Alternative funding arrangements for DB pension funds

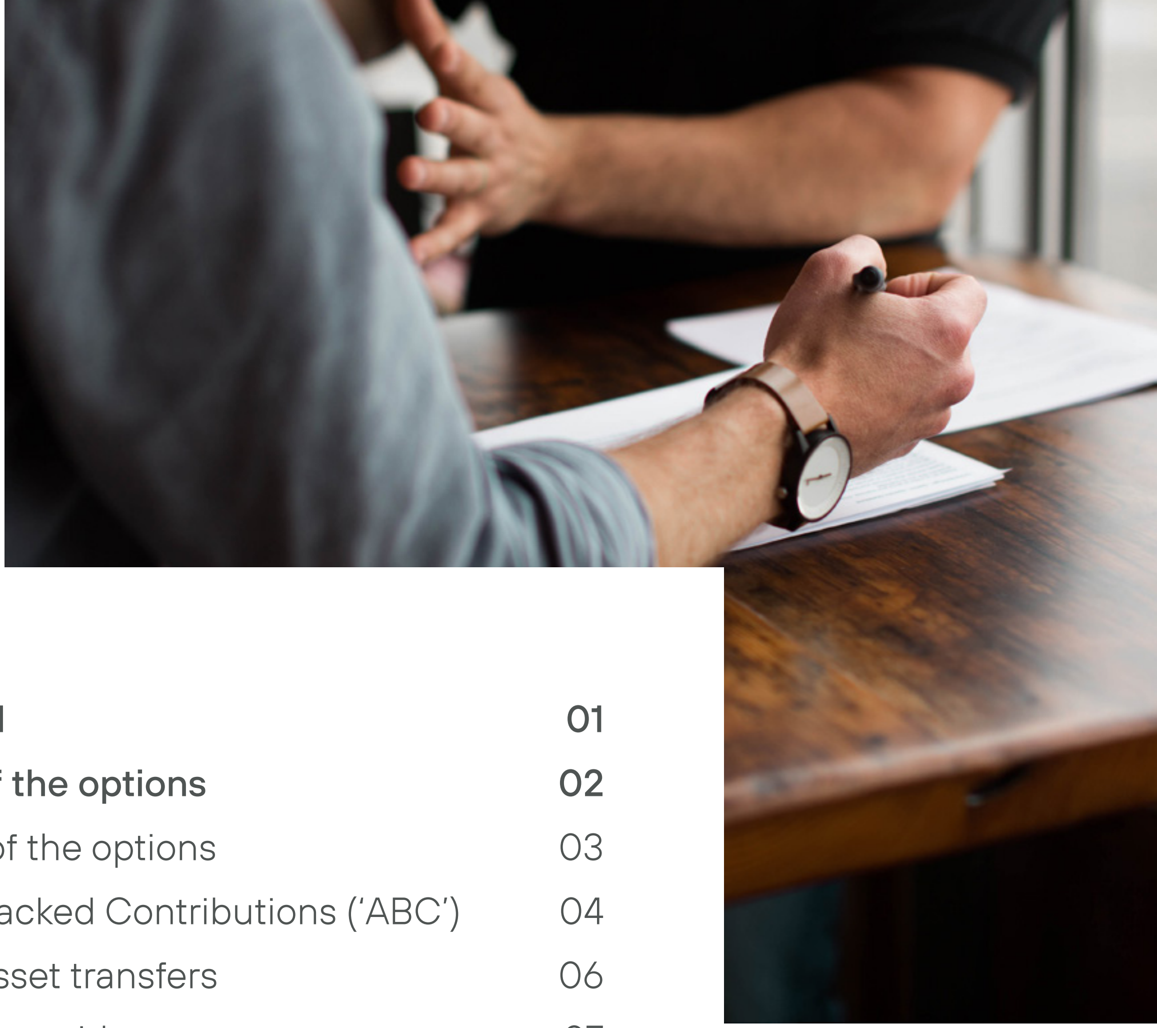
Helping trustees and sponsors understand the choices available

isio.

March 2020

Welcome to our review of alternative funding arrangements for Defined Benefit pension funds.

Meeting the funding needs of Defined Benefit pension provision can be a challenge for trustees and sponsors, as they seek to balance competing objectives. Over recent years, there has been an increasing use of alternative approaches to traditional cash funding to manage deficits, that we expect to become more prevalent once the new Code of Practice on DB funding is effective. This brochure provides detail on the options available and how they may work for trustees and sponsors, based on our practical experience of using them with our clients.



Background

What is currently happening on pensions?

Since 2018 the Government has acknowledged that the DB funding framework is working largely as intended but needs strengthening in certain areas. As a result a Pensions Bill is making its way through Parliament, which provides stronger powers to the Pensions Regulator and puts more responsibility on DB pension schemes to have a robust long-term strategy.

In tandem the Pensions Regulator ("TPR") is developing its new Code of Practice ("the Code") on DB funding to set greater clarity on the funding standard. Although guidance on Integrated Risk Management is already available, TPR wants the Code to focus on strengthening DB funding levels, increasing member security and reducing risks.

Absent any other action, the new rules could see deficit contributions increase significantly, reflecting the intention for higher deficits to be met more rapidly.

Schemes will be able to:

- follow a strict 'off-the-shelf' set of valuation rules in line with the Code, covering key assumptions as well as recovery plans – following this 'fast track' model will ensure your valuation is accepted by TPR.
- use more flexibility within the funding framework, but the Scheme's chair of trustees will be responsible for justifying this to TPR and explaining how in their specific circumstances the 'bespoke' approach meets TPR's objectives.

Background

What options are available to trustees and sponsors?

