PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

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DB
TASKFORCE
THE CASE FOR CONSOLIDATION

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The Pensions and Lifetime Savings Association is the national association with a ninety year history of helping pension professionals run better pension schemes. With the support of over 1,300 pension schemes with over 20 million members and £1tn in assets, and over 400 supporting businesses. They make us the leading voice for pensions and lifetime savings in Westminster, Whitehall and Brussels.

Our purpose is simple: to help everyone achieve a better income in retirement.

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FOREWORD

OVER THE LAST YEAR THE DEFINED BENEFIT (DB) TASKFORCE HAS SPOKEN TO A HUGE NUMBER OF PEOPLE INVOLVED IN DB PENSIONS. WE'VE UNCOVERED AND EXPLORED A HISTORY OF FRAGMENTATION, OVERREGULATION, INEFFICIENCY, AND SUB-OPTIMAL RISK MANAGEMENT.

WHAT'S THE PROBLEM?

Our research informed the clear conclusion in our Interim Report: the system isn't fit for the future. It is draining resources from employers and putting members' benefits at risk. Employers have spent £120 billion trying to plug deficits over the past decade, £13 billion in the first nine months of last year alone. But schemes with the weakest employers – schemes which hold 42 per cent of all benefit promises of schemes in deficit – have just a 50:50 chance of seeing them paid in full.

For those schemes, the choice between limping on over the next 20 to 30 years – posing high risk to employees' hard-earned benefits – and an expensive buyout deal with an insurance company is a poor one. For trustees of DB pension schemes, doing the right thing in the best interest of scheme members has become increasingly difficult. The need to find an alternative has never been more acute, and doing nothing is not an option.

This was the challenge set out for the Taskforce by the Pensions and Lifetime Savings Association, a challenge which had been much talked about but poorly addressed until now.

WHAT'S THE SOLUTION?

The alternative is the consolidation of DB schemes – the central recommendation of our Interim Report published in October 2016. The bringing together of schemes into larger entities, sharing certain functions to benefit from economies of scale and strong governance would have enormous benefits in reducing risk to scheme members, and also for sponsors and the wider economy.

We've studied a range of options – from simple consolidation of administration functions through to pooling of assets, combining governance and finally the pooling of liabilities with the removal of the employer. The right practical choice will have to be supported by a change of culture and mindset as well as legislation.

If we want to make a difference, we need to think and act boldly. The Government's Green Paper has opened the door to reform of the sector. It is now down to the industry to respond positively and bravely. There may not be another opportunity to help ensure a sustainable DB system.

I would like to thank the members of the Taskforce for their dedication and their willingness to embrace bold solutions, the PLSA team for its ongoing support, and everyone we have heard from for their insight.

This report is the product of a year's work and there are many more months, possibly years to follow as we – all those concerned with the outcomes of DB pensions – determine whether collectively we have the appetite and the resolve to address the failings of the system. Millions of savers depend on it.

ASHOK GUPTA

EXECUTIVE SUMMARY

DEFINED BENEFIT PENSIONS MATTER. THEY WILL BE A CRUCIAL SOURCE OF INCOME FOR MILLIONS OF PEOPLE FOR DECADES TO COME. HOW PENSION SCHEMES INVEST THE £1.5 TRILLION OF ASSETS THEY MANAGE FOR THEIR MEMBERS HAS MAJOR IMPLICATIONS FOR THE UK ECONOMY. AND CLOSING THE DEFICITS OF DB SCHEMES IS COSTING AND WILL CONTINUE TO COST EMPLOYERS BILLIONS OF POUNDS YEAR AFTER YEAR.

Members are bearing too much risk in the current system yet, notwithstanding recent high profile cases, are scarcely aware of it. Our regulatory system – designed to protect scheme members and operating precisely as Parliament intended – is mitigating this risk, but simultaneously concealing the fact that it exists. As the Green Paper on DB acknowledges,[1] there is a range of views as to exactly how widespread this risk is. But, on any analysis, it is not trivial and, as time runs out to solve the challenge of DB funding, now is the time to reduce it once and for all.

As the first report of the Taskforce showed, the current system is too fragmented, manages risk inefficiently and has rigidity baked into benefit structures. Consolidation – the process of bringing together and simplifying some or all of the elements of DB provision – has the potential to tackle each of these issues.

Consolidating individual elements of DB schemes can bring real benefits. Shared administration services, pooling of assets and shared governance can, to one extent or another, bring material reductions in cost and tangible improvements in investment returns. The wide variation in costs and quality of governance between schemes – principally between schemes of different sizes but also between different schemes in the same size band – makes this an obvious target for delivering greater efficiency and better value for money.

Consolidation of this type happens already in pockets of the sector, reflecting the fact that, even if there are challenges, bringing schemes closer together in these ways is possible. Regulation could however make it more cost-effective to share administration and governance by making it easier to standardise benefit features across different schemes. It could also help create a norm of consolidation, by nudging trustees to consider whether they could achieve better outcomes as part of regular reviews of scheme services and costs. Such measures could help to overcome the cultural and practical barriers that are sustaining current sector fragmentation.

Beneficial though consolidation can be it does not materially reduce members' exposure to risk. Our analysis suggests that even the most comprehensive consolidation of scheme services might reduce the proportion of members exposed to the risk of not seeing their benefits paid in full by only 1-2 percentage points.

Making a real impact and reducing materially the risk to members' benefits requires bolder action. In particular, it requires focus on the toxic combination of under-funded schemes and weak sponsoring employers. Removing the employer altogether, in return for financial consideration to replace the value of their covenant, and pooling both assets and liabilities in a new type of authorised 'Superfund' has the potential to transform the sector. Swapping many weak, and weakening, covenants for the properly-capitalised backing of a Superfund could offer:

- Members a step change increase in the probability of receiving their benefits;
- Employers an affordable means of removing themselves from the uncertain future of managing DB runoff; and
- Government and regulators a much less fragmented system more amenable to close and effective supervision and less likely to produce high-profile failures.

1 Security and Sustainability in Defined Benefit pension schemes, DWP Green Paper, 2017.

This report sets out an approach for the creation, authorisation and supervision of Superfunds, which can absorb existing schemes and permit employers to discharge their obligations in respect of transferring benefits. We believe they can work and could offer many schemes a much better route to protecting members' benefits than the current options of striving to afford buyout or struggling on alone.

It is clear from our initial analysis however that more work is needed to understand the affordability of Superfunds to sponsoring employers. There is a clear trade-off between the price of entry to sponsoring employers, the level of benefit security that a Superfund can offer and the attractiveness to potential Superfund providers. We want to ensure that the benefits of Superfunds can reach across large parts of the sector and will therefore focus the next phase of our work on analysing this trade-off. The next phase of the Taskforce's work will seek to build a framework which is robust, attractive to a wide range of participating employers and which is seen by all stakeholders as improving members' retirement prospects.

At this stage we can see the outline of the legal and regulatory changes which will help consolidation in general and Superfunds in particular to reach their full potential. As we develop the Superfund concept further through the Green Paper consultation period we will be recommending that the Government introduces:

- A new requirement on trustees to 'consolidate, improve or justify' with an annual report explaining either how they plan to consolidate or else justifying how existing arrangements produce better value for money;
- A review and overhaul of the regulations and guidance setting out the process for re-shaping scheme benefits to simplified structures of actuarially equivalent value (either within a scheme or upon transfer to a new scheme) – consolidation depends on clear standards that schemes and their advisers can implement with certainty; and
- A regulatory framework for the creation, authorisation and supervision of Superfunds, which will permit employers to discharge their obligations in respect of transferring benefits.

A shared interest in the role of a Superfund is clear from the Green Paper. The next steps for the Taskforce will be to work closely with Government and other stakeholders throughout the consultation period and beyond in order to find solutions to these issues and help to build consensus around the solutions. Pursuing this opportunity is essential to achieving sector sustainability.

UNDER PRESSURE – DB TODAY

- DB matters to millions of people who are relying on DB benefits to support them in retirement.
- DB also matters to the UK economy – £1.5 trillion is invested in DB schemes, supporting all parts of the economy.
- But the current system is fragmented, attempting to de-risk and requiring ever-increasing amounts of capital from corporate sponsors.
- Not only are DB scheme problems being made worse by the current economic climate, they are also contributing to economic weakness.
- There are risks and costs in the system that place strain on scheme sponsors and the economy – but they also have an impact on scheme members and future generations of pensioners.
- All this means doing nothing is not an option.

2 Purple book – DB pensions Universe Risk Profile, The Pensions Regulator and Pension Protection Fund, December 2016
3 PPF 7800 Index Update (January 2017), PPF, February 2017
4 Annual Survey, PLSA, 2016
5 DB pensions Universe Risk Profile, The Pensions Regulator and Pension Protection Fund, December 2016
6 PPF 7800 Index Update (January 2017), PPF, February 2017
7 PPF 7800 Index Update (January 2017), PPF, February 2017
8 PPF 7800 Index Update (January 2017), PPF, February 2017
9 Pension funds and index linked gilts: a supply/mis-match made in hell, Schroders, June 2016
10 Purple book – DB pensions Universe Risk Profile, The Pensions Regulator and Pension Protection Fund, December 2016
11 Purple book – DB pensions Universe Risk Profile, The Pensions Regulator and Pension Protection Fund, December 2016

THE DB TASKFORCE INTERIM REPORT IDENTIFIED FOUR AREAS THAT POLICYMAKERS SHOULD GIVE IMMEDIATE FOCUS TO ADDRESS THE CHALLENGES FACED BY DB SCHEMES TODAY, AND UNDERTOOK TO DEVELOP RECOMMENDATIONS TO TACKLE EACH OF THEM.

THE SYSTEM IS TOO FRAGMENTED

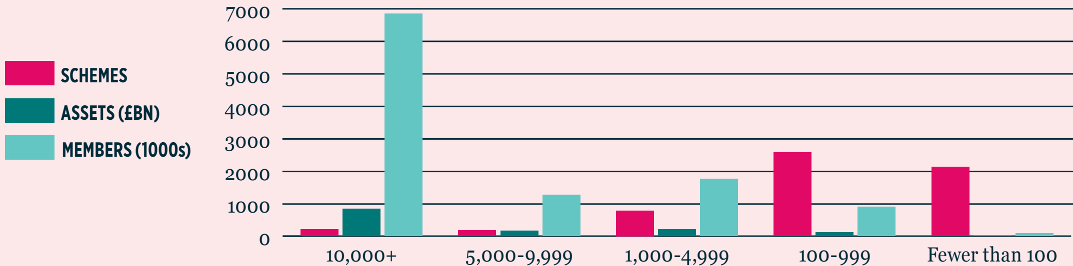
THE SYSTEM IS TOO FRAGMENTED

The Taskforce highlighted that there are too many small, sub-scale schemes. In an environment that is far more complex than the one in which those schemes were first created, the cost of provision more expensive, and economic conditions less benign, the proliferation of small schemes creates problems for sponsors, trustees and regulators.

Smaller schemes are generally characterised by poorer governance standards than their larger counterparts. They also struggle to leverage economies of scale and attract the quality of skills needed to operate and invest efficiently. They can also find it harder to navigate the highly intermediated nature of the UK pensions system. All this results in significant value leakage.

