

The PCS Alert

The latest in Defined Benefit Pensions



JLT PENSION CAPITAL STRATEGIES

It's a marathon, not a sprint

July 2011 sees the starting gun sounded on the countdown to next year's Olympiad. Whilst many will be hoping for a golden future, the latest actuarial valuations are showing just how high the hurdles are in the dreams of others.

The only way to fund a pension is to contribute cash (or other assets) into a scheme. Financing is different - there are other ways to ensure pension benefits will be paid that do not involve the immediate injection of money into the scheme.

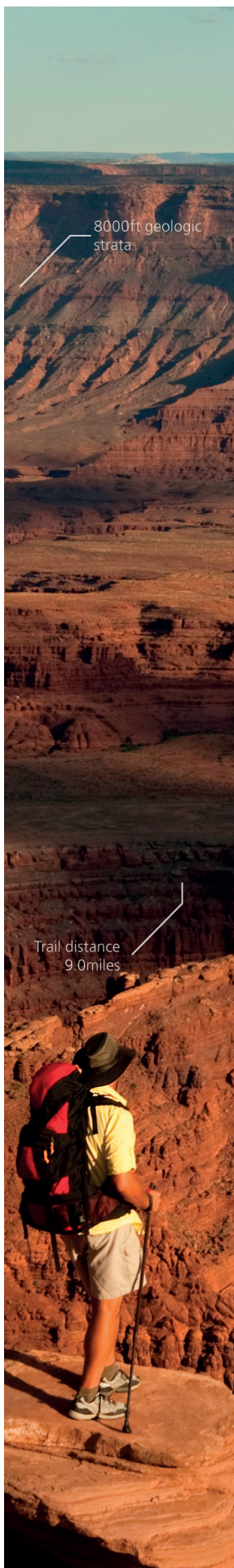
Cash contributions to reduce a pension scheme deficit are often seen as an inefficient use of capital because that cash may be better invested in core strategic objectives, such as developing new products or markets, or on acquisitions. There may be a concern that a "trapped surplus" may emerge from scheme overfunding due to overly prudent long-term funding plans required by either scheme trustees or the Regulator. The sponsor may be quite comfortable with the long-term 'manageability' of the deficit in the context of its overall balance sheet and not necessarily accept that the IAS19 or funding valuation calculation is a true reflection of its ultimate liability.

Funding and financing a pension scheme should definitely be "a problem shared" and as next summer will show, the most successful will have a team behind them working together over many years towards a common goal.

A structure that is 'neutral to positive' for company shareholders and lenders, but positive for the scheme trustees, whilst avoiding a trapped surplus should be welcomed. It may be possible to generate additional tax benefits from a suitable arrangement, but it should certainly provide extra security for the scheme's liabilities beyond reliance purely on the sponsor's "covenant".

Sponsors could raise capital through a specific bond issue or the sale and lease back of company property and contribute this cash to the scheme. Alternative Finance Initiatives (AFI) are methods of financing pension schemes that do not involve the immediate application of that new cash and include:

- Parental guarantees (where the parent company of a corporate group guarantees the pension debts of its subsidiaries)
- Security over assets (where trustees are granted a fixed or floating charge over a company's assets)
- Letter of credit from a third party e.g. bank (if the sponsor was wound up, money can be drawn against the third party up to a specified amount)
- Enhanced creditor status or 'subordination' (where other creditors of the sponsoring employer subordinate their claim to the pension scheme, in the event of the employer's insolvency, thus improving the employer covenant for the trustees)
- Settlor trust (assets are transferred to the scheme if the sponsor becomes insolvent or a deficit persists after a specified term)
- Asset backed financing (the scheme is gifted an income interest in "rent" or other receivables arising from company assets, but without creating an employer related investment)
- Contingent funding vehicle (property is transferred from a special purpose vehicle to the scheme if a deficit persists after a specified term)
- Escrow accounts (whereby money in an external bank account is made available to trustees upon the occurrence of a specified event).



August 2011
Alternative Finance Initiatives

Asset backed financing

What are the issues?

