Institute and Faculty of Actuaries

Current Issues in Pensions

Leeds 2016

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"Taking the strain"

The evolution of Employer Covenant assessment and how Covenant is being asked to absorb the current DB funding challenge

Current Issues in Pensions,

Institute and Faculty of Actuaries, 17 March 2016

Introduction: Nick Tinker

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- Employer Covenant advisor since 2006
- Joined Lincoln in 2015
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What Are We Covering?

1. What is the Employer Covenant?
2. Integrated Risk Management ("IRM") – a Practical Guide
3. The Pension Funding Dichotomy
4. The Evolution of Employer Covenant Assessment

What is the Employer Covenant?

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TPR's Guidance

July 2014: Code of Practice 3 – Funding Defined Benefits

- TPR's view on how trustees should approach funding and scheme risks

August 2015: Assessing and monitoring the Employer Covenant

- Practical guidance on how to apply the Code of Practice:
  - engaging Employer Covenant advisors
  - assessing the Employer Covenant
  - monitoring the Employer Covenant
- Designed to support the approach adopted in the context of Code 3

TPR's publications have driven a change in focus on Employer Covenant assessment

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What is the Employer Covenant?

"The Employer Covenant … represents the extent of the Employer's legal obligation and financial ability to support the scheme now and in the future"
TPR Code of Practice 03 – July 2014

July 2014 *Code of Practice* and August 2015 *Guidance* from TPR provide the regulatory backdrop to how we think about the Employer Covenant

Employers' legal obligation	• Understanding which entities are legally liable to support the scheme and the method of accessing that support
Employers' financial ability	• The financial position and prospects of a scheme's employers
Supporting the scheme - Investment risk	• The risk that the assets of the scheme perform worse than expected
Supporting the scheme - Funding risks	• The risk that the liabilities of the scheme are larger than expected

The Employer Covenant strength measures the relative ability of the sponsor to underwrite and fund the risks inherent in a Defined Benefit scheme

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Integrated Risk Management ("IRM"): a Practical Guide

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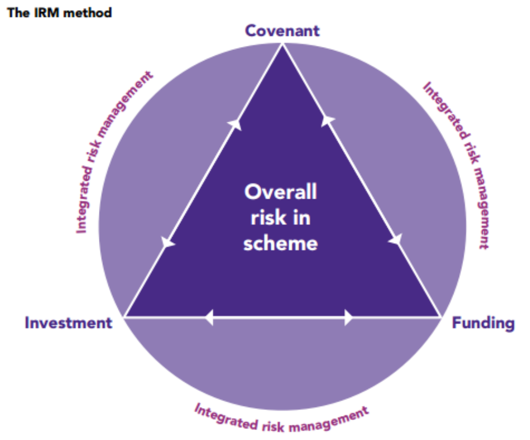
Integrated Risk Management



Source: The Pensions Regulator, *Regulatory Guidance: Integrated risk management*, December 2015

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Integrated Risk - The key theme from recent TPR guidance

"Trustees should take investment and funding risks based on the ability of the Employer to support the scheme"

Investment risks:
- "Return seeking"
- Bonds
- Interest rates
- Inflation

What are the risks?

Funding risks:
- Longevity
- Demography
- Regulatory
- Benefit changes

Covenant risks:
- Current ability to support scheme obligations and associated funding / investment risks
- Risk that Covenant changes

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Integrating Covenant with Funding and Investment

Below we outline how our nine-point Covenant rating scale is used by our clients to inform their choices of funding assumptions, investment strategy and appropriate recovery plan structure

VERY WEAK	WEAK	FAIRLY WEAK	SLIGHTLY WEAK	NEUTRAL	SLIGHTLY STRONG	FAIRLY STRONG	STRONG	VERY STRONG

Illustrative assumptions

How might Covenant inform an appropriate investment strategy?

	Very weak	Very strong
Investment strategy	All or mostly matching assets	All or mostly growth assets
Hedging	More	Less

How might Covenant impact reasonable funding assumptions?

	Very weak	Very strong
Discount rate assumption	Solvency	'Best Estimate'
Other assumptions	More prudent	Less prudent

How might Covenant inform the recovery plan (before considering affordability)?

	Very weak	Very strong
Initial recovery term	Shorter	Longer

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TPR's Guidance – 8 December 2015

"Provides practical help on what a proportionate and integrated approach to risk management might look like"

Step1	**Initial considerations** to put an IRM framework in place
Step 2	**Assess key risk areas individually** – impact and probability • Covenant • Funding • Investment **Assess risks bilaterally** – links, impacts, concentrations • Employer Covenant and funding risk • Employer Covenant and investment risk • Investment and funding risk **Consider all risks together** – links, impacts, concentrations **Assess risk capacity** (trustees / Employer) **Identify risk appetite** (trustees / Employer)
Step 3	**Manage risk** – set strategies / funding plans and put in place contingency plans to deal with material risks that crystallise
Step 4	**Document decisions**
Step 5	**Monitor scheme risks** and act as planned to deal with those that arise

Some key questions for IRM:

- What are the scheme risks?
  – are these risks correlated?
  – what are their probabilities?
  – can the Employer support them?
- What are the Employer / Trustee risk appetites?
- Does the Employer understand the risk profile in the scheme?
- What should we monitor?

