

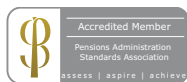
# SPENCE

## **Reducing Running Costs for Defined Benefit Pension Schemes**

May 2024

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# DB running costs - the elephant in the room

The UK's Defined Benefit (DB) pensions advisory and administration market is fragmented, with a wide variety of systems being deployed to manage schemes. Many schemes are serviced by older software, augmented by a range of sticking plaster solutions to get them to provide a basic service for pension members and fulfil their regulatory requirements.

This creates inefficiency within the market. Every pound companies spend on running their pension schemes is a pound not spent on member benefits, or other company priorities. For charities, it is a pound less for their charitable endeavours.

Spence estimates this results in **£105,000 of inefficiencies from poor practice and antiquated processes every year for an average 1,000 life scheme.** That's £300m a year of potential savings if extrapolated across the 3,000 DB schemes in the UK with 100 - 10,000 lives. Whilst most private sector businesses have moved to Defined Contribution (DC) schemes for their employees' pension provision, over 5,000 DB schemes remain. These will hold benefits for members for decades to come potentially resulting in missed billions of pounds of opportunities for operational savings over the remaining lifetime of DB schemes.

Modernising DB operating models is essential to reduce inefficiency and generate a wide range of benefits. This report shines a spotlight on the inefficiencies, analyses the savings that could be generated across UK DB schemes, and summarises existing solutions for accessing these savings.

## Get in touch

If you'd like to discuss the analysis in this report or how your scheme could access operational savings, please get in touch.



**Adrian Chapman** IMC  
*Business Development Lead*

**T:** 07971 980017  
**E:** [adrian\\_chapman@spenceandpartners.co.uk](mailto:adrian_chapman@spenceandpartners.co.uk)



**Alistair Russell-Smith** MEng, FIA  
*Charity and Corporate Advisory Lead*

**T:** 020 3837 2960  
**E:** [alistair\\_russell-smith@spenceandpartners.co.uk](mailto:alistair_russell-smith@spenceandpartners.co.uk)



## 1. What are the benefits of modernising DB operating models?

Beyond the cost savings, modernising DB operating models has broader benefits for scheme trustees and employers, including:

- ✓ Reaching insurance buy-out or superfunds quicker for schemes aiming at a settlement endgame;
- ✓ Generating more surplus for sharing with members or sponsors for schemes that run-on;
- ✓ Reducing operational risk by improving data integrity and calculation automation;
- ✓ Reducing cyber risk by holding information in a single, secure system to best meet TPR's cyber security principles<sup>1</sup>; and
- ✓ Improving the service that scheme members receive by freeing up administrators' time to focus on the customer experience. This will become increasingly more important as the wall of deferred members in DB schemes in their 50s and 60s start to draw their pensions.

## 2. Implications for future Government Policy?

For the Government, there are two policy reasons for addressing DB running costs now:

1. **Enabling run-on of DB schemes:** if the Government is serious about more DB schemes running-on rather than insuring, to better deploy the £1.4trn of assets in DB schemes to support the UK economy, then these changes need to take place to ensure running costs are value-for-money and that run-on has the support of sponsoring employers. The Pension Protection Fund's (PPF) 2023 Purple Book shows that in aggregate, the 5,051 Defined Benefit (DB) schemes in the UK are 134% funded on a PPF basis and 112% funded on an insurance buy-out basis. Deficit contributions are therefore ceasing for most sponsors, meaning they now have more focus on the running costs, placing these inefficiencies under more scrutiny.
2. **Making Pensions Dashboard a success:** using modern processes and systems is necessary for plugging DB schemes into Pensions Dashboard in a timely and cost effective way. There's a real risk of further delays to Pensions Dashboard if these changes do not take place.

