HYMANS ROBERTSON

A closer look at Clara-Pensions

Exploring DB Scheme Consolidation

September 2020

A closer look at Clara-Pensions

This is a fresh look at our first in-depth review of Clara-Pensions (Clara). In this issue, we shine a light on Clara's commercial consolidator 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. when might Clara-Pensions be an appropriate option to consider? and
4. what does the future hold?

Revisiting the Clara-Pensions model nearly two years later, it's incredible what has changed. And what hasn't.

While we've seen a seismic shift in life, work and DB consolidation, Clara-Pensions has remained fundamentally the same. However, the regulatory, economic and human backdrop for Clara-Pensions has changed considerably.

In the UK we've seen:

- **Clear regulatory support.** The Pensions Regulator (TPR) issued guidance in June 2020 for Superfunds[1] ('the Guidance'). This creates clear standards for the assessment of consolidators like Clara-Pensions
- **Heightened need.** TPR anticipates a rising tide of sponsor failures at an even higher level than what followed the financial crisis of 2007/8[2]. This is the corporate legacy of COVID-19. The industry needs innovation to make pensions safer.
- **Greater awareness.** Awareness of Clara-Pensions has increased over two-fold to 83% since 2019. This greater awareness is starting to influence long-term objectives for DB schemes too. Of those who reviewed their long-term objective in the past 12 months, a third of trustees did so to determine whether their scheme might benefit from commercial consolidation.[3]

It's clear that commercial consolidation is coming. The question remains when, not if.[4]

While DB consolidation encompasses a wide range of potential solutions, for commercial consolidators like Clara-Pensions and The Pension SuperFund, the first transactions into these vehicles now seem likely this year.

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.

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[1] See https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/db-superfunds

[2] See https://blog.thepensionsregulator.gov.uk/2020/08/05/trustees-must-remain-ready-for-covid-19-balancing-act/

[3] Source: Hymans Robertson, research amongst 100 Trustees of DB schemes with assets over £100m, 2020

[4] Hymans Robertson, DB consolidation: when, not if, 2018

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

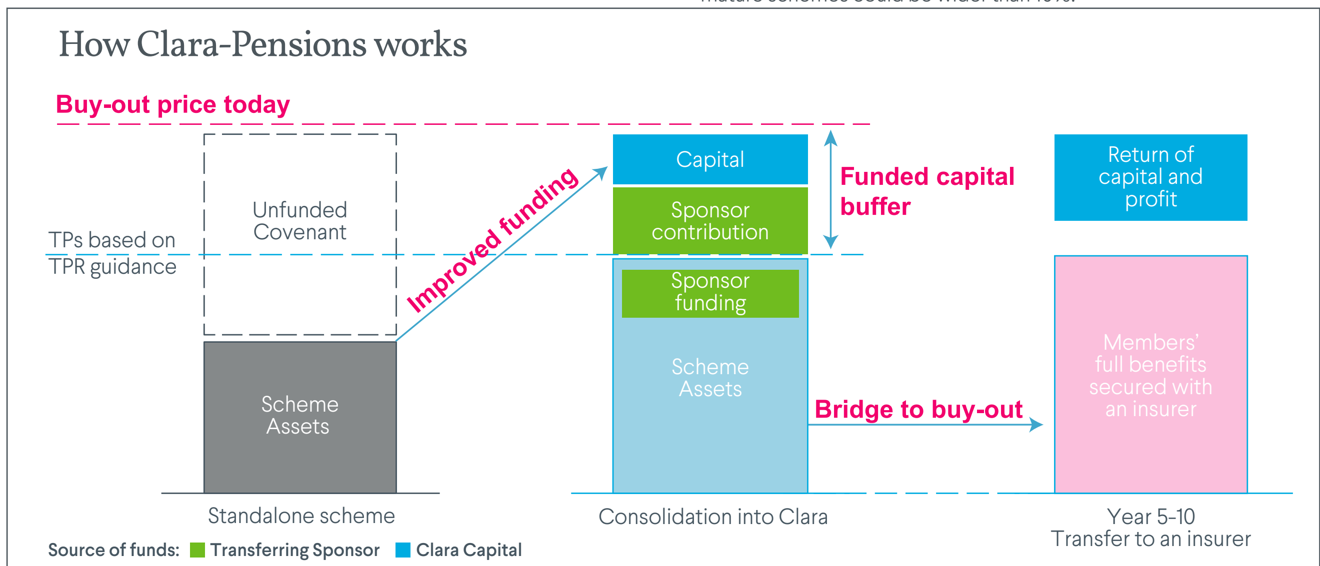
Clara-Pensions is one of two non-insured risk transfer solutions currently in the market. The other vehicle is The Pension SuperFund. Both vehicles involve the transfer of the scheme's assets and liabilities into a new DB pension scheme backed by additional capital from external investors. The sponsor support is replaced by the financial covenant of the funded capital buffer. However, the vehicles work differently in terms of structure:

- **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**.
- **The Pension SuperFund** combines all incoming assets and liabilities and runs them off in a single trust. As such, it is a **run-off vehicle**.

