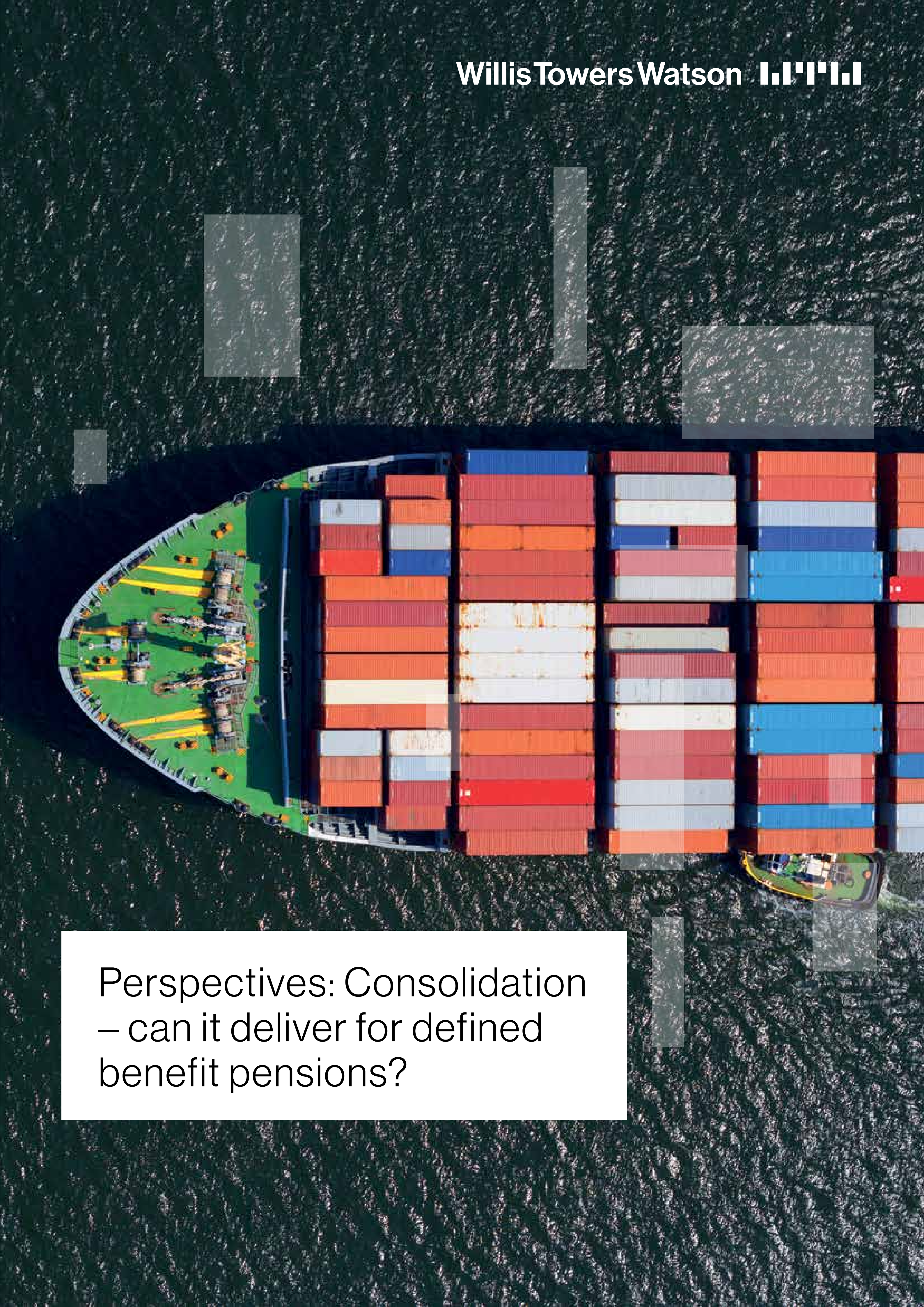
Willis Towers Watson



Perspectives: Consolidation – can it deliver for defined benefit pensions?

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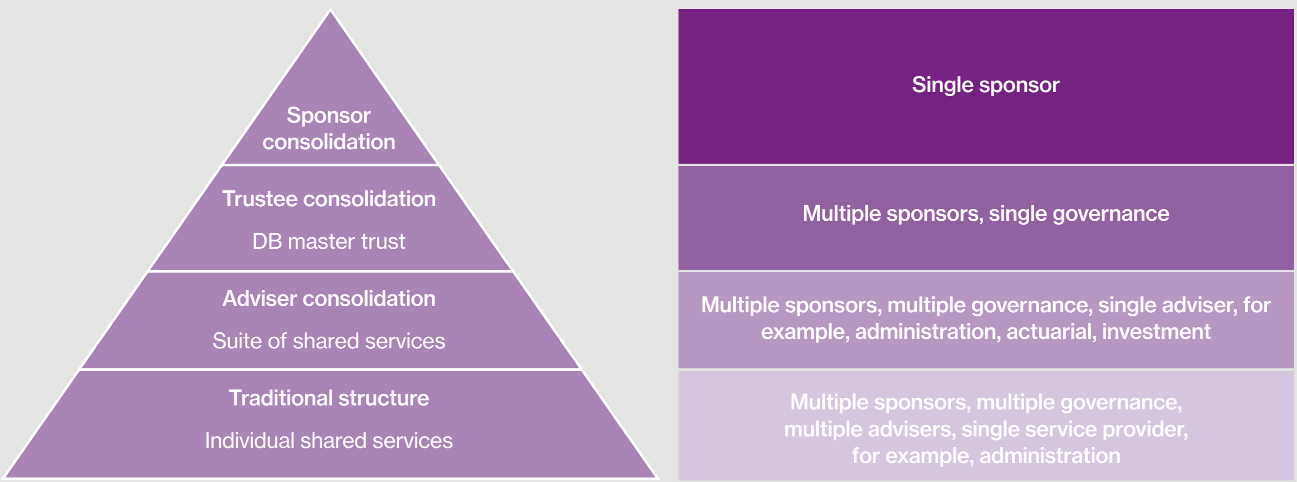
Introduction

The government wants to encourage consolidation amongst defined benefit (DB) schemes. This can help to reduce inefficiency – and ultimately cost – through economies of scale, improved investment strategies and better governance.

Consolidation was one of the key themes within the government's White Paper, *"Protecting Defined Benefit Pensions"*[1] and is a topic that has attracted much media coverage. However, most reporting has focused on the development of a new model, a 'commercial consolidator' which might provide an alternative strategy for managing DB legacy schemes and, potentially, better long-term outcomes for some members. Consolidation is however, far broader than a new model and the White Paper recognises that existing options – for example, shared administration services, asset pooling, fiduciary management, DB master trusts – deliver many of the same advantages and, arguably, do so more simply. The government believes that these are currently underused and is keen to address this.