There are a range of options available in the market, that trustees and sponsors have used in pension scheme funding negotiations to support a recovery plan and meet objectives — we see there being broadly four types of options (although there can be some degree of overlap between them):

- For immediate funding improvement
- For providing contingent cash
- For providing contingent support
- For providing covenant improvement

Improvement to funding position		More downside protection
Asset-Backed Contributions	Escrow	Sponsor restructuring
Direct asset transfers	Matching mechanisms	Improve insolvency position
	Funding corridors	Negative pledge
	Letter of credit or surety bond	
	Security	
	Parent Company Guarantee	
Some or all the funding deficit is recovered on implementation	Trigger based support provided to the scheme on certain events occurring	Scheme is given protection against any future adverse situations that the sponsor may face

Overview of the options

Further detail on the options is provided in the next section but the summary below highlights some of the key features.

In particular, we have illustrated how well each option can achieve the following:

- Deficit reduction – the level of immediate reduction in the pension scheme deficit
- Protection for members – the degree of improvement in protection of members' benefits
- Extended time horizon – the extent to which they support cash funding being spread over a longer period
- Investment strategy flexibility – the extent to which they support the scheme's investment strategy, seeking to achieve higher expected returns

Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Immediate funding improvement				
Asset-backed contributons	High impact	High impact	High impact	High impact
Direct asset transfers	High impact	High impact	Moderate impact	Moderate impact
Providing contingent cash				
Funding corridors	Lower impact	Lower impact	Moderate impact	Moderate impact
Escrow	Lower impact	High impact	Moderate impact	High impact
Matching mechanism	Lower impact	Lower impact	Moderate impact	Moderate impact
Providing contingent support				
Letter of credit or surety bond	Lower impact	High impact	Moderate impact	Moderate impact
Security	Lower impact	High impact / Moderate impact	High impact / Moderate impact	High impact / Moderate impact
Parent company guarantee	Lower impact	High impact / Moderate impact	High impact / Moderate impact	High impact / Moderate impact
Providing contingent support				
Sponsor restructuring	Lower impact	Lower impact	Moderate impact	High impact
Improve insolvency position	Lower impact	Moderate impact	Moderate impact	High impact / Moderate impact
Negative pledge	Lower impact	Lower impact	Moderate impact	Lower impact

Key: High impact, Moderate impact, Lower impact

Immediate funding improvement:

Asset-Backed Contributions

An increasingly popular option to improve scheme security and funding flexibility...

How does it work?

With an ABC, group assets are transferred to a Special Purpose Vehicle (SPV) in which the scheme holds a valuable interest. The assets provide collateralisation for a long-term payment stream to the scheme. In the event of insolvency the scheme has recourse to the value of the assets, but otherwise at the end of the arrangement (or earlier if funding triggers are met) the assets revert back to the group.

The structure of the ABC leads to an immediate improvement in the funding level of the scheme as the value of the interest in the SPV is recognised as an asset of the scheme from day one. However the cash flows from the group to the scheme are paid over an extended period of time — typically 15-20 years — supported by the asset collateral.

Why do this?

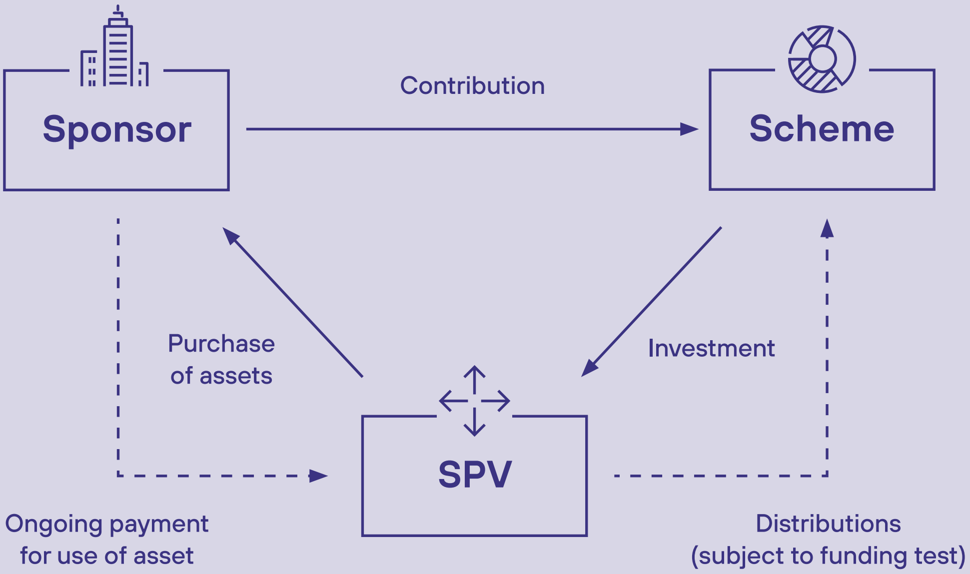
- Lowers annual cash contributions and reduces the risk of overfunding the scheme
- The value of the ABC can be recognised in the scheme accounts therefore immediately reduces the funding deficit and PPF levies
- The value of the ABC is treated as a pension contribution which can lead to an acceleration of tax relief
- Improved funding position and secure long term cash flows facilitate other liability management or risk reduction strategies
- Trustees of schemes are likely to be open to the concept but will need to consider ABC in the context of investment account cash flow requirements
- Can be revisited at future valuations, when the value of the ABC can be increased to address any new deficit emerging

However...

- Can be a relatively complex structure to establish, albeit there is now significant market precedent and regulatory guidance

When would this work?

- Sponsors with concerns on pension scheme over-funding
- Sponsors with large (>£10m) deficits looking for an effective long-term solution
- Sponsor has tax capacity or where there is potential for significant PPF levy reduction
- Sponsor with income generating assets (e.g. property or patents) or income streams that can be securitised (e.g. receivables)



Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Asset-Backed Contributions	●	●	●	●

Isio view

ABCs are a very effective and efficient way to address the pension funding challenges and, where they are appropriate, we consider that they offer the biggest benefit. Although the costs and complexity of set-up should not be underestimated, once set up they offer a long-term solution that can require minimal ongoing involvement. There is a wide range of potential assets that can be used and sufficient flexibility in structuring these bespoke arrangements.