Emphasis on Trustees and Employers working together to get the best from IRM

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An Integrated Approach to Risk

What exactly *is* an integrated approach to risk?

1. **Practically integrating advice**
   - Advisors collaborating to consider Covenant, investment and funding issues in their respective advice

2. **Considering investment risk relative to the Covenant**
   - Can the Employer Covenant "as is" support the level of investment risk being run in the scheme? Potentially tested against a VaR95 or specific economic scenarios

3. **Fundamentally integrating investment, funding and Covenant risks**
   - The correlation between investment risk, funding risk, and Covenant risk. Potentially tested through:
     – specific economic scenarios;
     – specific scenarios impacting Employer Covenant; or
     – consideration of random VaR scenarios

TPR's Guidance – Integrated Risk Management ("IRM")

Employer Covenant is integral to the IRM debate:

- "Best to start with the Employer Covenant assessment... to determine the extent to which it can underwrite the risks" (para 28)
- Important trustees understand Employer Covenant as well as the scheme's funding and investment positions before they take decisions which affect the scheme's funding (para 26)

"Ultimately the Employer Covenant underwrites the investment risks and funding risks"

Emphasis on advisory support:

- Advisors working together - "advisors who work well together should be able to help trustees make good decisions"
- Acknowledgement that an advisor may be best placed to set up the IRM

IRM In Practice

Case study 1 – Manufacturer

Investment
- VaR95: £350m
- Investments: 63% equity 13% corp bonds 24% gilts / swaps

Is everything in balance?

Funding
- TP deficit: £200m
- Solvency deficit: £750m

Covenant
- Free cash: £35m (pre pens/div)
- Dividend: £25m
- Total assets: £500m
- Net assets: £90m (pre pension)
- Net debt: £120m
- Market cap: £600m

IRM In Practice

Case study 2 – Professional Services

Employer position

- Business performing well
- Majority cash flow for drawings
- Limited balance sheet
- Significant effort to limit volatility to align drawings with earnings (e.g. dilapidations)
- Intergenerational partner considerations important
- Reluctant to increase recovery plan contributions

Inherent conflict

Trustee position

- Scheme small in context of Employer's annual fee income
- £60m Scheme assets
- £15m TP deficit (and growing)
- £25m VaR95 – material
- £2m annual contributions
- 3 years left on recovery plan
- Covenant "Fairly Strong"

Not a typical affordability debate – focus on:
1. the **risk appetite** of the Sponsor
2. the fair treatment of the **Scheme as a stakeholder**

The Pension Funding Dichotomy

The Employer Covenant landscape - Where are we now?

Scheme funding

But thankfully…

Economic improvement

- Enabling higher deficit contributions to address the scheme risks…?

Key factors at play….

- Sponsors prefer to rely on investment performance
- “Sustainable growth” objective
- Trustees more comfortable about improving Employer Covenant
- Remember… the Employer Covenant is a relative thing

Corporate performance is improving, trustees are providing flexibility

However, this is building up risk in the system, placing greater strain on the Covenant to underwrite these risks in future

The "Pension Funding Dichotomy"

The Pension Funding Dichotomy:
- When times are good, Trustees can be more relaxed about Employer Covenant risk and the Sponsor's wish to maintain lower levels of contributions. This leads to deficits not being funded and risks not being reduced
- When times are challenging, companies may not be able to afford the level of contributions required meaning deficits are not funded and risks increase

- Bigger issue in cyclical industries
- Remember – don't wait until it starts raining before you fix the roof…

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The Evolution of Employer Covenant Assessment

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The Evolution of Employer Covenant assessment

TPR guidance has led to material changes in assessing Employer Covenant

Area of focus	2010 approach	2015 approach
Relevant deficit	TP deficit (at valuation date)	Also consider VaR
Investment risk	Not expressly considered	“Does the Covenant effectively underwrite the investment risk in the scheme?”
Correlation of scheme and Covenant risks	Not expressly considered	Increasing appreciation and required awareness
Affordability	“quickly as is reasonably affordable”	What “sustainable growth” means for my Employer? Focus on discretionary cash flows and overall “financial flexibility”
Is the scheme being treated fairly?	TP deficit covered over a reasonable period (10 years)	Consider pension in relation to other financial stakeholders (equity / debt)
Primary use of Covenant output	Drive TP assumptions and affordability…	…now Covenant is also a key factor in settling investment risk budgets
	Focus on repairing the TP deficit	***Holistic view of scheme risk***

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Thank you

Questions?

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