Pension scheme consolidation

Current Issues in Pensions, 2018 series

November and December 2018
## Your speakers

<table>
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<tr>
<th>Location</th>
<th>Date</th>
<th>Speaker(s)</th>
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<tr>
<td>Leeds</td>
<td>1 November 2018</td>
<td>Richard Farr, Lincoln Pensions</td>
</tr>
<tr>
<td>Glasgow</td>
<td>15 November 2018</td>
<td>John McAleer, Aon</td>
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<tr>
<td>Bristol</td>
<td>29 November 2018</td>
<td>Costas Yiasoumi</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sam Jenkins, LCP</td>
</tr>
<tr>
<td>London</td>
<td>10 December 2018</td>
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Agenda – a game of two halves

<table>
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<tr>
<th>Part 1: Background and introduction</th>
<th>Part 2: Practical issues including example case studies</th>
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<tr>
<td>• Consolidation – why now?</td>
<td>• Types of scheme consolidators are targeting</td>
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<td>• What do we mean by consolidation?</td>
<td>• What a consolidator transfer might look like</td>
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<td>• The DWP’s March 2018 White Paper</td>
<td>• Key trustee considerations</td>
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<td>• A look at two of the new consolidators</td>
<td>• Example case studies</td>
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Key message: Consolidation introduces yet one extra dimension into end game advisory. Advice in this area has potential for creating high value add for clients and in enhancing member outcomes.
1. Background and introduction
The data tells us that mature schemes are becoming the norm in the UK

As the DB scheme market matures we would expect increased outsourcing of services, consolidation of services/providers and schemes to be (eventually) run on a more insurance like basis. Why is that …
### Key behavioural characteristics driving a mature scheme’s management

<p>| | |</p>
<table>
<thead>
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</thead>
<tbody>
<tr>
<td><strong>1. There is a real end point</strong></td>
<td>As accrual is nil or limited the scheme is definitely in run-off and in demise rather than in a long term static or growth mode. Therefore there is a definite albeit actuarially uncertain end point</td>
</tr>
<tr>
<td><strong>2. Benefit cashflows are known</strong></td>
<td>Other than member optionality and demographic uncertainties, long term nominal and real benefit cashflows are highly predictable or could be once the right work has been done</td>
</tr>
<tr>
<td><strong>3. Plausible time horizon to which to work towards</strong></td>
<td>20 years is a plausible maximum time horizon against which stakeholders (eg trustees, employers) will initiate activity today towards a long term target goal</td>
</tr>
<tr>
<td><strong>4. Key financial and operational risks could be locked down within a decade</strong></td>
<td>10 years is a sufficiently short but still long time over which the majority of pension schemes could and should tackle the issues relevant to mature schemes and by which time the most material funding shortfalls should have been rectified for most schemes</td>
</tr>
<tr>
<td><strong>5. Cashflow becomes king</strong></td>
<td>The funding impact of disinvesting in depressed markets due to mismatched cashflows is material</td>
</tr>
<tr>
<td><strong>6. Scheme becomes irrelevant</strong></td>
<td>As institutional memories about the pension scheme diminish it progressively becomes less and less relevant to the sponsoring employer and its ongoing business and priorities</td>
</tr>
</tbody>
</table>
Current forms of outsourcing / consolidation - examples

Existing forms of consolidation
- Shared TPA services
- Fiduciary mgt.
- Asset pooling
- DB master trusts
- Bulk annuities
- Professional trustees

Recent experience - examples

Consolidation is already happening – why do we need “superfunds”?

Current Issues in Pensions 2018 - Consolidation
Our Greatest Good for the Greatest Number discussion paper, published in December 2015, found that 1,000 occupational defined benefit (DB) pension schemes in the UK were under stress and in serious trouble because they were underfunded and backed by a financially weak sponsor.

A government policy shift from full benefits in all cases to seeking the ‘greatest good for the greatest number’.

Redirect government policy to focus on the ‘greatest good for the greatest number’, rather than the current focus on full benefits even where these can never realistically be paid.

The key issue is whether, after more limited forms of consolidation are completed, there are significant benefits of scale from merging assets and liabilities into a single scheme. These benefits would have to be greater than the considerable costs of mutualising deficits and sponsor covenant risks.

Full consolidation is not viable for the occupational DB pensions sector owing to high costs and limited benefits from mutualisation, but may be worthwhile for smaller schemes.

A move away from always focusing on full benefits

Consolidation
Facilitating Covenant Exchange. There needs to be an option available to schemes struggling with both underfunding and employer covenant risk, which allows them to exchange an unknown and intangible covenant for stronger and more secure backing from a larger sponsor. A Superfund vehicle could consolidate assets and liabilities of participating pension schemes, reducing the risk to members’ benefits and offering a new option which could release employers from legacy DB obligations and allow them to invest in business growth. Work should be undertaken by DWP, together with industry and TPR, to develop a regime that supports greater scheme consolidation and realises the potential benefits of covenant monetisation through Superfunds.