Winning Together

Strategies to Solutions

Sponsors may be asset rich, but cash poor - or not even aware they are asset rich; these ideas apply equally to intangibles such as brand values, as they can factories and offices. More recently we've been implementing structures based on receivable fee invoices. So whether you are a manufacturer, asset manager or service company, there's a structure that works for you.

Although some large arrangements have been well publicised, such as Marks and Spencer's property based structure or Diageo's variant based on whisky royalties, such arrangements are becoming "commoditised" as trustees and advisers get more experienced, so driving down the set up costs to £200,000 or less and making them viable for smaller funds and deficits.

Why use Alternative Finance Initiatives?

Pension funds need to source long-duration, inflation-linked assets to match the nature of the risks inherent in their liabilities, whilst still generating significant real returns to amortise the deficit and reduce reliance on the sponsor's covenant.

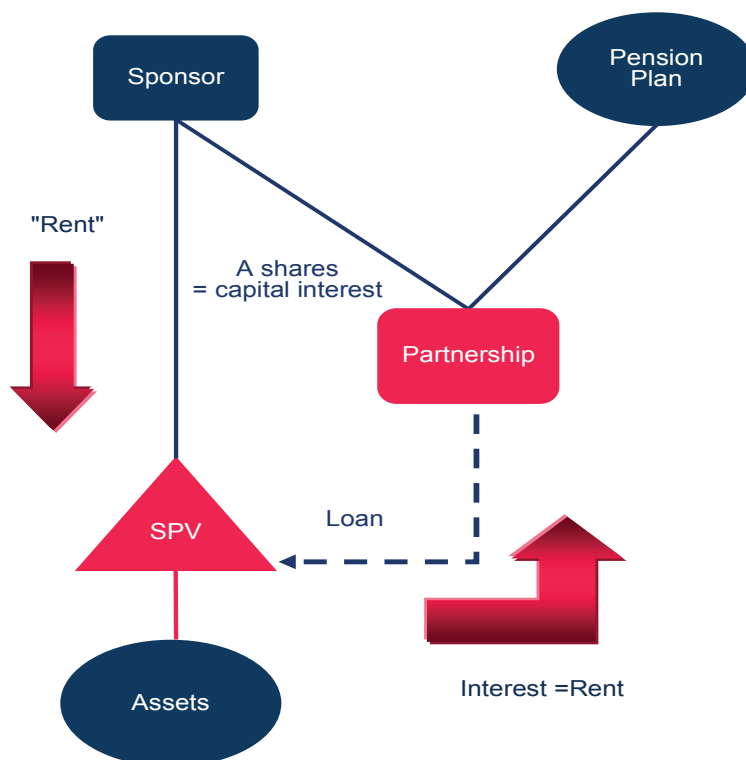
Pension funds cannot be deemed to trade, else they may lose their tax exempt status. In addition, there are legal and moral limits on employer related investments ("Self investment") even though the existing deficit may be best described as an unsecured loan to the sponsor.

We have helped our clients reduce their Pension Protection Fund (PPF) risk based levy through implementing asset backed financing and other contingent assets. Nearly 600 PPF contingent asset certificates were issued for 2009/10, reducing levy payments by £100m and the Pensions Regulator actively supports their use. In addition, AFI can assist with:

- The extra security that allows trustees to pursue a more aggressive investment policy that, through improved returns, may lead to the potential benefit of the members (from improved funding levels) and/or the employer (from reduced contributions).
- Immediate improved funding levels, less demanding "technical provisions" and/or a longer deficit recovery period.
- Surplus management
- Controlling Section 75 (Debt on Employer) triggers
- Facilitating corporate transactions - the deal struck between Marconi and its pension scheme trustees enabled Marconi to sell most of its assets to Ericsson, free of pension liabilities. The arrangement included security over money placed in an escrow account, in addition to an immediate cash injection to the Marconi pension scheme.

