

# corporate briefing



## Contingent funding – helping companies to reach a funding plan that suits them

### Summary

**Contingent funding arrangements can be an attractive solution to funding issues from the perspective of both companies and trustees. Typical key drivers are to manage the pension contributions and to reduce the Pension Protection Fund levy.**

**There are a number of options available – the most suitable will depend upon the specific circumstances of the company and the scheme – and the relative merits of each should be examined.**

### Background

Many companies will be about to enter discussions with the scheme trustees about the preliminary results of the first scheme-specific funding valuation. Our experience to date indicates that trustees are likely to be seeking higher contributions than those currently being paid (possibly significantly so), thus causing a tension with the other cash demands from the business. With stronger funding standards, the potential for a pension surplus to arise, either now or in the future, is becoming a very real possibility for many schemes – particularly if a reasonable proportion of the assets are held in equities (or similar investments). Whilst a surplus may initially appear attractive, it raises yet another set of issues for companies particularly if the surplus cannot be realised on the balance sheet.

Hence, for a number of reasons, the payment of cash into a pension scheme may be undesirable from a corporate perspective, yet agreement needs to be reached with the trustees regarding the contribution schedule. Contingent funding arrangements are becoming increasingly popular, providing a solution that both companies and the trustees can be comfortable with – potentially a 'win-win' outcome.

### What are contingent funding arrangements?

In essence, contingent funding refers to promises made to the pension scheme to pay agreed amounts to the scheme in pre-specified situations (often insolvency of the employer, default by the employer of the contribution schedule, or where the funding level has fallen below a particular level).

They are attractive to trustees because they provide additional security which is largely independent of the company and, often, provide a very high level of security in the 'worst case scenario' of employer insolvency. For companies, there can be a number of advantages depending upon the type of arrangement entered into although all reduce the need to directly pay cash into the scheme. The main forms of contingent assets, and the circumstances where they might be considered, are summarised in Table 1 overleaf.

Companies are becoming increasingly creative in employing contingent funding in a way that best suits their business. M&S' creation of a partnership with the pension scheme, containing M&S properties, as a means of improving pension scheme security, being a good example.



**Table 1 | Contingent assets**

	<b>Escrow accounts</b>	<b>Letters of credit</b>	<b>Parental company guarantees</b>	<b>Charges over fixed/floating assets</b>
<b>What are they?</b>	Accounts held by the sponsoring employer which would be assigned to the trustees in agreed circumstances	A banking facility typically providing financing to the scheme in agreed circumstances	Legal guarantees from a parent/associated company to stand behind the scheme in agreed circumstances (typical employer insolvency)	Legal agreements to convey company assets to the scheme (for example, properties owned by the company) in agreed circumstances
<b>Where are they useful?</b>	Cash is available or can be raised by debt	Employer is strong enough, or has collateral available to keep charges relatively low	A stronger parent company stands behind the sponsoring employer	Unencumbered assets of some form (for example, properties or trade receivables) are readily available

**Why use contingent assets?**

Some of the main reasons why our clients have been looking at contingent funding are:

- **Manage the cash flow** – companies typically have competing demands for cash and even where substantial contributions can be afforded in the short term, they may wish to retain the flexibility of keeping cash within the business. The contingent arrangements above (other than escrow accounts) allow extra security to be provided to the scheme, whilst retaining such flexibility. One of our clients has used a letter of credit to justify keeping contributions to a manageable level, thus saving millions of pounds that would otherwise have been required.
- **Avoid the risk of over-funding** – many schemes are now in surplus on an accounting measure and some companies are beginning to question why further contributions directly to the pension scheme are necessary, particularly as a large surplus may not be fully recognisable in the accounts. Even if this is not an immediate issue, superior returns from return-seeking assets means that it may well become so in the future, and contributions paid now may prove not to have been needed. An added difficulty is that surplus can be difficult to recover under current regulations – the company carries all of the downside risk but reaps none of the upside if assets perform well. Some of our clients have used escrow accounts to hold contributions that drip-feed into the scheme where the funding level drops below a certain agreed level.

- **Reduce the Pension Protection Fund (PPF) levies** – all of the contingent funding arrangements above (provided they meet specified conditions) can be used to reduce PPF levies. Parental guarantees can be particularly effective, and this is one reason why they are the most popular form of contingent funding arrangement. They can particularly work well in a multi-employer arrangement, without necessarily leading to further obligations on any of the employers. We were able to help one of our major multi-employer clients cut its PPF levies by 75 per cent using this technique.
- **Retain control over investment strategy** – once contributions are made to a scheme their investment becomes the legal responsibility of the trustees. Surveys have shown that the better funded schemes tend to have more conservative investment strategies. Providing additional security, contingent on the sponsor's insolvency, may make the trustees more willing to maintain a return-seeking strategy. Furthermore, the company can retain significant control of any assets in an escrow account, depending on how it is structured.

- **Taxation** – tax provisions delay the recognition of tax relief that is available if substantial increases in contributions are required. A contingent asset could help to manage the increase in contributions that would otherwise be required, so accelerating the recognition of tax relief.

There are a number of issues that companies need to consider before committing contingent funding to the pension scheme. Watson Wyatt has practical experience in dealing with these issues with the help of tax advisers, lawyers, and auditors.

**Further information**

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