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Pension Scheme Valuations Challenges and Opportunities in 2015
Dealing with a deficit & exploring alternative funding options

The issue

For many UK Defined Benefit pension schemes, an increased deficit will be an unavoidable outcome of a 2015 funding valuation. In turn, this will inevitably lead to a request from the pension scheme trustees (the "Trustees") to the sponsoring employer of the scheme (the "Employer") for additional deficit reduction contributions.

In such circumstances, whilst any deficit will ultimately need to be met by the Employer, the key objectives and/or priorities of the corporate may not align with making additional cash injections into the scheme. In addition, the corporate may be concerned about potentially overfunding a scheme if market conditions improve. So, how can companies deal with an increased deficit in an efficient and effective way?

Introduction

In our paper "Pension Scheme Valuations - Challenges and Opportunities in 2015" we highlighted the impact of falling long term gilt yields on pension scheme valuations and five actions companies could consider for their defined benefit pension schemes. In this paper we consider the third possible action: dealing with a deficit & exploring alternative funding options.

Background

Whilst a lot can be done in advance of a funding valuation (as we considered in our earlier paper in this series[1]), even with detailed preparation, a proactive approach and strong Employer-Trustee relationships, many corporates will still face significant deficits that will need to be addressed.

To deal with the deficit, the Employer can consider and discuss a number of options with the Trustees that can be broadly categorised into the following key areas:

Figure 1. key areas to consider when dealing with a deficit

1. The assumptions used to value the liabilities
2. The length and shape of the recovery plan
3. The use of contingent assets
4. Alternative funding solutions
5. Benefit changes and other solutions

Dealing with a deficit

If the initial results of the Trustees' funding valuation show a material increase in the deficit, the corporate will need to consider the magnitude of the increased deficit and the Trustees' proposals for additional deficit reduction contributions.

Where the Trustees' proposals for additional deficit reduction contributions are: (i) unaffordable to the Employer, (ii) would negatively impact the Employer's corporate strategy and/or (iii) could risk "overfunding" the scheme going forwards, the Employer should ensure it is using the full range of options and alternative funding solutions available, to deal with the deficit as efficiently and effectively as possible. Below we consider the range of available options and when these may be most attractive/suitable.

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Historically, Trustees have been guided by the Pensions Regulator that deficits should be eliminated "as quickly as the employer can reasonably afford".

In its updated Code of Practice for funding, the Pensions Regulator has revised its guidance to reflect the importance of Trustees and Employers working collaboratively and to recognise there is often a need to invest in businesses to achieve sustainable growth.

As a result, for 2015 funding valuations, we expect Trustees to be more open to exploring alternative options to short-term cash injections.

Figure 2: Options to deal with a deficit

Options to deal with a deficit			When might the option be suitable?											
			Trustees adopted overly prudent assumptions	Strong Employer	Strong parent/group	Not paying dividends / cash out from employer	Short-term cash restraints	Under utilised corporate assets	High or Medium Risk Investment strategy	Medium or Low Risk Investment strategy	Concern over overfunding	Paying discretionary benefits	Scheme open to future benefit accrual	Recovery Plan driving Employer towards insolvency
1.	The assumptions used to value the liabilities	Negotiate the level of prudence in valuation assumptions	✓				✓							
		Increase risk in investment strategy		✓			✓			✓				
		Grant additional security (e.g. parent company guarantees)			✓		✓	✓						
		Improving insolvency rank					✓							
		Negative pledges				✓	✓							
2.	The length and shape of the recovery plan	Inflation link payments					✓							
		Lengthen contribution period		✓			✓							
		Allow for asset out performance	✓	✓			✓		✓					
3.	The use of contingent assets	Contingent contributions					✓				✓			
		Contingent assets					✓	✓			✓			
		Escrow accounts									✓			
		Bank guarantees					✓				✓			
4.	Alternative funding solutions	Asset Backed Contributions					✓	✓			✓			
		Reservoir trusts									✓			
5.	Benefit changes and other solutions	Close to future benefit accrual					✓						✓	
		Reduce / stop discretionary benefits					✓					✓		
		Bespoke alternative corporate solutions					✓							✓

In the following sections of this paper we explore each of these 5 key areas and the options underlying these areas which the Employer could consider.