In other words, employers should be able to clean break from their schemes following a final contribution (of less than buyout shortfall) with the scheme then transferring into a “superfund”
# PLSA Four Models of Consolidation

<table>
<thead>
<tr>
<th></th>
<th>Unconsolidated</th>
<th>Model 1: Shared services</th>
<th>Model 2: Asset pooling</th>
<th>Model 3: Single governance</th>
<th>Model 4: Superfund</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sponsors</strong></td>
<td></td>
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<tr>
<td><strong>Trustees</strong></td>
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<tr>
<td><strong>Asset managers</strong></td>
<td></td>
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<tr>
<td><strong>Advisers</strong></td>
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<tr>
<td><strong>Administrators</strong></td>
<td></td>
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</table>

*Increasing integration*

Chart source: Based on a chart from The Case for Consolidation, March 2017, DB Task Force, PLSA
The benefits of consolidation (depending on your point of view / starting point)

- Cheaper than buyout
- Improved member service
- Higher likelihood of 100% member benefits paid
- Lower risk / better risk management
- Attract new capital to DB
- Encourage innovation
Example: Scheme expenses – what the data shows

<table>
<thead>
<tr>
<th>Size of scheme (members)</th>
<th>Assumed mean Technical Provisions</th>
<th>PV expenses (incl. PPF levies) assuming winding up in 25 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>12-99</td>
<td>£8m</td>
<td>9 to 14% of TPs</td>
</tr>
<tr>
<td>100-999</td>
<td>£60m</td>
<td>4 to 7% of TPs</td>
</tr>
<tr>
<td>1000-4999</td>
<td>£360m</td>
<td>3 to 4% of TPs</td>
</tr>
</tbody>
</table>

Consolidation benefit

Content source: Institute and Faculty of Actuaries (2018), Running Off Mature Schemes Working Party
DWP white paper – March 2018

“Commercially run consolidation vehicles would be a major shift in the Defined Benefit sector – but if designed properly we believe that they could both reduce some inefficiency within the system and have the potential to offer better long-term outcomes for certain scheme members whilst offering an alternative strategy for managing legacy Defined Benefit schemes”

Areas for future consultation

<table>
<thead>
<tr>
<th>1. Authorisation and supervisory process</th>
<th>5. Amount of capital buffer required</th>
<th>9. Interaction with the Pension Protection Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Criteria to be met for a scheme to be eligible for entry into a commercial consolidator</td>
<td>6. Investment strategy</td>
<td>10. Governance and alignment of interests</td>
</tr>
<tr>
<td>3. On-going relationship with the sponsoring employer</td>
<td>7. When third-party capital providers can extract profits</td>
<td>11. The regulatory framework and levies charged</td>
</tr>
<tr>
<td>4. Long-term funding objective for the consolidator</td>
<td>8. Minimum funding below which fund closes to new business</td>
<td></td>
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</table>

Consultation due soon. Legislation (where needed) perhaps in 2020

Current Issues in Pensions 2018 - Consolidation

Chart source: Protecting Defined Benefit Pension Schemes, March 2018, DWP
New style consolidator example – The Pension SuperFund

Selected features | The Pension SuperFund
--- | ---
Sectionalised? | No. Single non-sectionalised fund for all transferred schemes *
End game | Fund runs off in the long term. No specified finite lifetime or wind up target *
Price and top-up | “Purchase price” is 105% of self-sufficiency TPs. Investors add capital of 10% on top
Investor returns | Investors receive regular returns subject to capital adequacy *
Profit share | Members benefit from a share of the upside (eg as DC top up)

* Similar to a bulk annuity insurer
## New style consolidator example - Clara Pensions

### Capital provider pays c. 10% of buyout on scheme entry

<table>
<thead>
<tr>
<th>Capital provider</th>
<th>ABC pension plan</th>
<th>DEF pension plan</th>
<th>GHI pension plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>90%</td>
<td>90%</td>
<td></td>
</tr>
</tbody>
</table>

### Contingent top-up capital

- **ABC contingent top up capital**
- **DEF contingent top up capital**
- **GHI contingent top up capital**

### The Clara Pensions pension scheme

<table>
<thead>
<tr>
<th>Trustees</th>
<th>ABC assets</th>
<th>DEF assets</th>
<th>GHI assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ABC members</td>
<td>DEF members</td>
<td>GHI members</td>
</tr>
</tbody>
</table>

