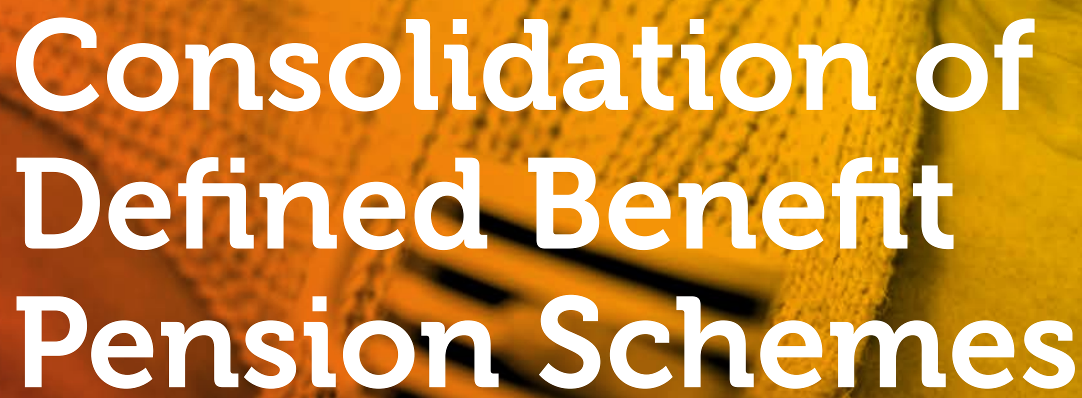

Consolidation of Defined Benefit Pension Schemes

Clara-Pensions consultation response

clara-pensions.com

Clara PENSIONS

A quick look at Clara-Pensions

Safer Pensions not Weak Insurance

The consolidation of defined benefit pension schemes is not a threat to the bulk purchase annuity market. An insured outcome for members is and will remain the "gold standard"—Clara's solution is built on this premise. Consolidation must not be confused with insurance. It must be regulated for what it is, a much safer pension for members.

Member-First

Consolidation is unfortunately not a solution for every scheme. It may however be an option for a large number and an opportunity to deliver a safer pension to their members.

Investment in UK Pension Schemes

Consolidation will encourage sponsors to fully fund their pension schemes today, with a clear benefit for doing so. It can drive investment in a part of the UK economy, which up to now has suffered from underinvestment.

Principles not Rules

The mathematics of pensions are the mathematics of uncertainty. In an effort to set standards and protect members there is an understandable desire to set clear rules. Clara believes that consolidation does require a strong authorisation and regulatory regime, but where possible this must be principles rather than rules based.

Policy not Solutions

Clara believes that a healthy choice of models will be essential for the development of consolidation. The competing models that have emerged so far do not just offer different prices but different solutions as well. This is to be encouraged as it widens the end-game options available to DB pension schemes. The outcome of this Consultation should therefore be the development of a policy framework that supports trustee choice and healthy competition, rather than aiming to regulate a particular participant.

Introduction

This document is the response of Clara-Pensions Limited to the public consultation 'Consolidation of Defined Benefit Pension Schemes', launched by the Government in December 2018.

We welcome the opportunity to comment on the Consultation. We are grateful for the engagement that the Department for Work & Pensions, HM Treasury, the Pensions Regulator and Pension Protection Fund have shown both before and during the consultation process. Clara is strongly in favour of a well-designed and robust legislative and regulatory regime for Consolidators of DB pension schemes[1]. This can only be in the interests of members, employers, the PPF and consolidators themselves.

Clara welcomes deeper engagement with all stakeholders, and we would be happy to provide further detail on any of the responses below.

[1] Clara's proposition will consolidate the assets and liabilities of UK defined benefit pension schemes, rather than the schemes themselves. The assets and liabilities of each pension scheme that are consolidated into Clara's scheme will become their own section supported by its own ring-fenced, permanent and funded capital. We recognise that other consolidators may take a different approach and have therefore used the term "scheme" throughout to refer to assets and liabilities.

Clara-Pensions—Key Points from our Consultation Response

- Consolidation is Good Policy—Consolidation offers better outcomes for members of UK defined benefit pension schemes. It will drive meaningful investment in UK pension schemes from both existing sponsors and new capital providers. This is a direct and immediate benefit to members and the UK economy.
- Safe Pensions Not Weak Insurance—Consolidators are pension schemes and should be authorised and regulated accordingly. There is and should be an appreciable "gap" between consolidators, who offer improved outcomes, and the near certainty of insurance.
- Strong Authorisation Regime—A credible authorisation regime will give trustees and members confidence in consolidation. Governance, systems and controls should converge towards a common best standard across UK financial services.
- Principles Based Gateway—Trustees are the gateway for the future of their pension schemes. Clearly articulated principles should support not supplant their end-game decision making.
- Flexible Legal Framework—The authorisation and regulatory regime for consolidators must be based on principles not rules. It should be flexible so that it can respond to innovation, new entrants and market conditions.
- Clara—The Consultation is not about one specific model—indeed we expect other solutions to emerge and regulation should facilitate appropriate innovation. Clara-Pensions however believes that our member-first solution—by design—best mitigates the valid concerns raised in the Consultation.

About Clara-Pensions —The Member-First Consolidator

Clara is the member-first consolidator for defined benefit pension schemes. We act as a bridge for pension scheme members, from the company that currently supports their pension to a long-term insured future.

Clara provides a safer pension promise today by combining its own capital and robust governance with additional contributions from sponsors, who can now transfer the burden of their pension liabilities to Clara. This frees up companies to focus on their future growth.

Clara will provide a low-risk journey to an insured buy-out, giving members the security of a fully-insured pension earlier. Only once all members have their full benefits secured will Clara provide a long-term return on capital for investors.

For more information, please visit our website at www.clara-pensions.com

How we've structured our response

Our response is structured as follows:

1. The opportunities offered by consolidation (page 6)
2. Clara's approach to consolidation (page 15)
3. Responses to the specific questions posed (page 18)
4. Other issues arising from the consultation (page 59)

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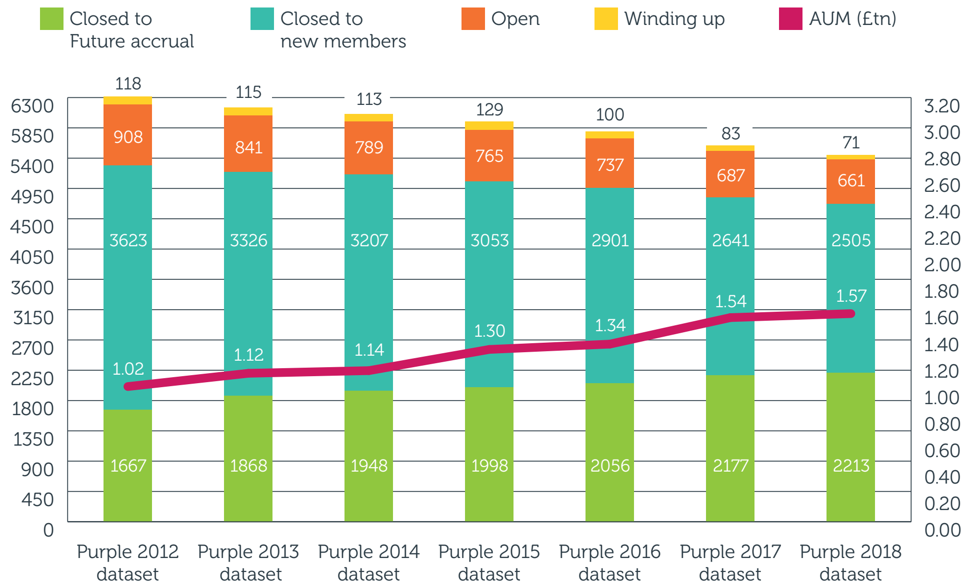
1 The opportunities offered by consolidation

- Reduce risk to members
- Funding defined benefit pension schemes today through upfront contributions and additional capital
- Create economic value through scale
- Provide members access to digital innovation
- Allow sponsors to focus on their core businesses
- More efficient use of capital is good for UK businesses. Enhancing companies' access to financing and strategic alternatives provides a more stable base for UK employment
- Create pools of capital with the governance, scale and desire to be providers of long-term patient capital to the UK economy

Chart 1: Schemes by status and Year



Source: Pension Protection Fund, December 2018, 'Purple Book'

Background

Defined benefit pensions are a valuable benefit for members, but one which is available to fewer and fewer employees. As the number of closed DB schemes has risen over time, the overlap between scheme membership and current employees has shrunk; and for the corporate sponsor the scheme is no longer a valuable human resources tool for attracting and retaining talent but a legacy liability. This trend away from DB toward a future dominated by Defined Contribution provision pre-dates the current debate over consolidation and has exacerbated the tension that exists between scheme members and the shareholders of sponsoring employers over the application of free cash flow.

The Government's White Paper in March 2018 launched an important debate on the role that consolidation can play in helping to secure the futures of DB members, but this debate has often failed to recognise that consolidation is not new. It already exists in many different forms. Scheme mergers have long been a feature of the DB landscape; and although entry into the PPF is not voluntary, the PPF is itself a consolidator of DB assets and liabilities. Commercial consolidation is also not new. The pension insurance market has been one of the most successful consolidators of DB assets and liabilities and all the current participants in the bulk purchase annuity market are profit-driven enterprises.

The pension industry already accepts the need for consolidation. Lincoln Pensions conducted a survey[2] during the Consultation period, which indicates that 60% of pension professionals believe consolidation will become a commonplace end-game solution.

It is common ground that consolidation can create economic value. The key question underlying this consultation is how that economic value should be shared between sponsors, members and capital providers–and in what order. Clara's position is clear. It must be member-first–increasing the likelihood their benefits will be paid as promised.

Benefits of Consolidation

We welcome the continuing recognition by Government of the benefits of consolidation. Bringing schemes together with additional protective financial capital can improve outcomes for both members and employers[3]—as the Pensions & Lifetime Savings Association's 'DB Task Force' said in their 'Case for Consolidation' report, this 'could transform the sector' for the better[4]. At present the pension promise made to most members will be met but the exposure to both the risks of employer insolvency and underperformance of scheme investments means the position is uncertain. Consolidation provides an opportunity to reduce these risks to members and reduce an ongoing burden on employers. We agree with Government, that 'the evidence … supports the case for consolidation in principle'[5].

Consolidation gives sponsors and capital providers a strong reason to allocate significant amounts of funding to DB schemes today. This is a material change in attitude compared to the running "conflict" over dividends and deficit recovery plans.

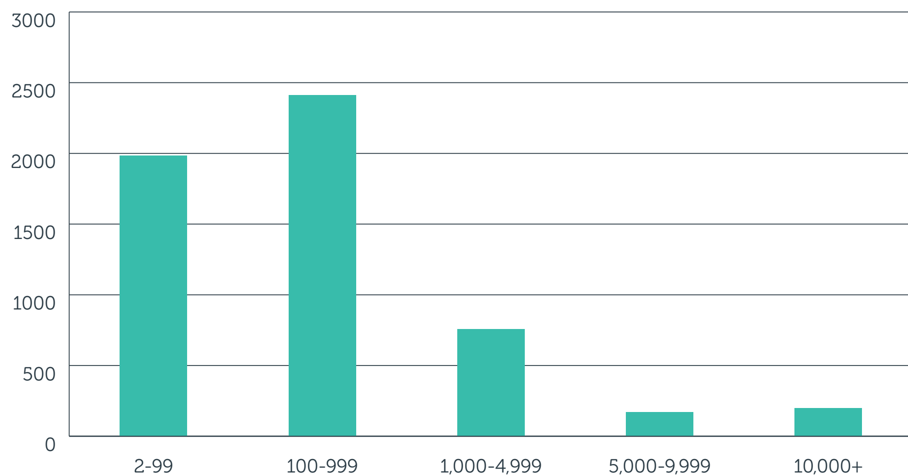
[2] Lincoln Pensions "DB Consolidation Survey—Superfunds" (http://lincolnpensions.com/superfunds-will-become-a-commonplace-solution-for-some-db-schemes/).

[3] Department for Work & Pensions, March 2018, 'Protecting Defined Benefit pension schemes', page 8

[4] Pensions & Lifetime Savings Association, Defined Benefit Task Force, March 2017 'The Case for Consolidation', page 26

[5] Department for Work & Pensions, March 2018, 'Protecting Defined Benefit pension schemes', Annex A, para 90, page 67

Chart 2: Distribution of schemes by size of scheme membership as at 31 March 2018



Source: Pension Protection Fund, December 2018, 'Purple Book'

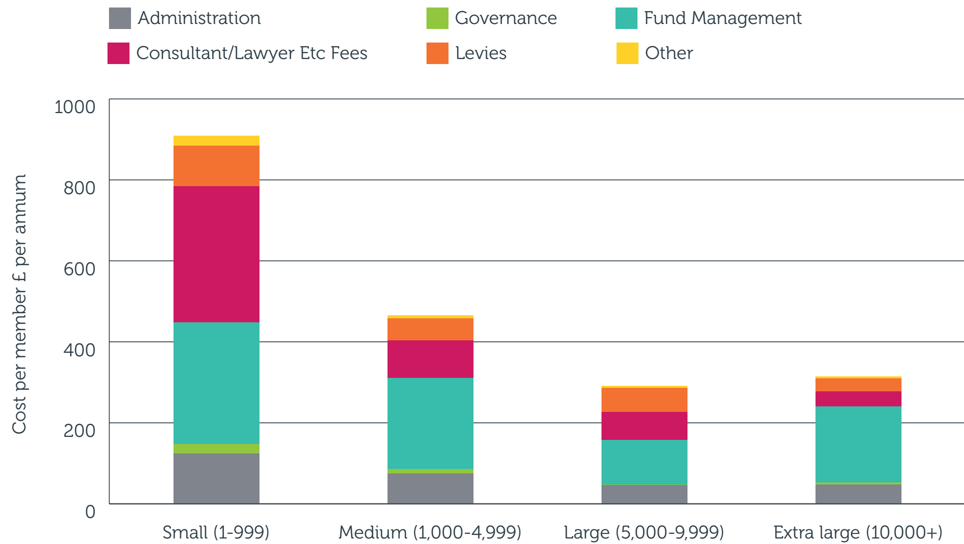
The Pensions and Lifetime Savings Association Defined Benefit Task Force identified a number of areas 'that policymakers should give immediate focus to (to) address the challenges faced by DB schemes.' These included:

- 'The system is too fragmented—there are too many small, sub-scale schemes'
- 'Risk bearing is sub-optimal—moving risk around the system rather than removing it.'

