Investment Insight:
Asset-backed contributions – as easy as ABC?

March 2014

Defined benefit: **Relevant**
Defined contribution: **Not relevant**

In our latest Investment Insight and our first thought piece for 2014, we delve into the world of asset-backed contributions (also known as asset-backed funding), a new but increasingly popular vehicle for pension schemes and sponsors. Here we provide an overview of what they are, how they work in practice and what sponsors and trustees should bear in mind when considering these arrangements.

What is it?

An asset-backed contribution (ABC) allows an employer to use their business assets in order to secure cash which is then paid to the pension scheme.

ABC arrangements are attractive to employers as they can address pension scheme funding issues immediately without having to commit excessive cash over relatively short periods. It also allows the employer to retain the ownership and control of the asset and the asset is normally fully returned to the employer at the end of the term of the ABC arrangement. In return, the pension scheme will have a stable profile of cash payments, (similar in many ways to a pension fund owning a bond that pays coupons) and, at the same time the pension scheme will have recourse to the asset if the sponsor becomes insolvent. So, importantly, if the employer defaults on a payment, the scheme is normally able to take full ownership of the asset.

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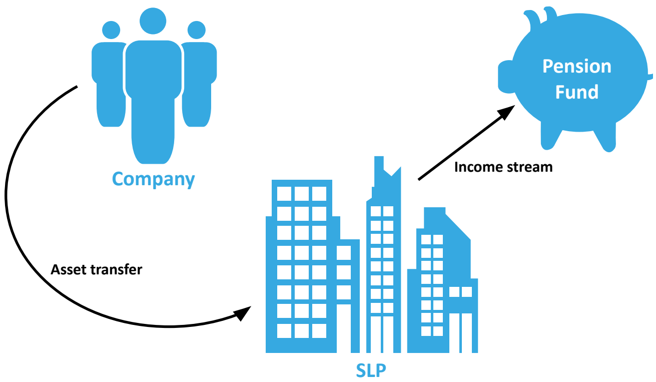
How does it work?

In a typical ABC arrangement, the asset is transferred into a partnership structure, usually a Scottish Limited Partnership (SLP). A SLP has particular legal characteristics which make it possible for a pension scheme to invest in it without falling foul of the pension legislation that limits the amount of investment into employer-related assets that can be made by a pension scheme. The employer (company) makes a contribution to the pension scheme which the pension scheme then invests in the partnership. The partnership then uses the assets to 'back' payments to the scheme, in the form of a regular stream of income payments. This partnership structure ring-fences the assets away from the sponsoring employer providing additional security for the pension scheme if the employer becomes insolvent.



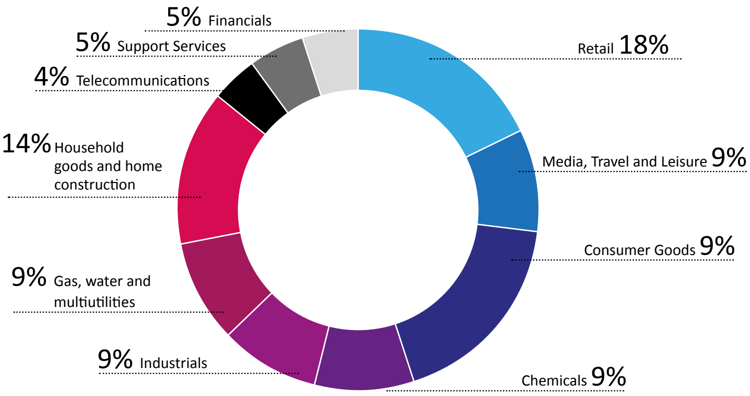
What Does the ABC Market Look Like?

The origins of ABC arrangements date back to 2007 when Marks & Spencer transferred a £500m interest in a partnership holding group property to their pension scheme.

