



## Pension Schemes and Contingent Assets

October 2007

Contingent assets are an increasingly popular way of managing the cost of a defined benefit pension scheme. They can reduce the PPF levy and cut the funding level a scheme needs to aim for. Trustees as well as employers often welcome the extra options that contingent assets give them. The PPF's deadline of 31 March 2008 makes January to March the high season for action; autumn is the time to plan.

A contingent asset is one that becomes available to a scheme's trustees only if a specified event happens. It could be the insolvency of the employer or the scheme failing to reach a particular funding level by a given time, for example.

The Pensions Regulator and the Pension Protection Fund both recognise that contingent assets support funding. The Regulator accepts a wider range of assets than the PPF but asset classes on the PPF's list are generally first choice because they are dual purpose.

### Reducing the levy

The PPF's annual risk-based levy reflects the size of a scheme's deficit (underfunding risk) and the probability of the employer becoming insolvent (insolvency risk). The PPF accepts that contingent assets can lower these risks, so it reduces its levy as long as the assets meet strict conditions.

Three types of contingent asset granted to the trustees can reduce the levy:

- type A – a guarantee for part or all of a scheme's deficit from a company associated with its sponsor(s) e.g. a parent company. Depending on the amount guaranteed, the levy is based in part or whole on the insolvency risk of the guarantor rather than the sponsor(s);
- type B – security (in the form of a first ranking charge) granted by an associated company. The asset charged must be cash, land in the UK, or debt or equity securities. Its full value is added to the scheme assets when the levy is calculated;
- type C – a letter of credit or guarantee issued by a bank. The effect on the levy is as for type B.

The PPF says it does not propose to add new types of permitted asset to this list for now. It reports that, so far, over 250 schemes have employed contingent assets, mainly type A.

The PPF uses insurance principles and so levels the playing field by insisting that contingent assets are set up using standard form documents and procedures. These give the trustees and other parties some room to negotiate, but not much. Among other things, the PPF insists that trustees take legal advice.

If a proposed party is based outside the UK the PPF imposes extra requirements that are designed to head off legal problems that could arise in enforcing obligations in foreign jurisdictions.

Depending on what the contingent asset is, other professional input may be necessary e.g. in valuing land and buildings.

The PPF's August 2007 consultation paper on the future of the levy says it plans to review the five funding bands it divides schemes into in order to distribute the overall burden of the levy. This reassessment is likely to affect the funding targets schemes want to achieve with contingent assets. It will be difficult for them to make plans until the PPF publishes details sometime during the autumn. When it does, schemes should make decisions without delay: contingent assets – particularly land (see *Hands On* below) – take time to set up and the deadline for cutting the levy for 2008/9 levy is that all the documentation must be with the PPF by 31 March 2008. This could be a particularly important date – see *the box*.

### Double deadline

31 March 2008 could be a crucial deadline. If the PPF goes ahead with its recent proposal, it will be the deadline for contingent assets to influence the 2008/9 levy and also the following year's levy, 2009/10. The PPF wants to get away from setting the levy annually in order to stabilise the cost for payers. However, this proposal has been criticised for delaying the impact of de-risking measures; the PPF may be urged to rethink.

Depending on how the PPF redistributes the total levy, some schemes might want to review contingent assets that are already in place to see whether they still achieve their purpose.

Another way of reducing the levy is, of course, to improve the employer's D&B failure score. Relatively minor steps can have a significant impact, so it is well worth seeing what can be done.

### Supporting funding

One of the Regulator's tasks is to check whether schemes meet the statutory funding objective of having enough assets

to meet their liabilities, or "technical provisions". This is a scheme specific question and the Regulator's approach to contingent assets is correspondingly flexible.

The Regulator's premise is that contingent assets are second best and that trustees should generally prefer cash. If trustees are thinking of accepting contingent assets, they should consider carefully whether they are appropriate to their particular scheme.

The Regulator says that contingent assets can support technical provisions or a recovery plan.

### Technical provisions

An appropriate asset can support technical provisions by, for example:

- allowing the trustees to hold more return-seeking assets like equities than they otherwise would. If the scheme takes credit for the higher anticipated returns, this lowers its technical provisions. The contingent asset needs to be structured to cover the risk that the higher returns do not materialise; and
- allowing the trustees to increase their assumption about the out-performance that their return-seeking assets will achieve.

Until the contingency arises, an asset backing technical provisions does not count when assessing whether a scheme meets the statutory funding objective.

### Recovery plan

A recovery plan can get support from a contingent asset:

- as security against the employer defaulting during the recovery period;
- as a safeguard where the recovery plan is back-end loaded;
- as protection against investment returns falling below what has been assumed; and
- to allow the trustees to accommodate the employer with a shape or length of recovery plan that they would otherwise reject.

The Regulator gives these examples of contingent assets that trustees might find acceptable depending on the circumstances:

- cash in an escrow account;
- security over land or securities;
- a guarantee from another group company; and
- an obligation from a third party like a letter of credit or bank guarantee.

Evidently, assets supporting technical provisions or a recovery plan need to become payable to the trustees on contingencies other than the employer's insolvency (which is the PPF's main focus).

Before trustees accept a contingent asset the Regulator urges them to ensure the employer makes a cogent business case for proposing it instead of cash. The Regulator also emphasises the

need for actuarial and legal advice and, depending on the asset, a professional opinion on its value.

### Hands on

We have advised on a number of contingent asset arrangements with multi-disciplinary input from our pensions, corporate finance and property teams.

Associate **Jeremy Benson** in our property team says, "The key is to plan well in advance. Then make an early start with the formalities – but not too early:

- the PPF has strict rules about legal investigation and valuation (due diligence) when it comes to using land as a contingent asset to reduce the levy. These take time and mean instructing the professionals no later than the end of January. They also mean that the transaction costs can be material;
- early planning is vital but the real work cannot be done too far in advance. This is because key documents in the form of the valuation report and the legal searches must be no more than three months old when the arrangement is put to bed. So substantive work completed before the beginning of January is likely to be wasted;
- the good news is that subsequent levy years are easier. There is some updating work but, broadly speaking, the PPF allows schemes to continue to rely on existing charges and certificates of title. Valuations are good for three years."

**Richard Clark**, associate in our corporate finance practice, says, "These are the main legal points about taking guarantees, security over assets other than land, and third party obligations from banks:

- to check the company giving the security has power to do so. The trustees need a legal opinion from their lawyer that the security is enforceable, and the lawyer cannot give this without checking these powers;
- to check that the underlying assets exist and are segregated – generally you cannot create security over part of an undivided whole;
- if the assets are held by a third party (e.g. a bank), ensure that they are willing to sign the papers required of them. Also, ensure there is a written custodian agreement (such as a mandate), as this needs to be assigned;
- it takes at the least three weeks from the production of the first drafts to agree all the documents. It is crucial to allow enough time; and
- finally, it is vital to register any security at Companies House within 21 days of its creation."

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