Observations on the PPF's assessment of guarantor strength for selected Type A contingent assets certified/re-certified in 2012/13

This note has been produced alongside additional FAQs (and following updated contingent asset guidance published in December 2012) to assist schemes and their advisers in assessing whether Type A contingent assets they may be planning to certify/re-certify for levy year 2013/14 meet the principal test that the reduction in levy achieved by acceptance of the contingent asset is commensurate with the reduction in risk to the PPF.

When considering the extent to which the risk to the PPF is reduced, the guarantor's ability to meet its obligations is key. This note summarises some of the themes that have emerged from the contingent assets that underwent more detailed examination prior to levy invoicing for 2012/13. Where we make references to volumes (such as 'vast majority', 'only a handful') of cases we are doing this in relation to those cases we examined.

1. A number of points have become clear as a result of the work done by the PPF, supported by external consultants, to assess the value of some of the guarantees underlying Type A contingent assets.

Where the guarantor is also an employer

Last man standing schemes

2. A number of last-man standing schemes saw contingent assets reviewed and approved, but there were a significant number of cases of contingent assets relating to last man standing schemes that were rejected where the guarantor was also an employer.

3. The risk reduction (or benefit) that putting in place a contingent asset offers is less clear cut for these cases – since the guarantor is already liable for the deficit on the scheme due to the last-man standing structure. However, the PPF has not concluded such a guarantee is automatically of no benefit to the PPF.

4. Since providing our observations on 22 February 2013, we have given further consideration to the treatment of last man standing schemes where the guarantor is an employer. This follows further representations about the assessment of guarantor strength where the guarantor is an employer in a last man standing scheme.

5. The approach that we have now followed is to recognise contingent assets where we consider it is likely the guarantor could meet the deficit of the

other employers (which are assumed insolvent) whilst still continuing to trade so that it can meet its own obligations over time[1].

Partial segregation schemes

6. Where an employer is guaranteeing the obligations of fellow employers, for the risk reduction to be consistent with the levy benefit that would arise, the guarantor would need to be able to meet the deficit of the other employers (which therefore must be assumed insolvent) whilst still continuing to trade so that it can meet its own obligations over time.

7. However, if the guarantor was unable to meet the deficit of the other employers and continue to trade (ie if it were to become insolvent itself), we do not envisage a scenario where the guarantor would then be able to meet the guarantee in full where all of the employers (including the guarantor) were insolvent.

Consideration of the insolvency of the employers

8. In the vast majority of cases, the Trustees had failed to consider the circumstances in which the guarantee would need to be called upon, ie the insolvency of the employer(s). In particular, very few schemes had considered the impact of the insolvency of the employer(s) on the guarantor's ability to meet the guarantee such as the impact on intercompany debtors and value of investments.

Focus on net asset value

9. There was a focus by Trustees on the value of the guarantor's net asset value compared to the guaranteed amount. There was little emphasis placed on considering the type of assets the guarantor owned or had access to, nor as to how readily those assets could be liquidated in order to meet the guarantee should it be called upon. Many guarantors' assets primarily consisted of a web of intercompany accounts and investments in subsidiaries, including the employer(s).

Distinction between covenant and guarantee

10. Many responses evidenced a confusion between the covenant afforded the scheme by the employers and any additional value/comfort to be gained

[1] Our approach as previously detailed was that where the guarantor was an employer in a last man standing scheme, it too had to be assumed to be insolvent for the purpose of assessing whether the levy reduction in recognising the contingent asset would be consistent with the risk reduction to the PPF.

from the guarantee. Some responses sought to identify additional value in assets that was not fully reflected in the accounts of the employers. This included the potential sale value of companies in the group, including in some cases the potential sale value of the guarantor when it was also an employer. However, nearly all of these cases referred to value which was directly attributable to the employer(s) in any event and therefore the covenant rather than the guarantee.

