

A short guide for employers

The employer covenant at a glance

The employer plays a vital role as scheme sponsor and effectively underwrites the risks that the scheme is exposed to, including underfunding, longevity, investment and inflation.

The employer covenant – the employer’s legal obligations to a DB scheme, and its ability to meet them – remains a crucial element in protecting members’ benefits.

The Pensions
Regulator

An important role

The regulator's June 2009 statement outlined how a covenant assessment can feed through to the setting of technical provisions and recovery plans. The industry responded well and we received positive feedback through our regulatory activity. Following last year's discussions, further guidance was requested to help understand how events that impact a pension scheme should influence covenant assessment, and what steps can or should be taken to improve scheme security after carrying out such assessments.

Encourage best practice

There are a variety of ways that trustees and employers can look to increase the strength of employer covenant where this is necessary or desirable. For example: agreements can be made, and included in recovery plans, for action if certain performance metrics are breached; contingent assets may be pledged to underwrite specific risks; negative pledges, such as not to grant new security without the agreement of trustees may be made. This may enable more flexibility in the length and shape of recovery plans where cash is constrained.

Trustees have a duty to ensure the security of their members' benefits, and in seeking to do this they rely on the continued support of the employer. It is in the best interests of all parties for there to be an open and co-operative relationship between the employer and the trustees.

As detailed in legislation, employers should provide trustees with the information they or their professional advisers reasonably require to assess and monitor covenant. Trustees should commit to any confidentiality agreements necessary in respect of such information. In this context, it is helpful for employers to make covenant studies prepared for other creditors available to trustees if they are not prohibited from doing so.

Maintain an open dialogue

Trustees and employers should prepare plans for crystallising the contingent employer support behind a scheme, if necessary. Without clear arrangements that lead to action in good time, it may be that trustees look to the employer to provide cash or other security at a time that the employer has many other competing demands for limited funds, or when it would substantially weaken the employer.

Where employers want to put forward a contingent asset or other arrangement as part of the scheme's funding strategy they will need to enter into a dialogue with trustees about the business case for this.

It is good practice for employers and trustees to agree a budget for monitoring covenant that is reasonable, allowing for the importance of covenant in trustees' decisions on funding, recovery plans and investment policy. If the employer pays for the covenant assessment for the trustees, the trustees should be allowed to liaise directly with the assessors and to agree their information requirements directly with the assessor.

Costs should be proportionate to the benefit of the assessment which will depend on the materiality of covenant to decisions on funding and the relative size of the liabilities and deficit of the scheme.

The guidance on monitoring employer support can be viewed on The Pensions Regulator's website: www.thepensionsregulator.gov.uk

Also available is guidance on internal controls showing how covenant monitoring fits in as part of an overall risk management framework.

How to contact us

Napier House
Trafalgar Place
Brighton
BN1 4DW

T 0870 606 3636

F 0870 241 1144

E customersupport@thepensionsregulator.gov.uk

www.thepensionsregulator.gov.uk

www.trusteetoolkit.com

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