Defined Benefit Pension Scheme Consolidation

The menu of options is expanding

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Introduction

For some time it has felt like the shift towards consolidation of Defined Benefit (DB) pension schemes has been a question of "when", not "if". Whilst this might not be the answer for all schemes, the case for consolidation for many schemes is becoming increasingly compelling. 2021 saw a flurry of developments that could indicate that we are reaching a tipping point. In this article we take a look back at the developments in 2021, recap the DB consolidation options that are available in the marketplace, and ask how DB consolidation might develop during 2022.

Market backdrop

It is easy to see why insurance buyout is the dream for DB schemes – it represents the ultimate discharge of risk for both trustees and sponsors, enabling the scheme to wind up completely and for the sponsor to focus on managing its business rather than its pension scheme. However, this prize comes with a high price, and for all but the most well-funded schemes it either takes a lot of time or a lot of money to reach this target.

For some schemes, even if their funding position is strong enough to make insurance buyout a realistic goal in the short term, the demand for insurance at the larger end of the market means there is a danger of smaller schemes being crowded out.

From a sponsor's perspective, as businesses emerge from the Covid-19 pandemic and are perhaps faced with shifting consumer trends (some in their favour, others not), it will be key for them to assess their cost base and how their pension obligations fit into that, especially given that for many employers their DB pension scheme is now a legacy funding matter rather than a live workforce matter.

From a trustee's perspective, the shift towards professional independent trustees continues to gather momentum, as it becomes harder for trustee boards to find willing member-nominated trustees and the burden on employer-nominated trustees grows.

Add in a number of new regulatory requirements focussed on raising the governance bar to improve member outcomes, and a potential new code of practice in relation to how DB pension schemes are funded, and it is easy to see why small schemes may now, more than ever, be looking at alternative means of achieving risk reduction and cost efficiencies outside of the traditional insurance market.

What happened in 2021?

Whilst it is fair to say the DB consolidation market has not yet taken off in earnest, there were some key developments in 2021 that could be seen as sowing the seeds for a growth in DB consolidation in the near future.

For example:

February 2021

Pension Schemes Act 2021
Although this did not cover DB consolidation directly, it introduced a number of items that are likely to focus the mind of trustees and sponsors on the end-game for their scheme. For example, the introduction of a long-term funding target, a formal Chair's statement of strategy, and a consultation on a new code of practice for funding DB schemes, all point towards an upping of the bar when it comes to setting a plan for the scheme's end-game and delivering against that plan. Ultimately this is to be applauded, as the developments are all aimed at improving outcomes for schemes and their members, but this could create challenges for trustees and sponsors along the way.

October 2021

Pension and Lifetime Savings Association (PLSA) self-certification regime for DB master trusts
This regime was designed to enable DB master trusts to provide trustees and employers with more information, clarity and comfort about how they operate. The fact that several DB master trusts have already completed their self-certification against this standard shows that the supply is there, and it is just a case of the demand catching up to meet it.

November 2021

Clara Pensions
Clara Pensions became the first vehicle to pass the Pension Regulator's assessment process for DB superfund consolidators. This marked a major step forward for a new form of commercial consolidator, which uses third party capital to help sponsors achieve a quasi-insurance solution with a lower up-front cost.

What DB consolidation options are available in the marketplace?

DB consolidation is a broad term. In its widest sense, DB consolidation is based around the principle of pooling pension scheme operations together to benefit from economies of scale. In the chart below we have provided a brief overview of the key DB consolidation options in the marketplace:

Increasing consolidation

No consolidation	Traditional model where pensions services (i.e. actuarial and investment consulting, administration and secretarial) are appointed independently and trustees are in-house or member nominated.
Independent trustee	Pension services remain as before, but a professional trustee is appointed to run the scheme with the aim of improving governance and efficiency. This may be a sole trustee or a board of 2+ trustees.
Investment consolidation	Invest platforms use scale to negotiate contracts with managers. Fiduciary management delegates investment decision-making to a third party specialist.
Master trust	Pension scheme is transferred into a segregated section of a multi- employer scheme, which pools schemes together to benefit from efficient service provision and professional trusteeship.
Superfunds	Similar to master trusts but with the added feature of additional risk capital being provided to replace the employer covenant of the sponsor.
Buyout	The ultimate form of consolidation insofar as multiple pension schemes' assets and liabilities are pooled with an insurance company, with the insurer taking over all risks and payment of pensions.

"Will 2022 be the year that DB consolidation truly takes off?"

What are the key considerations in deciding whether DB consolidation is right for you?

There are lots of criteria that can be used to consider whether DB consolidation is right for a particular scheme and, if so, which particular DB consolidation options might be best suited to that scheme. In reality there is no perfect solution – those consolidators which measure well against one criteria may not measure so well against others. It is therefore key for trustees and sponsors to work together to be really clear in setting the criteria that are most important for them, so that the various DB consolidation options can be assessed against that criteria.

