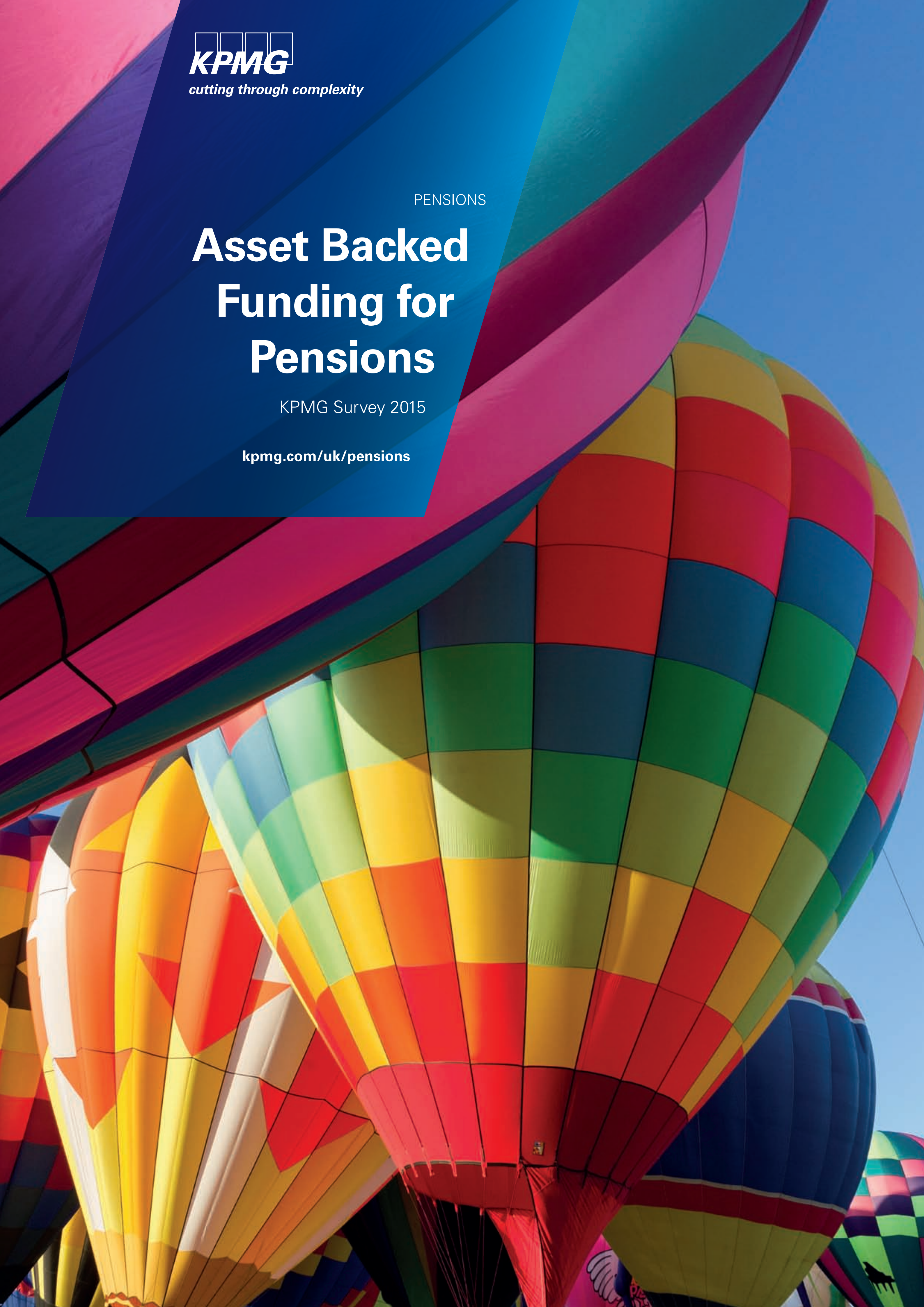

KPMG

cutting through complexity

PENSIONS

Asset Backed Funding for Pensions

KPMG Survey 2015

kpmg.com/uk/pensions

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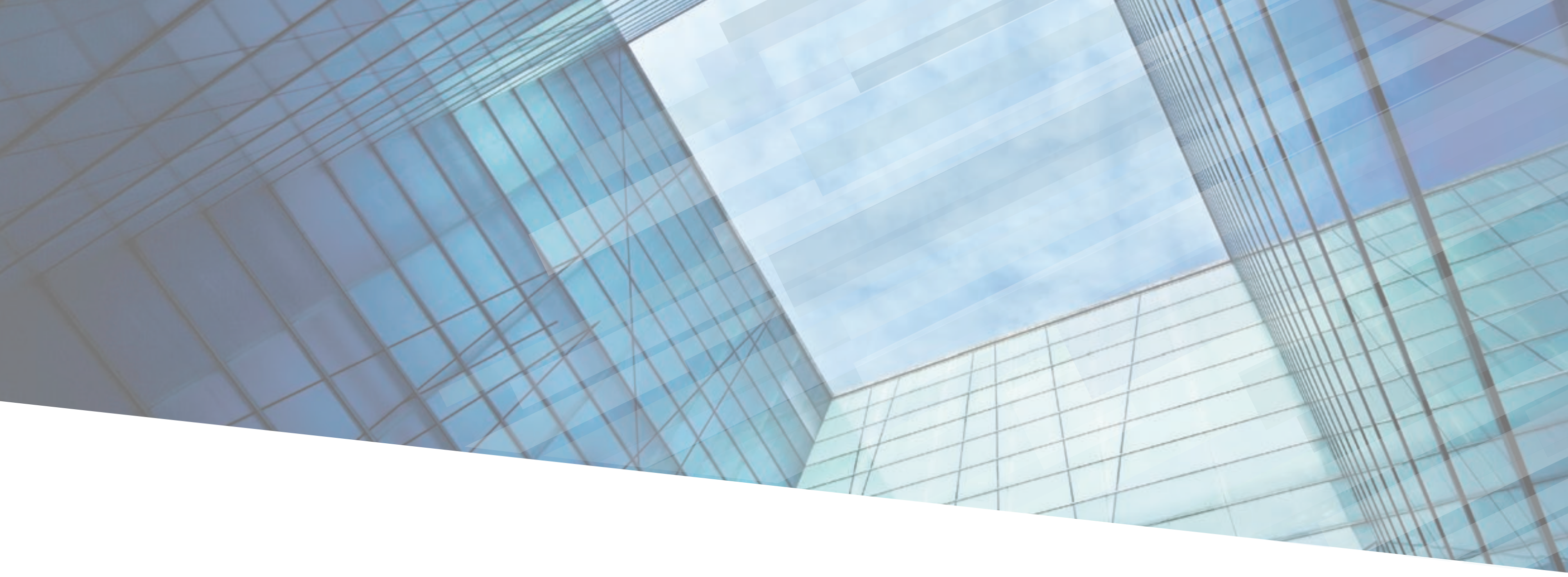
Asset Backed Funding

