

SESSIONAL PAPER

# Capital Backed Funding Arrangements

[Developments in the alternative risk transfer market for defined benefit pension schemes, Presented to the Institute & Faculty of Actuaries, Staple Inn Hall, London 14 September 2023]

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## Abstract

The rise in interest rates globally in 2022–23 led to improved scheme funding for many defined-benefit pension schemes. Many schemes in the UK now find themselves closer to, or at, a fully funded position on a low-risk basis (annuity buyout or self-sufficiency). Finishing the journey while managing the risk of losses on that journey is highly desirable, but may be difficult to achieve in practice.

However many schemes are not yet sufficiently funded to buy out liabilities in full with an insurer. Others may not wish to, and many who can afford to do so are not yet able to for investment reasons (such as holding illiquid assets) or operational reasons (such as the time needed to resolve member data issues). For schemes that instead look to adopt self-sufficient ongoing management with low dependency on the sponsoring employer, this may be difficult to maintain in practice. In short, there remains a risk that benefits will not be secured in full, which with hindsight could have been avoided.

The addition of capital to pension scheme assets has long been deployed to enhance the security of member benefits e.g., capital from insurers in the case of a buyout or capital from sponsors in the form of contingent assets.

More recently, providers have developed a diverse set of arrangements that draw on external capital to aid trustees and corporates to meet scheme funding ambitions. Capital Backed Funding Arrangements (“CBFA”) are in this context an additional tool in the trustee toolkit for delivering funding strategies.

This paper focusses on the UK-defined benefit market but the dynamics are applicable to other jurisdictions, with CBFAs being developed for wider markets (e.g., Ireland).

In this paper we:

- survey the current scheme funding landscape and consider the need in this environment for arrangements to support scheme funding journeys to deliver benefits in full
- summarise the key features of arrangements in the market that may support these objectives
- set out considerations for trustees and sponsoring companies when assessing these arrangements.

The aim of this paper is educational – to increase awareness of the key issues and potential solutions. Professional advice will always be required prior to any transaction. We welcome feedback from readers on further material that would be beneficial to support consideration of these arrangements.

**Keywords:** Capital Backed Funding Arrangements; investment strategy; journey planning; private capital; scheme funding

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The authors, each a member of the IFOA Capital Backed Funding Arrangements Working Group, have experience in investment, pensions and corporate consulting, covenant advisory, asset management, pensions and risk transfer law, and professional trusteeship. Each has direct experience advising or working with corporates and trustees on DB risk management, including alternative risk transfer arrangements. None of the authors of the paper represent CBFA providers, though the paper draws on the experience of members who do.

## 1. Introduction

### 1.1. Why Now?

Many defined benefit pension (DB) schemes now find themselves on track or ahead of their funding targets. In its latest Annual Funding Statement in April 2023, the Pensions Regulator (“TPR”) estimated that around a quarter of all DB schemes may now have sufficient assets to buy out their liabilities with insurance companies (The Pensions Regulator (TPR), 2023) (around £400bn of liabilities).

Funding shortfalls become harder to recover from in closed schemes, where benefit outgo exceeds contributions and investment returns. Reducing downside risks therefore becomes key as a scheme matures, if the rights accrued under the scheme rules are to be paid in full. There is a need, therefore, for a maturing scheme to move towards a position of strong funding with low reliance on the sponsoring employer, as discussed in TPR’s draft funding code of practice (The Pensions Regulator (TPR), 2020).

### 1.2. Finishing Well

Despite strong funding on paper, schemes may find that an insurance buyout is not feasible or desirable in the near term:

- Many schemes are not ready to buy out liabilities in full via an insurer, due to the time needed to prepare data, or the presence of illiquid assets that cannot be sold at fair value, for instance
- Others do not wish to due to, for example, corporate accounting implications or the potential loss of future surplus that might support discretionary increases, fund a defined contribution section, or be refunded to the company
- Others will not yet be able to, for example, due to ongoing accrual or other benefits that are difficult to insure in the current form

certain schemes may start to find it more challenging to access the bulk annuity market given increasing levels of demand may start to outpace supply (i.e. pricing resources, capital sourcing and asset sourcing would all need to increase from the current £30–50 billion annual deal volume shown in Figure 1 (Mercer, 2023) to meet expected demand, given the approximately £400bn of scheme liabilities already funded to buyout). This creates new issues around concentration of risk in the process, which is already receiving attention from the Bank of England and the Prudential Regulation Authority (Gerkin, 2023a, 2023b).

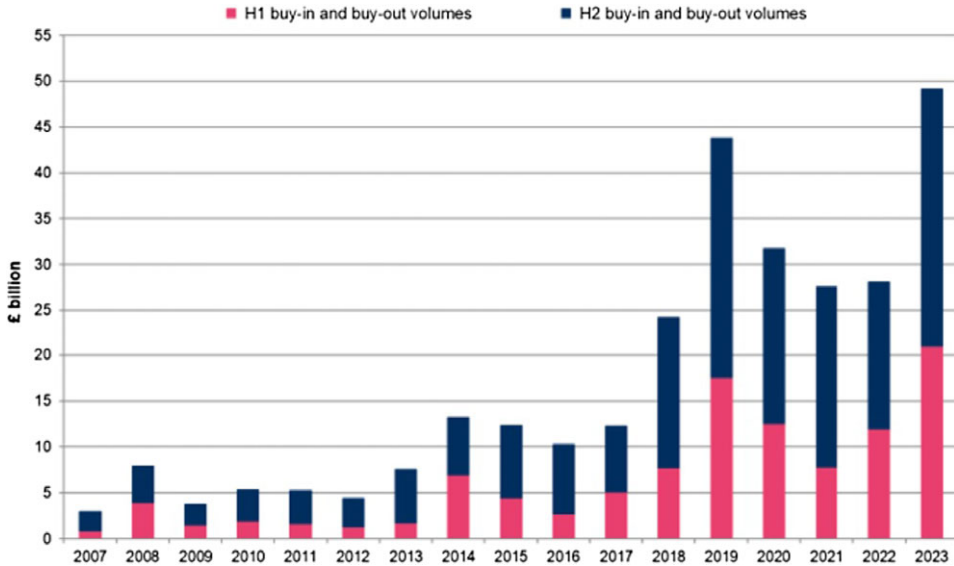


Figure 1. Risk transfer market values for bulk annuities and longevity swaps, 2006–2022.



Figure 2. Factors contributing to the demand for capital backed funding arrangements.

It is into this context that Capital Backed Funding Arrangements have come to the fore as a tool for the risk management of DB schemes (Figure 2).

The IFoA Target End States Working Party defined the “Target End State” as the “state for a scheme such that, when it achieves that state (providing it maintains it), member benefit entitlements will be met in full, with a high degree of certainty.” In practice, the target end state is likely to entail one or more of (1) a buyout of benefits by an insurance company (2) transfer to a superfund or (3) long-term “low dependency” runoff, for example within a DB master trust.

Meanwhile, as a scheme gets closer to its “Target End State,” the scheme’s risk profile, relative importance of different risks and importance of risks between different stakeholders will change. For example:

- As pension funding improves, an asymmetry of risk becomes more apparent, driving a greater desire to reduce downside risk than to retain upside potential.
- Under a conventional journey plan, a decision arises about whether it is better to reduce investment risk further, to protect against short-term market fluctuations but remain reliant on the company to underwrite the scheme for longer, or to maintain a higher level of return in the hope of reaching their end game sooner – but with greater risk of underperformance in the short term.
- The employer’s focus on the opportunity cost and tax implications of trapped surplus is likely to increase. For many employers, it may not appear to be an efficient use of capital to pay cash into the pension scheme to reach full funding on a buyout or low-dependency basis if this results in a heightened risk of trapped surplus emerging.
- The consequences of missed opportunities to secure benefits in full become more apparent, particularly if a company experiences unforeseen financial stress or insolvency at a time when scheme funding has fallen back. These risks may be of particular concern in the current economic environment when companies are already facing increasing stress on several fronts.

Improved scheme funding has increased the focus on the difficulties in balancing the different risks a scheme is exposed to towards the end of its journey plan.