The evidence for consolidation remains strong. The Government previously highlighted the challenges of a lack of scale among many schemes. These 'high levels of fragmentation' have been shown to be bad for scheme governance[6] and lead to higher costs[7]. This lack of scale also adversely affects investment performance[8] and limits investment opportunities.

[6] Department for Work & Pensions, March 2018, 'Protecting Defined Benefit pension schemes', para 141, page 30
[7] Ibid., para 142, page 30
[8] Ibid., para 142, page 30

Chart 3: Pension Funds' Adviser Costs (DB Schemes)



Source: Pensions & Lifetime Savings Association, October 2016, DB Task Force Interim Report, Figure 16

Lack of scale also means that members of smaller schemes are not getting access to innovation in how they engage with and understand their benefits. Larger schemes have the resources and governance to invest in a more digital future[9]. For example, the Marks & Spencer[10] pension scheme recently announced the deployment of member portals with very impressive take-up rates among their membership. Those members not only have better access to and understanding of their benefits, but at a scheme level data quality will be higher (making risk management more accurate), administration will be more accurate (and less costly) and they will be the first to benefit from valuable initiative like the Pensions Dashboard. Digital first is member-first. Clara wants to engage with our membership, therefore supporting the Pensions Dashboard, a member portal and an engaging member journey are all on our roadmap.

[9] Pensions Expert 28 November 2018 "Only one in 100 members wants paper comms, finds BAA scheme"
[10] Pensions Expert 16 January 2019 "M&S portal launch sees 12,000 DB members sign up"

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Small and fragmented schemes do not just create risk for members and a burden on sponsors, they have wider societal and economic impacts—the Government's Patient Capital Review Industry Panel has given a clear example of the opportunity costs[11]. The Panel found fragmentation and the current position of many DB pension schemes and their employers to be a major factor in the current lack of patient capital. This is 'a significant impediment to UK entrepreneurs' success'.

Given the long duration of their liabilities and relative high predictability of their cash flows, DB pension schemes should be well placed to extract an illiquidity premium from investments. In other words, pension schemes should be patient investors; and since all their liabilities are denominated in GBP, sterling denominated assets in the UK should be particularly attractive. In practice, however, it is only the biggest and most sophisticated schemes and pension insurers who routinely access these investment opportunities. It is a lack of scale that puts these opportunities out of reach of the smaller schemes.

Smaller schemes are not currently able to invest significantly in areas such as infrastructure and venture capital. Bringing a portion of these assets together into consolidators could create pools of capital with the risk management capabilities, governance, scale and desire to be providers of long-term, patient capital to the UK economy.

If the potential market for consolidation is assumed to be £200bn[12], a 10% reallocation of assets would create £20bn of new patient capital seeking productive investment opportunities in the UK.

Clara's investment strategy will be low risk and comprised predominantly of yield assets. As we achieve scale, we will seek to enhance our portfolio by identifying attractive opportunities to invest for the long-term. Clara's own capital will be provided by a long-term investor and therefore our capital structure is aligned towards patience.

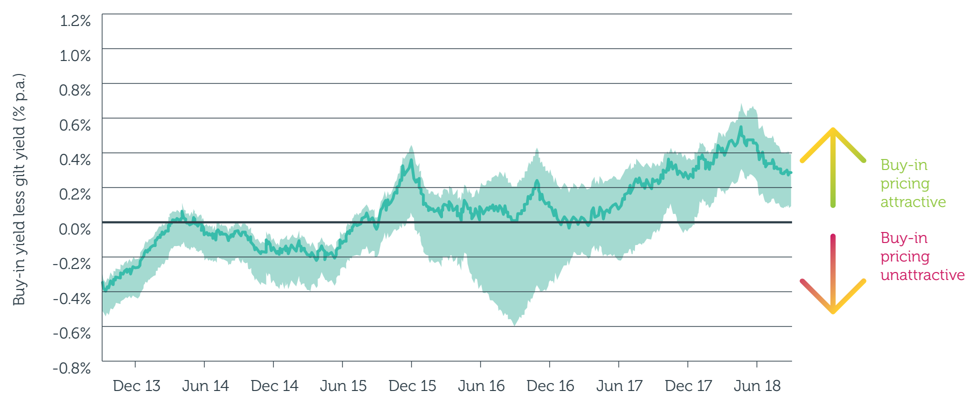
[11] Patient Capital Review Industry Panel Response, October 2017, para 2.3

[12] Clara's internal estimates suggest that the market for consolidation could be in the range of £100-200bn over ten years. Alan Baker of Mercer estimated the consolidation market to be in the range of £162-244bn ("Trustees pour cold water on wild consolidator claims" Pensions Expert 28 September 2018)

The Bank of England has also started to identify systemic dangers from the potential response of weak schemes and employers to financial volatility[13]. This research suggests that scale and strong funding, as offered by consolidation, should reduce the risks of smaller schemes and weaker covenants exacerbating financial crises (pro-cyclicality risk). More recent data has only served to strengthen the evidence base. Smaller schemes continue to be less likely to have taken advantage of the full range of risk reduction measures[14]. Smaller schemes are not disappearing—they remain an unchanged proportion of the DB pensions landscape and continue to pose higher levels of risk of making a claim on the PPF[15] (with the risk to full member benefits that reflects).

We agree with the Association of British Insurers that buy-out is the "gold standard" end-game for members of private DB schemes. Despite the undoubted success of the insured market, it is important to recognise that this solution is only available to a minority of schemes. The total value of all buy-ins and buy-outs over the 12 years to the end of 2018 only represents c.6% of all outstanding private DB pension liabilities[16]. 2018 was a banner year for the insured market, but since its inception volume and pricing have been volatile—further complicating trustee and sponsor decision making. Uncertainty can be a temptation to delay, with employers deferring contributions they would otherwise make, and members continuing to be exposed to employer insolvency risks and a potentially sub-optimal investment strategy.

Chart 4: Buy-out pricing volatility



Source: Hymans Robertson's buy-in monitoring service, November 2018
https://www.hymans.co.uk/media/uploads/Buy-in_monitoring_service_-_November_2018.pdf

[13] Bank of England Staff Working Paper 757, October 2018
[14] The Pensions Regulator, Tranche 11 Funding data, June 2018
[15] Pension Protection Fund, 'Purple Book', December 2018, Figures 4.4 & 6.3
[16] Data from LCP and Hymans Robertson on buy-out market volumes compared to PPF 7,800 Index aggregate scheme funding data

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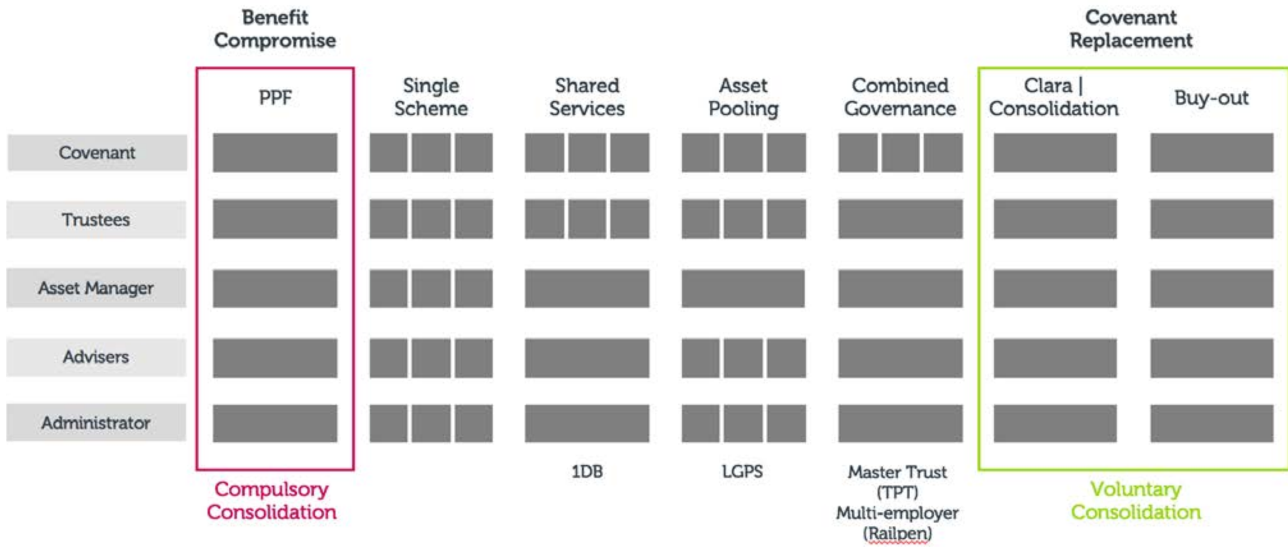
These are not new issues. Too many companies are held back by legacy pension obligations, consuming management time and dragging on company performance. Pension schemes simply running on prolongs this burden while leaving members exposed to the risks of employer failure and/or the failure of the investment strategy. As the PLSA DB Task Force noted, reducing investment risk simply increases exposure to the employer's insolvency risk.

These issues are more pronounced as more DB pension schemes enter the 'end-game'. Scheme liabilities are maturing, schemes are becoming cashflow negative and with many schemes closed, the link to the employer is weaker. As schemes plan for their future, and that of their members, simply continuing on, falling into the PPF safety net or struggling toward an unobtainable buy-out provide too narrow a set of choices.

> We know that most sponsoring employers want to do the right thing for the members of their pension schemes. Choosing to consolidate with Clara creates an opportunity to do something rather than simply managing an ongoing volatile liability and open set of risks which distracts from running the business and can impede new investment.

It is important to recognise that for many UK companies the existence of hard to quantify defined benefit liabilities is an absolute barrier to capital raising in both the debt and equity markets. Consolidation can give sponsors a new option to fulfill their DB pension promises and open their businesses to more efficient sources of capital. Supporting UK businesses supports UK employment and does not have to be at the expense of pension scheme members.

Chart 5: Different consolidation models



Source: Clara-Pensions

This consultation is timely. Consolidation could be achieved within the current pensions legislative and regulatory framework, but a specific framework is welcome. The Pension Protection Fund has demonstrated that the mechanics of consolidation, albeit with benefit compromise, already exist as part of the current pensions system.

The consultation proposals rightly strike a careful balance in ensuring consolidation is available to those members and employers who would benefit most. Access to consolidation should not be inappropriately broad but must not be too narrow and restrictive. Most importantly the right framework gives the opportunity for more members to receive their promised benefits in full.

It is essential that the framework of primary and secondary legislation and regulatory codes of practice is flexible, so that it can respond to innovation, new entrants, market conditions and practical experience as transactions take place.

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2 Clara's approach to consolidation

Clara-Pensions is the member-first consolidator for defined benefit pension schemes. Consolidation drives our solution, but it is not the destination. Clara is focused on reducing risk to and securing the pension of each individual member.

Although Clara has a commercial purpose, the interests of members, our capital providers and Clara itself are fully aligned around a single objective —deliver the most secure pension promise as efficiently as possible. To ensure this continued alignment, no capital or profit can be returned to capital providers until every member in a section has had their full benefit secured in the insured market.

The Clara structure has been built around six core principles.

1. **Member-First**—Clara's key objective is to secure members' benefits by putting members and their interests at the heart of everything we do. We want to enhance their security on the journey to buy-out.

   Clara's capital provider understands and accepts that economic returns are subordinated to the security of members' benefits, but Member-First is not just about economics, it is also importantly about the member experience.

   We believe that member engagement is key, and Clara's vision is to ensure members are educated and receive clear, concise communications when they need it. We want members to be able to understand any options they have. We believe that digital first is member-first and we are committed to making innovations like the Pensions Dashboard available to Clara members.

The benefits of Clara for members are not just about reducing risk and increasing the likelihood of their promised benefits being paid in full it is also very much about the member experience.

2. **Bridge to Buy-out**—Even following the introduction of Pension Freedoms the certainty of a known and regular pension is undoubtedly a valuable benefit. We believe that the pension insurance market offers the best long-term destination for members as the PRA's regulatory regime combined with the security of the FSCS already provide the highest level of security available to pension members. Unfortunately, this security is not available to the majority of members of private DB pension schemes.

   Clara does not aim to provide an alternative to pension insurance as the long-term solution for DB pension benefits. Instead Clara will lower the risk of the journey from the trust-based to the insurance-based environment —we will provide a bridge to buy-out for those that cannot get there in the foreseeable future.

Clara is not the end point of the member journey—we're a bridge to get them to where they need to be, reducing risk, making it more likely they'll get there.

3. **Permanent Capital**—The Risk Capital provided to underpin members' benefits is permanent and funded. It is first in and last out—it remains available until all members in a scheme have their benefits secured. It bears any losses first and can only be returned to capital providers when all liabilities in a section are secured. The objective of Clara's capital is to seek a reasonable return without the need for interim liquidity and only after members have had their full benefits secured.

4. **Aligned Interests**—Clara's permanent capital travels the full journey to buy-out with members. Clara is the member-first consolidator, therefore capital and profit can only be returned after members have had their full benefits secured. Our structure does not permit dividends, coupons or any other payments to be made to capital providers until such a time.

Clara's permanent capital, where profits can only be taken when member's benefits have been secured, means new additional funding for the UK pensions system. This is money that would not otherwise stand behind pensions. It is being invested into the UK making a positive contribution towards reducing risk to members.

