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Innovative solutions to age old problems

Ian Davies
Bridge Trustees Limited

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Innovative solutions to age old problems

How trustees, sponsors and their advisors can work together to overcome seemingly insurmountable problems with funding and conflicts.

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Thought leadership
Progress
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Education
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Volunteering
Research
Shaping the future
Networking
Professional support
Enterprise and risk
Learned society
Opportunity
International profile
Journals
Support

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Solutions

- Asset backed contributions
- Contingent assets
- PPF drop-in
- Pensions Regulator's approach

Asset Backed Contributions: Back-Drop

- Declining levels of funding
- Large contributions over last valuation cycle not had an impact
- Pressure from tPR
- Sponsors' cashflows

Advantages of Asset Backed Funding

- Helps sponsor's cashflow over an extended period: 15-20 years
- Possible acceleration of tax relief
- Potentially increased security for Members
- Offers flexibility in funding – including avoidance of trapped surplus

What's in it for Trustees?

- Immediate improvement in Scheme's funding position
- Bond-like asset
- Extra security
- Higher overall contributions?
- Reduced PPF levies

Market Trends?

- KPMG Survey 2012
 - Increasing number
 - Smaller schemes becoming involved
 - Average deficit reduction:
 - 2012: £100m
 - 2011: £150m
 - 2012: £350m

Market Trends: KPMG

- Still mainly retail but significant movement towards all sectors, particularly media, travel and leisure and consumer goods (30% of 2012 results)
- Majority of companies now outside FTSE 100 (86%)
- Fewer back end loaded payment structures (“Bullet Payments”)

Market Trends: KPMG

- Property still most popular asset
- Loan notes increasingly common
- IP and Brands
- 15-20 years most common term

Market Trends: KPMG

- Smaller schemes becoming involved so asset backed arrangements increasing in value relative to scheme size
- 2009/10: circa 5-10%
- 2011/12: circa 25-30%

H.M.R.C.

- Tax rules complicated
- February 2012 – specific legislation: ensures overall tax relief cannot exceed the actual amount of cash paid to the scheme
- Qualifying Conditions:
 - “structured finance arrangements”
 - annual payments are not more than 25 years in duration
 - no back end loaded payments

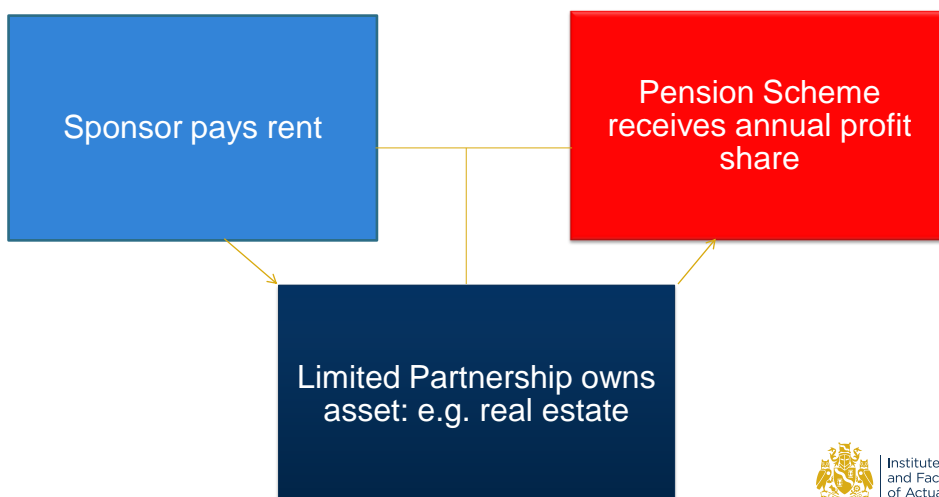
The Pensions Regulator's View

- Corporate Plan 2013-2016
 - notes increased use of “ABCs”
 - cautious about risks
 - asset valuations
 - ERI issues
 - should not take any longer for Scheme to reach its funding target
- 2013 DB Funding Statement
 - “integrated risk management”

Structure

- Asset securitisation to create an income flow over a set period
- Trustees invest in an SPV funding partnership
- To avoid employer related investment (ERI) issues asset normally held in a Scottish Limited Partnership
- Employer “general partner”
- Trustees “limited partner”

Typical Structure (simple form)



Why a Scottish Limited Partnership?

- ERI Rules
- Scottish Limited Partnerships have a separate legal identity
- English and Welsh Limited Partnerships otherwise the same but without this separate legal identity

ERI Rules

- S40, Pensions Act 1995 and OPS (Investment) Regulations 2005
- 5% limit: assets owned or used by employer or its associated companies
- Prohibits ownership of “shares” in a “company” which is associated with or connected with an employer (subject to 5% limit)

ERI Rules

- Interest in a Limited Partnership is capable of being a “share”, but it is not a share in a “company”
- Definition of company is either a “body corporate” or an “unincorporated body” outside of the UK
- Scottish Limited Partnership is not a body corporate, it is a Partnership but with separate legal identity

ERI Rules

- Collective Investment Scheme?
- Do not need to be authorised if group exemption applies
- May need to ensure pension schemes have corporate trustees in which the share capital is owned by the employer

Are the Trustees Investing?