Support of the wider group

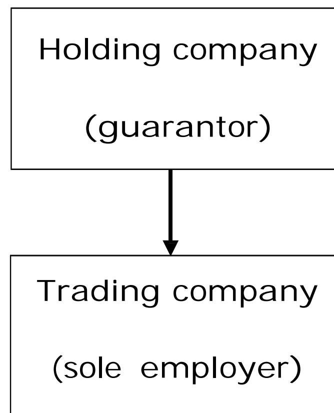
11. There were references in the responses to guarantor's ability to draw on the support of the wider group when there was no evidence of a legal right to do so. This was particularly the case if the scheme was part of a large multinational group.

Examples

12. We include at Appendices A and B some basic case studies to highlight weaker and stronger examples of guarantor companies. The PPF will consider each case on its own merits but we hope these examples give an indication of factors that may be persuasive.

Appendix A

Weaker example 1



Scenario

The sole employer to the scheme is the group's only trading company.

The group holding company is the guarantor to the scheme and does not trade.

There are no other companies in the group or others are dormant non trading companies

Issues

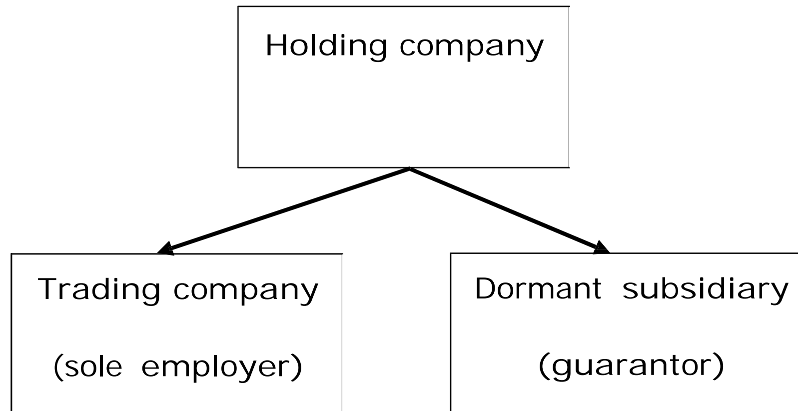
As the guarantor does not trade, its principal assets are investments in the employer and amounts due from the employer.

In the event of the guarantee being called upon, the employer will have suffered an insolvency event and therefore the value of the investment in the employer and any intercompany debt due from the employer would be at risk.

In the absence of other assets or investments to draw upon it is unlikely that the guarantor would be able to support the guarantee in event that it is called upon.

Appendix A

Weaker example 2



Scenario

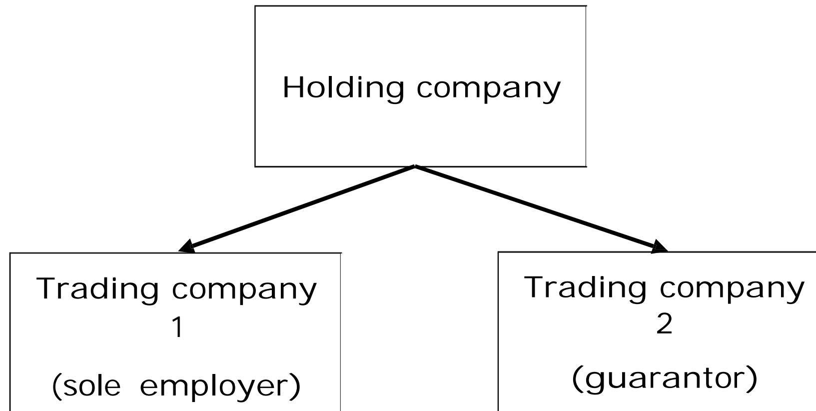
- The sole employer to the scheme is the group's only trading company
- The guarantee has been provided by a dormant subsidiary in the group which does not trade but has net assets in excess of the guaranteed amount
- There are no other companies in the group

Issues

- As the guarantor does not trade, its principal assets are likely to be amounts due from other group companies including the employer
- In the event of the guarantee being called upon, the employer will have suffered an insolvency event and therefore the value of the guarantors intercompany debts are likely to be materially reduced
- In the absence of other assets or investments to draw upon it is unlikely that the guarantor would be able to support the guarantee in the event it is called upon

Appendix B

Stronger example 1



Scenario

The sole employer to the scheme is one of the group's trading companies

The guarantee is provided by another trading company in the group that is not an employer to the scheme.

