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Current Issues in Pensions 2012

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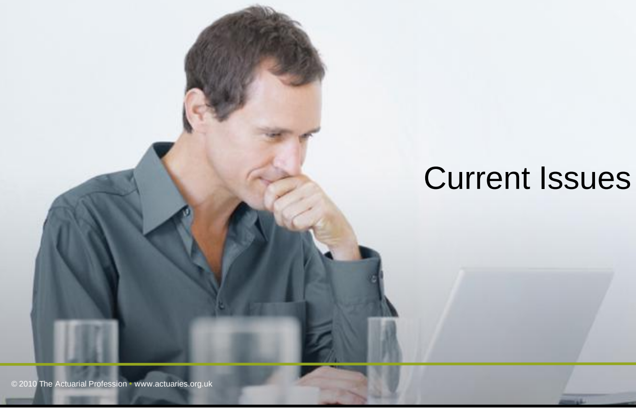

# Current Issues in Employer Covenant

22 March 2012



## Agenda

- What is covenant & what do we do?
- What is the link to investment & funding?
- How should the factors interact?
- Practical considerations?
- The Holistic Balance Sheet & IORP II

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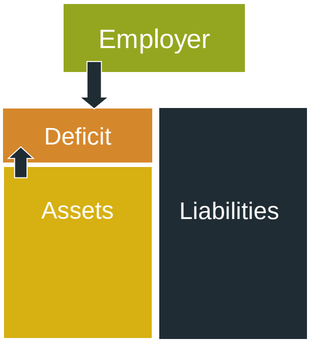
## What is covenant & what do we do?

- Funding level of DB schemes vary over time as assets and liabilities do not necessarily move together
- Schemes depend on sponsor contributions and investment returns to address any deficit
- Ability of sponsor to remedy any deficit should drive trustees' ability to reflect risk in setting Technical Provisions and investment strategy

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## Regulatory Guidance: Monitoring Employer Support

**(November 2010)**

- Greater emphasis:
  - prospective analysis of covenant
  - legal aspects of the covenant
  - monitoring the covenant
  - need for professional advice
  - need to understand insolvency priority
- Less emphasis on willingness
- Practical help:
  - assessing and monitoring covenant
  - appointing an adviser
  - the use of contingent assets

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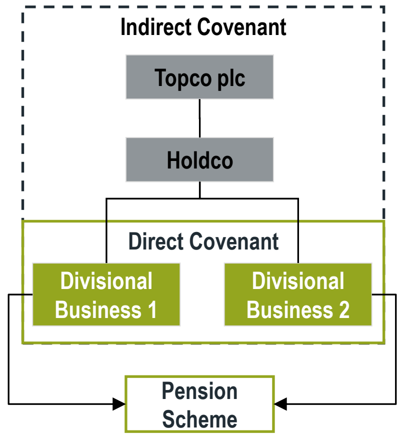
## Direct and Indirect Covenant

- ‘Direct Covenant’ represents the financial strength of the legally binding support provided to the Scheme, e.g. the Principal and Participating Employers
- ‘Indirect Covenant’ represents the extent to which support from the wider group can be taken into account, e.g. financial strength and ‘willingness’ of wider group to support the UK pension scheme

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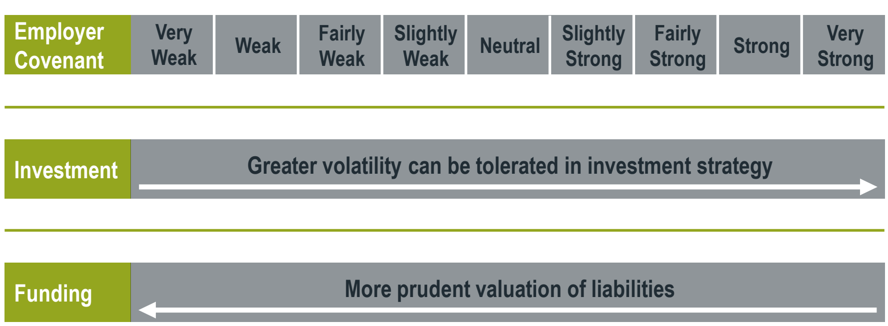
## An objective scale of reference – good or bad idea?

