



Institute
and Faculty
of Actuaries

Report into the impact of Dividends and other covenant leakage on Pension Scheme Funding

Institute and Faculty of Actuaries Working Party

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Overview

The Pensions Regulator (“TPR”) has increased its focus on dividends and covenant leakage propelled by corporate failures and reports of disparity between dividend payments and Deficit Reduction Contributions (“DRCs”). There appears to be very limited existing research on the link between dividends paid and the impact this can have on scheme funding and ultimately outcomes for members. TPR introduced clear links between covenant strength and its expectation for dividend to DRC ratios in the 2019 Annual Funding Statement and subsequent publications. While the underlying reasoning for this guidance is clear, the empirical support for the ratios appears less rigorous and could be open to challenge.

It is important that the recent focus on dividends does not distract from other forms of covenant leakage, which are often harder to identify and measure but are just as important to consider as they can potentially have a greater impact on scheme funding and security. Indeed, the case studies in this report from recent high-profile corporate failures show that other forms of covenant leakage appear to have played a more prominent role in some of the failures than dividends.

Trustees and Employers often look to actuaries to help them understand the latest regulatory requirements and how TPR might view valuation and funding negotiations. This increasingly means helping Trustees interpret TPR’s expectations when it comes to Recovery Plan lengths and the interaction with dividends. While actuaries are capable of communicating TPR’s expectations, they should also make clear the distinction between what is ‘guidance’ from TPR and what is legislatively required, i.e. the dividend ratios in the Annual Funding Statement are guidance and expectations, but there is no legislative requirement (at the current time) to adhere to that and actuaries should make this clear.

The wider funding and risk characteristics of the scheme and the financial health of the employer should be taken into account when considering an appropriate dividend to DRC ratio. These considerations may be significant and heavily influence the analysis. Therefore, a prescriptive approach to setting a dividend to DRC ratio may not be optimal and is unlikely to adequately reflect the unique circumstances of each sponsor (and scheme).

The above also relates to any advice given by actuaries to Employers, who are likely to want to understand the implications of being outside TPR’s expectations.

Typically actuaries do not have sufficient expertise to give advice on covenant matters of which covenant leakage is a subset. However, their professional responsibilities require them to raise concerns either about specific circumstances or the need for specialist advice. As a result actuaries need to have a good understanding of the matters involved and should engage with the covenant advisor wherever feasible.

TPR and, for example in the case of company failure, other statutory bodies might perhaps question the actuary’s professionalism where they perceive inequitable treatment particularly where further advice has not been sought.

The potential for covenant leakage at or around the time of a corporate event is heightened. As a result actuaries should be mindful of the situation and seek to ensure clients seek appropriate guidance and advice.

The upcoming consultation for the new Code of Practice is likely to further expand TPR’s view on dividends and how they interact with Scheme Funding. In addition, anticipated changes to the notifiable event requirements are likely to assist trustees with identifying some other forms of covenant leakage. We would encourage TPR to provide as much support and evidence for further guidance, especially in the case of publishing any ratios, if possible.

Whilst the material in this report was considered prior to the Covid-19 developments during 2020 the importance of the topics discussed are perhaps even more significant as is the consideration of the implications thereof.

In conclusion, whilst the level of dividend payments is a current key focus due to TPR's increasing attention in this area, actuaries involved in pension funding discussions should be mindful of the wider definition of covenant leakage and should consider each case on its own merits.

This report aims to consolidate the information available at the time of writing by bringing together the relevant background information, implications for actuaries and practical considerations. It also touches on how the areas discussed might impact corporate events and highlights potential future developments in the area of this report for consideration.

Section 1 - Background

1.1 Introduction

This report considers the interaction between defined benefit ("DB") pension scheme funding and other calls on an employer's cash flow, focussing on key areas of **covenant**¹ leakage as identified by TPR. Whilst TPR has increasingly focused on the payment of dividends to company shareholders, we also comment on other mechanisms which move cash or other assets from the employer to beyond the reach of the pension scheme, which have also now been recognised by TPR.

The objective of this report is to provide Scheme Actuaries, employer appointed pension actuaries and pension actuaries working in investment with a more in depth understanding of the priorities and relationships between deficit reduction contributions in the context of wider scheme funding, and different types of value outflow from the employer. The intention is to facilitate an enhanced understanding which will benefit them in their role as trusted pension scheme advisor, improving the collaborative discussions that take place around funding strategies, investment strategies and covenant strength as part of scheme funding and integrated risk management (IRM) discussions.

To be able to consider the interaction between pension scheme funding and employer covenant leakage, with a particular focus on dividends, there needs to be an understanding of the legislative and regulatory requirements relating to scheme funding, as well as the corporate drivers which give rise to dividend payments.

The scheme funding requirements are predominantly set out in TPR's Code of Practice 03: Funding defined benefits² ("the Code"), and throughout this document references are made to the legislation which drives its principles. Whilst actuaries involved with DB pension schemes will be familiar with this code, they are less likely to be familiar with the drivers which give rise to dividend payments, an area which is traditionally seen as falling within the expertise of a covenant advisor.

The following sections provide the context and background of both the existing funding requirements of DB pension schemes and the interaction of dividend payments with these requirements, as well as consideration of the other forms of covenant leakage which could impact the funding arrangements of a DB pension scheme.

We have included throughout the report a number of case studies and examples to help illustrate how the theory behind this relationship might be experienced in practice whilst providing actuarial advice.

In preparing this report we have considered a range of publicly available information available at the time when this report was written, with key reference material noted in the Appendix 4. In particular, this report does not reflect or speculate upon the impact of draft bills or consultations which may affect the future operating environment.

The interpretation of this research has been considered by the working party as a whole and does not necessarily represent the views of any one individual or of their employer.

¹ The employer covenant is defined by the Pensions Regulator as the employer's legal obligation and financial ability to support their defined benefit scheme now and in the future.

1.2 The role of dividends

We set out in this section an overview of why dividends are paid by companies, how they are determined and how they compare to other forms of covenant leakage.

Why are dividends paid?

Dividends are payments made by companies to their shareholders out of profits or reserves. These payments reward shareholders for their investment in the company and can be issued as cash, shares, or physical assets, although cash dividends are the most common. Dividend payments are determined by the Board of Directors and must be approved by the company's shareholders.

Once a company has met its obligations, such as paying interest on debt, it is free to determine how it splits its capital allocation and cash flow between payments to any DB pension scheme, reinvestment within the business, and rewarding shareholders. However, the payment of dividends has typically been seen as a positive indication of the financial strength of a company (both current and expected) with ratios such as the dividend yield (annual dividend income per share divided by current share price) and dividend coverage ratio (earnings per share divided by dividend per share) commonly being used by investors to provide an indication of the future prospects of a company, alongside other financial metrics and information. As a result of this external messaging it can therefore sometimes be the case that the DB pension scheme is seen as a lower priority.

For example, if the dividend yield for a particular company is low compared to other similar companies (by industry or sector) then this may suggest that the share price is high because the market believes the prospects for the company are currently strong. Similarly, if the dividend coverage ratio is low this may indicate concerns about the future prospects for a company to sustain the recent dividend levels.

Investors typically like dividend paying companies for a wide range of reasons. These include the regular income they provide, the expectation that dividends will grow each year and the use of dividends in determining company valuations. Further, investors often believe that dividend paying companies may be more stable due to the need to plan for dividend payments and avoid the potential impact that a dividend cut may have on a company's share price. In addition, the tax treatment of dividends is often beneficial to investors.

How are dividends determined?

Whilst the Board of Directors has discretion over the level of dividends to be proposed to shareholders there are a number of theoretical models that suggest the level of pay-out that should be provided.

The stable dividend policy model aims to provide steady and predictable dividend payments each year aligning dividend payments with the long term growth of the company. Under this approach, investors are protected, to a certain degree, from the volatility in the company's year-on-year profitability. Under this model, in good years a company should hold back or retain a higher proportion of profits than in bad years.

The constant dividend policy model provides shareholders with a fixed percentage of the company's earnings as dividends each year. In this way, investors share the volatility of the underlying financial performance of the company.

The residual dividend policy returns to shareholders the funds available after capital expenditure and working capital commitments have been met. This approach results in volatile dividend payments but arguably reflects most accurately the underlying business operations.

Other, more complex, dividend models exist including Litner's dividend model which states that a company adjusts its dividend payments to its target pay-out ratio over time and the capital structure substitution model

which hypothesises that the Board of Directors will favour the capital structure that maximises earnings per share.

However, in reality, whilst a company may have a stated dividend policy it is unlikely to follow one of the above models in isolation and real life factors will influence dividend pay-outs. These include, but are not limited to:

- Maturity of the company
- Industry norms
- Debt profile of the company
- Overall health of the wider economy

These real life factors could outweigh any of the theoretical dividend models and we have found no evidence that the models outlined above are widely adopted in their purest form. Further, most companies benefit from the flexibility that arises from not having a formal, stated dividend policy.

