



# Pensions

## Assessing and monitoring the employer covenant

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### Briefing

October 2015

**The Pensions Regulator has updated its TPR's updated guidance on assessing and monitoring the employer covenant. Aimed mainly at trustees of defined benefit pension schemes (and their advisers), the guidance is intended to identify good practice for trustees in assessing the strength of the employer covenant in relation to a DB scheme "as part of an integrated approach to managing scheme risks" and monitoring the covenant and taking action to improve scheme security.**

### Introduction

As noted in our [August 2015 monthly update](#), the Pensions Regulator (the Regulator) has recently issued guidance to help trustees evaluate and monitor the employer covenant standing behind their defined benefit pension schemes. The new guidance '[Assessing and monitoring the employer covenant](#)' is the first in a proposed series from the Regulator to help trustees apply the new DB Funding Code of Practice (in force from July 2014) and it sets out detailed 'good practice' guidelines which the Regulator will expect trustees to follow. In this briefing, we look at how the new guidance could impact on trustee and employee behaviour when considering covenant issues.

### What has changed?

The guidance was published in August 2015 and updates and supersedes the Regulator's previous covenant guidance issued in November 2010. Whilst many themes of the previous guidance remain, this updated version reflects changes arising from experience in the intervening five years. It also places more emphasis on the themes first espoused in the new DB Funding Code including: the need for a proportionate approach; working with employers in a spirit of collaboration and the Regulator's new statutory objective of not prejudicing the sustainable growth of employers.

The structure of the document is revised, with significantly more user-friendly detail for trustees and their advisers, with multiple examples and 'key points to consider'. Specific guidance is also given for trustees of non-associated multi-employer schemes and not-for-profit organisations.

## What is understood by ‘employer covenant’?

The guidance describes the employer covenant as ‘the extent of the employer’s legal obligation and financial ability to support the scheme now and in the future’. It makes clear that trustees are not required to eliminate all risk but do need to understand and actively manage inherent risk so that their risk-taking is informed by the employer’s ability to ‘address a range of likely future downside scenarios over a reasonable period’.

The emphasis is on understanding the risk of financial support being available when it may be needed and the ability of employers to make cash contributions to a scheme with the ultimate target of achieving full funding over an appropriate period.

## Proportionality

A key message for trustees is that there is no ‘one size fits all’ approach to covenant assessment. Accordingly, the covenant must be reviewed in the context of the scheme in question and must be ‘proportionate to the circumstances of the scheme and the employer’. The guidance lists a number of factors which might influence regularity and level of detail of a review, including the complexity of the employer’s legal or operational structure and the size of the deficit compared to the size of the employer. General relations between the employer and trustee will also be relevant, as will the extent of reliance on the covenant due to risks inherent in the scheme’s investment portfolio.

## DIY or external review?

Should the trustees appoint an external adviser to assess the covenant? The guidance acknowledges that this will depend on a number of scheme- and employer-specific factors but stops short of providing that advice must be taken (except in relation to certain issues, such as understanding partial wind-up rules for multi-employer schemes). The factors noted by the Regulator range from the expertise and experience of the trustees, any conflicts of interest which might exist and how these might influence the trustees’ ability to take an impartial view (for example, where a trustee also holds a senior role within the employer’s company) and, again, the complexity of the covenant and status of the employer. The decision on who carries out the covenant review relates directly to the attention the trustees are expected to pay to the guidance. The Regulator warns that if trustees decide not to take professional advice, they must be comfortable that they are able to carry out the steps set out in the guidance. Accordingly, trustees are faced with a tough decision between potentially incurring additional cost or meeting the onerous requirements of the guidance themselves.

## Working with the employer

The guidance echoes the sentiments of the DB Funding Code in stressing the importance of collaboration with employers. There are suggestions as to how best to facilitate information flow between the parties (for example, by use of confidentiality agreements or sub-committees) to ensure employers do not feel restricted in sharing sensitive business information. It is incumbent on employers to justify priority of other issues over the scheme and absent sufficient detail, trustees should resist compromising scheme security.

## Assessing the covenant

The Regulator provides substantial detail on what trustees should consider when assessing the covenant, and focuses on three main angles: ‘legal, scheme-related and financial’.

### Legal aspects

The Regulator expects analysis of various sources in order to establish legal obligations in respect of the scheme. Firstly, employer duties under the Trust Deed and Rules and any statutory schedule of contributions must be considered. Employers potentially liable for section 75 debt and whose insolvency would cause entry into the Pension Protection Fund must also be investigated. If third party support is provided, it is key that trustees understand the nature of that support and the Regulator urges caution in distinguishing between promises given to employers by their parent companies from those which are directly enforceable by the trustees. The Regulator acknowledges that in certain circumstances it may be appropriate for trustees to take account of informal support provided by an employer’s group company. However, it is clear that trustees should consider this only in the short term unless a substantial legal commitment is provided. Additional issues will need to be considered in multi-employer schemes, particularly those relating to partial wind-up, the extent of orphan liabilities and the focus of the trustees’ attention if the scheme is a ‘last-man-standing’ arrangement.

