www.professionalpensions.com | 25 July 2019

PROFESSIONAL PENSIONS

The top 10 investment management brands

Can sole trustees govern effectively?

How accreditation will hit professional trustees

A call to action on GMP equalisation

Working group sets out priorities for trustees

How DB consolidation is focusing minds

In this webinar, panellists discuss some of the key questions around defined benefit consolidation, including what it is trying to achieve and the suitability of various models

Q What are defined benefit (DB) consolidators and what do they aim to achieve?

Stewart Hastie
It's almost easier to start with what they are not. They're not insurance and they are not for every scheme – they are about trying to fill a gap within this industry; there are £2trn worth of pension liabilities in the DB market and insurance is not affordable for many of these schemes today or in the foreseeable future.

This type of consolidation is about a scheme giving up the sponsor covenant it has today and transferring the scheme to another that typically will be on a better-funded basis with lower risk but including the support of third-party capital.

Ultimately, DB consolidators or superfunds are aiming to improve member outcomes and benefit protection for those where insurance doesn't work.

Adam Saron
I agree. It is about filling a gap because consolidation already exists in the pensions world. We have the insurers – they are the gold standard outcome for DB members, but only available for the lucky few. The Pension Protection Fund (PPF) is also a form of consolidation – it's involuntary, an unwelcome outcome, but at the same time it's a welcome safety net. Thankfully, it's been deployed for even fewer members than insurance.

What about everyone in between? That is where consolidation can provide an outcome for a lot of schemes – but not for everyone.

> **"The PPF is a form of consolidation – it's involuntary, an unwelcome outcome, but at the same time it's a welcome safety net. Thankfully, it's been deployed for even fewer members than insurance"**
> Adam Saron, Clara Pensions

Luke Webster
It is about achieving better member outcomes within the pensions regime. Looking at the DB landscape in the UK, there are a great many schemes that would potentially be denied the benefits of consolidation because of the current high affordability hurdle of insurance. We're looking to provide a solution for those schemes and their members where insurance is not a realistic option.

We're acknowledging there is risk within the pension system. Currently that's distributed in a way that is not transparent and is confusing, particularly from a member perspective.

We have the situation where members of a scheme – if they have any deficit whatsoever – are wholly depending on their sponsor's success to maintain full benefits. If things go wrong, they're likely to be looking at a haircut either through a PPF-plus buyout or entry into the PPF itself.

Similarly, there are many sponsored schemes that are relatively large compared to the operating business. Therefore, the scheme deficit provides a present risk to the going concern of those sponsors.

We are trying to separate the investment and asset and liability management risk, and keep that within the pensions regime, leaving businesses to flourish and manage business risks. That provides a mechanism to achieve a transfer of funds into the pension system on day one by achieving a sponsor top-up to our entry criteria and attracting new investor capital to reduce the overall risk.

> **"There are a great many schemes that would potentially be denied the benefits of consolidation because of the current high affordability hurdle of insurance"**
> Luke Webster, The Pension SuperFund

It is about working with the risks of the pension regime, getting external capital in to achieve a net reduction and managing things in a resilient and professional way in the long term.

Q Can you explain in more detail how a capital payment works? Is this solely from the scheme's sponsor? Is the total amount required in cash up front or can it be an agreement to pay over time?

Adam Saron
The important thing about consolidation is it gives the sponsor the chance to fulfil their pension obligations. It isn't cost free and it's not necessarily cheap. Part of the funding comes from the sponsor – as it would do in any buyout – but crucially, the element that you get in a consolidator is the addition of the consolidator's capital. This changes the nature of the covenant as you're effectively switching your covenant from a floating one – from an industrial covenant that can be opaque and hard to assess – to what is effectively a financial covenant. The value of that covenant is funded with money up front and is transparent. You know what it's worth, but it is capped. That's effectively the trade: some capital from the transferring sponsor and from the consolidator.

Q How does the advisory market view these consolidators?

Stewart Hastie
Although I can't speak for every individual in the advisory market, I am cautiously optimistic. When the Pensions and Lifetime Savings Association's (PLSA's) DB Taskforce reported on superfunds, I was initially sceptical. How can something reduce risk but have lower reserves compared to insurance?

This is about filling a gap in the market and actually presents new options for schemes that sit in the middle ground between insurance and the PPF giving them real options to consider.

THE PANEL

CHAIRMAN Jonathan Stapleton
Editor at *Professional Pensions*

Stewart Hastie
Partner and head of pensions services for large corporates, KPMG

Adam Saron,
Founder and chief executive, Clara Pensions

Luke Webster
Co-founder and chief executive, The Pension SuperFund

The other part of this could be a challenging decision for a trustee: you'd be giving up that more opaque or uncertain employer covenant for a financial one. That's one of the key considerations for a trustee.

