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Capital Backed Funding Arrangements

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Why are we here?

Capital Backed Funding Arrangements (CBFAs) are agreements which commit to a particular

… investment return or financial outcome

… for a defined period*,*

… backed by capital *which underwrites this commitment*

- Third party capital to support de-risking is well established within buy-in market. CBFAs are not buy-ins.
- Trustees/sponsors keen to understand full range of options, BUT
- High barriers to understand CBFA market (time and cost)
- Working Party convened to address this need

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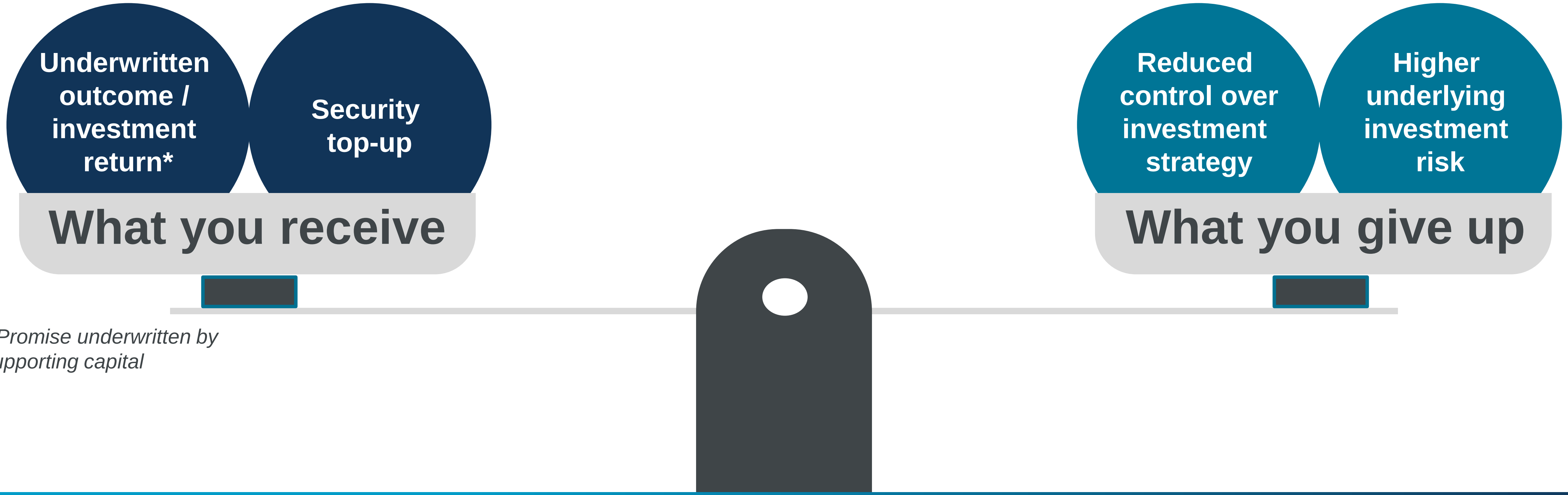
Overview of CBFA assessment



** Promise underwritten by supporting capital*

Need to weigh up pros and cons of CBFA solution

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Potential benefits of CBFAs

Reduce downside investment risk by underwriting fixed end date to deliver full-funding

Pay benefit cashflows while retaining some investment upside and flexibility

Strengthen and lengthen the sponsor covenant

Expertise & governance Strategies or economies hard to achieve by trustees directly

Path to buyout / superfund Framework ahead of time to improve ability to transact

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Not all CBFAs offer all these features

CBFAs supporting run-on strategies

Better funded schemes

Considerations

Implement

Ongoing support for members: discretionary increases and maintain trustee relationship

Capture value from expected surplus (meet DC costs / return of capital)

Minimum downside protection requirements (e.g. min buffer over buy-in cost?)

Delay / avoid accounting impact

CBFA
(3rd party capital)

DIY

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CBFA use cases for insurance endgames

Case 1

c.90% funded

Schemes close to buyout but not there yet

→ Substantial risk asymmetry
→ Hard to plan for

Case 2

c.100% funded

Buyout not yet viable

Need to hedge inv. risk

Need to retain some flexibility and upside

→ Buy-in pricing hedge would require re-risking – appropriate?
→ May make it harder to insure residual risk

Case 3

c.80% funded

Limited visibility on sponsor covenant 5y+

→ Risk that future corporate activity could crystallise benefit reductions despite strong funding

