The Trustee toolkit downloadable

How a DB scheme works

Tutorial four: Risks to employer covenant

By the end of this tutorial you will better understand:

- how to monitor employer covenant
- how to identify a weak or weakening covenant and understand its effect on a scheme

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

Risks to covenant

The Pensions Regulator expects trustees to assess their employer covenant when considering the right funding level for the scheme and discussing the appropriate contributions with the employer, as part of the valuation process.

This discussion is required by law to take place at least once every three years. However the employer's covenant strength (ie ability to meet its obligations to the scheme) may change between valuations.

What might indicate a weakening covenant?

Some examples of possible indicators that the employer's covenant is weakening are:

- the employer loses a significant customer (eg a sandwich maker loses its contract to supply a supermarket)
- falling demand for the product the employer makes (eg video cassette makers once DVDs were introduced)
- suppliers require faster payment of invoices, or cash on delivery – this indicates they are not confident the employer will be able to pay its debts as they fall due
- the employer asks the trustees to agree to reduce its payments to the scheme because of cash flow problems

Why is a weak covenant a cause for concern?

The employer's covenant strength is its ability and willingness to support the scheme.

Trustees will set the investment strategy for the scheme's assets and the level of ongoing contributions from members and the employer with this in mind.

As part of an integrated approach to risk management, when the covenant deteriorates, trustees need to consider how much this has increased the risks to scheme members getting their benefits, and what they should do to restore the overall level of risk to an acceptable level.

Blip or trend

Trustees should ask themselves whether the change is a short-term problem that will return to normal or whether it is an indicator of a longer term trend. Solutions that are sensible for a short-term problem may prove to be inappropriate when the situation is only going to get worse. Action taken by trustees should be proportionate to the circumstances.

Blip

For instance, a pharmaceutical company may be cash constrained when it is in the final stages of seeking regulatory approval for a particular drug, but anticipates high sales (ie good cash flow) once that approval is given. The trustees may, for example, be comfortable to reduce contributions to the scheme for a short period of time, in anticipation of a higher contribution level once the drug is approved.

Trend

In contrast, the same pharmaceutical company may be experiencing a drop in sales as its high-selling drugs come to the end of their patents, meaning other companies can start to compete with it (as they will not have to recoup the research and development cost of introducing the drug).

If the employer asks for a reduction in contributions in these circumstances, the trustees will need to know more about the employer's plans for the future in order to form a view about the employer's ability to support the scheme over time and what adjustments they may need to make as a result.

What trustees can do

Remember, trustees have a duty to ensure that scheme members receive their promised benefits.

Examining information and monitoring the employer covenant

Trustees should monitor the employer covenant on a regular basis and take action if the covenant appears to be weakening. Contingency planning will help to identify the potential steps trustees can take and when to take those steps. When examining information about the employer covenant, trustees need to:

- be alert to indicators like those listed
- consider what these might mean for the employer
- think about the risks the scheme experiences as a result
- consider possible solutions

Regular updates from the employer

Trustees should receive regular updates from their employer about its financial position and likely prospects. Where the trustees have seen indications of a weakening covenant, they may wish to ask for more frequent updates, or updates tailored to the area of concern.

What can trustees do for cash flow problems?

Where the issue is difficulties with cash flow, the trustees may wish (as in the pharmaceutical company examples earlier in this tutorial) to accept lower short-term contributions in recognition of what the employer can currently afford.

However the trustees will need to be confident that any increased contributions in the future will be affordable. If cash is likely to be constrained for a while, the trustees should discuss with the employer how else it can improve the position of the scheme, eg by the employer granting security to the scheme over its assets.

Why is this important?

This is important because the higher the ongoing funding level of the scheme (ie the proportion of assets to liabilities, where 100% funding level means the scheme is fully funded on an ongoing basis), the less exposed the scheme is to an employer's financial weakness.

Also important is how close the ongoing funding target is to the buy-out funding target; the weaker the employer covenant, the closer together these two targets should be. This is because the buy-out target is the cost of insuring members' benefits in full.

Trustees with a strong employer can rely on that employer's ability to pay significantly increased contributions to the scheme, but a weak employer is less able to afford to do this.

What if the employer should fail?

When the employer's covenant deteriorates, in addition to understanding the current position of the employer and the scheme, the trustees should check they understand the position of the scheme if the employer should fail.

Trustees will need to know what the scheme might receive if the employer becomes insolvent. The scheme is usually an unsecured creditor, and so the trustees should consider whether all the employer's assets would instead pass to a secured creditor (such as the employer's bank).

What about winding up the scheme?

Trustees will also need to check the scheme rules to understand when they have the power to wind up the scheme, if the position of the scheme on insolvency is likely to get worse over time, eg because the employer plans to grant security to another creditor, or because trading losses are consuming the available cash resources.

Taking advice

Depending on the complexity of the information, trustees may need expert advice on how the scheme's position is affected. They should seek this information even if it is not in the public domain. An investigating accountant and a lawyer (who has the relevant experience), will know what they should be asking and how to get any relevant missing information.

The trustees should ensure that such a professional is not the same individual who is also advising the employer or any other party to the transaction, as they are unlikely to be able to manage their conflicts.