The spectrum of de-risking options

How do you decide which are right for your scheme?

With the rapid expansion in the market of alternative de-risking options many clients are asking us - which options are relevant for my scheme? Understanding what each can offer is an important starting point.

Until recently, a scheme's options were predominantly limited to either a DIY type approach or using traditional insurance options of buy-ins, buy-outs or longevity swaps to reduce risk or settle liabilities. Whilst these options will remain the most appropriate for many schemes, the new alternatives will be attractive in some situations.

The range of new alternative options – which includes superfunds, capital-backed options and other insurance solutions* – are designed to either complement or replace a scheme's traditional de-risking options. The range of options can be broadly grouped as follows:

	"On balance sheet" options - keep the sponsor in place	*"Off balance sheet" options - remove link to the sponsor*
Traditional Options	DIY approaches/self-sufficiency Insured buy-ins/longevity swaps	Insured buy-out
New Alternative Options	Capital-backed options and other insurance solutions*	Superfunds

The attractiveness and appropriateness of each option depends on a scheme's circumstances and objectives. A sponsor's objectives may differ from the trustee's. However, as these options will typically require support from both, a common set of objectives will need to be agreed.

Which of these new options could be right for my scheme?

An alignment of both trustee and sponsor objectives is key to determining which options are appropriate for a scheme.

These objectives are likely to include whether:

- the covenant strength and financial support available from the sponsor support the option (see page 3);
- it supports the wider corporate objectives;
- the balance of costs and risks associated with the option are acceptable; and
- the option is appropriate from a reputational and regulatory perspective.

*This includes L&G's Assured Payment Policy (APP) and Insured Self-Sufficiency (ISS) solutions

Spectrum of options: High level summary

	"On balance sheet" options			"Off balance sheet" options	
	DIY approaches/ self-sufficiency	**Insured buy-ins/ longevity swaps**	**Capital-backed options and other insurance solutions**	**Superfunds**	**Insured buy-out**
Overview	Running investment or other risks with support from the sponsor (either directly or through contingent security). This can include the use of buy-ins and/ or longevity swaps (see next option).	Insurance products that reduce longevity or other pension risks (which benefit from capital protections of insurance regime).	External capital used to support a (typically) higher risk investment strategy. The capital provides downside risk protection and, in exchange, positive investment performance is shared with the capital provider (or in some models fees are paid).	External capital and top-up contribution from sponsor (if required) provided in exchange for sponsor removing themselves from supporting the scheme. The scheme transfers all its liabilities to the superfund.	"Gold standard" exit option for trustees and sponsors.
Typical candidate schemes	Typically larger (£1bn+) schemes that are comfortable with their level of risk given support available from sponsor.	Schemes which are ultimately targeting buy-out and who wish to manage and reduce risks along the way, particularly longevity risk.	Schemes willing to take a higher level of investment risk in exchange for additional capital (which the sponsor cannot provide).	Well funded schemes (or where cash available from sponsor), but where there is concern over whether sponsor can support scheme to buy-out.	Schemes which can afford the premium to buy-out, which will typically require the support of their sponsor.
Cost relative to buy-out	Varies depending on strategy and access to economies of scale. Actual cost unknown until all obligations paid.	n/a	Varies between offerings, but typically between 75%-95% of the buy-out cost.	Typically 80%-90% of the buy-out cost, but varies depending on scheme profile, etc.	n/a
Track record	Established route for schemes looking to manage risks over the long term.	Established market with volumes of buy-ins and longevity swaps totalling over £55bn in 2020.	Three transactions for L&G's "APP" solution, and one for a capital-backed option.	No transactions yet, but first expected later in 2022.	Long-established route to fully remove scheme liabilities.

New Alternative Options

How do I decide which options might be appropriate for my scheme?

Whilst there are many factors to consider - including your scheme's size and profile - for many the financial support available from the sponsor will be a key factor in determining which options could be appropriate. We have illustrated this interaction with sponsor covenant below.

Which options should I be considering based on my covenant strength?

	Sponsor covenant viewed as strong	*Some covenant concerns but no imminent risk of insolvency*	*Sponsor at imminent risk of insolvency*
DIY approaches/ self-suffiency	**Yes**	**Potentially** (if alternatives are not currently affordable)	**No**
Insured buy-ins/ longevity swaps	**Yes**	**Yes**	**Unlikely** (unless protects member outcomes on insolvency)
Capital-backed options and other insurance solutions	**Potentially**	**Yes**	**Unlikely** (sponsor's business needs to be viable to support the option)
Superfunds	**No**	**Potentially** (if buy-out unaffordable)	**Yes** (if buy-out unaffordable)
Insured buy-out	**Yes**	**Yes**	**Yes**

In practice covenant strength can change, potentially quickly (as the pandemic has shown). Even if a scheme is currently targeting full insured buy-out, it is important to understand the circumstances in which alternative options may become attractive, and have contingency plans in place. You are then in a strong position to proactively navigate unforeseen circumstances.

Our practical experience

Our work in this area includes:

- Acting as lead adviser on two of the three APP transactions to date;
- Full pricing processes with the superfunds and the ISS solution; and
- Advising early movers considering capital-backed options.

This has provided us with invaluable hands on experience of how the solutions work and where they will be most appropriate. We have set out some of the insights we have gained from this work below.

For **superfunds**, which replace the sponsor covenant, the early candidates have fallen into one of the following categories:

- Well-funded schemes with relatively little covenant support.
- Schemes with sponsors in financial distress.
- Cash injection from sponsor (or parent company) is contingent on a superfund transfer.
- Transfer is being driven by corporate activity.

For **capital-backed options**, the early cases we have seen are those where either:

- A sponsor has a viable business but the ongoing pension costs have become unaffordable. A higher risk investment strategy (supported by external capital) could both reduce these costs and allow the business to continue.
- A sponsor has an appetite for a higher risk investment strategy (i.e. to reduce their contribution requirements), but is not willing or able to provide their own capital to support it.

How would I take this forward?

Under forthcoming legislation, all schemes will be required to agree a ‘Long Term Objective’ and a journey plan to get there. It is therefore important at the outset to understand the options which might be appropriate for your scheme, and the current level of funding against these potential targets. After some initial planning, we suggest the best way to achieve this is to kick start a **strategic journey planning** discussion involving representatives from both the trustees and the company. This will help align views early, and make the best use of resources. We have helped a number of clients do this, and it is then simpler to make decisions on potential options along the journey. If you would like further information, please contact any of the team below (or your regular LCP contact).

Want to find out more? Please contact us:

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