The Trustee toolkit downloadable

How a DB scheme works

Tutorial three: Employer covenant

By the end of this tutorial you will better understand:

- what the employer covenant is and its importance in supporting the scheme
- what information trustees could consider to understand the covenant of an employer who is quoted, unquoted, not-for-profit or partnership
- how to use this information to understand trends about the employer

This tutorial is part of **Scenario two**.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at **www.trusteetoolkit.com**

The Pensions Regulator

Employer covenant

The support of a 'healthy' employer is crucial to members receiving the benefits they were promised. Conversely, probably the largest risk to any pension scheme is the loss of employer support, either through circumstance or design.

What is 'employer covenant'?

The legal obligation and financial ability of the employer to support the scheme is known as the employer covenant. The trustees' measurement of its strength will feed into a number of decisions they have to make with regard to the scheme.

In general terms the weaker the employer covenant, the more prudent the trustees should be in making assumptions about the future as a weak employer may be unable to fill the gap should the assumptions not be borne out in reality.

What does 'prudent assumptions' mean?

The assumptions might include:

- investment returns on the assets
- assumed inflation on member benefits
- increases in life expectancy

Taking investment returns as an example, if the trustees assumed that returns would be 8% a year and in reality they were 5% a year, a weak employer may not be able to make up the 3% a year shortfall. As the employer covenant is weak, the trustees should therefore select a more prudent (in this case lower) assumption for investment returns.

Getting the balance right

Should the trustees have an ongoing funding deficit they will want to know that the employer is making appropriate payments into the scheme while ensuring that the employer retains enough cash to invest in its future. This affordability question feeds into the overall measurement of the employer covenant.

Measuring employer covenant

Measuring the employer covenant can be complex and may require independent specialist advice however trustees should understand the support provided by their employer from both a legal and financial perspective. The trustees should understand and identify:

- exactly who the employer is (ie who is legally 'on the hook' for scheme liabilities)
- the robustness and enforceability of the obligations of the employer to the scheme
- the obligations of any other parties that are being relied upon by the trustees (including under any contractual arrangements such as guarantees or security over assets)

The trustees should assure themselves that the employer (and any third parties that are being relied upon) are able to meet their obligations.

Understanding employer covenant

The trustees should remember that a scheme is usually an unsecured creditor of its employer.

What if the employer fails?

If the employer were to fail, and its assets were already secured to a third party (such as a bank), there is a risk that there will be insufficient money left over after the third party has been repaid to meet the pension deficit.

What happens to the employer's assets?

Where a company is wound up as a result of its insolvency, its assets will be distributed to its creditors in order of priority, starting with secured creditors. If there are any assets left over when the secured creditors have been paid, those will be distributed pro rata among the unsecured creditors. For example, if £100 of assets is left to satisfy unsecured creditors with aggregate debts of £1,000, those creditors will receive 10% of the debt owed to them (£100/£1,000).

What can trustees do?

It is useful for trustees to consider how other creditor organisations (such as banks) protect themselves against the risk that money owed to them is not paid.

If a bank considered becoming an unsecured creditor of the employer, it would find out about the finances of the company and monitor its ability to repay not only the loan and interest, but it would also consider the size of debts owed to its other creditors and any security attached to those debts. A similar approach by trustees will help them to assess the employer's ability to support the scheme. This is so that they ensure, where possible, that the scheme is protected against short-term and long-term risk.

Even if it seems okay now, the situation can change quickly. It is important that trustees have mechanisms in place for regular monitoring and review.

What information could the trustees consider?

The types of things the trustees ought to consider when assessing the employer's financial position include (but are not limited to):

- the size of the scheme in relation to the size of the employer
- the nature and prospects of the industry in which the employer operates
- its competitive position and its relative size within that industry
- its management ability and track record
- its financial policies
- its profitability, capital structure (including balance sheet and financial leveraging), cash flow and financial flexibility, and that of any other group entity which has entered into a legally-binding commitment to support the scheme or the employer's obligations to the scheme
- its credit rating (if any)
- its plans for sustainable growth and how these may strengthen its covenant to the scheme

What to look for

Assessment of covenant should also be proportionate to the circumstances of the scheme and the employer. In depth analysis may not be needed, for example, if there has been no material change since covenant was last assessed or where the scheme is very small in comparison with a strong employer.

The level and type of information which trustees may find useful to check the financial health of the employer depends on the type of organisation it is. We will now look at:

- quoted company
- unquoted company
- not-for-profit
- general partnerships
- limited liability partnership

Quoted company

Oscar is a trustee of a quoted company listed in the FTSE 250. He's at a slight advantage here because quoted companies have to follow certain rules on financial disclosures. He'll also be able to read about the company in the financial press.

Sources of information

The documentation that Oscar and his fellow trustees should be receiving includes:

- annual statements
- report and account
- quarterly results
- business plans and budgets
- management accounts
- credit ratings
- details (including maturity and pricing) of the company's level of debt
- details of any security granted by the employer to banks and other creditors
- details of other creditors of the employer

Things that Oscar also has to look out for in the public domain include:

- corporate announcements
- profit warnings
- changes in credit ratings
- press coverage

Financial outlook

Trustees should be aware of any information about the financial outlook of the company. This will include looking at corporate plans and investigating any indications that the company might be in financial difficulties, for example evidence that suppliers are unwilling to give the employer credit, eg a reduction in creditor days.

