Consolidators: The next big thing or the emperor's new clothes?

Jonathan Sharp and Paul Williams consider where superfunds will fit within the DB de-risking market

It's taken almost a generation, but finally we're here. DB consolidators (superfunds as they are also known) are the logical conclusion of a generation of DB plan closures: companies today see DB plans as a hole in the balance sheet rather than a retention tool. The pension plan used to be the purview of HR; now it is the responsibility of the finance director.

What better then than to wave a magic wand and to see that liability disappear in a puff of smoke. But will it be that easy? Will the superfund industry even get off the ground, as the government so clearly hopes it will?

The DWP consultation on consolidation drills down into the detail and finds that there are perhaps more questions (74 to be precise) than the government anticipated.

These questions evidence how tricky it is going to be to get this right with so many stakeholders impacted by the superfund industry. But at its heart is the question of how to attract the capital necessary to create the industry.

The capital will come from those pension schemes whose trustees consider that a superfund is the best option available for the membership and from investors who consider that the potential returns outweigh the risks.

The employer is the obvious beneficiary of a transfer to a superfund: it is freed of its funding obligation, even though that may come at the cost of a one-off superfund entry contribution. The PPF should also largely be cleared of risk provided, as is envisaged, that there is a requirement to wind-up a superfund once its funding level falls below, say, 105 per cent of the PPF funding basis.

That leaves the member and the investors. Trustees' duties dictate that they may make a transfer to a superfund only if they are satisfied that members are more likely to receive their benefits in full than if they had continued in the scheme. Put another way, trustees will need to be comfortable that the superfund's capital buffer, comprising the entry contribution (pension plan assets plus any employer top-up) and investor capital, makes up for the loss of future employer support for the scheme. Where does this potentially position the market then?

It is self-evident that the stronger the employer covenant, and the closer a scheme is to being able to buyout with an insurer, the less attractive the superfund option will be for trustees compared to buyout (in fact the consultation proposes that schemes which are able to buyout benefits with an insurer now or in the 'foreseeable future' should not transfer into a superfund).

Equally, superfunds' own funding requirements mean they will not take on poorly-funded schemes without a substantial cash injection from the employer. These two forces create a pincer that is likely to push the market into the middle ground of relatively well-funded schemes (taking into account any employer top-up on entry).

There is also likely to be a bias towards schemes with weaker employer covenants, since schemes with strong covenants will be more confident of the employer being able to fund the scheme to buyout. There may be other factors at play: a cash-rich overseas parent may want to strengthen the balance sheet of its UK subsidiary, or a transfer to a consolidator may help a corporate deal over the line.

If there is indeed enough space for a market to develop, there will need to be sufficient regulatory flexibility to permit different models. A system of authorisation by The Pensions Regulator, backed by guidance that establishes parameters of acceptability, should give the balance of regulatory space and certainty that the industry needs.

The development of the industry must not, however, come at the expense of member security. The government is optimistic that there is genuine opportunity here. Only once the numbers are crunched will we know whether superfunds are the next big thing or the emperor's new clothes.

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