5. **Strong, Independent Governance**—Governance and risk management are the most important shared services that support the interests of both members and capital. We believe in the value of governance. The scale offered by consolidation provides both the economic rationale and resources to invest in the systems and controls to support strong decision making throughout our business.

   It is a great strength of trust-based pension schemes that benefits are provided under trust, separate from the sponsor. The Clara Pension Trust will itself be an occupation pension scheme with a strong board of trustees comprised of unaffiliated, professional, independent trustees.

The Clara model is trust based rather than contractual. Members remain members.

6. **Sectionalisation**—The assets and liabilities of each pension scheme that are consolidated into Clara's scheme will become their own section supported by its own ring-fenced and funded capital that will remain available to that section until all members' benefits are fully secured. Sectionalisation is not the obvious choice for consolidation, but it is the right one. We would argue that it is our "super power":

   - Member-First—sectionalisation allows Clara's capital providers to put members first.
   - Replication of Benefits—the benefits of each transferring scheme are replicated in the receiving section.
   - Clarity of Funding—it is clear to both the Regulator and transferring trustees what level of security is being provided to the members in each section.
   - Consistency of Funding—the security provided to members in each section is not affected by the entry of other sections to the platform.
   - No Cross-subsidy—Clara does not ask members of one section to subsidise or take responsibility for the legacy problems of other sections
   - Buy-ins—continue to support the members for whom they were originally purchased.
   - Reduce Risk to PPF—by removing the concentration risk associated with a single non-sectionalised scheme.

3 Responses to the specific questions posed

We've answered each of the specific questions raised in the consultation. We've tried to cross reference answers that relate to each other. This is complicated as areas like the Gateway Test and the Funding Regime for consolidators are intrinsically linked.

Question 1 **Are these characteristics wide enough to define a superfund? If not, how could superfunds be defined for the purposes of a future regulatory regime?**

The proposed definition is broadly appropriate, but we would argue against a check-list of criteria being used to define consolidators.

We can envisage models where the buffer arrangements, employer link or mechanisms for taking returns could be constructed to avoid the characteristics identified but the entity would be a consolidator and should be treated as such. In Clara's model, for example, the capital buffer is comprised of investment by external capital providers and a payment from the transferring sponsor. Despite, or rather because of, this structural nuance we are clearly a consolidator or superfund and would expect to be treated as such. Similarly, not all these features listed might apply to every transaction entered into by a consolidator, for example in certain circumstances a well-funded scheme may not require a further payment from a transferring employer.

It is our expectation that new models of consolidation will continue to emerge over time and therefore flexibility is crucial. We would argue that primary legislation should contain a non-limiting list of definitional characteristics and, importantly, the Regulator should be empowered to determine whether a structure is or is not a consolidator for the purpose of the proposed authorisation regime. This would also appear consistent with the approach adopted by the PPF[17].

Clara is in favour of greater flexibility because it facilitates new entrants to the market, which means greater competition, a stronger overall developing market, and wider options for schemes.

[17] "The 2019/20 Pension Protection Levy Policy Statement" Pension Protection Fund, 12 December 2018, paragraph 2.4

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Question 2 **Given the differences of superfunds and traditional DB occupational pension schemes, what are the additional risks and challenges associated with TPR regulating superfunds?**

The Pensions Regulator already regulates a very broad range of occupational pension arrangements. They have demonstrated the ability to evolve the regulatory regime to manage emerging models such as DC Master Trusts. We would also expect the eventual number of consolidators to be manageable given TPR's capabilities and resources.

We do however see three broad areas of risk and challenge for TPR.

- The existing regulatory regime governing occupational pension schemes means that trustees should properly consider how the emergence of consolidators changes their consideration of funding and insolvency risk. The suggested use of Chair's statements and changes to the Trustee Toolkit will be helpful in supporting this.
- Ensuring that the legislative regime gives sufficient flexibility and discretion to allow TPR to regulate consolidators (taking into account their varying business models) in an appropriately proactive and targeted way, including as the market develops.
- While we are comfortable that they will be able to do so (and are already doing so), TPR will need to develop and acquire a new set of capabilities and skills to effectively regulate this new area, for example the timely clearance of transactions. To the extent TPR needs to expand its resources, this can occur over time as the structure and depth of the consolidation market becomes clearer.

Question 3 **Are the proposed authorisation criteria the right ones for the superfund regulatory regime?**

These are appropriate.

- Effective supervision—Our understanding is that the requirement that consolidators 'can be effectively supervised' relates to the model of the consolidator rather than TPR capabilities. We would be concerned with any (temporary) gap in TPR capabilities creating a delay or bar to authorisation.
- Fit and proper persons—The individuals tasked with managing each consolidator must have the confidence of transferring trustees, the consolidator's own trustees, members and the Regulator.
- Effective administration, governance and investment—High standards of risk management and governance in all aspects of operations should be a benefit of consolidation
- Financial sustainability—Consolidators must be able to demonstrate access to the financial resources necessary to achieve scale.
- Member protection—Member-first is at the core of Clara's ethos.

Question 4 **Are there any circumstances in which it would be advantageous, or necessary, that the authorisation criteria are not applied to the whole superfund but instead to individual segregated sections when the superfund scheme is sectionalised?**

Clara's solution is built on a sectionalised occupational pension scheme. We believe sectionalisation confers valuable structural benefits which we describe above (see "Clara's Approach to Consolidation" on page 15). In our case, however, we would expect the authorisation criteria to be applied to the Clara group structure as a whole.

TPR should retain the discretion to apply the authorisation criteria to one or multiple sections within a pension trust if that/those section/sections are being operated as a consolidator or superfund in their own right. Any framework needs to be flexible to respond to different circumstances. Without a broad power to look through legal structures and appropriately identify, require authorisation of, and regulate a de facto consolidator there would be a wide gap in the authorisation regime allowing a consolidator to be built by stealth within a new or existing master trust or other multi-employer scheme.

Question 5 **Are these restrictions the right ones to ensure that superfund corporate structures are transparent and compatible with regulatory supervision? Are there any other measures that would aid TPR's ability to supervise superfunds?**

The Regulator is entitled to expect transparency in all matters, including corporate structure, from consolidators subject to its supervision. Aiding supervision through reduced complexity, where possible, should be encouraged. Clearly a simpler corporate structure would facilitate the identification of risks, and be easier to regulate; therefore, to the extent additional complexity can be avoided, that should be encouraged. Unfortunately, this will not always be feasible. We comment further on this below.

Consolidator vs Capital Provider(s)

Clara agrees that consolidators should expect TPR to be comfortable with their full corporate structure. The framework should however be clear about where TPR oversight of the consolidator structure ends to avoid capital providers and connected parties, who are subject to different regulatory regimes, being regulated twice. We are not suggesting that an entity could not be authorised under two separate regimes but rather, where possible, duplication and inconsistency should be avoided.

It is of course correct that the Regulator should have clarity and transparency as to the ultimate beneficial ownership of any consolidator. Both the FCA and PRA regulatory regimes include provisions to disclose ownership above pre-determined thresholds and require prior approval for changes of control. We would expect the regulatory regime for consolidators to include similar provisions.

As noted above, any restrictions on the legal structures within consolidator groups should not inadvertently be extended to capital providers.

Consolidator vs Investment Structures

Pension schemes sponsored by consolidators and supported by their buffer funds may control companies or other vehicles incorporated outside of the UK for investment purposes. They may control partnership structures. This may be because of the size of a holding or how the particular investments of a ceding scheme were structured. This fact alone should not prevent authorisation of a consolidator. This preference for UK based companies may better fit within guidance, rather than primary legislation, with flexibility built in to permit the consolidator to explain the approach and, if appropriate, achieve authorisation.

Complexity

Paragraph 32 of the Consultation correctly highlights that the corporate structures of a consolidator are likely to be complex. It is worth considering complexity in greater detail to determine whether it serves a valuable purpose and whether it can be mitigated to aid TPR's role in supervision. This complexity is likely to originate from four sources:

1. Securing the capital buffer and preventing its dissipation—The capital buffer represents the covenant of the consolidator. Clara believes that this needs to be funded, secured and available to trustees and the PPF if needed. The buffer entity should also be subject to regulatory intervention. If complexity delivers security, it is clearly valuable.
2. Protecting the PPF—This is clearly a desirable objective, but triggering PPF entry as a result of a discontinuance event through the automatic trigger of insolvency of a statutory employer while scheme (or section) assets are above the s179[18] level is not without complication.
3. Tax efficiency—Managers (like trustees) have a fiduciary duty to ensure a consolidator pays a fair and appropriate level of taxation having regard to the availability of reliefs and applicable legislation. Any such efficiencies do not only accrue to capital providers but to members first through a stronger consolidator covenant and lower required after tax investment returns (thereby leading to lower risk).
4. Moral Hazard—The Regulator's "moral hazard" powers to issue contribution notices and financial support directions under s38 and s43 of the Pensions Act 2004 are a potential impediment to attracting capital for consolidators. Capital providers understand and accept that any capital they invest in a consolidator is fully at risk, but they will not take on a risk that they (and their investors) could be "called" for uncapped further contributions. All consolidators will presumably be structured to eliminate this risk. If Government wishes to remove an unnecessary layer of complexity from consolidator structures, we would argue that the application of the "moral hazard" powers should be reviewed in relation to superfunds.

[18] S179 of the Pensions Act 2004

Question 6 **Should the corporate entities of superfunds be permitted to be established as partnerships or should they be required to be set up as a UK limited company?**

Clara does not have a firm view on this point.

Clara agrees that UK limited companies are preferable, and we have established our structure on this basis. UK companies are transparent with well understood accounting, taxation and reporting requirements. We also believe that incorporating the UK Governance Code into our governance arrangements is clear best practice. Partnerships in their various forms are less well understood, but it is important to acknowledge that the "corporate entity of a superfund" is more likely than not to include multiple legal entities and there can be sound reasons for using a partnership although the presumption should be against them.

It is worth highlighting that charities would also be inappropriate entities within a consolidator.

We also agree with the Consultation position that the consolidation regime should preserve the integrity of the current regulatory framework for insurers. Trustees, employers and members should be able to understand the risks and opportunities of these distinct regimes without confusion. Consolidation should be about providing 'safer pensions' rather than a 'cheap and less secure insurance' regime.

We think it right that those running and managing consolidators and the schemes they sponsor be held to high standards. Consolidation should not just reduce the risks to members from scheme funding and employer insolvency, it should reduce other risks, including poor governance.

Question 7 **Should TPR have a discretionary power to require evidence that individuals outside the superfund structure meet the fit and proper persons requirement?**

Where individuals influence or impact the affairs of a scheme and/or member benefits, this power would be appropriate.

Where an individual has already met the fit and proper requirement of a recognised equivalent regulatory regime (for example, FCA and PRA), we would hope that the Regulator would apply a presumption that the individual will also be fit and proper for the purposes of a consolidator.

Clara also notes the future convergence of the FCA's and PRA's approaches under the Senior Managers and Certification Regime and would encourage the Government to align any fit and proper provisions with the common standard emerging across UK financial services.

Question 8 **Would these requirements be sufficient to allow TPR to identify those subject to a mandatory fit and proper persons requirement?**

No. Clara believes that TPR should be able to look beyond these Statements of Responsibilities to consider actual corporate practice, as required. This would allow any other individuals with significant influence or with significant control in practice to be considered as TPR deems appropriate.

Question 9 **Should TPR have the power to interview individuals for the purposes of the fit and proper persons test?**

Yes. TPR should also have sufficient flexibility to draw upon external support when undertaking such interviews. Should any roles in a consolidator structure also be subject to other regulatory fit and proper person tests (noting our comments above) TPR should also be allowed to participate in shared single interviews.

As with the FCA regime these interviews should serve as a "benchmark rather than examination".

As a further point, any fit and proper persons regime should be flexible enough to allow responsibilities to be covered in the event of staff absence, new appointments or promotions without awaiting the outcome of an interview process (noting that any such interim appointments will need to become permanent within a set period of time and will require completion of any interview if requested by TPR).

Question 10 **Are there other areas that should be included as part of the mandatory fit and proper persons requirement?**

Yes. Mandatory fit and proper persons requirements should also extend to a person responsible for setting the basis on which liabilities and assets are accepted into the consolidator (for example, Chief Actuarial Officer).

Question 11 **Would introducing a set of standards of conduct for the superfund's corporate board be proportionate?**

Clara would hope that members of the consolidator's corporate board would be required to be fit and proper persons and that the board would have a majority of non-executive directors (see Question 14). Against this background, a further standard would seem redundant.

In the case of a traditional occupational pension scheme, it is often observed that the corporate board's responsibilities are not in alignment with the pension scheme trustees', and it is not incentivised to fully understand the defined benefit landscape. The corporate board's focus is linked to ensuring positive financial performance of the sponsor and delivering returns to shareholders. In the Clara model, the clear alignment of interests between members and capital providers will be a powerful incentive to ensure shared knowledge and understanding between the trustee and corporate boards.

Question 12 **What in your view should form the basis of any standards of conduct?**

Industry commentators have suggested that members of the corporate board should meet the same Technical Knowledge and Understanding Requirements as trustees. We would agree that the corporate board should familiarise itself with the workings of the trustee board and its obligations, but we would caution against inadvertently placing the corporate board "into the shoes of the trustees" and thereby compromising their independence.

Question 13 **In your view, are there any other elements that should form part of a potential integrity test, conduct requirement or competency test?**

The approach outlined is appropriate.

Assessing the balance of competencies on both boards will require TPR flexibility, discretion, and clear guidance. We would be uncomfortable if an individual with demonstrable relevant and appropriate competence were to fail the competence test because it was perceived that they did not fill an unrelated gap in the collective competence of the board.

We would also expect to see both the corporate and trustee boards being able to demonstrate appropriate experience of engaging with and/or representing members (or customers).

