The Pensions Regulator

Assessing and monitoring the employer covenant

Guidance

Provides practical guidance on how to assess the employer covenant of a DB pension scheme as part of an integrated approach to managing scheme risks, monitor the covenant and take action to improve scheme security.

Issued: August 2015

About this guidance

What is the purpose of this document?

It provides practical guidance on how to:

- assess the employer covenant of a defined benefit (DB) pension scheme as part of an integrated approach to managing scheme risks
- monitor the covenant and take action to improve scheme security

Who should use this guidance

This guidance is aimed at the trustees of DB occupational pension schemes and their advisers, but will also be of interest to the employers of these schemes and their advisers.

How should this guidance be used?

This document provides detailed good practice guidance on how to assess the covenant for the purposes of Part 3 of the Pensions Act 2004. More generally, following the approach in this guidance will be useful for trustees when they are assessing the covenant in other circumstances, for example before agreeing to flexible apportionment arrangements or when there is a change in the corporate group structure affecting the employers.

The extent to which trustees should read the whole guidance will depend on the circumstances of their scheme and employer and whether they intend to perform a covenant assessment themselves.

As a minimum, we recommend that all trustees read:

- ‘At a glance’ which summarises the key points of the guidance
- ‘Section 1: Introduction’ which covers the role of the covenant and how trustees should approach covenant assessments, including how to do this in a proportionate way and when to commission an external review

Trustees who assess their employer covenant themselves should read the whole of ‘Section 2: Assessing the covenant’ which explains how to assess the legal obligation and financial ability of the employer to support the funding needs and investment risk of the scheme. We would expect the trustee board as a whole to understand and put into practice the principles outlined in this section as they apply to their scheme.

Technical terms used in this guidance have the same meaning as in the DB funding code and Part 3 of the Pensions Act 2004, where applicable.

Trustees who commission external advice may find Section 2 informative. ‘Appendix A: Considerations for drawing up a brief for a covenant adviser’ will also be relevant to them.

The final two sections are relevant to all trustees:

- ‘Section 3: Monitoring the covenant and taking action’ explains how to set up a monitoring framework and how to develop contingency plans.
- ‘Section 4: Improving scheme security’ explains the benefits from improving the security of the scheme and examples of how this can be achieved.

The trustees of schemes sponsored by not-for-profit organisations should read ‘Appendix B: Further considerations for not-for-profit organisations’.

The trustees of non-associated multi-employer schemes should read 'Appendix C: Further considerations for non-associated multi-employer schemes'. Examples are used to illustrate key concepts and relevant issues that trustees could consider. Not all examples will be relevant to every scheme – the extent to which these apply will depend on the specific circumstances of each scheme and employer.

In respect of multi-employer schemes, references to 'employer' throughout this guidance should be read as a reference to all participating employers in a multi-employer scheme and, where relevant, to guarantors of their obligations to the scheme.

What other guidance could be useful?

- **Code of practice: Funding defined benefits** (/en/document-library/code-of-practice/funding-and-investment/funding-defined-benefits) (the DB funding code) provides a principle-based framework on how to comply with scheme funding requirements under Part 3 of the Pensions Act 2004.

- **Asset-backed contributions** (/en/document-library/scheme-management-detailed-guidance/funding-and-investment-detailed-guidance/asset-backed-contributions) provides guidance to trustees on best practice when considering entering such arrangements.

- **Identifying your statutory employer** (http://webarchive.nationalarchives.gov.uk/20170106081734/http://www.thepensionsregulator.gov.uk/docs/identifying-your-statutory-employer-statement.pdf) helps trustees understand why it's important to be clear who has legal obligations to their scheme under the legislation, and what they need to do.

- **Statement on double counting – section 75 debts / scheme funding obligations** (http://webarchive.nationalarchives.gov.uk/20170106081734/http://www.thepensionsregulator.gov.uk/docs/statement-double-counting-2013.pdf) is aimed at trustees and employers of multi-employer DB schemes, and their advisers.

- **Multi-employer schemes and employer departures** (/en/document-library/scheme-management-detailed-guidance/funding-and-investment-detailed-guidance/multi-employer-schemes-and-employ

er-departures)
helps trustees and employers of multi-employer schemes understand the different mechanisms by which an employer can depart from the scheme.

- **Abandonment of DB pension schemes** (/en/document-library/scheme-management-detailed-guidance/funding-and-investment-detailed-guidance/abandonment-of-db-pension-schemes)
outlines how trustees should deal with a proposal which involves the abandonment of a DB pension scheme.
- **Clearance** (/en/document-library/scheme-management-detailed-guidance/communications-and-reporting-detailed-guidance/clearance)
provides support to trustees and employers when dealing with scheme or employer-related events that may impact on their scheme, and when there is an application for a clearance statement.
- **Record-keeping** (/en/trustees/contributions-data-and-transfers/record-keeping)
describes an approach that we consider to be good practice for measuring the presence of member data items which are important in the administration of a pension scheme.

At a glance

1. The covenant is the extent of the employer's legal obligation and financial ability to support the scheme now and in the future.

2. Trustees should take investment and funding risks based on the ability of the employer to support the scheme. A sound understanding of the covenant is therefore an essential part of an integrated approach to risk management. Trustees should clearly document the assessment process and its conclusions.

3. Assessing and monitoring the covenant should be proportionate to the circumstances of the scheme and employer, including the degree of reliance of the scheme on the employer now and in the future and the complexity of the employer's operations.

4. Trustees should consider obtaining independent external advice where they lack the objectivity or expertise required to perform an appropriate assessment.

5. Trustees and employers should work openly and collaboratively together. A proportionate covenant assessment, aided by good information sharing, is in the employer's best interests so the scheme does not pose an unnecessary risk to its future sustainability.

6. The covenant assessment should focus on entities with a legal obligation to support the scheme. Trustees should be cautious about placing medium or long-term reliance on the continued support of entities without such an obligation. It may, however, be reasonable to rely on informal support in the short term where this has been given in the past and there are plans for this support to continue to be provided.

7. The strength of the covenant is relative to the scheme it supports. The covenant assessment should therefore focus on the support available from the employer in the context of the funding needs and investment risk of the scheme.

8. As well as assessing the strength of the current covenant, assessments should be forward-looking and focus on the ability of the employer to contribute cash to the scheme over an appropriate period to achieve and maintain full funding based on an assessment of the employer's forecast cash flows and the medium and long-term outlook for the business and the market in which it operates.

9. If the employer's plans to invest in sustainable growth restrict the funding available to the scheme, trustees should understand how the scheme will benefit by supporting this investment and whether other stakeholders are contributing appropriately.

10. The covenant can change quickly. Trustees should monitor the covenant regularly between valuations and have well-developed contingency plans so they can take decisive action if and when required.

[Download 10 key points about assessing employer covenant (PDF, 23kb, 2 pages)]

(/-/media/thepensionsregulator/files/import/pdf/ten-key-points-employer-covenant-at-a-glance.ashx)

Section 1: Introduction

Role of the employer covenant

The employer covenant is the extent of the employer's legal obligation and financial ability to support the scheme now and in the future[1].

Trustees do not have to eliminate all risks to their scheme but it is vital that they understand and actively manage the risks they are taking. A key principle of the DB funding code is that trustees' risk-taking should be informed by the ability of the employer to address a range of likely future downside scenarios over a reasonable period. The employer covenant underwrites the risks to the scheme and an understanding of the covenant should underpin the trustees' approach to:

- investment, for example the appropriate level of investment risk that can be taken
- funding, for example the overall level of prudence in the actuarial assumptions and recovery plan

Trustees should reconsider whether their funding and investment strategies are appropriate if there is any material change in the covenant.

Covenant assessments are useful to trustees not just when considering investment or valuation issues. They can be used in response to other scheme-related events such as transfer value calculations or scheme mergers, as well as employer-related events such as mergers and acquisitions, restructurings or share buy-backs.

Approaching covenant assessments

Assessing the covenant is about understanding the extent to which the employer can afford to support the scheme now and in the future, including the risks to this support being available when it is needed. It should focus on the ability of the employer to make the cash contributions to the scheme to achieve and maintain full funding over an appropriate period, including addressing reasonable downside risks.

Trustees need to understand the employer's covenant from a number of perspectives:

- **Legal** – the nature and enforceability of the obligations to support the scheme.
- **Scheme-related** – the funding needs of the scheme, now and in the future.
- **Financial** – the ability of the employer to contribute cash when required.

These three aspects of covenant assessments are covered in more detail in section 2.

Trustees, employers and their advisers use a variety of scales to rate the covenant. While such summary measures can help provide an overall picture of covenant strength and benchmark the covenant over time, the assessment should also provide sufficient information for trustees to be able to answer the following questions.

Key points for consideration

- Through which employers can the scheme access value?
- What is the trustees' assessment of the employer's current and likely future profitability and cash flows?
- How do these compare with the likely funding needs of the scheme both now and in a downside scenario?
- Over what period of time can the employer afford to repay the scheme's funding deficit?
- Is the scheme being treated equitably with other stakeholders?
- Could the employer afford to increase deficit repair contributions (DRCs) in the event of adverse scheme experience, and over what period of time?
- Do the employer's plans to invest for sustainable growth restrict support for the scheme? If so, how will the scheme benefit and to what extent are other stakeholders also supporting the investment?

- How much value could the scheme recover in an insolvency of the employer?
- What are the risks to the covenant and how may it change over time? What options are there to improve security to the scheme?
- What are the potential implications of all this for the scheme's investment and funding strategies?

[Download the key points to approaching covenant assessments as a checklist (PDF, 24kb, 1 page)](/-/media/thepensionsregulator/files/import/pdf/scope-covenant-assessment-checklist.ashx) (/-/media/thepensionsregulator/files/import/pdf/scope-covenant-assessment-checklist.ashx)

Example 1 below illustrates how an inadequate and a good covenant report may approach these key issues for the same scheme.

Example 1: Examples of inadequate and good analysis in covenant reports

Facts

- The sole participating employer is part of a strong group but is the only entity legally obliged to support the scheme.
- The wider group has stated it is willing to support the scheme but there are no plans for it to fund DRCs.
- The level of DRCs agreed at the last valuation is £1m per annum.
- Using the same valuation basis as at the last triennial valuation, the scheme funding deficit has increased from £12m to £20m. The deficit on a section 75 basis is £45m.
- The scheme's investment strategy has a three-year, 1-in-20 value at risk (VaR) of £8m based on the current level of DRCs.
- Based on the latest publicly available financial statements, the employer's pre-tax profit increased to £3.2m in the last financial year.
- Under UK accounting rules it is not required to prepare a cash flow statement.

- The company is forecasting an increase in annual cash flow from £2m to £3m. Net assets of the employer of £75m include £50m of tangible assets, cash of £1m, and debt of £1.5m.

Key analysis in an inadequate covenant report

- Since the last valuation, the employer has improved its profitability to £3.2m in the last financial year. It did not produce a cash flow statement and therefore we have not reviewed its cash flows.
- Profitability comfortably exceeds the existing level of DRCs.
- The employer has net assets of £75m, of which £50m are tangible assets including the factory and machinery used in its production process. This is significantly larger than the £20m scheme funding deficit.
- The wider group says it is willing to provide support to the scheme.

Conclusion:

We consider the covenant to be strong as the group is strong and the employer is profitable and has a large tangible asset base.

Key analysis in a good covenant report

- The employer is the sole participating employer of the scheme and source of committed financial support. The scheme has no legal recourse to the assets and cash flows generated by the wider group. In addition, there are no plans for it to provide financial support and therefore the wider group has not been considered in this assessment.
- Preliminary valuation results suggest the scheme deficit has increased by £8m to £20m since the last valuation. The preliminary results have been prepared using the same assumptions at the last valuation, updated only for changes in market conditions, and so are subject to revision. The scheme has assets of £60m.
- The employer has limited financial resources with cash of £1m and debt repayment obligations of £0.5m per annum for the next three years.

