

Reducing your Pension Protection Fund (PPF) levy for 2019/20

November 2018

Pension briefing

HIGHLIGHTS

2019/20 is the second year of the Pension Protection Fund (PPF)'s third levy "triennium" under the new levy framework.

Trustees who wish to reduce their pension scheme's risk-based levy by taking account of contingent assets or asset-backed contributions need to pay careful attention to the certification processes that have deadlines of 29 or 31 March 2019.

The deadlines to remember are:

- Certification (or re-certification) of contingent assets on Exchange – midnight, 31 March 2019 (plus submission of hard copies, below)
- Submission of hard copy contingent asset documents to PPF – 5pm, 29 March 2019 (plus certification on Exchange, above)
- Certification of asset-backed contributions to PPF – midnight, 31 March 2019
- Certification of mortgages and other security by submitting an officers' certificate and associated hard copy documents to Experian – midnight, 31 March 2018
- Submit data to Experian to impact Monthly Experian Scores – one calendar month prior to the Score Measurement Date
- Certification of deficit reduction contributions on Exchange – 5pm, 30 April 2019
- Certification of full block transfers on Exchange (or emailed to PPF in limited circumstances) – 5pm, 28 June 2019 (application for exempt transfer status must be emailed to PPF by 5pm, 30 April 2019).

Invoicing for the 2019/20 levy year is expected to start in autumn 2019.

The PPF issued draft documents for the 2019/20 levy year in September 2018 and is expected to publish final documentation in December.



CONTINGENT ASSETS

Background

Contingent assets may be put in place to shore up a scheme's funding position (and so reduce the amount of the scheme's PPF risk-based levy) without the sponsoring employer having to put extra cash into the scheme.

The PPF recognises three types of contingent asset:

- "Type A": guarantees given by an "Employer's Associate", which may be a company or undertaking in the same corporate group as a sponsoring employer of the scheme, or an entity which has a pre-existing legal or commercial relationship with a sponsoring employer. The PPF expects trustees to investigate the financial strength of the guarantor and to certify the amount they consider could be recovered from the guarantor if the guarantee is called on. For details on the PPF's approach, please see the next page;
- "Type B": security given to the trustees over cash, real estate or securities; and
- "Type C": letters of credit and bank guarantees.

Liabilities under Type A and Type B contingent assets may be capped in the following ways:

- by a fixed monetary sum (a "**fixed cap**");
- by reference to a proportion of the scheme's funding deficit on either the PPF or the section 75 (buy-out) basis (a "**floating cap**"); or
- by the lower of a fixed cap and a floating cap (on one of the above bases).

PPF standard documents

The PPF has produced standard documents for putting in place contingent assets. The current standards were issued on 18 January 2018 and replaced the previous versions issued in December 2014.

Why have the standards changed?

The 2018 revisions to the Type A and Type B contingent asset forms address concerns that, under the previous standard agreements, any deficit repair payments made by the employer, guarantor or another guarantor might have the effect of reducing the level of the cap on the guarantee.

The 2018 standard forms introduce the concept of pre-insolvency and post-insolvency caps. Broadly:

- all contingent assets with a fixed cap element must include a post-insolvency cap, which will be the amount taken into account when calculating the scheme's risk-based levy; and
- contingent asset agreements with a fixed post-insolvency cap may also include a cap on pre-insolvency liabilities – if so, the pre-insolvency cap must be one of the following:
 - unlimited (Option A);
 - a fixed sum at least equal to the post-insolvency cap (Option B); or
 - a fluctuating cap by reference to the employer's scheme specific funding obligations (Option C).

Re-execution of certain contingent assets

Existing Type A or Type B contingent assets with a fixed cap element must be re-executed using the 2018 standard forms before they can be certified for the purposes of the 2019/20 levy year.

Existing Type A or Type B contingent assets with a floating cap and no fixed cap element do not need to be re-executed before being certified for 2019/20.

Trustees and employers may decide voluntarily to re-execute an existing contingent asset using the new standard forms, if they so wish.

Process for re-executing contingent assets

Where an existing contingent asset agreement is being re-executed in order to meet the PPF's requirements, the same documents will generally be required as for certification of a new contingent asset, that is:

- a certified copy of the legal agreement;
- a legal opinion (which may be a refreshed or updated version of an existing legal opinion);
- a copy of the contingent asset certificate; and
- confirmations/advice in relation to the value of the contingent asset.