### **1.3. External Capital**

A diverse set of arrangements has been developed by several providers (including those listed in Section 7) that draw on external capital to aid trustees and corporates to meet scheme funding ambitions.

External capital has long been deployed to underwrite member benefits in the form of an insurance buyout. Indeed, the deployment by private equity firms of capital to buy insurance books is a trend that appears set to continue (McKinsey, 2023) given the mismatch in time horizon that can exist between public equity shareholders and pension/insurance liabilities. “Capital Backed Funding Arrangements” (“CBFAs”) are in this sense an additional tool in the trustee toolkit.

In contrast to a DB master trust, superfund, or pension buyout where there is a step-change in governance arrangements, the CBFAs considered in this paper are primarily an investment decision, time-limited and within the remit of the existing trustee board.

Through introducing external capital that may be called on before the employer’s own capital, CBFAs can potentially improve member outcomes in a number of ways:

- **Reduce downside investment risk** by underwriting the risk of poor investment returns. This may allow a scheme to achieve buyout or a low dependency position more predictably or earlier.
- **Pay benefit cashflows with added security**, while retaining some investment upside and flexibility. This may be attractive for schemes where buyout is unnecessary or infeasible, whether due to capacity constraints in the buyout market, a desire to support ongoing accrual, or a desire to earmark surplus growth for discretionary benefits such as additional pension increases.
- **Supplement the sponsoring employer’s covenant**, to provide assurance where sponsor covenant has more limited visibility or greater uncertainty.

The Government's response to the DWP's consultation on superfunds acknowledged the development of this market, noting that "the scope of the definition for superfunds needs to be sufficiently broad to accommodate these and any future developments"; and that "this would probably be supplemented by carve outs in the subsequent secondary legislation for those forms of consolidation or other models we do not think will benefit from being regulated under TPR's superfund regime" (Trott, 2023). The key distinction here is whether the ceding employer's link is severed or substantially altered either by the CBFA itself or at some point in the future.

In this paper, we focus on arrangements that are designed to supplement the existing covenant rather than substantially alter the employer's link. Nevertheless, the considerations in this paper will be relevant to superfunds to the extent they share the design features discussed.

We set out considerations for trustees and sponsoring companies when assessing whether a CBFA may improve the scheme's progress on its journey to secure benefits in full, and how it might be structured.

## 2. Key Features

### 2.1. What are CBFAs?

Capital Backed Funding Arrangements are agreements that offer a particular investment return or financial outcome for a defined period, backed by third-party capital that underwrites this commitment. The existing sponsor remains adhered to the scheme.

While CBFAs may take a range of approaches, the key benefits offered can be summarised as:

- **Downside protection:** Aim to underwrite investment risk, reducing the likelihood of future deficits arising as external capital is the first source to make good such deficits, reducing the risk that additional employer contributions are required. Some arrangements may also offer to underwrite other risks e.g., member mortality experience, scheme expenses or insurance pricing at maturity.
- **Pay benefit cashflows** with added security, but at lower cost than buy-in: Unlike a buy-in contract, some investment upside can be retained as well as the ability to terminate the arrangement if required.
- **Supplement the sponsor covenant:** Reduce the need for the sponsor covenant to underwrite adverse investment performance and may support the scheme in entering a continuing arrangement if the sponsor covenant deteriorates during its term, for example, due to sale of a business unit, additional employer debt, reorganisation of business operations or general deterioration in outlook for the sponsor's business.
- **Investment expertise and governance:** Can provide access to investment strategies, economies of scale, liquidity management or operating platforms that may be harder to achieve effectively by a trustee board directly.
- **Path to buyout or superfund:** In addition to the above, arrangements may support the scheme's ability to transact an insurance buyout at the end of its term by providing a more definite and/or shorter period in which to progress other workstreams as full funding draws closer, and potentially deliver an asset portfolio that more closely matches buyout pricing. Others establish a route to a superfund arrangement should the company fail during the term of the arrangement.

While the principle of CBFAs has been around for some time, most arrangements currently being marketed have yet to transact in their current form for a combination of reasons:

- Lack of information in the public domain
- Perceived "first mover disadvantage"

- Evolution of the Superfund regime and its eligibility criteria
- Some providers' arrangements being at an earlier stage of development (itself a consequence of the above)
- Rapid change in funding levels in 2022–23 has required time for trustees to assess appropriate next steps, which may differ from the prior journey plan.

One common theme of CBFAs is an intent to change the shape of the scheme's journey plan from one with a distribution of variable outcomes to one with a contractually agreed outcome or outcomes that are delivered with a high degree of certainty in all but the most extreme of scenarios.

The underlying investment strategy of the CBFA may run a higher level of investment risk or adopt significantly less liquid strategies than the scheme would otherwise run to achieve its target end state. However, the additional capital provided by the CBFA is intended to ensure that the funding level of the scheme in a downside scenario would be higher than under the status quo investment strategy.

We demonstrate this using two illustrative comparisons in Figures 3 and 4 below:

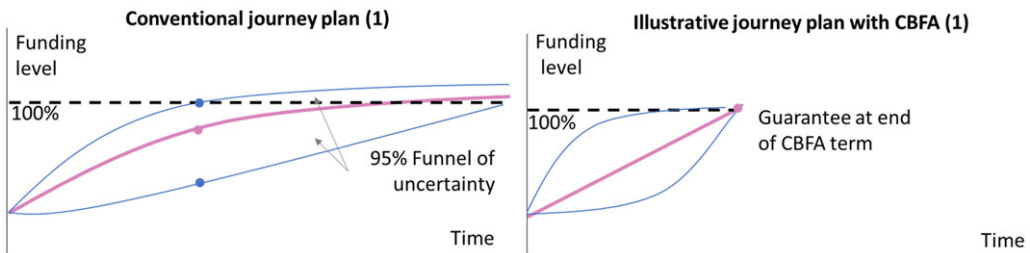


Figure 3. Conventional and illustrative journey plan (1).

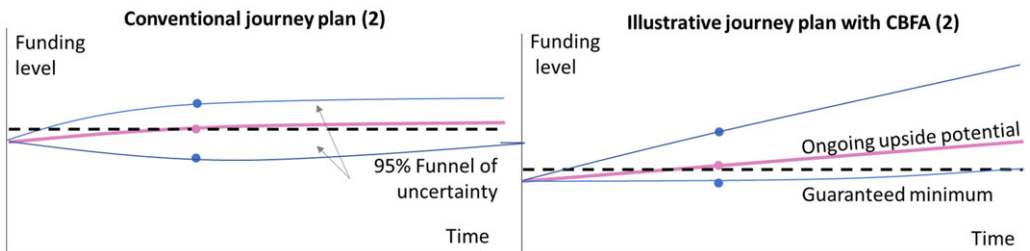


Figure 4. Conventional and illustrative journey plan (2).

It is particularly important to carefully consider the measures of risk being used to assess different strategies. Stochastic and deterministic modelling, and specifically analysis of extreme downside scenarios, could be useful tools to allow trustees and sponsors to make informed decisions when assessing CBFAs against alternative strategies.

We conducted interviews with seven CBFA providers. Based on these providers' responses we have grouped the main design features of the arrangements into three main areas in Figure 5. The providers' arrangements typically incorporate elements from more than one area.

## 2.2. Return Focus

This aims to reduce downside investment risk by underwriting the risk of poor investment returns.

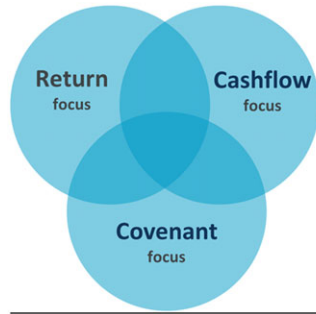


Figure 5. Main design features of arrangements of surveyed CBFA providers.

These arrangements typically target a defined return over the whole period (rather than year by year), expressed either as an absolute return, or a spread over government bond yields, such as gilts+1.5%–2.5% per annum, or to achieve full funding on actual or proxy buyout pricing (possibly within defined limits).