- The employer is forecasting improved cash generation from operations to £3m per annum due to reductions to its cost base and its forecasts are deemed to be robust. The employer's position within its sector remains strong.
- No cash flows generated by the employer are being extracted by the wider group and therefore they remain available to support the scheme.
- Based on the forecast increase in cash generation, the employer could potentially increase contributions to £2m per annum.
- The scheme's investment strategy carries significant investment risk and the three-year 1-in-20 VaR has increased to £8m. This means there is a 5% chance the deficit could be more than £28m in three years' time in the absence of any change in DRCs.
- The existing deficit and VaR combined could place a strain on the employer's available cash flows in a downside investment scenario.
- The trustees and employer could reassess their shared risk tolerance and consider how to reduce reliance on the covenant in the longer term, for example by reducing investment risk and seeking higher contributions in the short term.
- In addition, the trustees could ask the wider group to formalise the support it has said it is willing to provide. We expect this would improve the covenant and should increase the affordable level of DRCs. The improved covenant could be reflected in the scheme's investment and funding strategy.
- Finally, the employer's forecast performance is vulnerable to changes in energy prices. The trustees should consider stress-testing the covenant and the investment strategy in scenarios of adverse changes in energy prices, and possibly adjusting their investment strategy to reduce the scheme's overall risk exposure to energy prices.

Conclusions and recommendations:

As the scheme deficit remains large relative to the cash flows of the employer, we would characterise the strength of the covenant as 'tending to weak'.

Although the affordability of contributions to the scheme has increased, the scheme's funding requirements have also increased. Therefore, the covenant is materially unchanged since the last valuation.

Note:

The above example is for a scheme with significant challenges (high degree of reliance on the covenant, increased deficit and constrained employer affordability) and the covenant assessment is therefore relatively in-depth. Other scheme or employer circumstances may warrant a less comprehensive approach – see 'Taking a proportionate approach to assessing the covenant' for further information.

Download the examples of inadequate and good analysis in covenant reports
PDF **41KB , 2 pages**
(/-/media/thepensionsregulator/files/import/pdf/examples-inadequate-good-analysis-covenant-reports.ashx)

Trustees should clearly document the assessment process and its conclusions, whether they commission independent advice or decide to assess the covenant themselves.

When to perform a covenant assessment

As a minimum, trustees should undertake a full covenant review at each valuation. The covenant can change quickly and this can have implications for trustees' investment and funding strategies. Trustees should therefore monitor the covenant regularly between formal reviews and have well developed contingency plans so they can take prompt and effective action when required. See section 3 on monitoring and taking action.

Taking a proportionate approach to assessing the covenant

The covenant should be assessed and monitored with a level of detail and frequency proportionate to the circumstances of the scheme and employer. Some of the factors affecting whether a more or less detailed approach or a more frequent review is needed are set out below (the list is not exhaustive). Trustees should take into account all the factors relevant to their scheme when deciding on the required depth and frequency of review.

Key points for consideration

Factors suggesting a less detailed approach and / or a less frequent review (eg every three years)	Factors suggesting a more detailed approach and / or a more frequent review
The structure of the employer is straightforward, eg the employer is a single company which is not part of a group or has minimal interactions with its group.	The covenant is complex, eg the employer is part of a large group with a complex legal and operational structure.
The scheme has a low deficit on a prudent basis in the context of the employer's profitability and cash flow.	The scheme is under-funded and will require material DRCs and investment returns to reach full funding.
The employer is large relative to the size of the scheme and generates significant cash flows relative to the funding needs of the scheme.	The employer is small relative to the scheme and generates limited cash flows relative to the funding needs of the scheme.

The employer is able to invest in sustainable growth while making sufficient contributions to the scheme.	The employer is planning to invest in sustainable growth which will constrain the level of funding available to the scheme in the short term.
There are no significant competing calls on the employer’s cash flows (eg debt repayments).	There are material calls on the employer’s cash flows, for example it has significant debt repayment obligations which restrict the affordability of contributions to the scheme.
The operations of the employer have not changed since the last review was undertaken (relevant only if the last review was undertaken within the last three years).	The employer has undertaken material corporate activities, for example acquisitions or restructurings.
The employer operates in a stable sector.	The sector in which the employer operates is subject to significant change.
The investment strategy is lower risk and there is low reliance on the covenant to support	The investment strategy is higher risk and the scheme may require materially increased support from

downside investment performance.	the employer in a downside scenario.
The employer is open and transparent in its discussions with the trustees and provides, on a timely basis, the information they require to assess and monitor the covenant.	The employer does not co-operate with the trustees and instructs them to rely only on publicly available information.

Download the key points to taking a proportionate approach (PDF, 24kb, 2 pages) (/-/media/thepensionsregulator/files/import/pdf/taking-proportionate-approach-assessing-employer-covenant.ashx)

Covenant assessments should add value to trustees' decision-making. They should focus on the factors likely to affect the employer's ability to provide long-term support to the scheme and the trustees' ability to determine an appropriate investment and funding strategy.

When to commission an external covenant assessment

One of the key decisions trustees need to make is whether to commission an independent covenant review or assess the covenant themselves. This will depend on a range of scheme and employer specific risk factors.

One of these factors in isolation may not necessarily require the trustees to obtain external advice. Their decision should be based on a consideration of the overall impact of all these risk factors taken together and weighted appropriately based on the scheme's circumstances.

Key points for consideration

Relevant factors may include the following:

- The trustees **do not have the necessary expertise and experience** to assess the legal and financial aspects of the covenant.
- The trustee board as a whole is **not fully able to take an objective view**, for instance if an influential trustee holds an important role in the employer (see Example 2) – for further information on managing conflicts of interests see our guidance.
- The **scheme is highly reliant on the covenant**, for example the scheme is large relative to the employer, is under-funded or has a higher risk investment strategy.
- The **covenant is complex**, for example there is a complex legal or operating group structure or an asset-backed contribution (ABC) structure is being used.
- The covenant is undergoing **significant changes**, for example the employer is restructuring.
- The **employer and trustees do not have a good relationship** or the employer has been unwilling to provide requested information on a timely basis.

Download the points about when to commission an external assessment as a checklist (PDF, 23kb, 1 page) (/-/media/thepensionsregulator/files/import/pdf/deciding-internal-external-employer-covenant-assessment-checklist.ashx)

Trustees should periodically reassess whether to commission independent covenant advice as changing circumstances for the scheme or the employer may lead to situations where it can add greater value.

If trustees decide not to obtain professional advice and to perform their own assessment, they should be comfortable that they are able to perform adequately the steps set out throughout this guidance. This is important as an appropriate assessment of the covenant is essential to ensure that the scheme's investment and funding risks can be supported by the employer.

Appendix A outlines questions that trustees could ask prospective covenant advisers. Further guidance for trustees on managing relationships with advisers can be found in 'Relations with advisers'.

Example 2: Trustee board considering the need for external covenant assessment

Facts

- The finance director (FD) of an employer is also a trustee of the scheme and undertakes an internal assessment of the business which they present to the trustee board at each valuation. Their experience and expertise give them a dominant position on the trustee board.
- The other trustees have limited industry knowledge and do not have a financial background. They are concerned about their ability to challenge any views expressed by the FD regarding the strength of the company and its prospects.
- While the presence of the FD on the trustee board benefits the scheme, the trustees are aware that they need to ensure their decisions are not affected by the FD's potential conflict of interest and that they have negotiated robustly with the employer to protect the interests of members.

Guidance

- The FD's financial expertise and detailed knowledge of the company can provide beneficial insight to the trustee board but can also make it more difficult to assess the covenant objectively. Inherently, it is not possible for the FD to objectively review and challenge the forecasts for the employer that they have prepared.
- The trustees should consider commissioning an external review. The FD's views could be given to the advisers to provide them with additional information on the performance of the employer which may not be publicly available (subject to the FD's duties to their employer and any consent required to pass on confidential information).

Managing costs and tailoring the scope of external covenant assessments

Trustees should consider the costs of commissioning external advice in the context of the benefits it could bring to the scheme through the better management of scheme investment and funding risks. Trustees should also be mindful that an inadequate assessment of covenant could result in costs being misspent on inappropriate investment and/or actuarial advice. Trustees should consider what they are seeking to understand from the external covenant assessment.

Trustees may be able to obtain external advice that addresses only the questions that they have. A standardised review based solely on published or readily available historical information and which does not focus on future employer affordability, or consider this information in the context of the scheme's funding needs and investment risk (as set out in section 2), is likely to be of little added value. Such careful consideration of the scope of the assessment will ensure that the review adds greatest value and that costs are controlled.

Working with the employer

Our DB funding code[2] stresses the importance of collaborative working and the sharing of relevant and timely information between trustees and employers. They should seek to overcome confidentiality or disclosure issues, for example through confidentiality agreements or the use of sub-committees.

Trustees should be concerned where information they have reasonably requested is not provided by the employer. The onus is on the employer to justify why the trustees can rely on the employer for support when it is needed. If appropriate information is not provided to allow the covenant to be assessed, the trustees should consider reducing their reliance on the covenant when setting their investment and funding strategies (and effectively conclude that the covenant is weaker).

Where investing in the sustainable growth of the business is prioritised at the expense of the contributions required by the scheme, it is incumbent on the employer to justify why such investment will benefit the scheme and why the support of the scheme is necessary, for example through a reduction in DRCs.

In the absence of sufficiently detailed plans for the employer's proposed investment in growth, trustees should not be willing to compromise the position of the scheme to support that investment. Trustees’ approach to understanding the employer’s growth plans should be appropriate and proportionate to the circumstances, including the extent to which such plans would constrain DRCs.

Trustees and employers should consider whether there may be efficiencies from aligning the provision of information to the trustees to when the employer provides similar information to other stakeholders (eg for reporting to lenders on debt covenants).

Footnotes for this section

- [1] As defined in paragraph 61 of the DB funding code.
- [2] Paragraphs 26-28 and 87.

Section 2: Assessing the covenant

The covenant is the extent of the employer’s legal obligation and financial ability to support the scheme now and in the future.

Key points for consideration

Covenant assessments should focus on the following three key areas:

1. The **employer’s legal obligations to the scheme** – the strength of the covenant depends on the nature and enforceability of the legal agreements in place to support the scheme.
2. The **funding needs and investment risk of the scheme** – the strength of the employer and its ability to meet its obligations should be viewed in the context of the scheme’s size, funding position, exposure to investment risk and maturity.
3. The **financial support from the employer and any other entities** which materially affect the covenant by virtue of their relationship to the employer – the strength of the covenant depends on the likelihood of

these legal obligations being met now and in the future.

Assessing the employer's legal obligations to the scheme

Trustees need to understand the scheme’s covenant from a legal perspective to determine the nature and enforceability of the obligations to support the scheme.

Identifying the employers and analysing their legal obligations to the scheme can be a complex process and may require legal advice.

Key points for consideration

Trustees should identify employers that fall into any of the following categories:

- Participating in the scheme and **bound by the scheme’s trust deed and rules to contribute** to the scheme.
- **Required by a statutory schedule of contributions to pay contributions** to the scheme and, in a multi-employer scheme, the proportion that is payable by each employer.
- Who could be **liable**, now or in the future, **to pay a statutory debt** under section 75 of the Pensions Act 1995 (s75).
- Whose **insolvency** could result in the scheme or part of the scheme **entering a Pension Protection Fund (PPF) assessment period**.

Trustees should also be familiar with the balance of powers set out in the scheme’s trust deed and rules. In particular, the trustees should consider what powers they have to:

- set the level of ongoing contributions and DRCs under the scheme’s contribution power
- wind up the scheme and trigger a s75 debt

This will help the trustees understand their ability to take unilateral action if they are unable to reach a consensual outcome with the employer and will inform their discussions with the employer.

Other legal obligations to the scheme (reliance on guarantees)

Trustees should also identify other entities that have provided guarantees to the scheme and the extent of the guarantor's obligations (see Examples 3-5).