Immediate funding improvement:

Direct asset transfers

Possible solution when a sponsor owns approved assets that it is willing to transfer, but increases scheme reliance on sponsor and may create Employer Related Investment issues...

How does it work

- Sponsor agrees to transfer non-cash assets to the scheme unconditionally or in certain circumstances. A range of assets can be used, both tangible and non-tangible.

Why do this?

- Utilises sponsor non-cash assets to reduce the funding deficit
- The value of the sponsor asset is treated as a pension contribution which can lead to an acceleration of tax-relief
- Can support de-risking strategies

However...

- Sponsor loses control of asset and may lose income from the asset or have to pay the scheme for ongoing access to the asset
- Can increase scheme covenant risk concentration on the sponsor and may create Employer Related Investment issues for the scheme
- Cannot be revisited once enacted and may increase risk of a trapped surplus

When would this work?

- Asset-rich, cash-constrained sponsors
- Examples of asset transfers include property and interests in PFI investments
- Sponsor has tax capacity or where there is potential for significant PPF levy reduction

Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Direct asset transfers	●	●	●	●

Isio view

Contingent or direct asset transfers into schemes do occur but are uncommon due to challenges compared to alternatives, particularly Asset-Backed Contributions, which have greater flexibilities.

Providing contingent cash

Funding corridors

Cash contributions contractually amended upwards or downwards based on funding level triggers...

How does it work

Funding corridors are a means to automatically adjust the pace of cash funding if the funding level of the scheme moves outside set parameters.

The corridor is initially agreed between the sponsor and scheme and is monitored by the scheme actuary. If the scheme funding falls below the corridor additional cash is required to be paid in. Conversely if the scheme funding level moves above the corridor, cash payments can be reduced or deferred, or investment strategy de-risked.

Why do this?

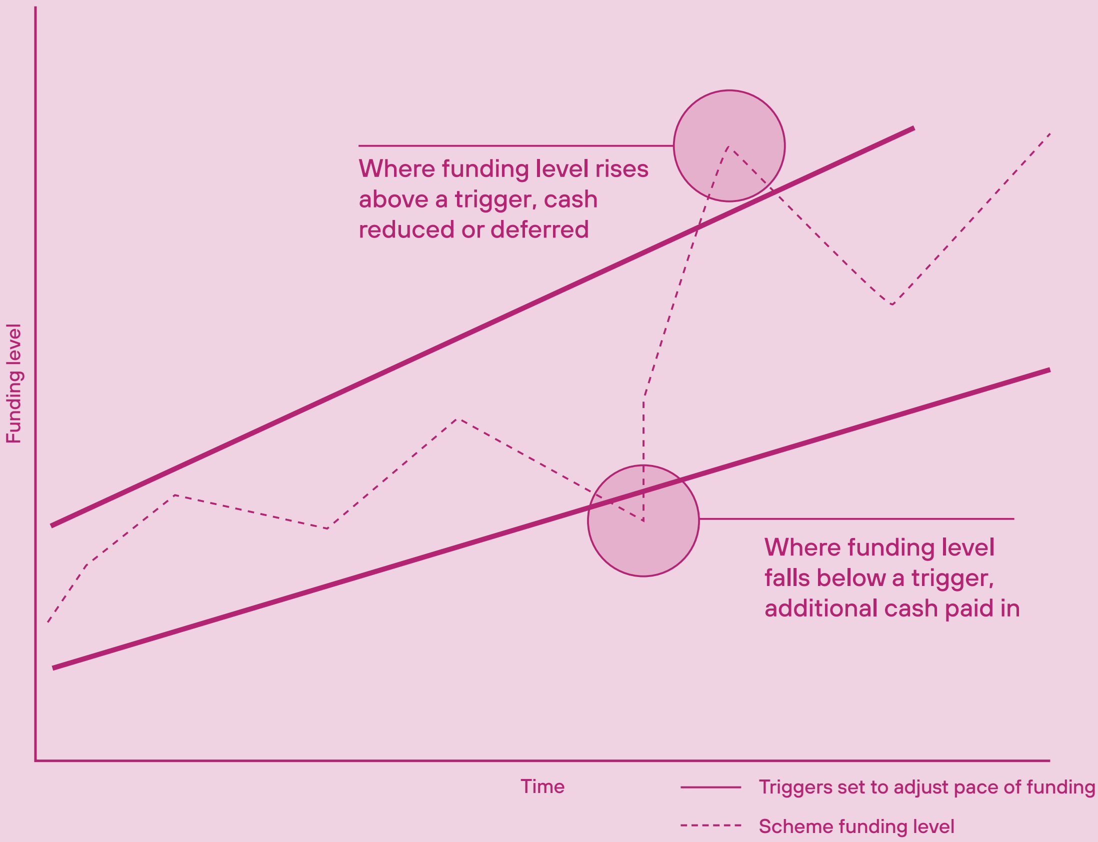
- Allows lower committed contributions in exchange for contingent contributions
- Can encourage more collaboration between trustees and sponsors on investment strategy
- Scheme can maintain path towards longer-term funding target
- Can expand to include other contingencies other than funding level (e.g. salary increases, mortality, inflation)

However...

- Contingent contributions not accounted for in recovery plan
- Additional cost of establishing terms and monitoring
- Additional cash calls may occur at an inopportune time for the sponsor

When would this work?

- Where the trustees and sponsor have agreed a flight path to self-sufficiency or buy-out
- The sponsor wishes to take more investment risk than the scheme is comfortable with
- The sponsor is concerned about trapped surplus



Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Funding corridors				

Isio view

Funding corridors are an increasingly common tool to balance trustee and sponsor objectives.

Providing contingent cash

Escrow

Can be effective when scheme and sponsor expectations are different...

How does it work

An escrow is an arrangement used to provide contingent security to the scheme without irrevocably committing cash. An escrow can be set up as a contractual agreement or under trust. Generally a trust structure is considered more attractive to the scheme as it provides additional protection on insolvency. When set up under trust, an escrow is sometimes referred to as a Reservoir Trust.

