Sackers

Alert – Protecting schemes from sponsoring employer distress

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Introduction

On 12 November, TPR published guidance for trustees of all DB schemes, encouraging them to prepare now for the possibility that their sponsoring employer could face financial difficulties in the future. Trustees should also be prepared for any issues arising from Brexit.

Key points

- As their pension scheme's first line of defence, TPR states that DB trustees should act quickly to protect savers if they spot the warning signs of employer distress or insolvency.
- TPR emphasises that the earlier risks are identified, the more options and time trustees will have to protect members' benefits.
- All schemes are advised to adopt an integrated risk management ("IRM") approach, with workable contingency plans and suitable triggers.
- Access to relevant and up-to-date employer information, and active engagement with employers and other stakeholders, will be important to ensure schemes are being treated fairly, particularly where the employer needs to undergo restructuring or refinancing, or is making disposals.
- TPR makes clear that trustees should take professional advice, where appropriate. While paying for advice at a time of financial distress may feel uncomfortable, it is important for trustees to have a good understanding of their options.
- If trustees believe there is a material risk to their scheme and consider themselves unable to protect their members, they should contact TPR.

Background

Despite the government economic support packages, COVID-19 continues to have a profound impact on the economy, which is challenging scheme sponsors and the pensions industry.

When sponsoring employers experience financial distress, TPR notes that consequential actions taken by those employers can lead to significant pension scheme losses. For this reason, it expects trustees to put systems in place which allow them to identify and respond to risks early. As the sponsoring employer moves along the “corporate stress curve”, the options available to mitigate loss to the pension scheme inevitably reduce.

Being prepared

Best practice IRM approach

Taking decisive action before a sponsor shows signs of distress increases the chances of mitigating downside risk in the future. While not intended to be exhaustive, TPR sets out the main actions it expects trustees to be taking already “as part of the proper governance” of their scheme. Such actions may also “reduce the risk of potential scheme losses” due to an employer restructuring, refinancing or insolvency.

Trustees should:

- understand the employer’s legal obligations to the scheme and the possible outcome for the scheme in a hypothetical insolvency
- ensure effective risk management processes are in place. Where possible, legally enforceable contingency plans (with specific trigger points) “represent the best protection for schemes”. If these are not feasible, trustees should at least agree the actions that should be taken if such risks were to arise
- review scheme governance. In particular, TPR advises trustees to agree an information sharing protocol with the sponsoring employer, so that it is clear what information should be shared and when. It may also be useful to put non-disclosure agreements in place to resolve any concerns the employer may have about sharing sensitive information
- monitor the employer covenant to identify and mitigate sponsor risk. Trustees should review and challenge financial forecasts, and stress test assumptions as a part of the monitoring process. They should also review the sponsor’s financial forecasts to see how it will meet future banking covenant tests, and review the timing of debt maturities so that key future financing risks can be monitored
- seek appropriate advice. Professional advice can highlight options or problems that may not be clear and, by supporting good decision-making, “can help save money in the longer run”. In addition, taking advice before a sponsor shows signs of distress could help trustees to secure a positive outcome for the scheme before other stakeholders compete for value.

Recognise the warning signs

To be able to act early, trustees must be able to spot when their employer is showing signs of financial distress. Although specific warning signs may vary according to the nature of the sponsor’s business, TPR considers the following to be key:

- cash flow constraints
- credit downgrades
- removal of trade credit insurance
- disposal of profitable business units

- loss of a key customer contract.

Distressed sponsor

Where trustees consider their sponsor's covenant is deteriorating, TPR expects them to:

- monitor the covenant more frequently and intensely. Trustees may also need to switch their focus from long-term forecasts to shorter-term financial information
- perform a detailed review of the scheme's position in distressed scenarios. This is likely to require specialist restructuring advice
- review their investment strategy. Investment risk becomes more significant as many investments rely on a medium to long-term horizon to smooth out short-term volatility
- understand the role of other stakeholder interests in distressed scenarios. Specialist advice should be taken when a sponsor has complex financing arrangements which involve multiple parties
- consider how to manage member concerns and protect them against scams. If members are worried about the scheme's sponsor, they could be more vulnerable.

Should the sponsor seek easements from the scheme, such as a deferral of deficit repair contributions, the trustees should take advice (see TPR's Covid-19 guidance for DB trustees). In brief, trustees should be satisfied that the scheme is being treated fairly in comparison with other stakeholders and creditors, and should look to other forms of security to mitigate risk.

If a sponsor insolvency is looking likely, to make sure that all options to protect the scheme's position have been explored, trustees are advised to take advice from restructuring specialists. Having familiarised themselves with its contingency planning guidance, they should also engage with the PPF to understand what practical steps will need to be taken to prepare the scheme for PPF assessment.

Action

DB trustees should review their current systems and processes to ensure they address the issues raised in this latest guidance, and be prepared to take necessary action to protect their members. For further information, please speak to your usual Sackers contact.

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