DB innovation: Consolidation as an emerging endgame

Following the recent announcement of superfund Clara's second deal, and proposals for a public-sector consolidator, Chloe Whelan looks at the innovation occurring in the DB consolidation space

Summary

- Consolidation, including commercial and public sector models, helps streamline defined benefit schemes for efficiency and cost reduction.
- However, consolidation also presents challenges given its lower level of security compared to buyout.
- The entrance of new consolidator models forces competition in the endgame market, which may ultimately benefit members.

With the announcement of a second deal from Clara Pensions, as well as of a highly anticipated public sector consolidator, attention has turned towards consolidation as an increasingly viable endgame option. However, concerns remain about the ability of consolidators to achieve scale, as well as their comparatively lower provisions in terms of member security.

Even with these concerns in mind, consolidation has thrown the endgame market into flux with increased competition. Defined benefit (DB) pension schemes find themselves with fresh options for both alternative and traditional endgames, which ultimately has the potential to improve member outcomes.

Understanding consolidation

Consolidation is a broad term used to describe several kinds of DB strategy. Generally, it involves delegating some or all responsibilities within a scheme, with the aim of achieving economies of scale, improved governance and/or lower running costs.

"Consolidation is a word that's used to describe five or six different things," says Dalriada Trustees managing director, Chris Roberts.

"There's a spectrum of consolidation, from governance consolidation all the way to superfunds at the higher end of complexity. That means it can be customisable depending on a scheme's needs."

Commerical consolidation

In commercial consolidation, a premium is paid to a consolidator, which becomes responsible for the provision of members' benefits. Thus, it offers sponsors and trustees a full risk transfer at a lower price compared to buyout.

Commercial consolidation has generated significant hype since the UK's primary provider, Clara Pensions, announced two deals in quick succession between November 2023 and March 2024. Furthermore, Clara CEO, Simon True, has claimed to have another £10-15 billion worth of deals in the pipeline.

Clara's second transaction, a £600 million bulk transfer with Debenhams Retirement Scheme, was seminal for two reasons.

Firstly, it was the first consolidation involving a scheme that had been through Pension Protection Fund (PPF) assessment. This restored benefits for all 10,400 members who previously were expected only to receive PPF compensation levels. Secondly, as part of the deal, Clara agreed to inject £34 million to provide increased certainty on the journey to buyout in five to 10 years' time.

Thus, this deal proved the potential of commercial consolidation to improve member benefits without cutting off future access to buyout.

Ndapt managing director, Marcus Hurd, says: "We talk a lot about innovative solutions in the industry but often they're just tinkering with existing models. This was truly a new way of doing things.

"For the members, it was a huge positive. The presence of a second deal was also helpful because proof of concept is one thing, but trustees needed to feel comfortable that this can be executed in multiple different scenarios."

However, TPT Retirement Solutions CEO, David Lane, says it may take time for confidence in commercial consolidation to grow.

"It's about understanding," he says.

"Clara has only been authorised for a year or so and it'll take the average trustee – and, in particular, the average member – time to get their head around it."

Public sector consolidation

Earlier this year, the Department for Work and Pensions announced its intention to contribute to the consolidation market by setting up a public sector consolidator (PSC). This option, which is forecast to be operational by 2026, is expected to be more affordable compared to commercial options but still involve a full risk transfer.

The PPF shared its initial proposals for a PSC, aimed at providing attractive pricing, terms and member experience to schemes of all sizes. The PPF also expressed its desire not to infringe on the commercial market, such as by refusing to offer scheme-specific benefits – instead, it will offer members full benefits through several standardised structures.

Barnett Waddingham partner, Richard Gibson, says the PSC was proof of a "momentum shift" in the consolidation market.

"There is much more interest in consolidation as an option," he says.

"We have many parties including our own government looking to put their hands in their pockets to contribute. This has moved from a grand idea into something very real."

There is, however, a drawback. The PSC is expected to focus on run-on, allowing it to invest in productive UK assets for the long term. This sets it apart from one of Clara's key selling points, in that it will not be a bridge to buyout.

However, concerns have been raised about the ability of the PSC to achieve scale, which would be essential for long-term investment strategy.

DB master trusts

Finally, DB master trusts offer a form of governance consolidation that maintains the link between a scheme and its sponsor. Under these agreements, some administrative responsibilities are transferred to the trust, which is governed by a single board of independent trustees, but each sponsor remains financially responsible for its own scheme.

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This relatively rarely used consolidation vehicle has begun to gain traction as a bridge to buyout, as potential cost and time savings may bring forward the endgame timeline.

Hurd says: "Master trusts can be a lot more efficient than a standalone scheme. They offer smaller schemes access to a much wider range of options than they might otherwise have."

Benefits and challenges of consolidation

The buyout market has become increasingly crowded, with just nine insurers aiming to serve more than 5,000 DB schemes. This environment causes pension providers to compete for insurers' attention, often to the detriment of smaller schemes.

As a result, consolidation allows smaller schemes access to benefits that previously were only associated with buyout, such as lower costs, economies of scale and risk transfer.

Gibson says: "With consolidation, smaller schemes experience a revolution in terms of access to the benefits that are par for the course for larger schemes.

"If this market continues to grow, these schemes could reap some of the privileges to which only larger schemes have previously had access. This means they will be able to run more efficiently at a reasonable price."

High levels of competition in the buyout market also requires schemes to undergo significant preparation to make themselves attractive to insurers. Consolidators, by contrast, may accept a lower level of organisation.

"If you go to an insurer, you have to be perfect on data, for example," says Gibson.

"One advantage of consolidation is that schemes don't have to be picture-perfect, which means it may be more practical for smaller schemes. Some consolidators may even help cleanse data on a scheme's behalf."

However, while consolidation comes at a lower price compared to buyout, it also provides less security. This means, thus far, it has been most attractive to distressed schemes where members' benefits were otherwise highly uncertain.

Lane says: "Insurers are rightly viewed as the gold standard in terms of security, but you're paying to have access to that.

"There is a trade-off with consolidation, in which trustees accept lower security but for a more accessible price."

Culture of innovation

Although consolidation is a newer endgame option, its impact on the DB market has been considerable. The entrances of these new players have forced greater competition among endgame providers, which may result in better member outcomes.

For instance, as Gibson notes, some insurers have responded to consolidation by lowering their requirements with regards to data cleansing and other administrative tasks.

"Insurers are being innovative. They have registered the potential threat posed by consolidation, which may challenge their legacy in the space," he said.

Roberts says innovation in the endgame market may help re-energise DB pensions for another generation.

"DB schemes play a crucial role in retirement planning for a large part of the workforce. It's important that we try to make them accessible again, try to find ways to reengage with DB for the longer term," he says.

"That's about making DB schemes sustainable, affordable and predictable. These innovations may give a longer lifespan to the DB idea."

However, as Hurd notes, take-up of alternative endgames requires tenacity on the parts of both consolidators and trustees.

"The pressure is on consolidators to make this option as compelling and easy as possible," Hurd says.

"Trustees also have to be bold and brave. If you're confident in what you're doing and you believe in it, it's time to take action and secure the best possible outcome for members."

Written by Chloe Whelan, a freelance journalist