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Asset-backed funding

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The questions every trustee should ask

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

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What are they?

What are they?

- Investment by pension scheme in Special Purpose Vehicle (a Scottish Limited Partnership)
- Investment funded by contribution from company (may be tax deductible depending on terms)
- Vehicle 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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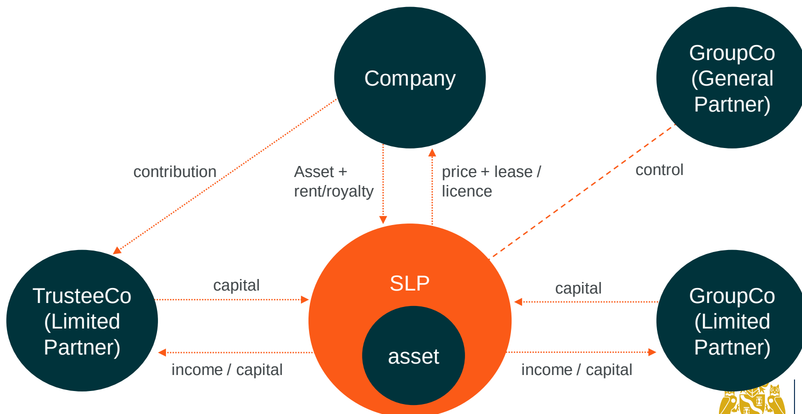
The typical structure



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What is the result?

- Value of investment is asset on scheme's balance sheet
- Investment value gives an immediate reduction in deficit
- Full funding requires cash flow to be received from vehicle
- Term typically longer than a traditional recovery plan
- Underlying assets give security for payments due to scheme
- Company controls vehicle and so retains control of asset
- Company usually retains capital gains/losses on the underlying assets
- Company can collapse vehicle at end of term

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Companies which have used them

EAT SLEEP & DRINK WHITBREAD

itv

YOUR M&S

Sainsbury's

GKN

Kingfisher

Pendragon | PLC

TUI Travel PLC

SEVERN TRENT WATER

Midlands

DIAGEO

John Lewis

Travis Perkins

Lloyds TSB

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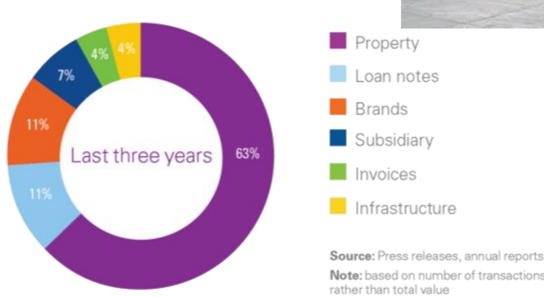
What assets have been used?



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Why do companies use them?

- Immediate reduction in the scheme's funding deficit at no cost to the company (except set up fees and expenses)
- Reduced annual cash requirements
- May get up front tax relief on its contribution to the scheme (subject to rules on spreading)
- May help reduce the risk of trapped surplus
- Lower PPF levy
- Make use of assets which cannot be used for capital raising or investment (e.g. brands, receivables)
- Obtain trustee agreement to scheme mergers

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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?

- 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

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

- 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

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

- 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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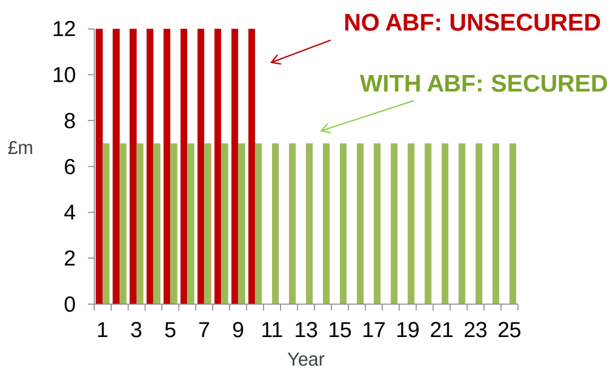
What are they worth?

