



cutting through complexity

TAX

Asset-backed Funding for Pensions

KPMG Survey 2011

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Contents

1. Highlights	1
2. What is an asset-backed funding structure?	2
3. What are the benefits for companies?	3
4. What are the benefits for trustees?	5
5. What is HMRC's view on asset-backed funding?	7
6. What has happened in the market?	8
7. Appendices	
Appendix 1	15
Appendix 2	19
Appendix 3	21

An underwater photograph showing a diver in the foreground, swimming towards the right. The water is clear blue, and there are large, dark coral structures in the background. Sunlight filters through the water from the top right, creating a bright, shimmering effect. The overall scene is serene and captures the beauty of marine life.

Asset-backed funding for pensions KPMG's 2011 Survey

Highlights

This is the second edition of our asset-backed funding survey. In this edition we look at how the market has developed over the year and how these structures are being used within the pensions industry.

- £5bn of asset-backed contributions have been made to pension schemes over the last 2 years
- There has been an increasing variety of assets used, including property, brands and receivables
- Asset-backed funding is no longer the preserve of very large companies or schemes, with a number of smaller contributions being made in this way
- The average period of these structures continues to increase with 15 to 20 year payment plans becoming standard
- Companies are taking advantage of structures already in place, with Sainsbury's and ITV making further asset-backed contributions over the past year

The number of asset-backed funding structures have continued to increase. These structures are now firmly established as part of the pension landscape as they are a cost effective way to finance the pension scheme even for smaller companies.

HMRC has been carrying out a consultation on the tax treatment on what they call "asset-backed contributions". This should provide increased certainty over the tax implications without impacting on the attractiveness of these structures. As a result we expect they will continue to flourish.

What is an asset-backed funding structure?

An asset-backed funding structure involves a sponsoring employer using business assets to generate cash which is then paid to the pension scheme.

This is achieved by transferring the assets into a separate entity such as a Special Purpose Vehicle (SPV) or a partnership. Typically the assets used will generate income such as rent or royalties although this is not essential and we have seen companies making use of other assets such as brands or income receivables. The vehicle then uses the assets to deliver payments to the scheme, which could be a regular income stream and/or lump sums. Typically the entity will be bankruptcy-remote from the sponsoring employer, providing the trustees with additional security if the employer becomes insolvent.

There are of course other solutions to funding pension deficits. For example we continue to see businesses making in-specie contributions directly to their pension scheme as an alternative to selling assets in the market to raise cash to meet the deficit - for example, Philips "contributing" its stake in semiconductor business NXP in September 2010 and Costain passing across a portfolio of PFI holdings in November 2010.

We have not covered these alternative solutions in this survey.

How easy are they to set up?

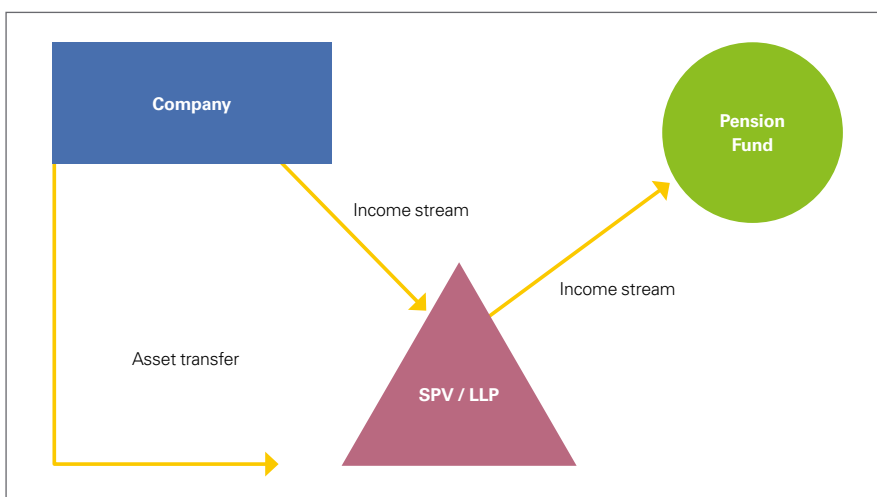
The potential benefits are significant but companies should appreciate that implementation can be complex and lengthy, with a range of technical expertise needed. Once suitable assets have been identified, several technical issues will need to be dealt with:

- Valuation
- Taxation
- Accounting
- Legal

Crucially, the trustees will need to be convinced that what they are receiving is a reasonable replacement for any cash contribution alternative. The trustees will need to consider how the structure integrates with their investment strategy.