Many of these options can be considered together as part of an integrated proposal. The likelihood of the Trustees agreeing to any particular requests will depend on the specifics of the overall proposal. For example, the Trustees may agree to use slightly weaker assumptions (resulting in a smaller deficit) or a longer recovery plan, if the Employer is investing profits back into the business for sustainable growth rather than paying out significant dividends. Conversely, if the corporate proposes increasing the risk in investment strategy, the Trustees will usually expect the Employer to quickly reduce any deficit caused by poor investment returns.

Ultimately the Trustees are likely to accept a proposal that they view as striking an appropriate balance between: quickly improving the funding position of the scheme, improving the security of the member's benefits and allowing the Employer to continue to grow its business.

1. The assumptions used to value the liabilities

UK legislation usually requires that the assumptions used to calculate the "Technical Provisions" (the assessed value of the schemes liabilities for funding purposes) are agreed by the Employer and the Trustees. The Trustees are required to set their assumptions prudently, based on market conditions at the valuation date and having regard to the scheme's Investment Strategy and the Employer Covenant.

Investment Strategy
A scheme's Investment Strategy is the set of principles that guides how the assets are invested. In particular, it will specify the asset allocation across the major asset classes (e.g. equities, bonds, property etc.)

Employer Covenant
The Pensions Regulator defines the Employer Covenant as the sponsoring employer's "legal obligation and financial ability to support their defined benefit scheme now and in the future".

In agreeing the assumptions, the corporate could consider the following options:

- **Negotiate the level of prudence in the valuation assumptions:** The strength of the Employer Covenant typically determines the level of prudence in the assumptions. Often the Trustees focus on setting each assumption prudently, rather than the overall level of prudence in the Technical Provisions. Considering the liability on a best-estimate (i.e. neutral) set of assumptions can show just how much prudence there is in the Technical Provisions as a monetary value. Often this is a very material number and a significant proportion of the deficit. The corporate, with the help of its pension advisors, can review the funding assumptions and negotiate with the Trustees to agree a mutually acceptable level of prudence in the valuation assumptions, which appropriately reflects the Employer Covenant.

- **Increase the risk in the Investment Strategy:** The Technical Provisions (and therefore deficit) is most sensitive to changes in the discount rate assumptions (i.e. the investment return assumptions). The discount rate assumptions are determined by the Scheme Actuary having regard to the Trustees' investment advisors' view on the likely return on each class of asset and the Investment Strategy as well as the Employer Covenant. If the scheme is invested in a high proportion of return-seeking assets such as equities, a higher discount rate could be justified than if the scheme was mainly invested in less risky asset classes such as government bonds.

  The corporate could consider requesting the Trustees review the Investment Strategy with a view to raising the proportion of return-seeking assets and therefore increasing the discount rate which will, in turn, reduce the deficit. For all schemes, the Trustees have the power to set the Investment Strategy and they may not be willing to increase the risk within the Investment Strategy. In addition, if a higher risk Investment Strategy cannot be supported by the Employer Covenant, this approach could just result in the Trustees adopting a higher degree of prudence in the discount rate. Hence this option is typically most appropriate where the Employer Covenant is strong and the Employer is happy to accept the potential downside as well as the upside risk associated with a higher risk Investment Strategy.

The corporate could also consider the following options to improve the Employer Covenant available to the scheme, which could support the Trustees adopting less prudent assumptions, resulting in a lower deficit.

- **Grant Additional Security (e.g. Parent Company Guarantees):** If the Employer has a parent company with a strong covenant or there is another group entity with a strong covenant, the parent or other group entity can grant a guarantee to the scheme. This gives the Trustees access to the assets of the parent company/other group entity in the event of the employer's insolvency, thereby improving the security of the scheme.

Parent Company Guarantees
A Parent Company Guarantee is where a parent company grants a guarantee to a pension scheme that it will meet some or all of the sponsoring employer's financial responsibilities (as set out in the terms of the guarantee e.g. up to £100m or the cost to buy out the scheme with an insurer) in the event that the Employer is unable to meet its financial responsibilities to the scheme.

