

# Opportunities for Investing in the UK Pensions Industry: DB Superfunds

25 March 2026

For the nine million members of private sector defined benefit pension schemes in the United Kingdom (which collectively hold around £1.1 trillion in assets), the hallmark of their pension is certainty: the guaranteed income they can rely on in retirement.

For the employers responsible for funding these schemes however, that same certainty translates to risk: namely, the risk that underperforming assets or changes in life expectancy mean more money is needed to fund members' pensions.

The options for managing this risk have long been binary, either involving liabilities being retained on balance sheet or, more commonly, a transfer to a life insurer through the purchase of a bulk annuity policy (known as a "buy-out").

Superfunds now represent a third option.

We have seen significant investor interest in the bulk annuity market, with L&G and Blackstone announcing a strategic partnership focused on private credit origination, and Athora, Brookfield and JAB each acquiring UK bulk annuity insurers.

The superfund market is still comparatively immature, with only one provider (Clara-Pensions) having executed deals, and one other (TPT Retirement Solutions) having publicly announced an intention to launch. However, we expect others to follow and take advantage of significant market potential which consultants have estimated to be between £150bn (PwC) and £600bn (LCP).

In this note we focus on the new opportunities for investors and asset managers presented by the growth of the superfund market, exploring:

- what superfunds are and how they are structured;
- how the commercial economics work; and
- key considerations for potential investors and participants.

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## WHAT IS A SUPERFUND?

Superfunds are trust-based occupational defined benefit (“DB”) pension schemes. They have trustees who are responsible for running the scheme and looking after members’ interests, they are regulated by the Pensions Regulator (“TPR”) and are subject to much of the same law and regulation that applies to the 5,000 other DB schemes in the UK.

There are, however, some significant differences between superfunds and “regular” DB schemes:

- Superfunds are consolidators. Rather than housing the benefits for employees of a single employer or corporate group, they are designed to accept transfers from multiple, unconnected existing schemes. The sponsoring employers of schemes that transfer into superfunds typically sever their liability for those schemes on transfer.
- A superfund doesn’t have a substantive sponsoring employer. Instead, a “capital buffer” provides financial support to protect members’ benefits (in lieu of the covenant provided by the original schemes’ employers)
- They are commercial enterprises. A superfund is made up of several component parts, including pension scheme, statutory employer, superfund corporate and capital buffer. Investors inject capital into the buffer in exchange for a long-term right to receive return on surplus.

These differences mean that superfunds warrant additional regulation and supervision. Currently this takes the form of guidance issued by TPR, but a new, permanent legislative framework is on the horizon and expected to take shape through the Pension Schemes Bill (the “PSB”), when enacted, and underlying regulations.

## HOW DO THE COMMERCIAL ECONOMICS WORK?

From an economic perspective, a superfund essentially consists of two pools of assets: those held in the superfund pension scheme (the “Scheme Assets”) and those held in the capital buffer (the “Buffer Assets”). Both asset pools are subject to overarching regulatory requirements relating to financial sustainability and capital adequacy. These requirements determine the minimum capital the superfund must hold (and the consequences of failure) and how the Scheme Assets and Buffer Assets are invested, as well as how surplus and capital are released.

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### **Capital Requirements**

As a starting point, the collective value of Scheme Assets and Buffer Assets must be at least equal to the scheme's "technical provisions". This is a common funding measurement in the DB pensions universe but in the superfund context must be calculated on a prescribed, prudent basis.

Additional risk-based capital is also required (in the form of the capital buffer), covering at least the market and longevity risk. The market risk element must currently be set so that when Buffer Assets are added to Scheme Assets, there is a 99% probability of the superfund maintaining funding at or above technical provisions over a five-year horizon (expected to shift to a one-year horizon under the new permanent regime). Importantly, a higher-risk investment strategy will generate a higher buffer requirement.

These funding requirements establish the baseline for a superfund on an ongoing basis. If asset values drop below certain thresholds, safety measures kick in to prioritise the security of members' benefits over investors' interests. These include the transfer of some or all of the Buffer Assets into the scheme itself, increasing the trustees' control over their management and usage.

### **Investment**

Two distinct legal frameworks govern the investment of Scheme Assets and Buffer Assets. Like the trustees of all DB schemes, a superfund's trustees bear legal responsibility for setting the investment strategy in relation to Scheme Assets, whereas the superfund corporate will be primarily responsible for determining the investment strategy for the Buffer Assets (though trustee consent will be needed under the PSB for material changes).

However, TPR is clear that it views the Buffer Assets as a proxy for the employer covenant and an important part of the longer-term security package for members (which may ultimately need to be transferred to the scheme trustees). As a result, it has set out seven principles that must be followed in relation to the investment of both Scheme Assets and Buffer Assets.