**Total day 1 funding is 100% of buyout for each scheme**

### Selected features

<table>
<thead>
<tr>
<th>Clara Pensions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sectionalised?</strong></td>
</tr>
<tr>
<td><strong>End game</strong></td>
</tr>
<tr>
<td><strong>Price and top-up</strong></td>
</tr>
<tr>
<td><strong>Investor returns</strong></td>
</tr>
<tr>
<td><strong>Profit share</strong></td>
</tr>
</tbody>
</table>

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### Notes:

- Source for features of the Clara Pensions is KPMG’s August 2018 publication “Superfunds: New solutions for DB pension plans?”. This slide intends to illustrate the concept and potential structure of superfunds in the UK DB environment. By its nature the slide is brief and, as the superfund market is quickly evolving, the information shown may be out of date. Clara Pensions should be contacted for current and full details where required.
Common theme – impact on “security of member benefits”

Both models require trustees to “monetise” employer covenant, thereby severing link to historic sponsor(s)

‘Status quo’

- Strength of the employer covenant given current funding / investment setup?
- Is employer covenant expected to strengthen or weaken over time?
- Do I understand what could go wrong?

Consolidator covenant

- Strength of consolidator covenant given day 1 “top-up”, investment setup and structural features?
- Governance and incentive structure?
- What could go wrong?
- What if “covenant top-up” is less than the covenant value?

Alternatives

- What alternatives are available & feasible?
  - Improve status quo while retaining existing employer structure
  - Transfer to alternative consolidator
  - “Captive replica” of consolidator structure
  - Buyout
- Do any of these yield a better outcome for security of member benefits?

What do I have today?

What is on offer?

Is there a better option?

Are members getting fair value for permanently severing the link to the employer covenant and transferring to a consolidator?
2. Practical issues including example case studies
What schemes are the consolidators targeting?

The consolidators see their core target market as schemes:

• where the sponsor covenant is less than strong, or the long-term covenant of the sponsor is uncertain, but a cash top-up is potentially affordable (and buy-out is not affordable)

• that are well funded (80%+ on the scheme’s funding basis) so the cash top-up is more likely to be affordable for the sponsor

• with liabilities of £50m+ (PSF), or £10m+ (Clara)

• relatively immature (e.g. the PSF is focussed on schemes with 20-80% non-pensioners)

• that are closed to future accrual

• have membership data in good order

It is acknowledged by the consolidators that their target market is a relatively small proportion of DB schemes (but 10% of UK buyout liabilities is still c.£300bn!)
How a transfer might work in practice

High level overview

- Initial feasibility / due diligence work and decision whether to investigate further
- Quotation requested from consolidator(s) (and possibly bulk annuity insurers)
- Decision whether to proceed based on pricing received
- Trustees of ceding scheme assess covenant of consolidator and confirm whether they are comfortable with the transfer proceeding
- Consolidator undertakes due diligence on scheme data and benefits
- Capital injection from sponsor (if required)
- Consolidator’s trustees confirm whether they are willing to accept transfer
- The Pensions Regulator expected to be consulted for clearance
- Assets and liabilities of ceding scheme transfer to consolidator
- Wind-up the scheme (following data cleansing / other wrap up tasks)
Key considerations for Trustees

- What members’ views will be
- How to assess the before and after covenant
- How is profit shared / incentives of capital investors
- How the regulatory position may change
- How much reliance can be placed on the Clearance regime
- Being the first mover in an unproven market
- Benchmarking consolidator pricing against buy-out pricing
- Consolidators governance & legal structure
- Consolidators commercial offering (e.g. data cleanse, residual risks, option factors)
- Consolidators investment strategy
Example case study 1: Covenant concerns but cash available

**Background**
A scheme with concerns over medium term covenant but sponsor has cash available now. If the sponsor pays the future contributions it has committed to as one lump sum, Scheme may be able to afford Consolidator’s premium.

**Possible real-life examples:**
Schemes in retail sector (eg “Amazon effect”)
Private equity owner (debt increasing)

<table>
<thead>
<tr>
<th>Value of future contribution commitments</th>
<th>Current position</th>
<th>Post consolidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>£500m</td>
<td>£550m</td>
</tr>
<tr>
<td>Accounting liability</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Consolidator’s premium</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Buy-out cost</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Total assets backing Scheme</strong></td>
<td><strong>£560m</strong></td>
<td><strong>£600m</strong></td>
</tr>
</tbody>
</table>

**Company / shareholder views**
- Is there a willingness to pay money now to remove Scheme (and its volatility) from the balance sheet?
- Consolidator offers a £50m saving vs buyout
- Removes the burden of cost and management time, allowing management to focus on core business activities

**Trustee / member views**
- Members may be more likely to receive benefits in full due to upfront sponsor funding (whilst it can afford it) and consolidator capital injection.
- Trustees likely to focus on the consolidator’s governance structure.
- Difficulty of placing a value on the sponsor’s covenant to compare to the capital injection from the consolidator.

