SOLICITORS JOURNAL

Pensions update

Feature | 10 September 2014

Jennie Kreser discusses what contingency methods employers' with pension deficits could be forced to take after the PPF publishes the results of its statutory consultation

Even as pension schemes and employers begin to leave the old defined benefit (DB) scheme to what some consider its long anticipated burial, and the young pretender, the defined contribution scheme takes centre stage, there remains some life in the old dog yet.

Life can turn round and bite you on the bottom – much like a poorly trained guard dog. Stay with me – these tortuous analogies will soon start to make sense – I promise.

To clarify, a DB pension scheme must have an actuarial valuation performed at least once every three years. If that analysis reveals a deficit in the scheme, in other words the liabilities outstrip the assets, then the trustees of the scheme must, with the agreement of the employer, put in place a cunning plan to try to fix that black hole within a reasonable length of time.

Cash-strapped times

What appears reasonable to The Pensions Regulator (TPR), the government watchdog, is not always reasonable to the employer, although the recently issued new code of practice on funding in DB schemes has relaxed this somewhat. In recent cash-strapped times, employers have struggled to pay large amounts of money (sometimes millions) into their pension arrangements when they needed every penny to simply keep the business going.

TPR and the Pension Protection Fund (PPF); the government lifeboat scheme that steps in when employers cannot meet their responsibilities to continue to fund the pension scheme, often due to insolvency; have long recognised that simply paying oodles of cash is not always the answer. While cash is always the preferred method of funding a recovery plan according to TPR guidance, nevertheless from the earliest days of specific scheme funding, contingent assets could be put up in order to bolster the scheme.

These contingent assets can take various forms, charges over property or shares for example, but one of the most common forms has been the type A contingent asset: a parent company guarantee.

In its simplest form, although the form itself is far from simple and little or no deviation from the standard is permitted, the parent or associated company guarantees the liability of the employer to meet the funding required, sometimes to the full buyout cost which is the most expensive criterion possible. Full buyout is the amount that an insurance company would charge to take over the liability for the scheme. This is often far higher than merely meeting the cost of liabilities as they fall due from the scheme.

Lack of stability

Many pension lawyers, including yours truly, have noted that over the past few years, it has become increasingly difficult to obtain certification (acceptance) or annual recertification of these type A contingent assets. Fairly recently the PPF undertook some stress testing of the worth of these contingent assets and found around 50 per cent somewhat wanting. In other words, they quite literally were not worth the paper they were written on due to the lack of financial strength and stability of the donor of the guarantee.

"Whilst we recognise that many contingent assets are of real value contributing to reducing risk to trustees and ourselves, we should only recognise those contingent assets where the reduction in risk they offer is consistent with the reduction in levy they would obtain."

All in all, nice and transparent.

Higher levy risk

Having said that, the complete removal of type A guarantees was immediately dismissed as a 'runner', for the simple reason that it would remove a significant plank from the armoury of companies wishing to reduce their risks and could result in much higher levies being paid by those companies who did have a good and valuable guarantee from a parent or other associated company. This would have gone completely against the TPR and PPF policy of reducing risk of default and seemed illogical to even suggest it.

There were of course other avenues to explore. These included:

- **Realisable recovery:** A catchy term which means that because trustees don't often actually know the real value of a guarantee, trustees should be made to certify a fixed amount that they can be certain the guarantor can actually afford to pay should the guarantee be called upon. I fail to see how this is different from the defined guaranteed amount which the current documentation clearly requires the guarantor to pay if a default event occurs; but I am a mere pension lawyer. The PPF consultation document puts it thus: 'This is because certification is often defined by reference to an up to date funding level calculated on the section 179 valuation basis, making allowance for smoothing and stressing. This measure may not be as clearly understood or known as the latest reported section 179 valuation results, particularly since the underfunding risk figure is calculated by the PPF'. Now I could be wrong of course, but I read that as suggesting that the reason trustees are confused is because of the PPF calculation itself.

- **Trustee certification** (see above): The new standard wording will read: 'The trustees, having made reasonable enquiry into the financial position of each certified guarantor, are reasonably satisfied that each certified guarantor, as at the date of the certificate, could meet in full the realisable recovery certified, having taken account of the likely impact of the immediate insolvency of all of the relevant employers.'

- **Risk score:** All sponsoring employers of a pension scheme are given a risk score by the PPF calculated by Experian which dictates the level of risk-based levy a scheme has to pay. The higher the risk score, the lower the levy (again, don't ask me why it's that way round – I am a mere pension lawyer). This proposal would effectively manipulate the risk score to take into account the potential liability a company is taking on by acting as a guarantor. The PPF acknowledge that more work needs to be done on this. That does not surprise me in the least as Experian, who have recently taken over from Dun & Bradstreet the work of analysis and calculation of the risk-based levy, have already caused delay due to the complexity of the work which they seem to have underestimated.

PPF control

So what does all this actually mean for schemes and for the trustees who run them? There is very little doubt that the PPF wishes and needs to keep under firm control the calls that may be made upon it due to defaulting employers and failing schemes. There is also little doubt that in the early days of scheme specific funding, trustees may have been lulled into a false sense of security by the apparent ease with which type A guarantees passed muster.

In attempting to link far more closely the value of the guarantee to the reduction in risk, the PPF cannot really be criticised, save for the additional cost that potentially may be incurred by schemes.

Detailed covenant assessments will need to be carried out – a covenant in this context meaning the ability and willingness to pay the liability owed. In the past, schemes may have got away with 'back of fag packet' type assessments or the finance director assuring the trustee board that the parent was 'good for the money'.

Now, sophisticated and detailed analysis and tracking by experienced covenant assessors are far more likely to be required. These do not come cheap, but at least it may result in a far more realistic picture being hung should the worse happen and the guarantee need to be called upon.

At the end of the day, we should of course remember that this is all about security of members' benefits. And that may be a price worth paying. **SJ**

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Issue:
Vol 158 no 34 09-09-14