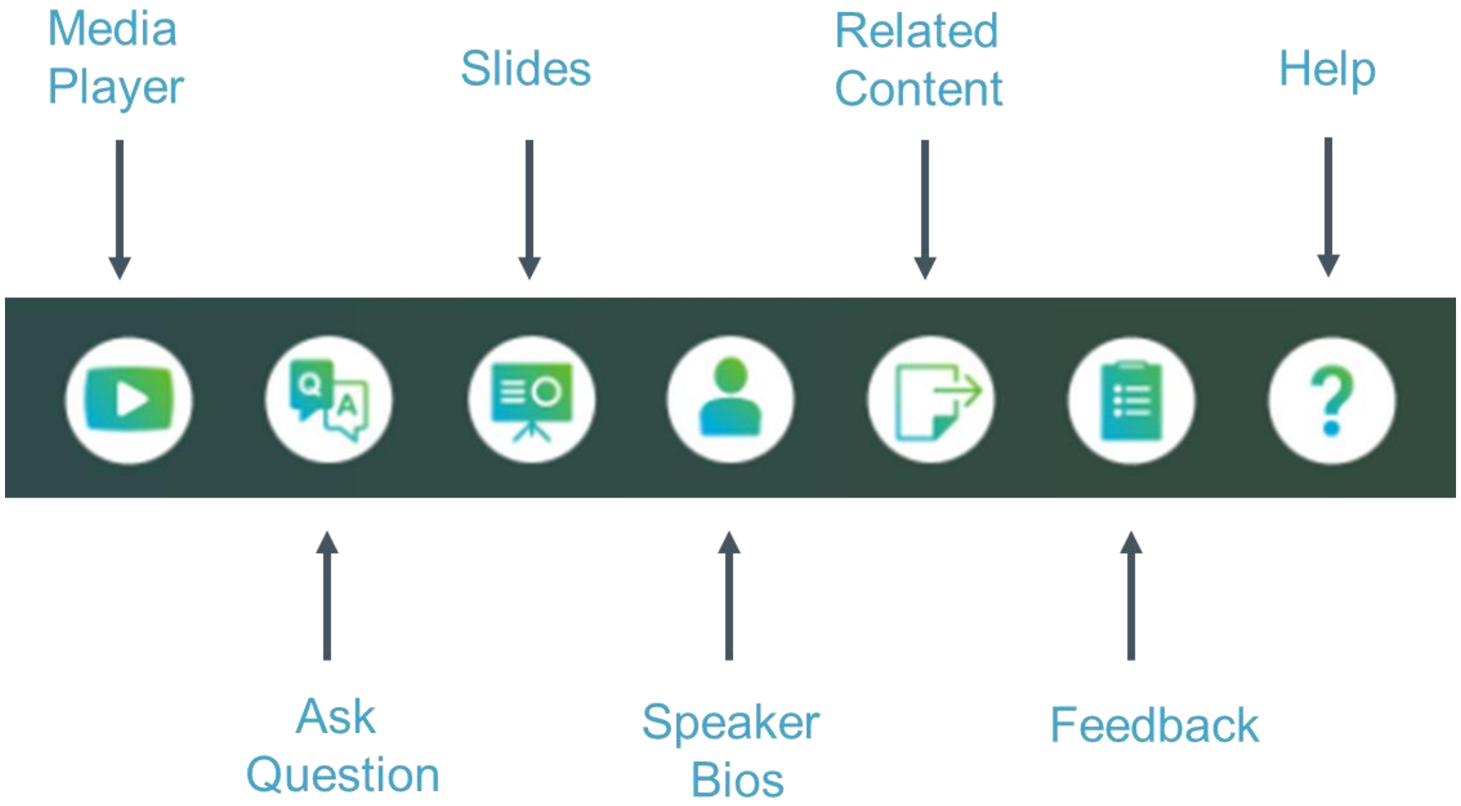
Alternative Risk Transfer: Assessment of Structures Beyond Traditional Insurance Buyouts

28 July 2023

Housekeeping



Speakers

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Partner & Head of Alternative Risk Transfer,

Hymans Robertson

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Head of Insurance Solutions,

M&G

Agenda

1. Typical corporate objectives
2. A closer comparison of LTOs and insurance
3. How alternative solutions could support corporate and trustee objectives
4. Recap of the range of solutions in the market
5. M&G update on alternative solutions

