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# Overview on covenant advice

## Gazelle Corporate Finance



November 2015



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# What do we mean by “sponsor covenant”?

In high level before we drill down a bit...

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

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

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

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

## Developing concepts

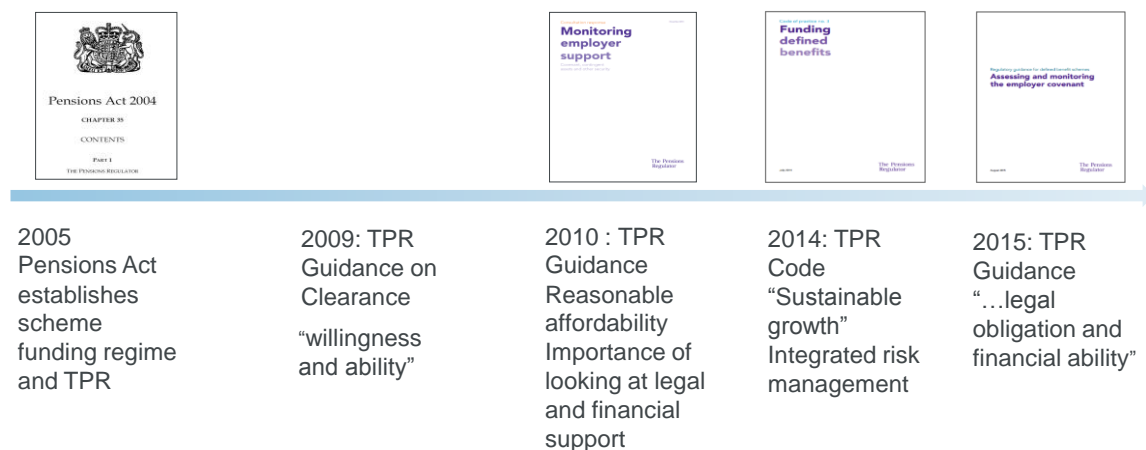
- Covenant as a primary risk concept in its own right, driving investment strategy, funding assumptions
- Scheme “integrated risk management”: dynamic, integrated, feedback loops not linear
- Common currency - covenant integration quantitatively rather than judgmentally

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## An evolving concept



Source: The Pensions Regulator website

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## 2014 Code on Funding Defined Benefits

### Update driven by:

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

### Integrated risk approach

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

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## 2015 Guidance

### Themes highlighted through the Guidance

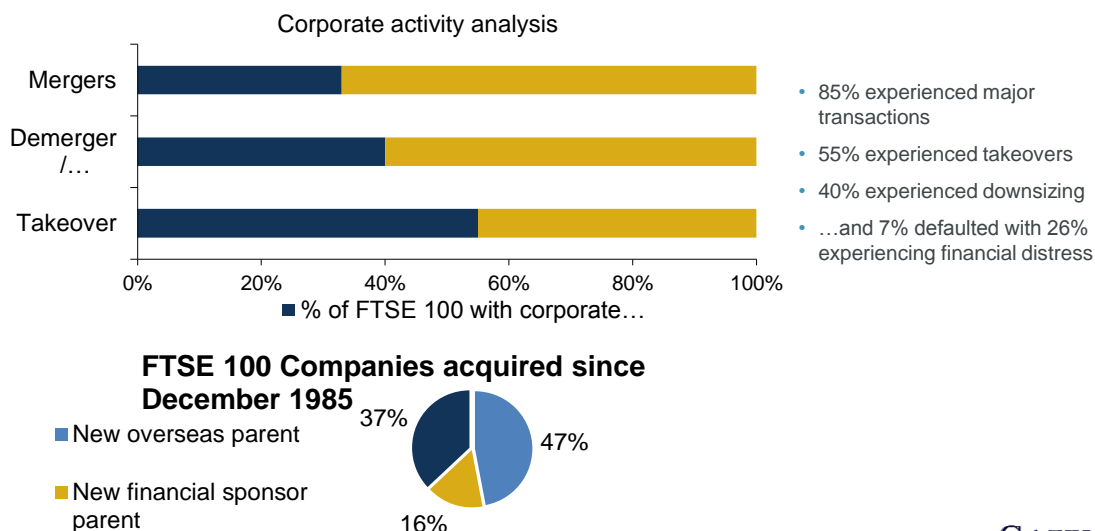
- **Covenant concept:**
  - “the extent of the employer’s legal obligation and financial ability to support the scheme now and in the future
  - “willingness” to support the scheme not supported by a legal obligation - only to be relied on in the short-term
  - guarantees and similar support also relevant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

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## FTSE-100 Index 1985-2010



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## When covenant is relevant

### Funding reviews:

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

### Setting investment policy:

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

### Corporate events:

- Mitigation of material detriment – actual and potential contingencies

### Scheme events

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

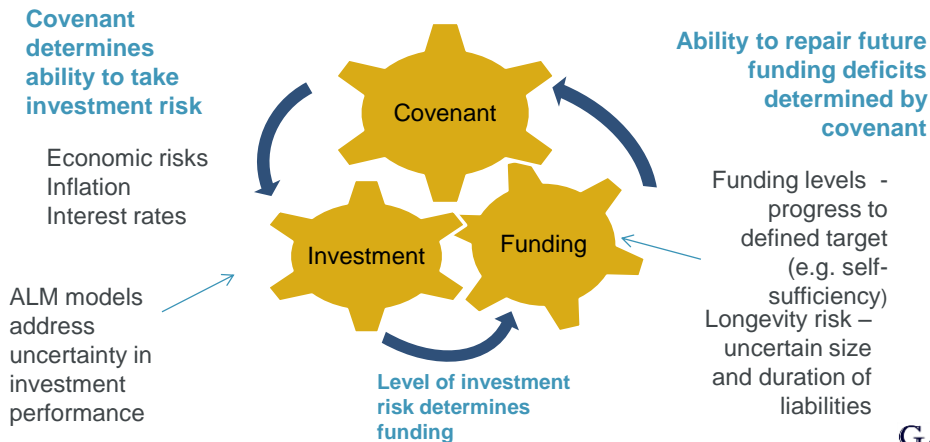
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## Integration of risks

Sponsor covenant is increasingly viewed “holistically” alongside other scheme risks



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## Integration of risks

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

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

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## Where next?

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

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

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