Escrows can be used to ringfence a cash lump sum, a proportion of cash contributions and/ or other sponsor assets. The escrow has the flexibility to make payments to the scheme or return cash to the sponsor, based upon agreed criteria (for example the scheme winding up or reaching certain funding levels).

Why do this?

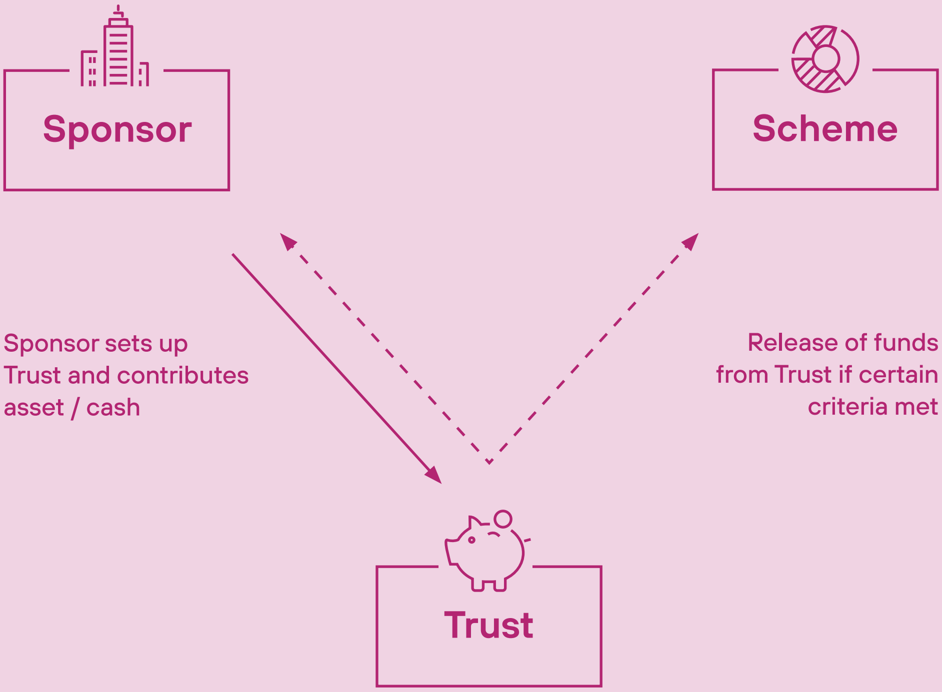
- Can help reconcile divergence in sponsor / trustee views on outlook for covenant, funding and investment strategy
- Can provide a framework for contingent payments as part of an integrated risk management plan
- Reduces over-funding

However...

- Can tie up cash / assets
- May have unexpected accounting consequences
- Escrow account will not attract the same tax relief as the scheme in relation to contributions and investment returns

When would this work?

- Sponsors with concerns on scheme over-funding
- Scenarios in which the sponsor wishes to take more investment risk than the scheme (or has significantly different views on other options, e.g. life expectancy)



Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Escrow				

Isio view

Escrows have become increasingly common as a mechanism to increase the funding flexibility, align divergent objectives and form a key element of an integrated approach to risk management. The precise design of the structure will be case specific but they are particularly beneficial when the trustees wish to be more risk averse than the sponsor. Escrows are often used as a short term solution.

Providing contingent cash

Matching mechanisms

Matching mechanisms are common for the scheme to share in sponsor financial upside, but contingent elements are not included in recovery plan calculations...

How does it work

In addition to contributions payable under the scheme's recovery plan, additional contingent contributions are paid, linked to the level of dividends, free cash flow or profits of the business. This allows the scheme to share in the potential upside of improved sponsor performance. It can often be explicitly linked to requests for lower cash contributions during a period of sponsor investment or turnaround.

Why do this?

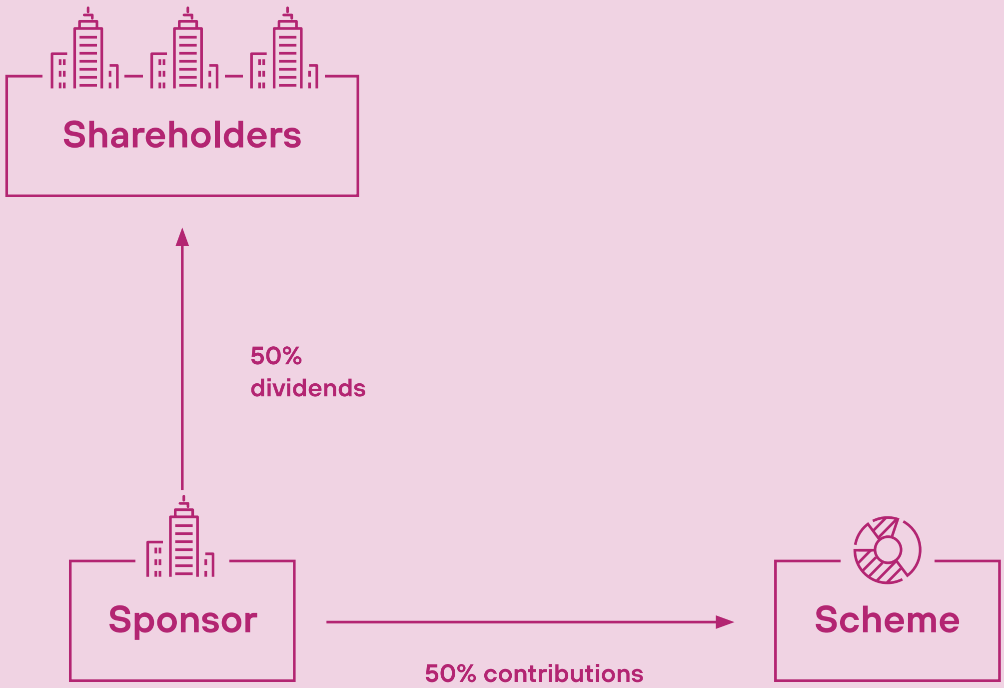
- Scheme can accept shorter term lower contributions with confidence that contributions will increase in line with affordability
- Sponsor can make a contingent commitment confident that payments will only crystallise when affordable
- Can establish a collective understanding to enable dividends or similar (e.g. share buy-backs) to proceed on an agreed acceptable basis

However...

