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Asset-backed funding

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29 October



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Agenda

- What are they?
- Are they legal?
- What are they worth?
- What else should I think about?



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What are they?

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What are they?

- Investment by pension scheme in Special Purpose Vehicle (a Scottish Limited Partnership)
- Investment funded by contribution from company
- Vehicle (SPV) acquires asset from company at market value
- Asset provides income for vehicle (e.g. rent/royalty)
- Vehicle uses income to pay "bond like" cash flow to pension scheme
 - Agreed share of income for fixed term
 - Defined rights to capital, may include termination payment

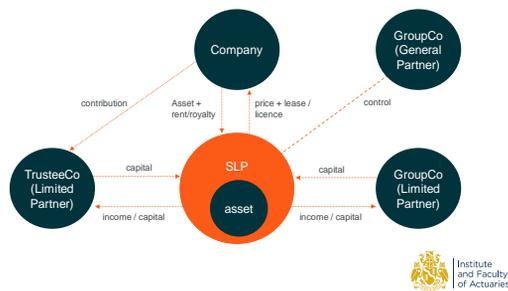


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The typical structure



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What is the result?

- Value of investment is asset on scheme's balance sheet
 - An immediate reduction in deficit / PPF levy
- Term typically longer than a traditional recovery plan
 - Reduced cash flows / lower risk of trapped surplus
- Potential tax benefits and wider strategic benefits
- Underlying assets give security for payments due to scheme
- Company controls vehicle and so retains control of asset
- Company can collapse vehicle at end of term



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Companies that have used them



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What assets have been used?



Possible to make use of assets which potentially cannot be used for capital raising or investment (e.g. brands, receivables)



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Are they legal?

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Legal issues

- Isn't this employer related investment?
- Even if it isn't technically employer related investment, isn't it inappropriate for trustees to take advantage of a loophole?
- What happens if the law changes, or Scotland leaves the UK?

Isn't this employer related investment?

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- Typically more than 5% of assets, so illegal if count as employer related investment
- Would be illegal for trustees to own underlying asset in most cases
- Risk that would be illegal if vehicle was a company, partnership or English Limited Partnership
- Scottish Limited Partnership is permitted because
 - Has separate legal personality: so not transparent
 - Not a body corporate, but within the UK: so not a share
- Need to avoid being Collective Investment Scheme 

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Isn't it inappropriate for trustees to take advantage of a loophole?

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- Entitled to take any option permitted by Parliament
 - Not entirely clear why other vehicles are not permitted
- Must be better than the alternatives
 - Deficit is like a loan to the employer
 - Vehicle, including the security from underlying assets, must provide better protection than traditional schedule of contributions

What happens if the law changes, or Scotland leaves the UK?

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- Scottish independence not necessarily a problem, but a risk
- Risk of general change of law over long term of vehicle
- Regulator statement: "underpin" to provide an alternative funding structure
- Contractual terms need to include change of law protection
 - Obligation to re-negotiate
 - Trustee exit and replacement funding plan



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What are they worth?

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What are they worth?

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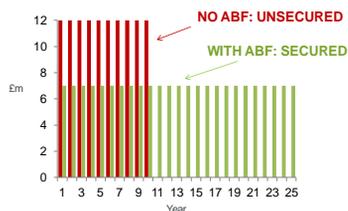
- Doesn't this just extend our recovery period, so why should we agree to it?
- Isn't the result that regular cash contributions are unacceptably low?
- Will the structure actually provide any security when we need it?



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Doesn't this just extend our recovery period, so why should we agree to it? Isn't the result that regular cash contributions are unacceptably low?

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- ABF does extend the recovery period but comes with some security
- Need to balance medium-long term covenant strength versus short-term affordability



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Comparison with other types of funding

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	Regular deficit funding	Charge over assets	ABF
Security for scheme	Security increases as contributions are paid	Immediate increase in security for the scheme	Immediate increase in security for the scheme
Deficit impact	Deficit reduces when contributions are paid	Possible reduction in deficit through less prudent assumptions, otherwise deficit only reduces as contributions are paid	Deficit will reduce immediately by the value of the ABF
Impact on cash	Based on what is "reasonably affordable"	May agree a reduction to cash contributions (depending on the charge)	Annual contributions can be spread over longer period, allowing for the additional security
Risk of trapped surplus	Shorter recovery periods increase the risk of trapped surplus	Surpluses may be less likely if longer recovery period	Significantly reduced risk of trapped surplus (longer period & funding triggers)



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Will the structure actually provide any security when we need it?

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- Income headroom reduces reliance on underlying asset security
- May be other contractual protections for any termination payment
- Security only required in default scenario
 - Still need company for buy-out funding
 - Can asset be sold without damaging company?
 - Can asset be separated from the company
- Better security position than without the vehicle



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What else should I think about?

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What else should I think about?

- As it is an investment, what is the impact on our overall investment strategy?
- What does the Regulator think of these structures?

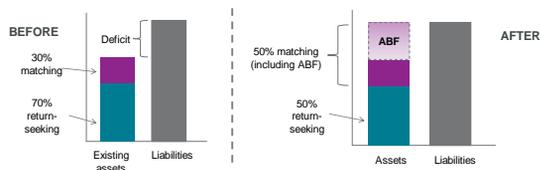
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As it is an investment, what is the impact on our overall investment strategy?

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- Additional "matching" assets presents an opportunity to review the investment strategy as a whole

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What does the Regulator think of these structures?

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- Issued statement in 2010
 - Risk of being illegal employer related investment
 - Should be described in scheme funding documents
 - Underlying assets must be independently valued
 - Clear and transparent communication with members
- Now seen a number of structures

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The future for ABF?

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- Now accessible for lower value transactions
 - Standardisation of basic structure
 - Helped by tax legislation
 - Reduced costs
 - Banks familiar with concept
- Greater variety of assets used
 - Brands
 - Loan notes/Guarantees

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Questions

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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.

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