

THE BOARD OF THE PENSION PROTECTION FUND

**Guidance on Contingent Assets
Part 3
Type B Contingent Assets**

2019/20

DRAFT

CONTENTS

1	THE GUIDANCE	3
1.1	General introduction	3
2	TYPE B CONTINGENT ASSETS	3
2.1	Overview	3
2.2	Security over cash (Type B(i)).....	3
2.3	Security over land (Type B(ii))	4
2.4	Security over securities (Type B(iii))	4
2.5	Liability caps	4
2.6	Requirements as to the Chargor as Employer's Associate	6
2.7	Deemed value based on liability cap.....	7
2.8	Recognition for levy purposes.....	7
2.9	Release of underlying assets where oversecured.....	7

1 THE GUIDANCE

1.1 General introduction

1.1.1 The Guidance in relation to Contingent Assets is comprised of four Parts. These are:

- (a) Part 1 - General Requirements;
- (b) Part 2 - Type A Contingent Assets (group company guarantees);
- (c) Part 3 - Type B Contingent Assets (charges over assets); and
- (d) Part 4 - Type C Contingent Assets (letters of credit / bank guarantees)

(the "**Contingent Asset Guidance**").

1.1.2 All four Parts that comprise the Contingent Asset Guidance incorporate (where still relevant to this levy year) the information in the previous guidance that collectively related to Type A, Type B and Type C Contingent Assets in the Guidance in relation to Contingent Assets for 2019/20.

1.1.3 This Part 3 of the Contingent Asset Guidance covers specific requirements in respect of Type B Contingent Assets and should be read in conjunction with Part 1 of the Contingent Asset Guidance.

1.1.4 Parties should particularly note the Board's requirements for the 2019/20 levy year in respect of re-execution of certain Contingent Assets. In order for Type A and Type B Contingent Assets to meet the Board's definition of Standard Form, any such agreements that contain fixed monetary caps must be re-executed for the 2019/20 levy year. For Type B contingent assets, the Board's expectation is that (as a matter of normal legal practice) contingent assets will be re-executed afresh rather than (for example) amended or restated.

2 TYPE B CONTINGENT ASSETS

2.1 Overview

2.1.1 Type B Contingent Assets comprise security granted by a company (the "**Chargor**") to the trustees of the scheme. The assets must comprise one of the types listed at paragraph 9 of the Contingent Asset Appendix, and will only be taken into account where the trustees have the first priority charge over the asset and there are no prior or pari passu security interests.

2.1.2 One issue that has caused some concern is whether Contingent Assets (particularly of Type B) fall foul of the statutory restrictions on employer-related investments. Ultimately this is a question of statutory interpretation and trustees should seek their own advice. However the Board's view is that contingent assets of the types it will recognise for levy purposes do not constitute an investment of scheme assets/resources of the scheme by the trustees, and that therefore the restrictions are not relevant.

2.2 Security over cash (Type B(i))

2.2.1 Full details of the certification and documentation requirements are contained in paragraphs 28 – 30 of the Contingent Asset Appendix.

2.3 **Security over land (Type B(ii))**

2.3.1 Type B(ii) contingent assets must be valued on a market value basis. However, if the land (or any part of it) is occupied by the Chargor, any of the employers covered by the security, or any of their associates, it must be valued on a basis which excludes any value attributable to the Chargor/employer/associate's occupation of the property. The trustees must therefore ensure that the valuation they provide is prepared on the appropriate basis, as a valuation wholly or partly on the wrong basis will result in the Contingent Asset being rejected. Full details of the certification and documentation requirements can be found at paragraphs 31-34 of the Contingent Asset Appendix.

2.3.2 The wording of paragraph 32(3) of the Contingent Asset Appendix, including references to "valuation date", "market value", and "special assumptions", is drawn from Guidance Note 2 contained in the March 2012 edition of the Royal Institute of Chartered Surveyors Red Book.

2.3.3 When certifying a new Type B(ii) Contingent Asset, the following should be submitted:

- (a) A full valuation which was less than three months old at the certification date; or
- (b) A full valuation which was more than three months old at the certification date AND a desktop / short-form valuation updating the full valuation which was less than three months old.

2.3.4 When recertifying a Type B(ii) Contingent Asset, the following should be submitted:

- (a) A full valuation which was less than 15 months old at the recertification date; or
- (b) A desktop valuation which was less than 15 months old updating a previously submitted full valuation.

