The Actuarial Profession
making financial sense of the future

Clearance
- are we all clear about it?

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Pension Protection Fund
Government Actuary's Department

Anti-avoidance Legislation : Objectives

- Ensure companies stand behind their pension promises
- Liabilities do not fall on PPF levy payers
- Objectives of powers
  - Protection of pension scheme benefits
  - Protection of the PPF
  - Improved confidence in DB schemes

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Contribution Notice

- Covers an act or failure to act
- One of the main purpose of the event was to prevent the recovery of all or part of the Buy-out debt
- Event occurred after 27 April 2004 and within 6 years of notice

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Contribution Notice (2)

- Can be issued to any party to the act who is connected or associated with the employer
- Must be reasonable to impose the liability on the person in terms of:
  - Relationship
  - Involvement
  - Purpose – including to protect employment

Financial Support Directions

Where the sponsoring company is:

- Service company: or
- Insufficient resourced

- Regulator can require support for up to full buy-out debt from associated companies

FSDs (2)

Insufficiently resourced

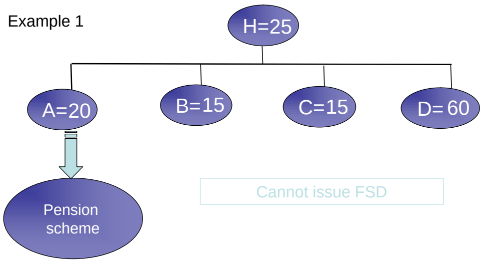
- Value of employers resources is < than 50 % of buy out debt

AND

- An associated company has resources that - added to employer's - equal or exceed 50 %

Financial support direction – Insufficiently resourced

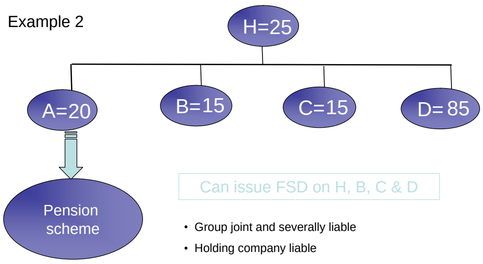
Example 1



Buyout deficit = 200
% of deficit needed = 100
Need to find a company with 100 – 20 = 80

Financial support direction – Insufficiently resourced

Example 2



- Group joint and severally liable
- Holding company liable
- Additional financial resources made available

Buyout deficit = 200
% of deficit needed = 100
Need to find a company with 100 – 20 = 80

Why Clearance?

- Protection of jobs
- Allow commercial activity to take place

Does an event affect the pension creditor?

1 – Creditors with fixed charges
2 – Preferential creditors
3 – Creditors with floating charges
4 – Unsecured creditors
5 – Subordinated creditors
6 – Equity

What is the pension creditor?

- MFR – too low
- PPF – does not cover all benefits
- SSF – not available yet but in future this is likely to be key
- S75 – unrealistic usually
- FRS17 – audited and on balance sheet. But has its problems too.

Events that impact the pension creditor

Three different types:

- Priority – a change in the level of security given to creditors with the effect that the pension creditor is now likely to receive a reduced dividend in the event of insolvency
- Capital Reduction – a reduction in the overall assets of the company which could be used to fund a pension deficit
- Control Structure – change in the control group structure including where appropriate a change in parent company

Cutting through to the underlying consequence of the event will simplify the clearance process

But the Trustees have no power…

- Oh yes they do
- Negotiate as an unsecured material creditor

The pension creditor should negotiate in the same way as any key material unsecured creditor

- Concrete and realisable recovery plan
- Additional cash or other assets
- Insurance of contributions (3 to 5 years)
- Escrow/Deposit up front
- Improvement in priority eg additional security
- Information
  - Monitoring
  - Covenants
  - Negative pledges

Priority - Granting of Fixed or Floating Charge

This means that, in the event of insolvency, there will be less for unsecured creditors.

