Defined benefit consolidation: what are the opportunities?

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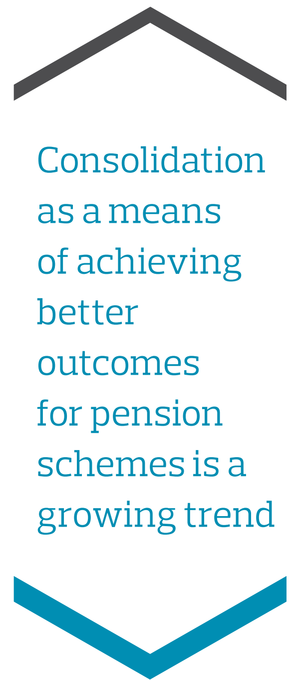
Contents

Introduction

Consolidation as a means of achieving better outcomes for pension schemes is a growing trend. It was specifically highlighted in the Department for Work and Pensions' (DWP's) 2018 White Paper on protecting defined benefit (DB) pension schemes.



However, 'consolidation' is a broad term; what does it mean in relation to pensions?

Consolidation seeks to achieve one or a combination of:

- creating efficiencies of scale
- improved governance through greater delegation to specialists
- access to additional options through scale
- transfer of responsibility for providing the benefits

There are several potential options to deliver consolidation, such as merging pension schemes or fiduciary investment management, most of which have been in existence for several years. What caught the headlines in the White Paper was the announcement of 'commercial consolidation'. In late 2018 the DWP issued a consultation, 'Consolidation of Defined Benefit Pension Schemes', which proposed how a framework for the authorisation and regulation of commercial consolidators could work. Two commercial consolidators, Clara-Pensions and The Pension SuperFund, have already launched their businesses.

Here, we look at commercial consolidators in the context of all the other consolidation options available. Whether you are a sponsor or trustee, the options that could be appropriate to consider will depend on your objectives and circumstances.

For example:

- Greater delegation can facilitate focusing limited resources on the most significant matters
- Consolidation of governance can save cost, raise standards and improve flexibility
- Transferring responsibility for providing benefits to a separate entity breaks the link with both the sponsor and the trustees

Your objectives

The form of consolidation that may work best for you is likely to be driven by your key objectives.

Click on a solution for further details.

Key objectives

Member benefits

Maintain benefits in the scheme
- Insurance buy-in

Potential for better benefits
- Some commercial consolidators

Security for existing benefits
- Insurance buyout
- Commercial consolidators

M&A activity

Have you already completed a transaction?

No
- DB master trust
- Commercial consolidators

Yes
- Scheme merger
- Commercial consolidators

Governance burden
- Fiduciary management
- Sole trustee
- Consolidate advisers
- Scheme merger

Company balance sheet
- Insurance buyout
- Commercial consolidators

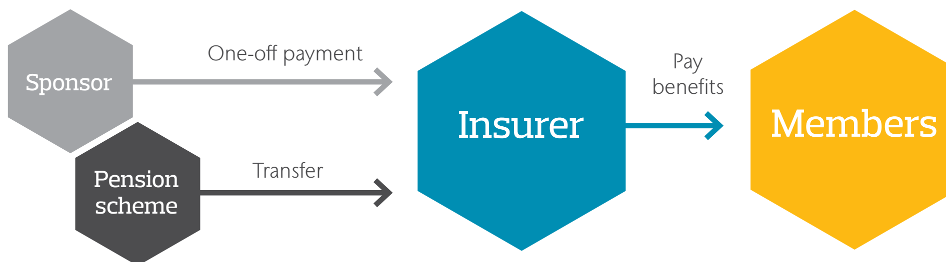
Cost efficiency
- Commercial consolidators
- Consolidate advisers
- DB master trust
- Scheme merger

Access best ideas
- Fiduciary management
- Scheme merger
- Sole trustee

Insurance buyout

What is it?

The purchase of annuities covering members' benefit entitlements. Initially purchased by the trustees but converted to individual annuities in the name of the member ('buyout'), at which point the pension scheme can be wound up.



Key benefits

- Strong level of benefit security for members, created by significant reserving requirements that encourage tight control of financial and longevity risks. Supervised by the PRA (part of the Bank of England) and the FCA, under EU and UK legislation, with regular public disclosure of solvency position and substantial supporting information on risk control. Financial Services Compensation Scheme is likely to apply if the insurer becomes insolvent
- Meets primary trustee objective of permanent solution to meet benefits in full
- Well-tested regime – decades of experience without any defaults or reductions to annuity payments
- The need to use a defined cleansed data-set and agree a benefit specification for the scheme with the insurer is more likely to provide future-proofed administration of member benefits
- Existing governance procedures around treating members fairly, with ongoing monitoring from the FCA
- Detailed contractual terms providing protection for trustees, and ancillary cover available to obtain permanent cover for residual data risks