- Our scale seeks to describe the risk, from a funding perspective, associated with the covenant and considers that risk in terms of the likelihood of being able to fully fund pension obligations over the life of the Scheme

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## Scheme-specific Funding and Employer Covenant: Theory vs Practice

| Intended process | In practice? |
|---|---|
| Start with covenant assessment | Start with affordability |
| Consider asset strategy | Asset strategy agreed unchanged |
| Consider Technical Provisions | Technical Provisions discussed |
| Consider affordability | Recovery Plan and Technical Provisions driven by affordability |
| Combine to structure appropriate recovery plan | Recovery plan agreed with Trustees |
| Recovery plan agreed with Employer | Covenant can become "Tick box" exercise |
| Regulator submission | Regulator submission |

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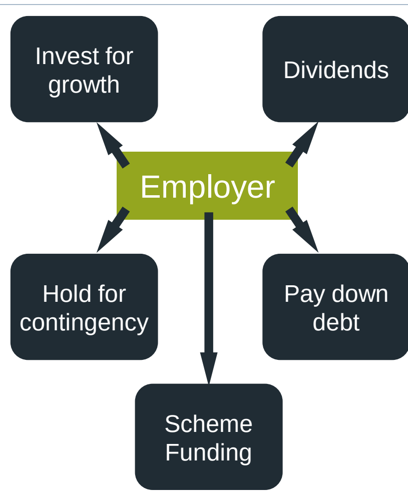
## Reasonable affordability

- Starting point will be to identify free cash flow generated by employer
- Scheme is not the only call on cash: absolute vs 'reasonable' affordability
- If debt paid down debt then this could be positive for the covenant
- Generally dividends not a reason to limit scheme contributions
  BUT where employer faces challenges it may need to call on shareholders

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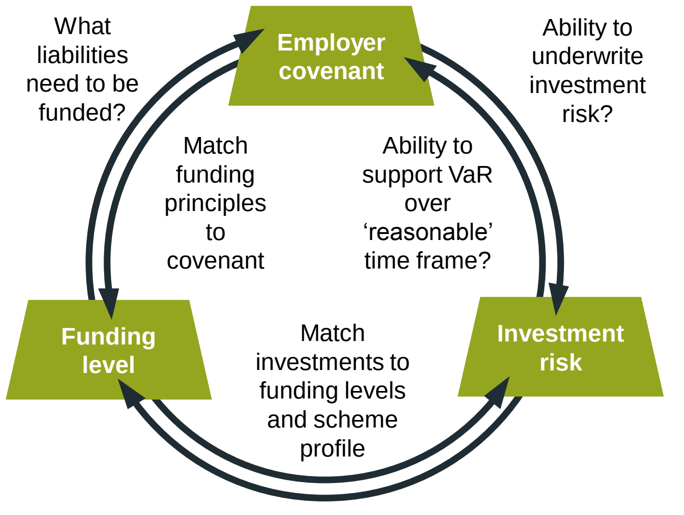
## Aligning covenant and investment strategy




Investment make-up impacts assumed returns and funding

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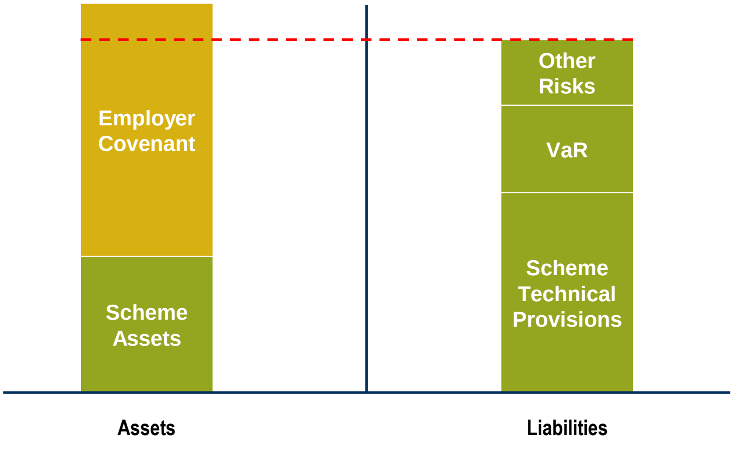
## How should the factors interact?