They typically involve:

- A defined period, for example, 6 years (possibly with the ability to extend if required); structures are not generally designed to be terminated early as the investment objective may be achieved using illiquid assets that mature during the life of the arrangement.
- Capital invested alongside scheme assets within a dedicated legal entity (most commonly for private capital providers), or implicit capital support (from the solvency capital of an insurance company).
- Level of capital provided to reduce the risk of failure to reach objective e.g., to below 1%.
- The trustees enter into a pre-agreed investment strategy aligned to the provider's approach, plus associated risk controls.
- Potentially a defined funding target (i.e., a contractual agreement that the scheme is fully funded on an agreed measure at the end of the defined period).
- An agreement to meet scheme cashflows falling due during the period.
- Surplus assets in excess of the agreed target return returning to the capital provider at the end of the term, possibly with a degree of risk sharing.

### 2.3. Cashflow Focus

This pays benefit cashflows with added security while retaining some investment upside and flexibility. These arrangements typically commit to paying a defined stream of cashflows to the scheme to meet members' benefits as they fall due. They differ from an insurance buy-in contract in that:

- Cashflows may be provided using a simpler approach than might be typical in a buy-in contract.
- The arrangement may be designed to exit during its life, allowing the assets to be used as part of a wider scheme transaction in future.
- Returns above the guaranteed return (such as gilt+0.5%-0.75%) might be shared with the scheme (similar to a with-profits fund arrangement).
- Protection may exclude certain risks (e.g., demographic risks such as longevity) or be limited (e.g. subject to minimum investment return).

These approaches seek to utilise the additional investment flexibility not available in traditional bulk annuity models to deliver benefit cashflows at a lower cost. However, care is needed to

understand the risk of any potential benefit cashflow mismatch where certain risks are excluded under the solution and the implications this may have.

**2.4. Covenant Focus**

This supplements the sponsor covenant. A new company, backed by capital rather than the original operating business, assumes an obligation as a “sponsoring employer” in addition to the current employer:

- The scheme may have charge over a defined pool or amount of assets that would be used to recapitalise the scheme in certain situations (for example if funding level falls below a certain threshold or an insolvency event occurs)
- The arrangement may involve an initial payment to contribute to the capital buffer
- The new company may specify limits or targets to the investment strategy or might be relatively “silent” depending on the arrangement

Primary responsibility for ongoing funding would remain with the existing employer but pass to the new company under certain circumstance@@

- The additional employer enables the term of such arrangements to be longer than those with a pure return focus e.g., more than 15 years for schemes with moderate-to-strong employer covenant
- A commitment may be included that the scheme secures liabilities with an insurer at a certain maturity, such as when the proportion of deferred members (which are more expensive to insure) becomes small
- CBFAs with provision to continue after the insolvency of the sponsoring employer will need to demonstrate how they will comply with TPR’s superfund guidance at that point (The Pensions Regulator (TPR) (2020, June), and may fall within the legislative definition of a superfund at outset if such legislation is published in the coming years (Trott, 2023).

**2.5. CBFA “Key Features”**

We set out below a framework for assessing CBFAs based on seven key features common to all CBFA arrangements we have considered. This framework may assist trustees and their advisors in assessing and comparing arrangements proposed to them against the scheme’s own long-term objectives.

**2.6. How CBFAs Could Meet Scheme and Sponsor Objectives**

Key feature	Current market options
1. Capital and covenant support (downside protection)	Many arrangements contribute as capital support an agreed percentage of scheme assets into a CBFA vehicle on day one; however, capital levels vary widely between providers. Some arrangements provide additional capital during the term of the CBFA, whereas for others the arrangement would end if the provider’s capital was extinguished. Insurance-based arrangements are supported by the insurer’s overall solvency capital. Under some CBFAs the provider may become an additional employer, potentially providing further security for scheme members in the event of insolvency of the initial scheme sponsor.

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Key feature	Current market options
2. Investment strategy and risk	<p>The investment strategy would typically underwrite a level of investment return that allows the return objective to be met with high degree of certainty within the target term, with surplus returns accruing to the provider (or shared), and low returns consuming the capital buffer.</p> <p>This contrasts with a traditional journey plan that may target a lower return to achieve the return objective and with actual investment performance and other experience determining the length of the journey.</p> <p>Most arrangements target high levels of interest rate and inflation hedging during the CBFA term. Some arrangements invest in contractual assets of a term similar to the CBFA itself, designed to liquidate naturally as the term approaches.</p>
3. Term	<p>Arrangements range in maturity from 5 years to 20 years. In setting the term, providers are seeking to find a balance that allows long enough for the return objective to be achieved with sufficient confidence, without tying up capital for longer than their capital providers wish. An initial premium payable to the scheme by the sponsoring company may be required to get the scheme to a sufficient funding level such that the solution can deliver its objective and be commercially attractive to the provider.</p> <p>The range of terms reflects both differences in the structures and the preferences of different capital providers. As this market is developing many providers are willing to explore variations in the terms of the arrangement that may expand the envelope of that target market.</p>
4. Target outcome or guarantee	<p>This may be a prescribed annual return (e.g., “gilts + x%” measured over the full term of the contract) or an explicit target to fund a scheme buyout based on market pricing at the time of maturity. Where buyout funding is the target outcome the commitment may be to full funding on a pre-determined “buyout proxy” or to support contractual negotiations.</p>
5. Surplus extraction and other costs	<p>Surplus, or economic upside over and above what is underwritten for the scheme, in most arrangements accrues to the capital provider. Some arrangements may share emerging surpluses or economic upside with the scheme. In some arrangements, the capital provider can reclaim any returns above the agreed capital buffer during the term of the CBFA. In other arrangements, there is no return of the capital until maturity.</p> <p>Additional costs such as investment management fees, vehicle administration and audit costs, vehicle director costs, etc. would normally be deducted during the life of the arrangement.</p>
6. Governance and control	<p><b>Investment strategy</b> needs to align with the contractual commitment and therefore will need to be determined at outset. A process will need to be agreed upon to monitor the investment performance and when certain changes can be made e.g., replacement of a manager in the case of underperformance etc., to preserve Trustee control but also ensure the arrangement remains on track, although cashflow-focused arrangements may carry more delegated investment discretion to deliver the prescribed cashflows. Clarity is also needed as to whether the arrangement constitutes fiduciary management.</p> <p><b>Joint decision-making</b> will be needed in some areas consistent with the risk exposure of the trustees and providers.</p> <p><b>Monitoring and reporting of capital adequacy:</b> Frequency and approach of reporting will also be agreed upon at outset to enable appropriate oversight by the trustees and their advisers.</p>
7. Early termination provisions	<p>Arrangements will set out the provisions for termination, including any penalty fees incurred on termination, of the contract in the following situations:</p> <ol style="list-style-type: none"> <li>i. Default of the <b>CBFA provider</b> e.g., a return of fund interpolated between initial investment and CBFA target</li> <li>ii. Insolvency of the <b>sponsoring company</b>. This may involve automatic transfer to an approved superfund, continued running on of the CBFA where a new employer has been established for the scheme, or a termination payment similar to (i) above</li> <li>iii. Voluntary termination of the CBFA by the <b>scheme trustee</b>.</li> </ol> <p>Penalties or costs may apply on early exit, particularly where there is voluntary termination by the trustee.</p>

Typical scenarios where a CBFA might support a scheme and its sponsoring company include the following:

- **Accelerated journey:** A scheme, 10 years from buyout on best estimate projections, might wish to focus on delivering a target return with high confidence to accelerate time to buyout or superfund entry to 5–7 years.
- **Journey protection:** A scheme 90% funded on a buyout basis with a 7-year expected time to buyout but Tending to Weak covenant might enter an arrangement to protect the 7-year journey to buyout against employer insolvency. If such support is designed to continue beyond any potential company insolvency, the arrangement may need to demonstrate how it can comply with TPR's Superfund's guidance.
- **Cashflow delivery:** A scheme 5 years from buyout might enter an arrangement to protect cashflows in the final stage of the journey, with potential access to upside returns for discretionary increases to members or to accelerate buyout.
- **Scheme run-on:** A large pension scheme with strong covenant may need (or want) to continue to run on the obligations over time. A CBFA could deliver sufficient returns to generate economic update and fund benefit enhancements for members, providing a mechanism to run-on the scheme that is in the members' interest.
- **Merger & Acquisition (M&A):** A company preparing for an M&A transaction might seek to satisfy its defined benefit pension obligations ahead of M&A activity. If insurance is not affordable, then a CBFA could be a helpful tool to reduce or remove the remaining company contributions required and/or reduce the risk of future contributions being required, thereby giving more certainty to the purchaser to allow the transaction to proceed.
- **Insolvency risk:** A scheme with a weak company covenant may be able to reduce its contributions to an affordable level, spread over a longer period, by adding an additional sponsor providing capital support to the scheme over that period. If such support is designed to continue beyond any potential company insolvency, the arrangement may need to demonstrate how it can comply with TPR's Superfund's guidance.