- Are often designed in a way to have low expected value (e.g. sponsors not expecting to pay dividends)
- Recovery plan lengths do not allow for any such contingent contributions

When would this work?

- Sponsors currently facing short term cash constraints but able to demonstrate longer-term growth plans
- Flexibility sought from scheme concerned about potential future covenant "leakage" via dividends



Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Matching mechanisms				

Isio view

Contingent contributions can be a very effective element of an overall valuation package to demonstrate equitable allocation of uncertain future cash generation. Where dividends are expected, dividend matching mechanisms can avoid repeated negotiations over each distribution. Appropriate design is critical from a sponsor and scheme perspective to ensure objectives of any mechanism are delivered in a cost-effective way.

Providing contingent support

Letter of credit or surety bond

An uncommon solution due to external cost, but can work in specific circumstances...

How does it work

In return for a premium, a bank or insurer provides a guarantee to the scheme for a fixed amount (via a letter of credit or surety bond). The guarantee is paid to the scheme under certain pre-agreed circumstances (e.g. sponsor default or insolvency). The sponsor uses this third party security as justification for lower cash contributions to the scheme.

Why do this?

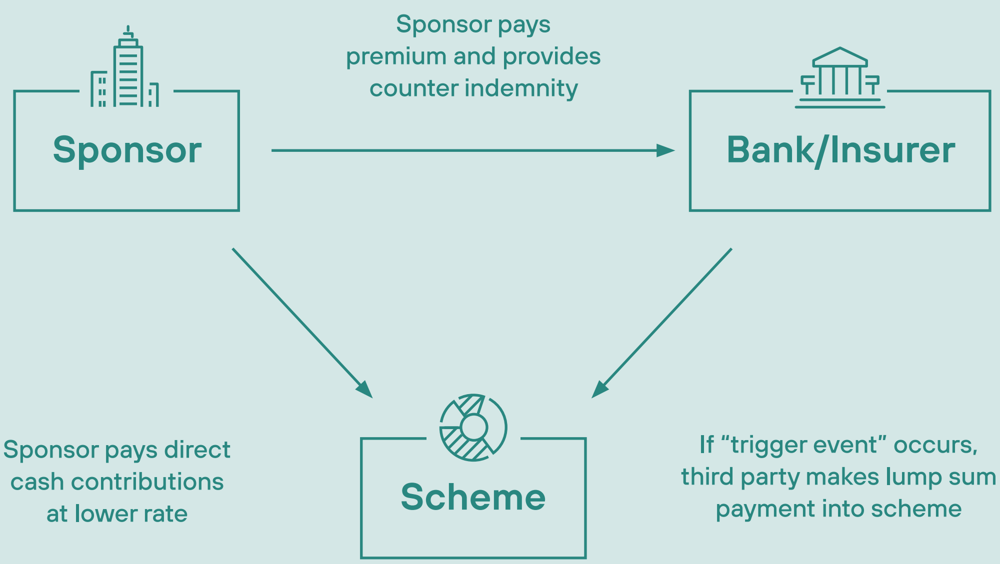
- Allows sponsor cash resources to be utilised for other commercial purposes
- Provides robust third party protection to the scheme
- Can provide stronger support for scheme than sponsor alone
- Can be structured to reduce PPF levy

However...

- Outside the public sector, few third party guarantees have been implemented, due to the "dead cost" of premia and often fixed term of instruments
- May affect future borrowing capacity

When would this work?

- Sponsors with a strong credit rating (BB or higher) and competing demands on cash
- Scenarios in which the provider has a more favourable view of sponsor financial strength than scheme
- Sponsors with concerns on pension scheme over-funding
- Schemes seeking to support sponsor growth whilst protecting members' interests



Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Letter of credit or surety bond	●	●	●	●

Isio view

There are relatively few examples of letters of credit / surety bonds being implemented in the private sector (commonly used by the Local Government Pension Scheme). This is mainly due to the opportunity cost of the third party premium, which could otherwise be utilised by the scheme or sponsor.

Providing
contingent support

Security

Direct security can protect or improve the scheme's position on insolvency, supporting funding flexibility but can also reduce financing flexibility for the sponsor...

How does it work

The scheme is provided with a fixed charge over a specific asset or debenture over all the assets of a sponsor. This can improve the scheme's recoveries on insolvency. More confidence in the fall back position on insolvency can allow the scheme to be more flexible on funding.

Why do this?