Corporate objectives for DB schemes

Fund running costs out of scheme assets

Avoid settlement loss on risk transfer

Access DB surplus

Stop / reduce deficit contributions

Get off balance sheet quickly

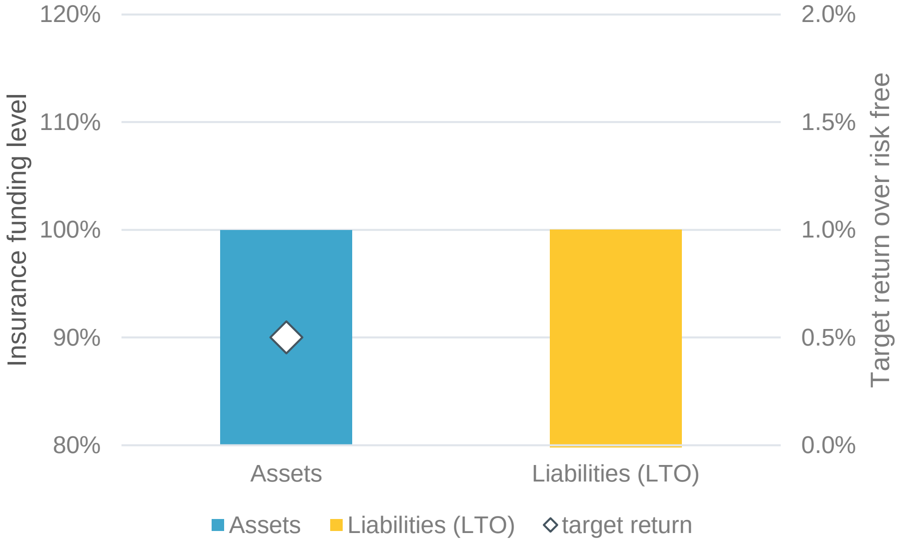
An asset?

A liability?

How can capital backed solutions help with these objectives?

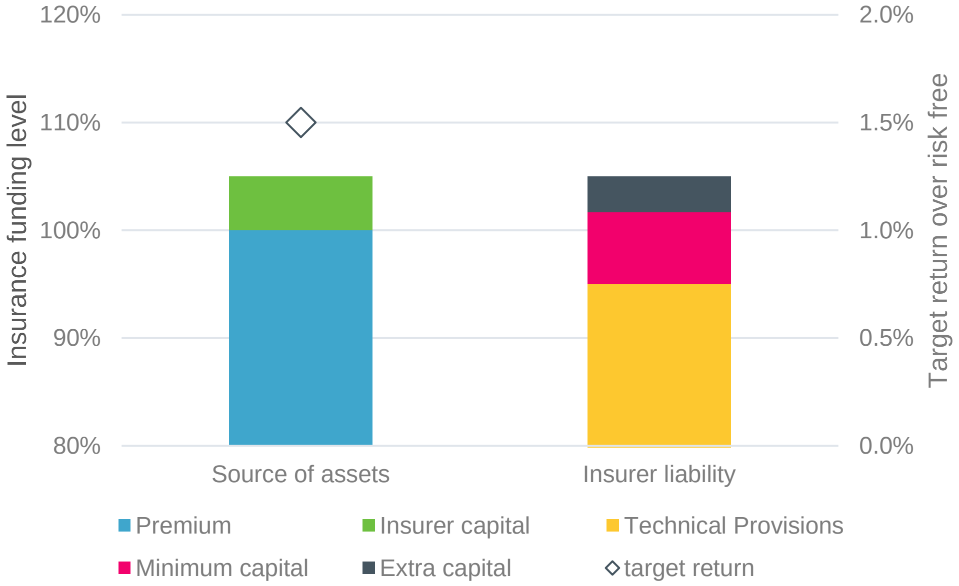
Comparing regimes

Fully funded scheme in pension regime



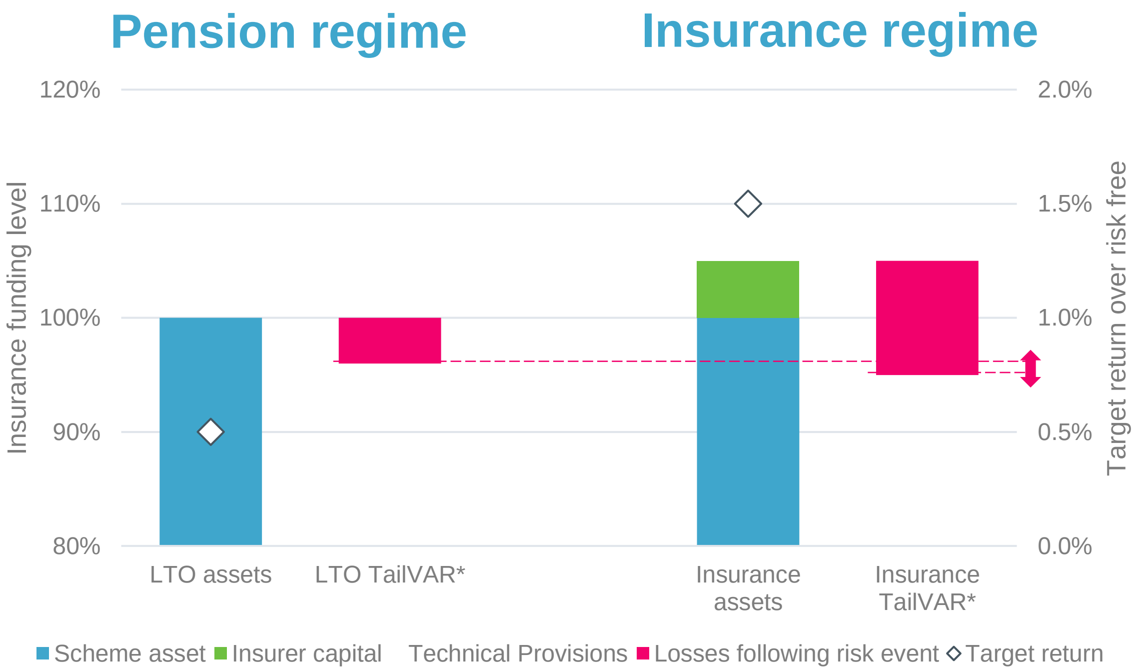
- Supported by sponsor covenant
- Low risk investment strategy
- Limited options to extract surplus