Assessing that and all the other ramifications is a complex matter. Trustees considering these options will need expert support and advice to make these decisions.

Q Are superfunds attractive where there is a risk of employers defaulting on their promise?

Luke Webster

Definitely. Consolidators are for any scheme for which other forms of endgame are not necessarily viable options. That encompasses a range of different circumstances: for instance, a situation where a scheme is in a good funding position and the sponsor is a strong business but the scheme is very large compared to the sponsor. Even though the sponsor has a strong business, it would never have the wherewithal to make a material dent in a large deficit.

Situations where the sponsor covenant is obviously weak would be our core market: where the sponsors are on the brink of insolvency because the scheme is not funded sufficiently to achieve a buyout. The alternatives for that scheme would be a PPF-plus buyout or the PPF itself. In either case this is likely to lead to some reduction in what the members had previously expected to be their full benefits.

A consolidator operating with slightly less capital and with somewhat more risk could offer a potentially higher level of base benefits. As long as risk is transparent, that's a legitimate consideration for scheme members and their trustees.

Models such as ours – where there's potential share for members in any outperformance – could enable those members to get closer or exceed their original promised benefits. That distressed state is an interesting sector for us.

Adam Saron

It is right to focus on the covenant issue because that is actually the big question. At Clara we're not in competition with insurers. Our solution is designed as a bridge to buyout. Our competition is the covenant. That's the question for trustees: is what they are being offered in Clara, or in another consolidator, better than the covenant they have today?

> **"The act of consolidation should create value. This then raises an interesting question: how should that value be shared, in what order and when, and how transparently?"**
> Adam Saron, Clara Pensions

The challenge of an industrial covenant is that it changes. It can change for the good; it can also change for the worse.

The problem with covenant or debt – because the deficit is a debt obligation in distressed situations – is that things move quickly. The trustees need to consider what the covenant is today and what they expect the trajectory of that covenant to be over time.

We have seen interest from schemes with different covenant positions. The most interesting interactions we have had are from trustees of fairly well-funded schemes who are interested in our solution because it enables them to deal with that last risk, the covenant risk.

They've done a good job of managing the investments, they've managed down the investment risk, they've dealt with administration, and they've dealt with data. But the one thing they can't deal with is the covenant risk. Consolidation can be a solution to that particular problem.

Q What's in it for the providers of the capital? What are their return expectations? How do these capital providers make their returns?

Luke Webster

If capital providers are putting their capital at risk, they will expect a return. Both of our solutions – Clara Pensions and The Pension SuperFund – have extremely conservative and low risk asset and liability management approaches. Massive outperformance is not really what we're about. Modest but consistent outperformance is more than sufficient to generate attractive returns for investors and, in our case, enhanced benefits for members.

There are only a limited number of ways you can structure the capital buffer into which external investors inject their funds. Within a given risk and reward structure for the whole scheme, that can be adjusted for individual parts.

It is possible that some consolidators will have high returns and high risk for investors. Others may have lower returns and lower risk for investors. In either case, you would expect the whole portfolio to be managed in a very low-risk way, seeking to achieve security and certainty of outcome for members.

Adam Saron

It comes down to a more basic point. From an economic perspective, bringing schemes together, having better governance, saving on costs and generating economic value – the act of consolidation – should create value.

This then raises an interesting question: how should that value be shared, in what order and when, and how transparently? Our capital providers expect a return. In our model, the when is important.

Clara's model is built as a bridge to buyout. Our guiding principle is the idea of always putting members first. That means safely delivering the members' full pension promise.

In order to create this bridge to buyout, we will bring funded capital to replace the sponsors' covenant. Crucially in our model, that funded capital is permanent. It travels the full journey to buyout with members. There are no returns of capital until every member has had their full benefits secured in the insured market.

There are many different ways of arranging the puzzle pieces. Our one is designed to put the member outcome first and only once that's achieved do you generate a return to capital. The returns you are looking for are modest and reliable.

In our structure, because capital is always there, we are the first loss piece. High risk is not in our interest because it rests on capital first. We want to get a return. That means we have to get members to buyout first.

Stewart Hastie

Insurance companies make profits in return for providing capital and DB consolidator superfunds also aim to do the same thing. It's returns for providing security.

It comes back to this question for schemes that are considering moving into this option – which is best, the opaque employer covenant you have today or the financial covenant from a consolidator, including clarity on when the profit is taken and when the profit is not taken?

