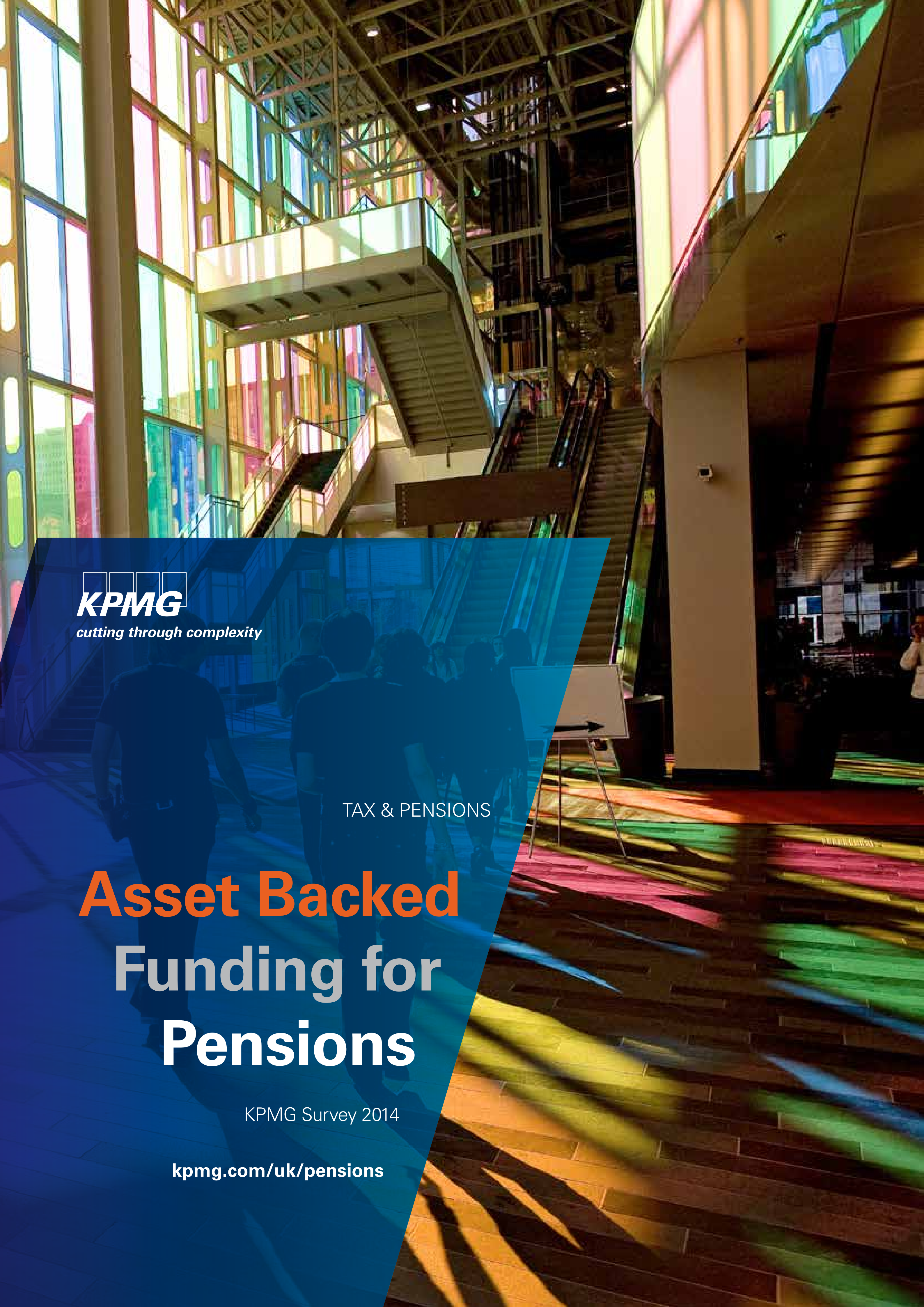

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cutting through complexity

TAX & PENSIONS

Asset Backed Funding for Pensions

KPMG Survey 2014

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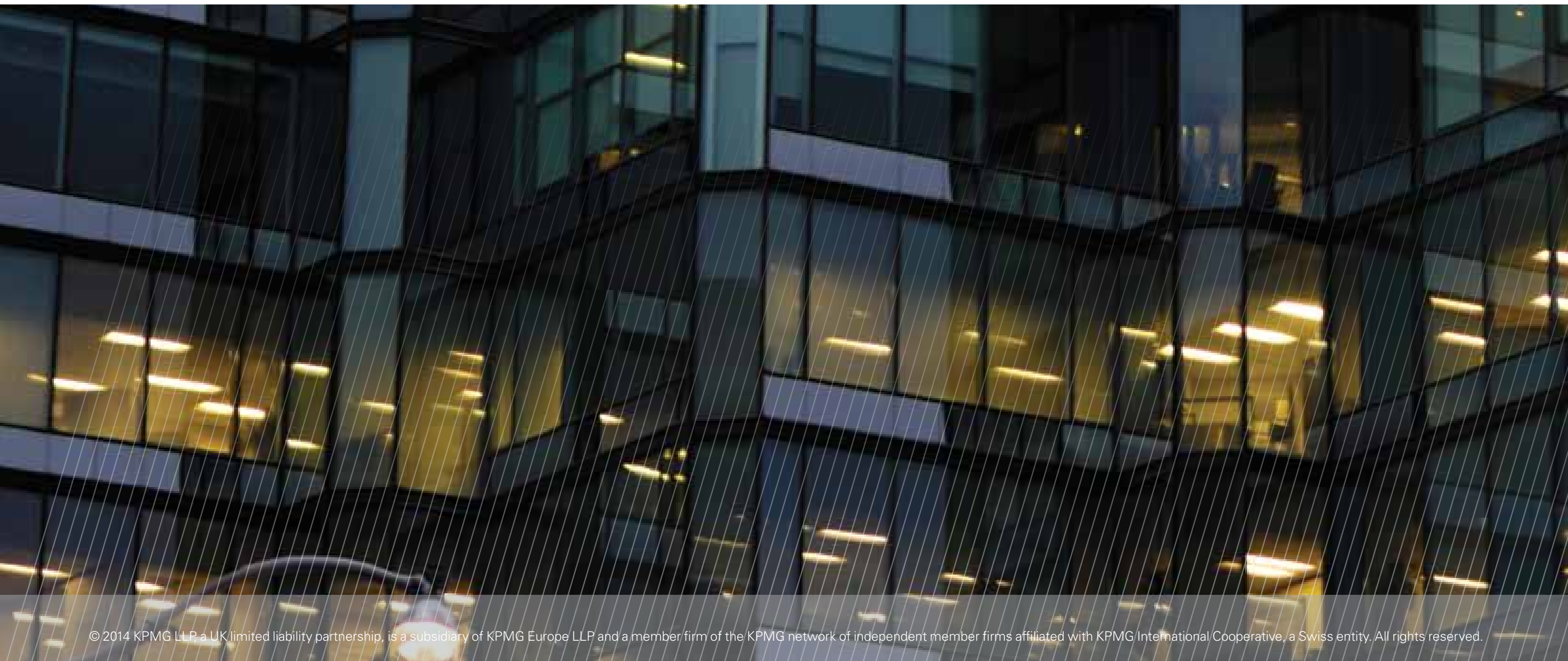


