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December 2020

Legal Update

The Pensions Regulator – guidance on protecting schemes from employer distress

Introduction

With the COVID-19 pandemic continuing to have a profound economic impact on employers, new guidance has been issued by the Pensions Regulator (**"tPR"**) for trustees of defined benefit schemes on remaining alert, planning, and being prepared. It is also a reminder of tPR's principles of good practice, particularly when seeking to future proof a pension scheme against a sponsoring employer's distress.

An overview of the guidance

The emphasis is on adopting **risk-based principles**, on an ongoing basis, to identify risks earlier and act sooner. Trustees, as the first line of defence for savers, are urged to take the steps set out below.

- **Review** their integrated risk management (**"IRM"**) and governance procedures and keep them under regular review. The IRM should be fully and clearly documented with workable contingency plans and specific trigger points (e.g. trustees should not wait for formal confirmation of a covenant downgrade at an actuarial valuation). Ideally these contingency plans should be legally enforceable. Trigger points could be warning signs, such as the loss of key customer contracts, irregular timing of payments, information not being freely shared or significant changes to the trustee board.
- **Understand**, with the benefit of appropriate advice, the legal obligations of the employer to the scheme and the possible outcomes for the scheme in a hypothetical insolvency. This will assist when assessing the scale of risk and, if relevant, any proposed mitigation. Familiarise themselves with the scheme trust deed and rules and any other legally binding documents – it is important that trustees understand what powers and protections they have under such governing documentation. A list of legal obligations to the scheme can be found at Annex 1 of the guidance.
- **Consider** scheme governance and any potential conflict of interests which will need to be managed, particularly for those holding senior roles within the sponsoring employer. Again, thinking about this now and having contingency plans in place for a sponsoring employer goes into insolvency will be helpful. Trustees should continuously review the skills and experience on the board and where there are gaps in knowledge, consider training or further appointments to ensure the board is well equipped to deal with unfolding scenarios which will often be time sensitive.

- **Engage** regularly with the sponsoring employer to identify keys risks early on. Agreeing an information sharing protocol upfront will be beneficial for times of distress. The pension scheme is generally one of the largest creditors of an employer and should be treated as such. Open dialogue with the employer is encouraged and trustees should be able to demonstrate why information is sought. The further along the distressed curve, the more frequent the employer's cash flow forecasts should be and so the trustee should ask for sight of such forecasts. Seek to understand the information being produced by management and align information requests. Areas to explore should include:
  - » What is the position of the other creditors?
  - » What is the capital structure of the sponsoring employer?
  - » What is the inter-company trading and financing position?
  - » When are the debt maturities?
- **Monitor** the covenant on an ongoing basis. Review and challenge financial forecasts and stress-test assumptions. Consider the impact forecasts will have on banking covenants and what scenarios might result in a covenant downgrade. The frequency of covenant monitoring should reflect any heightened risk profile. When heightened, the focus should move from long-term forecasts to short-term financial information. When an employer shows signs of distress, trustees should review the scheme's key risk areas to make sure this still satisfies the overall scheme objective. Trustees should also understand the potential returns to the scheme in a theoretical insolvency.
- **Act before** a sponsoring employer shows signs of distress and do not delay in putting robust scheme protections in place. Forecast banking covenant defaults may lead to lenders reducing undrawn cash or credit from a banking facility, seeking security and/or increasing schedules of repayment of debt. Any delay by the trustees at this stage may mean that lenders and other stakeholders are in a better position to exert control over the sponsoring employer and extract value, potentially to the detriment of the scheme.
- **Communicate** with and support members. Trustees are already expected to have well-established channels of communication with members. However, in times of distress tPR encourages trustees to ensure members are updated and understand the protections in place. Consider preparing a communications strategy now and providing education around potential scams linked to statutory transfers which may be more common when members are concerned about a sponsoring employer in times of sponsor distress.

