Creative funding strategies

Arron Slocombe and Tom McNaughton reveal the challenges and opportunities creative fund strategies can provide for scheme sponsors and the modern trustee

DB pension schemes are now as much a creditor risk to manage as an employee benefit. They can absorb as much c-suite and treasury team energy as that of the pensions team.

Contingent funding arrangements – bespoke legal structures supporting alternatives to 'simple' cash funding, using non-scheme assets – are unlocking mutually beneficial funding plans with longer term targets. The regulator's March 2019 Annual Funding Statement now explicitly recommends their consideration:

- "If concerned about risk of trapped surplus, consider using escrow, asset-backed contributions (ABCs), and contingency planning".
- "Strengthen short-term security through other means such as contingent assets and guarantees where available."

Contingent assets in context

Contingent assets sit alongside benefit changes (eg scheme closure, and RPI to CPI inflation switches) and consolidation (eg scheme mergers, asset pooling) in the modern trustee's and employer's toolkit.

There is no more collaborative area in the pensions field: legal expertise crossing pensions, funds, and banking must dovetail with specialist actuarial and covenant support to galvanise trustees and employers to meet their goals:

- Trustees: formal recourse to non-cash or non-scheme assets – or widening legal covenant support to group companies; pre-agreed triggers for funding injections; a framework for a better long term funding target (a specific regulator focus);
- Employers: as well as better cash management or spreading, the bespoke triggers and the potential for retaining control over (and potential return of) assets/investments.

Varieties of contingent assets

A non-exhaustive list includes:

- **Asset-backed funding** – typically trustees take a limited partnership interest indirectly linked to income streams from a group asset (eg property or even intra-group loans) – all structured properly to navigate 'employer related investment' constraints; with a legal 'underpin' to protect the trustees if it were unwound.
- **Guarantees** – from a parent or bank; tailored caps (fixed/floating); backing scheme ongoing contributions and/or s75 debts; 'evergreen' or fixed term; potential scope for guarantor replacement.
- **Escrow accounts, charged accounts, trust accounts** – different legal structures, but fundamentally similar: (1) a special vehicle (escrow account, ring-fenced company account, external trust), (2) an 'agent' role (escrow agent, custodian, or external trustees) to administer the vehicle, and (3) trustee and employer agreement governing applicable assets, control, and – again key – the 'triggers' for passing the assets into the scheme or – in good times – back to the employer.

More advanced forms may combine the above with other objectives (eg RPI to CPI switches, investment de-risking and buyout journey planning) into one carefully negotiated 'framework agreement' or 'memorandum of understanding'.

Triggers and consequences

Key to trustees, employers (and now TPR) is to document 'triggers' for contingent funding, cash or covenant support measures – and the pre-agreed consequences when engaged.

These usually cover downside risks but potentially also positive funding milestones.

Trustees

Trustees may be more focused on making assets and income streams 'bankruptcy remote', ensuring ring-fencing of assets, or legal charges or security (being careful not to label something as 'security' when it is not). Trustees may seek triggers at an earlier (measurable) stage of corporate distress than formal insolvency or to extend triggers to group companies. Particular care is required in respect of overseas covenant support.

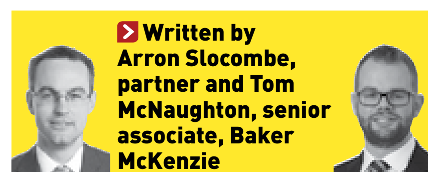
Employers

Treasury and legal teams must scrutinise the detail and at least share the agenda-setting with trustees. They must ensure 'pension' triggers align with debt facilities (say) and avoid cross-default triggers.

The future

Early fears that the white paper's focus on defining 'prudence' and 'appropriate' recovery plans would lead to a reversion to a prescriptive funding test – and conceivably stifle innovation – have eased with later reference to a 'comply or explain' approach.

The regulator's March 2019 Annual Funding Statement certainly shows that employers and trustees must add contingent assets to their toolkits.



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