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# A closer look at capital backed journey plans

## Exploring the alternative risk transfer market

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The next in our series of publications  shedding further light on the alternative risk transfer market is focussed on capital backed journey plans (“CBJP”s), which are now being offered by a range of providers (although only one transaction is in the public domain).

CBJPs are a commercial contract where a capital provider provides external loss absorbing capital to support the delivery of a promised return or outcome (e.g. fully funded on a specified measure or able to afford a buy-in) at the end of an agreed period (anything from around 5 to 25 years).  CBJPs therefore have the chance to increase member security and could help reach the target outcome sooner than would otherwise be the case. They can reduce reliance on the sponsor as well as accelerate the timeframe to buy-out.

These solutions are designed to operate for the agreed journey plan and not end early. They are therefore most relevant for schemes that are confident in the strength of the sponsor covenant over this period and do not have a material concern of sponsor insolvency part way through the journey plan. It is also possible that some of these solutions are structured to be “insolvency remote” and so seek to continue beyond the point of sponsor insolvency.

Within this paper we shine a light on how these operate by looking at:

1. What is a capital backed journey plan and how do they work?
2. How do the capital providers achieve a return?
3. Recommended decision-making framework
4. Due diligence process for CBJPs
5. How to assess capital adequacy
6. When CBJPs can be particularly attractive

There are a number of 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 £billion of committed capital from investors looking to build and grow this market.

The most commonly discussed CBJP products are the Aspinall vehicle, Portunes Capital Limited, that entered into the first CBJP transaction in April 2020 and the Pensions Safeguarding Solution (“PSS”). Very broadly:

- Aspinall agree to provide a set amount of capital for a period of 5-7 years and are only able to withdraw capital (and any profits) if they have delivered on the promised return or objective at the end of the journey.
- PSS target a longer timescale of around 10-15 with lower target returns and a capital buffer that can reduce over time if the scheme is on track (or ahead of schedule) of the objective and is intended to be structured to be “insolvency remote”.

In addition to these two, there are other parties across the investment and insurance market that are exploring providing their own CBJP solutions. These parties view CBJP solutions as an attractive investment opportunity and also a pipeline for future insurance business.

CBJPs therefore have the potential to grow into another option to support schemes in reaching their ultimate endgame.

If you would like us to take a ‘closer look’ at your own situation or learn more about CBJPs, please get in touch.

[1] Our **A closer look at Clara-Pensions 2022** is available at this link and on our website.

# 1. What is a CBJP?

**Trustee perspective**
The chart below provides an overview of a CBJP from a trustee perspective.

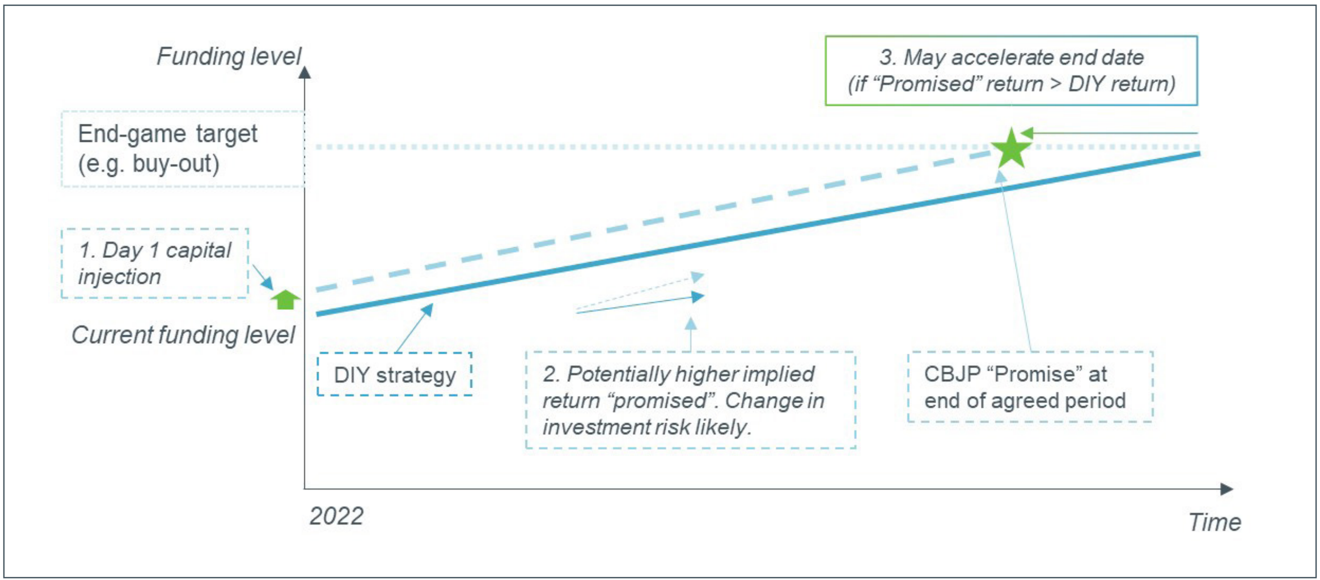
A capital backed journey plan provides trustees with access to additional capital for the duration of the journey. This reduces reliance on the sponsor to fund losses (see 1. in the chart below).