We recommended that work is undertaken to investigate the potential for scheme consolidation.

FIGURE 1: NUMBER OF MEMBERS, SCHEMES AND ASSETS UNDER MANAGEMENT BY SIZE OF SCHEME[12]



SCHEME RESOLUTION IS INFLEXIBLE

SCHEME RESOLUTION IS INFLEXIBLE

The Taskforce highlighted that the current system only allows binary outcomes of complete 'success' or complete 'failure' whereby a scheme can either be:

- Supported by a solvent employer and funded (or funding to provide full benefits); or
- Unsupported by a solvent employer, and transferred to the PPF with members receiving compensation which in aggregate replaces around 80% of the value of their scheme benefits.

We recommended that greater regulatory flexibility may help to achieve earlier scheme resolution and could mean that funding issues could be addressed before failure (of the scheme or sponsor) became inevitable, with better outcomes for scheme members.

12 Purple book – DB pensions Universe Risk Profile, The Pensions Regulator and Pension Protection Fund, December 2016

APPROACH TO BENEFIT CHANGE IS TOO RIGID

What started for many employers as a benefit offered on a 'best endeavours' basis has now become a hard-wired promise.

This, combined with improving longevity, has added significantly to the cost of providing pensions. As a consequence, sponsors in the UK do not have the 'pressure valves' available to sponsors of DB schemes in other developed economies. Greater benefit flexibility – such as that available to the PPF itself – may help to avoid or address problems.

We identified that work should be undertaken to investigate how a more flexible approach to benefit design/change could be implemented to help sustain schemes.

RISK BEARING IS SUB-OPTIMAL

Taskforce analysis[13] showed that the continued trend towards de-risking investment strategies is placing greater emphasis on making good deficits through contributions, with, consequently, a greater reliance on the sponsor's solvency. This effectively exchanges investment risk for solvency risk – on aggregate moving risk around the system rather than removing it.

We recommended that work should be undertaken to build a greater focus on risk to member benefits.

13 Estimation of the longer-term loss of benefits for UK defined benefit scheme members, Gazelle, 2016, http://gazellegroup.co.uk/Articles/Gazelle-Corporate-Finance-PLSA-Mousetrap-Study.pdf

INTRODUCTION

THE PLSA ESTABLISHED THE DB TASKFORCE IN MARCH 2016 TO ASSESS THE CHALLENGES FACING DB PENSIONS AND TO PROPOSE SOLUTIONS FOR A MORE SUSTAINABLE DB PENSIONS SYSTEM.

ASSESSING THE CHALLENGE

The Taskforce's Interim Report[14] focussed on the challenges facing DB schemes and their impact on members, employers and the economy. It laid bare the extent and nature of the risk to members' benefits that exists in today's DB system. Almost half of the schemes in deficit (46%) have a sponsoring employer that is classed by the Pensions Regulator (TPR) as 'weak' or 'tending to weak'[15]. These schemes hold 42% of all benefit promises of schemes in deficit. Yet analysis undertaken for the Taskforce[16] illustrated that their members have only a 50:50 chance of seeing those benefits paid in full.

The risk is not confined to the weakest employers. Around 6% of schemes with 'strong' employers and 20% with 'tending to strong' employers also face default, with a consequential reduction to members' benefits, before they have discharged their DB pension obligations.

The risk that DB scheme members won't receive their benefits in full is poorly understood. Research conducted for the Taskforce[17] shows that, despite the well-publicised travails of other employers' schemes, members of DB schemes start from a presumption that *their* employer won't fail and *their* scheme is guaranteed to deliver benefits in full.

In reality, many of the millions of people depending on DB pensions for their retirement livelihood may well have their expected benefits reduced as a result of sponsor failure. While the Pension Protection Fund (PPF) will continue to provide a valuable source of compensation to people in these circumstances it is only set up to cover, on average, less than 80% of the value of a member's benefits.

The system is not fixing itself. Employers continue to pump billions of pounds into schemes through deficit recovery contributions (DRCs), with £120 billion paid over the past decade, £13 billion in the first nine months of last year alone.[18] But they are running to stand still as deficit levels and recovery periods remain stubbornly high.

Taskforce analysis[19] shows that the continued trend towards de-risking investment strategies is placing greater emphasis on making good deficits through contributions (rather than investment performance), with, consequently, a greater reliance on the sponsor's solvency – this is effectively exchanging investment risk for solvency risk. In aggregate this is merely moving risk around the system rather than removing it.

Sponsor strength is the most important factor in preserving member benefits, but the pressure of trying to stay on top of deficits both weakens sponsors' financial strength and potentially crowds out other expenditure on capital investment, wages or contributions to other pension schemes.

14 PLSA, DB Taskforce Interim Report, 2016, www.plsa.co.uk/PolicyandResearch/DB/DBTaskforce.aspx
15 The Pensions Regulator, Scheme Funding Statistics Appendix, 2016, www.thepensionsregulator.gov.uk/docs/scheme-funding-appendix-2016.pdf
16 The Taskforce commissioned modelling from Gazelle Corporate Finance Limited's 'Mousetrap' Integrated Risk Model to help estimate and better understand the probability and quantum of longer-term DB member benefit losses: Estimation of the longer-term loss of benefits for UK defined benefit scheme members', Gazelle, 2016, http://gazellegroup.co.uk/Articles/Gazelle-Corporate-Finance-PLSA-Mousetrap-Study.pdf
17 Ignition House, Qualitative and Quantitative research, commissioned by PLSA between August and September 2016. It comprised of qualitative research (10 one-hour focus groups and 10 one-hour in-depth interviews with DB scheme members across Great Britain; plus 25 15-minute post-fieldwork in-depth interviews; and quantitative research comprising 15-minute online interviews with occupational pension holders.
18 ONS, Investment by Insurance Companies, Pension Funds and Trusts, 2016
19 Estimation of the longer-term loss of benefits for UK defined benefit scheme members, Gazelle, 2016, http://gazellegroup.co.uk/Articles/Gazelle-Corporate-Finance-PLSA-Mousetrap-Study.pdf

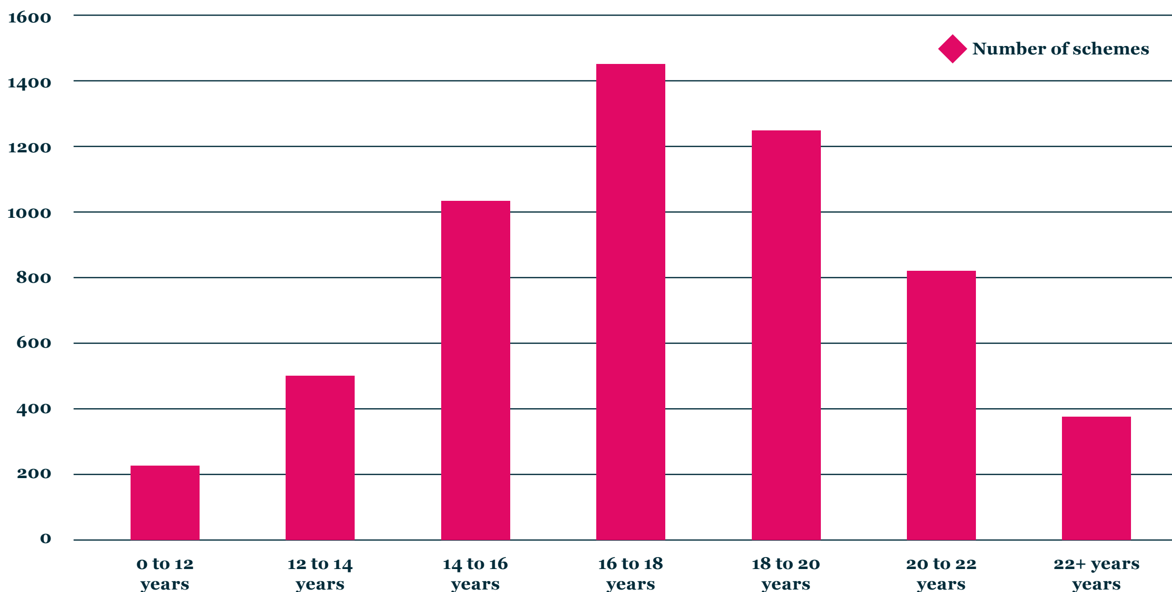
I FEEL QUITE LUCKY TO HAVE A FINAL SALARY SCHEME, BECAUSE YOU KEEP HEARING IN THE PRESS THAT THEY'RE CLOSING...IT JUST MAKES YOU FEEL HAPPY YOU'VE GOT ONE.

Pensioner member

While DB schemes will be paying out benefits for decades to come, the opportunity to fix the system and effect a material reduction in risk will disappear quickly as schemes hurtle towards maturity and negative cash flow (that is, where assets must be sold to pay pensions). The average scheme has 16-18 years until it reaches peak maturity (and there are over 700 schemes that have an estimated duration of 14 years or less). Beyond this point the ability to use investment returns to close deficits will reduce quickly leaving still-higher employer contributions as the only available source of funds to repair deficits.

Now is the time to act.

FIGURE 2: ESTIMATED DURATION OF UK PENSION SCHEMES[20]



SOURCE: TPR

20 The Pensions Regulator, Annual funding statement analysis, A review of defined benefit pension schemes with valuation dates between September 2015 and September 2016 (Tranche 11), 2016, http://www.thepensionsregulator.gov.uk/docs/db-analysis-tranche-eleven-review-2016.pdf

FINDING SOLUTIONS

The Interim Report identified the clear need for solutions which would improve the efficiency of the system and which would allow trustees of schemes in deficit and their sponsoring employers options beyond funding schemes to a level where little or no investment return is required.

The subsequent work of the Taskforce has concentrated on what an alternative might look like – assessing a broad set of solutions to the above challenge and setting out recommendations which can be used by Government, regulators, employers and the industry to set the DB pension system on the road to sustainability.

The challenges are not insurmountable, and the Taskforce believes that consolidation is at the heart of the solution, sharing the Work and Pensions Committee's recognition of the 'clear and substantial' benefits of consolidation[21]. In this report, the Taskforce demonstrates how greater consolidation can bring economies of scale and improved governance. The report highlights three different approaches to sharing services across schemes; all of which are being used by some schemes already, all of which could benefit many more.

But more work is needed to address the root causes of the risks to member benefits. This report also sets out the structure of a new model of consolidation – the 'Superfund'. The Superfund goes beyond consolidation of scheme services by separating schemes from their sponsors, directly tackling the risk inherent in the combination of poorly-funded scheme and weak sponsor. As such, it provides an attractive option for schemes with a weak employer covenant. However, the Taskforce also concludes that the Superfund model may be attractive to schemes with stronger employer covenants, perhaps those wishing to discharge their pensions obligations but discouraged by the current cost of buyout offered by insurers.

