

Briefing

Pension scheme consolidation

An alternative to traditional exit strategies?

RISK | PENSIONS | INVESTMENT | INSURANCE

Traditionally, there have been two main pension scheme exit strategies:

1. Prudent funding and running off the liabilities over time
2. A buy-out with an insurance company

However, recent developments in the market mean there are now other options for employers who want to deal with the cost and risk associated with running a DB pension scheme. These options come in the form of consolidation, and here we'll take a brief look at the various forms of consolidation available, before focussing on capital-backed consolidation, the offerings in the market, and how they work.

Of the two strategies mentioned above, bulk annuities continue to be popular - two of the UK's largest transactions in the second half of 2018 ensure this will be a record year for such transactions.

But for the first course of action, the time frame of pension liabilities means very few schemes will be run off by their current sponsor, and so most closed schemes are run until buy-out becomes affordable. However, this is not cheap, and our recent analysis of FTSE350 companies showed that, in aggregate, deficit contributions have increased by nearly 40% since 2014¹.

What is consolidation?

Pension consolidation is a broad concept, ranging from simplifying a scheme's governance structure, to merging with other schemes to take advantage of economies of scale.

It is not a new concept - both the Pension Protection Fund (PPF) and insurers involve consolidation, as do DB master trusts and scheme mergers. However, sponsors wanting to transfer risk have had only the option of bulk annuities - which may not be affordable for most companies.

Consolidation has been a hot topic in the industry for the past year or so, in particular the 'superfund' concept set out by the Pension and Lifetime Savings Association (PLSA) in September 2017.

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New superfund, or 'capital-backed consolidator', offerings entering the market offer non-insured risk transfer to pension scheme sponsors, and the first confirmed transaction may not be too far away.
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1 Barnett Waddingham report 'A turning point for FTSE350 pensions? Analysing the impact of DB pensions on UK business' (excludes one-off contribution of £4.2bn paid by Royal Bank of Scotland in 2016).

'Risk retained' consolidation

Beside the cost of actually funding a DB scheme, running one from day to day can be costly and time-consuming when you add up the administration, adviser and investment management fees, and potentially the hours for employees who act as trustees. For companies who are not looking to settle scheme benefits, or who are simply unable to, there are still options available to reduce this burden.

- **Scheme mergers**

Companies with multiple schemes may want to consider merging them into one, to reduce adviser and investment management fees. However, there will be one-off costs to this, which will reduce any cost saving.

- **Sole trusteeship**

The current trustee board is replaced with a single trustee (individual or company), usually a professional independent trustee. The costs associated with this may be offset by efficiencies gained through reduced training, easier decision making and removing the need to find trustees nominated by the employer or members. While some loss of scheme-specific knowledge may be a drawback, it won't take a professional trustee long to catch up, and they will have a better understanding of the wider issues than the average lay trustee.

Master trusts

In the wake of auto enrolment, DC master trusts, typically set up by a provider, have given many employers an easy, cost-effective way of providing their employees with a pension arrangement. Although the barriers are higher, DB master trusts are also gaining traction.

What does it involve?

The scheme transfers to the master trust; the benefits remain the same and the assets are sectionalised. The employer retains the responsibility for funding the scheme.

What's the benefit?

The scheme will be governed by the master trust, so will usually appoint the master trust trustees and advisers. This keeps ongoing costs down and ensures a high level of governance. As the assets and liabilities are sectionalised, the company retains the ability to be flexible with its approach to funding.

What are the downsides?

There will be reasonably significant costs associated with transferring to the master trust in the first place, which may offset the benefit. The company may also need to make an additional contribution to the scheme on transfer, either to satisfy the current trustees that the position on transfer is improved, or to meet any requirements of the master trust.

Who might it be suitable for and who are the key players?

A master trust may be suitable for a small scheme where a risk transfer option is unaffordable. Using a master trust brings the scheme economies of scale not otherwise possible, and members are likely to benefit from stronger governance.

Some of the main master trusts available are:

- TPT Retirement Solutions
- Citrus
- Deloitte



Consolidation through transfer to insurer

Buy-out is the most common way for an employer to exit a scheme. Even where schemes are targeting self-sufficiency, they are unlikely to fully run-off. Instead, they will buy-out when it becomes affordable, perhaps through a series of phased buy-in transactions before completing a final buy-out. However, buy-out is expensive and available only to the most well-funded schemes. Also, most employers looking to settle their pension liabilities will need to make a very substantial contribution to achieve buy-out. In fact, some employers will never be able to buy-out their scheme.

Buy-outs can also have a significant impact on an employer's accounts in the year the transaction takes place (representing the cost of settling the benefits at above the value of the liabilities shown in the accounts), although this does depend on how the exercise is structured.

Although bulk annuity pricing has been unusually favourable during 2018, there are some fundamental reasons for why annuities are comparatively expensive for most schemes and will remain expensive:

- The regulatory and capital regime of the insurance industry – insurers must hold substantial reserves against the risks in their supporting asset portfolios, and this feeds through to their pricing.