Figure 1. **Consolidation might, therefore, be considered as a hierarchy or tiered options**



1. March 2018. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/693655/protecting-defined-benefit-pension-schemes.pdf

The new commercial consolidator model has yet to be spelled out in detail, but might be considered a DB master trust where the employer covenant is replaced by a capital buffer. This is how it differs from the current regime as it allows the sponsoring employer to separate from its pension scheme through monetisation of its covenant.

This is similar to a buyout of liabilities, although the new vehicle will be outside the insurance regime and so not subject to the capital requirements of the Solvency II Directive. It should, therefore, be more affordable than an insurance buyout, but it will also provide a lower degree of benefit security.

Insurers are regulated by the Prudential Regulation Authority and hold capital that would cover benefit promises in all but the most extreme circumstances (economic and other shocks expected to occur as infrequently as once in 200 years – referred to as a 99.5% confidence level). The Financial Services Compensation Scheme (FSCS) would then cover any residual risk, ensuring members suffer no loss. Commercial consolidators will be regulated by The Pensions Regulator (TPR) and the required capital cover is not yet known, but is expected to be less than under the insurance regime. It would be odd for the government to develop a framework that it knows would not be commercially viable. It is not yet known whether commercial consolidators will be eligible for the Pension Protection Fund (PPF), but even if they are, PPF compensation would not deliver full protection, as is the case under the insurance regime once the FSCS is taken into consideration.

There will be a consultation on consolidation towards the end of this year and the Department for Work and Pensions (DWP) hopes to publish this around September/October. The intention is that this consultation will be well-developed, seeking views on firm proposals rather than anything that simply leads to a further (fourth) consultation. Thereafter, there would need to be legislative changes, at least for a new model and an appropriate authorisation regime for it. Legislation will be less critical for encouraging awareness and, where appropriate, the use of existing options.

DWP will need to make a 'bid' for a new pensions bill and bids usually need to be made over a year before the start of the parliamentary session in which they are to be considered. Whether they are accepted depends on their political importance, urgency and state of preparation.[2] The most optimistic timeframe would be for legislation to introduce the new framework in 2019-20. However, given the capacity constraints flowing from Brexit changes, an act of parliament in 2020-21 would seem far more likely, with implementation from 2021 or 2022. Moreover, it's not just DWP legislation that would be needed for a new vehicle. There could be a host of changes that need to be made to the tax regime also.

2. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/645652/Guide_to_Making_Legislation_Jul_2017.pdf

Is the existing DB landscape ripe for consolidation?

80% of schemes have fewer than 1,000 members whilst over 60% of all assets are held by the largest 4% – those with more than 10,000 scheme members.[3] According to TPR, small and medium-sized schemes fail to meet its expected governance standards more than larger schemes, and trustee decision-making is often not optimal.[4] The White Paper states that a "lack of opportunities to benefit from economies of scale means that small schemes tend to have higher administrative costs per member and are less likely to benefit from quality investment opportunities, for which advice comes at a premium". They are also less likely to be able to diversify their longevity risks.

Buying out benefits through an insurer would help to address these issues and the insurer settlement pricing is at its most attractive for almost a decade. However, there is less market appetite for taking on smaller schemes – insurers will understandably prioritise larger transactions – and smaller schemes may find it "difficult to be quoted a competitive price".[5] It is small to medium-sized schemes that DWP would expect to benefit most from transferring to a commercial consolidator, although as for insurance buyouts, it might be doubtful whether this would be the key target market for any new commercial consolidators.

Although fragmentation and scheme size deliver challenges, so too is the fact that most private sector DB schemes are now closed to future accrual and/or new entrants (less than 10% remain open to new entrants).[6] Businesses carrying closed schemes will usually wish to focus resource on their current pension provision and workforce, not legacy arrangements. This leads to fewer in-house experts and less support for trustees, with the end result that governance issues may play second fiddle to day-to-day delivery.

Consolidation, at whichever end of the scale, can help to overcome these challenges.

3. Purple book 2017, figure 3.11 - http://www.pensionprotectionfund.org.uk/About-Us/TheBoard/Documents/WEB_170407%20-%20PPF_Purple_Book_2017.pdf
4. TPR, 'DC and DB Research', September 2017. Available at: http://www.thepensionsregulator.gov.uk/docs/dc-db-research-response-september-2017.pdf
5. Paragraph 336 of DWP Green Paper "Security and Sustainability in DB pension schemes"
6. WTW Survey April 2018 "Where next for DB?"

Existing consolidation options

Any new consolidation framework is some years away, but there are existing consolidation options that can deliver many of the same scale efficiencies and governance savings. These include:

Consolidation option	Characteristics
Shared administration services	The most widely used of consolidation options is shared administration services. This takes advantage of using a firm who specialises in pension administration, and can adapt to the constantly changing legislative environment creating economies of scale across all the schemes it supports. Benefits extend beyond cost savings to a stronger governance process around administration, which helps trustee boards with areas such as pension scams and data protection compliance under the General Data Protection Regulation (GDPR).
Asset pooling	Asset pooling brings together the assets of multiple pension funds to create greater buying power. The key advantages of this are gaining access to certain private market investments and innovative investments that provide better matching of liabilities, for which minimum investment sizes and overall complexity can be prohibitive for smaller schemes. This approach can therefore allow schemes to diversify beyond that otherwise possible. Manager fees are also significantly reduced by asset pooling and we have seen some active managers reduce fees by more than 50% when assets are pooled in this way.
Fiduciary management	Fiduciary management has been growing rapidly over the last ten years. In 2007, 58 schemes with aggregate assets of £2 billion were reported to be using this approach, increasing to nearly 550 schemes in 2017 with £82 billion. Fiduciary management increases the power of the asset pooling option by outsourcing manager selection and governance of the asset portfolio to a specialist. Many fiduciary managers now have discretion over assets globally of over $100 billion and this buying power delivers significant savings across a wide variety of asset management products. It also allows these providers to employ highly-skilled staff specialised in the areas of risk management, portfolio construction and manager selection. It essentially provides small and medium-sized schemes with access to the expertise and opportunities normally available only to the largest global asset owners.
Combining administration, actuarial, investment and secretarial services	Traditionally, pension schemes have employed third-party service providers separately, for example, considering which administrator, investment consultant and actuary are right for them. However, for schemes where trustees have limited time and aren't supported by a full-time pension manager this approach brings significant challenges. Avoiding duplication of work or tasks falling between the provider gaps is not straightforward and the efficiencies gained from these providers working together seamlessly often result in reduced governance requirements and/or cost savings for pension schemes.
DB master trusts	DB master trusts have been in place in the UK market for a long time, but over the last few years a number of these have been promoted more actively. Master trusts can provide greater outsourcing and efficiencies than receiving all services from a single provider, through consolidating existing trustee boards. For some corporates, these efficiencies and cost savings can be appealing, but for others the move to a DB master trust can be a step too far as it involves the loss of influence within the governance structure. The professionalism of a master trust board may also be attractive, but the more successful the master trust, the greater the potential dilution of focus on the circumstances and needs of any single employer's section.

