

Consultation document

Guidance on monitoring employer support: covenant, contingent assets and other security

This is a consultation document on guidance for trustees and managers of occupational pension schemes produced by The Pensions Regulator ('the regulator'), the body that regulates work-based pension arrangements.

This guidance replaces the Contingent Assets guidance published in May 2006.

The Pensions
Regulator

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Introduction

We have produced this guidance to encourage trustees to take proactive steps to ensure that there is adequate security for their pension scheme.

The guidance sets out standard practice which we expect trustees to follow in assessing, monitoring and taking action on employer covenant.

It brings together into one framework the non-cash support provided by the employer to pension schemes by way of employer covenant, including contingent assets. It details the processes and objectives in ensuring that the support provided by the employer is adequate.

Background

In June 2009, The Pensions Regulator published a statement on scheme funding and employer covenant outlining the approach we expected to be taken to ensure prudence through the economic cycle whilst taking account of employer affordability.

The statement outlined how an assessment of covenant fed through to the setting of technical provisions and agreeing recovery plans. The industry responded well, and we have received positive feedback about our statements to date. However, many parties have requested further guidance to bring together the assessment of covenant in ongoing and event-based scenarios and to provide more guidance on the steps that can be taken to improve scheme security based on the assessment or monitoring of covenant.

Development of guidance

We have undertaken external research with both trustees and covenant advisers to find out more about how trustees currently assess, monitor and act upon employer covenant, and to find out what more we can do to assist trustees in understanding both the importance and practicalities of effectively managing the impact of the employer covenant on the pension scheme. Our research indicates that some schemes already have a sound approach. For others, improvement is necessary.

The questions that we are asking in this consultation reflect the areas that people have specifically requested that we cover.

Format of revised guidance

The guidance has been developed primarily as a web-based product.

Whilst copies of the guidance can be printed in full or in part, users will be able to access it online and navigate using a series of hyperlinks to various sections and other resources.

The guidance does not seek to duplicate material contained in other regulatory publications; however, it does include key messages and signposts users to other resources.

Consultation questions

The regulator would like to hear from trustees and other interested stakeholders on the areas covered in the guidance. We welcome all comments on the guidance, but would particularly welcome comments on the following issues:

General questions

1. Is the guidance helpful to trustees of schemes of all sizes?
2. Are the examples useful and appropriate?
3. Are the appendices useful and appropriate?
4. Does the guidance strike the right balance between specifying a process for monitoring covenant and not imposing disproportionate or unnecessary costs on trustees/employers?

Specific questions on each section

Section 1: Introduction – this section sets out the purpose of the guidance and explains the concept of covenant, how the need to assess it arises, and how it informs the decisions trustees make in relation to the scheme.

5. Does the guidance clearly explain the concept of covenant and how it relates to trustees' decision-making?

Section 2: Covenant – this section covers, in depth, the importance of measuring covenant, the importance of understanding a group's legal structure and the employer's legal obligations, what to consider when assessing the employer's financial position, and what to consider when deciding whether to appoint a professional covenant assessor.

6. Does the guidance equip trustees to ask the right questions of advisers and employers, and request the right information from employers and other scheme sponsors in order to assess the covenant?

Section 3: Security – this section sets out the alternative forms of scheme security other than cash payments to the scheme, what to consider when valuing such alternatives, and their interaction with scheme funding, recovery plans and the PPF levy.

7. Does the guidance help trustees to identify ways of improving covenant or scheme security?

Section 4: Monitoring and taking action – this section explains the importance of regular monitoring of covenant, and actions to take based on that monitoring.

8. Does the guidance help trustees in deciding what action to take as a result of a covenant review?
9. Does the guidance help trustees to understand when (and how quickly) to act following changes in covenant strength?

Responding to the consultation

Responses may be made in either of the following ways:

- By email to:
ccaconsultation@thepensionsregulator.gov.uk
(documents should preferably be in Word format)
- By post to:
Simon Wasserman
Regulatory Policy and Programmes
The Pensions Regulator
Napier House
Trafalgar Place
Brighton
BN1 4DW

We may need to share the feedback you send us within our own organisation or with other Government bodies. We may also publish this feedback as part of our response to the consultation. If you wish your comments to remain anonymous, please state this explicitly in your response.

If you wish your response to be kept confidential, please make this known and we will take the necessary steps to meet your request. However, please be aware that, should we receive a formal request under Freedom of Information legislation, we may be required to make your response available.

When responding, please advise whether you are responding as an individual or on behalf of an organisation (and if the latter, which organisation).

Closing date

This consultation document was published on **15 June 2010**. The closing date for responses to this consultation is **7 September 2010**.

The Government code of practice on consultation

This consultation is being conducted in line with the seven criteria of the Government code of practice on consultation:

1. Formal consultation should take place at a stage when there is scope to influence the outcome.
2. Consultations should normally last for at least 12 weeks, with consideration given to longer timescales where feasible and sensible.

3. Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence, and the expected costs and benefits of the proposals.
4. Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is designed to reach.
5. Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
6. Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
7. Officials running consultation exercises should seek guidance in how to run an effective consultation exercise, and share what they have learned from the experience.

Feedback on this consultation exercise

We value your feedback on how well we consult. If you have any comments on the process of this consultation (as opposed to the policy issues raised) please contact our consultation co-ordinator:

- By email to:
laura.butler@thepensionsregulator.gov.uk
- By post to:
Laura Butler
The Pensions Regulator
Napier House
Trafalgar Place
Brighton
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In particular, please tell us if you feel that the consultation does not satisfy the consultation criteria. If you have any requirements that we need to meet to enable you to respond, please let us know.

Impact assessment statement

The Department for Work and Pensions (DWP) is responsible for conducting impact assessments for new legislation affecting the legislative framework for pensions regulation. In some circumstances it may be appropriate for the regulator to conduct its own impact assessment, and publish this as part of its consultation exercise, where proposals have additional costs for the regulated community above those already imposed by the legislative requirements.

In the majority of cases our proposals will impose no significant additional costs above those already imposed by the legislation. Our 'comply or explain' approach means that where initial analysis suggests that there will be no significant cost impact on the regulated community, and an impact assessment is unnecessary, we should explain the reasons for this opinion clearly when we consult.

The guidance on which we are consulting merely seeks to clarify the requirements of trustees which have existed since the introduction of the scheme specific funding regime in 2005. In our opinion, nothing in the guidance introduces any new regulatory requirements or significant associated costs to pension schemes. In fact, where trustees ask the right questions and focus on the relevant issues when completing a covenant assessment, or ask the right questions to ensure that they get the most out of any external covenant review, there are potential cost savings to the scheme.