Transferring a DB scheme into Clara-Pensions gives a clean break for employers at a broadly 10% lower cost than insurance buy-out[5]. 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 a funded capital buffer, expected to be in the region of 20% of the DB liabilities. 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%.



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)?

2. What is the impact of Clara-Pensions on member outcomes?

The race against insolvency

In some senses, running a pension scheme is a long-distance race. A race to successfully secure/ fund all member benefits before sponsor failure. At any point in time, a scheme is in one of three states:

- **won the race** - secured or funded all member benefits;
- **lost the race** - sponsor becomes insolvent, scheme winds-up, and members receive reduced benefits; or
- **still in the running** - the sponsor is still solvent and the scheme still needs more money.

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. Insolvency stresses also seem more likely in the aftermath of COVID-19.

How Clara-Pensions improves scheme funding

A key benefit for scheme trustees of transferring to Clara-Pensions is that it triggers an upfront cash injection from the sponsor. This has a number of advantages for the scheme:

- There is 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;
- An additional injection of external funds in 'escrow' acts as a **capital buffer**, in lieu of covenant support;
- A future insolvency of the existing sponsor 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.

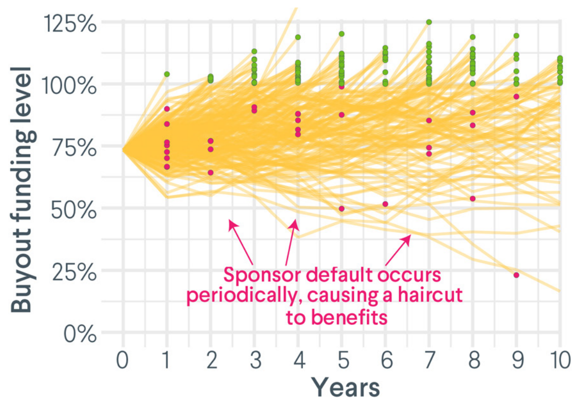
Better and more certain scheme funding

The range of funding outcomes from Clara-Pensions is much better than an example scheme[6] with a BBB rated sponsor. This is shown in the charts below.

Outside Clara (BBB Sponsor)

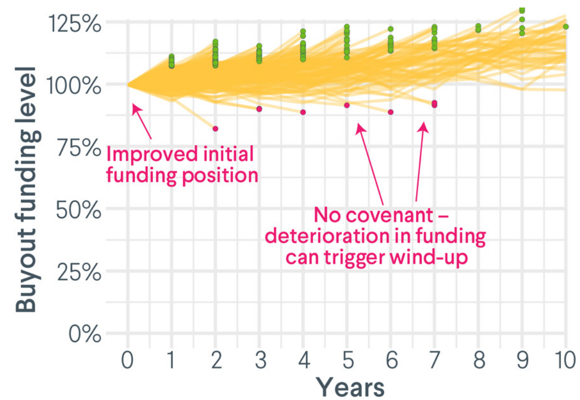
At the outset, the scheme is in the race. Over time, the funding position may improve enough that the scheme can buy-out all benefits (shown in **green**). However, there is a risk that the sponsor becomes insolvent before buy-out is achieved and the scheme is wound-up and reduced benefits are secured (shown in **red**). The picture varies depending on the strength of the sponsor covenant.

[6] This is based on a real scheme that is 70% buy-out funded with £100m of buy-out liabilities.