21 Work and Pensions Select Committee, Defined Benefit Pension Schemes: Sixth Report of Session 2016-17, December 2016

DEFINING CONSOLIDATION

CHAPTER HIGHLIGHTS

- **Consolidation has multiple interpretations**
- **This report considers four types of consolidation on a spectrum from administrative merger through to full scheme merger**

THE TASKFORCE RECOGNISES THAT CONSOLIDATION CAN MEAN MANY DIFFERENT THINGS TO DIFFERENT PEOPLE AND THAT IT WOULD BE POSSIBLE TO CONSTRUCT HUNDREDS OF VARIATIONS BY MERGING OR POOLING DIFFERENT COMBINATIONS OF THE CORE ELEMENTS OF DB SCHEMES (LISTED BELOW).

FIGURE 3: CORE ELEMENTS OF A DB SCHEME

We have, however, identified four basic structures. Models 1, 2 and 3 involve the consolidation of core elements of a scheme's operation. Models 1 and 2 could be adopted individually or together to achieve greater integration, which we describe in Model 3.

Model 4 (complete merger) is a fundamentally different model, involving the consolidation of schemes following the discharge of the individual schemes by scheme employers.

MODEL 1: Shared services

Many schemes share one set of administrative functions – achieving cost savings through economies of scale.

MODEL 2: Asset pooling

The assets of distinct pension schemes are consolidated into asset pools to be managed centrally on behalf of the different schemes. Schemes retain their governance, administration and back office functions and most of their advisers.

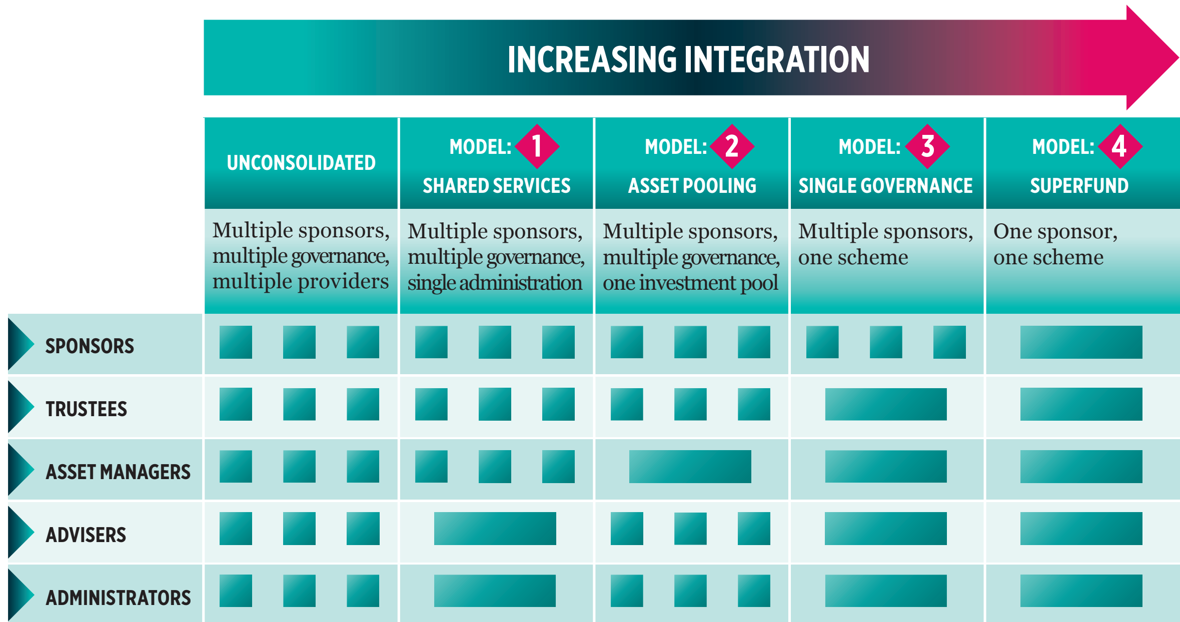
MODEL 3: Single governance

The assets of distinct different pension schemes are consolidated into a single asset pool and governance, administration and back office functions are merged.

MODEL 4: Full merger – Superfunds

Superfunds are created to absorb and replace existing pension schemes. Under this model, employers and trustees would be discharged from their obligations in respect of benefits that are paid from the Superfund scheme.

FIGURE 4: FOUR MODELS OF CONSOLIDATION



Models 1, 2 and 3 are achievable under the existing legislative framework and are being used successfully by a small proportion of schemes already. However, in response to the scale of the challenge identified, the Taskforce was encouraged to think and act boldly in seeking solutions. The complete merger, or 'Superfund', while not being provided for within the existing legislative framework, addresses the systemic issues facing the DB sector more effectively. This Report looks at the benefits, costs and barriers of models 1, 2 and 3 in detail, clarifying that – while all identified models of consolidation have significant benefits – the role of 'Superfunds' could be transformative for members, schemes, sponsors and the wider economy.

To understand how these models would impact the probability and quantum of risk to members' benefits the Taskforce commissioned analysis from Gazelle Corporate Finance Limited's 'Mousetrap' Integrated Risk model, building on the analyses in the Interim Report.

MODELS 1-3: CONSOLIDATING SCHEME ELEMENTS

CHAPTER HIGHLIGHTS

- Consolidation at any level can improve scheme performance through reduced costs and improved governance
- Higher levels of integration produces greater benefits but faces more barriers to implementation
- Consolidation of scheme elements, whilst beneficial, does not in itself materially reduce the risk to members' benefits

MODEL 1: SHARED SERVICES MERGER

The merger of administration functions, while not without difficulty, is the first level of consolidation available to schemes. Of the range of consolidation options available to DB schemes, it is probably the most familiar and the most used.

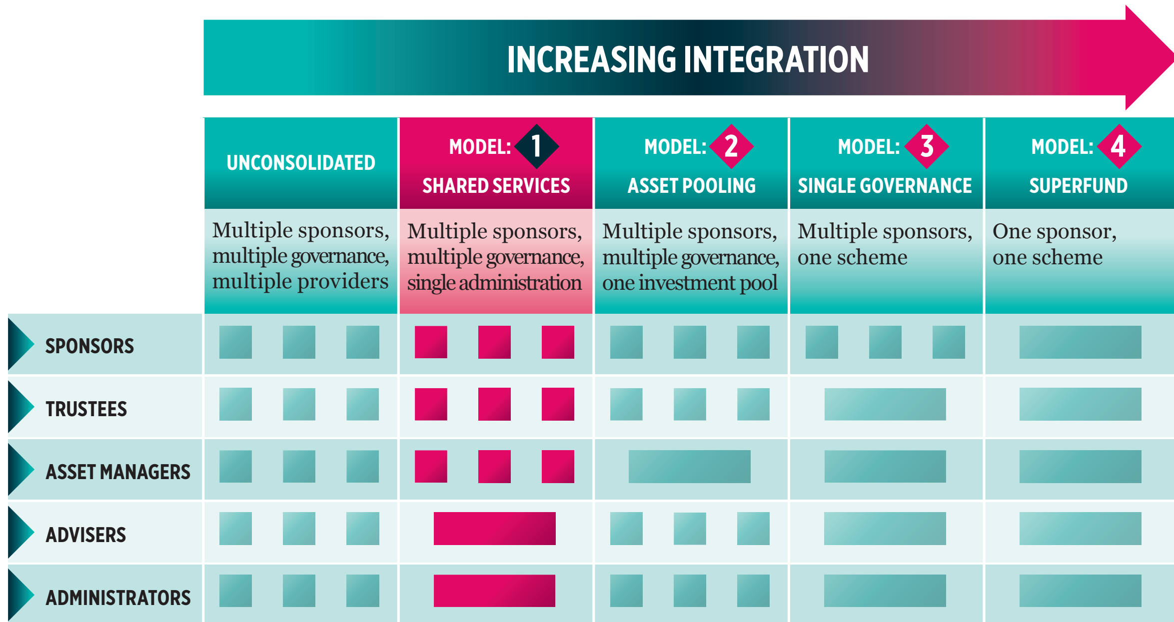
It can be implemented in many different ways, with some degree of variation in service and costs.

A MENU OF CHOICES:

Common examples of this model include individual schemes contracting with large scale third-party administrators to provide services; and group procurement by collaborating schemes to obtain third-party administration and advisory services together.

We have chosen to illustrate a 'plain vanilla' model in which many schemes share one set of administrative functions and some associated advisory functions.

FIGURE 5: MODEL 1



The types of services that the administrator would be expected to provide would include scheme communications, technical support, pensioner payroll, scheme accounting, scheme administration and data management.

COSTS

Pension scheme administration is standard in nature, and as a result one might expect costs to group around a standardised fee. However, evidence gathered by TPR demonstrates that schemes pay a wide range of charges – with smaller schemes paying considerably higher fees per member.

FIGURE 6: DB SCHEME RUNNING COSTS[22]

	ADMINISTRATION (£ PER MEMBER)				ADVICE (£ PER MEMBER)			
	PERCENTAGE OF TOTAL COSTS	AVERAGE COST	LOWEST COST	HIGHEST COST	PERCENTAGE OF TOTAL COSTS	AVERAGE COST	LOWEST COST	HIGHEST COST
Very large schemes (5,000+ members)	35%	£64	£21	£139	13%	£23	£8	£52
Large schemes (1,000-4,999 members)	31%	£87	£25	£214	23%	£65	£18	£158
Medium schemes (100-999 members)	36%	£182	£50	£368	29%	£146	£40	£296
Small scheme (12-99 members)	41%	£432	£108	£1,125	21%	£221	£55	£576

*costs have been rounded.

SOURCE: TPR

Although it might be possible to attribute some of this cost differential to poorer service levels or record-keeping in smaller schemes, it is more likely that the impact of fewer resources, less expertise and limited bargaining power is having a significant effect on the value for money being delivered[23].

22 The Pensions Regulator, DB scheme running costs research, 2014, www.thepensionsregulator.gov.uk/trustees/db-scheme-costs-tool.aspx#s14483 2014
23 Concerns also cited in The FCA's Asset Management Market Study, Interim Report, November 2016

The cost differences for what are, on the whole, broadly similar services are stark:

- The average difference in cost per member for both administration and advisory services (excluding investment) between the largest schemes (5000+ members) and smallest schemes is £566; the difference between the highest and lowest costs paid in the smallest and largest schemes respectively is £1,672 per member, according to TPR research.

In aggregate, this is adding an additional cost across all schemes, but particularly smaller and medium ones, of £0.6 billion per annum[24].

CASE STUDY

PREMIER'S DB MASTERTRUST SOLUTION OFFERS ACTUARIAL, ADMINISTRATION, CONSULTING, SECRETARIAL, INVESTMENT CONSULTING, LEGAL AND GOVERNANCE SERVICES FOR DB SCHEMES[25].

Its stated aim is to provide a "More cost effective solution for small / medium sized employers to manage their legacy defined benefit pension promises". Savings are created by aggregating smaller plans to obtain the economies of scale enjoyed by the larger funds. These savings are passed on to pension schemes in clearly defined cost structures. One example of the savings delivered for an incoming £38 million pension scheme is of reducing total costs (excluding regulatory levies) from £204 per member to £163 per member.

BARRIERS TO TAKE-UP

Given the relative accessibility and proven benefits of merging administration, the Taskforce has sought to identify the issues or behaviours that are acting as barriers to greater take-up of this model of consolidation.