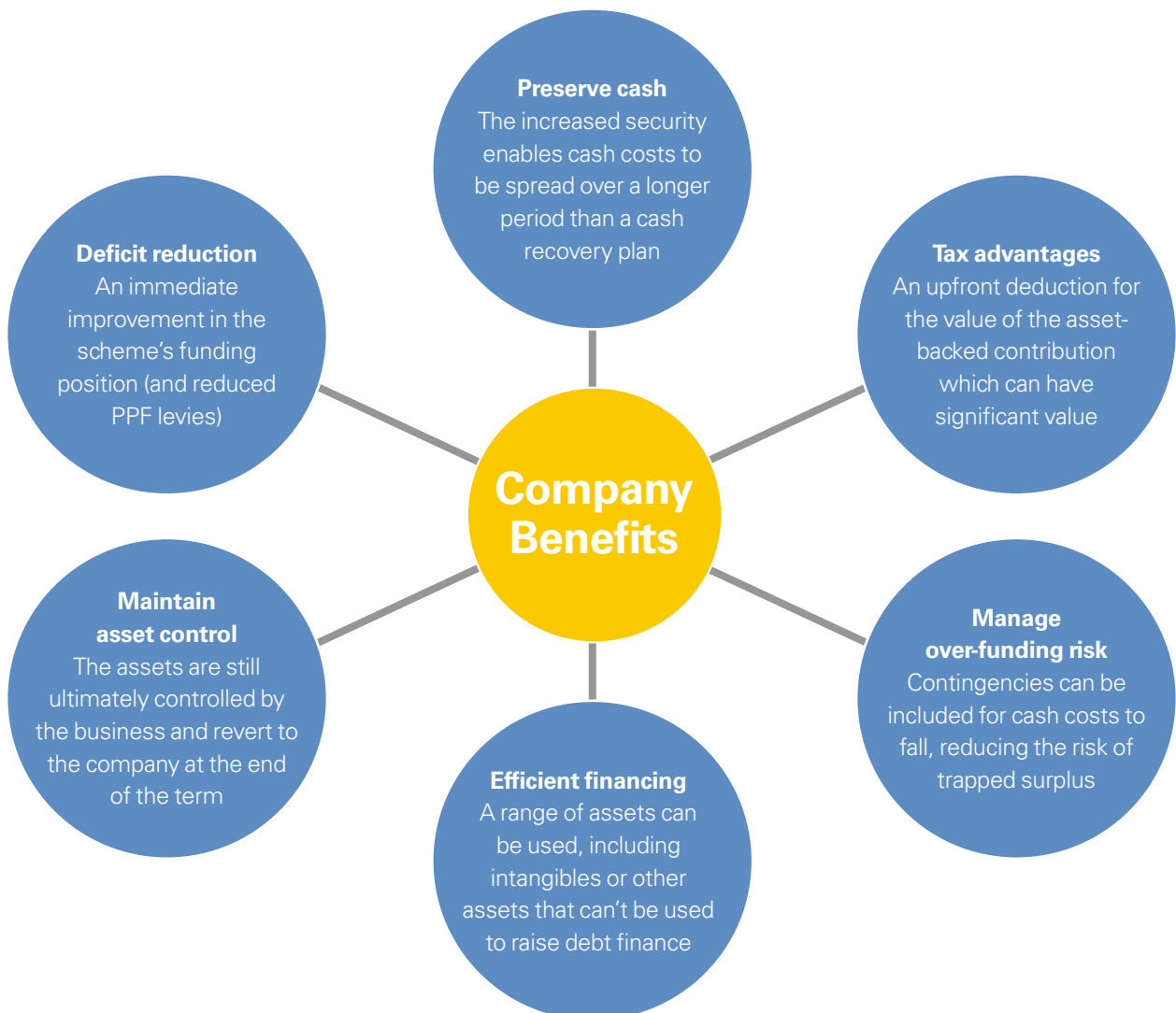
Clearly, there will also be commercial issues for the business such as selecting the right structure, identifying appropriate balance sheet assets, maintaining flexibility for the future and managing investor relations.

Appendix 1 provides some more detail on the key technical issues to be dealt with when implementing these arrangements.



What are the benefits for companies?

Asset-backed funding can have a number of advantages for companies over conventional recovery plans.





Asset-backed funding example

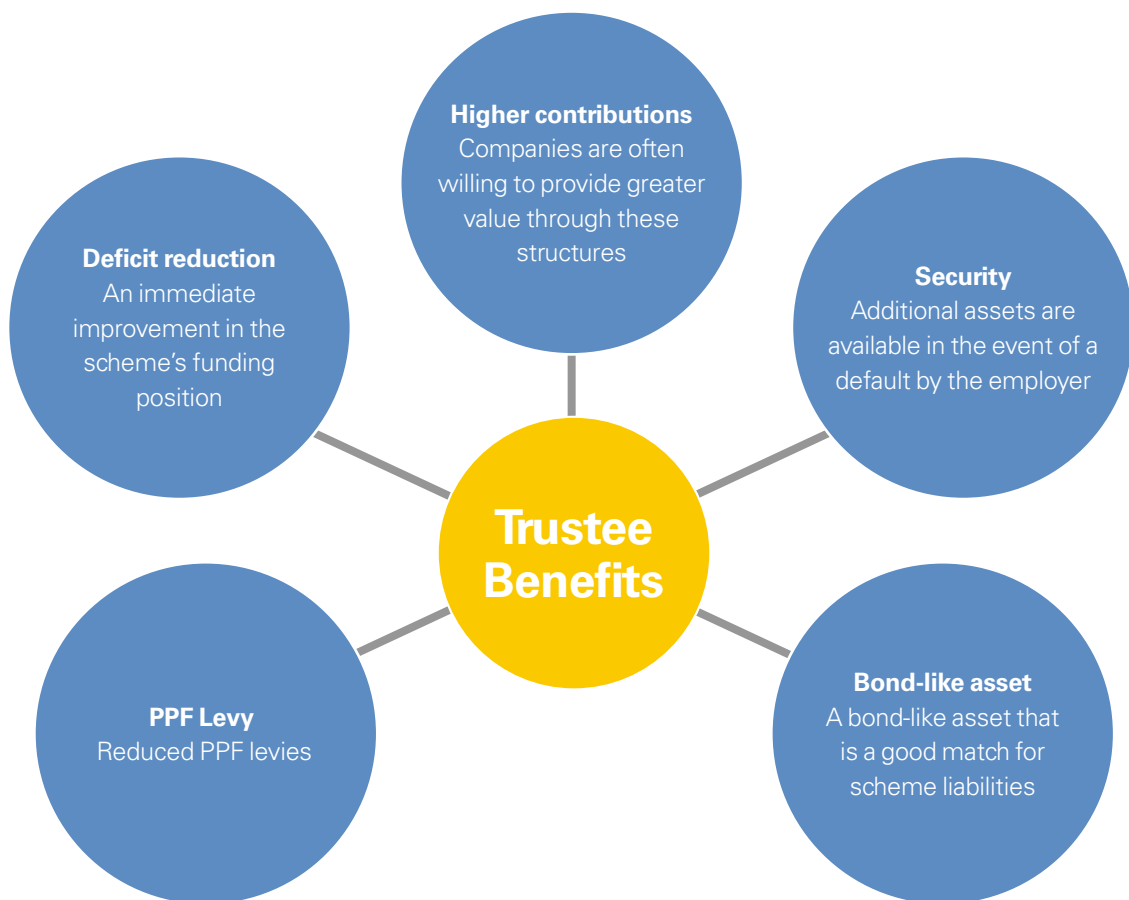
The table below shows an example of the impact that using asset-backed funding had for one organisation relative to a conventional recovery plan. The organisation was able to make pre-tax savings of £4m per year for the first 10 years as well as receiving up-front tax relief on the value of the contribution. Overall, the company is able to achieve effective savings of £7m plus PPF levy savings.