Insurance regime



- Capital buffer and PRA regime
- Higher target return on assets
- Insurers able to extract surplus (within limits)

Balancing capital against re-risking



** TailVAR includes mark to market risk in both pension and insurance scenarios*

- How much of the insurer capital is compensation for re-risking?
- How much capital is left to be security enhancing?
- The overall impact of moving from the pension regime to insurance depends on the funding level and investment risk.

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So what?

Fully funded scheme in pension regime

- ✓ Schemes can be funded to a point that benefits are also very secure and likelihood of requiring future contributions are very low.
- ? There will be a range of views to define that point.

Insurance regime

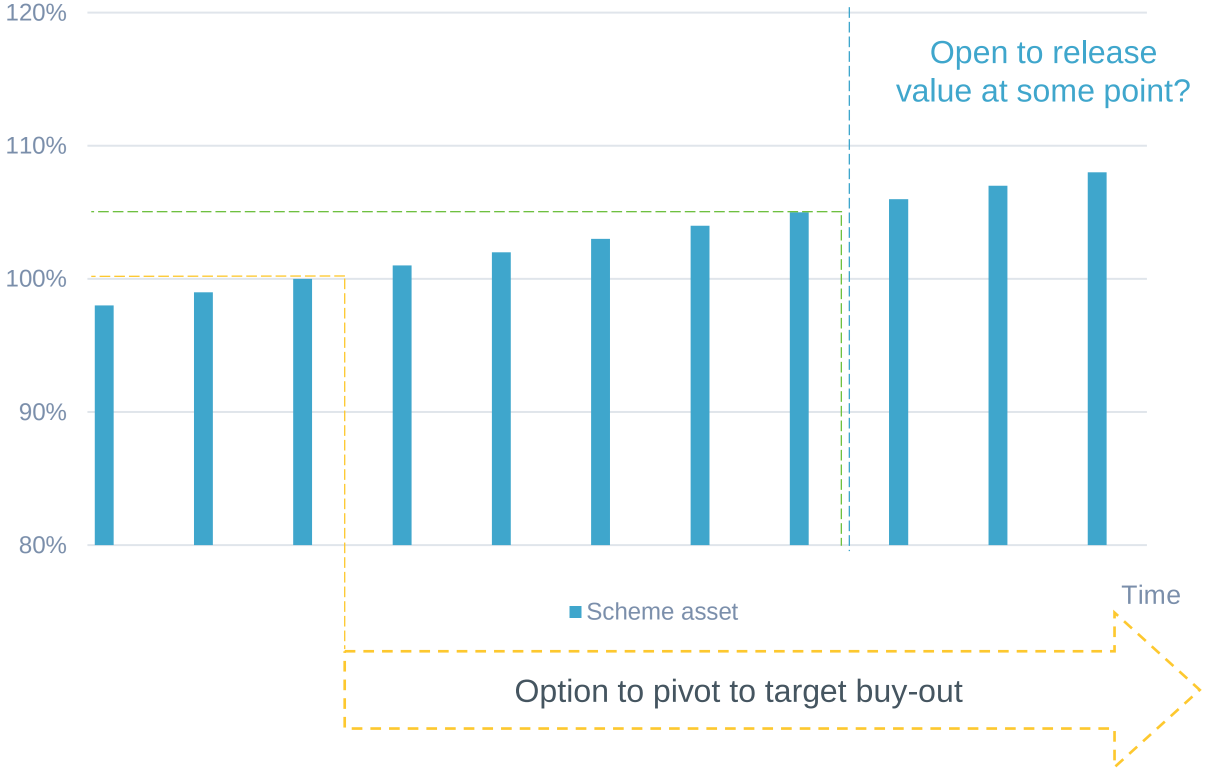
- ✓ Widely accepted to be very secure with an expectation of paying benefits in full.
- ✓ A level of security at which sponsors are allowed to break their exposure to a pension scheme.

