Pension Protection Fund

PPF response to DWP's consultation on consolidation of defined benefit pension schemes

1 February 2019

About the PPF

The Pension Protection Fund (PPF) was established to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover PPF levels of compensation.

The PPF is a statutory fund run by the Board of the PPF, a statutory corporation established under the provisions of the Pensions Act 2004. The PPF became operational on 6 April 2005.

On 10 July 2009 the Board of the PPF was also given the responsibility of being the scheme manager for the Financial Assistance Scheme (FAS). FAS provides assistance to members of eligible underfunded defined benefit schemes that started to wind-up between 1 January 1997 and 5 April 2005, or between 6 April 2005 and 27 March 2014 where an employer insolvency event occurred before 6 April 2005.

A. General Comments

1. This note sets out our views on the key issues in relation to the authorisation and ongoing regulation of consolidation vehicles, or superfunds, in response to the consultation published on 7 December 2018.

2. We believe that well run superfunds have the potential to increase security for a proportion of schemes and can play a helpful part in the orderly run down of the increasingly mature DB universe. However, there are significant risks posed by 'superfund' consolidators, both to members transferring to them and, assuming they will be eligible for PPF protection (as is envisaged by the consultation), to the wider pensions universe. Essentially, if the superfund model gains traction and superfunds achieve sufficient scale, they could pose a systemic risk to the PPF, and hence to PPF members, levy payers and the members of the schemes we support who would, in practice, be underwriting their investment strategy.

3. The government has been clear that superfunds will not be required to meet the same funding standards as insurers. Inevitably this means that scheme members will have a lower level of certainty that their benefits will be paid in full than if their scheme had secured their benefits with an insurer. Accepting this greater degree of risk is essential to make the superfund model work - If the funding requirements were the same as insurers, the price of entry would be the same too, meaning any scheme that could 'afford' to enter a superfund would actually be able to buy out (and we would expect them to choose to do so). The premise of superfunds is that they provide an increased level of security for members of schemes unable to afford to buy out.

4. However, we believe that any superfund allowed to operate must still provide a high level of confidence that it will pay benefits to its members in full (and, as a consequence, provide a high level of confidence it will not claim on the PPF). It will also require the arrangements for the superfund to be appropriately structured to ensure that commitments made can be relied upon. The consultation covers supervisability in relation to the superfund vehicle itself

– but the capital buffer may well be held outside the superfund vehicle in which case the same requirements need to apply to the buffer too.

5. We therefore welcome the government's intention to establish an appropriate regulatory framework for commercial consolidators as set out in the consultation document. The framework proposed appears to us to be broadly appropriate – though it will be important that the proposed controls are not diluted following consultation – and there are aspects of the proposals that could be clarified. There is a balance to be struck between specifying detail in legislation and providing flexibility for TPR to develop the regulatory approach as experience of superfund proposition grows. We think it important that government clearly specifies the level of risk it is prepared to tolerate within superfund consolidators giving TPR a clear standard to regulate against. Beyond that, we would favour providing TPR with more flexibility – and do not think the legislation should go so far as to specify situations in which TPR would be obliged to authorise. This would reduce the risk that a proposition can be constructed that 'ticks the boxes' but poses real risks (e.g. a proposition where funding is disproportionately in the capital buffer rather than the scheme).

6. We believe an effective regulatory regime for 'superfunds' must achieve four aims:

   i) Prevent superfunds from proceeding unless they are financially robust and provide a high degree of confidence that scheme benefits will be paid in full

   ii) Protect members and PPF levy payers from the potentially significant impact of 'superfund' failure

   iii) Ensure any change of control of a superfund doesn't increase the risk to members or the PPF. This would most naturally be by requiring trustee and TPR consent

   iv) Ensure any transfer into a superfund from a scheme is a move that provides greater security for the scheme members, and does not dilute protection for members already in the superfund.