Trading company 2 is profitable, generates significant cash from operations and has substantial headroom in its borrowing facilities

The employer (Trading company 1) is not significant to the group as a whole and the trading companies are wholly independent of each other

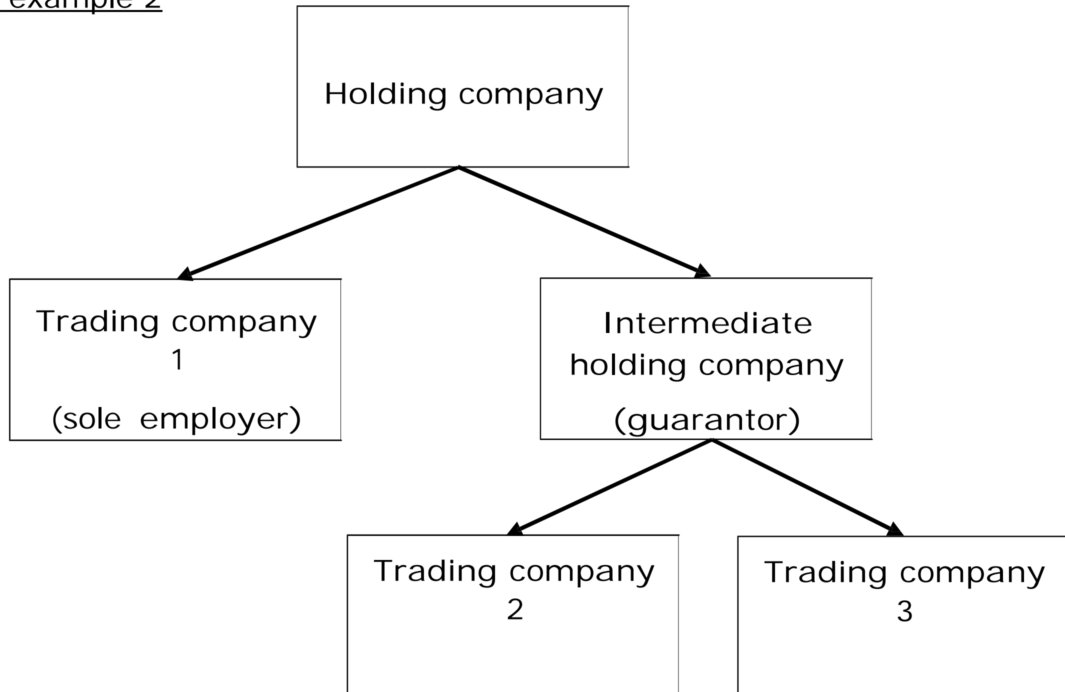
Issues

In the event of the guarantee being called upon, the employer will have suffered an insolvency event

On the basis that Trading companies 1 and 2 are independent, the insolvency of the employer should not unduly affect the assets and earnings of the guarantor The guarantor could therefore use cash generated from operations, the headroom in its borrowing facilities or the value in its assets or business to support the guarantee in the event it is called upon

Appendix B

Stronger example 2



Scenario

- The sole employer to the scheme is one of the group's trading companies
- The guarantee is provided by an intermediate holding company in the group that is not an employer to the scheme but does not trade
- Trading companies 2 and 3 are profitable, generate significant cash from operations and have substantial headroom in borrowing facilities
- The employer (Trading company 1) is not significant to the group as a whole and the trading companies are wholly independent of each other