Guidance on monitoring employer support: covenant, contingent assets and other security

At a glance

1. The covenant is an employer's legal obligation to fund the pension scheme now and in the future. The strength of it depends upon the robustness of the legal agreements in place and the likelihood that the employer can meet them. As scheme sponsor the employer underwrites the risks to which the scheme is exposed, including underfunding, longevity, investment and inflation.
2. All trustees should therefore have a framework for assessing and reviewing employer covenant, including regular monitoring. Trustees should regard this as just as important to the security of the scheme as monitoring fund performance. Our research indicates that some schemes already have a sound approach. For others, improvement is necessary.
3. Case studies are provided to help trustees take appropriate and proportionate action. Employers and trustees should work openly together, with trustees committing to confidentiality agreements if needed. Recent experience highlights how quickly circumstances can weaken even very strong companies. Trustees should ensure that the process they have in place remains fit for purpose in rapidly changing conditions.
4. Trustees should ask probing questions to understand the covenant the employer provides for the scheme; where they have any doubts about their ability to do this, they should engage the right professional help.
5. Covenant should be assessed objectively. The ability of employers or guarantors to meet their obligations should be viewed in the context of the scheme's exposure to risk and volatility – for example from investment returns and demographic change. Where trustees choose to accept these risks, they should be confident that the employer will be able to make additional contributions to compensate against adverse outcomes.
6. Trustees and employers should prepare plans for realising the employer support standing behind a scheme, should this become necessary. For example, this may encompass the provision of identified contingent assets to increase overall support or underwrite risks, or the agreement of negative pledges with the employer such as not to grant new security without the agreement of trustees. Without such arrangements, trustees run the risk that they only look to crystallise employer support at a time when the employer has many other competing demands for limited funds, or when it would substantially weaken the employer.
7. We expect trustees and employers to act proportionately in approaching covenant assessment and monitoring. It may not be affordable or appropriate for all schemes to put in place elaborate contingent assets. However, schemes can consider a variety of arrangements for increasing scheme security, such as positive and negative pledges and sharing in increased cash-flow.

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Section 1: Introduction

About this guidance

1. This guidance has been produced for trustees and managers of all occupational pension schemes with a defined benefit element, and sets out standard practice that we expect trustees to follow in assessing, monitoring and taking action on employer covenant.
2. The guidance brings together into one framework the support provided by scheme sponsors to pension schemes through employer covenant, and the additional security which may be provided by pledges, agreed actions or contingent assets.
3. The guidance is divided into four sections plus appendices, as follows:

Section 1: Introduction

Section 2: Covenant

Section 3: Security

Section 4: Monitoring and taking action

Appendices

The context

4. The regulator expects trustees and employers to take proactive action to ensure that there is adequate security for the scheme. Employer covenant is the legal commitment of the relevant employers to support the scheme. This includes statutory obligations and obligations to make payments under the payment schedule. It may also include other unsecured promises to provide future support to the scheme.¹
5. Trustees need to understand an employer's covenant from both a legal and a financial perspective; legally to understand the nature and enforceability of the various promises to pay, and financially to assure themselves that these promises are likely to be met.
6. The need for trustees to assess covenant arises, in part, from their legal obligations to:
 - have appropriate knowledge and understanding of employer liability under pensions law and their particular scheme's deed and rules;²
 - determine prudent methods and assumptions for the calculation of their scheme's technical provisions;³ and
 - prepare, maintain and revise statements of funding principles, recovery plans and schedules of contributions.⁴
7. The covenant effectively underwrites the risks to which the scheme is exposed, including existing underfunding, longevity, investment and inflation now and in the future. It needs to be adequate to offset a variety of different contingencies from short term (eg insolvency or employer exit) to long term (eg increasing longevity).
8. In order to assure themselves that they remain on course to meet their scheme's statutory funding objective, trustees need to be confident that they can rely on the employer's support at all times. They can do this by implementing a measuring and monitoring process which:
 - occurs at suitable frequency;
 - is of proportionate depth and intensity based on their circumstances;
 - is based on appropriate information; and
 - is based on expert interpretation of that information.

¹ For further discussion of the employer covenant see the regulator's Clearance guidance.

² s247(3)(a) and (4)(a), s.248(3) and (5)(a) Pensions Act 2004

³ Regulations 5(1) and (3) Scheme Funding Regulations 2005

⁴ s223, s226 s227 Pensions Act 2004

9. When reviewing employer covenant the trustees are seeking to determine:
- the nature and enforceability of the legal agreements to support the scheme;
 - whether they need to be more cautious in their approach to scheme funding;
 - whether they should adopt an accelerated recovery plan;
 - whether they should negotiate for the acquisition of some more tangible support, eg a legal commitment or contingent asset;
 - whether they need and are in a position to call in contingent assets or promises made by the employer;
 - the level of risk that they are able to sustain in the investment policy of the scheme; and
 - whether they need to call for an early valuation.
10. Where there is a need to strengthen employer covenant or support to the scheme, this can be achieved by:
- sponsors agreeing an action plan with the trustees, whereby they commit to certain courses of action now or as result of certain events or triggers; and/or
 - specifying particular assets or cash-flows which will be available to the scheme in certain circumstances;
- and entering into enforceable legal arrangements to secure those agreements.
11. The principles outlined in this guidance also underpin our regulatory processes, and we apply them in a risk-based and proportionate manner. Our initial view on covenant strength will inform our initial analysis of the prudence of scheme funding assumptions, and is one of the factors that help identify which funding plans to subject to closer scrutiny.
12. When valuations use assumptions which appear inappropriate we would normally engage in dialogue with all relevant parties in these circumstances. We approach the situation in a manner that is specific to the circumstances of the scheme and the sponsoring employer and employer group. In such discussions we also follow the principles outlined in this guidance when trying to understand the appropriateness (or otherwise) of the valuation assumptions and of the recovery plan.
13. Economic conditions can vary significantly even over relatively short periods of time. Different industries may experience lesser or greater volatility in the strength of the constituent employers, and individual employers may show greater volatility still.
- The strength of the employer covenant may therefore be subject to significant variation over relatively short periods of time, and trustees should be wary about accepting historical evidence alone to justify the ongoing strength of the employer covenant. Past evidence is helpful, but it is the employer's best estimate forecast of performance in the future that is more important when considering strength of covenant. Trustees should include assessment both of the point in the economic cycle of the employer's industry and of the employer's position within its economic cycle, and critically consider the employer's ability to recover if it is at a low point.

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14. The regulator's statements in 2009 gave examples of the flexibility of recovery plans. These were based on the principle that, whilst trustees should expect the employer to repair any deficit as quickly as affordable, the best outcome for the scheme is usually provided by security from a solvent employer.

In many cases such flexibility will still be necessary. To assess whether this is so, trustees should satisfy themselves concerning the strength of the employer to generate improved cash-flow. Where cash-flow has improved, the trustees should consider the extent to which the scheme should benefit from that improved cash-flow capacity and the replacement of contingent assets or other support by actual cash payments into the scheme.

Where employer covenant is weak and not anticipated to improve with market recovery, the trustees should be very cautious about accepting a long or back-end loaded recovery plan, and should carefully consider all their options.

