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A closer look at Clara-Pensions

Exploring DB Scheme Consolidation

January 2022

A closer look at Clara-Pensions

Now that Clara-Pensions (Clara) has completed TPR's assessment, we have refreshed our in-depth review of Clara to shine a light on its proposition, looking at:

1. **What is Clara-Pensions and how does it work?**
2. **What is the impact of Clara-Pensions on member outcomes?**
3. **How can you approach the 3rd gateway test, to consider the impact on member outcomes?**
4. **When might Clara-Pensions be an appropriate option to consider?**
5. **What does the future hold?**

Since our last review, while we've seen a seismic shift in life and work, Clara-Pensions has remained fundamentally the same as it has worked through TPR's assessment process.

It's clear that commercial consolidation is now coming. Key questions now focus on which schemes will look to transfer, how to determine if they should and how the superfund market will grow. This document seeks to provide some initial answers and predictions to these questions.

If you would like us to take a 'closer look' at your own consolidation solution – whether you are a master trust, insurer, commercial consolidator, sole trustee or investment platform – please get in touch.

1. What is Clara-Pensions and how does it work?

Clara-Pensions is a non-insured risk transfer solution that has been seeking to become an established superfund. The Pension SuperFund is another provider in the superfund market, but it has not yet completed TPR's assessment process at the time of writing.

Superfunds involve the transfer of a scheme's assets and liabilities into a new DB pension scheme backed by additional capital from the ceding employer and from external investors. They can adopt a range of different structures.

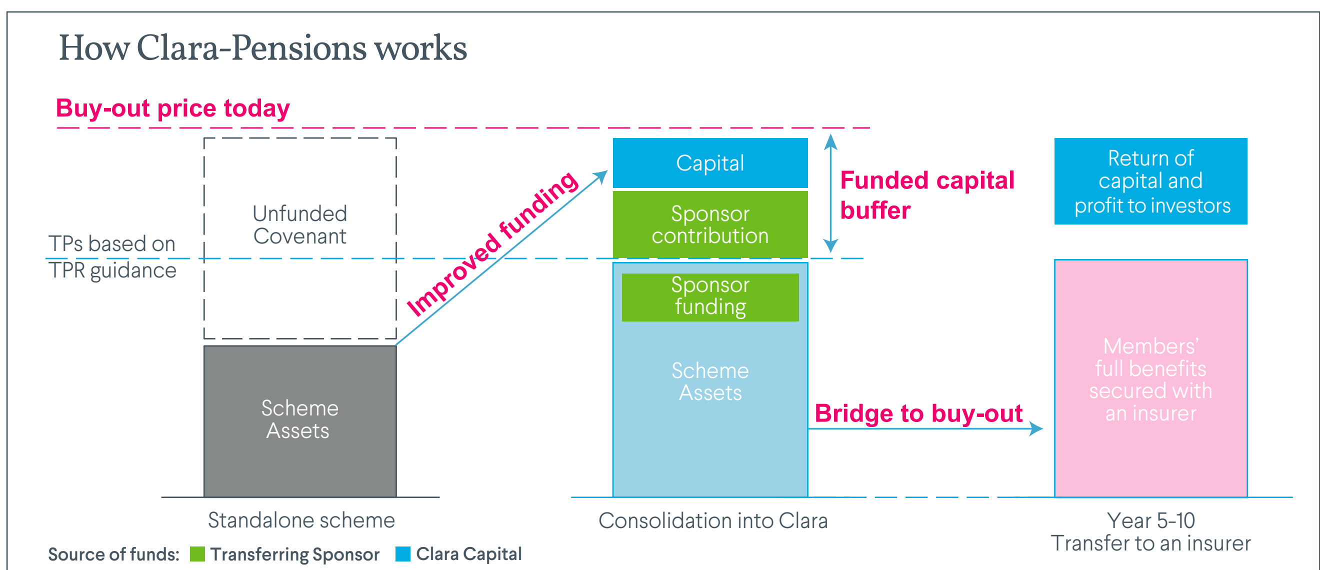
- **Clara-Pensions** manages each scheme's assets and liabilities in individual sections within its trust, and then transfers them to the insurance market when sufficiently well-funded. As such it is a **bridge to buy-out** for each scheme.
- **The Pension SuperFund** combines all incoming assets and liabilities and runs them off in a single trust. As such, it is a pooled **run-off vehicle.**

Transferring a DB scheme into a superfund such as Clara-Pensions gives a clean break for employers at a lower cost than insurance buy-out – the saving depends on the profile of the membership but could be around 10%.