Issues

- In the event of the guarantee being called upon, the employer will have suffered an insolvency event
- On the basis that the group's trading companies are independent, the insolvency of the employer should not unduly affect the assets of the guarantor
- The guarantor could use cash available in its trading subsidiaries (either from trading or headroom in borrowing facilities), the value of its subsidiaries' assets or the value of its investment in its subsidiaries to support the guarantee in the event it is called upon

Contingent Assets – additional FAQs

1. **What sort of information does the Board expect trustees to consider when assessing the financial strength of a potential guarantor?**

   As stated in paragraph 5.2.21 of the Board's 2013/14 Contingent Asset Guidance, the Board does not wish to be prescriptive regarding the sort of information which trustees could take into account when considering the guarantor's strength. As a general example, trustees could consider any publicly available information about the guarantor's financial position, including its most recent financial accounts. However, what information is appropriate is ultimately a question for the trustees to decide, based on the individual circumstances of the guarantor. The key factor is whether the information enables the trustees to be satisfied that the guarantor is good for the certified amount under the guarantee.

2. **If the existing PPF guarantor is an unlimited company, can the trustees provide the required certification if the guarantor could not meet the certified amount out of its own assets, but its parent company could, and indeed would have to do so because its subsidiary is unlimited?**

   If the existing PPF guarantor is an unlimited company, then evidence as to parental or cross-guarantee strength will not be sufficient to enable the trustees to give the certification. If the Board were to recognise the guarantee in these circumstances then the risk to the Board would not be from the unlimited company used in the levy calculation, but rather the parent company whose risk would not be factored into the levy calculation. The Board would therefore need to be satisfied that to recognise an unlimited company by reference to its parent company would comply with the risk reduction requirements in Rule G2.3 of the Determination. In order to maximise the likelihood of the contingent asset being accepted, the trustees could consider obtaining a PPF guarantee from the parent company, rather than the unlimited company.

3. **Does the PPF expect trustees, when considering the guarantor's financial position, to use only the most recent information, or can more historical information be taken into account?**

   While trustees will usually use the most up to date information available to them, there is no particular cut-off time for when information can no longer be taken into account in the guarantor strength assessment. Trustees should however consider whether the age of the information means it is no longer an accurate indicator of the guarantor's ability to meet its obligations, or whether it remains relevant for this purpose.

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4. **If a PPF guarantor has a cross-guarantee in place from a company which is financially stronger, and has a higher failure score than, the PPF guarantor, would this be acceptable to the PPF?**

   Our clear and strong preference would be for trustees to seek guarantees from businesses that are substantial in their own right. However, it is possible that there may be a situation in which a guarantee could be recognised where the guarantor would need to be able to rely upon a cross guarantee to meet the guaranteed sum. Before recognising a guarantee in these circumstances we would need confirmation that:

   (i) the ultimate guarantor was good for the money – and that their insolvency risk was as low as that of the business giving the trustees a guarantee – so that the risk we are focussing on in our levy isn't understated; and

   (ii) the trustees' position in seeking to recover the monies due under the guarantee was not materially weaker than it would have been had the guarantee been direct and expressed using the PPF's standard terms.

   In practice, it may be difficult to confirm that the trustees' position is not materially weaker as a result of reliance on the cross-guarantee rather than the PPF standard form agreement. Trustees should submit to us any legal advice they have obtained which supports this view, in the same way that we require confirmation from trustees' legal advisers that changes to the PPF standard form guarantee are not materially detrimental.

5. **Please can you confirm how you would expect the Trustees to consider the guarantor, (when assessing the guarantor's strength), where it is also a participating employer in a multi-employer scheme? Would they need to consider the reasonably foreseeable impact of insolvency of the guarantor or not?**

   In answering this question we assume that in addition to the guarantor there are two other scheme Employers (A&B).

   The trustees need to consider the impact on the guarantor of an insolvency in relation to both Employers A and B. For the purposes of the assessment referred to in paragraph 5.2.13 of the Board's 2013/14 Contingent Asset Guidance, the trustees need only consider the impact of the insolvencies of the employers whose insolvencies the guarantee is actually covering, in this case, Employers A and B.

