Statement by The Pensions Regulator

June 2010

Understanding employer support for DB schemes

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

In June 2009, The Pensions Regulator published a statement on scheme funding and employer covenant outlining the prudent approach we expected to be taken through the downturn.

The statement outlined how an assessment of covenant fed through to the setting of technical provisions and agreeing scheme specific recovery plans, based on what is reasonably affordable by the sponsoring employer. There has been a good response from the industry and positive feedback through our regulatory processes.

Following last year's discussions, we have had requests for further guidance on how to understand how ongoing events, which may impact the pension scheme, should influence covenant assessment. Guidance has also been requested on the steps that can or should be taken to improve scheme security after carrying out such assessments.

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Our research and casework experience indicates that some schemes already have a sound approach. For others, improvement is necessary.

It's important that trustees should understand The Pensions Regulator's main expectations of them, with regards employer covenant:

- Trustees should ask probing questions to properly understand the covenant the employer provides for the scheme, and where they have any doubts about their ability to do this, they should engage the right professional help.
- 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.
- All trustees should have a framework for assessing and reviewing covenant, including monitoring. Trustees should regard this as just as important to the security of the scheme as monitoring fund performance.
- Trustees of multi-employer schemes need a good understanding of employer covenant and the liabilities of employers and other guarantors. This will help them to quickly and confidently decide whether to approve an arrangement to enable employers to restructure or withdraw from the scheme.
- 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, or the agreement of negative pledges such as not to grant new security. 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.
- 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, there are a variety of arrangements schemes can consider for increasing scheme security such as positive and negative pledges and sharing in anticipated increases in cashflow.

'All trustees should have a framework for assessing and reviewing covenant, including monitoring.'

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Ensuring members can make informed decisions

As well as getting to grips with covenant issues, we will also be calling on trustees to play a more active role in guarding against transfers which may not be in members' best interests. In effect, transfers remove the underpin to member outcomes provided by the covenant to fulfil their DB promise - and shifts the risk onto members:

- Where members are asked to consider transferring their liabilities out of a DB scheme, or modifying their benefits in other ways, they need to have a clear understanding of the implications of giving up the benefit entitlement held within their existing scheme. We believe that they should start from the presumption that the transfer may not be in their best interest and critically assess the information provided to support a decision to transfer.
- Where transfer incentives or other benefit modification exercises are being run, employers should structure the exercise so that members have the information and access to impartial advice that they need to fully understand the reasoning behind their decision. Trustees should take responsibility for ensuring that this standard is met.

What is The Pensions Regulator doing to help?

The Pensions Regulator is producing new pieces of guidance for consultation:

Guidance for monitoring employer support will provide more information on what trustees should do to measure and monitor employer covenant. It will also outline action trustees should take to strengthen scheme security as a consequence of these assessments. It will provide guidance on how contingent assets and other arrangements can work alongside employer covenant to provide a further safeguard.

Guidance for trustees of multi-employer schemes will explain the importance of understanding who is legally responsible for supporting the liabilities in a multi-employer scheme; assessing the strength of the covenant supporting the scheme; and the options for mitigating the risk associated with the departure of an employer from such a scheme. The guidance covers all the mechanisms which may apply when an employer departs a multi-employer scheme including the two alternative mechanisms introduced in April 2010.

Following our focus on covenant issues, we will be producing revised guidance on transfer incentives, and other situations in which members are asked to consider substituting or converting their benefits. This will replace the current inducements guidance and set out a principles-based approach to the issue. We will also be consulting on this guidance over the summer.

All publications will be supported by bite-sized e-learning tools to help trustees get to grips with the guidance.

'...members need to have a clear understanding of the implications of giving up the benefit entitlement...'

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