

Briefing

DB consolidation

An alternative endgame?

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The Pensions Regulator (TPR) is [consulting](#) on a new regulatory regime, which will require trustees of defined benefit (DB) pension schemes to think carefully about their “long-term objectives”. It is often assumed that this will involve either:

- targeting a “buyout” or “buy-in” transaction with an insurance company; or
- achieving full funding on a “low dependency” basis (i.e. a basis which requires a low degree of support from the scheme’s sponsoring employer).

However, the entrance to the market of new commercial consolidation vehicles is likely to widen the range of options available to pension scheme trustees and sponsors in future. Our research suggests that consolidation will be the right option for some, but not all schemes. In this note, therefore, we provide some background to the new consolidation options and consider how trustees can assess whether this may be the right option for them – either in the short term or as their long-term objective.

Background to consolidation

Consolidation of DB pension schemes is not a new concept. The basic premise is that larger schemes are often (but not always) run more efficiently than smaller schemes. This can lead to benefits to the scheme sponsor (in terms of reduced running costs) and potentially for members too (for example, if more efficient management leads to better benefit outcomes).

A variety of consolidation models already exists, including scheme mergers and DB “master trusts”. A buyout transaction with an insurance company can also be thought of as a form of consolidation, since it involves a scheme’s assets and liabilities being pooled with those of other schemes, resulting in economies of scale.

At a glance

- Consolidation of DB pension schemes potentially results in a smaller number of better-run schemes, with benefits for both employers and members.
- New commercial consolidation vehicles are hoping to start carrying out transactions shortly. These would offer benefit security provided by an external capital investment, rather than ongoing employer support.
- Trustees will need to consider carefully, based on professional advice, whether consolidation or an alternative long-term destination provides the best outcome for their scheme members.
- In many cases, significant employer contributions will be required to make a consolidator transaction feasible.

However, from the employer’s perspective, all of these “traditional” consolidation models have drawbacks. In the case of a scheme merger or a transfer to a DB master trust, the employer remains exposed to many of the legal and financial risks associated with DB pension schemes, whilst potentially losing all control over the management of their scheme. In the case of a buyout, on the other hand, the strict capital requirements imposed on insurers may make the cost of a transaction prohibitive.

The new entrants to the consolidation market – the “**capital-backed**” consolidators – aim to address this by allowing employers to fully step away from their obligations to their schemes, at a lower price than would be possible through an insurer buyout, whilst still offering reassurance to trustees and members that the benefits are secure.

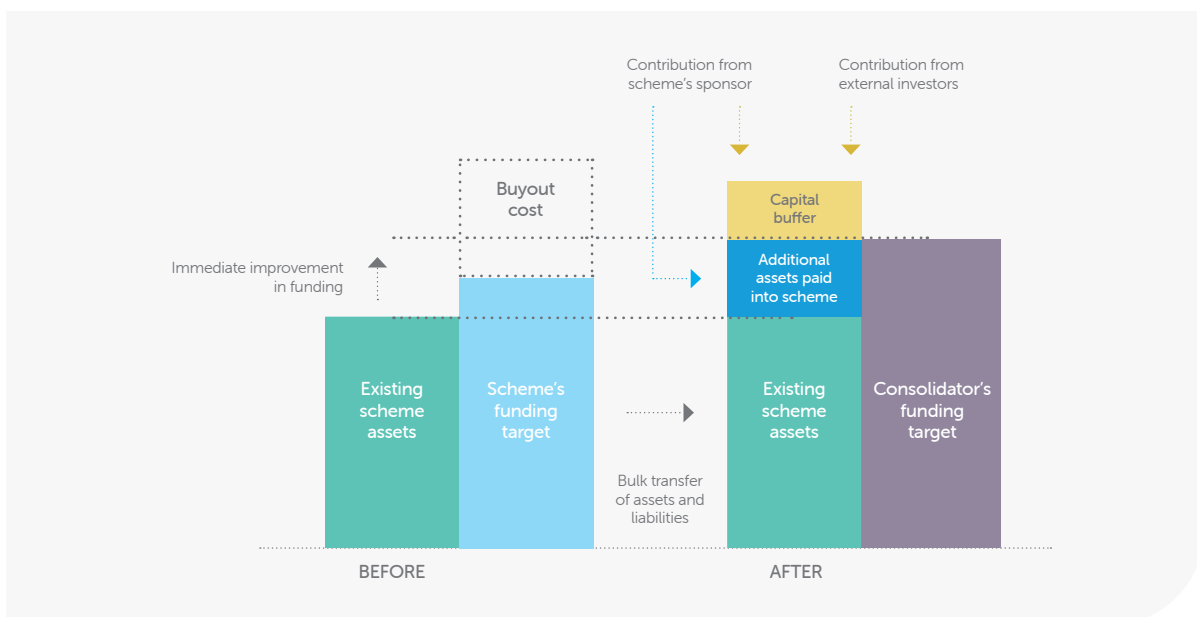
How do they work?

