

Endgame Options



A review of the market: with a focus on smaller defined benefit pension schemes

A sea of challenges

Defined benefit (DB) pension schemes face a multitude of challenges, from keeping up with ever-changing legislation and regulatory guidance, to protecting their members from pension scams and generally ensuring good governance.

Whilst a strong governance framework is entirely necessary and appropriate - to protect members' retirements - it places a very heavy time and cost burden on smaller schemes in particular.

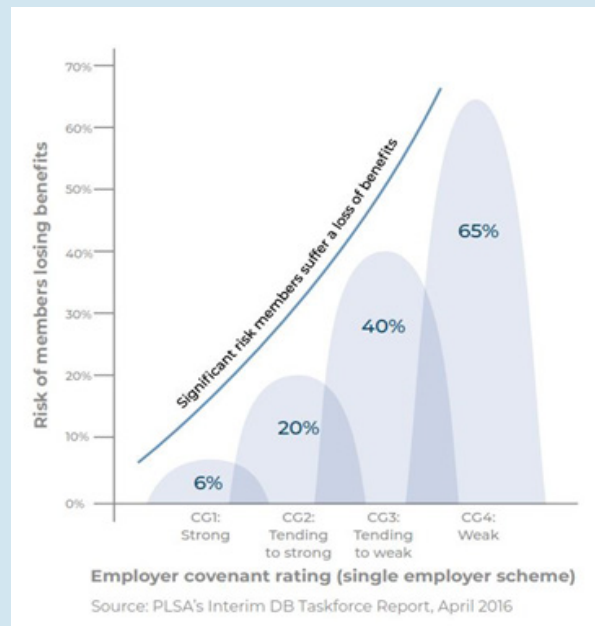
Poor governance and scams are not the only risks to members' benefits. The single biggest threat comes from the insolvency of the employer, which almost always leads to a cutback.

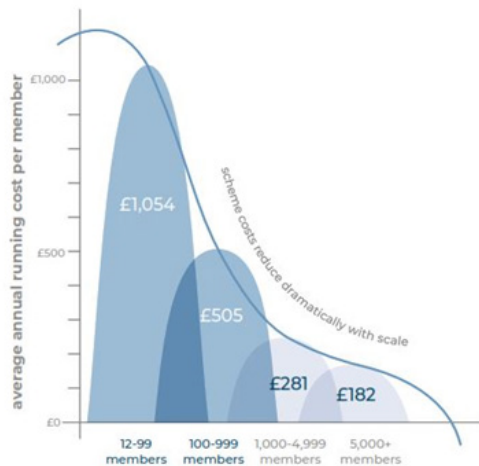
Risk to members' benefits

Each year, around 1% of schemes enter the Pension Protection Fund (PPF). Over the lifetime of a scheme, the risk of insolvency is significant, even for the strongest employers.

The Pensions and Lifetime Savings Association (PLSA) modelling showed the risk of benefit loss to be 6% in schemes supported by a Covenant Grade 1 (CG1) or 'strong' employer.

On top of these risks and governance challenges, smaller schemes suffer from huge diseconomies of scale, with running costs that are typically a multiple of the costs that large schemes pay for the same services (when expressed on a cost per member basis).





Source: Report for the Pensions Regulator prepared by IFF Research, April 2014

Cost inefficiencies

Smaller schemes – those with less than 1,000 members – are just too small to run effectively or efficiently on their own.

Many of the tasks that need to be performed, like undertaking triennial actuarial valuations, or preparing annual accounts, give rise to a significant amount of ‘fixed cost’, affecting smaller schemes disproportionately to larger ones.

Average annual running costs (that’s all fees including administration, actuarial and investment consulting, legal and covenant advice, but excluding levies and investment management costs) were reported to be over £1,000 per member for the smallest schemes in 2014.

The scale of the problem

Smaller schemes have just 10% of the £1.7 trillion of assets in private sector DB schemes. However, with around 4,250 smaller schemes in existence, they account for 80% of the market by number and are collectively responsible for the retirements of around one million members.

Many of these schemes are now just legacy arrangements, which no longer provide any advantage to the employer – only problems. It is no wonder that endgame options and consolidation are such hot topics in the industry.

Endgame options

When schemes are surveyed about their endgame strategies, the three options commonly considered centre around reaching self-sufficiency (or full funding on a low dependency basis), transferring to a superfund, or doing an insurance company buy-out.