7. To achieve the first three aims we believe the critical steps are:

   i) Establishing a funding based member protection trigger that requires the superfund to be recapitalised if funding falls to the level contributed by the scheme and its sponsor (ie investor capital has been consumed). Recapitalisation could either be from the existing investors or transfer to another superfund, and there should be a fall back of buy-out while it is still likely that benefits in excess of PPF compensation could be secured.

   ii) A second 'wind-up' trigger to require a superfund to cease operating when the risk of a claim on the PPF becomes too high. We agree with the consultation that this should be set at a level above that required to buy out PPF levels of compensation.

   iii) To require an appropriate funding cushion in respect of scheme assets and those in the capital buffer (taking account of the level of investment risk in both). This could either be direct (through a capital requirement and an associated measure of investment risk /restrictions on the assets held), or through the selection of a suitable required probability of paying benefits in full (which could allow different levels of investment risk depending on funding position), though there are challenges with either model.

iv) Setting legal and governance arrangements surrounding the superfund, the capital buffer, and any other components of the superfund design that are suitably robust – so that the protection measures listed above are effective in practice and that there is no scope within the rules for inappropriate exploitation of the scheme. There will also be a need for adequate sanctions if rules are broken – and it will be important for the forthcoming legislation establishing a new penalty framework to be reviewed to ensure it extends effectively to superfunds.

8. There is an interaction between these steps in that the level at which a wind-up trigger can protect against claims on the PPF depends on the level of risk run.

9. We consider the above are minimum security requirements, and that protection needs to be set at a level which ensures the risk of failure is low. We suspect that the cost will therefore limit access to schemes in a relatively strong position or in quite particular other circumstances that mean significant resources are discretionarily available to secure the transfer. By comparison, it is unlikely that many of the schemes government is most concerned about, ie those with weak funding and sponsors, can get access. However, the answer should not be to reduce the security of superfunds: we believe our principles of ensuring members and the PPF are protected are critical and the funding requirements that flow from that should not be diluted. Rather, we think the development of superfunds might set the framework for the next stage of thinking – how to help schemes who are struggling.

10. In addition, to ensure the government's policy aim of ensuring sponsors don't go for consolidation when they could have bought out, there needs to be a robust gateway, and we set out our thinking on that below.

B. Protecting members from superfund failure and limiting the impact on the PPF

1. Members are directly exposed to the risk of failure in the superfund's investment strategy, and if superfunds are eligible for PPF protection we will be exposed too. This is unlike the current situation with schemes where the employer provides the first line of defence. While we expect superfunds to pursue relatively low risk investment strategies, this will not remove the risk of investment failure. There is also the risk that the investment strategy is departed from if funding weakens – taking more risk to try to get back on track.

Member protection trigger

2. We consider that there is a strong case for a trigger requiring action to address a deterioration in the funding position of a consolidation vehicle where this exposes the members to significant risk of losing benefits. We suggest this could be at the point at which the superfund resources (including capital buffer) have dropped to the level that was originally supplied by the scheme and sponsor- so that the resources supplied by the investors have effectively been exhausted (i.e. the investor contribution is treated as the first slice of risk capital). At this point either the investors should replace the capital lost, the trustees should transfer the scheme to an alternate provider that can add replacement

capital or failing that, secure the liabilities through a buy-out while the scheme remains able to secure benefits above the level of PPF compensation.

3. We note the suggestion in the consultation that at this point all the assets remaining in the capital buffer should transfer to the scheme itself. We think that ownership of the assets should transfer to the trustees but that it may be helpful to provide them with flexibility for example to ensure the scheme is 100 per cent funded with the remaining assets transferred to a new buffer in the event there is a recapitalisation.

4. We note suggestions that, in addition to expectations that TPR would be informed in advance of an approaching 'breach', there may be a case for allowing a short 'grace' period where a trigger is breached. In principle, this could either be to reflect short term market volatility which might see funding 'bounce back' or to allow time for new capital to be put in place. However, careful thought would be needed in the design of any grace period if it is not to undermine the purpose of the member protection trigger. In view of the decline in funding that may have been required simply to use up the investors' capital, and the likely volatility in asset values that would give rise to it, allowing a grace period could easily lead to a situation in which funding declined further, making transfer to another superfund unlikely. And in the event that funding improved when re-measured (so that there was no recapitalisation) funding could then fall again repeating the cycle. Options could include requiring the remaining buffer or scheme to be de-risked immediately, so that any grace period is purely to allow a capital provider or buyout provider to be brought in, or there could be a case for a requiring action above the trigger level itself.