It can be helpful to consider the particular features that are in view by examining each of the three areas of focus (return, cashflow and covenant) in turn. Some arrangements have a single focus (e.g., the return target or cashflow delivery) while others cover all three areas of focus. Many providers are willing to explore variations in the terms of the arrangement so there may be considerable flexibility in a number of these areas.

### 3. Considerations for Trustees and Sponsoring Companies

When considering CBFAs, trustees should seek impartial expert advice that considers a range of potential solutions. This is particularly important if the topic is initiated by interest in one particular solution.

The CBFA market can be bewildering when first encountered, not least due to the number of new providers in recent years and the (welcome) flexibility of those providers. Most material has been prepared for direct engagements between a provider and pension schemes and is not easily shared. This can result in options not being considered, and therefore in missed opportunities to achieve scheme objectives.

A framework can help to enable effective comparison, assessment and discussion of these arrangements, and give sufficient introduction to enable the trustees or companies to identify appropriate next steps, including the nature of expert advice needed. This can help in making effective use of trustee resources and focus the agenda for trustee-company discussions.

In this section, we suggest such a framework to consider those key features as they apply to a scheme's own circumstances.

1. **Scheme objectives and circumstances:** do they indicate a CBFA should be considered?
2. **Features, benefits and risks:** how can they be assessed against those objectives and are they better than the available alternatives?
3. **Legal and regulatory:** Do trustees have the skill and power to transact, and what signoffs are required? Which controls are retained, and which are delegated/surrendered?
4. **Company considerations:** Contribution requirements, borrowing capacity, potential surplus, accounting impact.

The key consideration for trustees and sponsors is to understand what they are gaining as a result of entering into a CBFA arrangement (e.g., external capital support, future return or funding guarantees) and what they are giving up (e.g., cost, control or flexibility).

### 3.1. Scheme Objectives and Circumstances

The key here is understanding the trustee's and sponsoring company's objectives and priorities. For example:

- **What is the Target End State?** Some CBFAs specifically help to achieve an insurance buyout, some offer a roadmap to a superfund and others support a self-managed low-risk position (potentially to run beyond buyout affordability)
- **What is the target timescale?** Private capital appetite is strongest at a 5–10 year time horizon, though some arrangements may be shorter or longer.
- **What are the risks to the current timescale?** For example, risk of covenant deterioration over that period, risk of a decline in solvency or failure to reach the target end state.
- **Is the sponsoring company able to underwrite downside investment risk?** How is this risk currently managed?
- **Is an insurance buyout viable?** For example, are there benefits provided by the scheme (discretionary or otherwise) that cannot be insured cost-effectively?

This consideration of objectives at the outset can help identify the most valued features a CBFA can help with, such as:

- **Predictability:** Commitment to a fixed (or more certain) length of journey plan
- **Covenant visibility:** The perceived benefit to member outcomes of reaching the scheme's target end state in a shorter time horizon
- **Cost:** Delaying eventual buyout to save costs (for example, allowing the proportion of deferred members to fall)
- **Upside potential:** Aspiration for discretionary benefit increases or recovery of surplus
- **Downside mitigation:** The value of having a capital buffer in place before the company is required to contribute more
- **Governance:** Potential access to expertise to manage specific risks (interest rate, inflation, longevity, growth asset risks, liquidity)
- **Company funding:** Potentially support a different recovery plan that could better align with a company's own competition for capital
- **Corporate transactions:** Potentially support member outcomes in the light of any planned corporate actions.

These initial considerations help in assessing whether CBFAs merit exploring in detail and begin to inform the most desirable features to look for in a particular CBFA product.

It is critical to consider what conflicts of interest may exist or may arise in future. The interests of trustees, companies and CBFA providers may be aligned in many situations but may conflict in others: for instance, a CBFA provider may wish to defer buyout beyond the point that the trustees would wish to transact, in the hope of generating larger profits; an owner of excess returns who contributes limited capital will be incentivised to take more risk.

Some advisers have links to CBFA providers; others could be seen to be in competition with CBFA providers. Advisers should be open and transparent about these relationships, and about what actual or perceived conflicts they may have. Advisers should work with the trustees to manage and mitigate any conflicts professionally; actuaries must comply with the Actuaries Code and trustees should consider whether independent advice should be sought.

Consistent with CBFAs being one of the tools available to trustees, in considering CBFAs, it is also important to consider what alternatives might offer the same (or better) outcomes. Some examples of alternatives are discussed in Section 5 of this paper.

### 3.2. Features, Benefits and Risks

When trustees and the sponsoring company are reviewing the CBFA offerings, they need to consider the ‘Key features’ of the different arrangements as per Section 3. Having identified the nature of the guarantee or support being offered, we set out below some key questions to consider in Figure 6.

#### 1. Capital and covenant support

- **Level and availability:** How much capital buffer is proposed? What risks does this cover and what is the likelihood of the capital being needed? How is the capital held/ringfenced/invested? How does the scheme access it when needed? What is the minimum and maximum deal capacity that can be written, and could this impact the terms offered during the due diligence process?
- **Reliability (provider covenant):** What is the source of capital? Where the provider may be required to provide additional capital over the term of the CBFA (or at maturity), will they be willing and/or able to do so – potentially at times of significant market stress?
- **Structure:** What risks are covered by the capital buffer?
- **Limits:** What risks are not covered? In what way are any guarantees limited?
- **Nature of covenant support:** How will the CBFA provider underwrite the arrangement? Does the CBFA introduce an additional company? Could the CBFA constitute an actual or contingent Superfund?

#### 2. Investment strategy and risk

Some relevant risk considerations are as follows:

- **Initial assets:** Will the provider accept all current assets in specie or will some need to be sold? Some providers can accept and restructure illiquid assets – do they have the expertise to manage this and who bears the transaction costs of any restructuring?
- **Return expectations:** What level of return is sought? Is the target return credible (net of any fees arising) considering the assets backing the return? Is the target return required, despite any assurance of risk mitigation within the strategy?
- **Risk levels:** What investment risks are taken, and to what level? How is risk supported by the capital provided? Probability of member outcome modelling can be a useful lens as part of the range of risk measures used.



Figure 6. Some key questions to consider for trustees and the sponsoring company when reviewing CBFA offerings.

- **Risk modelling:** What range of returns is possible over the life of the strategy? What are the problematic interim valuations – illiquid assets for example may offer predictable returns over the whole period but be subject to significant path dependency that could be crystallised on early termination. How resilient are the projected outcomes to changes in risk model and parameters? How well are tail risks captured and considered?

The measures of risk used to assess the strategy should be considered carefully so that high-return strategies are not adopted simply on the basis of the risk model used. This is particularly important where upside accrues to the provider, but extreme downside could be borne by the scheme.

- **Liability hedging:** What level of interest rate and inflation hedging will be undertaken? What assets are available to collateralise any leverage? How is any residual risk covered? What happens in extreme market movements? Is there potential for a mismatch to arise between the payments generated by the CBFA and the actual cash commitments of the scheme?
- **Longevity risk:** How does the CBFA interact with longevity risk: is it covered within the CBFA? If so, how? If not, what impact could longevity risk have on projected outcomes?
- **Liquidity:** How illiquid is the strategy and does this align to the nature of the guarantee offered? How will the scheme cover any external liquidity needs? How will the strategy cover any potential for collateral calls? Does the CBFA provider offer a credit facility?
- **Pooling:** How do the benefits of any use of pooled funds within the structure compared to any loss of flexibility, visibility and control?
- **Risk coverage:** Where a guaranteed outcome is targeted (e.g., buyout) will this cover regulatory change during the period? If the trustee's understanding of benefits changes during the CBFA period, how would the impact be covered?
- **Ongoing risk management:** How are the key risks identified above monitored, controlled and reported on? What oversight, and by whom, is undertaken to identify any emerging risks?

