Summary
- Contingent funding arrangements are set to soar in popularity in the coming months and years.
- The types of contingent funding arrangements are numerous, with multiple benefits for DB schemes, wherever they are on their journey.
- Many schemes today are not aware of the full range of options they have, nor the associated pros and cons.
- Trustees should work with their advisers to ensure that arrangements are properly structured and well understood.

Their day in the sun

Francesca Fabrizi explores why contingent funding arrangements are predicted to become more mainstream among DB pension schemes today and how schemes can make the most of what's on offer

Contingent funding arrangements for defined benefit (DB) schemes are nothing new, yet their popularity is expected to soar in the coming months and years, influenced by the current economic climate, recent market trends and various regulatory pressures.

LCP's *Contingent funding handbook: Emerging trends and market practice*, published earlier this year, went as far as estimating that three-quarters of companies with large DB schemes could be using contingent funding arrangements in the near future, with several factors likely to contribute to their surge in popularity.

"I predict that, within the next two years, 75 per cent of companies with significant DB pension schemes will use contingent funding as an integral part of their governance processes to manage their legal, liability and reputational risks from the Pension Schemes Act 2021 regulator powers," comments LCP principal, Helen Abbott, in the report, while LCP partner, Phil Cuddeford, argues that this is an approach "whose time has come".

"Trustees can get the assurances they need about future funding of the scheme while sponsors are able to concentrate their resources on ensuring the business is still there in the future," he says.

The reasons for such an expected increase in arrangements are diverse, with LCP highlighting as many as 12 influential factors in its report, some more on trustees' radars than others, including the Pension Schemes Act 2021; Pension Protection Fund (PPF) levies; Covid-19; over-funding risk; and new funding regulation.

Contingent solutions can also take a variety of forms, as outlined in the handbook, "but generally involve the sponsor agreeing to contribute more to its pension scheme if certain triggers are reached in return for less upfront cash into a scheme".

Some of the more common arrangements, as detailed in the handbook, include contingent contributions, based on funding and/or covenant triggers; escrow-type accounts, which hold funds that can be drawn on by the pension scheme in certain circumstances but are not actually held within the scheme; parent company guarantees, where additional funding is provided by the parent if the immediate sponsor is unable to pay; asset-backed funding, where the scheme has a claim over an asset if needed; and 'guarantees' provided by banks or insurers.

The traditional benefits of such arrangements are also well known, explains LCP. "They can provide valuable additional security for pension schemes, helping make the case for a longer deficit recovery plan; for well-funded schemes they can help avoid 'trapped surpluses' where a scheme has more than it needs but the excess cannot easily be withdrawn; and they can help to underpin a more growth-orientated investment strategy because of the downside protection that they provide."

As a result, Cuddeford believes that contingent funding is no longer a niche area and that "virtually every sponsor and trustee board should have it high on their agendas now".

DLA Piper partner, Matthew Swynnerton, agrees that the combination of economic uncertainty and regulatory pressure is likely to impact the popularity, as well as the types, of contingent funding strategies going forward. Whilst traditional parent company guarantees have long been a popular form of contingent asset, and will remain so, he says, there are number of factors that will inevitably make other types of contingent arrangement, such as arrangements to contribute to the scheme when certain defined triggers are hit (for example, in relation to covenant or funding levels), together with escrow arrangements, contingent guarantees and reservoir trusts, more popular.

"Firstly, we have all seen the economic uncertainty caused by Brexit and Covid. Contingent funding arrangements can be used to improve covenant support for the scheme in times of uncertainty, whilst enabling the sponsor to retain cash in the business rather than tying it up in the pension scheme or resulting in trapped surplus."

This can be in members' interests if it has a beneficial impact on the sponsor's prospects and member employment, as well as providing increased security in respect of members' benefits.

Secondly, adds Swynnerton, changes in the regulatory regime may make contingent funding arrangements more popular. "The regulator taking a tougher stance on recovery plans, the broadening of the regulator's moral hazard powers under the Pension Schemes Act 2021 and changes to insolvency legislation could all result in the need for mitigation in scenarios where mitigation could previously have been avoided."

The fact that contingent funding arrangements are very flexible and can be structured in a way that suits the specific needs of the scheme may increase their popularity as a form of mitigation in these scenarios, he argues, "therefore, I think we can safely expect to see contingent funding arrangements increasing in popularity in the future".

Cartwright scheme actuary and head of pensions strategy, Jonathan Seed, concurs there are good reasons why contingent contribution arrangements will become more prevalent, as the focus has shifted from the three-year valuation cycle to the long-term journey plan.

