

## Monitoring employer covenant – “as important as monitoring investment performance”

The importance of monitoring the employer covenant has been highlighted by the recession and the fast changing fortunes of many employers. As a result of this, the Regulator issued a consultation document in June 2010

The consultation document sets out the Regulator’s view that *“All trustees should 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.”*

Whilst the Regulator considers monitoring to be very important, a recent research exercise performed on behalf of the Regulator has indicated that, although some schemes now have a reasonable approach when reviewing the covenant, improvement is necessary for many schemes particularly in the ongoing monitoring of the employer’s position between formal reviews.

### Does this really apply to me?

You may consider that you have a strong covenant. However consider the position of a number of high profile schemes whose employers have entered into insolvency in the last two years. Many did not anticipate the insolvency, which highlights the necessity to have a pre-agreed protocol in place for protection of the scheme and its members.

### How does the Regulator recommend that Trustees address this challenge?

The Pensions Regulator recommends that 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. This can be achieved by implementing a measuring and monitoring process which:

- Occurs at a suitable frequency;
- Is of proportionate depth and intensity based on the circumstances;
- Is based on appropriate information; and
- Is based on expert interpretation of that information.



### How does this look in real life?

Appropriate monitoring can take many different forms, ranging from a high level review on an annual basis to a detailed review of KPIs and other pre-agreed indicators on a monthly basis.

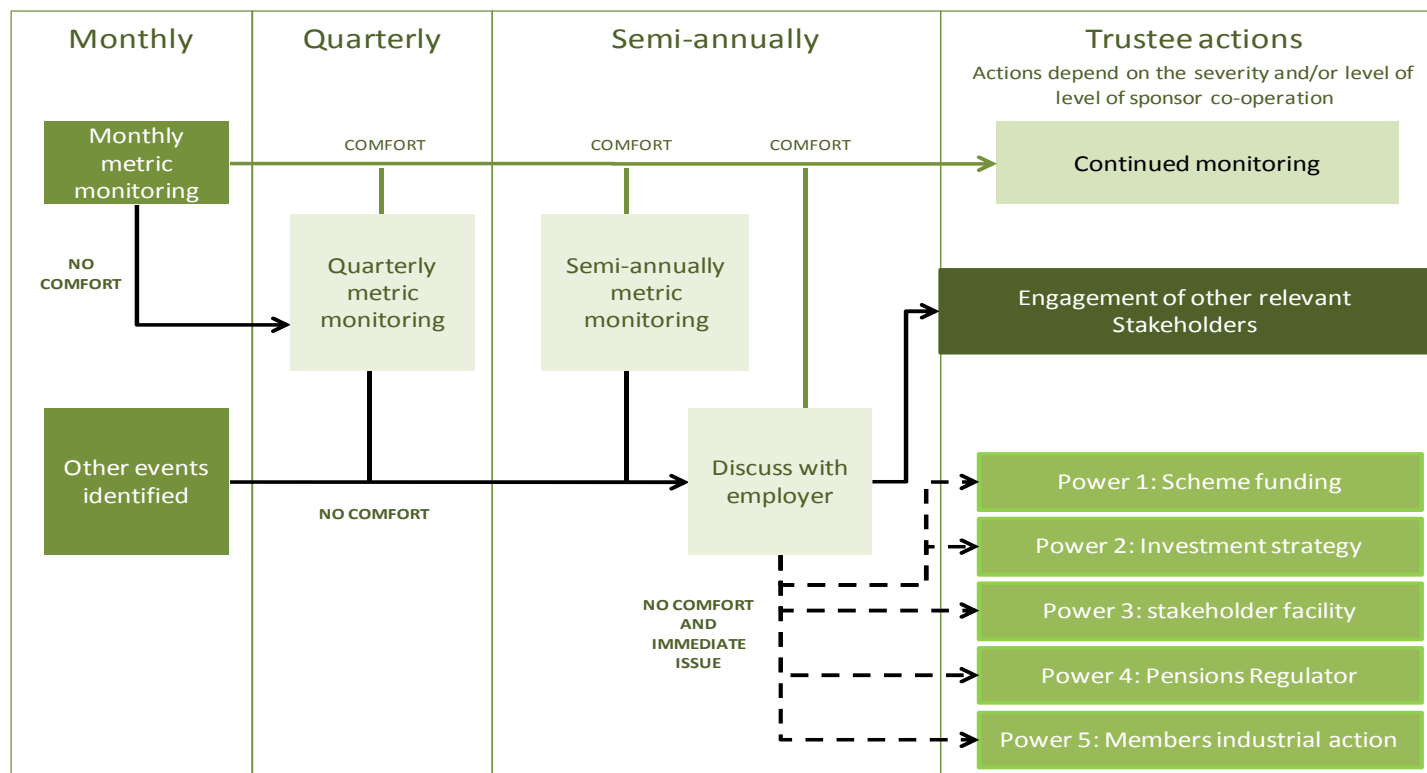
In practice, we have seen a range of examples and assisted in implementing monitoring processes for many clients. In general, a good quality monitoring process will have been tailored to the specifics of the employer’s business and its scheme, exhibiting the following key characteristics:

- A set of well defined and agreed KPIs through which the sponsor’s performance is measured;
- A pre-agreed template of escalation of monitoring where initial indicators trigger further investigation; and
- A mutually agreed process for protecting the scheme’s position once the covenant is sufficiently weakened.

Overall, by agreeing a process up-front, many of the difficulties of protecting the position of the scheme (and fulfilling the duties of the trustees) may be avoided.

An illustration:

The diagram below illustrates an example framework for a monitoring process agreed between trustees and a company. The aim of the process is to achieve a consensual approach to reviewing and monitoring the covenant which allows minimal disruption to the company under normal business conditions but a clear pathway of escalation in the event of a deterioration of the company's performance.



Each stage of escalation results either in comfort being obtained (and therefore no further action) or further escalation. This could eventually result in the use of trustee powers or the request for additional advice to assist in the process.

What are the benefits to the scheme?

The setup of such a process can have real benefits to the scheme and the security of the members' benefits:

- Company demonstrates an up front commitment to supporting the scheme;
- Provides a clear progression in the demands made by the scheme, in keeping with the severity of the situation being faced (and therefore prevents a situation of dis-proportionate analysis and demands where not necessary); and
- A balanced plan improves dialogue between the corporate and the trustee, strengthening the relationship.

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