Sizing up commercial consolidators as a settlement option

Aon's John Baines looks at the 'middle ground' option of commercial consolidation

In a world of uncertainty, questions that have occupied trustee and sponsors for many years become more pertinent than ever before: How to manage risk? How to control costs? How to take advantage of market opportunities? How to improve governance? And, most importantly, how do we best ensure that member benefits will be paid in full?

Since the initial Department for Work and Pensions (DWP) consolidation consultation in 2018, there has been a flurry of debate and preparation but, nearly two years on, the regulatory framework is still being developed to give schemes further confidence to transfer to a commercial consolidator. Perhaps this delay should not be a surprise, given the lobbying by many interested parties and the need to ensure the financing of such schemes needs to be sufficiently robust.

CONSOLIDATION IN AN UNPREDICTABLE WORLD

Commercial consolidators have a simple common goal: to provide greater security for members' benefits than is possible in the existing scheme. A common misconception is to dismiss consolidation because it is not as secure as an insurance buyout. In our view a consolidator should not be considered as a direct alternative to insurance for schemes that can afford a buyout; rather it provides a de-risking step for those schemes that cannot afford one.

With many sponsor covenants looking less certain in recent months and availability of cash contributions under increasing pressure, commercial consolidators offer a middle ground for many schemes.

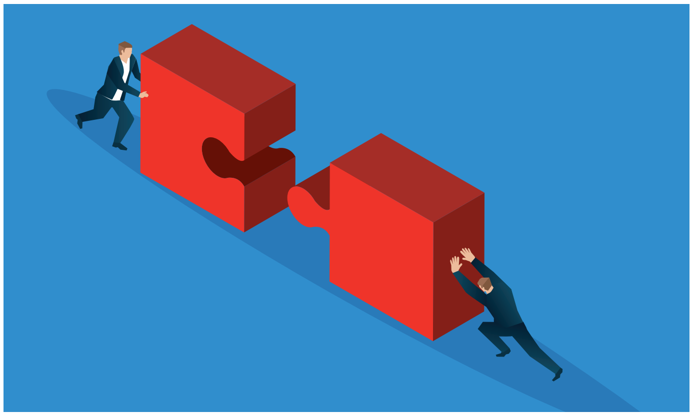
Finally, even though there are currently only two active consolidators in the market, the varying needs of different schemes are already catered for, most notably with either:

- A goal to provide even greater security for members through a buyout as soon as it becomes affordable, as provided by Clara; or
- In addition to improved security, offering a potential for improvement in member benefits should a surplus arise in their scheme, as provided by The Pension Superfund.

COMMERCIAL CONSOLIDATORS IN A NUTSHELL

The commercial regime

- The transaction is facilitated by a bulk transfer of all benefits and payment of a premium
- The remaining trust can then be wound up and is removed from the company balance sheet
- The consolidator is required to hold capital as additional security and takes on responsibility for making payments to the new scheme to fund members' benefits
- The consolidator is not a regulated insurer so does not provide the same level of security
- Any commercial consolidation regime is expected to be regulated by The Pensions Regulator.



OTHER CAPITAL-BACKED SOLUTIONS

To offer even more options for pension schemes, an alternative solution emerging is a capital-backed investment, an example of which is Legal & General's Insured Self Sufficiency (ISS).

The key difference compared to a consolidator is that these are investment solutions that remain within the scheme, rather than handing full responsibility to a third party. For this reason, capital-backed solutions are commonly referred to as 'on-balance sheet' solutions because the existing covenant remains and the scheme has simply invested assets in a de-risking product. This is akin to a consolidator in the way that a buy-in is to a buyout.

Our understanding is that any consolidation regulatory regime that is put in place will not apply to these types of products, because they remain 'on-balance sheet'. This can be a double-edged sword; on the one hand, this provides greater flexibility, but on the other it creates a greater onus on schemes to fully understand and to govern this arrangement going forward.

A BRAVE NEW WORLD

Any new solution that has such a large impact on scheme members should rightly be treated with caution by trustees. The dark clouds of early 2020 have, however, created an environment where there is a real need to embrace innovation across the market, particularly where member outcomes can be improved.

John Baines, partner, Risk Settlement Team, Aon