In the course of investigations we found a number of factors were at play:

- **Concerns about upfront costs**

  The challenge of securing funding or resource to undertake a merger of administration is considered to be a particular issue for smaller schemes – even where the long-term savings that would flow from any upfront expenditure are clear. The competing demands of scheme funding and regulatory change are often seen as much higher priorities.

- **Misalignment of interests – across multiple schemes and multiple employers**

  It is difficult to align the interests of employers and schemes that are otherwise unconnected. The fragmentation of the DB sector in the UK and the absence of a culture of industry-wide or regional schemes (such as those in the Netherlands) means there is no easy mechanism for interested parties to group together.

24 JLT's Report How do we get out of this pensions 'black hole'? January 2017, reached a similar conclusion
25 Premier Pensions Management, The Premier DB Solution A Modern Master Trust, 2017

- **Misalignment of interests – between advisers and the scheme**

  Few advisers operate administration platforms and it is not in the commercial interests of advisers to encourage schemes to merge onto competitor platforms. Heavy reliance upon advisers and the absence of appropriate adviser challenge from many schemes exacerbates this issue.

- **Dilution of control and establishing new relationships**

  Entering into a multilateral relationship is more complicated than maintaining an existing contract. A connected concern is that of a decreased level of direct access or control, and the fear that the new shared arrangement may not provide as good a service as the previous contract. A further barrier cited included a desire from some schemes with problematic relationships with their employers to seek distinct arrangements with suppliers even when economies of scale were available through employer service providers.

- **Governance shortfalls – gaps in trustee skills**

  Research demonstrates that a significant proportion of scheme trustees do not have the appropriate skill levels or experience to negotiate and oversee commercially robust contracts that deliver value for money for schemes.

  For example, only 49 per cent of schemes responding to a TPR survey said that all their non-professional trustees had a level of knowledge and understanding equivalent to that set out in the Code of Practice for Trustee Knowledge and Understanding (TKU), while 15 per cent said that either none of their trustees met the TKU or they were not aware of it. For smaller schemes, the figures were 38 per cent and 26 per cent respectively[26]. The same survey found that 24 per cent of respondents 'never disagree' with their external advisers, with the figure rising to 36 per cent for smaller schemes.

- **Differences in benefit structure**

  The multiple differences between schemes' rules and benefit structures, and the complexities currently involved in harmonising them, limits the efficiency of shared administration.

MODEL 2 – THE ASSET MERGER

In our second model, the assets of multiple pension schemes are consolidated into asset pools which are managed centrally on their behalf, but in accordance with individual scheme investment strategies. The schemes utilising the pool retain control of their governance, administration and other functions.

Greater integration is possible by adopting Model 2 together with Model 1, though either can be implemented separately.

A MENU OF CHOICES

Examples of this type of model include schemes utilising a common fiduciary manager or the service that's become known as delegated consulting; individually buying into a common platform or making use of group procurement to select managers; schemes investing a proportion of their assets to common investment vehicles; or schemes themselves accessing common investment pools with delegated investment mandates.

26 The Pensions Regulator, Trustee Landscape, Qualitative Research, A report of the 2015 Trustee Landscape, 2015

FIGURE 7: MODEL 2

INCREASING INTEGRATION

	UNCONSOLIDATED	MODEL: 1 SHARED SERVICES	MODEL: 2 ASSET POOLING	MODEL: 3 SINGLE GOVERNANCE	MODEL: 4 SUPERFUND
	Multiple sponsors, multiple governance, multiple providers	Multiple sponsors, multiple governance, single administration	Multiple sponsors, multiple governance, one investment pool	Multiple sponsors, one scheme	One sponsor, one scheme
SPONSORS					
TRUSTEES					
ASSET MANAGERS					
ADVISERS					
ADMINISTRATORS					

For participating schemes the key benefits from asset pooling are improved bargaining power when purchasing fund management services, access to higher quality advice and access to a wider range of investment opportunities that are not available to, or cost effective for, the smaller investor, such as infrastructure.

By participating in a pooled asset structure, schemes ought to reduce their costs for investment administration, commission and custodian fees and obtain higher returns for lower investment risk over the long-term.

While asset pooling retains multiple providers and platforms to support the day-to-day running/administration of the scheme, the appointment of a common set of investment advisers helps ensure a consistent and cost-effective approach to asset management across the pool.

This model also allows the pool to build a bespoke investment model that suits participants' needs. In addition, with a wholly delegated asset management function, trustees have increased capacity to respond to changing market conditions in a timely fashion or scrutinise manager performance, while also freeing up time to concentrate on setting and monitoring their funding strategy.

CASE STUDY

IN 2015 THE UK CHANCELLOR ANNOUNCED PLANS TO POOL THE INVESTMENTS OF 89 LOCAL GOVERNMENT PENSION SCHEMES (WITH £217 BILLION OF ASSETS UNDER MANAGEMENT) INTO SEVEN REGIONAL FUNDS CAPABLE OF MAKING MORE SUBSTANTIAL INFRASTRUCTURE INVESTMENT.

It is expected that by 2028 this pooling will deliver cost savings of c.£140-183 million per year, assuming the same asset allocations across all funds and today's asset values[27]. Allowing for investment growth of between 3 and 5 per cent would increase potential savings to up to £300 million a year. In addition, outperformance by active equity managers of only 0.25 per cent is predicted to add more than £150 million of value annually.

The cost savings are forecast to come from a number of areas including the consolidation of segregated mandates, reduced use of pooled vehicles and fund of funds, a switch from indirect to direct property, and more competitive fees from alternatives achieved through increased scale.

Each pool is estimated to expend implementation costs of around £2-3 million; a significant proportion of which will be staff costs.

COSTS AND SAVINGS

Smaller schemes pay proportionately much more for investment management than the very largest schemes; with an average difference of £133 per member and the greatest difference at £523 per member.

FIGURE 8: DB SCHEME INVESTMENT COSTS[28]

	INVESTMENT (£ PER MEMBER)			
	PERCENTAGE OF TOTAL COSTS	AVERAGE COST	LOWEST COST	HIGHEST COST
Very large schemes (5,000+ members)	43%	£78	£25	£171
Large schemes (1,000-4,999 members)	27%	£76	£22	£186
Medium schemes (100-999 members)	20%	£101	£28	£204
Small schemes (12-99 members)	20%	£211	£53	£549

27 Findings of Project POOL, Joint Working Group of Local Authorities, 2016, www.lgpsboard.org/images/Consultations/160122_Findings_of_Project_POOL_FINAL.pdf
28 The Pensions Regulator, DB scheme running costs research, 2014, www.thepensionsregulator.gov.uk/trustees/db-scheme-costs-tool.aspx#s14483 2014

Using these figures, we estimate that by bringing scheme investments in line with the very largest schemes, savings of at least £0.25 billion per annum can be made.

Other studies illustrate the substantial cost savings that can be made from consolidating assets into larger funds.

- Based on a study of more than 1,000 global pension funds, CEM benchmarking has produced analysis showing that for every tenfold increase in assets, pension schemes can gain a net value add of 7.6 basis points[29]. In addition, operating at scale can make it possible for a pension fund to invest a part or all of the fund's assets in-house, instead of appointing external managers. Those that can manage their assets in-house in the CEM dataset obtain a net value add of 22.1 basis points.
- A report on 'Facilitating Pooled Asset Management for Ontario's Public-Sector Institutions'[30] estimated that annual savings of between $75 and $100 million Canadian dollars could be made by bringing together the assets of Ontario's small public sector pension plans under common management, providing each pool facilitated at least $50 billion of assets. Over 75% of Ontario's public sector pension plans have less than $1 billion AUM each.

BARRIERS TO TAKE-UP

Although there are well-trodden paths for schemes to procure fiduciary management services, there is no clear route for private sector schemes to pool assets in a similar manner to the LGPS. The challenges facing individual schemes or employers that wish to establish asset pools are:

- **Technical complexity**

  Issues such as establishing the composition of the asset pool and understanding its legal status, together with complexities in setting up its day-to-day operating structure (e.g. Limited Partnerships, Authorised Contractual Schemes) require time, cost and resource. For smaller schemes these issues can appear to be high hurdles.

- **Resourcing**

  The ability of small, lower resourced schemes to appoint and/or recruit and retain investment managers, and put in place appropriate risk, compliance and legal support will limit the feasibility of both the initial set-up and long-term viability of the pool.

- **Alignment of interests**

  The success of pooling arrangements requires an alignment of interest among the parties involved, and has typically occurred in industry-wide, intra-group or otherwise connected schemes. Even where commonality already exists, concerns about differences in interests or surrendering control still occur; it is therefore likely that challenges will be multiplied in otherwise unconnected schemes.

29 The CEM benchmarking study considers the asset performance compared to a policy benchmark of over 6,000 data points between 1992 and 2013. The dataset consists primarily of larger global funds than the UK DB universe, with average Assets Under Management of $19.5 billion. CEM benchmarking, value added by large institutional investors between 1992 – 2013, http://www.cembenchmarking.com/Files/Documents/Research/Total_Fund_Value_Added_Final_Feb9.pdf

30 Facilitating Pooled Asset Management for Ontario's Public-Sector Institutions, 2012

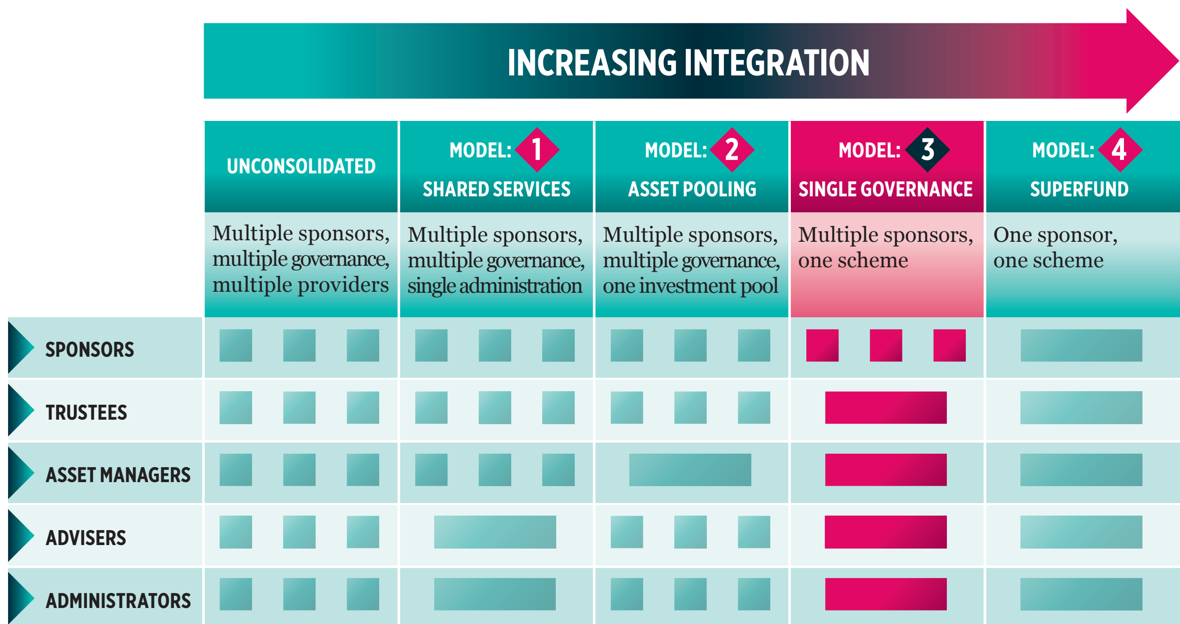
MODEL 3 – THE GOVERNANCE MERGER

This model combines models 1 and 2 and adds a further layer of integration, with multiple schemes managed and governed by one trustee board, sharing administrative and back office functions, advisers, and pooled assets.