This translates into a significant reduction in the corporate cash injection required to achieve this clean break. For example, if 70% funded on buy-out, the value of the required cash top-up falls by 33%.

Clara-Pensions runs a DB scheme under the existing occupational pension scheme framework, so the management of the scheme runs just like your own DB scheme. However, the crucial difference is that the covenant of the employer is replaced by covenant support from the capital buffer. The capital in the buffer is provided by external investors and a contribution from the employer.

[5] the Clara-Pensions cost depends on scheme maturity. The cost for more mature schemes is closer to buy-out and the cost for less mature schemes could be wider than 10%.



2. Why Clara-pensions can help meet trustee objectives

Trustees are tasked with seeking to manage pensions schemes to provide the benefits that were offered to members. At any point in time, a scheme is in one of three states:

- **Achieved objective** - secured or funded all member benefits;
- **Not succeeded in meeting benefit promise** - sponsor becomes insolvent, scheme winds-up, and members receive reduced benefits; or
- **Working hard to achieve success** – the sponsor is still solvent and the scheme still needs more money.

The solvency of the sponsor is therefore a key risk for schemes, even when schemes are sufficiently well funded that they are not relying on ongoing deficit contributions from the sponsor.

The risk of sponsor insolvency is very real. For example, a sub-investment grade sponsor's chance of failure between now and 2040 is more than 1 in 4. The outlook for many sponsors following the pandemic may also be less certain due to the shocks to operating models and as many aspects of life and work have fundamentally changed.

How Clara-Pensions improves scheme funding

Clara-Pensions can improve member outcomes in some circumstances. This is typically because:

- A cash contribution from the sponsor delivers a **funding level improvement**;
- In turn this enables **a lower risk investment strategy**, with more certainty that the assets will be sufficient to meet the liabilities;
- The financial covenant from the capital buffer may be considered preferable to retention of the existing covenant;
- The solution is "insolvency remote". Insolvency of the sponsor before the scheme is in a position to buy-out will no longer trigger a wind-up and therefore not lead to a reduction in member benefits.

For some schemes, these benefits can more than compensate for replacing the sponsor covenant, and give the scheme a much needed boost in the race to buy-out.

We have been working with Clara-Pensions since mid-2017 to iteratively test and evolve their proposition. The key element of this was to create a proposition that had a positive impact on member outcomes. To do this we've assessed Clara-Pensions through the lens of the strategic outcome measures that matter to members.

1. **Success:** what's the likelihood of paying members' pensions in full?
2. **Risk:** what do members lose in the bad times?
3. **Security:** what's the expected member outcome? (what % of full benefits will they receive)?

3. When will Clara-Pensions be an appropriate option to consider?

Central to TPR's guidance is the requirement for trustees of the ceding scheme, with the support of the sponsor, to be satisfied that three 'gateway principles' are met:

1 Gateway principle 1: can you buy out now?

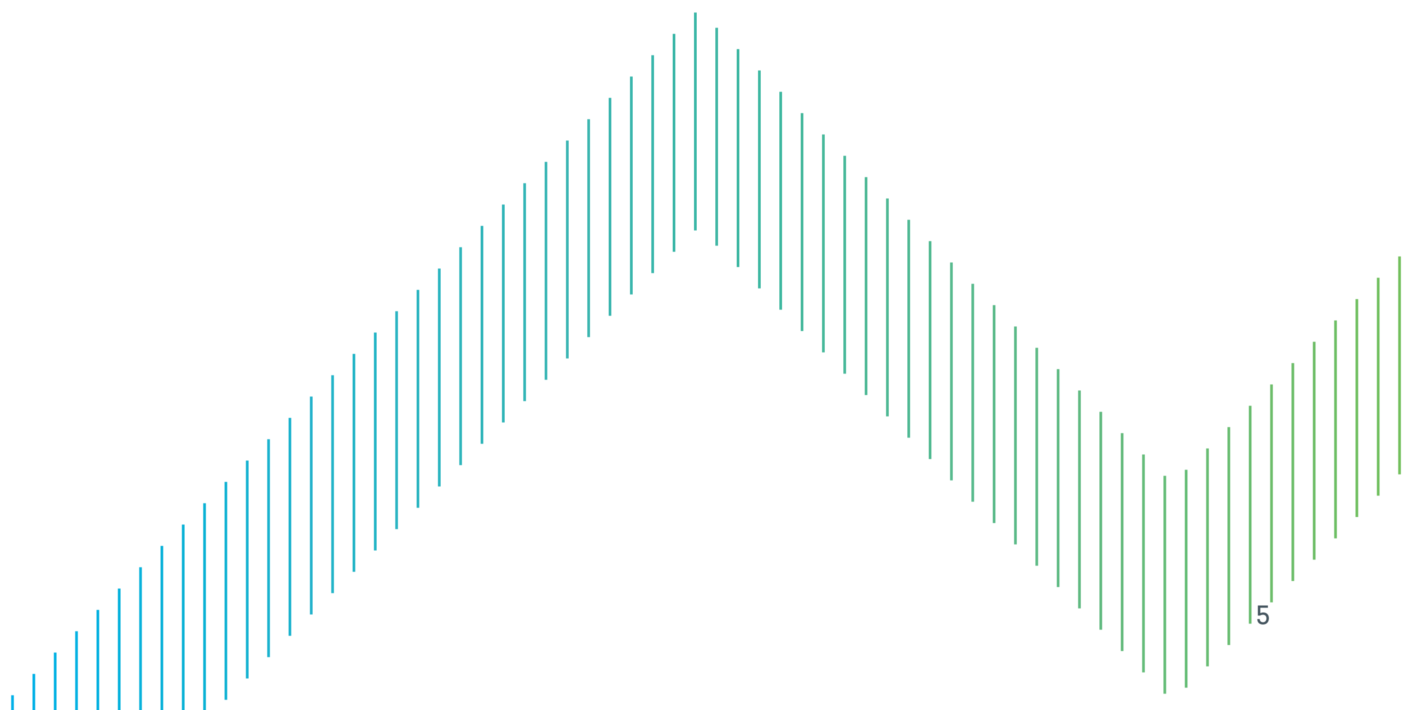
What it means: Benefits can be settled with superfunds at a lower cost than with insurers, as they are not subject to the same level of regulation as an insurer, and so should not be viewed an in equivalent option. As superfunds do not offer the same level of security, the guidance from TPR indicates that they expect trustees to have a preference for insurance over a transfer to a superfund if both are affordable now.

How to test: The trustees' assessment of whether buy-out is affordable should be based on the scheme actuary's estimated buy-out funding level at a date no more than one month before the date of the clearance application for the superfund transaction. Any insurance buy-out quotes received over the last year can also be considered.

2 Gateway principle 2: do you have a realistic prospect of reaching buy-out in the foreseeable future?

What it means: Projecting funding positions, allowing for the scheme's investment strategy, maturing of liabilities and sponsor contributions is a well-trodden path. If trustees believe that they are likely to be able to reach full insurance buy-out funding in the "foreseeable future" (typically thought of as 3-5 years), then TPR considers that members may be best served by continuing to run the scheme instead of transferring to a superfund.

How to test: This assessment requires schemes to test the outlook for the sponsor as well as the funding progression. Even if a scheme is well funded and is not expected to require any further contributions, buy-out may still not be possible as an insolvency event would require the wind-up of the scheme, triggering PPF entry or early annuitisation and a risk of a haircut to members' benefits. (The legislation that compels trustees to annuitise following sponsor insolvency was written before the emergence of superfunds, and so we hope this is revisited in the next Pensions Act.)



3 Gateway principle 3: does the transfer improve the likelihood of members receiving full benefits?

What it means: The final principle is the most nuanced and challenging to address and sets out a criteria for testing whether a member is expected to be better off following transfer. Trustees need to be confident that a transfer to a superfund will mean members are more likely to receive their benefits in full. This requires trustees to consider the different strategies, as well as the implications of severing the link to the sponsor.

How to test: Trustees are required to test the current strategy supported by the sponsor compared to the impact of transferring to a superfund supported by a capital buffer (and potentially a range of other possible strategies as well). Assessing the superfund transfer should be more straightforward as the superfund can provide analysis on areas like capital adequacy and the probability of paying benefits in full. However, testing the current strategy is more challenging, both in terms of incorporating the covenant risk into the assessment, and ensuring a consistent methodology with the superfund assessment.