A decision of whether to insure could be a choice between two very low risk options

Principles for a “run on” strategy

Stronger target to consider releasing value
(e.g. capital an insurer would hold)

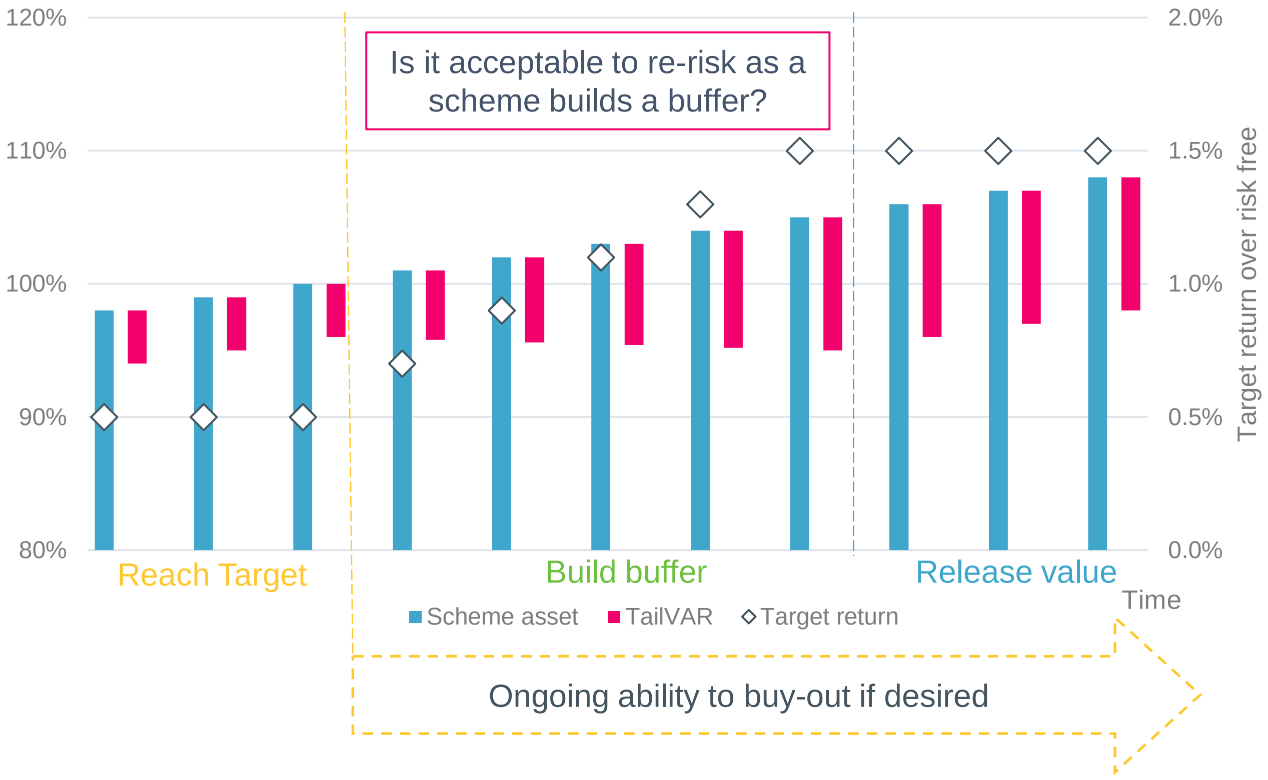
Low risk funding target
(e.g. low risk to benefits or of contributions restarting)



Questions for another day….