15. Throughout, trustees should bear in mind the costs of covenant monitoring and any proposed actions relative to the size of the scheme and the employer and to the potential benefit of the exercise. This framework is not intended to impose higher costs on the scheme than necessary.

Key points from this section:

- Covenant is the obligation and the ability of the employer to support the scheme, protecting against both short term and long term risks
- Scheme security can be further strengthened by the use of agreed action plans and contingent assets
- Trustees should monitor covenant regularly and appropriately
- The future is more important than the past in monitoring covenant
- Trustees should review employer cash-flow and consider the need for flexibility in recovery plans
- Trustees should act proportionately in monitoring covenant and seeking further security for their schemes
- We apply the principles outlined in this guidance in a risk-based and proportionate manner in our regulatory processes

Section 2: Covenant

Covenant and scheme risk

16. In terms of cash-flow: the employer covenant represents the ability of the employer to provide the necessary cash-flows envisaged to support ongoing accrual and deficit repair agreed in a recovery plan, and to account for any adverse performance compared to that assumed in plans.
17. A strong employer covenant means that the trustees can place reliance on the employer providing support to the scheme in the event of adverse outcomes arising from unmitigated risks such as investment, longevity or inflation. Therefore a strong employer covenant enables the trustees to follow an investment policy based on a higher proportion of return-seeking assets which carry higher risk. As a consequence they would be able to justify a discount rate for scheme specific funding that reflects these anticipated excess returns.

Conversely a weak employer covenant provides less scope for the trustees to adopt such a policy. In cases of very weak (or negligible) employer covenant, trustees need to justify why an investment policy that includes the acceptance of significant risk is in the best interests of scheme members.
18. Trustees should not rely on the Pension Protection Fund (PPF) as the guarantor of last resort being a factor that enables them to accept higher levels of risk within the scheme.
19. Both market conditions and the employer covenant are volatile and can deteriorate quickly; therefore trustees need to have mechanisms in place to monitor both. Where risks increase, trustees will need to consider whether the employer covenant is still sufficient to stand behind these risks or whether there is a need to increase scheme funding or security. Where covenant is deteriorating, trustees need to take steps to increase scheme security before the ability to do so is lost.
20. Trustees can plan ahead for this through the use of protection mechanisms outside the scheme including negative pledges, step payments in recovery plans, or contingent assets.

Case example 1:

Trustees concerned about funding volatility

The cash-flow and solvency of a large financial services company had been severely reduced by the recent economic downturn. As a result, the trustees had become concerned about the ability of the employer to support their scheme to provide full benefits in the future.

The trustees therefore commissioned an exercise to assess the level of investment risk the scheme could reasonably be expected to take. To do this they considered alternative assumptions leading to differing outcomes in their projections and producing a range of projected funding levels. They considered the lowest outcomes in the range, focusing on the deficit that would arise if they encountered the 50th worst outcome (in 1,000 projections) over the next 10 years.

They compared this potential deficit with an expert assessment of the anticipated employer covenant over this period to see if the company could be expected to have sufficient cash to cover this deficit at the relevant future dates. This indicated that they should not feel comfortable that the employer covenant would always be adequate to cover adverse scheme experience.

With this information they negotiated with the employer to examine the options available to them including de-risking. They agreed with the employer to retain the current investment structure, in return for which the employer agreed to provide contingent assets to the scheme. This provided the security that the trustees needed to address the potential risk.

Assessing employer covenant

21. When assessing the strength of the employer covenant it is necessary to assess both:
 - the sponsoring employer's legal obligations to the scheme; and
 - its financial position (both current and prospective).
22. The employer's willingness to fund the scheme is relevant to the reliance that trustees can place on employer support. However, they should be aware that assurances from the employer that are not legally binding may not protect the position of the scheme.
23. Trustees should understand the legal structure of the group and the order in which creditors may claim priority over different assets of the group (that is, the position or subordination of the pension scheme to other creditors).
24. The covenant or financial strength of a wider group of employers than those with direct legal obligations to the scheme may be relevant, particularly where:
 - any changes to the sponsoring employer will also affect the financial position of the wider employer group, for example by removing entities from the group or transferring assets (whether within or outside the group);
 - the sponsoring employers have provided valid reasons why the trustees should take the financial position of the wider employer group into account when assessing the employer's financial position;
 - there is existing support for the scheme from the wider employer group, for example in the form of a parental guarantee;
 - there is interdependency between entities in the wider employer group and the sponsoring employer which may affect the sponsoring employer's covenant; or
 - the financial position of the sponsoring employer is not of sufficient strength to support the scheme.
25. Employers and trustees should remember, though, that only certain members of the wider employer group (participating employers or those with contractual obligations) may be legally liable to contribute to the scheme. Therefore, whilst the wider employer group is always relevant, trustees should be cautious about over-reliance on the wider employer group.
26. Any advice provided to the trustees, or decisions made as a result of covenant monitoring or assessment, should be recorded and maintained as part of the trustees' records.
27. Given the complexity of assessing covenant, it is recognised that the process carries cost for the scheme. Nothing in this guidance is intended to produce cost to the scheme disproportionate to the related benefit. Trustees should consider the materiality of covenant to their decisions on funding, recovery plans and investment, and conduct the process in a way that is consistent with their needs.
28. Similarly, it is not intended to suggest that schemes or employers spend a disproportionate sum on the assessment of covenant relative to the value of liabilities in the scheme.

Case example 2:

UK subsidiary of overseas parent

The sponsoring employer was the UK subsidiary of an overseas parent company based in the USA. The UK pension scheme was significantly in deficit and the UK company was experiencing difficult trading conditions.

The overseas parent provided a letter of recognition acknowledging the UK pension scheme but did not provide a legally enforceable guarantee for the scheme. The trustees believed that the letter of recognition was issued primarily for audit purposes.

In the past, the UK subsidiary had been a core part of the group and a major site of production. However, within the last few years production had moved to the Far East and the UK had become largely a distribution operation and less important to the group than previously.

Although the trustees had no reason to believe that the parent company would not support the pension deficit, they were concerned because in the last couple of years the deficit had increased sharply due to the downturn.

The trustees commissioned a covenant review which began by considering the group structure. This highlighted the vulnerability of the trustees' position. It suggested that the trustees request a guarantee from the parent company (which they had been too nervous to do previously). As a result of negotiations the trustees agreed to a longer recovery plan than they would otherwise have done in return for a guarantee from the parent company.

Assessing the employer's legal obligation to the scheme

29. Identifying the employers, and analysing and assessing their legal obligations to the scheme, can be a complex process and will normally require legal advice. Employers and trustees should identify:
- those employers who could be liable, now or in the future, to pay a s75 debt.⁵ They will need to ascertain the likely amount of the s75 debt that may become due from each employer in a multi-employer scheme (see also guidance for employers of multi-employer schemes);
 - those employers required by a statutory schedule of contributions to pay contributions to the scheme (and, in a multi-employer scheme, the proportion of the total contribution that is payable by each employer);
 - those employers participating in the scheme and who are bound by the scheme's trust deed and rules (and the employer's powers and obligations under the deed and rules); and
 - those employers whose insolvency could result in the scheme or part of the scheme entering a PPF assessment period (and if so, the effect of such an insolvency).
30. In some cases, former employers will be included in the above categories because of the relevant statutory definitions. It is important to remember that some employers may not fall into all of the above categories.
31. Other legal obligations of either the employer or another entity in the wider employer group to the scheme will also be relevant, for example, obligations created in any guarantee, ancillary deed or agreement.