	Conventional recovery plan	Asset-backed funding structure	Comments
Remaining deficit	£85m	£0m	Immediate improvement in deficit
Annual contributions	£11m	£7m	Saving of £4m a year for first 10 years (before tax)
Payment term	10 years	20 years	Significantly longer payment plan
Tax relief	Received as cash is paid	Upfront tax relief on value of initial contribution	Initial cashflow saving is significantly increased due to upfront tax relief
Additional security?	None	Assets bankruptcy-remote	Additional security provided to the pensions scheme
Estimated PPF levy	£42,500 pa	£7,000 pa	Reduction in deficit leads to levy savings
NPV cost to company¹	£78m	£71m	Effective saving of £7m for the company (plus PPF levy saving)

1) Assumes Company's cost of capital is 7% pa

What are the benefits for trustees?

Asset-backed funding arrangements have significant benefits for trustees as well as for companies.



However, these structures can be complex with a number of issues to be considered, and the trustees should seek professional advice. Among the issues that the trustees should consider are:

- Is the arrangement legally robust?
- What security is being provided?
- How will the value of asset change over time?
- How will the asset be valued?
- Does the arrangement breach employer-related investment rules?
- What is the impact on overall investment strategy?

A group of people, mostly women, are gathered around a large, glowing lantern. They are all wearing orange shirts and looking up at the lantern with expressions of interest and admiration. The lantern is made of a translucent material and has a small flame inside, which is the source of the light. The background is dark, making the lantern and the people's faces stand out. The overall mood is one of unity and shared purpose.

What has the Pension Regulator said about the use of asset-backed funding?

- “Where trustees and employers want to increase the strength of the employer covenant or the security of the pension scheme, there are a variety of ways to do so. Examples include non-cash transfers to the pension scheme”
- “Non-cash transfers can include transfer of assets into a Special Purpose Vehicle which the pension scheme might own fully or partially”
- “Non-cash transfers may be an addition or alternative to cash funding”
- “Trustees need to clarify whether these investments may be classified as Employer Related Investments”
- “[Trustees] may need specialist legal advice ”
- “We expect to be informed about these funding mechanisms”

What is HMRC's view on asset-backed funding?

HMRC are looking into these types of assets. HMRC views these structures as a way to both meet the commercial needs of employers and offer pension schemes secure, high quality funding.



HMRC are looking to continue to help facilitate asset-backed contributions but wish to ensure that the structures do not generate unintended tax relief.

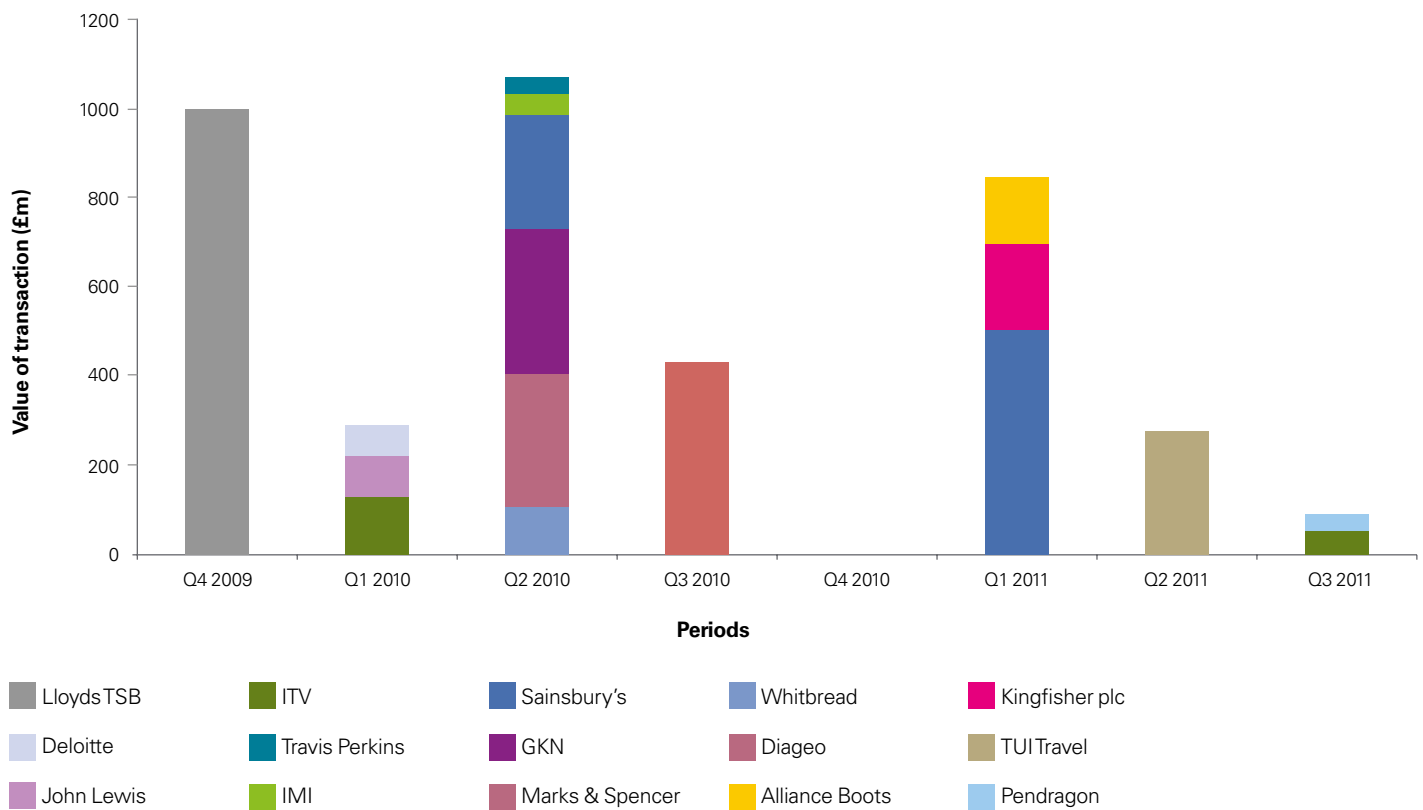
HMRC does have concern with these structures where the company is getting upfront tax deductions for contributions that may never be made to the pension scheme, or arrangements which seek to obtain a "double deduction" for the amount of the contributions. New legislation will be issued which is likely to restrict upfront tax relief to those structures which fall within a specific section of the tax code so that there will be a clawback of tax relief if the payments from the structure are less than anticipated at the outset.