Making profit out of DB pensions sounds a bit negative, but you need to consider that, in the world where you rely on the corporate sponsor, they are generating profits for other stakeholders from the capital they deploy. That has an impact on how the scheme is funded over time. Even not-for-profit organisations that sponsor DB schemes need to use the resources they generate to meet or fulfil their purpose. There will always be other demands competing with funding a pension as they exist today. With a DB consolidator at least it is clear what funds are available and when.

Q What are the differences between Clara Pensions and The Pension SuperFund and the centralised versus non-centralised approach?

Stewart Hastie

These are the two models that have emerged so far and they are quite different. The key differences stems from the structure.

The Clara model is about segregated cells. Each scheme would transfer and keep its own assets and not be co-mingled with other schemes that transfer. The capital buffer would also be separate. Essentially, from a transferring trustee point of view, you can still identify your scheme's assets post transfer and the capital buffer is there only for the benefit of your liabilities.

Compare that to The Pension SuperFund, where it is co-mingling assets and liabilities, and the capital buffer is there to provide for the entire scheme.

There are pros and cons to both models.

Some may feel more comfortable with segregation; others are relaxed about co-mingling that allows greater efficiencies of scale, greater pooling benefits and can have an impact on price and protection.

The other aspect – and a clear difference – is that The Pension SuperFund is primarily designed as a run-off vehicle whereas the Clara model is designed as a bridge to insurance buyout over roughly seven to 10 years. Both ultimately provide third-party capital as additional security for members' benefits over a period of time.

Q What should people going down this route expect? What is involved in consolidation?

Adam Saron

It is much like a buyout and the legal mechanism used to effect the transaction is the same – it is a bulk transfer without consent. All the considerations that arise in a buyout transaction will arise in a transfer to a consolidator because it is a crystallising event. It is the point when you have to decide who your members are and what the benefits are. That price can be set and assets and liabilities transferred.

I would expect all transferring sponsors and trustees to want to fully end their liability by winding up the scheme afterwards with the same risks they would entail in a buyout situation.

We're not insurers so we may have a little bit more flexibility around that process than the insurers. In Clara's case a buyout is our destination. We are going there sooner rather than later. We are thinking about those buyout considerations because even if it is not buyout ready at the time we complete the transaction, by the end of our journey it has to be because members' journeys with Clara end with their full benefits secured in the insured market.

Luke Webster

The legal pathway for a consolidation is the same as for a buyout. The only key difference is the pensions regime transfer. There are potentially some areas in terms of assets, for instance, that could be transferred where we can have a higher level of flexibility. We're building up to scale. Issues such as data quality and so on are more significant with the initial transaction. It will be a very thorough and comprehensive onboarding process.

Q Where does data and benefit risk sit?

Stewart Hastie

In a similar way to preparing a scheme for an insurance transaction, any work that's done to clean data or around member options will potentially improve pricing. Both parties will take on data risk but they will have to price for that as an insurer would. Similar considerations apply in a corporate transaction with a DB scheme with known material data risks. It's about understanding what the data and benefit risks are.

> **"In a similar way to preparing a scheme for an insurance transaction, any work that's done to clean data or around member options will potentially improve pricing"**
> Stewart Hastie, KPMG

Trustees can help to prepare their schemes for going into these vehicles but there can be a long lead-in time to do these things. If the trustee has significant concerns about the employer covenant, they will need to weigh up whether delaying the move into a DB consolidator creates more risk.

Q What is the critical mass in liability size – or the ideal size – for a consolidation to work?

Adam Saron

The benefits of consolidation come from scale. Transferring trustees have to ask the question: can the consolidator I'm looking to transfer into get to scale or are they already at scale?

It is a difficult question to answer because it depends on your perspective: when do you have scale and are you starting to get some benefits on the investment side? That's one measure.

There's another measure: where do you think you start getting cost breakeven?

Taking all these things together, it's not an exact science. The pathway to scale, the shape of it, and the timing of it matter. How much do you spend getting there?

It's a complex calculation.

Trying to put a number on it: is it north of £1bn; at £2bn? We've modelled it lots of different ways. You come up with lots of different answers.

It's a much more challenging question for trustees considering early transactions because they need to take on that risk and be compensated for it.

The partners we work with on the service side are providing service costs to Clara, even before our first transaction, as if we were at scale. Schemes entering Clara from day one will have the benefit of scale on costs immediately as well as the permanent protection of our capital.

Q Is there a minimum size scheme to accept into your superfund?

Luke Webster

The structure we have in place is a heavy duty and resilient governance one in terms of the trustee board and its resources including the checks and balances that we need to maintain across the whole administration and asset and liability management.