## 3. How can we be confident operational savings can be realised?

It's clear that transformative actions can yield results because we've already seen this work in the Defined Contribution (DC) market. The UK DC market has dropped member charges from over 1% in the early 2000s to less than 0.5% today. There is now a huge disparity between DC and DB operations. The CEO of a large firm that administers both recently commented in a Pensions Age article:

*“ One of the schemes that we administer has two million members. We have about 150 people that we require to service that scheme. It's a DC master trust. A significant proportion of the work is automated. But then we've got a DB scheme which has got 10,000 members and you'd probably take 150 people to do that as well! ”*<sup>2</sup>

In the last 10 years Local Government Pension Schemes have started to address inefficiencies, and following a programming of pooling investments to harness the benefit of scale and reduce the number of advisers claim to have realised £400m of savings<sup>3</sup>.

A similar programme of operational change now needs to happen in Private Sector DB operations.

1 [Cyber security principles The Pensions Regulator | The Pensions Regulator](#)

2 Bala Viswanathan CEO of Aptia, January 2024

3 DLUHC consultation outcome, November 2023, LGPS (E&W): Next steps on investments

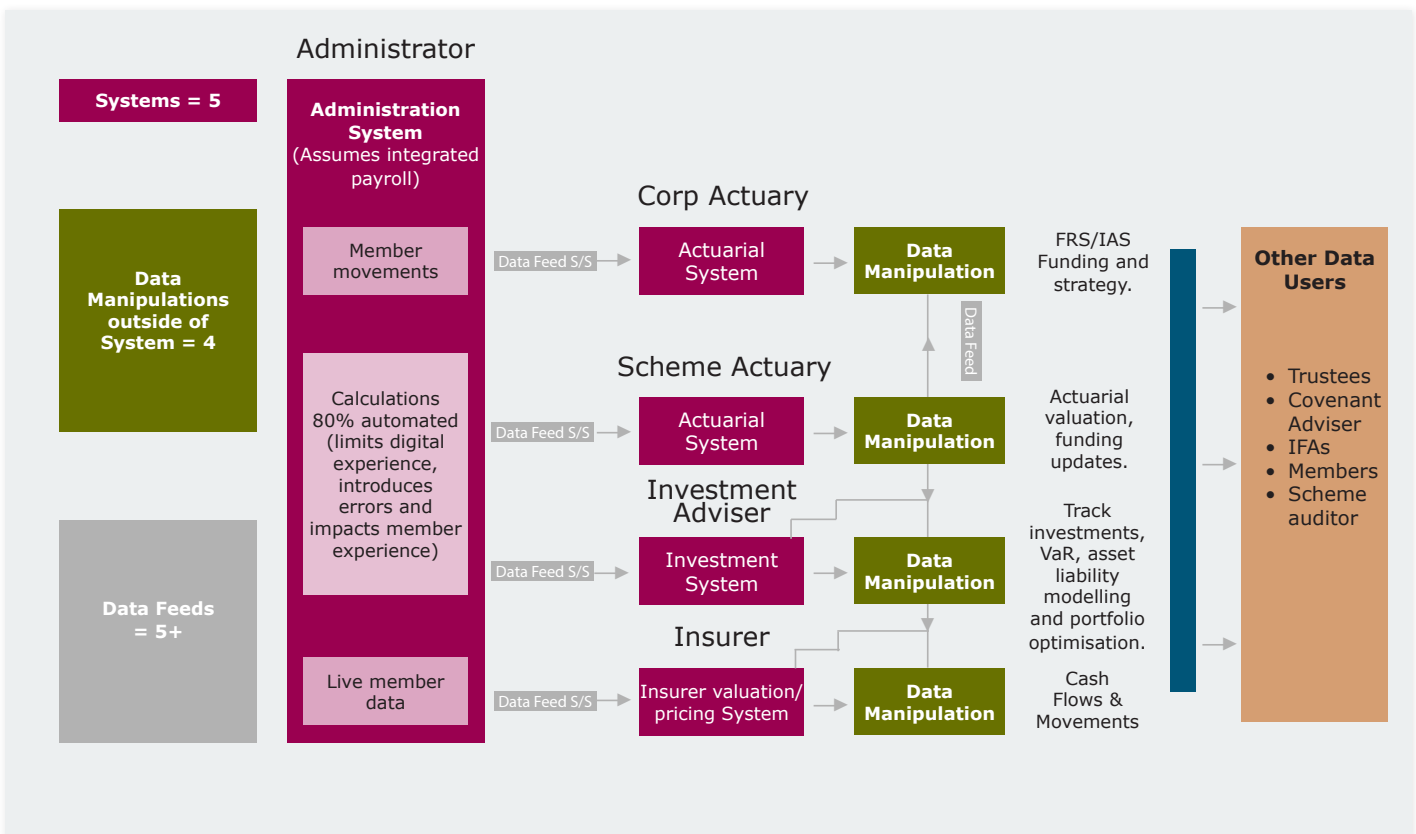
## 4. Shining a spotlight on the inefficiencies

