Assessing the employer covenant

It is essential for the trustees to form an objective assessment of the employer’s financial position and prospects.

Why is employer covenant important?
A defined benefit pension scheme relies upon funding from the sponsoring employer in order to provide members with the benefits that they have been promised. Members’ benefits are only at risk if a shortfall arises that the sponsor is unable to fund.

The ability of the sponsor to fund the scheme is of paramount importance. When making decisions regarding the contribution rates that the sponsor should pay, or the appropriate amount of risk to take within the investment strategy, trustees should always consider the level of contributions that can be reasonably afforded by the sponsor, and its ability to make further contributions should this be necessary, eg if investment returns are poor.

The Pensions Regulator agrees with this analysis, and has made it clear that, to protect members, pension trustees should act in the same way as other material creditors of the employer.

When is employer covenant important?
Employer covenant is always important, and trustees should put suitable mechanisms in place to ensure that the covenant is monitored and appropriate action taken if the strength of the covenant materially changes. There are particular circumstances when trustees will need to look at the covenant in more detail and we list these at the top of the next page.

Nigel Knowles
Trustee
Chemring Group Staff Pension Scheme

The LCP Employer Covenant Report was very useful... the Report was comprehensive, expressing clear opinions and providing practical guidance... and it represented excellent value for money.
Actuarial valuation
The strength of covenant is a key consideration when setting actuarial assumptions and negotiating any recovery plan with the sponsor. The discussions around the valuation are also often a good time to agree steps to strengthen the covenant to the benefit of all parties.

Investment strategy review
The strength of covenant will be a key consideration when deciding on the appropriate level of investment risk to be taken. The trustees will want to be satisfied that in adverse investment scenarios the sponsor will be able to fund the resulting shortfall.

Employer or scheme-related events
Where employer or scheme related events cause the covenant to materially change trustees will want to understand the impact. Such events include mergers and acquisitions, special dividend payments, refinancing or pension scheme mergers. If the impact on covenant is material then trustees need to consider whether the funding and investment strategies should be revised. Where the impact on covenant is materially detrimental, trustees should consider and agree the most appropriate mitigation with the sponsor.

How can LCP help?
To assess your covenant we have a team of experienced credit analysts. This team works closely with pension scheme actuaries and investment consultants to ensure that the results of the covenant analysis are presented and interpreted in a way that is accessible and useful to pension scheme trustees.

We believe that a desktop assessment of covenant is appropriate for most of our clients. This proportionate approach provides trustees with the information they need, at a competitive price. Our covenant assessment methodology uses tried and tested techniques employed by lenders to businesses. To ensure clients benefit from an up-to-date approach we continuously update this to incorporate developments in market practice. Our approach is familiar to finance directors, and uses readily available information. This is more efficient and makes it easier to communicate to management how we reach our conclusions.

We not only present the results of our analysis but give practical advice on the steps required to reflect the results in eg actuarial assumptions, the level of employer contributions and the scheme’s investment strategy.

The Pensions Regulator
Trustees should regard this as just as important to the security of the scheme as monitoring fund performance.
LCP covenant assessment: Three-stage approach

1. Assess
   - Undertake an assessment of covenant strength: this includes answering the questions identified by the Pensions Regulator and listed in the box below. We focus on the entities with a legal liability to fund the scheme and where they sit within the group structure. We form a view on the level of contributions that may be reasonably affordable. We assess the position of the scheme on insolvency. Finally, we put this analysis in the context of the financial position and investment strategy of the particular pension scheme.

2. Strengthen
   - Identify realistic ways to strengthen the covenant: eg the provision of a guarantee from another group company, a legal charge over a suitable asset, a letter of credit from a bank, or an escrow account are commonly used for this purpose. This stage would also include consideration of appropriate mitigation for an event which has a materially detrimental impact on the sponsor covenant.

3. Monitor
   - Set up a process to monitor the strength of the covenant. Our experience is that by working with the employer to develop the monitoring process, trustees can often use information that is already being produced as part of the employer’s own financial control cycle. This enables relevant information to be provided in a timely and cost effective manner.

Usually we would undertake a full assessment every three years to align with the actuarial valuation cycle. Additional assessments may be required if action is proposed that is expected to have a material impact on the employer covenant (eg a corporate refinancing) or on contribution volatility (eg an inter-valuation investment strategy review).

What questions should trustees be asking?
The Pensions Regulator has stated that, in order to assess the sponsor covenant, trustees will be seeking answers to questions including:

- what are the employer’s legal obligations to fund the scheme?
- what is the effect of the employer’s corporate group structure?
- what is the employer’s ability to meet ongoing demands as they fall due?
- what is the employer’s ability to stand behind any adverse experience in an ongoing situation, including the investment risk taken by the scheme?
- what would be the scheme’s position on insolvency of the sponsor?
- are there options to provide security for the scheme?

In many cases trustees will require independent advice to establish the answers to these questions.

The Pensions Regulator

Trustees and employers should recognise and understand that a scheme in deficit on any basis should be treated in the same way as any other material creditor.
Our covenant team of experienced credit analysts and pension scheme experts has wide experience advising in this area, and would be happy to discuss your particular circumstances and requirements. For more information on LCP's employer covenant assessment, strengthening and monitoring services, please contact:

James Atherton
Partner
david.atherton@lcp.uk.com
+44 (0)20 7432 6630

LCP is a firm of financial, actuarial and business consultants, specialising in the areas of pensions, investment, insurance and business analytics.