The legal relationships between the employer and the rest of the wider employer group are also relevant because these could have an impact on the sponsoring employer's ability to meet their obligations, for example if another entity within the group also has a legal call on the sponsoring employer's cash-flow or assets.

⁵ s75 Pensions Act 1995

Assessing the financial position

32. Once trustees have identified those parties with legal obligations to fund the scheme, they need to consider the financial position of those parties so that they can consider the likelihood that those legal obligations will be met. Both the current and prospective financial position will be relevant. Trustees may require professional advice to perform this exercise.
33. Trustees will need to decide what information they need to consider in respect of their particular scheme and employers. Professional advice may help them decide what information to seek, but it should include:
- the position of the employer, including its financial strength, intra-group relationships and policies, management records and future plans;
 - the scale of the obligations to the pension scheme relative to the size of the employer's operating cash-flow;
 - the nature of the industry sector in which the employer operates and the employer's position within the industry;
 - the position of the economy as a whole;
 - the relative priority placed on the pension scheme compared to competing calls on corporate finances, such as dividend payments, capital expenditure and bonus payments; and
 - an estimate of the value that might flow to the scheme on insolvency of the employer, as well as the likelihood of that eventuality (the assessment being based on past and current information and trends).

Appendix A outlines a suggested approach to the financial assessment of employer covenant and the information on which this could be based.

34. Employers and trustees should work openly together. Employers are required⁶ to provide to trustees 'such information as they or their professional advisers reasonably require for the performance of their respective duties'. In order to promote openness, trustees should be prepared to commit to confidentiality in respect of the supply of any information that might have price-sensitive implications if released into the public domain.

35. Assessment of employer covenant may not result in an absolute number; most covenant assessors routinely express their views as a category (for example 'very strong', 'strong', 'weak' or 'very weak'). A higher score or a stronger category means that a scheme may be better placed to accept a higher level of risk (that is anticipated to provide higher rewards) as the trustees know that the employer, or another party, acts as guarantor to the solvency of the scheme should experience be adverse.

Considering the use of professional covenant assessors

36. Trustees are responsible for ensuring that they have a sufficiently accurate assessment to enable them to take appropriate decisions and actions on funding assumptions, investment allocation and recovery plan form and duration. Trustees need to understand the degree of importance of the employer covenant in influencing these decisions and use this to define the level of detail or the areas on which they choose to concentrate in setting objectives for covenant assessment.
37. When deciding whether they have enough expertise on the trustee board to assess covenant or whether they need to employ external experts, trustees will need to consider their objectives and match those to the skills available. They are likely to need someone who:
- can understand the key factors that affect employer financial performance;
 - can understand the group structure and the employer's position within the group (including the legal obligations between members of the group);
 - has experience and expertise in analysing and understanding the information that predicts future changes to company performance; and
 - is not conflicted, and is able to provide an independent assessment (not relying solely on the opinion of the employer).
38. If existing advisers to the scheme are being considered to provide advice on covenant assessment, trustees should check that they have access to appropriate legal and financial expertise, as without this they are unlikely to have suitable qualifications to measure covenant.

⁶ Regulation 6(1)(a) of Occupational Pension Schemes (Scheme Administration) Regulations 1996

39. If trustees decide to take external advice, it is important that they select a covenant assessor based on an objective selection process. Trustees should prepare a role description detailing the outcome they require and then interview a selection of potential assessors (see Appendix B for suggested questions).
40. In preparing their brief, trustees may need to consider:
- the budget that they can afford and consider reasonable in the circumstances;
 - information from the company that identifies the critical factors that affect company performance;
 - how realistic it is to expect the company to be prepared to provide information to them or their covenant assessors on a regular and timely basis; and
 - whether there are any reasons to anticipate events or circumstances which are expected to adversely affect employer covenant.

The trustees should allow sufficient time at the outset when deciding on who to appoint as this is likely to produce better results and to save time later in the process.

Case example 3:

Trustee board, including finance director, considering the need for external covenant assessment

The Finance Director (FD) of a large manufacturing company was the chair of trustees for the pension scheme. He was aware that his expertise and experience gave him a dominant position on the trustee board.

Other trustees had limited industry knowledge and were concerned about their ability to challenge any views expressed by the FD concerning the strength of the company and its prospects. Their concern was both to be able to engage meaningfully with the FD and to demonstrate that their decisions were not affected by any conflict of interest that the FD might have.

The trustees therefore drew up a well defined brief to evaluate employer covenant and conducted a 'beauty parade'. The selected advisers interviewed company senior management including the FD and compared the information with that held on their own database.

As a result the trustees were much more confident that they had been able to apply independent checks to the internal covenant assessment provided by the FD.

Key points from this section:

- The level of risk that may be accepted depends on the strength of the employer covenant
- Both risks and employer covenant should be monitored
- Trustees need to plan ahead for the steps they will take to increase scheme security if necessary, before the ability to do so is lost
- Assessing covenant requires assessment of both legal obligations and financial position
- Different employers may have different responsibilities to the scheme which should be considered
- Measure current and prospective covenant
- Measurement is complex and requires judgement
- This guidance is not intended to cause schemes to spend disproportionate amounts to measure and monitor covenant
- Trustees remain responsible for the measuring and monitoring of employer covenant
- Trustees should lead the information requirements and protocol
- Unless trustees have the expertise and independence on the trustee board, they should consider appointing external experts to advise on covenant

