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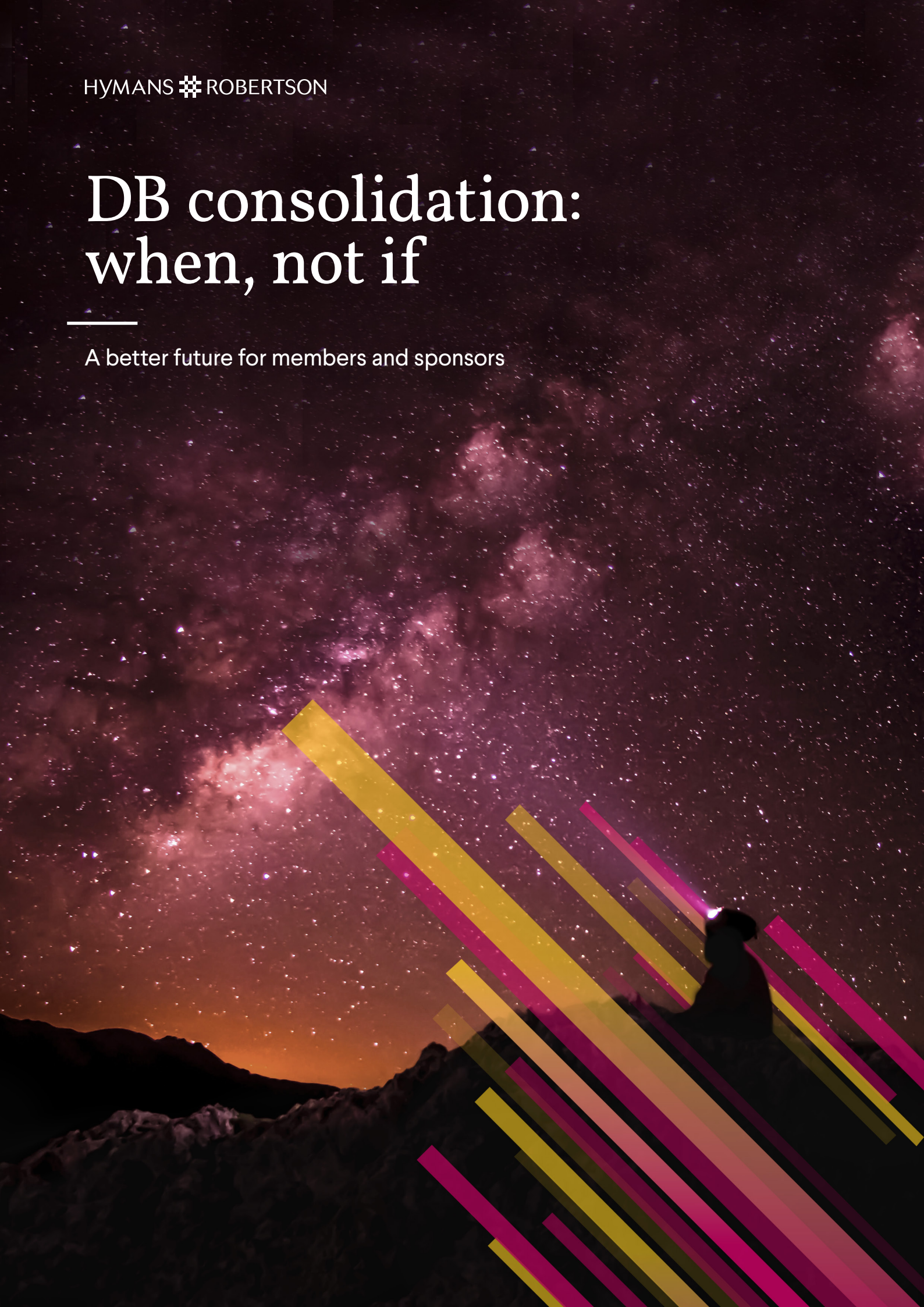
DB consolidation: when, not if

A better future for members and sponsors



The consolidation of Defined Benefit (DB) schemes is in vogue. It was:

- a key plank in the Department for Work and Pensions' (DWP) recent Green Paper;
- a core recommendation from the Pensions and Lifetime Savings Association (PLSA) DB Taskforce; and
- the Pensions Regulator (tPR) has repeatedly highlighted the regulatory challenge posed by thousands of small DB schemes.

