

PENSIONS COVENANT ADVISORY

SAFEGUARDING YOUR PENSION SCHEME AGAINST FINANCIAL DISTRESS



HEIGHTENED RISK OF FINANCIAL DISTRESS

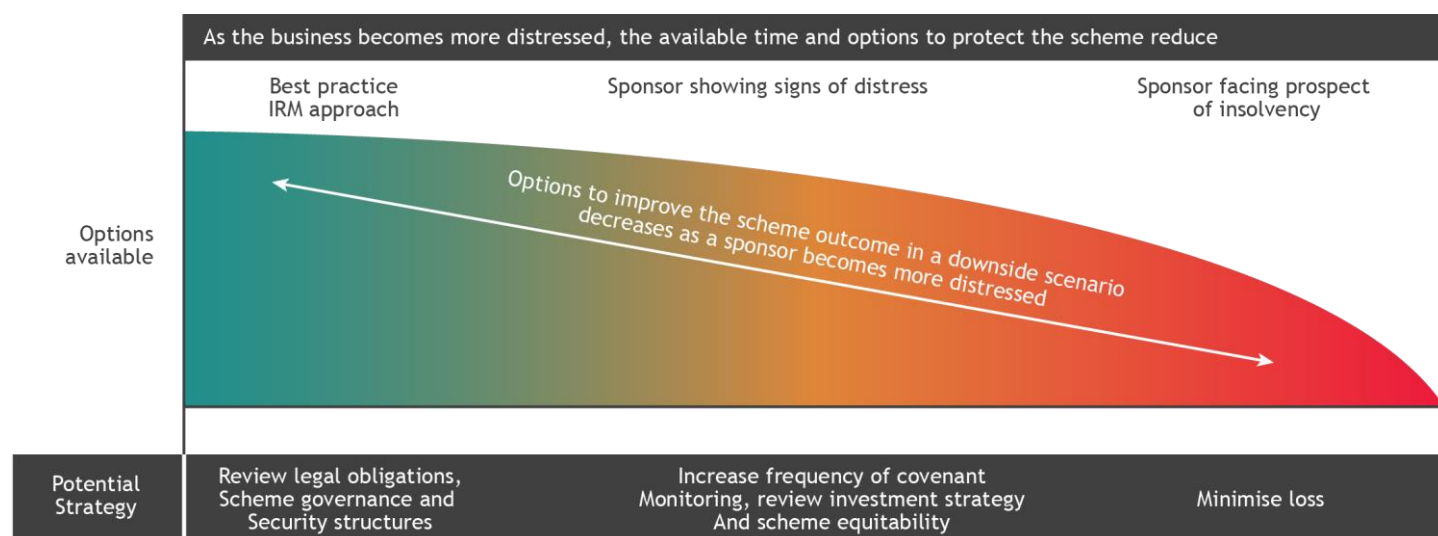
As we look ahead, the outlook for pension schemes appears more uncertain than at any other time. The economic consequences resulting from the ongoing COVID-19 pandemic, alongside rapidly developing technology, and global political turbulence has resulted in a heightened risk of financial distress for many employers.

It is important that trustees are alive to early indications of financial distress and understand how they can best protect the interests of their scheme.

In response to an increasing risk of weakening employer covenants, The Pensions Regulator (“tPR”) has published guidance titled ‘Protecting schemes from sponsoring employer distress’.

tPR’s key message is that once a sponsor has become financially distressed, options to strengthen the scheme’s position will become more limited as the sponsor travels down the corporate stress curve. Trustees should therefore remain close to the employer with regular communication and proportionate monitoring to ensure that they are in the best position to protect the scheme’s interests.

CORPORATE STRESS CURVE



Source: tPR guidance ‘Protecting schemes from sponsoring employer distress’

BE AWARE OF FINANCIAL STRESS AND DISTRESS

It is vitally important that trustees are aware of the need to identify corporate distress, which might be due to worsening trading performance or financial inflexibility. Trustees should be prepared to act quickly if they believe an employer is facing difficulties. Summarised overleaf are the typical **warning signs** to look out for and respond to.

tPR encourages **regular covenant monitoring** for good scheme governance. An IRM approach will give the trustees the best chance of identifying any potential risks to the covenant at an early stage, allowing the trustees to take the appropriate action and engage with employers and advisers early. This will enable trustee to reduce the risk of potential scheme losses from financial distress.

We have summarised key elements of tPR's guidance below which aims to provide trustees with the tools to safeguard schemes against financial distress.

NO SIGNS OF FINANCIAL DISTRESS

The sooner trustees act, the greater the prospects of protecting the scheme's position. Practising IRM is expected to highlight problems early on and is key.

The IRM approach should be fully documented with workable contingency plans and suitable triggers.

The guidance includes action that should be taken to demonstrate good governance:

- ▶ Understand the employer's legal obligations to the scheme and the outcome in a hypothetical insolvency
- ▶ Ensure effective risk management processes are in place with documented and workable contingency plans to mitigate key risks
- ▶ Review scheme governance including trustee skills and experience, clear documentation and record keeping and agreed information sharing protocol
- ▶ Monitor the covenant on an ongoing basis to identify and mitigate sponsor risk, challenge forecasts and test assumptions, understand the scenarios which might result in a covenant downgrade and understand the likelihood of this occurring
- ▶ Seek appropriate advice when making decisions which are material to the scheme or employer, you should seriously consider taking professional advice.

SIGNS OF FINANCIAL DISTRESS

The trustees should make sure they are aware of the key warnings signs for financial distress which includes:

- ▶ Reduced trading levels or losses
- ▶ Cash flow constraints
- ▶ Credit downgrades
- ▶ Removal of trade credit insurance
- ▶ Disposal of profitable business units
- ▶ Loss of a key customer contract
- ▶ Re-organisations and 'down sizing'.

As the financial health of an employer declines, other stakeholders are likely to compete for value alongside the scheme. To protect their scheme Trustees should:

- ▶ Engage early with the sponsor to understand the position
- ▶ Increase the frequency and intensity of covenant monitoring
- ▶ Perform a detailed review of the scheme's position including potential returns to the scheme in an insolvency, the position of other creditors and intercompany trading and financing positions
- ▶ Review the investment strategy and its exposure to risk
- ▶ Understand the role of other stakeholder interests
- ▶ In the event of transaction activity, review the impact on the sponsor's ability to continue paying scheme contributions and the impact on the recoveries to the scheme in an insolvency scenario
- ▶ Prepare a clear strategy for communicating with members in a distress scenario
- ▶ Be alert to scams and unusual transfer activity.

PROSPECT OF INSOLVENCY

If a sponsor insolvency is looking likely, trustees should immediately take professional advice from restructuring advisers to make sure all options to protect the scheme's position have been explored.

Trustees should be familiar with the PPF's contingency planning guidance and engage with them to understand what practical steps are needed.

If an RAA or CVA are being considered the trustees need to contact the PPF as early as possible.

The guidance recommends that trustees should be aware of:

- ▶ New regulatory procedures for distressed companies i.e the Corporate Insolvency and Governance Act. If there is a turnaround plan, the trustees will need to obtain a copy of the plan and with the help of specialist restructuring advisers, understand the impact of the plans on the scheme
- ▶ The notifiable events regime, which provides early warning of possible insolvency and allows tPR the opportunity to assist prior to a company entering a PPF assessment period.



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