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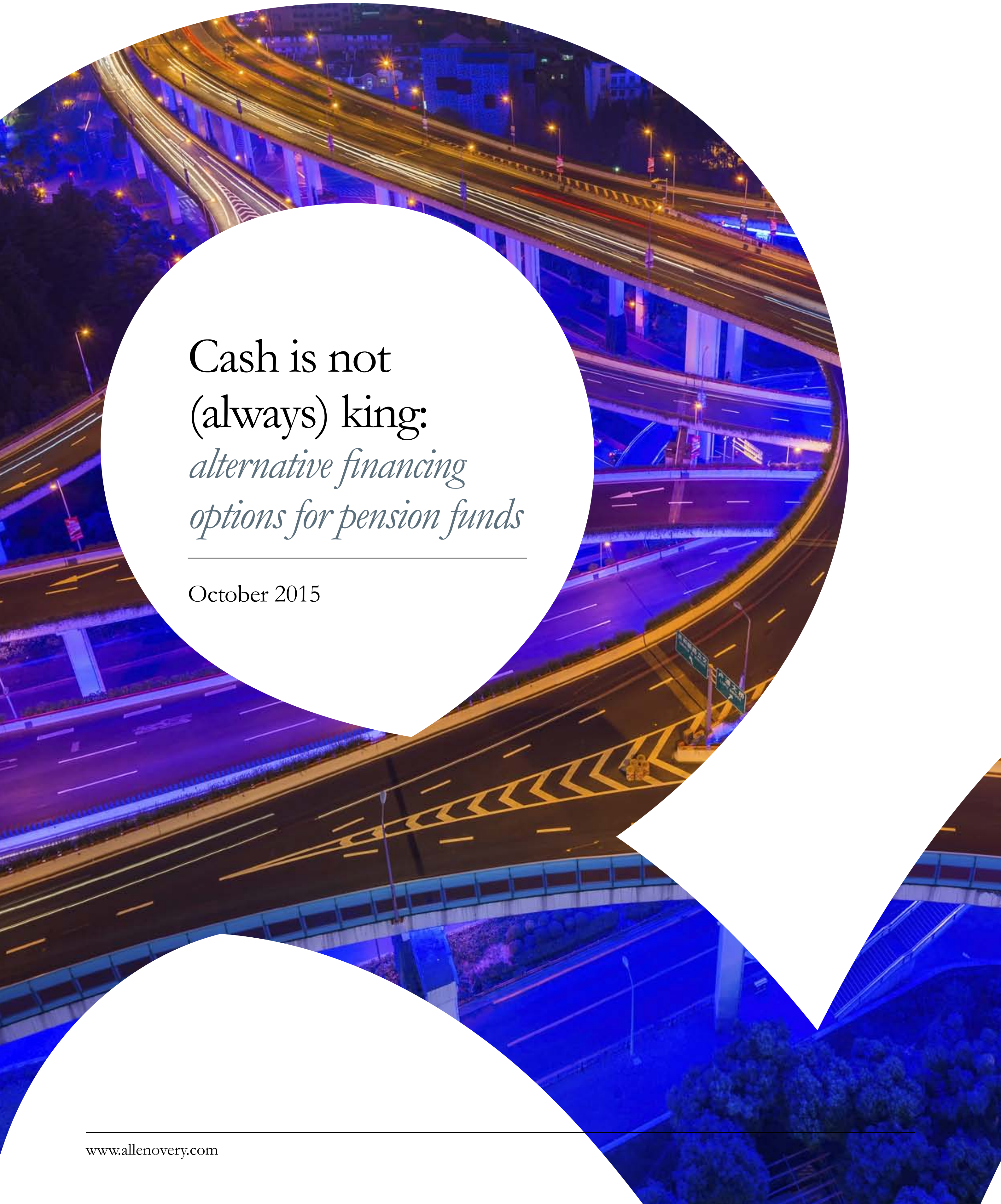

Cash is not (always) king: *alternative financing options for pension funds*

October 2015

Alternative financing options for pension funds

Pension scheme funding doesn't always have to involve direct cash contributions. That's the baseline, but in a tight economic environment, cash resources which could improve scheme funding or security may also be needed for business investment. Sponsors may also be concerned that cash contributions could end up trapped as surplus if interest rates and yields rise, with no tax-efficient route back to the business.

We advise schemes and sponsors on a range of solutions to resolve this dilemma. The right structure, implemented appropriately, can deliver significant benefits to both parties.

Here we outline some of the options, their pros and cons, and how they can be combined or tailored to fit your business and support your scheme.

'Trustees agreeing to lower contributions and to higher risk to support the employer's growth plans should seek to obtain security or other contingent assets.'

(The Pensions Regulator, Guidance on assessing and monitoring the employer covenant, August 2015)

Drivers for alternative funding

SPONSORS — TRUSTEES

- Avoid trapped surplus
- Retain cash in business
- Leverage assets/group support

- Support investment strategy
- Support longer/reshaped recovery period
- Reduce Pension Protection Fund levy

- Improve scheme funding/security
- Improve insolvency protection for scheme

Ways to achieve your objectives

Here are some of the most common options, and broadly where they lie in terms of complexity.