Question 14 **Should there be a minimum requirement on the proportion of independent NEDs on the superfund's corporate board or should this be left to TPR discretion? If so, what would be a suitable proportion?**

We agree that independent non-executive directors should be required on any consolidator's corporate board. Appropriate challenge to the managers protects the interests of both members and capital providers.

We believe that greater than 50% would be the appropriate minimum requirement for non-executive director representation on the corporate board. We would argue that this minimum percentage should not be prescribed in legislation but rather devolved to the Regulator. TPR should have the powers, flexibility and discretion to look in detail at the board composition of any consolidator—the appropriate composition of executive directors, independent NEDs and other NEDs—and require variation if appropriate.

We'd raise one final note of caution in relation to these standards. High standards of governance for consolidators is entirely right. Applying a much higher governance bar to consolidators than ongoing schemes does risk unintended outcomes—a trustee of a ceding scheme might be (perhaps rightly) barred from becoming a trustee of a consolidated scheme. TPR may wish to consider the implications for ongoing scheme governance of an appropriately robust regime for consolidator governance.

Ensuring member voices are heard

Clear and open communication with members—in both directions—should be at the heart of every consolidator. It is key for Clara. We think there is a difficult balance about how that best happens. Bringing together very distinct groups of members from a range of different sized schemes will create a varied membership. As Clara looks to consolidate new schemes and buy-out sections in the future, the membership will vary significantly over time.

So how can member voices be best heard and be most influential? Member nominated trustees have served members well in sitting alongside employer nominated trustees to balance the employer interest in ongoing schemes. Recent cases have however demonstrated the value that the expertise of professional independent trustees can bring. Rather than replicating the member/employer nominated trustee model from ongoing schemes, consolidators need a new robust approach.

Question 15 **Should superfund trustee boards consist entirely of independent trustees?**

Yes. The board of trustees of any pension trust within a consolidator's group should consist entirely of professional, independent trustees. Independent trustees, with duties under trust and pensions law, are an appropriate way to protect members and champion their interests.

Independence of the board of trustees should itself be an ongoing condition of authorisation. This is not the same as the board of trustees being comprised of independent trustees but goes towards ensuring that the actions of the board of trustees has not been inappropriately restricted through contract or management process.

As suggested in Paragraph 68 of the Consultation, the Regulator should approve any restrictions purported to be placed on the trustees outside the trust deed.

Question 16 **Should there be a non-affiliation requirement for the appointment of trustees to a superfund's trustee board?**

Yes. We would however note that the non-affiliation test should not be overly prescriptive and draw on experience of how the equivalent test for DC Master Trust has not always worked in practice.

Question 17 **Should superfund trustee boards be subject to the MNT/MND requirement?**

If the board of trustees of any pension trust within a consolidator's group is comprised entirely of professional, independent and non-affiliated trustees then member nominated trustees should not be required.

Question 18 **Should superfunds be required to establish member panels? Would such panels be an effective and proportionate way of ensuring that members' views are represented?**

Clara agrees that 'adequate systems and processes to ensure members' views are represented' should be a condition of authorisation The nature of the systems and processes should be flexible rather than fixed and TPR should have the ability to oversee mechanisms put in place to seek members' views and ensure that they are effective. These should evolve in response to member interest and demands. The test applied should be driven by outcomes in adequately representing members rather than by form. A specific requirement to establish member panels would either risk entities operating under that name that did not properly serve member interests or an overly prescriptive and formulaic approach.

Our understanding is that some schemes seeking to set up panels have sometimes found it difficult to attract members to serve on them, and it has been appropriate to use "member representatives" in their stead. Membership of a consolidator is likely to be equally diverse and similar arrangements might therefore be appropriate.

Clara is strongly committed to the value of member engagement, but a lack of member engagement is not a feature of consolidation, rather it is a challenge for the entire pensions industry. We agree that member panels may be an appropriate "safe" place to start, but an overly prescriptive requirement risks turning effective communication into a compliance exercise.

It is worth highlighting that neither the PPF nor the insurers are required to have member nominated board members or member panels.

Question 19 **In your view, would the areas outlined in this section enable TPR to assess the effectiveness of a superfund's systems and processes? If not, what alternatives would you propose?**

Yes, they are appropriate. In order to encourage new entrants to the market (and acknowledging that consolidators are generally "start-ups" at the point they seek authorisation) the requirements must though be proportionate to the risk to the PPF.

The key determinate of a consolidator's financial stability is its scale or, more specifically, its ability to reach critical scale. The systems and processes required to prudently manage a consolidator at the start of its journey are very different from those required as the consolidator achieves significant scale. Clara therefore strongly supports TPR having the power to grant, amend or withdraw authorisation (as outlined in paragraph 78) so as to allow consolidators to launch and grow safely and efficiently.

Question 20 **Are there other areas that should be included as part of the systems and processes requirement for superfunds?**

It may also be appropriate to consider:

- The financial processes and controls of the consolidator.
- The member engagement and communication processes.

Financial Sustainability

Before addressing Questions 21 to 31 on Financial Sustainability raised in the Consultation, we felt it important to openly acknowledge the realities of the current mutually exclusive regimes for the authorisation and regulation of defined benefit pension schemes and insurance companies in the UK. Our purpose is not to set one regime above the other, but rather to recognise that they are different and have emerged separately from their own histories.

Clara PENSIONS

The UK has rightly in the past eschewed proposals that would have seen insurance style funding for pension schemes, most recently in the revised Institutions for Occupational Retirement Provision Directive.

While most DB schemes were growing (open to new members and future accrual) this separate history made sense, but as more DB schemes have closed and matured the nature of their liabilities has changed from accumulation to run-off. Given the long-tail nature of these liabilities they do not sit comfortably on corporate balance sheets, which are in most cases not designed to manage financial run-off risk. It is worth remembering that a ten year corporate bond is considered to be long-dated!

By contrast insurance balance sheets have a long history of dealing with run-off risk of varying durations. As DB schemes have transitioned from accrual to run-off it is no surprise, therefore, that they acquired a shared future with the insured world as evidenced in the development and success of the bulk purchase annuity market for buy-ins and buy-outs.

Authorisation

As matters stand today, a newly established DB pension trust does not require authorisation by the Pensions Regulator (although it will require clearance from HM Revenue and Customs). By contrast a new insurer will have to submit itself to a lengthy application process before receiving authorisation to operate from the PRA.

Regulation

It is clear that the approach to ongoing regulation is very different (on many levels) in the pension and insurance markets. We would argue, however, that the key difference lies in the approach to default risk.

The pension regime implicitly recognises and contemplates the possibility of default. The Regulator, trustees and sponsors work very hard to avoid default and mitigate its severity through the scheme specific funding regime and approach to investments; but while most members will receive their full pension promise this is not true for all. The existence of the PPF is an explicit recognition of this reality. Pension schemes are not required to be funded to certainty or to any specified probability of paying pensions in full. In fact, the probability of paying pensions in full varies considerably between schemes (and between members of the same scheme) based on different funding levels and the relative strength of sponsor covenants.

The insurance regime, quite rightly, is seen as the "gold standard" in run-off provision. It is, by design, intended to provide 100% of members, with 100% of their benefits in almost all circumstances (but it is not zero failure). Its strength and clarity are achieved by requiring a solvency test to be met, in a range of extreme one year outcomes (broadly referred to as the 1/200 or 99.5% test).

Although insurance companies do fail, the PRA has a broad array of powers beyond Solvency II to ensure that there are very rarely losses to policy holders. This is further underpinned by the Financial Services Compensation Scheme. The pensions regime addresses failure with members' promised benefits reduced to PPF or PPF+ levels.

Safe Pensions not "Insurance-lite"

It is not possible to stand simultaneously in both the pension and insurance regimes. Therefore, to coherently consider Financial Sustainability each respondent must decide whether their perspective is from insurance or pensions.

Clara believes strongly that given consolidation is about pension schemes, consolidation should not be created as cheap or low security insurance, rather it must be designed and understood as very safe pensions.

The Government will have no doubt sought appropriate legal advice as to whether as a matter of law, consolidators are insurance companies. Clara's view is that they clearly are not—they are pension schemes.

The Consultation correctly recognises that consolidators can be established under the current legal and regulatory regimes for pensions. It is logical therefore, that an improved authorisation and regulatory regime for consolidators should develop from pensions. The burden of proof is on those advocating for an insurance-based approach to clearly explain why.

Question 21 **Should superfund financial adequacy be regulated through a pensions based funding requirement approach with an added test of probability of success or an insurance based approach using a Solvency II type balance sheet?**

Clara's clear view is that the regulation of consolidators will need to be rooted in the pensions-based funding requirement approach.

The Need to Accommodate Uncertainty

The insurance regime, as we note above is, quite rightly, seen as the "gold standard" in pension run-off provision. It is designed to achieve near certain (but explicitly not zero failure) outcomes, underpinned by a one year solvency test looking at extreme outcomes. For consolidation to provide a viable alternative, it has to step away from providing these near certain outcomes. This is a fundamental difference between the pension and insurance worlds.

The debate over which regime is right—insurance or pensions—is long-running and counter-productive. Both approaches are built around the same techniques (cashflow projections, discounting and sensitivity testing). We should acknowledge, however, that both are right as they have been designed to operate in different circumstances.

The insurance approach is designed to ensure (with a 99.5% probability) sufficient solvency over one year, recognising that you are operating in an uncertain world. Financial adequacy is therefore aiming to ensure you have sufficient assets to 'survive' all but the worse outcomes, and this is underpinned by a lifeboat scheme that underwrites 100% of benefits in the case of annuities (FSCS)[19].

pension approach recognises that, whilst undesirable, outcomes are uncertain. It therefore aims to maximise the member outcome given the amount of capital (either held as real scheme assets or represented by the sponsor covenant).

Successful consolidation should transform (reduce) the level of uncertainty inherent in DB pensioners relative to the status quo. The remaining uncertainty is still fundamentally pensions like (a lower risk better funded pension scheme with a contingent asset and partial PPF underpin) rather than insurance like. (A decision to move away from this would suggest that the current pension regime is not fit for purpose!)

Consolidators are Pension "Heavy" Structures

A commercial consolidator differs from a traditional occupational pension scheme in that the sponsor covenant is replaced by the buffer capital. In both structures, however, the real assets of the pension scheme are significantly larger than either the expected value of the sponsor covenant or the buffer capital. For both pension schemes and consolidators those assets are (rightly) controlled by the trustees.

By contrast, when pension assets and liabilities are transferred to an insurer, they become part of a single, well capitalised insurance company balance sheet. he insurer has full control over how both capital and assets are invested.

Consolidators' group structures are dominated by pension schemes and need to be authorised and regulated as such.

Like Insurance?

Paragraph 86 of the Consultation identifies certain characteristics shared by insurers and consolidators. This is not persuasive. There are plentiful examples of solutions provided by both insurers and other entities.

Insurers do provide financial guarantees, but these are also routinely issued by companies of all description. Protection against credit losses is provided by insurers as credit insurance but is also provided in the FCA regime in the form of credit default swaps. Most topically, insurers successfully provide annuities but this is dwarfed by the pension obligations supported by for profit corporate balance sheets.

[19] The FSCS underpin was not always 100% for annuities and could be subject to future amendment. Most classes of general insurance are only protected at 90%.

A Matter of Law

It is accepted that consolidators can be established under the existing pensions legislation and regulatory framework. It is Clara's clear view that as a matter of law consolidators include pension schemes in their structures—they are not insurance companies.

Can 'Insurance-lite' be applied to Consolidators?

While it would theoretically be possible to apply an 'insurance-lite' regime to consolidation, it is unclear what a move to a less secure version of insurance actually means for members, particularly where the lifeboat regime is not 100% of benefits (and indeed the PPF itself is not treated like an insurer). Any decision to move to consolidation would need to consider both the probabilities of reduced benefits AND the level of benefits that would be provided (acknowledging this is time sensitive).

It is not clear what the appropriate messaging would be to transferring trustees around an 'insurance-lite' regime. Rather than articulating an improvement in member outcomes consolidators will be defending capital inadequacy?

A Solvency II approach will certainly raise the cost of consolidation. At the very least it will narrow the range of assets available to consolidators and their pension schemes (which in itself may inappropriately fetter trustees' investment discretion). This may have an unintended knock-on effect for insurers by increasing the competition for matching assets.

Familiar and Understood

The Trustees of any scheme considering a transfer to a consolidator, should carry out an evaluation of member outcomes in both the consolidator and the existing scheme. That assessment is directly comparable if both alternatives operate under a common regime, particularly if this regime is one that the trustees and their advisers are familiar with. This also allows regulation to focus on ensuring consolidators adhere to standards of practice, and that trustees have the appropriate guidance and oversight to deliver improved outcomes to members.

An insurance-based approach to consolidation risks undermining insurers by creating a cheap competitor, almost conceptually indistinguishable from them, but conversely would still make consolidation too expensive for the pension schemes and their members, that should benefit from it.

Question 22 **Which of the suggested models would best ensure appropriate financial adequacy, and balance the interests of the various parties? Are there elements of other options that you think should be combined with your preferred option?**

As noted above, insurance-based tests become problematic when you remove the requirement for security of benefit. Security is a one dimensional test—are the assets under a range of uncertain outcomes sufficient to meet solvency requirements in full? The answer is binary. When you introduce a lower level of security, the answer becomes multi-dimensional. What is the chance that full benefits are paid? What is paid in the event that full benefits are not paid? How does time interact with these two elements? The level of risk and expected loss are unlikely to be constant.

The complexity and uncertainty associated with pensions lend themselves to a statistical model based assessment. Such models are routinely used to assess the probability and impact of particular outcomes on a range of scenarios. Clearly any statistical assessment has an element of model risk. It is tempting to consider setting minimum funding levels, prescribed valuation bases and contingency reserves to make allowance for this. We recognise that this is one solution to the issue, but again being overly prescriptive falls into solution rather than regulation mode. In line with comments on the insurance like solution, a consolidation vehicle could choose one or more of these to deliver a solution but it should not be a requirement.

