

Monitoring the Employer's Covenant

*A practical starting point for Trustees, Advisers and Employers
in relation to defined benefit pension schemes*

The Society of Pension Consultants
October 2007

Monitoring the Employer's Covenant

Introduction

Nearly all defined benefit pension schemes depend upon their employers (or “sponsors”). In most schemes, the employer is liable to ensure that there are enough funds to enable the promised benefits to be paid. If at present there is a deficit, then it is likely that the employer will be required to eliminate the deficit over a period of time. A scheme which is fortunate enough to be in surplus now might, in the future, have insufficient funding, and in these circumstances the ability of the employer to meet any additional funding requirement is clearly crucial.

It is because of this dependency that the Pensions Regulator requires Trustees to consider the ability and willingness of the employer to support its pension scheme as a vital step in the process of agreeing the valuation basis (or “technical provisions”) and any deficit recovery plan for a pension scheme.¹ The ability and willingness of the employer to support its pension scheme is referred to as the employer’s “covenant”.

Trustees are also required (as part of their statutory obligation to have sufficient knowledge and understanding) to understand the nature and strength of the employer covenant and its ability and willingness to meet the costs of members’ benefits, with especial reference to awareness of the employer’s business and its risk exposure.²

Irrespective of the requirements of the Pensions Regulator, it is clearly good practice for the Trustees of a pension scheme to understand and take into account the financial strength of an employer given its critical dependence on the employer to support the pension scheme.

This note is intended as a starting point for monitoring the strength of the employer’s covenant. It is intended to be of help both to Trustees and their advisers in formulating a practical and objective approach. We also hope that this note will be of help to employers and their advisers in understanding and responding to the needs of Trustees to monitor the employer’s covenant.

This note is not intended to replace the need to engage with appropriate professional advisers in considering the employer’s covenant. It is, rather, intended to form a basis for a discussion between Trustees, advisers and employers of an approach to routine monitoring.

This note has been drawn up by the SPC Council after discussion with a number of its member organisations.

¹ See in particular paragraphs 57 to 61 of [Regulatory Code of Practice 03: Funding Defined Benefits](#).

² See Unit 4c of the Pensions Regulator’s [Scope Guidance on Trustee Knowledge and Understanding](#).

Which covenant should be monitored?

Trustees should start by identifying which employers are legally liable to support the pension scheme.³ Where there is a group of employers it is vital to know which employers are legally liable to support the pension scheme. This is not necessarily the parent company of a group. Where there are two or more employers who are liable, their relative shares of liability should be established, and their individual financial positions considered.

Having established the position of the individual employers who are liable to contribute to the pension scheme, it is also appropriate to consider the health of the overall group. This would be on the assumption that the scheme is ongoing and on the basis that the liabilities of the pension scheme are seen as liabilities of the whole group (without necessarily considering exactly which legal entity is legally liable). However, it should always be remembered that, in the event of a formal insolvency or an employer leaving a continuing scheme, it is the separate financial positions of the principal and any participating employers that is relevant.⁴

Where a group of companies has more than one pension scheme, Trustees should consider how their scheme's financial position, particularly in the event of an insolvency, might be affected by the potentially competing claims from the other pension scheme(s).

Where a sponsoring company is a subsidiary of another, Trustees should consider the wider financial policy and practice of the group. For example, are profits routinely paid to the holding company either by way of dividend, management charges or by pricing mechanisms leaving the sponsoring company with limited finances?

Collecting information about the employer's covenant

Appendix 1 suggests financial data which might be collected on a routine basis. Much of this should be available from company accounts. However, it is worth extracting the relevant data items and presenting these in a summary way. This enables an overall picture to be developed (which can be difficult to identify in a lengthy set of accounts). A summary table also helps to identify trends over time.

Trustees should consider which items may be relevant and might be available in their particular situation, and it is helpful to discuss the data to be collected with a senior company financial officer (such as the Finance Director). It might also be appropriate for the data to be provided by a company officer.

