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Penfida - PMI Academy Covenant Manual

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Contents

Executive summary

An assessment of the employer covenant measures the ability of the sponsor to meet its obligations to a scheme, both now and in the future.

Covenant assessment is a relative concept and therefore the qualitative and quantitative strengths and weaknesses of the covenant must be considered in relation to the funding requirements and investment risk of a scheme.

A robust understanding of the covenant supporting a scheme allows for more informed journey planning and funding decisions, and is a fundamental strand of an integrated risk management approach.

Introduction

The purpose of this manual is to provide defined benefit (DB) pension scheme professionals with a single reference document on how to consider covenant appropriately and proportionately to enable informed decisions about how much risk a scheme should bear on its long-term journey plan.

Covenant, and appropriate assessment of the covenant, is becoming an increasingly important subject in the industry, receiving greater focus and scrutiny from The Pensions Regulator (TPR) and government policy.

The key learnings from this manual include the following:

- What covenant is and why it is important
- What a covenant assessment should consist of
- How to consider risks to the covenant, how they integrate with other scheme risks and how they could be addressed
- How to think about covenant in the new regulatory and legal landscape
- How fostering a good relationship between trustee and sponsor can be a key intangible asset.

What is covenant and why is it so important?

TPR defines the covenant as the employer's legal obligation and financial ability to support their defined benefit scheme now and in the future.

The strength of the covenant will, in part, determine how quickly a scheme needs, and is able to achieve, its long-term funding target, and how much risk it can bear on that journey.

The covenant underwrites the risks to a scheme, such as investment and mortality risk, and the sponsoring employer's ability to remedy a variety of downside scenarios in a reasonable timeframe. It should determine a trustee's appetite for risk. This is a key principle of TPR's DB Funding Code.

The importance of covenant assessment is not just in the context of triennial valuations and setting funding and investment decisions. It is also fundamental in adequately assessing the impact of corporate activity, such as mergers and acquisitions, non-ordinary shareholder distributions such as share buybacks and scheme-related events such as Flexible Apportionment Arrangements or scheme merger proposals.

What should a covenant assessment consist of?

1. Recourse

The starting point in evaluating the covenant is understanding where the legal obligation to your pension scheme lies. The strength depends on the nature and enforceability of any legal arrangements supporting a scheme.

There are several aspects to consider:

- Is the scheme a single-employer or multi-employer scheme?
- What is the nature of the employer(s) and where does it/do they sit within the group structure?
- Can the scheme rely on wider group support?

Is the scheme a single-employer or multi-employer scheme?

Determining who the participating employers are in a scheme is critical to understanding the covenant. Many schemes will be single employer schemes, with one UK entity to look to for financial support in all of the scheme's obligations.

As businesses have grown and evolved over time, it is possible that additional entities will have been added to the list of participating employers. The extent of any one employer's obligations to a scheme depends on the extent of members' liabilities attached to each employer or any relevant legal agreement.

A multi-employer scheme may be set up in several ways:

- Each employer is responsible for its share of liabilities based on its history of employing certain members
  • In this situation, each entity should be evaluated on a standalone basis relative to its share of the obligations
  • There may be a mismatch between the stronger entities in a group and where the majority of the liabilities sit

- Alternatively, the employers may support the scheme on a 'last man standing' basis, whereby, upon an insolvency of any one employer, its obligations are apportioned to the remaining employers on a pro rata basis, based on their original share of membership / liabilities
  • In this situation, each entity should be evaluated on its ability to support its own share of the obligations, as well as the whole scheme, as any one employer could be the 'last man standing'
- Finally, some or all of the employers may have joint and several liability to the scheme
  • Effectively, the scheme can look to the combined financial support of all employers. This may simplify any analysis required, particularly where one of the employers is the top company in the group

What is the nature of the employer and where does it sit within the group structure?

