Open Forum: Employer covenant
What it means and its impact on pension funding and investment
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Agenda

• Regulatory Framework and Recent Developments
• Covenant and Scheme-Specific Funding : Theory vs Practice
• Affordability
• Linking Investment Strategy, Funding and Covenant
• Q&A
Covenant: Link to funding and investment

- 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

The Regulatory Framework – Code of Practice 03 Funding Defined Benefits (February 2006)

- “It is essential for the trustees to form an **objective assessment** of the employer’s financial **position and prospects** as well as his **willingness** to continue to fund the scheme’s benefits (the employer’s covenant). This will inform decisions on both the technical provisions and any recovery plan needed.”

- “Trustees should aim for any shortfall to be eliminated **as quickly as the employer can reasonably afford**. What is possible and reasonable, however, will depend on the trustees’ assessment of the employer’s covenant.”
The Regulatory Framework – The Pension Regulator’s Trustee Toolkit: Strategic investment

- “Much will depend upon the trustees' view of the strength of the employer covenant and the extent to which they are confident in the employer's ability to make good any deficit which might arise in the future.”


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:
- willingness

Practical help:
- assessing and monitoring covenant
- appointing an adviser
- the use of contingent assets

Renewed Regulator focus on importance of covenant and monitoring
Scheme-specific Funding and Employer Covenant: Theory vs Practice

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<th>Intended process</th>
<th>In practice?</th>
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<td>Start with covenant assessment</td>
<td>Start with affordability (often objective is for no change to contributions or assets)</td>
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<td>Consider appropriateness of asset strategy</td>
<td>Asset strategy agreed unchanged (may be mitigation)</td>
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<td>Technical Provisions (reflecting covenant and assets) after taking actuarial advice</td>
<td>Technical Provisions and assumption discussions</td>
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<td>Affordability considered – competing demands for cash between stakeholders</td>
<td>Recovery Plan and Technical Provisions driven by affordability</td>
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<td>Technical Provisions, covenant and affordability combine to structure appropriate recovery plan</td>
<td>Recovery plan agreed with Trustees</td>
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<td>Recovery plan agreed with Employer</td>
<td>Covenant can become “Tick box” exercise</td>
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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 not to increase scheme contributions BUT where employer faces challenges it may need to call on shareholders
Observed situations

- Covenant assessment requested in month 13 (of 15 month statutory timescale) – discussions already taken place on funding assumptions and affordability
- Funding discussions carried out 12 months in advance so assumptions already set – may be in conjunction with other changes such as a scheme apportionment, benefit changes or cessation to accrual
- Even where there is a substantial shift in covenant over intervaluation period, employer cannot afford any more so TPs and assets unchanged
- Where business is restructured affordability is likely to be driven by the lenders

Why are funding, investment and employer covenant not more joined up?

- May not need to be – technical provisions and investments might take covenant into account less formally eg if there is a significant change
- Trustees need to be commercial in interests of scheme – if they are offered something of value for “no change” they may agree
- More focus on affordability
- Employer covenant is often viewed as “subjective” concept – potentially difficult to link quantitatively with funding and investment

We believe there are ways to improve this link
Linking Investment Risk and Covenant: Example 1: Tracking market cap

- Changes in market cap
  - Easy to understand / build triggers around changes
  - Captures “equity value” – but real pensions risk unlikely to be reflected (eg BA)
  - Issues with unlisted sponsors / sponsors listed in illiquid markets

Linking Investment Risk and Covenant: Example 2: Value-at-Risk approach

- “VaR” approach
  - Determine appropriate VaR confidence interval eg 95%
  - Estimate increased cash flow requirements associated with the 1 in 20 losses – can the sponsor “afford” these over recovery period?
  - Agree changes to asset mix if cash flow requirements cross agreed thresholds
  - If contingent assets available, could absorb the initial deficit change
VaR approach: Case Study

- 2 employers – A (strong) and B (weak) – overall rating (fairly strong)
- Market cap £500m; scheme assets: £100m; scheme deficit (ongoing basis): £45m – i.e. 70% funded
- Asset strategy: 40% return-seeking; swap overlay for rest
- A manufactures widgets and is twice as large as B; B provides ancillary services to 3rd party customer – A is effectively responsible for 67% of “risk budget”
- Based on “fairly strong” covenant; benchmark return-seeking allocation estimated at 50% - straddles “fairly strong” and “strong”
- Can company support additional funding required for a 1-in-20 year event? Monitor asset volatility and changes in “covenant” on an ongoing basis, having allocated benchmark to appropriate covenant ratings

VaR approach: keen to hear your views!

- Is 95% the right stress? Is 67% more appropriate?
- How does this fit in with scheme-specific funding?
- If there’s no change in covenant over a period, can scheme still de-risk or re-risk?
- How frequently to monitor?
- How would this work with a corporate event (eg a demerger of B – seen as a non-core business)?
Closing comments

- In practice funding and investment are often not driven by covenant
- Affordability is commonly the primary driver for funding discussions
- We believe it is possible to more quantitatively link covenant with funding and investment using VaR techniques
- Scheme Actuaries and Investment Consultants already prepare VaR analysis (ie Asset Liability Modelling) for Trustees
- By working with actuarial and investment advisers, the covenant adviser can encourage a more joined-up approach to risk management

Summary and Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.
The views expressed in this presentation are those of the presenters.