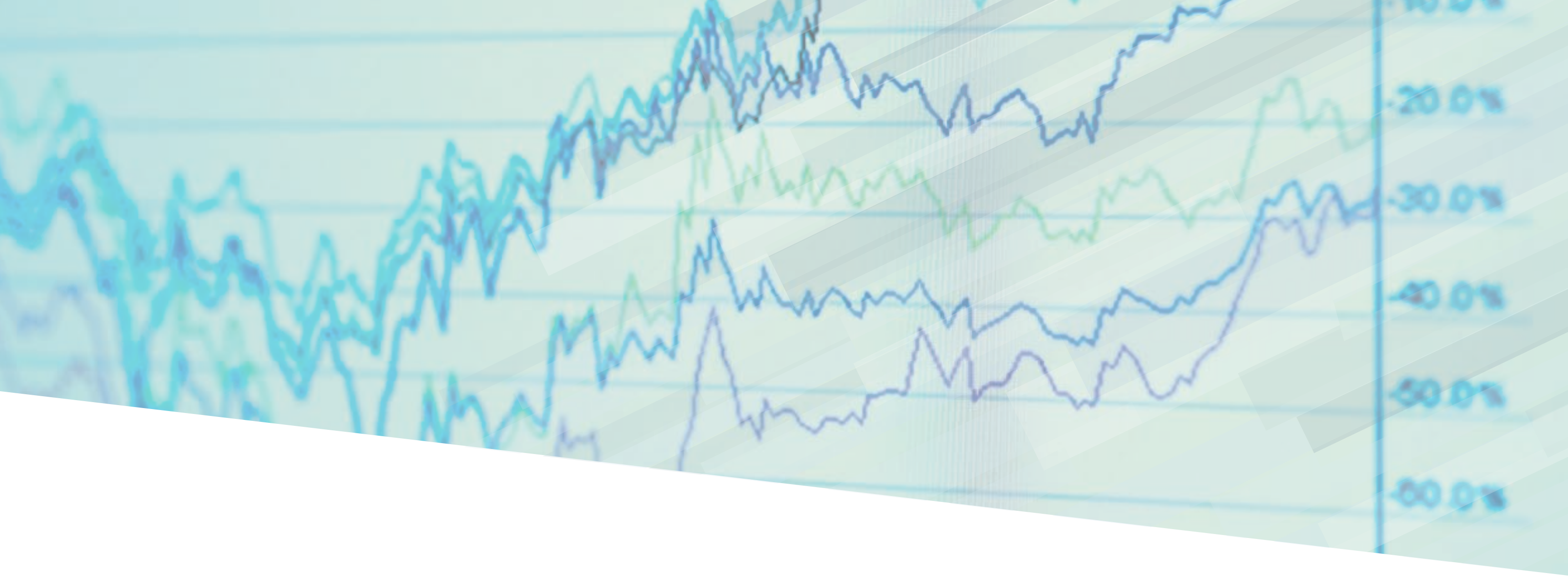


Highlights

This is the fifth edition of our asset-backed funding survey.

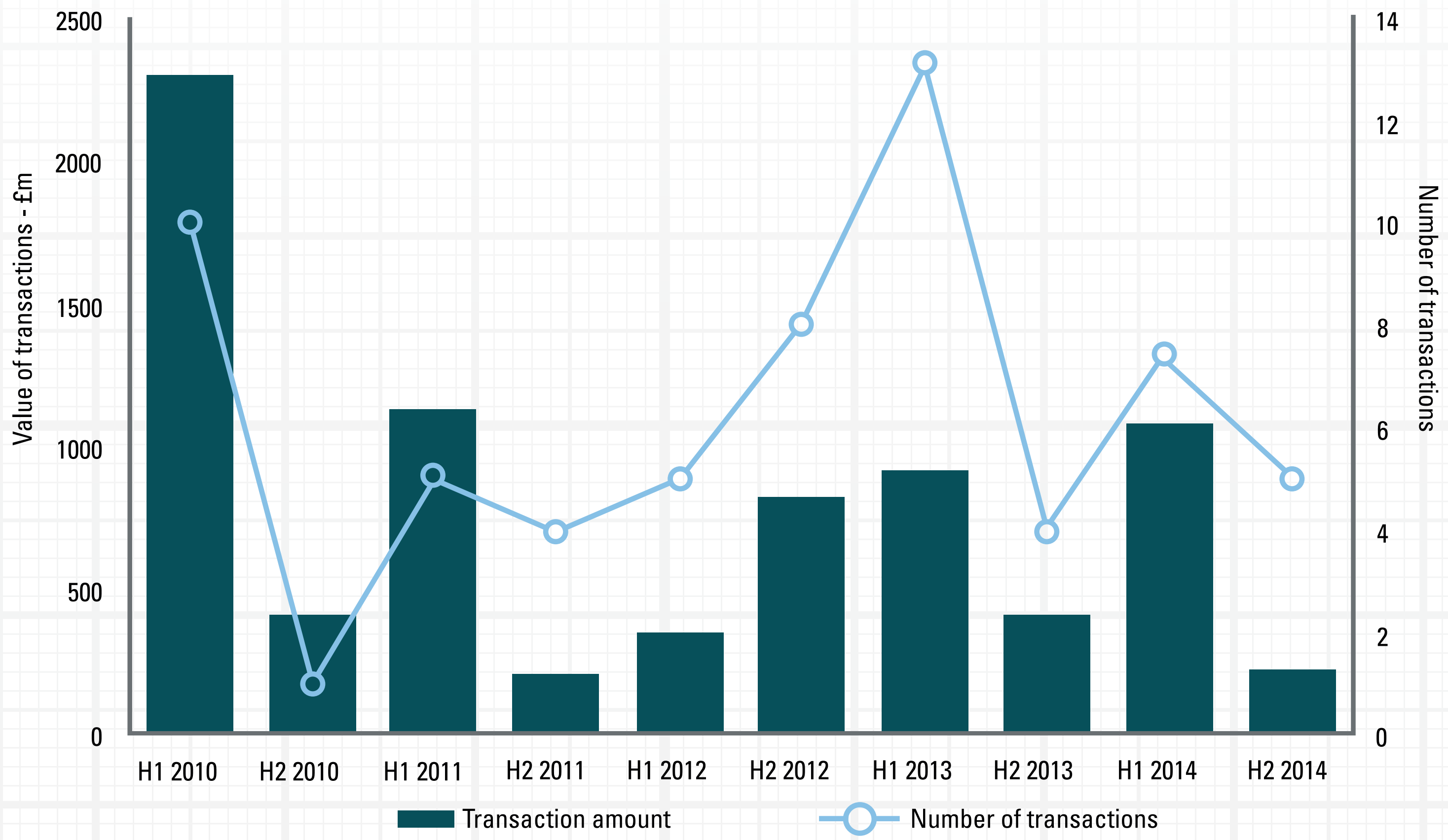
This year we look at how asset-backed funding continues to be a popular solution, but also consider some of the other alternative funding solutions commonly seen in the market such as escrow accounts, funding trusts (often referred to as reservoir trusts) and in-specie asset transfers.