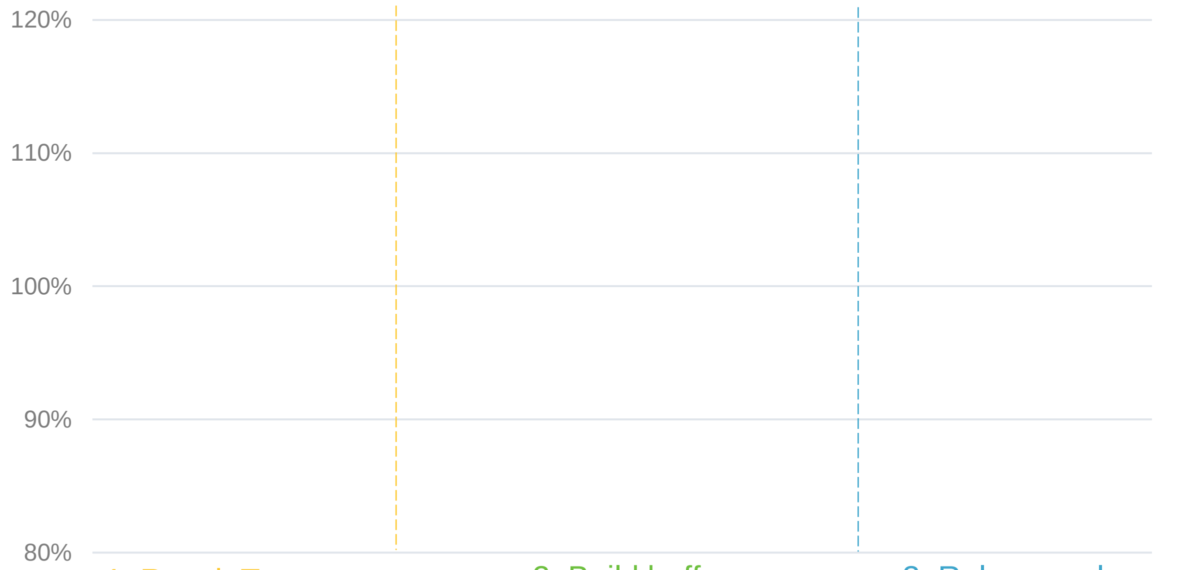
1. How to agree the best structure (run-on, captive etc)
2. How value is used (retained, improve benefits, fund DC, return to sponsor)

DIY: Balancing the buffer with re-risking?



Build a buffer in a controlled way
underwritten by sponsor covenant

How additional capital could help



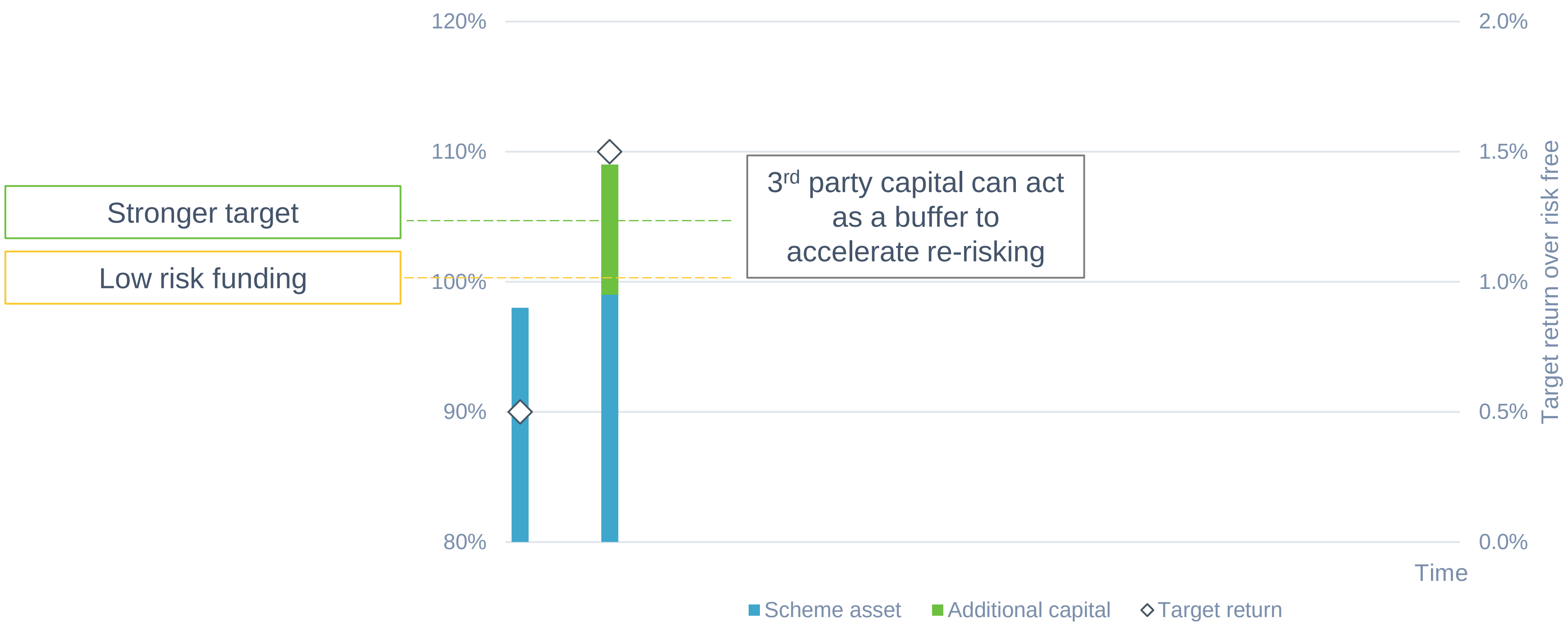
1. Reach Target
Underwrite risks to reach target. **For many this will be buy-in.**

