BARNETT WADDINGHAM
beyond the expected

Briefing

DB pensions in corporate transactions – an opportunity, not a hurdle

RISK | PENSIONS | INVESTMENT | INSURANCE

A defined benefit (DB) pension plan can often cause problems for a company trying to find a buyer. The risks associated with DB plans mean that the ongoing cost can be volatile, whilst the cost of buying out benefits with an insurer (until now, the only way to get the DB scheme off of the balance sheet without an insolvency event) can be prohibitively expensive.

In addition to this, The Pensions Regulator (TPR) is due to be given new powers that may make corporate transactions involving DB plans more cumbersome.

> However, recent developments in the market have provided a new option for dealing with pension plan liabilities: capital-backed consolidation.

This gives firms looking to engage in M&A activity a new and potentially more efficient way of being able to settle the liabilities of a legacy DB arrangement, which may improve the economics of a transaction.

A stronger Regulator

In 2018 the Department for Work and Pensions (DWP) published a White Paper on 'protecting defined benefit pension schemes'. As part of this, it was proposed that TPR's powers should be extended, in particular around corporate transactions. The proposals were consulted on, and the response earlier this year indicated that (amongst other things):

- Employers will be required to report to TPR where a 'material proportion' of an employer's business is sold (where it has responsibility for at least 20% of the pension plan liabilities) or security is granted on a debt that ranks as a higher priority than the pension scheme; and
- 'Declarations of Intent' should be produced at an early stage in a corporate transaction, setting out how the transaction is expected to impact the pension plan.

TPR will also be granted the ability to apply more punitive punishments in cases of non-compliance, which include civil penalties of up to £1million, and potentially criminal charges may be imposed in cases of "wilful or reckless behaviour" in relation to a pension plan.

"Strengthening the Pensions Regulator's powers and the existing sanctions regime" will be one of the main elements of the upcoming Pensions Bill, which was announced as part of December's Queen's Speech. We expect this Bill will be very similar to the draft Bill produced prior to the general election being called in November, so although the Bill's timing is uncertain we may see this sooner rather than later.

> Nevertheless, we expect this Bill to be reintroduced to Parliament (perhaps with slight alterations) in due course.

Enhanced powers for TPR may cause concern for some, though we believe that with adequate planning and thought being given to how to deal with the plan, meeting the new requirements should be reasonably straight forward. Nevertheless, it will be key for purchasers to take appropriate advice as part of the transaction to ensure they are compliant with the process.

A new option for settling liabilities

Whilst buyout remains the most common way to settle pension plan liabilities, and 2019 has been a record year for bulk annuity transactions, it remains expensive and for the majority of plans will require a significant injection of capital to be feasible.

> Capital-backed consolidation has been a hot topic in the industry for the past few years, and there are now two vehicles offering non-insured risk transfer for pension plans at (in theory) less than the cost of buying out benefits with an insurer.

However, these vehicles are designed to be an alternative to insurance, not a replacement; those plans that can afford to buyout would still be expected to do this by TPR (and by their trustees) and take advantage of the additional protection of insurance regulation.

The Department for Work and Pensions (DWP) consulted on a proposed authorisation and supervisory framework earlier this year but has yet to publish the results.

However, we do expect TPR to start to approve transactions in early 2020 using an interim framework and that the market will begin to accelerate, both in terms of the number (and size) of the deals being done and with new entrants to the market.

How does capital-backed consolidation work?

At a very high level, a consolidation transaction can be thought of as similar to a buyout transaction. The plan is transferred to the consolidator in return for a premium that is calculated on the consolidator's pricing basis. This will be prudent, but because this market is very unlikely to be as heavily regulated as the insurance market, and because some of the capital is being provided by the consolidator itself, the premium is likely to be lower than the cost of a bulk annuity transaction.

So what is in it for the consolidator?

Effectively, they believe they can make profit from two areas:

- Plan experience being better than assumed in their prudent pricing basis, i.e. that reserves are effectively released over time as less is paid out than expected; and
- Economies of scale resulting in asset outperformance and savings through administrative efficiencies.

How profit-taking is structured will depend on

Barnett Waddingham
beyond the expected

the consolidator and their model, e.g. this is likely to be different between consolidators operating as a run-off vehicle and those acting as a 'stepping stone' to buyout. Scale is clearly important in both of these areas, so all consolidators will be looking to achieve this as soon as possible. It may also depend on the outcome of the Government consultation, which looked to impose further limits on when consolidators can take profit from the fund.

