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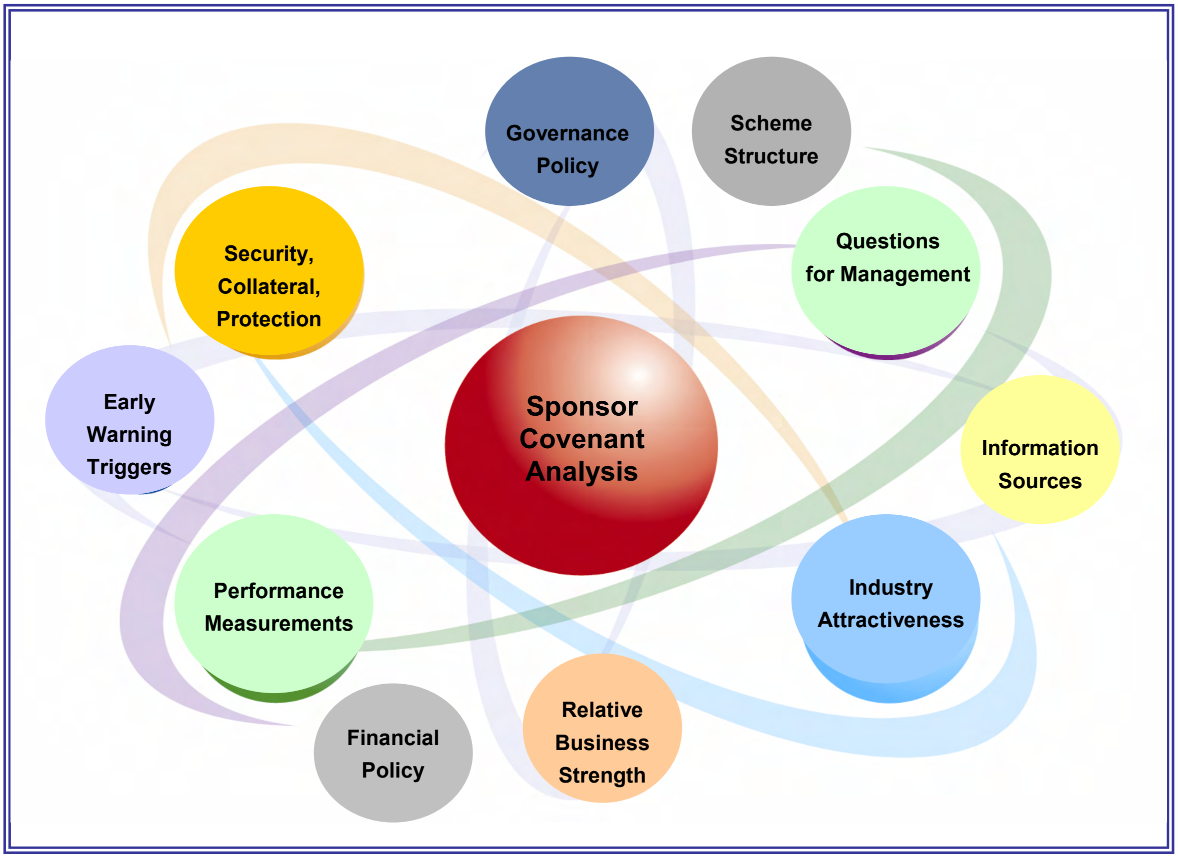
Issue 97: DB schemes – why your scheme sponsor is more important than ever

Now, more than ever, trustees need to understand whether their company sponsor will still be around in the long term. Why? It's because the biggest risk faced by many pension schemes is not volatile investment returns, nor is it interest rate changes or longevity improvements. Instead, it is the risk that their sponsor becomes unable to pay sufficient contributions to ensure that the benefits are paid in full. So, how can trustees begin to assess whether their sponsor is strong or weak and – more importantly – what actions should they take once they have made their assessment?

Sponsor Covenant Analysis – Key Issues

The chart below shows the key issues that trustees are facing in monitoring the employer covenant.



Sponsor Covenant – 10-point Plan for Trustees

Trustees should:

1. Carry out at least an annual review with the finance director. Trustees should not be the poor relations of other financial stakeholders, with inferior access to management and timely information.

2. Understand the industry risk of the sponsor. Remember that the long-term health of any sponsor is highly dependent on whether or not the industry has attractive characteristics (eg stable or growing revenues with decent profit margins).

3. Review the business plans of the sponsor. Does the plan make sense? How risky is it? Who are the sponsor's competitors and where does the sponsor rank among them?

4. Review materials produced by third parties. If the sponsor or its parent company is a quoted plc, there should be research reports with projections widely available. Similarly, if the sponsor or a related company has a credit rating, trustees should be able to access sector and company reports.

5. Check the financial policy of the sponsor – is it aggressive or conservative? High leverage and high dividend payments can create value for shareholders but mainly downside risk for the pension fund.

6. Review the company's financial performance. Trustees can track a handful of key parameters such as revenues, order book, profits, sales margin, etc. The trend analysis is more important than the exact definition of any parameter. It is a good idea to identify trigger points whereby trustees can initiate further discussions with the sponsor.

7. Check whether there is any evidence of willingness to look beyond the sponsor's covenant. For example, if the parent company agrees to increased funding rates or special contributions, etc, this shows tangible evidence of parent support.

8. Check where pension deficits rank in a default scenario. Note that pension funds rank as unsecured lenders in a company wind-up scenario and banks will normally have first charge on assets.

9. Understand the corporate organisation structure and relationships with the sponsor(s), parent companies and other group companies/schemes. Legally, the scheme relies solely on the sponsor(s), unless there is a contractually binding support agreement from a parent company or a third party.

10. Have a framework to manage the sponsor covenant analysis. It's not a one-off event and, like a regular medical check-up, tracking changes over time can be as important as the stand-alone results.

Weak sponsor – what can a trustee do?

Where the sponsor is weak, a higher funding target and accelerated deficit reduction plan should be ideally adopted in order to protect the security of members' benefits. However, in current conditions, there may be little or no financial flexibility at the sponsor. Now, in the short term, trustees need to balance their desire to get more funds into the scheme with the long term health of the sponsor and its ability to continue supporting the pension scheme.

But there are alternative forms of security to consider. At Hewitt, we have helped our clients introduce many different types of alternative security into their funding plans. One of the most common forms of alternative security is a guarantee – other solutions include a letter of credit from a bank or a charge on fixed assets.

Based on the results of Hewitt's 2008 Client Survey, sponsors are becoming increasingly receptive to the use of alternative security (depending on what is provided), as it can help manage cashflows, reduce PPF levies and reduce the likelihood of accounting surpluses arising that cannot be recognised on the balance sheet. And if cash remains tight, alternative or contingent security may just be the only win:win opportunity for sponsors and trustees.

If you have any questions on this Spotlight please contact your usual Hewitt contact or Aidan O'Mahony (+44 (0) 20 7939 4447).

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