PENSION CAPITAL STRATEGIES
Innovative Alternatives

May 2010

THE PCS ALERT
The latest in DB Pensions

"DEAR TRUSTEES, I'M AFRAID THERE IS NO MONEY. KIND REGARDS - AND GOOD LUCK!"

Dear Sid

It's not only Mother Hubbard's dog and the new incumbents of HM Treasury that have found the cupboard is bare - trustees are having to compete hard for expensive corporate capital and the latest round of valuations will do little to stem perceptions that pension schemes are less black swans and more black holes.

The only way to fund a pension scheme is to contribute cash (or other assets) into it. Financing is different; it includes other methods of ensuring pension benefits will be paid that do not involve the immediate injection of money or its equivalent worth into the scheme.

Contribution schedules based on valuations done in the last 18 months may turn out with hindsight to have been unduly conservative with the scope to recover the excess procedurally or fiscally prohibitive. Sponsoring companies should want to implement a structure that is neutral to positive for its shareholders, but positive for the scheme and trustees, whilst avoiding a trapped surplus. 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 to the scheme. Alternative Finance Initiatives (AFIs) are methods of financing pension schemes that do not involve the immediate application of 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 physical or intangible property)
- *Letter of credit from a third party e.g. bank* (if the sponsoring employer were to be 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, in the event of the employer's insolvency, to the pension scheme, 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)
- *Distribution of receivables* (pension scheme is gifted an income interest in rents receivable arising from company assets, e.g. real estate or intellectual property, without generating an employer related investments consideration)
- *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).

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.

Why use Alternative Finance Initiatives?
We have helped our clients reduce their Pension Protection Fund (PPF) risk based levy through implementing "contingent assets" such as AFIs. Over 400 PPF contingent asset certificates were issued for 2008/9 and the Pensions Regulator actively supports their use. In addition:

- *Investment strategy* - AFIs can provide trustees with extra security that allows them 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).
- *Funding* - if treated as an actual or contingent asset, AFIs can lead to improved funding levels, less demanding "technical provisions" and/or a longer deficit recovery period.

- *Surplus management* - Companies have expressed concerns about their scheme becoming overfunded without any mechanism for the excess assets to be returned to the business. AFIs can be used to overcome this problem.
- *Controlling Section 75* (Debt on Employer) triggers (for instance, a sponsoring employer may need to obtain trustee agreement in order to cease benefit accrual without triggering a scheme wind up).
- *Facilitating corporate transactions*, where one or more of the companies involved has a defined benefit scheme (usually with a sizeable deficit). For example, 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, in addition to an immediate cash injection to the Marconi pension scheme, security over money placed in a special escrow account.

What are the issues?
This will depend on the company and scheme(s) involved, but we have helped clients assess:

1. *Cost.* What costs, direct and incidental, are involved in implementing and managing the AFI and are there any minimum / maximum amounts involved to make it viable?
2. *Process.* What actions are necessary to make the AFI effective (e.g. trust deed & rules changes, impact on other scheme documents, registration requirements, etc.)?
3. *Regulation.* Does the jurisdiction of the scheme, sponsor or structure constrain options?
4. *Expediency/Term.* How quickly can the AFI be put in place and for how long?
5. *Objective.* Why is the AFI being implemented (e.g. not all will reduced the PPF levy)? Does the scheme actually have greater security post-transaction?
6. *Rating agencies.* Will the AFI have an impact on the credit rating or banking covenants of the sponsor company involved?
7. *Accounting.* What are the accounting implications (for both the company and the pension scheme)? Is a tangible value created from an actuarial perspective or in reducing the IAS19 liability?
8. *Tax.* What are the implications from an Inland Revenue perspective? What CGT, Stamp Duty or VAT liabilities may arise? What Corporation Tax deductions are available? What spreading periods apply for reliefs?
9. *Control.* Does the sponsor company retain control/use/right of substitution of any underlying assets transferred?
10. *Cash.* How liquid is the financing arrangement - does the scheme have immediate or deferred access to cash?

The Chief Secretary to the Treasury may have been left with nothing - most trustees are facing even less. A coalition with the sponsor will bring affordable certainty in these uncertain times and our comprehensive experience and independent market access can help both parties choose, implement and manage the right financing solutions

Yours sincerely,

Antony.

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