Why is it relevant to M&A activity?

One set of circumstances where the capital-backed consolidators may find some success is where the sponsoring employer of a plan is weak, but the plan is relatively well funded. Although the cost of buying out plan benefits may still be prohibitive, as noted above the cost of transferring the plan to a consolidator may well be less.

> So if a potential purchaser sees value in the company without the pension plan but the buyout cost makes a transaction unviable, it could now be feasible for the purchaser to instead fund the plan to the point where a consolidator transaction is possible.

In addition, although the process is expected to be broadly similar, a consolidator transaction could be slightly quicker than a bulk annuity transaction. Whilst a substantial amount of work is required on plan data and benefits before going to the insurance market, for early transactions (i.e. before they have reached scale) consolidators may be more open to taking on data and benefit risk. Whilst this may not be a long-term differentiator, it may be useful for upcoming transactions that are time-sensitive, and particularly for private equity deals.

More generally, TPR's increasing focus on long-term funding objectives for plans means that purchasers will need to think about a plan's endgame strategy, especially if they want to 'solve' the pensions issues before any potential exit.

Consolidation is a feasible endgame option in this scenario, and purchasers could target this alongside a wider liability management strategy e.g. introducing an integrated transfer at retirement option.

One hurdle to this strategy is that the trustees of the plan will need to be sure that members' benefits will be more secure than they would be if no transfer took place. This should be relatively straight forward to satisfy in many cases, as without the injection of capital and the consolidator transaction, the plan would be left to run on with a weak sponsor, and may end up not being able to pay full benefits.

> However, purchasers may need to be prepared to justify why providing the extra amount to allow buyout would make the transaction prohibitive.

TPR is also likely to be interested, both in terms of the corporate transaction (as set out above) and the pension plan transaction (at least until such time as any regulatory framework is legislated for). This could mean further advice is needed, particularly around whether the Regulator would potentially look to use its anti-avoidance powers. However, it would be difficult to justify this if it could be shown that the members will be in a substantially stronger position post-transaction.

> Communication will be a key part of this process, both in terms of communicating with the members and trustees of the plan and with TPR. It will be important for everyone to understand what is being proposed, and why.

BARNETT WADDINGHAM
beyond the expected

What are the risks?

There is an element of reputational risk for the purchaser; post-transaction there would be no recourse for the consolidator to come back to them to ask for more money, but it may reflect poorly on the purchaser if a consolidator were to fail and members received reduced benefits.

The consolidators and their capital backers bear the majority of the risk, including investment risk – they will only receive their returns if the fund can generate a profit. If the consolidator aims to later pass the risk to the insurance markets, they are exposed to all the usual risks of insurance pricing and availability. In the extreme cases, if capital were to be extinguished then this could be a risk for the members. The consolidator schemes will be eligible for PPF protection, and although in practice action would be taken well in advance of the PPF being required, there is a possibility of members receiving less than their original benefit promise.

What happens next?

Both consolidators have announced that 'seed' deals are agreed in principle and are awaiting regulatory sign off. The Pension Superfund have also announced that they have agreed a second, larger deal that will be considered for approval once the seed deal is completed. As noted above, once transactions do start being approved we'd expect the market to grow quite quickly, and in particular we do expect other firms to come to market with consolidator vehicles. Although any regulatory framework implemented following the consultation will require new legislation before it can be enforced, we do expect approval to be granted on a case by case basis using an interim regime. We believe these vehicles have the potential to facilitate more corporate transactions involving DB plans and should help reinforce that these plans can present an opportunity rather than a hurdle.

We would be very happy to discuss this with you if this is something you would like to explore further. Please contact your usual Barnett Waddingham contact or use the contact details below.

SIMON TAYLOR

Partner, Employer Consulting

simon.taylor@barnett-waddingham.co.uk

TOM HARGREAVES

Associate, Employer Consulting

tom.hargreaves@barnett-waddingham.co.uk

www.barnett-waddingham.co.uk

Barnett Waddingham LLP is a body corporate with members to whom we refer as "partners". A list of members can be inspected at the registered office. Barnett Waddingham LLP (OC307678), BW SIPP LLP (OC322417), and Barnett Waddingham Actuaries and Consultants Limited (06498431) are registered in England and Wales with their registered office at 2 London Wall Place, London, EC2Y 5AU. Barnett Waddingham LLP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries for a range of investment business activities. BW SIPP LLP is authorised and regulated by the Financial Conduct Authority. Barnett Waddingham Actuaries and Consultants Limited is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.