HYMANS ROBERTSON

RISK TRANSFER | **SPOTLIGHT**

Alternative risk transfer – the year the market changed gear?

The alternative risk transfer market has come of age following the first two superfund transactions.

Superfunds are a go

Attitudes toward superfunds have shifted a lot in the past few years. The difference is that Clara-Pensions is no longer just an idea. In late 2023 and early 2024 it completed the first two superfund deals in the UK. Hymans is delighted to have played a part in this market development, by leading the Debenhams transaction.

Table 1. Superfund transactions completed to date

Pension scheme	Sears Retail Pension Scheme	Debenhams Retirement Scheme
Scheme size	£590m	£600m
Members	9,600	10,400
Capital from Clara	£30m	£34m

As knowledge of Clara and comfort in superfunds grows, the momentum is likely to build, and we expect to see a steady stream of transactions with Clara. Clara has been building its capacity, following the familiar playbook we've seen insurers use in the past.

Superfund market outlook

Clara's business model is a 'bridge to insurance'. It will focus on ensuring schemes are making good progress on the path to insurance. We expect Clara to report in due course on schemes transferring to insurance.

The success stories of the first two transactions can only help build understanding and confidence, and strengthen transaction pipelines. Market perceptions have already come a long way, from widespread scepticism about superfunds to many stakeholders seeing them as a viable and valuable addition to the market.

What does the future hold for superfunds?

A range of capital providers are interested in putting capital at risk to underwrite benefits promised to members for very well funded schemes. This investment is an attractive risk-adjusted expected return, and we continue to see significant interest in making these investments – for example, the new entrants in the bulk annuity market represent a new wave of investors aiming to deploy capital.

If Clara continues to have success, we wouldn't be surprised to see two or three new superfunds emerge over the next three years as an alternative route to invest in the risk transfer market.

Superfund oversight

It will be interesting to see how the Pensions Regulator (TPR) responds to these changing market dynamics. TPR recently updated its guidance to allow superfunds to extract profit when their funding levels exceed a high threshold, as insurers can. This is an important change that will help a thriving superfund market to develop, and has been a long time coming.

The Government is developing legislation to oversee superfunds, which would allow TPR to fulfil its natural role as a regulator and not a rule-setter. As part of its oversight role, TPR closely scrutinises superfunds on an ongoing basis as part of an enhanced oversight regime and also reviews each proposed superfund transaction. It will be interesting to see how TPR manages a resourcing strain that could result from a flurry of transactions and interest from potential new entrants.

We'd be disappointed if regulatory bandwidth became a barrier to innovation and positive member outcomes. In due course, we expect TPR to conduct this review in a way to allow schemes to move at pace towards their preferred endgame – such as some form of 'fast track' option where the proposal is based on a tried and tested submission pack.

Figure 1. Oversight process for superfunds to write business

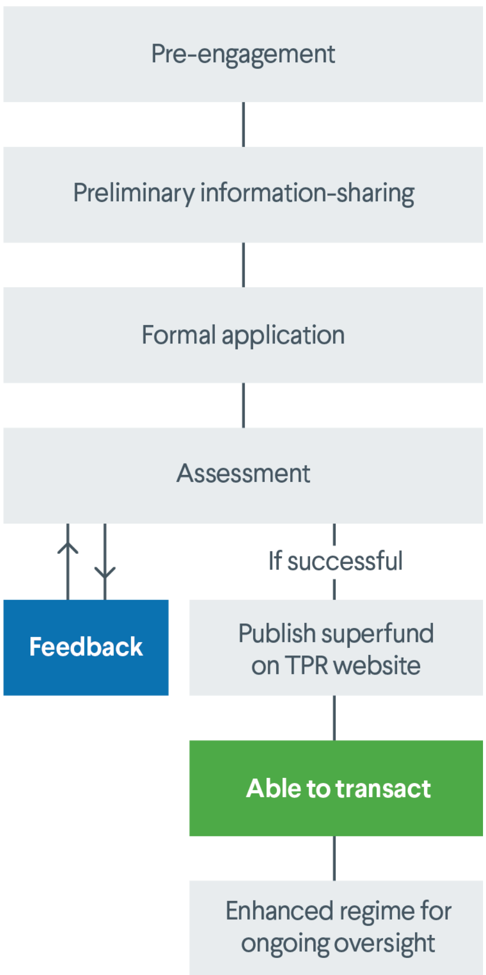
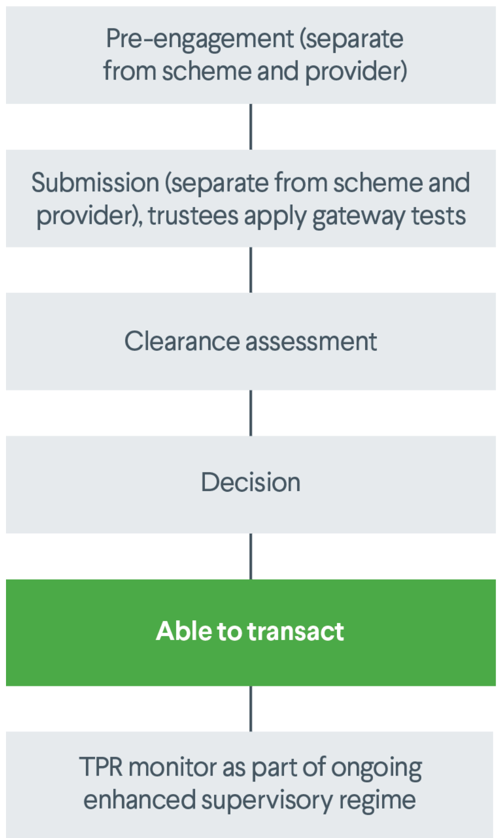