A MENU OF CHOICES:

Elements of this arrangement are common in multi-employer schemes. In some of these schemes one trustee serves all participating schemes and in some each scheme retains its own trustee. Scheme rules might be retained in their original form with individual variations, or they might be consolidated into one common set of scheme rules.

FIGURE 9: MODEL 3



In Model 3, the governance of the participating schemes is overseen by one trustee board, responsible for overseeing the asset pool, the common administration platform and managing a common set of advisers.

The schemes entering the consolidator become 'sections' within the new scheme. In this way, liabilities associated with each sponsoring employer remain segregated. This avoids different employers being 'on the hook' for one another's liabilities, and, if one employer becomes insolvent, their section of the scheme is eligible for entry into the PPF or must be wound up with benefits having been secured. At present these schemes exist in some industry-wide schemes, and can simplify the movement of employees between different companies. Other similar arrangements, open to employers from different sectors such as the Pension Trust, also exist.

COSTS AND SAVINGS

The model delivers all of the benefits from models 1 and 2, including better opportunity for investment outperformance, greater bargaining power for services and expertise and other economies of scale. It could also deliver a governance premium through a single highly skilled trustee board.

Combining these savings with those gained from models 1 and 2, we estimate that total annual savings could be at least:

Administration savings and Advisory savings (Model 1)	£0.6 bn
Investment management savings (Model 2)	£0.25 bn
Governance savings	£0.36 bn
Total (Model 3)	**~£1.2 bn**

*Governance savings attributed from TPR analysis[31]

The DWP's Green Paper cites similar cost savings, focusing on improving the value gained from consolidating the smallest schemes:

- "If all schemes comprising fewer than 100 members (around 2,400 schemes) merged into 'superfunds' of say more than 20,000 members, then running costs for these schemes might reduce from around £100 million per annum to around £20 million per annum.
- If schemes comprising fewer than 1,000 members (around 5,000 schemes) merged into superfunds of more than 20,000 members, then running costs for these schemes could reduce by £400 million a year."[32]

In addition, far greater savings could be made if pooling into schemes with hundreds of thousands rather than tens of thousands of members. Analysis from a comparison of 449 international pension plans, carried out by CEM benchmarking, indicates that with greater scale further efficiencies are possible, with cost savings for both the same asset mix and in administration. For example, an average 200,000 member scheme was reported to have a $57 per member saving relative to a 100,000 member scheme; with a 400,000 member scheme reported to have a further $29 per member advantage over a 200,000 member scheme.

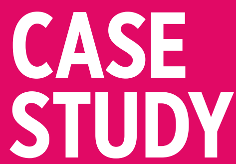
With the overlay of one common governance framework, we believe that much greater gains can be made by being able to 'look through' all aspects of the running of the scheme, improving strategic decision-making and co-ordination as well as delivering cost savings from administration and asset management functions.

There is some evidence that consolidated governance arrangements overseeing pooled investments could lead to better returns, if consolidation were also used as an opportunity to raise governance standards.

The Taskforce's Interim Report highlighted research by Keith Ambachtsheer estimating that the impact of good governance can be up to 1 per cent of the fund's value a year.[33] The presence of a governance bonus was confirmed in a more recent study by Urwin and Clark, who sought to identify a selection of institutional investors with the characteristics associated with good governance. They found that almost all of the funds meeting their governance best practice criteria had a performance margin of 2 per cent a year or more over their benchmarks.

If this was achievable more generally, a 'governance bonus' of similar value to that estimated by Ambachtsheer or Urwin and Clark would, accumulated over time, make a significant difference to a scheme's sustainability.

31 PLSA analysis of DB scheme running costs research, The Pensions Regulator, 2014, www.thepensionsregulator.gov.uk/trustees/db-scheme-costs-tool.aspx#s14483 2014
32 Security and Sustainability in Defined Benefit pension schemes, DWP Green Paper, 2017
33 Pension Revolution: A solution to the pensions crisis, Keith Ambachtsheer, 2007



RPMI PROVIDES GOVERNANCE, ADMINISTRATION AND INVESTMENT SERVICES TO PENSION SCHEMES OF THE RAIL INDUSTRY INCLUDING THE RAILWAYS PENSION SCHEME (RPS), BRITISH TRANSPORT POLICE FORCE SUPERANNUATION FUND (BTPFSF), BRITISH RAILWAYS SUPERANNUATION FUND (BRSF) AND THE BRITISH RAILWAYS ADDITIONAL SUPERANNUATION SCHEME (BRASS).

A sister company, Railpen, invests the assets of the railway pension schemes on behalf of the trustee. Combined this scheme has approximately 113 different sections, 186 different employers, 90,500 active members, and £22.5 billion AUM.

The assets of RPMI's participating schemes all have access to 'pooled funds' which are significantly larger than would be possible were sections to invest their assets separately, resulting in several advantages. For example, the asset allocation needs of sections can be considered separately from the appointment and monitoring of individual investment managers. The size of the pooled funds also allows all sections to benefit from economies of scale in investment management costs and access to a wide range of investments. Transaction costs can be reduced, as sections can buy and sell units of the pooled funds between each other.

BARRIERS TO TAKE-UP

Although there are large, well-established DB multi-employer schemes and mastertrusts which can deliver this model, or act as templates for others, these arrangements are not widely utilised:

- **There are few multi-employer schemes that are open to employers across every type of industry**

  The majority of industry-wide schemes are typically in 'historic' industries. They operate to service their own specific needs and are not structured to act as providers for external parties. Therefore, new arrangements would have to be created.

- **Alignment of interests**

  The participation of multiple parties will mean the operating model cannot be tailored directly to the individual needs of schemes. Even where there is a degree of choice and flexibility in services, schemes are likely to want to be satisfied that the gains outweigh a loss of direct control.

CONCLUSIONS: MODELS 1-3

It is clear that greater sharing of services or consolidation of the way schemes manage their assets or governance structures would have a positive impact on the efficiency of DB schemes today.

This would help to address the stark discrepancies in administrative costs between small and large schemes for broadly equivalent services, and mitigate the significant leakage of costs in fees to intermediaries and weak bargaining position of a large proportion of DB schemes.

Achieving these goals will not be without difficulty, with practical, legal and other challenges to overcome. However, with a range of savings from hundreds of millions to billions of pounds achievable, they should not be overlooked and would be of considerable day-to-day benefit for schemes.

We recommend that the Government takes steps to help realise these benefits by removing the legislative barriers to greater consolidation, and to the efficient operation of schemes more generally. This should include measures:

- To require schemes to demonstrate to the Regulator and their members that they are operating efficiently; and
- To establish a clear method for simplifying scheme benefits on an actuarially equivalent basis.

While these improvements would be very welcome, the Taskforce's conclusion is that Models 1-3 will not, by themselves, address the £800 billion shortfall in DB pension scheme funding or the risk of sponsor default.

This is borne out in the Mousetrap analysis below which indicates that Model 3, the most integrated option, would improve scheme efficiency, but would have limited impact on the risks of sponsor default over a 30-year time period.

We have therefore concluded that bolder steps are needed. We explore these in the next chapter.

FIGURE 10: PROBABILITY OF DEFAULT/FAILURE WITHIN 30 YEARS BY EMPLOYER COVENANT GRADE

	ORIGINAL MODEL	SINGLE GOVERNANCE MODEL*
CG1 Strong	6%	6%
CG2 Tending to strong	20%	19%
CG3 Tending to weak	40%	38%
CG4 Weak	65%	63%

*assuming a 25 basis points (bps) return enhancement

SOURCE: GAZELLE 'MOUSETRAP'

MODEL 4 – MERGING SCHEMES: SUPERFUNDS

CHAPTER HIGHLIGHTS

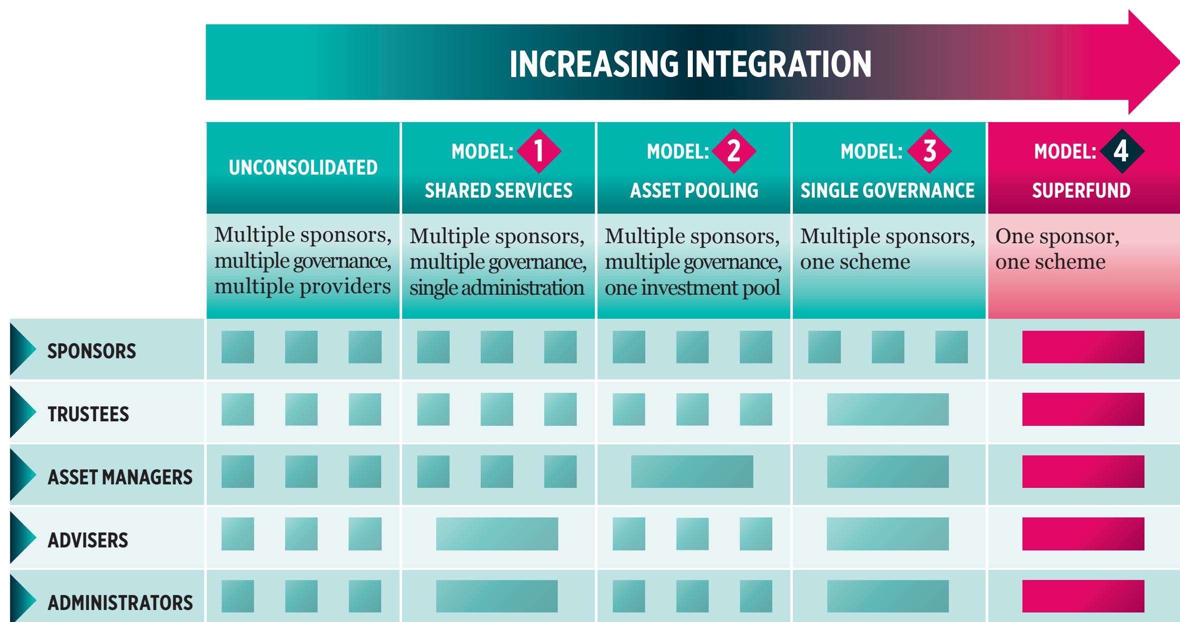
- The merger of assets and liabilities into Superfunds could transform the sector.
- Merger involves difficult decisions for both trustees and members and for sponsoring employers.
- But it has the potential to significantly reduce the risk to members' benefits.
- Employers would have a new, more affordable option for releasing themselves from legacy DB obligations.
- But it is still unlikely to be affordable for many employers at current benefit levels; further work is needed to understand the trade-offs between affordability, benefit level and benefit certainty.

