A new role for alternative financing

Paul McGlone explores how to manage the balance between security and overpayment through the use of an Escrow

At Aon Hewitt's recent pension conferences, the trustees present indicated just how much they wanted their schemes' members to get their benefits in full. However, they also showed how little they wanted to be asked for additional contributions once they had reached 'full funding'. Both reactions show that sponsors and trustees want a fully funded scheme to have a low chance of becoming underfunded again. How can this be achieved?

Conventional wisdom would suggest including a buffer in the funding level. Adding a buffer to the funding target means the assets are more likely to be sufficient without recourse to additional contributions. Unfortunately, that has one substantial downside – it is highly likely that the company has allocated more money than the scheme really needs.

An asset and liability model illustrates this easily. For a scheme fully funded on a gilts + 0.5% pa basis and running a gilts + 0.5% pa target portfolio, there is around 50% chance that the scheme will become underfunded.

Adding a 5% buffer reduces the chance of underfunding to less than 10%. But that means that in 90% of cases the scheme is overfunded – ie the company has tied up capital unnecessarily.

Resolving competing demands

This tension between security and overpaying will become increasingly real as funding improves. For many years, schemes have been well underfunded, and contributions in the short term were unlikely to leave the scheme overfunded. As funding positions improve, that becomes more likely.

Some degree of overpayment will be acceptable in the interests of prudence and security. But beyond a certain point we should expect sponsors to push back. That leaves us with a challenge: how do we balance the desire for security with the desire to not overpay.

Learning from insurance reserving

Insurance companies balance a similar tension between security and shareholder returns on an ongoing basis. The insurer sets aside additional money as reserves, the size of which is governed by the UK solvency regime.

Long-term, the insurance company expects to get back that reserve – and some of the core premium too – in order to make money for shareholders. Short-term, it is required to keep the reserve topped up to the necessary level. In a normal year, the insurer will expect to draw down some of the reserves, as benefits are paid out and the size/risks of the remaining policy reduce. In a good year it will be able to draw down more. In a bad year it will be able to draw down less, or possibly have to top up the reserves.

Pension schemes cannot be run in exactly this way - once assets are in the scheme they can only be taken out in very restricted circumstances and even then a 35% tax charge applies. However, by using assets outside of the pension scheme, but which are in some way 'pledged' to it and its beneficiaries, that difficulty can be overcome.

Escrow as a possible buffer

A buffer can be created outside of the pension scheme in several ways. One approach, viable even for the smallest schemes, is to use an Escrow. Here assets are set aside by the company and held by a third party, then released to the scheme or company based on pre-determined rules.

Contributions in an Escrow only receive tax relief when (if) the assets move into the scheme. Similarly, they do not get tax relief on returns. But the big advantage for the company is that the assets will be returned to them if they turn out not to be required, without a 35% tax charge and potentially sooner than would otherwise be the case.

A new lease of life?

This type of arrangement has been shown to be very attractive in the right circumstances to both trustees and sponsors. While Escrow has been highlighted here, other types of asset could equally be used, depending on the company's circumstances.

In terms of timing, as assets in the scheme reach a level that is realistically required to fund benefits (perhaps 100% funded on a neutral estimate), anything put into Escrow has a good chance of being returned to the sponsor in due course. As funding levels improve, more and more schemes are reaching those levels, and should be considering Escrows and other forms of alternative financing solutions.

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