Financial adequacy for a consolidator is NOT the same as the financial adequacy for the scheme or what one would think of as an insurer (even with a 'weakened' target security). The scheme is an independent entity that operates along an agreed set of principles. The security of this is determined by the boundary conditions: initial funding level, asset strategy, benefits and population. Member outcomes are an output of these factors rather than a design principle. Consolidators should be designed to achieve better member outcomes.

Financial adequacy for a consolidator is the ability of the buffer funds to represent the covenant and support the payment of benefits in full as they fall due. This will be entirely dependent on how the covenant is structured.

Regulation should therefore focus on ensuring that a consolidator can properly articulate and demonstrate:

- an assessment of its own financial adequacy, and the impact this has on member outcomes;
- how its governance and risk management processes support (or detract) from the statements on financial adequacy;
- a clear statement of its long-term funding objectives (for example, to achieve insured buy-out within X years; or to achieve stable population at £Ybn); and
- how its profit taking approach impacts this and is controlled by financial adequacy tests.

AND, provide support for and oversight of trustee decision making, so as to;

- ensure the information suggested above is representative of the benefits offered by the consolidator
- help trustees to understand how the comparative assessment of security of the consolidator compares to the security offered by the current sponsor
- help trustees to understand the range of alternative options available to trustees (insurance, accelerated funding, contingent assets, etc.); and
- ensure any gateway test is embedded in all transfers to consolidators

Question 23 **Does a 99% probability of paying or securing members' benefits over the lifetime of the scheme adequately protect members' benefits, and effectively balance the competing priorities of employer affordability and member security? If not, what would an appropriate probability be, and why?**

As explained above, it is difficult to meaningfully express outcomes for members in a single metric (and Clara believes the metric expressed in the question is an inappropriate one). Expressing a target in this way suggests a false sense of security. This is particularly problematic if this ambiguous target is then used as a design principle for any particular consolidation model. This inevitably means that the desired diversity in consolidation models will be demonstrated by meeting the minimum standards with differing levels of confidence. By extension, a more complicated or prescriptive minimum level of funding may reduce ambiguity but will further restrict the range of solutions available.

We recommend that regulation focuses on the areas outlined in our response to Question 22. We strongly believe the level of security offered by a consolidator should be an output of regulatory assessments rather than a principle of design. This is entirely consistent with the ambition of having a range of consolidators, providing differentiated solutions appropriate to different segments of the market. There is a huge gap between those schemes entering the PPF and those who achieve the 'gold standard' of insurance. It is unlikely that one solution will bridge this gap, especially when you consider the range of funding levels, level of maturity and strength of covenant of the underlying pension schemes' employers.

It is also important to recognise that any statistical assessment of outcomes will have an inherent element of model risk, and regulation should recognise that any relative assessment of outcomes should not be skewed by or be dependent on that model risk. The risk of this could be minimised by requiring consistent comparative assessment of outcomes: this would mean using the same model to assess the range of outcomes before and after transfer (this could be a statistical or deterministic approach using a regulation based and mandated set of scenarios). In addition, the threshold for transferring could be that members are expected to have a meaningful improvement in outcomes. The assessment of "meaningful" is clearly open to interpretation; but relying on trustees' discretion with a requirement to justify seems consistent with current trustee duties.

Members will not be well served if the analysis of the end-game solutions (including consolidation and the status quo) focuses on model inputs and outputs rather than member outcomes. It is important to not lose sight of the objective—providing safer pensions for members.

A Minimum Standard

Clara recognises that a minimum standard, however expressed, would provide credibility to the emergent consolidation sector and accelerate adoption among transferring trustees. It is Clara's understanding that there is broad consensus among both pension and insurance professionals, that any minimum standard must allow for a clear demarcation between the outcomes offered by consolidation and insurance.

Clara shares this view and believes that the proposed 99% probability is too high. It risks confusion with the 99.5% test under Solvency II and could potentially represent a higher level of confidence than that offered by insurers. This would seem to be an inconsistent outcome.

A high standard is outwardly attractive but too high a standard risks unintended consequences:

- The cost of entry into a consolidator will be high and therefore only benefit a small number of schemes and members;
- The cost of entry into a consolidator will be prohibitive so an alternative end-game solution for members will not exist at all;
- In order to balance the high cost, the only solution available to a consolidator is to follow a higher risk investment strategy. This would seem counter to the policy objectives of consolidation and risk attracting participants who are unwilling to place members first.

In addition to a minimum probability of paying benefits over the life of the scheme/section, Clara would encourage the Government to consider other alternatives as well. For example, the probability of paying benefits over a defined period (which would be easier to model).

The problem is easily understood if you consider two small schemes: the first has a weak covenant and limited sponsor resource to fund risk transfer; and the second has a strong covenant and sponsor that could afford to buy-out if it so chooses. The policy direction of the Consultation would want the first to have the option of consolidation, but the second should proceed to buy-out. If the security mandated for consolidation, and therefore its cost, is too high you will get a perverse result. The first scheme will be priced out of a solution and the second would pursue consolidation being cheaper but of almost the same security as an insured outcome. Clearly, a gateway would become very difficult to administer.

Question 24 **Should a superfund have a long term objective to secure benefits with an insurance company?**

We do not believe this is a necessary or appropriate requirement (although note that this is a stated objective of the Clara solution). As noted in our response to Question 22, Clara does strongly believe that any consolidator should have a long-term objective, and be required to articulate and demonstrate it.

It is also worth noting that this comment relates to long term objectives. The answer to Questions 37 to 40 discusses the appropriateness of insurance to trigger events.

Question 25 **Is the proposed authorisation basis suitable for this purpose? If not, what basis, if any, would you propose for this purpose?**

As outlined in our response to previous questions, we do not believe that the proposed authorised basis for financial adequacy is appropriate for the regulation of consolidation vehicles.

We do see some merit in having a specified basis to allow a comparative assessment of outcomes for members between their exiting scheme and potential consolidation vehicles.

Question 26 **Is a 97.5% probability of being 100% funded on an authorisation basis by the earlier of 2040 and the date the scheme reaches its estimated peak cash outflows consistent with the principle of a superfund having a 99% probability of paying or securing members' benefits at all times?**

Question 27 **Is the earlier of 2040 and the independently assessed point at which the superfund's membership reaches peak maturity a reasonable target date?**

Question 28 **Are the additional minimum standards in (iii) needed, in order to ensure a high level of protection for member benefits? In particular, are the additional minimum standards (that the superfund scheme itself is funded to 87.5% on the authorisation basis) required for every scheme entering a superfund?**

Clara's response to Questions 26 to 28 follows below.

As per our response to Question 24, we see these as examples of a potentially suitable long-term objectives rather than being an absolute requirement.

Question 29 **Should superfunds 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?**

Clara believes that transparency is an essential part of any regulatory environment. An integral part of this is ensuring that transferring trustees have sufficient information to assess the suitability of the vehicle to which they are transferring. A clear statement of assets (including buffer funds), liabilities, new business volumes and how profit taking might impact the security offered to members is a key part of this. More broadly, the basis and methodology underlying annual statements should be consistent with any long term ambition. If this is buy-out then an appropriate buy-out basis should be included—we recognise though that there is considerable variation in how such a buy-out basis is expressed or calculated.

It is important that the impact of system failure or discontinuance is understood. The appropriate disclosure should be driven by the discontinuance triggers.

As an aside there is clearly a discussion to be had about whether trustees of ongoing schemes ought to provide members with similar annual balance sheets. A case can be made that this would assist members to better understand a future transfer to a consolidator or insured buy-out.

Question 30 **Should superfunds be required to secure benefits with an insurance company as soon as practicable, once the scheme assets reach the buyout level of liabilities?**

Clara does not believe this should be a requirement.

In Clara's specific model, there may be limited situations where in order to accept a scheme into Clara it will be necessary to run on beyond the point at which that scheme (now section) could buy-out. This could potentially occur in a PPF+ case where there would be no sponsor funding contribution and it would be necessary to generate a surplus in the scheme at buy-out to afford Clara's capital a reasonable opportunity to make a return after members' benefits have been secured.

Question 31 **Should superfunds be required to maintain a minimum level of scheme funding regardless of approach to financial adequacy? This could include a separate long term objective for the superfund scheme itself to reach a buyout level of funding but to a lower level of probability than the superfund as a whole?**

Clara does not feel this should be a requirement. An additional funding underpin should be approached with care—it may lead to excessive prudence and cost. A balance is needed between improving member outcomes and degrees of certainty.

Clara PENSIONS

Question 32 **Is the failure test in relation to the PPF funding level proportionate and what probability of failure is acceptable?**

Clara agrees that protecting the PPF, and its levy payers, is a meaningful benefit of consolidation. Encouraging sponsors to fund their schemes today up to the level of entry required by a consolidator and attracting new, permanent and funded capital to support UK pension schemes materially reduces risk to the PPF. Clara's sectionalised model has the further benefit of mitigating the concentration risk that could accumulate over time in a consolidator that operates on a non-sectionalised basis.

Clara also believes that consolidators should be required to model and regularly report on their risk of triggering wind-up; and that this should relate to the PPF funding level given that this is the threshold at which risk of failure is borne by the pensions sector more generally rather than just the capital provider and members.

That said, Clara would argue that setting a probability of failure, defined as PPF entry, would be inconsistent with the existing pensions regime and with other proposals set out in the Consultation: The PPF exists specifically to deal with the failure of sponsors of occupational DB pension schemes. The appropriate test, therefore, should not be the probability of PPF entry but the probability of causing a loss to the PPF.

1. Paragraphs 124-129 of the Consultation suggest that a consolidator should be wound-up if its funding level falls below a threshold set at a level above the s179 funding level. If this is the case, a failing consolidator would enter PPF assessment with an asset surplus on the PPF basis and the probability of loss to the PPF would be negligible.
2. An authorisation requirement based on the probability of failure would result in consolidators being "charged" twice for the same risk as this potential cost to the pension industry is already reflected in the levy for consolidators proposed by the PPF. Providing for this risk through the PPF levy is a much more nuanced approach as the current PPF approach takes account of the different legal structures of consolidators as well as their likely different investment strategies.

Question 33 **What powers should TPR have to intervene should a funding level trigger be breached?**

TPR notification in the event a funding level trigger is breached should be an absolute requirement. It would also be reasonable, as a matter of best practice, for TPR to expect that both the trustees and managers of the consolidator would communicate with the Regulator if a funding level trigger breach appears likely in the short to medium term.

TPR already has wide powers of intervention, it is therefore important that the Regulator has the power to request relevant and timely information from both the trustees and consolidators to satisfy itself that appropriate remedial action has been both agreed and taken.

Clara PENSIONS

Question 34 **At what level above fully funded on the S179 basis should the winding up trigger be set?**

Question 35 **Is three months an appropriate period of grace to allow for any volatility in investments to recover before triggering a wind up?**

Question 36 **Is this minimum funding level trigger sufficient to provide adequate protection for the PPF while mitigating the risk that short term volatility might force a superfund into the PPF when it still might have a very good chance of meeting the long term objective?**

Clara's response to Questions 34 to 36 follows below.

Clara agrees that a winding up trigger on a s179 basis is appropriate to reduce the risk of claims on the PPF from the failure of a consolidator. The trigger should operate, however, to prevent unnecessary wind-up and allow an efficient and orderly wind up when required.

In designing an appropriate trigger mechanism, it is essential to consider six interdependent factors.

1. The Level of the Trigger—Clara believes that a trigger set at 102-103% of the s179 basis should provide more than sufficient protection, or a risk-based margin set above the PPF funding level could reflect the duration of liabilities and investment risk. This could be based on detailed modelling or use the levy calculation as a proxy for risk. A trigger level that is set too high will have the unintended effect of making consolidation very expensive (or unaffordable) for schemes that have a high PPF basis (for example, schemes with statutory minimum pension increases). Paragraph 135 of the Consultation correctly points out that the PPF liability basis of a scheme will converge upwards as the scheme matures and in other respects becomes less risky. It would be strange for this expected evolution of schemes to trigger a wind-up.
2. Measurement Period—Should there be a single measurement point, or is it more appropriate to have an averaging period? Clara would argue that an averaging period (for example, a rolling average of the trailing three month end valuations) would be more appropriate given the price volatility of assets (and liabilities).
3. Who does the measuring?—Given the severe consequences of breaching a wind-up trigger, Clara would argue that the triggering valuation needs to be verified by an independent third party (for example, the scheme actuary).
4. Length of the grace period—A three month grace period as a starting point seems reasonable, but the Regulator should have discretion to shorten or lengthen this to account for specific factors of individual consolidators, the background to the funding shortfall and the circumstances of the wind-up.

5. Remedy—The grace period should not just be used to allow asset prices to recover but should also be an opportunity to seek alternative remedies (for example, seeking further external capital to be injected into the buffer, or, perhaps, transfer to another consolidator). This more closely aligns with the DC master trust regime. Clara would anticipate that any such alternative would be subject to Regulator consent.

6. Consequences of Breach—If a remedy cannot be found, Clara agrees that automatic entry to the PPF assessment period is the right approach to ensure member protection.

Triggers based on the mark-to-market movement of assets (and liabilities) carry significant risk of unintended consequences. Clara would argue forcefully that the Regulator must therefore retain the discretion to waive the trigger, alter the grace period or agree alternative remedial action with the consolidator and its trustees.

Question 37 **Do you agree that there should be a Tier 1 funding level trigger to protect members' benefits at this level?**

Question 38 **What would be the best way of expressing this trigger?**

Question 39 **Is three months an appropriate period of grace to allow for any volatility in investments to recover before allowing trustees access to the capital buffer?**

Question 40 **Should TPR have the power to intervene and require wind-up or transfer if they believe the trigger has not been acted on in the best interests of members?**

Clara's response to Questions 37 to 40 follows below.