According to KPMG[1], the total value of transactions carried out in asset backed funding to date is over £7 billion. Here is a selection of recent ABC transactions:

Company[2]	Date	Transaction value (£ million)
Allied Irish Bank	October 2013	270
Taylor Wimpey	July 2013	100
Kier Group	June 2013	46
Birmingham Airport	March 2013	25
Selfridges	February 2013	35

In terms of companies entering into ABC arrangements, historically the dominant sectors were retail, media and industrials. More recently however, new sectors have entered the market as seen in the chart:



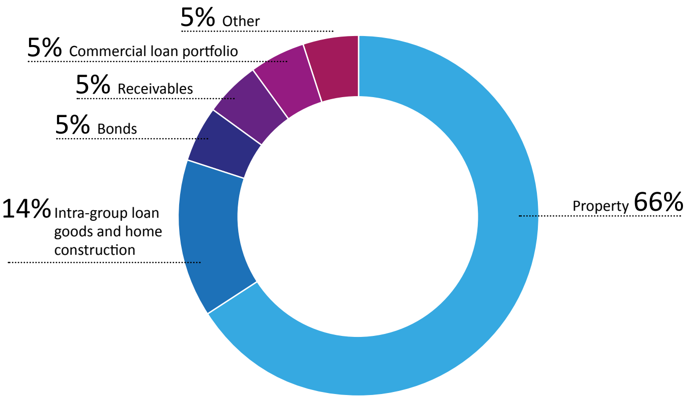
Source: KPMG analysis of London Stock Exchange data as at December 2013

Transaction Characteristics

Five years ago the average transaction size of an ABC was around £320 million. Since then the average transaction size has decreased to around £80 million in 2012/13. This points to an increase in the use of ABC arrangements by smaller as well as large pension schemes as some of the teething problems have been worked through by the early movers.

The most common term of the transactions is between fifteen and twenty years.

Property (see chart) is the most commonly used asset to back an ABC although cheese and whisky have also been used as assets! Intra-group loans are also increasingly popular, where the partnership holds a loan note issued by an entity which is not a sponsor (such as a parent company) thereby providing additional protection in the event of sponsor insolvency.



Source: KPMG analysis of press releases and annual reports as at December 2013.

1 and 2 Asset Backed Funding for Pensions. KPMG Survey 2014

A practical example of an ABC arrangement

Steps:

1) Sponsor sets up a partnership and injects £40m into it
2) Sponsor pays £100m to the pension scheme
3) Pension scheme invests the £100m in the partnership in return for a right to receive an annual income stream of £8m for 20 years
4) The partnership acquires properties from the sponsor for £140m and leases them back for 20 years at a rental of £8m per annum.

At this stage the sponsor has made a pension contribution of £100m and the pension scheme has acquired a new asset with a net present value of £100m (being the discounted value or the right to receive £8m for 20 years). The cash has moved full circle, ending up back with the sponsor.

Each year the sponsor will pay £8m rent to the partnership which will then be distributed to the pension scheme.

How can ABC help UK pension schemes?

Low gilt yields have been a real challenge for trustees since the financial crisis as liabilities and pension deficits have increased as gilt yields have fallen. Market consensus now suggests that gilt yields will revert to 'normal' (around 4%) levels in due course as quantitative easing is unwound on the back of improved economic performance. As a result, some pension schemes believe that their current pension deficits are inflated, increasing the risk of future trapped surpluses where they fund current deficits over short periods. The use of asset backed funding can, in certain instances, mitigate this.

ABC arrangements can also be used to finance such activities as merging pension schemes, facilitating insurance and in investment de-risking strategies. In simple terms ABCs provide an immediate improvement in funding levels as well as long term secure cash flows which can match liability cash flows in conjunction with other bond-like assets.

Despite the latest PPF Index pointing to an improving picture of pension deficits, deficits are still a problem for many schemes. We also hear from our members that there is growing demand for ABC as companies look for ways to avoid large increases in contributions while still trying to meet the needs of their scheme members.

There is also evidence to suggest that pension schemes feel under pressure from The Pensions Regulator not to extend their schemes' recovery plan and are looking for new ways to achieve this.