5. We do not think that a consolidation vehicle should be permitted to continue to operate once the investors' assets are exhausted, as this exposes members (and the PPF) to excessive risk. In particular, should the funding level fall further, the option to transfer to another provider would likely disappear, and because the risk of failure would become high, it would be necessary to charge a high levy – which would then prove a substantive drag on investment returns. In such a situation there would be a risk that the scheme / superfund would seek to increase investment returns to recover its funding position, potentially worsening it. We don't think this is a risk that PPF members and levy payers should be exposed to.

6. We note the suggestion that the scheme might continue to operate having failed a member protection trigger (paragraph 132). We do not believe that in the event of the consolidation vehicle failing, or the investor resources being eliminated, the scheme should necessarily be allowed to continue to operate – becoming in effect a scheme without a substantive sponsor (SWOSS). Firstly, it is possible that the scheme would be less well funded than the PPF and TPR would expect in relation to other SWOSS schemes at set-up, and secondly the superfund model envisages the superfund providing much of the infrastructure for effective operation. This could be expected to mean an orphaned scheme was poorly placed to operate independently (and indeed even those advisory resources it does inherit would have a poor track record).

A windup trigger to protect the PPF and the levy payers that support us

7. Given the potential size of a superfund, a deficit could become very substantial in absolute terms before the superfund initiates a claim on the PPF. A particular concern is that it is possible each superfund might invest in a similar way. In any case there is correlation across investment classes and a limited pool of potential investment classes, so that events that affect the investments of one would affect all. This means that, if one superfund collapses, others could also do so at the same time.

8. We therefore agree with the consultation proposition that there should be a 'wind up' trigger(s), to require a superfund to cease operating as soon as the risk of a claim on the PPF becomes too high. The consultation notes that this should be set at a level above that required to buy out PPF levels of compensation – and mentions a figure of 105 per cent.

9. Such a mechanism would limit the extent of any claim on the PPF, which would be a significant comfort to PPF members and levy payers, and in our view would substantially address the concerns expressed by eg the Work and Pensions Select Committee that the PPF could be irreparably damaged by the collapse of a single large superfund or string of superfund failures.

10. The right level for commercial consolidators will need to be considered carefully. However, it is worth noting that a trigger at or close to 100 per cent of s.179 would still leave PPF levy payers exposed - to an extent that depends on the level of risk in the consolidator's investments. This is because of the potential time lag between the trigger being breached and action taken. This in turn will depend on the frequency of monitoring (and any period of time allowed for to ensure the fall in funding is permanent and not just a reflection of short term volatility). There is then an additional period of time needed to wind up the scheme and for the PPF to take control of the investments. Over this period the funding position could fall further.

11. It is important to note that, at funding levels slightly above 100 per cent of s179, because the risk of failure (and cost to the PPF) is so high, the levy charge will be high enough to influence significantly the likelihood of success of the superfund[1]. In our view, it would be appropriate to set a wind-up trigger no lower than the point where failure is the expected outcome, taking account of the costs (including levy) that the superfund will have to pay – since at that point continued operation largely serves to increase the risk of adverse outcomes.