The capital provider also promises a return on the scheme's assets to achieve the agreed outcome at the end of the plan. If the promised return doesn't materialise, the capital is used to make up the difference.
If losses erode the capital put in at the start of the journey, then the provider has the option to, but is not required to, provide additional capital.

The investment return implied by the promised outcome might even exceed the scheme's current investment target (2.). In these situations, the impact of the CBJP would be to achieve the target outcome earlier, as well as providing capital to support risks on the way (3.).

**Impact on investment strategy**
As the capital provider is underwriting the returns on the assets it has an active interest in how they are invested and managed. Providers will expect trustees to adopt new investment management guidelines that have been agreed in advance between the trustees and the provider – these guidelines capture the commercial agreement to allow the provider to influence the investment strategy to meet the objective and generate a return on capital for the capital provider (the provider perspective is considered in more detail in section 2).

You could therefore think of a CBJP as being a bit like fiduciary investment management, but with additional capital underwriting investment returns and with layers of agreed controls and protections for how the assets can be invested.



Trustee rights and responsibilities to manage the assets will not change. However, there will be a strong commercial incentive for the trustees to invest in line with the guidelines over the period covered by the CBJP. Put simply, it is likely that the trustees will be required to make a significant payment if it chooses to terminate the CBJP early or deviates from the agreed guidelines.

Depending on the provider, it is also possible that the scheme's assets will be wrapped within a special purpose vehicle. This vehicle is primarily designed to support the governance framework for the assets and enable the capital provider to access returns if the agreed journey plan outcome is achieved.

**Regulation**

The decision to transact is primarily viewed as a trustee investment decision. As with any investment decision, trustees are required to get appropriate advice. Given the complexities and long-term nature of these transactions, this advice process will require extensive due diligence (see section 3 for further insights into this advice process).

CBJP transactions are generally not insurance instruments, nor are they transfers to a superfund. They are therefore not regulated by the PRA or subject to the interim superfund guidance. That said, the Pensions Regulator is monitoring the development of the CBJP market and expects schemes to discuss plans with them in advance of any transactions. Insurer regulation and the interim superfund guidance will still be helpful when considering due diligence on a CBJP solution, such as how risks and capital adequacy are measured, the impact on member outcomes and how the timescales to full buy-out should influence decision making.

# 2. Why are capital providers offering CBJPs?

The chart below provides another overview of a CBJP, but this time from the perspective of the capital provider.