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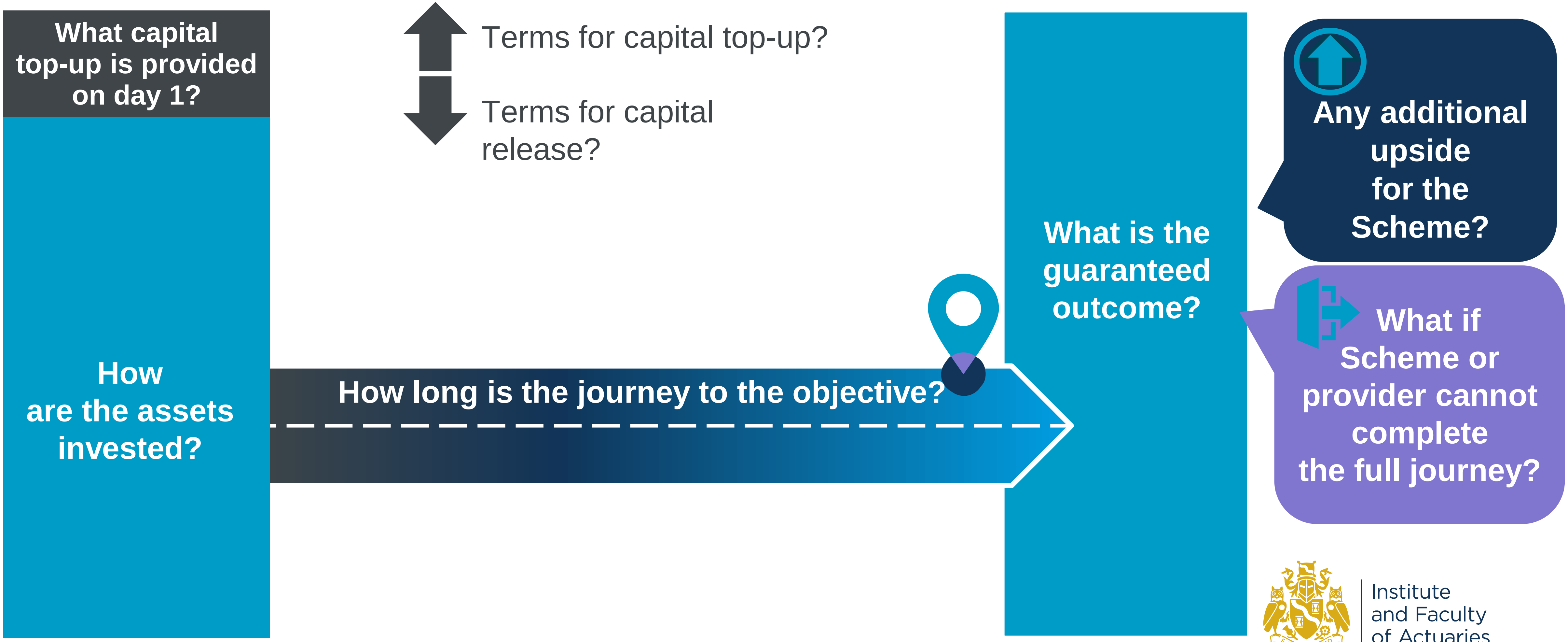
Key features of CBFAs