When assessing the impact of transferring to a superfund it may be appropriate to test a range of possible investment strategies, such as the target investment strategy and also the highest risk strategy permitted by the investment guidelines.

Trustees are expected to require specialist covenant advice to inform assumptions on the financial strength of the sponsor and the potential recoveries – both of which can be challenging to estimate. In contrast, the adequacy of external capital can be tested by simply comparing it to the funding shortfall for a given scenario.

Effectively integrating sponsor covenant into asset and liability projections will be crucial to test the third gateway principle. An example of how this can be done is set out in the following section.

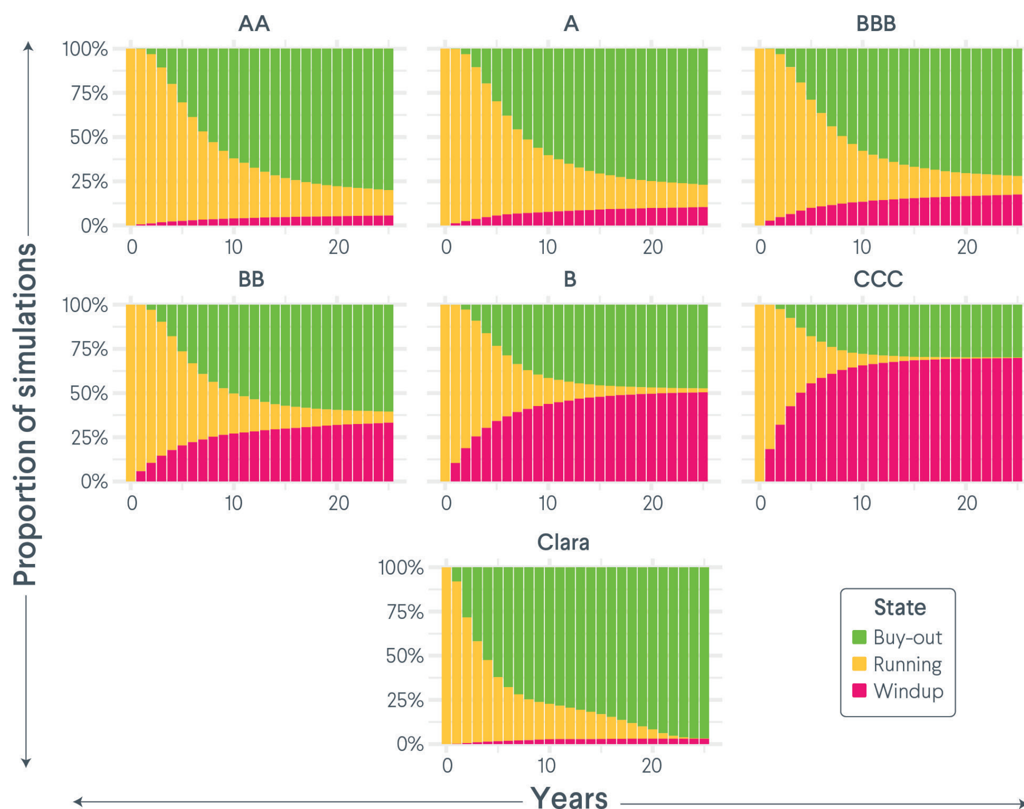
4. What is the impact on members?

Testing the third gateway principle:

For trustees that believe Clara-Pensions could help secure benefits, TPR is clear that it expects trustees to have robustly checked that members are more likely to receive their benefits in full following a transfer.

We set out below how we help trustees understand the impact on members of a transfer to Clara-Pensions:

- Under run-off, members are exposed to the possibility that the sponsor becomes insolvent before the scheme can secure all benefits fully. This is because the sponsor insolvency triggers scheme wind-up, forcing annuitisation and a reduction in member benefits if not fully funded on an insurance buy-out basis after receipt of any insolvency recoveries from the employer.
- Conversely, the risk to members within Clara-Pensions is that investment losses wipe out the buffer capital and reduce the funding level down to the wind-up trigger, in which case members are expected to receive a PPF level of benefits.
- The charts below summarise the likelihood of being in any given state in the race to buy-out over time, under run-off and under Clara for a range of different sponsor strengths. This is based on an assumed chance of default implied by pricing in credit markets and an assumed recovery rate following an insolvency. The analysis shown in this paper is indicative.
- As an example, a BBB rated sponsor has a 75% chance of success (paying pensions in full), whereas this falls to just 50% with a B rated sponsor. Conversely the chance of success in Clara-Pensions is significantly higher – this is shown by the reduction in the proportion of red outcomes.