We think about £5bn is our minimum operating scale. We want to get there as quickly as possible. That means in our triage of new opportunities, we will prioritise larger schemes. Once we've passed that rubicon, we'll be much more flexible. It becomes a virtuous circle as scale increases because we're a commingled fund. The potential

impact of uncertainty – which is bigger in small schemes – becomes diluted overall.

Once we're at scale, we hope to be able to offer a solution to much smaller schemes. At the moment we are prioritising large deals in order to hit that scale.

We welcome help from the government and The Pensions Regulator (TPR) as well as the advisory industry in making the process as painless as possible for smaller schemes. There are a lot of considerations for trustees. Smaller schemes potentially stand to benefit most from the economies of scale and improved governance that consolidation can bring. It is important the costs of getting to that point are not prohibitive.

We have seen some evidence of that being the case for small and well-funded schemes that could theoretically achieve buyout. They are not getting there because the cost of the transaction is too high.

Q When do you expect to announce your first deals and when are they likely to be completed? What do you think the market demand will be for this solution?

Adam Saron

We're impatient to get the first one done. Our focus on the first transaction – for every transaction – is about being right. There is another partner in the process who we haven't spoken about yet: the regulator.

TPR has been clear that consolidation transactions need to be cleared through them. We need to work with them in partnership. That process takes as long as it needs to take as the regulator also wants to get it right.

TPR is preparing for a future where consolidation transactions are fairly common. That means probably more than one or two a year. They need an organised system to deal with it. This is encouraging but may slow things down a bit.

There's a fabulous opportunity here. The level of interest from trustees and sponsors and advisers we're experiencing and our opportunity pipeline is at a level

> **"Smaller schemes potentially stand to benefit most from the economies of scale and improved governance that consolidation can bring. It is important the costs of getting to that point are not prohibitive"**
>
> Luke Webster, The Pension SuperFund

that exceeds our most ambitious upside case of a year ago. In this large space between the PPF and buyout, there is a demand for other options. With £2trn of liabilities, even a little bit of that is highly successful.

The insurance market has been a roaring success over the last 13 or 14 years. Not counting this year, the total transactions originated is about £120bn. It's a big number but in the context of £2trn, it's small.

Luke Webster

Our original market study just over a year ago now seems extremely conservative given the level of interest in the conversations we've had. We'll release details of ongoing transactions when it's appropriate to do so.

I'm sure my experience is identical to Clara Pensions in terms of interaction with the regulator.

Q When do you think we'll have a clear idea of exactly where we're going?

Stewart Hastie

The government is in a difficult position at the moment in terms of making progress on legislation. That's not to say it's not making any progress. My understanding is that the wheels are turning, just a bit slower than you would like with legislation.

We're seeing high demand in terms of interest in this particular option. We're already working with a number of trustees and sponsors. As the process develops, it will become more streamlined.

Demand is there. The regulator is caught between demand and people wanting to start while ensuring it is done in the right way. We want to make sure we get this right as an industry and within the constraints of the government's legislative timetable.

The expectation is that by the end of the year we'll see the first deals happening.

Adam Saron

Consolidation is legal today. It is deliverable under the current legislation. Even if we could wave a magic wand and say there was a pensions bill in the autumn, the timetable from primary legislation through secondary and then codes of practice and implementation is going to be years.

Practically, consolidation in the short and medium term is going to operate under the current pensions law. It's going to operate through TPR's existing clearance regime.

Q What are your final comments?

Luke Webster

Consolidation is a potentially huge opportunity for the pensions industry to organise itself in a more effective way, leading to better outcomes for members in the long term. I'm excited to be part of that.

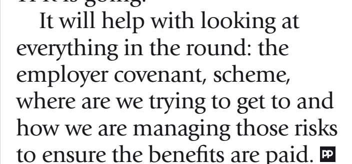
Adam Saron

The whole rationale behind consolidation is about making pensions safer. It's a recognition of the fact that there is risk in the pensions system. If there wasn't, you wouldn't need the PPF.

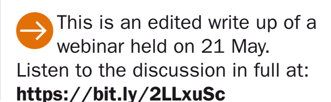
Is consolidation the complete answer to everyone's problems? Absolutely not. It is about making the situation better; it's about putting members first and increasing the chance they get their pensions paid in full. That's where everybody's focus must stay. It may be slower than we all like but we will get to the right answers in the end.

Stewart Hastie

This is an exciting and interesting new option. It's not for everyone but it does change the dynamics within the industry. It helps to focus the industry in terms of endgame planning, something that is consistent with the way TPR is going.



It will help with looking at everything in the round: the employer covenant, scheme, where are we trying to get to and how we are managing those risks to ensure the benefits are paid.



This is an edited write up of a webinar held on 21 May.
Listen to the discussion in full at:
https://bit.ly/2LLxuSc