Key points for consideration

When assessing the impact of a guarantee on the strength of the covenant, trustees need to consider the extent to which:

- the support of the guarantor improves the **affordability** of the required DRCs
- the guarantee improves the **outcome for the scheme on the employer's insolvency**

Example 3: Provision of section 75 guarantee to the scheme

Facts

The sole participating employer has a weak covenant. Its parent company has provided a guarantee to the scheme which covers all of the employer's obligations including unpaid DRCs and any s75 debts. This is an estimate of insuring the scheme's liabilities with an insurance provider and is the amount which would be due if the employer were to cease participation. The parent has been assessed as having a strong covenant.

Guidance

In the event that the employer is unable to fulfil all of its obligations (including DRCs or its s75 debt), the scheme can rely on the support of the parent which is therefore the ultimate source of the employer covenant. While trustees should still understand the covenant provided by the employer, the covenant assessment should reflect the strength of the parent as they can rely on its support. The trustees should take into account the cash flows of the parent when determining an appropriate recovery plan.

The trustees should be comfortable that:

- the parent would be able to meet its obligations under the guarantee in situations where it could be required to do so (this should also be informed by an understanding of the impact of a potential insolvency of the employer on the strength of the guarantor)
- the parent will, where necessary, provide funding to support the scheme and accepts that DRCs will also be assessed based on parental affordability
- where the parent is not a UK-resident company, the guarantee is enforceable in the foreign jurisdiction
- they understand the triggers which will allow the guarantee to be called and whether this could be for s75 debts or ongoing contributions

Example 4: Provision of PPF-compliant guarantee to the scheme

Facts

The sole participating employer has a weak covenant. Its parent company has provided a PPF-compliant guarantee to the scheme. This covers 105% of the scheme liabilities measured in accordance with section 179 of the Pensions Act 2004 (s179), which estimates the level of benefits guaranteed by the PPF, less scheme assets. The parent has been assessed as having a strong covenant in relation to its obligation under the guarantee.

Guidance

- In the event that the employer is unable to fulfil its obligations (which is likely to result in insolvency), the scheme can rely on the support of the parent up to the guaranteed amount (based on the latest s179 valuation). However, this does not cover the full extent of the employer’s obligations to the scheme on a s75 basis, which is higher than on a s179 basis.
- The obligations not covered by the guarantee (being the difference between the deficit on a s75 basis and the guaranteed

amount) will be solely reliant on the covenant provided by the employer. The overall covenant should be assessed based on the potential value of the guarantee and whether the parent is also willing to support payments of DRCs (ie to enhance affordability rather than just guaranteeing payment of a level of DRCs based on the employer's limited affordability).

Example 5: Obligations to cover scheme costs under contractual arrangements

Facts

The sole participating employer is a service company with a weak covenant. Under the terms of a cost-sharing agreement with its parent company to which it provides the services, all contributions to the scheme are recharged as set out in a service agreement. This covers both contributions due under the current schedule of contributions and those that will become due under schedules of contributions in the future. This contractual obligation of the parent has no termination date and will continue even if the services under the agreement cease to be provided. The parent has a strong covenant due to its high cash generation relative to the size of the scheme.

Guidance

- As the contractual agreement covers all future contributions, the covenant is ultimately supported by the parent on an ongoing basis. Affordability could therefore be assessed as being as strong as the parent if the employer is expected to continue as a going concern. In this case, DRCs should be set based on the higher cash generation ability of the parent.
- The trustees should be clear that this is an agreement between the parent and the employer rather than the trustee, and should understand what rights they have to enforce the parent's obligations, as an inability to compel it to support the employer's obligations to the scheme when required could mean that less weight should be placed on this agreement. The trustees should also understand what obligations the service agreement could impose on the parent in an insolvency of the employer and may need to obtain legal advice on these points. The overall covenant strength should be based on a balance of these points.

Obligations to support the employer rather than the scheme

Trustees should not confuse an obligation from a third party to the employer with an obligation to support the scheme. Such obligations do not necessarily provide the trustees with legal recourse to the third party and they may be unable to enforce the obligation. Therefore, they should be treated as a factor that affects the support provided by the employer rather than as a separate source of financial support for the scheme.

Reliance on informal support

Schemes may have received statements of willingness to support the scheme from entities that are not legally obliged to do so, often from parent companies of the employer. While such statements are to be welcomed, they are not legally binding and the provider's intentions could change over the long life of the scheme's liabilities. Therefore, it is not prudent to rely on such support in the long run and such assurances should be disregarded in the scheme's medium to long term when assessing covenant strength (see Example 6).

However, it may be reasonable to place reliance on such informal support in the short term where this is expected to continue and there are plans for this support to be provided. In determining what weight to give to this informal support in the short term, trustees should consider the parent's history of providing support to the employer. Where they decide to place reliance on this informal support, trustees should ensure that the recovery plan reflects the higher level of affordability the supporting entity brings.

Trustees should consider obtaining a suitable contingent asset to underpin this informal support if they place material reliance on such support and where the covenant would be materially weakened if it was no longer provided.

Example 6: Willingness to support the scheme not supported by legal obligation

Facts

The sole participating employer has a weak covenant. Its parent company has indicated that it is willing to continue to support the scheme and is, in practice, financing deficit repair contributions. The parent has been assessed as having a strong covenant based on strong cash flows. In addition, it has provided a letter of support to the employer for audit purposes to allow the employer's accounts to be signed-off on the going concern basis.

Guidance

- In the absence of a suitable legally enforceable obligation (such as a guarantee), the continued support of the parent cannot be relied upon indefinitely. Letters of support are not legally enforceable like a guarantee and should therefore be disregarded when assessing the covenant in the medium to long-term. In the long-term, the covenant is only provided by the employer and should be rated as weak. As a result, the trustees should consider reducing their long-term investment and funding risk.
- However, it may be reasonable to rely on the support from the parent in the short-term. This assessment may, among other factors, depend on the importance of the employer to the operations of the wider group. If the trustees intend to place some reliance on the short-term support of the parent (and therefore conclude that the covenant is currently strong) they should ensure that DRCs reflect the higher cash generation of the parent company compared to that of the employer.
- The trustees should monitor the ongoing support of the wider group and could obtain an undertaking from the employer to provide additional support if the parent were to stop supporting the scheme (eg security over assets).

Multi-employer schemes

Many schemes may have more than one employer and trustees should carefully consider which entities they focus their review on.

This section provides guidance on assessing covenant where all employers are under common control and their obligations to support the scheme are treated collectively.

Trustees should refer to 'Appendix C – Further considerations for nonassociated multi-employer (NAME) schemes' where:

- the employers are not all part of the same group (eg NAME schemes)

- group companies do not take a collective approach to supporting the scheme

Last man standing scheme

A scheme may be a last man standing scheme, which means that responsibility for outstanding liabilities falls on the remaining employers if an employer cannot meet its liabilities in full. In these circumstances, it may be appropriate to consider the covenant of the employers on an aggregated or consolidated basis.

When reviewing aggregated or consolidated financial information, trustees should be sure that the information only includes entities which are obliged to support the scheme. Otherwise the covenant assessment could be incorrect due to assumed reliance on entities which have no legal obligation to support the scheme.

Where aggregated or consolidated financial information is not available, trustees could review the individual support provided by the employers which, in practice, fund the largest shares of contributions to the scheme.

Although trustees can start with an aggregated or consolidated review in a last man standing scheme, they should also perform a more in-depth, individual review for some of the employers. Trustees should take a proportionate approach when determining the employers on which to focus individual covenant reviews. In particular, there should be focus on those employers with the greatest liabilities (who may or may not be among the stronger employers) and also the stronger employers, who are the most likely to end up with responsibility for the scheme's liabilities if the weaker employers cannot meet their liabilities in full.

The approach taken by the trustees should be proportionate to the level of reliance placed on the covenant to support the scheme's funding needs and investment risk. Where greater reliance is placed on the covenant, we would expect trustees to review a higher proportion of employers.

Formally segregated scheme

Where the scheme is formally segregated, trustees should treat each segregated section of the scheme separately, based only on the employers that have legal obligations for that section. The investment and funding strategy should be set separately for each section based on the assessment of its covenant.

Partial wind-up provisions

Where a scheme has partial wind-up provisions (meaning that when an employer ceases to participate, the assets and liabilities relating to that employer are segregated, or sometimes may be segregated at the trustees' discretion), trustees should understand each employer's share of the scheme's liabilities. This may require obtaining legal and actuarial advice. Such provisions can mean that the scheme may have relatively little recourse to the strongest employers and, therefore, that reviewing all employers on an aggregated or consolidated basis risks overstating the covenant. Trustees should assess the covenant separately for each employer if they believe there is a risk that the employers may not continue to support all of the scheme's liabilities on a collective basis.

Important

Useful information

The key source of information to assess the employer's legal obligations to the scheme is the scheme deed and rules.

Assessing the funding needs and investment risk of the scheme

The employer covenant is a measure of the ability of the employer to meet its obligations to the scheme. Therefore, it is important that the employer covenant is assessed in the context of and relative to the scheme's funding needs and investment risk to understand the nature of the employer's obligations.

Generally, any covenant review will be conducted prior to finalising the valuation assumptions, since it is used to inform these. The covenant review should be based on the most up-to-date scheme information available at the time and should be updated to take account of the final valuation and scheme risk calculations.

Key points for consideration

In particular, trustees should consider:

- the **size of the scheme's deficit relative to the size of the employer**. Ideally this will also include an assessment on a valuation basis that does not take account of the covenant (eg self-sufficiency) – this is to understand the full extent of the reliance on the covenant and avoid circularity (see Example 7)
- the **level of investment risk** – this will provide an indication of how the scheme's funding requirements could change over time. Deterministic or stochastic approaches are both commonly used and either can add value to trustees' decision making
- the **maturity of the scheme's membership** and the expected cash flows of the scheme (see Example 8) as this will affect the timing of the scheme's reliance on the covenant

Example 7: Assessment of covenant in the context of the scheme's funding needs

Facts

- Employer A is the sole participating employer of Scheme A and has forecast discretionary cash flows of £50m per annum, while Scheme A's deficit on a self-sufficiency basis is £200m.
- Employer B is the sole participating employer of Scheme B and has forecast discretionary cash flows of £60m per annum, while Scheme B's deficit on a self-sufficiency basis is £600m.

Guidance

Although the discretionary cash flows of Employer B are 20% higher than those of Employer A, the current funding needs of its pension scheme on a self-sufficiency basis are three times larger. Therefore, the covenant provided by Employer A to Scheme A is stronger than that provided by Employer B to Scheme B, all other things being equal.

Example 8: Assessment of covenant in the context of a mature scheme

Facts

The sole participating employer of the scheme has limited current affordability due to poor trading conditions since before the last valuation. However, it is forecasting improved cash flows in five years' time and therefore is likely to be able to afford higher contributions to the scheme. The scheme is closed to accrual and has a funding level of 70% on a technical provisions basis. 80% of the value of the technical provisions relate to pensioners in receipt of a pension.

Guidance

The scheme is underfunded and therefore the trustees will need to consider the affordable level of DRCs to reduce the funding deficit. Cash flow is currently constrained but may improve in five years' time, which could be taken as a potential improvement in the covenant. However, the high maturity of the scheme means that more emphasis should be placed on short-term affordability. The covenant should be assessed as weak in light of the scheme's needs.

Important

Useful information

Typical sources of information that can be used to assess the funding needs and investment risk of the scheme are:

- the scheme's latest triennial valuation and annual (or more frequent) funding updates
- an analysis of the scheme's forecast cash flow requirements (which may be prepared for an investment strategy review or as part of the actuarial valuation)
- an investment strategy risk analysis (deterministic and/or stochastic) and fund performance updates

Some of this information will be based on the scheme's records. The more accurate, comprehensive and up-to-date data held by trustees on the scheme's membership, liabilities and investments, the more robust their risk assessment will be. Where data is poor, trustees may need to be more conservative in their assumptions to allow for the unreliability of the data. See our good practice guidance on **record-keeping** (/en/trustees/contributions-data-and-transfers/record-keeping) for more information on this.

