

Reducing your Pension Protection Fund (PPF) levy for 2018/19

November 2017

Pension briefing

HIGHLIGHTS

2018/19 is the first 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 a deadline of midnight on 29 March 2018.

The deadlines to remember are:

- Certification (or re-certification) of contingent assets on Exchange and submission of hard copy supporting documents to PPF – midnight, 29 March 2018
- Certification of asset-backed contributions to PPF – midnight, 29 March 2018
- Certification of mortgages and other security by submitting an officers' certificate and associated hard copy documents to Experian – midnight, 29 March 2018
- Certification of accounting standard change with supporting evidence to Experian – midnight, 29 March 2018
- Submit data to Experian to impact Monthly Experian Scores – one calendar month prior to the Score Measurement Date (for new guarantors, by midnight on 29 March 2018).
- Certification of deficit reduction contributions on Exchange – 5pm, 30 April 2018
- Certification of block transfers on Exchange (or sent to PPF in limited circumstances) – 5pm, 29 June 2018

The PPF is consulting on the draft levy determination and on revisions to standard contingent asset agreements. The finalised levy determination is expected in December this year, with final form standard agreements expected in January. Invoicing for the 2018/19 levy year is expected to start in autumn 2018.



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.

PPF standard documents

The PPF has produced standard documents for putting in place contingent assets. The current standards were issued in December 2014. The PPF is currently consulting on revisions to the standard documents and intends to publish final versions in January. The consultation document explains that:

- new contingent asset agreements entered into after the date of publication of the new standards (expected to be in January 2018) must use the new documents;
- existing contingent asset agreements executed before publication of the final revised documents may continue to be submitted for recognition in the 2018/19 levy year (but action may be needed for 2019/20 – please see below);
- existing Type A and Type B agreements will not need to be re-executed using the new standards for the purposes of the 2018/19 levy – but see below; and
- for existing Type A and Type B agreements (including agreements executed after the consultation was issued but before publication of final documents in 2018) it is likely

that action to adopt the new standards will be required for the 2019/20 levy year.

The PPF has explained that the revisions to the Type A and Type B contingent asset forms are intended to clarify that:

- any deficit repair payments made by the employer, guarantor or another guarantor do not have the effect of reducing the level of the cap on the guarantee (the "Cap Interpretation" issue); and
- payments made under a guarantee but outside an insolvency situation should not erode the value of any cap on the guarantee: instead, the fixed cap must remain available in full in the event of the employer's insolvency (the "Cap Operation" issue).

The draft revised documents do not cover how the Cap Operation issue should work in relation to multi-employer schemes, as the PPF is seeking further input from the pension industry.

New contingent assets

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

- put in place using the PPF's standard form documentation (please see above about changes to the standard documents);
- 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; and
- submitted to the PPF in hard copy by midnight on 29 March 2018.

In addition, the trustees must submit a contingent asset certificate via the Pension Regulator's on-line Exchange system.

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 2018/19 risk-based levy calculation, no later than midnight on 29 March 2018. Further documentation may also be needed if, for example, the contingent asset has been amended.

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. 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 cap stated in the guarantee documentation; and
- confirm to the PPF that "*The Trustees, having made reasonable enquiry into the financial position of each certified guarantor, are reasonably satisfied that the*

certified guarantors (individually or in aggregate) as at the date of the certificate, could 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)."

- In a change from its previous policy, where there is more than one guarantor the PPF will now 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.

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

- to consider the likely impact of the immediate insolvency of all scheme employers on the guarantor's ability to pay; and
- in certain circumstances, 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 levy band to reflect the amount that it is guaranteeing under the guarantee.

Guarantor strength report

A new requirement applicable from the 2018/19 levy year is for trustees to obtain a report on the guarantor's financial strength from a professional advisor, where the annual levy benefit arising from a Type A guarantee is £100,000 or more. Points to note include the following.

- The trustees must obtain the report before they certify the Realisable Recovery.
- The PPF is consulting on the content of a report, which is expected to include a requirement for the professional adviser to accept a duty of care to the PPF Board.
- The report should be prepared by a covenant adviser, with input from advisers as the trustees consider appropriate.
- Where trustees base their certification of the Realisable Recovery on a guarantor strength report, any review by the PPF will look for the existence of a compliant report containing the appropriate duty of care, rather than directly testing whether the guarantor could meet the sum certified.
- Where the levy benefit is less than the £100,000 threshold, trustees may choose to base their certification on a guarantor strength report – meaning that any review by the PPF would consider the report rather than underlying financial information.
- The PPF intends to reject Type A guarantees which exceed the £100,000 threshold where the trustees failed to obtain a guarantor strength report by 31 March in the relevant levy year. 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 significantly 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.

- A report must be prepared for each time the guarantee is recertified. However, the professional adviser may decide whether the guarantor's circumstances call for a new or an updated report.

How do we 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.

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 online 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 29 March 2018.

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 has decided that from 2018/19:

- trustees may 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.
- 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, starting with the 2015/16 levy year. The mortgage age is the age of the newest registered mortgage or other charge over the employer's assets. 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 (a "**Refinancing 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**");
- all mortgages and other security where the employer's group 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 a certificate and associated documents (including copies of relevant contractual documents) to Experian by midnight on 29 March 2018.

The PPF has not yet issued guidance on mortgage exclusion for 2018/19. Guidance issued in March 2017 set out the position in relation to the 2017/18 levy year:

- certificates previously accepted in respect of Refinance Mortgages, Rent Deposit Mortgages, Pension Scheme Mortgages and mortgages where the credit rating requirement was met for 2017/18 were automatically carried over for use in calculating the 2017/18 levies; and
- certificates for Immaterial Mortgages had to be submitted for the new levy year. A new certificate was also required where the credit rating exclusion was being relied on, if the basis on which the credit rating test was met was different from the basis on which it had been 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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