DB schemes are clearly in need of help. Hundreds of thousands of members have seen their benefits substantially cut back over the past decade. Yet, companies have paid hundreds of billions of pounds in deficit contributions and, on average, seen deficits continue to rise. It is clear a different approach is warranted.

Top 3 drivers for consolidation

1. Reduce the cost of running DB schemes
2. Improve security of member benefits
3. Manage risks more effectively

Consolidation comes in many shapes and sizes. Some forms, such as consolidation through insurance companies or the Pension Protection Fund (PPF), are tried and tested. Some are emerging trends such as using DB master trusts. Yet others are currently only figments of the imagination, such as the PLSA superfund.

In this paper, we seek to highlight some of the main forms of consolidation, and how they can help DB schemes. The DWP's forthcoming white paper will be here soon. Now is the time for the industry to be clear on how best to adapt the rules to give DB schemes, sponsors and members the help they need. We hope this paper encourages positive debate, leading to better outcomes over the coming decade than we have seen in the past.

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Executive summary

Lessons to be learned

Better outcomes for DB scheme members and sponsors requires a change in approach. For the majority the focus should be on becoming more resilient to bad outcomes. This resilience has been most notable by its absence. The consequences have been eye watering costs for sponsors and benefit cutbacks for hundreds of thousands of DB members. According to the 2017 Pension Protection Fund Purple Book, despite the swathes of scheme closures and hundreds of billions in sponsor contributions, buy-out deficits have ballooned from around £500bn in 2006 to well over £700bn in 2017. We have also seen hundreds of schemes enter the PPF; causing pain for scheme members, employees and shareholders alike.

As an industry we do not seem to have learned our lesson. There are still vast and unnecessary levels of risks in the system – in the worst one year in 20, UK DB may need to find an extra £400bn[1] of cash to pay pensions.

There is no obvious barrier to reducing this. For example, through more efficient use of DB scheme's capital – using equity, credit and LDI leverage - and longer term cash commitments. This should be the priority for the industry. It would improve security in the system by £250bn – transformational for both scheme members and sponsors.

In contrast, administration and advisory costs for the entire industry are in the region of £1.5bn p.a. Asset management fees are higher, in the region of £5bn to £7bn p.a. So the costs of running these c5,500 schemes and providing benefits to over 10 million members are substantial. But set against a buy-out deficit of over £700bn, while cost savings will help, they will take an age to make a real dent.

Against this challenging backdrop, we look at the role that consolidation can play in moving us towards a better future for DB schemes, their members and sponsors.

Total UK DB running costs for 5,500 schemes with 10m members:

circa £6.5bn - £8.5bn p.a.

£1.5bn administration and advisory

£5-7bn asset management fees

[1] Hymans Robertson's response to DWP green paper "Defined Benefit pension schemes: security and sustainability

How consolidation can help

The table below sets out a range of consolidation options and the challenges they can help meet. Green indicates that for a typical scheme you would expect costs to reduce. Amber reflects that cost savings may or may not be achieved - it is very scheme specific. Red suggests no reduction in costs. However, what this landscape looks like for your scheme is worth closely considering in light of what each option is, and their pros and cons (more on this later). You may rightly reach a very different conclusion for your scheme. To bring this to life, the large number of amber lights reflects the fact that different schemes have different needs. Some have negotiated very keen investment manager fees, so a platform may add little; for others it could transform costs. What it does highlight is how the industry has responded creatively to offer a wide array of choice for schemes today, with potentially more to come through the DWP's impending white paper. In the body of this report, we explore these options in more detail and ask some renown industry experts to summarise how they help.

	Governance	Operational costs	Investment	Member security	Cost certainty	
Sole trusteeship	🟢	🟡	🟡	🟡	🟡	Governance changes
Master trust	🟢	🟢	🟢	🟡	🟡	
Investment platform	🟡	🟡	🟢	🟡	🟡	Cost savings and simplification
Merger and simplification	🟢	🔴 upfront 🟢 ongoing	🟢	🟡	🟡	
Insurance	🟢	🔴 upfront 🟢 ongoing	🟢	🟢	🟢	Changing sponsoring entity
Superfunds	🟢	🔴 upfront 🟢 ongoing	🟢	🟡	🟢	
Non-insured risk transfer	🟢	🔴 upfront 🟢 ongoing	🟢	🟡	🟢	

The right choice for you

Whether you are a sponsor, trustee or potential investor, consolidation has the potential to help you achieve your objectives. It's no silver bullet to the risk management challenges facing the industry, but nor should it be ignored. In our view, its role will only grow.