The charts above show how Clara-Pensions compares to sponsors of different strengths.
Two points come out strongly:

- The likelihood of success within Clara-Pensions is in-line with a sponsor of high credit worthiness; and
- The possibility of sponsor default is very real particularly when looking over a 10+ year timeframe.

5. Scenarios when Clara-Pensions can be an appropriate option

We expect early transactions will be driven by corporate activity, for example, sponsors where the covenant is significantly distressed or where insolvency is likely or M&A transactions where there is an opportunity for schemes to access capital they may not otherwise have access to in return for a clean break for the employer from its DB liabilities. As the process becomes more established and regulatory guidance is well understood, transactions could become more widespread.

Natural drivers for considering Clara-Pensions include:

- A desire to deliver full pensions following sponsor failure, but with insufficient funds to insure.
- Trustees that want to mitigate the risk of sponsor insolvency triggering wind-up and a haircut to members' benefits.
- M&A transactions where the scheme accesses additional capital in exchange for severing the employer from the DB liabilities.
- Schemes with overseas parents that have no legal obligation to fund the scheme but are willing to put cash into the UK subsidiary in exchange for severing the employer from the DB liabilities.

Which type of sponsors will benefit most?

From our modelling of sponsors who can source the required capital and with schemes that are more than 5 years from achieving buy-out:

- Clara-Pensions has a positive impact for sponsors akin to being A+ rated, though on balance it is not transformational and other considerations are likely to be more material.
- Clara-Pensions has a materially positive impact for BBB rated covenants, with other considerations material too.
- For sub-investment grade covenants, the impact on member outcomes is transformational and likely to be the key consideration in moving to a consolidator like Clara-Pensions.

6. What does the future hold?

Now that Clara has completed TPR's assessment we expect the first applications will be submitted in the near future, likely driven by actual or impending sponsor insolvency cases that have been engaging with TPR for some time. However, as the market builds, a shared and common understanding will emerge of what consolidators have to offer, and when they are in the best interests of members.

Future scale of Clara-Pensions

Clara-Pensions aims to build to transact on multiple £bn each year.

In the context of a market with around £2trn of pension scheme liabilities and given the backdrop of struggling sponsors in the wake of the economic impact of COVID-19, this seems reasonable.

However, the pace at which the market develops may be influenced by:

- Timescales for a formal legislative regime
- The success of early adopters – examples of schemes successfully achieving buy-out within Clara-pensions may help trustee appetite
- The pace of development of alternative superfunds. A range of providers could be a sign of a healthy market in operation.

Therefore, the speed at which this market develops will be heavily influenced by the success of early transactions and / or how quickly the legislative regime is put in place.

Superfunds as a contingency plan

Whilst transactions will be dependent on the gateway tests being met, one theme we expect to emerge with trustees is the use of superfunds as a 'Plan B' strategy on the route to their 'Plan A' of insurance or self-sufficiency as part of an overall risk management strategy.

With time horizons to buy-out potentially spanning decades, many sponsors won't survive that long – their sponsor fortunes will change and evolve. Any covenant deterioration may make superfunds an attractive option, removing the risk of having to wind-up and pay less than 100% of members' pensions.

In fact, without early contingency planning there is a risk of schemes waiting too long and missing the lifeboat that Clara-Pensions can offer. For such contingency planning to work, it is crucial for schemes to understand early on how superfunds work and assess when they may be a viable option. This will allow schemes to monitor if it's right for their members to pursue a Plan B, or even a new Plan A.

Concluding comments

Superfunds like Clara-Pensions have the potential to materially improve benefit security and transform member outcomes. We're pleased to see TPR complete their assessment and in doing so bring better outcomes for members one step closer to being in reach.

More widely, the regulatory backdrop is increasingly supportive of responsible innovation in this market and we expect more innovation to follow over the coming years.

Want to find out more?