Challenges

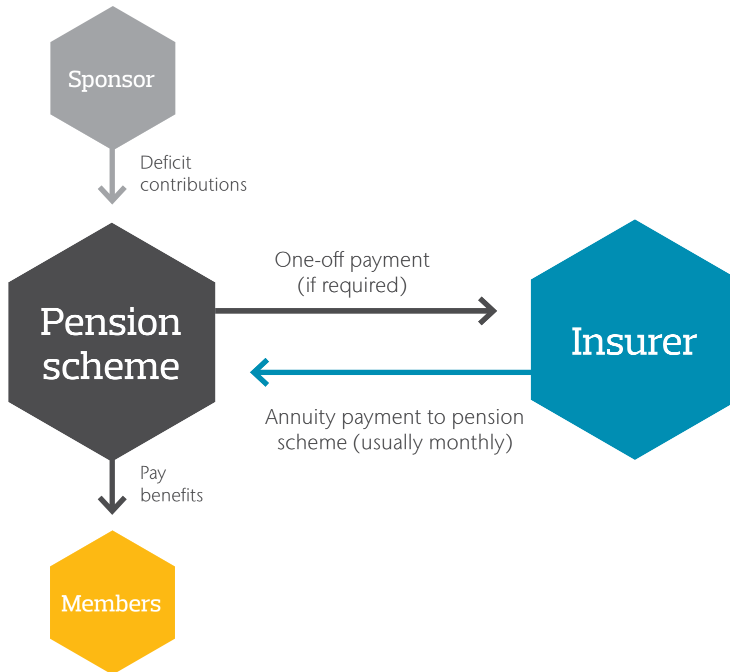
- Entry cost. Annuity purchase requires sufficient assets up front to secure the scheme liabilities. The insurance price is pushed up by the strong reserving requirements, especially for members who have not yet retired. The market can be less competitive for buyouts of less than £50M
- Cost can be high due to reserving requirements (especially in respect of members who have not yet retired)
- Some (very limited) benefit features not suitable for insurance, eg, long-term link to salary, a DC underpin to a DB benefit
- Permanent decisions need to be made on the treatment of any discretionary benefits
- Need to consider the accounting implications for sponsors (although these can often be mitigated) – particularly those with US parent companies

Click here if you want to know more

Insurance buy-in

What is it?

The purchase of annuities covering members' benefit entitlements, often only pensioners. Held as an asset of the scheme.



Key benefits

- Strong level of security (as per insurance buyout) although not allocated to the individual
- Well-tested regime with existing governance procedures around treating members fairly
- Members still ultimately able to rely on the sponsor's covenant as well as the insurer
- Ability to incrementally secure benefits when affordable, rather than waiting until the scheme as a whole can be secured
- Fewer accounting implications for sponsors

Challenges

- Annuity purchase requires sufficient assets up front to secure the scheme liabilities. The insurance price is pushed up by the strong reserving requirements, especially for members who have not yet retired. The market can be less competitive for buy-ins of less than £50M
- Permanent allocation of assets to annuity purchase, and so no potential for any future gain on assets or strategic investment changes in respect of assets used to fund the buy-in
- Cost can be high due to reserving requirements (especially in respect of members who have not yet retired)
- Residual risks are uninsured
- A buy-in provides ‘double covenant’ protection of the associated benefits (from the insurer and from the continuing sponsor) which can make it difficult in some circumstances to convert to a buyout (under which the sponsor covenant protection is removed)

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Commercial consolidators

What are they?

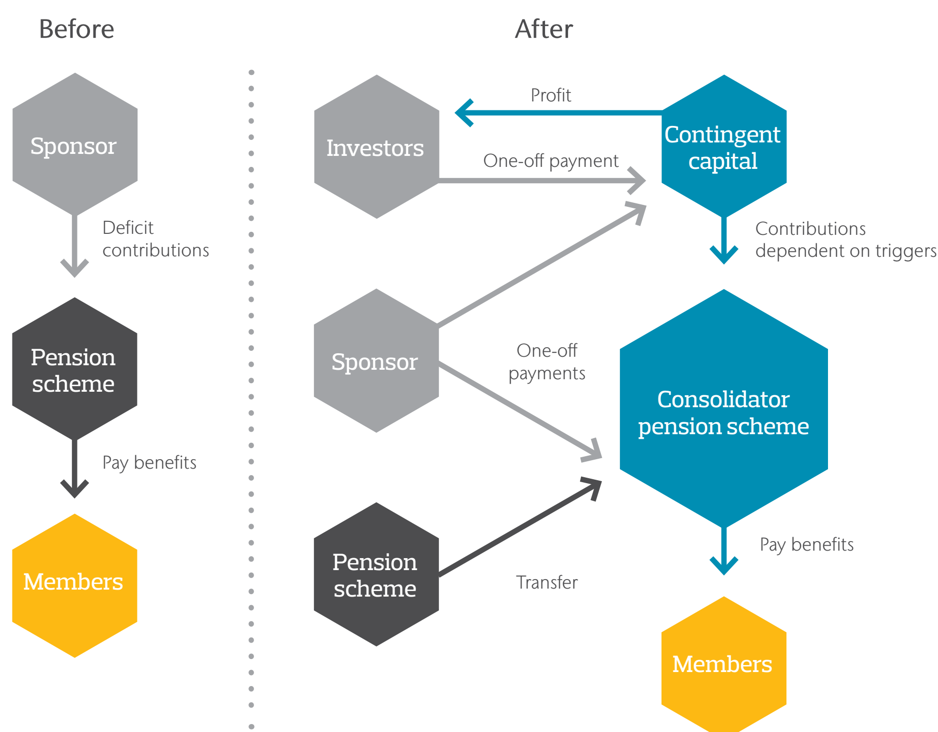
In essence, commercial consolidators offer sponsors and trustees a full risk transfer without the need to purchase annuities with an insurer. Instead, the benefits are transferred to the consolidator and on completion:

- The consolidator is required to meet the future benefit payments relating to the scheme membership
- There is no longer any link between the scheme and its prior trustees and sponsor
- A one-off payment from the sponsor will be required to achieve entry to the consolidator, but in general it is expected to be cheaper than annuity purchase.

Consolidator business models differ quite substantially. For example, some will target a buyout of the consolidated liabilities whereas others will run off the liabilities indefinitely. In addition, some target the payment of guaranteed benefits, whereas others offer the prospect of members receiving enhanced benefits.

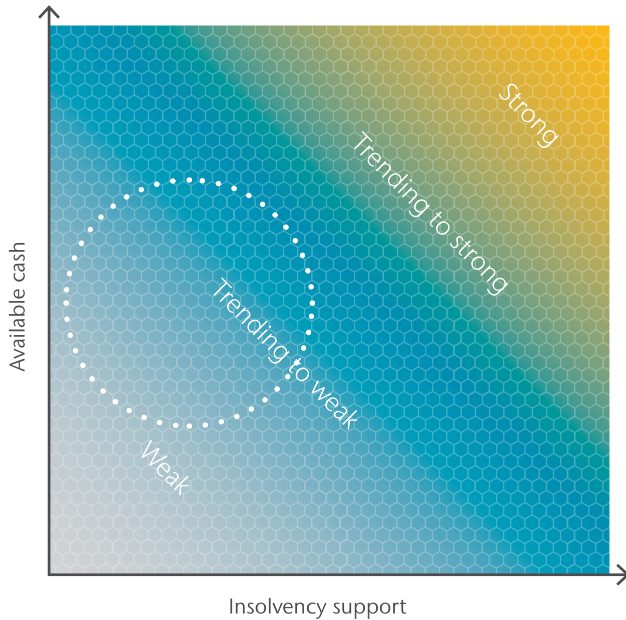
However, in either case, consolidators are expected to function inside the DB pensions regulatory framework, which carries lower reserving requirements and allows more flexibility in asset strategy when compared with the insurance regime. This enables the cost of transferring benefits to a consolidator to be lower than would be required to purchase annuities. However, this does mean that the protections are not as strong as those afforded by annuities (ie, Solvency II). Instead, consolidators would need to comply with the funding regime (albeit one that will be stronger for consolidators than for regular DB schemes) and be backed by the PPF.

The 'commercial' aspect of the consolidation refers to the fact that, like insurers, the consolidators are backed by capital investors, such as private equity firms, who provide funding to cover downside risks, held in a risk capital buffer that can be called on if needed, alongside the assets received from schemes and cash from sponsors. In due course, the capital investors expect to receive a return on their investment in the consolidator.



Ultimately, there is a trade off – the sponsor covenant is ceded, replaced by upfront funding.

Who might this option be suitable for?



There are some other situations in which a commercial consolidator may be an attractive option, for example:

- PPF+ cases, ie, well-funded schemes with weak or no sponsor which are either out of the PPF assessment or looking for an alternative to a Regulated Apportionment Arrangement approved by the Pensions Regulator
- UK schemes where most of the covenant or shareholder strength is overseas and the parent company does not want the complications of accounting and funding a UK trust
- Merger and acquisition targets where the ultimate exit strategy would see the business free from legacy pension obligations

A commercial consolidator is subject to the regulations of occupational UK DB schemes, but is different in nature to a conventional occupational UK DB scheme – not least with regard to the fact that profits can be extracted. A new regulatory regime will be required for consolidators, and the DWP's consultation paper in December 2018 set out draft considerations for authorisation. It also brought to light some key issues:

- What is the funding requirement that needs to be met by consolidators when taking on a transfer from a scheme; how should financial sustainability be assessed on an ongoing basis; and what contingency planning should be in place to protect members?
- Should there be a specified end-goal for securing benefits with insurance companies at the earliest possible opportunity?
- Should there be controls on assets in the risk capital buffer?