   The trustees will, of course, still have to consider whether, in the event of Employer A or B's insolvency the guarantor will be able to meet A and B's obligations to the scheme in addition to its own. Specifically, they will have to consider what impact Employer A and B's insolvency might have on the guarantor's funding position (and, indeed, its solvency) – whether,

for example, the guarantor's own business is dependent on the continued operation of one or other of Employer A or B.

6. How are last man standing schemes' guarantors assessed?

Last man standing schemes are assessed in the same way as in other schemes.

To decide whether a contingent asset should be recognised, we will consider if the levy benefit is proportionate to the risk reduction by assessing whether the guarantor could pay the guarantee in relation to all other employers (but excluding its own liabilities to the scheme) provided it is able to continue trading.

7. Why did you change your approach to last man standing schemes where the guarantor is an employer?

Following representations we felt that it was more appropriate to treat last man standing schemes in the same way as partial segregation schemes (i.e. the other employers would need to be considered as insolvent but not the guarantor). This reflects our conclusion that, while it might seem that a guarantee from an employer in a last man standing scheme was replicating a commitment that it had already made, it could offer an additional benefit to the scheme, including through ensuring that stronger group companies do not exit the scheme or through the guarantee being used for value before the last employer is insolvent.

8. In modelling the insolvency of the employer, should trustees simply consider the direct financial and operating relationships between the employer and the guarantor, or should they also include other group entities that might indirectly link the employer and the guarantor?

The indirect effects of an employer's insolvency should be considered. If an insolvency event has the potential to bring about the downfall of the guarantor – for example, if the group has cross guaranteed group bank borrowing or the group takes the entire output of the employer – this should be taken into account when assessing the guarantor's strength. Trustees need to think about whether the guarantor would be in a position to meet its obligations if the employer failed. In order to do this, they should think about all the circumstances in which an employer might fail, including those where other group members also fail.

9. Are trustees expected to consider how insolvency scenarios could arise commercially? For example, if the trustees were to identify that the employer's insolvency could be triggered by another group company's insolvency (irrespective of its likelihood) that would also impact the guarantor, what implications would this have for their certification of the contingent asset?

Trustees should consider all the scenarios in which an employer could fail. If the insolvency of a third party company is a possible 'trigger', but is unlikely, then it is reasonable to exclude it from the assessment. On the other hand, if the most plausible reason for the employer becoming insolvent is the failure of another group company, which would also have an impact upon the guarantor, then that impact ought to be considered. The correct approach will therefore vary depending on the circumstances of the individual case.

10. If a guarantor guarantees the liabilities of more than one employer in a multi-employer scheme, should trustees consider the guarantor's position in the event of a single or multiple employer insolvency?

Where a guarantor guarantees the liabilities of more than one employer, the combined effect of the employers' multiple insolvencies should be considered: in practice, the terms of the guarantee will cover this situation. In the event of a group failing, it is likely that the guarantor's obligations would extend to multiple debts.

11. If a guarantor guarantees the liabilities of employers in other schemes, should trustees consider the guarantor's position in the event of a single or multiple employer insolvency across those schemes?

If the guarantee covers the liabilities of sponsoring employers for other schemes, then the combined effect of the employers' multiple insolvencies should be considered. The only exception would be where obtaining information is particularly difficult, and a full analysis would therefore prove to be disproportionately costly and time-consuming (as detailed in our 2013/14 Guidance on Contingent Assets).

12. Does the PPF expect trustees to discount fully amounts owed by the employer to the guarantor in all cases, or alternatively to consider potential recoveries to the guarantor in the event of an employer insolvency?

In principle, it would be reasonable for trustees to consider recoveries from the employer, where likely. However, where in practice this would be difficult, the Board would consider it reasonable for them to be excluded from the analysis.