### 3. Term

- **Alignment:** How does the term of the arrangement align with the objective of the trustees and company?
- **Conflict management:** What conflicts could arise during this term and how are they addressed?

4. **Target outcome or guarantee**

- **What is the nature of the guarantee being offered** e.g., funding level, asset return, cashflows? How is it measured?
  - How will ongoing cashflows of the scheme be met?
  - What if there are changes to the underlying benchmark liabilities or return metrics? How are cashflows allowed for?

5. **Surplus extraction and other costs**

- **Provider:** If the provider receives 100% of the upside, is this appropriately reflected in the limitation to downside protection offered?
- **Scheme:** If surplus is shared with the scheme, what impact does that have on the level of protection offered? What proportion and structure of surplus is desirable for the scheme?
- **Timing:** When and how are any surpluses or profits extracted? Is it during the life of the arrangement, or only at the end? If surplus is extracted during the life of the arrangement, how is this controlled, how is the sufficiency of remaining capital assessed, and how are assets valued for this purpose?
- **Costs:** How do annual management charges and any other running costs compare against other similar products or the scheme's current approach? Do these costs offer value for money? What are the costs of entering into and exiting the solution?
- **Providers' financial interests:** What is the provider's financial interest (how do they make money)? What are the explicit costs? What are the implicit costs such as how the risk borne by the provider is priced (e.g., the likelihood of surplus foregone vs the likelihood of additional capital contributed)?
- **Conflicts:** How important is it for the provider to gain scale for the arrangement to be viable? Could a conflict arise concerning how soon capital is extracted if the objective takes longer to achieve than expected? Are there any conflicts between investment management and capital provider under the arrangement?

6. **Governance and control**

- **Legal structure:** How is the arrangement structured and constituted, how effectively is capital ringfenced? Are there any tax implications of the structure (for example if any overseas vehicles are used)?
- **Delegation and control:** What activities are delegated to the CBFA provider and what is determined jointly? Is the balance of duties appropriate to the nature of the strategy?
- **Services and operations:** Are any services provided beyond investment management, such as paying pensions or administration? How closely linked are the different services provided, and are they severable if one (or more) underperforms? Are the systems used to provide these services reliable – what operational due diligence will be required?
- **Complexity:** How complex or transparent is the arrangement? What complexities are reduced by entering the arrangement, and what complexities are introduced?
- **Monitoring and oversight:** What oversight, and by whom, do the trustees have to confirm whether the arrangement is delivering as expected? What options are open to the trustee if the arrangement does not deliver?
- **Regulatory oversight:** how, and by whom, is the CBFA provider regulated? What impact does that regulation have on the process, outcomes or protections for the scheme members?
- **Operational and management:** Who is responsible for running the CBFA, and do they meet appropriate “fit and proper” requirements? Could reward or incentive arrangements lead to conflicts of interest between CBFA personnel and the trustees? Does the provider have the right operational and management processes in place to oversee the arrangements? Have these been subject to any regulatory oversight? Which regulatory protection arrangements would apply - PPF/FSCS/other?

- **Readiness:** How does the provider demonstrate readiness to transact e.g., term sheets, third-party verification of promised outcomes, advisor support, documentation or third-party suppliers in place?
7. **Early termination provisions**
- **Exit penalties:** what exit penalties might apply, and in what circumstances?
  - **Company insolvency:** What happens to the CBFA if the sponsor becomes insolvent? Are the trustees able to access the capital buffer? Can the trustees exit the CBFA (see below)? Can/will the CBFA continue? If so, does the CBFA become a superfund and what safeguards are in place to ensure compliance by the CBFA with Regulator guidance or future regulation? What regulatory protection arrangements are available?
  - **Trustee choice:** Does the arrangement provide the option to exit? For instance, if a scheme reaches buyout funding, changes their desired end game or a corporate event changes the appetite to continue the arrangement.
  - **Erosion of capital:** What happens if asset under-performance erodes the capital buffer in part or in full? Is there a point when the provider is required to top up the arrangement? If top-up is not provided, will the arrangement terminate and what assets would the trustees receive? Do the Trustees have step in rights to intervene if the structure is not performing and if so, how do these operate in practice.
8. **Legal and regulatory considerations**
- We consider these points separately in Section 3.3.

### 3.3. Legal and Regulatory Considerations

Trustees' legal duties derive from a mix of the rules of the scheme, statutory provisions and regulation, trust law principles, and other court judgements and precedents. Key general considerations from a legal and governance perspective include the following:

- **Does the trustee board have appropriate expertise across its advisors** to assess CBFA options? This can inform any additional training, skills or specialist advice required as part of the process.
- **What advice will need to be received before transacting?** Advice will be needed for example across actuarial, investment, covenant and legal aspects. This should inform the role advisors play in the process, and when they are brought in.
- **What conflicts and differences in investment beliefs exist?** Conflicts may exist between:
  - company and trustee (such as the desire to reduce funding and accounting strains on the one hand and improve scheme funding sooner on the other)
  - investment advisor and CBFA provider (where the former offers delegated solutions of their own)
  - current investment managers and CBFA provider.

An understanding of bias and other behavioural decision-making dynamics within the stakeholders will also help with decision-making.

- **Do trustees have the power to transact** the proposed arrangement under the trust deed and rules of the scheme? This is fairly straightforward for a pure investment decision, but if a new employer is to be admitted (now or in the future), do trustees have the power to do what is proposed or does this rule out certain options? Trustees will need to consider potential benefits for members and whether there are circumstances in which members could end up worse off as a result of a CBFA than if they had not transacted.

Schemes will need to consider how their existing regulatory obligations fit with the CBFA structure and consider potential new regulations that may impact. For instance:

- **Funding:** How to value any guarantee in the actuarial valuation assumptions and contribution requirements.
- **Funding code:** As the new funding code comes in, how does the CBFA fit with the requirements of the new framework?
- **Investment risk tests:** Related to the funding code, how to stress test the structure given the ‘options-like’ payoff profile does not conform to traditional risk metrics based on distribution of outcomes (e.g., Value at Risk).
- **ESG:** What are the ESG credentials of the provider and how can the trustees meet their growing obligations to review and assess their investments through a sustainable investment lens?
- **PPF levy:** How will the contingent funding/asset arrangement be allowed for in any PPF levy stress calculations?
- **Tax:** The trustees will want to understand any tax implications of entering into the arrangement e.g., implications on future refund of surplus, risk of triggering any unauthorised payment. It may be appropriate for the trustees to obtain specific tax advice on the arrangement.
- **TPR:** What further steps are necessary, for the trustees and the provider? For example, has the provider engaged sufficiently with the Pensions Regulator (TPR)? While the way CBFAs are typically structured may mean there is currently no formal requirement to seek Pensions Regulator approval, and that a clearance application may not be appropriate, it is worth noting that some arrangements – or some aspects of them might fall within the scope of TPR’s Superfund Guidance either at the outset, or at some future point.
- **Superfunds:** Is the CBFA provider within the scope of TPR’s Superfund Guidance now or in the future?
- **CMA:** Is the CBFA provider captured by any of the fiduciary manager regulations set out by the Competition and Markets Authority investigation of investment consultancy and fiduciary management services?

**Future regulation:** As well as existing regulations, the trustees should be conscious of the potential for future regulations that could introduce additional governance to the CBFA structure for the trustees or company. It will be important to agree on appropriate “change of law” provisions in the legal documentation to ensure the trustees are adequately protected.

### **3.4. Additional Considerations for Sponsoring Companies**

While a CBFA is principally an investment decision that sits with the trustees, for the sponsoring company the arrangement has the potential to change its relationship with a scheme. The company will want to work closely with the trustee to examine those considerations set out in the previous section. It would be unusual for trustees to enter into a CBFA without the support of the company.

