

RISK MANAGEMENT INSIGHTS

## How to contingency plan

What does TPR mean by “contingency planning” and what should trustees be doing?

As part of its focus on Integrated Risk Management, The Pensions Regulator (TPR) has stressed the need for trustees to put “contingency plans” in place to guard against risks materialising in their scheme.

TPR now expects all schemes to put a plan in place. However, our recent survey of trustees’ approaches to risk management showed that only 17% of trustees had a formal contingency plan in place.

We explore what makes an effective contingency plan, what TPR expects of trustees and what options are available to trustees to improve the risk management of their schemes.

# What makes an effective contingency plan?

Contingency plans are simply the trustees' plans for how they will deal with the result of the risks they are taking materialising.

For example, what will they do if the funding level drops?  
What will they do if the employer covenant deteriorates?

An effective contingency plan strategy focusses on the biggest risks to the trustees achieving their objectives.

These will differ between schemes, but for most they will be:

- **Covenant:**  
The risk that the employer becomes less able to support the scheme or becomes insolvent.
- **Interest rate and inflation exposure:**  
The risk that the cost of buying matching assets (e.g. annuities or bonds) becomes more expensive.
- **Asset underperformance:**  
The risk that the actual returns on assets turn out to be lower than assumed.

⋮ In simple terms, these three significant risks are all about the same issue – the risk of having a deficit in the future of a size that the sponsor will find difficult to support.

Effective contingency planning is also proportionate to the circumstances. Trustees should spend more time thinking about their contingency plans if they are taking a lot of risk – for example, they are investing a large proportion of their assets in equities, or if they have a weak employer covenant.



Trustees should spend more time thinking about their contingency plans if they are taking a lot of risk.

## Is your current plan good enough?

As noted above, our recent survey showed that only 17% of trustees had a formal contingency plan.

In reality, all schemes already have a contingency plan provided through legislative requirements:

- **Prudent reserve:**  
Trustees targeting a prudent reserve is a contingency plan itself.
- **Triennial valuations:**  
The Scheme Funding regime requires trustees to review the contributions payable every three years in light of updated experience.
- **Employer debt:**  
If the employer does become insolvent the scheme has a call on the assets of the employer at the same level as other unsecured creditors.

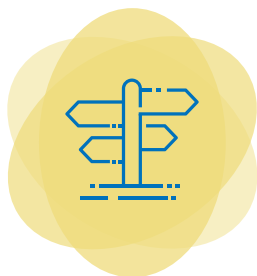
Many trustees may view these statutory contingency plans as sufficient. However, TPR would expect to see justification for this taking into account the risks in the scheme and the strength of the covenant.

To help with this, trustees should ask themselves three key questions:

- Could the employer afford to pay additional deficit contributions in the case of a “bad outcome” for the scheme’s funding?
- How risky is the employer’s financial position?
- How volatile is the funding position and employer covenant?

If the trustees have concerns after thinking about these questions, then they should try to improve their position.

Whatever the trustees’ views, they should document their discussions and conclusions for good governance and as evidence to present to TPR.



Only 17% of trustees have a formal contingency plan.

# Formal agreements - demonstrating a business case

One form of contingency planning is for the trustees to enter into formal agreements with the employer or other parties.

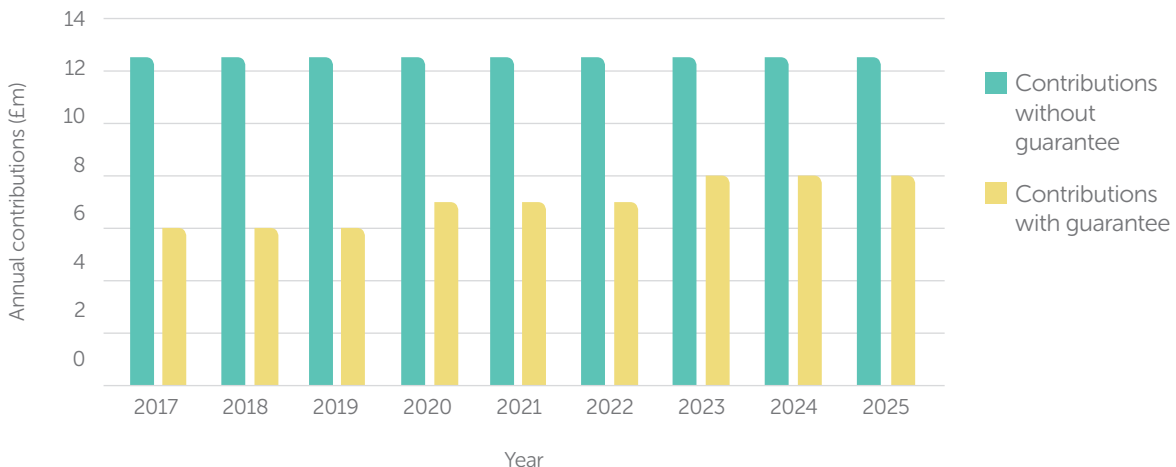
These agreements can take many different forms, but usually seek to improve the scheme's financial position in the event of a negative event happening (for example, employer insolvency). The difficulty with formal agreements is they normally require the employer or wider group's consent, which can be difficult to obtain.

A powerful way of achieving a formal agreement with the employer is to demonstrate the benefits to all parties through a clear business case. For example, a formal agreement may improve the security of members' benefits, which could allow the employer to pay lower contributions or for the trustees to take higher investment risk.