This is particularly relevant for those structures which include some contingency around future payments – typically related to the funding level of the scheme. Many of the implemented arrangements are already structured to meet HMRC's preferred treatment and it is not considered that the tax changes will impact on the attractiveness of these structures.

What has happened in the market?

The last 12 months have been a busy time for asset-backed funding as the number of structures in the market have continued to grow. The chart below shows activity over the last two years.

Timeline of Transactions



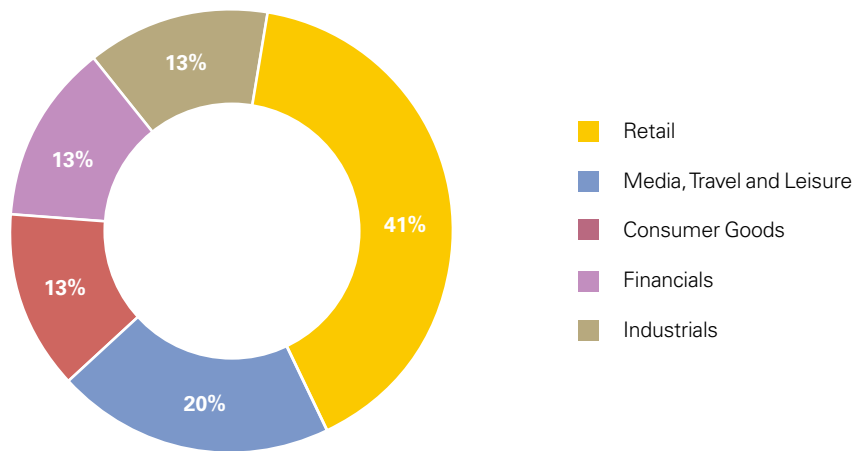
Source: Press releases, annual reports

Note: M&S has executed three transactions – in 2007, 2009 and the most recent in 2010. Only the 2010 transaction is reflected in the chart above. Sainsbury's had previously announced a structure with £750m worth of property. This was actually implemented in two steps as shown on the graph. Deloitte and IMI were not included in previous survey as announcements were made after it was issued.

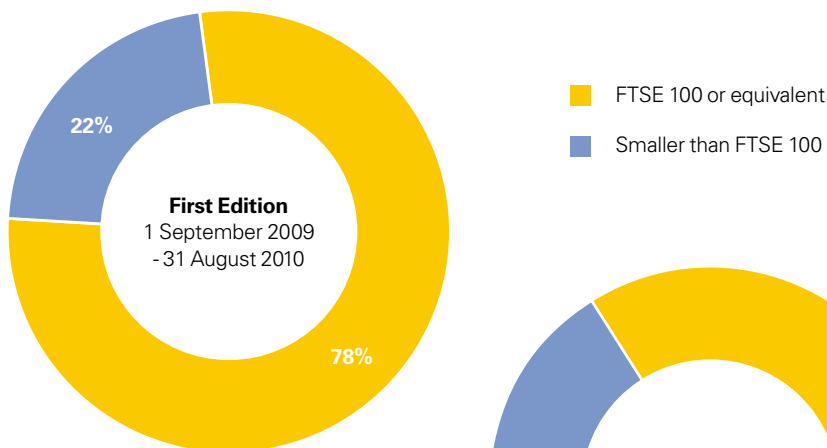
What has happened in the market?

Types of companies implementing asset-backed funding structures

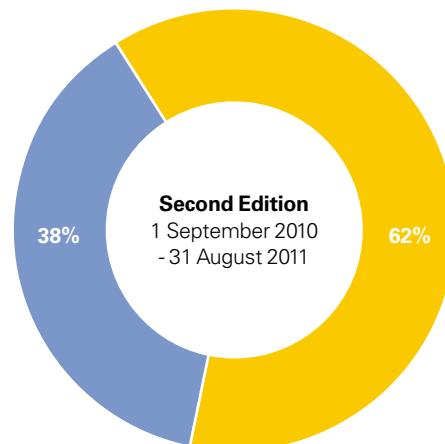
Initially these structures were mainly implemented by large companies in the retail sector, perhaps because their occupied property portfolios can be ideal for these structures. While retailers continue to use these structures, we are also seeing a wider range of companies make use of asset-backed funding to finance their pension schemes. The chart to the right shows the sectors that these companies are associated with.