If the company is proposing a CBFA it will be important to consider the factors relevant to the trustees so that engagement between company and trustees is kept on a collaborative footing.

All else equal, a CBFA aims to give a company increased certainty over the ultimate cost of its defined benefit obligations. Increased certainty of pension costs may offer the company advantages (e.g., impact on return on equity, borrowing costs, M&A activity). However, the added complexity of the structure could lead to greater due diligence by prospective investors and lenders.





Figure 7. Key areas a company may want to consider in assessing the feasibility of a CBFA.

We set out in Figure 7 some key areas a company may want to consider in assessing the feasibility of a CBFA:

### 1. Certainty of costs and contribution

- The scheme's lower reliance on the company and higher investment returns (under some arrangements) could result in lower future contributions. However, the risk from extreme downside events must also be understood.
- The external capital may need to be incorporated into the triennial valuation process when setting the level of deficit repair contributions required (if any).
- Specific scenarios will need to be developed to encapsulate the CBFA, such as early termination or erosion of the capital buffer.

### 2. Capacity to raise capital

- Companies with significant debt often find it difficult to raise capital to reinvest in the business – this dynamic is commonly known as debt overhang. Like bank debt, pension obligations can be a source of debt overhang. In assessing the quality of a business, an investor will not only look at the value of contributions being paid to a scheme; it will also want to understand the amount of risk that the scheme carries and the implications this could have on the company.
- Investors in weaker companies may welcome a CBFA. They may be attracted by the prospect of (i) lower ongoing contributions to the scheme and (ii) reduced likelihood of having to make further contributions during their investment period. A CBFA could play an important role in enabling a company to attract capital that can be reinvested in its business; however, some CBFAs may not be available to weaker companies.
- Improved borrowing capacity is unlikely to be the most important consideration for stronger companies looking to enter a CBFA. Stronger companies are more likely to be attracted by some of the other features of a CBFA discussed in this paper.

### 3. Potential surplus

- Most CBFAs would be expected to reduce the potential for a surplus to arise for a scheme, in return for the downside protection provided. However, some arrangements provide for surplus to be shared with the Scheme.
- The rules governing the distribution of any surplus assets vary between schemes. For some schemes, the company may be entitled to access the surplus (e.g., a taxable return of surplus, or to provide other pension savings, such as funding employer-defined contributions); whereas in others, surplus may need to be retained in the scheme and used for the benefit of members.
- The sponsor will want to understand any tax implications of entering into the arrangement e.g., implications on future refund of surplus or risk of triggering any unauthorised payment. It may be appropriate for the sponsor to obtain specific tax advice on the arrangement.

### 4. Accounting implications

- Executing a buy-in can incur a material charge to the corporate balance sheet and potentially P&L. This dynamic can result in preferences over the timing of executing an insurance transaction, in some cases aligning the timing of the buy-in with wider corporate activity (e.g., refinancing) or allowing sufficient time to manage stakeholders.
- By contrast, a CBFA could have a more favourable accounting treatment. Given that CBFA aims to improve the funding level over multiple years, stakeholders have ample time to plan for the expected accounting impact resulting from a buy-in.
- Depending on the structure of the CBFA, the third-party capital could in fact increase the net asset position of the scheme and its sponsoring company. Naturally, as the CBFA starts to unwind, a larger accounting charge would follow at the end of the term.
- Where accounting standards incorporate restrictions on the company's ability to recognise surplus (e.g., IFRIC 14 under IAS 19), a CBFA might, depending on its terms, be seen as limiting a company's rights to surplus and increasing the likelihood that asset restrictions apply.
- We expect that companies would want to engage with their auditors prior to transacting so that the accounting treatment throughout the arrangement is understood.

### 5. Sustainable growth vs new risks

- As previously noted, a CBFA can increase a company's operating flexibility to support sustainable growth. However, if a CBFA is not adequately capitalised, it can also expose the company to tail risks that the company will ultimately be required to underwrite.
- We expect that companies would also want to consider if a cashflow mismatch could arise as a result of limitations in the obligations covered by the CBFA. This is particularly relevant where detailed scheme data and legal due diligence have not been undertaken before entering the transaction and these risks are not covered by the third-party capital.

### 6. Communications

- CBFAs are relatively new developments, so at present there is limited market practice to inform how companies will communicate with employees, members and other stakeholders.

While there is unlikely to be a legal requirement to disclose the CBFA, we expect that companies would want to set out the benefit these structures can deliver to both members and shareholders.

## 4. Considering the Alternatives

Once the features of the arrangements are understood, their benefits can be quantified by comparing them with the scheme's current arrangements, and by comparing them to alternatives, which may include:

- DIY approach (investment-only solutions and/or ringfenced capital provided by the sponsoring company)
- DB master trust (professional governance arrangement with or without investment guarantees)
- Superfund (breaking the link with the company in return for a one-off capital injection)
- Insurance buyout (liability to pay benefits to members transfers to the insurer writing the bulk annuity in return for a premium. No further liability remains with the scheme)
- Insurance buy-in (commitment to pay benefits to the scheme for referenced individuals in return for up-front premium, but liability for pension payments to members remain with the scheme. The bulk annuity purchased is an asset of the scheme).

A key question is whether the scheme or sponsor could achieve its objectives (e.g., a shorter or more predictable funding journey, downside protection, or support to achieve the target end state) more effectively in some other way

### 4.1. DIY Approach

The trustees may be able to achieve similar outcomes to a CBFA without recourse to third-party capital. Investment approaches include:

- Derivative overlays (e.g., interest rate swaps and swaptions, equity put options and put spread collars) might provide protection by payment of a premium or surrendering upside
- Efficient allocation of investments amongst available asset classes could offer an acceptable path to meet the scheme's objectives, without the complexity of a CBFA.

#### 4.1.1. Contingent assets

Many companies have therefore pledged their own capital to support the investment strategy by way of "contingent assets," for example, to allow a scheme to increase the investment risk it is running and move ahead with its journey plan or to protect its position on a buyout basis while allowing for the cost of buyout to fall with the passage of time. Where employers have access to suitable capital, these existing structures could be used to achieve similar objectives to a CBFA:

- Escrow accounts, reservoir trusts, special purpose vehicles backed by a basket of securities and captive insurance vehicles are four of the more common approaches and **we compare these in more detail in Appendix B.**
- Other schemes have arrangements in place such as security over fixed assets, letters of credit, surety bonds, intercompany guarantees, investment underpin and covenant under-performance triggers.

Regulations set out when and how schemes can take account of these assets, to the extent that they are legally enforceable and provide sufficient value in the circumstances where they would be required. For there to be tangible value for trustees beyond what support may be provided by the employer covenant, there must be a focus on the legal enforceability by the trustees and the value in circumstances where they will be required.

#### 4.1.2 Comparison with CBFAs

A drawback of conventional contingent assets is that they are often not linked to the investment strategy of the scheme, making it difficult to size the capital contribution to the level of risk it is underwriting. Such contingent assets are also reliant on the sponsor having access to suitable capital: not all sponsors will be able to use these DIY approaches.

There is generally greater de-risking of the sponsor's balance sheet under a CBFA as there is additional, third-party capital to absorb deficits (up to a limit) arising during the term of the contract.

However, a company could contribute capital alongside a CBFA provider, reducing the expected cost of the solution and allowing the company to benefit from the governance of the CBFA provider.

Companies are likely to require specific advice when considering DIY options, including in relation to tax treatment and employer-related investment.

### 4.2. Defined Benefit Master Trusts

A DB Master Trust is a multi-employer pension scheme – employers are not generally connected and each pension scheme usually has its own ring-fenced section (Pensions Management Institute, 2020). While an authorisation regime was established for DC Master Trusts in 2018 (The Pensions Regulator (TPR), 2018), there is not currently a dedicated authorisation regime for DB Master Trusts.

#### 4.2.1. Comparison with CBFAs

DB Master Trusts offer governance and other scale benefits, rather than ringfenced investment capital and as such there is usually no commitment as to when full funding will be reached. As the market develops, it is possible that DB master trust providers may broaden their offering to incorporate capital-underwritten investment approaches similar to those offered by CBFA providers.