2. Build buffer
Use 3rd party capital as a buffer instead of DIY

3. Release value
Use additional capital to underwrite tail risk exposure

4. Protect against sponsor default

Use case: accelerate release of value



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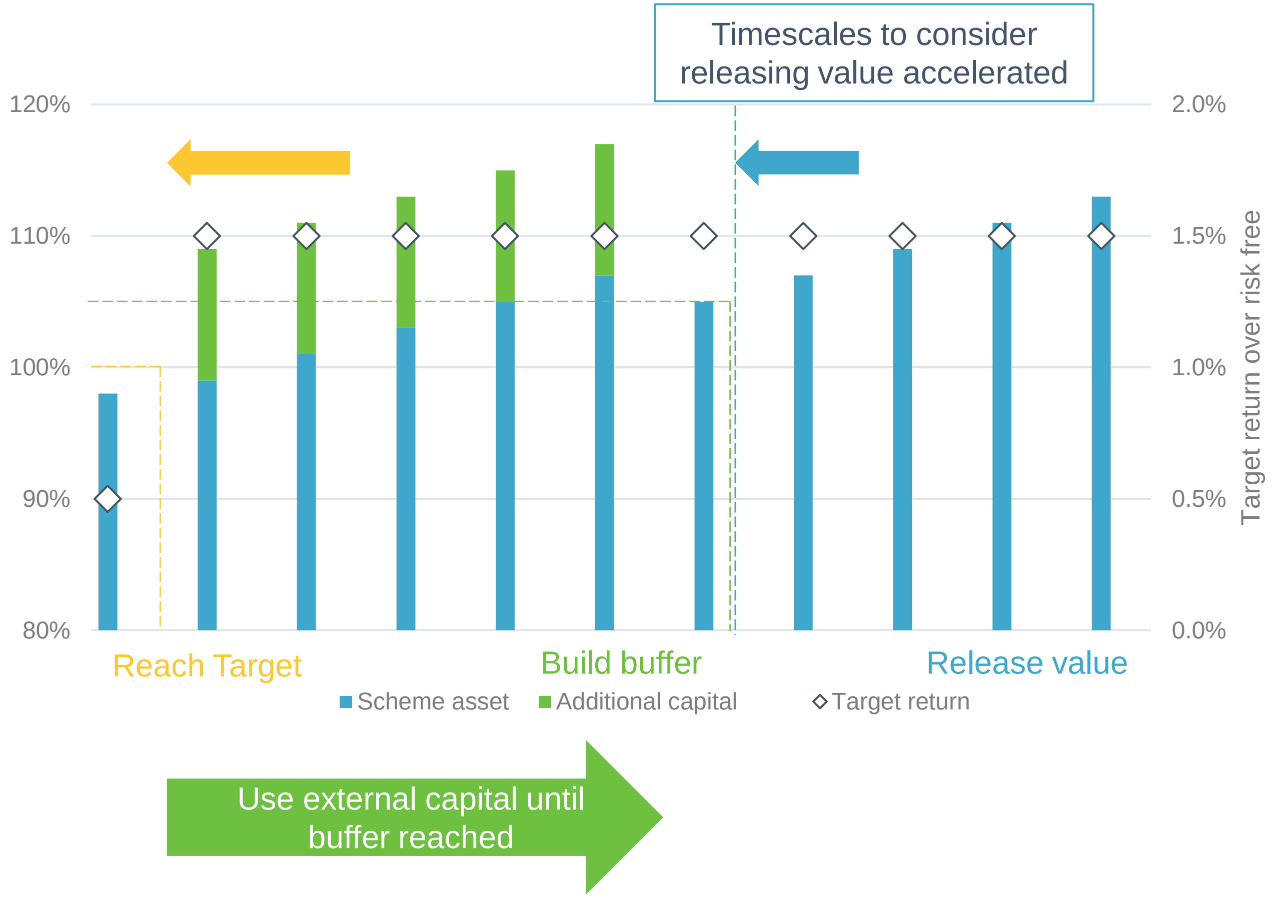
Use case: accelerate release of value



Continue to be supported by the sponsor covenant
Retain option to pivot to target buy-in

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Range of alternative solutions