In addition, the DWP make it clear that the purchase of annuities with an insurer remains the ideal way to secure member benefits, and so the expectation would be that DB schemes with a reasonable prospect of reaching buyout would not be appropriate for commercial consolidation.

Key benefits

- Discharges liabilities and enables the DB scheme to be wound up at a potential lower cost than purchasing annuities
- Provides greater security than the current situation, otherwise trustees should not allow the scheme to transfer to the commercial consolidator
- Commercial consolidator trustee board include professional trustees who help maintain strong governance

Challenges

- This is a new solution – and so there could be reputational concerns (eg, failure of consolidator and reduced member benefits). There is a lack of track record to assess administration experience or the long-term financial strategy. If a particular consolidator does not build critical mass, it may look to exit and pass on accumulated liabilities to another vehicle early
- It can be difficult for trustees to assess whether the consolidator provides greater security than the current situation as the structures are so different to the status quo and between consolidators. It will also be necessary to be sure that the sponsor can afford consolidator entry but cannot afford full buyout
- For schemes with a strong sponsor covenant, it is difficult to see why the scheme should be transferred to a consolidator rather than the scheme simply being run off over time or bought out

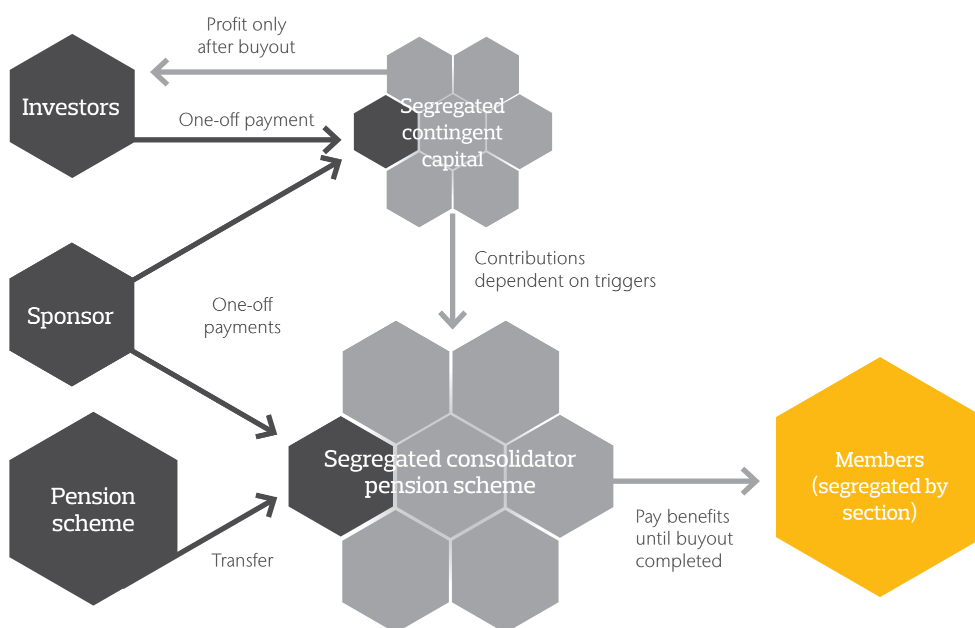
Overall, we expect commercial consolidation will be the right answer for only a small proportion of schemes. However, a significant market could still be created from even a small proportion of the approximately £2 trillion of UK DB pension liabilities.

The two consolidators that have announced their proposals to the market have proposed very different structures. We look below in more detail at these two consolidators and their proposals.

Focus on: Clara-Pensions

Clara describe their offering as a 'bridge to buyout', consolidating and managing schemes for a temporary period before securing them in the insurance market

- It operates on a sectionalised basis, whereby each incoming scheme represents a new section with no cross-subsidies between sections
- It intends to have a low-risk investment strategy
- If there is excess outperformance, it will look to accelerate buyout of the section
- Profits will be released to investors only once a section is fully insured. As annuity pricing is lower for pensions in payment, profit is generated due to the cost of buyout reducing as the scheme matures and members retire



Expected target market

Characteristics of schemes within the likely target market include those:

- Closed to accrual
- With a high proportion of deferred members or with previous pensioner buy-ins