- 12 new asset-backed contributions (ABCs) have been announced since we published our last survey in January 2014. While this is fewer than last year, when 23 new structures were announced, this demonstrates the continuing interest in asset-backed funding.
- We continue to see a wide range of schemes (small and large) benefit from ABCs, with transaction sizes ranging from £16m to £350m during the latest survey period.
  With £1.2bn of ABCs paid over the survey period, a total of nearly £9bn have now been made since the first ABC was implemented. We expect that 2015 will see this total rise to well above £10bn.
- Changes in market conditions during late 2013 and early 2014 eased the pressure on funding deficits, which may help to explain the reduction in demand compared to last year. However, as gilt yields have fallen to new record lows in the second half of 2014, which will put pension funding under renewed pressure, we expect to see a surge of interest in asset-backed funding over the next 12 months.
- An increasing number of ABCs now use a term of 25 years, the maximum permitted by HMRC in order to be eligible for up-front tax relief, which may indicate an increased level of comfort in ABCs among trustees and their advisors.
- Property remains the most common asset, however the use of intra-group loans remains popular. Other creative uses of assets in ABCs include the use of liquid natural gas (LNG) ships and company brands.
- During late 2013 and early 2014, we found an increasing number of client discussions focussing on the risk of trapped surpluses, which may help to explain an increase in the use of escrow accounts and reservoir trusts over the same period.



How has the ABF market developed over the past year?

