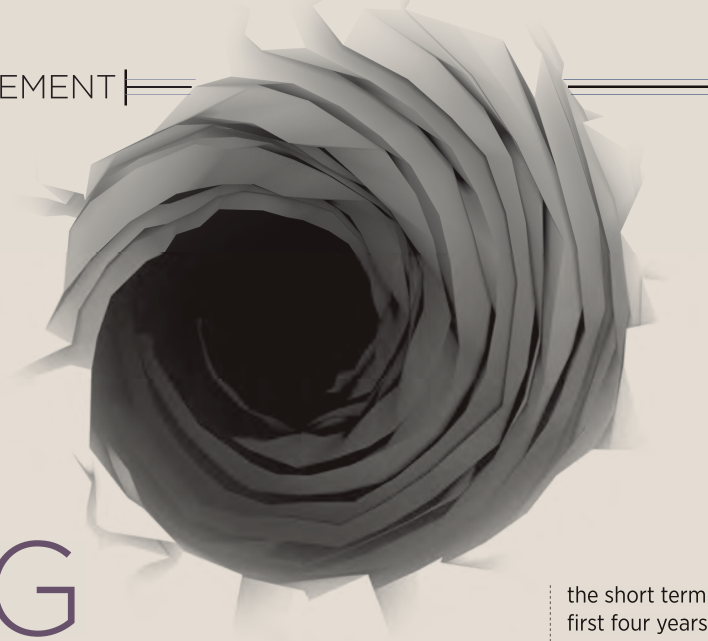


PLUGGING THE PENSION BLACK HOLE

IS ASSET-BACKED FUNDING THE ANSWER TO YOUR DEFICIT DILEMMA? BINA MISTRY INVESTIGATES

Just over five years ago, Marks & Spencer put in place the first asset-backed funding (ABF) arrangement to help it fund a significant part of its pension deficit. Initially, that sparked an interest in ABF arrangements, but they were considered viable for only those pension funds with very large pension deficits, running to hundreds of millions. In the past couple of years, however, ABF arrangements have come into the mainstream. Nearly 50 have been implemented, including some that have sought to fill pension deficits as small as £10m.

So what are ABFs? What are the key benefits? How do they work? What are the issues that need to be considered? And why has the level of market interest increased? We consider the answers to these questions below.

What is an ABF?

In a nutshell, an ABF is an insolvency-remote arrangement that provides a pension scheme with a future stream of cash payments, which are secured by unencumbered company assets. The future stream of payments is capitalised upfront, creating an additional asset of the scheme and improving the funding position. The term of the future payment stream would typically be longer than a conventional recovery plan, which becomes acceptable to the trustees due to the increase in security provided by the additional asset.

Key to the arrangement is ensuring the asset acting as security has value on a default event, as this is used to make good any outstanding future payments due. In the absence of any default events, the control and ownership of the asset rests with the company.

The key financial benefits

The key financial benefits from the company's perspective are:

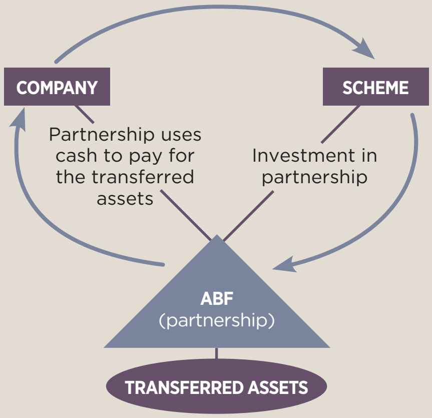
- Reduced and deferred cash payments, especially given potentially larger deficits in current market conditions.
- An acceleration of tax relief, which significantly reduces the net of tax cash flows in the short term (that is, the first four years, due to tax relief spreading rules on pension contributions).
- Reduced Pension Protection Fund levies as a result of the ABF being treated as an asset of the scheme.

TYPICAL BENEFITS OF A £100M DEFICIT FILLED WITH AN ABF

	10-year recovery plan	20-year ABF	Overall gain
Annual payments	£12.5m pa	£8.5m pa	£4m pa
Net of tax payments over four years	£40m	£7m	£33m
Net present value of total payments (net of tax)*	£67m	£56m	£11m

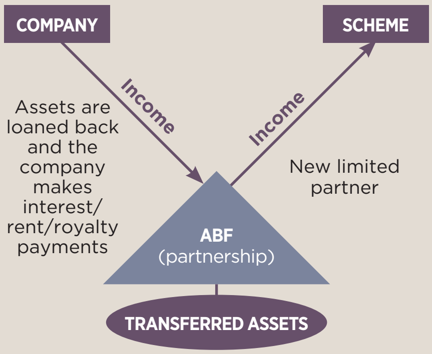
*Assumes a tax rate of 23% falling to 20% in year four, and an internal rate of return of 8% pa

STEP 1: PENSION CONTRIBUTION (CASH)



For example: property, receivables, inventory, subsidiary companies, loans, plants, brand assets, intellectual property

STEP 2



How does it work?