Section 3: Security

Increasing scheme security including the use of contingent assets

41. Where trustees and employers wish to increase the strength of the employer covenant or security of the pension scheme, there are a variety of ways of doing so. Examples include:
- agreements to abide by certain performance thresholds and to inform trustees when certain thresholds are breached;
 - granting the scheme priority alongside other creditors;
 - other improvements in priority, such as the subordination of other creditors, to improve the outcome for the scheme on insolvency;
 - negative pledges, whereby an employer makes a commitment not to do something such as grant new security without the agreement of trustees, or not to increase dividends;
 - commitment to increased funding on certain events, for example if profitability should improve (eg step payments in a recovery plan with 'true-up') or if investments perform badly;
 - a wider corporate group can look to take on joint and several liability for the funding of, or debts due to, the scheme;
 - scheme rule changes, whereby making an amendment to the scheme's trust deed and rules can change the balance of power to give the scheme greater security; and
 - the granting of specific contingent assets.
42. Contingent assets are assets on which a claim by the pension scheme would exist on the occurrence of one or more specified future events ('the contingent event') such as movements in corporate asset holdings, increased employer borrowing, employer insolvency, or the failure to achieve a specified funding level. Unless the events occur these assets are not available to the trustees to meet members' benefit payments. They are not included as scheme assets for the purpose of assessing whether a scheme meets its statutory funding objective (ie that assets are sufficient to cover technical provisions) until they are transferred to the scheme.
43. Some examples of the forms of contingent assets that are widely used commercially are:
- the provision of a group company guarantee such that the guarantor agrees to make a payment (or series of payments) to the scheme if the contingent event occurs;
 - security over other assets (eg property or securities) such that the asset is transferred to the trustees if the contingent event occurs;
 - a letter of credit, a guarantee or insurance from a third party such that if the employer were to default on payment of contributions to the scheme, money can be drawn against the third party up to a specified amount;
 - sterling cash put aside in a bank account and charged to the fund, some or all of which would be released to the fund on the occurrence of the contingent event; and
 - a special purpose vehicle (such as an LLP) in which the scheme has an interest, or from which it receives income, either immediately or on the occurrence of the contingent event.
44. In calculating its risk-based levy, the PPF recognises certain contingent assets. At the time of publication of this guidance, the first four of the types of contingent asset listed in paragraph 43 may be (subject to PPF recognition requirements) recognisable as contingent assets for the purposes of the PPF levy; the last is not. The regulator's guidance covers many of the same factors as the PPF's levy rules. However, there are differences, and trustees should not assume that if a contingent asset is suitable for scheme funding purposes it will automatically be acceptable to the PPF (or vice versa): see Recognition of contingent assets in the PPF risk-based levy.
45. Some forms of contingent asset require a third party to act as guarantor or provider of credit. Where this is the case, the trustees should assess and monitor the covenant of the third party and satisfy themselves that it has a sufficient credit rating so that the scheme is not exposed to undue risk of default. The PPF has specific requirements of third parties that it will recognise as guarantors.

46. Group company guarantees may be for a specific period or have no time limit. For scheme funding purposes the trustees will need to reassess what protection the guarantee provides in the light of the guarantor's ongoing financial situation on a regular basis, regardless of the time limit placed on the guarantee. For PPF levy purposes, only guarantees which are indefinite in duration can be recognised. However, the PPF standard form of guarantee permits release or reduction in certain circumstances, for example funding improvements.
47. Trustees should consider the costs of establishing and managing the contingent assets and who will bear these costs. To the extent that such costs fall on the scheme, trustees should ensure that they are fully reflected in all decisions concerning the suitability of the contingent asset and concerning the recovery plan.
48. Trustees are likely to need specialist legal advice to ensure that any contingent asset is available when needed, is properly enforceable and on particular legal issues such as employer-related investment. Employers may wish to take further advice on how the contingent asset impacts on their business. See Appendix C for examples of common contingent assets and some of the legal considerations involved.
52. For some forms of asset (eg a property), the current value will not be publicly available. 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.
53. For other forms of asset the value may be dependent on the continued existence of the employer. In such cases the trustees will need a qualified professional to provide an assessment of the asset in the event of the failure of the employer.

Relevance of security over assets to scheme specific funding and the recovery plan

Considerations when valuing contingent assets and additional security

49. The purpose for which a contingent asset is being valued may dictate the method of valuation and the value. It is possible for a particular asset to be viewed differently for PPF levy purposes from the way it is viewed for ongoing scheme funding.
50. The trustees will need to consider the value they are to place on the contingent asset or security for the purposes of making suitable changes to the recovery plan. For some, such as cash in a designated account, this will be straightforward but for others, such as property or a group company guarantee, careful consideration will be needed before allowing for the contingent asset in a scheme's funding strategy.
51. For most purposes the valuation of an asset should be at its anticipated value after a contingent event has occurred. Trustees should be aware that some assets which are closely related to the employer may decline in value at the same time the employer covenant deteriorates.
54. Many contingent asset agreements ring-fence assets which would otherwise form part of the overall employer covenant, and therefore allow trustees to more clearly anticipate the action they will take should there be a need to increase scheme security in the future.
55. There are a range of circumstances in which taking security over an asset can affect scheme specific funding and the recovery plan. Examples include:
 - allowing the scheme to invest in a higher proportion of return-seeking assets;
 - increasing scheme security should future experience prove adverse;
 - supporting long recovery plans where it becomes difficult to forecast the strength of employer covenant when it may be needed; and
 - reflecting the support of the wider group if they wish to identify with the scheme in this way.

Trustees need to consider the appropriateness of any asset secured in relation to the support it is providing to the scheme's funding strategy. For example, with a contingent asset where the contingent event is the failure to achieve some specified investment return, the asset needs to be sufficiently flexible and realisable to make up the actual underperformance. In such a case, cash in an account charged to the scheme is likely to be more suitable than a charge over property.

Where contingent assets are being used, trustees must decide how they will structure any recovery plan in the light of the contingent asset.

56. The trustees should consider a number of different factors before incorporating a call on assets into the scheme's funding strategy, including:

- the size of the deficit in the scheme;
- the value of the asset to the scheme on the dates any contingent event could occur; and
- the pace of funding being proposed.

57. Trustees will need to enter into a dialogue with the employer about the business case for including a contingent asset as part of the scheme's funding strategy. Trustees should consider whether they are foregoing anything in order to take advantage of a contingent asset or other arrangement: for example, does it replace higher contributions in a schedule of contributions, and if so, is the substitution beneficial to the scheme? They should ask employers:

- why the contributions that might otherwise have been required are not available to the scheme; and
- why a lower level of additional assets is required to cover the technical provisions.

58. Including a contingent asset in a scheme's funding strategy may reduce the cash-flows into the scheme. This may compromise the trustees' ability to meet benefit payments to members, especially if benefit payments exceed income. The trustees should ask the actuary to identify whether, in the normal course of events, the introduction of contingent assets will accelerate the need for the trustees to realise assets. In the light of this opinion, the trustees will then need to consider whether including the contingent asset remains appropriate.

Key points from this section:

- Securing an asset is a way of making employer covenant more tangible
- Contingent assets commit cash or assets from the employer or another party on the occurrence of a specified event
- Trustees should check with the PPF guidance to make sure that the contingent assets are acceptable to them if they intend to use them for PPF levy purposes
- Trustees and employers can consider a variety of mechanisms to strengthen covenant and increase scheme security where necessary
- Contingent assets can be expensive to manage, and trustees need to allow for these costs when considering their acceptability
- Trustees must ensure that the contingent asset agreement will guarantee the assets being accessible when needed
- When valuing a contingent asset, trustees need to allow for its anticipated value after the contingent event has occurred
- Taking security over an asset may give the trustees more flexibility in their decisions on funding and recovery plans
- Trustees need to satisfy themselves that the assets are of suitable characteristics to justify this flexibility
- Trustees must ensure that accepting security over an asset (rather than cash) does not compromise the ability of the scheme to pay benefits when due
- Trustees should check PPF guidance to ensure that any contingent assets are PPF-compliant for the purposes of the levy if necessary

Recognition of contingent assets in the PPF risk-based levy

1. The rules governing the extent to which contingent assets are recognised in the risk-based levy are set out in the PPF's 'Levy Determination' for the relevant year, plus associated guidance. The PPF's policies in this area gradually evolve year on year, and the latest information is available on the PPF website.
2. The PPF's rules for recognition are more prescriptive than the regulator's general guidance given here. This reflects the fact that an individual set of trustees can make a bespoke analysis of any contingent asset arrangement and the value it offers to their scheme. By contrast, the PPF needs to ensure that it only gives credit for assets of consistent strength, and that they are valued consistently and fairly for the purposes of the levy.

