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Making employer covenants easier

May 2016

Introduction

Trustees of defined benefit schemes need to know if the employer will stand behind its promise to fund the pension scheme and whether it is able to do so. The employer's covenant is its legal obligation and its ability and willingness to fund the scheme now and in the future. The Pensions Regulator expects trustees to assess and regularly monitor the employer covenant.

10 steps to monitoring employer support

1. Identify which companies are legally obliged to fund the scheme and to what extent. The wider employer group may also be important if, for example, a parent company has given a guarantee.
2. Encourage the employer to share information at an early stage. Bear in mind that the information the employer provides could be confidential and the employer might want the trustees to sign a confidentiality agreement. Trustees should also look at publicly available information such as statutory accounts, credit ratings and comments in the financial and trade press.
3. In most cases, trustees should carry out a full review of the employer covenant at each valuation. This will help them decide what level of risk is acceptable for the funding and investment strategies. The employer covenant effectively underwrites the risks to which the scheme is exposed such as underfunding, longevity and investment.
4. Covenant assessment is a complex process and trustees may want to seek independent professional advice to assist them in making their assessment. Trustees can rely on their own expertise but must ensure they do not have a conflict of interest if they are also employees of a scheme employer.
5. The Pensions Regulator expects trustees to monitor the covenant on a regular basis. They need to consider how often to do so. Working within the employer's existing financial reporting obligations will save cost and time but additional reporting may be required on certain key events, such as a business sale. It is good practice for covenant review (however informal) to be a standing trustee agenda item.
6. Trustees should be proactive and have in place processes so that they can act quickly if there are key triggers or warnings, such as the employer breaching one of its banking covenants or if there is a change in ownership of the employer.
7. Trustees can also use a regular covenant review to ensure they are better prepared if the employer's covenant significantly deteriorates such that it can no longer support the scheme. If this happens, the Pensions Regulator has powers to require other companies within the group to provide support. Understanding what the Regulator would look for and using the regular covenant review to gather helpful information about the group structure and the employer's function within the group is a simple but effective way of allowing the trustees to move quickly should the worst happen.
8. The Pensions Regulator's guidance requires trustees to focus primarily on the employer's legal obligation and ability to fund the scheme rather than the employer's willingness to do so. The employer's management and circumstances can change and trustees should avoid placing too much reliance on verbal assurances of support from management or on historical performance.
9. Trustees need to bear in mind that if any report suggests that the employer covenant is weak, they will have to act on this information. Additional funding could be sought from the employer or another form of security such as a guarantee. However, trustees must also balance the employer's needs and a solution that threatens the viability of the employer is unlikely to be in the scheme's or members' interests.
10. Trustees should keep the scheme investments in mind when assessing and monitoring the employer covenant. A weaker covenant may encourage trustees to invest in lower risk investments.

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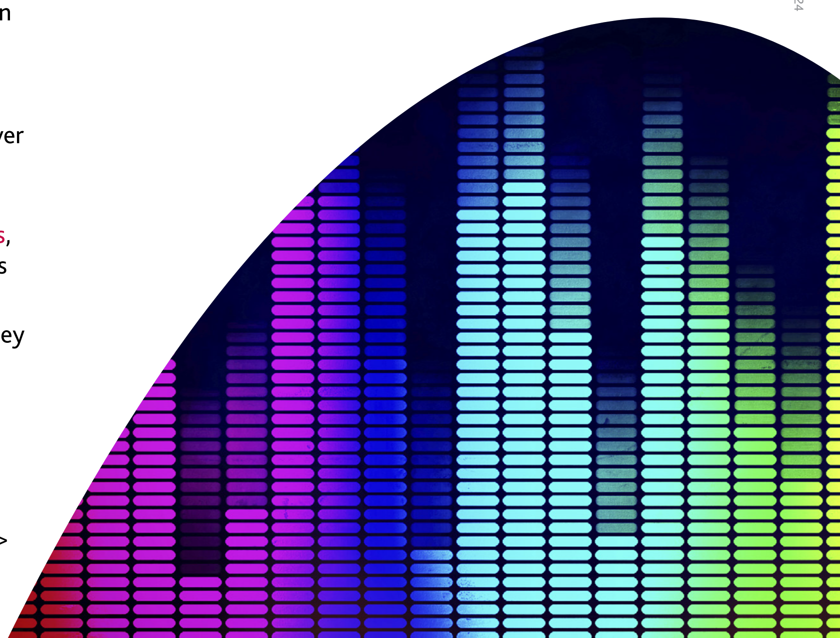

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Further reading

The Pensions Regulator has published a statement setting out what it expects of trustees in relation to the employer covenant. It has also published guidance for trustees on monitoring employer support as well as a short guide for employers.

Pensions law can be tricky… but it doesn't have to be. These 'making it easier' guides explain key issues in simple terms, giving practical help to trustees and employers.

The series is growing; additional copies can be downloaded from www.pinsentmasons.com

Current topics include: Using advisers; Scheme changes and Becoming a trustee

Comments and ideas for further topics are welcome…

Email: Stephen Scholefield