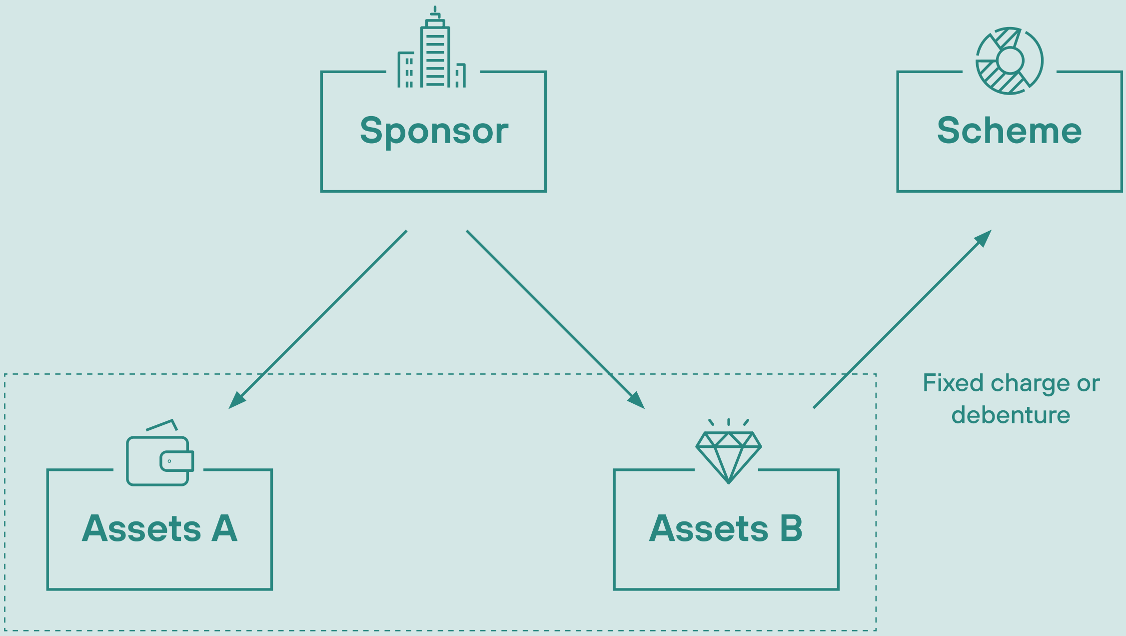
- Provision of security is a common means to improve a creditor's position on insolvency in exchange for greater flexibility or better terms. This can be seen as a low cost concession for sponsors which may secure a cash benefit in exchange for only a potential impact on other creditors in a future theoretical insolvency
- Sponsor retains operational use of the asset(s)

However...

- Security is registered on Companies House and so may result in adverse response from other creditors (for example reducing credit terms)
- Security is often includes legal powers over use/ disposal of assets and upon default that could prove adverse for the sponsor in the future
- Banks often already have security, which can reduce the benefit of security and increase complexity of negotiation

When would this work?

- Asset rich sponsors seeking flexibility in scheme funding
- Where divergence exists on perceived threat between sponsor and trustee of insolvency



Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Security				

Isio view

Granting of direct security to pension schemes is relatively common and can help align sponsor / trustee concerns regarding the balance of cash funding and security position. Once granted, scheme security can result in the scheme having a "seat at the table" in future refinancing or transactional situations.

Providing
contingent support

Parent Company Guarantee

Very common solution to covenant improvement and allows funding flexibility but can impact future corporate activity...

How does it work

A Parent Company Guarantee (PCG) is a form of contingent support for a scheme where a legal promise of support is provided from another Group company. In itself it does not improve the funding position of the scheme. However by supporting the employer covenant, a PCG can allow the scheme to adopt a more flexible funding approach.

Why do this?

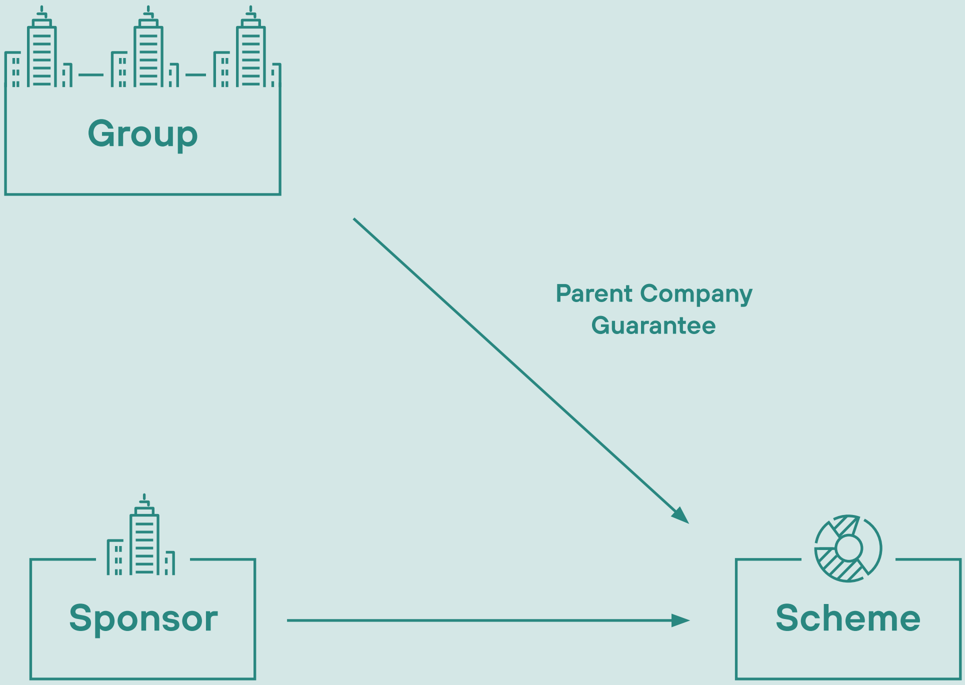
- Extends/improves covenant supporting scheme funding flexibility
- Can help align covenant to internal or external reporting, improving ease of covenant monitoring
- Has no direct cost and is often compatible (or can be easily negotiated) with external financing as PCGs are generally unsecured
- Various different approaches can be taken to the form, term and quantum of PCGs to balance parent company and scheme objectives
- Can reduce PPF levy if in PPF's standard form (which requires an 'evergreen' guarantee)

However...

- PCGs can inhibit future corporate flexibility – for example, requiring PCG release negotiations if the sponsor is subsequently to be disposed
- Funder consent can be required
- Various international jurisdictions have different legal restrictions on supplying guarantees and different approaches to enforceability
- Only able to grant it once if 'evergreen', with reduced sponsor leverage at future valuations

When would this work?

- Sponsors operating in stable and well resourced groups who are unlikely to engage in future corporate activity involving the sponsor



Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Parent Company Guarantee				

Isio view

PCGs are very common, with many entered into to secure PPF levy benefit. They can substantially strengthen covenant, supporting greater flexibility and also simplifying covenant monitoring. However, we work with many groups that subsequently regret granting evergreen PCGs when embarking on later transactions. As such, caution should be taken before entering into new PCGs.

Providing
covenant improvement

Sponsor restructuring

A group can take various actions to improve the covenant of subsidiaries...