Self-sufficiency

Self-sufficiency is a common objective. However, this surely begs the question, what next?

In the absence of any contingent capital support, the risk of sponsor default leading to a benefit cut remains, as does the risk of the employer having to make further contributions to the scheme.

New and emerging capital-backed solutions may be an option for some larger schemes. However, as these aim to support the scheme until it is able to buy-out with an insurer, self-sufficiency is arguably just a staging post on the journey to buy-out, rather than the endgame itself.

Other large employers may look to set aside additional contingent capital of their own, to support the scheme’s run off, or even set up their own captive insurer.

However, none of these capital-intensive options are available to, or feasible for, a smaller scheme. In fact, aiming for self-sufficiency and running on alone for an extended period is unlikely to ever be a cost-effective option for a smaller scheme.

Superfunds

Superfunds are another endgame option often mooted. However, they come with a high upfront cost and whilst they discharge the obligations of the employer, some risk to members’ benefits remain, because they are less secure than an insurer.

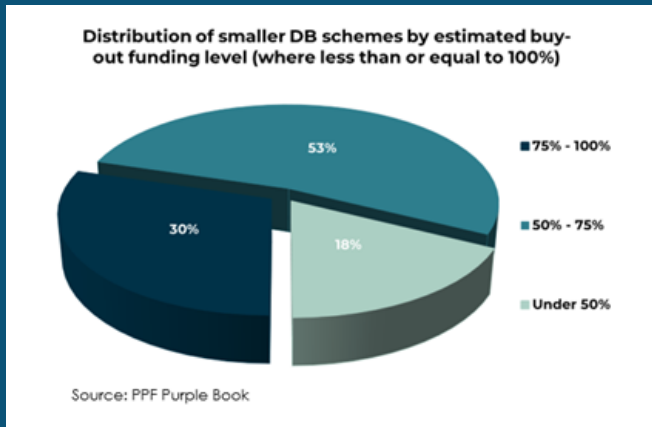
Also, superfunds are only available to schemes which meet the Pensions Regulator’s gateway principles. In particular:

- a scheme must have no realistic prospect of a buy-out in the foreseeable future (which is generally expected to be a period of up to five years and have regard to any additional contributions or security that the employer may be willing to provide), and
- the proposed superfund transaction must improve the likelihood of members receiving their full benefits.

These conditions limit the applicability of superfunds. Moreover, as the superfunds are trying to build scale as quickly as possible, they might not have much appetite to engage with smaller schemes, at least initially.

Buy-out

So, one could argue that buy-out is the only true endgame option for smaller schemes. However, buy-out isn't a viable option for many given current funding levels and the high upfront cost, certainly in the near term.



Smaller schemes also face an additional barrier, having to compete for the attention of insurers and often having to pay a significantly higher premium – another disadvantage of being sub-scale.

That leaves smaller schemes to contemplate less immediate solutions that will help them on their journey to meeting their endgame objective.

Consolidating towards an endgame

The number of consolidation options in the market for smaller schemes and the range of benefits they offer is growing.

Shared services

The use of shared services is very common, with full-service providers often appointed to meet the majority of a scheme's needs. This can help simplify governance arrangements and have a small beneficial impact on costs.

Asset pooling/fiduciary management

Fiduciary management is relatively new and still growing. A fiduciary manager will make certain investment decisions on behalf of the trustees, simplifying the governance arrangements.

By pooling assets, access can be provided to a wider range of asset classes too, potentially at a lower cost.

DB master trusts

DB master trusts have been around for a number of years, with several fairly well-established providers in the market to choose from. Whilst available to schemes of any size, they typically appeal to smaller schemes that may struggle to run as efficiently as they would want to on their own.

DB master trusts provide all the services that a scheme needs in one place, including administration, actuarial and investment advice, and covenant advice. They typically operate with a professional independent trustee and select a limited number of investment managers and funds to manage the assets. All these factors significantly reduce the governance burden.

The running costs the schemes incur tend to be significantly lower too, because the DB master trust's scale allows it to agree discounted rates with its service providers, typically saving schemes up to 30 per cent. However, schemes retain their individuality, and in particular can retain and set their own endgame strategies.

Stoneport

Launched in October 2020, Stoneport is the new kid on the block. Stoneport is a purpose-built consolidator for smaller schemes, specifically those with fewer than 1,000 members.