Research on the relationship between dividends and DRCs

Whilst TPR has been looking at the ratio of DRCs to dividends for companies in the FTSE350 since 2017, there is little independent research in the public domain that explores this relationship and also takes into account covenant strength. One of the few examples of this research is a working paper BoE #714 published by Philip Bunn, Paul Mizen and Pawel Smeitanka entitled "Growing Pension Deficit and the Expenditure Decisions of UK Companies" which used data supplied by TPR on deficit recovery contributions alongside accounting data from Worldscope on UK companies to look in detail at this relationship.

The significant conclusions reached in this working paper relating to DRCs and dividends were that companies with both higher current DRCs and longer recovery plans are associated with paying lower dividends. In particular:

- companies reduce dividends by 9 pence for each extra pound of recovery contributions; and
- increasing a recovery plan by an extra year reduces dividends by a further 0.03%.

The report also concludes that firms making contributions to address pension deficits reduce investment and dividends payments on average. However, there is significant variability at the individual company level which is lost at the aggregate level and overall this impact has only a small effect in macroeconomic terms.

As a result of the above, the authors concluded that TPR has been able to balance the need to close pension deficits whilst allowing businesses to continue operating in a sustainable way. However, the increasing focus by TPR on the ratio of DRCs to dividends suggests that it considers that greater action should be taken by companies to address pension deficits when compared to dividend payments. This could also signal TPRs wish for less variation in approach at the individual level reflecting a more equitable treatment of the pension scheme as an unsecured creditor alongside shareholders.

There are also some limitations with the research outlined above. In particular, it does not make any allowance for underlying covenant strength or other factors that might impact on DRCs and dividends (e.g. affordability, level of debt, industry and maturity) and this is likely to explain the variability at the individual company level. It is also limited to listed companies and is therefore not representative of the full make-up of sponsors of DB pension schemes. As a result, any conclusions drawn at the wide aggregate level may fail to identify significant issues. Similarly, any trends that might be expected to emerge as a result of TPRs increasing focus on this area may not develop as expected, due to these underlying factors.

If this research could be further refined and developed to segregate the data into company groupings with similar covenant (and scheme) characteristics this may potentially provide more relevant empirical evidence to facilitate this debate and inform guidance on appropriate ratios.

1.3 Other forms of covenant leakage

Information on dividend payments made by a company is readily available as it is disclosed in a company's annual report and accounts. Therefore, it provides an easy external metric to monitor, by both TPR and trustees, and, with little or no input from the company, a comparison with DRCs can be made. However, there are other forms of corporate activity that can result in a reduction in the value of the business that supports the pension scheme and TPR refers to these as covenant leakage. Examples of other forms of covenant leakage include, but are not limited to:

- Share buybacks - where a company uses assets to buy back its shares from the market
- Repayment of shareholder loans - loans provided by shareholders are typically the most junior ranking debt or treated as equity and therefore rank below the pension scheme in the priority order for repayment
- Asset transfers (including intellectual property) that are not carried out as part of an arm's length transaction and the consideration received for the asset does not reflect the fair market value that it might transact on should it be sold to a third party
- Disposal of subsidiaries not carried out at arm's length - as above, the consideration received for the subsidiary does not reflect the fair market value
- Inter-company payments and loans - the movement of cash between different entities within a group via payments and loans which may move assets beyond the reach of the pension scheme
- Management compensation in excess of normal payments - for smaller companies these may represent a significant degree of covenant leakage

It is unlikely that full information regarding these types of corporate activity will always be readily available in the public domain. However, it is essential that trustees request sufficient information from their Employer(s) to enable them to carry out a detailed analysis to ensure that they fully understand the impact of any such activities on the covenant strength supporting their scheme.

The notifiable events framework has helped facilitate the sharing of information regarding corporate activity associated with the sponsoring employer. Additional steps such as agreeing information sharing protocols, adopting a collaborative approach, and appointing an independent employer covenant advisor can also help ensure that all of these events are considered, as appropriate, and can reflect the unique circumstances of both the sponsoring employer and the pension scheme.

The table overleaf sets out examples of covenant leakage mechanisms and the types of sponsor that may be more likely to be involved. These examples are not exhaustive.

Method of covenant leakage	Type of sponsor
Dividends / share buy backs / distributions	Listed and privately owned companies, small and large all commonly engage in dividend payments. Share buy-backs are more common for public listed entities and the likelihood can vary by geographic location (i.e. traditionally more common in the U.S. than the UK).
Executive remuneration	Traditionally more prominent to smaller privately owned companies, partnerships and charities. In recent years it has been under increasing focus for large listed companies, although it may not be as material in respect of the overall financial resources compared to smaller privately owned firms or not for profit organisations.
Fees or charges to a parent or other group company	Multinational groups can charge management or royalty fees to overseas subsidiaries for the use of intellectual property, central services and other items. These charges and fees can be used as a way to extract value from a subsidiary in a tax efficient form but can lack transparency.
Loans and centralised cash pools	Large companies operating in multiple countries can set up centralised cash pool facilities which act as an internal bank and all cash within subsidiaries is 'swept' to the cash pool creating internal loan balances. This maximises cash management and enables the smooth transfer of cash around the group. Inter-company loans can also be used to facilitate the movement of cash around groups without declaring dividends.
Transfer of assets between group companies	This can be commonly observed in companies which are active in mergers, acquisitions and restructurings. This can involve transferring assets into legal structures which can be easily separated on a sale. There are a number of approaches to valuing the asset transfer but by principal should be based on an 'arm's length transaction'.

Many, but not all, trustee boards now appoint professional covenant assessors. All trustee boards must be comfortable that they understand the overall nature of their employer covenant and can draw satisfactory conclusions from the questions they ask management and the information that is provided to them. Trustees may ask questions of their Scheme Actuary which are connected to covenant related matters. The actuary may find it more challenging to address covenant related concerns in the absence of a professional covenant advisor. In all cases, asking questions along the following lines can be useful:

- How complicated is the group structure?
- What forms of covenant leakage might apply?
- What would the implications be?
- What can the trustees do to minimise the chance of these other forms of covenant leakage?

It can be helpful for an actuary to give a “what if” scenario. For example, “The pension scheme’s sponsor is in a group; 25% of the net assets of the sponsor are derived from an inter-company loan to a company that sits outside the covenant group. How would you assess the covenant if the loan were written off and what implications would it have for your investment and funding strategy?”

The more complicated the corporate structure the more options there are for a covenant to be weakened by corporate activity other than payment of dividends, and therefore the greater the need for formal covenant advice from a suitably qualified professional.

The case study below includes forms of potential covenant leakage that may not have been considered by the pension scheme’s trustees but which may have contributed to a sub-optimal outcome for the pension scheme.

1.4 CASE STUDY 1 - Toys ‘R’ Us

Reference: Correspondence between Frank Field, TPR, the Chair of the Trustees of the Toys 'R' Us Staff Limited Pension and Life Assurance Scheme ('the Trustees'), the Managing Director of Toys 'R' Us UK ('the Company'), and the PPF

<https://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/pension-schemes/parliament-2017/pension-schemes-17-19/publications/>

Timeline (table 1a):

Date	Event
2016	<ul style="list-style-type: none"> - 1 April 2016: Effective date of last triennial valuation, independent covenant advice was sought and the funding strategy aligned to that. - Managing Director of the Company had his pay increased to £1.3m, from £356,000 in 2014 and £1m in 2015, despite substantial operating losses and sustained deficit in the pension scheme.
2017	<ul style="list-style-type: none"> - A £585m inter-group loan was written off during year end 28 January 2017. Trustees were not notified. - The Company's loss before taxation for year end 28 January 2017 was £673.3 million. - The deficit in the DB scheme at same date was £18.4 million, up from £10.3 million the previous year. - The US parent company filed for bankruptcy on 18 September. - TPR contacted Trustees on 20 September and entered into discussion with them and the PPF. - A Creditors Voluntary Arrangement ('CVA') proposal was launched in December and the pension scheme entered PPF assessment.

	<ul style="list-style-type: none"> - Trustees took covenant advice and reconsidered the investment strategy and funding of the Scheme in light of the CVA proposal. A specialist was appointed to the Trustee board with insolvency and CVA experience. - The PPF proposed that the next 3 years' pension scheme contributions should be brought forward and paid in the months following CVA agreement, given that other payments were being made by the company, including royalties to the US parent. This would have protected the pension scheme from failure of the CVA, however this proposal was not accepted. - A revised CVA was agreed in December.
2018	<ul style="list-style-type: none"> - The Company became insolvent.