It is clear that greater consolidation of DB schemes, in any of the variations set out in the previous chapter, would greatly improve schemes' ability to benefit from economies of scale, and go some way towards addressing the systemic value leakage that occurs through duplication of costs and intermediation.

Such steps would be welcome. But, while they would deliver a marginal improvement to member outcomes, the Taskforce believes more radical transformation is needed to address the significant risks facing members.

The final option we have set out in our Report is intended to address this issue, and focusses on the creation of Superfunds (public or private) that provide more secure pensions for members by consolidating both the assets and liabilities of participating pension schemes and discharging solvent employers from their pensions obligations.

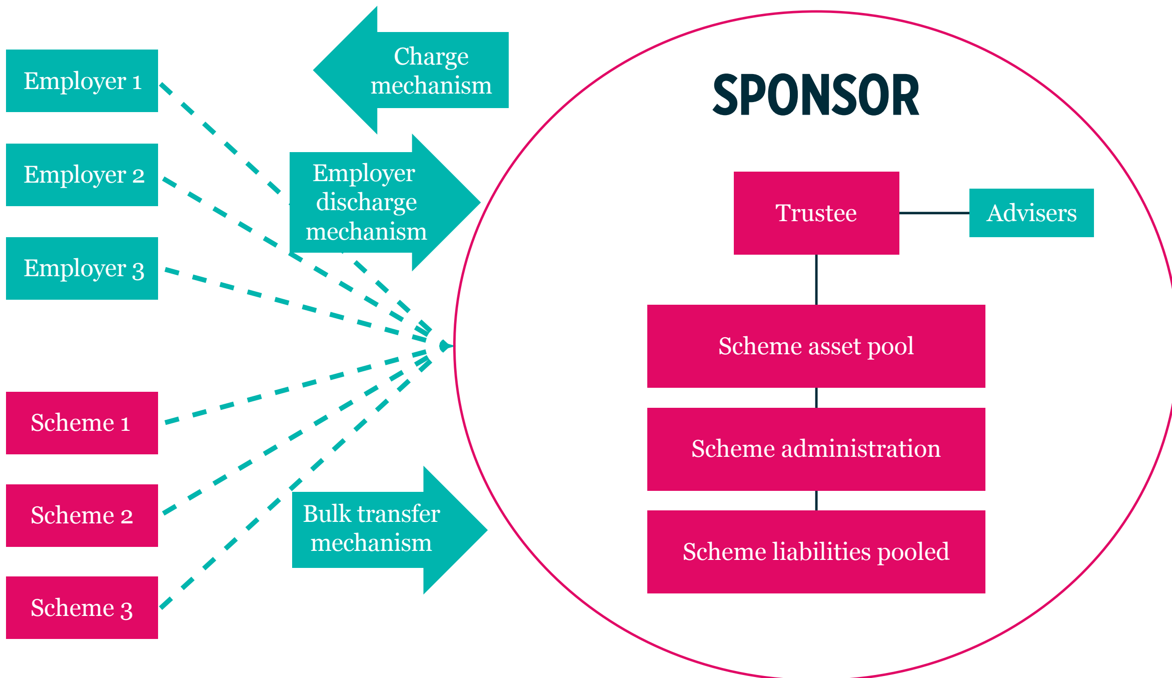
FIGURE 11: MODEL 4



In essence:

- Employers would pay a fee – either upfront or in the form of secured debt – to substantially reduce scheme underfunding and discharge themselves from responsibility for the scheme.
- If the trustees of the scheme agreed, following consultation with members, the scheme and all its assets and liabilities would be transferred to a Superfund.
- Members' benefits would be aligned to a common Superfund structure. Negotiations between sponsor, trustees and consolidator agree an actuarially equivalent conversion to the Superfund benefit structure.
- Superfunds would be authorised and supervised by TPR and would demonstrate the highest standards of governance.
- The Superfund would be managed to and maintained at a funding level which gives members greater prospects than now of receiving their benefits, and is less expensive to access than buyout.

FIGURE 12: ESSENTIAL FEATURES OF A SUPERFUND



THE SUPERFUND TARGET MARKET

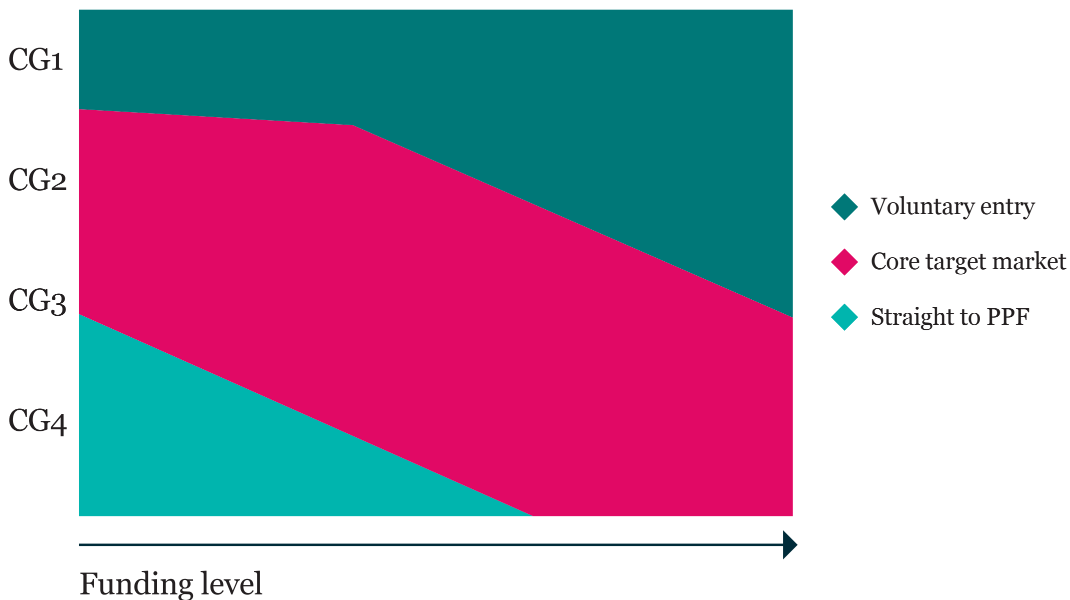
The Taskforce's Interim Report identified the range of risks faced by schemes in the four categories of employer covenant strength used by TPR. That analysis made clear the levels of risk faced by members of schemes with sponsors in the CG3 (Tending to weak) and CG4 (Weak) groups.

FIGURE 13: ESTIMATED MEMBER BENEFIT LOSSES ON DEFAULT

	ESTIMATED BENEFIT LOSSES ON DEFAULT	PROBABILITY OF DEFAULT	PROBABILITY WEIGHTED BENEFIT LOSSES
CG1 Strong	11%	6%	1%
CG2 Tending to strong	14%	20%	3%
CG3 Tending to weak	16%	40%	7%
CG4 Weak	19%	65%	12%

While some schemes in these groups are so poorly-funded that their members might inevitably end up in the PPF, joining a Superfund could provide significant benefits for many others. Although they have different characteristics, we would also expect Superfunds to be attractive to some schemes and sponsors in CG1 and CG2 groupings and they should be allowed to access the benefits available through Superfunds.

FIGURE 14: TARGET MARKET FOR SUPERFUNDS



The majority of employers in CG3 and CG4 are unable to afford full buyout, but many would like to make a clean break from their ongoing pension obligations and the risks they pose to the viability of the business. We believe that the Superfund option could create an incentive to raise capital from markets or creditors to enable a transfer to a Superfund, while also ensuring employers provide a secure outcome for their employees.

BREAKING THE LINK

Entry to a Superfund will be subject to a tri-partite agreement between scheme trustees, the scheme sponsor and the Superfund. Consultation with pension scheme members, or their representatives, will be vital to ensure their support and to aid decision-making.

To be viable the Superfund will need to be in a position to specify the terms of entry for each scheme and obtain full disclosure of the assets, liabilities and commitments of transferring schemes.

Schemes in deficit are likely to have to secure some form of commitment from their sponsor to reach an appropriate entry level. If a cash payment is not possible, then there could be alternative payments via, for example, tradable capital instruments with appropriate financial backing. Alternatively the Superfund could agree terms for payments from the employer over a short period.

A different arrangement will be required for ongoing payments, which clearly carry greater risk of default. A 'clean break' from past pension obligations must be achieved to ensure clarity for all parties. Ongoing payments will therefore need to take the form of secured debts (which the Superfund might insure against) from the sponsor or a strong group company. This will ensure that the Superfund can obtain appropriate levels of comfort, can mitigate its downside risk, and that payments from the employer are re-categorised from pension payments to commercial debts.

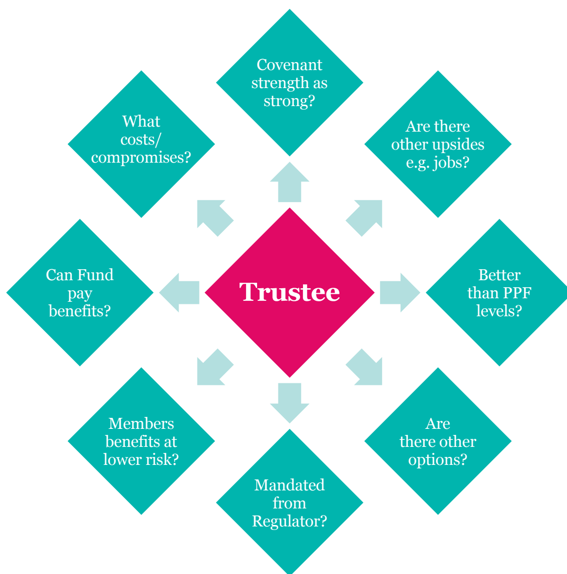


FIGURE 15: TRUSTEE DECISION-MAKING

The scheme trustees will need to assess the transfer as they would any scheme transaction.

The key terms to be agreed between the employer, trustee and Superfund before transfer are likely to include:

- A one-off payment or a series of payments, where necessary, to improve the scheme's funding position to a level required by the Superfund; and
- The alignment of the scheme's benefits to the Superfund's common benefit structure on an actuarially equivalent basis.

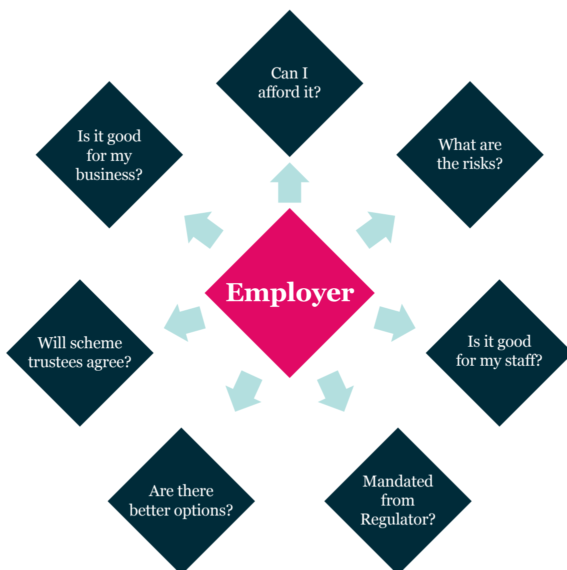


FIGURE 16: EMPLOYER DECISION-MAKING

Once the transfer has been agreed there will be a 'clean break' with the existing employer and the trustees will be discharged from their duties and any related obligations, which will be assumed by the Superfund.