The structure is a separate legal entity set up as a special purpose vehicle under Scottish partnership law, benefiting from its own legal personality. This avoids the self-investment restrictions that apply to pension schemes and helps with various other operational aspects. Investing as a limited partner, the pension scheme gains the rights to the interest (or income) from the partnership, but it would not have automatic ownership and control of the underlying assets.

What are the other benefits?

For the company, in addition to the cash flow benefits highlighted earlier, other benefits of ABFs include:

- An immediate reduction in the scheme deficit.
- Help in managing overfunding risk since annual payments can be suspended if the scheme is no longer in deficit.
- The company retains operational control of the assets and the flexibility to substitute these.
- ABFs can result in fewer issues around banking covenants and agreements with bond holders, compared with other structures, such as charges against assets.
- ABFs can help to facilitate other de-risking activity, investment strategy changes or other projects, such as merging schemes.

But an ABF has to work for the trustees, too, for it to be acceptable. The main benefits for the trustees can be:

- An immediate increase in security as a result of having a collateralised future income stream, compared with a conventional recovery plan.
- An insolvency-remote structure available on the default of an employer.
- A bond-like asset, providing a match to scheme liabilities.
- A better overall deal, especially if the employer is significantly cash-constrained.
- If the deferred cash payments and tax benefits for the company are being used to prioritise investment and growth in the business, this can be covenant-enhancing and improve the long-term security for members.

Which assets can be used?

For any ABF, it is critical to find a suitable asset that can be used for collateral, which genuinely provides additional security to support the deferral of contributions. While some assets are easy to understand and value, other potential assets, such as intragroup loans, can be more complex. Examples of assets used include:

Asset	Example company
Property	Sainsbury's
Receivables	Deloitte
Stock/inventory	Diageo
Intangibles – brands, IP	TUI
Plant and equipment	Severn Trent
Intercompany loans	*Daily Mail* and General Trust

What are the key issues and commercial terms?

Assuming a suitable asset can be identified, successful implementation requires agreement with the trustees on a number of commercially sensitive points. These points include the following:

- **Collateral value** – often structures are over-collateralised to protect against falls in the value of the asset at a time when it is most needed. What would happen to the underlying assets when the value falls, or indeed rises, are key areas to negotiate.
- **Affordability and the alternatives** – the initial preference of the Pensions Regulator and trustees may be direct and unconditional cash payments to the scheme over a short period. With larger deficits, this may not be feasible and the package of proposals would need to be considered as a whole.
- **Advice on the suitability of the investment** – the trustees are required to make an investment in the ABF, and therefore need to satisfy themselves that it is an appropriate and suitably priced investment, and to consider the diversification and risk profile aspects.
- **Substitution of assets** – the company and trustees would need to agree the conditions (for example, value and type) of permitted assets under the substitution clauses. It is likely the company will wish to retain flexibility to use the collateral in different ways in the future.
- **Changes in law** – the structure avoids being classed as an employer-related investment under pensions legislation. But changes in the law may mean alternatives would need to be considered in the future – as such, a plan B should be considered upfront.
- **Accounting** – usually an ABF is structured so that it does not qualify as a scheme asset for IAS 19, *Employee Benefits*/US GAAP purposes. For it to qualify, the trustees' interest in the structure would need to be 'transferable' and an appropriate financial liability is then recorded. On consolidation, the ABF would be balance-sheet neutral.
- **Tax benefits** – if set up in a particular way and with a certain payment pattern (for example, payments are of equal amounts or increase in line with the Retail Price Index up to 5% per annum, in intervals of no more than a year, and of a term no longer than 25 years), upfront tax relief can be obtained on the initial contribution.
- **Others** – for example: valuation of the income stream, valuation of the collateral assets, frequency of valuations, definitions for default triggers and insolvency, conditions for overfunding and additional governance aspects.

In conclusion, the popularity of ABF arrangements as a means of reducing the cash burden on companies with pension funds in deficit is likely to increase, because of momentum, innovation in the range of assets that can be used and a reduction in the cost of implementation. While there are a number of issues to work through, employing informed and knowledgeable advisers should enable successful and efficient implementation. Using a suitable asset as security that should retain its value in the event of employer insolvency means that an ABF arrangement can be a 'win-win' solution if structured properly, easing difficult funding negotiations in challenging market conditions.

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