Similarly, if the corporate has free assets that are not used to secure debt, the corporate could grant the Trustees a charge over the asset in the event of insolvency, which again improves the security of the scheme. We consider using contingent assets further in section 3.

Providing a Parent Company Guarantee or alternative security to the scheme could strengthen the Employer Covenant, but it could also impact the recovery for debt holders in the event of insolvency. Therefore, the corporate will need to consider the impact on the pension deficit alongside the potential implications on the cost of debt.

- **Improving Insolvency Rank:** Typically pension liabilities are unsecured and non-preferential i.e. they will rank lower than other secured obligations of the Employer in the event of insolvency. If permissible under existing debt arrangements, the Employer could give increased priority to pension liabilities to enhance the Employer Covenant, for example, by giving the scheme pari passu (equal) ranking with secured or unsecured debt. Again, the potential implications on the cost of debt will need to be considered in parallel.

- **Negative Pledges:** Under a negative pledge, the Employer makes a commitment not to do something, such as not to pay out dividends or take out additional debt which ranks ahead of the pension scheme without agreement of the Trustees (usually over a set period of time). This gives the Trustees the assurance that they will have access to any excess cash that the business generates and will allow them to place greater reliance on the Employer Covenant when setting the valuation assumptions and/or agreeing the Recovery Plan.

2. The length and shape of the recovery plan

Once the funding position of a scheme is agreed, the next step is to agree the Recovery Plan necessary to fund any resulting deficit. Some of the key options regarding the profile of the Recovery Plan are as follows:

- **Inflation link payments:** The Employer could seek to link the annual deficit reduction contributions to a measure of inflation, for example the Retail Prices Index. There is a clear economic rationale to this approach and the impact of linking contributions to inflation can harness the power of compound interest and help to keep short term contributions (e.g. for the period to the next valuation) relatively unchanged even in the face of an increased deficit.

Recovery Plan
Where a funding valuation results in a deficit, the Trustees are usually required to agree a Recovery Plan with the Employer. The Recovery Plan should set out how the deficit will be met and in particular, specify length and shape of the payments.

- **Lengthen contribution period:** If the Employer has short term cash constraints, alternative uses for cash (e.g. investment in the business) or is concerned about overfunding, the Employer could seek to increase the period of time over which the contributions are to be paid into the scheme. However the ability of the Employer to agree this with the Trustees will depend on the strength of the Employer Covenant, the long-term sustainability of the Employer and the risk inherent in the Investment Strategy.

- **Allow for asset out performance:** The Employer could also seek to take into account any expected asset out performance (i.e. over and above that assumed in the discount rate assumptions). Depending on the Investment Strategy, there could be potential for assets to produce a return greater than the discount rate assumptions, which have been set prudently. The Trustees may be more willing to reflect this additional return where there are contingency plans if these higher returns are not achieved (see section 3).

Example of allowing for asset out performance
If the scheme has £100m of liabilities (Technical Provisions) and a discount rate assumption of 4% p.a., the expected interest on the liabilities in Year 1 is c. £4m.

