

The Employer Covenant

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What is the employer covenant?

- A term commonly used when talking about DB scheme funding and investment strategy
- Used to be “ability and willingness of employer”
- Now tPR says it is “the extent of the employer’s **legal obligation** and **financial ability** to support the scheme **now** and in **the future**”

Legal obligation – more than willingness

- Who has the obligation to fund the scheme?
 - Generally only entities who voluntarily sign up to the terms of the scheme or who have guaranteed the obligations of a scheme employer
 - No general obligation on other group companies to fund the scheme

Legal obligation – more than willingness

- Trust deed and rules:
 - Who sets employer contributions? Division of liability among employers?
 - Who controls investment?
 - Use of surplus
 - Termination of contributions
- Funding agreements, contingent assets, guarantees
- Legislation and duty of good faith?

Employer's financial position

- **Current** financial position of employer
- **Future** prospects for the employer
- Benefits under DB schemes are usually expected to continue far into the future
- Impossible to predict finances far into future so **focus on short to medium term prospects**

Do you have to assess the covenant?

- No explicit requirement in Irish law
- Implicitly yes under Pensions Authority section 50 guidance and section 47 employer undertaking and contingent asset guidance
- IORP II - the own-risk assessment to include (Art 21.2(f)) "a qualitative assessment of the mechanisms protecting retirement benefits"

Expectations of the Pensions Authority

- Guidelines for setting investment strategy for DB schemes – PA's "view of good practice"
- Financial management guidelines for defined benefit schemes:
 - "Trustees should regularly discuss the sustainability of the current contribution rate with the employer. Such discussions should also cover the question of what would happen in the event that deficits occur in the future"

Expectations of the Pensions Authority

- Pensions Act requires trustees to undertake training on “the duties and responsibilities of trustees generally”
- Arguably includes training on the legal obligation part of the employer covenant
- FM guidelines - “Trustees should have a clear understanding of the contribution provisions under the trust deed and rules”

When to assess the covenant

- “Regularly” according to the FM guidelines – strength of covenant can change quickly
- When setting investment strategy
- As part of a triennial valuation
- Funding proposals
- Changes in principal employer

When to assess the covenant

- Change in condition of employer / group
 - Possible employer insolvency
 - Group re-financing or restructuring
 - Share capital reduction
 - Intention to wind-down operations
 - Industry specific risks
- Negotiation over final funding in scheme wind-up – provides a basis for agreeing final contribution amount

How to go about an assessment

- Decide why you are seeking an assessment
 - “Business as usual reasons” – valuation, periodic monitoring
 - Crisis – employer insolvency risk
 - Scheme ongoing but undergoing a major event (e.g. section 50 or change in principal employer)

How to go about an assessment

- What level of detail do you need?
- What level of expertise does the trustee board have (collectively)
- Attitude of employer – collaborative vs hostile
- Do you need external advice?
- Assessment should be proportionate to the circumstances

How to go about an assessment

- Weigh up the various factors and considerations
- Reach a decision on the sort of assessment needed
- Record the decision and the process of reaching it
- Implement – your advisers can help
- Assessment could be a presentation from the CFO through to a full external adviser review of the employer and group

And the assessment should cover ...

- The nature and enforceability of the employer's obligations to the scheme (and obligations of guarantors, chargors, former employers etc.)
 - Might need to speak to a lawyer on this
 - Consider different situations e.g. scheme wind-up, ongoing scheme
 - Non-binding assurances / past behaviour?

And the assessment should cover ...

- Scheme funding needs and investment risk
 - Maturity of membership
 - Future scheme cash flows
 - Size of scheme / funding requirement relative to size of employer
 - Level of investment risk in portfolio

And the assessment should cover ...

- Current and future financial ability of employer and other liable entities to fund scheme
 - Cash flow
 - Balance sheet and insolvency position
 - Market employer operates within
 - Reliance on / relationship with rest of group

Covenant assessment conclusion

- A variety of scales can be used to measure the covenant – traffic light system, strong to weak spectrum etc.
- Assessment should enable the trustees to reach a conclusion on the strength of the covenant and the level of contributions an employer can afford, taking account of the circumstances
- **Covenant assessment enables trustees to take better informed decisions**

What to do with the assessment?

- Setting assumptions for a valuation
- Contributions in funding proposal
- Investment risk tolerance
- Put in place measures to improve the covenant
- Negotiation over final funding in a wind-up

Potential problem areas

- Conflicts of interest
 - Provider of financial information is a trustee
 - Decisions flowing from the assessment
- Confidential information
 - Employer reluctance to provide projections
 - Use of NDAs
 - Information only given to external adviser

Potential problem areas

- External advisers
 - Agree scope of work with employer
 - Who pays fees?
 - Arrangements for provision of information
- Overseas entities
 - Different rules on priority in a wind-up e.g. trustee claim in Ireland has preferential status but has ordinary unsecured status in UK
 - Enforcement of judgment in another jurisdiction

Conclusion

- Employer's legal obligation and financial strength
- Regulatory expectation and part of own-risk assessment
- When, why, level of detail etc. decided by trustees
- To enable trustees to take better decisions
- See trustee support area of IAPF website for "Assessing Employer Covenants" guidelines

The end

Questions