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Jumping Through the Hoop

Trustees find themselves in a stand-off with the Pension Protection Fund over how to treat contingent assets. Laura MacPhee investigates the problems trustees face

"Cash is always king," says Vicky Carr, associate director at law firm Sackers. However, in a time of scarcity it's good to have a back-up. Contingent assets can reassure trustees that they have a back-up asset if they need one without denting the firm's balance sheet.

No employer wants to contemplate its own insolvency, but there are advantages in providing for that unwelcome eventuality. Putting a strong contingent asset in place could mean reduced Pension Protection Fund fees and a more flexible deficit recovery plan.

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However, trustees are finding it increasingly difficult to have contingent assets accepted by the PPF and The Pensions Regulator.

In an environment where equities and gilts are competing to provide the lowest yields, trustees can no longer rely on these traditional assets. That is why they are increasingly turning to contingent assets to help reduce costs and plug their yawning deficits.

The PPF and The Pensions Regulator have noticed this trend and clamped down on schemes trying to use this escape route. The rationale behind lowering the levy where there is a contingent asset is clear enough, since the burden of meeting the scheme's obligations would not fall on the PPF.

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This is reflected in the pensions lifeboat's approach to assessing such assets. As Chris Collins, the PPF's head of policy, says: "The key is that there actually needs to be a reduction in risk… the contingent asset would genuinely have to pay out, should there be an insolvency of the sponsoring employer."

This test became more stringent for parent company guarantees with 2012's introduction by the PPF of the guarantor strength requirement. Carr explains this means "trustees have to certify that on the date when it's put in place there is no reason why the guarantor couldn't meet its obligations at that date".

Again, this makes sense, since it would be unfair for a scheme to misrepresent its risk profile and pay a decreased levy on that basis.

A BROKEN SYSTEM?

Equally, though, trustees should know which hoops they will have to jump through if they want to use a contingent asset. The Association of Consulting Actuaries has criticised the PPF for its lack of transparency on levy calculations and urged it to provide schemes with more information.

This echoes the concerns of John Newbury, the trustee who publicly berated the PPF's chief executive Alan Rubenstein at 2012's National Association of Pension Funds conference. Newbury looks after Eastman Chemical Company's UK pension scheme.

Its sponsoring employer is the wholly owned subsidiary of a US company. The scheme has secured a parental guarantee (see case study), which the PPF has previously accepted and factored in to the levy calculation.

But trustees are required to re-certify their contingent assets annually, and this time there was a problem. The trustees uploaded the legal documentation to the Regulator's Exchange server before the March deadline, but for some reason the PPF did not receive it.

Whether this was down to a technical error, or they simply failed to press the submit button, the outcome was the same: a higher levy payment. Newbury explained to *Engaged Investor* that when the scheme appealed against the

PPF's decision not to allow the guarantee, the lifeboat scheme said they would not handle an appeal that came after it had made its calculation.

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But, as Newbury points out, "you wouldn't know they hadn't included the guarantee until you got the results of the calculation".

The PPF's Collins responds that "it should be possible to know everything has actually been recorded" by producing a screen shot to show it had been submitted. This is not a step that would necessarily occur to trustees, but given the problems some schemes have had, they would be well advised to take this precaution – Collins confirms that little can be done once the deadline has passed.

Eastman's experience is part of a wider trend, according to Jennie Kreser, partner at the law firm Silverman Sherliker. She says the PPF is clamping down on contingent assets in an effort to mitigate against "PPF drift", the assumption of some employers that they do not need to worry about their pension schemes as the PPF would pick up the shortfall.

Evidence of a clampdown is not borne out in the figures provided to *Engaged Investo*r in a response to a Freedom of Information request, which indicate that 30 parental guarantees have been rejected so far in the year 2012-13. This is consistent with numbers over the past five years.

However, the number of re-certifications by trustees dropped sharply to 580 from 785 the year before. This coincided with the PPF's introduction of more rigorous requirements and prescriptive guidance, so with this soft form of coercion achieved its goal of driving down the numbers.

THE NEED FOR CLARITY

Rightly, the PPF's aim is to make sure the parental guarantee is worth the paper it is written on, but it could do more to clarify its expectations.

Kreser gave the example of a scheme that had submitted a standard form guarantee without attaching a black-lined copy. The PPF rejected the application on this basis, even though its official guidance states this is not required. This makes it harder for trustees, and could deter them from using a perfectly legitimate contingent asset, thus costing the company more than necessary at a time of financial stress.

This could have an impact on the employer covenant, which would have a knock-on effect on the scheme's funding position. At the same time, The Pensions Regulator is also tightening up on contingent assets. It takes only a marginally less restrictive view than the PPF in terms of the range of assets that it will accept when considering a scheme's recovery plan.

Sackers' Carr says: "[The Regulator] isn't overly keen on them, and it will very much depend what the asset-backed structure it is, and what assets are in there."

Unusual asset classes are not unheard of in this arena, though. Xafinity director Hugh Creasy says companies, including Britvic and Guinness, have used their brands as contingent assets, so the intellectual property rights would serve to back their liabilities using the income stream they provide.

This is really only an option for household names, since the value of this type of asset is so nebulous. The Regulator would not accept such contingent assets lightly, and the PPF operates a blanket ban on them. The process is becoming harder for schemes seeking to use contingent assets, which is why it is important for trustees to engage with their advisers and discuss their options fully.

For some they may be a sensible way of bringing down costs and giving a true representation of the risk they pose, but for others it may prove too expensive.

Whatever an individual scheme decides, though, it is vital that they have sufficient information to make a reasoned choice.

Unless the PPF improves its transparency this will not be feasible without further expert advice, which could be the final financial tipping point for some schemes.