COMPLEXITY

- Charged account
- Simple 'escrow' arrangement
- Letter of credit

- Funding trust
- Surety bonds
- Charge over assets

- Funding partnership (asset-backed contributions)
- Guarantee – bespoke triggers
- Guarantee – pure PPF

INDICATIVE DURATION – SHORTER TO LONGER TERM

Some sponsors may have capacity to manage investments in-house, and may feel they can make cash work harder by taking on that role in a bespoke arrangement; others may wish to outsource management via a more standardised product. With a wide range of structures available, you don't need to be tied to a particular product or investment manager.

Combining techniques can be a powerful tool to mitigate default risk – for example, a guarantee may leave the scheme exposed to the risk of default by, or credit downgrading of, the guarantor. One way to mitigate this risk is to support the guarantee with an escrow arrangement including appropriate triggers for payment.

Comparing options: the pros and cons

	CASH FUNDING	CHARGED ACCOUNT/ ASSET	LETTER OF CREDIT	GUARANTEE
Brief description	Direct cash contribution to pension scheme	Sponsor provides security over cash account/ specific asset; trustees realise charged asset on trigger event	Bank or insurer agrees to pay scheme on trigger event(s) in return for premium	Promise of support from parent/other group company
Available when needed (e.g. insolvency)	Yes	Yes	Yes	Yes, subject to risk of guarantor default
Flexibility of terms	n/a	Limited	Limited	Limited if PPF recognition required
Recognised by PPF?	Yes	Yes if in PPF format	Yes if in PPF format	Yes if in PPF format
Investment flexibility?	Yes	n/a	n/a	n/a
Can excess funds be repaid to employer?	Not easily/ tax-efficiently	Yes	n/a	n/a
Can employer use funds/ asset?	No	Account – no Asset – yes	n/a	n/a
Tax deduction for employer?	Yes	No	n/a	n/a
Complex to establish?	n/a	No	No	Depends on specificity of trigger design
Other considerations	Baseline option	May allow sponsor to leverage non-liquid assets but viability is subject to other creditor interests	May help mitigate default risk e.g. under guarantee Could reduce capacity of sponsor to borrow for investment	Requires appropriate (strong) guarantor

	ESCROW ARRANGEMENT	SURETY BONDS	FUNDING TRUST	ASSET-BACKED CONTRIBUTIONS
Brief description	Cash/assets are held by a third party which will release part/all to scheme on trigger event/return assets to sponsor at end of specified term	Form of insurance: provider(s) pay scheme on trigger event(s) in return for premium	Assets placed in trust, to be transferred to scheme on trigger event/if deficit exists at end date Income may be mandated to sponsor, which may make matching contribution to scheme	Future payments to scheme are secured by income-producing assets held jointly by the scheme and sponsor in partnership vehicle. Sponsor contributes funds to allow scheme to purchase partnership share and transfers assets to vehicle while retaining operational use
Available when needed (e.g. insolvency)	Yes	Yes	Yes	Yes
Flexibility of terms	Bespoke triggers agreed between parties	Bespoke triggers agreed between parties	Bespoke triggers agreed between parties. Terms and duration highly flexible	Bespoke triggers agreed between parties. Structure dictated by tax regime; tends to be designed for long term
Recognised by PPF?	No	Yes, subject to conditions	No	Yes, subject to conditions
Investment flexibility?	Depends on provider	n/a	Yes	n/a
Can excess funds be repaid to employer?	Yes	n/a	Yes	Yes
Can employer use funds/ asset?	No	n/a	Generally no, but can potentially receive income	Yes
Tax deduction for employer?	Only when funds are paid to scheme	n/a	Only when funds are paid to scheme	Upfront tax relief on initial contribution; then matches cash paid to scheme
Complex to establish?	Not particularly; may be contract- or trust-based	Not particularly	Standardised structure available; triggers are negotiable	Tends to be more complex/bespoke to establish, especially in relation to triggers
Other considerations	May help mitigate default risk e.g. under guarantee	May help sponsor to maintain banking lines of credit for other business needs	Consider current and potential future value of assets (e.g. sale value on trigger event)	Requires appropriate and reliably income-producing assets to contribute to partnership Consider current and potential future value of assets (e.g. sale value on trigger event)

Designing triggers

To make any of these structures work for you, the key is to ensure that triggers are designed to address your specific concerns – for example:

- Breach of key performance thresholds
- Sale of part of business
- Deterioration in funding levels
- Loss of operating licence
- Failure to pay deficit contribution
- Sponsor/guarantor insolvency

Some trigger events may be non-critical, with a period allowed to remedy the issue, while others are critical and trigger immediate payment.

Assessing value

Trustees must consider the value to be attributed to any asset-based structure:

– What value do the assets have now? This can be tricky to assess if the relevant assets are integrated in the employer's business.

– What value will the assets have if a trigger event occurs? Is sponsor insolvency likely to devalue the asset at the point when the scheme needs it?

'Trustees need to consider the appropriateness of a contingent asset in relation to the support it is providing to the scheme's funding strategy… They should also consider what value it is likely to have in the context of insolvency of the employer.'

(The Pensions Regulator, Guidance on assessing and monitoring the employer covenant, August 2015)

Alternative funding: the process

1 Identify drivers for alternative funding

Identify key risks to scheme and sponsor

2 Cash or non-cash?

Establish business case for non-cash options

3 Identify options

Combine and tailor alternative options to fit identified drivers

4 Consider structural requirements

Trustees: consider value and access issues; wider investment duties

Sponsors: consider tax and accounting issues; other creditors

5 Design triggers

Design appropriate triggers to match identified risks

Specify consequences of each trigger event

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