Figure 2. Oversight process for superfund transactions



Gateway tests

An area in need of a fundamental review is TPR's 'gateway' tests. TPR uses these tests to assess whether a scheme can enter a superfund transaction. The tests have a narrow focus. They make no allowance for non-price factors, such as decarbonisation plans or administration service, which could be relevant for trustees making endgame decisions.

For example, a scheme's trustees might consider a superfund to offer a better member experience than an insurer, making it more appealing. Endgame decisions can be complex, and a blunt tool can be unhelpful.

There could be merit in TPR giving trustees the freedom to select their preferred endgame in line with their fiduciary duties to members. Doing so would be consistent with TPR's oversight of buy-in decision-making – TPR doesn't steer trustees away from buy-out if they have a crown guarantee backing members' benefits.

The gateway tests may be much better suited to a set of principles with trustees asked to 'comply or explain' as part of a 'fast track' review.

A shift in the Regulator's thinking

As superfund transactions are gathering pace, other capital-backed risk transfer arrangements have stalled. Providers still show a lot of interest in offering capital-backed solutions, but live discussions are struggling to make it through to transacting.

The first superfund transactions came about as schemes were compelled to act – put simply, they could transact with a superfund, or give their members reduced benefits. Capital-backed solutions have also been of interest to distressed schemes, but several issues have prevented transactions.

One issue has been uncertainty over how TPR and the Pension Protection Fund (PPF) will view a capital-backed solution after a sponsor insolvency. Trustees are concerned that being forced to exit a capital-backed arrangement would be value-destructive at a time when the scheme would already be grappling with an insolvent sponsor.

Over the past few years, TPR has taken a two-pronged approach to regulatory reform in this area. Changes in the content of various publications have been accompanied by encouraging debate about what schemes can or should do.

Over this time TPR's emphasis has shifted: the Regulator is clear that it supports a range of endgames and has less of a presumption that all schemes are on a journey to insure. This view aligns with the industry recognising that a range of factors can lead to a range of strategic decisions. Schemes that are large enough to run on could be taking a rewarded risk; other options could be to insure, or transact with a superfund or capital-backed solution.

What about the public-sector consolidator?

Recent government consultations have probed the possibility of a public-sector consolidator. If one were formed, it could be another valuable tool to help members whose benefits may otherwise be at risk.

Commercial consolidators can offer a lower entry price than insurers by offering less security. In contrast, a state-backed consolidator is likely to have access to more capital at a lower cost than commercial entities – so it has the potential to be stronger than an insurer and cheaper than a superfund.

This combination of implicit or explicit state backing and lower entry cost could make a public consolidator the preferred option for trustees and sponsors. To minimise its potential disruption to a large and active risk transfer market, a public consolidator is likely to come with entry tests or criteria. The devil will be in the detail, and we expect these rules will be challenging to agree.

What does all this mean for the risk transfer market?

The question isn't whether schemes will change their endgames, but how many schemes will, how quickly and to what. We look forward to playing a part in the continued growth of the superfund market, as it has the potential to lead to better member outcomes.

We're delighted to have launched our streamlined offering to trustees and sponsors considering Clara. This lets schemes engage with superfunds in a way that avoids the execution risk and higher costs usually associated with new products.

A backdrop of broader endgame discussions and TPR's change in emphasis have made the industry a little more friendly for alternative risk transfer. After many false dawns, it will be interesting to see if these conditions let the market grow or if demand will disappoint alternative providers.

Trustees and sponsors have more options than ever, and decisions about endgames aren't easy. It's crucial to work through them in an orderly way, and know the state of the market. Trustees and sponsors should keep an eye on the latest developments, and what might be on the horizon.

Want to find out more?

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