Source: London Stock Exchange, KPMG analysis

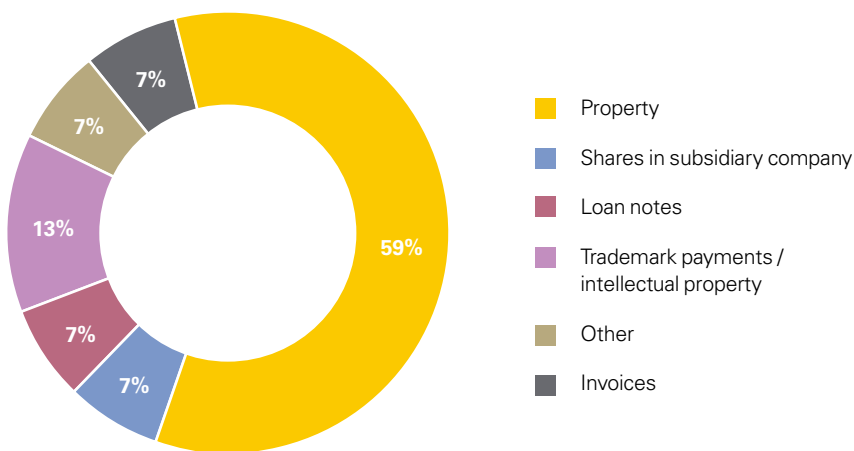


Source: London Stock Exchange
Note: (1) Alliance Boots is assumed to be FTSE 100 equivalent
 (2) Based on date of announcement



Size of companies implementing asset-backed funding structures

It is not only the sector of companies that are implementing these structures that has changed but also the size of the companies. In our last edition, nearly all the companies were FTSE 100 companies or of equivalent size. Since then we have seen an increasing number of smaller companies implementing asset-backed funding arrangements. The charts to the left show how the size of companies making asset-backed contributions has changed over the last couple of years.



Source: Press releases, annual reports

Note: based on number of transactions rather than total value

Types of assets used in asset-backed funding structures

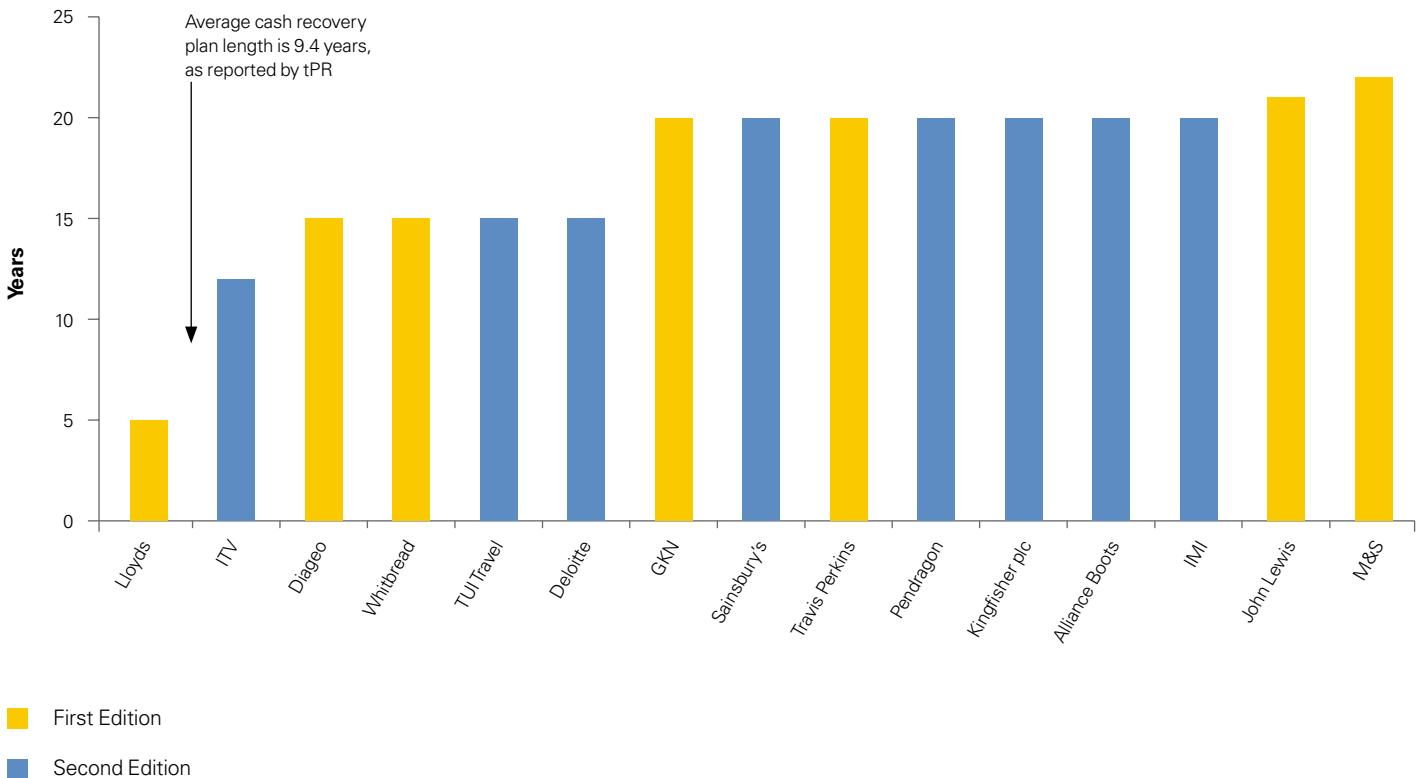
Companies are able to use a wide range of business assets to secure the payments from the SPV. Our last survey included structures implemented by GKN, using intellectual property and Diageo, using barrels of whisky. There has been further innovation in the type of assets used and we have seen TUI using their brands and Deloitte using income receivables to support these structures. However, property remains the most popular asset for use in these structures, due to its readily available income stream and perceived high level of security for the pension scheme. The chart to the left shows the types of assets used to secure the payments from the SPV.



What has happened in the market?

Length of cashflows

The chart below shows the payment term for asset-backed funding structures implemented to date.



