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Life & Financial Services Insights

Could superfunds disrupt the bulk annuity market?

The Pensions Regulator ("TPR") recently published details of an interim regime for the pre-authorisation of so-called "superfunds", which provide an alternative means of settling defined benefit pension liabilities for schemes that might otherwise have aimed to insure their liabilities with an insurer.

We have already published an article summarising this interim regime. However, a key issue for insurers is how much disruption the new regime might cause for the bulk annuity market.

What is a superfund anyway?

A superfund acts very much like a bulk annuity insurer in that it will agree to take on the obligation of paying the benefits due to the pension scheme members in exchange for a one-off, up-front payment. However, the key difference is that the superfund is not an authorised insurance company. Instead, it is a trust-based pension scheme into which all the liabilities are consolidated, backed by a capital buffer. This capital buffer would likely be funded through a combination of the margins within the premium and seed capital provided by the owners of the superfund. It supports the superfund's risks and, at some point, the owners hope to extract profit from the capital buffer.

Superfunds are not subject to Solvency II, nor are they regulated by the PRA. The government plans to create a legislative and supervisory framework, but until then superfunds will be regulated by TPR.

Importantly, TPR has confirmed its expectation that pension scheme sponsors and trustees should look to consolidate only if buy-out is unaffordable, with no reasonable prospects of buy-out in the medium term.

How does TPR's interim regime compare to Solvency II?

Area	TPR superfund guidance	Solvency II
Permitted investments	Few prescriptive requirements, other than an initial restriction on illiquid assets. Investments could be in equities, corporate bonds, alternative fixed interest, gilts and swaps, although riskier assets will attract a higher capital charge.	Although most investments are permitted, a bulk annuity writer needs to achieve a Matching Adjustment ("MA") to be competitive. MA regulations require firms to invest in bond-like assets delivering fixed cash flows.
Liability discount rate	Gilt yield + 50bps.	Can be approximated as the yield on assets less a prescribed allowance for cost of future defaults and downgrades. Typical range of 100-150bps over swaps.
Risk Margin	Not applicable.	Likely to be at least 8% of best-estimate liability for pensions in payment (if not reinsured)[1]. Higher for deferred pensions.

Area	TPR superfund guidance	Solvency II
Structure of capital requirements[2]	99% value-at-risk over five years	99.5% value-at-risk over one year
Calculation of capital requirements	Calculated by firm and reviewed by TPR. Modelling by TPR suggests capital requirement may be 18%-28% of liabilities assuming 50/50 split of deferred and in-payment.	Calculated using Standard Formula, or by a firm's Internal Model. Typical range for insurers is between 7% - 10% after reinsurance and books typically weighted towards in-payment

1. *Institute and Faculty of Actuaries Risk Margin working party estimated that the Risk Margin for a block of in-payment annuities with a duration of 10 years might be 8.4% if the insurer used the Standard Formula to calculate its capital requirements; see here.*
2. *It is important to note that a 99% 5-year VaR and a 99.5% 1-year VaR approach are difficult to compare – it is not necessarily the case that a 99% 5-year VaR is weaker than a 99.5% 1-year VaR, or conversely.*

Could superfunds disrupt the market for pensions in payment?

Historically, insurers have mainly targeted pensions in payment within their bulk annuity deals, albeit more bulk annuity writers are targeting deferred pensions in recent years – as seen in our 2020 Risk Transfer Report. Insuring pensions in payment is attractive for insurers because:

1. the duration is sufficiently short that the insurer can source matching fixed-interest assets which satisfy the MA requirements; and
2. there is an active reinsurance market for pensions in payment – and it is normally cheaper for insurers to reinsure these liabilities than to hold both the associated Risk Margin and the capital requirement for longevity risk on their balance sheets.

Based on the table above, it does not seem obvious to us that superfunds will have any particular regulatory capital advantages over insurers when it comes to competing for blocks of pensions in payment. However, it is difficult to make a comprehensive assessment of this, since TPR's estimates for a superfund's capital requirements are based on a 50/50 split of pensions in payment and deferred pensions.