Specialist functions and advisers are needed to run a DB scheme, including:

<p><b>An Administrator</b></p> <ul style="list-style-type: none"> <li>to pay pensions, settle retirement and bereavement claims, manage scheme data and complete scheme accounts;</li> </ul>	
<p><b>An actuary</b></p> <ul style="list-style-type: none"> <li>to value the scheme</li> </ul>	
<p><b>An investment consultant</b></p> <ul style="list-style-type: none"> <li>to advise on the asset strategy</li> </ul>	
<p><b>A lawyer</b></p> <ul style="list-style-type: none"> <li>to advise on legal issues, responsibilities and obligations;</li> </ul>	
<p><b>An auditor</b></p> <ul style="list-style-type: none"> <li>to review the scheme accounts; and</li> </ul>	
<p><b>A covenant adviser</b></p> <ul style="list-style-type: none"> <li>to check on the financial viability of the sponsoring employer.</li> </ul>	

Inefficiencies occur with how the advisers interact and how data flows between them. It is complex, not well automated, and with a market in run-off, some stakeholders do not want to invest to make it more efficient.

The graphic below shows the operational system for a typical DB scheme. The process is fragmented with data moving between, on average, five different systems. This results in a lack of automation, overuse of spreadsheets, data manipulation off system and basic tasks performed by overqualified resources.



This operational inefficiency has built up over many years for the following reasons:

- **Lack of investment** - since moving from paper-based recording and calculations to electronic records and spreadsheets, administration systems have not been updated to embrace the fluidity of information sharing and automation. Instead, different systems and processes are bolted together. This has been exacerbated by consolidation in the adviser market, and the subsequent need to tie different systems together.
- **Complacency** – administration is seen as a “sticky” service that is difficult and expensive to move. Trustees and employers can therefore be discouraged from pushing for and looking for efficiencies.

The outcome is that there is now a huge variance in cost from one provider to another. Independent specialists, KGC Associates, run annual surveys of costs and services across the industry. In their most recent Administration Survey the basic administration cost for a 1,000 member scheme ranged from £22,000pa to £56,000pa with an average cost of £41,000pa.

“ We see a lot of variance in costs for what typically amounts to the same or a very similar service. Much of this can be attributed to providers’ operating models, their relative investment in technology and the efficiency of their processes. ”<sup>4</sup>

**Kim Gubler, Director KGC Associates**

This “old world” operating model needs to change to realise the potential cost savings.

## 5. What impact do these inefficiencies have on DB scheme running costs?

Spence has assessed the current running costs of the 3,010 DB schemes in the UK with between 100 and 9,999 members, and the level of savings that is possible by improving operating efficiency.

Schemes with under 100 members are excluded because the economics of automating at this size are less compelling, and because forthcoming regulatory developments mean these schemes should be able to access a public sector consolidator from 2026 onwards. Schemes with over 10,000 members are excluded because the UK’s largest schemes should have sufficient oversight and scale to capture some of the savings that the mass market hasn’t been able to capture to date.