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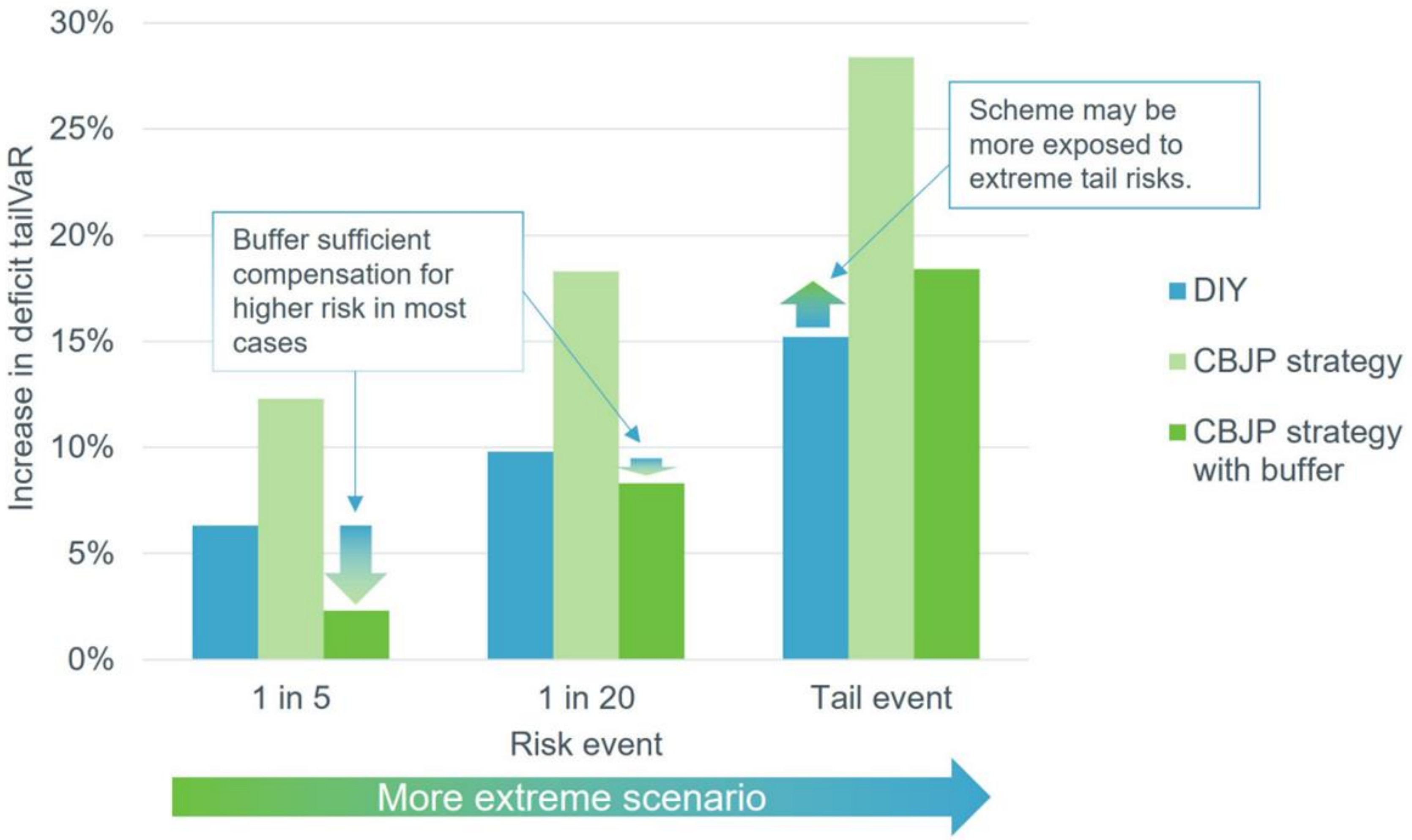
Portfolio risk vs capital buffer - stress testing



Source: Hymans Robertson

Case 1

Type 1: Return focussed arrangements

Scheme 10 years from buyout (best estimate); enters a CBFA to accelerate this to 7 years with increased certainty of achieving that outcome

5-10% capital provided on day 1

Leveraged high quality credit investments + LDI hedging (equivalent to g+3-4% pa return)

Capital top-up if required to maintain target

Any surplus returned to CBFA provider at end of term

7 years

“Guaranteed” outcome of g+1-2% pa over 7 years, (with potential commitment to support buyout transaction at end of term)

No sharing of upside with scheme

If terminated early: Arrangement is terminated at fair value

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Case 2

Type 2: Cashflow focussed arrangements

Scheme 5 years from Target End State - entering CBFA to protect cashflows in final stage of journey, with potential access to upside returns for discretionary increases to members

Capital as per PRA requirements ("1 in 200")

MA eligible credit portfolio (e.g. expected return g+1.5%pa)

Solvency capital varied as per PRA regime

Paying defined cashflows

"Guarantee" to deliver expected cashflows (pricing equivalent to e.g. g + 0.5%pa)

90% share of surplus returned to the Scheme

No surrender penalties: can be terminated at any time

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Case 3

Type 3: Covenant focussed arrangements

Scheme 90% funded (buyout basis) 7 year expected time to buyout, but Tending to Weak covenant. Entering CBFA to protect this timescale against employer insolvency, and potential discretionary benefit increases at buyout

Capital to maintain P(success) >99%

Capital contributed if required to maintain P(success) >99%

Protected equity / high yield credit + LDI hedging (equivalent to g+3% pa return)

7 years

No guaranteed outcome but targets buyout funding

Scheme: 20% share of surplus after 7 years

Provider becomes sole employer if sponsor fails

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What should trustees (and their advisors) consider?

Early termination provision	Legal and regulatory	Capital and covenant support
Governance and control	What do you get and what do you give up?	Investment strategy and risk
Surplus extraction and other costs	Target outcome or guarantee	Term

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Employer lens

CBJP reduces ongoing Scheme reliance on Employer

But, employer remains the backstop underwriter of risk

Conclusion

- CBFAs offer tangible benefits to DB schemes to change the investment and covenant risk profile supported by third party capital;
  - Downside protection, covenant improvement, investment expertise, governance, route to buyout / low dependency.
  - Differing solutions can support a range of different funding strategies
- But new risks to consider

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Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

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