2.3.5 Where there are multiple properties contained in a single Contingent Asset, and the properties were valued on different dates, the date entered on the contingent asset certificate should be the oldest of those valuation dates (to ensure that the Board's requirements are met in respect of all valuations).

2.4 **Security over securities (Type B(iii))**

2.4.1 Full details of the certification and documentation requirements are contained in paragraphs 35 – 37 of the Contingent Asset Appendix.

2.5 **Liability caps**

2.5.1 Type B security agreements require the amount recoverable from the Chargor in respect of Secured Scheme Liabilities to be capped. There are, broadly speaking, five types of cap:

- (a) a fixed sum;
- (b) a fluctuating cap based on the scheme's s179 funding level;
- (c) a fluctuating cap based on the scheme's s75 funding level;
- (d) a combination of (a) and (b) above, i.e. the lower of a fixed sum and a fluctuating cap based on the scheme's s179 funding level; and

- (e) a combination of (a) and (c) above, i.e. the lower of a fixed sum and a fluctuating cap based on the scheme's s75 funding level.

2.5.2 The January 2018 standard form agreements have changed the structure of the fixed element caps, to clarify the circumstances in which payments by the Chargor under the agreement will reduce the cap. The forms introduce the concept of pre-insolvency and post-insolvency caps. All Contingent Assets that include a fixed cap must include a figure for the post-insolvency cap (which will be the relevant figure to be taken into account for levy calculation purposes). In addition, parties to an agreement with a post-insolvency fixed cap may choose to insert a cap on their pre-insolvency liabilities, so that their agreement contains two caps.

2.5.3 To explain the pre-insolvency caps available for use in the new (January 2018) standard form, where the parties have chosen a fixed cap for post-insolvency demands:

- (a) Option A is expressed to be "unlimited". What this means is that the chargor must pay out the full amount of the Secured Scheme Liabilities. It is up to the Chargor to ascertain what the extent of that might mean in the context of the scheme in question.
- (b) Option B, which envisages a pre-insolvency cap of a fixed sum, provides that the pre-insolvency cap shall not be less than (but may be greater than) the post-insolvency cap, less any pre-insolvency demands. Option B is structured in this way so as to ensure that a fixed sum pre-insolvency cap is meaningful for those who wish to include it (i.e. not trivial). This fixed sum cap will be reduced over time by any pre-insolvency demands made.
- (c) Option C is a fluctuating cap rather than a fixed sum, and is defined by reference to the employer's funding obligations under the scheme-specific funding provisions of the Pensions Act 2004 (e.g. schedule of contributions and recovery plans) and (if selected) any further funding obligations under the scheme rules during the Reference Year in question. This Option C refreshes every Reference Year. The reason it is drafted with specific reference to the scheme-specific funding requirements is so that the Chargor can ascertain what the limitation means in concrete terms, and can explain this (as may be needed) within their business.

2.5.4 Parties who wish to cap the pre-insolvency liabilities therefore have the option of choosing a fixed cap at a robust level, or a fluctuating cap (refreshing each year) based on anticipated annual liabilities.

2.5.5 For post-insolvency demands in a fixed cap agreement (i.e. caps including a fixed monetary sum element), post-insolvency demand payments erode the post-insolvency cap. No pre-insolvency demand payments erode the post-insolvency fixed cap - this is because a cap that may not protect a scheme's position on insolvency would involve a fundamental reworking of our levy calculation for schemes with Contingent Assets (which may lead us to conclude that no levy recognition could be given). So, in a multi-employer scheme scenario, if a post-insolvency demand is made in respect of one employer, the amount paid by the chargor will reduce the overall remaining cap.

2.5.6 For fluctuating caps (i.e. by reference to s75 or s179 funding levels), there is no cap to erode, so any payments made by the Chargor as a result of any demands (whether pre or post insolvency) will not affect the way that the cap continues to be calculated for any future demands.

2.5.7 For caps where there is a "lower of" formulation, paragraph 2.5.5 above applies to the fixed element, and paragraph 2.5.6. above applies to the fluctuating element.