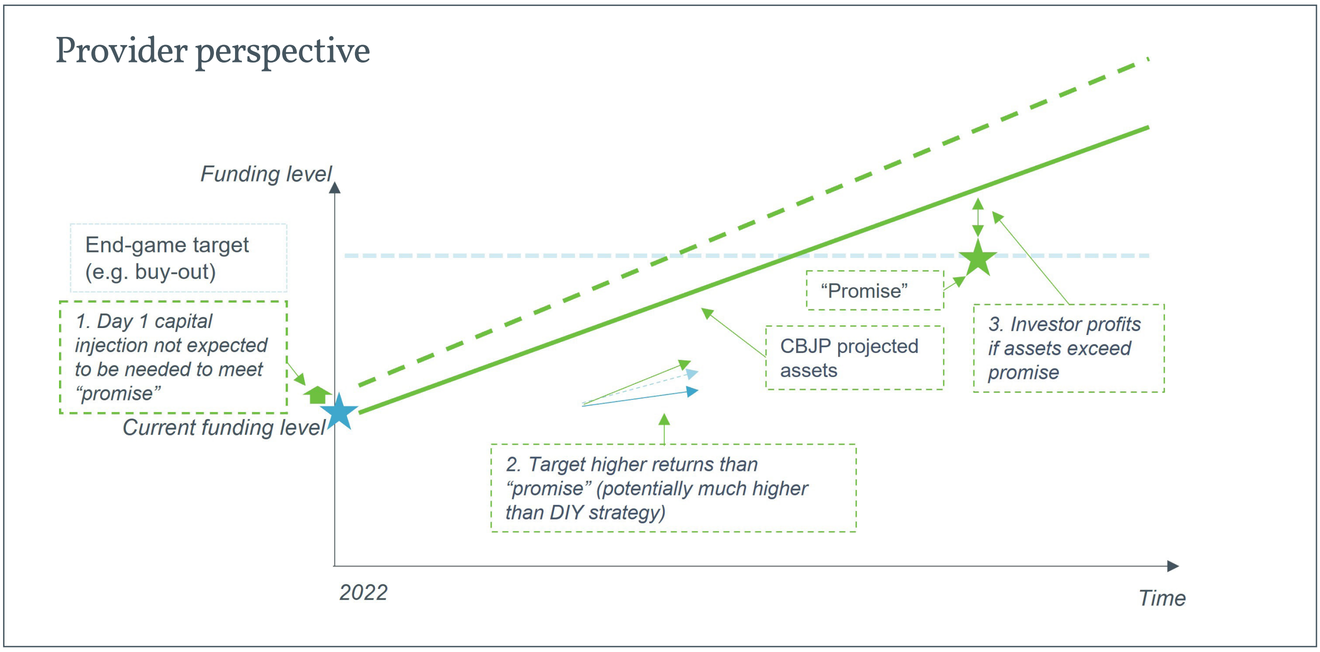
**Provider perspective**
The capital backed journey plan provider is seeking to profit from the arrangement. If all goes to plan, the expectation is that the loss absorbing capital is not required (see 1. on the chart below). The capital provider seeks to generate profits by investing in a way that means the scheme's assets will generate a higher return than necessary to meet the "promise" (2.) and so the assets will exceed the target at the end of the journey plan (3.), with the excess given to the capital provider.

**Business model**
As set out above, the capital provider is seeking to make money by investing the scheme's assets in higher returning portfolio than necessary to generate the "promised" return to the scheme and then taking the excess as their profit. They will profit if the assets exceed the promise at the end of the journey plan, after taking account of their cost of providing the capital and other costs and expenses associated with the CBJP. (This has many parallels with the objectives of shareholders of an insurer – they too look to profit by investing the premium received in assets that have a higher expected yield than implied by the pricing they offer.)

The level of profits for the capital provider are associated with the returns on the assets, the strength of the promise, and the level of capital and expenses.

**Why are investors keen on the CBJP market?**
There are many reasons why CBJPs are be seen as an attractive opportunity by a range of investors as, unlike the insurance market they are not regulated by the PRA. This means the market has a much lower barrier to entry, compared to establishing a regulated UK insurer.

The 5-10 year investment timescales, along with a clear exit strategy will also be attractive for venture capital and other investors acting as capital providers.



# 3. CBJP decision framework

CBJP plans have many attractive features and can provide schemes with an alternative lower risk path to their long-term objective. However, there are some clear challenges.

**Arguments supporting CBJP**

- Higher target returns "promised", with risks backed by external capital
- Can cover other risks (longevity, member options take up, insurer pricing)
- Potential for greater funding level stability (depending on how valued)
- No expected detrimental accounting treatment

**Arguments against CBJP**

- Risk reduction limited to level of external capital provided
- Reduced exposure to upside and loss of optionality
- Limited track record without established commercial terms
- Implementation costs and execution risk elevated for first transactions

Given the complexities and long-term nature of these transactions, trustees will want to go through an extensive due diligence process to make sure they fully understand the implications of the transaction. It is important that this due diligence process is carried out in a cost-effective way – only incurring costs in analysing the next layer of detail if the solution has sufficiently demonstrated benefit to the scheme.

With this in mind, we have set out below our process to consider the merit of these structures. But before doing so have noted why assessing a CBJP can be particularly challenging during the infancy of the market with a range of structures and also why some of the usually comforting factors that apply to bulk annuity transactions are not relevant in this market at the moment.

**Existing comforts from buy-in selection processes ....**
Trustees generally have an expectation and high degree of confidence that buy-in processes will result in a suitable contract with a fair price and reasonable commercials terms for a range of reasons, including:

- PRA oversight and the Solvency II regulatory regime are typically considered to be a robust framework to ensure insurers are well capitalised and governed.
- Experienced advisors have a strong understanding of expected market pricing and the range of commercial terms available within the market .
- Competitive tension between a wide range of insurers suggests that profit margins are not excessive.
- Mature market has led to extensively negotiated contractual terms that have converged in many areas and are generally viewed as reasonable and acceptable.
- Strong working knowledge among trustees (in particular professional trustees), consultants and lawyers on processes to select a provider and meet ongoing contractual requirements.

