



## Developments in Covenant Assessment

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## Developments in Covenant Assessment

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- Covenant monitoring and measurement
- Integrating financial strategy
- Short term challenges
- Longer term challenges
- Issues for multinationals
- Insolvency
- Contingent Assets
- The Holistic Balance Sheet

## Covenant assessment

Measurement of covenant risk: November 2010 TPR Guidance

- Already best practice for larger well run schemes?
- No longer “willingness and ability”; is the focus now just on legal obligation and financial position?
- KPIs, metrics and actions arising
- Annual monitoring/ standing item – how frequent?
- Using in-house and external skills

Management of covenant risk

- Incorporating educated risk judgment
- Integration with pension risk management

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## Covenant assessment

### The legal structure of covenant support

- TPR focus on the participating employer group alone
- Is the particular structure historical accident or fit for purpose?
- Informal reliance on parental group – affordability yes? – insolvency no
- ... but can judgements about insolvency/default be made without reference to the wider group?
- *Is a change in the support structure the easiest way to resolve covenant deficiencies?*

### Affordability of pension contributions

- Apparently straightforward to measure ( e.g. coverage of pension costs by free cash flow)
- ...but requires detailed cash flow projections to analyse and stress test
- ... and subjective assessment required on the validity of competing claims on cash flow (shareholders, bankers and capital investment)
- Long term liabilities vs. long term sponsor growth prospects and investment needs
- *Reasonable affordability is a matter of professional judgment*

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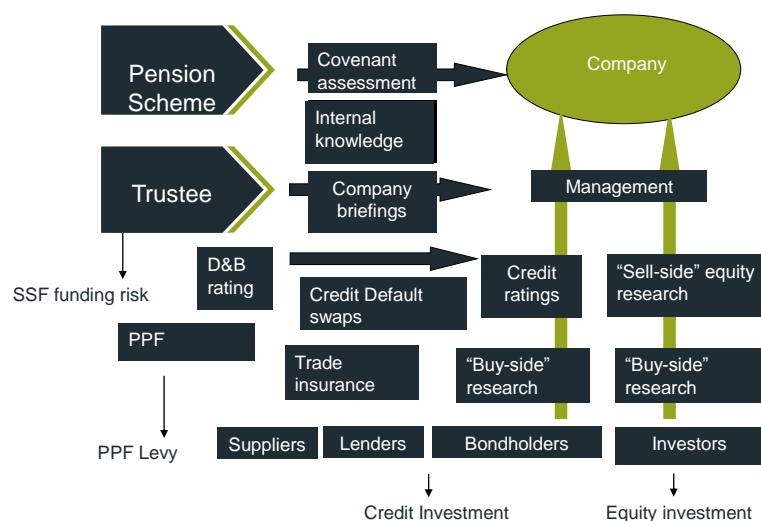
## Integrating financial strategy

- Nature and strength of the covenant
- Strategy for de-risking/flight-path to self-sufficiency
- Actuarial assumptions for Technical Provisions
- Actuarial assumptions for Recovery Plan
- Sponsor's use of capital
- Sponsor's share price and credit rating

*It is not all actuarial!*

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## Different stakeholders monitor corporate strength from differing perspectives



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## Shorter term challenges

- Business / economic cycles: poor macro-economic prognosis, developed vs. emerging market
- Funding and liquidity challenges
- ...but a number of corporates *are* performing well and generating cash in the UK

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## Longer term challenges

### Changes in the FTSE 30 from 1985-2011

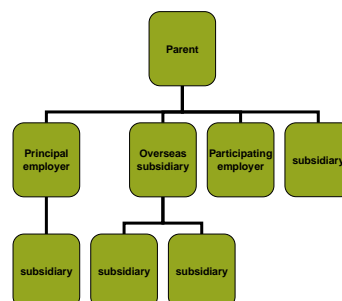
- Significant merger and demerger activity
- 10 acquired by overseas parents
- Not binary “default/ healthy” (only 1 defaulted)
- Only 4 companies remain intact
- Only 4 companies had a benign experience

*Significant changes in corporate risk exposure can be expected over the life-time of a scheme*

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## Issues for schemes supported by global corporations

- A particular UK pensions challenge with global corporate sponsors
  - Centralised treasury and allocation of capital, cash pooling
  - Management and market reporting by product / activity not by statutory entity
  - Tax driven restructurings
- ...pressure to distribute up to the parent
- This does not sit easily with TPR position



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## Insolvency and other Risks

