ALLEN & OVERY

Pension Risk – *market update*

News from our Pension Risk Group – February 2015

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"A deficit shown on a pension scheme valuation is not the same as an immediate cash call on your business – but it can have significant financial implications"

The funding conundrum

In the current low-interest, low-yield environment, reported deficits in defined benefit (DB) pension schemes are increasing. The Pension Protection Fund (which acts as a lifeboat for members of DB schemes whose employers become insolvent) recently reported that the aggregate deficit of the 6,057 private sector schemes it covers rose by more than GBP100bn in January 2015 – an increase of 38% in a single month.

Figures like these make good headlines, but they're just a snapshot based on particular valuation dates. By contrast, pension provision is a long-term undertaking. A deficit shown on a pension scheme valuation is not the same as an immediate cash call on your business – but it can have significant financial implications, with potential for the demands of the scheme to affect corporate investment decisions and M&A activity.

A pension scheme valuation process which results in a reported deficit of assets against liabilities will trigger negotiations between the trustees and the scheme sponsor. This process is governed by legal requirements and the Pensions Regulator's Code of Practice on funding defined benefits.

One outcome of that process could be an agreement to pay deficit reduction contributions – but many clients are concerned that, if interest rates and yields rise, current deficits could turn into future surpluses. Paying cash into the scheme now could mean that it ends up trapped as surplus later, with no tax-efficient access for the scheme sponsor.

Our first feature in this update looks at some options corporates can consider to address these issues. To find out more, get in touch with your usual Allen & Overy adviser, or any of the members of our Pension Risk Group, listed at the end of this update.

This update includes links to more detailed briefings. If you are reading this in hard copy and would like more information, or to receive future issues by email, please contact **pensions.team@allenovery.com**

Squaring the funding circle

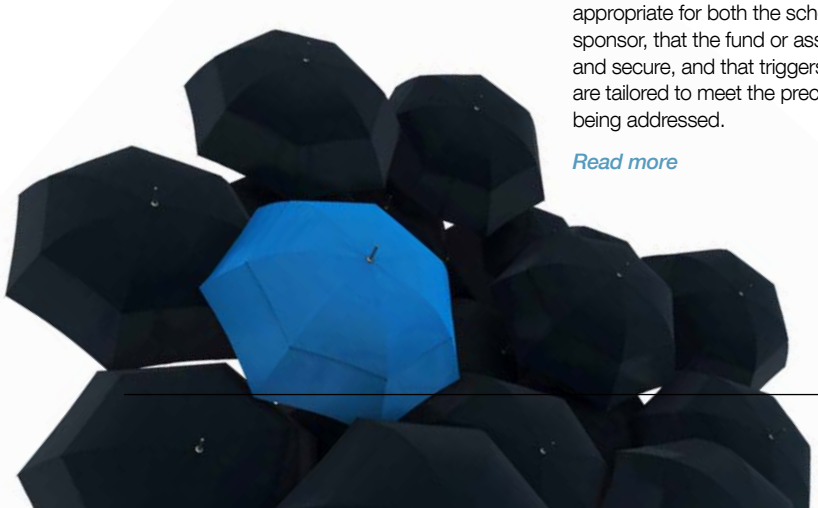
Corporates are increasingly looking at forms of alternative financing – that is, ways of improving scheme funding or security while retaining cash in the business and avoiding the risk of trapped surplus. These techniques often leverage corporate assets or wider group support; the right structure, implemented appropriately, can deliver significant benefits to both parties. These structures can also be used to undergird a more return-seeking investment strategy, or a longer/reshaped recovery period (the period over which the deficit must be paid off).

ALTERNATIVE FINANCING: A SOLUTION?

We have substantial experience in developing new solutions and helping clients – both sponsors and trustees – to implement appropriate structures. Some options are relatively straightforward and can be implemented quickly, or you can combine elements for a more tailored result. More sophisticated options offer greater scope for bespoke tailoring, with flexibility about the assets used, duration and trigger events.

You can read more about the various options on the Funding solutions page of our Pension Risk Group website, or download our summary of different structures.

Read more



FUNDING TRUSTS: FLEXIBILITY AND ACCESSIBILITY

Complexity and cost can be a barrier for smaller and mid-sized schemes looking to explore the use of alternative financing tools, but our legal technology, developed on much larger transactions, can be adapted to make structures such as funding trust arrangements accessible to schemes of all sizes.

Assets held in a funding trust are transferred to the scheme if a trigger event occurs or if a deficit persists after the specified term. Part or all of any income can be paid to one beneficiary (sponsor or scheme) while capital is held on trust for another. The assets, terms and duration of the trust can be flexed to meet the specific requirements of the scheme and sponsor.

The key is to ensure that the structure is appropriate for both the scheme and the sponsor, that the fund or assets are appropriate and secure, and that triggers for payment are tailored to meet the precise risks being addressed.

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SURETY BONDS AS SECURITY FOR SCHEME FUNDING

For the first time, surety bond arrangements can now be certified as contingent assets for Pension Protection Fund levy purposes, potentially leading to a reduction in your levy bill. That's an added bonus, since surety bonds may also represent a more efficient use of cash for the scheme sponsor than making deficit reduction contributions, and can have corporate financing advantages compared to, for example, a bank letter of credit.

A surety bond is an undertaking by an insurer to pay the holder (for example, a pension fund) under specific conditions – for example, in the event of sponsor insolvency or non-compliance with an agreed deficit recovery plan. We recently advised the trustee of a FTSE100 company on a groundbreaking GBP400 million structure which replaced existing bank guarantees with surety bonds, providing security to the scheme while freeing up the sponsor in relation to its own financing arrangements.