Publicising existing consolidation options

The government is keen to improve trustee and sponsor awareness of the wider benefits of consolidation. However, this would appear to be an area where thinking is at an early stage as the White Paper says only that it will "work with the Regulator to consider how their Trustee Toolkit" could be used to achieve this.

One way that it proposes to address some of the behavioural and decision-making challenges is to develop a new accreditation regime for existing forms of DB consolidation. Its hope is that accreditation "would offer members, trustees and sponsors confidence that these vehicles meet or exceed a set of clearly defined standards". As with the government's plans to improve awareness of these consolidation benefits, there is no detail of what the accreditation standards might be. This is however, intended to be light-touch and might be considered more of a kitemark than a formal regime.

Another of the White Paper proposals is that trustee boards should be required to appoint a chairperson. A large proportion (85%) already do so, but this is less prevalent (74%)[7] amongst small schemes. The chair will be required to provide a statement to TPR, reporting on key scheme funding decisions, along with the triennial valuation. However, the statement could also be used to report on whether consolidation forms part of a scheme's long-term objectives and the reasons supporting the trustees' view. Over the coming months, TPR will be engaging with stakeholders on multiple White Paper issues and it is intended that, amongst other things, this will help determine what information should be reported in a DB chair's statement.

7. OMB on behalf of TPR, 'Trustee Landscape Quantitative Research', October 2015. Available at: http://www.thepensionsregulator.gov.uk/docs/trustee-landscape-quantitative-research-2015.pdf

Commercial consolidation vehicles: key concerns for different parties

Commercial consolidation vehicles might be considered a 'buyout lite' as liabilities are removed from the sponsor. The framework for this is outside the insurance regime and so vehicles operating within it would not be subject to the same costs (for example, the returns required by insurers on the solvency capital levels that must be held), but neither would members of new vehicles have the same near-guarantees afforded by insurance companies (and, in extremis, by the FSCS). This conflict creates significant challenges for the government, TPR, trustees of existing schemes, corporate sponsors of existing schemes and the consolidators themselves.

Some commercial consolidators are planning to launch before a new legislative framework exists, confident that they will be able to comply with any new requirements, which may have retrospective effect.

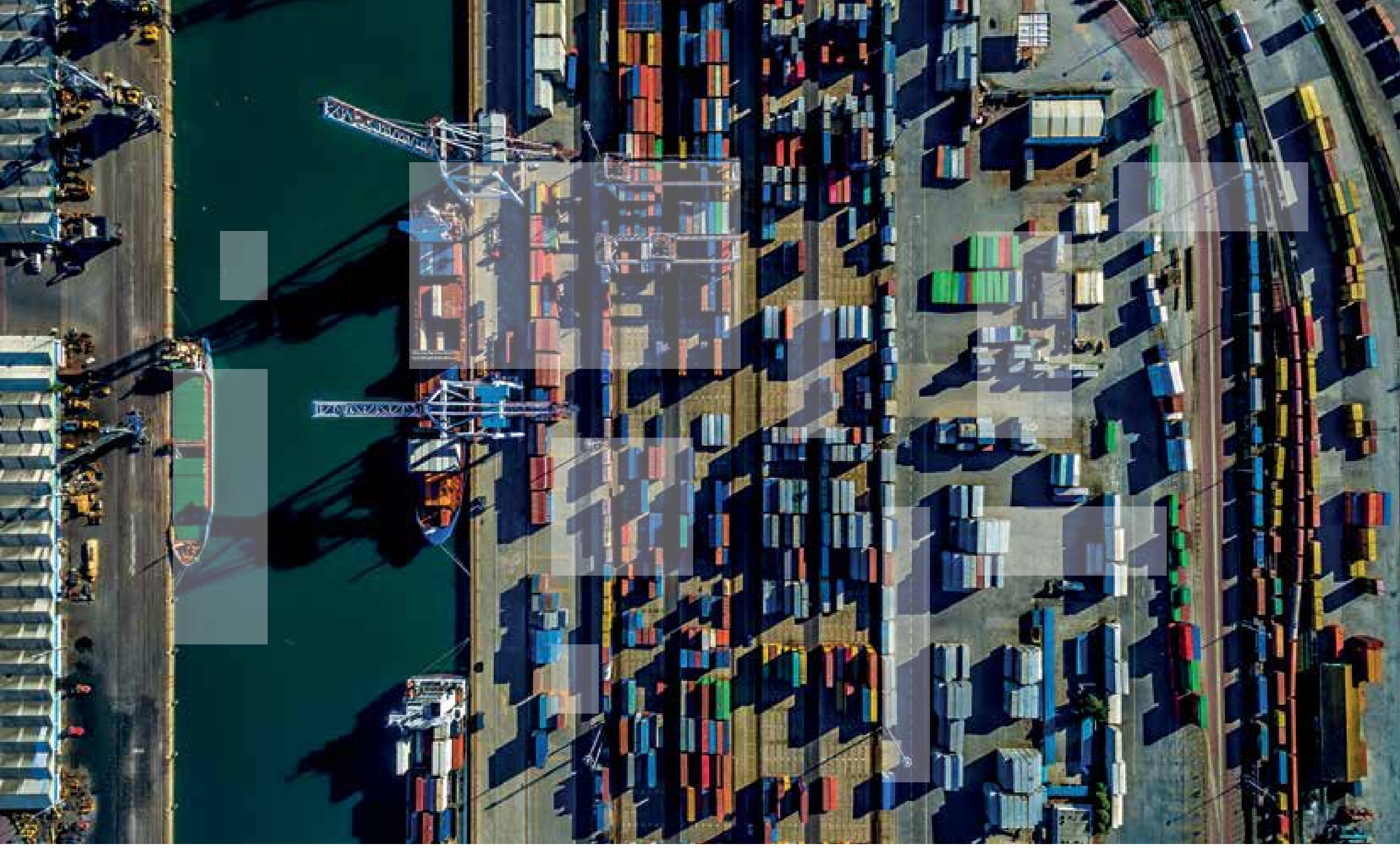
The viability of any commercial consolidator is likely to depend on pricing, which will be heavily influenced by any minimum level of benefit security required under legislation. This is not yet known and persuading trustees of existing schemes to transfer to a commercial consolidator, before the final rules have been established, may be a challenge. To offer some indirect reassurance in this regard, trustees may seek clearance from TPR for any transfer. One-third of DB trustees believe that a transfer to a commercial consolidator would "very strongly appeal" to scheme sponsors.[8]

Given the focus on underfunded DB schemes associated with recent high profile business failures, it seems unthinkable that the government would allow a weak regime to be put in place. The government cannot be seen to have allowed employers to separate from their pension scheme if the risk to members of not receiving benefits in full, increases markedly. Neither does it wish to develop a framework that lies unused because new consolidators are not commercially viable. There will also be concerns about possible 'regulatory arbitrage' between an insurer-provided solution and the protections provided and those within a 'buyout lite' commercial consolidation vehicle. All of this will be judged through perfect hindsight.