If you'd like to discuss this analysis 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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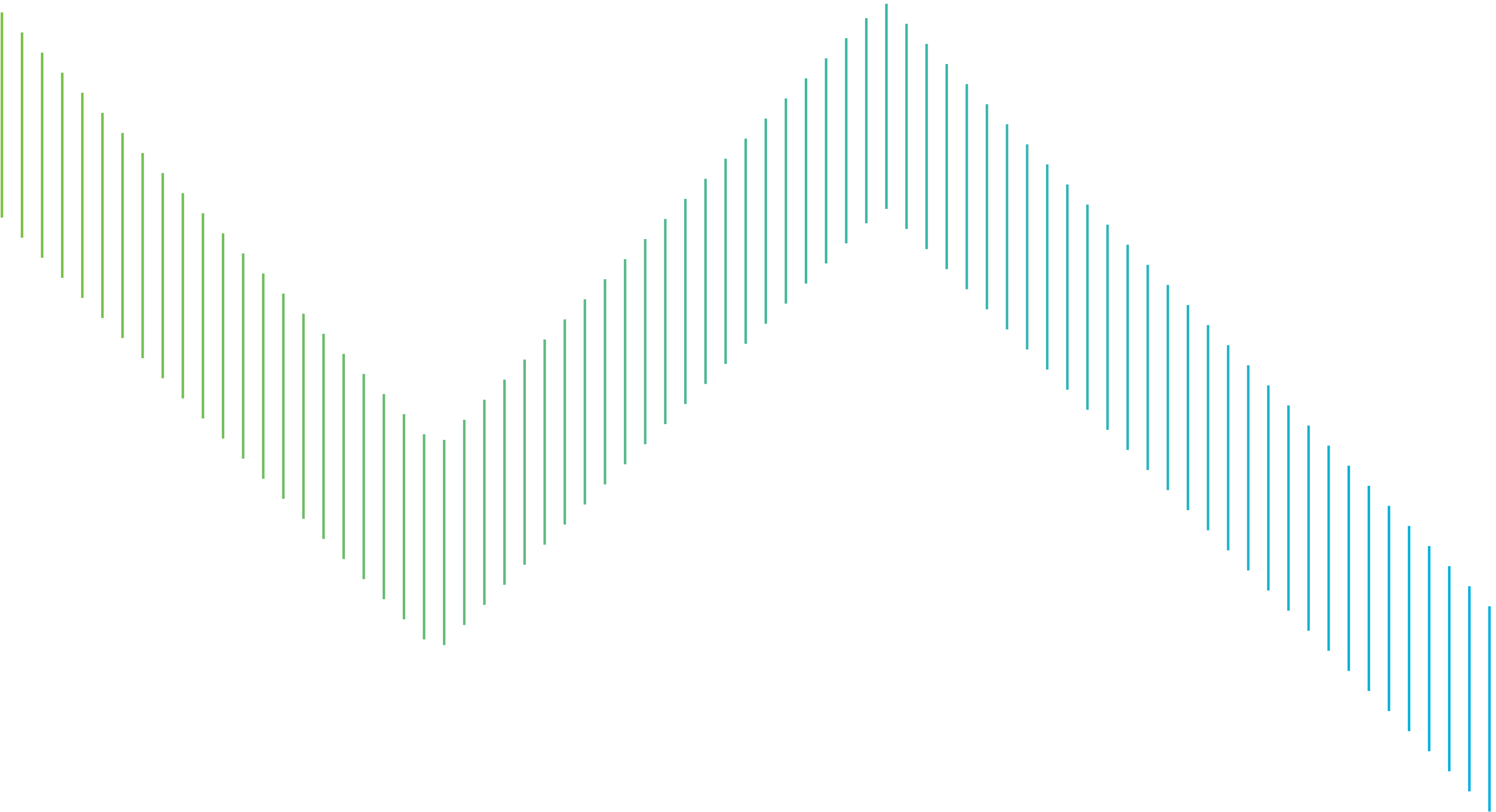
Appendix – Reliances & Limitations

As with all analytics, the results contained within this report are dependent on the model used, the calibration of the model and the various approximations and estimations followed. We have adopted a standard Hymans Robertson stochastic calibration and used the same model that we use for all our DB clients whether corporate, trustee or expert witness.
Asset liability modelling involves judgement. No inferences should be drawn from the modelling results other than those confirmed by us in writing. The modelling presented here has several key reliances beyond our typical analysis for pension schemes, due to the innovative nature of the Clara-Pensions proposition. We ask that actionable conclusions should not be drawn without confirmation from Hymans Robertson.

Full details of the modelling used for our analysis can be provided upon request



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