Summary
- The flexibilities in The Pensions Regulator's latest employer covenant guidance, twinned with the focus on the integrated nature of risk management, have helped improve the relationship between trustees and sponsors.
- There are concerns that the latest TPR employer covenant guidance has softened trustees' negotiating power when it comes to asking for detailed and sensitive financial information from sponsors.
- With the declining number of open DB schemes, there is a danger that employers will lose interest in running them. However, the cost of buyouts and buy-ins is still considered expensive so sponsors may prefer to manage the investment risk instead of paying a premium and passing a scheme over to an insurer.

One step at a time

It has taken over a decade for the majority of DB trustees to become comfortable with covenant assessment. But the long journey has been worth it as schemes and sponsors now interact in a sophisticated and mutually beneficial way

It used to be said that defined benefit pension scheme trustees moved about as fast as a tortoise on holiday. Some still do. Which is probably why more than a decade on from when The Pensions Regulator took over from the Occupational Pensions Regulatory Authority, trustees are still getting to grips with covenant assessment.

It's also why the regulator – apart from having to justify its own existence – keeps releasing updates on how trustee boards can better understand just how deep their sponsoring employers' pockets really are.

The latest specific guidance on the subject was released last August. It was complemented in December by an integrated risk management code, which urged schemes to look at the covenant risk in close conjunction with investment and funding risks.

Darren Redmayne, the managing partner at Lincoln Pensions, a company that provides covenant testing advice, says that the flexibilities in the latest guidance, twinned with the focus on the integrated nature of risk management, have helped improve the relationship between trustees and sponsors.

"It has led to a much more informed

and joined up set of discussions," he says.

"So rather than it being a binary relationship, like it was five years ago, where trustees would have asked if their covenant was strong, middling or weak – it is now a much more multi-faceted discussion about risk management.

"The bulk of our work was rating covenants against our nine-point scale. Now we deal with a much deeper set of questions around what the right balance is between company contributions and investment risk."

This has led to advisers such as Lincoln linking up with consultants to analyse investment risk and how it compares with a company's cash flows.

A further step in the right direction?

The regulator's guidance gives trustees and employers a clear framework for assessing employer covenant and how that should influence funding and investment strategy. According to Spence & Partners head of corporate advisory services Richard Smith, it is also well balanced. It reminds schemes to maintain sensible practices, such as keeping a keen eye on the covenant at all times, rather than only at triennial valuations. But it also outlines what a proportionate approach should look like.

"The guidance reinforces the importance of collaborative working between trustees and employers, and this can only enhance the relationship between the parties," he says.

"However, in my experience, most schemes were already acting in line with the spirit of the revised guidance, so its publication has not had a material impact on schemes' operations."

The influence of last August's publication is also questioned by PTL client director Melanie Cusack.

As a provider of independent trusteeship, she wonders whether the guidance has in fact softened trustees' negotiating power when it comes to asking for detailed and sensitive financial information.

"I've got an example where the sponsor turned around to me and said, 'Legally, I don't have to provide you with any of this information. I'm required to work with you responsibly, but I actually don't need to tell you any of this'.

"And you think to yourself, well that's not in the nature of how the regulator wants us to work together. And that's a shame because it can actually work in the sponsor's favour if you've got a robust covenant assessment; then you can have less prudence."

Cusack also believes the added emphasis on the covenant has led to some fractured relationships.

"Sometimes employers ask why trustees are looking for answers to certain questions. And you have to really work on explaining that if they give us the required information then we can understand why they're saying they can't afford a certain level of contribution. But if they don't give it to us, then we're just going to assume that they can afford it."

Long term, however, Cusack believes that these sorts of disputes can be healthy: "The relationship can come out the other end as a better one. Sometimes you've got to break it before you fix it."

Less engaged?

A relationship can only thrive however, if both parties put the effort in. And with the declining number of open DB schemes, there is a real danger that employers will start to lose interest in running them. And as Smith points out, the conveyer belt of alterations to DB rules has increased the chances of this happening.

"The end of contracting out has been the most important recent development affecting open DB schemes, with many employers using this as a trigger to close schemes to accrual," he says. "And the additional NI costs to employers and employees have been

viewed as the final nail in the DB coffin – it will be very interesting to see the number of schemes that close in 2016."

Cusack says that in some cases, closed schemes soon become irrelevant ones.

"Some sponsors get bored by the legacy thing," she says. "They see it as paying for a pension scheme that people earned 20-odd years ago. There is a generational issue that will become more pronounced as we go on.

"That's hard and why sponsors will be pushing to get it off their balance sheet."

Redmayne's experience is somewhat different however.

He points out that the cost at the moment of doing buyouts and buy-ins is still perceived as being expensive. As a result, most sponsors would rather run some investment risk than pay a premium and pass a scheme over to an insurer.

What's more, taking a back seat with a DB scheme is a dangerous game.

"The moment you take your eye off the ball, you wake up and the investments or the liabilities are running away. And we're absolutely not seeing that," he says.

"There's been no backing down in the amount of work done in DB."

Written by Marek Handzel, a freelance journalist

Sponsors' growing interest in investment strategies

As trustees have been working ever more closely with employers over the covenant, so to have the latter begun to take a more active role in investment strategies.

A recent survey conducted by Punter Southall found that 69 per cent of sponsors were now showing more interest in where their money was going. The law states that employers should be consulted on investment matters, but this development has seen them go beyond their basic duties.

Seventeen per cent of respondents even said the employer took the lead in discussions on investment strategy and countered trustee proposals with their own views on asset allocation.

However, this is still seen as no-go area for many employers. Spence & Partners' Smith says there is no reason for them to hold such a view.

"Every employer should be taking a very active role in the investment strategy of the DB scheme they sponsor," he says.

"It never fails to amaze me that many employers think they should not, or cannot, get involved in their scheme's strategy. Nor should employers rely on the investment advice being provided to the trustees from their advisers or managers – it is vitally important that employers take independent advice on their schemes' investment strategy and approach the trustees on the front foot."

He says that trustees and employers should have the same long-term goal, which is to ensure that all members get the benefits they expect. Both parties should work as closely together as they can to achieve that target.

Cusack says that the practice is one that she encourages. Particularly in situations where trustees want to be comfortable with the risk they are taking in their investment strategies, while the sponsor wants to aim for maximum returns.

"It is better if the sponsor is at the table, going through that process, understanding why the trustees aren't just saying, 'right, put it all on red'", she says.

"Then it also stops the sponsor from coming back and saying 'well you made a bad investment, we put money in and now it's gone and you're asking for more'. If the employer is involved then the trustees can avoid having that thrown at them."