**CONCLUSION:** Funding of £50m plus capital support of £50m strengthens covenant and is expected to lead to better outcomes for members in most future scenarios.
Example case study 2: Cash available that may otherwise not be

**Background**
A scheme with a parent company that has no legal commitment to pay contributions into the scheme, but which is willing to pay a one-off contribution to remove the pension scheme from the sponsor’s balance sheet.

**Possible real-life examples:**
Scheme with an overseas parent company.
To facilitate a disinvestment (see case study 4 too)

<table>
<thead>
<tr>
<th>Cash injection</th>
<th>Current position</th>
<th>Post consolidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>£500m</td>
<td>£550m</td>
</tr>
<tr>
<td>Deficit contributions</td>
<td>£20m</td>
<td>n/a</td>
</tr>
<tr>
<td>Future expense contributions</td>
<td>£10m</td>
<td>n/a</td>
</tr>
<tr>
<td>Capital reserve</td>
<td>n/a</td>
<td>£50m</td>
</tr>
<tr>
<td><strong>Total assets backing Scheme</strong></td>
<td><strong>£530m</strong></td>
<td><strong>£600m</strong></td>
</tr>
<tr>
<td>Value of sponsor covenant (above future contribution commitments)</td>
<td>?</td>
<td>Nil</td>
</tr>
</tbody>
</table>

**Company / shareholder views**
- Reputational risk to the sponsor/parent company if the consolidator subsequently fails
- Potentially most cost-effective way for the parent company to remove the pension scheme from the sponsor’s balance sheet.

**Trustee / member views**
- In the on-going position, can any reliance be placed on the parent company if the sponsor was to get into difficulty?
- If the parent can afford the consolidator’s premium, can it not afford the full buy-out cost?
- Has a parent company guarantee been explored?

**CONCLUSION:** Unless existing covenant (plus any reliance that can be placed on the parent company’s covenant) is viewed as better than the post-consolidation position, cash injection from parent company and a move to a consolidator likely to strengthen position significantly.
Example case study 3: Well funded scheme with weak sponsor

**Background**
A scheme which is well funded relative to the Consolidators premium, where no material value can be placed on the sponsoring employer’s covenant.

**Possible real-life examples:**
Scheme which is prudently funded but with serious covenant concerns.

<table>
<thead>
<tr>
<th></th>
<th>Current position</th>
<th>Post consolidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>£550m</td>
<td>£550m</td>
</tr>
<tr>
<td>Deficit contributions</td>
<td>Nil</td>
<td>n/a</td>
</tr>
<tr>
<td>Future expense contributions</td>
<td>Nil</td>
<td>n/a</td>
</tr>
<tr>
<td>Capital reserve</td>
<td>n/a</td>
<td>£50m</td>
</tr>
<tr>
<td><strong>Total assets backing Scheme</strong></td>
<td><strong>£550m</strong></td>
<td><strong>£600m</strong></td>
</tr>
<tr>
<td>(including future unsecured contribution commitments)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value of sponsor covenant</td>
<td>Negligible</td>
<td>Nil</td>
</tr>
</tbody>
</table>

**Company / shareholder views**
- For this example we would expect it to be a Trustee led process.
- The Company is likely to be supportive of removing the pension scheme from the balance sheet.

**Trustee / member views**
- In the current position, is any non cash funding support available (eg parent guarantee) if the sponsor was to get into difficultly?
- Do the Trustees have confidence in the Consolidator being able to secure member benefits with a high probability of success… compared to them managing the scheme themselves towards an ultimate buy-out.

**CONCLUSION:** Trustees likely to be running/investing scheme in a similar way to a consolidator, but a move to a consolidator provides a significant capital buffer for a scenario where experience moves materially against the scheme.
**Example case study 4: Pension scheme is a barrier to a deal**

**Background**
A sponsor’s pension scheme makes an acquisition unattractive, so stakeholders are looking to remove pension scheme from the balance sheet at the lowest possible cost.

**Possible real-life examples:**
Private equity owner
Sponsor engaging in M&A activity

**Company / shareholder views**
- Potentially most cost-effective way to remove pension scheme from the balance sheet.
- Whether stakeholders have confidence working with a Consolidator as part of a time critical acquisition process, given they are (to date) untested

**Trustee / member views**
- Key focus will be assessing the relative value of the sponsor’s covenant compared to any cash injection as part of a deal (plus the capital injection from the consolidator).
- Concern over being pushed into a non-insurance solution which does not have the protections of the insurance regime.

**CONCLUSION:** Unless existing covenant is viewed as stronger than the post-consolidation position, cash injection as part of a deal (which would otherwise not be on the table) and the capital injection from the consolidator likely to strengthen scheme’s position significantly. May have wider benefit by facilitating a rescue deal of business, for instance.