If a consolidator were to fail and the original sponsoring employer still existed, there would be no legal obligation to make good any losses (in the absence of inappropriate advice or procedures having been followed, anyway). Complete separation of the original sponsor and scheme is clearly a significant attraction of transferring to a commercial consolidator. However, depending on the circumstances, some reputational risk may remain – it is not difficult to see media and political pressure being applied on the original employer to step in and help.

There will be a duty placed on the trustees of the original scheme to satisfy themselves that the funding level of, and security in the consolidator effectively covers the on going support otherwise expected from the original sponsoring employer. Given trustees' responsibility to protect the interests of members, they would struggle to recommend a transfer unless there is something in it for the members anyway. The most likely benefit is an increased chance of full benefits being payable. Trustees weighing up a transfer are unlikely to find this straightforward, particularly if the costs and the long-stop protections of the alternate regimes are markedly different. Legal, actuarial and covenant advice are all likely to be needed.

8. WTW Survey April 2018 "What next for DB?"



Who are the targets for new consolidators?

Transferring into a commercial consolidator will not be attractive to all schemes – it has to make economic sense.

The largest schemes may wish to run off their liabilities over time. They are likely to be investing in assets that closely match their liabilities, have the scale to achieve full, competitive access to markets and hedge their key risks – they have the same investment freedoms as commercial consolidators and no requirement to hold a buffer (as the sponsor covenant still exists) as well as no requirement to deliver a return to investors.

It is small and medium-sized schemes who are currently targeting an insurance buyout that are most likely to be in the commercial consolidators' market (probably with emphasis on the latter).

Corporates and trustees may have differing opinions on the merits of transferring to a commercial consolidator. Where a scheme is well-funded with a strong sponsor, trustees may be reticent about bringing forward separation of the employer and scheme, for example, if holding out for a relatively short further period would enable an insured buyout with the full member protection that it offers.

Poorly funded schemes are unlikely to be able to afford entry to either a commercial consolidator or insured buyout.

From a trustee perspective, a transfer to a commercial consolidator might be attractive where the scheme is well funded, but there is less confidence in the sponsor covenant or its durability. This latter point may be where there is most uncertainty – covenant is notoriously difficult to assess beyond the short term – even an employer with an investment grade credit rating has a 3% chance of insolvency over 30 years.[9] Were the employer to fail, it might be that the assets then available would deliver a lower level of benefit through an insured buyout or the scheme's admission to the PPF than might have been achieved through an earlier transfer to a commercial consolidator. This is the assessment that trustees will need to make (factoring in also, that employer covenant risk would be replaced by consolidator default risk).

If the cost of buyout through a commercial consolidator is only slightly different from a buyout with an insurer, it is difficult to see many trustees (or corporates) viewing them as attractive. If it is materially cheaper, they will need to consider to what extent the likelihood of members receiving full benefits reduces – the fundamental trade-off is between cost and security.

9. Para 150 of White Paper

How much will a buyout through a consolidator cost?

Commercial consolidation is expected to be a lower cost option than an insured buyout. How much lower is not clear as this will depend on both yet-to-be established legislative requirements and the commercial consolidator model itself.

Fundamentally, there is a trade-off between cost and risk. Insured buyouts are subject to the requirements of the Solvency II Directive; they are able to take little risk and must hold substantial capital buffers. This enables them to offer near guarantees that benefits will be delivered in full. To be cheaper, a commercial consolidator would need to operate with less capital, but is then likely to need to take greater investment risk to deliver benefits in full. Whether any buffer it holds is sufficient to protect against investment and other risks that manifest themselves is the crucial element in assessing the likelihood of benefits being paid in full.

Within a commercial consolidator, the closer the level of member protection comes to that offered by an insurer, plus the closer the assets that it holds match its liabilities, the closer the cost of entry would be to an insurance buyout.

The Pension SuperFund, which was announced shortly after publication of the DWP White Paper, expects that "the value of liabilities on a conservative pension fund 'consolidation basis' could be between 85%-90% of the value an insurer would place on such liabilities".[10]

It would appear very unlikely that commercial consolidation will be available to schemes that are poorly funded. The average insurance buyout funding level across all schemes in the PPF universe as at 31 March 2017 was 66.9% (71.5% for schemes with between 2 and 99 members and 64.1% for schemes with between 100 and 999 members).[11]

There is already legislation[12] that prescribes a minimum buffer, additional to technical provisions (TPs), for DB schemes without a sponsor. We understand that the government's view is that this applies only to those schemes that are set up without a sponsoring employer (as opposed to schemes set up with a sponsoring employer, but where events have led to it running on without a sponsor).

That buffer is 4% of the TPs (as determined by the pension scheme) plus 0.3% of any capital at risk (in relation to death benefits). Commercial consolidators could be established under this regime, but a buffer at this level might be considered, at best, inadequate.

Appendix A offers a more detailed consideration of the cost issue.

10. http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/defined-benefit-pensions-white-paper/written/82220.html
11. Figure 4.6 of Purple Book 2017, page 19
12. The OPS (Regulatory Own Funds) Regulations 2005 No 3380

How might commercial consolidators operate and make a return?

Commercial consolidators will have different models and there could be significant differences in approach.

However, the capital buffer that they (will be required to) hold is expected to come, at least in part, by monetisation of the sponsor covenant that was originally supporting the original pension scheme. Any balance will need to be provided by the commercial consolidator (whether directly or from one or more third-party investors).

To provide a return on capital invested, the consolidator will need to find a way to extract gains from favourable experience (for example, investment outperformance). It is not yet clear what restrictions the government will place on this, but it will wish to avoid accusations of allowing business to profit at the expense of members.

It seems likely that a consolidator will wish to achieve consistent pricing and security of benefits across generations of new entrants. This might require (notional) sectionalisation of schemes and all the complexity with which this is accompanied.

In the absence of sectionalisation, this would imply the potential for cross subsidy whenever a new entrant joined the consolidator. For example, if investment performance is more favourable than assumptions, the funding level and/or capital buffer will increase. Unless the cost of entry is ramped up to take into account the higher levels, joining the consolidator would dilute these for existing schemes. Conversely, if experience was unfavourable, unless the cost of entry reflected the reduced funding/capital levels, part of any transfer value paid in would be used to absorb the existing deficit. Neither seems likely to be attractive.

What do we still need to know about consolidators?