Inside Clara

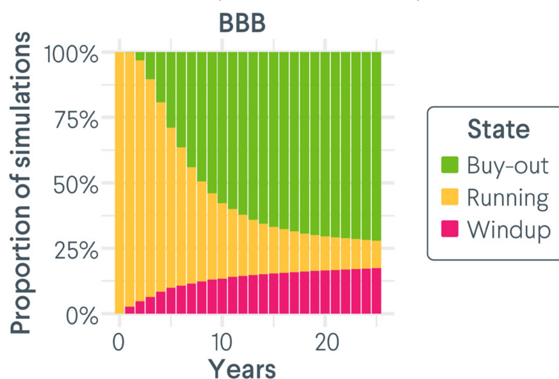
Within Clara, the up-front injection of capital strengthens the initial funding position of the scheme. As the scheme matures and buy-out pricing improves, the section may be in a position to buy-out even allowing for a return on external capital (shown in **green**). Conversely, there is a risk that the funding position will deteriorate to below 105% of the Pension Protection Fund (PPF) funding level (a trigger point in TPR's guidance), at which point the section is assumed to be wound-up and reduced benefits are secured (shown in **red**).



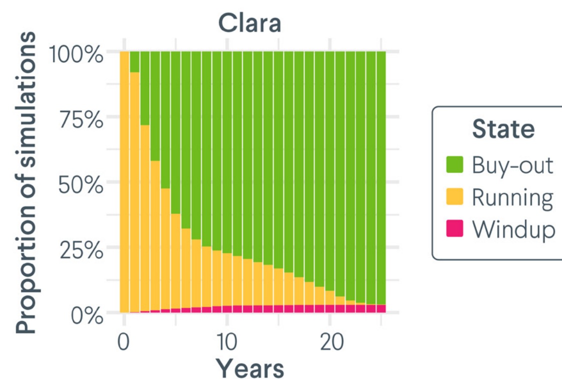
In bad times, non-pensioner members on average lose less within Clara, as illustrated by the red dots on the chart above – to quantify non-pensioner members would on average have a haircut of 18% to their benefits in event of default outside of Clara, but only 7% within. In fact, the average member receives greater than 99% of their benefits within Clara, so a much higher success rate.

What does this mean for the ultimate destination of the Scheme?

Outside Clara (BBB Sponsor)



Inside Clara



We noted earlier in the publication that we assess the success of Clara-Pensions through the lens of the strategic outcome measures that matter to members. As can be seen above, the chance of success in Clara is significantly higher than for a BBB sponsor – this is shown by the reduction in the proportion of **red** outcomes.

How much worse off could members be?

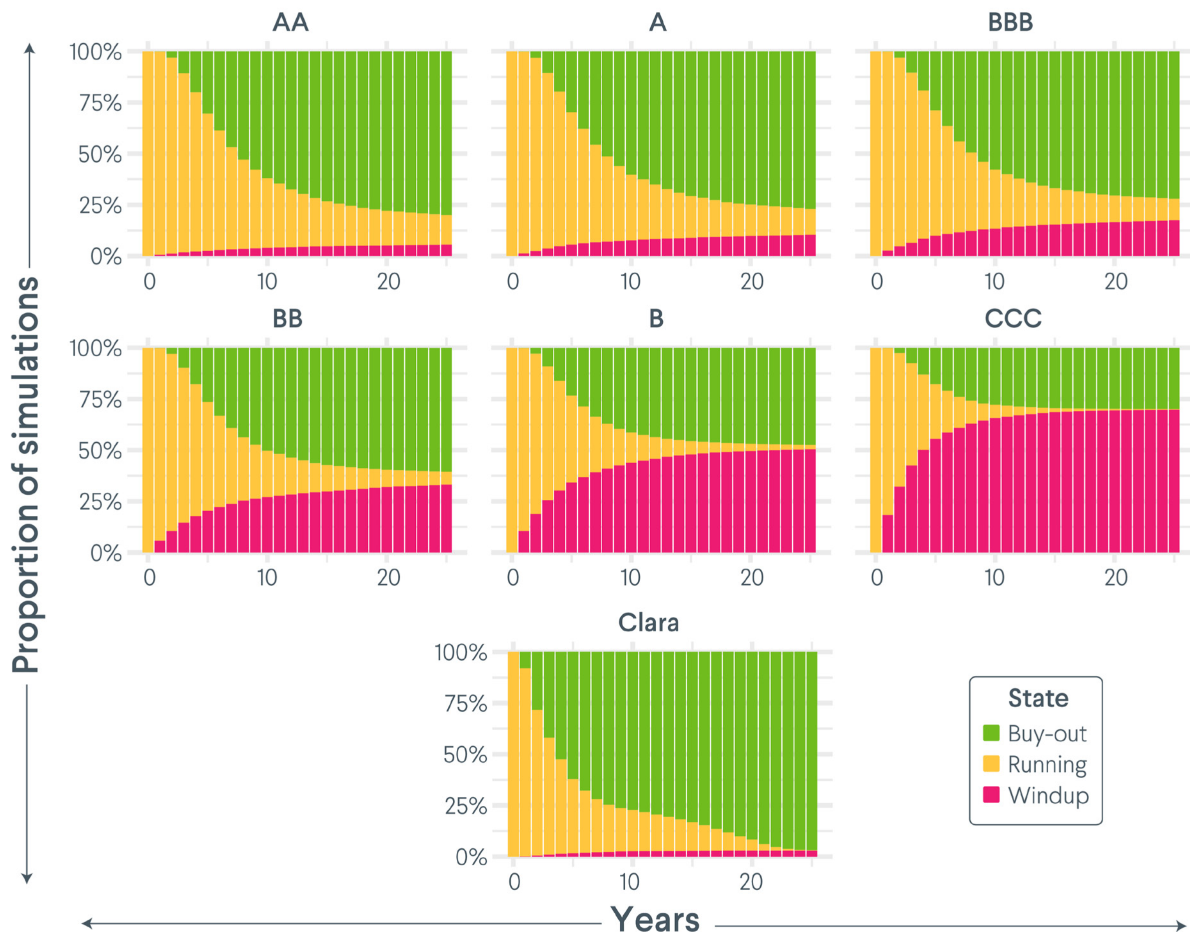
What does this mean for the members of pension schemes? What is the risk under each route?

