Making an entrance

Commercial consolidators – aka superfunds – have entered the DB de-risking market to a flurry of interest, with the first schemes to join them expected to move soon, possibly once regulatory oversight is confirmed. Laura Blows explores these new entities and the considerations trustees should have when contemplating consolidation

Summary

- Interest in DB consolidation has occurred in recent years due to rising deficit contributions, high-profile pension scheme failures, such as BHS and Carillion, and government consultations into its feasibility.
- A new model of DB consolidation has emerged, that of superfunds. With these, the entire responsibility for the scheme is passed to the consolidator to manage for a lower cost compared to an insurance buyout. However the level of security for the members' benefits is higher with a buyout than in a superfund.
- So far two superfunds have entered the market - Clara Pensions, which manages each scheme's money in separate sections until buyout is achieved, and the Pension SuperFund, which works on a self-sufficiency model with all its schemes' assets and liabilities combined.
- Trustees have to determine the level of control they are willing to relinquish when deciding on which of the various consolidation options, such as asset pooling, DB master trusts, commercial consolidators or buyout, to undertake.
- Despite the regulatory structure of superfunds still being determined, commercial consolidators are expected to have a key role within the DB de-risking market.

When someone new enters the room, it's only natural to take a look. If, as they enter the room, murmurs spread that the entrant may just spark new life into the party, excitement and anticipation builds.

So it is with the emergence of a completely new type of DB scheme solution – that of the commercial consolidator, also known as superfunds. For the first time, trustees can move their DB scheme into one of these models and sever the sponsor's ties to the scheme, without it having to be sufficiently distressed to fall into the PPF or having to pay the higher costs of an insurance buyout.

Growing need

It is therefore no wonder this new middle ground option is turning heads. But their walk into the pensions 'room' has been gathering pace over recent years.

Hymans Robertson partner and head of corporate DB Alistair Russell-Smith points out that of the 5,500 DB schemes in the UK, around 4,000 are under £100 million. "It costs around £8 billion per annum in adviser fees and asset management fees to run these schemes. Economically it cannot be efficient to carry on like this."

It may not be efficient, but these costs are nothing new. Attention on the matter increased recently due to greater awareness of the amount of covenant risk faced by DB schemes, as demonstrated by recent high-profile corporate failures such as BHS and Carillon, Lincoln Pensions director Adolfo Aponte states, along with "a desire to show that the UK is open for business against the backdrop of Brexit and a record amount of deficit contributions paid by UK companies".

Also spurred on by the PLSA's work highlighting the benefits of DB consolidation, the government swung into action with the Department for Work and Pensions (DWP) White Paper, *Protecting Defined Benefit Pension Schemes*, published in March last year, which proposed a consultation into DB consolidation. Submissions for the consultation closed earlier this month, with expectations that DB consolidation will be included within the upcoming pensions bill this year.

With this, the political and industry opinion has shifted, Society of Pension Professionals (SPP) president Paul McGlone says. "With so many companies collapsing with a pension scheme left behind, it has become more widely accepted that consolidators making money out of running legacy schemes is reasonable if it allows UK plc to better honour its pension obligations."

So far, two commercial consolidators have entered the arena, each offering a different version of consolidation.

The superfunds

Clara Pensions is one of the new superfunds. Its model is to serve as a bridge between the pension scheme and insurance buyout.

Instead of cross-pooling, Clara Pensions works on a sectionalised model, whereby the assets and liabilities of each pension scheme consolidated into Clara's scheme will become their own section, supported by their own ring-fenced and funded capital. This capital will remain available to that section until all members' benefits are secured through a buyout. Only once every member in a section has had their full benefits will Clara's investors receive a return on capital.

Its CEO, Adam Saron, describes this as a 'member first' model. "We want to take on responsibility for pension schemes today and provide them with a safer and more efficient journey to

buyouts in the future," he says.

Instead of aiming for buyouts, the other commercial consolidator on the scene, The Pension SuperFund, has a 'run off' model akin to scheme self sufficiency. Also in contrast to Clara, The Pension SuperFund is non-sectionalised, so all the transferring schemes' assets and liabilities are blurred.

Each year, it says, one-third of any improvement in The Pension SuperFund's funding level above 100 per cent will be paid into a separate members' trust, which The Pension SuperFund determines will either be used as a one-off payment to members or held in reserve.

This is unusual, The Pension SuperFund managing director, asset and liability management and solutions, Antony Barker, states, as "one discussion I can be pretty sure that has never been had when the FD meets the trustees is 'you know all those deferred pensioners, is there any way we can make their benefits bigger'?"