Key advantages and disadvantages specific to Clara

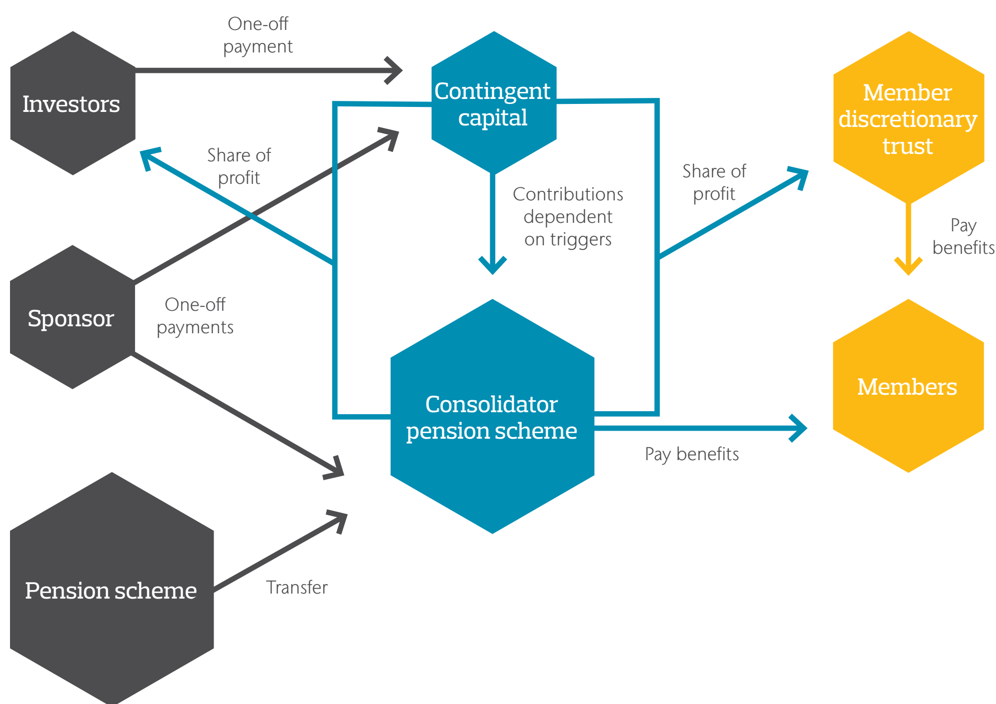
Advantages
Limited timespan for reliance on Clara
No risk of early profits being taken. (Any outperformance would be used to accelerate securing annuities in respect of member benefits)
Sectionalised nature means no cross subsidy between schemes and no dilution risk as new schemes enter

Disadvantages
No potential increase of members' benefits, even if there is outperformance
Clara acts as a stepping stone to buyout – is it needed? If the sponsor covenant can support the scheme over the intermediate period, why give up the 'profit' from the scheme maturing?

Focus on: The Pension SuperFund ('PSF')

PSF are aiming to provide a long-term run-off solution, whereby the PSF will meet members' benefits indefinitely as and when they fall due.

- All assets and liabilities are pooled together, not kept in distinct sections
- It intends to target investment returns not dissimilar to the PPF, of around 1.8% pa above the liability discount rate. Rates and inflation exposure will be hedged systematically, with longevity risk hedged tactically
- Profits can be released on an annual basis to investors, but only if the combined funding level, including the capital buffer, is above 115%. One third of any excess arising from the trust would also be shared with members under the trustees' discretion, most likely as additional DC benefits



Expected target market

Characteristics of schemes within the likely target market include those:

- Closed to accrual
- With a high proportion of deferred members and ideally no pre-existing pensioner buy-in

Key advantages and disadvantages specific to PSF

Advantages
Potential upside for members if there is outperformance
If there is a member expectation for benefits to be provided above those that are guaranteed, this allows for the possibility that those expectations may be met
Larger pool of assets which may provide better access to investment strategies, including illiquid assets, as peak cash outflows are not expected until late 2030s