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The PPF's new policy reflects growing sponsor interest in this new alternative financing tool. Contact us to find out more.

Regulatory update

Impact of DC flexibility for DB schemes

The radical changes to member options for accessing defined contribution (DC) pension savings from April 2015 could have significant implications for DB schemes and sponsors.

How many DB members will choose to transfer their benefits out of the DB environment in order to take advantage of the new flexibilities? Estimates vary widely; to the extent that members do transfer or cash out their benefits (see below), it's likely to be good news for scheme sponsors from a liability management perspective.

However, schemes – and sponsors – should monitor the position closely. Unexpectedly high demand could affect your scheme's run-off profile, increase the volatility of scheme funding, and require changes to the scheme's current investment strategy. Trustees may, for example, need to review liquidity levels, liability-driven investment arrangements and wider scheme funding assumptions.

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Cashing out low-value benefits

From April 2015, members aged 55 or over will be able, subject to scheme rules, to cash out:

- DB rights as a lump sum, if their aggregate pension rights across all registered pension schemes are worth GBP30,000 or less; and
- DB or DC rights worth GBP10,000 or less from any occupational scheme (and up to three personal pension schemes).

There are potential liability reduction opportunities here, and many schemes and sponsors have been considering the possibility of sending targeted communications to eligible members to raise awareness of the possibility of exchanging their rights for a cash lump sum, or to make them a specific offer to do so.

Care is needed: where such communications are made on a 'one-off' basis, they may trigger a requirement to offer members independent financial advice or guidance, the cost of which could negate the potential advantages for schemes and sponsors. However, the guidance requirement does not apply in cases where the invitation to cash out is 'ordinarily available', so the key is to identify what activity would be considered 'business as usual'.

If this could be relevant for members with deferred rights in your DB scheme, talk to us about the issues for trustees and best practice in engaging with members.

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DB/DC transfers

The cash value of a member's DB benefits – known as the CETV or cash equivalent transfer value – is generally lower than the liability assumed under the scheme's funding basis, and may be significantly lower than the potential buy-out cost. From a funding perspective, transfers out could be advantageous to the scheme, as long as the transfer value basis is appropriate for the scheme's current funding position – otherwise, CETV payments might be over-generous.

It could be the case that members who have no dependants or who have reduced life expectancy are more likely to transfer from DB to DC; bear in mind that providers are likely to consider this factor in pricing any future buyout.

From a sponsor perspective, transfers will also have other cost implications: where a member with DB rights worth more than GBP30,000 seeks to transfer or convert those rights to a DC arrangement, trustees will be required to check that the member has taken 'appropriate independent advice'. Where an employer initiates a transfer, it must pay for this advice (at an estimated cost of around GBP1,170 per member).

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Current trends

De-risking isn't just a UK issue. Our German, Belgian and U.S. experts have extensive experience in advising on a range of liability management and de-risking structures, meeting the specific needs and regulatory requirements of each jurisdiction.

Germany

In Germany, for example, employers increasingly seek to externalise their past service liabilities from internal, unfunded book reserve schemes into insurance or insurance-type external schemes, or to make use of a 'retirement company', a special purpose vehicle restricted to holding pension liabilities and the corresponding assets. This is also a useful tool in group restructurings to detach pension liabilities from group companies.

We have advised several national and international entities on restructurings involving the outsourcing of significant pension liabilities ranging from EUR60-250m into pensioner companies. We also advise on smaller, highly complex projects, enabling German corporates to settle pension liabilities relating to senior executives, providing the companies involved with greater freedom of action through the removal of risk and cancellation of existing liens on securities.

Belgium

Employer liability on the insolvency of an insurer has been a live issue in Belgium, as in other jurisdictions, in recent years. We recently represented a client in legal proceedings in Belgium and in Spain initiated by employers offering, and employees benefitting from, pension arrangements insured with a provider which was forced into liquidation by the Belgian pensions regulator.

Innovation in pension plan design, to help Belgian and multinational clients contain costs and to limit the accrual of future defined benefit liabilities, has also been a feature of our recent work. New structures, such as variable pay plans, and the conversion of plans from defined benefit to defined contribution, are among the solutions we have implemented.

We provide combined and integrated advice, for example on investment techniques. In one recent project, we advised a large multinational company on different options for pooling pension assets internationally, including analysis of how to establish a pooling arrangement through a captive insurance company (either established in the EEA or offshore) and the various options available to it through that captive insurer.

The United States

In the U.S., plan sponsors are increasingly seeking to implement formal risk management strategies to limit the financial risks associated with their defined benefit pension plans and to transfer plan liabilities off their balance sheets.

The most widespread options in the U.S. include transferring pension plan liabilities to third-party insurers by purchasing group annuity contracts, and removing liabilities from company balance sheets by cashing out plan participants. Offering lump sum payments to retirees has been somewhat controversial in the past, but the strategy has withstood legal challenges and this de-risking trend looks set to continue.

To find out more, contact our local experts: **Click here** to read more.

About us

The Allen & Overy Pension Risk group brings together experts across a broad range of specialisms to help you achieve a seamless transition through each stage of your de-risking journey.

We deliver tailored solutions to address the unique requirements of each employer and pension scheme, balancing the needs and interests of all parties to reach agreement efficiently.

For more information, visit our website www.allenovery.com/pensionrisk
or get in touch with your usual Allen & Overy contact.

Derisking Consultant of the Year

FT Pension and Investment Provider Awards 2014

Allen & Overy is the first law firm to win this award, which recognises our performance, innovation and client service on a range of market-leading derisking deals.

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"Its cross-disciplinary approach provides clients with an impressively broad service, allowing them access to banking, restructuring, derivatives and regulatory and corporate expertise."

Chambers 2010

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