The study focusses on administration, actuarial and investment costs (ongoing and project work) because these are the main areas where operational efficiencies yield savings. Schemes do have other running costs that are outside the scope of this analysis, including legal fees, trustee fees, covenant adviser fees, scheme audit fees, and in some cases the cost of in-house resource.

### THE DATA SET

Schemes <sup>1)</sup>	Band B	Band C	Band D	Overall
Size (number of members)	100 – 999	1,000 – 4,999	5,000 – 9,999	100 – 9,999
Number of schemes	2,190	667	153	3,010
Average number of members	347	2,259	7,052	1,112
Average scheme assets	£57m	£346m	£1,144m	£176m

1) Data source: PPF 2023 Purple Book

**ESTIMATED EXISTING RUNNING COSTS (AVERAGE PER SCHEME IN EACH BAND)**

The table below sets out Spence's estimate of the existing "old world" running costs for an average scheme in each band. The methodology underlying the estimate is explained below the table.

Annual Running Costs	Band B	Band C	Band D	Overall
Administration	£50,000	£150,000	£300,000	£85,000
Actuarial	£40,000	£100,000	£170,000	£60,000
Investment consulting	£35,000	£85,000	£140,000	£50,000
Projects	£60,000	£150,000	£300,000	£90,000
<b>Total</b>	<b>£185,000</b>	<b>£485,000</b>	<b>£910,000</b>	<b>£285,000</b>

1. Administration and actuarial fees are based on median levels for each scheme size from TPR's 2014 running cost analysis. Based on reported data from KGC's Administration and Actuarial Cost surveys, fees have remained fairly flat since then, so no inflationary uplift has been applied (i.e. operating cost increases assumed to be offset by savings from existing technology and automation developments).
2. Investment consulting fees are broadly 85% of actuarial fees, broadly representing market levels of fees.
3. Project work is set at 40-50% of ongoing fees, again broadly representative of market experience over the last 20 years. There is a current short term spike of project activity in relation to GMP equalisation, risk transfer and pensions dashboards, and so many schemes will currently experience higher costs (and therefore proportionately higher savings) than detailed in the table above).

**Independent check on these fee estimates**

Spence has separately reviewed the latest financial statements of 30 companies with pension schemes of around 1,000 members, and the median running costs for these schemes is £500,000 pa. Separate analysis by Spence of charity accounts for 30 charity sector DB schemes with average assets broadly equalling the overall average above of £176m show median running costs of £450,000 pa. Given the running costs in company accounts include PPF levies, and legal, covenant, auditor and trustee fees, Spence considers the above estimates of administration, actuarial and investment consulting fees to be consistent with median costs disclosed in company accounts.

These running costs have also been separately reviewed by KGC and Cosan Consulting, both of whom consider them as representative of current market fee levels.

*“ I don't think anyone involved in running pensions would challenge the findings. The way schemes are run is overdue an overhaul. There are some examples of good practice particularly in the UK's largest schemes, but truly slick tech led operations are rare. As well as the obvious implications on cost there is a big impact on risk. Where operations are using sub optimal models and poor IT architecture, risk will be increased, whether that is simply getting things wrong (i.e. paying the wrong benefits), reputational risk from delivering poor service or cyber risk. ”*