Covenant Leakage considerations and issues:

When the CVA proposal was launched in December 2017, the Work & Pensions committee entered into correspondence with various parties to establish whether there had been inequitable treatment of the pension scheme. The correspondence highlighted two key areas of potential covenant leakage that occurred prior to the CVA proposal being launched:

The inter-company loan

- £585m that was owed to the Company was written off, and the trustees were not notified. They therefore were not able to determine whether this would result in covenant leakage prior to the loan being written off.
- The company subsequently advised the trustees that this was part of a group reorganization and did not affect the covenant provided to the scheme as it sat within another part of the group structure. In a letter from the Trustees to the Work & Pensions Committee dated 12 December 2017, after the CVA proposal was launched, the Trustees wrote that 'on becoming aware of it, (they) have taken steps to assess any impact on the scheme'. Although it is not clear exactly when the Trustees were notified, it does not appear that they had been able to consider this prior to the CVA proposal being launched.

Remuneration Package

- The increase in the Managing Director of the Company's remuneration could also be considered as a form of covenant leakage, if it resulted in money being diverted away from the pension scheme at a time when the Company was in difficulty. The increase was explained by the Company as 'appropriate given the scope of responsibilities... during an important time of transformation for the UK business.... to reflect the urgent need for his talent, expertise and leadership.'
- In a letter dated 22 December 2017, the Company defended its distribution of funds between paying money into the pension scheme and other uses, saying that it was 'using its resources in a way that helped to attract and retain the right senior leaders to drive the business forward during a critical time in the company's history and at the same time protect the interests of all the staff. Both the company and the group remain committed to getting this balance right.'
- Two months later in February 2018 the Company became insolvent, with the pension scheme estimated to have a c.£30m deficit on the PPF assessment basis.

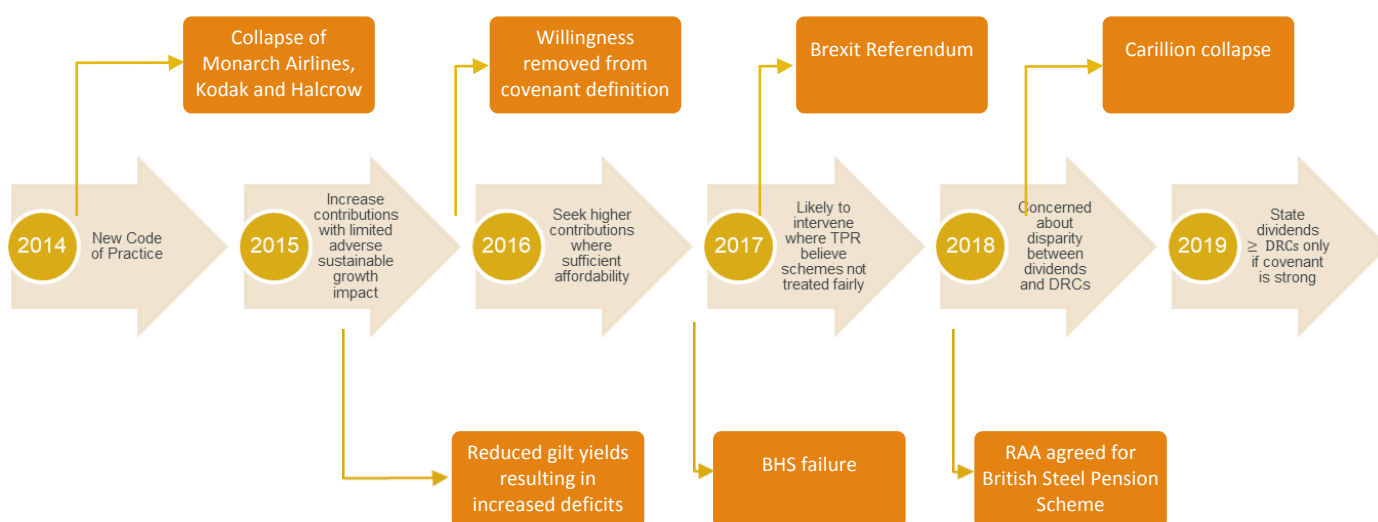
Dividend policy does not appear to have been highlighted in any of the correspondence. However, other forms of covenant leakage were significant.

1.5 Development of Current Funding Regulations

The Code was first introduced on 15 February 2006 and was developed in light of TPRs objectives which were introduced by the Pensions Act 2004³. It was subsequently revised in June 2014 to reflect a further objective in relation to the exercise of TPRs function to minimise any adverse impact on the sustainable growth of the employer.

Since April 2012 TPR has issued Annual Funding Statements aimed at trustees and employers of DB pension schemes who are undertaking their scheme valuations with effective dates in the period from the previous September to the September following issue. These have been used to convey additional messages for consideration in respect of the applicable tranche of valuations, supplemented with data analysing TPRs Scheme Returns submitted in connection with such valuations.

Whilst the Code has therefore only been revised once at the time of the publication of this report, the focus of TPR and hence direction taken by trustees and employers, has been expressed via these Annual Funding Statements which take account of updated market conditions and the impact of external events. The key messages from recent Annual Funding Statements and pertinent events at that time are illustrated in the diagram below.



With big name collapses following the introduction of the new code of practice (such as Monarch Airlines shown above), TPR sought to increase DRCs and hence improve funding levels and member security where contributions were affordable. Further high profile collapses (such as BHS and Carillon which are discussed in detail in this paper), coupled with volatile market conditions following Brexit, saw TPR express growing concern about equitable treatment of pension schemes versus other stakeholders and take a tougher stance on companies regarding covenant leakage.

As a flavour of the points being raised, Appendix 1 summarises the statements highlighted each year.

1.6 Current funding guidance

We set out in this section an overview of the current funding guidance which is relevant to the consideration of dividends and covenant leakage.

Code of practice 03: Funding defined benefits

The Code states nine key funding principles. These principles recognise the wide range of situations UK pension schemes find themselves in. When specifically considering covenant leakage three of these principles stand out:

- **Working collaboratively:** The trustees and employer should work together in an open and transparent manner to reach funding solutions that recognise the needs of the scheme and the employer's plans for sustainable growth.
- **Balance:** Trustees should seek an appropriate funding outcome that reflects a reasonable balance between the need to pay promised benefits and minimising any adverse impact on an employer's sustainable growth.
- **Fair treatment:** Trustees should seek to ensure that the scheme is treated fairly amongst competing demands on the employer in a manner consistent with its equivalent creditor status.

These principles allow flexibility but also present a challenge to trustees in determining the appropriate balance between the needs of the pension scheme and the demands of the employer. It is accepted that dividend payments are part of normal business activity which can be consistent with both the employer's sustainable growth plans and the trustees' funding objectives to pay benefits as they fall due.

TPR states in the Code that scrutiny of the employer dividend policy of an employer with a "strong" covenant would be disproportionate and unnecessary. Therefore, trustee scrutiny can be limited to those situations where the covenant strength is a concern, where the timing of proposed dividends is unusual or where exceptionally large dividends are proposed. Trustees should consider obtaining additional security or a share of any upside from the success of the employer's growth where dividend payments will result in employer covenant becoming weaker and to address any resulting material impact.

Annual Funding Statements

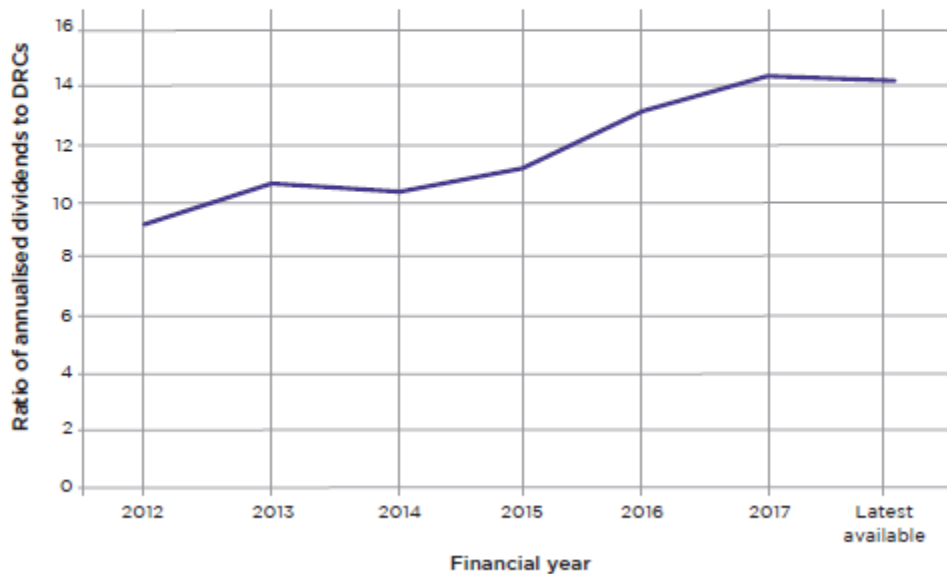
The Annual Funding Statements issued by TPR provide further insight for trustees of TPR's expectations given the prevailing economic environment. These statements have always made reference to the funding principles set out in the Code, in particular the need for fair treatment and balance. However, in 2018 there was a significant change in tone. TPR expressed concern about the growing disparity between dividend growth and stable DRCs and made reference to recent corporate failures which highlighted the risk of long recovery plans while payments to shareholders are significant relative to DRCs.