**... in contrast to assessing a CBJP**
None of the bullets set out above apply to the CBJP assessments at this time. Some of these points will become more applicable in the future as the market evolves. As with any new alternative risk transfer structure, trustees and sponsors will wish to undertake extensive due diligence to understand these solutions and to ensure terms are reasonable and competitive. These will require specialist advisors and may have significant associated costs, depending on how the key questions are tackled. CBJP providers will undoubtedly look to increase execution certainty by engaging in serious discussions with a relatively small number of target schemes, particularly as they grow to scale. However, trustees may wish to consider the range of different options available in the market to consider which is best for them, or at the very least satisfy themselves that working with only one provider is in line with their trustee duties.

Whilst there are some challenges, it is also worth noting however that there are a lot of highly motivated providers and so the first schemes to enter into these transactions may well secure terms and pricing that is not available at a future date. The early mover benefits from being among the first to transact could more than compensate for the associated challenges.

## Suggested decision framework

The table below sets out a cost efficient process to work through when deciding whether to enter into a CBJP before moving onto the implementation stage.

We have included an indicative timescales for this process, which may depend on the provider and could be significantly accelerated if required.

### 1. Feasibility study

(3 months)

- Clarity on target endgame and existing plan to get there
- Confirm structure appears to be preferable to existing strategy
- Impact on CBJP on key measures if key requirements could be met
- Identify key risks/red flags

Yes/no decision to proceed to consider providers

### 2. Validation

(3 months)

- Overview of key commercial differences between solutions (capital, investment risk, "promise", operational and commercial). Consider relative attractiveness and any challenges for each structure.
- Consider future evolution of market and potential for new entrants given long term nature of contract
- Engage with preferred provider(s) for high level indicative pricing and negotiation on "heads of terms" for a transaction
- Agree preferred solution(s)

Yes/no decision to proceed to detailed due diligence

### 3. Detailed due diligence

(6 months)

- Detailed review of proposition for preferred solution(s)
- Negotiate governing documentation
- Obtain "transactable" offer
- Advice on whether terms are deemed to be commercially fair and reasonable

Yes/no decision to proceed based on findings of detailed due diligence

### 4. Selection decision

(3 months)

- Review findings of due diligence against agreed objectives
- Final advice on all key aspects of the transaction
- Agree changes to governance/ operational requirements post signing to monitor and manage CBJP

Final decision to implement transaction

# 4. Due diligence

As stated above, trustees will need to conduct detailed due diligence to build their understanding of how the CBJP works and the consequences for how the scheme will operate and how the commercial consequences of deviating from the agreed framework may shape decision making.

We do not seek to cover all relevant areas within this paper but have highlighted some key issues that we expect will receive specific attention.

## Key commercial points

Feasibility studies and the subsequent due diligence should provide a full overview to support decision making. This will include:

1. **Structure of the capital buffer,** to confirm the enforceability of any claims along with any rights to allow the provider to reduce the size of the buffer if the journey plan progress as expected. Trustees will want to be satisfied that the buffer will provide the additional security promised, and may also want to form a view of the capital adequacy in stressed scenarios.

2. **Investment strategy.** Both parties will negotiate a set of investment guidelines for the assets during the period of the CBJP. As well as considering the target investment strategy, trustees should also consider the upper limit of investment risk that is possible within the CBJP and the process for agreeing any amendments to the guidelines.

3. **How the "promise" is defined,** the risks that are covered or excluded and any exclusions or carve outs for when this promise is not delivered. For example, it may be reasonable to agree to limitations for extreme market events (e.g. an insurance promise may require a minimum number of active insurers in the market, with an alternative promise at the end of the journey plan if that condition is not met).

4. **Governance arrangements,** rights for the capital provider and reporting requirements and valuation processes (in particular for illiquid assets or direct lending).

5. **Early termination rights for either party and any payments due,** with specific focus on scenarios where the termination is due to factors outside of either parties control. For example, outcome on sponsor insolvency and PPF assessment is likely to be of specific interest. Trustees may be keen to ensure that terms of any contracts do not further impede their ability to pay as close to full benefits as possible.