Suitability

Neither Clara Pensions or The Pension SuperFund claim to be a solution for every type of scheme and scheme circumstance.

According to Aponte, superfunds will be looking for schemes that are closed to future accrual and have a meaningful population of deferred members. Distressed schemes are unlikely to be of interest, as "consolidators are commercial entities and will look to take schemes that can afford their entry requirements", Pensions Management Institute (PMI) president Lesley Carline explains.

So it seems the individual scheme's circumstances would be a major factor in determining whether to enter into a commercial consolidator, and if so, which one would be most appropriate.

"A scheme that is a few years away from buyout may find there is less risk spending those final years within a consolidator targeting buyout than working alongside its own sponsor," McGlone says. "A scheme going through wind up with benefits higher than PPF levels but lower than 100 per cent may conclude that a better option is to pass the benefit to a consolidator who can use outperformance to fill some of the gap in member benefits."

According to Russell-Smith, Clara appears to be an easier structure for trustees to agree to. "The sectionalisation means the health of the rest of the fund is not a concern, and the security of members' benefits appears higher than The Pension SuperFund," he states.

"However, in practice there may not be many situations where trustees face this choice. As an example, if The Pension SuperFund is cheaper than Clara, the sponsor may only be willing or able to fund a transfer to the Pension SuperFund. The decision for the trustees would then be The Pension Superfund versus the status quo, rather than The Pension Superfund versus Clara," he adds.

Trustee considerations

Trustees have a number of factors to consider when weighing up the pros and cons of consolidation. These include the cost, employer covenant, the consolidator's ethics and philosophy, member benefits, governance structure and the overall endgame for the scheme.

Moving the scheme into a commercial consolidator, where it can benefit from economies of scale and remove the sponsor from any further obligation following this last payment to the superfund – at a lower cost than handing over the scheme to an insurer through a buyout – seems likely to be beneficial to many.

"A buyout is never really going to be on the radar for very many schemes and employers," Pensions and Lifetime Savings (PLSA) head of DB Joe Dabrowski says. "They're in a position where they have to either run on or they all end up in the PPF. Giving them something that's a little bit more in their reach, that is also very secure and robust, is very welcome."

An additional benefit, Carline adds, is that the commercial consolidators are likely to offer DC level of member communications, such as financial education tools, along with online services.

But ultimately, trustees must weigh up the loss of the employer covenant against the upfront cash injection and subsequent financial covenant from the capital buffer in the commercial consolidator and decide whether their members will be better off and their benefits safer in or out of the consolidator.

Member benefits within a consolidator do seem broadly safe, as their higher funding level requirements and lower risk investment strategy increased the probability of all member benefits being paid out in one case from 56 per cent to over 99 per cent in Clara, research from Hymans Robertson found.

There are no legal barriers for schemes to move into a commercial consolidator, Hogan Lovells partner Duncan Buchanan says, but "there is risk for both trustees and more importantly, for members because the business model of the commercial consolidators is yet to be tested".

But according to Sackers, there are barriers to full-on consolidation, such as considerable upfront costs, covenant information and confidentiality, and the difficulties involved in consolidating schemes with different benefit structures. "Whether these are all legal barriers is a moot point but there is certainly a need for the new market consolidators to prove themselves and show their business models will work if there are adverse events," Sackers partner Janet Brown says.

For the Association of Member-Nominated Trustees (AMNT) committee member Bill Trythall, this, along with the lack member representation within the management structure of commercial consolidators, is a cause for concern.

"There has been great focus on superfunds' authorisation structure but less so on the supervision side," Trythall states, "which we believe is slightly worrying as to whether they will be monitored once they are up and running, particularly without anybody whose role it is to blow the whistle."

As there's a certain amount of political weight behind it, another worry is if commercial consolidators do not work out well, things may be altered so to improve the consolidators' lot, "meaning the risk to the members is correspondingly increased", he adds.

At some stage it is "almost inevitable" that a consolidator will fail, McGlone says. "Trustees will have to accept that risk going in, and the test will be how that is managed. But to point back to the sponsor at that time and say 'the sponsor is still solvent' would be flawed, as a key reason that the sponsor survived may be because it was able to pass the pension scheme to the consolidator."

Spectrum

Pension Insurance Corporation (PIC) chief origination officer Jay Shah warns that trustees will come under "immense pressure" to transfer to a superfund rather than to an insurer because it is cheaper. "It is cheaper precisely because it is less secure *[than a buyout]*," he states.

