Summary
- There are over 5,000 DB schemes with fewer than 1,000 members. The majority of these are closed but few are going through a wind-up process.
- Small schemes can benefit from a simple operating and investment structure, along with close member engagement.
- Costs are the biggest problem for small schemes as they face higher charges compared to larger schemes.
- Small schemes may struggle to buy specific administration functions from an overall service package offering.
- Small schemes may be unable to access services amd solutions open to large schemes, to the extent that some small schemes may have no online communications for members.
- Small schemes can let bigger schemes experiment with new ideas and then are able to use the successful developments once commoditised.

Small but significant

David Adams explores the unique issues facing those managing small-sized DB schemes

It's easy to overlook the continued significance of small DB schemes. In November 2016 there were just over 5,000 DB schemes with 999 members or fewer, including 2,177 with between five and 99 members; and 202 with between one and four members, according to The Pensions Regulator's research on the DB pensions landscape. As you might expect, a large majority of these schemes are closed to new membership and future accrual, but only a small minority are going through a windup process.

Schemes with less than 1,000 members have a total of just over a million members between them, including just over 96,000 people in schemes with fewer than 100 members. But just over half a million members are deferred; and only about 9 per cent of the million-plus members (92,812) are still active members. Set those figures in the context of the long-term decline of DB schemes and it is clear that even if it will be decades before all the small DB schemes disappear, the clock is already ticking.

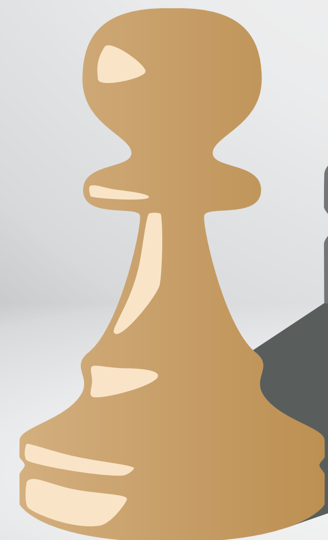
Governance challenges

Yet this does not necessarily mean that being a member or the sponsoring employer of a small scheme is a bad position to be in, says Pensions and Lifetime Savings Association (PLSA) head of governance and investment Joe Dabrowski.

"Small can be beautiful," he says. "It is possible to have a small scheme that is run very effectively, has good funding and a strong employer behind it, with knowledgeable, independent trustees. A scheme may also be small enough to benefit from having a relatively simple asset structure and a clear operating structure; and close engagement with members. So it can work well. But there are lots of challenges facing smaller schemes."

The most obvious challenges are those that also face larger schemes: growing liabilities and costs caused by increased longevity, the current financial and economic environment; and changes in legislation and regulation.

The question as to whether a small scheme is meeting member needs



depends largely on the standard of administration and support provided by trustees and the sponsor, says Pensions Administration Standards Association (PASA) deputy chair Kim Gubler.

"We see small schemes that work very effectively, engaging with service providers and administrators," she says. "But effort needs to go into enabling the smooth operation and delivery of administration. Many small schemes struggle with the time and attention that takes.

"Much depends on how the employer sees the scheme. In some cases they may be quite happy paying deficit contributions and not want to bring it to a buyout. That might be a strategy pursued on the basis of 'this works – why change it'?"

"Smaller schemes can sit back and let others take on the cost of building new methods, then ride on the back of that"

Costs

Cost is the biggest problem, because the fixed overheads of a small scheme are very similar to those of a much larger scheme. Dabrowski points to PLSA research illustrating this. "In the worst cases, in a small scheme with between about 12 and 100 members, you could be paying £1,000 more per member per year compared to a very large scheme with over 5,000 members," he says. "The highest per member per year cost we found *[during the research]* for a smaller scheme was £1,125, whereas the highest for a large scheme was £139."