### 4.3. Superfunds

A superfund is described in TPR's guidance as a model where the scheme employer is replaced by a new employer backed with a capital buffer, or a special purpose vehicle employer with sufficient capital. Where the model could remove the scheme employer, TPR's guidance states that provision should be made so the Superfunds Guidance can be complied with at that time. TPR's guidance encourages any potential Superfunds to engage with TPR early. Superfunds are expected by TPR to hold sufficient capital to withstand adverse shocks to 99% confidence level over 5 years. This is effected by a bulk transfer of liabilities to the new entity with its own governance, administration and trustee board. TPR has set out guidance for superfunds along with an assessment process, and legislation is expected to place this on a more formal footing (see the DWP's consultation response on Consolidation of defined benefit pension schemes published on 11 July 2023).

In addition to capital, a superfund offers levels of risk management, governance and ongoing oversight by TPR. A scaled superfund may be able to provide economies of scale in respect of investment, administration and enabling services, and (where applicable) could interface more effectively with the buyout market than many smaller schemes acting independently. The severing of the company's obligations also has clear advantages and allows the ceding scheme to be wound up.

Noting all these advantages, a superfund may not be appropriate in all circumstances:

- It might be unnecessary for many employers in a strong financial position who may prefer to underwrite the scheme's risk budget over time than inject further capital now
- Superfunds are expected only to be an option where prescribed "gateway tests" are met. Schemes that do not meet these tests (e.g., where the scheme is too well funded, or the scheme is expected to reach full funding on a buyout measure in the foreseeable future) will not be able to transfer to a superfund (Department for Work & Pensions (2023))
- It could be unaffordable (or impractical) for others due to the need for up-front capital injection
- It may be undesirable by employers who remain committed to their scheme members, particularly where many of them remain employees
- Superfunds are generally unable to accept schemes with members actively accruing benefits
- There is currently only one superfund that has successfully been through TPR's assessment process, which limits competitive tension and choice.

#### 4.3.1. Comparison with CBFAs

Under a CBFA, capital is available *in addition* to the employer's ongoing obligation to underwrite the scheme. However, where the CBFA model could result in employer replacement at some point in the future, TPR's "superfunds" guidance states that arrangements should be made for compliance at that time – with early engagement with TPR encouraged.

#### 4.4. Insurance Buyout

Insurance buyout has a reputation as the "gold-plated" solution to pension de-risking from a Trustee perspective: Insurance companies are regulated by the Prudential Regulatory Authority to hold sufficient capital to withstand adverse shocks at a 99.5% confidence level over a one-year period and still have sufficient resources to transfer obligations to a third party following such a shock. Most bulk annuity writers are substantially better funded than this minimum. Policyholders are expected to benefit from the Financial Services Compensation Scheme (FSCS), though in practice there have been no claims on the FSCS for pension buyout policies: where insurers have run into difficulties, pension buyout policies have typically been transferred to another insurer.

Insurance buyouts face similar considerations as superfunds in that:

- It might be unnecessary for employers in a strong financial position that wish to underwrite the scheme's risk budget over time than inject further capital now
- It could be unaffordable (or impractical) due to the need to provide an up-front capital injection.
- It may be undesirable by employers who remain committed to their scheme members, particularly where many of them remain employees
- Insurance companies are generally unable to accept schemes with active members accruing further service benefits
- It is generally thought to be a non-recourse solution: after the premium is paid, with any adjustments due to data, no further liability for benefits applies to the sponsor or the trustee
- This is the principle - in practice there may be legal or moral obligation due to insurer failure, for example, but many entering into insurance buyouts do so in the belief that they are de-risking fully and any residual liabilities are minimal.

Unlike superfunds, insurance buyouts do not require consideration of gateway tests or specific regulatory clearance. There is a wider range of insurance providers active in the market and appetite for different pension schemes with different characteristics can vary between insurers at any given time.

However, there may also be a reluctance on the part of the employer and/or scheme trustees to transfer significant value from the scheme to the insurer, where a significant profit is recognised, rather than enhancing member benefits or paying a refund of surplus to the employer.

#### *4.4.1. Comparison with CBFAs*

Many CBFAs offer capital buffers that are lower than would be held by a buyout insurer, and do not benefit from FSCS protection.

- This lower (though potentially still significant) capital buffer means the capital can be provided at lower cost; however, it also means the protection for trustees and members is lower
- The additional flexibility in terms of the length of the journey plan, funding target etc. allows the solution to be tailored more closely to a scheme's circumstances, such as members with optionality in the benefit structure which are expensive for an insurer to underwrite, or schemes with some ongoing accrual or aspiration for discretionary increases
- Investment flexibility means that higher returns can be targeted, allowing the cost to be reduced further
- And the time-limited nature means the arrangement can be exited, potentially at a cost, recognising that no arrangement is risk-free.

Finally, whereas buyout may require up-front payment of the expected lifetime cost of capital, a CBFA can allow this to be reduced and deferred, either over the lifetime of the arrangement or at its maturity, once investment performance has been delivered

### **4.5. Insurance Buy-In**

Many of the comments of Section 4.4 relating to insurance buyout apply also to insurance buy-in. In a buy-in, the policy remains a bulk policy in the name of the trustee of the pension scheme and benefits are paid in respect of referenced members to the scheme. The scheme retains liability for paying benefits to members.

#### *4.5.1. Comparison with CBFAs*

The comments in Section 5.4 relating to insurance buyout apply. In addition, as the scheme is still ongoing, the trustee would receive the benefit of protection from both the FSCS (in respect of the annuity contract) and the PPF (as the pension scheme is ongoing).

### **4.6. Next Steps**

The focus of this paper has been to offer a framework to enable an effective initial comparison, assessment and discussion of these arrangements, and to give sufficient introduction to enable the reader to identify appropriate next steps. If, following discussion, one or more arrangements are to be pursued, we offer Appendix A as a potential framework for those next steps.

## 5. Conclusions

CBFAs can offer tangible benefits for defined benefit pension schemes to secure member benefits in full: downside investment protection, covenant improvement, access to investment expertise, governance arrangements, and potential assistance to prepare for an insurance buyout or a low-dependency strategy.

Arrangements offer distinct benefits when compared with DIY approaches, superfunds, DB Master Trusts and conventional insurance risk transfer policies. However, there are new risks to consider, and this remains a relatively new area with limited standardisation or information in the public domain. It is important to understand how an arrangement works both in the normal course of events, in periods of stress and if the arrangement is terminated.

In this paper, we sought to set out a framework to enable an effective initial comparison, assessment and discussion of these arrangements, and to give sufficient introduction to enable the reader to identify appropriate next steps. That will include a requirement to take expert, independent advice before transacting.

We welcome feedback from readers on what further information would be most beneficial to support consideration of these arrangements.

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## Appendix A. Next Steps

Having identified that transacting a CBFA would be a feasible means of achieving or accelerating the schemes' objectives, trustees should be well placed to undertake more detailed assessment to complete the assessment, selection and appointment:

- 1 **Assessment:** The relevant arrangements will need to be considered in detail.
- 2 **Decision-making:** Trustees will need to decide on how best to consider the relevant arrangements in detail: Will it be led by a sub-committee? How involved does the company want or need to be? How much time should be set aside? Are there any external constraints on the timescale? Does that impact the types of arrangements that can be considered?
- 3 **Advice:** Professional advice will be important as part of this detailed review, including to explore the questions identified above as well as other questions that may arise as part of this process. This will need to cover funding, investment, legal and covenant considerations. Advisors with experience, working with the providers themselves, and transferrable experience from assessing other schemes may help conduct this assessment efficiently. Trustees should consider how conflicts are mitigated, for example some advisors are affiliated with a particular CBFA, and some CFAs will result in less need for an advisor compared to, say, a fiduciary management approach.
- 4 **Costs:** It will be important to understand the likely setup costs and where relevant any unwind/exit costs and how these compare to the costs of the scheme under other governance models.
- 5 **Operations:** It will also be important to consider the practical setup, operation and monitoring of the CBFA arrangement.
- 6 **Residual risk and extreme downside risks:** The CBFA may not cover all risks so the assessment should also consider what assets and risks will remain outside the arrangement, to confirm that they can be managed without undue concentration or leverage. It is also important to assess the impact of extreme downside events and how the scheme might be impacted if it was or wasn't to proceed with a CBFA solution.
- 7 **Ongoing monitoring:** consider reporting requirements, especially risk measurement and performance versus the target objectives, as well as any ongoing governance structures needed to ensure appropriate oversight by the trustee board, taking independent advice.
- 8 **Flexibility:** trustees and sponsors should discuss potential variations to the structure on offer from a particular provider to the extent that the arrangement does not exactly match their scheme requirements. In the early stages of this market there is an opportunity for pension schemes to work with providers to construct a CBFA which best meets the scheme objectives (as opposed to being restricted to choosing from the "best fit" product among the default options available).
- 9 **Final selection:** On the basis that a CBFA is established to be in the interests of members compared to the status quo strategy or other available options, the key terms and criteria of the final providers can now be compared and a formal meeting arranged with the providers to identify a preferred provider.
- 10 **Detailed due diligence** can now proceed with the preferred provider, including in relation to the practical setup, operation and monitoring of the CBFA arrangement.
- 11 **Legal documentation:** The governing documents, including the financial and legal terms, will need to be agreed.
- 12 **Final professional signoff** can then be provided based on these documents.
- 13 **Onboarding** would then follow.

## Appendix B. Contingent assets – selected examples

	Escrow	Reservoir Trust	Special purpose vehicle	Captive insurance vehicle
Description	Contribution (typically cash although gilts and other investments may be used) made to a bank account or another party as the escrow agent, which is an employer account over which a charge is granted in favour of the trustee, with pre-defined triggers for payment to scheme or company in circumstances such as funding underperformance or insolvency of company	Similar to an escrow arrangement, although the company sets up a trust to be used as the vehicle to hold the assets meaning no charge is required to be granted by the employer. This is looked after by a set of reservoir trustees, who have a fiduciary interest to act in the best interests of the beneficiaries of the company and pension scheme	Company sets up a special purpose vehicle in an insolvency remote structure, which is used to hold assets (e.g., Scottish Limited Partnership)	Captive insurance vehicle is a type of self-insurance vehicle set up as a subsidiary of the company. Typically, a fronting insurer acts as it would in a traditional buyout, but rather than retaining the assets, it passes them to the company-controlled captive
Where applicable	Schemes on journey plan to endgame	Schemes on journey plan to endgame	Schemes on journey plan to endgame	Schemes at or close to buyout funding
Set up	Relatively simple (if cash)	Can be complex	Can be complex	Likely to be very complex
Investment	Investment options may be limited	As agreed by trustee and company	As agreed by trustee and company	As required by insurance regime
Pros	<p><b>Trustee</b></p> <ul style="list-style-type: none"> <li>• Certainty over the value of the capital buffer</li> <li>• Funding flexibility – assets could be tipped into scheme along the journey if needed</li> <li>• Potentially enables active members to continue accruing and granting of discretionary benefits, depending on agreement</li> <li>• Trustee is a secured creditor in relation to the escrow assets in the event of an employer insolvency</li> </ul>	<p><b>Trustee</b></p> <ul style="list-style-type: none"> <li>• Investment flexibility</li> <li>• Funding flexibility – assets could be tipped into scheme along the journey if needed</li> <li>• Potentially enables active members to continue accruing and granting of discretionary benefits, depending on agreement</li> <li>• Ring-fenced pool of assets (outside of employer) for trustee to access in event of employer insolvency</li> </ul>	<p><b>Trustee</b></p> <ul style="list-style-type: none"> <li>• Investment flexibility</li> <li>• Potentially enables active members to continue accruing and granting of discretionary benefits, depending on agreement</li> <li>• Ring-fenced pool of assets (outside of employer) for trustee to access in event of employer insolvency</li> </ul>	<p><b>Trustee</b></p> <ul style="list-style-type: none"> <li>• Protection under insurance regime</li> <li>• Retains link between company and scheme vs. traditional buyout</li> <li>• May be able to agree a share of surplus</li> </ul>
	<p><b>Company</b></p> <ul style="list-style-type: none"> <li>• Simple set up</li> <li>• Mitigates trapped surplus in the scheme; escrow assets are employer rather than scheme assets and so do not fall within rules on</li> </ul>	<p><b>Company</b></p> <ul style="list-style-type: none"> <li>• Investment flexibility</li> <li>• Mitigates trapped surplus in the scheme; reservoir trust assets are not subject to rules on return of scheme assets to employers</li> </ul>	<p><b>Company</b></p> <ul style="list-style-type: none"> <li>• Investment flexibility</li> <li>• Mitigates trapped scheme surplus in scheme as assets are not subject to rules on return of scheme assets</li> </ul>	<p><b>Company</b></p> <ul style="list-style-type: none"> <li>• Benefit from profit that would be transferred to insurer</li> <li>• Direct Company control of investment strategy within captive in accordance with</li> </ul>

(Continued)

(Continued)

	Escrow	Reservoir Trust	Special purpose vehicle	Captive insurance vehicle
	return of scheme assets to employers	<ul style="list-style-type: none"> <li>No requirement to grant security over reservoir trust assets</li> </ul>	<ul style="list-style-type: none"> <li>Potential favourable tax treatment on upfront contribution</li> <li>No requirement to grant security over SPV assets</li> <li>SPV can hold a wide range of different assets</li> </ul>	insurance regulations <ul style="list-style-type: none"> <li>May be diversification with other employee benefit or business risks</li> <li>May offer path to consolidate assets across multiple schemes</li> </ul>
Cons	<b>Trustee</b> <ul style="list-style-type: none"> <li>Investment strategy may be less flexible than preferred</li> </ul>	<b>Trustee</b> <ul style="list-style-type: none"> <li>Negotiation of terms may be more complex than a cash escrow as documents tend to be less standardised</li> </ul>	<b>Trustee</b> <ul style="list-style-type: none"> <li>Negotiation of terms may be more complex than a cash escrow as documents tend to be less standardised</li> </ul>	<b>Trustee</b> <ul style="list-style-type: none"> <li>Complex to set up</li> <li>Clear member communication vs. a traditional buyout</li> </ul>
	<b>Company</b> <ul style="list-style-type: none"> <li>Investment strategy may be less flexible than preferred</li> <li>Grant of security over account may be prohibited by banking facilities</li> <li>Balance sheet impact must be considered</li> <li>May not trigger tax relief on contributions until funds are paid into scheme</li> <li>May not offer significant extra capital flexibility to Company compared to paying contribution directly to scheme, particularly if the escrow is expected to run for a longer period.</li> </ul>	<b>Company</b> <ul style="list-style-type: none"> <li>Negotiation of terms may be more complex than a cash escrow</li> <li>Balance sheet impact will need to be considered</li> <li>Tax treatment of reservoir trust and assets within it needs to be considered</li> <li>May not trigger tax relief on contributions (although this could be structured around)</li> </ul>	<b>Company</b> <ul style="list-style-type: none"> <li>Negotiation of terms may be more complex than a cash escrow</li> <li>Balance sheet impact will need to be considered</li> <li>Tax treatment to be considered</li> <li>May limit Company's use of assets under the SPV</li> <li>May be complex to unwind if desired</li> </ul>	<b>Company</b> <ul style="list-style-type: none"> <li>Complex to set up</li> <li>High costs involved</li> <li>Pension risk would not be taken out of the business</li> <li>Capital requirements may be onerous</li> </ul>
What happens on company insolvency?	Scheme would be assessed for eligibility to be admitted to the PPF (with members receiving PPF levels of compensation). During the assessment period, the PPF will determine if a scheme rescue is possible or if a scheme can afford to secure benefits which are at least equal to the pensions the PPF can pay. If these are not possible, the scheme members will be transferred to the PPF. If these are possible, the scheme will either continue or wind up with higher levels of benefits with an insurer. The benefits secured may be less than full scheme benefits.			A policy with a fronting insurer would continue. Company-controlled captive may be impacted by any guarantees from the company.

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