Assessing the financial support from the employer

Approach to assessing financial support

Covenant assessments should mainly focus on the employer's ability to contribute cash to the scheme when required now and in the future.

The covenant assessment should look forward rather than backward as the focus is on understanding the strength of the covenant now and how it could change in the future. Trustees should use past recent employer performance (eg the last three years) as an indicator of future performance but should also form their own opinion of employer forecasts, the outlook for the employer's industry, and its competitive position within it.

The financial assessment of the employer should cover the financial support the employer can provide in the short-term (within two years), medium term (two to five years), long-term (beyond five years) and in the event of employer insolvency.

Key points for consideration

1. The employer's **current financial resources** (ie financial health).
2. The employer's **prospective financial performance** (ie cash flows).
3. The markets in which the employer operates, the **medium and long-term outlook** for those markets and the employer's competitive position in those markets.
4. The estimated outcome for the scheme in the event of **employer insolvency**.
5. The **impact of the employer's wider group**.

Employers can differ widely and while the detailed assessment of their financial support may vary significantly depending on the industry sector in which they operate or other employer circumstances, the key areas for consideration outlined in this guidance will be broadly consistent across the majority of employers.

Affordability is a key determinant of covenant strength. Where the employer generates sufficient resources to support the scheme but is unwilling to provide the contributions required by the scheme, trustees should reflect this accordingly in their assessment of affordability, and therefore of the covenant.

While this guidance sets out the key areas separately, trustees should not consider any one factor in isolation. They should instead use their judgement to assess how all the relevant factors taken together determine the overall support provided by the employer in the context of the scheme.

Interpreting financial information

When reviewing financial information, it is important that trustees understand the financial substance of the underlying transactions and balances rather than simply focus on how they may be presented according to accounting standards (see Example 9).

Example 9: Understanding the economic reality of transactions

Facts

A limited liability partnership is the sole participating employer. Under accounting standards, its profits are stated before drawings by the partners which are treated as drawings from equity (analogous to dividends). The partnership forecasts a profit of £25m next year. However, free cash flow (stated after drawings) is expected to be only £5m due to drawings by the partners of £20m. Generous partner remuneration is crucial in attracting the best personnel and could reasonably be expected to be £15m per year based on similar partnerships in the industry.

Guidance

Although profits are stated before drawings due to accounting standards, reasonable partner drawings are, in substance, a cost of the business. In this example, the affordability of contributions to the scheme (a key factor in assessing the covenant) should be considered after the reasonable level of drawings of £15m, giving an available cash flow of £10m. The £5m of drawings in excess of a reasonable level could be treated as an extraction of value by the owners. The trustees should be comfortable that the scheme is being treated at least equitably with the owners (the partners) and that the surplus extraction is not detrimental to the covenant. If the trustees consider that it is detrimental, they should also consider our clearance guidance.

Trustees should also ensure that the financial information they are reviewing excludes pensionrelated balances and transaction. Including such items may lead to over or understating the support provided to the scheme. These could include making adjustments to remove:

- the pension liability or asset calculated in accordance with the relevant accounting standards
- any deferred tax asset or liability recognised in respect of the pension liability or asset
- interest income and expense on pension assets and liabilities respectively

In addition, when reviewing measures of employer profitability, trustees may find it more informative to consider profits on a pre-tax basis as employer pension contributions are often tax-deductible.

A. The employer’s current financial resources

Understanding the employer’s current financial resources will help trustees assess the affordability of contributions in the short term.

Trustees should understand the nature and value of the assets and liabilities of the employer. This will allow them to understand both the immediate availability of financial resources and also how the current financial position may affect future financial performance.

Key points for consideration

Areas that trustees may want to consider include:

- The **liquid financial resources** available to the employer, including cash on hand, committed undrawn borrowing arrangements (such as overdraft facilities) and the terms of these facilities. This will affect the immediate availability of contributions to the scheme.
- The **capital structure** of the employer (the relative proportions of debt and equity), including the term, date for refinancing, interest rate, insolvency priority and covenants of any debt (see Example 10). This will affect competing needs for the employer's cash flows and therefore the affordability of contributions to the scheme.
- The **capital intensity** of the business. Highly capital intense businesses are likely to need to invest heavily in maintaining capital equipment and may require significant investment expenditure to grow.
- The level of **working capital** (current assets less current liabilities) relative to historical levels and how this may be expected to change in future (see Example 11). It is also relevant to understand the items which make up the business' working capital (ie which balances: cash, stock, debtors and creditors) and their relative liquidity as this can affect the availability of cash flows to support the scheme.
- The origin, size, counterparty, and (for debtors) recoverability of significant **intercompany balances and group cash pooling arrangements**. Where relevant, understanding these cash flows can be crucial to understanding the affordability of contributions to the scheme.
- **Financial commitments** including lease obligations and contracted capital expenditure.
- Any **contingent liabilities** of the employer that are not recorded on the balance sheet (see Example 12). Examples include performance bonds, cross-guarantees and ongoing legal disputes which could

constrain the affordability of contributions to the scheme in certain circumstances.

Fixed assets (such as land and buildings or intangible intellectual property) may represent a significant proportion of the employer's book value. However, they do not support the scheme on an ongoing basis if the employer is unable or does not intend to realise additional cash flows from these assets (eg through outright sale or use as security to raise debt). While they may affect the employer's ability to withstand financial shocks and therefore increase financial robustness, they are more relevant to assessing the likelihood and outcome of insolvency, which is addressed later in this guidance.

Example 10: Impact of capital structure

Facts

The capital structure of a sole participating employer is 80% long-term debt and 20% equity. The debt is not secured on the assets of the employer. Interest and capital is being repaid by scheduled repayments over a ten-year period.

Guidance

The employer is highly leveraged due to the high proportion of debt in the business. Were trading to decline, there could be a risk that the scheduled debt repayments could account for a larger proportion of the employer's operating cash flows, limiting the affordability of contributions to the scheme. The trustees may consider taking a weaker view of the current covenant as a result. Cash flows, and therefore the covenant, may improve once the debt has been repaid.

Example 11: Impact of working capital balances

Facts

The sole participating employer provides services under long-term contracts. Although its contracts are profitable, the employer experiences significant fluctuations in its cash and working capital balances due to the different timing of payments by its customers and to its suppliers. The employer forecasts that its free cash balances will fall to low levels at several points over its forecast period. The employer has been unable to arrange an overdraft facility on reasonable terms. This could indicate limited affordability of contributions to the scheme to repay the funding deficit.

Guidance

The trustees could accommodate the variation in the employer's cash flows by developing a variable recovery plan (ie fixed payments that differ from year to year depending on forecast cash flows) which does not expose the scheme, and therefore the employer, to unacceptable levels of risk. For example, the recovery plan could allow for a low level of contributions in years in which cash balances are forecast to be low and higher contributions in years when significant payments are forecast to be received from customers. The trustees could protect the position of the scheme by seeking appropriate contingent asset support and dividend restrictions to reflect constrained liquidity.

Example 12: Impact of contingent liabilities

Facts

The sole participating employer is subject to an ongoing legal claim in relation to a historic contract. Its legal advisers believe they have a strong case and expect that no payment for compensation will be required and therefore no provision has been recorded in the employer's financial statements. However, the potential compensation payable should the employer lose the case could be material. This information is disclosed in the notes to the employer's financial statements under 'Contingent liabilities'.

Guidance

The trustees should be aware of the potential material impact on the covenant if the case is lost and should seek regular updates from the employer. Given the trustees are not directly involved in the claim, it is acceptable for them to rely on the employer's updates and views of the case, unless there is a good reason not to. The trustees and employer should consider what action could be taken if the covenant is materially weakened. Trustees should also be aware of the potential legal costs which could be incurred in defending the claim and factor this into their assessment of the affordability of contributions from the employer.

Use of business valuations and credit ratings

A comparison of the value of the employer (such as its enterprise value) relative to the size of the pension scheme obligation may be informative but trustees should remember that the ability to make cash contributions to the scheme when required is the key determinant of covenant strength. As such, enterprise value comparisons should be considered with caution as they can over-simplify the covenant and they should not replace more detailed covenant analysis.

In addition, while it may be informative to review the credit rating of the employer, this should not be seen as a substitute for a covenant review. The purpose and basis of the credit rating is a short to medium-term measure of credit worthiness which is not wholly consistent with the long-term nature of scheme liabilities and their inherent volatility, nor does it consider the strength of the employer relative to the size of its obligations to the scheme.

Important

Useful information

Typical sources of information the trustees could use to assess the employer's current financial resources include:

- the balance sheet and supporting notes set out in the latest audited financial statements
- more recent management accounts where the latest financial statements are not recent
- summaries of the terms of any drawn or undrawn financing facilities (including debt covenants)
- a schedule of intercompany balances showing the counterparties
- a summary of contingent liabilities (eg guarantees, performance bonds, ongoing legal claims)

B. The employer's prospective financial performance

An assessment of the employer's forecast performance (cash flows) is essential to understand the affordability of contributions to the scheme over the forecast period. Although the length of the forecasting period will vary between employers, in many cases it may be reasonable to assume that a similar level of performance will continue at least until the next scheme funding valuation.

Although an analysis of past performance helps to develop an understanding of an employer's strengths, the challenges it faces and the reliability of its forecasts, covenant is inherently forward-looking. A review of the employer's forecast financial performance is therefore critical to understanding the covenant.

Trustees and employers should focus on the employer's forecast cash flows rather than its profit or surplus, as this is a better measure of the ability of the employer to make cash contributions to the scheme.

Trustees should understand the key sensitivities and vulnerabilities in the forecasts, the assumptions on which the forecasts are based, and whether these assumptions are consistent with the investment and funding assumptions in the scheme.

Where appropriate, trustees should review the assumptions used in the forecasts to assess whether they are realistic. Trustees may also find it informative to perform a sensitivity analysis to consider the impact on covenant strength, and the risk that the recovery plan may not be affordable, if the forecasts are not borne out in practice. This may be particularly appropriate where trustees intend to place greater reliance on the long-term covenant, for example where the employer proposes a long or back-end loaded recovery plan.

Setting an appropriate recovery plan

Where the scheme's valuation concludes that it has a funding deficit, trustees and employers are required to put in place a recovery plan for additional contributions to reach and maintain full funding over an appropriate period of time.

The appropriate recovery period will be different for each scheme but trustees and employers should seek to ensure that the overall risk in the scheme is such that it does not threaten the security of members' benefits or the future sustainability of the employer. The longer the recovery plan, the greater the risk that the deficit could increase due to adverse scheme experience and that even higher contributions may be required in the future.

Key points for consideration

In addition, trustees should consider the following factors when agreeing a recovery plan:

- The level of **DRCs that can be afforded** by the employer based on the review of discretionary cash flows as part of the covenant assessment (see below). This does not necessarily mean that all of an employer's discretionary cash flows should be contributed to the scheme.
- The employer's **plans to invest in sustainable growth** (see below).
- The timing of **when support is most available** from the employer and the degree of certainty over the future strength of the covenant.
- The level of **prudence in the technical provisions** relative to the investment strategy.
- The **maturity of the scheme** and the timing of expected benefit payments, and
- The value of any **contingent asset support** provided to the scheme, and then scenarios in which the value of that support would be realised.

In some recovery plans it may be appropriate to allow for an element of higher investment performance relative to the discount rates used to calculate the technical provisions. Such an approach reduces reliance on contributions payable from the employer during the existing recovery plan as only part of the technical provisions deficit is met through contributions. Trustees and employers should be aware that this will increase the level of risk in the scheme and should consider whether effective contingency plans are needed to address the impact of the additional investment returns not being borne out and invoke these if necessary.

Assessing affordability

Trustees should assess affordability based on the discretionary cash flows of the employer after payment of liabilities that arise from normal operating activities (eg trade creditors, tax liabilities), scheduled debt repayments and expenditure on maintaining or replacing existing fixed assets.

