The beauty of an escrow

Isio's Innovative Funding Group

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Royal Mail, Schlumberger, Smiths Group and telent have all used bespoke escrows as part of their pensions strategies. Isio's Matt Brown looks at why, and how using an escrow can help to solve competing sponsor and trustee objectives for DB pension scheme funding.

Escrow arrangements, sometimes referred to as Reservoir Trusts, are often talked about in the context of pension scheme funding. But, in practice, they are not widely used other than for short-term cash deferral. We explain here how Isio's Innovative Funding Group has developed escrow arrangements to be used as part of the journey plan towards the long-term funding objective (LTO).

So, what's the problem?

The new Defined Benefit Funding Code of Practice will instruct all trustees and sponsors to agree a joint plan to achieve a low-risk, long-term target over a reasonable timeframe. Trustees will (understandably) expect this plan to include contributions while sponsors will be concerned that they could be irrevocably committing more cash than is necessary.

An effectively designed escrow arrangement is a way to secure contingent funding options that seek to balance these competing objectives. At Isio we believe escrow is an ideal solution for an employer that can afford to make significant contributions but is concerned this will lead to overfunding.

The benefits of escrow

Funding towards the LTO mitigates risks to pension scheme members if their employer fails. If structured properly, funds put into escrow should be equally valuable to a scheme facing employer insolvency as cash contributions paid into the scheme.

Once contributions are paid into a scheme they are unlikely to be returned to the employer until all risks have been transferred to a third party or the last member has died. In most cases this really is way into the future. However, contributions paid into escrow could be returned much sooner, for instance on reaching full funding on a low-dependency basis.

Trustees may prefer contributions into the scheme to the same level of contributions into escrow. But where the potential for funds to be returned allows an employer to contribute more to an escrow than they would directly to a scheme, then this presents a 'win-win' for employer and trustees.

Escrow long-term objectives

Long-term objectives typically fall into two categories:

1. Transfer of liabilities to an insurance company (i.e. buy-out) or to a commercial consolidator.

2. Retention of liabilities but fund on a low-dependency basis, significantly reducing reliance on the sponsor.

Escrow arrangements are beneficial for either case in providing security for trustees during the journey to reaching the LTO. But they allow contributions to be returned to employers in a timely and tax efficient way when surpluses emerge against the long-term objective.

Risk transfer

Buy-out pricing fluctuates. So putting funds into a scheme to target buyout may result in a scheme being able to return excess to the sponsor - but with a 35% tax cost. An escrow arrangement allows only the funds that are required to execute a buy-out to be transferred to a scheme at the point of risk transfer. All the remainder can be returned to the employer tax efficiently.

Low-dependency target

In funding towards an LTO, sponsors will be asked to pay in more than is expected to be required. This is because not all the expected investment return will be allowed for. If this investment return is realised it will create a surplus on the low-dependency basis - but one which cannot easily be returned to the sponsor. Diverting some or all of these contributions to escrow can overcome this risk.

For example, telent and the Trustees of its G.E.C. 1972 Plan completed a £4.7bn full buy-in in 2019. The use of escrow, rather than putting the cash into the scheme allowed c.£90m of excess fund to be returned to telent tax efficiently.

We recently worked with a large employer to design a bespoke escrow arrangement as part of a journey plan to LTO. A significant proportion of ongoing contributions will be paid to escrow over the next six years. The funding agreement contains various trigger points over the period to the LTO target date where the funding level is assessed and distributions made from escrow, if required, after allowing for investment return. Any remaining funds, after reaching the desired LTO will be returned to the employer.

Probability distribution of NPV at employer cost of capital (net of tax relief)

"Isio's insight and modelling was invaluable in designing an escrow and wider security arrangement which balances our risk of overfunding and the Trustee's need for insolvency protection. They also helped us understand the risk posed by the bullet payment from our legacy Asset Backed Funding structure and negotiate removing it."

Director of Tax at a large Isio client

How big is the benefit?

Potentially huge! The chart shows the probability distribution of net present value of contributions measured at an employer's cost of capital (allowing for tax relief). The straight line is the value of fixed contributions of £5m p.a. for 5 years paid into a scheme. The second line shows the probability distribution if the same level of contributions were paid to escrow and used to fund any deficit on the low-dependency basis in 10 years' time (with the remainder returned to the employer).

In this example there is a 25% chance that all escrow funds are paid to the scheme. This means the additional 'cost' to the employer versus paying contributions directly to the scheme is the deferral of corporation tax relief. However, there is a 60% chance that the entire escrow is returned to the employer, so the only 'cost' is the tied-up capital.

With loads of contingent funding options – why escrow?

There are many funding options used to balance trustee and employer objectives within an Integrated Risk Management framework, such as Asset Backed Funding structures and funding corridors. The full range of alternative funding options and the scenarios in which they are best employed are considered here.

A well-designed escrow is an effective mechanism for employers who are prepared, and able, to commit cash towards reaching the LTO, but where they are concerned about overfunding. When staring at large current deficits this may feel like a limited risk, but time after time our stochastic analysis has demonstrated that with longer-term time horizons associated with the LTO the risk of trapped surplus is significant.

Many employers may have dismissed escrow arrangements when considering a long-term funding plan. Our experience shows that in many situations they have a key role to play.

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