Summary
While not a new trend, consolidation is on the rise, particularly as regulatory bodies pressure small schemes to consider banding together.
• When done well, consolidation can reap great rewards, but if schemes are too hasty there are risks too.
• Schemes must plan properly and get their house in order before choosing a consolidator.
• If a scheme decides to consolidate, there are significant steps they need to take. These include cleaning data, coming up with a communications plan and putting good governance in place.

The promises and pitfalls of pension scheme consolidation

Consolidation can offer benefits to small schemes, but trustees must choose wisely or they risk leaving members worse off, writes Sara Benwell

Small schemes have never been under more pressure to consolidate. Regulators are breathing down the necks of trustees, encouraging them to reap the rewards that are often associated with banding together.

It's not a new trend. The Pension Protection Fund and bulk annuity insurers have been consolidating pension schemes since the Pensions Act 2004. Meanwhile, the emergence of defined contribution master trusts has seen many employers opting to outsource their pensions responsibilities, rather than taking on the expense and governance headaches of running a small scheme.

Fidelity International head of pension products James Carter says: "The variety and nature of risks facing pension schemes and their members have expanded and deepened in recent years – with threats including the uncertainty posed by investment markets and cyber threats."

Royal London director of policy Steve Webb adds: "We are some way short of the Australian 'comply or explain' approach to persevering with running small pension schemes, but The Pensions Regulator are getting increasingly vocal on the need to make sure that members of small schemes are properly protected and that if small schemes can't demonstrate they are providing good outcomes to members then they need to do something about it."

The risks of hasty consolidation
When done well, consolidation in both DC and DB can reap rewards, but there are still risks that need to be considered before making the decision to outsource.

Dalriada Trustees professional trustee Vassos Vassou explains: "One concern is that members lose the security of the sponsor covenant by being moved to a consolidator. Members will not thank trustees that move them to a consolidator, which in time proves to have diminished their outcomes.

"Other risks also exist. For example, the chosen administrator may perform badly, meaning that the service members get is poor. The Department for Work and Pensions is very keen to push consolidation. It is seen as a way of removing the governance problems around small schemes. This does have some risk associated because there is a chance the initiative fails and then members' confidence in our pension system will take another hit."

TPT Retirement Solutions CEO Mike Ramsey agrees that trustees need to consider it carefully. He says: "When scheme sponsors and trustees consider outsourcing their DB pension schemes, they are often – quite rightly – concerned whether their scheme responsibilities and members will be well looked after. Some consolidators involve sponsors relinquishing their link with members, which can be a concern for trustees."

Mercer head of fiduciary management UK, Ben Gunnee, thinks that full outsourcing, where the sponsor link is severed, will see the lowest take up among trustees. He says: "This is likely to be the least used form of consolidation over the next five years or so, as the number of schemes that have the right characteristics is lower than for the other forms of consolidation."

For defined contribution schemes, the dangers of poor governance, investment strategy, administration or communication can be even greater. If a master trust underperforms, then people's pots could be eroded or members might even be put off from pension saving altogether and opt out.

In DC, there is also a fear is that some of the smaller master trusts are themselves poorly governed and risk member outcomes. Fortunately, the Master Trust Assurance Framework has made significant strides here. The new regulations have more than halved the size of the market and should help make sure that the remaining authorised schemes better protect members by upholding high standards.

Preparing for consolidation

To get consolidation right, those responsible for small schemes need to analyse their membership's needs carefully and choose the right consolidation vehicle. This can be tricky as the options available to trustees are broad and quite varied.

Mercer leader of risk transfer, journey planning and DB consolidation, Andrew Ward, explains: "Consolidation can mean different things to different people and there is a wide range of options, from appointing a professional trustee, through asset pooling; fiduciary management; DB master trusts and superfunds all the way to bulk annuities.

"The relative merits of each of these need to be understood with reference to key criteria such as governance, investment delegation, flexibilities, cost/ fees and security. Once the options are fully understood, and initial preferences are identified then more detailed feasibility work can take place to analyse whether a potential consolidation option actually has legs."

One mistake trustees can make is to leave some of the finer planning too late, choosing a provider – or even the type of vehicle – before they've done the right preparation and research. This can lead to problems further down the track.

PTL managing director Richard Butcher says: "They should have done most of the prep well before they get to this stage. You should always start a process with 'what do we want to achieve?' and then execution is at the 95th percentile of the process.

"There'll be a project plan that will include, at a high level, legal process, admin (cleanse and transfer), investments (alignment and transfer), stakeholder engagement (eg members, regulator etc)."

Ward adds: "The key here is to understand the scheme specific circumstances and objectives. A superfund solution (Clara or Pension SuperFund) will be right for schemes, say, who are relatively well funded and have sponsors that look weak in the medium to longer term but can fund a capital injection today.

"However, they might be less appropriate for poorly-funded schemes – where the contribution requirement is too great; very well-funded schemes – where buyout is deemed a safer option; or schemes with very strong sponsors – where giving up the sponsor covenant is unattractive. A structured approach to assessing each option is the most sensible approach."

He points out that consolidation choices should be periodically reconsidered to make sure that the approach taken remains fit for purpose.

This is particularly important as there is nothing to stop schemes moving from one sort of consolidation vehicle to another and for some schemes this might be the best approach to achieving their funding goals.

For instance, it is possible that a scheme could start off using fiduciary management and then over time take this further via transfer to a DB master trust before ultimately buying out with a bulk annuity provider.

Webb argues that for DB schemes, the process of consolidating can be complex and there are lots of factors to consider.

He says: "Member benefits in a DB scheme may also be structured in different ways (eg different levels of widows benefits, different pension ages etc) and there is much to be said for standardising benefits between the two schemes at point of merger."

Of course, defined contribution plans must be similarly well prepared, and lots of the same steps will apply. Choosing the right master trust is critical, as is getting governance, administration and communications right.

Smart Pension director of policy and communications Darren Philp says: "Small DC schemes should choose *[a master trust]* carefully. Focus should particularly be on governance and value for money, and the master trust's experience in managing transitions.

"They must also get their data in order. Make sure records are up to date and in good shape and reconciled. This helps massively with any transition and reduces risk to both the ceding and receiving scheme."

Mercer partner, workplace savings proposition lead, John Breedon, adds: "An important first step is to check whether the transferring scheme is fully able to move and that there are no complexities such as secured rights – for example GMP underpins. The impact on all the stakeholders including benefit administration and payroll teams also needs to be considered."

The final critical component for both DB and DC schemes alike is creating a communications plan. This is one of the most important factors to consider when it comes to making changes to members pension provision, and trustees must make sure they keep savers up to date and that messaging is reassuring, simple and uses engaging language.

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