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XPS Covenant News

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Update on contingent assets

Speed read

- The Pensions Regulator set out its expectation that sponsors and trustees consider the use of contingent assets and non-cash funding solutions in its Annual Funding Statement 2019
- Contingent assets can provide an alternative source of support to cash for defined benefit pension schemes potentially allowing more flexibility in setting technical provisions and recovery plans
- Trustees should take care that a contingent asset is not double counted so that it is not supporting both the technical provisions and the recovery plan, unless it is adequate for both purposes
- Allowance can be made within the PPF's risk based levy for certain contingent assets, if they comply with the relevant requirements
- When developing their long term funding strategy trustees and sponsors should consider whether the use of contingent assets would better enable them to achieve their goals

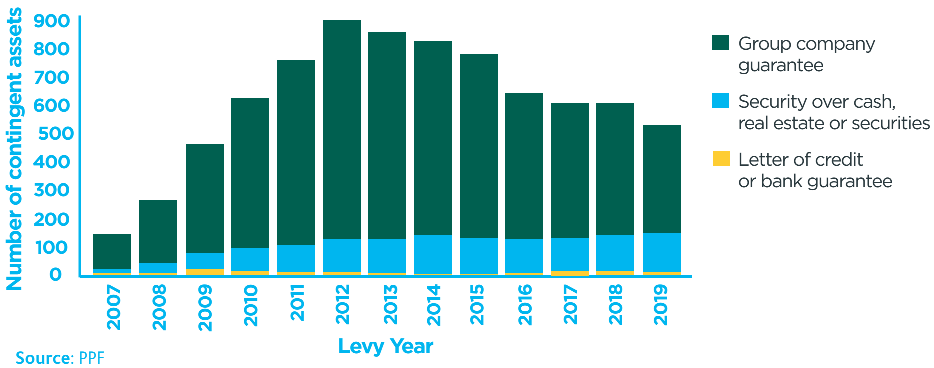
The Pensions Regulator (TPR) highlighted in its Annual Funding Statement 2019 the use of contingent assets and non-cash funding solutions when developing integrated risk management plans and long-term funding strategies. This note provides an update on the use of contingent assets for scheme funding and contingent planning purposes.

> Money often costs too much.
>
> **Ralph Waldo Emerson**

Background

TPR formally introduced the concept of contingent assets for funding purposes in its original Code of Practice 03: Funding defined benefits published in February 2006. Subsequently the Pension Protection Fund (PPF) published guidance in September 2006 on how it would allow for contingent assets in the calculation of its risk based levy. According to TPR approximately one fifth of defined benefit schemes have additional security in the form of one or more contingent assets. Not all of these contingent assets are eligible for recognition by the PPF but the chart below provides an indication of how the use of contingent assets has developed over time.

Contingent Assets by type



Source: PPF

The fall in the number of contingent assets recognized by the PPF in more recent years reflects the more stringent requirements introduced by the PPF for trustees to demonstrate the value attributable to the contingent asset for recognition in the risk based levy calculation.

Contingent assets: '*those assets on which a claim by a scheme would exist on the occurrence of one or more specific future events. Unless the events occur these assets are not included as scheme assets for the purposes of assessing compliance with the statutory funding objective*'.

TPR Code of Practice no. 3: Funding defined benefits

Types of Contingent Asset

Common forms of contingent asset include:

- sterling cash put aside in a bank account and charged to the scheme such that some or all of the cash would be released to the scheme on the occurrence of the contingent event;
- security over other assets e.g. property, such that the asset is transferred to the trustees if the contingent event occurs;
- a letter of credit or a guarantee e.g. a bank guarantee from a third party, such that if the company were to default on payment of contributions to the scheme, money can be drawn against the third party up to a specified amount; and
- a group company guarantee whereby another company within the same group provides a guarantee to pay a sum to the scheme in the event of the sponsoring company's insolvency.

Other forms of contingent asset exist such as surety bonds and reservoir trusts but these are less common.

It is also possible to provide alternative non-cash commitments to the scheme such as negative pledges (i.e. a pledge not to do something such as pay a dividend, increase levels of secured debt), agreements to consult with the trustees in the event of future corporate activity and bespoke profit sharing mechanisms.

Use of Contingent Assets

The following examples demonstrate how contingent assets can be incorporated into a scheme's funding strategy:

- a contingent asset may allow the trustees to pursue an investment strategy that includes investing a proportion of the scheme's funds in return-seeking assets (e.g. equities) that is higher than they would otherwise wish to hold. An appropriately structured contingent asset may provide protection to the scheme against the risk that scheme assets do not provide the anticipated excess returns;
- contingent assets can provide the trustees with security against employer defaults during the term of a recovery plan; and
- where the employer's contribution payments in a recovery plan are back-end loaded, an appropriately structured contingent asset can provide the trustees with security against employer default during the period in which the employer's cumulative contributions remain below the level at which they would otherwise have been without the introduction of the back-end loading.

Trustees should take care that the contingent asset is not double counted so that it is not supporting both a recovery plan and the technical provisions, unless it is adequate for both purposes.

Key considerations

Sponsors and trustees should consider various matters before implementing contingent assets and non-cash funding solutions. These include weighing up the complexity and cost of adopting such an arrangement versus the likely benefits to the sponsor and the scheme.

The trustees will need to take legal advice, especially regarding whether the agreement is enforceable and in ensuring that no other party has a preferential interest in the contingent asset.

The sponsor and trustees may need to take additional advice from their actuary regarding the expected future course of the scheme's funding level, the risks arising from the use of the contingent asset and the risks inherent in the choice of assumptions used to calculate the technical provisions.

The trustees will need to consider how to place a value on the contingent asset with help from their covenant advisor. They should also allow for the fact that the contingent event may not occur for some time and that the value of the asset at that time may be lower than its current value.

We expect to see an increase in the use of contingent assets and non-cash funding solutions in response to TPR's Annual Funding Statement 2019. These mechanisms can provide a valuable source of alternative support for defined benefit pension schemes and should be considered when developing a scheme's integrated risk management plan and long-term funding strategy.

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Events

12 Sep 2019 **03 Dec 2019**	**London** **London**	Trustee Knowledge & Understanding (TKU) Course
17 Oct 2019	**London**	Trustee Training: Understanding LDI (Half-day Course)
24 Sep 2019	**London**	Training Course: Funding, Covenant and Integrated Risk Management (Half-day)
03 Oct 2019	**London**	London Pensions Conference

Event booking

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