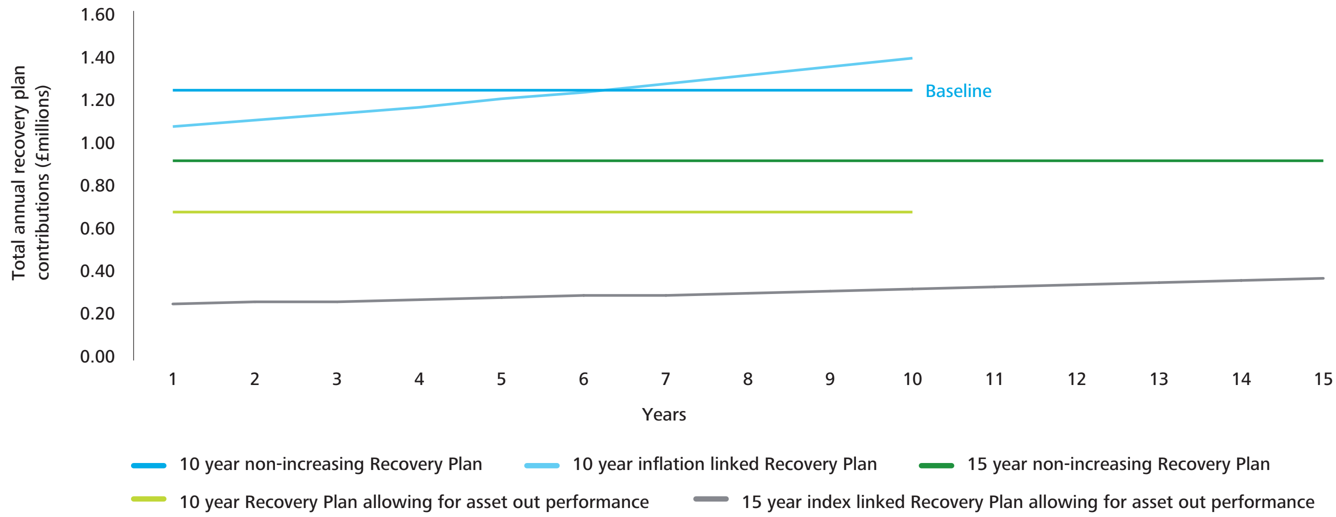
If the scheme has assets of £90m (a £10m deficit) and the expected return on assets (best-estimate assumption) is 5% p.a., the expected return on assets in Year 1 is c. £4.5m.

At the end of Year 1 (ignoring cash flows for simplicity) we expect the deficit to be £9.5m (£104m of liabilities and £94.5m of assets) i.e. £0.5m of the deficit has been met via asset out performance.

As a result, allowing for some or all of the "best estimate" out performance when setting the Recovery Plan leads to reduced employer deficit reduction contributions. However, if the assets fail to meet the higher return assumption, the deficit will not reduce and additional employer deficit reduction contributions will be required at the next funding valuation.

The graph below illustrates the financial impact of the options listed above assuming a baseline Recovery Plan to remove a £10m deficit over a 10 year period.

Figure 3. Illustrative Recovery Plan profiles



Assumptions
Scheme has a £10m deficit (£100m of Liabilities, £90m of assets), Discount rate = 4.0% p.a., RPI inflation = 3.0% p.a., asset outperformance = 0.5% p.a. above the discount rate

In this illustration:

- inflation-linking the Recovery Plan reduces the Year 1 contributions by c. 10% from the baseline Recovery Plan;
- extending the recovery period by 5 years reduces the Year 1 contributions by c. 25% from the baseline Recovery Plan; and
- allowing for 0.5% p.a. asset out performance reduces the Year 1 contributions by c. 45% from the baseline Recovery Plan.

If, for illustration, it were possible to agree all of the above (i.e. a 15 year, inflation linked Recovery Plan that allows for asset out performance) the Year 1 contributions would reduce by c. 80% from the baseline Recovery Plan. However, in our experience, it would be unusual to agree all of these options together unless the Employer Covenant was strong, there were very good reasons for not quickly paying down the deficit (e.g. using the cash to invest in the Employer) and/or there were contingency plans in place.

3. The use of contingent assets

Contingent assets provide additional funds to the pension scheme in specified circumstances, e.g. Employer insolvency. They typically take the form of charges over assets, escrow accounts, reservoir trusts and bank guarantees etc. Whilst they do not directly "fund" a deficit, the additional security provided by these arrangements may enable trustees to agree less prudence in the funding assumptions (as discussed in section 1) and/or allow greater flexibility in the length and shape of the Recovery Plan (as discussed in section 2). Some of the options include:

- **Contingent contributions:** The Employer or another group entity could arrange to make additional cash contributions to the pension scheme contingent on certain events. For example, the contributions could be linked to profitability or free cash flow. This would allow the Employer to make contributions when they are affordable and therefore prevent the Employer from overcommitting in the short term. Alternatively, the contributions could be contingent on events that cause the Employer Covenant to deteriorate. For example, the contributions could be linked to dividend payments or be required if the Employer takes on additional debt, or disposes of part of its business. Whilst companies generally do not like restricting corporate activity in this manner, these restrictions may be preferable to the higher deficit reduction contributions otherwise required.