12. We also note that in our work on SWOSS schemes we concluded that in order to have sufficient confidence that a SWOSS could pay benefits in full it must:
    - have a level of funding in excess of 100 per cent on a s.179 basis
    - have an annual levy of no more than 0.5 per cent of scheme assets (as the levy increases with investment risk, this effectively caps the level of risk a scheme could take)

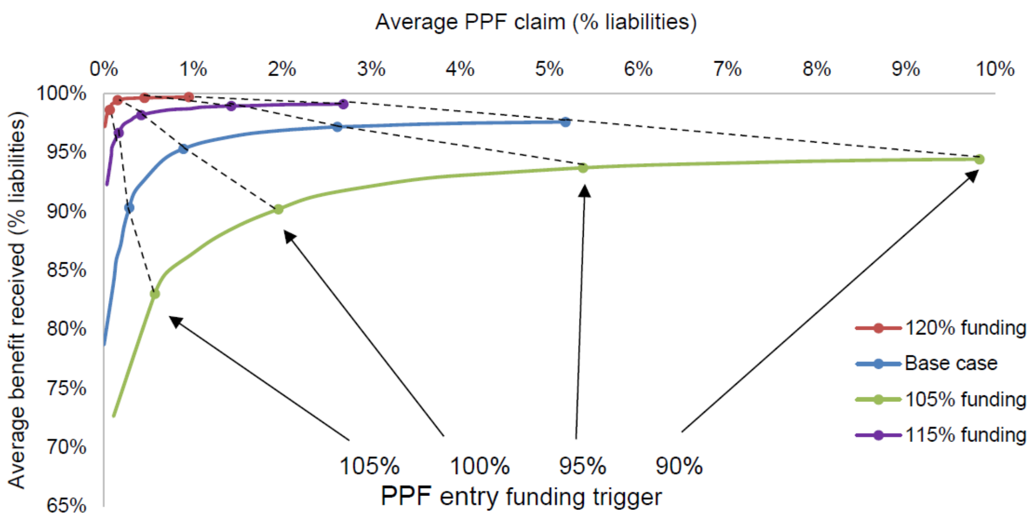
[1] The levy charge is calculated using an option pricing methodology which prices the risk of funding falling below 100% of the cost of providing compensation i.e. the price of a claim.

- be pursuing a sustainable strategy (for instance, it must as a minimum be fully funded allowing for all expenses including expected levy payments).

13. From the modelling done when we set out our levy rules in 2017 it appeared that simultaneously achieving the second and third of these became progressively more difficult – implying a progressively narrower range of possible investment strategies – before it became impossible to achieve with funding below around 103%.

14. We note that the higher the trigger, the more likely it is that the protection for the PPF will be effective, but also the more likely it is that it will be triggered, causing a scheme to wind up when it could have continued and bought out benefits. Stochastic analysis carried out for us illustrates this trade off – showing how altering the level of wind-up trigger for a SWOSS would affect the likelihood of the scheme succeeding in paying members in full and the expected level of claims on the PPF. The trade-off between the increased benefit to members and increased claims on the PPF shifts markedly as the wind-up trigger is lowered below 105% as shown in the graph[2]. In essence, this is because the number of outcomes where there is a claim on the PPF (and the average size of claim) increases rapidly and there are relatively fewer outcomes where the scheme manages to pay benefits in full or buy out.

