More mergers ahead?

Lynn Strongin Dodds explores whether consolidation remains the name of the game for DC master trusts

Summary
• Master trust consolidation may have slowed but the direction of travel is for more mergers.
• Master trusts of a certain size are being more selective in who they acquire in the next round.
• Scale and resources will be even more important as DC schemes invest in a broader range of assets.

Although the tempo may have slowed this year, consolidation remains the name of the game in the master trust world. Regulatory and economic pressures will continue to be the main themes, with smaller trusts struggling to achieve the scale, resources and deep pockets required to tighten governance and invest in a wider array of investments, including illiquid assets.

As WTW senior director, James Colegrave, notes, there was certainly an initial consolidation rush as many well-governed schemes concluded that their members would be better off in a master trust. This was driven by both sponsors and trustees. "Consolidations have now slowed," he says. "When we look to WTW's *2023 DC Pension and Savings Survey,* we can see that many smaller, perhaps less well-governed, schemes have yet to consolidate, with the remaining, larger, own-trust schemes committed to continue, at least in the more immediate term."

A pause

One reason causing a pause for thought is the volatility in stock markets over the past two years. Trustees have adopted a more cautious stance due to the Russia-Ukraine conflict, as well as the uncertainty over the macro-economic picture, given the rising inflation and interest rates.

However, SEI DC and solutions managing director, Steve Charlton, believes that the pace has not waned, but the dynamics have changed. The flurry of activity seen a few years ago has meant that the industry is in the second wave and players will be more selective. "There are a lot of bigger players who do not want to sell," he says. "The question is who will blink first and make the first move. It is also about finding the right opportunities for your model. For example, we are looking at a large number of assets and members but a modest number of employers."

Hymans Robertson head of DC investment, Alison Leslie, echoes these sentiments. "The low hanging fruit has happened where there have been natural synergies," she says. "We now expect to see consolidation among master trusts that are not necessarily structurally aligned or between commercial and non-commercial ones. The trend is also being driven by The Pensions Regulator (TPR), who has already announced that it would like to see 90 per cent of members belong to a scheme of £30 billion or more by 2030."

This was reiterated in Chancellor of the Exchequer, Jeremy Hunt's, 2023 Autumn Statement. The government estimated that only four of the commercial authorised master trusts had funds under management in excess of £10 billion at the start of the second half of 2023. Its forecast was based on Department of Work and Pensions (DWP) research into existing trends and projections.

Opinions differ on the numbers but last October, LCP principal, Philip Audaer, predicted there will be just 10 to 12 master trust providers within the next five to 10 years from the current 36 authorised master trusts – which account for 20.7 million DC memberships.

Advantages

There is no argument though over the advantages of mergers. Market participants note that smaller, less robust trusts that join forces with a larger counterpart will create a more stable and resilient pension landscape. Those with heft can also benefit from economies of scale, lowering costs and enhancing returns for members. Last but not least, it ensures stronger regulatory oversight and safeguarding members' interests.

In addition, many think it encourages innovation and efficiency within the

sector. In other words, a consolidated market can better weather economic challenges, offer improved retirement outcomes, and generate greater public trust in pensions.

Looking ahead, LCP DC team partner, Lydia Fearn, believes that "future consolidation may be driven by the forthcoming value for money (VFM) policy, when it lands". These views are also reflected in the Pensions and Lifetime Savings Association (PLSA) comments, which note that the VFM framework for DC workplace pensions will enable smaller schemes to benchmark larger trusts across measurable metrics, such as investment performance and costs.

The devil, of course, is always in the detail and the Financial Conduct Authority (FCA) will be consulting on the finer points next spring. This follows earlier joint papers from the DWP and TPR which have aimed to enable those running pension schemes to compare and improve the VFM they provide. It also looks to generate competition and remove under-performing schemes from the market.

Many industry participants also see the Mansion House Compact as a contributing factor in creating alliances. The government objective is to get DC schemes to invest up to 5 per cent of their default funds into unlisted equities by 2030. Currently it is around 1 per cent and DC schemes must now consider the use of illiquid assets in their defaults and update their SIPs no later than 1 October 2024, according to Colegrave. Importantly, if illiquids are not to be used in the default, the trustees must explain why that is the case.

"This, along with the proposed new VFM requirements, will undoubtedly prompt more consolidations," he says. "However, we worry that many of the smaller, less well-governed schemes will just muddle though, perhaps unaware of the new requirements. This is where TPR will need to use their power to encourage the consolidation of those less well-governed schemes."

Challenges

Size will matter as it will not be easy for smaller schemes to invest in illiquid assets. Colegrave believes that it may prove difficult because "by their very nature, those illiquid assets cannot just be sold. However, he expects many of the master-trusts to become more creative in accepting the in-specie transfer of illiquid assets – potentially then holding them within their much larger defaults – or hybrid schemes could potentially hold on to the illiquid assets through their DB section investment portfolios.

He adds: "Although the presence of illiquid assets will make it more complicated to transfer a DC scheme or a DC section into a master trust, we expect that there will often be a solution that can be found. We will just need to learn to

think out of the box."

Fearn stresses that it is still early days, and that the implementation of illiquid assets is still being developed. She believes that current solutions allow, in the main, liquidity within the funds.

For those funds that may experience gating, she says, "they could either remain in place until such time members can be transferred out or they could be moved 'as is' to a new provider, where the new provider can manage the liquidity over time. We expect to this become more of a discussion point as the illiquid allocation grows and any scheme or master trust moving to a larger scheme should ask for clarity on how this will be handled before any transfer begins".

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Invesco EMEA head of consultant relations and UK pensions, Sachin Bhatia, also points out that some of the key differences are linked to the ability of third parties, such as platforms and administrators, to link to illiquid assets. "As the UK DC market has to date had little exposure to illiquids there has been limited focus on this," he adds. "However, given current market attention on illiquids we expect schemes, master trusts and related third parties to start focusing on this issue more going forward." There is a view that in time many will leverage the Long-Term Asset Fund (LTAF),which launched two years ago. This comprises of an open-ended authorised structure, covering private equity as well as venture capital, real estate, private debt and infrastructure. Unlike most existing retail vehicles, LTAFs do not offer daily dealing, but fund managers have to align their redemption terms with the liquidity of their underlying assets.

The larger master trusts already invest in illiquid assets and Leslie expects "consolidation will bring scale for accessing LTAFs and for now I think they will be the preferred vehicle for accessing private markets. Overall, size and scale will be important because larger master trusts will have more influence on pricing, which is a concern in private markets. Although value over cost should be a focus that is not always the case, even if the potential outcomes may be beneficial."

Written by Lynn Strongin Dodds, a freelance journalist