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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

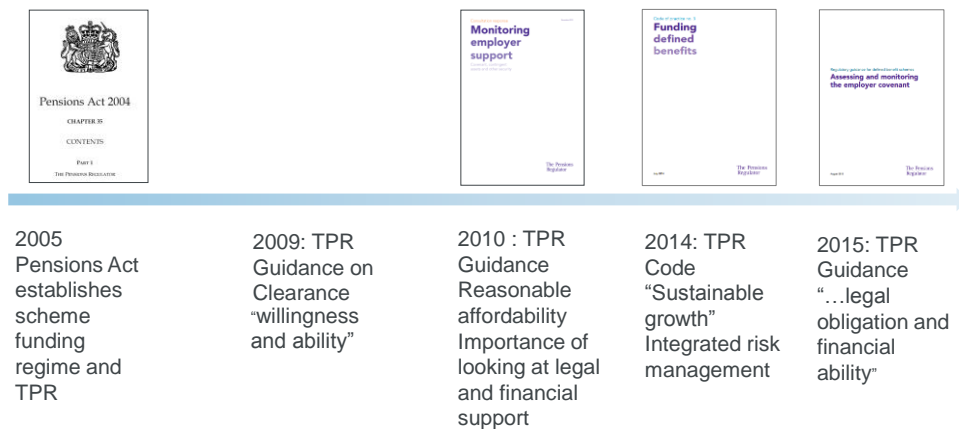
- Covenant as a primary risk concept in its own right, driving investment strategy, funding assumptions
- Scheme “integrated risk management”: dynamic, integrated, feedback loops not linear
- Common currency - covenant integration quantitatively rather than judgmentally

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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

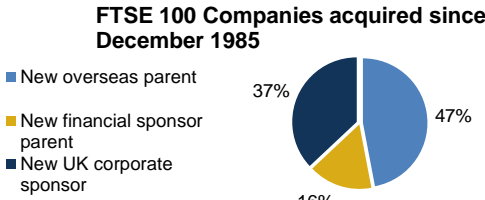
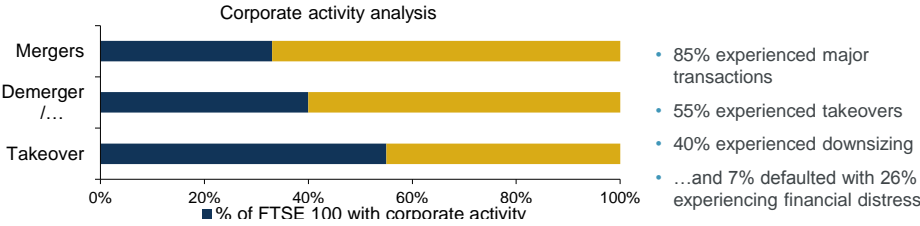
- **Covenant concept:**
 - “the extent of the employer’s legal obligation and financial ability to support the scheme now and in the future
 - “willingness” to support the scheme not supported by a legal obligation - only to be relied on in the short-term
 - guarantees and similar support also relevant 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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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”

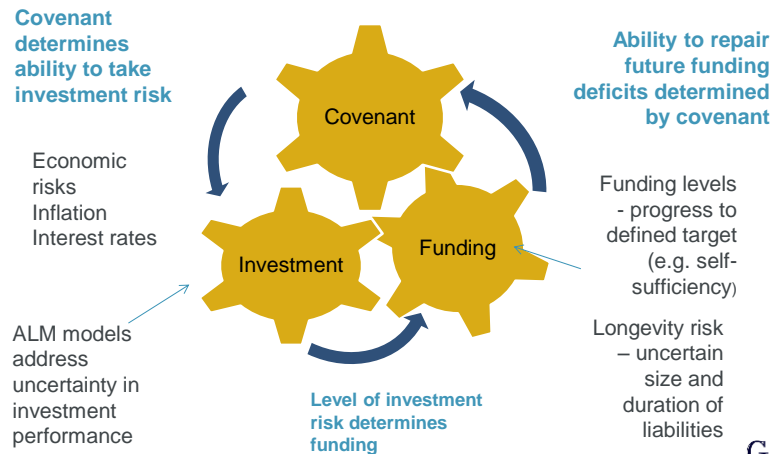
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Integration of risks

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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