Key feature	a. Return focus	b. Cashflow focus	c. Covenant focus
1. Capital and covenant support (downside protection)	Capital to reduce the risk of failure to reach objective e.g. to below 1%. Injected at outset or held in a separate account for the benefit of the pension scheme	Insurer provides capital in line with PRA requirements Arrangement can be exited at any time, e.g. if required on sponsor failure	Provider becomes an additional employer - effectively creating a "last man standing" scheme
2. Investment strategy	Scheme-specific guaranteed outcome, e.g. gilts+ 1-2% pa; Backed by e.g. credit, private debt, LDI and potentially protected equity	Guaranteed return e.g. gilts+0.5%-0.75% Invested in an insurance company with-profits fund	Similar to return focus, although a wider range of assets may be included, including retaining existing scheme assets
3. Term	5-7 years with option to extend in certain circumstances. Longer terms possible with greater covenant focus.	No defined term	For tending-to-strong covenant schemes, terms of up to 20 years. For weak covenant schemes term will be much shorter.
4. Target outcome or guarantee	Typically a return consistent with achieving either buyout or low dependency at end of term	Deliver target cashflows under an insurance framework	May include a commitment to buy out
5. Governance framework	Trustee and CBFA provider agree investment strategy, generally aligned to provider's approach	Trustee appoints provider to deliver cashflows. Provider determines investment strategy	Varies – additional employer may be relatively "silent" or may drive the investment strategy
6. Surplus extraction	All surplus above guaranteed outcome returned to CBFA	Scheme can benefit from upside e.g. Scheme gets 90% share of excess returns (remaining 10% to with-profits fund)	e.g. 20% share of surplus for scheme on maturity of CBFA
7. Early termination provisions	May be subject to penalties. On sponsor insolvency, tPR and PPF will determine if there is a basis for continuation.	Termination at any point with no surrender penalties	Arrangement is designed to continue beyond sponsor insolvency.

Summary from forthcoming IFoA paper titled:
Capital backed funding arrangements: Developments in the alternative risk transfer market for defined benefit schemes

Corporate Risk and Investment Solutions

Endgame Solutions

Endgame Solution considerations

- Having a risk buffer is essential when considering Endgame Solutions
- Such a buffer can either be inside the scheme or outside it.
  - Extra scheme funding (needed to cover risk, but not for benefits)
  - Long-term reliance on sponsor covenant (not ideal for most schemes)
  - Contingent assets - charges over property, escrow accounts etc
  - Fully outsourced to an insurer (covering 1 in 200 year losses)
  - Partially outsourced – to a third-party capital provider

Insurer Balance sheet

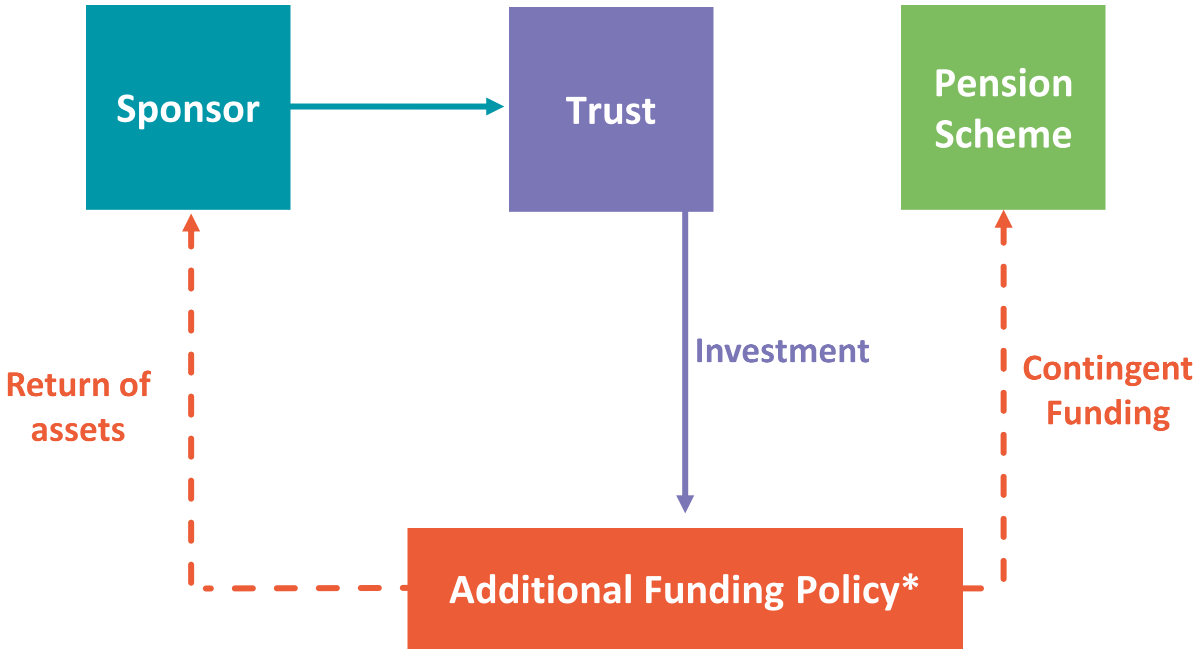
- Risk buffer
- Margin for Uncertainty
- Best Estimate Liability

DIY investment approaches | **Contingent assets/Escrows etc.** | **Capital-backed journey plans** | **Partial insurance solutions** | **Buy-Ins** | **Commercial Consolidators (“Superfunds”)** | **Buyout**