The trustees should also monitor positive trends, such as increased profits and cash generation, as this may mean the employer is able to contribute more to the scheme. They should also take a view on the employer's position in the market place (eg the strength of the competition and trends in market share) and the state and prospects for the general economy.

Possible conflict of interest

As described in the Module: 'The trustee's role', trustees have to consider their conflicts of interest. Trustees may also be directors or senior employees privy to confidential information about the employer. This can make their ability to assess information provided to them as trustees problematic.

Unquoted company

Rosalind is a trustee of a scheme sponsored by a smaller unquoted company. The types of documentation that Rosalind and her fellow trustees need to see and the things they should be looking out for are largely the same as for Oscar.

Sources of information

With unquoted companies some of this information will be harder to find, as it will not be in the public domain. However sources include:

- the employer itself
- Companies House for financial statements and some details of security that has been granted or released
- management accounts
- business plans
- assessments by credit ratings agencies

Unquoted companies are not under any obligation to issue profits warnings, and may not seek publicity through press releases, so trustees must work harder to remain fully informed.

Not-for-profit

Alison is a trustee of a scheme that has a charity as its employer. Trustees of schemes set up by not-for-profit organisations still need to keep a keen eye on the finances of the organisation particularly to the sources of income and events which may impact them.

Types of organisations

These organisations generally include:

- companies limited by guarantee
- charities
- government agencies
- many professional associations
- other trade bodies
- trade unions

Types of charities

Charities vary greatly. For example, some have endowed funds made up of gifts and bequests that are subject to a requirement that the funds be maintained and invested to create an income stream for the organisation. Others rely on current income, most of which they disburse. Trustees need to take these differences into account and may require specialist advice.

Sources of information

The sorts of things Alison needs to check up on are the same as for an unquoted company.

In her case, as the charity is a company limited by guarantee rather than a trust or an unincorporated association, she would be able to get information in the employer from Companies House and/or the Charity Commission.

There is no official registry for trusts or unincorporated associations and so these will not be registered with Companies House.

Possible sources

As a reminder, Rosalind's sources were:

haven't repeated these bullets after this point as it's repetitive/ unnecessary in this linear format

- the employer itself
- Companies House for financial statements and some details of security that has been granted or released (in Alison's case, she may need to contact the Charity Commission)
- management accounts
- business plans
- assessments by credit ratings agencies

General partnerships

Bob is the trustee of a scheme that has a firm of solicitors as its employer which is organised as a general partnership.

Sources of information

Although Bob still requires the same type of information as Rosalind, a partnership is not required to publish accounts and he will need to request the information directly from the employer. Bob will also need to understand who is liable, as a partnership is not a distinct entity from its partners, and so the scheme liability will fall on the partners as individuals. Bob may require specialist advice to understand how the liability of the different partners is calculated, such as when a partner retires.

Limited liability partnership

Antonia is a trustee of a scheme that also has a firm of solicitors as its employer however this is a limited liability partnership (LLP) and is itself a separate legal entity and will be liable in its own right to the scheme.

Sources of information

Antonia will need the same information as Rosalind.

Obtaining and analysing the figures

It is the duty of trustees to make sure they get to see all the relevant information. Once they have the information, they need to make sure they can analyse it properly.

Employers

Employers have an obligation to disclose to the trustees of their scheme the information reasonably required by the trustees for the performance of the trustees' duties. The employer may request that the trustees sign a confidentiality agreement so the employer feels more confident in sharing information, including potentially market-sensitive information, with the trustees. The trustees may need to take legal advice regarding the terms of such agreements.

Obtaining information internally

There are a number of different routes that trustee boards use to obtain information from non-publicly available sources, including:

- holding regular meetings with the employer
- commissioning regular reports on the strength of the employer's business, and the business of the wider group if relevant
- recruiting a director or senior employee of the company, such as the finance director, to the trustee board (although both the director or employee and the trustees should be aware that this may lead to conflicts of interest which should be adequately identified, managed and monitored)

Using information gathered

The key to analysing the data is to use it to help look forward, rather than just at the present state of the company. To do this, trustees must look at the trends in both profit and turnover. They should consider:

- the employer's profit forecast
- relative size of the company and scheme in financial terms
- other liabilities of the employer and whether they are secured
- anything material that's happened that could affect the employer covenant and/or the scheme
- internal information such as management accounts
- anything remarkable (good or bad) or unexpected in the information received

External covenant advice

The trustees may want to augment their analysis of the employer by commissioning a report from an independent specialist covenant adviser.

Where they wish to produce their own covenant analysis they will need to consider their capacity, independence and experience to achieve this. The report can cover all the aspects the trustees review themselves but may be most useful when focused on specific areas which may be more complex or where the trustees require a greater visibility.

Specialist advice is particularly important where there has been a material change to the employer or the wider group, such as refinance of the group's banking facilities.

The trustees should always consider the cost of such specialist advice. The resources committed should be in line with the benefits expected to be delivered for the scheme.

The overall purpose

Once trustees have processed the information, it will help them to:

- assess the ability of the employer to continue supporting the scheme
- integrate and align the scheme's investment strategy to the employer's financial position (eg by adopting an appropriate amount of risk)

The DB pension scheme regime depends on the support of the employer. Trustees have to make a judgement on their employer's financial viability. The most significant risk, above all others, is that of the employer becoming insolvent.

Useful links
TPR has provided guidance for monitoring employer support, which can be read at www.tpr.gov.uk/covenant-guidance.