Pension Funds Insider

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Contingency plan

30 November 2017

Cash will always be king but contingent assets can be a workable compromise

For pension trustees, cash will always be king. However, the employer may not have the cash available to pay into the pension scheme at the rate that trustees would like. Or the employer may simply not want to pay that amount of cash into the pension scheme, preferring to invest it in the business. Contingent assets can be a workable compromise. They allow employers to pay cash into the pension scheme at a lower level or for a longer period while providing trustees with protection against risks which are of concern to them.

There are various scenarios in which a contingent asset may be used, including:

• as part of the funding package agreed by trustees and employers in relation to actuarial valuation discussions;

• as mitigation where there has been a deterioration in the employer covenant;

• to underpin investment risk taken by the trustees; and

• to obtain a reduction in the Pension Protection Fund (PPF) levy (in which case the contingent asset must be in the PPF's standard form and meet the other prescribed PPF requirements).

A contingent asset sits outside the pension scheme unless a 'trigger event' occurs, at which point trustees may call upon the contingent asset and seek to realise value from it.
The trigger events are usually keenly negotiated. Employers do not want to 'lose' the assets into the pension scheme too soon, whereas trustees want to ensure that they are adequately protected.
The starting point for trustees considering contingent assets is to identify what risks they are seeking to mitigate. Insolvency of the employer is a standard trigger event but others can be catered for, such as a funding level trigger whereby if the scheme funding level falls below a particular level, amounts tip from the contingent asset into the scheme. Identifying the risks will assist the trustees in determining what type of contingent asset may be appropriate, although ultimately what type of contingent asset is available will depend on what assets the employer has in its business and the type of support it is willing to provide – this is a negotiation after all.
The most common types of contingent asset are:

• guarantees: the guarantor agrees to pay amounts to the scheme if the employer fails to;
• escrow arrangements: the employer places cash and/or securities into a third-party account held by a custodian. Assets tip from the account into the pension scheme following a trigger event;
• legal mortgages: the employer provides the trustees with a mortgage over real estate. Trustees can sell the property and realise value upon the occurrence of a trigger event;

• letters of credits/surety bonds: a third party bank (letter of credit) or insurer (surety bond) issues this in favour of the trustees. The trustees claim money direct from the bank or insurer when a trigger event occurs.

• asset-backed contribution structures (ABC): the employer places assets in a special purpose vehicle in which the trustees have an interest. An ABC typically has a dual function – to fund a pension scheme deficit by way of regular cash distributions and to provide contingent asset support, by way of access to the assets, in the event of a trigger event occurring.

Each type of contingent asset has its own pros and cons. Which one is best will depend on the specific circumstances and what the trustees and employer are seeking to achieve. However, the range of options available and increased familiarity with them in the pensions industry means a growing number of trustees and employers are finding that contingent assets are a viable solution.

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