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In Praise of Contingent Assets

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Foreword

Contingent assets have long been an important part of the UK pensions landscape. They have helped unlock corporate transactions, supported funding negotiations, protected members against covenant deterioration and provided flexibility where cash funding alone could not achieve the right outcome. Yet, despite their proven value, they have become less prominent in recent years.

Partly, this reflects stronger funding positions across many defined benefit (DB) schemes. At the same time, the new DB Funding Code and accompanying covenant guidance have understandably focused attention on contingent assets that support low dependency funding strategies. There is, however, a risk that their wider strategic value has been overlooked.

This SPP paper argues that contingent assets deserve renewed attention. Properly designed, they are not simply technical funding devices or insolvency protections. They are flexible risk-sharing instruments that can strengthen member security while preserving sponsor flexibility and supporting sustainable covenant outcomes.

This is becoming increasingly relevant as more schemes consider endgame options such as run-on and surplus release. These strategies require thoughtful management of covenant risk alongside funding and investment risk, and contingent assets can play an important role in achieving that balance.

The purpose of this paper is not to suggest that contingent assets are appropriate in every circumstance, but to encourage trustees, sponsors and advisers to reconsider them as an important strategic tool within modern pension risk management.

Adrian Bourne, Co-Chair, Society of Pension Professionals (SPP) Covenant Committee

Introduction

The context in which trustees and sponsors assess pension risk has evolved significantly over the past decade. Improved funding levels, maturing schemes and the introduction of a new regulatory funding framework have all contributed to a broader approach to decision-making. The focus is no longer solely on the level of deficit or the affordability of contributions, but on achieving an appropriate balance between funding, investment strategy and employer covenant over the long term inextricably linked to a Scheme's strategy and "endgame"..

This evolution has changed the questions trustees are asking. Rather than simply seeking additional cash, discussions increasingly centre on how risks can best be allocated and managed throughout a scheme's journey plan. Endgame planning, integrated risk management, run-on strategies and the potential for surplus release all require trustees and sponsors to consider a wider range of options than in the past.

Against this backdrop, contingent assets occupy an interesting position.

Historically, they were most commonly associated with downside protection and Pension Protection Fund (PPF) levy management. Guarantees, security arrangements, escrow accounts, letters of credit and other forms of contingent support were frequently used to mitigate covenant detriment arising from corporate transactions, improve recoveries in an insolvency scenario or provide comfort while funding deficits were repaired. Their value was well understood, both commercially and through the PPF levy framework.

Today their role is less clear. The new DB Funding Code places greater emphasis on contingent assets that support the achievement of low dependency funding by the Relevant Date. While this provides a useful framework for assessing certain forms of support, it is only one lens through which contingent assets should be viewed.

While the new DB Funding Code places explicit emphasis on contingent assets that help achieve low dependency by the Relevant Date, it is vital to distinguish between Funding Code metrics and broader covenant management. Both TPR's broader guidance and recent Annual Funding Statement explicitly recognise that contingent support retains significant value for trustees. It provides essential downside protection, manages covenant volatility, and enables run-on, even where that support falls outside formal Funding Code valuation metrics

So, many arrangements that may have limited recognition for funding purposes can still provide significant protection against covenant deterioration, facilitate corporate activity or support longer-term strategic objectives.

This paper explores that broader perspective. It considers how contingent assets can help trustees and sponsors manage uncertainty, support commercial flexibility and address covenant risk in ways that cash contributions alone cannot always achieve. It also examines the characteristics of effective contingent assets, common misconceptions surrounding their use, and the role they may play as pension schemes increasingly consider run-on, surplus release and other evolving endgame strategies.

Contingent assets are not a solution for every circumstance, nor should they be viewed as a substitute for prudent funding. But where they are designed with a clear purpose and aligned to the risks they are intended to address, they remain one of the most versatile tools available to trustees and sponsors seeking better long-term outcomes.

> *Contingent assets are not a solution for every circumstance, nor should they be viewed as a substitute for prudent funding.*

What Problem Are We Trying to Solve, Are Contingent Assets Neglected?

Contingent assets come in many forms (security, guarantees, escrow accounts, surety bonds, letters of credit) and with a wide range of triggers.

In practice, parent and group guarantees represent the vast majority of contingent assets in the market. They are often the most readily available and cost-effective instrument to implement, particularly where an employer's key operational assets are already pledged to senior lenders. However, while guarantees are widely used, their ubiquity can sometimes overshadow other valuable contingent structures such as escrows, security over real assets, or letter-of-credit facilities, which offer distinct risk profiles.

