Summary
• It may be wise for trustees to stay in close contact with employers' management teams due to the rapidly-shifting economic environment that the pandemic has precipitated.
• Drawing up a protocol for the information shared between trustees and management teams can forewarn the former of potential upcoming covenant breaches.
• Being prepared for employer distress with contingency can help to improve member outcomes.

The Covid covenant conundrum

Duncan Ferris explores how the pandemic and the economic difficulties it has catalysed may affect the way trustees monitor employer covenants, looking into communication with sponsors and planning for the worst

A number of high-profile companies have fallen into financial difficulties in recent months as the pandemic drags on and businesses continue to feel the heat. Travel and retail companies have been particularly in the spotlight due to restrictions on travel and opening restrictions, with big hitters such as Arcadia and Flybe collapsing, but businesses from all manner of industries could be feeling the pinch from the effects of Covid-19. As such, this is a key time for trustees to consider their sponsors' ability to adhere to covenant arrangements.

After Mercer's *Pensions Risk Survey* found that the accounting deficit of FTSE 350 companies' DB schemes had climbed from £73 billion at the end of September 2020 to £75 billion on 30 October, Mercer chief actuary, Charles Cowling, warned that covenants were facing "big pressure" and urged trustees to "monitor their situation wisely". But how should trustees monitor the covenant and how has this changed under the influence of coronavirus?

Covid changes

It's important to establish that the fundamentals of covenant assessment remain unchanged but, in some cases, trustees may need to adapt to take steps such as increasing the regularity of their monitoring.

Grant Thornton partner and head of pensions advisory, Paul Brice, states that the pandemic and its impact on sponsor trading has "led to many trustee boards needing to assess and monitor covenant very dynamically – staying close to management teams and receiving regular financial updates".

He continues: "Trustees have often needed to respond very quickly to measures taken by sponsors and other stakeholders such as lenders, managing the tension between helping sponsors survive and ensuring a sustainable funding position for schemes."

Dalriada Trustees professional trustee, Sarah Ballantyne, argues that the economic environment that has been catalysed by the pandemic has left employer covenants "more susceptible to rapid change, and unfortunately the likelihood is that this will be adverse".

She continues: "Many trustee boards have used the uncertainties caused by Covid-19 to request further and more regular financial information from their sponsor."

Ballantyne adds: "Whilst for some schemes monitoring on an annual basis may have been appropriate before Covid, circumstances may now mean that more frequent monitoring is appropriate.

"For example, on some schemes we are monitoring on a monthly basis and receiving information on short-term cashflow forecasts. Frequency and depth of monitoring is therefore very much scheme specific."

Communication

It seems clear that increased communication is key in these financially unstable times, but what is the best way to conduct this dialogue?

BESTrustees trustee executive, Ann Rigby, recommends that trustees "involve the employer right from the start so they understand the assessment process, timescales and potential impact of that assessment on funding".

She continues: "Also bear in mind that any requests for information need to fit in with the employer's own work schedules. Finally, redacted reports should be shared with the employer to agree all factual information before the report is presented to the trustees."

Ballantyne agrees and adds that

discussions should be held with the employer "on its financial outlook, trading and liquidity position" so that the trustee board can fully understand "what issues may be on the horizon".

To improve trustee monitoring on sponsors' trading and financial position, Ballantyne also recommends drawing up an "information sharing protocol".

She explains that this could give trustees warning of future corporate events such as "a breach or anticipated breach of banking covenants, refinancing or material increase in debt of sponsor, provision of security or negative pledges".

Lincoln Pensions managing director, Dan Mindel, agrees and sees the possibility of more information sharing as a potential learning experience, stating: "Management teams of employers have many competing demands, and trustees should be sensitive to this in their interactions.

"Ideally, information requests should leverage management information that is used in the normal course of business, or that provided to other creditors such as lenders. Increased sharing of information and interaction can be mutually beneficial, in providing trustees with more visibility and understanding, which in itself can reduce risk over the longer term."

This all sounds like it could be a good opportunity for trustees to get to know sponsors' management teams, but Brice points out that there will be occasions where "trustees will need to be assertive if there is any risk that a scheme's position will be unduly compromised relative to other stakeholders".

Regulation and legislation

The issue of monitoring employer covenants has also been affected by advice from regulators and new legislation from Westminster.

For example, The Pensions Regulator (TPR) released guidance for covenant monitoring, in which the regulator recommended trustees "enhance the level of covenant monitoring over the short to medium term" and released a series of questions to help with the monitoring process.

In cases where there is only short-term visibility, TPR recommends that trustees only agree to short-term concessions from the sponsor, make reductions or suspensions shorter if they are not confident of receiving relevant financial information in the near future and carefully consider how appropriate substantial contribution suspensions might be.

Looking at the legislation side of the coin, Mindel says: "The expedited introduction of the Corporate Insolvency and Governance Act has created additional complexity for trustees to navigate as they and their advisers try to understand how the new moratorium and arrangement might impact their scheme (positively or detrimentally)."

The legislation referenced by Mindel came into force in June and was designed to improve the likelihood of business' survival by adding new procedures by which companies that have fallen into financial distress might be rescued. The act introduced a new moratorium to give companies breathing space from their creditors while they seek a rescue, as well as a new restructuring plan sanctioned by the court that will bind creditors to the plan.

Mindel adds: "With the impending changes to regulatory legislation through the Pension Schemes Bill, many trustees will need to be more considerate of insolvency outcomes in their covenant assessments for the foreseeable future."

Contingency planning

The other key facet of covenant monitoring is planning for different scenarios, as Mindel comments that mere monitoring "can only help so much and must be coupled with robust contingency plans".

He explains: "Not all events can be easily anticipated, with Covid-19 being an example, but a robust contingency planning process should consider the appropriate actions in response to broad down-side scenarios, alongside specific events that can be reasonably foreseen.

"Contingency planning should also consider how investment, funding and covenant down-side scenarios interact, noting that Covid-19 has impacted all three areas."

Ballantyne comments that "preparation, quality advice and trustee experience of stressed financial covenants can all improve member outcomes", but warns that if this is not done before "stress turns into distress" then there is the risk of "being placed last in the queue of creditors to take protective action".

Brice notes that there are a number of scenarios that trustees could consider depending on the scheme sponsor in question, with these including key downside scenarios such as "a breach of lending covenant; a liquidity crisis; asset disposals or acquisitions; or, at worse, insolvency".

On a more positive note, she says that trustees can establish some more upbeat contingency plans, depending on the state of their sponsor, by considering upsides and recovery options, which might result in plans such as "contingent contribution plans driven off agreed performance metrics to get cash into a scheme as the sponsor recovers".

Good news or bad, it seems sensible that trustees prepare themselves for any eventuality as the unpredictability of 2020 looks set to bleed into 2021. But with good news about scientists developing vaccines hitting the front pages in November, we can hope that the new year will bring a dose of economic recovery to our shores and sponsors.

Written by Duncan Ferris