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Asset-backed Contributions
The importance of trustee due diligence

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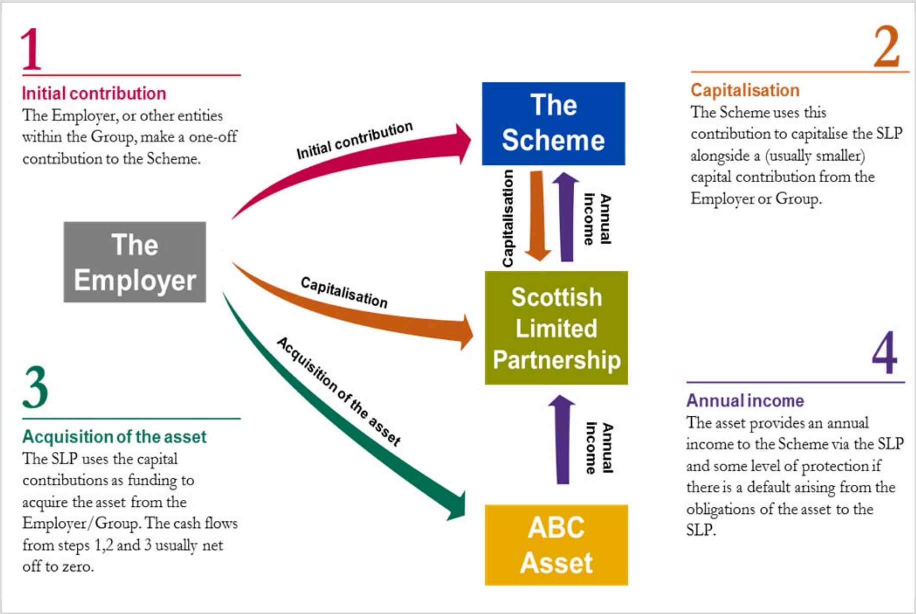
What is an ABC? Basically a contractual funding arrangement where an income stream is provided to a scheme, usually via a special purpose vehicle and is treated as an asset, thereby reducing or eliminating the scheme's deficit.

Background

After first appearing in the late 2000s, asset-backed contribution (ABC) structures have become much more widespread since the turn of the decade. Such structures broadly incorporate arrangements that securitise the assets of an employer to provide a future income stream to its related DB pension scheme.

These structures can be backed by a wide range of assets including real estate, book debts, stocks and brand rights, and generally involve the usage of a Scottish Limited Partnership (SLP) to prevent a breach of Employer Related Investment (ERI) regulations.

An example of an ABC structure



Key issues

ABC structures can be mutually beneficial to employers and schemes: they provide security to schemes that may not otherwise have been available; they can allow for reduced deficit reduction contributions (DRCs); and can further improve employer liquidity via associated tax benefits.

However, when considering proposals to implement an ABC structure, trustees need to ensure they have done their homework. They not only have to satisfy themselves that members are getting a fair deal, they also have to demonstrate to the Pensions Regulator (tPR) that they have undertaken sufficient independent due diligence to make such complex decisions in the first place.

Their investigations need to encapsulate a number of important covenant-related issues, as well as many legal, actuarial and investment considerations.

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To make such structures cost effective and cash flow efficient, they often need to be in place for many years, so the initial key questions for trustees should include:

- How does the profile of the cash paid into the scheme under the ABC structure compare to that which could otherwise have been obtained under a conventional recovery plan?

and, if it is less favourable;

- Does the security provided by the asset within the structure adequately compensate the scheme for adopting the less favourable cash flow profile?

Key work streams

All scenarios are likely to be different, but key due diligence work streams to follow up on these points may include:

- An initial feasibility study to assess if the proposed ABC structure is in the best interests of members. We have acted in numerous scenarios where the benefits of a structure have been sold by a provider to an employer, which has then presented the solution as a 'silver-bullet' to trustees. We have then been appointed late in the day to advise the trustees with both sides considering due diligence to be a mere formality, before we have uncovered fundamental flaws in the proposed arrangements. Uncovering such issues has caused unnecessary friction between trustees and corporates, and had we been appointed earlier in the process we would have been able to work with the employer's advisers to amend initial proposals to make them more suitable for the trustees
- An assessment of the impact on covenant of the employer's proposals and a concise cost benefit analysis for the trustees of entering into such arrangements
- Independently valuing the asset. It is worth noting that the degree of comfort trustees could take from an independent valuation is likely to vary significantly depending on the type of asset. For example, more comfort is likely to be taken on the valuation of an office building in a high demand location compared to the valuation of a service company's brand, particularly as the time the trustees will need to rely on the asset will be a time when the sponsor has failed
- Verifying the ability of the asset to generate scheduled payments to the scheme
- Estimating how the return to the scheme in the case of the employer's insolvency could change over time, with and without the ABC structure in place

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The key services we offer include: an initial feasibility study; a review of covenant impact; valuations advice; negotiation support in negotiations with the Group; and assistance in dealing with enquiries from the Regulator.

Key work streams (continued)

- Assessing how easy it would be to enforce the scheme's claim over the asset on a default event, and considering how enforcement would be funded
- Establishing if the value of the asset can be maintained independently of the employer being solvent (a property with alternative uses would be much more palatable than brand rights as noted above), and the costs of continuing to operate/maintain the asset (which is often an afterthought and can come as a surprise to employers)

The latter point underlines one of the reasons why tPR appears to be suspicious of ABC structures. It is only a quirk of Scottish law that allows them not to fall foul of ERI regulations, whose purpose is to ensure that covenant risk does not overly contaminate investment risk.