Highlights

This is the fourth edition of our asset backed funding survey. This year we are looking at how the asset backed funding landscape continues to evolve and adapt to changes in market conditions and the regulatory environment.

- The rate of asset backed funding implementations has accelerated – 23 new asset backed contributions (ABCs) have been announced since we published last year's survey. This compares to seven new structures announced during the previous survey period.

- Nearly £2bn of new ABCs have been made, taking the total value of transactions to date to over £7bn.

- The average transaction size has decreased considerably since our first asset backed funding survey was published (c.£80m over 2012/13 compared to circa £320m in 2009/10). Seven new ABCs of £25m or less were implemented in 2012/13, compared with only three prior to that, highlighting that asset backed funding is increasingly seen as a solution for smaller as well as larger schemes.

- The most common terms are still 15 and 20 years, however we are seeing companies implementing structures with terms of up to 25 years.

- Property remains the most commonly used asset, however the use of intra-group loans is increasing in popularity.

What is the outlook for future transactions?

We expect the rate of new implementations to continue gathering pace. Some of the main drivers behind the continuing popularity of these structures are:

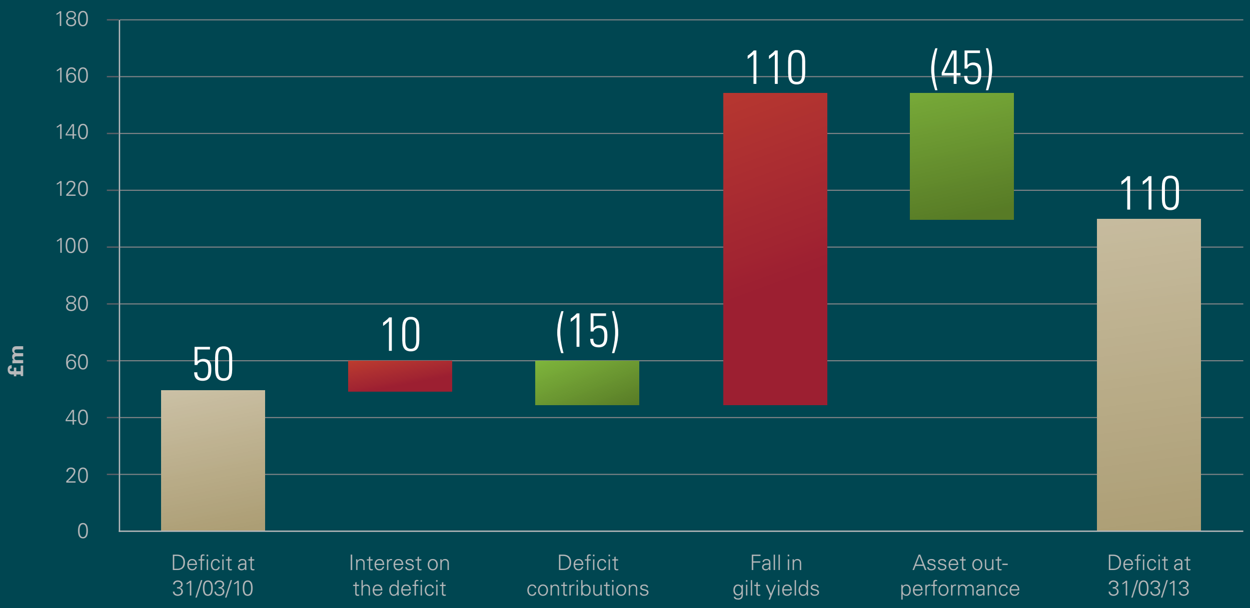
- Scheme funding valuations carried out in 2013 will typically result in significantly higher deficits than those carried out in 2010. Asset backed funding gives an alternative to increased cash contributions and allows cashflows to be spread over a longer period.
- Gilt yields remain low, but with the expectation that they will revert in the future to "normal" levels. Amidst uncertainty on how long this reversion will take, many view current deficits as being inflated, increasing the risk of future trapped surplus which can be mitigated through the use of asset backed funding.
- The ability to use asset backed funding to finance other goals such as merging pension schemes, facilitating insurance or investment de-risking.
- Recent guidance provided by the Pensions Regulator acknowledges the increasing popularity of these structures and dispels any lingering myths that the regulator might look to introduce barriers to implementation.

Why are companies using asset backed funding?

DECLINE IN FUNDING LEVELS

Valuations carried out over 2013 have been conducted against the backdrop of economic pressures from the Eurozone crisis as well as continuing low levels of economic growth in the UK. Yields in April 2013 were at their lowest level in history, and while conditions have improved since then, 2013 valuations are likely to show significantly higher liabilities than in 2010, only partially offset by the asset returns many schemes have enjoyed.

FIGURE **1** **Change in deficit since 2010 for a typical scheme**



Source: KPMG LLP, January 2014

An example of how a typical scheme's funding deficit may have developed is shown in the graph above. The fall in real gilt yields has more than offset the asset outperformance and deficit contributions. Whereas companies with 2012 valuations were often facing a similar deficit to 2009, companies with 2013 valuations are likely to see a significant increase in their deficit. There is now even more demand for asset backed funding as companies look for ways to avoid large increases in contributions while still attending to the needs of pension trustees.