### Scheme related (funding needs and investment risk)

The Regulator believes that the covenant review should be carried out (as a minimum) every three years preceding agreement of the tri-ennial valuation. However, more frequent reviews may be necessary if scheme circumstances dictate, such as a major restructuring of the employer or a transfer exercise. The trustees will need to understand a variety of scheme-specific factors about the funding and investment needs of the scheme to properly evaluate the covenant. These will include an analysis of the size of any deficit versus the size of the employer, the level of risk within the scheme’s investment portfolio, the maturity of the scheme membership and accordingly, its cash-flow requirements. Understanding these aspects will inform the trustees’ decisions on setting their funding targets at an appropriate level.

### Financial (assessing employer support)

The most detailed section of the guidance is that describing the trustees’ evaluation of the employer’s support and how affordable that is likely to be when the scheme most needs it. This will involve:

- a detailed analysis of the employer’s current financial resources and its prospective financial performance
- the medium and long-term outlook for the relevant scheme employers and the wider industry within which they operate
- the impact of the insolvency of any employer, or that of any wider group.

Trustees should place more emphasis on cash-flows and future projections than on surplus or profits declared in previous years’ accounts, They should also be live to any vulnerabilities and sensitivities in projections made by the scheme’s employers and consider whether any assumptions match those adopted for the purposes of the scheme’s funding requirements. Business valuations and credit ratings should be considered, but with caution, as they are often an outdated measure. Trustees should focus on the more tangible areas of support which employers can provide, focussing particularly on discretionary cash-flows after taking account of the costs and expenses of running and maintaining the business.

## Sustainable growth

In accordance with the DB Funding Code, trustees should seek to minimise adverse impact on the employer's sustainable growth plans. Where the employer wishes to use discretionary cash flows for growth rather than meeting its obligations to the scheme, the trustees should consider how such plans will impact the covenant in the long-term and when those growth plans might benefit the scheme. It is also relevant to consider whether the trustees are being asked to 'take a hit' whilst other stakeholders in the employer company such as shareholders continue to receive dividends. The trustees should also explore with employers whether scheme security could be improved in the interim by contingent assets.

The employer's obligations to the scheme are likely to last for an extended period given the long-term nature of pension liabilities and, as such, it is acknowledged that sustainable growth plans are of benefit to the trustee as well as the employer. However, where investment in growth is likely to restrict the funding available to the scheme, it is important that trustees understand the employer's plans as part of their assessment of affordability.

## Outcome in employer insolvency

Trustees are still required to consider how the insolvency of scheme employers or the wider corporate group will affect the scheme. This will include an evaluation of the extent of the trustees' legal rights and claims in a possible insolvency, understanding other material creditors, contingent liabilities of the employers and the value (or lack) of intangible employer assets such as supply agreements or trademarks. There is, however, a recognition that the emphasis to be placed on recovery in an insolvency scenario must be proportionate to the likelihood of any insolvency and accordingly, expert advice may be required to assess this.

## Monitoring the covenant and taking action

The strength of the employer covenant can change materially over a short period of time, having wide-ranging implications for the scheme's investment and funding strategy. The Regulator urges trustees to have processes in place to monitor certain key events or thresholds which could have a material impact on the covenant, allowing quick reaction should the need arise. Triggers for covenant reassessment might include:

- material changes in current and forecast affordability
- changes to the group structure
- refinancing or dividend payments
- adverse movements in key performance indicators
- reputational damage to the employer or
- significant changes to the employer's industry.

Trustees should also monitor the employer's governance and, in particular, be aware of the impact key personnel changes may have on the business.

## Improving scheme security

The final section of the guidance gives trustees some examples of how they might improve scheme security to counteract any weakness discovered as part of the covenant review. This might involve seeking a commitment to increase funding on certain events, negotiating some form of asset security, guarantee or negative pledges. The Regulator also asks trustees to consider whether they can improve the scheme's position in an insolvency situation (such as subordinating other creditors) or seeking to amend rules to give trustees greater control on contributions or in a wind-up scenario.

## Comment

It is clear the Regulator has felt the need to equip trustees with extensive information to assist them in understanding that the covenant process is an essential part of an integrated approach to risk management. Accordingly, the detailed practical guidance with its 29 case studies and user-friendly format will be of significant assistance to many trustees, and is therefore welcome.

The key theme of the guidance is the need for trustees to take a holistic approach to the employer covenant and to understand the extent to which covenant changes interact with, and have a consequential impact on, scheme funding and investment. This is a commendable and clear message with the aim to ensure that trustees understand that the employer covenant underpins effective risk management.

There are a number of areas for trustees to tackle, such as determining a proportionate approach, deciding whether to engage an external covenant adviser and shifting their mind-set from the more traditional emphasis on balance-sheet strength to focus instead on future cash-flow generation.

However, in general we consider the guidance is a positive step in educating trustee and employer behaviour when it comes to employer covenant and it has generally been well received by the pensions industry.

## Contacts

If you would like further information  
please contact:



**Peter Ford**  
**Partner, London**  
Tel +44 20 7444 2711  
[peter.ford@nortonrosefulbright.com](mailto:peter.ford@nortonrosefulbright.com)



**Lesley Browning**  
**Partner, London**  
Tel +44 20 7444 2448  
[lesley.browning@nortonrosefulbright.com](mailto:lesley.browning@nortonrosefulbright.com)

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