On balance sheet → **Off balance sheet**

Additional Funding Solution

Additional Funding Solution
Avoiding trapped surplus



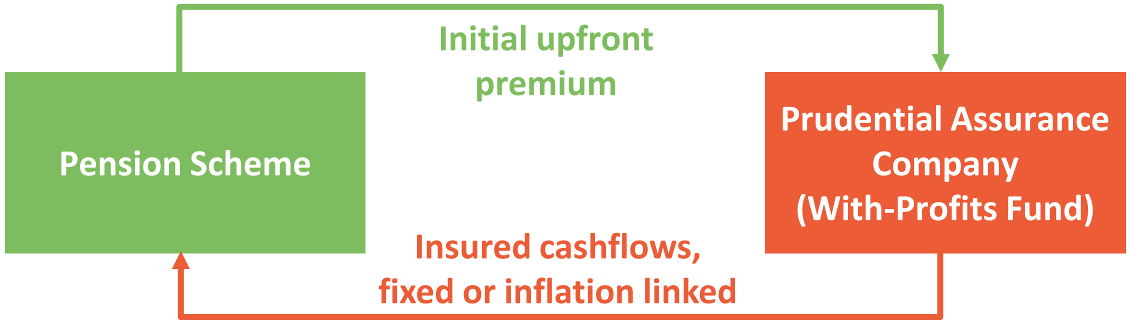
- Sponsor purchases a policy which is held on trust for the benefit of the pension scheme*
- Provides a downside protection “buffer” to the pension scheme while avoiding trapped surplus.
- A means for DB plan trustees to obtain additional security without requiring the sponsor to put additional assets in the plan.
- Can be tailored to the Trustees’/Sponsors preferences in terms of the how the assets are run and the events that trigger distribution

*This is essentially an Insurance Escrow, open to a range of M&G funds

Secured Plus Policies

Secured Plus Policies

Access to credit returns, without the risk



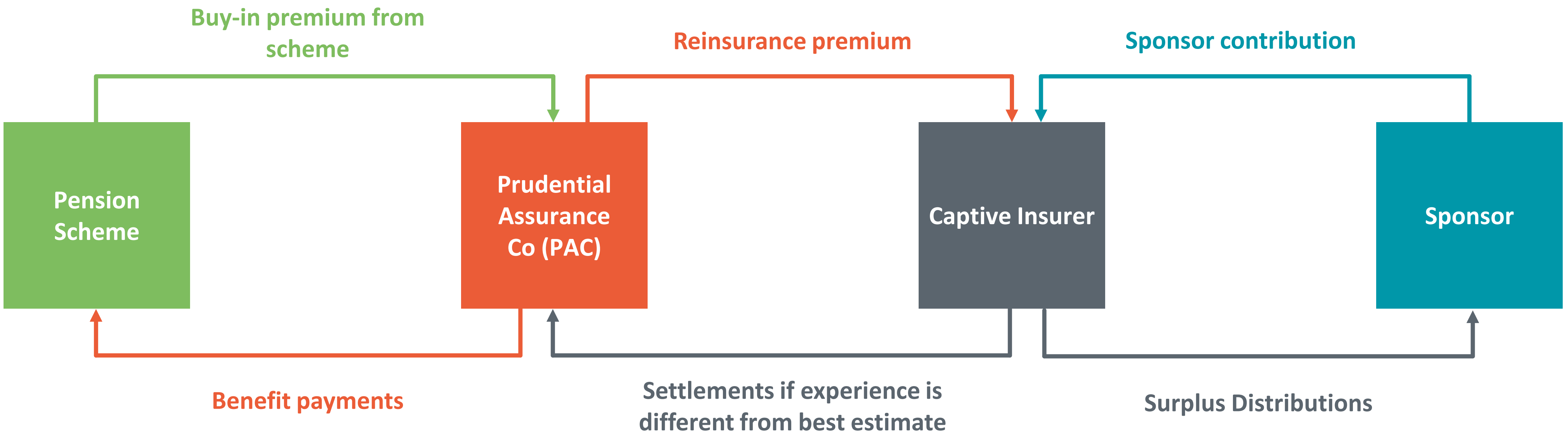
- Guaranteed minimum return in excess of risk-free
- Cashflow matching
- No longevity risk protection – an investment solution only

- Assets backing the policy comprise a portfolio of investment grade credit:
  - Very similar to a bulk annuity
  - However, profit in excess of the guaranteed return is split 90:10 between M&G and the Scheme

M&G Captive Reinsurance

Captive reinsurance

How does the solution work?



The **Trustee** enters into a standard buy-in policy with PAC. Scheme members benefit from a fully insured solution

M&G manages the assets for the transaction

Captive insurer underwrites the risk for PAC that assets are insufficient to meet expected benefit payments

The **Sponsor** is eligible for surplus release from the structure as this emerges over time, in exchange for its contribution at inception to complete the Cell's capital requirements

Q&A

Thank you