INCREASED PRESSURE ON TRUSTEES AND EMPLOYERS

Many schemes and their sponsors will be facing:

- A big deficit to fund, when large deficit contributions have already been made.
- Pressure from the Pensions Regulator not to extend their recovery plan or allow for expected improvements in market conditions.
- Cash constraints facing the sponsor.

This leads to a real risk of putting in place an excessively cash-consuming contribution schedule which could impact detrimentally on business viability and growth, reducing the strength of the company covenant. In many cases this is not in the interests of the trustees or the employer.

WHAT DOES THIS MEAN FOR ASSET BACKED FUNDING?

During 2013, an increasing number of companies saw asset backed funding arrangements as an ideal deficit reduction solution in the prevailing economic climate. We expect this will continue during 2014 for similar reasons:

- They allow employers the freedom to retain cash for investment in and development of the business. The regulator has discouraged material extensions to existing plans without appropriate security, and asset backed funding arrangements can provide this security.
- The additional security and immediate improvement in funding position offered to trustees will provide more certainty for members' benefits and reduce the pressure to accelerate funding.
- They can reduce the risk of future emerging trapped surplus in the scheme which could arise if market conditions improve.
- Acceleration of tax relief on contributions can be achieved if the structure complies with HMRC's requirements.

The Pensions Regulator's new guidance on Asset Backed Contributions

On 19 November 2013, the Pensions Regulator published new guidance on Asset Backed Contributions ("ABCs") to Pension Schemes, setting out the regulator's expectations of trustees when considering such arrangements.

This follows a period over which ABCs have become an increasingly common way for companies to provide financial support to their defined benefit pension schemes. The guidance broadly reflects the way that well-advised trustee boards have been approaching these structures, and as such is unlikely to lead to a significant shift in the way they are viewed by scheme trustees. However, it should help sponsors who are looking to take asset backed funding proposals to trustees, since it acknowledges that these structures are becoming more mainstream and provides a framework for trustees to consider them.

While we do not believe the guidance will lead to a material change in practice, it might promote a more methodical and consistent approach in some areas. However, each asset backed funding structure can be very different, and the regulator's generic guidance has been unable to capture all of the nuances that may exist, so sponsors will still need to clearly set out the specific benefits of their proposal for trustees to review.

What are the risks for trustees?

In its new guidance, the Pensions Regulator cites the key risks which trustees should consider in relation to ABCs. We have considered each of these in turn below.

INFLEXIBLE SCHEDULE OF PAYMENTS, DELAYING FULL FUNDING

The regulator argues that the extended payment period offered by asset backed funding structures leads to a greater probability of the scheme being underfunded if the sponsoring employer fails before the end of the payment term. However, one of the purposes of the ABC structures is to provide increased security in the event of a sponsor insolvency, since a properly designed structure will deliver significantly greater value in such circumstances than an unsecured recovery plan.

Another concern is that recovery plans are typically reviewed every three years, allowing trustees to re-consider the appropriateness of the payments, for example if a higher level of contributions becomes affordable or the covenant of the sponsor deteriorates. By contrast, ABC income streams are agreed at outset and provide long term, secure cash payments. The regulator expresses particular concern over payment terms which incorporate a final "bullet" payment, although these are becomingly increasingly rare following HMRC's review last year.

Whilst it is true that ABC payments are fixed at outset, valuations will continue to be carried out at least every three years and additional contributions paid if the deficit increases (which could be a result of deterioration of the sponsor covenant) or if more cash becomes available. In the meantime the ABC will provide additional security where cash is not immediately available.

WEAK UNDERLYING ASSETS OR LIMITED LEGAL CLAIMS ON THOSE ASSETS

Trustees need to consider what the value of the underlying asset would be if the company were to become insolvent, as well as whether the speed at which the asset could be realised on insolvency would affect its value.

Trustees can mitigate the risks by ensuring that appropriate due diligence is carried out on the assets and the legal structure of the arrangement.

MASKING THE SCHEME'S OVERALL RISK PROFILE

The regulator states that the funding position of schemes can be distorted by the fact that future payments from the ABC are recognised before they are paid. Its concerns are based around the fact that "the scheme remains reliant on the sponsoring employer and/or the ABC being able to make future payments in order for the scheme to reach this target."

It is important to remember that in most cases a large special contribution is made to the scheme which the scheme agrees to invest in acquiring rights to income from the structure – not dissimilar to investing in a bond. Providing the security offered by the arrangement is robust, the risk of reliance on the sponsoring employer to make the ABC payments can be mitigated.

WEAKENED COVENANT

The regulator states that, in some cases, "The establishment of the ABC could damage the employer covenant which supports the scheme", and highlights the fact that in some cases trustees may already have access to the asset being transferred to the ABC.

We would expect this to be considered by any well advised employer and trustee in assessing whether an ABC is right for them. In most cases we would expect that an ABC structure would improve the security position of the pension scheme, not injure it.

ILLEGALITY OF THE STRUCTURE

If an asset backed funding structure was found to breach the employer related investment restrictions, the regulator considers that the overall structure could be void. The more common view is that such a breach may make it unlawful for the scheme to continue to participate in the structure and would be required to withdraw. Again, this risk can be mitigated by seeking appropriate legal advice and ensuring that suitable underpin arrangements are in place in the unlikely event that it becomes necessary to unwind the structure.

HOW COULD SCOTTISH INDEPENDENCE AFFECT ASSET BACKED FUNDING?

The possibility of Scottish independence has led to some uncertainty around the potential impact this may have on Scottish Limited Partnerships (SLPs). This uncertainty may lead some companies to consider deferring a decision to implement until the future is clearer.

