

Response to:

Consultation on the Pensions Regulator's Guidance on Monitoring Employer Support: Covenant, Contingent Assets and Other Security - published June 2010

General Observations

ITS welcomes the guidance which builds on the previous statements made to employers and trustees on scheme funding. We welcome the fact that it ties the guidance given to underlying statutory and legal requirements, giving trustees a clear understanding of their legal duties.

Our responses to the specific questions are as follows:

General Questions

1. Is the guidance helpful to trustees of schemes of all sizes?

In general terms we believe this to be the case. The guidance makes reference in several areas to action taken by trustees in assessing the covenant being both appropriate and proportionate given the size of the scheme, the size of the employer, and the potential benefit of the exercise, all of which we welcome.

2. Are the examples useful and appropriate?

Yes. However, it might help to have an example from a small or medium sized scheme indicating how the trustees set about agreeing terms for an independent review given a limited budget and weak sponsor, and how they set about making use of the information obtained.

3. Are the appendices useful and appropriate?

The appendices will provide useful check lists for trustees. In particular Appendix A will assist trustees in focusing on the relevant considerations for their particular employer and scheme, and may encourage greater dialogue between employer and trustees. This in turn may obviate the need for external financial advice in all circumstances; if the trustees are well educated and well informed on the employer's business they may have the confidence to reach decisions based on the information provided to them backed by rigorous internal assessment.

We welcome Appendix 2 as it should help trustees focus on the important issues to consider when appointing a covenant assessor and re-emphasises the point that one size does not fit all. We believe that it is not always necessary to go for a 'bells and whistles' approach when appointing a covenant assessor, and would like to see further development in the market amongst suppliers so that trustees are not always pushed towards a Rolls Royce solution when agreeing the scope of the review. We would also like to see more development in the market place of regular covenant updates as part of the service, much in the same way as many actuaries now provide regular funding updates. These could use a simple traffic light or balanced scorecard

approach, and could be produced to coincide with funding updates prepared for trustee meetings, preferably at minimal additional cost.

4. Does the guidance strike the right balance between specifying a process for monitoring covenant and not imposing disproportionate or unnecessary costs on trustees/employers?

We note that the proposed framework is not intended to impose higher costs on a scheme than necessary; nevertheless the inevitable consequence of the increased monitoring is bound to have a disproportionately greater effect in terms of increased cost on small and medium sized schemes. There is a clear indication that a full review of covenant should be carried out at least before each scheme specific funding valuation. Where the trustee body does not have sufficient expertise or ability to make an independent assessment of information provided by the sponsor there is an expectation that they will take both legal and financial advice. Small and medium sized schemes are less likely to have the necessary expertise and therefore more likely to incur additional cost. We believe the increased costs of monitoring the covenant for smaller schemes will accelerate the move to closure and buy out amongst employers. However, it is difficult to see how trustees can discharge their duties without having due regard to the employer covenant, and therefore it will be hard for trustees or employers to argue that the steps required are disproportionate.

Section 1

5. Does the guidance clearly explain the concept of covenant and how it relates to trustees' decision making?

We believe it does. There is a clear move away from box ticking exercises towards encouraging trustees to assess covenant in the wider context including overall assessment of risk, and appropriateness of investment strategies and technical provisions.

Section 2

6. Does the guidance equip trustees to ask the right questions of advisors and employers, and request the right information from employers and other scheme sponsors in order to assess the covenant?

The emphasis in the guidance is on trustees and employers working openly together which we welcome. Nevertheless there will be sticking points where either the employer is failing to provide full and frank disclosure, or the trustee and employer cannot agree on how to address a funding issue.

We do question the reference to the Occupational Pensions Schemes (Scheme Administration) Regulations 1996 as supporting a legal requirement to provide information to assess covenant. The Regulations relate to pension scheme administration and we believe they must be read in the context of trustees as administrators, despite the apparently wide wording of regulation 6(1)(a).

The guidance makes a useful distinction between the employer's legal obligations and financial position, both of which should be explored along with 'willingness'. The inference is that where there is insufficient expertise on the trustee board professional advice from lawyers and financial experts will be required. Without wishing to promote our own cause unduly, this is yet another instance where the professionalism brought by an independent trustee who is not involved in the sponsor's business can add value when questioning or negotiating with scheme

sponsors. Whilst an independent trustee cannot replace professional advisors, there may be less need for such advice where there is an independent trustee alongside suitably experienced trustees with in depth knowledge of the sponsor's business.

Section 3

7. Does the guidance help trustees to identify ways of improving covenant or scheme security?

Yes. However, costs of using contingent assets, including the due diligence needed, may be disproportionately high for small or medium sized schemes, and the guidance could make this clearer.

The guidance is helpful in pointing out that contingent assets which do not meet the PPF requirements for recognition may still be valuable additions to security, particularly in view of the expense of putting PPF-compliant assets in place and the general unwillingness of employers to do so.

The guidance makes clear that trustees must consider the appropriateness of any contingent asset in relation to the support it is providing to the funding strategy which we welcome as it further emphasises the need for trustees to view funding and investment strategy alongside the covenant.

Section 4

8. Does the guidance help the trustees in deciding what action to take as a result of a covenant review?

We welcome the practical examples given showing how the trustees must balance a number of future considerations including the ability of the employer to continue in business by using cash flow to fund future growth. We also think the list of considerations in paragraph 65 is a useful reminder that employer covenant is not just about fixing contribution levels following a valuation.

9. Does the guidance help trustees to understand when (and how quickly) to act following changes in covenant strength?

Yes. There is sufficient emphasis on need to keep covenant under review as regular item on trustee agenda to ensure that this is an ongoing process and that there are a number of actions which the trustees may wish to take as a result of a change in covenant strength. The guidance assumes the trustees will wish to take action if there is a breach of triggers in their funding plan, however, it is equally likely that the employer may wish to re-negotiate a funding plan or seek release of a contingent asset if there is significant strengthening of the covenant and it might be useful to give trustees some guidance on the matters they should consider if faced with such a request.

Independent Trustee Services Ltd

03.09.10

Contact Nita Tinn

Nita_tinn@itslimited.org.uk