In fact, looking at all the options now available, and the history of DB schemes over the last decade, we believe that over the next generation the DB landscape will be completely transformed:

25 years of consolidation

2017		2042
5,588	Schemes	1,000
10.5m	Members	3m
1.3m	Active members	<0.1m
£1.5tn	Assets	£700bn
c30,000	Trustees	c2,000
c40,000	Benefit sections	c4,000
c£800bn	Solvency deficit	c£200bn
80p in £	Value to members	97p in £

The future DB universe

- Lower risk for longer strategy halves risk to members
- Data cleansing and benefit simplification halves administration and core actuarial fees
- Asset pooling reduces investment fees by c£3bn pa
- 1 million members consolidated into insurance or banks through transfers out
- 2 million members consolidated into insurance through buy-out
- 1 million members consolidated into DB master trusts
- Sole trusteeship streamlines governance for most schemes
- 500,000 members consolidated into the Pension Protection Fund

Sole trusteeship

What is it?

A sole trustee replaces a full trustee board with a single entity (person or company) that acts as trustee to the scheme. Typically, it is a professional independent trustee company that acts as sole trustee, and there are now hundreds of examples of this approach to governance in the UK.

	Pros	Cons
Governance	• Removes the need to find company and member nominated trustees. • Can be more nimble and commercial in decision making.	• Lose historic knowledge of scheme/ members that can inform decisions. • Many trustee boards already have effective governance structures, so will see limited need for change.
Operational costs	Can reduce adviser fees through streamlined decision making, removing training, and less formal meeting time.	Cost of employing professional sole trustee if one is not already employed.
Investment	Depends on the knowledge and expertise of the sole trustee vs the board they replace.	
Member security	An effective trustee board will help however it is structured.	
Cost certainty	An effective trustee board will help however it is structured.	

What does the future hold?

Sole trusteeship is on the up. There are a range of drivers including: difficulty recruiting interested and qualified company and member trustees; the ever rising expectations being placed on trustees; and, the increasing complexity of DB risk management.

Zahir Fazal
Director, BESTrustees

At BESTrustees we're seeing increased interest in sole trusteeship as a governance solution for a variety of schemes. We hear from sponsors who are interested in saving scarce management time and establishing a business to business relationship with the Trustee which is able to take account of corporate strategy. Trustees are also being challenged more and more by the ever growing regulatory demands and it can be difficult to find member nominated trustees. However, sole trusteeship has to be done well and with appropriate oversight. And of course it may not be suitable for all schemes. But the increasing shift towards this governance solution shows every sign of continuing

DB master trust

What is it?

Schemes can transfer all of their assets and liabilities into a section of a larger DB trust, and then close down their old scheme. This consolidates the running of the scheme into the DB master trust alongside other former schemes and alongside other employers. There is no cross subsidy of risk between different employers. The DB master trust will have its own advisers, and may also provide a new trustee board to support all of the sections.

	Pros	Cons
Governance	Depending on the chosen trust, it can use the DB master trust trustee, who by its nature will be experienced. This can help if there are issues with the current trustee model, or with sourcing appropriate trustees.	Can lose historic knowledge in the transfer process, and alongside economies of scale in governance there will be a degree of loss of flexibility.
Operational costs	Can reduce adviser fees through economies of scale for the multiple sections of the master trust.	There will be some project costs involved in making the switch.
Investment	Likely to generate economies of scale due to greater assets under management, and be able to access more sophisticated strategies that are traditionally unavailable to smaller schemes.	
Member security	Can be improved if governance and investment benefits improve risk management, or cost savings used to improve scheme funding.	
Cost certainty	Can be improved where risk management is enhanced.	

What does the future hold?

DB master trusts have been around for many years but have yet to take off. In the Defined Contribution (DC) world, master trusts have captured the imagination in recent years. And with consolidation and cost saving rising up the agenda, perhaps their time has come in DB.

Michael Penny
Trustee of Citrus Pension Plan

"DB master trusts are an efficient, affordable way for employers to ensure employees' pension needs are taken care of in a quality pension plan managed by experts. While it frees up busy employers to focus on their day jobs, employers can still play an active role with Citrus, and our trustees and advisers work in partnership with employers. Each employer has its own 'section' – essentially a separate scheme. This means employers have considerable flexibility in setting their own funding and investment strategy. With a history of over 20 years, Citrus offers both scale and track record. Employers benefit from economies and improved governance from being in the trust with others, as well as active management of their costs and risks. A key benefit of scale is opening up the universe of investable assets that are not available to small schemes."