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Using contingents assets can:

- be more cashflow-efficient for the employer;
- provide protection against the risk of overfunding schemes; and
- in some cases can reduce levies to the Pension Protection Fund.

- **Contingent assets:** Similarly to contingent contributions, the corporate could agree to transfer non-cash assets to the scheme in certain circumstances or events. Potential assets include: property, stock as well as other intangible assets such as patents or brands.

Figure 4: Examples of potential Contingent Assets

Tangible Assets	Corporate Assets	Intangible Assets
Property Plant & Machinery	Cash, currencies and financial instruments	Copyrights, trademarks and patents
Stock	Receivables	Brands
Software	Loans	Other Contracts
Art collections	Subsidiaries	
	Other Investments (e.g. Joint Ventures)	

- **Escrow accounts:** An escrow account is usually a cash account held at a bank in the name of the corporate, but that the corporate cannot draw upon, unless agreement is reached with the Trustees. In the event certain conditions are met (for example, the scheme is not fully funded in 5 years, or the sponsor becomes insolvent) the funds are transferred to the scheme.

- **Bank guarantees:** This is effectively a form of insurance whereby a bank guarantees to pay up to a pre-agreed maximum (e.g. the buy-out deficit or set amount) into the scheme in the event the Employer fails to meet its obligations to the scheme. A bank guarantee will typically be appropriate where there is concern as to the Employer being able to make deficit reduction contributions or fund the deficit. However, these can be expensive to implement, difficult to renew and usually they have a negative impact on the corporates' ability to borrow.

4. Alternative funding solutions

Alternative funding solutions, whilst more complex than cash, can allow corporate assets to be used to provide upfront pension funding, whilst preserving cash and allowing the corporate to maintain day-to-day operational control of these assets.

- **Asset Backed Contributions ("ABC"):** ABCs typically work by the Employer and the pension scheme establishing a Scottish Limited Partnership ("SLP") into which group assets (e.g. property, brand, loan notes, receivables, stock) are transferred. These assets will be leased or licensed back to the company, to generate an income stream to provide annual cash distributions to the pension scheme.

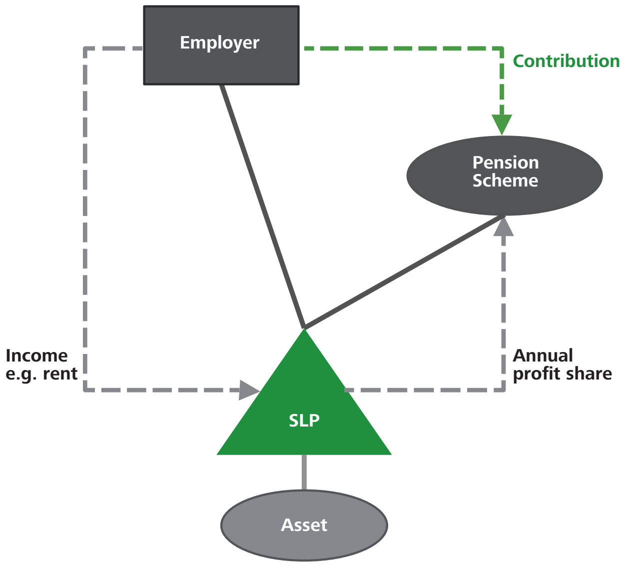
  The pension scheme holds an interest in the partnership of an agreed nominal value, which typically delivers an annual profit share to the pension scheme (e.g. fixed annual payments over a 15 to 25 year period) and is collateralised by assets which have value independent of the corporate and are ring-fenced for the benefit of the scheme.

  ABCs can provide a means of immediately funding a significant proportion of a pension deficit, whilst conserving short-term corporate cashflow. In addition, upfront tax relief may be available if certain conditions are met (noting that corporation tax rates are due to fall over the next few years).