With a shared goal of reaching full funding on a buy-out basis by the end of 2045, before looking to secure the then remaining benefits with an insurer, schemes joining Stoneport arguably have an endgame of buy-out too. However, much of the risk and hassle is removed far sooner, when Stoneport becomes a centralised scheme, which it expects to do by the end of 2022. There is no upfront cost of joining either, only the cost of any advice the trustees and the employer wish to take.

Stoneport increases the chance of members receiving their benefits in full to more than 99%. It achieves this by pooling employer covenants, as well as the assets and the liabilities of the schemes that join. Strict entry criteria and conditions for Stoneport to become a centralised scheme apply, to protect both the members and the employers that join.

By structuring itself to be able to spread the fixed elements of cost over a much bigger membership, Stoneport can reduce running costs by 80% or more for the smallest schemes, to below £200 per member per year.

Run by three professional independent trustees, Stoneport provides all the governance advantages of a DB master trust and opens up the potential for smaller schemes to benefit from a good governance premium, which academic research suggests can boost investment returns by 1-2% per annum.

When it comes to the endgame buy-out in 2046, further savings will be made, by securing the remaining benefits in one large transaction.

Stoneport aims to do more for its members too, giving them online access to their information and benefits, and tools to help them understand and explore their retirement options. By making it easier to access and digest that information, Stoneport helps members to make better retirement choices for themselves.

The future of consolidation

The UK's private sector DB market has long been acknowledged as being too fragmented. Whilst there has been a clear shift to closing schemes to new entrants and/or future accrual, we are yet to see a significant move towards consolidation. Although the number of DB schemes has reduced from 7,400 in 2008 to 5,300 in 2020, this has largely been due to employer insolvencies and scheme wind-ups.

The Pensions Policy Institute predicts that the number of schemes will fall to 4,000 by 2030, with the buy-out market reaching £770 billion by that time, leaving around £1 trillion invested in the remaining schemes. Meanwhile, the Department for Work and Pensions (DWP) project that the superfund market will grow to between £5 billion and £10 billion over the next five years.

Stoneport is looking for just 100 smaller schemes to join it over the course of the next eighteen months or so, when it completes its consolidation and becomes a fully centralised scheme. Meanwhile, the established DB master trust market seems set for continued but steady growth.

So, it appears that none of the current endgame and consolidation options are likely to radically alter the pace at which the UK's DB market runs off.

If we look beyond our shores, we see that some countries have had far more consolidation in their DB markets.

Concluding remarks

The only true endgame for smaller schemes currently is arguably buy-out. DB master trusts and Stoneport are two of the consolidation options which can help smaller schemes on that journey. Their key features are summarised below:

	DB master trust	Stoneport
Continued employer support	Yes	Yes
Covenant provided by	Employer	Employer then all employers
Main employer rationale for joining	Cut costs/admin	Cut costs/admin and improve benefit security
Regulation	Occupational pensions legislation	Occupational pensions legislation
Upfront costs	Due diligence and transfer paperwork costs	Due diligence and transfer paperwork costs
Governance	Various models	Professional trustees appointed by the employers collectively
Risk to members' benefits	Security improved by good governance	Risk that members do not receive their benefits in full falls to below 1%
Endgame strategy	Unchanged	Buy-out in 2045

Any trustees and employers considering consolidation as a way of addressing the challenges their schemes face will need to carefully weigh up all the options before making their move.



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Australia: The number of corporate DB plans in Australia fell from over 4,000 in 1997 to just 30 in 2016. This was fuelled by the growth of its master trust market in the 1990s, when settlement options were cheap and at a time when it was relatively easy to switch one DB benefit for another of equivalent value, or to convert DB benefits into defined contribution (DC) benefits. It is hard to imagine similar economic and regulatory conditions developing in the UK.

Netherlands: Meanwhile, in the Netherlands, there were more than 1,000 pension funds in 1997, falling to fewer than 200 currently. The contraction there was driven by a push from the regulator, aided by the ability to harmonise benefits.

It is possible we will see regulatory intervention in the UK too. The DWP recognises the benefits of scale and are firm believers in consolidation. Smaller DC schemes are already being pushed in that direction, with new regulations this autumn requiring trustees of schemes with less than £100 million of assets to 'justify their continued existence' by conducting a new value for members assessment.

The current inability to harmonise benefits has been cited as a barrier to progress in the DB market. However, Stoneport has demonstrated it is possible to develop a solution that works within the existing regulatory regime, and it may be that others now seek to do the same.

