The employer covenant

Paul Thornton and Donald Fleming ask what good governance really means today and how the sponsor covenant has been developing

With trustees increasingly expected actively to monitor the sponsor covenant and to have what we characterise as a "seat at the table" alongside the company's other major stakeholders, the relationship between the trustee board, the employer and third parties has changed in recent years. The Pension Regulator's recent guidance on Monitoring Employee Support sets out very clearly that having a framework for assessing and reviewing the covenant is now an integral part of good scheme governance. It is in fact vital to put trustees in a position to make appropriate decisions about scheme funding and about corporate events which may affect the employer's ability to fund their scheme.

The trustee-sponsor relationship is often characterised today as analogous to that between a company and its bank creditor, although the characteristics of a pension scheme mean there are limits to the analogy. Nonetheless, trustees can learn from how banks and bondholders behave, particularly in a restructuring context. In turn, trustees can expect a more business-like, less paternalistic approach from company boards.

Trustee boards are developing governance structures to reflect the new realities. Examples of this are changes in board composition, with the position of 'insiders' such as the finance director increasingly seen as conflicted, and the use of structures, such as standing sub-committees, to deal with the challenges of decision-making on matters that cannot wait for the next scheduled full trustee meeting.

As the concept of covenant assessment becomes embedded in trustee governance, so the appropriate management of confidential financial information becomes important, perhaps leading to an informal agreement to share agreed information, a written protocol or even in some situations a legal agreement which documents the respective parties' obligations similar to the information undertakings in a bank facility agreement. The trustees or their covenant adviser will seek to establish a dialogue with senior management comparable to that with investors and perhaps with its lenders. For listed companies, the extent to which information is "price sensitive" and whether it can or should be disclosed publicly or privately with trustees is an extremely delicate matter which demands considerable judgment and sensitivity from trustees and their advisers. Confidentiality agreements are increasingly common.

The post 2004 regulatory framework for Clearance requires trustees to be continuously and actively engaged participants, addressing issues and asking questions that, in many cases, have not been raised with the sponsor company before, such as: how should the trustees react to a change of ownership of the company; or how does the company's strategy affect the scheme? Further, trustees have the right to be provided with relevant financial information in order to do so. This places new demands and responsibilities on trustees, most critically when the sponsor is in financial distress. They need: to put themselves in a position to engage responsibly with the sponsor, with due regard to corporate timetables and governance; to act proportionately in assessing the likelihood and potential impact of risks on the scheme and on their course of action; and to adhere to high standards of confidentiality.

In a reflection of corporate governance for listed companies, best practice for trustee boards is to establish a risk management framework through which the covenant is monitored on a regular basis. This framework includes sponsor covenant risk, funding risk and investment risk, areas which are intrinsically linked.

Effective pension management in relation to the sponsor covenant therefore requires developments in governance structures, behaviour and approach. On this foundation, trustees and their advisers can then work constructively with sponsors to ensure that the pension scheme is properly supported, and sponsors can deal with the financial needs of the pension scheme consistent with their management of other financial commitments.

This article is taken from a forthcoming book "Good Governance for Pension Schemes" (Cambridge University Press), of which the authors are joint editors

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