RUNNING A SUPERFUND

Private Superfunds will be occupational pension schemes, and operate within the existing regulatory framework. Some adaptations will, however, be required to ensure that the current regulatory system is able to govern their operation appropriately. In particular, the Superfunds would need to be authorised and supervised in a different way from existing pension schemes.

Authorisation would be dependent upon demonstrating and maintaining sufficient financial strength, the highest standards of governance, probity, administration and investment capability – tests which are not specifically required under the current regulatory system.

Over time, with multiple, large-scale market participants, it would also be necessary to ensure that private Superfunds remained competitive, diversified systemic risk sufficiently, and did not become 'too big to fail'. Similar requirements would need to be applied to a Public Superfund, through relevant Government or parliamentary oversight.

Changes introduced for DC master trusts in the Pension Schemes Bill, currently passing through Parliament, provide a useful example of how an authorisation regime for large pension funds can operate.

CASE EXAMPLE

THE PENSION SCHEMES BILL 2016 INTRODUCES A NEW REGULATORY PACKAGE FOR MASTER TRUSTS DELIVERING AUTOMATIC ENROLMENT. ITS PURPOSE IS TO PROTECT SAVERS AND MAINTAIN CONFIDENCE IN PENSION SAVINGS, AND IT AIMS SPECIFICALLY TO ENSURE THAT THOSE SAVERS ARE PROTECTED.

It introduces a new regulatory package for the authorisation and supervision of master trusts, requiring that they demonstrate certain key criteria on establishment and on an ongoing basis:

- TPR will act as a market gatekeeper with authorisation powers. In order to be authorised, schemes must satisfy TPR that a given number of authorisation criteria are met.
- There will be a fit and proper regime covering trustees – including the assessment of the competence of the board in the round and its ability to oversee the business.
- There must be a business plan and TPR must be convinced that the scheme is financially sustainable.
- The scheme must hold sufficient funds to facilitate wind-up. It must also hold sufficient funds to run on for a given period of time which will be defined in secondary legislation.
- The scheme must have a discontinuance plan.

In addition, Superfunds should be expected to meet strong funding criteria. This might, for example, require that they maintain a funding level consistent with a 90 per cent minimum probability of being able to pay Superfund member benefits in full, on an ongoing basis.

Superfunds could be provided by a public body such as a public corporation (that would not require a Government guarantee), by private sector providers, or in a mixed market. The Taskforce believes that a Public Superfund could play an important role in a) providing a benchmark solution, and b) acting as a catalyst for a new market in the same way as NEST has for automatic enrolment.

In the longer term, the success of Superfunds is dependent upon the creation of a thriving, innovative, market with competing consolidators providing a variety of propositions and keen pricing for schemes wishing to consolidate. We anticipate their economic model could be similar to bulk annuity providers, but operating within a more flexible framework. The basis for entry would need to be defined in order to be attractive to existing market participants, such as insurers, consultancies and asset managers, as well as new providers of capital.

SUPERFUNDS AND THE PPF

It is important that the Superfund is sufficiently robust to withstand severe economic shocks, or has appropriate safety valves to enable an orderly recovery. It is equally important that if the Superfund appears likely to fail then members are protected.

As private Superfunds are intended to operate within the existing regulatory framework, we believe they should be eligible for the PPF. Their emergence would, of course, need to be reflected in the pension protection levy[34].

We have not sought, at this stage, to speculate about how that might be done, nor how the creation of Superfunds might reduce the likelihood of claims on the PPF. Equally, we have not considered the levels of protection that Superfund members could receive from either the PPF or an alternative Public Superfund.

Their differing structure and nature may, however, present opportunities to provide protection like that provided by the Financial Services Compensation Scheme (FSCS).

A SIMPLIFIED BENEFIT STRUCTURE

The Interim Report highlighted the problems that inflexible benefit design and complex, unwieldy regulations have caused for schemes, sponsors and member understanding.

To address these, benefits provided in the Superfund would operate better on a standardised basis, with common rules for indexation, revaluation and survivors' benefits. This approach will ensure efficient scheme administration, simplify and enhance member communication, and assist in managing liabilities.

34 We note the PPF has recently consulted on adjusting the levy for schemes that could operate without an employer.

SUPERFUND MODELLING

To understand the impact of a Superfund, we used the 'Mousetrap' model to assess the effects on the security of members' benefits and illustrate the funding requirements for schemes and employers[35].

We made the following assumptions:

- The initial funding level of the Superfund is 'gilts flat' (i.e. liabilities are valued using a gilts-based discount rate), with premiums for entry reflecting this requirement;
- The mean outperformance on risk-bearing assets, and outperformance on matching assets, will be +0.25% higher for the Superfund, reflecting lower costs and better governance;
- The Superfund will have a broadly similar asset allocation strategy to the PPF: 60% cash and bonds, 20% alternatives, 10% equities, 10% hybrid assets; and
- The Superfund holds a 'buffer', in the form of a capital reserve[36].

We considered scenarios in which sponsors met a full payment premium up front to enter the Superfund, fully funded on a gilts-flat basis, and scenarios in which employers made payments in instalments. As noted below, we believe a range of alternative bases/funding levels may also be worth examining.

The Mousetrap analysis indicates that the Superfund can offer considerable improvements in benefit security from lower costs, enhanced funding and investments, with much lower risks of default for transferring schemes.

The modelling results indicate these benefits are realisable even where sponsor payments are made over a period, as a debt obligation rather than in an upfront premium.

The level of 'buffer' available to a Superfund in the form of capital reserves does however have an impact on the comparative levels of attractiveness in relation to benefit security for schemes of differing Covenant Groups.

This is important, because a key determinant of the operation of Superfunds will be the trade-off between the expected levels of security of the entity and its ability to carry risk. Too little risk could impact its ability to offer attractive pricing, and too much risk would unduly impact member security.

We compared these results against our analysis of the risks to members' benefits in each of the Covenant Groups, as set out in the Interim Report. It indicates that the Superfund would provide a high level of security and a much faster level of funding improvement compared to typical schemes.

FIGURE 17: THE PROBABILITY OF THE SUPERFUND REACHING SOLVENCY FUNDING (UPFRONT PREMIUM) VERSUS EXISTING EMPLOYER COVENANT GROUPS

SUPERFUND	AFTER 10 YEARS	AFTER 20 YEARS	AFTER 30 YEARS
5% buffer	79%	87%	87%
10% buffer	83%	96%	97%
CG1 Strong	51%	84%	90%
CG2 Tending to strong	31%	57%	67%
CG3 Tending to weak	24%	45%	52%
CG4 Weak	16%	29%	32%

SOURCE: GAZELLE 'MOUSETRAP'

35 Further information about the modelling assumptions and results will be published alongside the Report.
36 It would be possible to produce a similar effect through permitting a degree of flexibility in benefit payments.

The positive funding probability of the Superfund relative to most categories of scheme is also borne out in the results modelling the risk to members' benefits. They indicate that the Superfund would provide greater benefit security in nearly all examples, and would provide particularly strong improvements for members in schemes with CG3 and CG4 sponsors.

FIGURE 18: COMPARATIVE ESTIMATED LOSS TO MEMBER BENEFITS ON DEFAULT

WITHIN 30 YEARS	ESTIMATED BENEFIT LOSSES ON DEFAULT	PROBABILITY OF DEFAULT/FAILURE	PROBABILITY WEIGHTED BENEFIT LOSSES
Superfund 5% buffer	15%	12.9%	2%
Superfund 10% buffer	16%	3.5%	0.6%
CG1 Strong	11%	6%	1%
CG2 Tending to strong	14%	20%	3%
CG3 Tending to weak	16%	40%	7%
CG4 Weak	19%	65%	12%

SOURCE: GAZELLE 'MOUSETRAP'

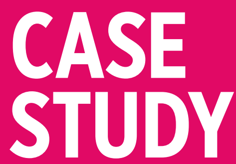
COSTS TO SPONSORS

The costs to sponsors for entering a Superfund would be subject to a number of factors depending on the operating model – whether it was private or public and the level of 'buffer' or flexibility allowed.

Irrespective of these issues, moving into a Superfund at close to this funding basis will be considerably less expensive than seeking to buy out, and more achievable for willing sponsors. Active competition has the potential to reduce prices further. It is self-evident, however, that the funding basis and level of benefits offered by the Superfund will need to be carefully explored. Otherwise, the number of schemes and employers that might be able to afford entry to the Superfund will be limited, as will the number of members who might see their risk reduced.

Given the transformative effect Superfunds could have for the DB sector, the Taskforce intends to carry out further work and modelling to understand the benefits and costs of entry in greater depth in the next phase of its work.

Superfunds could be more accessible for more schemes if benefits could be reduced on entry or subject to a lower level of indexation. Alternatively, future levels of indexation could be made conditional on economic conditions and the funding position of the Superfund. Trustees, in consultation with members, are likely to want to assess whether members would, in aggregate, benefit from a transfer to a Superfund with benefit reductions. The Taskforce will consider, taking account of the member research undertaken for the interim report, the parameters within which benefit reductions could be considered.



THE CANADIAN PROVINCE OF NEW BRUNSWICK FACED THE TYPICAL GLOBAL PROBLEMS ASSOCIATED WITH DB PLANS – LOW INTEREST RATES AND INCREASING LONGEVITY LEADING TO SUBSTANTIALLY INCREASED LIABILITIES.

Rather than moving to conventional defined contribution plans, New Brunswick embarked on a new style of plan and associated governance regime – Shared Risk plans, introduced in May 2012. The principal objective behind their pension reforms was to make public and private sector plans "secure, sustainable and affordable for both current and future generations."

There are three key components to the system:

(i) A plan design based around DB pensions (typically career average, with continued future accrual) separated into base benefits and ancillary benefits. Base benefits are designed to be paid with a very high degree of certainty – 97.5 per cent. Ancillary benefits, typically indexation and revaluation of benefits, are targeted with a high degree of certainty – 75 per cent – but are only paid when the finances of the plan permit it.

(ii) A financial framework that makes the employer cost a fixed amount – or potentially variable in a small range, say 16-18 per cent of pay. There are no deficit contributions required. Benefits would be adjusted to stay inside the controlled cost framework, with indexation being the first to be reduced or cut if finances deteriorate. Restoring lost increases would be a priority as finances improve. If surplus arises, additional ancillary benefits may be granted.

(iii) There is a strong regulatory risk management framework to ensure equitable treatment of generations of member benefits, by adopting transparency of financial reviews and integration of the investment, benefit adjustment and (restricted) contribution increases. Annual reviews are undertaken using full stochastic reviews of the development of the plan.

Experience to date has been favourable, despite continued difficult financial conditions. In general, there have been no benefit reductions since the introduction of the plans, and targeted indexation has been granted. One criticism of the approach has been that in order to assess the probabilities of the future outcomes – the 97.5 per cent and 75 per cent for base and ancillary benefits – using the stochastic projections, a large number of (subjective) inputs are required, and that significantly different outcomes result with different inputs.