In general we would expect all stakeholders (eg DB pension schemes, lenders, and shareholders) to be considered equitably in a manner consistent with their equivalent creditor status. In practice, employers sponsoring more than one DB scheme will often need to have regard to the funding negotiations with the trustees of all its schemes.

Trustees of shared cost schemes (where the contributions are shared between the employer and trustees on a formulaic basis) should understand whether this could effectively restrict the extent to which required increases in DRCs could be provided and therefore affect affordability.

The trustees should use the same assessment of the affordability of DRCs in their assessment of covenant strength and when setting an appropriate recovery plan (see Example 13).

Example 13: Consistency of affordability assessment

Facts

The sole participating employer believes that it provides a strong covenant due to high discretionary cash flows in the context of the scheme’s funding needs. However, it says that it cannot afford the trustees’ proposed recovery plan (which provides for an equitable portion of its cash flows to be contributed to the scheme) as it needs to retain cash in its business.

Guidance

The assessment of affordability for assessing the covenant should be consistent with that for setting DRCs. If the employer needs to retain cash in the business, then discretionary cash flows available to the scheme will be lower. To the extent that the remaining cash flows are materially reduced relative to the scheme’s funding needs, the trustees should consider whether the covenant is weaker than suggested by the company.

Please note that this example assumes that the retention of cash is not required to support the employer's sustainable growth, a concept which is described separately below.

Assessing sustainable growth plans

As set out in the DB funding code, trustees should put in place funding solutions that minimise any adverse impact on the employer's sustainable growth while continuing to meet the needs of the scheme.

The employer's obligations to the scheme are likely to last for an extended period of time given the long-term nature of pension liabilities. It is therefore in the scheme's interest that the employer is able to adequately invest in the sustainable growth of its business so it can continue to support the scheme in the long-term.

Although such investment can constitute a significant call on the employer's discretionary cash alongside the required contributions to the scheme, many employers are likely to be able to afford both. But where investment in growth is likely to restrict the funding available to the scheme, it is important that trustees understand the employer's plans as part of their assessment of affordability.

Sustainable growth can mean different things to different employers. For some employers investment in growth may be required to halt a decline or enable their business to stand still during particularly challenging times, while others may have plans to actively grow their business. The key for trustees is to understand the context of an employer's circumstances, including what will constitute success for its business, without second-guessing the employer's business and investment decisions. Understanding the employer's objectives can help the trustees better understand what the growth plans may mean for the scheme in the short and long-term.

Not all capital expenditure will lead to sustainable employer growth. Some capital expenditure may be required to maintain or replace existing assets or to keep pace with competitors. In these situations, it may be appropriate for trustees to consider such expenditure as a nondiscretionary expense rather than an investment in sustainable growth. This would reduce the discretionary cash flows available to support the scheme (see Example 14).

Where the employer is proposing to use some of its discretionary cash flows to finance investment in growth, trustees should consider the implications for the support the employer can provide to the scheme. In particular it is useful to consider the following questions (see Examples 14 and 15).

Key points for consideration

Does the investment in sustainable growth constrain the level of cash flow otherwise available to the scheme? And where it does:

- How will the employer's growth plans will impact on the covenant?
- When will growth be able to fund an increase in contributions?
- Are other stakeholders contributing appropriately?
- Can scheme security be improved by contingent assets?

Does the investment in sustainable growth constrain the level of DRCs?

Many employers, particularly those with stronger covenants, can afford to invest in the growth of their business without reducing the level of contributions to the scheme. In those cases, trustees only need to review the employer's investment plans at a high level so they can satisfy themselves, for the purpose of their general covenant assessment, that the employer has a track record of investing sustainably to maintain its strength.

Where the employer's proposed plans restrict the funding available to the scheme, trustees should seek to understand more fully how this plan may impact on the scheme, with a level of due diligence proportionate to the extent to which support is constrained and to the level of risk in the scheme.

How will the employer's growth plans impact on the covenant?

Trustees should understand how the planned investment in growth will affect the covenant. Where the investment is not within the employer (eg it is within another group company), the trustees will need to understand how the employer and/or scheme will benefit from it. Trustees should seek to ensure that there is no deterioration in the covenant as a result of the employer funding investment in other parts of the corporate group.

Trustees should not accept lower DRCs to support investment in sustainable growth outside of the employer which the scheme or employer will not benefit from unless the employer provides adequate mitigation (eg a guarantee from the parent).

When will growth be able to fund an increase in contributions?

Where trustees are accepting reduced contributions to enable the employer to invest in sustainable growth, they should understand what the employer is seeking to achieve and how its proposed investment in growth will benefit the scheme (eg through increased contributions when the investment generates increased cash flows). Trustees should seek to agree a recovery plan which reflects the expected improvement in cash flows resulting from the investment in sustainable growth.

Are other stakeholders contributing appropriately?

Where funding to the scheme is restricted, trustees should seek to understand whether the scheme is being treated fairly with the other stakeholder of the employers and in particular whether equity providers are also supporting the employer's investment plans (eg through a reduction in the level of dividends) and whether debt is being used appropriately to help fund the costs of long-term investment (see Example 15).

Can scheme security be improved by contingent assets?

Trustees agreeing to lower contributions and to higher risk to support the employer's growth plans should seek to obtain security or other contingent assets (see section 4).

Example 14: Impact of capital investment on affordability and recovery plan

Facts

The sole participating employer is forecasting an operating cash inflow of £15m per annum but intends to spend £4m per annum replacing obsolete fixed assets and £8m per annum over the next three years on developing a new product line which it expects will provide it with a competitive advantage and improve its future profitability. The employer is currently paying DRCs of £5m per year.

Guidance

The £4m expenditure on replacing obsolete assets is required to allow the employer to operate at its current level and does not represent investment in sustainable growth. This should be treated as a business expense and the level of contributions that is potentially affordable should be assessed as £11m (operating cash flow less £4m).

The investment in the new product line represents an investment in sustainable growth which could benefit the covenant in the long run. The trustees should consider whether it would be in the scheme's best interests to accept a lower level of DRCs of £3m in the short-term (based on the affordable level of contributions less the cost of developing the new product line) in order to strengthen the long-term covenant.

If they decide this is appropriate, the trustees should ensure that they are being treated equitably with the other stakeholders of the employer. For example, shareholders could contribute by accepting a reduction in the level of dividends (which the scheme could ensure through an undertaking by the employer not to pay more than a certain level of dividends). The trustees should also take appropriate action to ensure that the scheme shares equitably in any future improvement in performance (for example through profitrelated discretionary contributions on top of the fixed recovery plan contributions), and should explore whether contingent asset security is available.

Example 15: Request to reduce DRCs when dividends are being paid

Facts

The sole participating employer is proposing that DRCs be reduced to support investment in the employer. The employer pays a large proportion of its cash flows as dividends each year and does not intend to reduce the level of dividends to help to finance the investment.

Guidance

As the employer is not reducing its dividends, the proposal does not appear to treat the scheme equitably compared to shareholders. Therefore, the trustees should consider making a counter-proposal whereby all stakeholders contribute equitably to investment in sustainable growth and share in its benefits.

Important

Useful information

Typical sources of information the trustees could use to assess the employer's financial performance and sustainable growth plans include:

- statements of profit and loss (or equivalent) and cash flows from the latest financial statements
- forecasts of future financial performance and cash flows
- explanations of key assumptions underlying the forecasts
- sensitivity analysis performed on the forecasts
- analysis of the accuracy of past forecasts including reconciliation for past variances
- details of planned material capital expenditure
- details of the employer's plans for sustainable growth, including all sources of funding and the impact on the employer's future cash flows

C. The markets in which the employer operates and the medium and long-term outlook for those markets

The employer's obligations to the scheme are long-term and will typically extend beyond the period for which forecasts are available. Therefore trustees should understand the underlying sensitivities and pressures that may impact the employer's performance in the medium to longterm and form a view on how the covenant may change over that period.

The level of detail required of this review will depend on the scheme's reliance on the covenant in the long-term. All other things being equal, higher risk investment strategies or longer recovery plans place greater reliance on long-term support from the employer. Therefore trustees will need to consider the medium and long-term outlook in more depth to enhance their understanding of the employer's ability to provide this support if required.

While some trustees may have an understanding of the employer and its industry from current or previous employer-related roles, trustees should take an objective view when considering the prospects of the employer.

Key points for consideration

Trustees should consider (see Example 16):

- the nature and **prospects of the industry** in which the employer operates
- the employer's **competitive position** and market share within that industry (including how diversified that market share is)
- forces that shape the **level of competition** in that industry
- the employer's **sensitivity to industry cyclicality**
- the impact on the sector of the **outlook for the economy** as a whole

Example 16: Example of the impact of market analysis on covenant

Facts

The sole participating employer has a large market share in an industry with high barriers to entry. However, demand has declined over the last ten years and is expected to continue to do so in the near future. This is due to technological innovation which has caused consumer demand to switch to a new substitute product where there are lower barriers to entry.

Guidance

- The employer's traditional industry is under threat from falling demand due to technological innovation, although its competitive position within that industry appears to be secure. While the new product presents a significant opportunity, lower barriers to entry in that market mean the employer may struggle to establish a dominant position in the new market. As such, the covenant appears to have weakened and there is significant uncertainty over its strength in the longer term.

- The trustees should consider whether they should plan to adjust the investment and funding strategies to reflect the risk of deterioration in cash flows and so the weaker covenant and to reduce reliance on the covenant in the long-term.

Important

Useful information

Typical sources of information the trustees could review to assess the medium and long-term outlook for the employer's market include:

- analyst reports for the employer and the industry
- news articles
- industry periodicals

Trustees may also find it useful to use common tools such as a 'Strengths, Weaknesses, Opportunities and Threats' (SWOT) analysis to identify the key internal and external factors which may impact on the employer's future performance.

Scenario planning

Scenario planning can be a useful tool to help trustees understand projections about long-term covenant risks and how these interact with investment and funding risks as part of an integrated approach to risk management. For example, where proportionate, the trustees could forecast how the employer and the scheme could each be affected by certain scenarios and what this would mean for the covenant. This could help trustees:

- identify the key drivers of the covenant
- identify the key aspects of covenant which should be monitored

- assess the level of risk associated with different investment strategies
- develop a plan for how the investment and funding strategies would be adjusted if the covenant were to change
- assess the level of risk associated with longer or back-end loaded recovery plans
- assess the suitable length of a recovery plan or scheme journey plan

D. The outcome for the scheme of employer insolvency

Although insolvency of the employer may appear unlikely within the foreseeable future, trustees should remain aware of the long duration of the scheme's obligations to its members and therefore of the employer's obligations to the scheme. The financial health of many employers may change significantly over the life of a pension scheme and it is not possible to guarantee the continued existence of any employer.

Trustees should therefore understand the potential outcome for the pension scheme in insolvency. The level of detail of this review should be proportionate to the risk of insolvency and the reliance placed by trustees on realising value from fixed assets to fund the scheme (for instance, if the scheme has significantly de-risked, the trustees would be less reliant on an employer in the event of insolvency).

For example, where the risk of insolvency is remote and the scheme will be funded from trading cash flows, a high level understanding of the scheme's claims on key assets and ranking relative to other creditors may be sufficient. By contrast, where insolvency becomes more likely or where significant reliance is placed on the value of tangible assets, it may be necessary to develop a more detailed estimate of the return to the scheme in insolvency.

Key points for consideration

These may include:

- the **likely cause of insolvency** (eg whether it relates only to the employer or to events in the wider group)

- the entities against which the scheme would have a **legal claim** in insolvency (both employers and providers of contingent support) and the size of those claims
- whether there would be **claims from other material creditors** against those entities (such as debt holders) which could compete with the claim of the scheme, and the relative priority of those claims in insolvency (including the impact of fixed and floating charges and the structural subordination of creditors in parent companies to those in subsidiaries) (see below and Example 18)
- whether the **book value of the assets** shown on the balance sheet of the employer reflects the value that could be recovered from them in distress, net of the costs of realising that value (see also paragraphs 100-103 of the DB funding code and our guidance on ABCs)
- what **material contingent liabilities** could crystallise in insolvency (such as cross-guarantees of the obligations of other entities or performance bonds) that could reduce the recovery by the scheme

Trustees should be aware that intangible assets may retain little (if any) value in an insolvency scenario as their value may be highly correlated with the financial performance of the employer (eg intellectual property). Therefore, trustees should consider this carefully if they are relying on security over intangible assets.