The Tranche 14 analysis report issued in May 2019⁴ highlighted these concerns with the statistics overleaf:

Dividend trends

Figure 10a shows the distribution of the ratio of DRCs to dividends paid by employers of DB schemes in the FTSE350 (representing around 200 companies and 470 schemes) from 2012 to latest available financial year end accounts, with material DB pensions exposure (through direct participation or majority shareholding in participating employers).

Figure 10a: Ratio of dividends to DRCs (where both dividends and DRCs are non-zero) – current FTSE350 companies sponsoring DB/hybrid pension schemes



Sources: TPR, FAME published by Bureau van Dijk

In the 2019 Annual Funding Statement⁵ there are only three references to “dividends”, but this statement gave a firm steer on TPRs expectations regarding dividends and covenant leakage. Within this statement, TPR states:

- Where dividends and other shareholder distributions exceed DRCs, we expect a strong funding target and recovery plans to be relatively short.
- If the employer is “tending to weak” or “weak”, we expect DRCs to be larger than shareholder distributions unless the recovery plan is short and the funding target is strong.
- If the employer is weak and unable to support the scheme, we expect the payment of shareholder distributions to have ceased.

This was the first time TPR had included the statement that “weak” employers should not be making dividend payments. TPRs definitions of different covenant strength gradings (including “weak”) are included in Appendix 3.

1.7 CASE STUDY 2 - Carillion

The following case study draws out information regarding the contribution and dividend history of Carillion which was gathered by the Work and Pensions Committee during their investigation into the collapse and the impact on the associated DB pension schemes

Reference: <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76902.htm>

Timeline (table 2a):

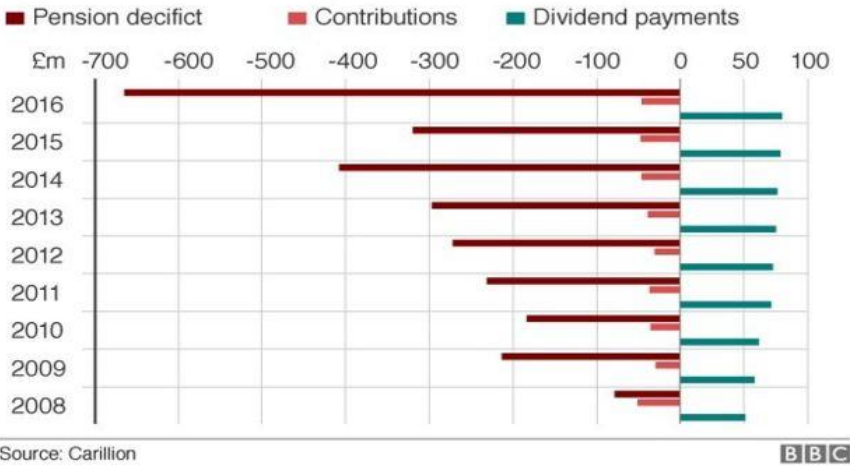
Year	Event
2009	<ul style="list-style-type: none"> Failure to conclude 2008 valuation within 15 month deadline. Company wanted less prudent assumptions to reflect the stronger covenant they felt they offered. Specifically, the company requested use of a discount rate of 5.25% p.a. whereas trustees felt it should be no higher than 4.5% p.a. Furthermore, the company said they could not afford more than £23m p.a. in contributions whereas trustees were requesting £35m p.a. based on the covenant advice they had received. Valuation concluded 7 months late, contributions of £24m p.a. over 16 years agreed.
2012	<ul style="list-style-type: none"> Failure to conclude 2011 valuation within 15 month deadline. Trustees requested contributions of £65m p.a. over 14 years to remove £770m shortfall. Company proposed deficit should instead be £620m using a less prudent discount rate, and that allowing for post valuation experience the contributions should be £33.4m over 15 years. Independent covenant advice said company could afford £64m p.a. upwards whilst maintaining an acceptable metric of 2 times free cashflow, and noted that historically other demands on capital had been prioritized over DRCs in order to grow earnings and support the share price.
2013	<ul style="list-style-type: none"> TPR writes to trustees and company to indicate contributions in the range £33m to £39m would not be acceptable. Company refused to increase offer.
2014	<ul style="list-style-type: none"> Compromise is reached based on a new valuation date of 31 January 2013. Improved market conditions between those two dates reduced the deficit from £770m to £605 million. The Trustee reluctantly accepted initial annual contributions of £33 million p.a., in line with Carillion's original offer and £30 million less than the Trustee originally requested. While recovery contributions were scheduled to rise to £42 million from 2022, there would be new negotiations in the meantime. The Carillion Group would also only guarantee payments due up to end of 2017. Beyond then, schemes would only have recourse to individual sponsor companies within the group. It was also agreed that the next valuation, based on the position at 31 December 2013, would be based on the same assumptions and would not consider the total level of contributions.
2017	<ul style="list-style-type: none"> March: 31 December 2016 accounts published, with record dividend of £79 million announced. June: £55 million dividends paid. July: profit warning issued, following which the Trustee agreed to defer pension contributions worth £25.3 million due between September 2017 and April 2018, on the basis that the sponsor would otherwise have been insolvent. Carillion sought to offload its pension schemes into the PPF in a bespoke deal. It didn't have sufficient funding to produce a proposal that would have been attractive to the Trustee, TPR or the PPF.
2018	<ul style="list-style-type: none"> January 2018 Company enters liquidation.

The progression of funding levels, dividends, DRCs and profits are shown in the charts 2b and 2c:

(Chart 2b)

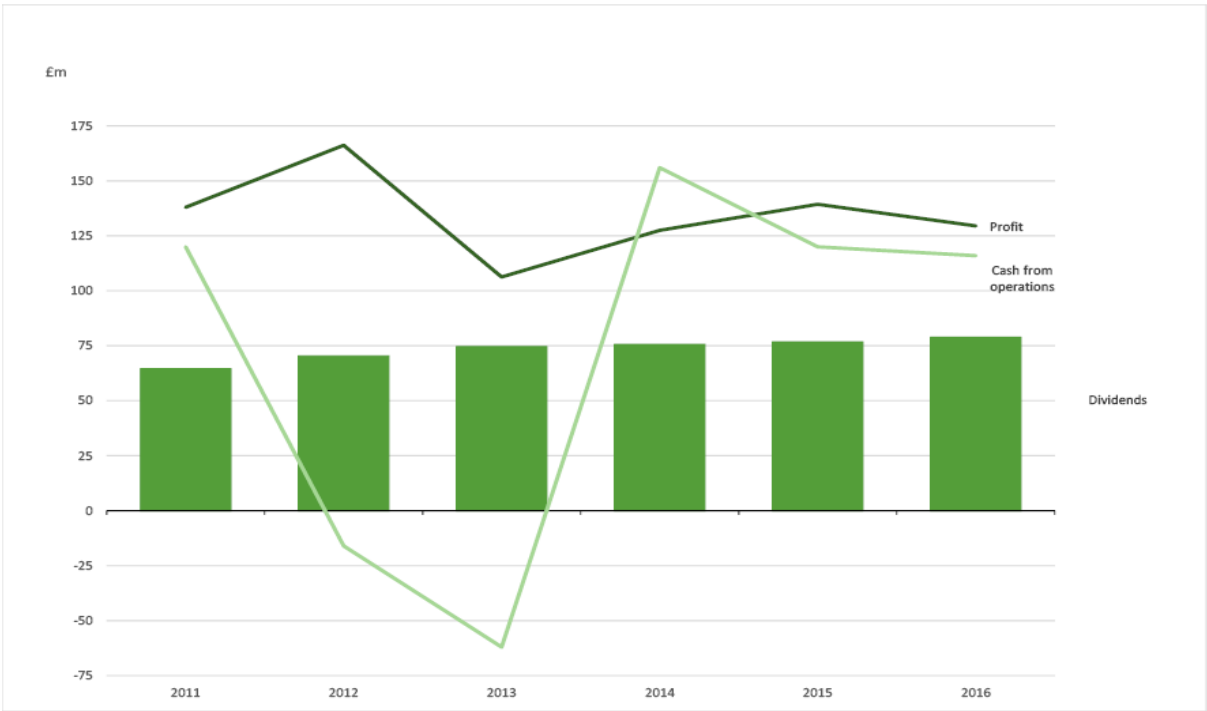
Carillion: Pensioners and shareholders

The pension deficit grew as dividends rose



Reference: <https://www.bbc.co.uk/news/business-42853895>

(Chart 2c)



Note: Profit figures used in the chart above are Profit after tax figures

Covenant Leakage Observations

- Dividends were increased annually for the last 16 years, regardless of how profit levels moved (Chart 2c) and despite there being a pensions accounting deficit of £316m at 2015 which increased to £587m at 2017. Final dividend paid was £55m in June 2017 compared with annual deficit reduction contributions of £50m.
- The company refused requests from the Trustee to establish a formal link between the level of dividends and pension contributions.
- TPR had been proactively engaging with Carillion sponsors and trustees for a number of years whilst valuations and recovery plans were being agreed, but had not used any of their intervention powers.
- The performance indicators used to determine bonus payments did not include managing the risk of pension deficits.
- There had been a sustained resistance from the company to put in contributions to the pension scheme at the required levels, despite growing deficits.
- The Chairman of Carillion had previously been found guilty by the Pensions Ombudsman in 1994 of breach of trust and maladministration in respect of the use of pension scheme funds at Coloroll, where he was Managing Director and a pension scheme trustee.
- TPR case study has suggested that the ratio of dividends to DRCs on a scheme by scheme basis was not as extreme as other FTSE 350 DB scheme sponsors (<https://www.ft.com/content/ceeeb2a4-f9ee-11e7-a492-2c9be7f3120a>).