In the current economic climate, tPR is encouraging all trustees to take action, understand their legal obligations and seek appropriate advice, where relevant. The guidance recognises that paying for advice at a time of financial distress may feel uncomfortable, however trustees need a good understanding of their options to protect the scheme and its members. Specialist advice is particularly important when a sponsoring employer has complex financing arrangements involving other parties and trustees need to be able to understand the scheme's position in relation to other creditors.

Contingency plan for investment risk

The guidance highlights the significant investment risk when there are concerns about sponsoring employer distress as pension scheme investment strategies are usually long-term. Sponsor insolvency can crystallise short-term investment losses so trustees should consider the value at risk, what level of investment is supportable and whether the level of interest rate or inflation hedging can be increased.

Trustees should also consider implementing a contingency plan on the following:

- **Review** the investment governance to ensure trustees can react quickly to what is commonly a fast-changing situation;
- **Understand** any additional asset classes, where relevant and prepare for the hiring of any new investment managers; and
- **Decide** on the de-risked asset allocation which should be targeted, including the level of interest rate or inflation hedging associated with such a strategy.

Employer request for easements

A sponsoring employer may seek various easements from the scheme when it is in distress, which may include a request to defer deficit repair contributions or to release security held over assets. A request for the release of security may be to facilitate the employer selling certain assets or obtaining funding. However tPR recognises it is very unlikely that security release will be in the members' best interests so specialist legal and financial advice should be sought.

Trustees should regularly engage with their sponsoring employer to obtain as much information as possible about the easement sought to enable the trustees to ensure that the scheme is being treated fairly and that any burden is shared proportionately with other creditors/stakeholders. They should consider the scheme's position if any such easement is to be granted and whether the sponsoring employer is more likely to be able to continue as a result as against the scheme's position if the employer becomes insolvent now. The guidance suggests that trustees consider whether it is appropriate to call a valuation, use contribution powers or enact/reset contingency plans already in place.

Impact of corporate activity

Corporate activity such as refinancing or restructuring might cause material detriment to the pension scheme. It is important for trustees to understand what is being contemplated, why and what impact this will have on the scheme. If trustees consider a transaction will cause, or already has caused, material detriment then the trustees should seek mitigation, albeit the chances of obtaining mitigation may be limited in a distressed situation.

Restructuring plan - likelihood of insolvency

If a sponsoring employer insolvency is looking likely, specialist advice should be obtained to consider all options available to protect the scheme's position, which may include enforcement. Trustees are reminded of their reporting obligations in certain scenarios and the practical steps to take to prepare for a Pension Protection Fund (**"PPF"**) assessment, such as:

- reviewing steps to realise charges and assets contingent on the employer's failure;
- putting in place contingency plans for documents and data held on company premises;
- reviewing employers for PPF entry purposes;
- putting in place contingency plans for payroll and banking independent of the employer; and
- making sure a complete set of governance documents is held.

The Corporate Insolvency and Governance Act 2020 (**"CIGA"**) came in to force in June 2020 and introduced new procedures for distressed companies including a new restructuring plan and a standalone moratorium. CIGA is a complex piece of legislation, largely untested and includes potential new risks to be addressed by trustees. TPR suggests obtaining specialist advice on these new procedures and the risks they pose from a restructuring professional.

Commentary

The guidance from tPR is a timely reminder that, in this current climate, trustees should be taking active steps to plan ahead, review their legal position and prepare for all eventualities.

What should trustees be thinking about from a practical perspective?

Financial health of the scheme's sponsoring employer	Points for trustees to consider
Best practice to mitigate scheme risk	• Legal obligations • IRM • Governance • Covenant monitoring • Advice
Where sponsoring employer is showing signs of financial distress	• Regular sponsor engagement • Increased covenant monitoring • Scheme security structures • Investment strategy • Equitable treatment • Corporate activity/transactions • IRM triggers • Specialist advice
When insolvency of sponsoring employer is likely	• PPF contingency planning • Scheme administration • Security arrangements • Investment liquidity • Specialist advice

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