Trustees should also act with proportionality – the information required will depend on the circumstances, and the reassurance required where an employer is very large, profitable and stable and the pension liabilities are small in proportionate terms will clearly differ from a situation where the pension scheme is exposed to greater risk of an employer's failure. The position of a scheme and its sponsoring employer will also have a bearing on the extent to which it is important to focus on the buy-out solvency position.

³ The position will reflect the provisions of section 75 of the Pensions Act 1995 and the provisions of the Scheme's Trust Deed and Rules.

⁴ The Pensions Regulator has powers in certain circumstances under the "moral hazard" provisions of the Pensions Act to require other members of a group of companies to support a pension scheme where they would not otherwise be liable ([see sections 38 to 51 of the Pensions Act 2004](#)).

However, Trustees should be aware that over the (lengthy) lifetime of a pension scheme, even very strong companies can falter or fail.

Deciding which particular measures to use and the frequency of data capture and measurement is complex. Too much data risks turning valuable information into “clutter” whilst too little information, or data which is out of date is clearly inadequate. Furthermore, what is relevant and timely for one business may not be the same for another apparently similar business within the same group.

It is also important that the information used is consistent from one period to the next. Changes in accounting policy or the use of different sources of information to extract data can result in significantly different figures. Internal accounts or information produced to manage the business on a day-to-day basis may not reflect fully the results in the published accounts. Internal management figures are usually more timely and adjusted from period to period to reflect estimates made to produce the previous period's management information. Published information will be less timely and the availability reduced although it is likely to be more accurate and comparable with previous periods.

Trustees should also consider putting in place arrangements to receive the additional information listed in Appendix 2, to the extent that it is available and relevant to their particular circumstances.

A formal financial presentation by and discussion with a senior company financial officer at regular intervals (perhaps every 6 months) will be very helpful and can provide valuable information and assistance to Trustees. Trustees should also request the employer to share with them at an early stage any significant plans for restructuring or acquisitions and disposals, to the extent that these may be of material significance to the pension scheme's position.

Some of this information is likely to be confidential, and some may be price sensitive. Appropriate confidentiality undertakings (and restrictions on dealing in the case of quoted companies) are likely to be required.

A formal agreement with the employer, setting out the types of information and the circumstances when it will be provided (e.g. immediately on publication for accounts and on the happening of defined trigger events for other information) should be considered.

Expert advice and assistance may be desirable in establishing the appropriate data to record.

Obtaining and considering this information should become part of routine activity for Trustees. It is not unreasonable for Trustees to require this information – indeed it is their duty to consider the employer's covenant and an employer is obliged, on request, to provide the Trustees with such information as they or their professional advisers reasonably require for the performance of their respective duties.⁵ Trustees and employers should seek to work together to provide and consider the relevant data in an open and constructive manner.

⁵ See regulation 6(1)(a) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 ([SI 1996/1715](#), as amended)

However, if Trustees are unable to obtain the appropriate information they should consider seeking assistance from the Pensions Regulator. Employers should be aware that Trustees will be duty bound to take a very cautious view and approach to the employer's covenant.

The position if there were to be an insolvency

Appendix 3 sets out some relevant considerations in the event of an employer becoming insolvent. Trustees need to consider what would be the position if their employer were ever to become insolvent and the scheme were to be wound-up.

Making use of the information

Trustees should be aware that they should expect to review any information which they receive, and consider how it is relevant to the employer's covenant. This might be done by having a standing item on meeting agendas to note information received since the last meeting and to consider any implications. To avoid being overloaded, Trustees should be clear in their own minds about the relevance of information which they are requesting: they should only request information which they need.

It is essential to ensure that an individual is responsible for filing (perhaps electronically) the information which is obtained in a systematic manner and ideally in a way that is accessible to the Trustees and their advisers. A secure web-site dedicated to the Trustees and their advisers can be a practical solution.

Trustees should also stand back from the detail of the data and consider the overall prospects for the employer:

- Is it in a business market which is growing?
- Is the employer in a strong position within its industry?
- Is its market share growing?
- How profitable is the business?
- Has the employer been investing enough to maintain its market position and profitability?
- How vulnerable to competition is the employer (perhaps from developing economies overseas)?
- What are the employer's strengths, weaknesses and vulnerabilities?
- If the employer is part of a larger group of companies, how strong is the overall group, and how committed to the business is the parent?

