DB end game alternatives: Capital-backed journey plans

Laura Blows explores what capital-backed journey plans are and the role they could play within DB schemes' end game strategies

Summary

- A capital-backed journey plan (CBJP) is a generic term for a range of products that give pension schemes access to external capital to help them meet their funding and investment objectives using an agreed investment strategy and timeframe.
- CBJPs can provide many benefits, including the increased certainty of reaching the end objective, greater funding stability and 'promised' higher returns.
- However, in return for access to the provider's capital, the scheme must give away upside in investment returns. Also, the timeframes of some CBJPs may be longer than schemes would look to target.

As DB scheme funding has become more dynamic in recent years, so too has the journey to their endgame destinations, with an increasing number of options available to help DB schemes de-risk *[see boxout]*.

One new addition is capital-backed journey plans (CBJPs), also known as underwritten journey plans.

CBJPs

A CBJP is a generic term for a range of products that give pension schemes access to external capital to help them meet their funding and investment objectives, such as becoming 100 per cent funded or targeting buyout. An investment strategy and a timeframe to meet that goal is then agreed between the scheme and third-party provider.

"The provider will put up its own capital to increase the chance that the scheme reaches the agreed objective, with the capital providing protection against under-performance against the plan. In return the provider will retain any upside from generating asset returns above those needed to deliver the plan," Aon partner, Colin Cartwright, explains.

There are a wide variety of capital buffers that can be offered, including "physical assets that are held alongside the pension scheme assets in a lockbox structure, which the scheme has a first call over, so they can't go back to the provider until they have delivered what was promised. In other cases, I've seen them be guarantees or a mixture of both", PwC head of alternative pension solutions, Matt Cooper, states.

"A key feature of CBJPs is, unlike superfunds, they don't change sponsor covenants, so that the employer stays connected to the pension scheme. You also keep the existing trustee, so it's really an investment decision," he adds.

"Most of these deals are typically structured as a commercial contract and so are not regulated by the PRA or covered by the FSCS, but a small number of providers can offer these as an insurance contact," Hymans Robertson head of alternative risk transfer, Iain Pearce, adds.

There are currently eight providers who will quote on CBJPs, Cooper says, "and if you go back maybe 18 months or two years, there was just one provider in this market". The first entrants were private equity firms and now includes large fund houses and asset managers entering the market, he adds.

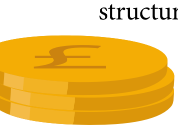
According to Hymans Robertson's May 2022 report, *A closer look at capital backed journey plans,* there are several providers who have a CBJP offering and are either actively promoting them or quietly targeting specific schemes where a CBJP could help. To support these endeavours, there is over a £1 billion of committed capital from investors looking to build and grow this market, it states.

CBJPs present an opportunity for capital providers to invest in the rapidly growing DB de-risking market without requiring that investor to establish an insurer, which is a long and costly process, and so can be an attractive option for new entrants, Pearce notes.

On the trustee side, "experiences such as the stress in the LDI markets around the time of the mini-Budget demonstrate the enduring risks facing schemes and so, if anything, should increase trustee interest in seeking out opportunities to de-risk if able", he adds.

Suitability

According to 2020 Trustees trustee director, Duncan Willsher: "The beauty of a CBJP is that they are suitable for a wide range of schemes, and because of the bespoke nature of them, using different variables such as time, security, end goal and whether the sponsor pays a premium or not, they can be structured



to help schemes wherever they are in their journey plan."

However, Cartwright believes CBJPs are most appropriate for DB schemes that have strong sponsors who are relatively small compared to the pension scheme and so may be constrained in their ability to pay the required level of contributions.

"The sponsor needs to be strong as these products are not covered by The Pensions Regulator's DB superfunds guidance and so are not typically viable if the sponsor becomes insolvent," he explains.

Cooper predicts that a scheme would need to be "at least £50 million, maybe even over £100 million of assets before a provider would quote at the moment".

"It is likely that it will take a number of transactions to build understanding and confidence in these products but then we could well see CBJPs carving out a role within the industry"

Case study

The first capital-backed journey plan (CBJP) by a UK pension scheme was completed in May 2020.

The structure of this CBJP saw capital 'locked in' alongside scheme assets, allowing scheme members to benefit from an additional layer of security in addition to the existing sponsor covenant.

A future date for the buyout of benefits was also agreed at the outset, with the assets then invested to target the cost of buyout at the agreed date and provide a suitable return on capital.

This allows the unnamed scheme to draw down cash as needed to pay benefits until the buyout is achieved, with interest rate and inflation related risks hedged out in full during the period.

The new structure is expected to allow sponsors to give 'undivided attention' to their business, while trustees are able to deliver 'enhanced security for member benefits' thanks to the external capital.

The transaction was led by Aspinall Capital Partners on behalf of Portunes Capital, which was the investment vehicle for the transaction.

Both firms were advised throughout the process by PwC, in addition to Travers Smith for corporate and financial aspects of the transaction.