Trustees may find it helpful to develop an estimate of the value that might flow to the scheme on insolvency of the employer (which could include preparing an estimated outcome analysis) as it could help the trustees to develop appropriate monitoring triggers and contingency plans.

Trustees should be mindful that estimates of the likely outcome of insolvency may change over time. Insolvency usually follows a period of decline where assets may reduce and creditors competing with the pension scheme may improve their priority ranking. This could cause the insolvency outcome to be significantly less than originally estimated.

Understanding the likely outcome of insolvency can be complex. Trustees will generally need to obtain expert advice to understand the outcome for the scheme in insolvency if they are placing material reliance on this.

Structural subordination

Where a scheme has recourse to a company or companies within a group, trustees should consider whether it is appropriate to look at the employer and subsidiaries on a consolidated or an individual company ('solus') basis.

Reviewing the group on a consolidated basis can conceal restrictions on cash flow into the employer from cash generating subsidiaries or the potential impact of structural subordination on the likely outcome to the scheme in insolvency (see Example 17).

The greater the reliance on the cash flows from subsidiaries or on the potential outcome from insolvency, the more likely it is that it would be proportionate for the trustees to obtain advice which is not only on a consolidated basis.

Example 17: Impact of structural subordination on the returns to the scheme in an insolvency

Facts

The XYZ Group has a holding company with three operating subsidiaries. The group has £135m of net assets (book value), before taking account of either their unsecured bank debt or the pension deficit. All the assets sit in the subsidiary companies, evenly spread across each. The pension deficit on a s75 basis is £105m and the only employer is the holding company. The unsecured bank debt is £75m and is lent directly to the three operating subsidiaries, £25m to each.

Guidance

Looked at on a consolidated basis, a high level review of the likely outcome from an insolvency of the group would show the following:

Assets and liabilities	Value

Net assets	£135m (book value)
Realisable value in insolvency	£90m
Total liabilities: • Bank debt • s75 deficit	£180m • £75m • £105m
Return to bank and scheme creditors	£90m / £180m = 50p in the £1
Return to pension scheme	**£52.5m**

However, in reality, the value would be apportioned as follows:

Assets and liabilities	Value
Net assets in each subsidiary	£45m (book value)
Realisable value in insolvency	£30m
Bank debt in each subsidiary	£25m
Surplus value available to the holding company from each subsidiary	£5m
Total surplus to the holding company from each subsidiary	£15m

Return to the pension scheme	**£15m**

In this simplified example, the trustees should assess the return to the scheme in the event of the holding company's insolvency based on the accounts of the individual entities as, in effect, the pension scheme is being subordinated to the creditors of the employer's subsidiaries in its recourse to the assets of those subsidiaries.

Important

Useful information

Typical sources of information the trustees could review to assess the outcome of insolvency include those set out in sections A and E, but also:

- details of any security provided over the employer's assets
- recent valuations of material assets owned by the employer

E. The impact of the employer's wider group

Where relevant, the trustees should understand the employer's position in the wider group, its interactions with other group companies and the impact this can have on the covenant. The level of detail required of this review should be proportionate to the extent of the interaction between the employer and the wider group, whether for trading, financing or other purposes.

The wider group can present risks that competing calls for cash (eg inter-company lending or security for group debt) may reduce the availability of cash flows to support the scheme. Trustees should consider the impact that this might have on the covenant if these risks materialise and give them appropriate weight in their assessment (based on the degree of integration between the employer and wider group). However, the wider group can also provide opportunities to support the covenant (eg guarantees).

An understanding of the group structure and individual company accounts allows a fuller understanding of the covenant compared to a review of the group's consolidated financial information alone.

Key points for consideration

Relevant considerations may include:

- The **value accessible** by the scheme from the wider corporate group. This could include an assessment of the value held within subsidiaries of the employer (which should be considered to form part of the covenant) and also of which group companies could provide contingent support to improve scheme security.
- The extent of **trading and interdependency** between the wider group and the employer (see Example 18). This should allow trustees to understand the vulnerability of the employer to the condition of the wider group as part of assessing the employer's covenant or the ability of the wider group to support the employer. Common examples include cost-sharing agreements and intra-group purchasing arrangements.
- The **flows of cash and capital** within the group (see Examples 19 and 20), such as intra-group financing and cash-pooling arrangements, including the liquidity of intra-group debtor and creditor balances. The extent to which the employer is supporting or supported by the wider group through dividends or changes in intragroup debt can affect the extent to which the employer's financial resources are available to support the scheme.
- The **capital structure** of the wider group (see Example 21) (such as the relative weightings of equity and long-term debt) and the extent of reliance on the employer to service debt obligations or returns to the group's shareholders. This could also indicate the ability of group companies to provide security for the scheme.

Example 18: Impact of intra-group trading on employer covenant assessment

Facts

The sole participating employer is part of a group and acts only as a local distributor for the group's products which are manufactured by its parent. The employer purchases the products from its parent under a transfer pricing agreement approved by Her Majesty's Revenue and Customs (HMRC). This allows it to make a small profit on the sale of the products commensurate with the low level of business risk faced by the employer.

Guidance

The trustees will need to review the covenant provided by the employer as outlined above. However they should also review the financial condition of the parent as the employer is dependent on the parent for its business and the parent will largely determine the costs incurred by the employer. Trustees should also take a view regarding the likelihood that:

- while such a transfer pricing agreement could ensure that the employer will be profitable, it could also prevent future increases in affordability
- the parent could cease using the employer to distribute its products and therefore the parent should not be considered to be the long-term source of the covenant (in the absence of a legal obligation to the scheme)
- the approval of an intra-group agreement by HMRC does not necessarily mean that the agreement is in the best interests of the employer or the scheme

Example 19: Impact of intra-group receivable balances on employer covenant assessment

Facts

The sole participating employer is part of a group and, as a result of a historic transaction, is owed £50m by its parent company. The parent acts solely as a holding company and owns no other subsidiaries.

Guidance

The only asset of the parent company is the investment in the employer and this balance cannot therefore be repaid unless value is extracted from the employer. Therefore, this balance does not improve the affordability of contributions to the scheme and should substantially be disregarded when assessing the covenant. The extent to which it should be disregarded depends on the ability of the trustees to recover some of the balance in insolvency.

Example 20: Impact of group cash pooling on employer covenant assessment

Facts

The sole participating employer is part of a group and participates in the group's cash pooling arrangements. Cash balances are 'swept' to a group financing company each night which holds the group's external financing arrangements. The employer has no external financing arrangements of its own and is currently owed £100m by the group cash pool (which is recorded as an intercompany debtor). This has increased by £60m over the last three years.

Guidance

Balances due from intra-group cash pools may not be as easily recoverable as those due from a bank. When considering the impact of the intercompany debtor on the affordability of contributions to the scheme, trustees should consider whether the counterparty is able to repay the amount owed and over what period. The increase in the balance owed by the group cash pool indicates that surplus cash is being generated by the employer and that higher contributions to the scheme could be affordable if required.

Trustees should consider the relative priority given to the scheme compared to competing calls on corporate finances, acquisitions and repayment of debt. The trustees should ensure that the scheme is treated equitably to the obligations of the wider group as extraction of value by other stakeholders could result in material detriment to the employer covenant (see the Clearance guidance).

Example 21: Impact of debt in the employer's group

Facts

The sole participating employer is part of a group and generates the majority of the group's cash flows. Its parent has issued external debt on which it is paying interest and making capital repayments. As the employer is a significant part of the group, it has been helping service the debt (although it is not legally obliged to do so) and pays regular dividends to the parent.

Guidance

The trustees should factor in the employer's support for the group's debt obligations when assessing the affordability of contributions to the scheme. However, where the debt is not a legal obligation of the employer (and the employer has not benefited from this debt) the trustees should seek to ensure that the scheme is treated equitably with the parent's shareholders to fund repayments of the debt.

Trustees should also be aware of any security provided over the employer's assets in respect of the liabilities of another group entity and contingent liabilities of the employer (such as performance bonds or cross-guarantees) and the conditions in which they could crystallise.

Important

Useful information

Typical sources of information for the trustees to consider to assess the impact of the wider group include:

- a chart setting out the ownership structure of the group
- the group's consolidated financial statements
- information on the material trading relationships in the group that affect the employer, together with any formal trading or financing agreements
- the employer's intra-group debt position and changes in this over time
- information on the group's capital structure and dividend policy
- details of any cross-guarantees or security provided by the employer in respect of group debt (which may be available from Companies House)

Section 3: Monitoring the covenant and taking action

Ongoing monitoring

The strength of the employer covenant can change materially over a short period of time. This could have significant implications for the scheme's investment and funding strategy. Trustees should therefore monitor the covenant regularly between formal assessments alongside key investment and funding risks. This will enable them to act quickly when required[3]. The frequency and depth of monitoring should be proportionate to the circumstances of the scheme and employer.

Trustees should identify the key aspects of the covenant to track and decide on appropriate triggers or thresholds based on their assessment of what level of change would have a material impact on the covenant and therefore their funding or investment strategy.

Key points for consideration

The key covenant factors to be monitored will vary by employer but could include (see Example 22):

- **material changes in current and forecast affordability** of contributions to the scheme
- **changes to the group structure**, either directly affecting the employers or other entities, which have a material impact on the covenant (such as a subsidiary of an employer)
- any **plans to refinance** or to raise external financing in the group
- **dividend payments** (or analogous extractions of value such as changes in intra-group debt) above a specified level
- adverse movement in the employer's **key performance indicators**
- **reputational damage** to the employer's brand
- **significant changes in the employer's industry** such as the merger of two of the employer's competitors,

regulatory changes or material technological innovation
- **governance or key personnel changes** to the employer

[Download the points to consider about ongoing monitoring (PDF, 59kb, 2 pages)](/-/media/thepensionsregulator/files/import/pdf/ongoing-monitoring-employer-covenant.ashx)
(/-/media/thepensionsregulator/files/import/pdf/ongoing-monitoring-employer-covenant.ashx)

Example 22: Example of monitoring framework

Facts

The trustees of a scheme are concerned about the risk of a future weakening in the covenant as a result of changes in its industry. In such an event, they believe that the level of investment and funding risk would need to be reviewed and that higher contributions from the employer may be required. The employer's dividend policy is to distribute 50% of post-tax profits to its parent company.

Guidance

The trustees could set up a monitoring framework which would include trigger points which they have identified would indicate or lead to a material weakening of the covenant and would result in the trustees taking action. Below are some of the triggers which may lead the trustees to react:

- Payment of a dividend in excess of 50% of post tax profit.
- A 10% fall in the employer's revenue relative to the time of the last valuation.
- A change in credit rating.
- Loss of a customer which represents more than 5% of the business.
- A change in ownership of the employer or its group.
- A change in the price of a key commodity (eg oil).
- Non-renewal of a key contract.

- Inability to refinance debt twelve months before scheduled maturity (for significant debt obligations).

The above triggers are given as examples only. Appropriate triggers and actions will depend on the specific circumstances of the scheme and the employer.

Although such actions may represent additional calls on the employer's resources, they would reduce the risk that the scheme poses to the employer and the likelihood that adverse changes in the scheme could make an already difficult situation worse.

Contingency planning

Where the trustees' monitoring identifies material changes in the covenant, trustees should have contingency plans in place so they can react appropriately. Paragraphs 52-56 of the DB funding code recognise that trustees' contingency plans should not necessarily cover and mitigate all eventualities nor establish enforceable actions. This will depend on the level of risk the scheme is running.