Section 2 - Implications for Actuaries

2.1 Why it is important to actuaries

As part of the scheme funding valuation process, trustees must assess the strength of the employer covenant. The trustees should understand the current strength of the employer covenant and how it could change in the future.

When assessing the financial position of the employer and the ability of the employer to contribute cash to the scheme when required, the trustees should consider all forms of cash calls on an employer. These may include dividends and other forms of potential covenant leakage.

Client expectations

Actuaries should never give advice in areas they do not have sufficient expertise to do so. This could include giving covenant advice to trustees and/or employers. However, actuaries are often regarded as trusted advisors and whilst they may not be engaged directly to give covenant advice, trustees and employers may expect their trusted actuary to have a certain level of understanding of the issues affecting an employer's covenant, including covenant leakage. Indeed arguably it is not possible to give advice on appropriate levels of risk and duration of funding plans, or how these fit in the wider IRM framework, without understanding the covenant and taking the covenant review into account.

Professional requirements

In addition to client expectations, actuaries have professional responsibilities. The relevant professional requirements which could relate to employer covenant are covered in "APS P1: Duties and Responsibilities of members undertaking work in relation to pension schemes" and include:

- to "inform the trustees on becoming aware of any significant matter which relates to his/her regulatory, contractual or other professional responsibility and/or might have an impact on the financing of the scheme, and which he/she considers might lead to the trustees needing to request advice or further advice, either from the Scheme Actuary or another adviser."
- To share any "material concerns about the way the trustees are fulfilling their duties and responsibilities" with the trustees "and take such consequential action as is appropriate in the circumstances".

Given the importance of employer covenant on the financing of schemes, if the Scheme Actuary or trusted actuary has reservations regarding either the covenant being provided to their scheme or the trustees' perception of it, they should robustly raise their concerns with the trustees and suggest they revisit their assessment and/or consider obtaining independent covenant advice. This includes any concerns around forms of covenant leakage that may be taking place. In order to do this, actuaries should be able to understand and question any covenant assessment undertaken by the trustees and their advisors. Actuaries should be supporting their client to consider the implications of their covenant to inform the structure of recovery plans and design mitigations or contingency plans to cover any potential concerns.

2.2 Implications on funding valuations

Actuarial assumptions for funding valuations

Trustees are responsible for selecting the assumptions used for funding calculations, after obtaining advice from their Scheme Actuary and discussion (normally including reaching agreement) with the employer². Actuarial advice given to trustees and to the employer, in relation to funding negotiations, is subject to regulation (including the Actuaries' Code⁶ and the relevant Actuarial Practice Standards⁷) and technical standards (TASs). Calculations can be performed on the basis trustees (and/or employer) select, but if the trustees ultimately choose to adopt assumptions the Scheme Actuary thinks are professionally unsupportable then he or she needs to consider their professional responsibilities.

TAS 300⁸ states that "communications shall include sufficient information to enable the user to understand the level of prudence in the assumptions".

As part of an integrated approach, trustees should already be considering the strength of the covenant as part of the assumption setting process, and in particular should understand how the level of covenant and perceived changes to it will influence both the choice of appropriate assumptions and the level of prudence within them. This will include consideration of covenant leakage where appropriate.

It is therefore the Scheme Actuaries' responsibility to communicate the impact of these issues to the trustees.

Recovery Plans

Where there is a deficit on the Scheme Funding Objective ("SFO") assumptions as at a formal actuarial valuation date, a recovery plan must be put in place, detailing the DRCs payable to the scheme. It is the trustees, (normally including reaching agreement with the employer), who are responsible for setting the DRCs. The Scheme Actuary must certify that the DRCs are sufficient to be expected to make good the SFO deficit.

A complex area is the determination of what contribution level is affordable for any recovery plan. In the absence of any detailed information, trustees will need to challenge the employer(s) as to what they can afford and, as far as they are able, exercise judgement as to what is reasonable and appropriate and record their reasoning.

In doing so, trustees should also extend their considerations beyond just dividend payments, and consider other forms of covenant leakage such as repayment of shareholder loans and inter-company payments (see 'The role of dividends' section on page 7 of this report), to ensure that these are not affecting the equitable treatment of the scheme under the proposed recovery plan.

Whilst the responsibility of this affordability assessment lies with the trustees (with the help of independent covenant advisors, if required), they may look upon their actuary to help build a repayment structure which ensures their objectives and responsibilities are met given the results of this assessment. This may require the actuary to consider alternative deficit removal periods, cash contribution structures, and non-cash funding alternatives which reflect the assessment of employer affordability whilst ensuring the scheme is being treated equitably relative to other stakeholders.

Regulator intervention

TPR might question the Scheme Actuary's professionalism where it believes the scheme funding package is not as generous as it should be or doesn't appear to be equitable with the treatment of other stakeholders given the covenant available to the scheme and there is no evidence that the Scheme Actuary has challenged this. TPR is empowered to appoint another actuary to carry out a skilled person's report, at the

expense of the trustees, to, for example, advise the trustees on appropriate valuation assumptions or covenant strength.

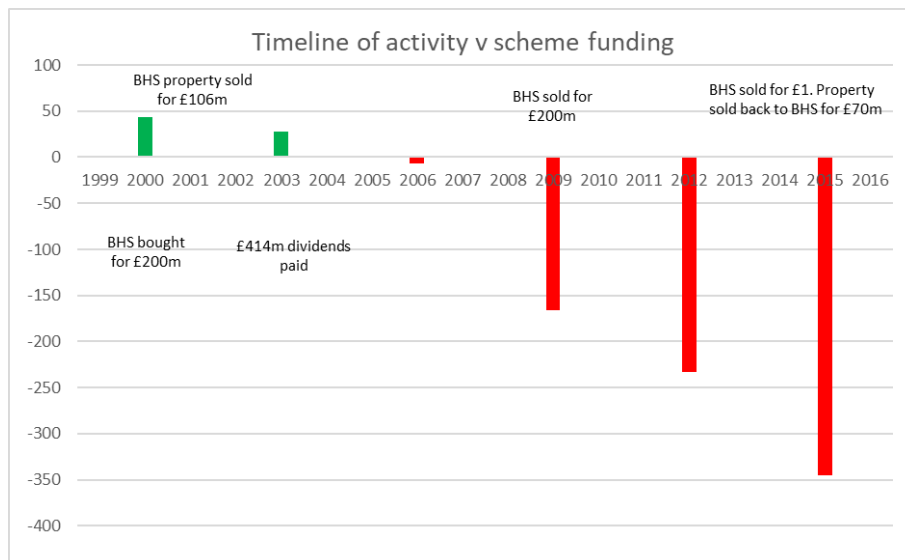
Future funding regimes

The above is all based on the funding regime as the time of the writing of this report. Whilst there is an expectation of some changes to this regime in the forthcoming Code of Funding we would anticipate that these issues remain relevant to many, if not all, of DB pension schemes.

2.3 CASE STUDY 3 - BHS

The following case study extracts information gathered by the Work and Pensions Committee for their review of the failure of BHS and the treatment of the pension schemes in the run up to its collapse.

Reference: <https://publications.parliament.uk/pa/cm201617/cmselect/cmworpen/54/5402.htm>



Commentary

- Sir Phillip Green bought BHS in 2000 for £200m.
- Sold property to Carmen Properties Ltd, a property company of which Lady Green was the ultimate beneficial owner, in 2001 for £106m as part of a sale-and-leaseback arrangement.
- BHS Ltd paid £414m in dividends between 2002 and 2004. Over the same period, after tax profits were £208m.
- Sold to Taveta Investments (No. 2) Limited (a Green family company) for £200m in 2009
- Sold in 2015 for £1 to Retail Acquisitions Limited (RAL).

Covenant Leakage observations

- Dividends were paid between 2002 and 2004 when the entity was profitable and the pension schemes were in surplus, therefore a comparison of dividends to DRCs would not have been applicable.
- The dividends paid over 2002 to 2004 of £414m exceeded the after tax profits of £208m over the same period.
- The property that was sold to Carmen Properties Ltd in 2001 for £106m, was sold back to BHS for £70m at time of sale to RAL in 2015. BHS had paid £153m in rent over that period.