Commenting on the deal at the time, 2020 Trustees founder and chair of the scheme, Antony Miller, said: "Alongside the consolidation vehicles, the capital-backed journey plan answers the government call for pensions innovation and provides the market with a real solution that is sorely needed, especially in the current climate.

"It also shows that these types of capital-backed structures can be implemented quickly and at relatively low cost."

Considerations

For those schemes that do implement a CBJP, there are many benefits they may receive, including the access to capital other than from the sponsor, the flexibility of both the CBJP design and of the trustees still managing the scheme, the greater certainty of reaching the end objective and the cheaper cost of doing so. There is also greater funding stability and 'promised' higher returns, along with the potential to run higher investment risk and so reduce the time to reach a long-term target.

It is not all positive though; CBJPs do also come with some potential downsides.

Cartwright notes that the timeframes of some of these products may be longer than the trustees and sponsor would look to target. Plus, in return for access to the provider's capital, the scheme must give away upside in investment returns. On the flip side, if losses against the agreed plan are too large, they could exhaust all the provider's capital.

These products typically work best in a stable funding environment rather than one where solvency funding is improving quickly, he adds, and there is a question if these products will deliver their wider aims in a lower leveraged LDI environment, or whether the supporting business model may need revising.

It is important schemes consider

whether the size of the capital buffer is adequate for the downside funding risk that may being run, "because when you have a third party promising a level of return to the pension scheme, you've got to assess that counterparty risk, as you would do whenever you enter into other assets", Cooper says.

"CBJPs do bring extra complexity, extra monitoring requirements, and some pension schemes may not need the extra complexity, especially if they have got a super-strong covenant and are happy to carry on with their current model," he adds.

According to Willsher: "CBJPs are complex legal agreements and the way the assets are managed can be complex too. The worry of having to get the deal right first time, can also be concerning for trustees and sponsors."

Delays

Could this be the reason why, despite the opportunities a CBJP could provide, there has only been one deal announced so far, back in 2020? *[see boxout].*

"Certainly plenty *[of schemes]* have looked at it, but some of those who were looking have found they have accelerated towards their end game over the course of the recent yield rises, and so have had to restructure or call off the deal. Additionally, as more solutions have come to market, or have been close to market, trustees and sponsors have been keen to see what the other options are," Willsher says.

Pearce also notes that the market is clearly still immature.

"Each provider has developed their own version of CBJPs and so each market offering is not directly comparable. This can mean that it can be quite challenging to understand the range of options and get to a position where trustees are comfortable entering into a multi-year CBJP," he explains.

"The pensions industry does take time to embrace new innovation, and this is new," Cooper states. "The transactions are complex. They're not something that trustees are familiar with. They'll need a lot of due diligence on the provider, a lot of expertise, professional advice, and that's expensive to do."

Role

Despite the lack of deals announced, CBJPs are expected to have a role to play within the DB de-risking sector.

Cooper does not expect CBJPs to become as big as the bulk annuity, with its approx £50 billion of transactions a year, "but over time, it could become a reasonable, not insignificant part of the risk transfer market".

However, CBJPs are not competing with buy-ins and are very much a complementary option for pension schemes, Pearce notes.

He adds: "It is likely that it will take a number of transactions to build understanding and confidence in these products but then we could well see CBJPs carving out a role within the industry."

Written by Laura Blows

The range of DB pension risk transfer solutions

Capital Backed Investment Products - Additional capital provided by third party to support investment risk during journey to full buyout. Capital can be provided directly, or in alternative form eg surety bond

Longevity Swap - Asset owned by the pension scheme which insures longevity risk for a proportion of liabilities (typically pensioners). Longevity risk is typically transferred to reinsurance market

L&G Structured Products
- Insured Self Sufficiency (ISS) -L&G provide investment management and additional security to support long term run-off (or potentially ultimate buyout), but without full protection against extreme downside outcomes
- Assured Payment Policy (APP) - A buy-in style insurance policy based on expected, not actual, cashflows which insures investment-related risk, but not longevity risk Includes the potential to convert the policy to a buy-in in the future

Superfunds - *Full risk transfer for sponsor and trustee, covering all scheme liabilities but with lower capital protection than buyout*
- Clara Pensions- 'Bridge to buyout' model – scheme held as segregated section within 'superfund' until later buyout
- The Pension Superfund – 'Run-off' model – scheme added to consolidated 'superfund' targeting long-term run-off. One-way profit-sharing model could enable uplifts to member benefits

(Partial) Buy-In - Bulk annuity held as a scheme asset which matches a subset of liabilities (often pensioners)

Captive Buy-In - As per buy-in, trustee receives bulk annuity from regulated insurer but insurer reinsures policy to sponsor-owned captive insurance vehicle. Insured risk transfer for trustee while sponsor retains upside

Buyout - Fully insured solution for liabilities of all scheme members. Full risk transfer for sponsor and trustee. Often considered 'gold standard'

Source: The range of DB pension risk transfer solutions, Mercer, September 2021