How does it work

Various group actions can be taken to improve employer covenant, for example an injection of shareholder capital, changes to dividend policy, changes to intercompany trading relationships or changes to financing/security arrangements. Often such steps are relatively low cost/impact from a group perspective but can significantly improve the direct covenant supporting greater scheme flexibility.

Why do this?

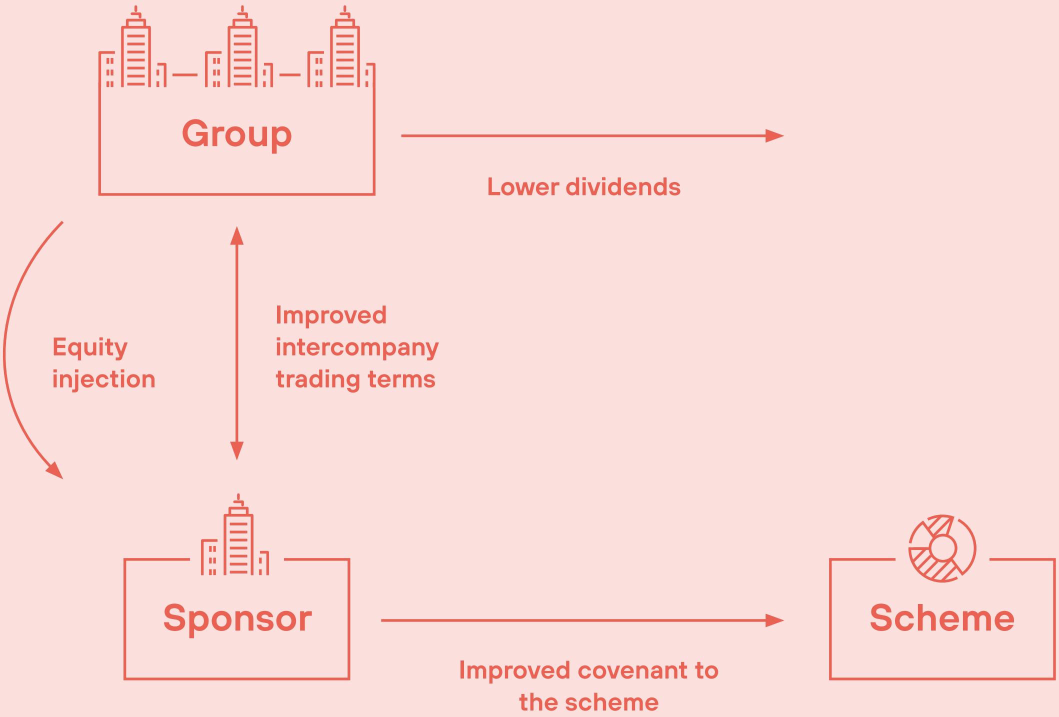
- Relatively simple steps with little group impact can materially improve scheme perception of covenant strength
- Covenant improvement actions (such as equity injections or intercompany changes) can also have a beneficial impact on other stakeholder perceptions of financial strength

However...

- Any impact on covenant is subjective and so the expected outcome of any covenant improvement steps taken should be agreed between the sponsor and the scheme in principle in advance

When would this work?

- Groups with material intercompany trading or financing relationships



Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Sponsor restructuring				

Isio view

Directors, shareholders and the scheme are generally aligned in a desire for covenant to strengthen but structural steps to improve a sponsor's covenant within a group generally weakens another part of the group. However, in larger groups, certain steps can often be designed to improve the direct covenant without material impact upon the group's strategy or financial position, creating opportunities for "win-win" situations.

Providing
covenant improvement

Improve insolvency position

Simple steps can be taken within groups to improve scheme recoveries on theoretical insolvency...

How does it work

As an alternative to direct security, it can be possible to improve the scheme's position upon insolvency by subordinating competing intercompany claims. Other ways to improve the scheme's position on insolvency include making other group companies participating employers of the scheme or injecting group assets or capital into the sponsor.

Why do this?

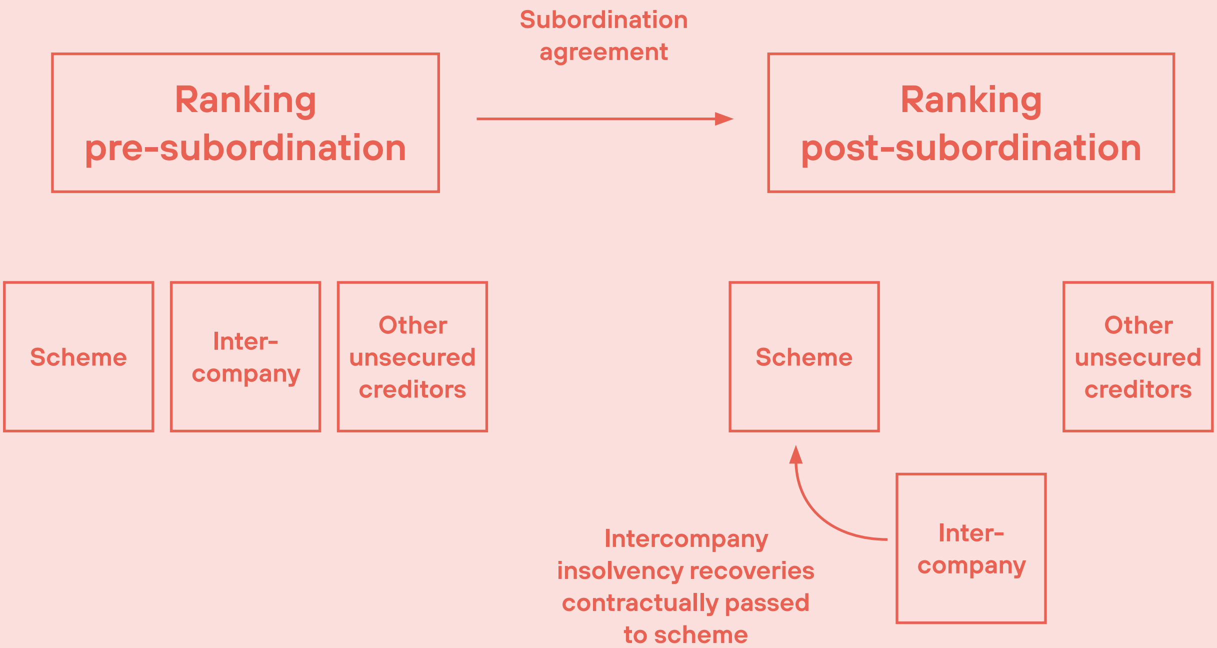
- Improves scheme position on a theoretical insolvency allowing greater funding flexibility
- Intercompany subordination can be viewed as low cost as the group does not ever expect / is in control of sponsor insolvency

However...