Investment platform

What is it?

A platform offers investors a "one stop shop" to access a wide range of pooled funds run by different asset managers. Typically platforms use their own life insurance company. Clients sign a single platform document (the life policy) and through that gain access to all of the funds on the platform. Part of their appeal is the simplicity of operations, reporting and transitions this leads to.

	Pros	Cons
Governance	Makes it easier to manage DB scheme assets while still retaining strategic consulting advice and decisions by the trustee.	Like all consolidation options, economies of scale imply some compromise on the full flexibility that bespoke solutions offer.
Operational costs	In theory, platforms should use bulk buying power to access lower management fees; in practice, this does not appear to be happening effectively yet. Transition, reporting and other operational costs can be lowered.	In addition to transition costs there will be platform fees of 3-5bps p.a.
Investment	The largest platform now offers c500 funds from 45 managers; this will be enough to cover the needs of many smaller schemes, but the larger schemes still likely want more flexibility than platforms can currently offer.	
Member security	No material impact, unless major cost savings generated and used to fund benefits.	
Cost certainty	No material impact.	

What does the future hold?

Platforms are de rigueur for DC members as the only solution that can deliver investment to individuals cost effectively. Given the pressure on DB costs, we think DB schemes will go the same way. There are also increasing returns to scale if this is used to drive down asset manager costs; given the CMA investigation into investment consultancy and fiduciary management services, this feels well aligned with the industry's direction of travel.

David Morton
Head of Trustee DB Investment Consulting, Hymans Robertson

"Appointing a platform provider is likely to be most attractive for schemes who are seeking a low governance model. Depending on the fund holdings and negotiated fee arrangements, platforms may also offer some cost savings. Relative to fiduciary management, platform solutions allow trustees to retain control of investment decision-making. That autonomy does mean that some ongoing governance requirements are retained – due diligence in relation to new investments, monitoring of managers, strategic reporting for example. The decision on whether or not to use platforms will depend on the specific circumstances of individual schemes, but their development is a progressive step that is worthy of further investigation."

Merger and simplification

What is it?

Many corporate groups find they sponsor multiple DB schemes. Even those with a single scheme often have more than one advisor, multiple benefit sections and data that needs lots of manual processing as it is not fit to be automated. Savings in management time, clarity of strategy and cost savings can be realised through merging schemes into one, reducing the number of advisors and cleansing data and benefit information.

	Pros	Cons
Governance	Fewer stakeholders leads to simpler and more effective management.	Achieving simplicity will take management time and effort.
Operational costs	Depending on how sprawling the current situation is, there can be substantial cost savings realised.	The costs of simplification can be material in the short term, particularly dealing with legacy data issues.
Investment	If multiple schemes are merged they can have greater buying power than standalone schemes, although it does depend on how effectively they invest today.	
Member security	No material impact.	
Cost certainty	No material impact, although simpler governance can improve risk management.	

What does the future hold?

Companies are seeking to steadily merge schemes, especially those that have closed to accrual. The greater transfer value uptakes from freedom and choice, as well as buy-in work, are also causing schemes to tackle historic data issues. Even if a scheme merger is not feasible, many of the same benefits can be achieved by consolidation of advisers.

If the DWP is serious about cost savings, finding a way to encourage the industry to move to a single benefit scale is a huge opportunity. While the short term work will be large, it will set pensions up for the dashboard, massive operational cost savings, and improved understanding by members.

Nigel Tinsley
Pensions Director, BAE Systems Group Pensions

"In the interest of good governance, we decided to appoint a single firm of actuarial advisors to our seven DB schemes in order to realise the benefits of a more joined up approach. The decision to consolidate from our prior model of having three firms to one single firm has achieved greater efficiency and consistency, while retaining each Trustee group's integrity and independence."

Insurance

What is it?

Trustees can purchase insurance in the names of individual scheme members who become policyholders of an insurance company, which pays them their promised benefits. This is commonly called a scheme buy-out. While it is often thought of as a risk reduction route (for members and scheme sponsors), insurers are also consolidation vehicles for DB pensions. The largest insurers make payments to hundreds of thousands of scheme members and invest tens of billions of pounds of assets to meet the pensions promised.