Neil Bowden of Allen & Overy has advised on a number of ABC implementations and in particular the issue of Scottish independence:

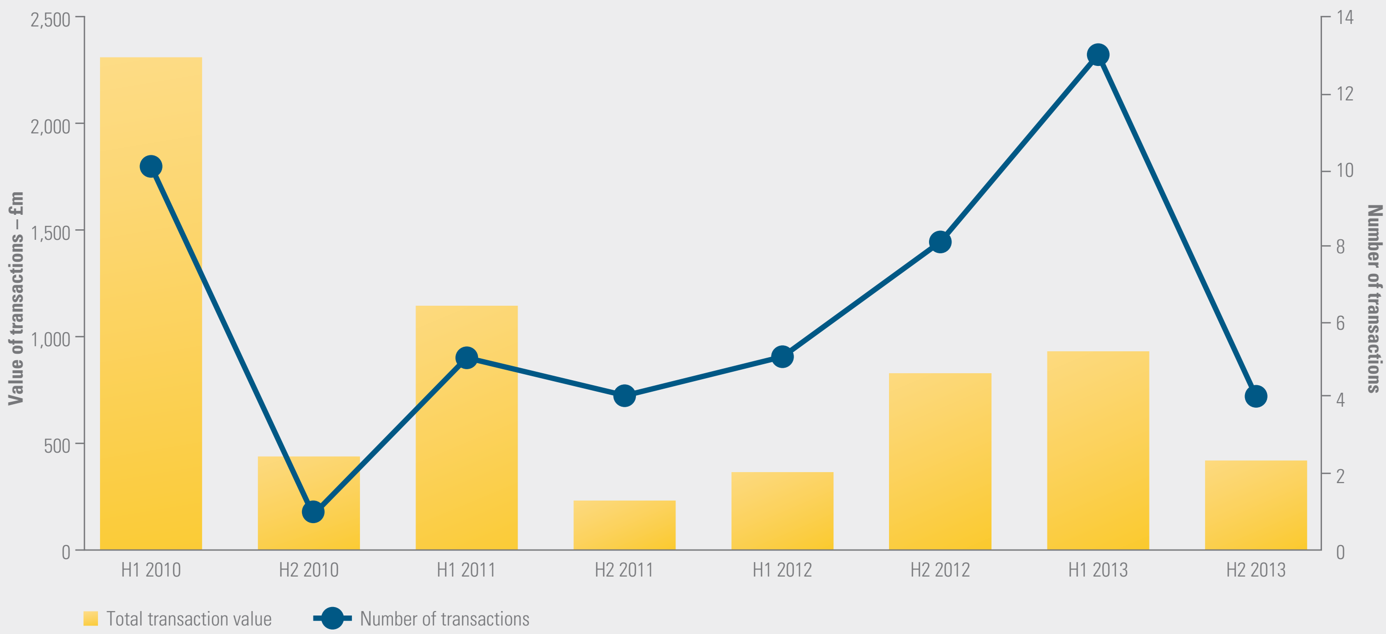
"The impact of Scottish independence on ABCs is sometimes overstated. The restrictions on employer related investment look at any "share or other security" held by trustees. A Scottish Limited Partnership falls outside the restrictions on two counts. Firstly, because it is an unincorporated body within the UK, since the statutory definition of "securities" does not include shares in such a vehicle. Secondly, because a partnership interest in itself, Scottish or otherwise, is generally not considered a "share" and therefore should sit outside the regime anyway. So while Scottish independence would remove one limb of the analysis, it is not the case that the structure would no longer work. In any event, asset backed funding vehicles invariably include robust "change of law" mechanics and therefore any future challenge should be able to be dealt with through restructuring."

Provided that companies and trustees seek legal advice and put in place adequate contingencies, we do not view potential Scottish independence as a barrier to future implementation of ABCs.

What has happened in the market?

The number of structures in the market has continued to grow over 2012/13, with more than 20 transactions carried out since our 2012 survey. This is nearly half of the total number of transactions carried out to date.

FIGURE **2** **Timeline of transactions**



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

Note: *Transactions shown for H2 2013 will understate the true total, as it excludes implementations during November and December 2013 as well as any structures that had been implemented but not yet publicly reported by 31 October 2013*

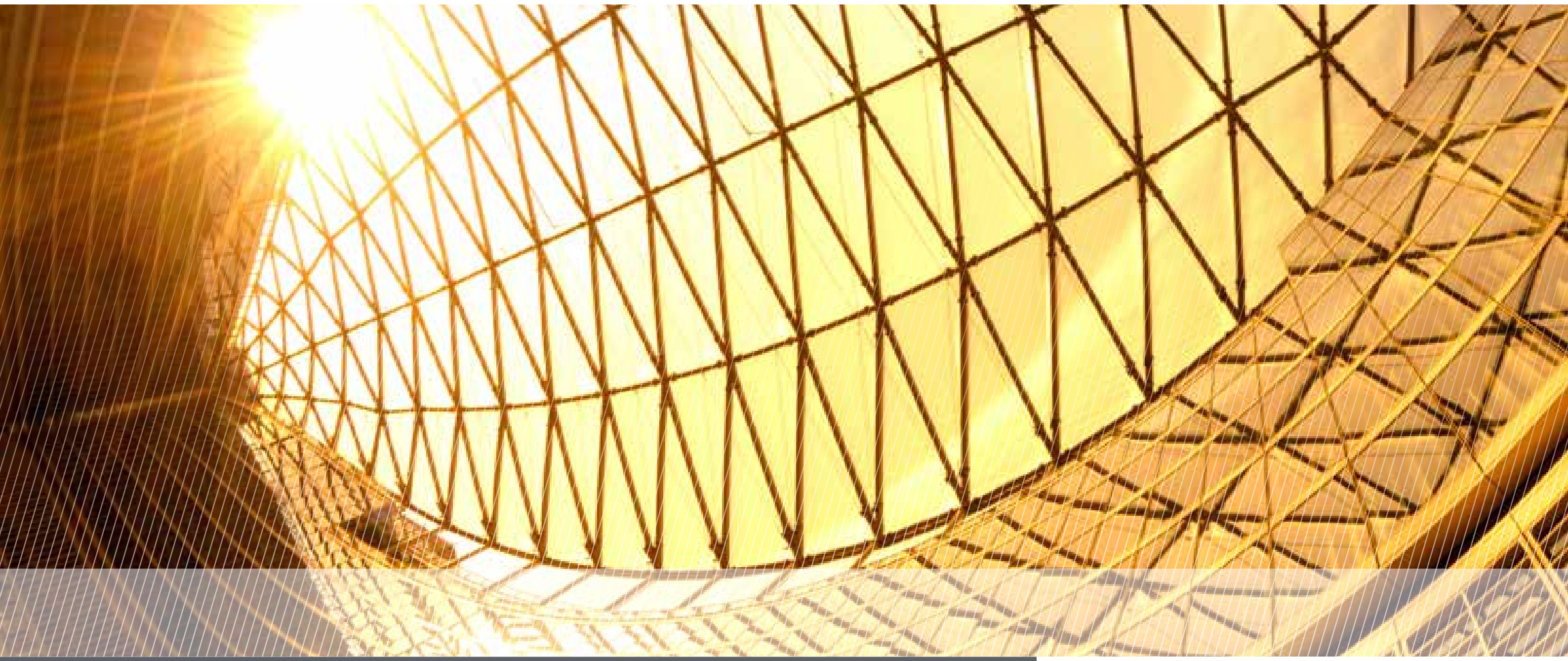
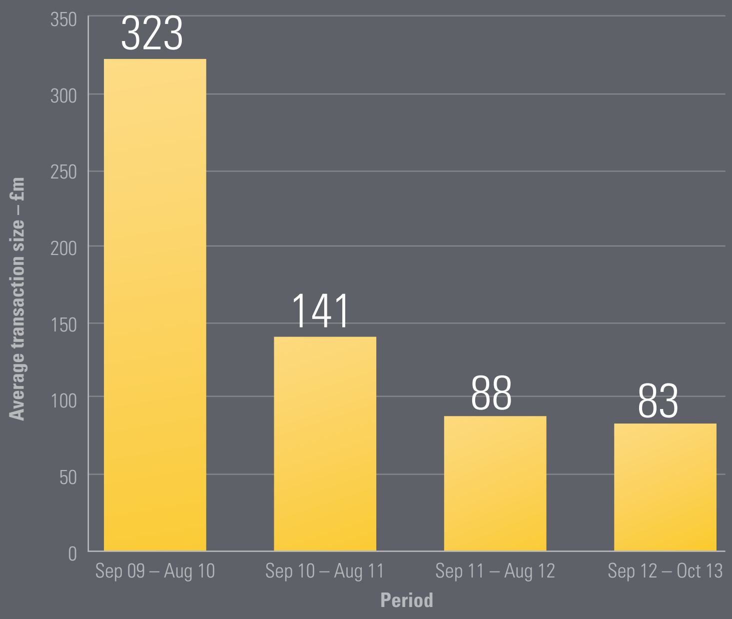