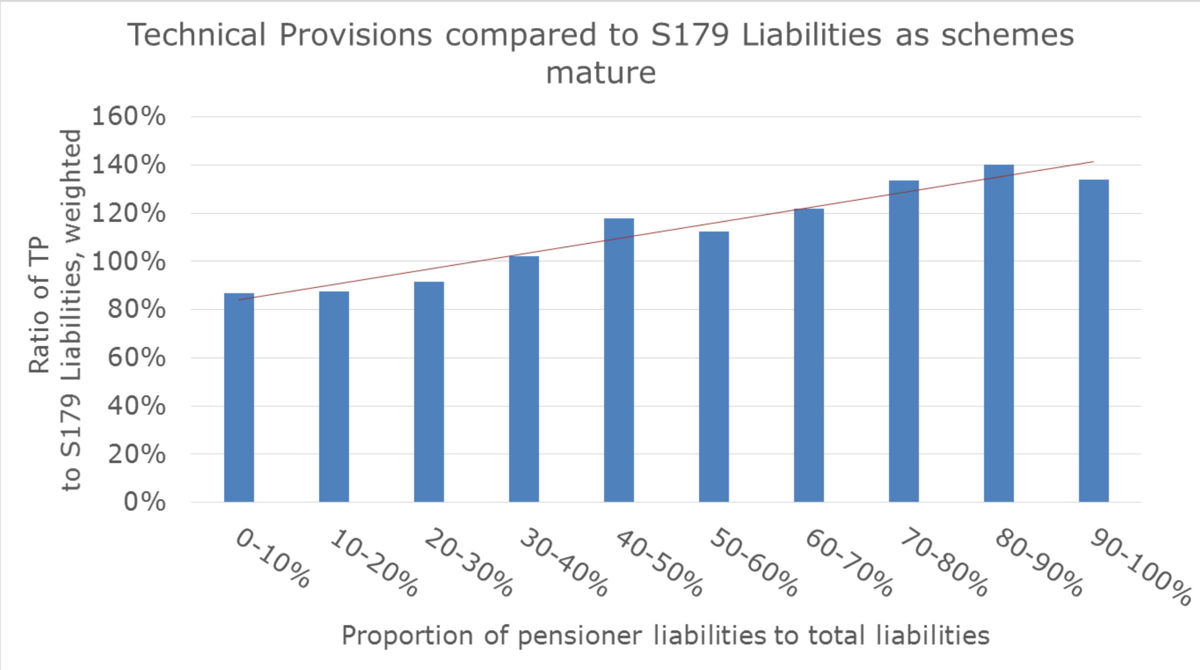
Funding level cases – Member benefits and PPF claim variation with PPF entry trigger (all simulations)



15. On balance, therefore, we consider a trigger at 105 per cent would provide an appropriate margin, though it would not entirely protect the PPF. We would also note that this is a lower level of funding than is implied by technical provisions (TPs) for schemes with sponsors - in aggregate TPs are 107% of s179 and for schemes that aren't among our largest 500 the figure is 110%. It would seem inappropriate to design a system that allows a superfund to operate at a lower level than that, in the absence of a recovery plan with external resources being paid in and an employer covenant.

[2] Each curve shows for a starting funding level (the base case of 110% funding and higher and lower starting points) the impact of different level of the wind-up trigger (with the 105/100/95/90% being specific points highlighted) in terms of the proportion of full benefits achieved across all simulations and the average size of claim. In addition to claims on average increasing in size, they would also become more common.

16. We considered the risk that increasing scheme maturity might lead to a s179 based trigger becoming problematic. However we see that as scheme maturity increases, TPs actually become even stronger relative to s179, suggesting this will not be a problem. (This initially counterintuitive result is likely to reflect that conventional schemes strengthen their funding basis as they mature.)



17. In setting a requirement for a trigger, we think it would be appropriate to specify a number of features that should be present, in addition to the funding level. In our policy statement on the Levy Rules for 2019/20 we set out high level principles we would look for (which are also set out in TPR's Guidance for Superfunds). These include:

- the trigger has to be expressed in relation to PPF liabilities
- the trigger will need to act automatically
- that when funding drops below that level, scheme wind-up and the insolvency of the sponsoring employer will be triggered within an acceptable period. (As noted in the DWP consultation, this is likely to require a trigger that acts on the employer directly)
- the rule to be suitably defined and permanent – so any ability to alter the trigger would need to be constrained
- a requirement for adequate monitoring arrangements

18. There may also be a need to place a requirement on trustees and managers to act promptly eg through the equivalent of a 'resolution plan' required as part of the DC master trust authorisation regime.

19. The consultation asks if there should be a period of grace to allow for funding volatility. Although in principle this might seem attractive, it seems reasonable to expect the wind-up trigger would be at a level well below a member protection trigger. In the event that both

were breached therefore that would imply a sudden collapse in funding, which would make a grace period risky. Any grace period also worsens a moral hazard risk, since there is a strong incentive to take additional investment risk to get back on track. We think it would be complex to design a grace period that was effective in offering protection - it would need to be strictly time-limited, there should be a stop loss level, and very regular monitoring of the funding position eg a monthly valuation, with a power to require an element of de-risking to limit the risk of things getting out of control. Given this we are not convinced it would be worthwhile, especially in the context of the other triggers.