Asset backed financing

The premise is simple: the company uses existing business assets to generate cash which is then paid to the pension fund, without breaching employer related investment regulations. This is achieved by transferring the business assets to a separate entity, a special purpose vehicle ("SPV"), typically a company or a partnership. These assets will generate income such as rent or royalties, although this is not essential, to deliver a pattern of payments to the pension scheme. This income can be a mixture of regular payment streams and/or lump sums/balloon payments, but typically is expressed as debt interest. The vehicle is bankruptcy remote from the sponsoring employer, thus providing increased security to the trustees in an insolvency event. However the partnership interests may be consolidated for group accounting purposes so avoiding a negative impact on the sponsor's balance sheet.



What are the issues?

This will depend on the company and scheme involved, but we have helped clients assess:

- What costs, direct and incidental, are involved in implementing and managing the AFI and therefore what size of amounts involved make it viable?
- What actions and documents are necessary to make the AFI effective?
- Does the jurisdiction, regulation or governance of the scheme, sponsor or structure constrain options?
- How quickly can the AFI be put in place and for how long?
- Why is the AFI being implemented (e.g. not all will reduce the PPF levy)? Does the scheme actually have greater security post-transaction?
- Will the AFI have an impact on the credit rating or banking covenants of the sponsor company involved?
- What are the accounting implications (for both the company and the pension scheme)?
- What are the implications from HMRC's perspective? What Capital Gains Tax, Stamp Duty or VAT liabilities may arise? What spreading periods apply for reliefs?
- Does the sponsor retain control/use/right of substitution of any underlying assets transferred?
- How liquid is the financing arrangement - does the scheme have immediate or deferred access to cash?

Winning Together

The Pensions Regulator has increased pressure on trustees to seek contingent assets from employers while they can, so that they are not left exposed to crystallising employer support at a later time when it is weakened. The Pensions Regulator is expecting to see a greater use of asset-backed funding solutions and has even suggested these structures to trustees and companies as a solution. As such, it is likely to welcome those where it improves the security of members, as long as the trustees have taken the necessary steps to ensure that the structure is robust and have considered all other options.

What this highlights is that either the company or the trustees can take the initiative in starting discussions as there are benefits to both.

The principal benefits to the sponsor arising from the structure are:

- Acceleration of tax deductions in respect of the gross initial 'contribution'
- Immediate reduction in scheme accounting and funding deficit
- Eliminates risk of trapped surplus arising from scheme overfunding
- Reduction in PPF levy
- Reduced total annual cash commitments from extending repair period
- Ability to negotiate less demanding technical provisions and potentially an extended recovery period
- No net change to the Group balance sheet or impact upon P&L (Profit & Loss) on consolidation

The principal benefits to the scheme trustees are:

- Immediate contribution of an asset immediately reducing the funding deficit
- Provides Trustees with more protection in the event of sponsor insolvency
- The asset can be structured to provide bond like cash-flows which are a good match for liabilities
- The structure can benefit the cash flow profile of the group which will improve its 'covenant' as scheme sponsor

So is funding your pension liabilities just too big a mountain to climb? Is dealing with the deficit too big a ravine to cross without considerable risk to the sponsor or the member's benefits? We don't think so - but it may need some different thinking to succeed.

In the same way, achieving sporting success next year and beyond requires doing the right things now, as Pensions Week reported "SPVs are no longer cutting edge. At least looking into them is just good cash flow and covenant management"

JLT Pension Capital Strategies

St James House,
7 Charlotte Street,
Manchester, M1 4DZ
Tel 0161 242 5395
Fax 0161 242 5306
Email antony_barker@pensionstrategies.co.uk
Web www.jltpcs.com

Whilst all reasonable care has been taken in the preparation of this publication no liability is accepted under any circumstances by Jardine Lloyd Thompson for any loss or damage occurring as a result of reliance on any statement, opinion, or any error or omission contained herein. Any statement or opinion unless otherwise stated should not be construed as independent research and reflects our understanding of current or proposed legislation and regulation, which may change without notice. The content of this document should not be regarded as specific advice in relation to the matters addressed.

JLT Pension Capital Strategies. A trading name of Pension Capital Strategies Limited. Authorised and regulated by the Financial Services Authority. A member of the Jardine Lloyd Thompson Group. Registered Office: 6 Crutched Friars, London EC3N 2PH. Registered in England No 5651461. VAT No. 244 2321 96