- Can it be argued that the trustees are receiving a gift from the employer, so are not making an investment for ERI purposes?
- Subscription to SLP
- What advice is needed by the trustees
 - valuation
 - authorised adviser “suitability and security”

Other Investment Issues

- Diversifying investments
- Liquidity
- Value if corporate failure?
- Demonstrating due process e.g. to the Pensions Regulator

What does a Scottish Limited Partnership look like?

- Agreement governed by Scottish law and written by Scottish lawyers
- Parties should be Scottish, if possible – nominee companies
- Conduct and execute business in Scotland
- Must be a true partnership – trustees have a share in profits



Partnership Agreement

- Employer transfers asset (e.g. property) to the SLP
- Employer acts as General Partner so has day-to-day control
- Trustees as Limited Partners do not have control
- Trustee protections such as “step-in” rights
- Cannot “over protect” trustees in case structure ceases to be a Partnership



Other Documents

- Subscription or contribution agreements
- Lease between employer and SLP
- Options
- Tax clearance
- Scheme funding documentation
- Advice reports

Valuation of Asset

- Over-collateralised in practice
- Headroom significant factor in determining an appropriate discount rate
- Contingency e.g. surplus - switch payments to future service contributions if Scheme still open to accrual

Accounting Treatment

- Employer has choice:
 - pension scheme asset: shown on company balance sheet as a liability
 - pension scheme asset with deduction from shareholder equity to reflect minority interest of Scheme
 - not treated as a pension scheme asset: no impact on group accounts

Tax

- Minimise tax costs of asset transfer
- Full tax relief for amounts paid to the scheme
- Acceleration of tax relief subject to spreading – requires contribution to pension scheme which trustees use to subscribe for interest in the Partnership

Conclusions

- Increasingly common
- Amounts involved becoming smaller as take-up from sub-FTSE 100 increases
- Structures still complex requiring highly specialised valuation, legal and accounting advice
- tPR reluctantly accepts but has issued warnings



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Contingent Assets

- Very different to asset backed contributions
- Trustees given a legal charge over company property to provide greater security for members' benefits
- PPF have model documents
- Land acceptable for PPF levy reduction purposes but other assets e.g. intellectual property are not



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Contingent Assets

- Simple structure: legal charge over specific asset
- New variants coming to market
 - brands and other intellectual property rights
 - floating charge
 - security might be for less than market value with owner retaining disposal rights to a certain value or headroom check

Dairy Crest

- Floating charge over 20m kilos of maturing cheese worth £60m
- Part of a package dealing with £84m deficit (accounting basis)
- Greater security for trustees in the event of insolvency
- Unlike ABC's no tax relief for the company

If it all goes wrong!

- If insolvency is inevitable might be possible to negotiate a PPF drop-in
- PPF not interested in very small schemes
- If can demonstrate better outcome for the PPF might be possible to decouple the pension scheme from the sponsor group

If it all goes wrong!

- Requires a capital injection of an amount greater than Scheme would receive on insolvency
- PPF will take 33% stake in employer
- Liabilities are apportioned to a Newco which participates in the Scheme for a short period

If it all goes wrong!

- Law is complex
- Necessary for mitigation payment to be made before the insolvency event in respect of Newco
- Creditors voluntary arrangement then follows which is the “insolvency event” required for transition into the PPF

If it all goes wrong!

- Clearance required from tPR
- Clearance doesn't give blessing to the documentation
- Procedural steps subsequently reviewed by PPF Assessment Team
- Bridge appointed to a scheme where PPF drop-in failed
- Second “bite of the cherry”, but at considerable financial cost

The Pensions Regulator

- New statutory objective
- Draft pensions bill
 - *“in relation to the exercise of its functions under Part 3 only, to minimise any adverse impact on the sustainable growth of an employer”*

The Pensions Regulator

- Annual Funding Statement
 - tPR will consult later this year on revisions to its scheme funding code of practice to reflect the new objective
 - *“trustees may need to make greater use of the flexibilities available than needed for their preceding valuations”*

The Pensions Regulator

- *“What is reasonably affordable for the employer”*
- *“Can the current level of contributions be maintained?”*
- *“..... whether it is appropriate to agree lower contributions and this may also include a longer recovery plan”*
- Solution neither damages the employer’s covenant nor benefits other stakeholders at the expense of the Scheme

The Pensions Regulator

- *“If investment in the business is being prioritised at the expense of what otherwise would have been affordable contributions, it is important that it is being used to improve the employer’s covenant”*
- Trustees should take: *“..... an integrated approach to addressing covenant, investment and funding risks..... and allow for an appropriate level of risk to be taken that is neither overly prudent nor overly optimistic”*

Conclusions

- Increase in number of ABC's
- Contingent assets will still feature for the purposes of member security and funding negotiations
- PPF drop-in – for when there is no funding solution
- tPR's statutory objective



Questions



Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.