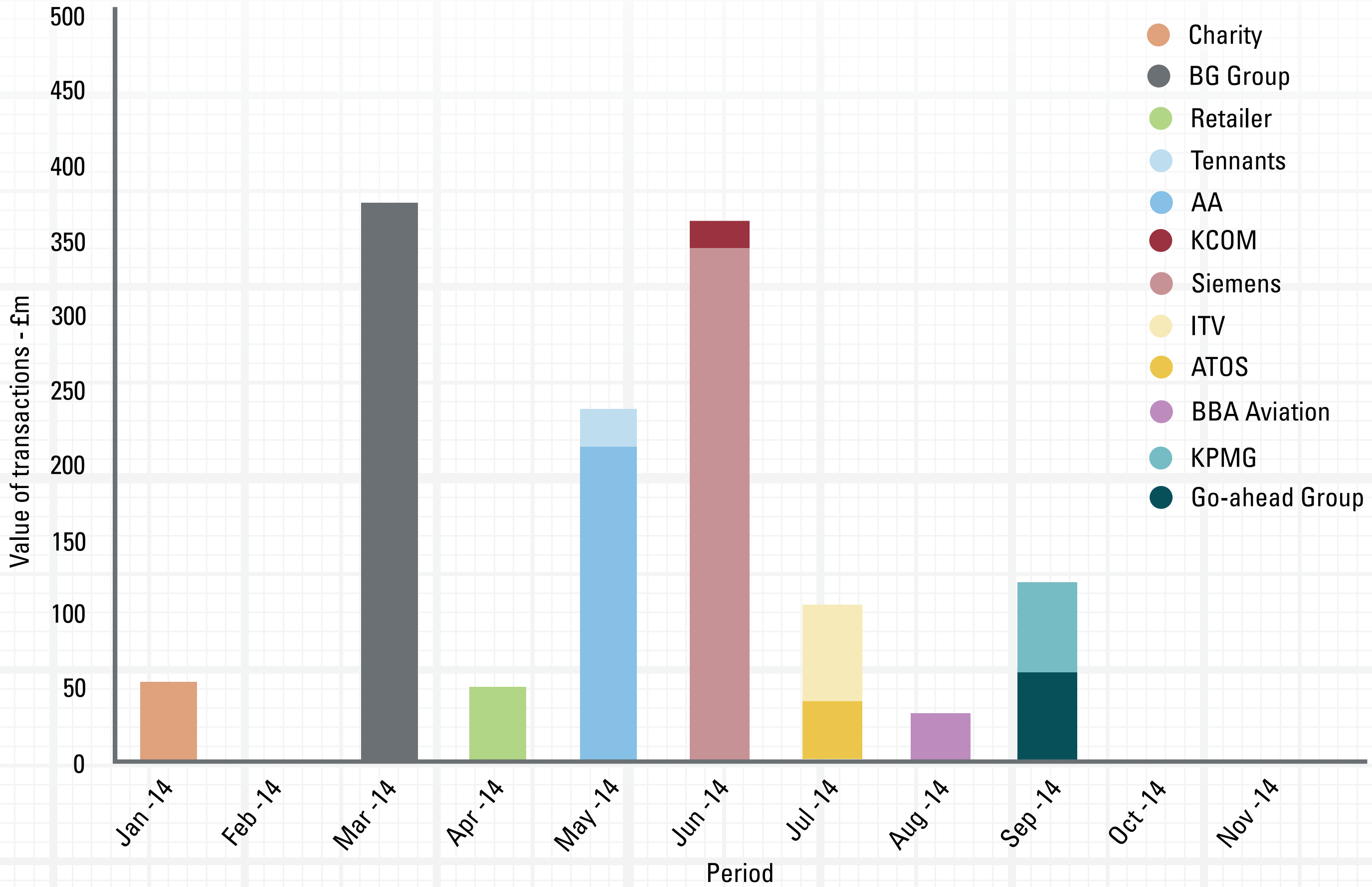
The rate of new ABCs has fallen since its 2013 peak, but we continue to see a steady stream of new implementations, as illustrated by the chart below. In particular, the total volume of transactions remains high as a result of some large ABCs announced during the year to 31 October 2014.



What has happened since our last survey?

Twelve new ABCs have been announced since we published our last survey. The chart below shows when these arrangements were publicly announced and the transaction size in each case.

Transaction sizes ranged between £16m and £350m, with the majority falling between £50m to £100m. However, there were a number of transactions in excess of £200m, while three of the ABCs implemented were valued at £25m or less, highlighting the appeal of ABCs to both small and large schemes and companies.



Why did the number of new ABCs reduce in 2014?