At the same time, the average cost of running any DB scheme has been rising: by 37 per cent, from £400 to £546 per member, during 2016, according to the PLSA. The rise is due to increased fund management and custody costs and was most severe for smaller schemes – here defined as those with fewer than 5,000 members – which saw a 63 per cent increase, with average cost per member, per year costs rising to £787. It's easy to see how those per member costs would be higher still for those schemes with fewer than 1,000 members.

One of the best ways to reduce costs is through more efficient delivery of administration, but this is very difficult for smaller schemes. "A lot of the things that big schemes can do to bring costs down aren't worth doing for a small scheme – for example, automating back office processes," says Pinsent Masons partner Stephen Scholefield. "If you've only got a small number of members the cost of putting automation in place means it isn't worthwhile. So smaller schemes often end up with a looser operating structure, with more manual calculations, and all the risks associated with that."

Access to services

Another problem for small schemes is that it is not usually possible to buy specific administrative functions from an overall service package offered by service providers. "It is very difficult to find a third-party administrator prepared to do just the administration if the advisory element has been outsourced elsewhere," says Gubler.

Smaller schemes also struggle to access the best services and solutions in other areas, suggests Trafalgar House client director Daniel Taylor.

"Small schemes tend to find it hard to access some services and solutions available to big schemes, *[such as]* more sophisticated investment options or de-risking tools," he says. "Even in terms of member engagement – many small schemes are working with the minimum or no additional services. Many have no digital presence."

PTL managing director Richard Butcher agrees. "You won't get the country's best actuaries dealing with a small scheme," he says. "You won't get access to the best new ideas – you'll have to wait until some of the best new investment concepts are commoditised before you can use them."

There may also be problems in maintaining the highest standards of governance. "Typically, smaller schemes will have fewer resources available and less expertise to call on," says Dabrowski. "Trustee meetings might be less regular. These schemes are potentially more reliant on advisers."

Smaller schemes are also at least as likely as are other DB schemes to suffer from a shortage of individuals keen to act as member-nominated trustees, as the numbers of individuals within the sponsor's workforce who are also members of the DB scheme declines.

Advantages

But there can be some advantages to being small. One is that employers may be able to participate in debates with trustees about the governance and future of the scheme in a way that would be much more difficult with a larger scheme. Trustee and employer alike may well be in a better position to engage directly with members.

There may even be an advantage to be gained through being able to act more swiftly, in some situations, than could a larger scheme.

Nor is a delay before a scheme starts to experiment with new ideas in investment or administration necessarily a bad thing. "You don't always need to be at the cutting edge of things with pensions," says Scholefield. "Smaller schemes can sit back and let others take on the cost of building new methods, then ride on the back of that. The entry costs for smaller schemes looking to do what used to be seen as quite esoteric stuff are coming down all the time. The obvious example would be things like longevity insurance and swaps."

The writing on the wall

But in the longer term, the writing is on the wall for small DB schemes. "There's a big legacy of DB schemes, but they are on a pathway to run-off," says Dabrowski. "The big question is whether they will get there without calling on the PPF or some other intervention being needed."

Consolidation is another possible answer *[see p53]*. It is also possible that fiduciary management services will evolve to a point where they offer a realistic alternative to buyout for at least some smaller DB schemes.

Meanwhile, some small DB schemes will continue to operate in their current form. "Those schemes that do not move towards consolidation will include those where trustees want to maintain significant input into the investment strategy of the fund," suggests Taylor. "There might be a particularly sophisticated trustee board in terms of investment knowledge, or the arrangement may be providing a very specific benefit arrangement to members, and *[trustees]* wouldn't want to lose control of that."

Scholefield is sure that some scheme trustees and employers will want small DB schemes to continue operating, assuming that the employer can support the scheme. "The challenge for the industry is how to find ways of letting small schemes benefit from the advantages of being small, yet access the sophistication that's usually only available to larger schemes," he says.

That is a challenge that at least some in the industry will continue to address, in the interests of members and employers. There may still be plenty of life left in some of these small DB schemes.

Written by David Adams, a freelance journalist