Plugging the hole: the ABF solution

James Burdett, Jonathan Sharp and Jon Unger look at how an asset-backed funding structure can help fill the pension deficit gap

Some employers are finding that increasing pension deficits are putting greater pressure on their available cash. There are various options open to employers in this situation, and one of these is the asset-backed funding structure ("ABF").

Basic Structure of an ABF

An ABF involves the employer placing an asset in a special purpose vehicle. Historically the asset of choice was real estate (owned and occupied by the employer), but this has developed so that we have seen sponsors making use of a variety of different assets on their balance sheets. These range from intellectual property (e.g. brands), cheese and whisky (2.5 million barrels of it) through to purely financial assets created for the purposes (e.g. loan notes).

In a typical ABF arrangement, the sponsor transfers an income-producing asset into a partnership structure, usually a Scottish limited partnership ("SLP"). A SLP has particular legal characteristics which make it possible for a pension scheme to invest in it without falling foul of the UK pension legislation limiting the amount of investment into employer-related assets that can be made by a pension scheme (the SLP is not deemed an "employer-related asset").

The structure is implemented by the employer making a contribution to the pension scheme, which the pension scheme uses to invest in the SLP. The SLP in turn uses the cash to acquire an asset (e.g. real estate, brands) from the employer the use of which is leased back to the employer for a guaranteed income stream. The SLP thereby ring-fences the asset from the employer providing additional security for the scheme in the event of the employer's insolvency. The employer benefits from being able to continue to use the asset, but the value of the trustee's investment (usually based on the capitalised value of the expected income stream) is recorded as an asset of the scheme, thus reducing the scheme deficit. The income to the scheme agreed under the ABF effectively replaces all or part of the deficit repair contributions which the employer would otherwise have to make under a recovery plan.

Suitability of ABFs

ABF's durability in the market is testament to the benefits that these schemes can offer both employers and trustees. However, before proposing an ABF arrangement to trustees, employers should consider if other options are more suitable, such as guarantees, granting security or escrow arrangements. One key factor for employers will be whether there is a suitable asset either in existence or that could be created.

Particular benefits of an ABF include:

1. The employer's ability to retain cash in the business, strengthening its long term position.
2. The scheme benefits from an immediate improvement in its funding position, which reduces the annual cash contributions required and reduces the PPF levy.
3. The structure can be tailored to meet particular pension payment profiles and the payments can be stopped if the deficit is eliminated, thus preventing the risk of trapped surplus.
4. The employer can benefit from an acceleration of tax relief as a deduction can normally be claimed on the contribution paid to allow the scheme to acquire the asset through the SLP. The tax landscape is much more complex following the 2012 changes to rules on pension deductions and the 2014 introduction of transfer of income stream rules through partnerships, so specific advice is needed on this area.

The Pensions Regulator issued guidance on asset backed contributions in November 2013, which recognises that ABFs can be beneficial for pension schemes in certain circumstances. The key requirement under the guidance is that a separate 'underpin' agreement is executed to ensure that equivalent pension contributions continue in the event that the ABF arrangement is found to be legally invalid or should be "unwound" (for example, this could be relevant in the event of Scottish independence).

Legal advice is needed from several different areas, including pensions, corporate (advising on the SLP terms), and others depending on the asset involved (e.g. real estate or IP), along with tax advice. Specialist advice will also be needed to value the particular asset and determine the terms for the flow of cash from the ABF to the pension scheme.

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