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Options for bridging the funding gap

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Introduction

- Schemes in deficit
- Historically
  - Compromises or nothing
  - No safety net
- Introduction of PPF and The Pensions Regulator

What this presentation is not about

- Other ways of limiting scheme liability
  - Cost reductions
  - Changing scheme structure
  - Investment strategy
- All of which may help to bridge the funding gap, but not through funding of the shortfall

What is the funding gap?

- Depends on appropriate scheme funding basis
- In turn, this depends on:
  - Strength of covenant
  - Attitude of employer
  - Standing of scheme, for example,
    - Closed to future accrual
    - Membership profile – active –v- deferred/pensioner
    - Likely future of the scheme
    - Balance of power

Why the scheme deficit is unique?

- Trade creditors – ROT/terms of trade
- Finance creditors – security
- HMRC – involuntary creditor but special powers
- The scheme is also an involuntary creditor, but has no special powers.
- Unsecured bank – portfolio risk

Comparison with unsecured bank

- Bank
  - Short term
  - Profit making
  - Can withdraw facilities
  - Portfolio – managed risk
  - Provisions
  - Vast experience
  - Shareholders
- Pension scheme
  - Long term
  - Non-profit
  - Involuntary creditor
  - Only scheme
  - Deficit = loss of benefit
  - Inexperienced
  - Members

Employer covenant

- What it means
- Why is it important?
- Comparison with D&B "failure score"
- 2 key factors
  - Probability of default
  - Risk of loss

How to assess the covenant

- Annual Information required:
  - Annual financial statements
  - Business plan/projections
  - Bank facility letters
  - D&B failure score
- Monthly monitoring of changes in the covenant
  - Management accounts and KPIs
  - Changes in bank facilities
  - Movements in intra-group indebtedness

Transactions - e.g. leveraged buy-outs

- Often funded by unsecured debt – competes with scheme for funds (free cashflow?)
- May be funded by secured debt – ranks above scheme
- If employer's shares are purchased, employer's assets can be used as collateral

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Employer covenant – example

- Shares in employer to be sold by parent
- Greater profitability and bigger net assets of new parent - apparently a stronger covenant
- So, probability of default is less
- BUT: what if the scheme would receive less in the event of the employer's failure?
- There is then an increased risk of loss
- Judgement of balance between the two factors
- The conclusion…

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Traditional options

- Cash – payment by employer in mitigation of deficit, to satisfaction of trustees
  - From available resources
    - Includes cash balances and
    - Existing unutilised bank facilities
  - New debt
    - Secured
    - Unsecured
  - New equity
    - Ranks behind scheme
    - Can be "cheap" money

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Traditional options

- Compromise – managing the deficit:
  - Lump sum payment
  - Payments from expected free cashflow
  - % of future profits
  - Security/assets if available
- Compare outcome with the level of PPF benefits

Contingent assets - Framework

- Clearly defined categories of asset
  - Type A assets – guarantees from “Associates”
  - Type B assets – charges over cash or assets
  - Type C assets – guarantees from third parties
- Certain qualifying criteria
  - Must be created as per the PPF’s standard documentation
  - Must remain in force for the long term
  - Reduction or replacement as funding improves is allowed
  - For multi-employer schemes, must cover the liabilities of all associated sponsoring employers

Type A assets – introduction

- Explanation
  - Guarantee given by associated company
  - S435 Insolvency Act 1986 definition
- Qualifying criteria
  - Associate must have lower probability of failure than employer (i.e. a higher “failure score”)
  - If not, then it will be ignored for levy purposes

Who is an “associate”

- Section 435 Insolvency Act 1986

- Husband, wife or relative
- Partner, or husband, wife or relative of a partner
- Employee (including directors and officers)
- Trustee

- A company is an associate of another company if:
  - Same person controls both
  - Controlled by a person and his associates
- Control is
  - >1/3 of voting power
  - Acting as shadow director

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Guarantees

- Provided by an associate – usually will be within the same group
- Will be unsupported – relies solely on the guarantor’s word/covenant

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Risks of an unsupported guarantee

- Intra-group indebtedness
- Cross guarantees
- Domino effect
- BUT: could be very valuable, especially if the guarantee amount is relatively small compared to size of the guarantor

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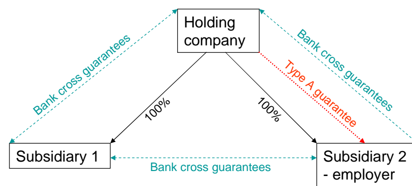
Group example



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Type A assets – summary

- Pros
  - Simple to effect
  - Keeps it "in the family"
- Cons
  - Only as good as the associate's covenant
  - At the time it needs to be relied on

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Type B assets – introduction

- Explanation
  - Security granted by the employer
  - Must be a first fixed charge
  - Can only be over:
    - Cash
    - UK land
    - Debt or equity
- Qualifying criteria
  - Cash
    - Sterling only
  - Land
    - Appropriate valuation within 3 months
  - Securities
    - Securities must be held by a custodian
    - Must be securities in which trustees could invest scheme assets