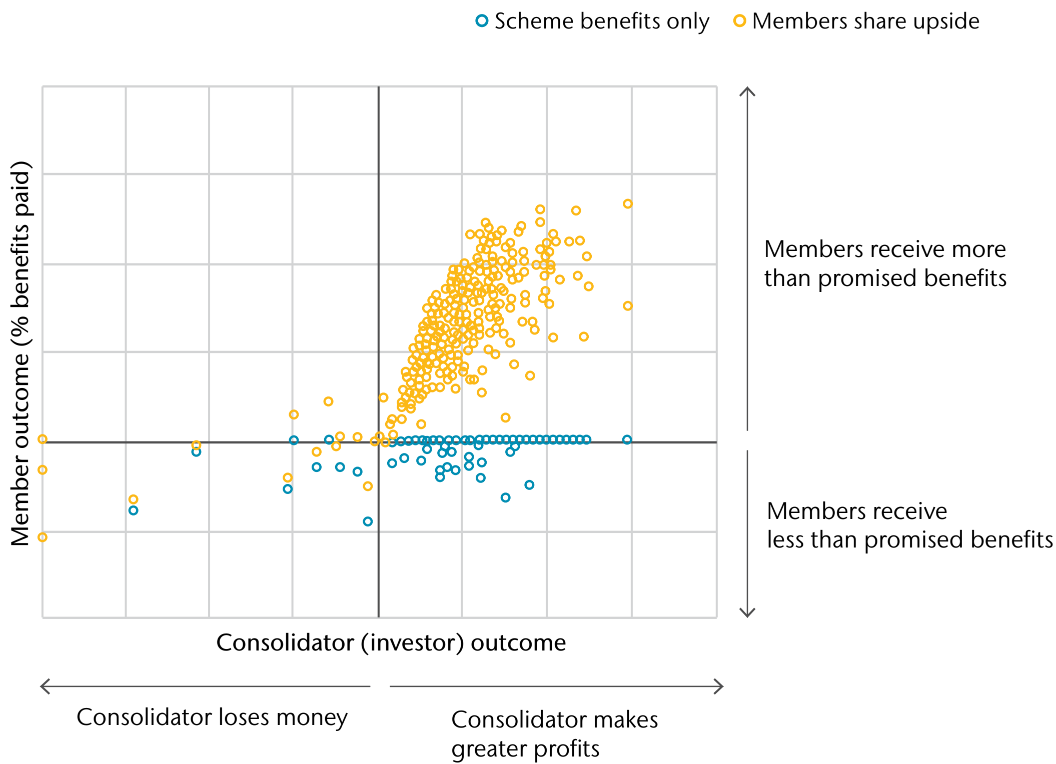
Disadvantages
Risk of investment strategy not achieving return required, although capital buffer will guard against short-term fluctuations
Long-term reliance is placed on the PSF in order for members to receive their benefits, although contractual benefits will have already been funded to a prudent minimum funding level at the point of transfer
Risk of cross-subsidy between schemes although all transferring schemes need to meet minimum funding level in order to transfer, which is probably above their current technical provisions
Regret risk if profits are taken in the early years but subsequently PSF fails and members receive reduced benefits. Profits cannot be distributed until the 115% capital level is maintained

How can you assess?

The decision to transfer to a consolidator is potentially a very tough decision both for the sponsor and, particularly, for the trustees of a scheme. In practice, the appropriateness of doing so will need to be considered based on the specifics of the scheme, the sponsor and the consolidator. Aon can help trustees and sponsors consider and model what the outcomes could be for members, to help trustees and sponsors who are considering this route to consolidation.

This chart shows how we can provide outputs which can help you analyse a commercial consolidator's model.

Simulated consolidator and member outcomes



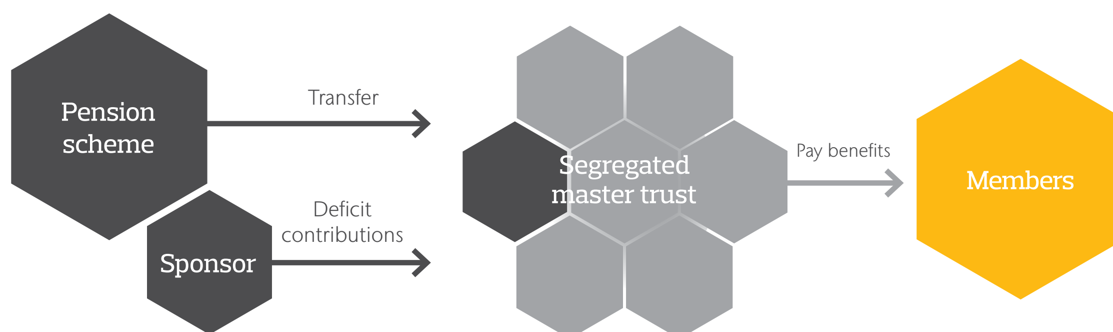
Please note that the chart shown here is generic and does not represent a specific consolidator's business model.

DB master trusts

What is it?

A sponsor transfers its DB scheme to a section in a common DB master trust, with its own ring-fenced assets and liabilities. The trust would be governed by a single board of independent trustees, with each sponsor retaining financial responsibility for funding its own section.

This remains a relatively rarely-used vehicle (with the exception of some industry-wide schemes). However, while not currently widely used in the UK private sector, there has been a strong trend towards DB master trusts in other mature DB trust-based markets such as Australia and the Netherlands. In addition, DC master trusts are now well established in the UK.



Key benefits

- Potential cost and time efficiencies from pooling governance, advisers and assets, which could provide potential to reach the 'end-game' sooner
- Potential high-quality, sustainable governance – a growing issue for many sponsors as trustee succession planning becomes a key issue

Challenges

- Potential loss of a degree of control on scheme funding and input into investment strategy
- Requires scale from the DB master trust in order to take advantage of the key benefits

Consolidating advisers

What is it?

Using the same adviser for various services required for an ongoing DB scheme – in particular scheme actuary, investment adviser and administration.