Where a guarantor strength report (please see below) was produced on the same guarantor for the 2018/19 levy year, the PPF will accept a refresher report explaining what has changed.

For Type A contingent assets (guarantees), an alternative to re-execution is to move to the new standard forms by way of amendment and restatement. The PPF expects to require the same documents and certificates as for re-execution, but has asked for views. This should be confirmed in the finalised levy documents, expected to be published in December.

Re-execution of a Type B contingent asset will require creation of a new charge in favour of the pension scheme. The PPF has confirmed that a charge over real property should be registered at the Land Registry before completing the PPF's levy documents.

New contingent assets

If a new contingent asset is to be recognised by the PPF it must be:

- put in place using the PPF's standard form documentation;

- supported by various associated documents, including a legal opinion and, in some cases, confirmation that the benefit to the company providing the contingent asset has been considered and established;
- submitted to the PPF in hard copy by 5pm on 29 March 2019; and
- certified via the Pensions Regulator's on-line Exchange system by midnight on 31 March 2019.

We can help prepare all the necessary documentation.

Recertifying existing contingent assets

Existing contingent assets must be recertified via Exchange to be recognised for the purposes of the 2019/20 risk-based levy calculation, no later than midnight on 31 March 2019. Further documentation may also be needed if, for example, the contingent asset has been amended, or if the trustees are required to obtain a guarantor strength report (please see below).

A new legal opinion is usually not necessary, unless the legal position has changed so that trustees might be unable to give the relevant certifications without an updated opinion.

If your scheme's existing contingent asset was put in place using documentation other than the PPF's standard form current at that time, the contingent asset should be re-executed using up-to-date standard form documents.

We can help with any questions about the recertification process and, where necessary, assist in preparing any further documentation that needs to be submitted to the PPF.

Particular requirements for Type A guarantees

The PPF will only recognise a Type A guarantee if the trustees:

- certify the amount they consider to be the "**Realisable Recovery**" under the guarantee, whether or not the guarantee includes any fixed sum cap. This will involve identifying a specific sum the trustees are satisfied that the guarantor could pay if the guarantee is called on. Broadly, the Realisable Recovery will be the lower of this figure and any fixed monetary post-insolvency cap stated in the guarantee documentation; and
- confirm to the PPF that "*The Trustees, having made reasonable enquiry into the financial position of the certified guarantor, are reasonably satisfied that the Certified Guarantor, as at the date of the certificate, could meet in full the Realisable Recovery certified (and where this certificate covers multiple Certified Guarantors, that they can each meet in full the Realisable Recovery certified), having taken account of the likely impact of the immediate insolvency of all the relevant employers (other than the Certified Guarantor where that Certified Guarantor is also an Employer).*"

Where there is more than one guarantor the PPF will allow separate Realisable Recovery amounts to be certified in relation to each guarantor, rather than requiring each guarantor to be certified individually for the full amount of the guarantee. This does not alter the obligations of each guarantor: under the guarantee agreement, each guarantor must be jointly and severally liable for the sums guaranteed.

Before certifying the Realisable Recovery, the PPF expects the trustees:

- to take proportionate steps to consider the likely impact of the immediate insolvency of all scheme employers on the guarantor's ability to pay; and

- where the guarantee is expected to reduce the scheme's risk-based levy by £100,000 or more, to obtain a guarantor strength report before certifying the Realisable Recovery (please see below).

A different Realisable Recovery may be certified year on year, as trustees' views of the guarantor's financial strength and the scheme's funding position may change.

The PPF will usually adjust the guarantor's own levy band to reflect the amount that it is guaranteeing under the guarantee.

Guarantor strength report

Where the annual levy benefit arising from a Type A guarantee is £100,000 or more, trustees must obtain a report on the guarantor's financial strength from a professional advisor. The requirement for a guarantor strength report first applied in respect of the 2018/19 levy year.

Points to note include the following.

- The trustees must obtain the report before they certify the Realisable Recovery.
- The professional adviser will be required to accept a duty of care to the PPF Board, so that the Board may rely on the contents of the report for the purposes of the levy.
- The report should be prepared by a covenant adviser, with input from advisers as the trustees consider appropriate.
- Guarantor strength reports will be assessed on a pass/fail basis, to confirm whether they had been obtained by the certification deadline and whether they met requirements set out in PPF guidance.
- Where the levy benefit is less than the £100,000 threshold, trustees may choose to base their certification on a guarantor strength report.
- The PPF will reject Type A guarantees where the levy benefit exceeds the £100,000 threshold and the trustees fail to obtain a guarantor strength report by the "Measurement Time" (5pm on 29 March 2019 for 2019/20). However, it will have discretion to recognise a Type A guarantee in exceptional circumstances where the trustees reasonably believed that the levy benefit would be less than £100,000 but, due to unforeseen circumstances, the threshold was breached. In this case, the trustees would be expected to commission a guarantor strength report after certifying the Realisable Recovery.

