The case for DB consolidation

David Adams looks at the DB pension consolidation options becoming available to schemes and the reasons why regulators, the government and providers are getting involved in a growing market

Summary
• There are multiple reasons why consolidation may be a good option for DB scheme sponsors and members, including the chance to benefit from economies of scale, and to safeguard or replace the covenant.
• TPR and the government are keen to encourage DB scheme consolidation to benefit scheme members and employers, and help more schemes engage in 'productive investment'.
• Consolidation options include DB master trusts, superfunds and various bundled services offerings

If anyone doubted the desire within The Pensions Regulator (TPR) to encourage consolidation of defined benefit (DB) schemes, the speech delivered by its CEO, Nausicaa Delfas, at the Pensions and Lifetime Savings (PLSA) conference in October 2023 should have removed those doubts. Delfas said that many DB schemes "lack scale to deliver the best returns", with 70 per cent of the 5,000 or so in the UK today holding assets of £100 million or less. "That is why all trustees should be asking themselves tough questions about consolidation," she suggested.

The government is also in favour of more consolidation. A few months earlier, Chancellor, Jeremy Hunt's, Mansion House speech included an announcement about a call for evidence to investigate how DB schemes might increase use of 'productive investment' in private capital including private equity, start-ups, and infrastructure or other long-term illiquid assets. The government identified consolidation of DB schemes into superfunds as one possible solution.

There are other reasons why trustees and sponsors might find consolidation attractive: After years of economic and uncertainty, many employers and their pension scheme's covenants are weak. Some employers (and some trustees) may also have concerns about standards of governance, as trusteeship has become more complex in recent years, leading to difficulties in finding and training new lay trustees and more use of professional sole trustees.

At the same time, the question of how to work towards an endgame has become more urgent for many schemes during the past 12 months, after the economic events of autumn 2022 boosted scheme funding levels significantly, so shortening the timescales to a possible buyout.

A range of options

One option is consolidation within a master trust. The DB master trust market is much smaller than the equivalent market for DC schemes, but also more complex, with a range of different options available. The original scheme's benefits structure is retained, and some master trusts also work alongside the existing trustee board, allowing it to retain oversight of the scheme within the larger vehicle.

"DB master trusts are not changing the basic premise of a sponsor being there, but they are generating efficiencies by being part of a bigger arrangement," says Hymans Robertson, partner Iain Pearce. "That feels like it should be quite a positive step for a lot of schemes."

Examples include TPT Retirement Solutions' DB Complete offering, a master trust that can provide investment, actuarial, covenant, administration, accounting and governance services. TPT head of business development, Jonathan Jackaman, offers an illustrative example of a £200 million scheme with several thousand members making cost savings of £500,000 per year through joining the master trust. Schemes in the master trust also still retain the option of proceeding to buyout at a later stage.

The PLSA expects this market to grow and has created a self-certification service that DB master trusts can use to provide information about their structures, governance, operations and processes for joining and leaving. At the time of writing, Abrdn, Citrus, Isio, Mercer and TPT Retirement Solutions had completed self-certification.

But joining a master trust is not the best course of action for every scheme. PwC head of alternative pension solutions, Matt Cooper, thinks that at present more schemes and employers are interested in using bundled outsourced service packages to benefit from economies of scale while retaining some control.

Jackaman acknowledges this point of view. For these schemes, he suggests, alternative solutions, such as TPT's DB Connect offering, might be an option. It offers consolidation of fiduciary management, actuarial, covenant, administration, accounting and secretarial services, but the existing scheme structure and the trustee board are unchanged.

TPT Retirement Solutions business development director, Nicholas Clapp, says the company aims to be completely agnostic about whether a scheme uses this solution or joins its master trust: "It's important that the decision is made on what's best for the members, the trustee board and the sponsor."

Superfunds – slow start, but a bright future?

The other type of arrangement that could play a big role in consolidation of DB schemes is the superfund, an arrangement that replaces the employer's covenant with a capital buffer provided by external investors. As we have seen, the government is enthusiastic about superfunds, partly because of the potential they could offer as engines for productive investment. Jeremy Hunt announced plans for a regulatory regime to support superfunds during his Mansion House speech.

The problem with the superfund concept at present is that the only one in operation at present, Clara, has found it difficult to make much headway, in part because the sudden change in funding levels during late 2022 persuaded some employers and trustee boards to pause and review consolidation strategies.

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PLSA head of DB, Tiffany Tsang, says the organisation supports greater statutory support: "If superfunds get a statutory footing, then hopefully the market would be able to grow."

Cooper says that TPR figures suggest there are about 500 DB schemes, collectively holding about £100 billion in assets, that are reasonably well funded but supported at present by understrength covenants – exactly the sorts of schemes that would benefit from joining a superfund.

"That to me says there is a market that will allow a small number of superfunds to get to a significant scale," he says.

Pearce adds: "When you look at the insurance market we see a highly competitive landscape, with lots of providers wanting to deploy capital to fund pensions.

"With a superfund the basic premise: To underwrite UK pension schemes' risks to seek a return, equally applies. So, it will be interesting to see what future growth that Clara experiences; and whether that triggers new entrants into that space."

Another consolidation model is capital-backed journey plans, which are based on a partnership between an investor and a trustee that settles an investment strategy to enable the scheme to reach a target funding level – such as buyout – within a given timeframe. The investor provides a capital buffer, which is invested alongside scheme assets and could be topped up in unfriendly economic conditions. At the end of the arrangement the investor retains assets beyond the target funding level.

The need to help the smallest schemes

But all these forms of consolidation leave many of the smallest schemes – those that could gain the most from consolidation, in theory – underserved.

"The nut that has yet to be cracked is the smaller scheme," says Clapp. "At the moment there are thresholds below which a scheme will find it difficult to take up one of the consolidation options. I'd like to think that the market is able to bring down those threshold levels to help these small schemes. But that's going to require more technology and data-driven processes."

Muse Advisory CEO, Ian McQuade, is optimistic about the ability of providers to meet the needs of smaller schemes in the longer term: "There's an awful lot of capital looking for a return and therefore people are being creative and trying to come up with ways … to use capital to help schemes get to where they want."

Clapp believes the next couple of years will bring further clarity on the best ways to meet the many and varied needs of schemes. "I think in the next couple of years there will be a greater consensus on the different consolidation options," he says.

Written by David Adams, a freelance journalist

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