- Covenant provides cover for Technical Provisions, investment risk (VaR) and other risks (regulatory, longevity, etc)

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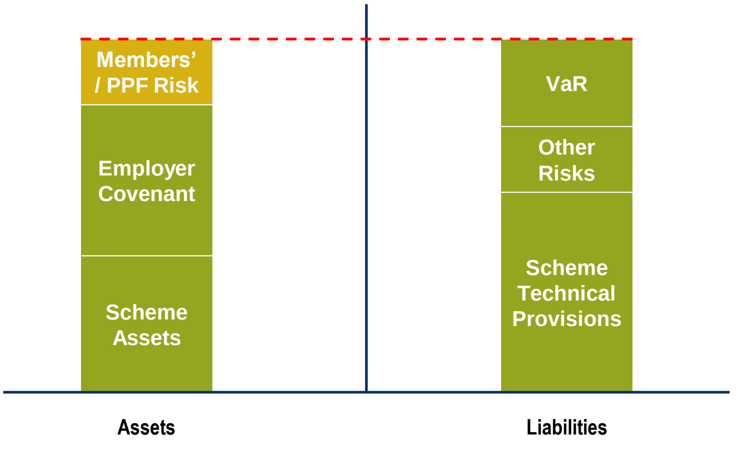
## How should the factors interact?

- Where Covenant is insufficient, risk is borne by Members and/or PPF

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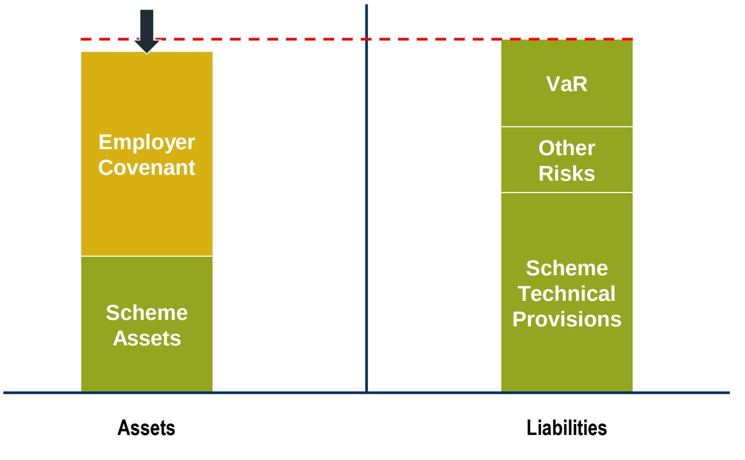
## How should the factors interact?

- As covenant strength falls…

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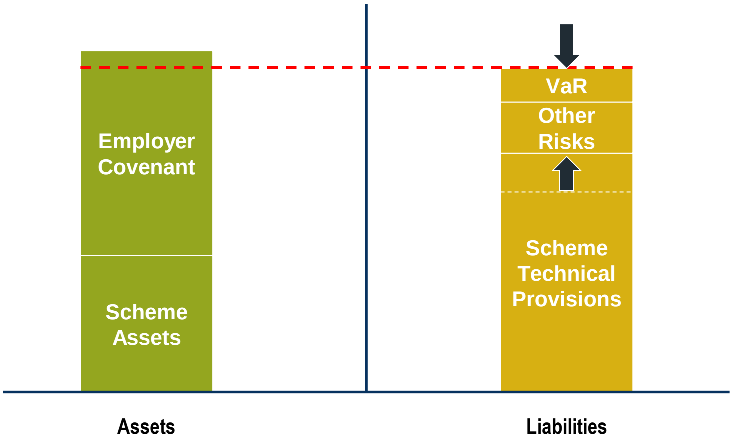
## How should the factors interact?

