Asset backed funding

The use of Asset Backed Funding (ABF) has become an increasingly mainstream solution to help fill pension scheme deficits. Such structures, which become a scheme asset, have been used by over 35 pension funds to date. Many others are exploring or implementing them. The increased popularity has been driven by innovation in the range of assets used and because ABFs have become ‘tried and tested’ and cheaper to implement.

If structured properly, with an appropriate asset that retains value on insolvency, an ABF can be a ‘win-win’ solution, easing difficult funding negotiations in current challenging market conditions.

What is an ABF?

In a nutshell, it is an insolvency remote arrangement that provides the 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 asset of the scheme. 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 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. Absent default, the control, and ownership of the asset rests with the company.

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The key financial benefits

The key financial benefits for the company are:

- Reduced and deferred cash payments, especially given larger deficits in current 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 PPF levies as a result of the ABF being treated as an asset of the scheme.

Figure 01 opposite demonstrates the typical benefits for a £100m deficit filled with an ABF.

Figure 01. Illustration: £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 4 years	£40m	£7m	£33m
Net present value of total payments (net of tax)*	£67m	£56m	£11m

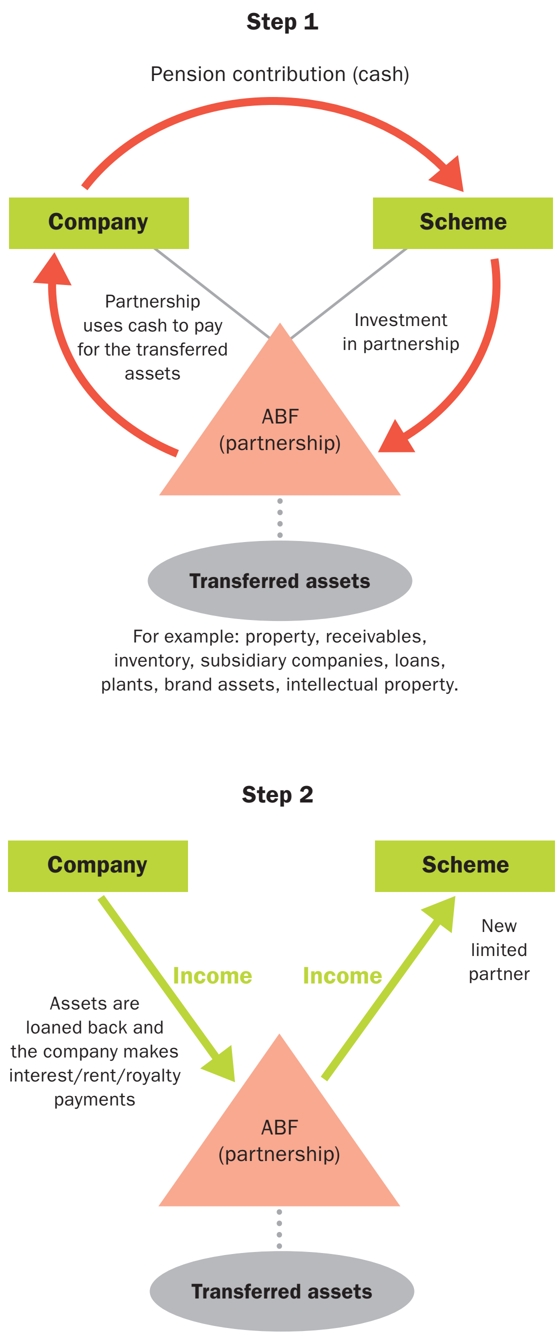
*Assumes a tax rate of 23% falling to 20% in year 4, and an IRR of 8% pa

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.

Figure 02. How an ABF works



What are the other benefits?

For the corporate

- An immediate reduction in the scheme deficit.
- Helps manage over-funding risk, as annual payments can be suspended in the scheme if it 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 to other structures, such as charges against assets.
- Can help facilitate other de-risking activity, investment strategy changes or other projects, such as merging schemes.

For the trustee

- An immediate increase in security as a result of having a collateralised future income stream, compared to 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.

Key issues and commercial terms

- **Assets** – critical to the structure is finding a suitable asset for collateral purposes that genuinely provides additional security to support the deferral of contributions. Whilst some assets are easy to understand and value, other assets such as intra-group loans, can be more complex.
- **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 commercial considerations.
- **Affordability and the alternatives** – the pensions regulator's and trustees' initial preference 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.
- **Suitable investment advice** – 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. 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. However, changes in law may mean alternatives would need to be considered in the future – as such, a plan B should be considered upfront.
- **Others** – for example: valuation of the income stream, valuation of the collateral assets, frequency of valuations, definitions for default triggers and insolvency, conditions for over-funding and additional governance aspects.

Figure 03. What assets can be used?

Asset	Examples of companies using these
Property	Sainsburys
Receivables	Deloitte
Stock/inventory	Diageo
Intangibles – brands IP	TUI
Plant and equipment	Severn Trent
Inter-company loans	Daily Mail and General Trust

Other considerations

- **Accounting** – usually an ABF is structured such that it does not qualify as a scheme asset for IAS19/US GAAP purposes. For it to qualify, the trustee's 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 RPI up to 5% pa, 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.

Further information

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