**Philip Dickinson, Director Cosan Consulting**

**THE COST OF THE INEFFICIENCIES (AVERAGE PER SCHEME IN EACH BAND)**

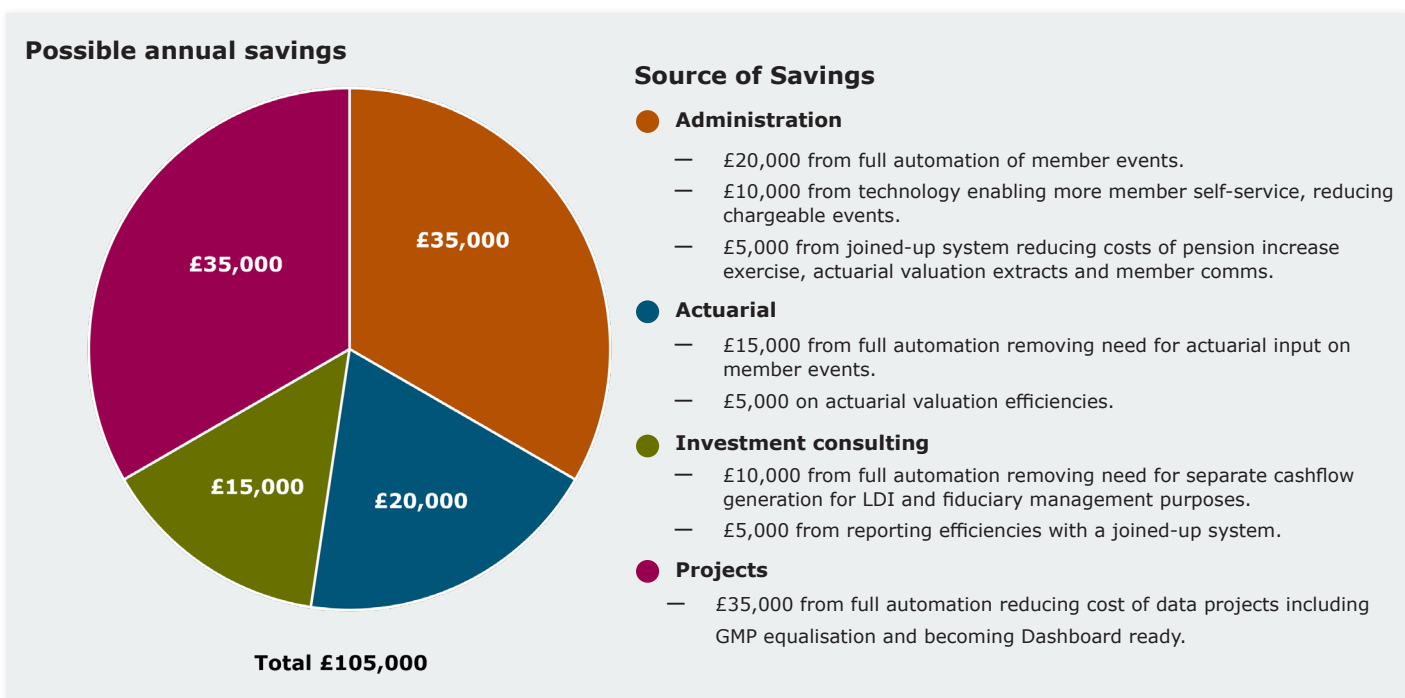
The table below shows the average cost of the inefficiencies, and therefore also the savings that might be possible for an average scheme in each band. An explanation of the inefficiencies and savings for an average scheme then follows.

Annual cost of inefficiencies	Band B	Band C	Band D	Overall
Administration	£25,000	£50,000	£100,000	£35,000
Actuarial	£15,000	£30,000	£50,000	£20,000
Investment consulting	£10,000	£20,000	£30,000	£15,000
Projects	£25,000	£60,000	£120,000	£35,000
<b>Total</b>	<b>£75,000</b>	<b>£160,000</b>	<b>£300,000</b>	<b>£105,000</b>

**6. What savings might be possible?**

The inefficiencies come from data sources not being joined up and a lack of automation. Savings therefore come from full automation and deploying a joined-up platform for core administration, actuarial and investment calculations. Improved funding levels and the increased professionalism of trustee boards also play their parts by reducing reliance on advisers. While some cost of moving from an old world to a new world operating model is inevitable, we expect that the payback period from the subsequent cost savings is under a year.