FIGURE 3 **Average size of transactions**



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

Note: *Transaction value for Renold has been estimated based on information provided in company accounts*

Timeline based on date of announcement

Asset backed funding is increasingly seen as a solution for smaller as well as larger schemes, with the trend of reducing average transaction size continuing in 2012/3. Seven new ABCs were implemented during 2012/13 with a value of £25m or less, compared with just three prior to that.

COMPANY SECTOR

Initially dominated by large retailers, we are now seeing an increasingly wide range of companies in the asset backed funding market.

FIGURE **4** **1 September 2012 to 31 October 2013**

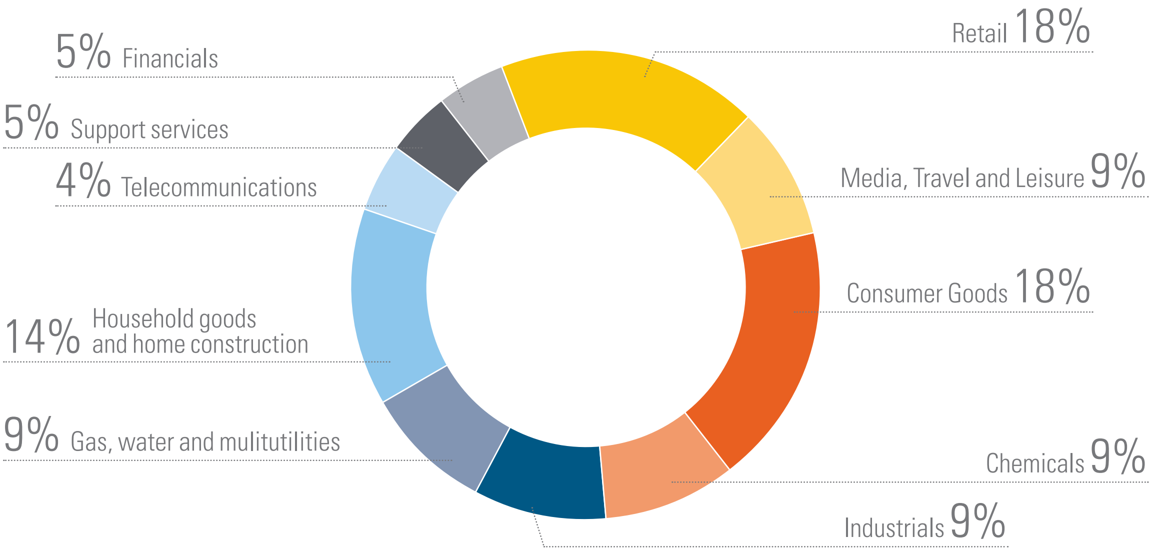
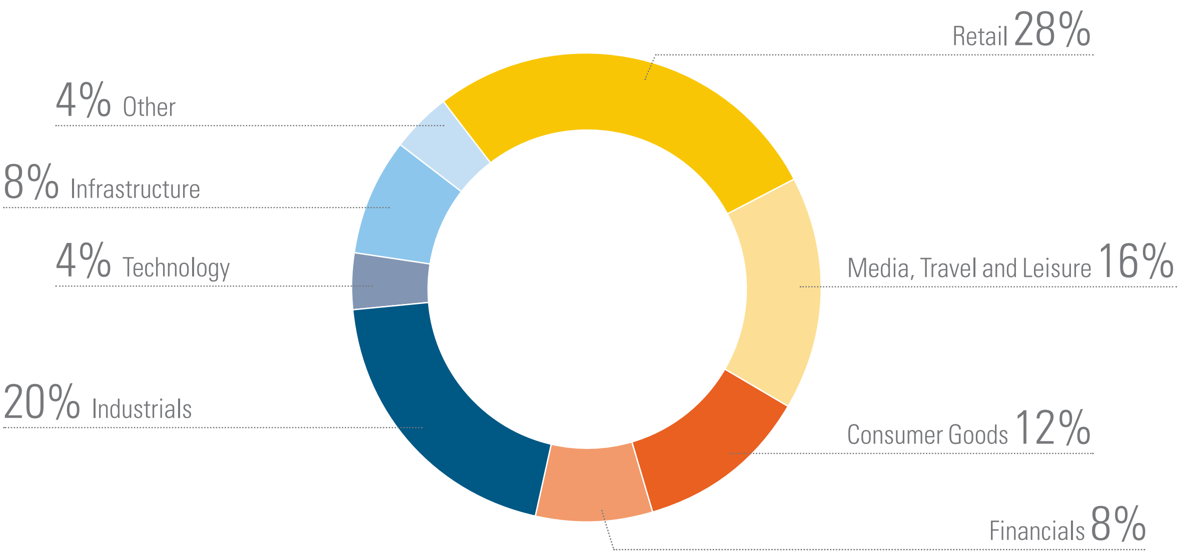