There are currently two organisations who have announced that they plan to participate in the capital-backed consolidation market: the **Pension Super Fund** (PSF) and **Clara-Pensions** (Clara). While their proposed models have some important differences – explained in more detail below – their high-level approaches to transactions are the same.

Broadly, both PSF and Clara expect to be operators of a single large DB scheme, to which other schemes’ assets and liabilities will be transferred. In both cases, the key difference to other (non insurance-based) consolidation models is that, at the point of transaction, the existing sponsor’s obligation to support the scheme (the “employer covenant”) is severed and replaced with a “financial covenant” provided by external capital.

More specifically:

- The transaction would involve a “bulk transfer” of the scheme’s assets and liabilities to the consolidator’s scheme.
- In exchange for accepting these liabilities, the consolidator would require the sponsoring employer to make an additional contribution such that the scheme is fully funded on a prudent basis (typically more prudent than the existing funding basis).
- The sponsoring employer, along with external investors, will pay additional capital into a “buffer” (i.e. a pool of assets held outside the main scheme). The buffer will only be called upon in the event of adverse scheme experience; if all assumptions are borne out as planned, then these additional assets will not be needed and can be extracted by the external investors, providing a return on their initial capital.
- In the meantime, the consolidator’s scheme is operated in the same way as any other occupational DB scheme (albeit potentially subject to an enhanced supervisory regime). There will be a board of trustees who are responsible for appointing advisers and administrators to ensure that benefits are paid correctly and the financial position of the scheme does not deteriorate to an unacceptable level.



For illustration only - not to scale

PSF and Clara argue that this model allows them to help employers remove their pension scheme risks in a cost-effective way – i.e. typically less expensive than a buyout transaction with an insurance company – whilst at the same time providing trustees and members with a high degree of confidence that the promised benefits will be paid in full.

The current providers in more detail

Although the transaction process for PSF and Clara is broadly the same, there are significant differences between the ways in which they plan to operate after transactions have taken place. Crucially, PSF intend to operate as a long-term run-off vehicle (i.e. with no intention of transferring liabilities to the insurance market), whereas Clara intend to operate as a shorter-term “bridge to buyout”. These different approaches can be summarised as follows:

	PSF	Clara
Timescales	Long-term run-off vehicle – i.e. benefits paid directly from PSF scheme until last member has died	Clara aims for each transferring scheme to be bought out in the insurance market within 5-10 years
Scheme structure	Non-sectioned – i.e. all transferred assets and liabilities are pooled	Sectioned – i.e. transferring schemes are administered (and bought out) separately
Capital policy	Scheme is initially funded on PSF's prudent basis, with an additional proportion of liabilities held in capital buffer. Performance is monitored annually, with any positive experience being shared between asset managers, external investors and (possibly) additional benefits for scheme members.	Scheme is initially funded on Clara's technical provisions (TPs) basis, with difference between TPs and estimated buyout liability held in capital buffer. Capital and profit is only returned to investors after each section has been bought out.
Source of return for investors	Actual scheme experience is expected to be more favourable than prudent funding assumptions, allowing excess capital buffer to be paid to investors.	Buyout pricing is expected to become more favourable as each section matures, allowing investors to extract the share of the capital buffer originally contributed by the employer.

What are the risks?