	Pros	Cons
Governance	All governance passed to the insurer.	Typically only works for schemes closed to accrual.
Operational costs	Insurers run very cost effectively due to economies of scale and data that is much cleaner than a normal DB scheme would have.	The operational costs of getting to a buy-out (let alone the insurance premium which is currently off putting to most) are very substantial.
Investment	Insurers managing billions or tens of billions in DB assets are able to access investment opportunities available to only the largest schemes.	
Member security	Significantly higher security than all but the most well-funded schemes with the strongest covenants.	
Cost certainty	Generally these structures offer complete cost certainty to sponsors, which is one of their most appealing features.	

What does the future hold?

Flows of money from DB schemes to insurers have been substantial over the past decade, averaging around £10bn each year for the past few years. However, £10bn is well under 1% of DB scheme assets. If funding conditions stabilise, and as schemes mature, these flows are likely to grow several times over in the coming years.

Costas Yiasoumi
Head of Core Pension Risk Transfer, Legal & General

"Within our annuity and pension buy-out business, we're responsible for the pensions of over a million individuals in the UK. Because we have significant scale in terms of actuarial, investment and administration resource, we find that we can operate more efficiently than a typical pension scheme and we pass these savings onto pension schemes when quoting for buy-ins and buy-outs. In the case of buy-out, we not only help trustees and sponsoring companies better secure and protect their members' benefits, but we also help them remove costs, such as legal, accounting and covenant advice as well as PPF levies. In our view, more and more schemes will consolidate into insurers, first through buy-ins but ultimately through buyouts over the coming years. This will lead to far fewer entities, operating at much greater scale, with far greater efficiency and security for scheme members."

Superfunds

What is it?

Superfunds are the proposed new consolidation vehicle outlined by the Pension and Lifetimes Savings Association's DB Taskforce[1]. They are a proposal to exchange the unknown and variable covenant offered by weaker employers into a cash investment from external investors hoping to make a return on their capital. For scheme sponsors, they provide a way to remove their DB schemes from their balance sheet at a cost well below buy-out.

	Pros	Cons
Governance	All governance passed to the superfund.	Typically only works for schemes closed to accrual.
Operational costs	The superfund would have economy of scale, and is seeking to simplify benefit scales leading to greater savings.	The operational costs of moving to a superfund would be material.
Investment	Superfunds should reach critical mass to deliver sophisticated investment strategies not available to smaller schemes.	
Member security	The DB Taskforce's modelling suggests that members could receive full benefits in over 90% of the scenarios they've modelled.	
Cost certainty	Superfunds offer complete cost certainty to sponsors, which is one of their most appealing features.	

What does the future hold?

The DB Taskforce recognised that legislative change would be required to breathe life into their superfund idea. Given the challenges of Brexit, it seems unlikely to us that there will be the required willpower in Government to tackle the more controversial aspects of this, on members' rights and security, in the current parliament.

Ashok Gupta
Chair, PLSA DB Taskforce

"The large number of small schemes in the UK DB system means that schemes may struggle to fix the problem of underfunding and deal with the issue of a weaker covenant by themselves. We believe the PLSA Superfund would have the potential to offer great benefits to members, employers, the regulator, the industry, and the economy. Members get a better chance of more pension benefits being paid. Employers get a lower cost alternative to a buy-out. The regulator gets a sector with better managed risks. The economy benefits from improved investment by superfunds and employers are freed from onerous DB burdens. We believe employers would pay more [to a superfund] if as a result they could be released from future liability for the scheme."

[1] https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2017/DB-Taskforce-third-report-Opportunities-for-Change.pdf

Non-insured risk transfer

What is it?

This is an emerging solution. It will involve transferring all scheme assets and liabilities into a new DB pension scheme, whereby sponsors can break the link to their DB scheme and exchange their uncertain covenant for a fixed cash sum and additional capital supplied by external investors. It keeps the scheme within the DB regime, with PPF protection. Trustees would seek clear covenant advice showing that the upfront improvement in funding (through additional cash) combined with the capital available to the scheme would leave members with greater benefit security compared with maintaining the status quo.

	Pros	Cons
Governance	All governance passed to the consolidation vehicle.	Trustees of transferring members would want to ensure the governance of the receiving scheme remained robust in future.
Operational costs	Economies of scale would generate material ongoing savings.	The one off costs of the bulk transfer, including all areas of advice, would be substantial.
Investment	Covenant consolidators will need to reach critical mass to deliver sophisticated investment strategies and management fee levels not available to smaller schemes.	
Member security	Post transfer, the consolidator would have to materially lower the risk to members' benefits, or the trustees would not transfer members in. However, this would be higher risk (and lower cost), than a traditional buy-out.	
Cost certainty	Covenant consolidation offers complete cost certainty to sponsors if they obtain clearance from tPR, one of their most appealing features.	