Whether single employer or multi-employer, the covenant strength can vary based on the principal activities of the employer and its position within the group:

- An employer can be the principal UK operating entity of a group which holds the majority of the group's operating assets and intellectual property. In this circumstance, the cash flow generation of the covenant may be more predictable, and the scheme is closer to the economic value and cash generation of the group
- Where an employer is a holding company, whilst it may hold investments in other group entities, its cash flow could be dependent on the availability and timing of subsidiary dividends, often out of the control of the sponsoring employer's directors
- Where an employer is a service company, unless there are any formal agreements which provide additional support from the wider group, the covenant may be rated weak as the employer itself is likely to have little economic substance beyond the service contracts to other parts of the group. This value therefore risks being undermined in the event of group financial distress.

Wherever the covenant sits, any covenant assessment will include a financial analysis of the employer(s), including prospects and balance sheet strength (e.g. competing creditors).

Can the scheme rely on wider group support?

The Pensions Regulator notes that, whilst it may be reasonable to rely on informal group support in the short term (e.g. statements of willingness to support the scheme from a parent company), such assurances should not be considered in the long-term assessment of covenant and journey planning.

Wider group support can be relied on where it is legally binding, for example via a guarantee, and is limited to the terms of that guarantee (which can be limited in both duration and scale).

Where reliance is being placed on wider group support, affordability should be considered at the same level when considering recovery plan length, i.e. reflecting the higher level of affordability that additional support brings. This is because a strongly rated covenant is also likely to have good affordability to support both a recovery plan and the impact of a Value at Risk (VaR) event.

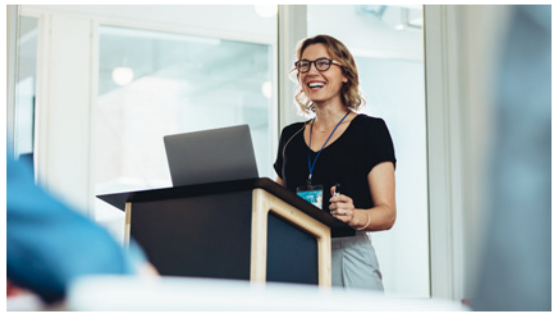
Where wider group support is informal, it can be bolstered by the scheme seeking a suitable contingent asset to underpin it. The effect of this mechanism is that the underlying asset would become an asset of the scheme in the event of a (defined) default by the employer or the wider group.

Conclusion

The identification of recourse and its strengths and limitations is the starting point of covenant assessment.

As well as identifying who the employers are, it is also important to know where they sit within a wider group, their financial significance and what other creditors or contingent obligations may compete for the same value. This is because, ultimately, cash flow pays pensions. The level of confidence in the availability and predictability of the cash flow a scheme has access to now and in the future is therefore a key determinant of both covenant strength and the level of risk it is appropriate for trustees to be running in a scheme.

What should a covenant assessment consist of? (Continued)



2. Funding Position

Covenant assessment is relative by nature, comparing the financial value available from the entity (or entities) to which a scheme has recourse to the obligations of the scheme. The extent to which a scheme relies on its covenant is determined by the size of its deficits, on various bases such as the technical provisions, a low-reliance basis (e.g. long-term funding objective and self-sufficiency) and the buyout / s75 estimate.

This comparison should also account for the level of investment risk being run in the scheme, as that investment risk, should it come to bear, would need to be funded by the covenant to avoid unduly increasing recovery plan and/or placing the ultimate funding objective in doubt.

Conclusion

By establishing the extent and degree of reliance that can be placed on the covenant, a scheme's journey plan and investment risk can then be tailored to the covenant that supports it, or the covenant enhanced (e.g. by guarantees to extend recourse or by contingent assets) to better match the extent of the obligation.

What should a covenant assessment consist of? (Continued)

3. Assessing the sponsor's financial capacity

The aim of the covenant assessment is to assess the sponsor's ability to support the scheme's journey plan going forward, in both ongoing and insolvency scenarios.

Below, and in line with guidance from TPR, we set out the key questions that should be covered in the following areas:

- Building the background – Quantitative analysis
- Building the background – Qualitative analysis
- Assessing the sponsor's ability to meet the scheme's needs going forward in ongoing situations, both normal course and with downside sensitivities
- Assessing the sponsor's ability to meet the scheme's needs in an insolvency.