Could ask for

- Security for pension scheme ranking alongside bank
- Cash to get up to FRS17
- Guarantees from other companies in the group
- Negative pledge – a promise that no more security will be given without agreement
- Information about employer's finances and future plans

Return of Capital - Payment of Dividends

- This means there is less cash for creditors.
- And a longer wait for the pension scheme to get rid of its deficit
- Why is that important? Depends on strength of employer covenant
- But nothing (except diamonds) is forever
- Get a share of the money available
- And get deficit paid off quicker

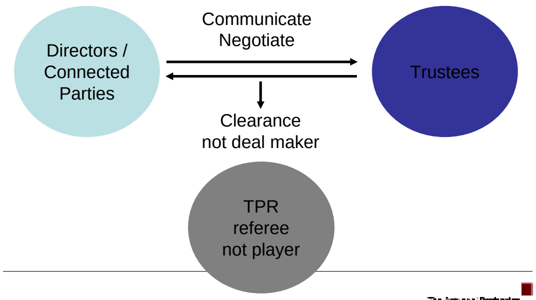
Repayment of Subordinated Loans

- Repayment of secured debt is usually good (security released for unsecured creditors)
- But some loans are subordinated
- E.g. in event of insolvency they would be paid after unsecured creditors
- Trustees should use the opportunity to negotiate accelerated deficit repayment

Change in Control Structure

- Good or bad?
- Check the credit rating or scoring
- If that is not available get independent advice
- If new/remaining employer is weaker seek mitigation
  - Cash
  - Guarantees
  - Negative pledges

Key parties in a Clearance Request



Clearance Process

- Initial assessment
  - team allocation
  - acknowledge receipt
  - initial case conference
- Information gathering
  - from both applicants & trustees
  - purpose ensure full understanding of transaction & effect on scheme
- Agree final application
  - reach agreed conclusion between all parties
  - updated application may be necessary
- Issue documents
  - Warning Notice, Determination Notice, Clearance Statement
  - Comfort letter

Trustees

- Understand the employer's financial situation
- Monitor transactions/ restructuring that may impact on the pensions scheme
- Work with the employer
- Demonstrate gravitas at the negotiating table
- Recognise and ensure conflicts are properly dealt with
- Obtain independent advice financial / legal / actuarial
- Be an intelligent consumer of that advice
- Aware of confidentiality responsibilities

Employers

- Full and accurate disclosure to the trustees and Regulator
- Recognise the pension creditor as a serious creditor
- Provide reasonable time frames when requesting clearance
- Act in accordance with issued guidance
- Pay for Trustees to get independent advice
- Work in partnership with trustees and Regulator

Case Study

Background

- Company A is a UK subsidiary of a European services business. Annual sales c. £120m.
- Business historically loss-making (loss in 2004 c. £80m and accumulated losses of c. £330m) and was acquired recently by a VC house from the insolvency of former parent.
- Acquisition was debt-financed using secured senior bank debt, mezzanine finance and unsecured shareholder loan notes.
- Balance sheet is 3.5x leveraged.

Case Study

- Defined Benefit pension scheme has c. 3000 members of whom c. 400 active
- Scheme is in deficit:
  - Fund size £88m
  - Section 75 £125m
  - FRS 17 £53m
  - Ongoing basis £26m

Case Study

Event

- Typical VC-house restructuring of group balance sheet to re-leverage and facilitate return of capital
- Fresh debt is raised through 3rd-party asset-backed financing secured on business consumables. Finance will be raised based on 50% of value of consumables. Debt will rank in priority to the pension creditor.
- Proceeds of fresh debt will be used to repay majority of secured senior debt plus certain of the shareholder loan notes which are unsecured and rank alongside the pension deficit.

Case Study

Impact on Pension Scheme

- Security given to new lenders in priority to pension scheme.
- Unsecured capital returned to shareholders whilst pension fund in deficit.
- However VC house had taken pension liability when acquiring business in 2003 and expressed commitment to work to resolve deficit over time.
- The cost of the new secured debt is lower in aggregate than the debt it replaces, thereby releasing cash to service the pension fund.

Case study

Considerations

- The shareholder loan notes are unsecured and therefore rank pari passu with the pension deficit.
- Company C financial performance has historically been weak and relied upon parental support (including owners pre-2002).
- How can the member's benefits be protected?
- Independent Business Report prepared for Trustees by accountants.

Major implications

- The pension creditor should negotiate in the same way as any key material unsecured creditor
- Trustees and Employer must work together
- Trustees must become more financially aware
- Employer must treat the pension scheme with respect
- And finally….For actuaries, the move to Scheme Funding may increase their role in looking at the impact of relevant events and possible changes to funding