- 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?
- Whilst the asset security looks helpful, doesn't setting up the structure reduce the remaining employer covenant?
- Will the structure actually provide any security when we need it?

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?



- 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

	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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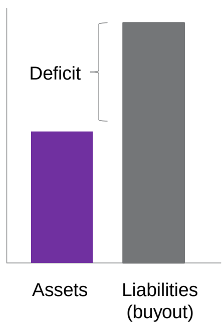
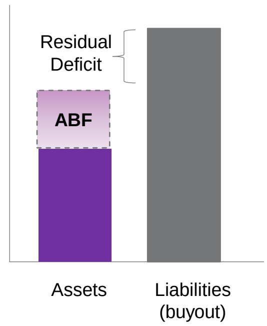
Whilst the asset security looks helpful, doesn't setting up the structure reduce the remaining employer covenant?

BEFORE

- Trustees typically an unsecured creditor
- On insolvency, trustees try to recover buyout deficit from residual business assets
- May not get 100% recovery





AFTER

- Trustees have priority on assets supporting the ABF
- On insolvency, trustees get their proceeds from the assets within the ABF
- Recover any remaining buyout deficit from residual business assets

- **ABF brings the trustees closer to the assets of the sponsor in the event of an insolvency**

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

- 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?
- Aren't these expensive to implement? Wouldn't it be better for the company just to pay the money into the scheme rather than spend it on adviser fees?
- What does the Regulator think of these structures?
- Will this structure significantly increase our governance burden?
- Will this structure stop us doing things like a buy-in or a scheme merger until the end of the term?

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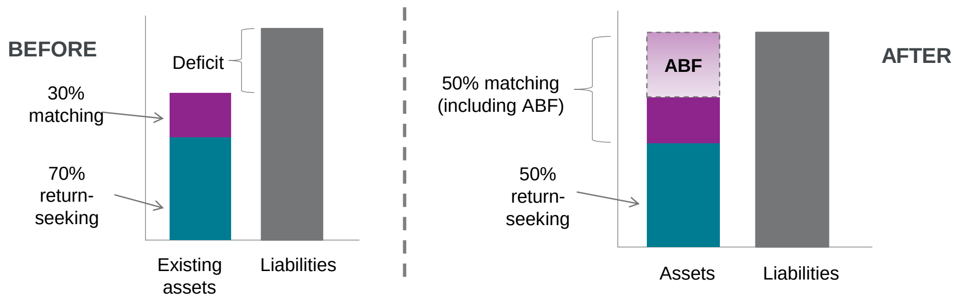
As it is an investment, what is the impact on our overall investment strategy?



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

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Aren't these expensive to implement? Wouldn't it be better for the company just to pay the money into the scheme rather than spend it on adviser fees?

- Initially, it was very expensive to implement these structures
- As the market has developed, the cost of implementing an ABF structure has fallen significantly
- Payback period is usually 1 – 2 years
- Costs should be considered in the context of the possible benefits (to the trustees and the sponsor)

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What does the Regulator think of these structures?

- 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: tacit acceptance

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Will this structure significantly increase our governance burden?

- Limited liability partner status: no day to day involvement
- Scheme investment duty to monitor, but different type of asset
- Scheme asset value needs to be acceptable to auditor
- Need governance framework
- Documentation likely to include
  - Trustee rights to receive regular information
  - Trustee rights to require underlying asset valuation
  - Trustee rights to take control
- Consider skills/ability to exercise rights

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Will this structure stop us doing things like a buy-in or a scheme merger until the end of the term?

- Important to put in context of scheme's long term strategy
- Buy-in/Buy out issues
  - Insurer will not take interest in vehicle and company will not let them
  - Investment strategy impact of gilts backed buy-in if have ABF asset
- Merger issues
  - Merged scheme may take on interest, but contractual terms may not be appropriate
  - Covenant cross subsidy issue from underlying security
- Need flexibility in structure

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The future for ABF?

- 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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