Many sponsors face cash constraints and there is a reluctance to commit to cash consuming contributions that could negatively impact their business plans. Often this is not in the interest of either the trustee or the pension scheme as it weakens the company's covenant.

Summary of the Benefits and Concerns around ABC

Pros:

1. Employers can retain cash for business development thereby strengthening the sponsor's long term position.
2. The Pensions Regulator has discouraged significant extensions to recovery plans without the appropriate security: ABCs can provide this required security.
3. The additional improvement in the scheme's funding and security provided by the ABC can provide greater certainty for member benefits.
4. Trapped surplus risk is mitigated as an element of the deficit is funded over the long term and most ABC arrangements contain a mechanism to turn off further payments when the pension scheme becomes fully funded.
5. The sponsoring employer can benefit from an acceleration of tax relief as a deduction can normally be claimed on the contribution paid to allow the pension scheme to purchase the partnership interest (provided the ABC structure complies with HMRC's requirements).

Cons (as per The Pensions Regulator[3]):

1. TPR argues that given the long-dated nature of ABC structures, there is a greater risk of the scheme being underfunded if the sponsoring employer fails before the end of the payment term. However, an appropriately structured ABC will provide security in the event of sponsor insolvency which will address this.
2. TPR is also concerned about the inflexible nature of the income streams that are determined at the outset of the ABC deal and is particularly concerned about 'bullet' payments lumped at the end of the ABC's tenure should a deficit remain. These types of bullet structures are now rare as they do not meet HMRC's requirements.

3 TPR 'Asset-backed contributions. Guidance for trustees and their advisers'. November 2014

3. Trustees have to be comfortable that the correct level of due diligence is undertaken on the asset backing of the ABC and on the ABC's legal structure to ensure that if the company became insolvent then there would be sufficient value and liquidity in the underlying asset. TPR made a similar point when it raised concerns that the funding position of the scheme can be distorted by the fact that future payments from the ABC are recognised before they are paid. This worry should be lessened if the underlying asset is strong. TPR states that 'The establishment of the ABC could damage the employer covenant supporting the scheme'. This clearly depends on the strength of the underlying asset.

And what does the Financial Reporting Council (FRC) think?

The FRC recently launched a crackdown on companies using asset-backed contribution structures that reclassify pension obligations as equity instruments in their accounts whereby the company's obligation to make future payments to its pension scheme is transformed into an equity instrument in the company's consolidated accounts which in turn has a favourable impact on financial solvency, gearing and reported comprehensive income. Clearly pension schemes need to be vigilant to ensure that the structure conforms to the regulations. Indeed, some companies have felt obliged to adjust existing structures to reflect pressure from the FRC.

What are our members saying about ABC?

"As a Director of Group Pensions, I have direct experience of implementing one of these structures. They are not right for everybody but by working through a number of key issues it is possible to quickly determine when they are effective for both the Company and Trustee."

Peter Flanagan, DHL

Conclusion

The use of asset-backed contributions is still in its infancy but it is growing in popularity among pension schemes. Many of the early challenges of these types of structures have been worked through by the first movers and it is clear now that smaller schemes as well as larger schemes are in a position to consider such a vehicle that may address stubborn pension deficit issues without trapping surpluses. TPR and the FRC are carefully monitoring developments in the use of ABC and have highlighted risks for trustees to consider. As with any financial instrument, due diligence and adherence to regulation are key determinants of success.

ABC arrangements are not as easy as ABC but I hope sponsors and trustees who are less familiar with ABC arrangements are, as a result of this thought piece, better equipped to decide if ABC arrangements are something that they would like to find out more about in the future.

The bottom line on ABC is that at their best these structures improve the funding position and improve the security for members without requiring immediate cash that sponsors may be unwilling or unable to pay.

If you have feedback on this edition of Investment Insight, or would like to speak to us about forthcoming editions, please contact our lead investment policy adviser: **Helen.Roberts@napf.co.uk**.