### The position on insolvency/default

- Reflects value of the residual business / assets and scheme's relative creditor ranking
- "Desk-top" insolvency analysis can give some indication based on available information and some approximate value "haircuts" against asset categories
- *The path to insolvency: tortuous; finance providers competing for priority and imposing harsh terms to waive banking covenants*

### Risk factors

- *Long-term funding risk implies assessment also of wider business risk factors e.g.:*
- Cyclicity or exposure to business or macro economic cycles?
- Discontinuance risks e.g. political or regulatory change, environmental, technological shifts
- Risks inherent in the financing structure (e.g. utility vs. industrial sponsor)

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## Contingent Assets

- Increasingly offered by sponsors and the range of asset classes is also growing (property, brands, treasury stock, whisky, receivables)
- Sorting the wheat from the chaff - securitisation market warnings
- Double jeopardy risk
- Governance
  1. Is it a reasonable asset for a pension scheme?
  2. Constructive engagement
  3. Due diligence and evaluation

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## Evaluation of Contingent Assets

### Attractions to the Company

- Tax and cashflow advantages (to current FD)
- Presentation to the market

### Attractions to the Scheme

- Contingent asset: quasi security

### Possible concerns / issues for the Company

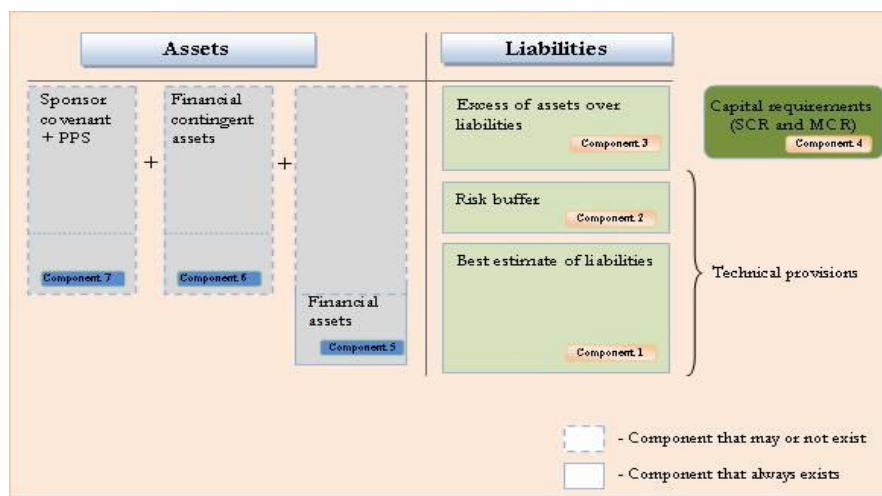
- Long term asset structures / (quasi) securitisation
- Risk to e.g. banking facilities
- Potential constraint to future finance raising?
- Significant implementation costs

### Concerns/ issues for the Trustee

- Real value compared with cash contributions?
- Risks associated with long-term inflexible arrangements
- Additional complexity – requires detailed “what if” scenario planning and ongoing monitoring

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## EIOPA consultation – the Holistic Balance Sheet



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## The Holistic Balance Sheet

- Places sponsor covenant in its proper perspective - a vital element of pension security
- Numerous challenges to practical implementation – EIOPA will conduct a Quantitative Impact Study
- Concerns about its use - what is the purpose of precise quantification?
- Is a Pension Protection Scheme really an asset?
- The Occupational Pensions Stakeholder Group prefers “Holistic Framework”

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## Quantification?

- Case 1 - Strong covenant:
  - Sufficient to certify deficit covered?
- Case 2 - Weak covenant:
  - No point in measuring with precision?
- Case 3 - Weak covenant of Statutory Employer but strong covenant of wider group:
  - Real issue is strengthening the legal position?

*What will the Regulator do with the information?*

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## Implementation Issues

- Huge range of sponsor circumstances
- Valuation of intangibles, such as brands
- Intercompany guarantees and cash sweeps
- Reliance to be put on the wider group
- *“EIOPA recognises that there is much further development needed to implement the HBS concept and that cost/benefit analysis will be important.”*

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## Concepts in the IORP Directive challenged under HBS

- Self-investment constraints
- Exclusion of internally funded (book reserved) pensions

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## Treatment of Pension Protection Schemes

Distinction between ongoing and insolvent sponsor

- Ongoing - PPS irrelevant other than cost of levy - ongoing prudent funding assumptions or flight plan
- Insolvent - PPS highly relevant - no further action available

*Is a PPS really an asset for the HBS?*

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