C. Ensuring any superfund is financially robust

1. The critical protection for superfund members and for the PPF (and those who fund or depend on us) is downside protection - through the various triggers – but additional measures will be needed to address two issues:

   - that the level of investment risk that could be run means that the triggers don't actually achieve the protections they are supposed to

   - that the incidence of failure could be too high – with schemes setting up just above the trigger points and then having to close in the near term, damaging confidence.

2. So it will be important to ensure that a superfund is financially robust. The consultation sets out a number of options for this, though we consider that rather than these being cumulative it may be more sensible to see them as alternatives.

3. We can for example see merit in the proposition that superfunds should demonstrate their solvency over the long term through stochastic modelling that demonstrates the level of certainty that benefits will be paid in full (i.e. that they are able to pay benefits in full in the required percentage of the scenarios generated) using appropriate assumptions[3]. The modelling would need to look over the long term and reflect the impact of costs on the scheme (including the PPF levy) and of any profit withdrawal in line with the superfund's proposed approach, meaning that the more aggressive the profit extraction model the superfund proposition has the harder it would be to pass the test.

4. However, the demands that this would place on the regulator should not be underestimated. There could be substantial challenges in basing regulation on such an approach, particularly before a superfund market is well established. In effect this would require either regulatory approval of models or specification of a model to use. Specifying a model that is appropriate for all potential superfund business models would be challenging. Also challenging would be ensuring realistic investment assumptions (eg for alternative investments, matching portfolios and LDI-type approaches), and especially for demographic assumptions where

[3] It might be most appropriate to provide TPR with a power to specify standard assumptions and to require their agreement if the assumptions are to be varied.

schemes can be quite idiosyncratic. Additionally, if the cost is to be recovered from market participants, this could be a barrier to entry.

5. An alternative might be, at least initially, to see stochastic modelling as illustrative, and to use minimum standards in relation to eg the minimum additional capital held and the associated level of investment risk that can be taken (i.e. this should reduce as the level of capital reduces). The choice of risk weighted capital requirements could be informed by stochastic modelling. Within the options consulted on this would effectively be option (iii) but with TPR having the choice to delay / not implement a requirement in relation to probability of success measured stochastically. Such an approach does have disadvantages, in terms of potentially requiring a more bespoke approach for example to the impact of profit extraction on capital levels.

6. We agree with the consultation position that the tests should also be applied on an ongoing basis. Where an established superfund fails to demonstrate the required strength it should be prevented from writing new business unless new capital is provided or the position of the fund is otherwise strengthened. In this context one key question is the extent of recourse to the backers of the superfund and whether any profit should be able to be extracted before the liabilities are discharged. Requiring liabilities to be bought out before profit could be extracted would align the interests of investors and members in improving security. At the least, if profit is to be able to be extracted we would argue that this should be at a level above the initial minimum level for authorisation and/or should be 'on risk' for a period of time (i.e. capable of being called upon to shore up the position of the superfund) or even held in escrow to ensure significant short term profits are not taken from a vehicle that struggles in the medium to long term. There may also be a case for regulatory pre-approval (or at least 'non-objection') to profit extraction.

7. The consultation indicates potential levels for the probability of paying full benefits and of failure (at 99% and 1% respectively). We consider that further analysis would be needed to determine appropriate levels – though 99 per cent appears high. In principle, any probability of success requirement – whether used directly in regulation or to inform minimum standards – needs to reflect the risk appetite government has for scheme failure and against which TPR can then regulate. A way to think about this is to consider "Are you content to see 1 in X schemes fail in first 10 / 20 years". The desire to price cheaper than insurers should not drive where this level is – it is risk appetite that should. The capital requirement also needs to be sufficiently high to imply that investment risk taken by the superfund (including in the capital buffer) is limited – particularly where funding is close to a trigger. There may be other considerations – such as to ensure that the regime appears sufficiently low risk to be attractive to trustees and members.

