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Protecting schemes from sponsoring employer distress

The Pensions Regulator has published new guidance for defined benefit (DB) pension scheme trustees to help them understand how to protect their scheme and spot signs of financial distress in their sponsoring employer.

Whilst financial distress can be experienced by employers at any time, current economic uncertainty caused by the COVID-19 pandemic and Brexit heighten the risk for some employers.

Waiting for a sponsoring employer of a DB scheme to show signs of financial distress can severely limit the options of the trustees, so early diagnosis is important.

Background

The UK is facing a period of increased economic uncertainty as a result of the COVID-19 pandemic and Brexit, particularly if the UK leaves the EU at the end of the year without a trade deal.

Trustees are encouraged to be on the lookout for key signs of financial distress in their sponsoring employers including, cash flow constraints, credit downgrades, removal of trade credit insurance, disposal of profitable business units and loss of key customer contracts.

The guidance

The guidance requires trustees to:

- make sure the right risk management and governance procedures are in place;
- respond when other stakeholders such as creditors or lenders act to protect their own position;
- prepare a communications strategy to support members when they're facing uncertainty; and
- do the right thing to protect scheme members if insolvency is inevitable.

Integrated risk management (IRM)

The IRM concept is not new. It involves trustees examining how employer covenant, investment and funding risks relate to, and are affected by, each other. All trustees are expected to adopt, and regularly review, a fully documented IRM policy with workable contingency plans and suitable triggers in place. This should highlight problems at an early stage and allow trustees to act expeditiously.

Part of this will involve engaging regularly with sponsoring employers and, if applicable, other creditors, to identify and manage risks at an early stage. Where robust scheme protection is not in place third parties, such as lenders, may be in a better position than trustees to exert control over and extract value from a distressed employer.

Objectively stress testing the employer covenant (e.g. challenging financial forecasts), will help trustees to determine the potential impact of stressed scenarios on the sponsor and its resilience to cope with adverse market conditions.

It is important trustees have a good understanding of their employer's legal obligations to the scheme, under both scheme documentation and insolvency legislation. They should also be aware of where the scheme would stand in a hypothetical insolvency.

Review scheme governance

Most things pension scheme trustees have to do come back to governance, and a trustee board with the right mix of experience, structures and processes in place is more likely to make decisions effectively, manage scheme risks, and protect the scheme.

Thus, the guidance expects trustees on an ongoing basis to review:

- trustee skills and experience to ensure there is sufficient collective knowledge to navigate the risks to the scheme throughout its journey plan.
- conflicts on the trustee board. Managing conflicts of interest is a foundation of good trustee decision-making. When faced with a distressed employer, managing conflicts of interest may become more challenging, especially for those who hold senior roles within the sponsoring employer.
- clear documentation and record-keeping. Clear documentation of trustee decisions is part of good scheme governance, helps trustees focus on key points and protects them from possible Regulator action.
- their agreed information sharing protocol. Trustees and the sponsoring employer should be clear on what information should be shared and when. During periods of heightened distress, when the employer's time is stretched, information sharing can be overlooked in the absence of a legally enforceable information sharing agreement.

Responding to stress warning signs

The warning signs will vary according to the nature of the employer's business and the area in which it operates. Trustees should decide the appropriate warning signs for their employer and monitor accordingly.

If employers are moving into financial distress other creditors are likely to seek to reduce their own exposure to the business, for example, by taking new security or seeking additional collateral. Trustees should review changes to the scheme sponsor's capital structure, including debt maturities and new money coming into the sponsor, and understand the terms of the refinancing agreement before it's finalised. This way trustees can properly assess the impact on the scheme. Early engagement with the employer can increase the chance of the scheme being treated fairly with other stakeholders.

Where there are signs of an employer getting into financial distress the frequency and intensity of monitoring employer covenant strength should be increased. In this situation the focus of covenant monitoring should shift from long term to shorter term financial information. Trustees cannot wait for formal confirmation of a covenant downgrade at a triennial actuarial valuation. Instead they should immediately take steps to understand the potential returns to the scheme in a theoretical insolvency. With complex group structures trustees will also need to understand the inter-company trading and financing positions, as these could have a material impact on what the scheme might get in an insolvency.

Review investment strategy

Most investment strategies are based on assumptions in the medium to long term, but an employer insolvency can crystallise short term investment losses. Thus, if an employer is showing signs of financial distress trustees should immediately review their investment strategy and consider what level of investment risk is supportable, as well as the level of interest rate/inflation hedging in their scheme.

Taking specialist advice will be more important than ever at this time.

Employer requests for scheme easements

An employer in financial distress may seek various easements from its pension scheme obligations as part of a wider restructuring process. For example, there may be a request to suspend or defer employer deficit repair contributions. Trustees faced with such requests should seek specialist advice which will involve fully understanding the scheme's position and the obligations of the sponsoring employer. Trustees can only agree to such requests if the scheme is being treated fairly against other creditors and stakeholders. Releasing a security over an asset is extremely unlikely to be an option for trustees in a distressed situation. At this point any decisions of the trustees, and advice given to them, should be fully documented.

Information sharing

An employer in a distressed situation will have competing demands on its time. However, information requested by trustees should be provided in a timely manner. A pension scheme is likely to be one of the employer's most significant creditors and should be treated as such.

Transaction activity

Any corporate transaction activity by the employer should be reviewed by the trustees against the employer's ability to continue paying scheme contributions. Trustees should seek mitigation if a transaction has caused, or will cause, a material detriment to the scheme.

In distressed scenarios, employers may consider scheme-related options, for example, a regulated apportionment arrangement (RAA) or a company voluntary agreement (CVA), which could facilitate a wider restructuring of the sponsor, while also securing the best possible outcome for members.

If these are being considered, trustees should contact the Regulator and the Pension Protection Fund (PPF) as early as possible. This is because an RAA needs Regulator approval, for which it will usually require a full application for clearance, and also requires the PPF to indicate no objections. The PPF also has a vote in any CVA involving a sponsor of a DB scheme.

Member communication

Trustees will need to consider how to communicate with members in a distress situation. The employer's financial position may already be in the public domain, or visible to employees, and it is important to keep members informed of what is going on and the steps the trustees are taking to manage the situation. At this point members will be particularly susceptible to pension scams or making rash decisions with their benefits. Trustees should therefore take extra care in respect of members who take their benefits or seek to transfer them, monitoring any sudden increase in transfer activity.

Where an insolvency is inevitable

Where an employer's insolvency is looking likely, or is inevitable, trustees should immediately seek specialist advice (if they have not already done so) to make sure all options to protect their scheme have been explored. Where a scheme has a security structure in place trustees should know how and when to enforce the security.

Trustees should engage with the PPF and understand the practical steps they need to take to prepare for a PPF assessment.

The Corporate Insolvency and Governance Act 2020

This Act came into force on 26 June 2020. It introduces new procedures for distressed companies, including a 'restructuring plan for companies in financial difficulty' and the ability to arrange a payment holiday (called a moratorium). The Act focuses on business rescue and survival and while it may be good for pension schemes in some cases, it also introduces more risks for trustees. The Act is complicated and trustees facing a potential moratorium need to engage specialist advice.

Comment

This guidance from the Regulator is very timely in the face of the current economic uncertainty being faced by the UK caused by the impact of COVID-19 on many businesses and ties in with increased sanctions on employers coming through shortly in the Pension Schemes Bill.

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