FIGURE **5** **Previous surveys**



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

TYPES OF ASSETS USED IN ASSET BACKED FUNDING STRUCTURES

We have seen a significant increase in the number of structures using intra-group loans during 2013, although property remains the most popular asset. The charts below shows the types of assets used to secure ABC payments.

FIGURE 6 **1 September 2012 to 31 October 2013**

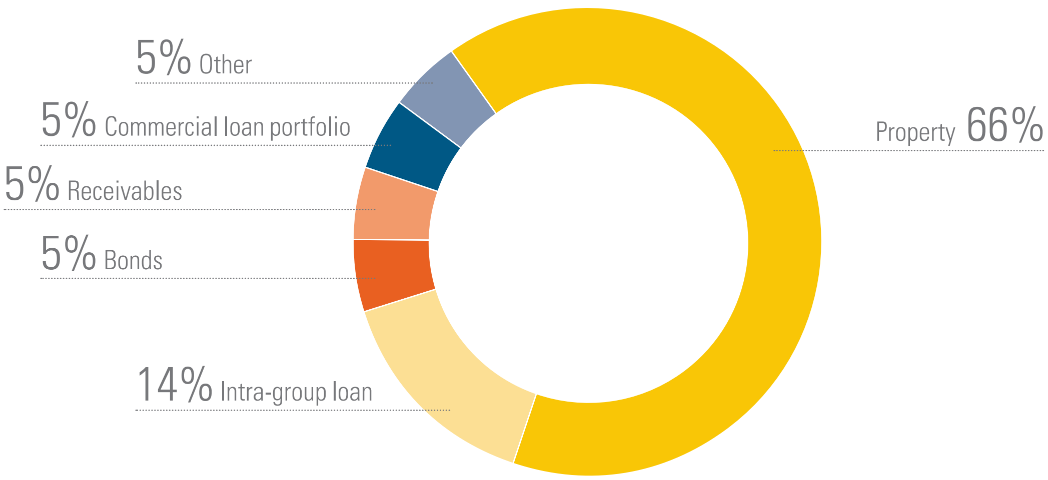
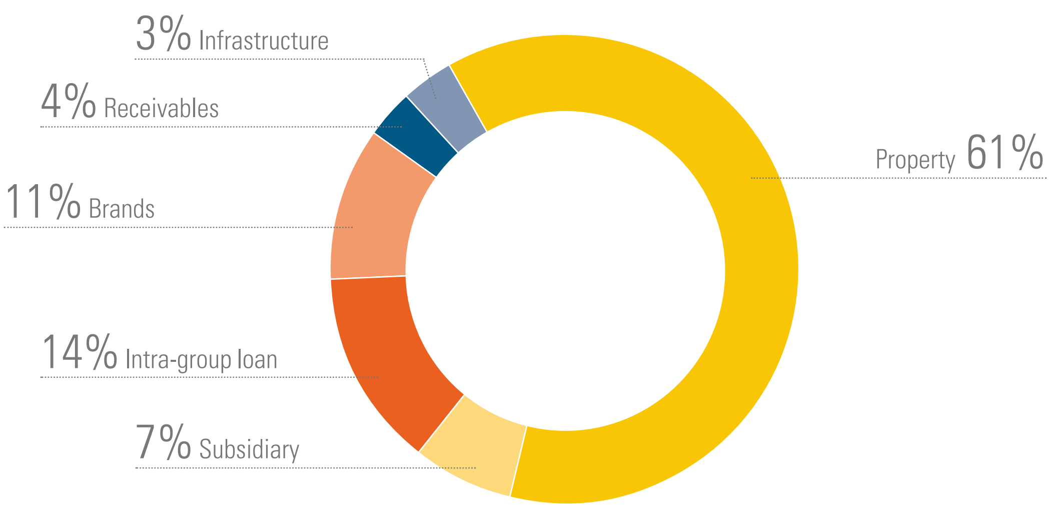


FIGURE 7 **Previous surveys**



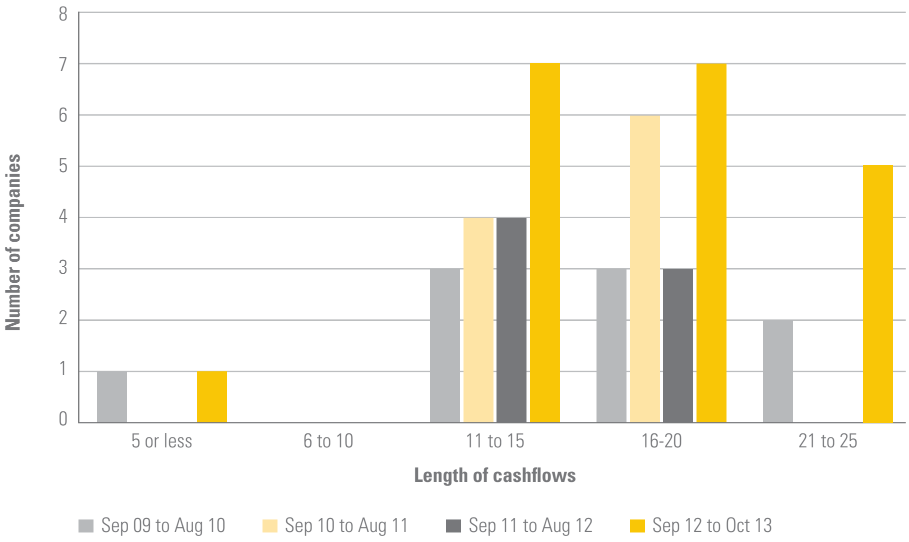
Source: *KPMG analysis of press releases and annual reports as at December 2013*
Note: *Based on number of transactions rather than total value*
Greencore Group used both property and trade receivables, so has been counted twice

LENGTH OF PAYMENT TERMS

The chart below shows the distribution of terms for asset backed funding structures implemented to date. We have seen a range of terms being used over 2012/13, from four years to 25 years. This was the first time we have seen structures extending beyond 22 years with three structures having a term of 25 years, the maximum permitted by HMRC rules.

