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Alternative De-Risking – do you understand the options?

On 6th November, Clara Pensions announced the first UK commercial superfund deal worth £590m, enhancing benefit security for c10,000 members who were formerly members of the Sears Retail Pension Scheme.

This represents a significant step in an area of the pensions industry where innovation has proved historically tricky and buyout has traditionally been seen as the gold standard. Given this news, it's a good time to look at the steps that have led up to this point and what alternative solutions to buyout, pension schemes have.

Timeline to the first superfund deal

2018

- Clara Pensions and The Pension SuperFund launch
- DWP White Paper on "protecting defined benefit pension schemes"
- DWP consultation on "consolidation of defined benefit pension schemes"
- TPR's first Defined Benefit (DB) superfund guidance

2020

- TPR's amended DB superfund guidance

2021

- Clara Pensions is the first provider on TPR's list of assessed DB Superfunds

2023

- Mansion House speech including reforms of the UK pension market
- DWP consultation response on "consolidation of defined benefit pension schemes"
- TPR latest DB superfunds guidance
- The Pension SuperFund withdraws from the market
- Clara Pensions completes its first transaction

What other alternative risk transfer solutions are available?

As has been well publicised, the buyout market has seen historically high levels of activity with 2023 set to be a record year. However, many schemes can't afford buyout currently and are seeking extra security for members, given the challenges many sponsors are facing.

Consolidation is not a new idea but has proved difficult for private-sector DB schemes in the UK. However, with recent government impetus, the consolidation movement is growing and now with Clara's first transaction announced, more schemes could follow. Clara takes on the liabilities of the scheme, severing the link to the sponsor, for around 90% - 95% of the price of buyout. The assets from each scheme are ringfenced and all member benefits are subsequently paid to members from the Clara Pension Scheme, supported by third-party capital. Clara also has an option to buyout the scheme further down the line. Consolidators do still face challenges (e.g. severing the link to the sponsor is a significant step and consolidators are not backed by the insurance regime and hence can be viewed as less secure) but there are circumstances where this will be the right approach for members.

There is also innovation in the capital-backed journey plan (CBJP) space with many high-profile asset managers offering solutions. Most CBJPs underwrite a target investment return or a funding target like gilts flat or buyout and provide the scheme with additional capital. The CBJP provider would take charge of the investment strategy, but the day-to-day running of the scheme and payment of benefits would remain with the trustees. To date, two CBJPs have claimed transactions, although TPR notes no CBJP assessments have been completed.

These alternatives focus on schemes that can't afford buyout, but there are also options for schemes at the other end, that are very well funded on a buyout basis and may not want to cede extra capital to insurers, and instead run the scheme on with added protections and provide discretionary benefits to members.

Should you consider alternatives?

Whilst buy-in or buyout may be the right answer for many schemes, it may not be the right solution for your scheme at this time. It is helpful to understand the suite of alternative solutions, to consider whether a different approach can more successfully balance the objectives of sponsors, trustees and members.

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Third-party ESG rating divergence and the need for fundamental analysis

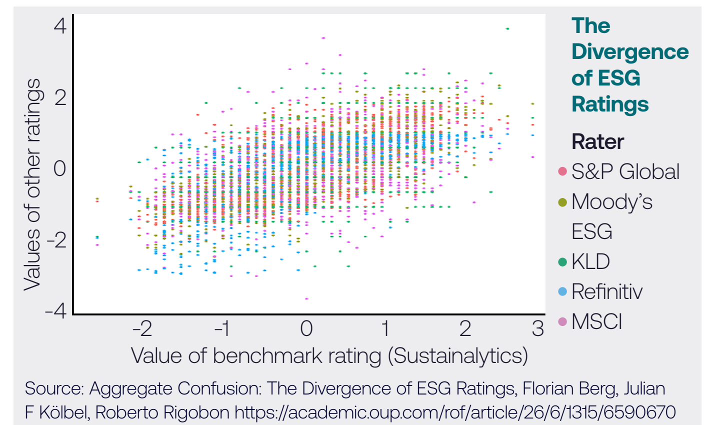
As trustees continue to increase their focus on Environmental, Social and Governance (ESG) risks to their sponsor and their assets, it is becoming increasingly clear that ESG ratings do not all work to the same basis. The significant divergence in rating outcomes has been made clear across a number of academic articles (see chart opposite).