The government proposal for a new consolidator vehicle is still early-stage thinking. The top level detail exists, but there is little currently sitting below that in the public domain. The White Paper identified a number of issues that need to be worked through and government intends to put forward firm proposals in a consultation that it hopes to launch in September/October 2018.

a) Establishing a commercial consolidator

There is currently no special authorisation or supervisory regime for consolidator schemes. The government believes that this should fall to TPR and will need to legislate to give TPR appropriate powers. While this may require new processes and checks, the defined contribution (DC) master trust model would seem a good place from which to start when considering some of the requirements. We would expect however, the final regime to be considerably more complex and, given the similarity to an insurance buyout, expect it to share many characteristics from the insurance supervisory regime, including ongoing, annual reporting.

b) Entry criteria

Entry conditions will be prescribed within legislation. The government says that "in most cases" it expects the trustees, sponsor and receiving consolidator scheme to take separate legal, actuarial and, in the case of the transferring trustees, possibly covenant advice. A Code of Practice or other statutory guidance might also feature as may a requirement for data, equalisation and administration risks to be minimised, prior to transfer. Quite what the government has in mind in relation to this risk-minimisation set of conditions is not fully clear, nor whether it really needs to become involved in the details. We would expect a consolidator to set its own contractual minimum requirements to prevent exposure to potential risks (or to incorporate these into its costings and the entry price).

c) Ongoing relationship with the sponsor

As well as a 'clean-break' solution, the government wishes the new regime to be sufficiently flexible to allow options where the original scheme sponsor retains an attachment to the consolidator – for example, where assets transferred to the consolidator do not meet the full entry price, perhaps through an equity stake or debt repayment arrangement.

The White Paper mentions that it might be possible to make a series of structured payments rather than a one-off 'price'. Whether a consolidator would be attracted to offering such a facility would depend on its business model – it would involve greater risk, which has associated costs. It might also deter stronger-funded schemes, those that were willing and able to pay the clean-break price, from joining, for example, if there were any cross-subsidy of additional cost. Please refer back to page 9.

It seems possible also that under a regulated apportionment arrangement, where an employer is facing impending insolvency, and the pension scheme is to be split off from the sponsor, a commercial consolidator might be a suitable recipient.

d) The consolidator's long-term funding objective

Consolidators will be required to set a long-term funding objective that ensures their "long term viability and an adequate level of security" for members. The funding regime will be stricter than the existing scheme-specific regime – see section on page 8, "How much will a buyout through a consolidator cost?". It is unclear how frequently valuations might need to be undertaken, but given the additional risks being taken on by consolidators (and members), it would seem unlikely in the extreme for these to be less frequent than the existing triennial valuation regime. The government may press for more frequent valuations, placing the burden on the pensions industry to persuade it otherwise. However, the most likely scenario would seem to be triennial valuations, but with annual reporting for intervening years – these may be more or less detailed than those required under the existing regime.

e) Capital buffer

Again, as noted on page 8, consolidators are likely to be required to hold a capital buffer. There are also likely to be regular 'stress tests' and 'value at risk' assessments to establish whether the buffer is both adequate and accessible. Failure to maintain the buffer at a minimum level will trigger regulatory intervention (initially, most likely to be a recovery plan to return to the minimum level within a short, set period for example, 12 months).

f) Investment strategy

A low-risk or cashflow-matching investment strategy may be required or, more likely, encouraged, along with the hedging of 'unrewarded risks'. This could be achieved by linking any capital buffer calculation to the investment risk being undertaken (similarly as occurs under Solvency II for insurers) and by delivering strong, and possibly narrow, guidance on how prudence should be interpreted.

g) Profit extraction

The government acknowledges that provision of risk capital to a consolidator will normally be conditional on financial reward for the provider. However, it is wary about allowing commercial organisations to make "excessive profits at members' expense" and will consider restricting the charges that can be made. Moreover, it may place restrictions on the extraction of 'profits' if these extend beyond any excess which would flow from buying out liabilities in full with an insurer.

h) Funding

Highlighted as an area that "will need further consideration", a funding floor, below which the consolidator cannot accept new business, may be set. The floor would be reached if assets are lower than the long-term funding objective and the entity financing the commercial consolidator is unable to meet any recovery plan contributions and minimum capital without further inward investment. Whether the consolidator has to wind up might depend on whether it can secure a turnaround without new business funding any shortfall.

i) Interaction with the PPF

The government has yet to decide whether consolidators will be eligible for entry to the PPF. It will need to strike a balance between the interests of all stakeholders – TPR, the PPF, the members, the consolidator's backers and other levy payers.

If the funding requirements and capital buffer deliver an effective guarantee of being able to buyout (with an insurer) liabilities at least equal to PPF compensation levels, then there would seem little need for PPF cover. However, eligibility for the PPF (although adding to consolidator costs) would offer comfort to schemes considering a move to a consolidator and would also offer a safety net – both financial and political in nature. This is perhaps the most likely outcome with levy costs reflecting the minimal risk to the PPF.

The impact of consolidators on the PPF and levies is unclear. If consolidators are outside the PPF and the pension rights taken on by consolidators are better funded than the average, this would be likely to increase the mean risk posed by schemes staying in the PPF universe and result in an increase in the levy for the remaining schemes. However, if consolidators are to be eligible for the PPF and/or the stricter funding regime (for all schemes) that was outlined in the White Paper leads to better-funded schemes in aggregate, this will reduce the risks to which the PPF is exposed and, all other things being equal, the levy should then reduce over time.

j) Governance and alignment of interests

Consolidator schemes could grow to multi-billion pounds with hundreds of thousands of members. The standard of governance will therefore need to be appropriately high and the regime for DC master trusts, particularly the fit and proper persons test, will be the starting point for those operating consolidators. Recognising that there could be some potential conflicts of interest between consolidator managers and financial backers, the underlying principle will be to ensure that there is sufficient protection to members whilst recognising the interests of investors.

k) Regulatory framework and (non-PPF) levies

To enable the 'ongoing supervision' of consolidators, the government foresees a need for additional TPR resource. TPR's corporate plan published May 2018 identifies an effective 40% increase in headcount by 2020-21, although how much of this is earmarked for commercial consolidator authorisation and oversight is not clear. However, this will mean an increase in TPR costs and levies. Ultimately, if consolidation proves successful, the number of schemes to be regulated will be smaller, allowing a more efficient regulatory regime.

Barriers to consolidation (new and existing options)

The logical question, if consolidation brings significant advantages and there are existing options, is why is it not more widespread?

There are a number of barriers that stand in the way of consolidation. Which of these apply, or to what extent, will depend to a large extent on the consolidation approach under consideration, but potentially include the following.

a) Vested interests

Employers, trustees, service providers and advisers will often have vested interests.

Trustees may fear losing control over the day-to-day running of the scheme or, if a move to a consolidator or master trust is contemplated, their positions. They may also have reservations about potential liability if the commercial consolidator fails and they are found, with the benefit of hindsight, not to have followed correct/reasonable process and/or taken appropriate advice.