8. The consultation explores whether in addition to demonstrating sustainability through stochastic modelling there might need to be:

- a long term funding objective – either to buyout or to achieve a level of funding relative to an authorisation basis and/or

- minimum standards in relation to the superfund's own assets, the maximum investment risk to be taken etc.

9. It is not clear that additional regulation of funding levels would be needed beyond a requirement for satisfactory outcomes from stochastic modelling on a basis approved by TPR / requirement for risk weighted capital - provided these are set at an appropriate level. For example, it is not clear what a long-term funding objective would offer in a context where there is no ongoing sponsor to make future contributions. In relation to minimum standards, as set out above we think these will be required in relation to capital held and investment risk (at a minimum). It might also be appropriate to limit departures from the initial investment strategy on which authorisation was obtained – since if funding fell there is a strong incentive to take additional investment risk to get back on track – potentially compounding the problem.

10. The interaction of the financial adequacy aspects of authorisation and proposed funding level triggers may also benefit from further consideration. There appears to be overlap between annual testing of financial adequacy and the various funding-based triggers that are also proposed, which for example could lead to a superfund simultaneously passing and failing tests of whether it could take on new business. It is also unclear what will be the impact of failing the proposed annual financial adequacy test - which it is suggested leads to removal of authorisation (without setting out what follows from this).

11. There seemed some uncertainty about whether the authorisation basis would be fixed or scheme specific. Our view is that, to be a robust protection, it should be the former.

D. Ensuring the legal and governance framework for the superfund is appropriate

1. It is clear that ensuring strong governance will also be key to a superfund's long term viability. In addition to controls on financial strength, therefore, we support the government's plans (as noted in the consultation) to set minimum standards for governance, including to ensure that trustees and others involved in running superfunds pass a 'fit and proper' test. In addition, we would also suggest that a governance regime ensures suitable protections for members in relation to potential benefit exchange exercises (such as transfers out), which some superfunds might pursue vigorously.

2. To ensure member protection it will be critical that the trustees are able to challenge effectively the superfund management – so we would support a strong role for independent trustees. Traditionally pension schemes have at least a third and often half their trustees member-appointed to protect members. While we recognise that there may be practical difficulties with a conventional approach, we would suggest exploring models such as that used with DC master trusts or TPR appointment/approval (and potentially restrictions on replacement).

3. Alongside trustee independence, another protection would be to ensure that the new sanctions regime is fit for purpose for superfunds.

4. The structures established need to protect superfund trustees from measures that could fetter them ie a threat of withdrawing the buffer, and that access to the buffer should not be capable of being lost (eg if trustees wanted to move to a new investment firm / set a different strategy).

5. There is also a risk that superfund models could arise which seek to exploit the pension scheme through requiring the use of particular suppliers for scheme services – which might allow value to be extracted from the scheme (or capital buffer) otherwise than through any agreed profit extraction model.

6. The consultation's main focus is on the superfund itself, but the capital buffer may well be held in a vehicle outside the main corporate. In such a situation the authorisation regime will need to set minimum standards in relation to capital buffers (eg in relation to form held in, legal protections, restrictions in terms of nature of assets) to ensure that they can be relied upon to be available to the scheme when needed to meet a fall in the value of scheme assets. The assessment of the robustness of the security provided by the capital buffer is likely to be a particular challenge in the early years of authorisation. The superfund model is fundamentally built on the notion that the capital buffer can be regarded as available to the scheme at need, yet those promoting the superfund model consider standard approaches to offering such security (such as the PPF's contingent asset regime) are insufficiently flexible to be used. In our 2019/20 Policy Statement we set out the following as appropriate criteria to consider before concluding that a buffer offered suitable protection:

    - Buffer fund assets cannot be released outside of defined circumstances (eg in line with a defined profit extraction rule)
    - The risks within buffer fund investments cannot be increased after initial assessment without a re-assessment of financial sustainability (through the significant events framework) and TPR confirmation of approval
    - Changes in buffer fund asset allocation cannot be made without consultation with scheme trustees
    - There is a robust, legally enforceable mechanism for the assets of the buffer fund to transfer to the scheme if there is a trigger event

7. We consider it would be helpful if the regulatory framework supported such criteria.

E. Ensuring transfers to a superfund provide greater security for members

1. While tests along the lines set out above will ensure that a superfund is, in and of itself, robust, they will not necessarily ensure that any scheme transferring to it is substantively increasing the level of security of its members. That will require an assessment to take place, before any transfer is permitted, of the security currently provided by the scheme with its

employer against that provided by the superfund (and of the security of the combined scheme against that of the superfund prior to transfer).