Paragraph 130 of the Consultation justifies the Tier 1 trigger as follows: "members might reasonably expect to get full benefits even in the case of a superfund which is deemed to be failing but is not an immediate risk to the PPF". This loses sight of the policy objective of consolidation—it should be safe pensions, not weak insurance. The correct test, therefore, is are the members' benefits more secure with the consolidator rather than the transferring sponsor? It is not whether members benefits will be 100% protected even in the case of consolidator failure.

Clara believes that the proposed Tier 1 funding level trigger would be redundant. Paragraph 135 of the Consultation correctly recognises that this trigger will certainly become conflated with the wind-up trigger, which will create confusion and uncertainty in how consolidators seek to remedy what will be a stressed financial position.

In circumstances where Tier 1 is "at risk", Tier 2 will already have been breached, thereby preventing the consolidator from writing new business. If a consolidator found itself in the "no man's land" of not being able to write new business and at risk of a complete loss of capital in the event of wind-up the economically rational consolidator would seek to preserve capital by either buying-out (if possible) or transferring to another consolidator. It is worth highlighting, however, that both of these alternatives are unlikely to be feasible at these levels.

If as Clara suggests no Tier 1 trigger should exist then this question becomes redundant.

If a Tier 1 trigger **is** considered appropriate, it is submitted that the risk TPR is trying to mitigate would be better addressed through the existing statutory valuation process. If, on the trigger, a statutory valuation was called, and the outcome of that valuation was that the scheme was underfunded and had no prospect of recovering, the trustees and sponsor (in this case the consolidator) would be required to agree a deficit recovery plan. The trustees lead this valuation process and it may therefore be a better solution to give the Regulator the power to trigger a valuation?

The proposed level of the wind-up trigger is objective in that it is linked to s179, which is well understood. If the proposed Tier 1 trigger is applied, it is clear that any level suggested would be subjective and potentially arbitrary. Rather than struggling to select an arbitrary subjective level, it would be preferable to recognise the subjectivity through a regulatory discretion to trigger a valuation, which would bring all recovery options to the fore.

Question 41 **is this a reasonable basis on which to prevent new business being written, or should this be left to the discretion of the superfund trustees on the basis they should not be accepting new business if it would have a detrimental effect on existing superfund members?**

The Tier 2 (or new business) trigger is sensible in the context of a single fund consolidator, where the interest of potential new members could be unfairly compromised if they were required to subsidise existing members of a consolidator where funding levels were below the authorisation basis. That said, it seems highly unlikely that transferring trustees would agree to transfer into a consolidator when as a result of the transfer, or indeed prior to it, the consolidator's existing funding level had fallen below the authorisation basis.

It is important for Clara to highlight that a new business trigger does not make sense in the context of our sectionalised solution, where each section is funded with its own permanent and ring-fenced capital. The strength of this structure is that it explicitly prevents cross-subsidy between different groups of members with different funding levels. Denying a potential incoming section the benefits of consolidation just because one section has fallen below the tier 2 trigger is contrary to the policy objective of consolidation as a whole, and the interests of both the members of the underfunded section (who may yet benefit from greater scale) and the potential transferring scheme.

It is important to recognise the role of trustees in this as well. Although not relevant in a sectionalised scheme to address the risk identified in the consultation, it confers a further degree of protection if, for any other reason, it is not in members' interests to accept new business.

Question 42 **Is it reasonable to only allow investors to take a profit after they exceed the requirements for authorisation and if so on what basis?**

Question 43 **Is it reasonable to retain investor profits for a period to mitigate against profits being taken from market volatility rather than genuine outperformance?**

Question 44 **Should superfunds be restricted from taking profit until the funding level is above that required to secure a buyout?**

Clara's response to Questions 42 to 44 follows below.

External capital is absolutely fundamental to consolidation—it brings funded resources, not otherwise available, to support members. Capital reduces the risk to members by bearing the first losses and therefore must have a reasonable expectation of profit (albeit we note that, although no models have emerged, the consolidator framework would not preclude not-for-profit capital). The key questions therefore are what is a reasonable profit and when (or in what order) is profit extracted?

Clara strongly believes that this Consultation is about establishing the best policy framework for consolidation and is not about different models of consolidation. While consolidation is not a solution for all DB schemes it can be a meaningful end-game for many. Clara firmly believes that a competitive market, and especially one that allows different models to emerge, is in the best interests of both sponsors and members.

Clara's approach is member-first—there is no profit extraction until all members in a section have their full benefits secured. That said, there is no reason that an appropriately structured profit extraction mechanism cannot be part of a consolidator offering. It is, however, a clear reality that any profits distributed to capital providers before members have their full pension promise fulfilled would reduce the value of the consolidator's covenant. It will be important that sponsors and transferring trustees fully understand the implications (both positive and negative) of placing their members into such a structure.

It would seem sensible that any proposed extraction of profit should be notified in advance to both the Regulator and the consolidator's trustees. It remains an open question how profit extraction can be calibrated to ensure that the ongoing covenant is not depleted below a prudent level of safety. Whatever test is applied for profit extraction will also have implications for how new business is written and will need to be applied consistently.

Question 45 **Is it reasonable to allow a sectionalised superfund to take profit or write new business if one or more sections are inadequately funded?**

Yes.

A particular section may be weakly funded for a range of reasons—some outside of the control of the consolidator, for example legacy asset exposure, idiosyncratic actuarial experience or historic issues which have emerged. Any blanket prohibition on taking profit or writing new business would be disproportionate and disregards the benefits of sectionalisation.

In addition, it is critical to acknowledge the importance of attracting risk capital to the consolidation market. Capital providers understand and accept that any capital they invest in a particular section of a consolidator is fully at risk until such time as those members' benefits are secured, but it is a disproportionate risk to the return to expose their investment to the risk of every section in the consolidator.

It is important to reiterate that Clara strongly believes that this Consultation is about establishing the best policy framework for consolidation and should not be about determining a prescriptive model of consolidation.

Question 46 **In relation to the criteria for financial adequacy and funding level triggers discussed above, should each segregated section within a sectionalised scheme:**
a) be considered separately for financial adequacy purposes and also considered separately for the funding level triggers;
b) be aggregated together (along with the capital buffer) for assessing financial adequacy but each section is considered separately in relation to funding level triggers;
c) be considered separately for assessing financial adequacy but be considered together as a whole when assessing whether the collective scheme funding position meets any of the funding level triggers; or
d) be aggregated together (along with the capital buffer) for assessing financial adequacy and considered together as a whole when assessing whether the collective scheme funding position meets any of the funding level triggers?

Both financial adequacy and applicable funding level triggers should be assessed on a section by section basis, having fully taken account of the capital available to support that section. For authorisation, however, the business model ought to be considered as a whole when determining the overall viability of the consolidator.

Sectionalisation is Member-First

Clara's solution is sectionalised at both the asset/liability and capital levels. The assets and liabilities of each new scheme that enter Clara will become a section within the Clara Pension Trust. Capital too, is sectionalised in that each section has access to its own funded, permanent and ring-fenced capital. Sectionalisation is not the obvious choice for consolidation, but it is the right one—it is our "super power":

- Member-First—sectionalisation allows Clara's capital providers to put members first.
- Replication of Benefits—the benefits of each transferring schemes are replicated in the receiving section.
- Clarity of Funding—it is clear to both the Regulator and transferring trustees what level of security is being provided to the members in each section.
- Consistency of Funding—the security provided to members in each section is unchanged by future transactions.
- No Cross-subsidy—the security provided to members in each section is not affected by the entry of other sections to the platform.
- No Cross-subsidy—Clara does not ask members of one section to subsidise or take responsibility for the legacy problems of other sections
- Buy-ins—continue to support the members for whom they were originally purchased.
- Reduce Risk to PPF—by removing the concentration risk associated with a single non-sectionalised scheme.

Question 47 **Does this approach provide adequate protection for members, while effectively balancing the interests of the investors?**

Neither of the approaches outlined in paragraphs 149 to 152 of the Consultation provide balance between member and investor.

"Option 1" is untenable because of the taxation of surpluses arising in DB pension schemes. It is outwardly attractive to suggest that in the event of a deficit in the scheme assets should pass from the buffer to the scheme and the reverse should apply in the case of a scheme surplus. Unfortunately, the tax treatment associated with the flow of surplus from scheme to buffer, effectively makes scheme contributions a one-way valve.

"Option 2" is also flawed in that it is at odds with how pension schemes operate, is unbalanced between scheme and buffer and would be operationally impractical:

- There are many occupational pension schemes with current funding deficits. This, however, does not give the trustees of those schemes the power to operate a portion of the sponsor's business. That is effectively what Option 2 suggests.
- If the trustees have the right to control a portion of the assets in the buffer in the event of a deficit in the scheme, it would be logical (although mischievous) to argue that the capital provider should control a portion of the scheme assets in the event a surplus arises. This would be a dangerous and unadvisable logic to pursue.
- If trustees are handed control over a portion of the buffer assets, how do you determine which assets and how will such control be practically administered? Should they have control over specific assets or a pro-rata share of all? More confusingly, what would be the position of the trustees under the Financial Services and Markets Act 2000 and would they be liable to the capital providers for negligent management?

Clara believes that the solution to this problem is straight-forward and clear.

Central to this is an understanding that consolidation replaces the existing sponsor's variable covenant with a fixed covenant. This fixed covenant has three components:

1. The amount of funded capital within the buffer vehicle;
2. The investment strategy associated with those assets. A higher risk strategy weakens the covenant and a low-risk strategy strengthens it; and
3. How the buffer assets are secured, protected from dissipation and made available to the trustees (and Regulator through its "moral hazard" powers) to support the scheme.

If the consolidator is structured correctly, the necessary balance between **first** protecting members and incentivising capital is achieved as follows:

- Trustees have control over the investment decisions associated with scheme assets. This is already the position under the existing arrangements for DB schemes and must be maintained;
- The consolidator (on behalf of capital providers) should have control over the buffer assets. This too is analogous to other pension schemes where the operating business that is the covenant is run by its management reporting to its board of directors.

- If deficits arise in the scheme, these should be dealt with using the same mechanisms that trustees and sponsors use today. The one clear caveat is that in the case of consolidators, deficit recovery plans that extend beyond the short term would be inappropriate. Consolidators are likely to be more actively managed than most pension schemes with a close and continuous dialogue between trustees and the consolidator. Well managed consolidators will identify emerging deficits in advance and work with their trustees to appropriately mitigate them.
- In a consolidator the trustees should have the benefit of an 'overlay' of a restriction on dissipation; no such protection is generally available from a traditional sponsor.
- It is necessary to acknowledge that because of the tax point raised above, consolidators will be wary of moving assets from the buffer into the scheme. Provided the buffer is secure, protected from dissipation and made available to the trustees when needed, this issue can be managed.

Question 48 **What are the minimum requirements on a buffer fund in order for the scheme to be able to rely upon the assets being available in the event they are needed?**

Question 49 **Should there be minimum standards on the capital buffer to ensure it can be relied upon in stressed situations?**

Clara's response to Questions 48 and 49 follows below.

It would be difficult and unnecessary to prescribe a particular structure for the buffer fund as it can be appropriately designed in a myriad of constructs. It could be unhelpful to stifle innovation in this developing market by setting parameters that go beyond the general principles the Government is striving to set out. It is, however, possible to clearly state the principles on which buffers should be structured:

1. Availability—the buffer should be available to the trustees to ensure that they are able to receive the assets into the scheme in a discontinuance event;
2. Protection—the buffer must be protected from dissipation and financial leverage. The question of dissipation will need to be thought through carefully by consolidators that are proposing profit extraction as part of their financial model;
3. Proximate to the Trustees—the buffer should be proximate to the trustees and structured to be available for contribution into the scheme when needed; and
4. Regulated—the buffer should be within the scope of the Regulator's "moral hazard" powers.

The legal structure of each consolidator's buffer should rightly be tested as part of TPR's authorisation and oversight regime.

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Question 50 **Is it reasonable and proportionate to require superfunds to provide detailed fund guidelines, and does this provide the regulator with sufficient information?**

It is important to bear in mind that scheme assets will always be multiple times the size of the buffer assets and that scheme investment decisions currently are, and must remain, under the control of the trustees.

It is of course both reasonable and proportionate for the Regulator to require a detailed understanding of the investment strategies for both scheme and buffer assets. The Regulator must be notified of any material changes to either investment strategy.

Both the detailed fund guidelines and line by line position reporting should be available to the Regulator on request, but Clara believes that they would provide TPR with too much detail for effective oversight and decision making. They would crucially lack any sense of context or strategy.

There is also a danger of TPR becoming too closely involved in trustee decision making. The current framework for ongoing schemes of trustees ultimately being responsible for the investment strategy, advised by consultants and with appropriate reporting remains suitable for consolidators, albeit with the consolidator overseeing the buffer fund(s).

Question 51 **Should superfunds be required to submit their modelling for TPR to review, or should TPR develop a model against which they can assess all superfund proposals?**

Clara agrees 'that sufficient detail should be provided to TPR to enable them to understand the assumptions and approach used in the modelling'. Any consolidator should be able to demonstrate how risks have been considered and assumptions have been tested.

Clara believes that any work undertaken to provide assurance around modelling or to test assumptions used should also be shared. TPR should also be able to commission appropriate external analysis of any models used.

Clara believes that this oversight of models is like to be more useful to TPR in testing model outputs, and more appropriate regulatory oversight, than reviewing of the detail of the modelling work itself.

Clara does not believe it appropriate for TPR to develop a standard single model against which a range of different consolidators and consolidation approaches would all be tested. That said, in addition to their own assumptions there is a good argument for consolidators to also be required to disclose their outcomes using a common set of assumptions. This would greatly aid trustee decision making through direct comparability of different models of consolidation.