Additionally, superfunds are intended to provide full settlement for sponsors and trustees, and therefore will not be directly competing with insurers for pensioner buy-ins.

What about deferred pensions?

At present some schemes may be unable to complete a buy-out with an insurer owing to the cost of insuring deferred pensions – which tends to be higher than the cost of insuring pensions in payment. However, superfunds may have some regulatory capital advantages when it comes to deferred pensions:

Challenge	Superfunds	Insurers
Backing assets	Permitted to invest in equities, albeit with a high capital charge Fewer restrictions relating to fixed-interest assets.	May struggle to find sufficiently long-duration fixed-interest assets that yield an appropriate spread and equity investment unsuitable due to MA restrictions.
Longevity risk	No Risk Margin requirement. TPR has suggested that longevity risk component of capital requirements may be around 3% of liabilities.	Limited (but growing) reinsurance market. Insurers have to hold both Risk Margin and longevity risk component of capital requirements if risk not reinsured. Compounding this, the risk is longer tailed.

Is it desirable to have two different regulatory regimes for the same transactions?

Having separate regulatory regimes for superfunds and insurers can certainly be questioned, since they are engaged in broadly similar activities. Some insurers have already criticised what they see as regulatory arbitrage, and the Governor of the Bank of England has also expressed concerns that superfunds may pose a risk to financial stability.

However, others have argued that there are a significant number of pension schemes for which the securing of benefits with an insurer is unlikely to be a viable option in the foreseeable future. Transferring these schemes to a superfund may provide the members with a greater level of security than the sponsoring employer can provide, even if this is less secure than buying out with an insurer.

Ultimately, over time, it could be difficult to keep two regimes for fundamentally similar liabilities and so some movement, either in terms of the insurance regulation, post-Brexit, or from the TPR is possible.

Could insurers take advantage of the superfunds regime?

While there doesn't seem to be a way of transferring existing insurance liabilities to superfunds, in theory it may be possible for insurers to set up superfunds themselves that could compete for new consolidation deals. This might allow an insurer to both leverage its existing expertise and take advantage of the apparently less onerous regulatory regime for deferred pensions. Whether this could be approved in practice remains to be seen. Additionally, there is potential that any benefits gained consolidate out at a Group level.

So what does all this mean for the bulk annuity market?

Two models for superfunds have emerged so far:

1. **The Pensions Superfund** – which aims to manage the liabilities itself for the entire duration of the run-off, meaning that the business is never transferred to an insurer;
2. **Clara-Pensions** – which aims to manage the liabilities until many of the deferred members have retired, at which point it will transfer the liabilities to an insurer.

The interim regime includes a provision that surplus cannot be extracted from a superfund within the next three years, unless the superfund buys out its liabilities with an insurer. This may be problematic for the run-off model, unless TPR changes this requirement.

Given this, and that TPR appears to be focusing on schemes for which buy-out is unaffordable and unlikely to be achievable in the next five years, superfunds and insurers may well be playing in different markets, and could even be complementary. Some schemes which might have previously fallen into the Pension Protection Fund will now ultimately be transferred to an insurer, via a superfund.

The Clara-Pensions model should not ultimately change the destination of a pension scheme, but may delay the point at which the scheme is bought out by, and creates returns for, an insurer.

Another factor as to whether this will impact insurers is the sheer scale of liabilities that will ultimately be seeking buy-out - there is plenty of business to allow both insurers and superfunds to operate successfully.

The level of impact on an insurer is likely to be dependent on their current appetite for different types of schemes, most notably in terms of deferred / in-payment and size of scheme – early superfund deals are not likely to not be in the £3bn+ category that the likes of PIC, L&G and Rothesay transacted in 2019.

However, this is clearly a developing area, and much will depend on how the new regime is perceived by pension scheme trustees and sponsors; how the superfund regime develops in the future; and whether the UK seeks to make changes to the insurance regulatory regime at the end of the Brexit transition period.

If you would like to discuss anything mentioned in this article, please do get in touch.

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