To what extent may be under debate, but there seems to be some blurring of lines for where insurers start and commercial consolidators begin.

However, the Department for Work and Pensions (DWP)'s *Consolidation of Defined Benefit Schemes* consultation seeked to define those edges. It requested opinion on a new legislative framework for authorising and regulating superfunds.

One of its proposals was a 'gateway', preventing any schemes that seem likely to be able to buyout within the next five years from entering a consolidator, to stop "any employers who may be tempted to seek to discharge their responsibilities through a superfund, when buyout is a realistic prospect".

This does not go far enough for the Employer Covenant Working Group. Its chair Donald Fleming states that external covenant advice should be a mandatory requirement of the process, "and we propose that the threshold should be set higher, to help reduce the moral hazard risk of a sponsor contriving the conditions for entry".

While the Society of Pension Professionals (SPP) president Paul McGlone acknowledges the gateway as an understandable way to encourage insurance when it can be afforded, he warns the gateway could have adverse consequences.

"If a scheme is 95 per cent funded on a buyout basis, has no access to contributions, and is expected to move towards buyout over five years, the question will be whether it is safer to spend that five years with its own sponsor or within a consolidator targeting buyout. With a weak sponsor at risk of insolvency the sensible choice may be the consolidator, but the gateway may prevent this," he explains.

Or, as Saron succinctly states: "If you're a high street retailer, five Christmases is a hell of a long time."

Instead of a gateway, Pensions and Lifetime Savings Association (PLSA) head of DB Joe Dabrowski recommends schemes having to identify its endgame – be it buyout, consolidation, self-sufficiency, etc. "So if a scheme changes path, say from buyout to consolidation, it would have to justify to The Pensions Regulator why," he explains.

Another contentious issue is capital adequacy. As schemes no longer have the ongoing support of an employer covenant, should commercial consolidators be subject to the same Solvency II-style level of funding as insurers?

The DWP's consultation suggests superfunds should operate on a 99 per cent probability of paying benefits in full.

However, with insurers using a 99.5 per cent probability of paying full member benefits, K3 Advisory managing director Adam Davis says that this too-slight difference "will exclude schemes who need the solution the most, i.e. those that are poorly funded and with a weak covenant".

In contrast, the PLSA's DB Taskforce considered 95 per cent to be more appropriate.

In its consultation response, The Pension SuperFund stated that "since superfunds are firmly intended to be pension fund solutions, it does not seem reasonable that they should be subject to additional constraints modelled on insurance, which do not apply to other pension schemes. In fact, this increases the blurring of lines and risks creating confusion".

Superfunds may consider it unreasonable, but it would be completely understandable if a consolidator is more lightly regulated and requires less capital, that an insurance company cries foul, Gatemore Capital Management partner Mark Hodgson says. "In that instance the consolidator is playing regulatory arbitrage, which would be unfair."

Despite their pleas to be treated like a pension fund, the PRA believes that commercial consolidators should be required to publish an annual balance sheet using market valuations and including liabilities valued on a buyout basis, together with a buffer fund based on the Solvency II approach.

The PRA may have its strong views, but it is The Pensions Regulator (TPR) that is to authorise commercial consolidators, and give approval to schemes looking to move into one.

According to Asspociation of British Insurers (ABI) policy adviser, long-term savings, Hetty Hughes, the regulator of superfunds will need strong rule-making and supervisory powers, which is "more like the PRA than TPR".

Shah agrees, saying: "This requires a large, experienced and expert regulatory infrastructure. The TPR does not have this. That is a real concern if TPR is to be the superfund regulator. Many (including PIC) are saying that superfunds need to be regulated by the PRA rather than creating a new mirror regulatory system within TPR."

Ultimately it needs to be decided which these new superfunds are more akin to – a pension fund or an insurance product.

Hughes says that, as profit-seeking financial institutions, superfunds will be providing very similar services for employers and their DB scheme members to that of insurers. However, both The Pension SuperFund and Clara Pensions are adamant that they are pension funds, not insurers, and should be treated so accordingly.

Room for all

A sense of scale is needed, Saron states, because "as successful as the insurers have been, taking on about £85 billion of liabilities over the past 13 years, there's still about £2 trillion *[of UK DB liabilities]* left".

Within that £2 trillion are often small schemes, or ones looking to buy out deferreds, which struggle to gain insurer interest.

"Over a third of the DB schemes in the UK will struggle to insure their benefits even if they can afford it. That is almost 2,000 small- and medium-sized businesses that cannot shift the burden of a DB pension scheme from their balance sheet even if they have the means to do so," Davis says.

Therefore, it shouldn't be a 'turf war' between insurers and superfunds, Barker states, "as we can easily be in two very different and very large fields, working together over the hedge when sensible to do so".

Insurers and superfunds should be able to operate in a wide enough area to not bump into each other. The new entrants could be beneficial to the insurance marketplace, or they could end up treading on insurers' toes. Much depends on both the result of the consultation and how the dust settles after the initial disappointment it will undoubtedly cause for some. It remains to be seen whether these neighbours will become good friends.

Written by Laura Blows