- …so should risk, leading to higher Technical Provisions as investment return assumptions fall and prudence in funding basis increases

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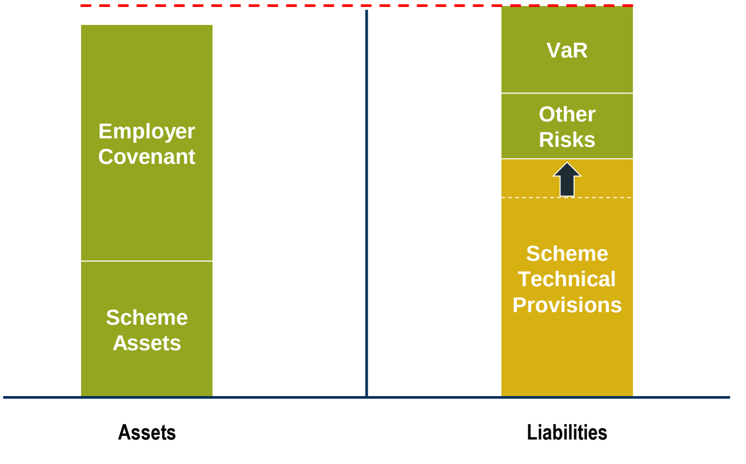
## How should the factors interact?

- Alternatively, increased Technical Provisions resulting from a scheme valuation…

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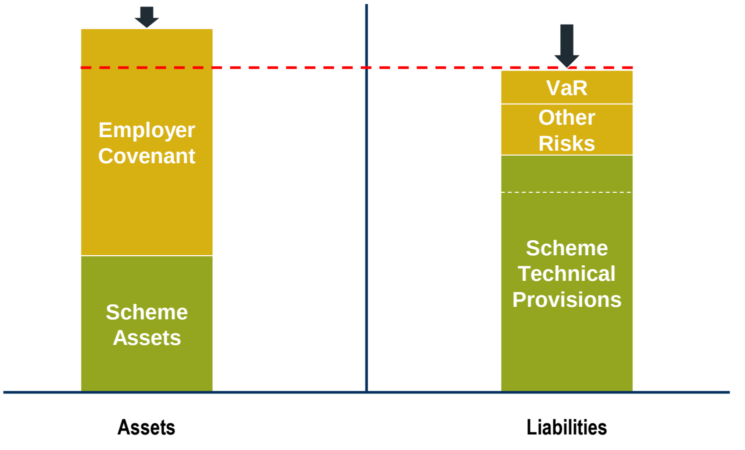
## How should the factors interact?

- …. may prompt risk reduction – Covenant may also deteriorate as a result of funding movements

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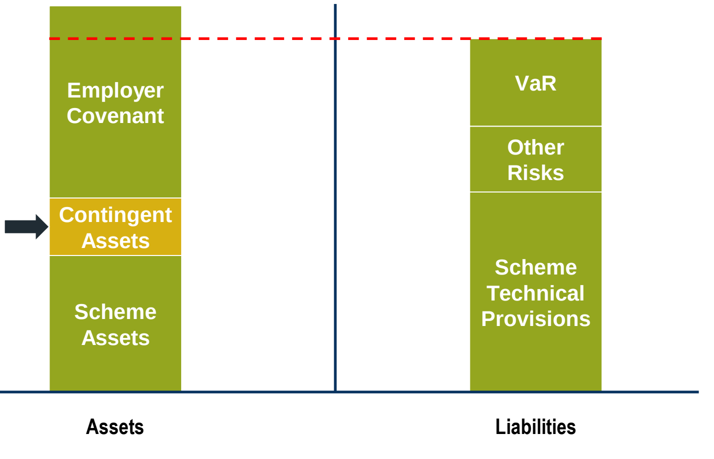
## How should the factors interact?

- Contingent assets might be used to boost Scheme support – Covenant enhancement will depend on nature of assets

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# Practical considerations

- Example benchmark return seeking asset allocation

| Employer Covenant | Very Weak | Weak | Fairly Weak | Slightly Weak | Neutral | Slightly Strong | Fairly Strong | Strong | Very Strong |
|---|---|---|---|---|---|---|---|---|---|
| Ongoing | c10% | | 10% - 30% | | | 30% - 50% | | 50% | |
| Closed (young) | c5% - 10% | | 10% - 15% | | | 15% - 30% | | 30% | |
| Closed (mature) | c5% | | 5% - 10% | | | 10% - 15% | | 15% | |
| Funding | More prudent valuation of liabilities | | | | | | | | |

