Financing the deficit

human resource services

Pension deficit funding
Terry Simmons

The pension scheme problem – the deficit

- Many UK pension schemes currently have a deficit
- Primarily caused by falling equity markets, lower expected future investment returns and increasing life expectancy
- Companies can no longer walk away from their pension promises
- The shortfall will have to be made good at some point

<table>
<thead>
<tr>
<th>FRS 17 position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
</tr>
<tr>
<td>Assets</td>
</tr>
<tr>
<td>£46m</td>
</tr>
<tr>
<td>£30</td>
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<tr>
<td>Cash to remove deficit</td>
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<tr>
<td>Contributions for future service benefits</td>
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<tr>
<td>Total Company contributions</td>
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A pension solution - background

- The solution is based on an idea first proposed by Fischer Black in 1981.
- The principles of the idea are:
  - No change in the financial position of the combined entity (firm plus pension fund).
  - But there are tax advantages.
  - And some cost savings.
- There are a number of conditions needed for this to work:
  - Pension fund deficit
  - Significant equity assets in pension fund
  - Tax paying
  - Low cost borrowing

A pension solution

Scheme

Pensioners
Deferrals
Actives
Liabilities
Assets

Company

Corporate debt / bank loan

Cash
Equities
Bonds/gilts

human resource services
A pension solution

- Pay £16m to the scheme
- But get tax relief on payment (ie pay £5m less tax)
- Therefore only need to raise (£16m less £5m) = £11m

Why do it and what are the implications?
Why do it?

- There are tax savings
  - Debt interest payments receive tax relief to reduce tax bill
- Good PR with employees
  - Confidence of receiving benefits
- Reduce costs
  - Reduce PPF levy
- Gross roll up
  - Gross roll up in the pension scheme versus net in the company
- There can be initial cash flow savings
  - Depends on how you organise debt

But

- Exchanging known flexible funding for prescriptive funding
- Need to satisfy the previous criteria

The proposal can reduce future cashflows

Protecting the funding position
Protecting the funding position

- Remove funding risk from the pension fund
- Switch all equities to bonds

Maintaining equity exposure

The shareholders may want to maintain equity exposure
Now not possible through scheme
Gain exposure for shareholders through the company directly
An equal amount of risk is added in the Company by buying back their own equities - keep exposure to the risk element
Summary

Several ways to meet funding deficits

* Paying off the deficit in one go
  - Good HR
  - Tax advantageous
  - Cash savings

* Also consider protecting the fully funded scheme

* Equity exposure can be obtained but through the company