Section 3 - Practical considerations

This section provides some thought provoking examples and scenarios to help illustrate the relevance and importance of the context surrounding the scheme and the employer when considering the ratio of dividends to DRCs and other forms of covenant leakage.

3.1 Examples of practical considerations

If attention is being given to the level of DRCs relative to dividend payments, consideration should also be given to the environment in which the scheme operates and the specific circumstances of the scheme. In particular, it is important to consider:

- Scheme size, status, funding level and approach;
- Sponsor size and profitability.

Examples

Below are some examples to illustrate the relevance of the context surrounding the scheme and the sponsor when considering the relative levels of dividends and DRCs.

Example 1 - Strength of funding basis is driving the level of DRCs

Background

- Company A and Company B are identical in all respects except as noted below. Both operate DB pension schemes.
- The schemes operated by Company A and Company B both have assets of £150m.
- Company A and Company B both pay £5m p.a. in dividends - dividends do not exceed DRC payments so there may appear to be equitable treatment of shareholders and DB scheme stakeholders.

Funding strategies

Company A

- High risk, low prudence funding and investment strategy;
- DRCs of £5m p.a. will remove technical provisions deficit over 4 years roughly.

Company B

- Low risk, high prudence funding and investment strategy;
- DRCs of £5m p.a. will remove deficit over 11 years roughly.

Conclusion

- Company A, with the high risk, low prudence funding and investment strategy, looks to avoid key triggers such as long Recovery Period, low funding level.
- Company B, with the low risk, high prudence funding and investment strategy, is more likely to be on TPR's radar in terms of Recovery Plan length and low funding level.
- In the absence of any formal additional long-term funding target Company B could however be considered to provide more comfort to the trustees reflecting the acknowledged long-term commitment to contributions
- It is therefore important that the strength of funding basis is considered in conjunction with ratio of dividends to DRCs.

Example 2 - The relative size of the Group sponsoring the scheme and the funding position

Background

- The sponsor of a DB scheme is paying dividends of £200m p.a. and DRCs of £10m p.a.
- Dividends are 20 times the level of DRCs.

Considerations

On the face of it seems unequitable, however this is not necessarily the case if:

- the Group is so big relative to the size of the scheme that the monetary amount of dividends is reasonable even if the ratio to DRCs looks extreme; or
- the scheme is so well funded, DRCs are understandably low relative to dividends. For example, if the scheme has a £20m deficit on a prudent funding basis, 2 year recovery plan.

Example 3 - The source of the dividend payments

Background

- There are two identical schemes both with identical ratios of dividend payments to DRCs.
- One of the schemes has a sponsor that is paying the dividend from profit earned that year.
- The other has a sponsor that is using distributable reserves to make the dividend payments, i.e. they are raising debt to fund the dividend which is in excess of cash generation and annual profitability.

Considerations

- Dividends being paid from distributable reserves are likely to cause greater concern than dividends that can be paid from distributable profits, despite identical ratios of the level of dividends to DRCs.

3.2 Covenant leakage scenarios

The scenarios below are hypothetical; they are not based on any actual pension scheme or company.

The scenarios do not contain sufficient information for a conclusion to be reached. They are structured to provoke thought, both in terms of the specifics of each example and also in the wider issue of covenant leakage.

The examples below are recreated in Appendix 2 along with suggestions for how to think about the issues.

Scenario 1: Change to dividend policy

A covenant assessment indicates that a pension scheme's sponsor covenant is "tending to strong".

Dividends over the past three years have been of a similar amount at around 40% of the sponsor's profits, which have been broadly flat.

The deficit on a technical provisions basis for the current actuarial valuation show that the deficit has increased by 25% since the last valuation. The previous recovery plan was eight years long with a flat payment schedule. The sponsor has proposed maintaining the starting level of deficit contributions though introducing an annual 3% p.a. increase. This would result in a nine-year recovery plan.

As part of the negotiations regarding the recovery plan, the sponsor mentions that it is intending to double dividend payments.

The trustees' view is that this is unreasonable given the increased deficit and the proposal for only small increases in the deficit contributions. They have asked for the contributions to the pension scheme also to be doubled.

The Company counters that it has suppressed dividends for the past five years as it was building up a war-chest for acquisition; the acquisition is no longer going to take place so the sponsor wants to resume payment at the previous level. The Company notes that it is not looking to return the whole of the unpaid dividends to the shareholders in one go.

What issues and factors should the corporate and scheme actuaries consider in deciding whether the trustees' demands are reasonable?

Scenario 2: Fees to parent company

Company A is a US-head-quartered company. It has a UK-based subsidiary, Company B, which is sponsor to a DB pension scheme that has a material funding deficit. Company B has been assessed as having a "weak" covenant owing to it having a weak balance sheet and low profitability. It is a well-run company but is consistently barely profitable and does not pay dividends. However, it does pay material licensing fees to its parent.

Why might you consider this to be a form of covenant leakage? What factors would you highlight when raising this with the party you are advising?

Scenario 3: One-off larger dividend

A profitable Company wishes to make a large one-off dividend payment to its shareholders to mark a milestone. The payment is five times larger than the regular dividends and ten times larger than annual recovery plan payments. The Company raised its dividend proposal with the trustees when seeking agreement on a new recovery plan.

What considerations are relevant in seeking agreement to an appropriately short(er) recovery plan or, as scheme actuary, why might you also recommend the trustees seek further covenant advice?

Scenario 4: Not-for-profit covenant leakage

The remuneration for a chief executive of a charity, which she founded 25 years ago, is similar to the median remuneration for a FTSE350 company CEO. The charity's annual income is one-tenth of an average FTSE350 company's income. Other employees' salaries are in line with market rate.

The charity has a material funding deficit and the charity's view is that it can only afford to pay off the funding deficit over twenty years.

You are the scheme actuary and the trustees have asked for your views.

What extra information would you request and what points would you make to the trustees to assist them in their negotiations with the charity?

Scenario 5: Share buy-back

A business has been owned by the same family since inception. The fourth generation of the family currently own all the shares in the company. The succession plan for the company involves the company buying back the shares on the death of a family member. This approach has kept the shareholder and management group close-knit and aligned over generations.

The most recent actuarial valuation reveals a funding deficit. The Company has significant distributable reserves, such that it has been categorised as having a strong covenant by a professional covenant adviser. The trustees have requested the funding deficit be recovered over the following five years. The company claims that this is not possible as it needs to hold significant reserves in case of a shareholder death.

The Trustees have asked you whether it is reasonable for there to be a long(er) recovery plan. What are the factors you would take into account in forming your response?

Section 4 - Implications of corporate events

4.1 Background

Corporate events cover a broad range of transactions which can have a significant immediate impact on the covenant supporting a pension scheme. Transactions can include: mergers & acquisitions, disposals of business or assets, joint ventures, internal reorganisations, refinancing of existing debt or changes to capital structures and large value distributions such as special dividends and share buybacks. The list is non-exhaustive and trustees need to carefully consider the covenant impact of any such event in line with guidance from TPR and after seeking professional advice.

"Moral Hazard" provisions were introduced by the Pensions Act 2004 (the "Act") from 6 April 2005 and were added to considerably by the Pensions Act 2008. These means were intended to enable TPR to prevent actions by an employer to avoid a pension debt, resulting in that debt being transferred to the PPF. The Act allows TPR to issue Contribution Notices, Financial Support Directions and Restoration Orders. TPR has the power to use these provisions against both current and former employers, although time limits do apply. A Code of Practice sets out the circumstances in which TPR expects to use this power, and further guidance and examples have also been published.

4.2 Considerations

The potential for covenant leakage in corporate events is high and during particularly complex transactions, it can be hard to identify. While this is not the focus of this paper, some high level comments have been set out below with a focus on dividends.

While actuaries are generally not well equipped to carry out analysis of covenant leakage, they may be in a better position to inform trustees of the risks of such transactions and the precautionary step to take professional advice should the trustee board not have the required skills or impartiality. Actuaries should alert their client to the risk of covenant leakage inherent in corporate transactions and encourage them to seek specialist advice where relevant. Actuaries should also help inform the discussion around the potential impact of the corporate transaction, in the light of said covenant advice, on the pension scheme.

Large dividends made prior to, or as part of a corporate transaction, can result in a significant transfer of value away from the legal bounds of the employer covenant. It is important for trustees to assess the size, destination and purpose of any dividends which are outside of any agreed dividend policy or historic practice.

Acquisitions or divestitures can be on a 'cash free, debt free' basis. In such scenarios, the business being transferred will have all debt repaid and any cash in excess of working capital requirements paid out (usually through dividends or the clearing of inter-company balances). In these scenarios, if cash balances represent a significant proportion of the balance sheet strength, it can result in a deterioration of the covenant supporting the pension scheme.

The method of funding any dividends as part of a transaction should be carefully reviewed i.e. whether the dividends are funded through cash or for example increased debt - which could include increased balance sheet risk and lower future cash flow after interest servicing.