"They will be one of the key tools used a part of a scheme's IRM framework, for example to support funding strategies that involve allowing for more investment risk," argues Seed. Also, as schemes get closer to buy-in and buyout, contingent contribution arrangements can be used to avoid the risk of over-funding.

"They effectively give trustees and employers another option when setting their funding strategy, which will be welcomed by many schemes as we deal with the impact of Covid over the next three years and beyond," he adds.

Different scenarios

Seed is already seeing contingent funding structures becoming more common among clients in a number of different situations.

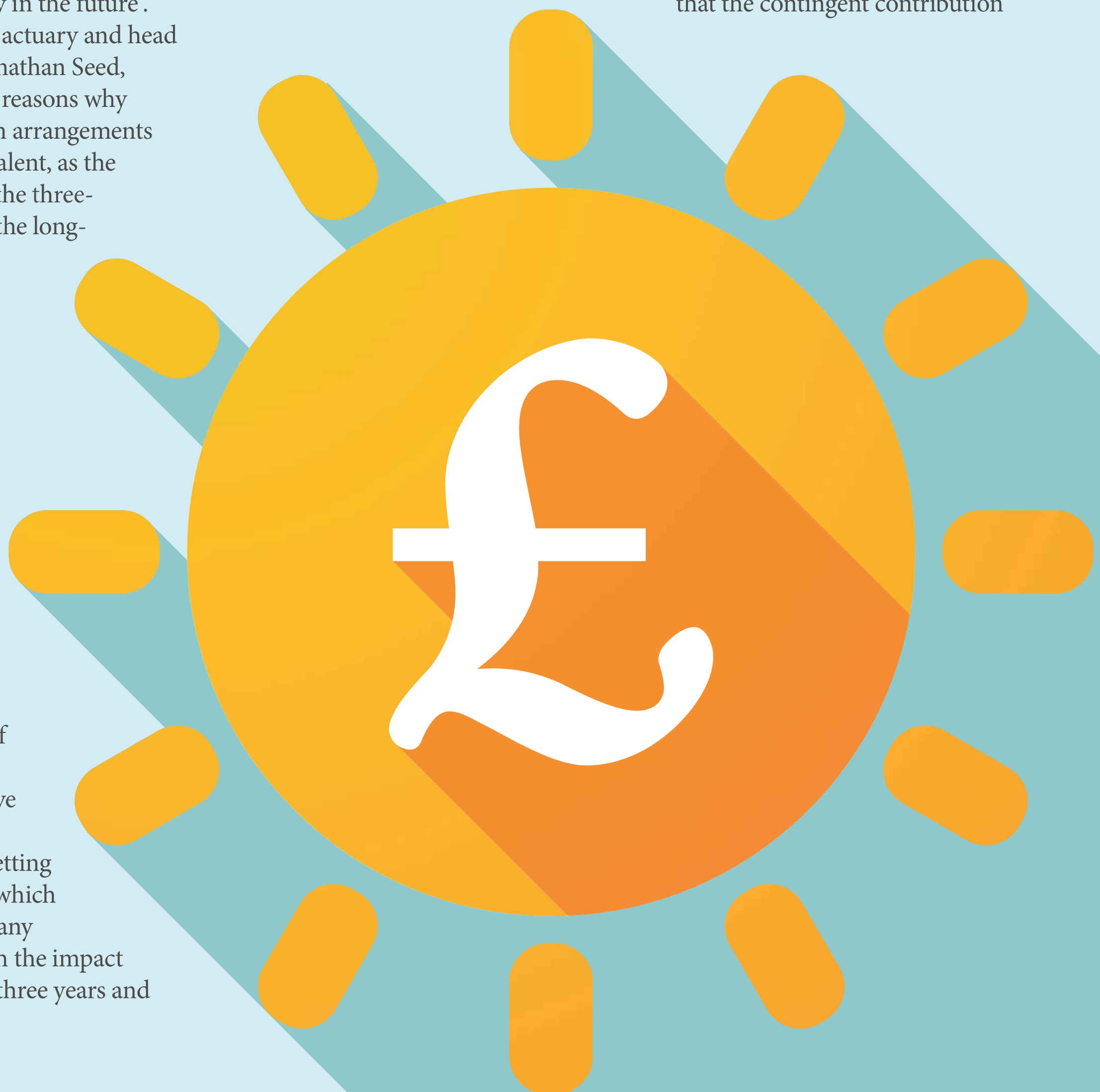
First, he says, to provide more flexibility on funding assumptions and contribution levels. "For example, if some outperformance is allowed for in the discount rate, regular contributions can be lower with contingent contributions payable if the outperformance does not materialise."