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 the scheme to wind-up and to deliver lower levels of benefits to members than promised.

Conversely, the risk to members within Clara is that investment losses wipe out the buffer capital and reduce the funding level in the section to 105% of the level underwritten by the Pension Protection Fund (the assumed wind-up trigger per the Guidance[1]).

The charts below show 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.

It shows that for our example scheme, with a BBB rated sponsor, it has a 75% chance of success (paying pensions in full) – this falls to just 50% with a B rated sponsor.



The charts above show how the race might progress with sponsors of different strengths, and within Clara. and how long it might take to reach the finish line. Two points come out strongly:

- **The likelihood of success within Clara 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 time horizon.**

Do all members lose to the same extent?

The likelihood of a scheme paying less than full benefits is only one side of the equation. In this scenario, two relevant questions are:

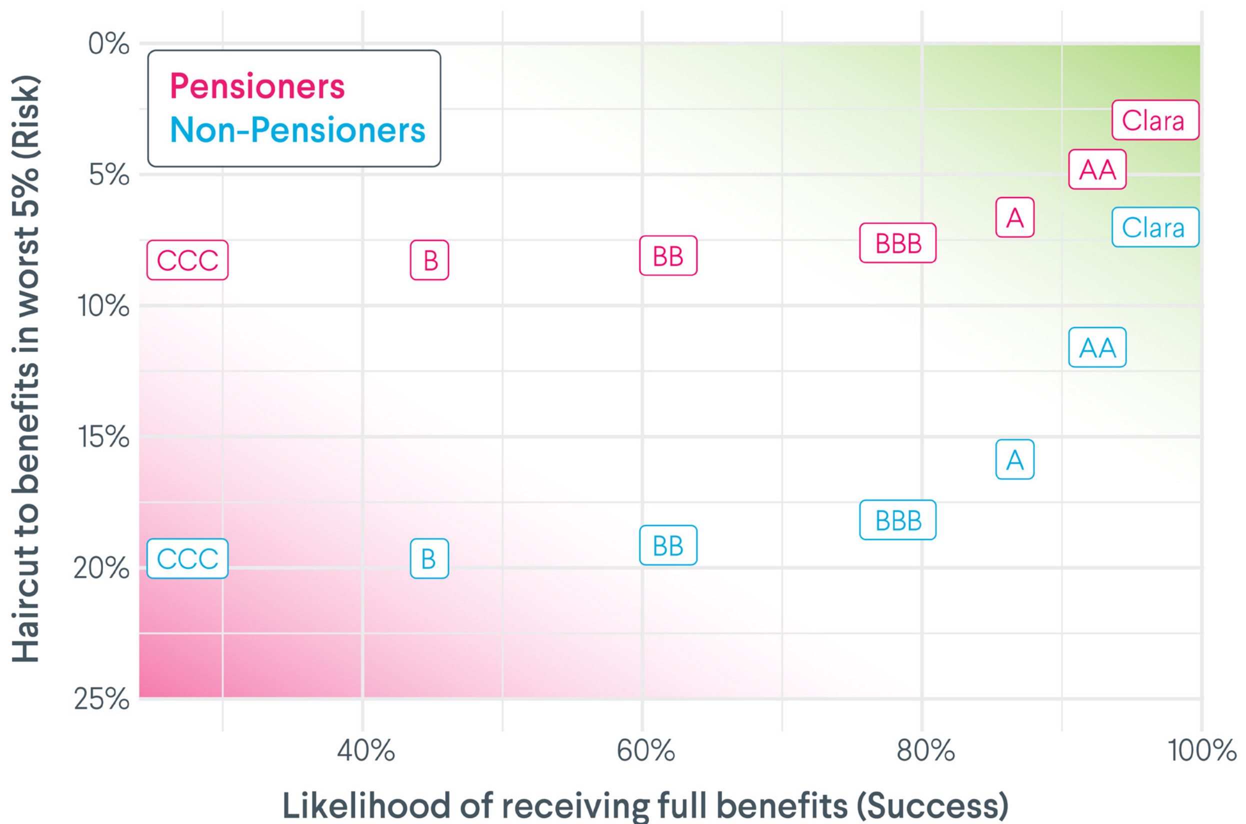
- **Who fails to finish the race?**
- **How far do they fall short?**