Similar considerations apply to advisers also. Would, for example, an investment consultant be keen to recommend fiduciary management, if by so doing it put its own position at risk? This might be less of a consideration within a firm that provides both investment consultancy and fiduciary management services, but here there could be a potential conflict of interests. The Competition and Markets Authority (CMA)[13] is investigating this, looking at issues such as whether consultants steer existing clients to their own fiduciary management offering, when others – or a different solution - might have been more appropriate? The outcome of the CMA investigation is expected in July 2018, but an interim working paper suggests that measures to support competition and mitigate conflicts include trustees seeking third party advice, running tenders or inviting proposals.

Employers might fear losing influence over the investment strategy, which could then flow through to the employer contribution and/or deficit recovery period.

b) Data accuracy

When considering an insured buyout of liabilities, the cost to do so cannot be confirmed until the member data records are confirmed as 'clean' and complete (alternatively, there may be an additional risk premium). The same will be true for a transfer to a commercial consolidator scheme – the government is also considering requiring that administration risks must be minimised as a condition of entry. Ensuring that records are accurate can require considerable resource and the associated cost of doing so must compete with other scheme administration priorities. Historically, this has been an area where schemes have been particularly poor, with many delaying verification of records and data to the point at which benefit calculations are made, for example, retirement.

This lack of focus has been criticised for many years, but more recently has started to be addressed. The profile of this issue is now higher than ever, for a number of reasons

- Accompanying the abolition of contracting out of the earnings-related element of the State Pension (April 2016), HMRC offers a service through which schemes can reconcile their contracted-out records against those held by HMRC. However, there is a deadline for this and any scheme that has not raised queries by 31 October 2018 will be unable to do so.
- 2018 scheme returns to TPR will include a new question asking trustees to provide their common and scheme-specific (conditional) data scores. This is part of a governance drive from TPR to remind trustees that they are ultimately accountable for good record-keeping of their scheme, even though third parties may administer the records on a day-to-day basis. The change is likely to result in many trustees and pension managers looking more closely at the integrity of the member data.
- From 25 May 2018, new laws regarding data protection come into force through the GDPR. The GDPR places more onerous obligations on data controllers (including trustees) requiring them to keep records and documentation about processing activities, implement data security requirements and comply with requirements for reporting breaches, as well as carry out data protection impact assessments where appropriate.

All of these encourage schemes to ensure that their member records are complete and accurate.

13. https://assets.publishing.service.gov.uk/media/5abba6b240f0b67d64e21b4c/icim-fm-conflicts-of-interest-working-paper.pdf

c) Scheme characteristics, structure and simplification

Where schemes pool investments, schemes with different characteristics such as maturity and funding level may have difficulty agreeing investments which meet their employer and member needs.

The most efficient consolidation scheme from an investment perspective would be one in which the assets and liabilities of schemes are not segregated or ring-fenced in any way. However, this is difficult where there are different benefit designs and maturities as it would involve cross-subsidy and sharing of risks, such as investment, mortality and covenant risk.

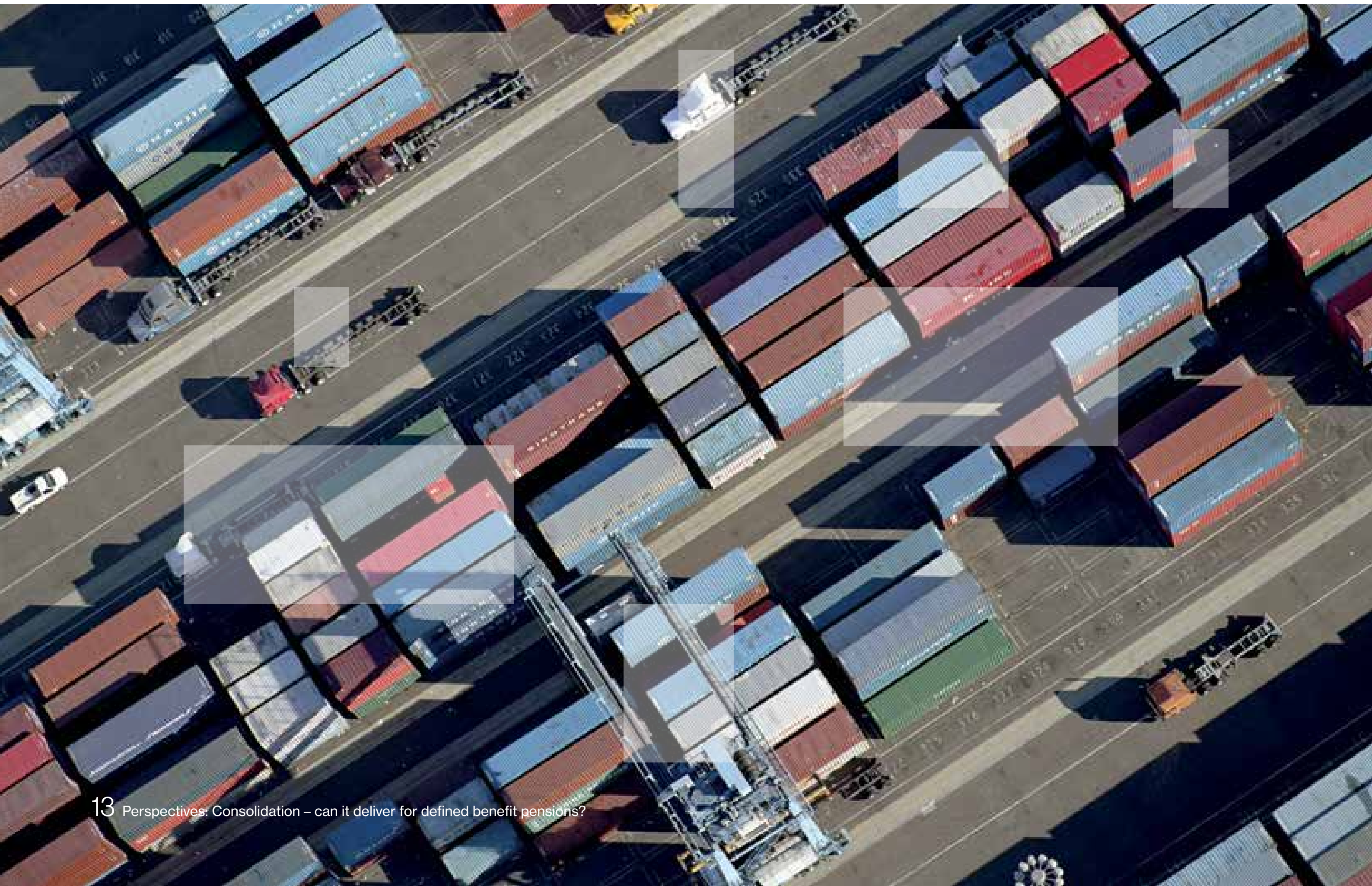
If benefits could be simplified to a common structure on transfer in, this would facilitate greater efficiency and reduce the degree of cross-subsidy. However, moving members to a new benefit structure, without their consent, is not straightforward, particularly if reliant on actuarial certification that there will be no members who lose – a judgement that can only be made with the benefit of hindsight.