If transactions involve a change in ownership of a pension scheme's statutory employer, it is possible the new owner will not have full knowledge of any pre-existing agreements or understandings between the statutory employer and trustees covering dividend policy. This could be especially true if the transaction completed in a short time frame with limited time for due diligence by the purchaser. It is important for trustees to engage with any potential new owner's or significant stakeholders early on in any such process to build relationships and share expectations and understandings.

Further, trustees should seek to formalise any pre-existing agreements and understandings prior to any corporate activity to ensure that they are enforceable and remain in place following any change in ownership.

When there are changes in ownership, the new owner could seek to change the existing dividend policy which could also indicate a wider change in the new owners intentions for the business (i.e. higher dividends at the expense of lower investment could weaken the long term covenant support).

If transactions are taking place in a distressed environment, normally when there is significant cash flow pressures or an insolvency event (actual or prospective), dividends would not normally be expected. Any dividend proposals in such scenarios should be rigorously examined. Trustees and their advisers can carry out analysis such as drawing up a summary of what each stakeholder involved in the transaction is giving and receiving to ensure any dividends, or other value leakage, is not treating the scheme unfairly.

The Department of Work and Pensions consultation on an updated notifiable events regime included enhanced requirements for employers to consider the impact on pension schemes during corporate transactions. This should lead to increased, and earlier, engagement with trustees. This could strengthen trustees' ability to protect against any covenant deterioration which will include detrimental dividend payments. This is part of a wider, more significant, refresh of regulation which includes the new Code of Practice being produced by TPR. It is likely the regulatory environment will change materially in the next couple of years which introduces an element of uncertainty in the short term.

Further guidance on corporate transactions

Further guidance on corporate transactions can be found on both TPRs and the Employer Covenant Practitioners Association websites:

- TPR's guidance on understanding corporate transactions:
<https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/corporate-transactions>
- TPR's guidance on Clearance: <https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/clearance>
- Employer Covenant Practitioners Association guidance on assessing the covenant impact of corporate transactions in distressed and non-distressed situations:
<https://ecpa.org.uk/publications.html>

Section 5 - Potential future developments

The working party have extended their knowledge and understanding of the issues related to the impact of covenant leakage, through dividend payments and other forms, on DB Pension Scheme funding. All information and resources used to develop this knowledge and understanding are listed in Appendix 4. We would be delighted if we could provide input into any Institute and Faculty of Actuaries response to related consultations on this, or related, topics issued by TPR. We feel the research undertaken to date could usefully inform such a response and would add value to the discussion.

The working party have identified that, whilst there are a number of related papers on the topic of dividends, their derivation and relationships to funding, there are fairly limited resources available which explore the topic with regard to UK DB funding in any great detail. The working party would be happy to contribute to any further research into the impact and consequences (intended or otherwise) of the relationship and would encourage TPR to share in greater detail its justification for its chosen approach to facilitate understanding within the pensions community.

In a similar vein the working party would be happy to be involved in such further debate on this topic hosted by the Institute and Faculty of Actuaries or interested Industry bodies. Further, the working party intends to revisit this research when the revised draft Code of Practice on the funding of DB pension schemes is published by TPR.

Section 6 - Appendices

Appendix 1: Key remarks highlighted in historic Annual Funding Statements

2012	<ul style="list-style-type: none"> • Under the funding framework, a DB pension scheme's funding strategy must be tailored to its own specific circumstances. • We recognise that the current economic conditions will put pressure on pension scheme funding. • Planning for an uncertain future is a key part of pension scheme management. • It is a requirement for trustees to calculate technical provisions based on prudent assumptions. • As a starting point, we expect the current level of deficit repair contributions to be maintained in real terms. • We will consider whether the flexibility in the funding framework has been used appropriately.
2013	<ul style="list-style-type: none"> • Trustees may need to make greater use of the flexibilities available than needed for their preceding valuations. • Trustees can use the flexibility available in setting the discount rates. The assumptions made for the relative returns of different asset classes may rise or fall from preceding valuations. • As a starting point, trustees should consider whether the current level of contributions can be maintained. • Allow for an appropriate level of risk to be taken that is neither overly prudent nor overly optimistic. • We are moving away from setting triggers focused on individual items such as technical provisions and continue to evolve a suite of risk indicators as part of our filter mechanism. • We intend to run a similar process again this year for some schemes undertaking their 2013 valuations.
2014	<ul style="list-style-type: none"> • We are setting out our key messages for schemes undertaking valuations. • Our analysis shows that many schemes carrying out 2014 valuations are likely to have a larger funding deficit. • Trustees should manage risks through a proportionate application of an integrated approach. • We will be applying our regulatory approach consistently with our policy.
2015	<ul style="list-style-type: none"> • We are setting out our key messages for schemes undertaking 2015 valuations. • The level of risk taken must be appropriate to the circumstances of each scheme and employer. • We anticipate that most schemes will set funding strategies based on lower expected investment returns than at their last valuation. • Schemes with additional capacity to take risk should be able to address their deficit through a modest extension to their recovery plans, a modest increase in DRCs and/or changing their assumptions relating to investment returns.

	<ul style="list-style-type: none"> • Whereas many sponsors may be able to afford increases in contributions whilst minimising any adverse impact on their sustainable growth, others may be facing challenging financial conditions. • Trustees should understand the impact of worsening or improving market conditions on the scheme's position. • When we decide to engage with a scheme, we seek to understand the trustees' decisions in relation to specific risks and the quality of their decision making process.
2016	<ul style="list-style-type: none"> • We are highlighting some of the key principles from the code and providing guidance. • It is important for trustees to measure the sensitivity of the scheme's assets and liabilities and the impact on the scheme's funding position. • Trustees should consider the longer term view of expected risk and returns. • We expect trustees to seek higher contributions where there is sufficient affordability for the sponsor. • Trustees should decide how much and when to hedge against risks as part of their IRM approach.
2017	<ul style="list-style-type: none"> • This statement highlights some of the key issues we have identified facing schemes with 2017 valuations. • We expect trustees of stressed schemes to reach the best possible funding outcome. • Trustees should monitor the scheme's position against any journey plan including reviewing the length of time to reach the scheme's long term target. • Trustees need to have a contingency plan in place in the event of a downside risk materialising. • We are likely to intervene where we believe that schemes are not being treated fairly
2018	<ul style="list-style-type: none"> • We apply an integrated approach to assess the overall risk profile of each scheme • Where sponsors are reasonably holding back cash by extending the recovery plan because of Brexit uncertainty, trustees should make sure that shareholders are also sharing the burden. • We are concerned about the growing disparity between dividend growth and stable deficit reduction payments. • Where distributions appear unreasonable relative to contributions, we expect trustees to negotiate robustly with the employer. • We are now clearer about what we expect from trustees, are quicker to act and are tougher on those who fail to act in the interests of members. • We have brought enforcement proceedings against some trustees who have not submitted their valuations within the 15-month statutory timescale. • We can choose from a selection of interventions from our regulatory toolkit, depending on the risk posed by the scheme.

Appendix 2: Practical considerations - covenant leakage scenario examples

Covenant leakage scenarios

The scenarios earlier in the report are set out below along with a brief response/issues to think about.

As noted earlier, the scenarios do not contain sufficient information for a conclusion to be reached. They are structured to provoke thought, both in terms of the specifics of each example and also the wider issue of covenant leakage.

The key is to step back and think about what information might be useful to the trustees - or indeed the corporate - in helping them to make decisions.

For example, it can be instructive to consider what the covenant would be assuming future proposed covenant-deteriorating action had already taken place. If a proposed event had already taken place:

- What would the covenant rating be?
- How would the trustees assess the technical provisions under this new rating?
- What are the implications for the level of deficit contributions and the recovery plan?

It can be helpful to show the sponsor that the trustees are thinking along these lines as this can help the sponsor to reassess the 'value' of a proposed action.

As with all actuarial work it is vitally important to:

- Consider relevant information
- Disregard irrelevant information
- Document your conclusions

Scenario 1: Change to dividend policy

A covenant assessment indicates that a pension scheme's sponsor covenant is "tending to strong".

Dividends over the past three years have been of a similar amount at around 40% of the sponsor's profits, which have been broadly flat.

The deficit on a technical provisions basis for the current actuarial valuation show that the deficit has increased by 25% since the last valuation. The previous recovery plan was eight years long with a flat payment schedule. The sponsor has proposed maintaining the starting level of deficit contributions though introducing an annual 3% p.a. increase. This would result in a nine-year recovery plan.

As part of the negotiations regarding the recovery plan, the sponsor mentions that it is intending to double dividend payments.

The trustees' view is that this is unreasonable given the increased deficit and the proposal for only small increases in the deficit contributions. They have asked for the contributions to the pension scheme also to be doubled.

The Company counters that it has suppressed dividends for the past five years as it was building up a war-chest for acquisition; the acquisition is no longer going to take place so the sponsor wants to resume payment at the previous level. The Company notes that it is not looking to return the whole of the unpaid dividends to the shareholders in one go.