Historically, contingent assets provided downside protection: they enhanced a scheme's outcome in the event of a (hypothetical) insolvency, and (perhaps more meaningfully) created a strong incentive for the wider group of a sponsor to support the sponsor through distress as well as providing trustees a seat at the table in distress situations. Triggers typically related to non-payment of scheduled contributions or insolvency. The improved security of members' benefits and reduced exposure for the PPF was rewarded through a reduced PPF levy for contingent assets that met certain requirements.

Under the new Funding Code, contingent assets must "help" a scheme achieve Low Dependency by the Relevant Date to positively impact the covenant and receive value as Supportable Risk. This has shifted focus away from downside protection and towards scheme funding – at a time when many schemes are, conversely, shifting focus away from scheme funding toward management of downside risks.

This has led some sponsors to focus narrowly on Funding Code recognition. However, trustees and sponsors should not confuse regulatory metric recognition with real-world downside mitigation. TPR's wider regulatory perspective continues to endorse contingent assets as effective tools for balancing risk, protecting member security, and supporting scheme journey plans.

Contingent assets are often negotiated during corporate transactions, where the hypothetical insolvency outcome is a key test of covenant detriment. This remains important, and contingent assets are a helpful tool where cash mitigation may not make sense for well-funded schemes. However, insolvency outcomes do not form part of the covenant metrics reported under the new Funding Code.

Many sponsors are now questioning whether contingent assets should be released if they are not rewarded under the new Funding Code, and scheme funding levels have improved. Trustees may find themselves struggling to articulate the value of their contingent assets but at the same time express a reluctance to release them without some mitigation.

But the fundamentals have not changed. Trustees want to ensure that their members receive their benefits in full and on time. Covenant is a concentrated risk and inherently uncertain, and scheme funding has volatility. Contingent assets are a way to address that uncertainty and / or mitigate detriment whilst allowing sponsors flexibility and use of their cash flows to invest in sustainable growth and enhance the longer-term covenant.

Downside protection is particularly important for schemes looking to run on. Contingent assets can provide valuable downside protection where trustees have concerns about the ability of a sponsor to support a run on strategy, potentially allowing greater upside for sponsors and members through investment returns and surplus release.

> *Contingent assets can provide valuable downside protection where trustees have concerns about the ability of a sponsor to support a run on strategy...*

What Makes a Good Contingent Asset – the Covenant Perspective

A good contingent asset should be tailored to the purpose it is serving, with a strong focus on the risks it is mitigating in the context of the scheme's journey plan, as well as balancing sponsor objectives and flexibility.

It should not be overly complex but should reflect careful consideration of the risks it aims to mitigate.

Compliance with the new Funding Code allows recognition within a supportable risk calculation but may not be necessary if the covenant is already adequate under TPR's framework and trustees are more concerned about downside protection.

Nonetheless, the Funding Code and TPR's covenant guidance provides valuable principles that are relevant to all situations:

- The contingent asset needs to be legally enforceable; and
- Sufficient to provide the specified level of support when required

In relation to guarantor covenant strength & asset encumbrance, for group/parent guarantees, trustees must look beyond the parent balance sheet. They should assess whether the guarantor's own assets are already encumbered by bank debt or subject to prior-ranking claims. A guarantee is only as strong as the unencumbered net recovery value of the entity backing it in a distress scenario.

It is easier to negotiate contingent assets outside of a distress situation, but it is important they are robust and deliver what is needed in such a scenario.

Contingent assets should have clear trigger events – what is the trigger and what are the implications? Triggers should be thoughtfully calibrated by reference to the implications (too early can lead to difficult discussions about waiving a trigger event; too late and the asset may have lost value).

A strong understanding of the asset underpinning any value that will flow in a trigger event is also important, particularly as contingent assets are often relied upon for an extended period. Assets may not be worth their book value or going concern fair value in a distressed scenario, and an appropriate buffer can help address this.

Third party contingent assets such as surety bonds and letters of credit may retain value in distress, but careful drafting is needed around renewal, the absence of which could leave trustees facing a lack of cover, or a distress scenario triggered by expensive terms.

Ultimately, there is no such thing as a perfect contingent asset but careful thought can result in appropriately tailored "good" contingent assets that help trustees and sponsors achieve their objectives.

Myth busters

While contingent assets are incredibly versatile, several long-standing misconceptions often prevent trustees and sponsors from utilising them effectively. This section deconstructs these common myths to separate regulatory and practical realities from outdated assumptions.

"Cash is always better"

Cash is often the simplest and most certain form of support, particularly where a scheme has an immediate deficit or liquidity need – but it is not always the right answer. Higher contributions can sometimes weaken covenant by reducing the sponsor's ability to invest, manage leverage or respond to trading pressures. A well-designed contingent asset can improve member security while preserving sponsor liquidity and long-term covenant strength. Trustees should consider which form of support best improves member outcomes over the long-term.