Some forms of formal agreements also can result in a lower Pension Protection Fund levy, which can also provide a good business case in isolation.

Even if a formal agreement is not possible or desirable, many trustee boards would benefit significantly from informal discussions with the employer on each parties' expectations, if their plans do not go as anticipated.

## Example business case for employer of granting guarantee



## Types of formal agreements

There are many different types of formal agreements that can reduce risk. The key to designing an effective formal agreement is to consider exactly which risks you are aiming to protect against.

### Protection against employer insolvency

Employer insolvency is often the biggest risk that trustees face, and so protecting against this is a high priority.

Security over an asset of the employer can be very effective as it gives trustees a tangible asset that it can sell if the employer does become insolvent and protects against other creditors diluting the scheme's share of the value in the business. However, any assets the employer does have are often unavailable, for example because they have already been pledged to a bank.

Parent guarantees give the trustees access to financial support of the wider group and therefore can be very effective if the wider group is much stronger than the scheme's employers. These are the most common form of legally enforceable contingent assets and are relatively straightforward to set up.

Guarantees can also be obtained from third parties (for example, banks). However, these can be quite expensive if they are adding significant value.

### Protection against weakening covenant

Trustees also face risks from the employer covenant weakening over time and becoming less able to support the risks taken in the scheme.

If the triennial valuation cycle is not sufficient, trustees can build covenant-dependent conditions into their funding agreements. For example, contributions that step-up if the covenant deteriorates.

"Negative pledges" are agreements by the employer not to do something without the agreement of the trustees. These can be very useful in protecting against the covenant worsening.

For example, the employer could pledge:

- not to move money outside the reach of the pension scheme to another part of the group or to shareholders.
- not to diminish the scheme's creditor status by granting security to a third party.

## Protection against worsening funding position

If the Trustees are taking more risk in the scheme than they would like they could seek to protect their position from deteriorating.

For example:

- Step-up in contributions if the funding level falls.
- Pre-agreed funding principles, such as agreements on future deficit spreading periods.
- Cash funding alternatives such as asset backed funding vehicles or escrow accounts.

## The devil is in the detail

How valuable a formal agreement is very much depends on the detail of the agreement. Trustees should consider:

- **Trigger events:** What events trigger these contingency plans and do these remove enough risk? How are these trigger events measured – is this disputable?
- **Scheme benefits:** What is the benefit to the scheme in the circumstances that it is triggered? For example, how much value could the scheme attribute to the intellectual property of the employer if the employer went insolvent? Also, how does the benefit compare against the total risk in the scheme?
- **Amendment:** Is it possible to amend the agreement and who has control over this?



## How formal agreements can work in practice

We recently advised a client that was looking to develop a comprehensive financial management plan for the scheme, targeting a fully de-risked and liability matched investment strategy in the mid-2020s and thereafter moving on to buy-out. This plan aimed to strike a balance between the trustees' desire to reduce risk and the employer's business needs.

As part of the plan the trustees and employer agreed to the following:

- **A parent company guarantee** was provided to the trustees to give the trustee greater comfort on the covenant.
- **Agreed deficit spreading:** Any deficits that arise at future actuarial valuations are spread over a pre-agreed period.
- **Contribution triggers:** Contributions payable to the scheme would be significantly accelerated if certain covenant triggers were hit. These triggers included:
  - triggers based on company accounting ratios;
  - loss of the company's investment-grade credit rating; and
  - a significant movement of assets out of the group.

### **Recovered contributions**

From the company's side, there are mechanisms that will allow any accelerated contributions to be recovered if, for example, the investment-grade credit rating is regained.

### **Escrow account**

Further regular contributions are paid into an escrow account and in the event that the remaining growth-seeking assets underperform, this money is moved into the scheme. As well as protecting the scheme, this also protected the employer from the risk of overfunding.

### **Recovering contributions**

Contributions can also be made as 'loans' to the scheme once the funding level is close to 100% on the de-risked basis to avoid the risk of overfunding.



# Unilateral trustee powers

Whilst working in co-operation with an employer is desirable, trustees do have some contingency planning options if this is not possible.

## “De-risking” triggers

Trustees only need to consult with the employer on changes to their investment strategy, such as de-risking. Trustees can set triggers to remove investment risk if their covenant deteriorates.

For example, trustees switch 20% of their assets from equities to bonds if the employer’s credit rating deteriorates.

## Early valuation

Ultimately, trustees can choose to call an early valuation if they believe that it is worthwhile, although this is a rarely used power.

## Planning for the upside

Trustees also should spend some time thinking about the upside of the risks they are taking.

- Can they get agreement to share in the employer’s potential future success? For example, extra contributions if the employer is more profitable than budgeted.
- De-risking triggers designed to remove investment risk quicker than allowed for in the valuation if the scheme’s funding position is better than expected.



## Monitoring is key

Monitoring is a key part of risk management and contingency planning in particular. Trustees' monitoring should be designed with their scheme's circumstances and objectives in mind.

It should incorporate any contingency plans they have and look to answer the most important questions facing the scheme's future. For example:

- Have any formal triggers hit?
- Is the scheme on track to meet its objectives?
- Has the employer covenant changed and does this impact the scheme?
- Are there any opportunities to take advantage of favourable investment experience?

Illuminate Monitor is our online tool designed to help trustees answer these questions.

To find out more about  
Illuminate please visit  
our website:  
[barnett-waddingham.  
co.uk/illuminate](https://barnett-waddingham.co.uk/illuminate)





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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch with Chris Ramsey via the following:

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