- 2.5.8 A Type B charge granted to the trustees of schemes or sections where the employers are not associated by a permanent community of interest ("non-associated schemes") must have a fixed cap (and not one of the other formulations) to ensure that the credit given for such assets in the levy calculation is fair.
- 2.5.9 Alternative formulations for the liability caps are not generally allowed. However, caps of the form "the higher of Cap(a) and Cap(b)", where Cap(a) is one of the five caps set out above and Cap(b) is an alternative measure, are acceptable. They will be valued by the Board as though only Cap(a) applies, and should be certified accordingly.
- 2.5.10 Parties should note that the caps described in this section apply across (a) the Chargor's covenant to pay (in clause 2 of the agreement) and (b) the ability of the trustees to apply any proceeds of enforcement against the charged asset against scheme liabilities.
- 2.5.11 The recovery upon enforcement of a Type B security will, of course, also be limited by the value of the underlying assets over which the security is granted. Both the liability cap and the value of the underlying assets will therefore affect the value of the Contingent Asset credited for the purposes of the risk based levy.
- 2.6 **Requirements as to the Chargor as Employer's Associate**
- 2.6.1 The Chargor must be an Employer's Associate, as defined in paragraph 4(7) of the Contingent Asset Appendix, of at least one (but not necessarily all) of the scheme employers.
- 2.6.2 To fall within the wider definition of Employer's Associate in paragraph 4(7)(b), the Board must be satisfied that:
- (a) the Contingent Asset was given or paid for because of such an existing relationship between the person and the employer(s); and
 - (b) the person giving or paying for the Contingent Asset had a genuine and substantial reason for doing so regardless of any payment or other consideration received by it as a result of doing so.
- 2.6.3 The Board must be satisfied that a sufficiently strong relationship exists between the employer and the Chargor. This could be evidenced, for example, via long-term contracts between the parties that recognise a sharing of the pension scheme liabilities, but will ultimately depend on the individual case.
- 2.6.4 Similarly, whether or not there is a genuine and substantive reason for giving the Contingent Asset will depend on the individual case. If, for example, the Chargor will ultimately (through the particular relationship) bear the cost of higher levies if no Contingent Asset were in place, that Chargor would appear to have a genuine reason for giving the Contingent Asset.
- 2.6.5 The Board does not expect to receive evidence but if provided, for example, via a letter to the Board, the writer of the letter should base their view on having seen the requisite documentation. It is acceptable to include a statement as to associateship in the legal opinion, on the basis that the legal advisor has had sight of the relevant documentation or confirmations from the relevant parties and can therefore provide the confirmation as a matter of fact.

2.7 **Deemed value based on liability cap**

- 2.7.1 The value of Type B Contingent Assets for the purposes of the levy calculation is based on the liability cap and the value of the underlying assets. Further details are at paragraph 5 of the Contingent Asset Appendix.
- 2.7.2 The deemed maximum liability is calculated based on asset and liability information (including deficit-reduction contributions) certified to the Board prior to the start of the relevant levy year. Valuations (usually on a s179 basis) are rolled forward to a consistent date, on the basis published by the Pension Protection Fund.
- 2.7.3 The deemed maximum liability under the Type B security is then calculated as the actual limit on the Chargor's liability that would apply on the date referred to above, based on the asset and liability information referred to in the preceding paragraph.
- 2.7.4 The deemed liability limit under a single Type B Contingent Asset is not affected by the existence of any other Contingent Assets.
- 2.7.5 The value of the Type B Contingent Asset taken into account for the purposes of the levy will be the lower of (a) the deemed value of the liability cap and (b) the actual value of the underlying charged assets, based on the bank statement/valuation (as appropriate) provided to the Board. No adjustment is made to the value as per the bank statement or valuation to take account of any accrual of interest or fluctuations in value since the valuation date.

2.8 **Recognition for levy purposes**

- 2.8.1 Where there is more than one Type B Contingent Asset, the values are simply added together for the purposes of the levy and are treated as assets, including being subject to stressing and smoothing.
- 2.8.2 Full details of how Type B Contingent Assets are recognised for levy purposes can be found at paragraphs 17 and 18 of the Contingent Asset Appendix.

2.9 **Release of underlying assets where oversecured**

- 2.9.1 The standard forms of security agreement allow the Chargor to request that some of the assets are released. Following a request, the trustees must release assets to the extent their value exceeds the assumed value of the liability cap. Clearly it will be more feasible to release assets that are easily divisible, such as a proportion of the cash in a charged bank account or part of a portfolio of securities, than indivisible assets such as real estate.
- 2.9.2 The standard form agreements do not require the chargor to "top up" the assets if their value falls or if the actual funding situation deteriorates (even if some of the assets have previously been released under the provision described above). Trustees are however free to negotiate such "top-up" arrangements in addition to the standard terms. If the Contingent Asset arrangement is not "topped-up" the next year's levy will reflect the deterioration in the funding position. If a "top-up" arrangement is put in place, the next year's levy will reflect this "topped-up" position.