This level of divergence might be expected when the precise meaning of a 'good' ESG outlook can be far from clear and when rating methodologies have not had time to move towards a consensus approach (unlike the generally consistent methodologies used in credit ratings). However, the risk is that these divergent outcomes may ultimately discourage trustees from assessing ESG completely - which we believe is far from the message that trustees should take away!

Not only are ESG factors an increasingly clear source of risk for DB scheme sponsors, regulatory pressure is rising for trustees to understand these risks and accurately report them (The Pension Regulator's regulations for climate-related disclosures). Trustees must be able to, therefore, understand ESG risks and integrate that understanding into their covenant assessment and strategic planning.

High-level, black-box and comparative-rating strategies will not allow trustees to meet these aims. However, by undertaking a fundamentals-based assessment of their sponsor, with clear definitions of how ESG risk is being classified and using data sources that can be easily reviewed, trustees will be in a stronger position to understand risks and take relevant actions to protect members' benefits.

This is an approach that will be familiar to trustees who have for many years understood that credit ratings and company provided information should always be interrogated if a true picture of the employer covenant is to be developed - now, trustees need to turn that same approach to a 'new' area of risk.



Source: Aggregate Confusion: The Divergence of ESG Ratings, Florian Berg, Julian F Kölbel, Roberto Rigobon https://academic.oup.com/rof/article/26/6/1315/6590670

Ask the Analyst: What we have upcoming in 2024

As the macroeconomic environment continues to evolve, with inflation reducing but remaining "sticky", the Bank of England has indicated that interest rates are likely to remain at current levels for longer than previously expected. As a result of this ongoing squeeze on corporate finances, we are anticipating an increase in restructuring and refinancing activity from corporate sponsors. Trustees will be seeking to appropriately manage and mitigate the impact of these pressures on covenant strength, and we may see an increase in contingency planning workshops and event driven advice as a result.

The regulatory landscape is ever-shifting, and trustees will need to proactively consider the covenant implications of a number of key events. These might include the new DB Pension Regulations, an upcoming general election, developing geopolitical events and wider ESG requirements. We will be closely monitoring these changes with a view to supporting trustees through uncertain times.

Finally, as gilt yields have risen many DB pension schemes have seen substantial improvements in funding. Trustees are now (in many cases unexpectedly) in a position to consider endgame solutions. As such, our Risk Solutions specialists are preparing for another year of high levels of activity in the endgame solutions market.

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Regulatory developments: Autumn Statement 2023

The Chancellor, in his Autumn Statement, restated the Government's commitment to the pension fund reforms he set out earlier in the year in his Mansion House speech, in addition to restating plans to drive pension scheme investment in the UK economy. He also set out ambitious plans to consolidate Local Government Pension Schemes (LGPS) by 2025, but stopped short of setting out plans to consolidate DB schemes.

He did, however, announce plans to 'open the Pension Protection Fund (PPF) as an investment vehicle for smaller DB schemes', which would extend the PPF's current mandate as a lifeboat fund. The proposal seeks to address the challenges faced by small DB schemes around disproportionately high scheme management costs and lack of access to the same investment options as larger DB schemes.

To align with corporation tax, the tax rate on refunds of surpluses to employers will reduce from 35% to 25%, effective from 6 April 2024. Alongside this, the Government will undertake consultations to consider changes to the rules around when scheme surpluses can be repaid to sponsors. This change would be welcome news for employers and could open the endgame option to run-on, rather than buying out, to more schemes – but this is all subject to any potential changes to rules around surpluses as well as the key focus of maintaining the security of members' accrued benefits.

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