For example, the PPF publishes standard forms of agreement for the different asset types and will only recognise contingent assets which follow very closely the standard form. Recognition is also dependent on certification or re-certification of the contingent asset through the regulator's **Exchange** system on an annual basis, before the relevant data deadline.
3. The PPF's requirements mirror closely the issues which trustees are recommended to consider under the preceding paragraphs. For example:
 - the trustees must obtain and submit a formal legal opinion covering specified matters such as enforceability, including a foreign opinion where appropriate;
 - jurisdictional requirements and, in the case of third party providers (such as banks), credit rating and regulatory requirements must be met;
 - for security over assets, trustees will have to obtain and submit periodic valuations on a specified basis, and will have to demonstrate registration of the security where appropriate; and
 - for security over land, certificates of title are also required.
4. Putting in place a PPF-compliant contingent asset can significantly affect a scheme's levy bill for the current and future levy years. However, it is not a trivial exercise and trustees should seek professional advice well in advance of the relevant data deadlines (currently 31 March each year) if they are contemplating a contingent asset arrangement.

Section 4: Monitoring and taking action

Ongoing consistent monitoring

59. It is important to recognise that the strength of the employer covenant can change rapidly, and therefore trustees will want to ensure they have mechanisms for regular monitoring and review. Trustees need to be in a position to act quickly to strengthen scheme security if necessary. Trustees may want to delegate some of the duty to assess and monitor covenant to a sub-committee.

60. A full review of covenant should be conducted before each scheme specific funding valuation. This would normally occur at 3-yearly intervals.

As part of this process, trustees should consider establishing (or updating) a formal plan agreed with the employer that specifies the process by which covenant will be monitored.

Although the shape of the monitoring plan will be led by the particular needs of each scheme and the circumstances of the employer, it is good practice for these plans to contain:

- key business performance measures which, in the trustees' opinion, reflect the employer covenant to be monitored (the trustees should consider expert advice in formulating the information to be measured); and
- clear plans for the action which will be taken if performance measures or other metrics are breached such as the transfer of specified assets (or equivalent cash) to the pension scheme.

Trustees should recognise the value of spending time at the outset to establish these plans based on relevant information to be presented in a manner that they can understand and interpret, and which enables the trustees to decide when to act.

61. In most cases it will be appropriate to review covenant annually once the financial results and annual plans of the sponsoring employer are known. The degree of depth of the update should depend on the assessment by the trustees and their advisers of the extent to which covenant has changed materially over the previous year or may be forecast to change significantly in the future.

62. Trustees should have a standing item on their meeting agendas to note employer covenant. They should compare performance against the monitoring plan that they have set. The importance of this will depend on the significance of employer covenant to their funding and recovery plans, as well as performance against metrics.

They should check that there are no company events over the period since the last meeting, or anticipated before the next meeting, that should give cause for a more detailed review or the seeking of immediate mitigation. This standing item should also consider the ability of the employer to generate sufficient cash in the period until the next trustees' meeting to pay contributions due in that period.

63. Recent experience highlights how quickly circumstances can weaken even very strong companies. Trustees should ensure that the process they have in place remains fit for purpose in rapidly changing conditions.

64. One-off events may lead to a need for immediate mitigation because of the impact on the ability of the employer to meet the ongoing funding commitments to the scheme or the ability to stand behind the full cost of securing members' benefits (s75 debt) if appropriate. Such events may be the departure of an employer from a multi-employer scheme, events which prevent recovery of some or all of a s75 debt, or events which materially weaken the employer covenant. These are discussed in more detail in our clearance guidance.

Actions to take based on monitoring of covenant

65. Trustees should consider the effect that employer covenant has on the issues they face in the way that they manage the scheme, including:
- how current funding is to be maintained;
 - how the deficit is to be made up if necessary;
 - whether the investment strategy is appropriate;
 - whether the scheme can justify the level of risk it is carrying;
 - whether the trustees need to review the assumptions for funding valuations; and
 - whether the scheme is exposed in the event of insolvency and, if so, how this is to be mitigated.
66. Trustees should be prepared to act early and quickly if the metrics or triggers in their monitoring plan are breached or if they are aware of corporate events that may have a materially detrimental effect on the security of members' benefits. They should engage actively with the sponsoring employer to discuss the situation at the earliest opportunity, as other creditors would.
67. Where the monitoring plan includes specified actions, the trustees need to actively consider implementing it. This could include calling on contingent assets or increased funding as specified in the plan.
68. Where an event (whether internal or external) has raised a serious concern about covenant, the trustees need to be prepared to take actions that go beyond those in the monitoring plan. These might include:
- bringing forward the next actuarial valuation to quantify the current scheme funding level;
 - adjusting the valuation assumptions to reflect a view that covenant may be weak; and
 - realigning the investment portfolio to be consistent with a weaker covenant.

If the trustees have serious concerns, they are encouraged to contact the regulator at an early stage to raise these concerns. The regulator will consider whether regulatory assistance may help resolve the situation.

Case example 4:

Competing demands for cash; back-end loaded recovery plan

A medium sized, growing company in a developing industry had positive cash-flow but had competing demands for that cash.

In particular, they were in the middle of a major new product development which they were convinced would secure the future of the company and provide significant continued growth. Therefore they did not feel able to fund the deficit in the pension scheme as requested by the trustees.

The trustees commissioned a covenant review specifically to consider the future prospects for the company both with and without the new product.

The advisers spoke to senior management and then used their general financial forecasting expertise to confirm the reasonableness of the projections.

As a result the trustees negotiated with the company, agreeing to extend the recovery plan (and hence reduce the early year payments) in return for an agreement that the recovery plan payments would increase in a specified way in line with profitability.

Case example 5:

Realigning the asset portfolio to reflect a decrease in covenant

A substantial successful company with strong positive cash-flow which is several times larger than its scheme has agreed an investment strategy with a high return-seeking element on the back of this strength. A major division encounters substantial difficulties as a result of the arrival of a strong competitor from overseas which seeks to buy UK market share. The remaining divisions are still able to provide support for the scheme but the margins on which the technical provisions and investment strategy are based are disappearing. The employer has breached the covenant monitoring plan metrics that it had agreed with the trustees at the previous valuation. The employer appeals to the trustees to allow it to reduce existing contributions so that it can limit the impact on shareholder sentiment of a dividend cut and invest to counter the new threat.