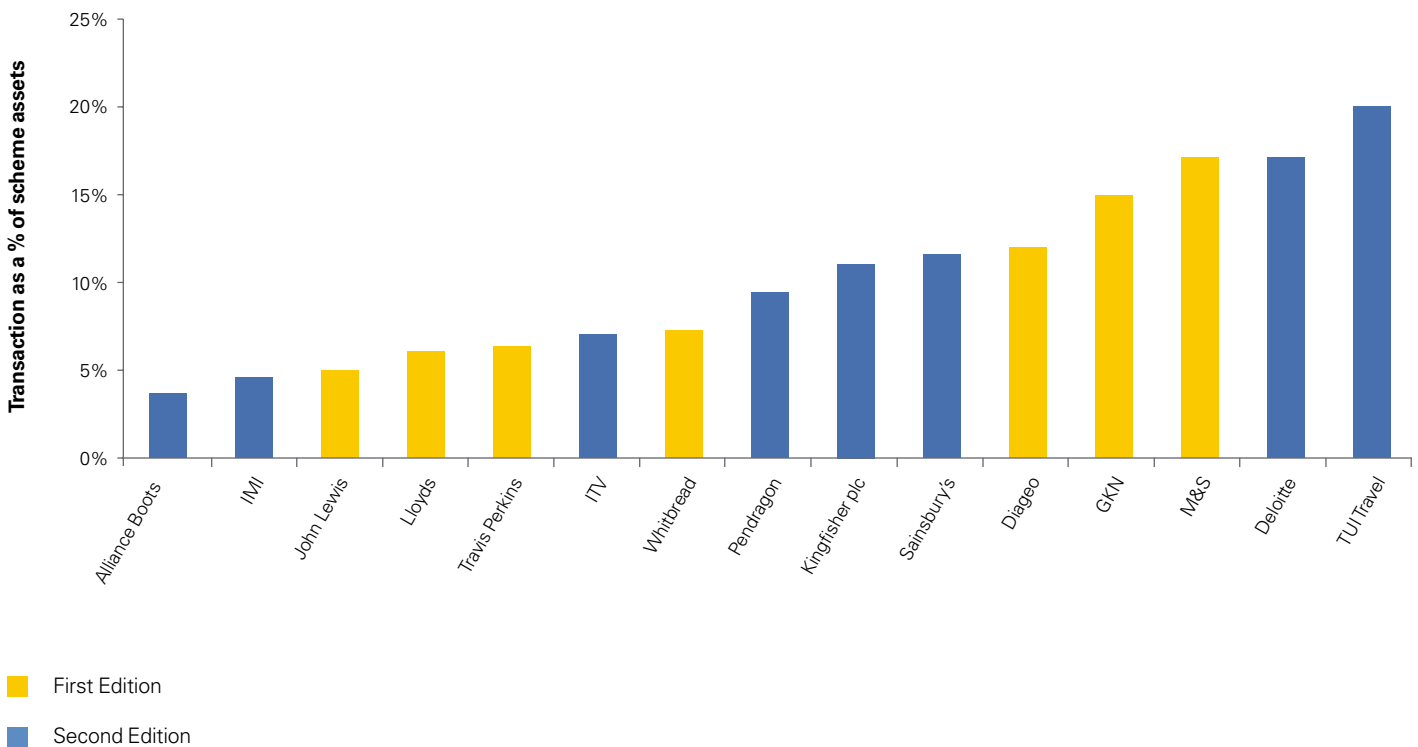
Source: Press releases, annual reports

Term for M&S is based on the aggregate of all 3 tranches

These structures allow the company to spread contributions over a longer period of time. The Pension Regulator reports that the average length of a recovery plan used by pension schemes is 9.4 years, whereas the average payment terms for these structures is 17.2 years, and the majority have terms of 20 years or more.

Transactions size relative to scheme assets

The chart below compares the size of the arrangements implemented with the pension scheme assets disclosed under IAS 19.



Source: KPMG analysis, annual reports

Note: Marks and Spencer, the amount shown below is based on the total of the three transactions they have carried out

Employer-related investment rules impose a limit of 5% of scheme assets that can be invested in the sponsor. In the majority of cases, these structures exceed 5%, but their nature means that they don't count as employer-related investment.

Some argue that this is in breach of the spirit of the self-investment requirements and is a concern of

the Pensions Regulator. However, schemes with large deficits already have significant financial interests in their sponsor, which is akin to "self-investment." It would be perverse for trustees to turn down the opportunity to significantly improve the scheme's funding level if that is the best way they can protect the interests of members.

Since the SPVs are bankruptcy-remote, if the company falls into insolvency then the value of the assets in the structure will be available to meet the outstanding payments due to the scheme. This should put the scheme in a better position than if no structure had been put in place.

What has happened in the market?

What's the outlook for future transactions?

The popularity of these asset-backed funding structures continues to grow, and they are no longer seen as a solution only for the largest companies and schemes. We expect the growth in their use to continue, with asset-backed contributions topping £10bn in the next five years.

These structures could be potentially implemented by half of the FTSE100. However, an increasing number of smaller companies may also view them as viable alternatives to cash funding.

As the range of company assets used increases, we may see more innovative use of assets in these structures.

HMRC have carried out a consultation on the tax treatment of these structures which should provide increased certainty over the tax implications without impacting on their attractiveness, and as a result we expect these structures to continue to flourish.





Appendix 1

Key implementation issues.

Valuation

The value of the “asset” held by the pension scheme represents the market value of the future income stream. Some analysis is needed to determine the appropriate credit rating to include in the discount rate, which will need to reflect the risk profile of the company and specific asset backing in the structure.

Most of the structures implemented so far have been over-collateralised (ie the value of the assets transferred is larger than the value promised to the pension scheme). The degree of headroom is a significant factor in determining the discount rate, as the greater the headroom, the greater the security of the income stream promised to the trustees. It also allows for an increase in the distribution to the pension scheme should this be needed in future (as Marks & Spencer, ITV and Sainsbury’s have done).

