Summary
- The DB pension sector is highly fragmented and ripe for consolidation.
- Consolidation is not for everyone – an insured buyout is more secure for those who can afford it.
- Trustees should wait until the regulatory framework is in place and the market is more established before using the new consolidators.

Little and large

A new Pensions Bill is set to energise the consolidation market but what schemes should take the plunge? Stephanie Hawthorne reports

Millions of members' benefits are at risk of not being paid in full if their sponsoring companies fail; the vast majority of schemes cannot currently afford buyout, and are unlikely to be able to do so in the foreseeable future. This is a major problem for the fragmented and declining defined benefit (DB) industry.

Small pension schemes in particular are at risk. Costly to run, the waste of money is huge – the annual cost of administering a small scheme can be over £1,000 per member, while larger schemes can reduce this to under £200 per member. And over 4,000 DB schemes have fewer than 1,000 members. Of those, nearly 2,500 have fewer than 100 members.

As well as administrative cost savings, larger schemes tend to have more sophisticated governance procedures, often using professional trustees and investment consultants, which can lead to better returns on investments. So could consolidation be the answer to the issues facing smaller schemes?

Legislative framework

The white paper, Protecting DB Pension Schemes, in the spring trailed a government consultation to encourage efficiencies and facilitate consolidation. More recently a DWP spokesperson told *Pensions Age* that "this autumn we will be consulting with the pensions industry and stakeholders to develop a legislative framework and authorisation regime applicable to all forms of commercial consolidation".

The government is certainly keen on the idea. Minister for Pensions and Financial Inclusion, Guy Opperman, at the PLSA Annual Conference in Liverpool last month, said he was a genuine believer in "big and better".

Consolidation is an "alternative option for schemes and sponsors who have no realistic prospect of being able to fund an insurance buyout either now or in the foreseeable future", he stated, whilst at the same time flagging a new Pensions Bill due summer 2019.

A popular option

The idea of DB consolidation has also seen support from the industry, as PLSA head of DB, LGPS and standards, Joe Dabrowski, says, "superfunds could be attractive for schemes of all sizes". Many DB schemes themselves have also expressed an interest in consolidation, Hymans Robertson partner Patrick Bloomfield notes.

"I'm aware of one consolidator with an active pipeline of around three dozen schemes. There are other, more traditional consolidation service model operators who've been around longer and have prospect pipelines many times bigger than this," he says.

In terms of why schemes are interested in consolidation, TPT Retirement Solutions head of direct distribution, Adrian Cooper, says there are several triggers that can lead to a scheme wanting to consolidate. This includes wanting to "plough back cost savings into the scheme to get to self-sufficiency buyout faster" and the amount of "management time taken up by the scheme".

For other schemes, consolidation may be considered by those that have "difficulty replacing trustees, reviewing one service line but then taking the decision to review all services/operating model, M&A activity where the acquirer does not want to run the scheme," Cooper adds.

Consolidator choice

There are various consolidators in the market, ranging from the established DB Complete, TPT's consolidation master trust solution, where the link with the sponsor remains unbroken, to two new consolidators on the block: Clara and The Pension SuperFund, each with a different model and both currently gearing up for their first clients.

The Pension SuperFund CEO Luke Webster (and formerly chief finance and risk officer at London Pension Fund Authority) says the superfund has around a dozen "well developed conversations" moving towards final bids, and 20-30 early stage discussions. The superfund is "prioritising transactions in excess of £100 million", Webster says.

Clara Pensions co-founder and CEO, Adam Saron, whose corporate board is chaired by Lawrence Churchill CBE, says Clara has seen particular interest from sponsors whose DB volatility is distracting from their main business activities, those undergoing corporate M&A activity, those with overseas parents who do not understand the UK pension system and from trustees who are worried about the financial future of their company but cannot yet afford buyout.

He explains: "Each pension scheme entering Clara will have access to funded, permanent and ring-fenced capital from day one, meaning that Clara can support member security until all the pensions in a section are insured. Investors cannot extract capital or profit until that happens."

In terms of the models used by the operators, The Pension SuperFund sees the money in the superfund pooled with the other schemes' assets, after bulk transfers of DB pension assets and liabilities. There will be no changes to existing scheme members' benefits. Instead of the security of having a sponsor's covenant behind the scheme, there will be an asset-backed contribution to 115 per cent of liabilities.

On the other hand, Saron says that Clara acts as a bridge for pension scheme members between a company and the gold-standard of an insured buyout. "We will use third-party capital to support members' pensions," he says, "making it viable for each scheme to enter the insurance market at a later stage. Our aim is to deliver the most secure pension as soon as possible for members."

Explaining TPT Retirement Solutions' model, Cooper says that all services are consolidated under one roof – i.e. actuarial, investment, administration, covenant, legal and professional trusteeship. "This generates significant efficiency savings that are increased further, due to TPT's not-for-profit status," he notes.

Not for everyone

Most sponsors would welcome the option of being able to offload their legacy defined benefit liabilities – the real question is whether they can afford the premium charged by a consolidator (whether as a one-off payment or a contractual payment plan) and whether members and trustees are happy to sever the link with the employer's covenant.

Capital Cranfield Pension professional trustee Andy Scott says: "The schemes that are most suitable for entry are ones where the scheme is reasonably well funded (at or above the PPF level) and the covenant is reasonably strong just now, but is likely to deteriorate in the future, making full buyout unlikely."

Another requirement, says Scott, is that the entrance fee is affordable to the company. "If all of these situations apply, then members are likely to receive better than PPF benefits and they are protected from the deterioration of the employer covenant."

At The Pension SuperFund, Webster says that schemes that are significantly underfunded and whose sponsors cannot make a top-up to the superfund's entry level are unlikely to be able to access the benefits of consolidation through its route. "If freedoms arose from legislative change, for instance conditional indexation, we would be able to help a broader section of the market," he adds.

Hogan Lovells partner Duncan Buchanan says: "If the sponsor has a strong covenant, then it is likely that the trustees will hold out for an insurance solution – securing benefits through buyouts. Trustees who are asked to move their schemes to a consolidator will need to be satisfied that it is in the members' interest to make the move."

Not only that, Buchanan says that it must be demonstrated that the move will lead to a better member outcome. "Trustees will need advice on this and their current advisers may face conflicts (as they will lose a client if the transfer takes place). In the early days, before a formal authorisation/regulation system is in place, trustees may want to see regulator clearance for the transfer to a consolidator."

Ending a link with a sponsor without an insured level of security will only be right for some schemes but using third-party administrators, fiduciary management and having the same trustees across different schemes can also give some of the benefits of consolidation.

Trustees also have a vital role to play in explaining any possible move to a consolidator to their members who may not realise the difference between getting their pension from an employer's scheme, a consolidator or an insurance company.

Look before you leap

A caveat: with most consolidators the employer covenant ceases on the transfer. Therefore, it is essential that consolidators have access to large amounts of risk capital and that this capital is readily available when needed to fund benefits.

Buchanan concludes: "If I were a trustee, I would want to wait until the promised regulatory framework is in place and the market has established itself. This is likely to be in a few years' time – in the meantime I would work with the employer to prepare the scheme for the transfer – undertaking data cleansing and GMP reconciliation exercises."

Written by Stephanie Hawthorne, a freelance journalist