What issues and factors should the corporate and scheme actuaries consider in deciding whether the trustees' demands are reasonable?

The corporate plan had been covenant-enhancing: save money and then buy another business with the cash. The new plan is detrimental to the covenant. So, it is reasonable for the trustees to request higher contributions, though not necessarily in proportion with the dividend increase.

From the information provided, it appears that the company is looking to pay out 80% of annual profits as dividends in the future. This may have been the case five years ago but it is likely the pension scheme deficit was much smaller (or a surplus). It is worth checking what the funding position was five years ago and highlighting any difference to the sponsor. In other words, there may be a new reality that the sponsor needs to understand.

If the sponsor were determined to make the uplifted dividends without increasing contributions as requested, they might also suggest some form of guarantee or other security to help the trustees accept the agreement.

Scenario 2: Fees to parent company

Company A is a US-head-quartered company. It has a UK-based subsidiary, Company B, which is sponsor to a DB pension scheme that has a material funding deficit. Company B has been assessed as having a “weak” covenant owing to it having a weak balance sheet and low profitability. It is a well-run company but is consistently barely profitable and does not pay dividends. However, it does pay material licensing fees to its parent.

Why might you consider this to be a form of covenant leakage? What factors would you highlight when raising this with the party you are advising?

Without an enforceable guarantee provided by the overseas parent, the payments out of the company are reducing the covenant.

The key question that the scheme actuary should encourage the trustees to seek to answer is the role of the licensing fee: how is it calculated? Is it to extract the maximum amount tax-efficiently from the UK-based subsidiary or does the amount paid appear reasonable? To help answer this question it will be useful to know how the amount is set and how it varies year-on-year.

The trustees will need to think about how they can influence a reduction in the fee with a corresponding increase in payments to the pension scheme and/or whether they can secure support from the overseas parent. For example, what powers in the rules do the trustees have to realise a debt on insolvency? Could this be used as a bargaining chip with the US owners?

The corporate actuary should point out to the sponsor the implications of the weak covenant rating (i.e. possible de-risking of assets by the trustees and resultant “locking in” to a level of deficit) and how the rating could be improved.

Scenario 3: One-off larger dividend

A profitable Company wishes to make a large one-off dividend payment to its shareholders to mark a milestone. The payment is five times larger than the regular dividends and ten times larger than annual recovery plan payments. The Company raised its dividend proposal with the trustees when seeking agreement on a new recovery plan.

What considerations are relevant in seeking agreement to an appropriately short(er) recovery plan or, as scheme actuary, why might you also recommend the trustees seek further covenant advice?

It may be appropriate to seek further covenant advice. For example, would the covenant assessment have been different if the cash had been paid out the day before the year end? If so, this should be the trustees’ new starting point. And if this is the case, how would this affect the assessment of the technical provisions?

If there were no material change in covenant, it may be reasonable simply to seek to agree higher deficit contributions each year, i.e. agree a shorter recovery period.

Scenario 4: Not-for-profit covenant leakage

The remuneration for a chief executive of a charity, which she founded 25 years ago, is similar to the median remuneration for a FTSE350 company CEO. The charity's annual income is one-tenth of an average FTSE350 company's income. Other employees' salaries are in line with market rates.

The charity has a material funding deficit and the charity's view is that it can only afford to pay off the funding deficit over twenty years.

You are the scheme actuary and the trustees have asked for your views.

What extra information would you request and what points would you make to the trustees to assist them in their negotiations with the charity?

It would be helpful to have the reasoning behind the assertion that twenty years is the shortest affordable recovery plan and to identify the key factors influencing the position. Given the potential length of the recovery plan and difficulty in confident predictions over that time-frame consider any available security that might be made available to the trustees.

It would be helpful for the trustees to understand the justification for the chief exec's salary and for them to also find out what salaries are paid to chief execs of similar sized charities.

If this information is available, the Scheme Actuary could show the trustees how much shorter the recovery plan would be if the difference between the chief exec's total remuneration and the median total remuneration for a similar sized charity were paid in to the pension scheme. Would this make a material difference to the length of the recovery plan?

Scenario 5: Share buy-back

A business has been owned by the same family since inception. The fourth generation of the family currently own all the shares in the company. The succession plan for the company involves the company buying back the shares on the death of a family member. This approach has kept the shareholder and management group close-knit and aligned over generations.

The most recent actuarial valuation reveals a funding deficit. The Company has significant distributable reserves, such that it has been categorised as having a strong covenant by a professional covenant adviser. The trustees have requested the funding deficit be recovered over the following five years. The company claims that this is not possible as it needs to hold significant reserves in case of a shareholder death.

The Trustees have asked you whether it is reasonable for there to be a long(er) recovery plan. What are the factors you would take into account in forming your response?

It may be reasonable. There are various issues for the trustees to consider. For example,

- *Can the company show that this approach is its standard practice?*
- *What would the covenant rating be if the amount being set aside for a future buyback were discounted? How would this affect the assessment of the technical provisions and what contributions would the trustees request if this were the case?*
- *What level of dividends are being paid and how do these compare with free cashflow and the trustees' deficit recovery request?*
- *Are other forms of security (such as contingent assets) available?*

Appendix 3: The Pensions Regulator's employer covenant strength gradings

Source: The Pensions Regulator's Defined Benefit Funding Regulatory and Enforcement Policy

Appendix B Segmentation

89. We use four broad categories to rank employers from strong to weak according to how well they are able to support the scheme. This is used as an initial assessment of the covenant for the purpose of segmenting our universe, prioritising our resources and targeting our policies. Where we engage further with schemes we will be transparent about our views. These will be refined further as they are informed by our more detailed understanding of the scheme's and employer's circumstances from our engagement.

90. The categorisation below is not intended to define our expectations for the exact nature of trustees' own covenant assessments. Our funding code of practice gives guidance for trustees in this respect.

91. We recognise that this approach differs from that of the PPF when looking at employer strength for risk and levy purposes. The following definitions of the categories are not designed to be rigid descriptors, but are indicative of the employer's place on a continuum of covenant strength.

Covenant grade 1 (CG1) - Strong

92. Very strong trading, cash generation and asset position relative to the size of the scheme and the scheme's deficit. The employer has a strong market presence (or is a market leader) with good growth prospects for the employer and the market. The scheme has good access to trading and value if the employer is part of a wider group. Overall low risk of the employer not being able to support the scheme to the extent required in the short/medium term.

Covenant grade 2 (CG2) - Tending to strong

93. Good trading, cash generation and asset position relative to the size of the scheme and deficits. Operates in a market with a reasonably positive outlook and the employer has a stable market share. Outlook is generally positive but medium-term risk of employer not being able to support the scheme and manage its risks.

Covenant grade 3 (CG3) - Tending to weak

94. Concerns over employer strength relative to the size of the scheme and deficit and/or signs of significant decline, weak profitability or balance sheet concerns and/or high vulnerability to economic cycle. No immediate concerns over insolvency but potential risk of decline.

Covenant grade 4 (CG4) - Weak

95. Employer is weak, to the degree that there are concerns over potential insolvency, or where the scheme is so large that, without fundamental change to the strength of the employer, it is unlikely ever to be in a position to adequately support the scheme.

Appendix 4: Reference documents and sources

Section	Ref	Link
1	1	https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/guidance-assessing-monitoring-employer-covenant
	2	https://www.thepensionsregulator.gov.uk/en/document-library/codes-of-practice/code-3-funding-defined-benefits-
	3	http://www.legislation.gov.uk/ukpga/2004/35/contents
	4	https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-analysis-tranche-fourteen-review-2019.ashx
	5	https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-annual-funding-statement-2019.ashx
	6	https://www.actuaries.org.uk/upholding-standards/standards-and-guidance/actuaries-code
	7	https://www.frc.org.uk/actuaries/actuarial-policy/technical-actuarial-standards
	8	https://www.frc.org.uk/getattachment/d47aecc1-89a7-40af-8bfe-6ac095be6d2a/TAS-300-Pensions-Dec-2016.pdf
Appendix 1	1	https://webarchive.nationalarchives.gov.uk/20160105124142/http://www.thepensionsregulator.gov.uk/docs/pension-scheme-funding-in-the-current-environment-statement-april-2012.pdf
	2	https://webarchive.nationalarchives.gov.uk/20160105124124/http://www.thepensionsregulator.gov.uk/docs/DB-annual-funding-statement-2013.pdf
	3	https://webarchive.nationalarchives.gov.uk/20160105124138/http://www.thepensionsregulator.gov.uk/docs/db-annual-funding-statement-2014.pdf
	4	https://webarchive.nationalarchives.gov.uk/20160105124141/http://www.thepensionsregulator.gov.uk/docs/db-annual-funding-statement-2015.pdf
	5	https://webarchive.nationalarchives.gov.uk/20160701134008/http://www.thepensionsregulator.gov.uk/docs/db-annual-funding-statement-2016.pdf
	6	https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-annual-funding-statement-2017.ashx
	7	https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-annual-funding-statement-2018.ashx