“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,*

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Introduction: Nick Tinker

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- 20 years’ advisory experience
- Employer covenant advisor since 2006
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- Head Lincoln’s Leeds office

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What Are We Covering?

1. What is Employer Covenant?
2. Integrated Risk Management
3. The Pension Funding Dichotomy
4. The Evolution of Employer Covenant Assessment
What is Employer Covenant?
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
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.
Independent review drivers – recent experience

Common themes

– **Nudges from Brighton**
  - Guidance, e.g. IRM
  - “The Regulator didn’t like our 2012 valuation…”

– **Events**
  - “We’ve always done it ourselves but now the employer’s up for sale”
  - “The management team has changed and/or we’re not sure about management’s plans for the business… we’re concerned”
  - Employer proposals, e.g. longer recovery plan, asset-backed contributions

– **Encouragement from advisors**
  - Direct/indirect covenant assessment
  - Elephant in the room

Fewer schemes able to make the case not to obtain independent covenant advice
When to commission an external covenant assessment

“Trustees should periodically reassess whether to commission independent covenant advice as changing circumstances for the scheme and employer may lead to situations where it can add greater value.

If trustees decide … to perform their own assessment they should be comfortable that they are able to perform adequately the steps set out throughout the guidance.”

Assessing and monitoring the employer covenant, August 2015
Integrated Risk Management
Integrated Risk Management

The IRM method

Covenant

Integrated risk management

Overall risk in scheme

Investment

Integrated risk management

Funding

Integrated risk management

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
Integrating Covenant with Funding and Investment

Our nine-point Covenant rating scale is used by clients to inform their choices of funding assumptions, investment strategy and recovery plan structure.

How might Covenant inform an appropriate investment strategy?

Investment strategy

- All or mostly matching assets
- All or mostly growth assets

Hedging

- More
- Less

How might Covenant impact reasonable funding assumptions?

Discount rate assumption

- Solvency
- ‘Best Estimate’

Other assumptions

- More prudent
- Less prudent

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

Initial recovery term

- Shorter
- Longer
**IRM – Case study**

**Case study 1 – Manufacturer**

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

**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

Is everything in balance?
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

**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”

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**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?

**Key factors at play…**

- Enabling higher deficit contributions to address the scheme risks…?
- 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…
TPR’s Guidance – Sustainable Growth

Assessing and monitoring the employer covenant – August 2015:

• “If the employer’s plans to invest in sustainable growth restrict the funding available to the scheme, trustees should understand how the scheme will benefit by supporting this investment and whether other stakeholders are contributing appropriately.” **Executive Summary**

• “The employer’s obligations to the scheme are likely to last for an extended period of time given the long-term nature of pension liabilities. It is therefore in the scheme’s interest that the employer is able to adequately invest in the sustainable growth of its business so it can continue to support the scheme in the long-term.”

• “Although such investment can constitute a significant call on the employer’s discretionary cash alongside the required contributions to the scheme, many employers are likely to be able to afford both. But where investment in growth is likely to restrict the funding available to the scheme, it is important that trustees understand the employer’s plans as part of their assessment of affordability.” **Section 2**
Sustainable Growth – practical steps

<table>
<thead>
<tr>
<th>Trustees and employers must take certain steps</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk that sustainable growth could prove to be a rogues’ charter</td>
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- Communication
- Onus is on the employer to make the case
- Trustees need to assess and challenge the case
- Understanding the context of an employer’s circumstances and objectives
- Trustees shouldn’t be second guessing employer’s business and investment decisions
- Capex: sustainable growth vs. maintenance and replacement (discretionary?)
Sustainable Growth – practical steps

Key questions

1. How will the employer’s growth plans impact the covenant?
   • what’s the case?
   • is the investment in our employer?

2. When will growth be able to fund an increase in contributions?
   • jam tomorrow?
   • how do trustees ensure that the scheme sees the benefit?

3. Are other stakeholders contributing appropriately?
   • shareholders – dividends, rights issue?
   • appropriate use of debt?
   • is the scheme being asked to take the strain?

4. Can scheme security be improved by contingent assets?
   • can we mitigate the increased credit risk?
The Evolution of Employer Covenant Assessment
# The Evolution of Employer Covenant assessment

TPR guidance has led to material changes in assessing Employer Covenant

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

**Focus on repairing the TP deficit**

**Holistic view of scheme risk**
Thank you

Questions?