We can analyse this by looking at the likelihood of receiving full benefits (**Success**) versus the haircut to benefits in the worse 5% of possible outcomes (**Risk**). We look at this across different generations of members (specifically, pensioners and non-pensioners). This is illustrated below, where 'top right' is where you want to be.

How Clara improves outcomes

The pain of loss is not spread equally across generations – today's deferred members are more exposed to pension scheme failure than today's pensioners. This is unsurprising, given a greater haircut is applied to deferred members within the PPF, and they have to wait longer to receive benefits (given more opportunity for failure to occur in the meantime). However, the question of inter-generational equity is clearly an important factor in deciding how best to deliver members' pensions.

Clara can reduce the level and inequity of loss – with an improvement in security particularly significant for younger members. For example, the haircut in a downside 1-in-20 outcome for a non-pensioner member would be c. 18% given a BBB sponsor. This would be reduced to c. 7% within Clara. The results within Clara will vary by scheme though the broad story remains the same.



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

We expect early transactions will be driven by corporate activity, for example, covenant distress following COVID-19 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:

- 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.
- 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.

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.

4. What does the future hold?

In the near future, we expect there will be an initial trickle of transactions likely driven by actual or impending sponsor insolvency. 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 look after £5bn of liabilities by 2023 and has indicatively priced around £10bn of transactions.

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, some schemes may choose to hold off until a formal legislative regime is in place for authorisation and the market is established. 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. (The Regulator has suggested that formal legislation could be up to five years away).

However, consolidators like Clara-Pensions are not appropriate for schemes that expect to be able to insure benefits in full within 5 years, consistent with the 'gateway' proposals in the 2018 Department for Work & Pensions (DWP) consultation[7].

Superfunds as a contingency plan

Nonetheless, 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. 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 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.

[7] See https://www.gov.uk/government/consultations/defined-benefit-pension-scheme-consolidation/consolidation-of-defined-benefit-pension-schemes

Concluding comments

Commercial consolidators like Clara-Pensions have the potential to materially improve benefit security and transform member outcomes. We're pleased to see that the regulatory backdrop is increasingly supportive of responsible innovation in this market. We expect more innovation will follow over the coming years. In our view, this can only lead to a better future for DB pensioners.

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.

For further context to our modelling, a numerical summary of the modelling results is shown below. The charts in this paper show the results of scheme 1, while the impact on member outcomes for scheme 2 shows the sensitivity of the results to the benefit promise compared with PPF benefits.

Scheme 1: Modest benefits in excess of PPF level

	SUCCESS – chance of paying members' pensions		RISK – member loss in the bad times		SECURITY – expected member outcome	
	Outside (BBB)	Clara	Outside (BBB)	Clara	Outside (BBB)	Clara
Non-pensioner	75%	>97%	18%	7%	97%	>99%
Pensioner	75%	>97%	7%	3%	99%	>99%
Total	75%	>97%	13%	5%	98%	>99%

Scheme 2: Typical benefits in excess of PPF level

	SUCCESS – chance of paying members' pensions		RISK – member loss in the bad times		SECURITY – expected member outcome	
	Outside (BBB)	Clara	Outside (BBB)	Clara	Outside (BBB)	Clara
Non-pensioner	75%	>99%	23%	1%	97%	>99%
Pensioner	75%	>99%	13%	<1%	99%	>99%
Total	75%	>99%	18%	1%	98%	>99%

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