Seed has also seen many employers reduce or suspend dividend payments over the past 18 months, and thus he expects to see contingent contribution arrangements put in place to protect the scheme when dividends restart.

They are also being used, he explains, to provide protection against future deterioration in the employer covenant; as well as to ensure continued financial support as schemes get close to buyout where a sticking point can be the risk of trapped surplus and the associated tax implications. "Here, cash can be held in escrow and only paid into the scheme if it's actually needed."

Also on buyout, some employers have a pre-agreed extra contribution if the scheme gets to within a specified distance of buyout, says Seed. "This prevents the employer regret risk of 'if we'd known the buyout deficit was down to £x million, we'd have written a cheque.'"

In all cases, however, Seed emphasises that the contingent contribution



arrangement should be used as part of a wider funding and risk management approach typically including cash contributions, close covenant monitoring and, in some cases, contingent assets.

PwC partner, Raj Mody, also believes that contingent funding arrangements and structures are likely to become more prevalent in the coming years but, rather than place too much emphasis on regulatory pressure or covenant concerns, he instead believes it is because more and more pension schemes will end up with a surplus. "That surplus will be trapped, or only refundable to the sponsor under certain very limited situations and then taxable, so it's not an optimal strategy to overfund a pension scheme," warns Mody.

Indeed, PwC's *Pension Funding Index* for June 2021 reported that the funding status for the UK's 5,300 corporate DB pension schemes continued to show that schemes are, on average, in a clear surplus position.

It's important to note, also, that the regulatory system already pushes schemes to fund prudently. So, by design, schemes will end up with a surplus as eventually those prudent buffers can unwind and the additional funding won't be needed. That is one of the underlying economic drivers for contingent funding, continues Mody.

An optimal approach therefore, he argues, is to hold additional support funding in separate vehicles, where funds can be refunded back to the sponsor without adverse consequences or loss of value if they end up surplus to requirements. "This is good for member security as sponsors are more likely to be able to commit more support in these structures, knowing that in case they overshoot they can access the surplus funds more easily and efficiently."

Tips for pension funds

But what does this mean for pension funds trustees and what might they need to bear in mind when it comes to contingent funding arrangements for their own schemes?

"Primarily, trustees should work with their advisers to ensure that any arrangements are properly structured to suit their specific needs, but whatever form they take it is vital that contingent funding arrangements should be documented in a legally binding agreement to be effective," warns Swynnerton.

Trustees should also work with their advisers, he argues, to ensure that they fully understand the extent of the security provided – what are the termination triggers, for example? Has the provider of the security sought to include any provisions that could constrain how they exercise unilateral trustee discretions, such as investment decisions?

Seed agrees that, with any type of contingent arrangement, it is essential that the contingent events and implications are clearly defined and understood. "In other words, you need to be very clear on what is measured, how and when it is measured, where the trigger levels are and exactly what will be paid if a trigger is hit," says Seed.

It is important to also recognise, he adds, that while the trustees and employer may have the same long-term objective, they will also have different priorities. "As a trustee it's essential to understand why the arrangement is being used and whether you should negotiate something else as part of the overall deal."

Depending on the terms of the security, trustees may also need to make service providers, such as the scheme administrators or any fiduciary managers, aware of certain terms to ensure that they do not cause inadvertent breach or termination of the security, says Swynnerton.

"It should also be borne in mind that if one of the aims of the contingent arrangement is to reduce the PPF levy, then the documentation will need to follow the PPF's standard form for the relevant type of contingent asset," he adds.

As with many aspects of pension provision, the problem of too much choice can also cause more confusion among trustees than add value and, as a result, argues Seed, many schemes today are not aware of the full range of options they have, nor the associated pros and cons. "For trustees, cash may still be king but, for many employers, other options will be needed in the current environment and for years to come. It's important that trustees are aware of these other options and understand when and how they should be used."

Finally, he adds, trustees need to be very careful on covenant. "You need to be sure the employer will be able to pay if a trigger event happens. This is likely to mean closer monitoring of covenant where contingent contribution arrangements are in place."

All in all, he concludes, contingent contribution arrangements should be part of the discussions and, for many schemes, will be one of the key tools when it comes to valuation, long-term planning and risk management.

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