The trustees evaluate the position and determine that they can no longer justify the existing investment strategy and require a risk reduction programme, a substantial increase in contributions, and security over the more saleable parts of the firm's property estate. Dividends fall significantly, as does the share price. However, there is a stable platform for the business and the scheme going forward.

69. The regulator expects trustees and employers to take proactive action to ensure that there is adequate security for the scheme. However, we recognise that in some cases such action will be ineffective or unavailable. Where employer covenant is negligible or, in extreme cases, effectively nil, trustees will need to take a defensive stance towards the funding of the scheme.

They should consider:

- reviewing all scheme costs including advisers, investments and future accrual;
- the impact that the scheme may have on the future viability of the employer;
- how the scheme will progress to the point where it can pay members full benefits given the effective absence of employer support;
- the appropriateness of the risk inherent in their investment policy and other assumptions, given the absence of employer covenant to underwrite them; and
- how they should act in the interests of all scheme members, including the impact of priority drift (for example, whether paying full benefits to current pensioners is likely to reduce the level of benefits that can be provided in future to current non-pensioners).

Key points from this section:

- Conduct a full covenant review before each scheme specific funding triennial valuation
- Agree a monitoring plan with specific triggers to act
- The triggers should enable the trustees to take appropriate action before covenant weakens too far
- Review annually based on updated financials
- Standing item on covenant on each trustee meeting agenda (specific scheme/company circumstances to determine level of detail)
- If significant corporate events occur, be prepared to take appropriate action
- Trustees should act early if they anticipate that covenant will weaken or has weakened
- Actions will include those set out in the monitoring plans or calling in contingent assets, realigning the investment portfolio, bringing forward the next actuarial valuation and/or strengthening the valuation assumptions
- If trustees have serious concerns they should involve the regulator at an early stage
- Where covenant is negligible, a detailed assessment of costs and risks is required

Appendix A: Assessing the financial strength of employer covenant

(reproduced from clearance guidance)

Assessing the employer's financial position

1. Assessing an employer's financial position can often be a very complex process. The level of detail necessary for such a financial review should be proportionate to the level and materiality of (i) the scheme size relative to the size of the sponsoring employer, (ii) the deficit within the scheme and (iii) any potential detrimental events where these are anticipated.
2. The relevant factors to consider in assessing the current and prospective financial position of the employer may vary depending on the circumstances and may include:
 - the nature and prospects of the industry in which it operates;
 - its competitive position and its relative size within that industry;
 - its management ability and track record;
 - its financial policies;
 - its profitability, capital structure (including balance sheet and financial leveraging), cash-flow and financial flexibility; and
 - its credit rating (if any), which may have some bearing on these considerations. However, the credit rating on its own should not be seen as a substitute for an independent review, unless the detail of the analysis behind the rating is made available and is acceptable to the trustees.
3. In many circumstances the nature and structure of a wider corporate group than the legal sponsor of the scheme will also be relevant, including the ultimate owners of the employer or the corporate group. The extent of a review of the corporate group will depend upon the reasons for the review and on the nature and materiality of any event which might be detrimental to scheme security.

Relevant considerations may include:

 - the legal domicile of the entities within the wider corporate group, including the ultimate owners;
 - any restrictions or limits on capital and cash-flows within the group;
 - whether there is interdependency between the wider group and the employer, for example:
 - whether the employer is providing services to the rest of the group;
 - whether the employer services debt that sits elsewhere in the group;
 - whether there is security over the employer's assets in respect of any debt; or
 - what additional funds, if any, exist within the wider employer group that the scheme may have recourse to, either through a financial guarantee or other legal right.
 - what additional covenant, if any, is provided by the wider corporate group, and whether the structure of the group adds strength to the covenant of the employer;
 - any investment timeframe of the ultimate owners, covering the manner in which they extract returns on any capital invested and whether the ultimate owners have any legal obligations to support the scheme;
 - the potential for the scheme to have access to additional funds from the wider corporate group; and
 - the nature and enforceability of any contingent security provided to the scheme by the wider group.
4. Employers and trustees should be careful to review the financial position of the employers and the wider corporate group in the context of each entity's legal relationship with the scheme and the extent of its enforceable obligations.

5. The scheme is usually an unsecured creditor of the employer. The priority of an unsecured creditor, with regard to the realisation of the assets of a company in the event of insolvency and when compared to other creditors, is broadly summarised below:
 - a. creditors with fixed charges;
 - b. preferential creditors;
 - c. creditors with floating charges;
 - d. unsecured creditors (usually including the pension creditor);
 - e. subordinated creditors;
 - f. equity
6. Trustees and employers should also keep in mind the long-term nature of the employer's pension obligation, and should therefore consider the employer's long-term future.
 - information from rating agencies or credit scoring institutions;
 - information from credit specialist advisers;
 - information that relates to the risk-based element of the PPF's levy;
 - any new developments in the credit advisory services market aimed at assisting the trustees to evaluate the employer's financial position; or
 - publicly available information such as press reports, broken briefings and the employer's website.
8. Employers should recognise that it is in the best interests of all concerned to have properly informed, knowledgeable and competent trustees. To achieve this, they should share information relating to the employer covenant and plans for the scheme and any event that may affect the pension scheme security with the trustees at the earliest opportunity.

Information from the employer

7. Information that may assist with the assessment of employer covenant may include the types listed below. The level and type of information that is appropriate will depend upon the specifics of the company and the industry in which it operates. Types of information may include:
 - updates on the group's financial position, including key performance data and future business plans;
 - statutory company accounts (and management accounts if appropriate) to ascertain its profitability, capital structure, cash-flow and financial flexibility;
 - independent business reports;
 - confirmation of compliance with banking and other creditor covenants;
 - information relating to security that has been or will be granted;
 - any reviews of the scheme, or any plans or proposals in relation to the scheme;
9. Under the scheme administration regulations, the employer and its auditor or actuary is obliged, on request, to provide trustees with such information as the trustees or their professional advisers reasonably require for the performance of their duties. This includes information reasonably required to assess the employer covenant.
10. Trustees should be prepared to commit to confidentiality agreements in order to promote the sharing of information.