What does the future hold?

There are several consolidators working on coming to market over 2018. Given the struggles facing many schemes and sponsors, and the call for private sector solutions from the DWP, it feels to us like an idea whose time has come. Given the implications for member security, we hope the DWP in its white paper and the Pension Regulator in practice, will energetically engage with and support the best solutions in this space while weeding out any that could be damaging to members.

Adam Saron
CEO of Clara Pensions Limited

"Covenant is not a static measure, it is difficult to evaluate and harder to monetise. Covenant evolves over time, changes with corporate structure and can deteriorate rapidly. Non-insured risk transfer can help by fixing the covenant. In doing this, it can increase the chance of schemes securing members' benefits with an insurer in time. This is achieved by providing additional upfront funding and capital to call on that would not otherwise be available. Like all DB schemes, non-insured risk transfer solutions must put the members first. It's critical for governance and economics to be driven by securing members' benefits."

What option should you consider?

Having explored the various flavours of consolidation, it's clear there are many options available to schemes to help reduce cost and ultimately improve the security of peoples' pensions.

Consolidation should be considered in the context of your scheme's long term strategy. To understand your priorities and identify the role consolidation could play in your scheme's future, there are a series of key questions you should ask and revisit:

START HERE

Do you expect your sponsor to make it to the finish line, i.e. to be able to pay the last members' pension, or insure all pensions in full?

NO → Consider non-insured risk transfer

YES

1. Review your risk profile. Are you taking the right risks and no more than required?
2. Can you improve security and cash stability through a fully integrated approach to risk management?[1]
3. Look at your cost outlays with these questions in mind to determine which type of consolidation you should consider:

Do you feel you are spending too much management time and effort running your scheme? → Consider sole trusteeship

Is there scope to reduce investment operational costs, such as reporting, and increase the speed and ease of asset transitions? → Consider asset platforms

Are your investment, advisory and admin fees higher than average for a scheme of your size?[2] → Consider DB master trust or merger

Do you plan to insure your scheme in the long term? → Consider phased buy-ins to reduce running costs and get best possible pricing

The right options to consider will be scheme-specific. Contact one of our experts to discuss your scheme's strategy and the role consolidation could play in helping you meet your long term objectives.

[1]See http://hymans.co/betterfutureDB
[2]Find out through tPR's cost comparison tool: http://www.thepensionsregulator.gov.uk/trustees/db-scheme-costs-tool.aspx

Our experts

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Jon advises a wide range of corporate clients, including public sector corporations, FTSE100 companies and a number of UK insurers. His strategic approach helps clients to manage the cost and risk involved in achieving their objectives.

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Methodology

Our analysis is based on the data from the following sources:

- The Pension Protection Fund's 2017 purple book
  http://www.pensionprotectionfund.org.uk/About-Us/TheBoard/Documents/WEB_170407%20-%20PPF_Purple_Book_2017.pdf

- Hymans Robertson's 2017 Risk Transfer report
  https://www.hymans.co.uk/news-and-insights/research-and-publications/publication/hymans-robertsons-2017-risk-transfer-report/

- The PLSA DB Taskforce's third report
  https://www.plsa.co.uk/Policy-and-Research/Defined-Benefit/DB-Taskforce

- Hymans Robertson's 31 July 2017 DB Index
  https://www.hymans.co.uk/news-and-insights/research-and-publications/research/the-future-of-db-the-calm-before-the-storm/

- DWP Green Paper "Defined Benefit pension schemes: security and sustainability"
  https://www.gov.uk/government/consultations/defined-benefit-pension-schemes-security-and-sustainability

- Hymans Robertson's reponse to DWP's Green Paper "Defined Benefit pension schemes: security and sustainability"
  https://www.hymans.co.uk/news-and-insights/research-and-publications/publication/dwp-green-paper-response-may-2017/

- The Pension Institutes "Greatest good for the greatest number"
  http://www.pensions-institute.org/reports/GreatestGood.pdf

We have extrapolated recent trends based on the underlying data and analysis contained within these reports supplemented by our professional judgement on likely future outturns for the UK DB pension scheme industry.

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