



Pensions

Using contingent assets to reduce cash contributions

Stock market volatility continues to adversely affect UK defined benefit pension plans. In an economic climate where cash is not always available we look at how employers can use contingent assets or contingent funding arrangements to help with cash flow.

What is a contingent asset?

A contingent asset is an asset that will produce cash for the trustees of a pension scheme if one or more specified events occur. The most common specified events are:

- the sponsoring employer's insolvency; or
- the scheme failing to achieve a specified funding level.

Typically, contingent assets take the form of a bank guarantee or letter of credit, charge over company property or business assets, or a parent company guarantee. They benefit a scheme's sponsoring employer as it reduces their liability to make direct contributions into the scheme.

Why would you want to put one in place?

There are two other reasons why employers may want to use contingent assets in their scheme funding arrangements. First, the Pension Protection Fund (PPF) recognises contingent assets in its calculation of a scheme's risk-based levy, which is calculated according to the risk that the employer will become insolvent and the level of

underfunding in the scheme. Using a contingent asset reduces the risk of one or other of these factors. For example, a parent company guarantee would in effect change the insolvency risk of the sponsoring employer as part of the scheme's underfunding is guaranteed.

Secondly, the Pensions Regulator recognises contingent assets that meet certain criteria in its approach to the regulation of scheme funding. On 18 February 2009 the Regulator issued a statement to employers regarding the impact of the current economic conditions. In it, the Regulator reassured employers that the scheme funding regime was flexible enough to cope with the economic downturn. Commenting on the statement, David Norgrove, Chairman of the Pensions Regulator, said:

"Trustees of pension schemes in deficit are unsecured creditors of their sponsoring employer. We are sensitive to the pressures many of these employers face in current economic conditions with falling asset prices and increasing deficits. There is no reason why a pension scheme deficit should push an otherwise viable employer into insolvency. But the pension scheme

recovery plan should not suffer, for example, in order to enable companies to continue paying dividends to shareholders.

Any employer who believes that an existing recovery plan is at serious risk of jeopardising the company's future health or solvency should discuss this with their pension scheme trustees, and we would encourage schemes and sponsors to talk to us if they have concerns."

Over the coming year, many employers will be reviewing their existing recovery plans and/or agreeing new ones with trustees. Putting a contingent asset agreement in place can help sponsoring employers agree longer and/or back-end loaded recovery plans. Trustees may also request one where they want security against the risk of employer default during the period of a recovery plan. They are, therefore, a serious option for cash-stripped employers in these current times.

What are the requirements relating to contingent asset agreements?

The PPF only recognises contingent assets that are created using its own standard documentation. They must remain in force for the long term although the standard documentation permits their reduction or replacement as funding of the scheme improves.

To ensure that a contingent asset is used by the PPF in calculating a scheme's risk-based levy, they must be re-certified each year. For a contingent asset coming into force no later than 1 April 2009 (including those already in force that need to be re-certified for another year), they must be certified by no later than 5pm on 31 March 2009. Whilst it is too late to have a contingent asset in place for the 2009/10 levy year, it is not too early to think about one for the 2010/11 levy

year. In addition, they are worth considering given that the Regulator will take them into account on scheme funding.

The Regulator's position on contingent assets is more flexible than that of the PPF. They do not have to approve an individual scheme's funding strategy and do not, therefore, require a standardised approach. Nevertheless, the Regulator does expect certain requirements to be met, including, for example, that a parent company guarantee should have a term of three years or less and that if a financial institution is providing a letter of credit, that it be AA-rated or higher and be located in the Organisation for Economic Co-operation and Development (OECD) group-member country (see OECD country web sites: country web pages).

What else do we need to think about before putting a contingent asset agreement in place?

This very much depends on the nature of the contingent asset being considered.

Giving a parent company guarantee could adversely affect the guarantor's ability to borrow in the future or could increase the costs of extra borrowing. It may also affect how external rating agencies assess the guarantor, which could impact on its value. A parent company giving such a guarantee will also be brought within the notifiable events framework. This may be unattractive for the guarantor as it will mean they have to notify the Regulator of changes in its credit rating and certain changes in senior company personnel. However, the Department for Work and

Pensions is currently consulting on removing these events from the notifiable events framework which, if implemented, will alleviate any potential guarantor's concerns.

Charges or second charges over land or business assets can be attractive for an asset-rich business. However, sponsoring employers will need to check the terms of any existing charges as they may contain covenants that prevent the sponsoring employer from granting further security or granting any charge which ranks in preference to the lender's security. In addition, in a falling property market, a realistic valuation of the asset may be more difficult.

Where a sponsoring employer has an existing banking facility, a letter of credit should be a reasonably low-cost option. However, letters of credit can often be costly and less straightforward if there is no established facility. In addition, as a letter of credit extends the company's level of borrowing, it may also affect the sponsoring employer's ability to borrow in the future and could affect their credit rating.

Another option would be to use an escrow account. These are used by companies when they want to ensure that their contributions are not 'locked in' to a pension scheme. Whilst they are accepted by the Pensions Regulator in its scheme-specific funding approach, they are not acceptable to the PPF in calculating the risk-based levy. Nevertheless, they are a useful option for sponsoring employers and are usually negotiated following an actuarial valuation, but could also be

put in place following a corporate disposal.

When agreeing an escrow account, trustees agree a slightly lower level of employer contributions under the recovery plan. In return, the sponsoring employer pays a set amount into a separate escrow account (usually held by their bankers) and agree that the funds within it can be released to the trustees on the occurrence of certain 'trigger events', for example, on the insolvency of the sponsoring employer or the winding up of the scheme.

If none of the 'trigger events' occur, the monies in the escrow account are returned to the sponsoring employer on the expiry of the recovery plan. A sponsoring employer considering such an approach will need to check the extent to which an escrow account may restrict its borrowing facilities with the bank. They will also want to ensure that the account is held in such a way that permits it to be shown on the sponsoring employer's balance sheet.

Where can I find out more?

If you would like to investigate ways of controlling your pension scheme's cash commitments in the current economic climate, whether through the use of a contingent asset or in other ways, please speak to Catrin Young or a member of the TLT pensions team.

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