## Particular focus on early termination events

In order to generate the target level of returns the CBJP will involve transitioning the existing portfolio to a new benchmark which will incur transaction costs. Transaction costs and timescales to transition to the new portfolio can impact the ability to deliver the target return in the early years. The portfolio as a whole will not be expected to exceed the promised return until towards the end of the agreed period.

Early termination is therefore an area where there is specific tension between both parties as the assets may not be sufficient to meet the promise and, the anticipated returns may not have materialised yet. It is likely that the scheme would be penalised for voluntary early termination with the capital provider seeking to protect it's expected profit margins. However, a more balanced position may be possible for involuntary early termination. Here both parties are expected to pay particular attention to the outcomes in the case of sponsor insolvency where it may be necessary to terminate the CBJP and use the assets to insure members the highest pensions possible.

This due diligence is likely to require actuarial, legal and potentially covenant advice.

# 5. Assessing capital adequacy

## Assessing the adequacy of additional capital

As stated above, the "price" for a capital backed journey plan is the aggregate of the amount of capital, investment guidelines and "promise" offered by the CBJP. In addition to ensuring that this package is commercially reasonable in aggregate, schemes may wish to focus on the extent to which the capital provides support to the scheme over and above the extent that might be required to support the associated increase in investment risk.

## Impact on investment risk

The agreed investment guidelines will provide an indication of the impact on investment risk, and whether a CBJP is expected to lead to an increase in risk facing the scheme. The charts below illustrate how a CBJP could impact an investment portfolio.

**Low risk DIY**

**CBJP portfolio**


## Amount of capital

The size of the capital buffer required from the capital provider will be set out in the contracts. Schemes will wish to review how this buffer will be provided and receive appropriate legal advice to ensure that the trustees are able to access this capital if the agreed triggers for doing so have been met.

Trustees will also wish to ensure that the assets that can be provided for this buffer are reasonable and the range of potential assets is taken into account in the overall assessment of the solution. For example, if illiquid assets are provided as capital should a haircut be applied to estimate transaction costs? If volatile assets are provided, is it appropriate to use a stressed valuation when assessing capital adequacy?