CASE STUDY (Cash is always better?)

A company experiencing cash-flow stress sought to halve its £6m annual payments under a 5-year Asset Backed Contribution schedule. In exchange, the sponsor provided a third-party bank guarantee covering the scheme's full solvency deficit, triggering in the event of default. The arrangement included an annual valuation update and renewal process to ensure full coverage against scheme liability changes and deficit repair progress without exposing the scheme. This reduced immediate cash outflows for the employer whilst simultaneously providing the scheme robust protection against sponsor default.

"Contingent assets are too complex"

Contingent assets can be complex, but they do not need to be. Many arrangements can be documented and monitored proportionately, particularly where the parties use familiar structures. Escrow arrangements, guarantees and charges can all be tailored to a scheme's circumstances whilst using a well-trodden paths for formally documenting the agreement e.g. some banks now offer "off the shelf"blocked accounts with pre-packaged security terms whereby trustees and sponsors can separately document agreed payment terms.

The alternative may be more complex: trying to negotiate protection only once a sponsor is under pressure, when time, information and leverage are limited. Simplicity should be a design objective, rather than a reason to dismiss contingent assets.

CASE STUDY
(Contingent assets are too complex?)

An employer who resisted prudent funding assumptions and believed gilt yields would rise, funded the scheme on a central projection ("best estimate") basis. The difference between this central estimate and prudent technical provisions was paid into an escrow account. After 10 years, escrow funds would be allocated to the scheme or returned to the company based on actual performance. This effectively served as an internal capital-backed journey plan, reducing the employer's immediate contributions and avoiding trapped surplus, while keeping the scheme fully protected and preserving its investment strategy.

"Contingent assets are expensive to implement"

There will usually be advisory, legal and monitoring costs, and these should be assessed against the benefits of contingent assets in balancing competing employers and trustee objectives. Cost is often manageable where the structure is proportionate to the risk being addressed and unnecessary bespoke features are avoided. Standard form documentation, originally developed for PPF levy management purposes, has helped create market familiarity with guarantees, charges and other common structures. Cost should therefore be weighed against the scheme risk being mitigated, and against the potential cost of relying solely on higher cash contributions or leaving the risk unaddressed.

"Contingent assets are difficult to value"

Valuation can be challenging, but that does not make contingent assets unusable. Trustees already make judgements about uncertain future support, including employer covenant, future cash flows and the period over which support can be relied upon. Contingent assets should be assessed with the same discipline: what triggers access, what value is likely to be realisable, what legal or practical limits apply, and how the support interacts with the funding and investment strategy. In many cases, scenario analysis or value ranges may be more useful than a single point estimate.

CASE STUDY
(Contingent assets are too difficult to value?)

A DB scheme's sponsor had an £18m deficit and limited cash flow, but its ultimate parent had a strong balance sheet. The parent declined a full "look-through" guarantee to avoid ongoing funding commitments, but offered an insolvency and deficit-repair guarantee. By assessing expected recoveries in distress, the trustees quantified that the guarantee raised recovery from 15p to 85p in the pound. Though Technical Provisions assumptions remained unchanged, this quantified support justified extending the recovery plan from 4 to 8 years freeing up £2.5m.

"They only matter in distress"

Contingent assets are not only relevant once a sponsor is in difficulty. They can support journey planning, facilitate corporate transactions or reorganisations, and provide a framework for sharing risk where trustees and sponsors have different priorities. That said, they are especially valuable in downside scenarios because protection agreed in advance is usually more effective than protection sought during distress. By then, the scheme may be competing with other stakeholders and the sponsor's ability to provide fresh support may already have reduced or be legally challenging e.g. as a preference. Agreeing support while the sponsor is healthy if therefore preferable as well as supporting good governance.

"Non-look-through guarantees are not worth having"

The "look-through" guarantee concept has helpfully clarified when trustees may assess a guarantor as standing behind the employer's ongoing funding obligations when assessing affordable contributions. But a guarantee that falls short of that standard can still have significant value.

Even if it is excluded from Low Dependency calculations, a non-look-through guarantee secures distress priority as it grants trustees a direct claim against a stronger parent entity, elevating the scheme's standing in the creditor hierarchy during an insolvency. It also provides negotiating leverage. As it gives trustees a seat at the table in corporate restructurings and M&A, ensuring scheme interests are protected. Furthermore, it unlocks journey plan Flexibility. Quantifying the backstop support can justify longer recovery plans or lower immediate cash calls, preserving sponsor liquidity for growth.

Ultimately, a guarantee's true value should be judged by its purpose, triggers, enforceability, and real-world downside protection and not purely by its regulatory classification.