Improvement to covenant strength?

As set out in its 2013 Annual Funding Statement, tPR recognises that a *"strong and on-going employer alongside an appropriate funding plan is the best support for a scheme"*. The additional short-term liquidity provided to employers by ABC structures can help improve covenant strength, provided it is used to invest in the business and does not leak out to equity or other stakeholders. Trustees could consider obtaining assurances as to the employer's usage of the additional liquidity as a condition of them agreeing to ABC proposals.

The importance of trustee due diligence

ABC structures can be hugely complex and trustees will require specialist independent advice in many areas before they can consider agreeing to any employer proposals. The issues set out above can be the tip of the iceberg of what trustees will need to consider if presented with an ABC proposal. In addition, tPR will likely take a dim view if sufficient evidence has not been gathered to support the trustees' decision making to enter into this kind of arrangement. However, if a case can be made to support the assertion that the structure at least maintains (and potentially improves) the security to members' benefits, then ABCs can be viable funding options in assisting schemes and employers to meet their objectives.

Further reading:

http://www.thepensionsregulator.gov.uk/guidance/asset-backed-contributions.aspx

Case studies

Project Apple

The Group intended to dispose of a Scheme employer and to provide mitigation through the implementation of an ABC structure based upon a loan note issued by one of the Group's non-employer subsidiaries.

We undertook an initial feasibility review on the draft heads of terms provided by the Group and immediately identified a number of issues that would make it difficult for the Trustees to agree to the proposal as it stood, including the form of security on offer.

We then reviewed the impact on covenant of the ABC structure, considered the income the Scheme would receive versus its existing recovery plan and undertook a valuation of the business supporting the loan note. Following the completion of this work we assisted the Trustees in their negotiations with the Group regarding improvements to the initial terms on offer, and formulated a synthetic credit rating for the loan note issuer to assist with setting a discount rate for the Trustee to value the interest in the SLP.

Project Flight

The Group proposed implementing an ABC structure based on property as a replacement for the contributions that would otherwise have been due to the Scheme as part of a recovery plan following a triennial valuation. We were engaged to advise the Trustees on whether the Group's offer was in the interests of the Scheme's membership.

After establishing the baseline covenant strength and affordability, we carried out due diligence on the ABC structure itself, including how the rental cash flows paid to the Scheme would compare to a 'normal' recovery plan, the ability of the asset to provide income to the Scheme and its worth on a hypothetical insolvency.

Our initial conclusion was that the structure on offer was not sufficient for the Trustees to forego a 'normal' recovery plan unless certain changes to the proposal were made. We subsequently supported the Trustees in negotiating these changes and the ABC structure was implemented.

Project Partnership

The Group had proposed that an ABC structure was implemented in order to provide the Scheme with a regular income, in addition to normal deficit reduction contributions. The asset underpinning the structure was a portion of the Employer's trade debtor book, which the Scheme would be able to take control of and realise for value in certain adverse circumstances. The structure also had up-front tax benefits for the Group.

We were engaged by the Trustees to provide an assessment of the quality of the Employer's debtor book in order that they could establish whether, via a debt factoring arrangement, it was capable of providing sufficient income to the Scheme in line with the Group's proposal. We also concluded upon the likelihood of the Employer experiencing trading difficulties or failing (which would have allowed the Trustees to take control of the debtor book) and the likely issues that may be encountered in attempting to monetise balances due from the customers of a failing/failed business.

Project Silver

The Trustees initially sought advice from us on the implications of accepting an ABC partnership based on trade debtors as offered by its Employer, a firm in the professional services sector.

We reviewed the proposal and provided initial advice that, given the estimated set-up/monitoring costs and relatively small size of the deficit, the ABC structure was not economically feasible. After some discussion, the Employer felt the same way and the ABC proposal was abandoned.

The Trustees subsequently asked us to perform a review of affordability and provide support in negotiations. We established an underlying trend in performance, but also the need to maintain inter-generational fairness between partners and an incentive for succession. This resulted in a second offer which was acceptable to all parties.

Our asset-backed contributions specialists

Darren Mason

Head of Pensions & Partner

Darren has advised companies, schemes and lenders in over 100 assignments, which have included changes in covenant as the result of a transaction, clearance applications, employer covenant in SSF valuations, ABC structure reviews, contingent asset solutions, covenant monitoring and restructuring involving scheme sponsors.

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Kathryn Hiddleston

Head of Restructuring & Partner

Kathryn has specialised in dealing with restructuring underperforming businesses and insolvency for nearly 25 years. She is the chairman of the R3 tax committee and sits on various committees with HMRC to influence policy and draft legislation to aid in restructuring. Her work has included restructuring in relation to pension scheme deficits including advice in relation to Uniq, Kodak, Yell and UK Coal.

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Chris West

Director

Chris has a broad range of valuation and strategy development experience in the UK and worldwide. His experience includes valuation of listed and unlisted securities, intellectual property and intangible assets both in the UK and abroad across a variety of sectors with experience of over 40 intangible asset valuations.

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Kevin Hollister

Associate Director

Kevin is an actuary with 15 years' experience of advising employers and trustees on de-risking DB schemes. He has undertaken asset liability modelling exercises to identify and quantify individual risks in schemes and advised on the most cost-effective solutions to mitigate them.

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Jon Wolff

Associate Director

Jon advises trustees on covenant issues ahead of triennial valuations for SSF purposes, assessing changes to employer covenant following corporate transactions and advising on clearance applications. He has worked on numerous ABC cases both for trustee clients and whilst on secondment at tPR.

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