

Deals

IAPF AGM and Benefits Seminar Employer Covenant

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Contacts



John Casey – Advisory Partner

- Partner within the advisory practice in PwC and specialises in transaction services and related mergers and acquisitions.
- Specialises in the completion of due diligence, financial reviews and debt advisory.
- Recent assignments have included the Government refinancing of Bank of Ireland and the valuation of bank loan transfers to the National Asset Management Agency.

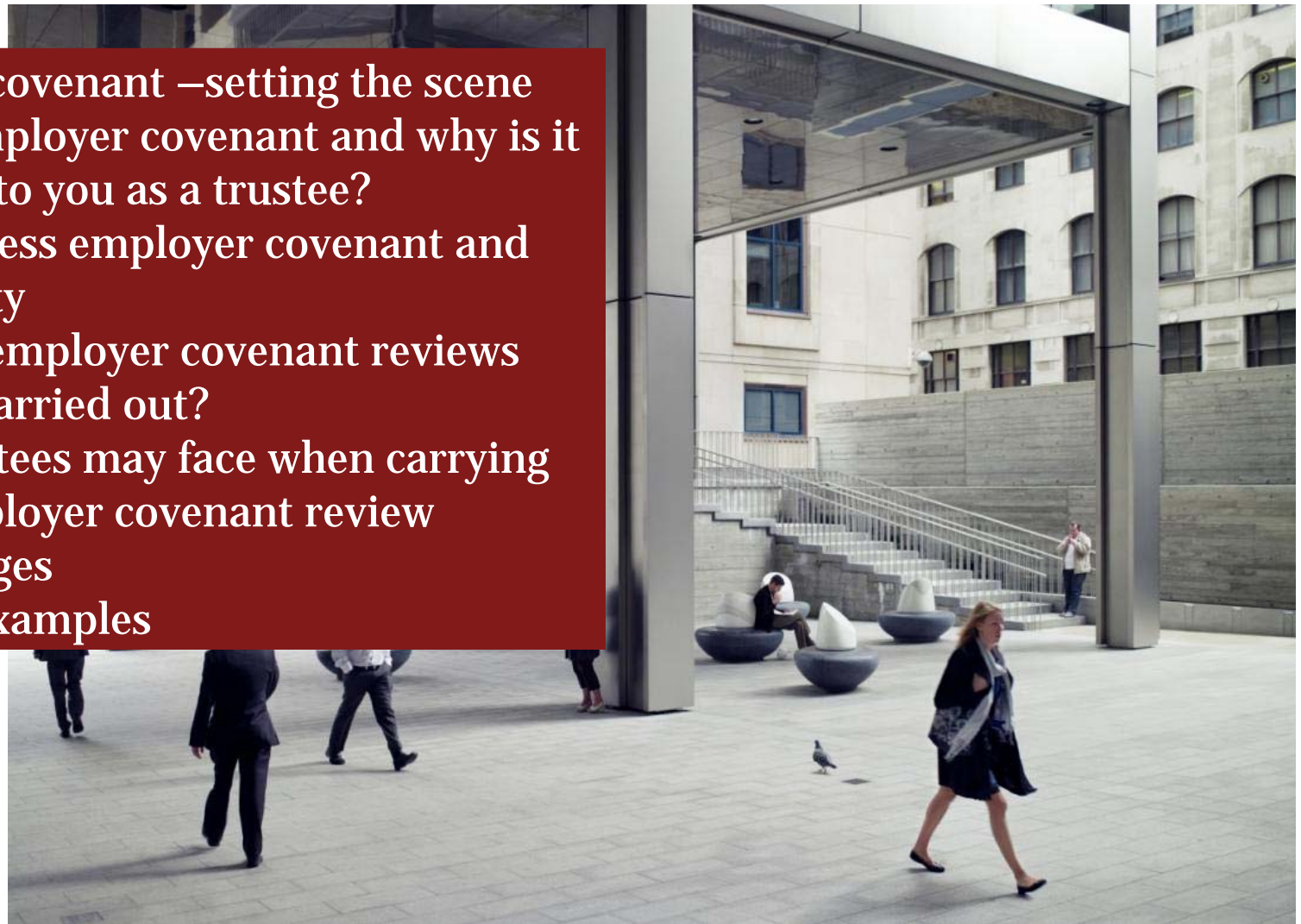


Una Warnock – Employer covenant specialist

- Manager within the Northern Ireland employer covenant team.
- Core member of the UK national covenant team and has recently completed a six month secondment to London.
- Experience working on a wide range of covenant assignments advising both trustees and corporates across a number of sectors, including, financial services, construction, manufacturing, aviation and utilities.