How should trustees approach the certification requirement?

PPF guidance states that trustees should take proportionate steps in order to assess the Realisable Recovery. They are expected to be comfortable (rather than certain) that the guarantor could meet the Realisable Recovery. In some cases, it may be appropriate (or required – please see above) for trustees to obtain professional covenant advice. If the trustees are not required to obtain professional advice and decide not to do so, they should document the reasons why it was considered unnecessary: the PPF may request information about the trustee's analysis of the strength of the guarantor at a later date.

The PPF has emphasised the importance of trustees asking probing questions. In particular, it is essential for trustees to consider in detail what the knock on effect of the employer's insolvency will be on the rest of the group. This

may include considering:

- the reduction in value of shares in the employer held directly or indirectly by the guarantor;
- the impact on the value of other assets owned by the guarantor, such as brand value or intercompany investments;
- how readily the guarantor's assets could be realised;
- the loss of inter-company debts owed by the employer;
- the loss of supplies made by the employer to the group;
- where the guarantor is also an employer in the scheme, the impact on the guarantor of the insolvencies of other participating employers.

Practical steps the trustees could take include making enquiries of the guarantor's directors and management or seeking a letter of comfort from the guarantor. However, trustees should be able to demonstrate that they have challenged assertions made by the guarantor and, where appropriate, obtained third party evidence to support their view. In addition, trustees should not give the confirmation purely on the basis that they have attempted to obtain information and been unsuccessful.

Where a review of the guarantor has previously been conducted that is consistent with current PPF guidance on contingent assets, a simple update that considers what has changed since that review will generally be acceptable. The PPF has confirmed that this approach also applies to the re-execution of a Type A contingent asset with a fixed cap where the scheme is making no other changes.

ASSET-BACKED CONTRIBUTIONS

An asset-backed contribution arrangement (ABC) will only be recognised as a scheme asset for PPF levy purposes if it is certified by the scheme trustees.

The starting point is that the face value of the ABC arrangement, as shown in the scheme assets data, will be deducted from the value of the total scheme assets for the purposes of valuing the scheme's PPF deficit.

The trustees may then certify a value for the ABC (the "ABC Value") which will be added back into the scheme assets if it meets the PPF's requirements. Trustees are permitted to certify the lower of:

- the "**fair value**" of the ABC (based approximately on the value given to it in scheme accounts); and
- the "**stressed insolvency value**" of the ABC, reflecting the amount the trustees could reasonably rely upon recovering if all scheme employers (and guarantors) became insolvent.

To complete the certification process, steps the trustee will need to take include the following.

- Obtaining a valuation of their ABC arrangement from a suitably qualified professional in line with PPF guidance. The PPF's guidance allows for a lead valuer to prepare the valuation using information provided by other advisers.
- Where the PPF has recognised an ABC arrangement for a previous levy year, the ABC may be recertified with either an updated version of the previous valuation or a full valuation: it is for the valuer to decide whether a full valuation is required.

- Obtaining legal advice about the legal structure and enforceability of the ABC arrangement and the trustees' rights under it if all scheme employers (and guarantors) become insolvent. The legal advice needs to be given to the professional valuation expert.
- Where an ABC has previously been certified and the underlying legal position has not changed, the valuer may rely on the previous legal advice, provided that the legal advisers confirm that their previous advice remains current and that there are no material changes which may materially affect the basis on which the advice was given.
- Both the valuation and the legal advice must contain express wording that they can be relied upon by the PPF.
- The trustees must certify to the PPF that, having regard to legal advice, the ABC arrangement is legally binding, valid and enforceable and does not breach employer-related investment restrictions.
- The trustees must also certify other basic information about the ABC arrangement online by midnight on 31 March 2019.

The PPF does not provide standard form templates for the valuation or legal advice, so trustees and their advisers should consult the PPF's determination and guidance to ensure that all applicable requirements are met.

If the scheme has more than one ABC arrangement, separate certificates must be completed for each arrangement.