The government acknowledges that simplification could be advantageous, but has not been convinced of any need for a statutory override that would allow trustees to simplify members' benefits without their consent.

Instead, the government points to the existing guaranteed minimum pension (GMP) conversion legislation, on which DWP consulted in 2016.[14] For schemes that contracted out of the earnings-related element of the state scheme before 1997, this allows trustees to change the GMP into a standard scheme pension provided certain conditions are met – without member consent. DWP also believes that conversion can extend to pension rights beyond GMP as, within its GMP conversion consultation, it stated that the "pension that accrued alongside the GMP that is to be converted may also be put through the conversion process". This may therefore, as well as addressing gender inequality issues, provide a means of delivering considerable simplification.

A Pensions Industry Working Group, with whom DWP has been consulting, has suggested some small changes to the conversion legislation, following which DWP is "considering minor changes for the near future". It is also in discussion with HMRC about cross-over issues, for example, where addressing equalisation issues inadvertently gives rise to negative consequences in relation to the annual allowance.

14. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/599457/government-response-to-occupational-pension-schemes-regulations-2017-and-related-issues-consultation.pdf



What actions should trustees and corporates be taking in response to the White Paper?

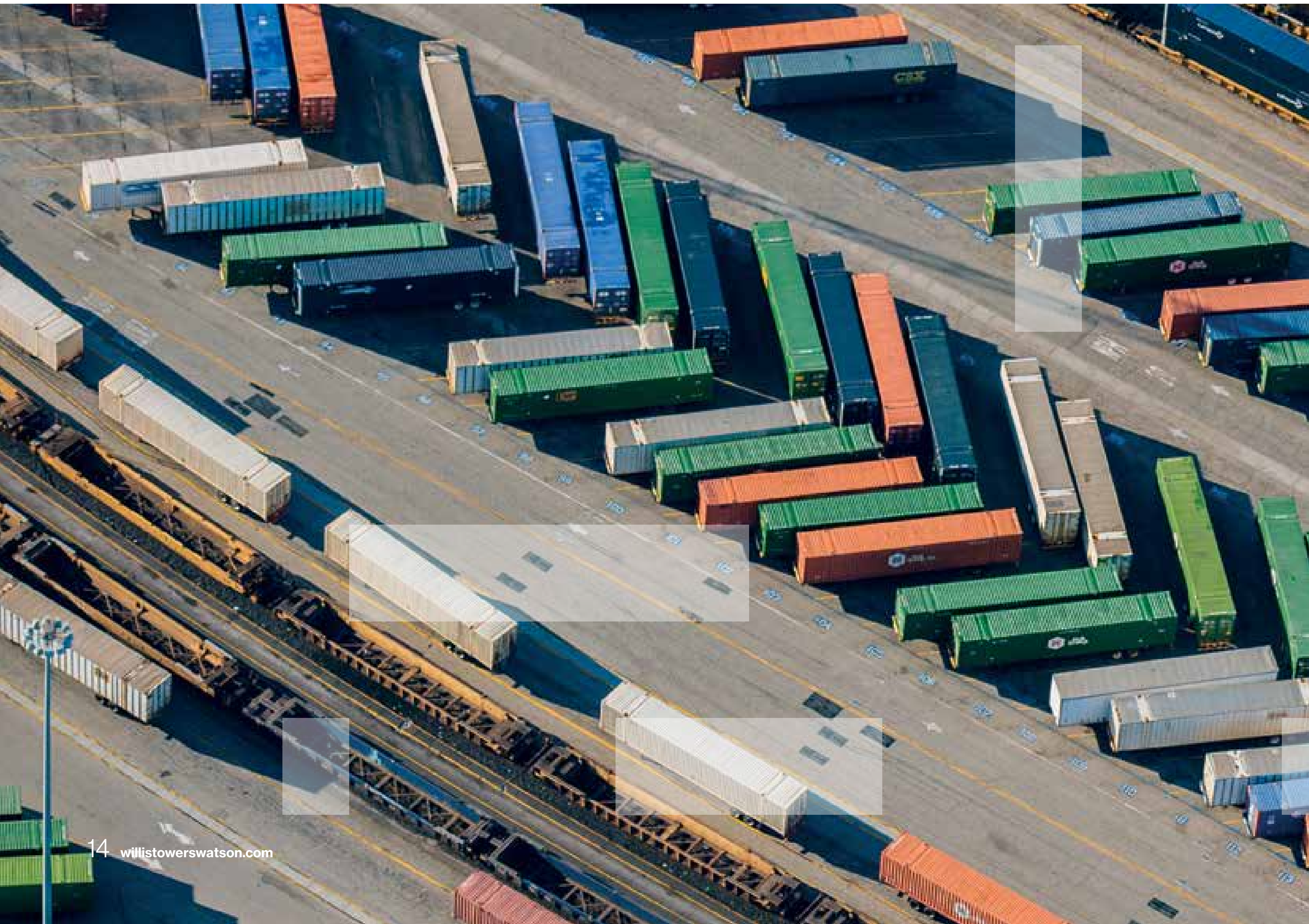
With the exception of very large pension funds, which generally already have the in-house resources and skillsets to deliver their pensions strategy effectively and at an appropriate cost per member, there could be advantages for both trustees and corporates in reviewing their governance and service provider structure in advance of any new accreditation or TPR/government publicising their availability.

There can be financial and governance benefits from outsourcing administration, asset pooling, fiduciary management and/or using a single provider for all services. The government is clear that it wishes pension schemes to take advantage of these, where appropriate. However, with all of these options comes a loss of control, whether that is over member communications, choice of investment managers or the technology used to provide a solution.

Trustees and corporates should be considering these pros and cons on a regular basis to determine whether moving another step along the consolidation line will benefit their members, or allow them to save cost by reducing internal resources or taking advantages of the scale that consolidation brings.