Appendix B: Appointing a covenant assessor

Considerations for drawing up a brief for a covenant assessor

1. It is important that trustees ensure that they commission a report that will support them in their decision making and is proportionate, in cost and depth, to the benefit they will gain from it. Therefore trustees should be wary of standard box-ticking reports, but rather spend some time considering what they want from a report and assessing the services offered by potential covenant advisers.
2. The following is a non-exhaustive list of questions that may help trustees decide how to approach covenant assessors and to draw up a brief for them to provide a quote.
3. Understanding the firm's experience and expertise:
 - How many other pension fund clients do they advise:
 - in total?
 - within the same industry as the sponsoring employer?
 - of similar size to the sponsoring employer?
 - Supply biographies, qualifications and experience of people who will be conducting and checking the assessment.
 - How many professionals do they have acting in this capacity? Are they financial, legal or both?
 - Supply relevant references (it is advisable to ask for more than will be checked to enable the trustees to choose from among the references offered).
4. What process should be followed for covenant assessment?
 - What information requirements would they have:
 - as essential?
 - as preferred?
 - What information and recommendations would be provided by different types of assessment :
 - generic?
 - desktop review only?
 - desktop review plus discussion with sponsoring employer senior management?
 - forensic accounting analysis?
 - other?
 - How will you handle the situation where the employer is not willing to share information?
 - How does the approach differ where the sponsoring employer is a subsidiary of an overseas parent company?
 - What process would the assessor follow and what timescales to delivery?
 - Costs?

5. What should the report include?

- Ask firms to supply a sample format of their report.
- How do different firms rate the strength of covenant:
 - number/value?
 - rating relative to industry?
 - rating not related to industry?
 - category?
 - other?
- Are there specific issues about the employer or the wider group's structure or finances that you would like to understand?
- Do you want advice on what is 'reasonably affordable'? Considered over how many years?
- Do you want to link covenant to recommended actions:
 - by reference to a monitoring plan?
 - by reference to contingent assets?
 - linked to valuation assumptions for scheme specific funding, recovery plans and to the scheme's investment policy risk profile?
- How will you use the report as an aid to decision making?
- What emphasis should there be on past performance, current performance and anticipated future performance of the sponsoring employer?

Characteristics of a suitable report

6. The suitability of a report will depend on the employer's and the scheme's specific circumstances but in general it should:

- be based on reliable statistics (either published or unpublished and provided by the company) but should also be forward-looking and anticipate any future changes to covenant;
- measure only those factors/parameters that are relevant measures and predictors of covenant (this should include business metrics as agreed by the company as being key indicators of performance);

- indicate how much the employer is predicted to be able to reasonably afford over the next three years. The report should include the assumptions underlying this assessment and a statement of how vulnerable this assessment might be to alternative future conditions;
- indicate suitable trigger points for actions to be included in the monitoring plan. These trigger points should reflect the points at which the trustees should start to have concerns about future company performance;
- be presented in a way that trustees can understand and which allows them to interpret the information in a way that enables them to act appropriately based on the report;
- contain a contextual summary (if the report is lengthy) which indicates the key results and any indicated actions;
- provide a measure of covenant. This could be in a category (eg 'strong') or a monetary amount. In any case the report should provide the trustees with a clear indication of how the employer's covenant compares with median covenant for the employer's industry and prospects for that industry; and
- help the trustees to understand that the pension scheme is only one of the creditors of the employer, and that to be able to pay pension contributions (or a recovery plan) the employer must also be able to satisfy fairly their obligations to other creditors and investors if the employer is to continue as a viable entity.

7. If the trustees want the report to consider the willingness of the employer to finance the scheme, then it should specify on what past or present evidence the willingness is being assessed.

Appendix C:

Legal considerations when considering arrangements to increase scheme security including contingent assets

1. When considering the issues which relate to contingent assets, the trustees are likely to require independent specialist legal advice. The trustees may need, amongst other things, to ask their lawyer:
 - to confirm that the agreement is directly enforceable by the trustee and whether there are any jurisdictional or other limitations on that enforceability, and to advise what remedies will exist for any breach;
 - whether or not prior to the agreement the contingent asset is unencumbered. Encumbered assets may still be appropriate as contingent assets if the trustees are aware of the encumbrance and remain comfortable, with appropriate advice, that they will receive the value that they have attached to the asset should the contingent event occur;
 - that prior to, as part of, or subsequent to any agreement, no party may take an interest in the contingent asset which is preferential to the scheme's interest or may reduce the scheme's interest;
 - what the effect of the agreement is and how durable it is. For example, if the contingent event is the insolvency of the sponsoring employer, then trustees should ask the lawyer to confirm the likelihood that the contingent asset will in fact be available to and enforceable by the scheme once the insolvency event has occurred (the value that will attach in insolvency should be separately considered);
 - to advise on whether the mechanics for payment to the scheme are appropriate, including any time limits by which payments should be made;
 - to liaise with the trustees' financial advisers to assess the general outcome on insolvency, including legal issues such as whether any entity providing support might be subject to structural subordination because realisable assets are held by its subsidiaries;
 - whether the contingencies or trigger events are appropriate to the circumstances and match the trustees' expectations of what the arrangement will achieve;
 - whether there might be any overriding claims on relevant assets (for instance if they form part of regulatory capital requirements for the relevant entity or group);
 - whether the arrangement could be amended without the consent of the trustees;
 - how amounts payable are described or defined (for example, how 'buy out' might be defined in the arrangement);
 - to advise on any measures that might be put in place to ensure that any assets or entity relied on by the trustee do not significantly reduce in value (for example ring-fencing, a trust in favour of the scheme, suitable custodians, or appropriate security);
 - whether the trustee will be entitled to receive information updates about any relevant assets or entities providing support;
 - whether the trustees are fettering their discretion in any way by entering into the arrangement;
 - what effect the winding up of the scheme may have on the arrangement;
 - what control, if any, the trustees will have over any relevant assets (eg whether the trustees will be able to influence how assets held in escrow are invested);

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- to advise on the drafting generally, as well as the appropriate form of the documentation (eg whether a deed is appropriate if there is no consideration provided by the scheme);
 - to advise on whether the entity providing support already has obligations to the scheme (eg because it is already a participating employer in a 'last man standing' scheme) and if so, whether the arrangement could be less valuable than it initially appears to be;
 - that whoever is providing the contingent asset has authority to do so; and
 - that the arrangement would be consistent with:
 - the Employer Related Investment (ERI) restrictions in section 40 of the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378);
 - statutory requirements for investments by trustees (including section 36 of the Pensions Act 1995);
 - the scheme's Statement of Investment Principles;
 - the trustees' fiduciary duties; and
 - any other investment provisions of the scheme.
2. Contingent assets need not always be located within the UK. There are likely to be particular legal issues arising where the contingent asset is located outside the UK and/or the agreement is subject to the law of another country. As a result, trustees are likely to require legal advice from a lawyer or lawyers qualified in the relevant jurisdiction or jurisdictions (eg in the jurisdiction referred to in the governing law clause of the contingent asset documentation), including advice on insolvency issues.
 3. The regulator's view is that certain investment arrangements that may be agreed by trustees and employers, including some limited partnership structures, or non-voting redeemable preference shares, could be ERI. Employers and trustees should take legal advice as to whether any proposed asset could be considered as ERI.
 4. The regulator cannot provide a definitive interpretation of the law and this guidance must be read in conjunction with relevant legislation.

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Consultation document

Guidance on monitoring employer support: covenant, contingent assets and other security

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