Key benefits

- Quicker timescales for valuations, calculations, investment strategy reviews and preparation of information for scheme report and accounts
- Potentially lower costs by reducing the level of frictional costs associated with sharing of information between third parties – for example there should be less data manipulation for actuarial valuations, and no reliance on third-party scheme cashflow data for investment reviews
- Consistency of reporting methods across service lines, reducing governance requirements – this helps trustees and sponsors focus on risk management and strategic overview
- Avoids duplication of work or work falling between provider gaps. Fewer suppliers to manage and often a single point of contact who takes ultimate responsibility for all services

Challenges

- Need to ensure that each service line continues to be reviewed and assessed as thoroughly as one might do with separate advisers. In particular, there needs to be an understanding of how to unwind such an arrangement if one or more of the service lines are underperforming
- Making sure that the trustees do not receive a restricted opinion which is based on the viewpoint of just one adviser
- Limited to advisers who provide all relevant service lines

Fiduciary management

What is it?

- The delegation of the day-to-day management of a pension scheme's investment portfolio to an expert fiduciary manager
- The fiduciary manager is responsible for the implementation of investments and running the portfolio, with clear accountability to the trustees
- Trustees retain responsibility for setting the strategy, risk/return objectives and any guidelines or parameters
- Trustees can choose to delegate responsibility for all of their assets (full fiduciary) or some of their investments such as hedge funds or equities (partial fiduciary/a 'sleeve')

Key benefits

- Effective way to delegate day-to-day investment decision making, while still retaining control of the overall objective of the investment strategy. This frees up trustees' time to focus on the key strategic aspects of their scheme
- Trustees can benefit from the scale of investments that the fiduciary manager can offer, including access to a wider range of investment options that might otherwise be unobtainable on an individual basis by pension schemes (depending on their size and governance)
- Nimbleness: this approach means opportunities to de-risk or new investment ideas are captured and implemented quickly and efficiently. There is no need to wait for trustee meetings and selection processes to make changes. This allows trustees to be confident of not missing an opportunity to lock-in gains as funding levels improve or as new investment opportunities arise
- Expert fiduciary managers are in a position to use their scale to negotiate best possible pricing with underlying investment managers, reducing costs to the scheme. This discount can make a significant difference, particularly for small schemes

Challenges

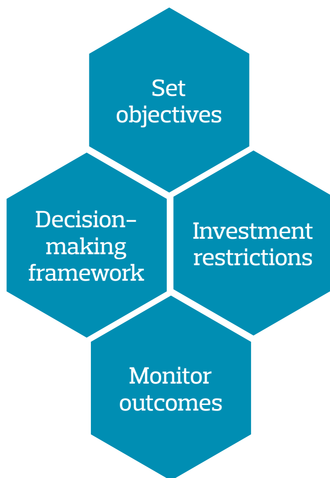
- Understanding what is included in the package of services
- Comparing providers remains a challenge. In particular, comparing the performance of providers is a key problem, although this is becoming easier with more standardised disclosure
- Addresses investment-related risks (relative to liabilities). Other risks, such as poor quality of data and longevity, remain

Click here if you want to know more

Division of responsibilities under fiduciary management

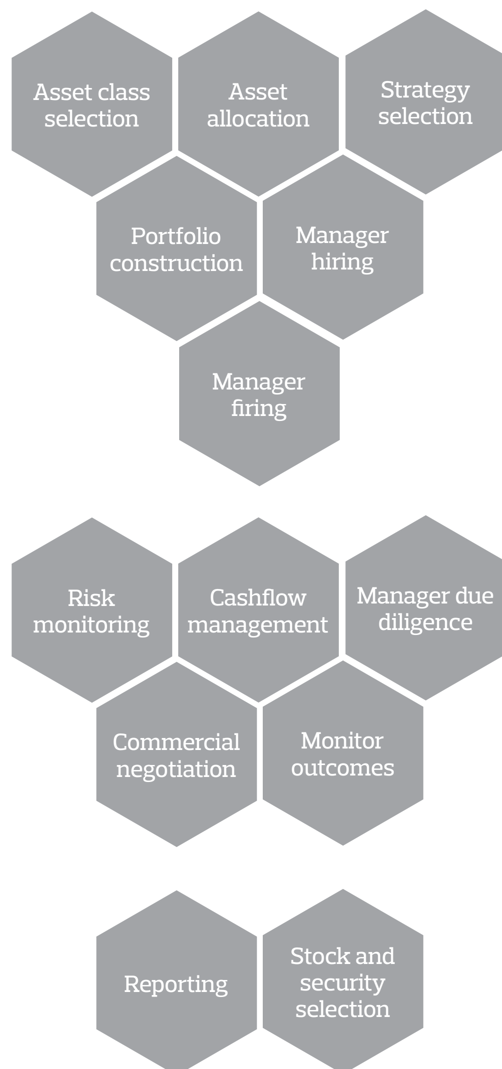
Trustees:
Plan the journey and monitor progress