This shows that companies are looking to these structures as a way to spread cashflows over a longer period than a traditional recovery plan would permit. As a result, the average term has increased slightly, although terms of 15 or 20 years remain the most popular.

FIGURE **8** **Term of structure**



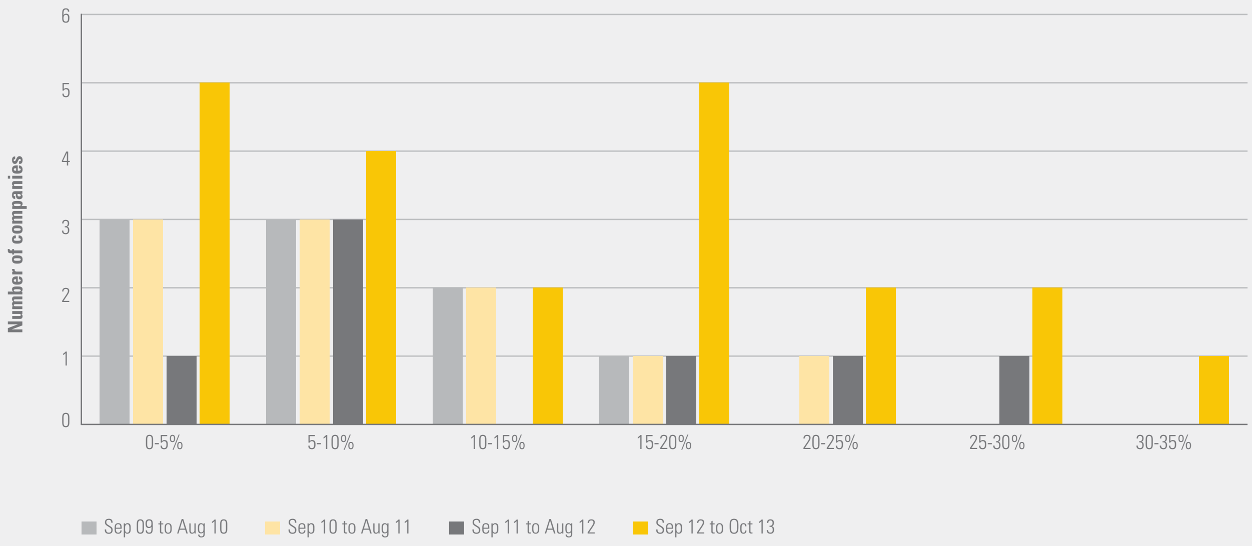
Source: *KPMG analysis of press releases and annual reports as at December 2013*
Term for M&S is based on the aggregate of all 3 tranches
Term for Severn Trent estimated to be around 20 years

These structures allow companies to spread cashflows over a longer period of time. The Pensions Regulator reports that the average length of a recovery plan used by pension schemes in the most recent valuations is 7.5 years, whereas the average terms for ABCs is 17.6 years.

TRANSACTIONS SIZE RELATIVE TO SCHEME ASSETS

The chart below compares the size of the arrangements implemented with the pension scheme assets disclosed in company accounts. We noted in last year's survey that there appeared to be an emerging trend towards transactions which are a greater proportion of total scheme assets. This has continued over 2012/13, with nearly half of the structures implemented representing over 15% of scheme assets. In one case the structure accounted for more than 30% of the scheme's assets, the highest proportion seen to date. This trend may reflect increased confidence among pension trustees in the robustness of these structures and the security they provide.

FIGURE **9** **Transaction as a percentage of scheme asset**



Source: *KPMG analysis of press releases and annual reports as at December 2013*
Note: *Where more than one transaction has been carried out by one company, the proportions above are based on the sum of the value of all transactions*

Appendices

APPENDIX 1
What is asset backed funding?

An asset backed contribution, or ABC, involves a sponsoring employer using business assets to secure cash which is paid to the pension scheme.

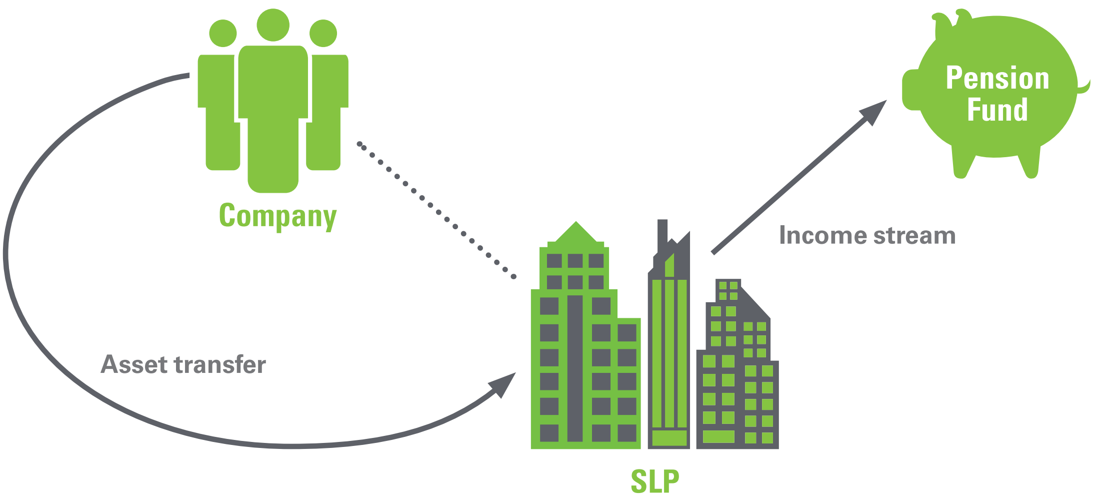
This is achieved by transferring the assets into a separate entity, usually a Scottish Limited Partnership. Typically the assets used will generate income such as rent or loan interest, although this is not essential and we have seen companies making use of other assets such as brand names or income receivables. The vehicle then uses the assets to 'back' payments to the scheme, which could be a regular income stream and/or lump sums. Typically the entity will be bankruptcy-remote from the sponsoring employer, providing the trustees with additional security if the employer becomes insolvent.