The key considerations in assessing each DB consolidation option are likely to come from the following list:

Upfront cost and cost of transition

This can be an obvious barrier for some forms of consolidation, and so the benefits of making a move to a DB consolidation vehicle need to be worth the costs. Key points to understand are: are there any transition costs associated with transfers of investments or service, is there an immediate funding requirement, and what professional advice is needed to facilitate any transition?

Ongoing cost

As a general rule one can expect a move to a DB consolidation vehicle to achieve ongoing cost savings going forward, whether that be through reduced investment management costs, reduced administration costs, or removing the obligation for ongoing costs entirely. Understanding the specifics of these cost savings is important so that these can be compared to any upfront costs – for example using a "payback period" analysis.

Risk management

As a general rule, the further down the consolidation spectrum one goes, the better the levels of risk management. For example, insurance buyout is the ultimate form of risk management as all pension obligations are transferred to the insurer. Other forms of consolidation can still achieve significant reductions in risk (often retaining the link to existing employer covenant), but it is important for trustees and sponsors to understand the specifics of each option, so that any residual risks are understood and mitigated where possible. Investment, funding and covenant risks will be particularly key.

Governance structure and control

A key differentiator between some of the consolidation vehicles is the governance model that they operate, and hence the balance of powers between various stakeholders. Some stakeholders may be concerned about loss of control, whereas others will see the passing of a governance burden as a positive – it all depends on the circumstances, and so understanding the dynamics of each consolidation option is key.

Where might DB consolidation go in the next 12 months?

It feels like the case for DB consolidation is growing and if we look at this from a "supply and demand" point of view, it does feel as though a lot of pieces are now falling into place. The question is, will 2022 be the year that DB consolidation truly takes off?

On the supply side, there has never been a more wide-spread group of viable DB consolidation options in the marketplace. The October 2021 PLSA self-certification regime for DB master trusts, and the November 2021 regulator approval of Clara, feel like landmark moments in terms of providing trustees and sponsors with greater information and comfort about relatively new consolidation options that provide genuinely viable alternatives to the traditional insurance buyout model.

On the demand side, there is still a gap to bridge – thereare doubtless many sponsors and trustees having feasibility discussions with DB master trusts and superfunds, but as yet there are only a small number of DB consolidation vehicles who could say they have achieved scale. Having said that, given the market backdrop described above, it is easy to see why sponsors and trustees may now, more than ever, be assessing their DB consolidation options and filling the pipeline of DB consolidators.

One final thought to finish. The UK pensions industry is often accused of moving at a glacial pace. That is no doubt true in some areas, but in other areas we have seen momentum gather very quickly once inertia has been overcome - the pace with which Environmental, Social and Governance focus and DB consolidation have gathered momentum after a slow start are recent examples of this. There are good arguments to be made that some of the developments seen in 2021 could give the DB consolidation market the momentum it needs to truly take off. As to whether 2022 is the year, only time will tell!

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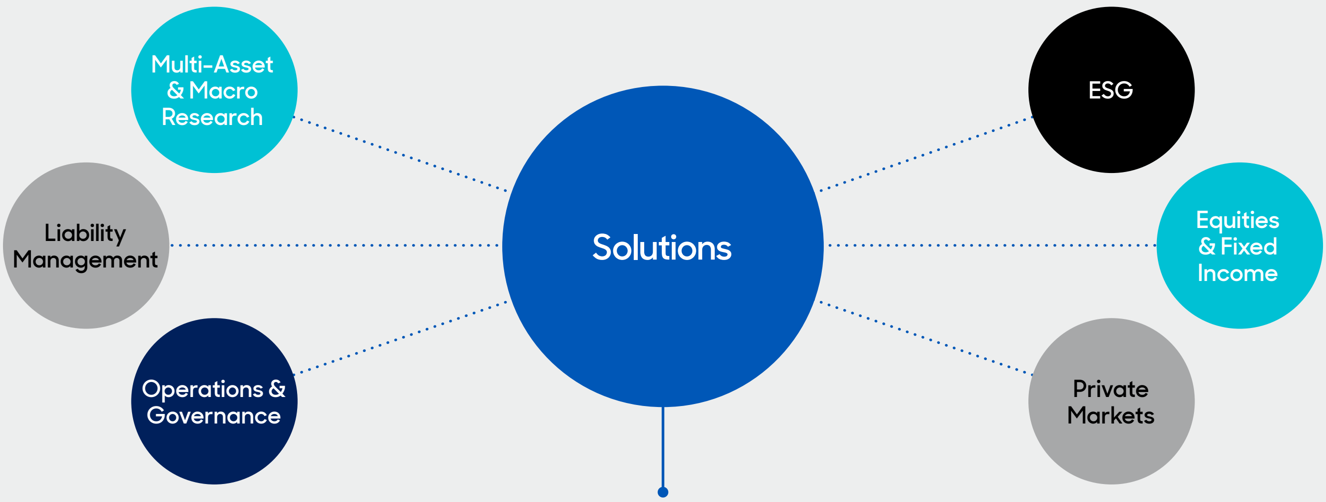
Source: abrdn, 2022.



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