Trustees should also consider the significance of the pension scheme in the overall finances of the company, and whether the pension scheme is affordable on a long-term basis. Where the liabilities relating to the pension scheme are large in relation to the business the long term viability of the scheme and/or the business needs careful consideration. It will also be relevant to consider whether there are other pension schemes that might also be relying on the same sponsoring employer(s).

The Trustees should discuss how the information will be used. Collecting data on its own serves little purpose. The following observations and pointers are offered:

- The information should form the basis of the starting point of the Statement of Funding Principles, any Recovery Plan, Statement of Investment Principles and annual funding reviews. Discussion of the level of risk that it is appropriate to accept (in terms of funding, recovery periods and investment strategy) should refer to the recorded data relating to the employer's covenant as well as any extenuating or relevant circumstances.
- Trigger points might be set by reference to particular measures or indicators, which when reached would prompt action or consideration of certain steps, such as commissioning a new valuation, or reducing investment risk. However, Trustees should avoid taking a purely mechanistic approach to trigger points and consider them as an early warning system rather than an event requiring automatic reaction. Movement through a trigger point may or may not require action by Trustees or their advisors. Similarly, the establishment of trigger points should not preclude Trustees from action before a trigger point has been reached.⁶
- An unsecured creditor of significance, such as a scheme, would typically seek to protect itself – either by obtaining security (“*contingent assets*” in the jargon) or by obtaining covenants (such as promises not to grant security over assets (referred to as “negative pledges”) or agreements not to incur borrowings above agreed levels). The availability and extent of any security or enhanced rights that may be offered to Trustees of a scheme will be different for each employer. Where enhanced rights are offered Trustees will require specialist assistance to maximise the benefit and extent.
- Trustees should consider their ability and readiness to react to significant (and potentially adverse) information. It may be appropriate to consider contingency plans, and the possibility of a sub-committee to react promptly to developments.

The approach and technique for monitoring an employer's covenant is under development, and will undoubtedly develop significantly over the coming months and years. This note is intended as a starting point for discussion, and no doubt Trustees, their advisers and employers will have suggestions and refinements to propose. The Regulator has also suggested that there may be circumstances where it will be appropriate for Trustees to consider taking specialist advice from professionals experienced in covenant reviews or where circumstances require specific consideration. These circumstances are not covered in this note.

The SPC would welcome any comments and suggestions for future development of this note. This note is not intended to constitute advice, or to replace the need for advice in specific circumstances.

Society of Pension Consultants
October 2007

⁶ Trigger points might also reflect positive improvements in a business and might prompt a request to share in some of the improved fortune (e.g. by making a lump sum contribution or by granting security).

Appendix 1

Regular financial monitoring

Measure	£ or %		
	Latest	200[6]	200[5]
Assets [1] <i>Consider breaking down into relevant types of assets – e.g. current and other assets</i>			
Liabilities [2] <i>Consider breaking down into relevant categories – e.g. by reference to type and term. Trustees should seek to understand the claims of other creditors. Trustees should also understand the details of the company's capital structure and financing, and any implications for data to monitor.</i>			
Net assets [3] (i.e. [1] – [2])			
Secured creditors⁷ [4]			
Net assets available to unsecured creditors (i.e. [3] – [4]) <i>What assets are available to support the scheme?</i>			
Earnings before interest, tax, depreciation and amortisation (or 'EBITDA') <i>A measure of the profitability of the business (operating profit plus depreciation and goodwill amortization). This can then be used as a basis for looking at operating profitability margins.</i>			
Free cash flow <i>How much cash is there to support the scheme? This is looking at how much actual cash is generated by the business and how the company uses its cash: so one deducts payments that the Company must pay out (bank interest, taxes) or that it is expecting to have to pay out (dividends to shareholders, capital expenditure on investment).</i>			
Net profit after tax <i>How much profit is there to support the scheme?</i>			
Dividends paid <i>How much is being paid out from the company (and therefore not available to support the scheme)?</i>			
Profit for the year retained in the business <i>How much is being retained within the company which could be available in future to support the pension scheme?</i>			
Values and Ratios			
Interest cover (%) <i>Earnings before interest and tax divided by interest paid. This is a measure of how sensitive the company is to increases in interest costs</i>			

