PENSIONS IN 30 PODCASTS

10 ONGOING SCHEME FUNDING - contingent assets

Key Points

- Contingent assets are additional employer or group assets that trustees can access on the happening of a specific event or events
- Examples of contingent assets are guarantees, charges and letters of credit
- Contingent assets may be used to give increased flexibility in terms of the approach taken to scheme funding by employers and trustees or to give trustees greater comfort as to the security of the pension scheme
- Trustees need professional advice before agreeing to accept a contingent asset so they can be satisfied that the contingent asset is validly given and can be enforced by them if the contingent event occurs
- The PPF has standard form documents for some types of contingent assets

Main sources

- Pensions Act 2004, Part 3 (Scheme Funding)
- The Pensions Regulator's Code of Practice No.3 on "Funding Defined Benefits" (July 2014): link
- The Pensions Regulator's Guidance "Assessing and Monitoring the Employer Covenant" (August 2015): link
- Pension Protection Fund website: link

What are contingent assets?

Contingent assets are usually only relevant to defined benefit (e.g. final salary or CARE) occupational pension schemes and this note considers contingent assets in this context.

Contingent assets are additional employer or group assets that the trustees of a pension scheme can access on the happening of a specific event or events. Such event(s) are often linked to the employer's solvency or the scheme's funding level. For example: if the employer fails to pay sums due to the scheme; if the employer becomes insolvent; or if specific funding targets are not met.

The use of contingent assets has become more common in recent times with:

- employers of schemes in deficit using them as an alternative to making immediate increased cash contributions in order to meet their funding obligations to the pension scheme; and
- trustees requesting that contingent asset arrangements be put in place to ensure that there is adequate security in place for the pension scheme.

Types of contingent asset

The most common types of contingent asset are:

- a guarantee given by a parent company or another group company to make a payment or series of payments to the pension scheme if the contingent event occurs;
- a charge over real estate, cash or securities which would be transferred to the scheme if the contingent event occurs;

More information

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- a letter of credit or third party guarantee such that if the employer defaults on payments to the scheme, the trustees can claim money (up to a specified level) from the third party under the terms of the letter of credit or guarantee;
- an asset backed contribution arrangement where assets are put into a vehicle in which the pension scheme has a direct interest (the value of the pension scheme's interest being, broadly speaking, the present value of the anticipated cash flows it will receive from that vehicle).

When might a contingent asset be appropriate?

Contingent assets can be used to help achieve the following:

- Increased flexibility in setting the technical provisions for the scheme: as a contingent asset is not immediately available to the pension scheme, it does not count as a scheme asset in assessing whether the scheme has sufficient assets to cover its technical provisions and so meet the statutory funding objective. However, trustees may be able to agree to adopt less prudent assumptions than they would otherwise use if they have a contingent asset that they can call upon if the assumptions are not borne out in practice;
- Increased flexibility in setting the recovery plan: trustees may be able to agree a longer recovery plan, or a back end loaded recovery plan, if they have a contingent asset that they can call upon if the employer fails for any reason to make the contributions due to the scheme;
- Introducing additional risk into the investment strategy: if trustees wish to invest in a higher proportion of return seeking assets, a contingent asset may give them comfort in the event that the investment performance is not as anticipated;
- Increased comfort for trustees: if a covenant review shows that the employer with legal responsibility for the scheme is not financially strong enough to support the scheme, a contingent asset may give trustees comfort that scheme members are protected in the event of that employer failing and enable the trustees to accept more risk than the employer covenant can support.

Professional advice

Both employers and trustees will usually require professional advice from specialist advisers when putting in place a contingent asset arrangement.

From a legal perspective, the contingent asset arrangement will need to be formally documented. Trustees will also need to be satisfied that the contingent asset is validly given and can be enforced by them if the contingent event occurs.

From an actuarial and funding perspective, trustees must be satisfied that the technical provisions and/or the shape of any recovery plan they have agreed is reasonable taking into account the type and value of the contingent asset being offered. This will include an independent assessment of the value that should be attributed to the contingent asset (e.g. in the case of real estate, an independent property valuation; and in the case of a parent or group company guarantee, an assessment of the strength of the company giving the guarantee versus the amount guaranteed).

Pension Protection Fund standard documents

The Pension Protection Fund (or PPF) has standard form documents for the first three types of contingent asset mentioned above. There is no requirement for trustees and employers to use these standard form documents but, if they do and the contingent asset is accepted by the PPF, the contingent asset arrangement can serve to lower the annual PPF levy.