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Nature of security

- Most security is a variation of:
  - Fixed charges
  - Floating charge
  - Trust/Escrow
- For example, a typical bank debenture will encompass both fixed and floating charges

Fixed charges

- Charges over specific assets
- Must be registered at Companies House
- Mortgagor can't sell, or charge these assets without the mortgagee's consent
- Most frequently applied to property or equities
- Security over property must also be registered at The Land Registry

Fixed charges

- Can also attach to chattel assets* (known as a chattels mortgage)
- Property is usually regarded as an appreciating asset, but chattels are a depreciating asset
- Book debts - depends on control exercised by lender

* Chattel assets include plant and machinery

Floating charges

- Allows the mortgagor to deal with the assets subject to the security in the “normal course of business” – no control over use and sale
- Applies to stock and most fixed assets – very flexible tool
- Value is less easy to ascertain than fixed charge – it can change on a daily basis

Value of a floating charge

- Priority - ranks after:
  - Preferential creditors – only arrears of wages and holiday pay since September 2003
  - “Prescribed Part” – introduced in Enterprise Act 2003.
    - Computed as a proportion of “net property” available to floating charge holder
    - 50% of first £10,000 and 20% of remainder
    - Capped at £600,000

Fixed and floating charges - example

	Fixed £'000	Floating £'000
Realisations from assets before costs	1,000	1,000
Less:		
Preferential creditors	n/a	(75)
Costs of realisation	(100)	(100)
"Net property"	900	825
Prescribed part (only applies to debentures created after 15/09/03)		
50% of £10,000	n/a	(5)
20% of balance (£825,000 - £10,000)	n/a	(163)
	-	(168)
Available to secured creditor	900	657

- Floating charge creditor can receive significantly less than realisations, mostly due to priority of other creditors

Security - example

- ICI Pension Fund
- Created new subsidiary – Receivables Funding Ltd ("RFL")
- Book debts and cash assigned to RFL
- Fixed and floating charge over book debts created in favour of pension scheme up to £250m
- Ranked ahead of banks
- Unlikely to qualify as a contingent asset

Availability of security

- What if employer is already fully committed?
- Priority with other lenders
  - Second/third charges
- Suitability of assets
- Realisable value – not book value

Funds held in Escrow/trust

- An agreement between two parties in which money (or property) is kept by a neutral third party until a particular condition is completed
- Money will be physically held in another account, either:
  - To a solicitors' client account, or
  - To a separately held account within the company, but outside existing security arrangements
- May be tax implications of Escrow payment

Type B assets – summary

- Pros
  - Value separate from employer covenant
  - For cash security, value is certain and in liquid form – easily accessible if necessary
- Cons
  - Unlikely to be available in a highly geared employer
  - No growth in cash held
  - Securities and land not immune to devaluation
  - Need to sell land

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Type C assets – introduction

- Explanation
  - Letter of credit
    - Usually issued by a bank
    - Promise to pay specific amount at specific time/ on specific event
  - Bank guarantee
  - Not Credit Default Swap – at least in 2006/7 levy year
- Qualifying criteria
  - At least a 12 month maturity, ending on 31 March
  - If not replaced / renewed, trustees can demand face value
  - Must be made in sterling

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Letters of credit

- Document issued by bank or financial institution
- Promise to pay in event of default by employer
- Part of company/group banking facilities

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Type C assets – summary

- Pros
  - Strength of issuing party
  - Ability to demand face value if not replaced or renewed
  - Liquidity in the event of default
- Cons
  - may utilise existing banking facilities, so may not be available to highly geared employer

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Credit default Swaps – introduction

- What is it?
- Is it insurance?
- How/when it can be used

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What is a CDS

- A bilateral contract under which the “Protection seller” agrees to compensate the “Protection buyer” if the “Reference entity” experiences a “credit event”
- In this context:
  - The Protection seller is the financial institution accepting the risk
  - The Protection buyer is the pension scheme
  - The Reference entity is the employer
  - The credit event is insolvency or other defined default

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Comparison with insurance

- Similarities
  - Pension scheme pays a regular premium to the “insurer”
  - Premiums cease on expiry or the credit event
  - If a credit event occurs the insurer pays its obligations to the pension scheme
- Differences
  - Pension scheme does not need to have suffered loss
  - Terms are usually different
  - Pension scheme does not need to have an insurable interest

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When to use a CDS

- Fully committed employer/group
- Inadequate returns in insolvency
- Slight risk of failure – more expensive as failure score fall
- Large enough deficit to warrant expense

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Summary

- Even without available cash, the scheme could ensure that the deficit can be met
- Understanding the covenant is fundamental to assessing options – the starting point for negotiation
- Just because certain security doesn’t comply with the Contingent Assets regulations does not mean that it is not good security.
- Need to ensure that the type of security matches the need for cash in the scheme
- Fundamentally, get close to employer and work together to achieve optimum outcome

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QUESTIONS?

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