The chart below gives more detail on the possible savings for an average scheme.



**Deploying these efficiencies across all 3,010 schemes in this analysis could drive up to £300m pa of savings across UK DB schemes.**



## 7. What solutions are available for accessing these savings?

The good news is there are already a range of “new world” operating models available in the market, as set out in the table below. Most of these have had significant investment, use technology effectively, and in some cases rely on just one system to manage all data flows. These solutions just need to be adopted by more schemes to fully access the savings. With improved funding levels, maturing of schemes and the increasing professionalism of trustee boards, we expect it’s inevitable that more schemes will adopt these models. But, schemes should move quicker than they are at the moment to maximise the savings and benefits.

Option	Description	Pros	Cons	Commonly used by
Bundled services	Use a single provider for multiple services.	Cost savings (particularly joining admin and actuarial)	Lose breadth of view. Reliance on one service provider.	Smaller schemes typically less than £300m in assets
Sole professional trustee	Replace board of 3+ trustees with a professional sole trustee	Quicker decision making. Access to service provider panels.	Loss of scheme knowledge. Not necessarily any optimisation of operational systems.	More mature schemes, transactions (corporate and risk transfer)
Multi-trust solutions	Standardised platform run across a book of schemes by an advisory or trustee firm	Cost and governance savings. No loss of control.	Standardisation cannot accommodate bespoke solutions.	Smaller schemes typically less than £300m in assets
DB mastertrusts	Multiple schemes operated under single trust	Cost savings from economies of scale. Outsources all governance.	Perceived loss of control for sponsor. Standardisation cannot accommodate bespoke solutions.	Smaller schemes, corporate transactions

## 8. Top tips for trustees and sponsors

Here’s seven top tips for trustees and sponsors to assess the scope for operational efficiency in their DB scheme:

1. **Review data exchanges** between your advisers and the costs involved. There are “new world” ways to transfer and securely share data electronically to save time, cost and reduce operational risk.
2. **Assess the risks in multiple data flows**, such as GDPR and cyber risk.
3. **Check the right people at the right level are doing the work.** Are actuaries carrying out basic data cleansing tasks? Check sign-off procedures (for example on member transfers) to ensure multiple layers of checking are adding value and controlling risk, not just adding cost.
4. **Calculate the payback period on automation.** Investment to build automation in the short term will yield savings over the long term. The benefits in effort and accuracy are worth it.
5. **Consider bundling services with a single provider.** Does having multiple advisers, opinions and operating models help, particularly as funding levels improve, debates around contribution levels fall away, and trustee boards professionalise?
6. **Consider multi-trust solutions to take advantage of economies of scale.** There are a range of purpose-built multi-trust solutions available that yield immediate savings.
7. **Get an independent expert view on your operations.** Are you operating best practice? Are the fees you are paying appropriate and value for money?

# SPENCE

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## **Belfast**

Linen Loft  
27-37 Adelaide Street  
Belfast BT2 8FE  
T: +44 (0)28 9041 2000

## **Bristol**

Spaces Castle Park  
Programme Building  
Bristol BS1 2NB  
T: +44 (0)117 959 5002

## **Glasgow**

The Culzean Building  
36 Renfield Street  
Glasgow G2 1LU  
T: +44 (0)141 331 1004

## **London**

46 New Broad Street  
London  
EC2M 1JH  
T: +44 (0)20 7495 5505

## **Manchester**

St James Tower  
7 Charlotte Street  
Manchester M1 4DZ  
T: +44 (0)161 641 6312

## **Birmingham**

Edmund House  
12-22 Newhall Street  
Birmingham B3 3AS  
T: +44 (0)121 389 2314

## **Leeds**

Princes Exchange  
Princes Square, Leeds  
West Yorkshire LS1 4HY  
T: +44 (0)113 426 4487

[spenceandpartners.co.uk](http://spenceandpartners.co.uk)