Agenda

- Employer covenant –setting the scene
- What is employer covenant and why is it important to you as a trustee?
- How to assess employer covenant and affordability
- When are employer covenant reviews normally carried out?
- Issues trustees may face when carrying out an employer covenant review
- Key messages
- Practical examples




Employer covenant – setting the scene


Within the UK the concept of employer covenant assessment was largely a result of regulation enforced as part of the Pensions Act 2005 which created the Pensions Regulator.



Although RoI does not currently have the same level of regulation, the trustees of RoI pension schemes have a number of key duties governed by Trust law and the Pensions Act 1990.



The recent Irish pensions court case in relation to Element Six highlights the potential risks for trustees and has set a benchmark for assessing trustee decision making processes and interaction with sponsoring employers.



Due to the deterioration in market conditions there is a risk that the number of schemes being wound up will increase which may result in a greater amount of litigation against trustees in relation to their actions.

What is the Employer Covenant and why is it important to you as a trustee?

The covenant is an employer's ability to:

- fund a scheme now and in the future; and
- underwrite risks to which a scheme is exposed.

In our experience, having an understanding of employer covenant has the following benefits for trustees:

- Promotes regular communication and interaction with the sponsoring employer which helps build relationships and results in a more consensual process;
- Provides trustees with greater visibility over the employers ability to support the scheme and meet contributions going forward;
- Allows trustees to agree the assumptions which drive the triennial valuation;
- Enables trustees to make better informed decisions in relation to investment strategy; and
- Increased protection for trustees as evidence of fulfilling duties – key consideration within Element Six case.

How to assess employer covenant

- An employer covenant review is an objective and independent assessment of the overall financial strength of participating employers of a pension scheme.
- Assess the strength of employer covenant based on a number of key areas.
- Suggest a “traffic light” approach which provides a clear and understandable evaluation of the strength of each of these – providing a rating ranging from weak to strong – and enables monitoring of trends.

Area of review	Current	Trend since [20XY]	Weighting
Group structure & legal powers			
[Wider group - optional]			
Balance sheet - ongoing			
Current and forecast profits			
Current and forecast cash flows			
Markets			
Ongoing covenant			High
Group structure & legal powers			
Balance sheet - exit			
Exit covenant			Low
Overall assessment	Tending to Strong		

KEY

Weak Tending to Weak

Strong Tending to Strong

Affordability: Helping trustees understand and agree on what is “reasonably affordable”

Trustees should aim for any shortfall to be eliminated as quickly as the employer can **reasonably afford**. What is possible and reasonably affordable will be informed by the trustees' assessment of the employer's covenant.

Availability to fund scheme payments increases

Non discretionary cash flows

Either required legally, or are essential to maintaining the business.

These may include:

- Tax
- Necessary R&D
- Working capital
- Operating expenses

Discretionary cash flows

Over which management has a higher element of control. These can improve the covenant.

These may include:

- Expansionary Capex and R&D
- Dividends
- Bonuses

Balance sheet

The cash and debt position also determine the company's ability to make contributions

Consider the following:

- Future working capital requirements?
- What non-cash assets may be available to the plan?

When are employer covenant reviews normally carried out?

**Section 50
Applications**

**Wind- up
situation**

**Agreeing funding
proposals**

**Corporate
transactions –
e.g. Change in
ownership,
group structure**

**Changes in
market
conditions**

**Other significant
events which
impact the
employer or the
scheme**

Potential issues trustees may face in assessing employer covenant

Potential issue

How can this be addressed?

Initial resistance from sponsoring employer

Communication with the employer at the beginning and throughout the process to enable them to feel fully involved in the process and understand the trustees' objectives. This can result in a more efficient and consensual process for agreeing funding proposals.

Additional cost

As no scheme is the same, the extent of the covenant review should be tailored to meet the trustees' needs and objectives. This can range from a high level desk top review to a more detailed analysis.

Conflicts of interest

Trustees need to be mindful of potential conflicts of interest and duties. An independent employer covenant review can provide a transparent process which trustees can use to support key actions and decisions and assist with discussions with the employer.

Employer covenant – key messages

Fulfilling trustees duties including proper process and documentation is key and is likely to come under greater scrutiny as a result of the Element Six court case and the risk that more schemes may be wound up due to economic conditions.



There are a number of clear benefits for both trustees and employers in carrying out an employer covenant assessment including the integration of covenant with agreeing funding assumptions and assessing affordability.



A suggested approach is a “traffic light” approach to assess the core areas of employer covenant. This can be tailored to meet the trustees’ specific needs and objectives.



Employer covenant reviews are carried out in a range of situations including section 50 applications, wind-ups and agreeing funding proposals.

Practical examples

Thank you

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