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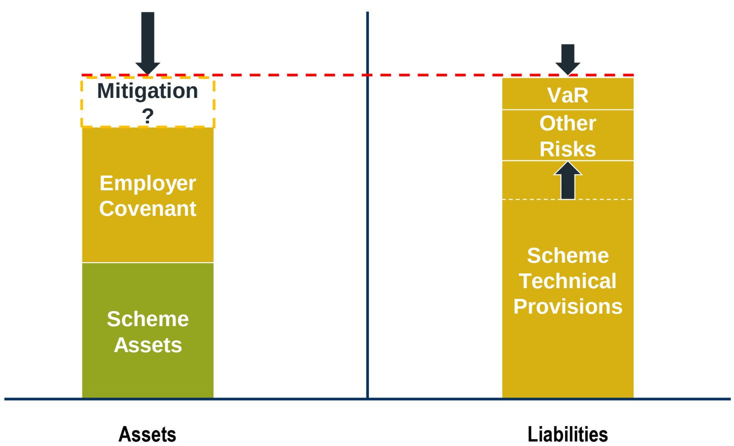
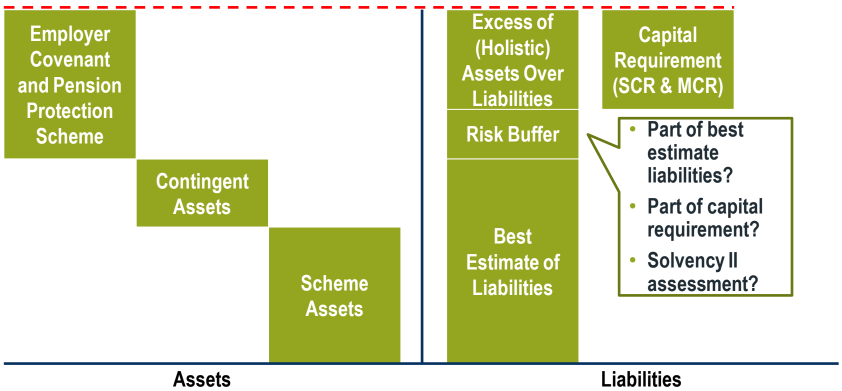
# Example – sale of business line

- Loss of covenant may leave a scheme lacking support and could give rise to mitigation covering both de-risking of investments and funding basis changes



## EIOPA consultation – the Holistic Balance Sheet




**KEY**

EIOPA – European Insurance & Occupational Pensions Authority
IORP – Institutions for Occupational Retirement Provision
MCR – Minimum Capital Requirement
SCR – Solvency Capital Requirement

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## Can covenant be quantified? Nice idea but…

- 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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## Treatment of Pension Protection Schemes – the UK environment

- Distinction between ongoing and insolvent sponsor
  - Ongoing/sufficient – PPF ‘shielded’ by Employer Covenant
  - Insolvent/insufficient – PPF regarded as (limited) part of holistic assets
- Where should PPF be on the holistic balance sheet?

*Is a PPS really an asset on the holistic balance sheet?*

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## Best estimate of liabilities – two approaches to funding

‘Risk free’ rate

Two levels of technical provisions

- Level A – Europe wide ‘risk free’ valuation basis
- Level B – expected investment return
- ‘Scheme owned’ assets to cover Level B only?
- Level A and B converge over time?

*How will current arrangements change?*

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## Implementation issues

- Huge range of sponsor circumstances
- Valuation of ‘unusual’ assets, such as brands
- Reliance to be put on the wider group & PPS
- Insolvency risk & ‘Failure Score’
- Quantitative Impact Study
- Time frame?

*“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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## Closing comments

- Funding and investment decisions often not driven by consideration of Covenant
- We believe it is possible to link Covenant more quantitatively with funding and investment using VaR techniques
- Scheme actuaries and investment consultants already prepare VaR analysis (i.e. Asset Liability Modelling) for trustees
- Consistent with developing thinking regarding “PPF drift”
- By working with actuarial and investment advisers, the Covenant adviser can encourage a more joined-up approach to risk management
- IORP II encourages a holistic view and an integrated approach

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