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Overview on covenant advice
Gazelle Corporate Finance

November 2015

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What do we mean by "sponsor covenant"?

In high level before we drill down a bit…

Covenant risk means reliance on sponsor resources – ultimately the risk to security of member benefits

- An evolving regulatory concept: how is the scheme supported legally and financially?
- Key elements:
  - ability to generate cash to support deficit repair contributions and asset underperformance
  - worst case ability to secure benefits on a wind-up/insolvency

Covenant risk needs to be viewed dynamically and in conjunction with other risks to the scheme

- Companies change (e.g. due to transactions, strategy, business dynamics)
- Investment and funding risk tolerance changes
- Regulatory best practice on measuring and managing covenant risk is also evolving

Developing concepts

- Covenant as a primary risk concept in its own right, driving investment strategy, funding assumptions
- Scheme "integrated risk management": dynamic, integrated, feedback loops not linear
- Common currency - covenant integration quantitatively rather than judgmentally

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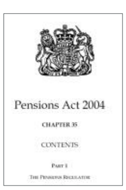
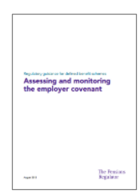
An evolving concept





2005 Pensions Act establishes scheme funding regime and TPR

2009: TPR Guidance on Clearance "willingness and ability"

2010 : TPR Guidance Reasonable affordability Importance of looking at legal and financial support

2014: TPR Code "Sustainable growth" Integrated risk management

2015: TPR Guidance "…legal obligation and financial ability"

Source: The Pensions Regulator website

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2014 Code on Funding Defined Benefits

Update driven by:

- Additional objective "to minimise any adverse impact on the sustainable growth of an employer"
- Developments since 2005 (closure of DB schemes, low interest rates, increased longevity, financial crisis, QE)
- Draft gave insight into how TPR segments the pension landscape – however "Balanced Funding Outcome" Indicator was not included in the final Code

Integrated risk approach

- Covenant "underwrites scheme risks and underpins the trustees' investment and funding strategies"
- Risk assessment tools encouraged – not to predict outcomes but to appreciate order of magnitude of all scheme risks, trade-offs and options to manage them
- Larger complex schemes - more sophisticated approaches: stochastic and/or scenario modelling

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2015 Guidance

Themes highlighted through the Guidance

- **Covenant concept:**
  - "the extent of the employer's legal obligation and financial ability to support the scheme now and in the future
  - "willingness" to support the scheme not supported by a legal obligation - only to be relied on in the short-term
  - guarantees and similar support also relevant to the extent to which they improve affordability or outcome on insolvency
- **Proportionality and consistency**:
  - covenant does not operate in isolation – "strength" relative to scheme's funding needs and investment risk
  - stronger covenant consistent with higher affordability
  - "sustainable growth" objective
- **Dynamic and behavioural:**
  - should look at short-term (within 2 years), medium term (2-5 years) and long-term (beyond 5 years), and insolvency
  - forward looking, contingency planning
  - collaborative, proportionate, risk-based approach
  - integration of risks

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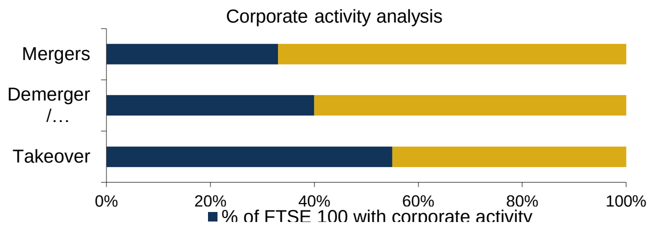
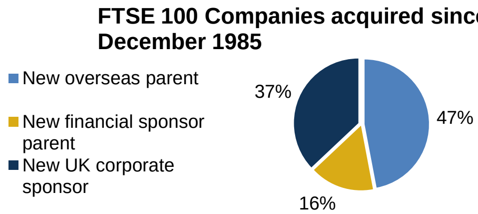
FTSE-100 Index 1985-2010



- 85% experienced major transactions
- 55% experienced takeovers
- 40% experienced downsizing
- …and 7% defaulted with 26% experiencing financial distress



When covenant is relevant

Funding reviews:

- Degree of prudence in Technical Provisions
- Recovery plan design and contingent asset protections

Setting investment policy:

- Reliance on sponsor over time
- Impact of de-risking

Corporate events:

- Mitigation of material detriment – actual and potential contingencies

Scheme events

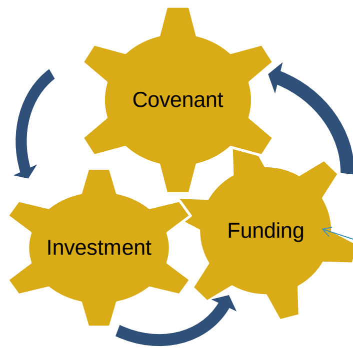
- Scheme merger – legal and de facto hurdles
- Scheme apportionments – regulatory “funding test”

Integration of risks

Sponsor covenant is increasingly viewed "holistically" alongside other scheme risks

Covenant determines ability to take investment risk

Economic risks
Inflation
Interest rates



Ability to repair future funding deficits determined by covenant

Funding levels - progress to defined target (e.g. self-sufficiency)

ALM models address uncertainty in investment performance

Level of investment risk determines funding

Longevity risk – uncertain size and duration of liabilities

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Integration of risks

Implications of viewing covenant in terms of the risk to the security of member benefits

- **It focuses attention on the increased reliance on the sponsor to fund deficit repair:**
  - closed, maturing, de-risked schemes are increasingly reliant on contributions to make up investment shortfalls
  - discounted benefits are expensive in a low rate / low return scenario and mortality improvements must be sponsor funded
  - contribution schedules are regularly re-negotiated: "affordability", "sustainable growth", default risk over time
- **It highlights the uncertainties inherent in a defined investment strategy:**
  - ALM conventionally assumes set recovery plan profiles, with no increased reliance on sponsor for future deficit repair and no affordability constraints
  - correlation of sponsor risk exposure and asset exposure
- **It highlights the inadequacies of a "snapshot" view of risk given the long-term uncertainties:**
  - covenant risk can be, at different times over the projected liability period, both discontinuous and trend-like

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Where next?

Assessment and positioning of covenant risk will continue to develop. Our perspective:

- long-term covenant risk CAN be captured by stochastic modelling techniques
- Where next for EIOPA? Covenant is more than a notional balance sheet item
- Equally important is the advice following the assessment of risk.

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