LCP INSIGHT CLARITY ADVICE

Contingent funding

An overview of the different options you may consider

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In the current challenged times, we expect to see greater innovation in solutions agreed between trustees and sponsors, including contingent funding solutions. Indeed, in a recent survey we found around 1/3 of schemes expected some form of contingent funding to feature in their next funding agreement. Schemes can adopt a range of different solutions, depending on their situations, to protect against different events. We outline these contingent funding options here to help you understand which one may be right for you.

Contingent funding is evolving...

Cash

- Escrow account
- Contingent contributions - funding
- Reservoir trust
- Contingent contributions - covenant

Credit

- Parent company guarantee
- Letter of Credit
- Surety bond

Assets

- Direct asset transfer
- Asset backed contributions
- Charge over assets

Corporate actions

- Negative pledges
- Sponsor restructuring
- Issue debt to fund pension
- 3rd party capital

Cash

01 *Escrow account*

An independently managed bank account to which a sponsor adds funds which flow to the scheme (or back to the sponsor) on certain conditions. Generally can be called upon in sponsor insolvency. Can help prevent over-funding already well funded schemes or sometimes to underwrite an investment strategy that may carry more risk than trustees would prefer. Assets in escrow can be invested as agreed between trustees and sponsor.

02 *Reservoir trust*

Similar to an escrow account but the funding is held in a trust. There is greater freedom as to how the funds are invested.

03 *Contingent contributions - funding*

Where a sponsor agrees to pay additional contributions to a scheme if its funding does not progress as expected. For example, if a scheme's deficit had not reduced as much as expected as each recovery plan year passes then an additional payment is made to bring plans back on track. Sometimes a funding corridor approach is used in conjunction with an escrow or reservoir trust so that any 'over-funding' can potentially be accessed by the sponsor.

04 *Contingent contributions - covenant*

An agreement that additional contributions will be made should certain covenant related triggers be breached. These could reflect negative or positive covenant indications, eg negative event triggers could be attached to a credit rating downgrade; positive event triggers could be attached to an increase in profitability – such as a percentage of a dividend paid over a certain amount paid in contributions.

Credit

01 *Parent company guarantee*

A guarantee in favour of the scheme provided by the sponsor's parent company (or another group entity of suitably additive covenant strength). Guarantees can be provided to support a scheme's liabilities on a certain basis, or sometimes the recovery plan. Trustees should seek to understand what the guarantee covers and so how much reliance they can place on it.

02 *Letter of credit*

A letter issued by a bank to one party, in this case the scheme, guaranteeing certain specified obligations of another party, in this case the sponsor. In the event that the sponsor does not fulfil its obligations to the scheme, the scheme can call in the letter of credit and the bank will make the payment due (and then seek to recover the amounts due from the employer).

03 *Surety bond*

Similar to a letter of credit but issued by an insurance company rather than a bank.

Assets

01 *Direct asset transfer*

Non-cash assets are transferred to the scheme. This could be property or investment assets. Sometimes non-tangible assets such as trademarks have been transferred. For some assets the scheme then earns an income from the sponsor (subject to certain sponsor related investment restrictions).

02 *Charge over assets*

Scheme is provided with a fixed or floating charge over sponsor assets. Effectively a mortgage. The charge provides that the scheme will get priority access to the asset in the event of the sponsor's insolvency and there will also be conditions if the sponsor wishes to dispose of the asset.

03 *Asset backed contributions*

Assets are placed into a special purpose vehicle (usually a Scottish Limited Partnership) in which the scheme and sponsor have an interest. The asset generates an income for the scheme and there are also insolvency related provisions securing the asset (or a share of it) in favour of the scheme. Complex and costly to set up and manage.

Corporate actions

01 *Negative pledges /dividend 'sharing'*

A negative pledge is a sponsor's commitment not to do certain things without consultation and agreement with the scheme. For example, not to grant security over its assets to another party. With some negative pledges there is a pre-agreed penalty which is often the case with a dividend sharing mechanism that is expressed as a negative pledge: eg the sponsor commits that it will not pay dividends in excess of deficit reduction contributions without a matching payment to the pension scheme.

02 *Issue debt to fund pension*

A company may find it is cheaper to issue and service bond or other debt to facilitate a one off payment to its pension scheme than agree to a long term recovery plan. A debt obligation to a bank or other lender will also not be volatile in the way that a pension scheme deficit can be.

03 *Sponsor restructuring*

Where a group takes actions to strengthen the direct sponsor covenant. This could be by an equity injection, write off of inter-company debt owing, or transferring business or assets to the sponsor.

04 *3rd party capital*

Capital is used as extra layer of protection for the scheme supporting its journey to buyout.

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