Question 52 **Should TPR have a 'fall back' model for cases when the modelling provided by superfunds is not adequate?**

Clara believes that appropriate and robust modelling should be an authorisation requirement and therefore inadequate modelling should either not arise, or, if it does should trigger remedial action rather than the use of a 'fall back' model.

Question 53 **Should there be any other reporting requirements of either the corporate entity or pension scheme to ensure effective supervision?**

The approach proposed seems appropriate.

TPR should, however, be clear on the level of stress testing and sensitivity analysis likely to be required and the purpose behind it. There is also a strong practical case to make for a single return for both scheme and corporate entity as both are based on the same underlying data.

We believe that the requirement for annual Chair's statements that applies to ongoing schemes should also apply to consolidators.

Question 54 **Should the corporate entity and pension scheme have to disclose their strategic asset allocation and investment risk limits so that TPR can effectively supervise the investment strategy?**

Yes. This would be a more proportionate and appropriate approach than that considered under Question 50. There would obviously be a relevance threshold for the level of investment risk information needed by TPR for the effective supervision of consolidators.

Question 55 **Should superfunds be required to regularly publish publicly available material on their financial position and operations?**

Clara strongly supports transparency for the benefit of members, the Regulator and schemes considering a transfer to a consolidator.

Public quarterly reporting in a rigid format is likely to engender short-termism. Clara therefore suggests any public disclosures are on an annual basis but that as part of the agreed approach to member engagement and communication materials would be available to provide appropriate levels of education and information. The test that TPR should apply is whether the consolidator is delivering the engagement approach and strategy agreed.

The experience of recent years is that defined benefit pension benefits do need to be explained in context and not presented simplistically otherwise members are placed at risk of being misled and poorly advised to their detriment.

Consolidators will also have broader audiences beyond members—regulators, investors, policy makers, wider civil society etc. Each must have access to suitable information about the consolidator.

Question 56 **Would the proposed events outlined in Table 1 meet the aims of the significant events framework?**

Yes, although Clara believes that materiality thresholds, together with clear guidance on the interpretation of those thresholds, will be necessary in respect of certain events listed. This is most clearly illustrated when considering the consolidator's business plan, which encompasses every aspect of the consolidator's operations. At what threshold does a tactical change become a notifiable strategic change?

This is an impossible question to answer. The only practical solution is through a close regulatory relationship between the Regulator and the consolidator where information is shared as a matter of course. Given the difficulty in identifying where a materiality threshold should be drawn, Clara would argue that the notification requirements under the significant event framework can be satisfied through regular information sharing with the Regulator and will not require a formal notification process.

Clara also believes that changes to a consolidator's corporate structure should also be notifiable.

Question 57 **How could we define 'significant deterioration' in relation to investment performance and funding level?**

It would be appropriate as part of the authorisation process with TPR to agree appropriate thresholds on the basis of the consolidator's model and its specific circumstances. These should be revisited as part of the annual review process of the consolidator and any reviews of its modelling framework, and in the context of the consolidator's scale.

Question 58 **Should TPR's executive arm have the power to unilaterally commission a skilled persons report in relation to superfunds with TPR acting as the end user?**

Yes, although the cost of unilaterally commissioned reports should fall on TPR rather than the consolidator itself. Given the level of information likely to be provided by a consolidator, the agreed authorisation basis and ongoing monitoring, TPR should develop significant expertise in overseeing consolidators. Skilled persons reports are a useful tool and therefore TPR should have access to them but as an exceptional tool commissioned by TPR's board.

Question 59 **Would an enforceable Code of Practice be sufficient to allow TPR to respond quickly and proactively to emerging market risks and supervise effectively?**

Yes. As noted in the Consultation and at a number of points in this response, consolidation is an evolving area. There are new models emerging and issues will emerge as the sector develops. A rigid legislative framework should not be created for consolidators; rather (and where possible) TPR should use flexibility and discretion in a risk-based, consolidator specific and proportionate manner which can evolve as the sector evolves. Flexibility will encourage innovation and new entrants to the market, resulting in increased competition which will strengthen the offering for members in this space. An enforceable Code of Practice will benefit consolidators and ultimately members in creating a fluid regulatory system without gaps, and able to respond to market development while properly holding consolidators to account.

Question 60 **In your view, what areas of a future code should be enforceable?**

As noted above and below, Clara believes that for most key areas of consolidator operation—such as authorisation, funding, governance and transactions—legislation should create the framework and detailed implementation should be left to the Code of Practice. The scope for such Code is therefore likely to be broad.

Clara would therefore argue that the whole Code of Practice should be enforceable, but the Regulator must retain an appropriate power to grant specific exemptions on a case-by-case basis to allow for variability in different consolidators' models.

Question 61 **Would the proposals outlined in Chapter 4 allow for the effective regulation of superfunds? Are there any other powers needed for TPR to intervene where necessary to effectively regulate superfunds?**

Clara believes that the consultation has considered all of the relevant areas.

Question 62 **Should superfunds be subject to a bespoke levy to fund their ongoing regulation?**

Clara believes it is appropriate that consolidators pay the costs associated with their authorisation.

We do not believe that a consolidator specific levy is appropriate. The number of consolidators is likely to be limited and the framework detailed in the consultation outlines a high-touch regulatory regime. While ongoing costs of this regime might possibly be appropriately recouped from consolidators, it would be inappropriate that a small number of consolidators might bear the costs of more intrusive scrutiny of a failing consolidator. The costs of such a resolution might be significant and recovering these from better run competitors would be unfair.

It might also be the case that if a consolidator specific levy were adopted, complete and detailed transparency from Government and the Regulator might be expected as to how monies raised from such a levy were calculated, spent and ring-fenced.

Consolidation Transactions—The Gateway

Clara unambiguously supports the principle of a "gateway" for schemes considering consolidation or any other end-game solution. Clara's solution has been built as a bridge to buy-out—the "gold standard" outcome for members of closed, defined benefit pension schemes. While the long-term health of the bulk purchase annuity market is crucial to the success of Clara's model it would be wrong to construct a gateway to protect insurers. Consolidation must put members first, therefore so too must any gateway.

A well-conceived gateway should meet the following conditions:

1. Strengthen not Replace the Existing Gateway—Trustees of existing DB pension schemes are already tasked with the fiduciary obligation of paying benefits in full as they fall due. They are already the gateway for decisions about schemes' 'end-games'. Any additional regulatory gateway in respect of consolidation should support, not supplant their decision making.
2. Member-First—Any scheme decision must be the best option for members giving them a better chance of receiving their full benefits.
3. Principle not Rule Based—DB schemes all exist with different benefit structures, funding and sponsors therefore any well-meaning attempt to draw bright lines will only create perverse results.
   The market has already misinterpreted paragraph 201 of the Consultation as an absolute, but for a high street retailer five Christmases is likely to be a highly challenging period whereas a long-term regulated monopoly can probably model their business reliably beyond ten years (depending on where they are in the regulatory cycle).
4. Recognise that no action is a decision—Any gateway test should not just consider whether members might do better by waiting for buy-out but also what is the risk of them doing worse?

Question 63 **Do these principles achieve the policy aim?**

We agree with the policy aim. Trustees should consider the specific circumstances of their scheme and rely on professional assessments to guide their decision making. Regulatory oversight should then reflect those specific circumstances.

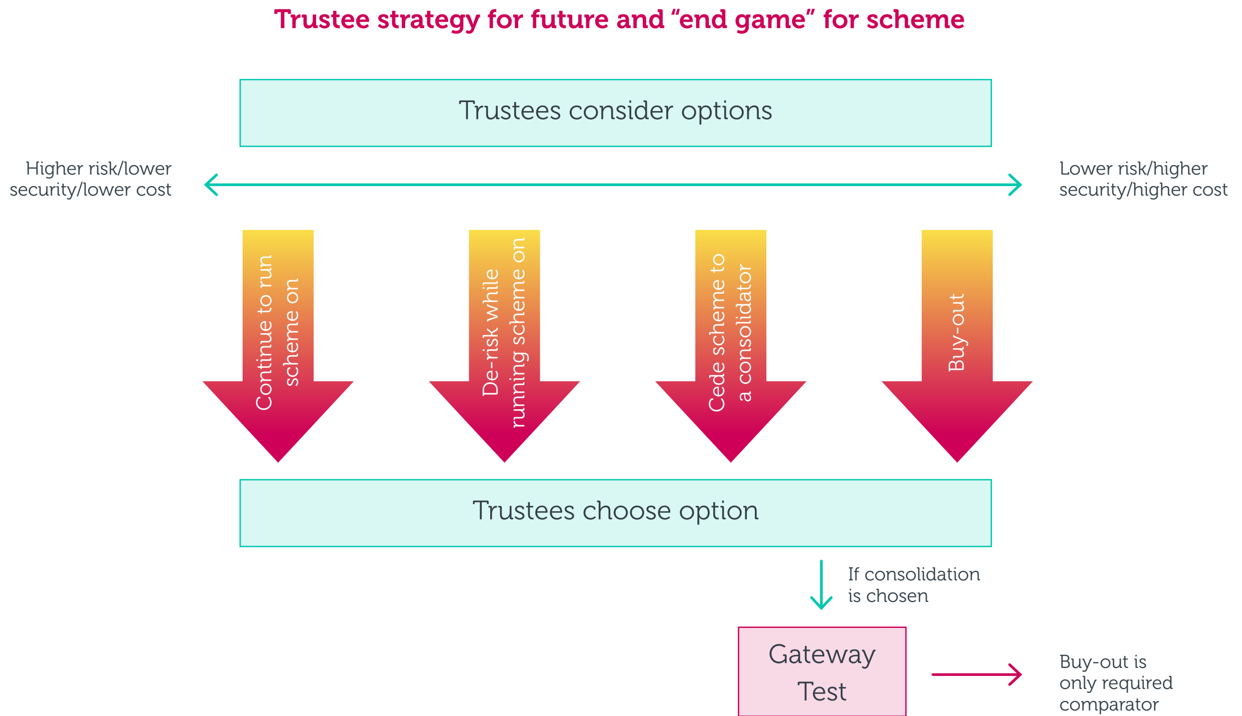
It is right that trustees should be considering the strategy for the pension scheme and potential 'end-game' destinations for their members. They should be thinking about the risks weak scheme funding and employer insolvency might pose to their chosen path and might ultimately pose for members. The combination of scheme funding and sponsor strength (or, indeed weakness) may pose a significant risk to members receiving their full benefits. Alongside this, the role that consolidation, buy-out or any other 'end-game' solution might play should be a natural part of trustee consideration and decision making.

There should be suitable requirements and guidance about what trustees should be considering as part of making decisions about the future of their scheme. It is right that tests are applied to ensure that moving to a consolidator offers the best available outcome at that time for members. Clara agrees that any type of formulaic gateway could create perverse outcomes. This is also true of overly prescriptive principles.

The purpose of the gateway test should be to protect members by supporting good trustee decision making about **all** future options. It should be a framework for trustees deciding the future for their scheme, where consolidation might be one option. As currently presented, the gateway is a test for trustees deciding on consolidation alone, which might be one of many available options. Members would be best served by options, and the risks they pose, being considered together.

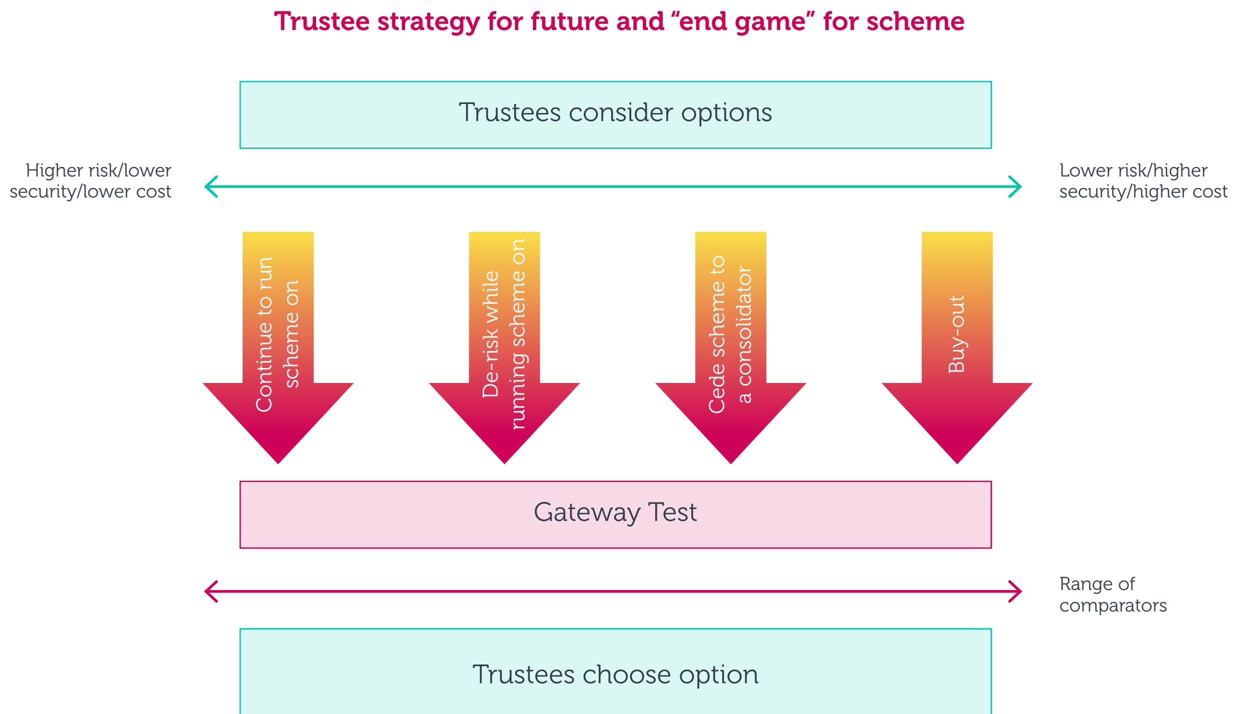
While the factors to be considered are appropriate, Clara believes that the proposed gateway test for transactions has been framed too narrowly—it would be better as a framework for trustee decision making about all 'end-game' options available to their scheme and members—including consolidation, but not just consolidation alone. Members moving to a consolidator should not be an isolated event, with decision making and analysis sitting in isolation, as the current gateway test could be construed. Likewise, the comparator in deciding to move to a consolidator is not simply the possibility of moving to an insurer but also the risks to members of the status quo. The likelihood of members receiving full benefits should be considered in a range of scenarios.