Further complexities in the valuations come from the nature of the payments. The payments can be structured to be contingent on the future funding position of the scheme. A number of the structures implemented incorporate a possible “bullet” payment at the end of the recovery period should a

deficit remain. Often this is based on the prevailing technical provisions at the end of the term, which provides another uncertainty in the valuation. In some cases, the contributions stop if the scheme tips into a surplus, or are used instead to fund future service contributions.

The value agreed for the purposes of establishing the recovery plan may well be different to the value required for the scheme accounts which require “fair value” - the amount for which an asset could be exchanged between unrelated willing knowledgeable parties in an arms-length transaction. In some cases





the conditions of the agreement are inextricably linked to the pension scheme and because of this and the differing tax treatments of a hypothetical third party, market value may be significantly below what the asset is worth to the pension scheme. In addition the discount rates used in the actuarial valuation (which underlie the deficit) may differ from market discount rates leading to a difference in the valuation of underlying cashflows.

For PPF levy purposes, the reduction in deficit will be equal to the value required for the scheme accounts.

Accounting

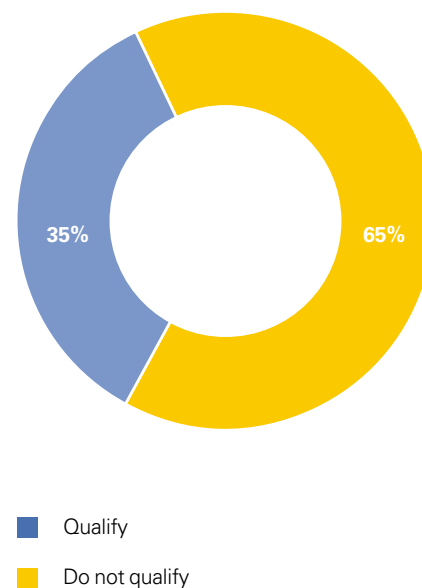
In all cases where the partnership structure has been implemented, the SPV established is controlled by the business and therefore included within the consolidated results.

If the structure allows for the assets to qualify as a plan asset of the pension scheme – which is achieved if the asset is transferable to a third party – then the pension deficit under IAS19 or FRS17 is reduced by the amount of the assets transferred. The expected return on the

scheme's assets will also consequently increase to the benefit of the profit and loss.

The accounting treatment for the balancing entry in the financial statements depends on the nature of the obligation and agreement between the group (including the SPV) and the pension scheme. For example different structures might be treated as equity minority interests or as a direct financial liability on the balance sheet. This will also drive whether or how any future changes in value and interest on the liability are reflected in profit and loss – which in turn can influence the tax treatment. Clearly it is important to consider the impact on credit metrics and other profitability measures when looking at the most appropriate structure and accounting treatment.

Alternatively, if the asset is not considered a plan asset under the accounting standards, then there is no corresponding liability or minority interest to consider, and generally very little impact on the consolidated accounts.



The chart above shows the percentage of companies where the structure has qualified as an IAS19 plan asset.

In our experience, these structures are generally viewed by credit rating agencies as neutral. In considering indebtedness and leverage, rating agencies adjust for pension deficit, therefore reducing the pension deficit and increasing financial liabilities ought

Appendix 1 - key implementation issues

to have no net impact – although this is not necessarily the case if the funding deficit exceeds IAS19 / FRS17. Companies where credit rating is a key concern often discuss the issues with the rating agencies before finalising their structures.

Tax

From a corporation tax perspective, the key issues to be considered are minimising the tax costs of transferring the assets to the structure and obtaining a full tax deduction for the amounts ultimately paid to the scheme. Generally the vehicles can be structured such that the result is a full tax deduction over the life of the structure for the cash paid with a significant acceleration of tax relief.

How is the acceleration obtained? Contributions paid by an employer under a registered pension scheme are deductible in the period of payment (subject to the spreading rules) provided they are made wholly and exclusively for the purposes of a trade or are an expense of an investment business. Strictly contributions have to be monetary contributions to be considered as paid. However, it is possible for an employer to agree to pay a monetary contribution and then to settle this debt by way of a transfer of assets. As such, provided a funding plan is formally agreed with the trustees and then settled by passing cash to the scheme, the value of the vehicle interest can be treated as a contribution

and therefore qualify for a tax deduction. Depending on the quantum of the contributions, under the spreading rules the tax deduction may need to be spread over a period of up to four years.

Other issues that will form part of the tax analysis will be ensuring that the structure does not give rise to irrecoverable VAT or Stamp Duty Land Tax liabilities.

From the pension scheme's perspective, as the scheme will be holding the investment in the structure for the purposes of a registered pension scheme, the income will be exempt from tax.

Legal

Duncan Buchanan of Hogan Lovells has advised on a number of these arrangements and he comments on some of the key legal issues below:

"There are three main issues from a legal perspective:

- establishing the SPV, ensuring that participants' rights are clearly defined (particularly on insolvency) and transferring the assets to be held by the SPV;
- ensuring that the SPV structure is acceptable to the pension scheme trustee and its advisers. In particular, making sure that there is no breach of the employer-related investment



restrictions which apply to pension schemes; and

- checking the group has sufficient legal capacity to enter into the SPV - for example, considering limits



or restrictions under financing arrangements and, where appropriate, advising on listing rules.

While these issues are technical and complicated it is usually possible to find a

way forward and design a structure that is acceptable to all parties and meets their needs. Pension scheme trustees value the additional security that a SPV provides to their schemes and early

concerns about regulatory opposition to these structures has reduced partly as a result of HMRC's recent consultation on asset-backed pension contributions."

Appendix 2

Details of transactions included in 2010 survey.