There are of course other solutions to funding pension deficits. In the past we have seen businesses making in specie contributions directly to their pension scheme as an alternative to selling assets in the market to raise cash to meet the deficit – for example, Costain passing across a portfolio of PFI holdings in November 2010 and HSBC's contribution of bonds to its scheme. More recently, AIB transferred €1.1bn (at face value) of loan assets to its Irish pension scheme.

Others, such as Dairy Crest, have provided trustees with a more straightforward charge over assets, increasing security but without reducing the funding deficit.

We have not covered these alternative solutions in this survey.

FIGURE **10** **Asset backed funding structure**



APPENDIX 2
Key implementation issues

VALUATION

The value of the "asset" held by the pension scheme represents the value of the future income stream usually derived by discounting the payment stream at an appropriate discount rate.

Most of the structures implemented so far have been over-collateralised, i.e. the value of the assets transferred is larger than the value promised to the pension scheme. The degree of headroom is a significant factor in determining the discount rate, as the greater the headroom, the greater the security of the income stream promised to the Trustees. It also allows for an increase in the distribution to the pension scheme should this be needed in future.

Further complexities in the valuations come from the nature of the payments. The payments are typically structured to be contingent on the future funding position of the scheme. A number of the structures implemented incorporate a possible "bullet" payment at the end of the recovery period should a deficit remain. Often this is based on the prevailing Technical Provisions at the end of the term, which provides another uncertainty in the valuation. In some cases, the contributions stop if the scheme moves into surplus, or are used instead to fund future service contributions.

The value agreed for the purposes of establishing the recovery plan may well be different to the value required for the scheme accounts which require "fair value" – the amount for which an asset could be exchanged between unrelated willing knowledgeable parties in an arms-length transaction.

For PPF levy purposes, the reduction in deficit will be equal to the value required for the scheme accounts.

ACCOUNTING

In all cases where the partnership structure has been implemented, the partnership established is controlled by the business and therefore included within the consolidated results of the business.

For the majority of ABCs implemented to date, the asset is not considered to be a plan asset under the relevant accounting standards. Payments from the ABC are treated as employer contributions in the accounting period in which they are made and there is very little impact on the consolidated accounts.

Alternatively, if the ABC is transferable to a third party, the structure will qualify as a plan asset of the pension scheme and the pension deficit under IAS19 or FRS17 is reduced by the value of the ABC.

The accounting treatment for the balancing entry in the financial statements will typically be as a direct financial liability on the balance sheet, leaving the overall balance sheet position unchanged.

TAX

From a corporation tax perspective, the key issues to be considered are minimising the tax costs of transferring the assets to the structure and obtaining a full tax deduction for the amounts ultimately paid to the scheme. If HMRC rules on ABCs are followed, the vehicle can be structured such that the result is a full tax deduction over the life of the structure for the cash paid with a significant acceleration of tax relief.

How is the acceleration obtained? Contributions paid by an employer under a registered pension scheme are deductible in the period of payment (subject to the spreading rules) provided they are made wholly and exclusively for the purposes of a trade or are an expense of an investment business. Under the arrangements the employer will make an initial contribution to the pension scheme (the ABC) which the pension scheme will then use to make an investment in the partnership. The amount of the ABC will therefore be a contribution for tax purposes resulting in upfront tax relief in respect of this amount . Depending on the amount of the ABC, under the spreading rules the tax deduction may need to be spread over up to four years. The employer is then entitled to a further deduction over the life of the arrangement for a proportion of the actual payments made to pension scheme to ensure that the overall tax relief equals the total cash paid.

From the pension scheme's perspective, as the scheme will be holding the investment in the structure for the purposes of a registered pension scheme, the income will be exempt from tax.

APPENDIX 3
Details of ABCs made since previous surveys

Company	Date publicly reported	Transaction value (£m)
Cemex	December 2012	299.3
Centrica	December 2012	84
	June 2013	360
Persimmon	December 2012	57.8
IPG	December 2012	25
Calor Gas	December 2012	75.3
William Grant	December 2012	12.3
Morrisons	January 2013	90
Scotmid	January 2013	11
Premier Farnell	February 2013	18
Selfridges	February 2013	35
Alliance Boots	March 2013	127
Johnson Matthey	March 2013	50
Birmingham Airport	March 2013	25.3
Scapa	March 2013	58
Renold	March 2013	40*
Kcom	March 2013	10
Chivas Brothers	April 2013	60.5
Kier Group	June 2013	46
A. G. Barr	July 2013	20.4
Taylor Wimpey	July 2013	100
Greencore	September 2013	32.8
Allied Irish Bank	October 2013	270

*Estimated using information on annual income and payment term

APPENDIX 4
Details of ABCs in previous survey periods

Company	Date publicly reported	Transaction value (£m)
Marks & Spencer	2007	500
	2008	200
	May 2010	300
Lloyds	Jan 2010	1,000
John Lewis	Jan 2010	95
GKN	March 2010	331
Whitbread	May 2010	100
ITV	May 2010	124
Travis Perkins	June 2010	35
Sainsbury's	June 2010	Up to 256
Diageo	July 2010	430
IMI	June 2010	48.6
Kingfisher	January 2011	Up to 200
Sainsbury's	March 2011	Up to 600
Alliance Boots	March 2011	146
Manufacturing company	May 2011	20
TUI Travel	May 2011	275
Pendragon	July 2011	35
ITV	July 2011	50
Deloitte	July 2011	70
Agfa Graphics*	July 2011	36
Doosan Power Systems*	2011	11
Britvic	Feb 2012	105
Communisis plc	March 2012	9.8
Qinetiq	March 2012	32.3
Midlands Co-operative Society limited	March 2012	118
Severn Trent plc	May 2012	98
Daily Mail and General Trust	July 2012	150
Canal and River Trust	July 2012	125

** Not included in previous surveys*

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