  Further, the future financial position of pension schemes is highly uncertain, especially given the current low yield environment. One risk faced by Employers is that they will pay excessive contributions into the scheme in the short term, only to find the scheme becomes overfunded in future due to better than expected investment returns or lower than assumed longevity or inflation experience. ABCs can be designed to protect against this overfunding risk by linking payments to the funding position of the scheme.

  The diagram below sets out the basic structure. Depending on the assets used and the overall objectives of the corporate, changes can be made to the structure to create bespoke solutions.

Figure 5: An illustrative ABC



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Whilst there was a decline in the number of ABCs implemented in 2014, we expect there to be renewed activity in this area, as large deficits re-emerge and overfunding becomes a key concern.

ABCs have historically been limited to some of the largest pension schemes, but we have seen a significant trend towards lower cost implementation and smaller schemes using these to fund deficits.

For schemes with a £10m or larger deficit ABCs are now viable funding solutions.

Why use an ABC?	
Cash preservation	Cash efficient for the company, as ABCs enable cashflows to be spread over a longer period than a typical recovery plan
Immediate deficit reduction	ABCs enable an immediate and often significant improvement to the cash funding position
Tax relief	An upfront tax deduction may be available if certain conditions on the implementation of structures are met
Overfunding Protection	ABCs can be designed to reduce the risk of paying too much cash into the scheme
Security of member benefits	Scheme trustees gain access to a valuable corporate asset, with a value independent of the Employer's circumstance
PPF levy	The recognition of the structure as a pension scheme asset can result in reduced PPF levies
Control	The Employer still maintains operational control of the underlying corporate assets
Facilitates wider objectives	The improved funding position achieved by ABCs can facilitate de-risking and investment discussions with the trustees, in addition to scheme mergers

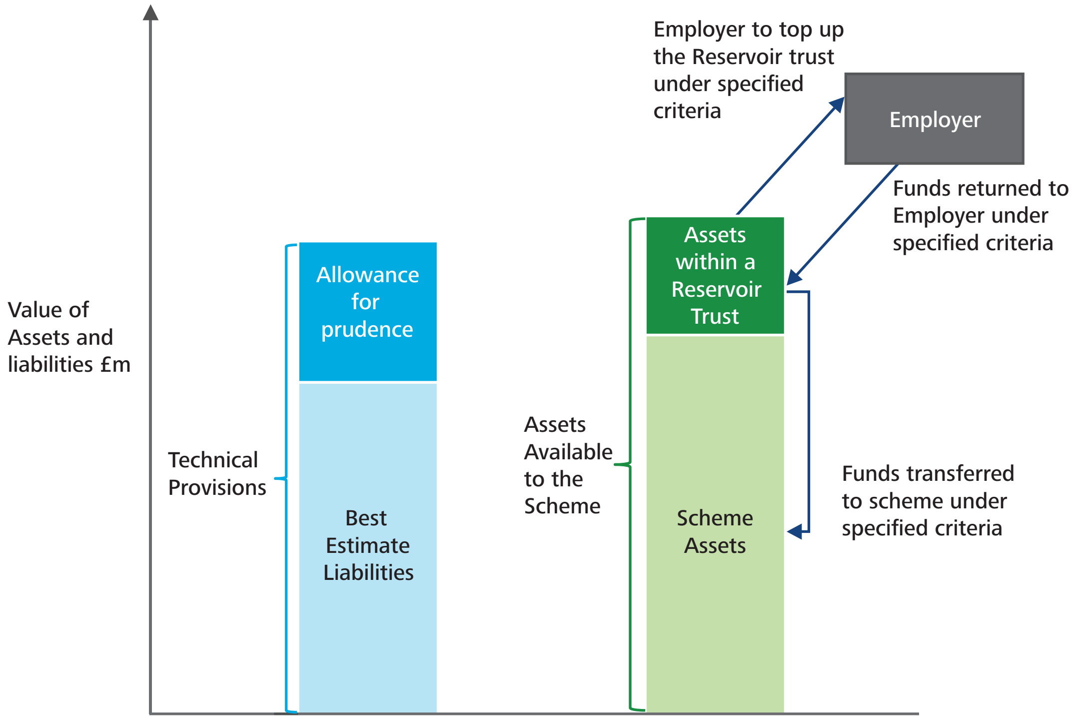
For schemes with a smaller deficit or where no suitable assets exist, Employers could explore other alternative funding options that offer the Trustees similar levels of security to an ABC or Escrow Account, and that offer corporates similar protections against overfunding to an ABC, but without the cost of the low returns of cash in an Escrow account.