Questions that should be considered and revisited to ensure members get the best outcomes and the best experiences include:

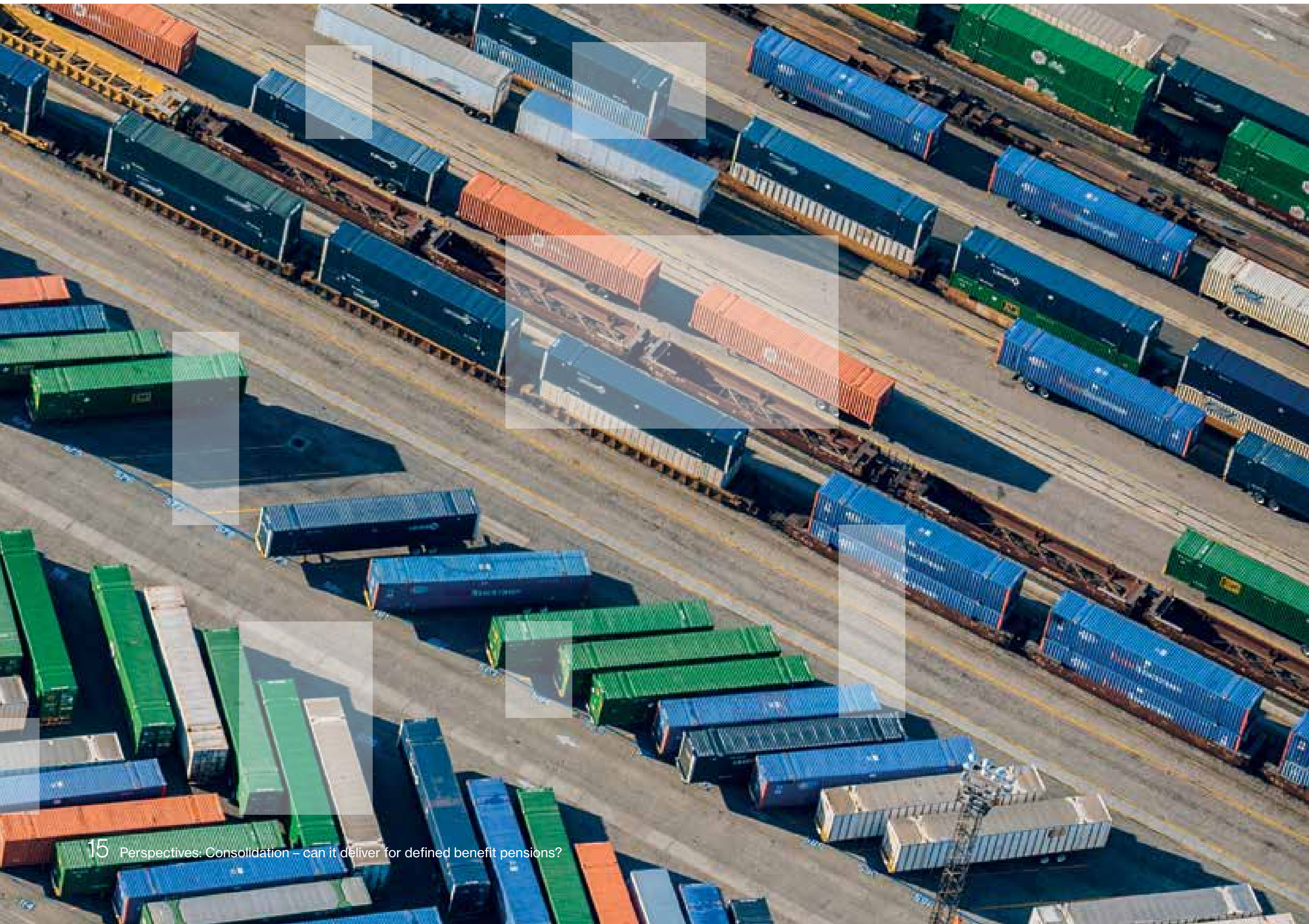
- Is the current governance structure fit for purpose?
- Are there existing consolidation options that we should be considering?
- Might a DB master trust or commercial consolidator be right for our scheme?



When will we learn more?

The government intends to consult on the commercial consolidation framework towards the end of 2018, with an aspiration to deliver this around September or October. It wants that consultation to provide detail, not simply to ask questions that lead to a further consultation. Given the absence of any detail provided in the White Paper, this will be quite a challenge and, to meet it, DWP will need to be engaging now with TPR and other stakeholders.

Encouraging awareness, and the use of, existing consolidation options does not necessarily require new legislation. However, the government is considering a new accreditation regime for these, in which case proposals for it would form part of the broader consultation. The government also intends to supplement increased awareness through other channels, such as TPR's Trustee Toolkit. No timescale is offered for this, but given its links with any new accreditation regime, it would perhaps be surprising to see new guidance earlier.



Appendix A: How much will a buyout through a consolidator cost?

Any cost comparison between an insured buyout and entering a commercial consolidation vehicle is straightforward – £x versus £y. What will be more complex is the relative attraction of either option.

The cost for either will be dependent, in part, on the underlying asset portfolio and the return achieved on those assets.

An insurer is required to hold assets that match their liabilities – in terms of duration, amounts and currency - which deliver fixed cashflows and cannot be recalled or recouped.

Insurers then discount their liabilities using the risk-free interest rate specified by the European Insurance and Occupational Pensions Authority (EIOPA). However, this can be increased by a 'Matching Adjustment' (the extra yield earned over risk-free, net of an EIOPA-specified 'Fundamental Spread', intended to represent default risk) that can be earned on their asset portfolio.

If commercial consolidators follow the current rules for DB pension schemes, they would be able to base their discount rate on the return they expect to receive on assets (over the duration of the pension scheme's remaining lifetime) and could also choose to invest in non-matching assets in expectation of receiving a higher return (and using a higher discount rate). However, this would also present greater investment risk.

Another cost differentiation is likely to be the capital buffer to be held.

Under the current DB pension regime, employer-sponsored pension schemes rely on the sponsor's covenant, rather than having to hold a capital adequacy buffer. With no employer sponsor standing behind the pension promise, there needs to be additional capital available to absorb shocks. Insured buyouts encounter this same issue and must hold a buffer – the solvency capital requirement (SCR) – that would enable them to continue to meet liabilities in full, in the event of shocks expected to occur no more frequently than once in 200 years (a 99.5% confidence level). This is locked-in capital on which the capital provider will need to earn a return.

Commercial consolidators will also (be required to) hold a buffer and this might be funded, at least in part, from the monetised sponsor covenant. However, the confidence level inherent within the buffer is not yet known.

In addition to the SCR, an insurer must hold a risk margin – an amount, as part of its own TPs that represents a 6% cost of capital for holding the part of SCR that relates to non-hedgeable (primarily longevity) risk.

Within a commercial consolidator, the closer the level of member protection (the confidence level within the SCR) comes to that offered by an insurer, plus the closer the assets that it holds match its liabilities, the closer the cost of entry would be to an insurance buyout.

There is already existing (Regulatory Own Funds) legislation[15] that prescribes a minimum buffer (additional to TPs) for schemes that themselves:

1. Underwrite risks related to death, disability or longevity (biometric risks)

2. Guarantee a level of benefits

3. Guarantee a given level of investment performance

We understand that the government's view is that this applies only to those schemes that are set up without a sponsoring employer (as opposed to schemes set up with a sponsoring employer, but where events have led to it running on without a sponsor).

The minimum buffer is 4% of the TPs (as determined by the pension scheme) plus 0.3% of any capital at risk (in relation to death benefits).

15. The OPS (Regulatory Own Funds) Regulations 2005 No 3380

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