2. Ensuring this complex assessment is done robustly will be important. While we recognise that some commercial propositions are expressly targeting buying out schemes' liabilities once they achieve a sufficient funding level, our concern is to mitigate the risk to scheme members through situations where a scheme transfers to a superfund which doesn't target buy-out when it could have gone on with their employer to secure buy-out.

3. While we consider that this is a judgement best made by the scheme trustees, it will be important for the regulatory regime to ensure they take appropriate expert advice, and to provide a mechanism to intervene and prevent transactions if that is necessary to protect members. We also consider that information on the 'covenant' provided by the superfund should not be left to the superfund itself to define. Instead the regime will need to ensure that such information is accurately and neutrally presented, and that the results of the modelling described above should be made available to the trustees and TPR.

4. In view of the irreversible nature of moving to a consolidator, it would only be appropriate for a transfer to take place if there is a significant increase in security, so that the advantage offered by the consolidator is clear-cut. There should therefore be a presumption in favour of the status quo, and perhaps a further review in a later year, if benefits in security are more limited.

5. The gateway test should therefore indicate that security needs to be substantially better. Assessing what level of improvement is suitably substantial will be difficult initially, and we consider it would be better to establish the principle in legislation but ensure that regulation gave some flexibility to the Regulator to develop an approach over time.

6. The comparison of security between an existing sponsor that may be able to afford buy-out longer term – but perhaps not for 10 or more years – and a superfund which aims to run on an ongoing basis may be difficult[4]. It may require weighing the benefits of an immediate improvement in security with a larger (but less certain) improvement at a later date.

F. Levy rule for consolidators

7. In the light of the possibility of superfunds (or 'consolidation vehicles') emerging in the near term, in December 2018 we published a levy methodology for commercial consolidators for levy year 2019/20.

8. We based the way we calculate the levy on the methodology we use for schemes without a substantive sponsor (SWOSS), with adjustments to reflect the unique risks posed by consolidators. In particular, our approach reflects that the level of risk posed could be increased by the extraction of profits, and that – in the absence of a new regulatory regime –

[4] The situation may be simpler where the superfund is itself targeting buy-out over a shorter period than the sponsor could achieve.

consolidators could seek to operate without 'wind up triggers' in place (a critical safeguard, limiting the deficit that can arise in the event of investment failure). Our analysis shows that the effect of the new rule is that levies paid by strongly funded, well run consolidators will be small. Less well funded schemes who aren't taking action to protect PPF levy payers and members (by putting in place wind up triggers) may face a substantial levy charge.

9. We are clear that this is our first iteration of a levy rule for consolidators. In the years ahead, as the new regulatory regime takes shape and as the market develops we expect to adapt and change our approach, so for example to the extent that the regulatory framework can be demonstrated to reduce the risk of consolidation schemes this may be reflected in our approach. Our goal will remain the same: to set a robust, transparent methodology that delivers a risk reflective levy.

Conclusion

We believe that key issues to resolve post consultation include:

- the design of a member protection trigger
- the design of a trigger for wind-up to protect the PPF
- Following from those, the selection of a probability of success measure that reflects the government's risk appetite for superfund failure and protects members / the PPF from excessive investment risk or alternatively a set of minimum standards for risk-weighted capital held having the same result.

In addition, for the regime to operate effectively it will be essential to put in place requirements in terms of legal structures and governance arrangements to ensure that the resources that are committed are in practice available if needed, and that trustees are able effectively to protect members.

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