If the trustees decide against completing a valuation and certification process for an ABC arrangement, they may still gain credit for any payments actually made to the scheme under the arrangement. A separate, but less comprehensive, certification process applies to this. This alternative process also allows trustees to check that the amount deducted from their scheme assets in respect of the ABC arrangement is accurate.

Where other payments have been made towards repairing the deficit, or a block transfer made, in a scheme with one or more ABCs, trustees should consider the interaction between these and their ABC certification.

ABCs based on real estate with multiple properties

Following representations that there can be practical difficulties in obtaining individual certificates of title for each property under an ABC arrangement where multiple properties are involved, the PPF now allows trustees to provide alternative evidence of title to the valuer. If the valuer has sufficient confidence about the ownership of the properties to offer a duty of care on the valuation, then the PPF will accept this.

Of course, trustees may continue to certify an ABC using certificates of title.

What is an ABC?

In recent years, many schemes and sponsoring employers have put in place asset-backed contribution arrangements (ABCs) as a means of supporting a scheme's funding position while reducing the risk of "trapped surplus". ABCs vary but, typically, an income-producing asset (such as property) will be held by a third party (usually a Scottish limited partnership), with income from the asset being passed to the scheme trustees via distributions from the partnership.

The capitalised value of the trustees' interest in the partnership is treated as a scheme asset, thereby increasing total scheme assets and reducing or eliminating a deficit. In practice, the arrangement typically provides for the distribution to the trustees to be paid over a number of years. The governing documents of the partnership may specify events (such as insolvency of the employer) which will cause the arrangement to be "unwound" ahead of schedule, in which case a final payment may be made to the trustees.

Why are trustees required to certify ABCs?

The PPF considers that assets held within ABC arrangements are typically related to the employer's business (for example, a factory which is then leased to the employer) and their value is therefore connected with the employer's financial health. There is concern that the value given to an ABC arrangement in the scheme's accounts may be greater than the amount the trustees could reasonably expect to obtain if they had to sell the ABC asset in an insolvency scenario.

The PPF is concerned with a pension scheme's likely position should its sponsoring employers (and any guarantors) become insolvent. The PPF has therefore decided that only the realistic value of an ABC asset on insolvency should be taken into account in any reduction in a scheme's risk-based levy.

INSOLVENCY RISK: "MORTGAGE AGE" CERTIFICATIONS

As part of Experian's method of assessing employer insolvency risk when calculating PPF levies, "**mortgage age**" is taken into account. The mortgage age is the age of the newest registered mortgage or other charge over the assets of the employer (or assets of the employer's parent or other member of the employer's group). The PPF considers that, in general, businesses with more recent charges have a greater risk of insolvency.

Some types of mortgage or other charge need not be taken into account when calculating insolvency risk. These types of mortgage or charge are considered to be unconnected with higher insolvency risk, provided they meet the PPF's requirements. The five categories are:

- mortgages or other charges created on refinancing, where the refinancing is on the same or better terms than the original finance arrangement and the new mortgage is effective no more than 14 days after the release of the original mortgage (a "**Refinance Mortgage**");
- security given by tenants to landlords over deposits for leasing a property (a "**Rent Deposit Mortgage**");
- security given by an employer in favour of pension scheme trustees (a "**Pension Scheme Mortgage**"); and
- security which is "immaterial" compared to the employer's total assets (an "**Immaterial Mortgage**"); and
- all mortgages and other security where the employer, or another group company, has a sufficiently strong credit rating and certain other criteria are met.

To ensure that a mortgage or other charge is not taken into account by Experian, one of the categories above must apply,

and the employer must provide an officer's certificate and associated documents (including copies of relevant contractual documents) to Experian by midnight on 31 March 2019. In a change from previous years, for refinance mortgages it will be sufficient to submit copies of the relevant pages of the mortgage documents, plus a summary sheet, rather than sending full copies.

Guidance issued for the 2019/20 levy year confirms that:

- certificates previously accepted for calculation of the 2018/19 levy in respect of Refinance Mortgages, Rent

Deposit Mortgages, Pension Scheme Mortgages and mortgages where the credit rating requirement is met will automatically be carried over for use in calculating the 2019/20 levy; and

- certificates for Immaterial Mortgages must be submitted for the new levy year. A new certificate is also required where the credit rating exclusion is being relied on, if the basis on which the credit rating test is met is different from the basis on which it was met in previous levy years.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

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