Gaining momentum

Sean Farrell explores the growing trend towards consolidation within the pensions sector

At a time of upheaval in the pension industry, consolidation will be one of the dominant themes of the next decade.

Whether you are an individual saver with multiple pots, a sponsoring company or a scheme trustee, you should be thinking about efficiencies and other benefits of consolidating assets.

The Pensions Regulator and the Department for Work and Pensions expect trustees of small schemes to consider consolidation, but this is not just a matter for these schemes. All schemes should make sure they understand their options when it comes to consolidation.

The new defined benefit (DB) superfunds, notably Clara-Pensions and the Pension SuperFund, have received lots of attention but they will not be the answer for all (or even the majority of) DB schemes. There are a range of options that can improve efficiency, governance, asset allocation and outcomes for members of both DB and defined contribution (DC) schemes.

Consolidation does not have to happen in a single move. There are options for schemes to test the water and put themselves on a path to their ultimate goal. Briefly, the main options are:

- Appoint a professional or sole trustee to bring more expertise to the board and improve governance
- A fiduciary management model that delegates investment to a third party, potentially enhancing governance, efficiency and investment options
- Master trusts take on trusteeship, governance and administration while maintaining the corporate sponsor's responsibility for the scheme
- Superfunds go a step further by taking on financial responsibility for supporting a DB scheme
- A buyout by an insurance company is seen by many as the 'gold standard' and the ultimate endgame objective for many DB schemes.

There has already been significant pension consolidation in the UK. Bulk annuities were a relatively niche activity just over a decade ago but have grown exponentially. Last year saw a record level of activity, with about £25 billion of liabilities secured in this way, and that is set to be surpassed in 2019 with more than £30 billion of transactions expected to take the aggregate total to around £150 billion. In another indicator of consolidation, the number of funds adopting fiduciary management has risen from about 60 in 2008 to approaching 900 in late 2018.

The experience of other countries shows once consolidation is actively encouraged it gains further momentum. A decade ago Australia had about 7,000 pension schemes; now there are about 2,000. In the Netherlands the number has dropped from about 700 to 200 in that time.

In both countries, legislation played a significant part in driving change. That active encouragement is now taking place in the UK. With about 5,500 DB schemes, the UK has a relatively large number of schemes and The Pensions Regulator wants trustees and sponsors to consider whether consolidation can provide better outcomes for members.

Mercer head of risk transfer Andrew Ward says: "This could be the most significant period of change since UK pension schemes were first set up. If the speed of contraction in the number of schemes mirrors other geographies the impact could be phenomenal. The industry has got a job to do to make sure the overriding aim of securing the best outcomes for members continues to be met."

Trustees face increased demands and complexity as rules change and DB schemes try to navigate towards the endgame. The government and the regulator want trustees to consider whether they have the right level of professionalism to make the necessary adjustments in a more complex environment.

Pension flexibility is prompting many companies to consider allowing members to draw down their retirement savings. This places an extra burden on schemes that may not have the money or expertise to run such a programme.

These demands coincide with what looks like a more difficult period for markets. After a relatively benign decade the world economy is slowing and markets may not grow at the same pace in the next 10 years. Trustees will need to be nimble and decisive – and with yield curves inverting, DB schemes may not be able to rely on bond yields to do the work for them.

There have also been improvements in the market that can make consolidation more attractive for trustees and sponsors. The Pensions Act 2017 provided assurance about standards for DC master trusts; those master trusts that have applied for authorisation will hold reserves and be monitored by the regulator.

Mercer solutions leader for DC and individual wealth, Philip Parkinson, says: "In the DC market we have an ever-increasing governance burden for single trust-based schemes. The DWP is consulting on more legislation and is likely to ask: 'If you're not consolidating, why not?' Across the industry, both demand and supply are pushing towards consolidation."

Which option to pursue, or whether to stick with the status quo, depends on a range of factors including the scheme's size and trustees' expertise and time. The long-term goal and a DB scheme's funding level, sponsor covenant and maturity are also considerations.

There are also important trade-offs in costs, member security, flexibility and other factors. A DB buyout is likely to be the most secure option but also the most costly. A superfund may offer lower costs than a buyout but is also less secure and ends the link to the employer.

These two solutions may feel to many like an 'all or nothing' answer. But there are more flexible options that can provide immediate benefits and act as a step towards greater consolidation further down the line.

DB master trusts are likely to be less costly than either the buyout or superfund options while maintaining the sponsoring employer's responsibility for funding deficits. Despite being relatively less high profile to date, they may emerge as a more mainstream solution for schemes seeking to consolidate.

Installing a professional trustee or moving to a sole trustee approach can ensure the board has the know-how to optimise governance and outcomes for members. Though not strictly a consolidation step it can be a first move towards increasing effectiveness and efficiency.

Fiduciary management services have existed for decades and are generating increased interest as an option that delivers benefits of consolidation while keeping the sponsor's link and leaving other routes open.

Mercer fiduciary management principal, Tim Banks, says: "It's a very big decision for a trustee to remove the covenant. Fiduciary management has been around for a long time, it's tested and it's no longer one-size-fits-all. For a corporate sponsor it can be a first step to get trustees over the line to a superfund or a buyout."

Consolidation has the potential to create longer-term gains for members beyond the immediate benefits from economies of scale and professional expertise. These include greater competition for fewer, bigger investment mandates, improved fee arrangements and better member engagement.

Mercer's UK chief investment officer, Jo Holden, says the pooling of local authority assets from 89 funds into eight highlights positive changes that consolidation can bring about.

"There is no doubt the local government schemes have benefited from consolidation," she says. "There has been a reduction in fees and in our view there's a governance advantage because previously the schemes spent so much time dealing with asset managers instead of concentrating on the overall risk-return funding strategy."

Changes to fees do not have to be a 'race to the bottom', she adds. "We have seen interesting discussions around models that move beyond performance-related fees to discounts for long-term relationships or fixed fees linked to inflation."

Consolidation offers economies of scale to invest in technology and services to help members make decisions in a way that most individual schemes would struggle to achieve. There are likely to be further such demands as the state transfers responsibility for pensions to individuals.

Ward says: "The potential benefits of consolidation are clear and there are more choices than before but this isn't an easy decision. You need to understand your options and objectives and consider them together.

"For many schemes the status quo will remain a valid option. But you should make sure you have considered all the alternatives and that you can demonstrate this when the question is asked."

Tim Banks, Jo Holden, Philip Parkinson and Andrew Ward, who were interviewed for this article, will be discussing consolidation on 16 October in a Specialist Session at the PLSA Annual Conference & Exhibition

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