Responsibilities



Fiduciary Manager:
Implementing the solution to achieve it

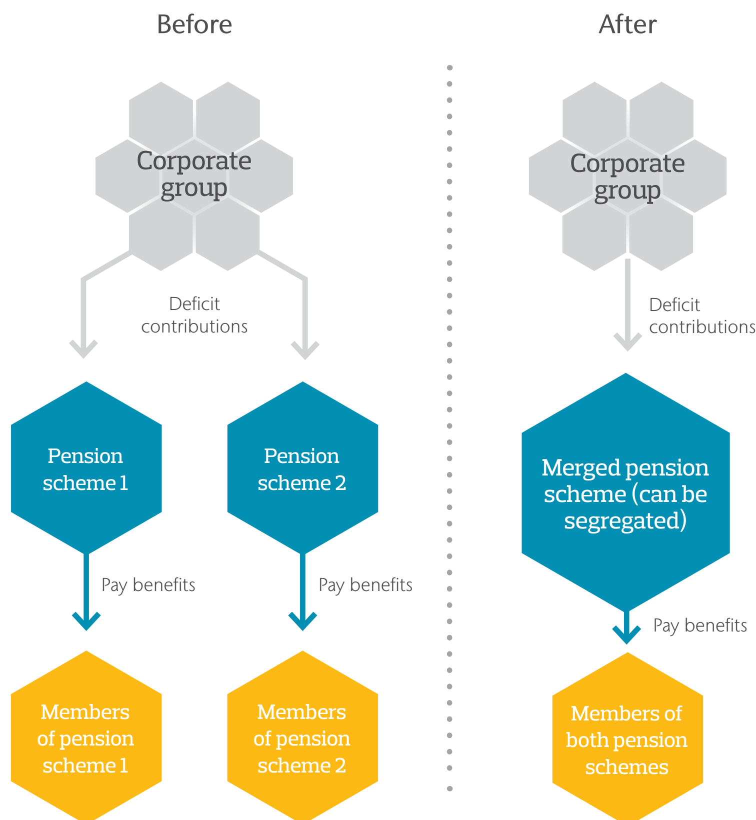
Responsibilities



Scheme mergers

What are they?

Combining multiple schemes into a single new or existing trust. The merging schemes may be fully combined or kept separate in segregated sections, but there will be a single set of trustees and advisers. This is typically used to combine multiple pension schemes within a corporate group, which might have arisen from historic practices or following merger & acquisition activity.



Key positives

- Benefits of consolidation across all advisers and trustees – reducing ongoing administration costs and improving efficiency by streamlining processes; for example, by having a common approach to actuarial valuations, and/or investment policy
- Reductions in meetings and in trustee and corporate management time
- Enables sponsors to engage more efficiently with funding requirements and discussions
- May provide small schemes within a corporate group with access to more ideas and opportunities, and increased negotiating power on investment manager fees and any eventual risk settlement pricing
- Can provide an opportunity to simplify benefits and powers
- May improve covenant

Challenges

- Opportunity limited to corporate groups with multiple schemes
- Costs of initial merger can be significant
- A full merger (which achieves the highest efficiencies) may be difficult if schemes have significantly different powers, funding positions, or covenant
- It can make future divestiture of part of a business more complex
- Some of the positives mentioned above may be possible to achieve more simply by combining valuation dates, trustee board and/or advisers, while still keeping the schemes separate

Sole trusteeship

What is it?

Sole trusteeship is where the trustee board of a pension scheme is replaced by a sole corporate trustee, with that corporate trustee being a professional trustee firm rather than a company associated with the scheme’s sponsor. The directors of the professional trustee firm are effectively the trustees of the scheme, although in practice one nominated director would normally take lead responsibility.

Key benefits

- More timely decision-making
- Reduced level of trustee training and education required
- Sole trustee may assist in getting value for money from other advisers
- Ability to make faster progress on projects
- Clarity of succession planning for the trustee; no need to find new trustees, particularly member-nominated ones, regularly
- Enables key employees to focus on the sponsor's business rather than have time used up through being a trustee

Challenges

- Risks a lack of diversity in, and peer review of, decision-making
- Understanding the fees of the sole trustee, and potentially comparing to the fees associated with a conventional board (including time-costs)
- Risk of stagnation due to limited changes at trustee firm
- Concern about a lack of connection between the sole trustee and scheme membership
- Care is required to manage the potential conflict of interest as the sole trustee is remunerated by the sponsor but in some circumstances also negotiates with it

Understanding a changing landscape

There are several consolidation options available to schemes, trustees and sponsors, both existing and new. Whether any of these are right for you depends on your objectives, goals and circumstances. We think that a focus on improving the efficiency and governance of DB schemes is most welcome and the resulting focus on getting to the 'end-game' for DB schemes is also an important development.

We are interested in hearing your thoughts on DB consolidation and your input on this important area. We also would be delighted to speak to you in more detail about any of the solutions we have mentioned. Aon has significant experience in relation to all the existing solutions. If you would like to discuss this with us, please contact your usual consultant or one of our consolidation team.

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