Both PSF and Clara are keen to emphasise the security provided to members through their prudent funding bases and the additional capital buffers that are made available in the event of poor performance. However, it is important to note that these consolidators will operate outside of the traditional bulk annuity insurance market, and therefore will not be subject to the same stringent capital requirements (and policyholder protections) that currently apply to insurers.

There is therefore a risk that, if the capital buffer is fully used up, a consolidator could fail with no further funds available, leading to members receiving less than their full benefit entitlement. There will be a “safety net” in the form of a minimum level of benefits provided by the Pension Protection Fund (PPF), and indeed we expect both PSF and Clara to put in place mechanisms to ensure that members’ benefits are protected above the PPF compensation level (e.g. through winding-up triggers)¹. Nevertheless, trustees might understandably have some hesitation in agreeing to a capital-backed consolidator transaction, particularly while these consolidators are in their infancy.

Trustees and employers should also bear in mind that there are potentially significant regulatory hurdles to a transaction – i.e. even if all parties agree that consolidation is the right option, in some cases it will be necessary to obtain explicit clearance from TPR before the transaction can proceed.

1. The different models proposed by PSF and Clara mean that the outcomes for members in the event of either consolidator failing are potentially quite different. The pooled structure of the PSF scheme means that significantly worse than expected experience is likely to affect all members to some extent. By contrast, the sectioned structure of the Clara scheme means that each member's benefit security should only be affected by the performance of that member's section – i.e. some members could receive full benefits while others' benefits are reduced.

Which schemes are likely to pursue consolidation?

In order to be comfortable that consolidation is the right destination for a given scheme, trustees will need to consider whether such a transaction has the potential to improve benefit outcomes for members. Some of the factors that trustees might consider are as follows:

- **Employer covenant.** Trustees of schemes with a weak or uncertain employer covenant might feel that moving to a consolidator vehicle allows them to mitigate the risk of employer support being inadequate in future. This might particularly be the case if the trustees are concerned about an overseas parent company's long-term commitment to funding UK pensions, or if there is a likelihood of future corporate transactions leading to a loss of control for the existing sponsor. On the other hand, if there is a strong and reliable employer covenant then trustees may feel (and TPR is likely to expect) that members' interests are best served by waiting until an insurance transaction becomes affordable.
- **Distance from buyout.** Trustees of schemes which have a realistic chance of reaching buyout in the short to medium term (say the next five years), whilst running an acceptable level of risk, would generally be expected to focus on that as their primary target. It is therefore only those schemes who are still some way from buyout, or who have no prospect of getting there without a significant cash injection from the sponsor, who are likely to be prepared to accept consolidation as a benefit settlement option.
- **Maturity.** The consolidators are able to offer more attractive pricing than traditional bulk annuity insurers in respect of non-pensioner members who are still several years from retirement. This means that trustees of relatively immature schemes (those with a high proportion of non-pensioners) might find that consolidation offers an opportunity to secure all benefits at a time when this would not be possible through the insurance market. By contrast, more mature schemes (consisting mainly of pensioners) might see relatively little difference between the prices quoted by consolidators and insurers.

One further group of trustees who might consider consolidation are those involved in "PPF plus" wind-ups – i.e. cases where the scheme's sponsor undergoes an insolvency event but the scheme does not enter the PPF. These cases are likely to be more complex, but consolidation could potentially allow trustees to secure a higher level of benefit for their members than would be achievable in the insurance market.

What's next?

TPR have previously consulted on an "authorisation" regime for the consolidators. In due course this will need to be formalised in primary legislation, but TPR already has the ability to approve transactions on a case-by-case basis.

Although no firm timescales have been given for the new authorisation regime, we understand that TPR have already held detailed discussions with both PSF and Clara with a view to agreeing an interim regime. We are also aware of other potential entrants to the commercial consolidation market who may make their announcements once TPR provide greater clarity around the authorisation regime.

In the meantime, any trustees or sponsors who are considering the consolidation option are likely to need to take detailed legal, actuarial and covenant advice.

If you would like to discuss DB consolidation in more detail, please contact your usual Barnett Waddingham consultant or alternatively use the contact details below.

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