- Only works for groups and in certain conditions (for example, significant intercompany creditors)
- Can limit future flexibility to change group financing strategy

When would this work?

- Sponsors operating in groups with either significant intercompany creditors, portable assets or sister companies that could become sponsors



Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Improve insolvency position				

Isio view

The conditions to implement measures to improve the scheme's insolvency position without using security are relatively uncommon but can form an effective element for agreement for a flexible scheme funding package.

Negative pledge

Can be used to give a scheme the confidence that covenant will not be eroded unexpectedly...

How does it work

Under a negative pledge, the sponsor makes a commitment not to take specified action(s) (for example, the granting of asset security, sale of an asset or payment of dividends), without scheme consent.

Traditionally, negative pledges generally referred to legal documents that protected a creditor's position on insolvency. However, scheme negative pledges have been extended to cover many aspects of possible covenant erosion. The consequences and remedy process for a breach of a negative pledge need to be established but can include additional scheme powers to, for example, demand contributions or wind up the scheme.

Why do this?

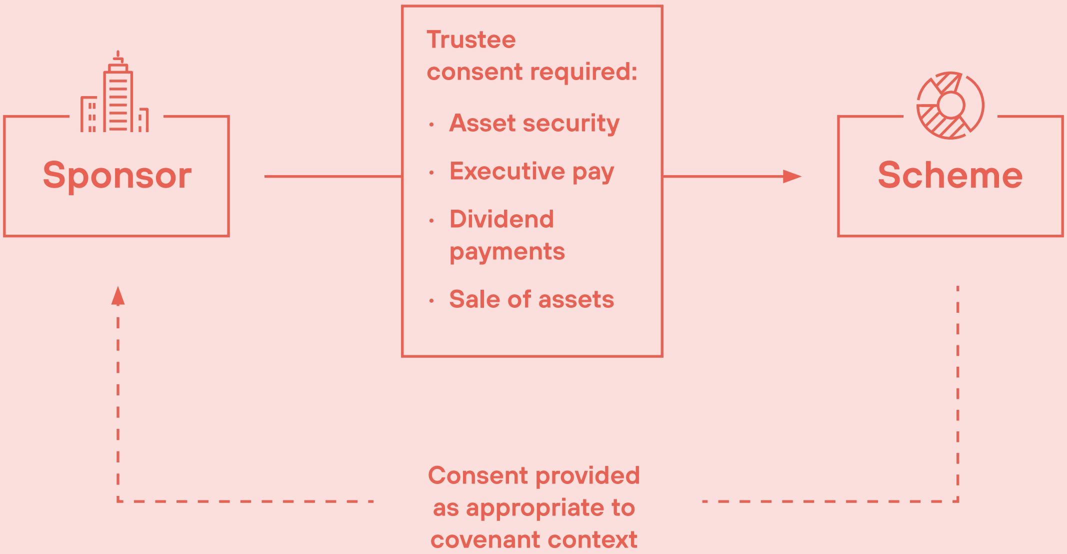
- Provides the scheme with assurance that no active sponsor steps that could lead to adverse impact will occur without consultation / consent. The greater reliance on the enduring nature of sponsor covenant can lead to a more flexible approach to the funding valuation

However...

- Can restrict the sponsor from executing actions that may be in the best interests of the covenant
- Requirement for scheme consent can slow execution of transactions

When would this work?

- The scheme has concerns regarding the future of the covenant on which the sponsor is more confident and willing to provide assurances
- Sponsors with weaker covenants seeking flexibility in scheme funding



Option	Deficit reduction	Protection for members	Extended time horizon	Investment strategy flexibility
Negative pledge				

Isio view

Negative pledges have become a common negotiating element tabled by trustees in exchange for funding flexibility. They can help secure important concessions from schemes but also comes with commercial risks that sponsor financial or operational freedoms are constricted in the future by failure to secure timely trustee consents.

Next steps

"The regulator recognises that innovative funding mechanisms such as Asset Backed Contributions (ABCs) may help employers meet their obligations to schemes and can, in certain circumstances, improve a scheme's security by providing access to valuable assets which were previously out of reach...."

TPR Asset-Backed Contributions — November 2013

1

Sponsor and trustee to set and agree objectives in relation to covenant, investment and funding

2

Consider current funding targets and the strategies to achieve these, including associated risks

> “We recognise that contingent assets or asset-backed funding might be appropriate more widely, for example, where cash flow is constrained but security is available, or if the employer has concerns over trapped surplus...“
>
> **TPR Annual Funding Statement 2019**

3

Understand range of non-cash alternative options to support strategies

4

Review and identify feasible options that meet objectives

5

Implementation of selected options

How should I assess the options?

We have considered a number of non-cash options that trustees and sponsors can consider implementing as part of funding valuation discussions and wider Integrated Risk Management planning. Which option works best will depend on the objectives of the respective parties, in the context of cash, risk and long-term security of members' benefits, as well as the potential level of non-cash funding support available. We have helped trustees and sponsors implement a number of these options in the past and we would be happy to support you through the process, particularly with the introduction of the new Code of Practice on DB funding. If you would like to understand any of the options covered in this booklet in more detail, please speak to one of the contacts on the next page or your regular Isio pensions contact in the first instance.

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