

What Makes an Effective Employer Covenant Assessment?

1. Introduction

The Pensions Act 2004 introduced the requirement for pension scheme trustees to assess the strength of the sponsoring employer's covenant as part of the valuation process. In addition, the Regulator's moral hazard powers and the clearance process introduced the concept of "materially detrimental events" in respect of acts taken by sponsors of pension schemes. This includes events which change the covenant offered to support the pension scheme.

At Punter Southall we detail below the key components that make a successful employer covenant assessment and the pitfalls to avoid.

2. Key Components for Success

2.1 Meaningful advice in the context of the pension scheme

The employer covenant assessment should provide a direct translation of the strength of the employer into the implications for the pension scheme. For an assessment carried out as part of the valuation process this should include an assessment of how much prudence should be contained in the funding assumptions and a measure of what could be considered "reasonably affordable" in respect of deficit recovery contributions. For an assessment carried out in respect of a one off event a clear analysis of the level of detriment that the pension scheme is being exposed to as a result of the sponsor's actions should be included along with the level of mitigation that should be requested.

2.2 Stands up to Regulator scrutiny

The Pensions Regulator may ask the Trustees to justify the level of prudence adopted in their funding valuation or the deficit recovery contributions agreed. If the Trustees have commissioned an employer covenant assessment this can be shared with the Regulator. Therefore, it is key that the assessment directly meets the Trustees' requirements and is in a suitable format to pass to the Regulator.

If the Trustees are negotiating an appropriate level of mitigation in respect of a corporate event and the negotiations breakdown the discussions may be brought to the attention of the Regulator who may wish to review the advice received by both parties. The Trustees position will be strengthened if the advice received is creditworthy and focused.

2.3 Allows for interlinking

It should be possible for the strength of the employer covenant to be directly incorporated into the level of financial support provided to the pension scheme through the payment of cash contributions or other security measures. Triggers can be developed as an early warning system, such that once breached the Trustees should open negotiations with the employer for additional support to be provided to the pension scheme to reflect the weakening of the covenant but before the employer is too weak to bolster support for the scheme e.g. if the market capitalisation of the sponsor falls by a certain percentage or trading losses emerge.

2.4 Creates a greater understanding of the employer's business

Overall the employer covenant should facilitate the Trustees' understanding of the sponsoring employer(s) and their business to enable better decision making in the future. The employer covenant assessment should be adding value by educating the Trustees and enabling them to deal competently with issues surrounding the covenant going forwards.



3. Pitfalls to Avoid

3.1 Restatement of the material in the company accounts with no additional analysis

To add value the employer covenant assessment must provide additional advice and analysis for the Trustees to be able to incorporate into their decision making rather than simply restating the facts and figures already shared with the Trustees.

3.2 One size fits all approach

The Regulator states in his guidance on clearance that *“The level of detail necessary...will usually be proportionate to the level and materiality of the potential detriment.”* thereby recognising that a one-size-fits-all approach is not appropriate. The review commissioned by the Trustees should have a tightly defined scope to avoid incurring unnecessary fees and contain the level of detail appropriate to the Trustees decision making requirements.

3.3 Static or backward looking

It is futile to simply analyse the performance of the employer over recent years without due regard to future prospects. The employer covenant assessment should provide a concrete view on future expectations. This is crucial since the trustees are considering the long term liabilities of the pension scheme and therefore have to consider the long term support offered to the pension scheme going forwards.

3.4 No allowance for the competing demands on the employer

It is widely accepted that the best outcome for the pension scheme and its members is for the sponsoring employer to remain healthy in the long term so that continued support can be provided to the pension scheme. To that end it is necessary to balance the needs to the employer to grow and develop its business as well as to support the pension scheme. The employer covenant assessment should make allowance for this and the long term future of the business should be given due importance.

4. Conclusion

The employer covenant assessment is an important item in the Trustees tool kit. It is therefore important that the Trustees get the maximum value from any employer covenant assessment that they commission. The above points should help guide Trustees in selecting the type of assessment that they require.

If you would like further information on assessing the employer covenant or wish to commission a review please contact Jacqui Woodward on 020 7839 8600 or email jacqui.woodward@pstransactions.co.uk

About Punter Southall

Punter Southall offers a full range of actuarial, employee benefit consultancy and pension administration services across the UK and advises over 1,000 pension schemes and our pension scheme clients range in size from around 20 members to over 100,000 members and from owner-managed business to industry-wide schemes.

We are part of the Punter Southall Group which provides a unique combination of actuarial, pensions consultancy, administration and investment services for pension scheme trustees, employers, private clients and institutions.