However, trustees should discuss key risks with the employer and what potential options for action there might be so that both parties are ready to respond as soon as a trigger is breached.

Trustees should clearly document their monitoring framework and contingency plans.

Footnotes for this section

- [3] See DB funding code paragraphs 49-51 and 85-87.

Section 4: Improving scheme security

Increasing scheme security

Trustees and employers should consider how the security of the scheme could be improved. This can allow trustees more flexibility in managing the scheme's funding strategy (including deficit), which can be beneficial to both the scheme and the employer.

Key points for consideration

There are various ways to achieve this, and some examples are given below:

- **Commitment to increase funding on certain events** (eg in the event of underperformance of scheme assets or a share of any dividend payments/share buybacks (see Example 23).
- Provision of **asset security** to the pension scheme such as:
  - Security over assets
  - Letters of credit
  - Escrow accounts (or equivalent arrangements)
  - ABCs (see our guidance)
- **Guarantees from other entities** in the employer's group.
- **Negative pledges** whereby an employer commits not to perform certain acts without the prior agreement of trustees (eg grant new security over assets or to extract value from the employer).
- **Improving the scheme's insolvency priority** (eg the subordination of other creditors).
- **Amending the scheme's trust deed and rules** to change the balance of powers to give the scheme greater security (eg over the setting of DRCs, or powers to wind up the scheme).

Trustees need to consider the appropriateness of a contingent asset in relation to the support it is providing to the scheme's funding strategy. For example, cash or other financial assets in an account charged to the scheme is likely to be more suitable to support a higher-risk investment strategy than a charge over property as it could provide for an immediate increase in contributions in the event of adverse investment performance. They should also consider what value it is likely to have in the context of insolvency of the employer.

Trustees should also consider whether they are foregoing anything in order to take advantage of a contingent asset or other arrangement (eg whether it replaces higher contributions in a schedule of contributions) and, if so, whether the substitution is beneficial to the scheme.

Considerations when valuing contingent assets and security

Trustees need to consider carefully the value placed on contingent assets or security. The valuation of an asset should reflect its anticipated value after a contingent event has occurred. Trustees should be mindful that assets whose value is closely related to that of the employer may significantly decline in value at the same time as the employer covenant deteriorates and when the contingent asset may be needed by the scheme. In some cases the value of the contingent asset will be readily apparent (eg cash held in an account charged to the scheme) but, in other cases, determining its value may be more complex.

For some forms of assets (eg property), the current value may not be publicly available and the employer's valuation basis used for accounting purposes may not be appropriate (as this may be based on the depreciated cost). In such cases, the trustees will need a qualified professional to provide an assessment of the current open market (or forced sale, if appropriate) value of that asset.

For other forms of assets the value may be dependent on the continued existence of the employer (eg a brand name, publishing rights, bespoke machinery or premises). In such cases the trustees will need an expert to provide an assessment of the value that the asset would have in the event of the failure of the employer (since this is the circumstance in which the scheme would need to rely on it).

Where a contingent asset requires a third party to act as guarantor or provider of credit, the trustees should monitor the covenant of the third party and satisfy themselves that it would be able to meet its obligations in the scenario in which it was called on to do so. Where a guarantee is of limited duration (and not indefinite) trustees should also consider how the covenant will change once the guarantee expires.

Trustees should focus on the incremental value that the asset provides to the scheme, and to consider whether the scheme already benefits from this asset, especially where it is provided by an employer of the scheme.

Trustees should not assume that a contingent asset provided to enhance the covenant will automatically be acceptable to the PPF, and vice-versa. For further information on PPF-compliant contingent assets, see ‘Guidance in relation to contingent assets’.

In addition to assessing the value of assets provided as security, trustees should consider:

- the jurisdiction in which the security sits and its enforceability
- setting an appropriate frequency to monitor changes in the value of the security over time
- agreeing protections with the employer in the event that the security loses value

Example 23: Contingent support for a higher-risk investment strategy

Facts

Having reviewed the covenant provided to the scheme by the sole participating employer, the trustees have concluded that it has weakened since their last assessment and can no longer support the level of investment risk in the scheme. Therefore, they are proposing to reduce investment risk by reducing equity holdings in favour of gilts. The employer is concerned that gilt prices are unattractive and that reducing equity holdings could require higher contributions from the employer. No formal support is provided to the scheme or employer by its parent company.

Guidance

The trustees could consider maintaining the existing investment strategy providing they obtain contingent support from the employer or its group. They could agree additional contributions to be made in the event of adverse investment performance. The trustees should be comfortable that the provider of this support would be able to afford the additional contributions, and that cash in an escrow account charged to the scheme could be used to ensure that funding would be available, if required.

Appendix A: Considerations for drawing up a brief for a covenant adviser

The following is a non-exhaustive list of questions and prompts to help trustees decide how to appoint a suitable covenant adviser.

The circumstances of each scheme are unique and the work commissioned by the trustees should be specific to the needs of their scheme.

Therefore not all of the questions and prompts in the list below will be appropriate for all schemes. Trustees should regard these questions as prompts to use as they feel appropriate.

Understanding the firm's experience and expertise

- How many other DB schemes (or their employers) do they advise and do they have experience in the employer's industry?
- How many professionals do they have acting in this capacity and what are their professional backgrounds?
- What experience do they have of integrated working with other advisers (eg actuaries and investment advisers)?
- Obtain the biographies and information on the qualifications and experience of people who will be conducting the assessment.
- Obtain references from their previous clients. It is advisable for trustees to ask for more references than they need to give them a sample from which to choose.
- Ask firms to supply a sample format of their report and explain how they assess the covenant.
- Check firms are not conflicted through provision of advice to the employer.

What process should be followed for covenant assessment?

- How will the advisers adjust the scope of their work to meet the needs of the trustees?
- How will they integrate the covenant analysis with the scheme's investment and funding risks?
- What information requirements would they have? What will they do if the employer is not willing to share information?
- What process would the assessor follow and what is the expected timescale of their work?
- How will the advisers treat confidential information? How will they assure the employer about the use of the confidential

information. How will they ensure that they can address confidential issues in their report to the trustees?

- What will their fees be for this work and what fees will they charge for any follow-up advice?
- Are they willing to share their report with the employer, other advisors and relevant stakeholders (including The Pensions Regulator) and on what terms?

What should the report include?

- Specific issues about the employer or the wider group's structure or finances that you would like to understand.
- Key risks or opportunities that should be analysed.
- Advice on what level of contributions the employer could afford without impacting on its sustainable growth.
- Advice on actions that could be taken to improve the covenant or on potential monitoring plans.
- A conclusion with an opinion about the strength of the covenant and an analysis of the employer's cash flow/the level of DRCs the employer can afford.

Appointing a covenant adviser checklist
PDF 60KB , 2 pages
(/-/media/thepensionsregulator/files/import/pdf/appointing-covenant-adviser-checklist.ashx)

Appendix B: Further considerations for not-for-profit organisations

Introduction

This section is aimed at the trustees, employers and advisers of DB pension schemes sponsored by not-for-profit employers (NFPs). It should be read in conjunction with the main body of the covenant guidance as the general approach and principles it outlines apply to all employers.

NFPs are organisations:

- where some (or all) of their activities are of a non-commercial nature

- which rely on donations (or other discretionary income or subscriptions) to fund those activities

NFPs encompass a wide range of organisations including charities, unions and unincorporated associations.

The fact that NFPs do not aim to generate returns to shareholders does not itself change how their covenant should be assessed. However, the nature of some NFPs' activities and financing arrangements means that some of the factors outlined in the guidance may apply differently or that additional factors will need to be considered.

Relevance of covenant to NFPs

The NFP covenant underwrites their DB pension scheme's investment and funding risks. The scheme can pose risks to the NFP as it could do if the employer were a commercial organisation. Therefore, a good understanding of the covenant is still an essential part of an integrated approach to risk management for schemes with NFPs.

Where NFPs have material commercial operations, these should not be treated differently to other commercial operations and should, therefore, be analysed in accordance with the main covenant guidance. Where NFPs have material elements of both commercial income and donations, these should be analysed as distinct operations (see Example B1 and B2). The overall assessment of covenant should be based on an appropriate combination of the covenant provided by commercial and non-commercial activities.

Example B1: Assessing the NFP covenant with high proportion of donation income

Facts

An NFP with a DB scheme derives most of its income from donations, with a smaller (but still material) income share from contracts (some for a number of years) with local authorities to provide services. The donation income is used to finance discretionary expenditure which could be varied in the short-term.

Guidance

- When assessing the covenant, the trustees should treat the NFP employer as essentially having two distinct operations.
- The donation income may be, by its nature, volatile and subject to reputational risk; however, the related expenditure is discretionary. As such, the affordability of scheme contributions to the scheme should not be materially affected by a decline in donation income as the discretionary expenditure could be reduced. This extent to which discretionary expenditure can be reduced may be limited by the potential impact on the employer's reputation (and the potential for more donations), especially if contributions were to become too great a proportion of donations.
- The local authority contracts should be treated as a commercial activity to which the general covenant guidance applies.
- Given the proportion of income from each, the overall covenant assessment of the NFP should place greater weight on the affordability of contributions supported by the donation income subject to the NFP's discretionary activities.

Example B2: Assessing the NFP covenant with low proportion of donation income

Facts

An NFP derives most of its income from fee-paying service users. It also receives a smaller (but still material) amount of donation income as grants which are used to finance discretionary education programmes.

Guidance

When assessing the covenant, the trustees should treat the NFP as essentially having two distinct operations. The income from fee-paying service users should be treated as a normal commercial activity to which the general covenant guidance applies. As in Example B1, the education expenditure is discretionary and could be expected to be reduced if donation income falls.

As such, the affordability of contributions to the schemes may not be affected even if there are grant reductions given the income generated by services. Given the proportion of income from each type of activity, the overall covenant assessment of the NFP should place greater weight on the affordability of contributions from the income derived from the fee-paying service users.

NFP-specific considerations in assessing the employer covenant

The employer’s legal obligations to the scheme

Trustees should understand the legal status of the NFP employer (for example, whether the employer is a charitable incorporated organisation, a company limited by guarantee, a charitable trust, an unincorporated association, an industrial and provident society or another body).

The legal status of the employer may be complex, with implications for the employer’s ability to support the scheme, both on an ongoing basis and in insolvency. It may affect the covenant assessment.

The employer’s financial support

1. Current financial resources

A key consideration is to understand the extent and nature of any restrictions on income, assets or reserves (see Example B3). This is likely to be of particular importance where certain income and assets are restricted to a specific use that is narrower than the NFP’s purposes as set out in its governing documentation (‘restricted funds’). These restricted funds will be subject to ‘special purpose trusts’. The type of NFP to which these restricted funds are most likely to apply is a charity.

Restricted funds might not be able to be used to fund the pension scheme. It will, however, depend on the scheme’s and NFP’s specific circumstances. Trustees should not necessarily presume that income or assets shown as restricted in the financial statements cannot be used to fund the scheme. Pension liabilities that derive from the specific purpose of the restricted funds may fall within their scope (for example, restricted funds may sometimes be used to fund the pension scheme where staff who are members of the scheme are engaged on a project related to the restricted funds or for time working on projects that involve restricted funds).

The trustees should consider taking legal advice where the scheme has significant reliance on the covenant and such restricted funds form a material part of the covenant. The extent and nature of these restrictions will also be of interest to the employer, and the trustees and employer may wish to consider getting joint legal advice.

Example B3: Impact of income and asset restrictions on covenant of a NFP employer

Facts

An NFP is the scheme's employer. The majority of the NFP's income is derived from a mixture of donations and grants. They are used to support the NFP's general objective of supporting community education. The NFP also derives a material portion of its income from a legacy fund formed from the bequest of a deceased patron. It is treated as a restricted asset by the NFP.

This fund was set up with the specific objective of publishing a community newsletter. The fund is invested in listed securities. The legacy fund asset (and the associated income) is treated as restricted for accounting purposes as the intention of the legacy fund is to finance an activity that sits alongside, but is distinct from, the NFP's general objectives.