Although ABCs remain popular, improvements in market conditions during late 2013 and early 2014 will have reduced funding deficits, in turn easing the pressure on trustees to demand increased contributions from sponsors.

The Pensions Regulator's revised Code of Practice and regulatory policy for funding DB pension schemes, published in June 2014, will have further eased pressure on companies to fund deficits uncomfortably quickly. The Regulator's new statutory objective is to minimise any adverse impact on the sustainable growth of employers which gives more flexibility on how sponsors manage their pension deficits. The Regulator's new approach therefore supports longer deficit recovery plans for strong employers, which may reduce the need for alternative funding solutions such as ABCs going forward.

However, while stronger employers are likely to see greater acceptance of longer recovery plans, many trustees will still welcome the security offered by ABCs, particularly as the current record low level of gilt yields starts to affect future funding valuations. In addition, we are seeing ABCs increasingly used to support wider changes, such as scheme mergers or significant de-risking. For this reason, we expect demand for ABCs to remain strong.

Alternative funding solutions

Asset backed contributions are by no means the only alternative to paying cash contributions to the scheme. The use of cash escrow accounts has been common for a number of years, while in recent years we have seen increased use of alternatives such as reservoir trusts and in-specie asset transfers.

As the focus for some companies has turned more recently towards the risk of future trapped surplus, we have seen a number of examples of escrow accounts and reservoir trusts being used which provide funds to the pension schemes only if certain conditions are met. While asset-backed funding can equally offer a solution to trapped surplus risk, the use of these contingent funding vehicles perhaps reflects a desire to avoid the perceived complexity associated with implementing an ABC.

The table below highlights some of the features of these alternative forms of funding and provides examples of companies that have used them.

	Type of arrangement	Description	Considerations	Examples
Contingent	Cash escrow	» Cash, or securities, paid into an escrow account held separate to the scheme's assets » Pre-agreed triggers allow release of funds either to the scheme or back to the sponsor	» Funds in escrow are not part of scheme assets, so are easier for the sponsor to recover if a surplus arises » Funds are available to the scheme on sponsor insolvency, providing additional security » Ties up assets, as overall level of funding required may be greater than if cash was paid into the scheme	» Rentokil » National Grid » Smiths Group
	Reservoir trust	» The sponsor sets up and contributes to a trust » Pre-agreed triggers allow release of funds to the scheme or back to the sponsor (e.g. if funding level increases/decreases) » Trust may be located in the UK or overseas	» Considerations similar to that of a cash escrow account » Trust structure provides greater certainty on insolvency than an escrow account » Set up costs are higher than for traditional escrow	» BAE » Invensys » Man Group
Committed	In specie-asset transfers	» Assets such as property, bonds or shares are transferred directly to the pension scheme » Transfer is treated as contribution to the scheme	» Attracts up-front tax relief on the value of the scheme "contribution" » Relatively simple solution compared to other alternative funding arrangements » Reduces the risk of selling assets when market conditions are not favourable » In specie contributions may be subject to stamp duty » Assets are no longer owned by the Group (unlike ABC)	» HSBC » John Lewis » Costain

Who should consider alternatives to cash funding?

Cash funding remains the most common approach to tackling deficits, and will be the default option for most trustees and companies. However, the alternatives discussed in this survey can provide greater flexibility allowing companies to preserve cash that may be better used in the business or reduce the risk that cash becomes trapped in the pension scheme.

No one solution will be right for all schemes, and companies will have to weigh up the alternatives carefully depending on their circumstances. Asset backed funding continues to offer a number of advantages, including the potential to reduce up-front cash contributions, reduce deficits and Pension Protection Fund (PPF) levies, and provide an acceleration of tax relief. However, there are a number of alternatives which may offer some of the same benefits.

While the Regulator's latest guidance should ease the pressure on trustees and sponsors, there will still be a desire to ensure the security of members' benefits. The PPF's latest levy determination will also prove helpful, as it offers encouragement to sponsors and trustees looking to use ABCs to reduce their PPF levies. In view of these factors we expect that interest in alternatives to cash funding will continue to grow over the years to come.

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