Valuation can be challenging, but that does not make contingent assets unusable.

The Future for Contingent Assets

As scheme funding has improved, the nature of pension risk is changing. For many schemes, the principal question is no longer simply how to eliminate a funding deficit, but how to manage covenant-related risks around run-on, surplus release and endgame execution. Contingent assets are well suited to helping bridge any gap as well as providing guard rails.

As policy makers seek to make surplus extraction easier and more attractive, trustees are likely to place greater emphasis on mechanisms that preserve offer downside protection. Contingent assets offer a natural means of sharing value with sponsors and members while retaining protection against adverse future experience.

Run-on and surplus release discussions inevitably bring significant focus on the long-term strength and resilience of the employer. In practice, trustees will seek evidence of a very strong covenant before considering such a route but in a very volatile world that can simply be too challenging.Contingent assets therefore have the potential to:

> support run-on and/or surplus release for schemes where covenant visibility is limited or where Schemes seek additional protection against long-term uncertainty; and

> facilitate larger releases of surplus where appropriate, increasing sponsor liquidity and/or member benefit enhancements while maintaining downside protection.

However, contingent assets can also support endgame options that ultimately break the link to the sponsor covenant. For example, as insurers continue to develop more flexible transaction structures, contingent assets may increasingly act as bridging mechanisms, allowing schemes to execute transactions sooner than might otherwise be possible while accommodating sponsor liquidity constraints, asset transition plans and other transaction-specific challenges. For example, a contingent asset can secure a deferred premium when a scheme holds illiquid assets, allowing those investments to mature naturally rather than being sold at a loss to pay the insurer upfront. Alternatively, sponsors can fund an escrow to cover potential buy-in "true-up" costs during data cleansing, which protects the insurer while ensuring any leftover cash returns directly to the sponsor without tax penalties.

Similar considerations may also arise for superfunds and other risk-transfer or consolidation solutions, where contingent assets can help facilitate transactions by addressing specific execution, covenant or funding concerns.

It is important to recognise that, for many schemes, the consideration of endgame options is an evolving journey rather than a one-off decision. Contingent assets may be used to preserve that optionality, allowing stakeholders to avoid making irreversible decisions today. For instance, by using a contingent asset (such as an escrow or guarantee) instead of making immediate, irreversible cash contributions, sponsors avoid trapping surplus cash in the scheme. This secures the scheme's risks in the short term while keeping the door open to either pivot to a buyout or return the capital to the sponsor later as market conditions evolve.

Beyond endgame planning, broader changes in corporate ownership and financing structures may also increase demand for contingent asset solutions. Future trends affecting sponsors may include the growth of private equity ownership and increasing consolidation across industries. Such developments are often accompanied by a desire for capital efficiency, transactional flexibility. While contingent assets like charges or escrow structures avoid trapping cash in the scheme, parties must carefully balance this flexibility against practical trade-offs. Pledging physical assets or creating fixed/floating charges can constrain an employer's balance sheet, potentially complicating future debt refinancings or M&A exit strategies. Designing contingent assets for Private Equity or growth scenarios therefore requires flexible release mechanisms, substitution rights, or predefined exit triggers that protect the scheme without locking up sponsor corporate activity.

While much attention is currently focused on well-funded schemes, some schemes retain significant reliance whilst in deficit on a Low Dependency basis. The traditional application of contingent assets in funding, M&A and restructuring scenarios will remain highly relevant to this cohort.

Perhaps counterintuitively, the future for contingent assets may be brightest not among the weakest-funded schemes, but among the strongest. As schemes increasingly consider run-on, surplus release and innovative endgame structures, the challenge is no longer simply finding additional funding. It is finding efficient ways of balancing opportunity with protection. Well-designed contingent assets are uniquely capable of achieving both.

Conclusion

Contingent assets have never been an end in themselves. Their value lies in enabling trustees and sponsors to achieve better outcomes by allocating risk more efficiently, balancing member security with sponsor flexibility, and supporting commercially sustainable solutions.

As DB schemes move into a new era of stronger funding, integrated risk management and increasingly diverse endgame strategies, the conversation should move beyond whether support is provided as cash or as a contingent asset. The better question is which form of support best addresses the risks the scheme actually faces.

Contingent assets should be more widely praised. They are not second-best solutions or simply substitutes for cash. Properly designed, they are sophisticated instruments that can protect members, facilitate corporate activity, preserve covenant strength and unlock solutions that might otherwise prove unattainable.

Used thoughtfully and for the right purpose, contingent assets enable trustees and sponsors to share risk intelligently rather than simply transfer it. That makes them not just relevant, but increasingly valuable.

They deserve a more central place in modern pension strategy.

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About The Society of Pension Professionals

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