- **Reservoir trusts:** Where a corporate is concerned about overfunding and the risk of trapped surplus, it is possible to establish a "Reservoir Trust" to hold a reserve fund for scheme in the event the scheme's assets are insufficient to meet the scheme's liabilities, but where any excess funds can be returned to the Employer.

  Reservoir Trusts are effectively a modern take on escrow accounts. However, the key difference is that the monies invested in the trust can typically be invested more flexibly (e.g. in equities and bonds) and achieve higher returns than assets being held in a cash account.

Below we show an example of how a Reservoir Trust works:

Figure 6: Illustrative example of a Reservoir trust



The conditions in which funds are transferred to the scheme can be specified by the Trustees and Employer in the Reservoir Trust's governing documentation (e.g. if the Best Estimate Liabilities are greater than 90% of the Scheme Assets or in the event of the Employer's insolvency). Similarly, the conditions in which funds are returned to the Employer can be specified (e.g. if the Reservoir Trust plus Scheme Assets are greater than 110% of Technical Provisions).

An additional agreement can be reached in the Recovery Plan for Employer to fund the Reservoir Trust, or top it up in certain conditions (e.g. the Technical Provisions are greater than 90% of the Reservoir Trust plus Scheme Assets).

5. Benefit changes and other solutions

Whilst we would expect the majority of Employers to deal with a deficit using the 4 key areas we have already outlined in this paper, there are some other options which can be appropriate to consider:

- **Closure to future benefit accrual:** Where the scheme is open to future benefit accrual, the Employer could consider closing the scheme to accrual and providing future benefits in a new (usually defined contribution) pension scheme. This will cease the future build up of benefits within the scheme and in addition, if the salary link can be severed, the funding reserve held for future salary increases (i.e. increases above the increase entitlement to members with a deferred pensions) on benefits already accrued can be released, resulting in a one-off improvement in the funding level.

- **Reduce / stop discretionary benefits:** Where the Trustees or Employer have been granting discretionary increases (for example: discretionary pension increases or allowing members to retire early without reduction) these will either be funded for as they are granted or a funding reserve (i.e. an additional liability) will be held in the expectation they will continue to be granted.

  The Employer could engage with the Trustees to explore whether it would be possible to cease granting these discretionary benefits. If the Employer has been funding for these increases (i.e. a reserve is held in the Technical Provisions), stopping such increases would improve the funding position of the scheme as the reserve is released and the Technical Provisions are reduced. In turn, this would reduce the deficit contributions that the Employer is required to pay into the scheme.

  However, if the discretionary benefits have been granted for a number of years, there may be an expectation of the scheme members to continue to receive these benefits. Removing these benefits could result in negative reaction from the employees and the unions. The potential legal implications of any custom and/or practice in this area would need to be explored.

- **Bespoke alternative corporate solutions:** In very rare occasions, where the corporate has used all of its options to deal with a deficit, the deficit remains unaffordable and it is pushing an otherwise viable business towards insolvency, the corporate can consider bespoke alternative corporate solutions

  In such circumstances, insolvency is not always the best outcome for the stakeholders (including the Pensions Regulator and the Pension Protection Fund) and the corporate can work with their advisors to see if alternative bespoke solutions can be found.

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By bringing its full range of pensions, actuarial, investment, covenant, M&A, insolvency, audit and tax specialist together, Deloitte has become a market leader in developing some of the most creative bespoke alternative solutions that maximises value for companies, share holders, employees, pension scheme members and other stakeholders.

Contact us

Deloitte has an extensive network of professionals working in an integrated way to bring cutting edge pensions advice and solutions to our clients. If you would like to speak to us about any of the opportunities raised in this series of papers or in preparing for a valuation please feel free to make contact with us using the details below or directly through your usual Deloitte contact.

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Designed and produced by The Creative Studio at Deloitte, London. J1060