These principles are on the whole (save in relation to specific concentration risk limits and limits on illiquid holdings) not prescriptive but rather are intended to encourage an approach to investment strategy that ensures appropriate liquidity and transferability of both asset pools.

In practice, the day-to-day management of Scheme Assets and Buffer Assets will be delegated to asset managers who will operate within an overall strategy aimed at balancing member protection and investor appetite. There are fewer restrictions on

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investment options (for both asset pools) in comparison to the rules that apply to insurers, but the combination of TPR's expectations and the link between investment risk and capital buffer quantum provide effective guardrails.

### **Surplus and Capital Release**

For investors, the mechanics for releasing value from the superfund structure will be key. There are two related concepts here: surplus that may be generated within the pension scheme, and surplus in the capital buffer.

There is an existing legal framework that defines how surplus can be released from DB schemes, though this is currently subject to such release being permitted under the scheme's rules, the trustees having passed a resolution to allow release of surplus before 6 April 2016 and the trustees being satisfied that effecting a release is in the interests of scheme members.

The PSB simplifies these requirements to a degree. It effectively grants trustees the power to release surplus even where not currently permitted by scheme rules and removes the express requirement for them to conclude that a release is in members' interests. However, trustees will still need to comply with their overarching fiduciary duties and be comfortable that in releasing surplus they are exercising their powers for a proper purpose.

This framework will also be the basis for the release of surplus from superfunds, but the PSB also specifically envisages that regulations may require TPR consent to effect surplus release.

Regulations will also set out the detailed mechanics to release surplus from the capital buffer. These are expected to follow the current mechanics under TPR guidance, which permit release where the value of Scheme Assets and Buffer Assets together exceed technical provisions and the minimum capital buffer requirement by a specified threshold, over a period of time, though underlying regulations may introduce further conditionality.

Importantly, the legal framework for release of both scheme surplus and capital buffer excess envisages releases occurring while the scheme is ongoing. In other words, there is no need for the superfund to insure liabilities before returning capital to investors, which was the position under the original TPR guidance.

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## KEY CONSIDERATIONS FOR POTENTIAL INVESTORS

The superfund market is nascent, but we expect that the introduction of the permanent regulatory regime will see multiple providers enter the market. This creates significant opportunity for investors and asset managers.

Key points for these potential participants to be aware of include:

- **Authorisation and regulatory readiness.** The PSB will formalise the process for new entrants obtaining approval to transact, based on the existing principles established by TPR's guidance. In light of the additional risk that concentrating pension liabilities in commercial schemes could present, this process will continue to be rigorous and will assess all key aspects of a provider's proposal, including the individuals who will perform key roles, the structure of the superfund itself, the proposed investment strategy and capital arrangements.
- **Structuring considerations.** Superfunds are comprised of several component parts, which can be structured in different ways. The pension scheme itself could be sectionalised for each individual transferring scheme, commingled or offer either option (with some transferring schemes being entirely ring-fenced and others being commingled in an omnibus section). There is also flexibility as to the structuring of the capital buffer(s), which could be established as special purpose corporate entities, or as funds. Prospective investors will need to consider the pros and cons of each variable, including attractiveness to clients, economies of scale and tax implications.
- **Moral hazard exposure.** Participants in a superfund structure should be aware of TPR's moral hazard powers, which allow TPR in certain circumstances to require persons "connected or associated" with the statutory employer to provide financial support or pay specific amounts to a pension scheme. The definitions of connected or associated are broad, and, depending on the structure of a superfund, could potentially extend to investors.
- **Pipeline and gateway tests.** Government policy has been clear that schemes which can afford to buy-out should not be pursuing a superfund transfer; however the previous requirement that a scheme must have "no realistic prospect of buy-out in the foreseeable future" is not replicated in the PSB. This means that while schemes that can afford to buy-out will still fall outside the scope of the superfund market, trustees should be able to pursue the superfund route based on current funding levels, without needing to conclude that a future buy-out is not feasible.

- **Capital and surplus release mechanics.** The capital adequacy requirements are lower for superfunds than they are for bulk annuity insurers, however there is currently less certainty as to the route to return on investment (in particular whether TPR consent for surplus release from the superfund scheme will be needed, and if so the conditions that will apply). The government is clear that members' interests must always come first, but has also identified the potential benefits for the UK economy of bringing new capital into the pension system, and the need for superfunds to represent attractive prospects for investors if they are to facilitate this.
- **Fee architecture and value leakage controls.** Superfunds promise consolidation of liabilities and assets at scale, which creates opportunity for asset managers and other service providers. Innovative and high performing offerings will be attractive to superfund providers and investors, but participants should be aware that a perception of improper value leakage will attract regulatory scrutiny, and all fees charged will need to be fair, transparent and appropriately benchmarked.

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