⁷ All creditors ranking prior to the pension schemes

Company gearing ratio <i>There are various measures, including debt as a % of shareholders' funds or debt as a % of capital employed (i.e. debt plus shareholders' funds). These are measures of how dependent the company is on borrowings</i>			
Ongoing valuation deficit divided by pre-tax profit <i>How significant is the pension deficit to the company's profits?</i>			
Change in deficit if equities fall by 10% <i>What is the implication of a fall in equities? – to be considered in the light of measures of company finances in the table</i>			
Change in deficit if bond yields fall by 1% <i>What is the implication of a fall in bond yields (which will increase liabilities)? – to be considered in the light of measures of company finances in the table</i>			
Dun & Bradstreet “failure” score (for PPF levy) <i>The D&B score attempts to calculate the probability that the company will become insolvent in the next year</i>			
Additional measures for a quoted company:			
Market capitalisation			
Total pension liability as a % of market capitalisation <i>How significant are the pension liabilities to the value of the company?</i>			
Ongoing valuation deficit as a % of market capitalisation <i>How significant is the pension deficit to the value of the company?</i>			
To be developed in the light of the particular employers:			
Key-performance and “health” indicators used in the industry or by the company (e.g. market share; like-for-like sales; return on capital)			

The data should be reviewed in line with the company’s usual accounting practice and policies, and where appropriate aligned to avoid the need for unnecessary further analysis or manipulation.

Data should be collated and reported consistently, and tracked over time to enable trends to be identified and discussed. Data should ordinarily be collected and maintained over at least a rolling 3-year period. The periodicity of the collection of the data will vary depending upon the nature of the business, availability, timing and cost among other matters.

Appendix 2

Additional “ad hoc” information to be considered

- Annual Report and Accounts for the Group
- Annual Report and Accounts for participating employers
- A schedule of key dates in relation to the group and its financing (including dates when accounts are published)
- Any ratings agency reports (where company debt is given a credit rating)
- Progress against announced business targets
- High level budgets and forecasts
- Any notifiable events affecting the employer⁸
- Filings at Companies Registration Office
- Changes in the Group’s structure
- Significant acquisitions or disposals of subsidiaries or key assets
- Awareness of key terms and covenants in banking and other facilities
- Any breach of banking or other creditor covenants, or any other formal notification required to be given to creditors (to be provided to Trustees as and when notified to creditors)
- Description and quantification of security interests of third parties over company assets (including negative pledges)
- Any significant press statements, releases or coverage

Further information for quoted companies:

- Interim financial reports
- Any material Stock Exchange announcements
- Copy of presentations to analysts
- Reports from influential equity analysts

⁸ These are events which the employer is required to notify to the Pensions Regulator

Appendix 3

Insolvency considerations

Trustees should establish what the position would be if the scheme was ever to be wound up, or if the relevant employer(s) were ever to enter formal insolvency proceedings or to cease to participate in the scheme. In these circumstances, the statutory debts (under section 75 of the Pensions Act 1995) need to be identified, and considered in conjunction with the financial position of the individual participating employers.

Trustees should consider what assets might be available if an employer's assets were to be realised in the context of an insolvency. The value of the assets in an insolvency can vary significantly depending upon the nature of the business, the nature of the assets, timing and many other matters. In some cases this can be significantly less than the value shown in a balance sheet (for example if there are intangible assets or goodwill which would not be likely to be reflected in what could be realized if a break-up sale was ever necessary). Trustees are likely to require specialist advice and assistance in seeking to establish the range of values that may be applicable in these circumstances. Equally, Trustees should consider those assets where the carrying value in the balance sheet of an employer may understate its true worth or its value in an alternative use.