Guidance

- Where proportionate, the trustees should consider obtaining legal advice on whether all (or some of) the income from the legacy fund can be used to support contributions to the scheme. Where this is possible, the covenant assessment should take it into account when assessing affordability of contributions; the trustees could consider setting a higher level of DRCs if required. Where the legacy fund and its income are considered to be restricted and not available to support the scheme, then both should be excluded. This would result in the trustees forming the view that affordability is lower and the covenant potentially weaker.

- If the trustees are reliant on income from the restricted funds to pay DRCs, they should be aware of any risk concentration. It may be possible that adverse scheme investment performance could be mirrored by that of the restricted fund.
  Trustees should consider the risk that contribution affordability from the restricted funds could fall at the time where the contribution needs of the scheme have increased.

2. Prospective financial performance

Assessing affordability

As for commercial employers, it is important that trustees assess the various income streams and cash generation of the NFP and their likely trends over time (see Example B1).

Key points for consideration

In particular, trustees should consider:

- the **diversity of income sources**, including the extent of reliance on voluntary income (eg public or corporate donations and grants), contract income, and commercial income (eg sales of products or investment returns)
- the **future outlook of these income sources** (eg certainty provided by direct debits, prospects for growing donation base or the term and likely renewal of public grant funding)
- the availability of **possible alternative income sources** that the NFP may become eligible for (eg grant funding)
- the availability of **reserves** and the NFP's policy towards retention of reserves
- the availability of income from **permanent endowment funds**
- the level of **discretion in the costs** incurred by the NFP
- any **key risks** (eg reputational risks) **to these income streams** and whether the NFP has clear policies for managing these risks

Assessing sustainable growth plans

For an NFP, sustainable growth can mean various things, from expenditure on developing fundraising channels and expansion of charitable operations to simply remaining viable (in other words it could be about 'sustainability' rather than 'sustainable growth').

Given the NFP's reliance on discretionary donation income for sustainability, trustees should be cognisant of the impact that the level of the scheme contributions as a proportion of donation income can have on donor perceptions and therefore their donor's willingness to support the NFP, and possibly also on the income from its commercial operations (as perceptions about the brand can affect all aspects of an NFP's operations).

This all needs to be carefully balanced. Taking too high a proportion of donations as contributions may reduce the likelihood of future donor support. Trustees could consider supporting sustainable growth where this is likely to lead to higher DRCs in the future. However, insufficient funding of the scheme may lead it to take greater investment risk. This could create risks to the scheme and the NFP. Investment downside outcomes could increase the scheme's deficit to a point where it poses real difficulties to the NFP and undermines donor support. Analysis of affordability should be used to agree a risk tolerance with the employer taking these factors into consideration.

3. Market outlook

Key points for consideration

When assessing the outlook for the sector and the position of the employer within the sector trustees should consider:

- the **reputation** and public profile of the employer and the impact on future donations
- the **quality of governance** of the organisation including its efficiency, management of reputational risks, and contingency plans for potential shocks to income (eg reputational damage), or demand for services
- the **competition for income** from other organisations
- the **demand** for the services it offers

4. Position on insolvency

Insolvency of NFPs can be complex due to the legal status of the employer and complexities of charity and trust law. Where proportionate, the trustees may need to obtain expert advice to help understand the position of the NFP and the scheme (including

PPF eligibility) in insolvency. Where the NFP is a charity, trustees may find the Charity Commission's guidance on managing financial difficulties and insolvency in charities helpful. This can be found on the **GOV.UK website** (https://www.gov.uk/government/publications/managing-financial-difficulties-insolvency-in-charities-cc12/managing-financial-difficulties-insolvency-in-charities)
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Trustees should also be aware of the impact of any material restrictions on the use of assets or grants in insolvency. These restrictions could reduce the NFP's support to the scheme.

5. Impact of the employer's wider group

NFPs may form part of a group performing different activities. In these situations, trustees should consider whether (and how) the scheme is supported by the main sources of value in the group.

Trustees should also understand the NFP's reliance on the wider group for funding and the obligation of other group entities to support the NFP. Where the NFP is reliant on funding from the wider group, for example a subsidiary funded by a legally distinct endowment, trustees should understand the obligation of the wider group to continue to provide support.

Monitoring and taking action

An NFP's discretionary donations can be vulnerable to the employer suffering reputational damage. As this could happen over a short period of time, it may not be appropriate to wait until the next valuation before taking action. Where discretionary donations are a material part of the NFP's covenant assessment, trustees should consider monitoring this on an ongoing basis along with the NFP's donation income levels.

Appendix C: Further considerations for non-associated multi-employer (NAME) schemes

Introduction

This guidance is aimed at the trustees, employers and advisers of nonsegregated NAME schemes.

The general covenant guidance is useful in understanding the covenant provided by individual employers within a NAME scheme.

This section of guidance relates to the additional complexities which apply when the covenant is provided by multiple, non-associated employers.

NAME schemes are often complex and a bespoke approach based on expert advice is likely to be needed.

NAME scheme-specific considerations in assessing the employer covenant

The employers' legal obligations to the scheme

Key points for consideration

In addition to the considerations set out in the main guidance, trustees of NAME schemes should also assess:

- the **legal obligations and status** of each employer
- whether any employers have employed **active or eligible members** under statute or the scheme's trust deed and rules
- the **mechanics of employer withdrawal** (does the scheme have segregation provisions and/or 'last man standing' arrangements?)
- the **trustees' powers** under the trust deed and rules **to** (i) **impose contributions** (some NAME schemes give trustees unilateral contribution powers) (ii) require participating employers to remain in (or contribute to) the scheme even after they have paid their s75 debt
- the **likelihood of employer withdrawal and its impact**
- an estimate of the quantum of **each employer's liability** to the scheme (this should be based on an understanding of each employer's share of the scheme's liabilities, including orphan liabilities)

The employers' financial support

Approach to setting the contribution structure

A key consideration for the trustees of NAME schemes will be the set up of a contribution structure and how that will be applied to each employer. A contribution structure is an approach to allocating contributions between the employers (for example contributions may be evenly spread among all employers or distributed unevenly). It will be informed by the considerations outlined above. These considerations and the contribution structure will also inform the trustees' approach to assessing affordability and, therefore, to assessing the covenant.

When putting in place a contribution structure, trustees may recognise the more limited financial capacity of weaker employers and adjust the structure accordingly. For example this may result in a weaker employer who has the same quantum of liabilities as a stronger employer paying the same value of DRCs as the stronger employer but over a longer period. Where trustees are open to such adjustments, it is important that they have clearly defined parameters.

When setting current contribution structures, the trustees should also consider how they would respond should the scheme's deficit increase and, say, the position of the weaker employers fail to improve relative to the stronger employers. Unless some consideration was applied to the contribution structure, the stronger employer could then end up, following every valuation, continually supporting the weaker employers.

These sensitive issues can be made even more acute by the fact that employers within NAME schemes may be commercial competitors. Subject to these considerations and strict controls, the trustees could still implement an approach which ensures overall contributions are not constrained by the position of the weakest few employers.

Approach to assessing affordability

The cash flow of participating employers is a key determinant of covenant strength and should be used to assess the levels of the scheme's investment and funding risk. The approach to assessing covenant and each employer's affordability will be informed by the contribution structure.

A proportionate approach to assessing affordability for a NAME scheme may consider a sample of all employers rather than reviewing each employer in detail. At the very least, trustees should still consider the cash flow across all employers (even if only at a high level) and how the position of the weaker employers will impact the level of DRCs that is affordable.

Some potential, non-mutually exclusive approaches are outlined below.

Concentrated contributions

Where contributions are concentrated in a few employers, a proportionate approach may include:

- a detailed review of those employers whose covenant poses the greatest risk to the overall covenant (usually those who will be responsible for the largest share of contributions) and a highlevel review of the other employers (see Example C1)
- a detailed review of the employers expected to make the greatest share of future contributions to determine whether they do have the greatest cash generating potential (see Example C2).

Evenly distributed contributions

Where contributions are more evenly distributed among employers of a similar strength and the scheme is well-funded, a random sample could be used for a more detailed review as representative of the overall population (see Example C3). In this situation, general sector analysis will also be useful.

Where contributions are more evenly distributed across employers who are both weak and strong, assessments of affordability should include assessments of the employers with weaker covenant, to identify what level of contributions is achievable for both the strong and the weak employers.

Where contributions are more evenly distributed among employers and a high level of investment risk is being taken (and, therefore, there is a greater risk of reliance on the covenant to support higher DRCs in a downside scenario), a greater proportion of employers should be assessed in detail to understand their ability to underwrite the investment risk.

Recovery plans

For NAME schemes, setting a recovery plan with a level of DRCs that only reflects affordability for the weakest employers may be insufficient. This may expose employers to the unnecessary risk of future increase in contributions being required, which could lead to financial distress.

Equally, trustees should be mindful that a recovery plan suitable for the strongest could cause financial pressures onto weaker employers, placing them in financial difficulties, and could be a contributory factor of insolvency.

Example C1: Assessment of covenant and affordability for a concentrated NAME scheme

Facts

A NAME scheme has ten participating employers of differing sizes and 50% of contributions are expected to be paid by one employer.

Guidance

- As half of the scheme's contributions are expected to be paid by one employer, the trustees should perform a detailed review of that employer together with higher level reviews of the remaining employers to assess their affordability. Such higher level reviews could include basic analysis of recent financial performance and the current financial position.
- It may be reasonable for trustees to aim for a recovery plan based on the affordability of the largest employer. However, the trustees should consider whether they would be willing to accept longer recovery plans (potentially supported by appropriate contingent assets) from employers where the proposed DRCs could cause financial pressures. If this is the case, then the trustees should consider reducing investment risk as this indicates limited ability to increase contributions to the scheme if needed.

Example C2: Assessment of covenant and affordability where contributions are allocated based on historic liabilities

Facts

A NAME scheme with ten participating employers sets contributions for each employer based on an apportionment of historic liabilities. The employers are currently of a similar size and nature such that cash flows from each employer are expected to be broadly the same. However, historical liability shares vary between employers such that three employers are responsible for 70% of the contributions.

Guidance

Although the employers are of similar size, the source of future DRCs is concentrated within a few employers. Therefore, the covenant assessment should focus primarily on these employers. A higher level review of the remaining employers should be performed.p>

Example C3: Assessment of covenant and affordability for a diversified NAME scheme

Facts

A NAME scheme has 100 participating employers which are all of a similar size and nature such that the contributions from each employer are expected to be broadly the same.

Guidance

- As the future contributions are evenly distributed and the employers are of similar sizes, the trustees could choose a sampling approach to the detailed assessment of a number of the covenants – while undertaking a high level review of the other covenants. This sampling could be performed on a rotating basis so that all employers are reviewed over a period of time. The size of the sample should depend on the extent of reliance on the covenant, which will be a function of the scheme's investment and funding risks.
- Trustees should be mindful that the extent to which employers are similar could change over time and they should review the suitability of this approach on a regular basis.

Working with the employers

Discussions with the employers of NAME schemes may be complicated by competition between the employers. For instance stronger employers may be less willing to accommodate their weaker employer competitors with a more flexible contribution structure.

Where trustees have concerns over an employer, they may conclude it is important a more detailed review of that employer. The trustees should consider whether the employer concerned should pay for the full costs of the review. This is likely to be in the employer's interest as this review could strengthen the case for a flexible contribution structure shaped around the employer’s circumstances.

Dealing with confidential information

Trustees should be mindful that the employers in NAME schemes may be competitors. The trustees should respect employers’ reservations about making sensitive information available to the trustees.

Key points for consideration

Trustees should try to assuage this valid concern by, for example:

- using **confidentiality agreements**
- **delegating to a covenant sub-committee** whose membership is tailored to avoid review of sensitive information by an industry rival
- **redacting covenant assessments** to remove sensitive information before they are provided to certain members of the trustee board