Company	Date publicly reported	Transaction value £m	Transaction details
Marks & Spencer	2007	500	<ul style="list-style-type: none"> Property worth approx £1.1bn transferred to the partnership in 3 tranches. Properties have been leased back to the company
	2008	200	<ul style="list-style-type: none"> The 2007 structure gave the trustees rights to an income of £50m pa for 15 years, which was increased to £72m pa following the addition of further property in 2008
	May 2010	300	<ul style="list-style-type: none"> From 2010 the trustees were granted a further £36m pa for 15 years starting from 2017 plus a capital sum in 2031 equal to the lower of £350m and the funding deficit at that time From March 2009, payments were made contingent on the level of dividends Recognised as a plan asset in the Group accounts
Lloyds	Jan 2010	1,000	<ul style="list-style-type: none"> £5bn of assets in the form of notes in the Group's securitisation programmes transferred into the partnership Trustees receive annual payments of approximately £215m over 5 years until 31 December 2014 Recognised as a plan asset in the Group accounts
John Lewis	Jan 2010	95	<ul style="list-style-type: none"> Property worth £150m transferred into the partnership, with flexibility to substitute alternative properties in the future Trustees receive an income stream over 21 years followed by a bullet payment of between £0.5m and £99m, depending on the scheme's funding level at the time Not recognised as a plan asset in the Group accounts
GKN	March 2010	331	<ul style="list-style-type: none"> Assets in the form of property and trademarks transferred into the partnership Trustees receive payments of £30m pa for 20 years, which can be used to satisfy future service contributions if the plan moves into surplus in the future The payments cease if the plan becomes sufficiently in surplus and are discretionary (linked to dividends) Recognised as a plan asset in the Group accounts



Company	Date publicly reported	Transaction value £m	Transaction details
Whitbread	May 2010	100	<ul style="list-style-type: none"> • Properties and certain other assets worth £228m transferred into the partnership, with flexibility to substitute alternative properties in future • The trustees receive income from the partnership for a period of 15 years, followed by a bullet payment to remove any remaining deficit up to a maximum of £110m • Not recognised as a plan asset in the Group accounts
ITV	May 2010	124	<ul style="list-style-type: none"> • Partnership backed by SDN Ltd (a digital terrestrial television multiplex licence-holder wholly owned by ITV) • Trustees receive income of £8.4m pa for 12 years, followed by a bullet payment to remove any remaining deficit up to a maximum of £150m • Not recognised as a plan asset in the Group accounts
Travis Perkins	June 2010	35	<ul style="list-style-type: none"> • 16 Travis Perkins freehold properties transferred into the partnership • Trustees will receive an income for a period of 20 years subject to funding levels • Recognised as a plan asset in the Group accounts
Sainsbury's	June 2010	Up to 256	<ul style="list-style-type: none"> • Properties worth £256m transferred into the partnership • A further £501m worth of properties was transferred in 2011
Diageo	July 2010	430	<ul style="list-style-type: none"> • Maturing whisky reported to be worth around £500m transferred into the partnership • Trustees receive an annual income of £25m for 15 years, followed by a bullet payment to remove the deficit up to a maximum of £430m

Appendix 3

Details of transactions included in 2011 survey.

Company	Date publicly reported	Transaction value £m	Transaction details
IMI	June 2010	48.6	<ul style="list-style-type: none"> • Value of assets transferred £60m • Right to receive income of £4.4m pa for 20 years • Recognised as a plan asset in the accounts
Kingfisher	January 2011	Up to 200	<ul style="list-style-type: none"> • Properties worth £200m transferred to the partnership • The scheme receives an income stream of around £12m pa for 20 years • Not recognised as a plan asset in the accounts
Sainsbury's	March 2011	Up to 600	<ul style="list-style-type: none"> • Properties valued at £501m were transferred into the partnership on 25 March 2011. This is in addition to the £256m transfer of properties in 2010 • The scheme's interest in the partnership entitles it to an annual distribution of approximately £35m for 20 years combined • The properties transferred to the partnership will revert to Sainsbury's ownership in 2030 in return for a cash payment equal to the amount of any remaining funding deficit on the scheme at that time, up to a maximum of £600m • Not recognised as a plan asset in the Group accounts
Alliance Boots	March 2011	146	<ul style="list-style-type: none"> • The Group contributed an interest in the partnership worth £146m, and transferred a number of properties to the partnership under a sale and leaseback arrangement • The partnership will make annual distributions of around £10m to the scheme for 20 years • A capital sum equal to the lower of £156m and any funding deficit in the scheme at that point in time will be paid in 2031 • Not recognised as a plan asset in the Group accounts



Company	Date publicly reported	Transaction value £m	Transaction details
TUI Travel	May 2011	275	<ul style="list-style-type: none"> • TUI UK will make royalty payments for brand use • The brands are valued at £305m • The partnership will make annual distributions to the pension schemes of £16.5m pa for 15 years until 2026 • The firm is committed to make payments of up to £275m to cover any deficit that may remain at the end of this term in 2026 • Not recognised as a plan asset in the accounts
Pendragon	July 2011	35	<ul style="list-style-type: none"> • Property transferred by Pendragon will be leased back to the firm • Property was split between 6 pension schemes with one scheme receiving assets as low as £1m • This will generate £2.5m pa (increasing by 2.25% pa) for 20 years, and will enable the company to reduce contributions scheduled for 2012 from £18.5m to £2.5m • Recognised as a plan asset in the accounts
ITV	July 2011	50	<ul style="list-style-type: none"> • The partnership's interest in SDN Ltd (a digital terrestrial television multiplex licence-holder wholly owned by ITV) will provide collateral for payments • Annual distribution of £2.6m for 12 years from 2011. This is in addition to the £8.4m agreed in 2010 • ITV will make a payment of up to £50m in 2022 • Not recognised as a plan asset in the Group accounts
Deloitte	July 2011	70	<ul style="list-style-type: none"> • Income flows to the scheme from receipts for money owed to the firm as a result of day-to-day business • The annual income will be based on an annual rate of return of interest designed to reflect the pre and post retirement discount rates used to determine the technical provision of the scheme at successive actuarial valuations • Payment stream for 15 years followed by a bullet payment of between £0.5m and £74.5m, depending on the scheme's funding level at the time • Not recognised as a plan asset in the accounts

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