Chart 6: Gateway test as proposed



Source: Clara (drawing on consultation)

Chart 7: Gateway test as suggested by Clara



Source: Clara

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Clara would suggest therefore that the principles discussed in paragraph 205 be reframed. Clara agrees that schemes reasonably able to buy-out should be expected to do so. Clara proposes that all options available to the trustees should be considered in terms of their likelihood of members receiving full benefits—not just consolidation.

There is also an implicit presumption in the gateway test as currently framed that trustees are only considering a single consolidator in their decision making. Given the likely emergence of different consolidation models it should be expected that trustees are considering different consolidators as part of their decision making. The currently proposed gateway test would be problematic in these circumstances.

Trustee Duties

Paragraphs 197 and 200 make reference to trustees acting "in the best interests" of members/beneficiaries. There is no such general duty in trust law (see MNRPF [2015] EWHC 448 (Ch), para 229); rather one must look at the purpose of the trust and particular power the trustees are exercising.[20] With consolidation the key power being exercised is a bulk transfer power. Clara's view is that the purpose of such powers is usually to facilitate a change to the sponsoring employer's pensions arrangements in a way that does not undermine the chances of the relevant benefits being delivered.

It may be Government's policy objective to establish a test for transfer to a consolidator based on members' best interest; but in order to meet that objective we would caution against setting a test that is formulated solely around "improving the security of members' benefits". It is right that security should form a part (indeed, a large part) of the trustee's consideration of whether it is in the interests of members to transfer to a consolidator but it is conceivable that the transfer to a consolidator may bring the same level of security to members' benefits but confer additional benefits of improved governance, access to improved investment options etc which overall, weigh in favour of a transfer to a consolidator.

Question 64 **Is five years a reasonable timeframe to assess a scheme's potential to reach buyout in the foreseeable future?**

We agree that 'up to five years' might be an appropriate timeframe in a stable market environment, but this cannot become a "rule" and schemes must be allowed the flexibility to consider both longer and shorter assessment periods where appropriate. A reasonable time horizon for modelling the likelihood of being able to afford buy-out may vary significantly based on employer covenant (including willingness to fund), opening scheme funding position and expectations about the buy-out market. 2018 was a banner year for the bulk annuities market, but care should be taken not to set policy based on potential peak market conditions.

[20] This approach was followed in the Court of Appeal in British Airways v Airways Pension Scheme Trustee [2018] EWCA Civ 1533

Potential to reach buy-out should be considered against the risks of employer insolvency over the appropriate time horizon. As alluded to above, five years may present members with a significant risk of employer insolvency in some sectors. Too prescriptive a test might leave members exposed to significant employer insolvency risk. This is a risk that members and the trustees cannot easily mitigate. If forced by the gateway test to continue to run this risk, the question must arise as to whether the Government should provide options to underwrite the open risk.

Clara would also note that 'being able to afford buy-out' and being able to do so in practice may be very different. Experience of market capacity and issues of scale would indicate that undertaking a buy-out transaction might not be possible even where affordable. Data issues and illiquid assets that are not attractive to an insurer can also hinder the execution of a buy-out, but may be manageable in a consolidation transaction.

Clara notes the suggestion that covenant advice with a "clear conclusion" should be provided to trustees, and duly taken into account. It may in many cases be difficult to provide clear advice on the likelihood of a scheme being able to afford buyout over a specific timeframe. The formulation of a prescriptive gateway should not compromise trustees' decision making.

Clara believes that the appropriate timeframe should be a matter for trustees and be subject to TPR's oversight and guidance rather than being set out in legislation. The overriding focus should be on good member outcomes.

This test must be looked at from the trustee's perspective as well. It is conceivable that a situation could arise where a buy-out for the scheme is judged to be affordable at some point within the five year period, but there is a significant risk to the security of the scheme (perhaps due to corporate activity) before that point. In such circumstances the Trustees might clearly feel the best option would be a move to a consolidator to minimise risk, but would be prevented from making that decision because of a prescriptive gateway.

Question 65 **Are there any other important factors that trustees should take into consideration as part of the transfer to a superfund?**

As noted above, the risks to members of the ongoing position of the scheme should be fully considered.

The willingness of the employer to fund the scheme should also be considered, including consideration of any funding conditional on a transfer to the consolidator. This funding might be available to fund a transfer to a consolidator, but not otherwise available for general scheme funding in the ordinary course. Ability to fund on its own may not be sufficient.

Given that there may be different consolidator models, trustees should be able to demonstrate understanding of the model they intend to move members to and whether it appropriately answers to their fiduciary duties. For example, are the consolidator's long-term objectives consistent with those of the transferring scheme?

Question 66 **Should a scheme looking to join a superfund be required to meet a specific minimum funding level at the point of transfer, for example 87.5% funded on the authorisation basis?**

It is right that ceding schemes are sufficiently funded to enter the consolidator so as to reduce risk to members and to not inappropriately dilute the consolidator's funding level. A reframing of the gateway test as suggested above removes the need for a specific minimum funding level to be enshrined in legislation.

The combined fiduciary duties and likely concerns of both transferring scheme and consolidator trustees will likely enforce a minimum funding level for transferring schemes.

Transferring trustees will be primarily concerned that the total asset stack (scheme assets, sponsor contribution and consolidator's capital) will deliver a better outcome for members and improve the likelihood of benefits being paid in full. Their second concern will be that their members' security is not diluted and does not subsidise existing (or future) members of the consolidator. The consolidator's own trustees by contrast will require a minimum funding level to ensure that the existing members do not subsidise incoming members.

Clara's sectionalised solution avoids any conflict around cross-subsidisation and minimum funding levels; but all incoming schemes are required to be fully funded on the Clara basis.

Consolidators will each have their own minimum funding levels, therefore the regulatory framework should focus on the principles that trustees and their advisers can use to assess the relative levels of security offered by different consolidators.

Question 67 **If you think there should be a minimum scheme funding level for entry to a superfund, should it be based on the authorisation basis or a buyout basis? What percentage minimum funding threshold do you think would be appropriate?**

The basis and threshold for minimum funding should be determined on a consolidator specific basis.

Question 68 **Should external covenant advice be a mandatory requirement of the superfund transaction process? In what circumstances would covenant advice not be required?**

Clara believes that external covenant advice is appropriate in most circumstances where trustees are considering the strength of their sponsoring employer(s) both to understand the risks of the scheme continuing and any potential move to a consolidator. This type of advice is a particularly important tool for trustee decision making.

It is important, and especially so for smaller schemes, to ensure that transaction costs are controllable. Clara would argue that there should be a strong presumption in favour of formal covenant advice, but that it should ultimately be a matter for the transferring trustees. Where appropriate, the Regulator should recognise that trustees may repurpose existing reports or draw on advice from other advisers.

Ultimately, the level of covenant advice should reflect the extent to which the exchange of covenant for capital is ambiguous.

Question 69 **Should it be a requirement for those providing covenant advice to be regulated by either the Financial Conduct Authority or the Financial Reporting Council?**

Yes.

Question 70 **Do you agree that the current legislation regarding bulk transfers should apply to transfers to a superfund? Please give an explanation for any changes you recommend to the legislation.**

Clara agrees that bulk transfers are the appropriate mechanism to affect transfers to consolidators. Bulk transfers are a well established and well understood legal mechanism. It is the mechanism used today for insured buy-outs. Familiarity should provide comfort to transferring sponsors and trustees as well as helping to reduce the cost of consolidation transactions.

It would be appropriate that the current bulk transfer legislation is reviewed and explicit references to consolidators and transfer to consolidators are included where appropriate. To avoid any uncertainty, the Government should seek to clarify that transfers to a consolidator by bulk transfer will be considered to be a "financial transaction"[21] under the legislation.

Question 71 **Should TPR decide whether each scheme transfer to a superfund can proceed or only have the power to prevent a scheme entering a superfund if they judge that the principles set out in the gateways are not being met.**

Clara agrees that it would be inappropriate for 'TPR to be a decision maker in each and every transaction'. We believe that an evolution of the current Clearance regime with a streamlined application specific for consolidation would be the most appropriate mechanism for TPR to retain oversight of transfers to a consolidator. We believe that seeking Clearance would be appropriate in the vast majority of cases and that where Clearance was not sought TPR would retain the ability to pursue the ceding scheme and connected parties if an issue emerges.

The proposed changes to the notifiable events framework in relation to consolidation are important and appropriate. There should be no circumstance where a consolidation transaction occurs without TPR receiving either or both of prior notification and a Clearance application.

[21] Regulation 12(2)(b) Occupational Pension Schemes (Preservation of Benefit) Regulations 1991

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Question 72 **What checks should TPR do on a proportionate and objective basis to satisfy itself a transfer to a superfund is likely to be in the best interests of members?**

Clara believes it will be for the trustees, given their legal duties, to satisfy themselves that a transfer to a consolidator is in the best interests of members. The ability of TPR to 'second guess' legitimate and appropriate trustee decision making should be limited. TPR can best play a role in testing how the decisions have been arrived at rather than the decision itself. This will likely be a consideration of the reasonableness of the trustees' decision and any advice taken—including on the legal consideration in taking the decision.

In seeking to test the trustees' decision making process, TPR will likely want to verify whether:

- The trustees have considered the full range of 'end-game' solutions available to the scheme, including (but not limited to) the affordability and executability of an insured buy-out.
- The trustees understand the structure, advantages and disadvantages of their chosen solution.
- The trustees have considered and understand the probability that members will receive their full benefits in the status quo.
- The trustees have considered and understand the probability that members will receive their full benefits in the proposed consolidation or other end-game solution.
- The trustees have considered and understood the sponsor's ability and willingness to fund the scheme and alternative solutions both today and going forward.
- The trustees have been appropriately advised.

Where trustees decide not to adequately consider buy-out, consolidation or other suitable 'end-game' solutions; but rather continue to run the existing funding and covenant risks the question must be asked what happens in the event of members not receiving their promised benefits? Trustees will be at risk if they do not adequately discharge their fiduciary obligations, but will inaction receive equal regulatory scrutiny as the positive decision to transfer to a consolidator?

Question 73 **What further powers should TPR be given to allow it to regulate effectively both superfunds and transfers to superfunds? Please provide reasons for any additional powers suggested.**

Subject to our comments above Clara believes that the proposed TPR powers are appropriate.

Question 74 **Should these schemes continue to be known as "defined benefit master trusts" or is there a more suitable name that can be used to distinguish them from DC master trusts?**

"Defined benefit master trusts" is an appropriate description for the existing models that the market is familiar with and distinguishes them from consolidators (or superfunds). A forced change is more likely to lead to confusion.

Paragraph 225 of the Consultation trails the likely changes to the funding regime requiring trustees to set their long term or end-game objectives. This does raise a question of how commercial DB Master Trusts will set these objectives where objectives like buy-out and consolidation, which if in the best interests of members may not be aligned with the Master Trusts' commercial best interests?

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4 Other issues arising from the consultation

We have identified a number of other minor issues arising from the consultation that we would note.

'Costs, assets, and liquidity plan'

Paragraph 169 of the Consultation implies that all costs arising from the running of a consolidator would ultimately be borne "without cost to members". Clara understands this as meaning costs normally borne by a pension scheme should continue to be borne by the equivalent parties in the consolidator framework. For example, scheme appointments like a third-party administrator, scheme legal advisor and scheme actuary would continue to be paid from scheme assets. If these costs are paid by the consolidator or out of buffer assets the independence of these appointments would be immediately compromised. Clara would welcome additional clarity on this issue.

Fraud Compensation Fund

Clara notes the wider debate about whether the framework for the Fraud Compensation Fund and its levy remain relevant and appropriate given the changing nature of pensions frauds and the pension landscape.

Given the specific regulatory regime being considered for consolidators and the need for clarity as how consolidators might be eligible for the FCF (for example, how would buffer funds be protected?), Clara believes consequential legislative changes should be considered at this stage of the development of consolidation.

Interaction with the DC Master Trust regime

It is likely that some schemes ceded to consolidators may include associated DC benefits. It may be in the best interests of members for these benefits to be transferred to the consolidator rather than discharged at the point of transfer.

There is therefore the possibility that a consolidator may inappropriately fall within the definition of a DC Master Trust. Clara's view given the regulatory requirements that will fall on any consolidator is that it should be clear that only one of the regimes should apply where the overlap is a function of consolidation rather than a separate business activity. It would be appropriate for TPR to have discretion to apply aspects of the DC Master Trust regime within the consolidator framework as required.

List of Abbreviations and Definitions	
DB	Defined benefit.
DC	Defined Contribution
Consultation	Consolidation of Defined Benefit Pension Schemes Public Consultation, December 2018
DWP	Department for Work & Pensions
FCA	Financial Conduct Authority
FCF	Fraud Compensation Fund
FSCS	Financial Services Compensation Scheme
PPF	The Pension Protection Fund
PRA	Prudential Regulatory Authority
The Regulator	The Pensions Regulator
TPR	The Pensions Regulator
White Paper	"Protecting Defined Benefit Pension Schemes" Department for Work & Pensions White Paper, 19 March 2018

You can find more information about Clara-Pensions at www.clara-pensions.com. Please do get in contact if you'd like to know more about us or the benefits of consolidation. We'd love to talk to you.

This document is our response to the Government consultation 'Consolidation of Defined Benefit Pension Schemes' published in December 2018. We hope others will find our views on consolidation of interest. Our response though is not intended other than for responding to the consultation.

January 2019