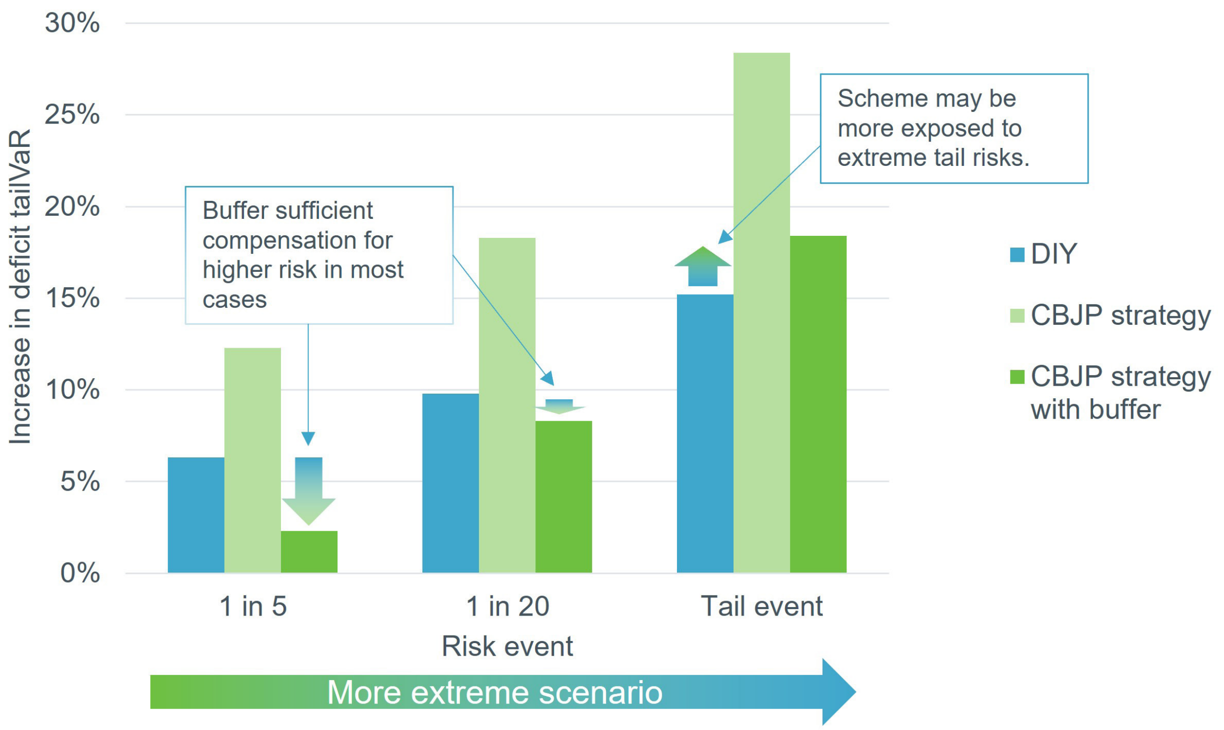
## Assessing the adequacy of capital

Increased levels of investment risk will mean that the potential losses following a risk event are likely to be greater. To illustrate how this capital adequacy can be tested, below we have considered the adequacy of a buffer for a range of increasingly extreme risk events for a given investment strategy.

The chart shows the risk for the notional "DIY" strategy, the risk for an illustrative CBJP investment strategy (before considering the impact of capital), and the CBJP risk after allowing for the capital.

As shown in the chart, the impact of the CBJP is a lower overall risk exposure for the scheme for most risk events, but with the scheme potentially exposed to a higher degree of risk for the most extreme "tail risks". Therefore, for the CBJP illustrated here, the CBJP can be very helpful at smoothing out volatility and increasing certainty that the scheme will reach its target within a particular timescales, for all but the most extreme scenarios.

It is possible to repeat this analysis for different investment strategies or capital buffers to explore the range of options that could be attractive to both the capital provider and the scheme.




## Note on interpreting capital adequacy

For any given capital risk buffer, it is possible to construct very extreme tail events that mean losses will exceed that buffer. For example, insurer capital requirements are designed to withstand a 1:200 year risk event – there will be very extreme shocks that could threaten the capital levels of an insurer. It is therefore important to view capital adequacy testing as exploring the resilience of structures and not necessarily a test to see if a level of capital can never be breached (as they all can).

# 6. When CBJP may be particularly attractive and looking to the future

Section 2 highlighted how a capital backed journey plan can reduce risk for a pension scheme on its path to a given objective. Combined with an implied rate of return "promised" by the CBJP, the overall structure has the potential to be an attractive investment decision and could be helpful in a wide range of scenarios. We have provided some examples below:

**Managing risk on the route to buy-out. A CBJP can be seen as a way to "iron out" the distribution of possible outcomes, as the CBJP means the outcome is relatively certain except in the case of an extreme risk event.**

**Increased certainty of timescales to reach buy-out: The specified timeline may be helpful to support planning and the getting ready to efficiently plan to wind-up a scheme – for instance when reviewing provider contracts.**

**Reduce the likelihood of requiring contributions from the sponsor.**

**Accelerate timeline to reach a funding target, without increasing sponsor covenant risk.**

**Desire to get access additional capital, following corporate activity which reduces covenant strength.**

**Desire to transfer some risks before buy-out is possible (e.g. insurance pricing risk).**

There are a number of entities that are actively looking at providing capital backed journey plan solutions, motivated by the opportunity to leverage scheme assets in a way that will provide them with a return on their capital and also provide more certainty to pension scheme members. There will be a significant variation between providers on how these are structured and key commercial terms. Especially at this stage of the market development, there is also scope to tailor these structures to address specific sponsor and/or trustee requirements. We therefore expect to ultimately see a range of transactions with different providers over time.

A key milestone for the successful growth of this market may ultimately be a degree of standardisation between transactions and providers so that these solutions become more familiar and lower the barriers to transactions due to the time and effort for schemes to educate themselves about these structures. Those that do go through this process will find a number of highly engaged providers looking to establish themselves, and the market more widely, and so may ultimately be able to secure some very attractive terms.

# 7. Concluding comments

Capital backed journey plans represent a new way of applying third party capital to increase the security of members' benefits and reduce the chance that a contribution will be required from the sponsor. There is a growing list of providers now actively targeting transactions or quietly developing their proposition to be able to do so in the future, following a range of strategies of different models.

We welcome this market development and expect to see an increasing number of transactions in the coming years as trustees and sponsors become increasingly comfortable using these solutions to help meet their objectives.

## Want to find out more?

If you'd like to discuss this paper in more detail or explore whether transferring to a consolidator may be worth considering for your own scheme, please don't hesitate to get in touch with one of our experts.

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## Reliances & Limitations

This document provides a high-level overview of the capital backed journey plan market at the time of writing only and is not advice. We ask that actionable conclusions should not be drawn without confirmation from Hymans Robertson.