SUPERFUNDS:
SUMMARY OF BENEFITS FOR DIFFERENT STAKEHOLDERS

MEMBERS

- Significant improvement in likelihood of receiving full benefits
- Higher standards of governance, communications, administration and regulatory oversight
- Improved employer solvency results in better job security

SPONSORS

- Entry to Superfund is less expensive than buyout
- Removes risk and volatility of current pensions accounting
- Ability to focus on and invest in core work (where managing scheme is one of many roles)
- Improved market perception of business
- Ability to free themselves from legacy obligations

CONSOLIDATORS

- Ability to utilise capital to generate attractive returns in area of potentially very strong customer demand
- Ability to innovate business models to access a large market providing access to investment funds, administration and other services and customers

REGULATORS

- Significant reduction in risks facing DB sector
- Stronger ability to supervise sector through oversight of fewer, larger, more professional funds.

IMPACT ON THE ECONOMY

Superfunds could offer a more affordable means to manage the impact of legacy DB schemes on UK employers that are struggling under the weight of their commitments, and who have seen deficits rise even in the face of increased contributions.

Addressing these issues could enable greater investment in jobs, wages and corporate growth. In addition, capital raised by employers to enter a Superfund would be much more efficiently allocated in the economy by operating at scale, with high levels of investment skill. Superfunds would also have the ability to exploit pension scheme illiquidity by investing more heavily in infrastructure, residential property and other real assets.

RECOMMENDATIONS AND NEXT STEPS

IT IS CLEAR THAT GREATER CONSOLIDATION WOULD HAVE A SIGNIFICANT POSITIVE IMPACT ON THE EFFICIENCY OF DB SCHEMES TODAY. THE TASKFORCE'S INITIAL MODELLING SUGGESTS FURTHER THAT FULL MERGER INTO A NEW TYPE OF SUPERFUND COULD DELIVER MATERIALLY BETTER OUTCOMES FOR MEMBERS, REDUCING RISKS TO THEIR BENEFITS AND THE RISK OF THEIR SPONSOR DEFAULTING.

There is much more work to be done by the Taskforce in evaluating the operating model for Superfunds. In particular, while our initial modelling illustrates how the concept could work for schemes where the funding gap appears affordable to sponsoring employers, we will be looking for views on the trade-offs involved in extending access to many more schemes. Would reduced benefit levels, lower indexation, or the introduction of conditional indexation be acceptable trade-offs in some circumstances?

The Taskforce will also develop proposals for the measures that the Government would need to introduce in order to break through the cultural, practical and legislative barriers that are restricting access to the benefits of consolidation today. In outline, these will include:

Improving efficiency: to generate improved outcomes and scheme governance, and address inappropriate complacency, we recommend the introduction of legislation requiring trustees to demonstrate annually to the Regulator and their members that their scheme is delivering value for money.

Where schemes fail to meet benchmarked efficiencies and no extenuating circumstances are offered the Regulator should intervene, requiring them to improve (within 12 months) or consolidate their scheme within an alternative arrangement. If trustees do not feel that consolidation is in the best interests of their members, they should be required to justify their decision.

Benefit simplification: the regulations and guidance setting out the process for re-shaping scheme benefits to simplified structures of actuarially equivalent value (either within a scheme or upon transfer to a new scheme) should be overhauled to provide clear standards that schemes and their advisers can implement with certainty, and also provide common frameworks for member consent (which define both when consent is required and what constitutes consent).

Superfunds: Government should bring forward legislation that removes barriers to consolidation. In particular, further work should be undertaken to build a regulatory framework for the creation, authorisation and supervision of Superfunds, which can absorb existing schemes and that permit employers to discharge their obligations in respect of transferring benefits.

ANNEX A – TASKFORCE MEMBERS

ASHOK GUPTA (CHAIR)

Ashok is a non-executive director of New Ireland Assurance, a J.P. Morgan European Smaller Companies Trust, the Ethical Journalism Network, and is a member of the FRC Codes and Standards Committee and Actuarial Council. He also chairs eValue Investment Solutions.

He was recently joint deputy chair of a Bank of England Working Group on Procyclicality. He was formerly Chair of AA Insurance Services, Chair of Skandia UK, a Founder Director of the Phoenix Group, a NED of the Pensions Regulator and NED of J Rothschild Assurance plc (now St James Place Capital).

His executive career has included Group Strategy Director at CGU (now Aviva), FD & Actuary of Scottish Amicable and a Principal of Towers Perrin.

DUNCAN BUCHANAN

Duncan is a partner in the London Pensions group of Hogan Lovells International LLP. Duncan advises both employers and trustees on the operation of work based pension schemes. He has advised schemes entering and exiting the PPF and also on restructuring benefits. Duncan is the immediate past President of the Society of Pension Professionals and is a member of the Association of Pension Lawyers.

FRANK JOHNSON

Frank joined RPMI Railpen Investments in 2004 as Finance Director and became Managing Director, Investments in 2009, supporting the Trustee of the multi-employer rail industry pension schemes. He oversaw the investment business streams of RPMI and Railpen Investments, with assets under management of some £20 billion, until his retirement from RPMI in 2015.

Frank is an independent non-executive director at First State Investments, UK and at GO Investment Partners. He is also a non-executive director of the Pensions and Lifetime Savings Association and Chairman of the Association's Defined Benefit Council. He also sits on the board of the Railway Benefit Fund, a registered charity.

Frank is a chartered accountant and holds a Commerce degree. Before joining RPMI, Frank held a number of finance director posts in the transport sector.

PAUL JOHNSON

Paul is a senior associate at Frontier Economics and a Research Fellow at the Institute for Fiscal Studies. Paul has worked in the economics of public policy for 20 years including stints as a director at HM Treasury, Chief Economist at the Department for Education and Skills and Deputy Director at the IFS. Paul has also been deputy head of the Government Economic Service an a council member of the ESRC.

Paul has researched and published widely on pensions. He was recently asked to lead a review of auto-enrolment by the new government, and was a member of the advisory Pension Provision Group set up by the last government. He is a member of the council of the PPI.

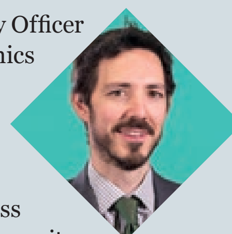
JACKIE PEEL

Jackie is UK & Ireland Benefits Director at Mars, a multinational food company. Her principal responsibilities are for the defined benefit (final salary and cash balance) and defined contribution pensions arrangements. She is also a member of the Mars Global Benefits Leadership Team which steers the company's strategic direction for benefits. Jackie has also held in house-pension roles at Barclays Bank and Pensions Director at VT Group plc where she was a Trustee of the Shipbuilding Industries Pension Scheme.

She is a non-executive director of the PLSA and vice-chair of the Association's Defined Benefit Council.

Before moving in-house, Jackie spent 17 years with Aon Hewitt in various roles specialising in Executive benefits and Global benefits.

TIM SHARP



Tim is a Policy Officer in the Economics and Social Affairs Department at the Trades Union Congress where he oversees its work on pensions and investment issues. He develops and promotes the TUC's policy agenda in these

areas and supports its network of pension trustees. Tim has worked at the TUC since June 2014 having previously been the London-based City Editor for Scotland's Herald newspaper. Tim has an MA in Politics from the University of Edinburgh and an MA in History from Birkbeck, University of London as well as the Financial Planning Certificate from the Chartered Insurance Institute.

STEPHEN SOPER

Stephen has recently joined PwC in the role of Senior Pensions Adviser. He previously held the positions of Interim Chief Executive and Executive Director for Defined Benefit (DB) Regulation on the board of the Pensions Regulator.

A Chartered Banker, Stephen began his career at RBS in 1986 within the international banking division and subsequently worked in executive positions at the Allied Dunbar Group, Zurich Financial Services, Eagle Star and Aon.

ROBERT TALBUT

Robert Talbut was CIO of Royal London Asset Management for ten years through to the end of 2014 and has worked in financial services for over 30. His experience covers portfolio management, business strategy, people management and remuneration and finance. He had previous asset/business management roles at Threadneedle, ISIS/F&C and Chase Manhattan. He has provided strategic asset allocation advice to a range of institutional clients and has a strong interest in the accountability of management to shareholders and of institutions to their ultimate clients.

He now performs a range of consultancy and NED roles spanning asset management, insurance, pensions and charities.

PAUL TRICKETT

Paul is a non-executive director at Aviva Life UK, Thomas Miller Holdings and Insight Investment. He is chair of Railpen Investments and the Aberforth Smaller Companies investment trust. Previously Paul has held roles as Head of the EMEA Global Portfolio Solutions Group at GSAM, Head of EMEA Investment Consulting at Towers Watson and CEO of the British Coal Pension schemes.

KEVIN WESBROOM

Kevin is an experienced pension consultant who has been advising pension clients for nearly 35 years. He is a qualified actuary and currently the UK lead for Global Risk Services, a fusion of actuarial and investment skills designed to help clients make sense of rapidly changing investment markets and new developments such as buy out, longevity and risk driven solutions.

He is practising what he has been preaching about phased retirement by working four days a week. If his views about the shape of future pensions are right, then his final phasing into full time retirement, and the end of private sector DB pension provision, could come together in 10 years time!

LESLEY WILLIAMS

Lesley is Group Pensions Director at Whitbread, with responsibility for corporate pensions strategy and to the Trustee Company for the operation of the Pension Fund and its investments. The Whitbread pension fund has a closed DB and open DC section. Lesley has worked in the pensions industry for almost 30 years, with previous positions in Gateway Foodmarkets, Abbey National, the Pearl Group and Henderson Global Investors. She is a Fellow of the PMI and has an MBA. She has been a Council member of the Pensions and Lifetime Savings Association since 2009, and became chair of the Association in October 2015.

ANNEX B – TERMS OF REFERENCE

TO UNDERTAKE A REVIEW OF THE CHALLENGES CURRENTLY FACING FUNDED DEFINED BENEFIT (DB) PENSION SCHEMES, AND MAKE RECOMMENDATIONS TO GOVERNMENT WHICH WILL (A) HELP ENSURE THE SUSTAINABILITY OF OPEN DB SCHEMES AND (B) HELP CLOSED DB SCHEMES RUN OFF MORE EFFICIENTLY AND ULTIMATELY SECURE MEMBER BENEFITS.

In reaching its recommendations the DB Taskforce will:

- examine the challenges facing funded DB schemes and the potential impact of these challenges on members' benefits, the health of sponsoring employers, workplace pensions provision and the wider economy;
- assess a broad set of solutions to the many and varied challenges facing DB schemes and, in particular DB schemes' own assessment of the feasibility, impact and risks associated with these various solutions; and
- consider the balance between scheme members, employers and other employees.

The Taskforce will seek evidence from DB schemes and their sponsoring employers as well as government, regulators, scheme advisers and a wide range of industry stakeholders in order to fully assess the impact of any proposals and build a consensus around solutions to support DB pensions.

The Taskforce will ultimately issue a report setting out the Taskforce's view of the DB landscape and set out recommendations which can be used by government, regulators, employers and the industry to help ensure a sustainable DB pensions system.

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DB
TASKFORCE
THE CASE FOR CONSOLIDATION

MARCH 2017

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