

# BBS briefing note

## **Guidance on monitoring employer support: covenant, contingent assets and other security**

The Pensions Regulator has recently issued a consultation document on guidance for trustees and managers of occupational defined benefit pension schemes. The guidance sets out the standard practice that the Regulator expects trustees to follow in assessing, monitoring and taking action on the employer covenant, and replaces the Contingent Assets guidance of May 2006.

This *BBS briefing note* summarises the proposed guidance.

### **BACKGROUND**

The covenant is an employer's legal obligation to fund their pension scheme now and in the future. The strength of the covenant depends upon the robustness of the legal agreements in place and the likelihood of the employer meeting those agreements. All trustees should therefore have a framework for assessing and reviewing employer covenant, including regular monitoring.

The Regulator has developed the guidance following research with both trustees and covenant advisors with the aim of assisting trustees in understanding the importance and practicalities of managing the impact of the employer covenant on the pension scheme.

The Regulator expects trustees and employers to be proactive in ensuring that there is adequate security for the scheme. This will require the trustees to understand the enforceability of any promises made by the employer and the additional security offered

by negative pledges, agreed actions or contingent assets.

### **THE GUIDANCE**

The Guidance has three sections covering:

- Covenant – assessing the employer's legal obligation to the scheme, its financial position and considering the use of professional covenant assessors.
- Security – the use and valuation of contingent assets and their relevance to scheme funding and recovery plans.
- Monitoring – establishing a robust monitoring process and taking action.

### **COVENANT**

A strong employer covenant means that the trustees can place reliance on the employer providing support to the scheme following adverse experience from unmitigated risks such as investment, longevity or inflation. A strong covenant, therefore, enables trustees to consider following a higher risk investment strategy, with less risk being appropriate where the covenant is weak.

However, the strength of covenant can weaken quickly, as demonstrated over the last few years, and hence mechanisms need to be in place to monitor the covenant and enable actions to be taken quickly to protect the interests of the scheme.

In assessing the strength of an employer, its financial position and its legal obligation to the scheme must be established, recognising that any support which is not legally binding may not protect the scheme. However, trustees should consider whether support from a wider group of companies than those with direct legal obligation may be relevant.



## BBS briefing note (continued)

In cases of a multi-employer scheme, or where the structure of the employer is complicated, measurement may be complex and require judgement.

If the trustees do not think that they have sufficient expertise or independence they should seek advice from external experts, although doing so does not relieve them of their responsibilities. The guidance provides advice on how to select a covenant assessor and the characteristics of a suitable report.

### SECURITY

The employer can increase the security of a pension scheme in a variety of ways, including the provision of negative pledges, the commitment to increase funding on certain events, and the granting of specific contingent assets such as a group company guarantee or a charge over property.

Contingent assets are assets on which a claim by the scheme would exist on the occurrence of a specified future event. As such, they are not included as a scheme asset for the purpose of assessing whether a scheme meets its statutory funding objective until the event occurs.

In agreeing to a particular security, trustees should ensure that they understand the costs of managing the asset, the value to be placed on the asset in different circumstances, the legal status of the security and, in particular, the contingent events in which it can be "called –in".

### MONITORING

Trustees should conduct a full review of the covenant before each actuarial valuation.

It is also good practice to put in place a monitoring plan with specific triggers to act in the intervening period. More regular reviews are appropriate where the trustees believe that the covenant has changed materially over the previous year or may change significantly in the future.

Standard agenda items at trustee meetings to consider the employer's covenant are also recommended.

If significant events do occur, trustees should be prepared to take action early and quickly. This may involve engaging with the employer, calling in a contingent asset, bringing forward an actuarial valuation or realigning the investment portfolio to be consistent with a weaker covenant. Trustees may consider it appropriate to raise their concerns with the Regulator.

However, in cases where the covenant has become negligible, the actions above may be ineffective and trustees may have to consider a more detailed assessment of risks and costs, in the best interests of scheme members.

### BBS VIEW

The Guidance provides helpful assistance to trustees as to how they should assess and monitor the employer's covenant. This complex area is fundamental to the trustees' role and the guidance provides practical support, whilst acknowledging the need for trustees and employers to be proportionate in this area.

BBS will be continuing to work closely with its clients to assist them in putting appropriate processes in place.

This BBS briefing note is based on BBS's understanding of the law and is provided for information only. It should not be relied upon as a definitive statement of the law and detailed legal and financial advice should be obtained on the specific circumstances before proceeding.