The commercial consolidators themselves agree that well-funded schemes should not be considering this solution, and instead should aim for

buyout. "We estimate that 12 per cent of the FTSE350 are already sufficiently well funded to buy out," Russell-Smith says. "However, commercial consolidators are likely to take off for the next tranche of schemes where buyout is still over five years away, and the cash injection required to transfer to a consolidator is very material to the prospects of the scheme."

But superfunds and buyouts are not the only options available for trustees looking at de-risking their scheme through consolidation. Instead, there is a broad spectrum of possibilities.

The choices depend on the amount of scheme control the trustees are willing to sacrifice. On the one side is the pooling of investments or administration services in order to achieve cost efficiencies through economies of scale. Here the trustees still maintain control of the scheme. On the other side are insurance buyouts, whereby the trustees and sponsor can hand over the entire responsibility of a scheme to an insurer for a fixed cost. The insurer then guarantees member benefits will be paid in full.

Commercial consolidators sit just below buyouts, whereby the trustees and sponsor still hand over responsibility for the scheme, but for a cheaper cost than a buyout. However, there is still the risk that the consolidator now running the scheme may itself fail, and member benefits not paid out in full (which would have been guaranteed under a buyout).

Below commercial consolidators is that of DB master trusts, which provide some of the benefits of consolidation in terms of governance and operational efficiencies, while not 'cutting the cord' with the sponsor relationship – unlike superfunds that replace the existing sponsor covenant, Employer Covenant Working Group chair Donald Fleming says.

"In principle, a DB master trust can accommodate any type of scheme, such as very small to very large, closed and open to accrual. However, the advantages of a DB master trust are probably most obvious for smaller schemes, where the scale of a DB master trust offers the prospect of lower running costs and access to a wider range of asset classes, plus improved governance," Citrus DB Master Trust trustee Michael Penny says.

A DB master trust can provide a scheme with savings of around 30 per cent typically, TPT Retirement Solutions head of direct distribution Adrian Cooper states.

"Another reason why schemes may use a DB master trust may be due to succession planning issues with trustees on the scheme," he adds.

Taking action

But what should those schemes whose trustees have decided upon a commercial consolidator do to prepare for the move?

The Pensions Regulator (TPR) provides guidance for schemes in this situation, but according to Russell-Smith, those wanting to move should ensure they have clean data to speed up the transaction. They should also engage early with the consolidator to avoid pitfalls such as spending a large amount on consulting, to only then find out that the move is not possible.

Many are not yet at this stage. Most trustees are interested in this topic but "for the majority it is just window shopping at the moment rather than serious interest", McGlone says.

Recent research from Lincoln Pensions found 46 per cent of respondents recognise consolidation as a potential endgame they may consider in the future, but just 11 per cent said they were currently considering this option. Increased security was considered its biggest benefit by 71 per cent, with 42 per cent citing improved funding and 21 per cent improved governance. The biggest disadvantage was the risk of consolidator failure, followed by an uncertain regulatory regime.

The future of the nascent superfund market will depend on DWP's next move, Aponte warns, as some of the proposals included in the DWP's recent consultation could limit the pool of potential candidates for consolidation. "In that case, it is questionable whether it would be worth the effort of introducing a new regulatory regime where a close analogue already exists with insurance solutions." However, there are more than a handful of schemes and sponsors already actively evaluating superfund consolidation, Aponte notes.

"Once the first deal is done, which it will be, there will be no going back," Gatemore Capital Management partner Mark Hodgson states. "The concept will have been proven and there is more capital looking to swallow up pension funds for a healthy return. If those returns really are attractive, there may well be rush of consolidators to market who have been waiting in the wings."

Indeed, there are already a handful other providers that have superfund products waiting in the wings. Recently, Legal & General stepped out with its Insured Self-Sufficiency (ISS) product, which works in a similar way to a commercial consolidator, but without severing the sponsor link.

However, it appears that TPR has learnt from the rise of multiple DC master trusts, which led to unsustainable numbers, Carline says, so it will ensure there are just a few DB consolidators, so that oversupply doesn't lead to problems.

K3 Advisory managing director Adam Davis is hopeful that superfunds could provide much-needed capacity to small pension schemes who struggle to get traction in the buyout market. Shah agrees, highlighting that bringing together small schemes was the "original purpose" of superfunds.

This hope could come true, as Barker states that The Pension SuperFund's ultimate end game is to develop a 'cookie cutter' approach for onboarding sub-£1 million schemes – "but this is something for 2025 rather than today's challenge".

It seems that now commercial consolidators have entered the room, they will be making themselves at home within the DB consolidation landscape.

Written by Laura Blows