

PREMIER PENSIONS MANAGEMENT

LEGISLATION UPDATE : 05/07

Contingent Funding

Until recently contingent funding has not been greatly used in the UK pensions sector. Over the past 12 months, a number of companies have started to consider other ways of supporting the pension fund other than through direct investment, via employer contributions. The main reasons behind this appear to be a desire to defer pension contributions due under the Scheme Specific Funding Requirement.

Contingent funding can also be used to improve security, which may be necessary as a result of the (lack of) strength of the Principal Employer (or as an addition to a strong employer). To acknowledge this, The Pensions Regulator and the Pension Protection Fund will take contingent assets into account within Scheme Specific Funding and when calculating PPF levies.

Contingent funding means payments that can be made to a pension plan under pre-agreed circumstances. This can include reductions in funding levels or changes with the employer's credit rating. There are various types of contingent asset and they can include:

- Escrow account, pledged asset
- Letter of credit, credit/equity default swap, or
- Parent company guarantee (if it has any value!)

The circumstances of the Principal Employer will determine whether contingent funding arrangements are appropriate, these could include:

- Cash flow management
- Unusable surplus (in the plan)
- Taxation
- Agreement over investment strategy
- Reducing the PPF levy

Cash Flow

Under the Regulators guidance Trustees are encouraged to act as an unsecured creditor of the Company. Payment of the deficit over a short as possible time frame would be a sensible option the Trustees might want to implement. If a contingent asset is provided by the Company, the Trustees may be able to agree a less rigorous funding plan.

Unusable Surplus

The legislative structure of UK pension plans does not facilitate a return of surplus to the Company in a simple way. In some circumstances a refund is not allowed at all. Whilst this might sound novel, prior to 1999 many plans had large surpluses and a number of plans are now finding the funding levels improving to the extent that a surplus is a real possibility. Contingent assets can be useful in this circumstance as it will address the security issue without the Company paying (what could potentially be) unnecessary contributions into the plan.

Taxation

Tax relief on contributions may not always be available, particularly if one off special contributions are being considered. It may prove more tax efficient to hold certain assets within the Company rather than in the plan.

Agreement over Investment Strategy

The Company could use contingent funding as a way of getting the Trustees to agree to a certain type of investment strategy which they may be reluctant to adopt if they have concerns about the strength of the employers covenant. Providing additional security contingent on the employer's insolvency or underperformance of the investment strategy may help the Trustees consider these alternative investment options.

Reducing the PPF Levy

The PPF Board allows the use of contingent funding (in some forms) to be taken into account when calculating the risk-based levy. The contingent asset can therefore reduce the cost of the levy. The PPF paperwork is quite prescriptive, but it is worth considering, especially for companies with poor credit ratings or large PPF deficits.

Summary

The use of contingent funding can have a material impact on cost and control for companies looking to manage their plans. Other stakeholders in the business will need to be aware of any security which is provided to the Trustees, but this is an area which is generating more interest and is another tool for companies to consider.

For Trustees it can also have a positive impact as it can provide a degree of security should the Principal Employer become insolvent or funding triggers are breached.

We would recommend that companies and trustees review the options they have available to them and whether this could have a positive impact on funding and/or security before committing to a particular approach.

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This update includes general information and cannot be relied upon for individual schemes issues. You should contact your adviser or Paul Couchman at Premier Pensions Management Ltd, Capital Business Centre, Units 14 & 15, 22 Carlton Road, South Croydon, Surrey, CR2 0BS. DL: 020 8916 2129. Email:

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