- Deferred members are significantly more expensive to insure than pensioners. There is greater duration risk (the average payment term for a deferred member is further away than it is for a pensioner), but there is also uncertainty as to when they will retire and how much cash they will take, and this creates a (relatively) higher price.

Even schemes that closed to benefit accrual in the 1990s are still likely to have a fair proportion of deferred members.

Although companies can try to reduce their deferred membership by means such as enhanced transfer exercises, most schemes will probably have to wait until their scheme's members are mostly pensioners before buy-out becomes affordable.



Capital-backed consolidation

Capital-backed consolidators effectively give sponsors the option of a non-insured risk transfer. These vehicles are a new development, and although only two are currently being marketed, we expect more to follow in the short- to medium-term. In particular, as this provides an alternative to insurance, we anticipate insurers may attempt to enter this market.

However, despite being an alternative, these funds are not designed to be a replacement for insurance. We would expect schemes where buy-out is affordable to still pursue that route, as it offers the additional protection of insurance regulation. In fact, for some schemes such as those that are predominantly pensioners, buy-out may be no more expensive than the superfund premium, or even slightly cheaper.

So let's look at the stakeholders. Why does this kind of vehicle benefit them, and what might their concerns be?

STAKEHOLDER	ADVANTAGES	CONCERNS
Sponsor	<ul style="list-style-type: none"> • Certainty of cost • For the right scheme, settles benefits for less than the cost of buy-out • Removes scheme from balance sheet 	<ul style="list-style-type: none"> • Still unlikely to be feasible without a reasonable cash injection from the sponsor • The advisory and related costs of transacting are likely to be relatively high, though arguably no higher than preparing for and carrying out a bulk annuity transaction
Trustees of ceding scheme	<ul style="list-style-type: none"> • Immediate improvement in funding level • For the right scheme, improvement in overall covenant • Unlike a buy-out transaction, could cover data and benefit risks 	<ul style="list-style-type: none"> • Less secure than insurance • Must be able to demonstrate that the financial covenant provided by capital is an improvement on the sponsor covenant
Members	<ul style="list-style-type: none"> • Improved benefit security as a result of initial contribution from sponsor, plus additional capital provided • Governance structure likely to be more rigorous • Could receive bonuses through profit sharing if this is offered • Current benefit structure maintained 	<ul style="list-style-type: none"> • Confusion or suspicion concerning change in provider
Consolidator and capital provider(s)	<ul style="list-style-type: none"> • Economies of scale reduce average costs • Contingent capital alongside liability hedging should allow additional investment returns through gearing • Expected to generate profit either through experience (compared to prudent pricing basis) or through movement of members from deferred to pensioner 	<ul style="list-style-type: none"> • Parties involved may want TPR to clear each transaction, at least at the outset. Although no deals have yet transacted, we would expect this to be quite an involved process initially, though it should get easier over time

What are the risks?

The capital providers bear investment risk, and will only receive their returns if the fund can generate a profit. If the consolidator aims to later pass the risk to the insurance markets, they are exposed to all the usual risks of insurance pricing and availability.

Once the capital is used up to cover any poor investment returns or benefit errors discovered, then any further deterioration is going to cause problems for the members - though these vehicles are still potentially eligible for PPF protection. In practice, we would expect action to be taken well in advance of the PPF having to come into play, but with no facility for the consolidator to extract further cash from previous employers, there is no other protection for members.

Current market overview

There are currently two providers offering propositions in the market that fall within the label of capital-backed consolidators:

	THE PENSION SUPERFUND www.thepensionsuperfund.com	CLARA-PENSIONS www.clara-pensions.com
HIGH-LEVEL STRATEGY	The Pension SuperFund (PSF) has no intention of insuring benefits – it aims to be a long-term pension scheme.	The schemes that transfer to Clara would be sectionalised. The aim is to buy each one out within 5-10 years and Clara will run member option exercises on the path to buy-out.
CAPITAL PROVIDED ON ENTRY	<p>The original sponsor must make a contribution to ensure the scheme is 105%-funded on a self-sufficiency basis prescribed by PSF. The additional 5% goes into an asset-backed contribution (ABC) structure, leaving the 'superfund' 100%-funded.</p> <p>The backers would contribute an additional 10% of the scheme's liabilities into the ABC on the same basis.</p>	<p>The original sponsor must make a contribution to ensure the scheme is funded halfway between 100% of Clara's prudent basis and full buy-out.</p> <p>The backers would supply the remainder of the expected buy-out cost.</p>
CAPITAL DISTRIBUTION	<p>Each year, the superfund's performance is checked. If any improvement in superfund funding level above 100% occurs, one third of this is paid to a 'members' trust' for the trustees to decide how to use. This could be held in reserve or for a one-off bonus payment to members. The remaining two-thirds is paid as a performance fee to the asset managers.</p> <p>If the combined funding level in the superfund and ABC is over 115%, PSF has the right to distribute some of the excess to the investors.</p>	<p>The risk capital supplied by the investors will only be returned as and when each sectionalised scheme reaches buy-out with full member benefits.</p> <p>Part of investors' return will derive from the improvement in funding level as members retire and become cheaper to insure.</p> <p>Funding will not be shared between the schemes, so some schemes may successfully buy out (resulting in a return to investors), while others struggle.</p>
CONDITIONS FOR ENTRY	<p>The Regulator will be consulted if a scheme wished to transfer to either fund. Authorisation regime may be implemented in due course.</p> <p>Both require good quality data and for any benefit issues to be resolved i.e. similar to a buy-out.</p> <p>PSF also requires a scheme to be substantially funded over 100% of s179 levels.</p>	
TARGET SCHEMES	<ul style="list-style-type: none"> • Schemes with a liability value between £200 million and £10 billion • Closed to future accrual • Technical Provisions funded to between 80% and 120% • Deferreds would be between 20% to 80% of the membership 	<ul style="list-style-type: none"> • No defined scheme size but confirmed they would consider below £50 million and above £500 million • Closed to future accrual • Larger proportion of deferred member preferable, to generate savings as members retire
INVESTMENT STRATEGY	<p>Similar or lower-risk profile compared to an insurance portfolio.</p> <p>Includes full hedging of interest rates and inflation. Will allow for return-seeking asset classes.</p>	<p>Similar investment strategy to insurer portfolio.</p>
KEY INDIVIDUALS	<p>Chris Hitchen has been announced as Company Chairman.</p> <p>Two of the fund trustees have been confirmed:</p> <ul style="list-style-type: none"> • Richard Wohanka (Chair) • Antony Miller – 2020 Trustees • A third independent trustee will be appointed. 	<p>Lawrence Churchill has been announced as Company Chairman.</p> <p>Fund trustees have been confirmed as:</p> <ul style="list-style-type: none"> • Alan Pickering (Chair) – BESTrustees • Michael Chatterton – Law Debenture • Frank Oldham – ITS

Hypothetical case studies

As capital-backed consolidators are a new entrant to the market, there are no examples yet of how these have helped in practice. Therefore, we have considered a couple of recent cases, and suggest how a capital-backed consolidator could have provided an alternative solution.

Please note that these are based only on information available in the public domain. They simply theorise on how these vehicles may have helped, and in practice there may have been other issues that could have affected the situation.

Menzies Pension Fund

As reported by Professional Pensions in August 2018, the Menzies Pension Fund recently completed a £75 million buyout with Pension Insurance Corporation. The company could not fund the full buy-out, so agreed a payment plan with PIC to gradually insure all benefits (though we don't know over what period). This allowed the scheme to lock in pricing at an earlier stage, and allowed the sale of the business to a private equity firm.

Although there are obviously benefits to agreeing a payment plan, it stands to reason that it will cost the sponsor more in total than if it had been able to pay the full premium at the outset.

In this situation, it seems logical that a capital-backed consolidator could have helped. Although we don't have details, it is possible that the lower contribution requirements for the consolidator could have avoided a payment plan. This gives the sponsor certainty of cost, without committing it to future cashflows, and provides a structure which included removing data and benefit risk.

GKN Pension Schemes

Earlier this year, Melrose Industries completed an £8.4 billion hostile takeover of GKN and pledged up to one billion of contributions to its two DB schemes, bringing one scheme to a 'self-sufficiency' level and doubling deficit recovery contributions to the other. It has more recently emerged that Melrose is now trying to buy out the benefits for the smaller of the schemes.

Could capital-backed consolidators have given Melrose another strategy? A self-sufficiency level is unlikely to be too far away from what a capital-backed consolidator might want, so it would certainly have been feasible for them to have considered getting this scheme off the balance sheet straight away. This could have reduced the need for future contributions that rely on the sale of existing GKN or Melrose businesses.

Insolvencies

These cases are less clear, as often schemes end up either transferring to the PPF or securing PPF-type benefits.

But consider, if capital-backed consolidators had existed and the cost of securing the scheme had been lower, would Sir Philip Green have been more willing to ensure BHS scheme members got the benefits they had been promised?

More generally, could consolidators provide an alternative to the PPF, using risk capital to attempt to improve member outcomes alongside generating a return on investment? Clearly this wouldn't be appropriate in all circumstances, and would require some re-working of the Regulated Appointment Arrangement regime. But if it could be achieved, it would give an option to distressed employers looking to rescue their business, while also giving their pension scheme members a chance of getting more than they would otherwise get in the PPF.

What does the future hold?

As with any new proposition, there is uncertainty as to the likely popularity of capital-backed consolidators. It will be crucial for the consolidators to reach scale quickly, to allow efficiencies to materialise. But it will be equally important that they have access to sufficient capital should demand become significant.

⋮ DWP's White Paper, published in March 2018, promises to consult on new legislation for consolidation as well as an accreditation regime to build confidence in consolidation. The outcomes of this consultation will be instrumental in how widespread capital-backed consolidation becomes.

In the meantime, we are seeing increasing interest from sponsors and trustees in considering consolidation as part of their long-term journey planning, and are monitoring developments in this area. If this is something you would like to discuss for your scheme, please contact us either through your usual Barnett Waddingham contact, or using the contact details below.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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