Building the background – Quantitative analysis

In assessing the sponsor's current financial resources, detailed analysis will need to be undertaken on underlying strategy and associated revenue, profit and cash flow generation, asset backing and competing creditors. This will demonstrate how the sponsor has been able to support the scheme historically and, more importantly, expectations for the future to highlight any concerns about the quality of the balance sheet and liquidity sources.

Key questions include:

- How has the sponsor's revenue, profitability and cash flow generation developed over the last few years? Has it been stable, growing, declining? Has it been predictable and how is it expected to behave in the future?
- What assets and liabilities comprise the balance sheet? What tangible asset-backing does the sponsor have? How realisable are the assets?
- Who are the key competing creditors? How does the scheme rank in the capital structure? Are there any debt maturities in the short term that may be a cause for concern?
- What sources of liquidity are available? Is there access to external capital (debt or equity), and are there any limits?

Building the background – Qualitative analysis

The covenant assessment should also consider the prospects for the markets in which the sponsor operates and the sponsor's position within these markets. This analysis will set the context for forecasting financial performance and highlight key risks that may undermine the strength of the covenant going forward, e.g. corporate events.

Key questions include:

- What are the strengths, weaknesses, opportunities and threats (SWOT) that exist with regards to the industry sector?
- What is the sponsor's position within the industry? How has that changed and how is it expected to change going forward?
- How does management's strategy for the business compare to the SWOT analysis and other peers in the industry?
- How is the sponsor addressing regulatory nd environmental, social and governance (ESG) considerations?

Assessing the ability of the sponsor to meet the scheme's needs going forward in ongoing situations

Having built up the background, the covenant assessment on an ongoing basis will focus on the sponsor's ability to meet the scheme's needs and should be under two lenses:

How large is the scheme relative to the sponsor?

- This can be based on forward-looking valuation methodologies (for example, a discounted cash flow analysis based on forecasts constructed in the context of the background analysis) or balance sheet bases. The larger the scale, the more comfort the trustees can take

What is the sponsor's ability to meet contributions?

- The scheme's cash funding requirements will need to be considered in the context of the forward-looking expectations for cash flow generation and balance sheet capacity. The larger the sources of affordability, the more comfort the trustees can take.

Assessing the sponsor's ability to meet the scheme's needs in an insolvency

The covenant assessment should also address the scheme's risk of insolvency given that there is likely to be a disconnect between the sponsor's ongoing value and what residual value may be available in an insolvency scenario. This is an area of increasing focus from TPR.

Key questions include:

- What is the likelihood of insolvency?
- What recovery might the scheme get in an insolvency scenario?
- Do competing creditors claim priority over the scheme?
- How do the scheme's powers and levers impact the analysis?

Conclusion

A robust covenant assessment taking account of these factors will:

- Allow the trustees and sponsor to assess the comfort around the scheme's journey plan
- Highlight risks that may undermine the strength of the covenant
- Inform valuation discussions and negotiations
- Set a baseline against which intervaluation developments and the impact of corporate events can be judged.

How to consider risks to the covenant, how they integrate with other scheme risks and how they could be addressed

Different sponsors operating in different industries and geographies face different covenant risks. However, there are some general categories of risks that should be considered across all sponsor groups.

These include:

• Business underperformance
• Corporate activities such as:
• Change of ownership
• Major acquisitions and disposals / demerger
• Refinancing
• Internal restructuring

- Excessive covenant leakage e.g. through disproportionate shareholder returns

Contingency planning is key to allow trustees to take action to mitigate against adverse covenant events when necessary. Trustees, sponsors and advisers will want to consider and, ideally, quantify the impact of these risks through scenario analysis to help:

- Develop an appropriate 'business as usual' funding and investment strategy that is within the risk tolerance of the covenant
- Develop a game plan to be able to react quickly to these covenant downside events and translate the degree of covenant deterioration into new funding and investment targets, as and when needed.

Following the scenario analysis, trustees, sponsors and advisers may decide that protection may be required to mitigate the impact of certain events. In this instance, trustees and sponsors should discuss appropriate contingent protections and triggers, and agree what potential mitigation the sponsor should provide and / or what potential actions trustees might take as soon as a trigger is breached. Examples of ways to improve scheme security on a contingent basis could include:

- Cash contributions
- Security (e.g. legal charge over assets, letters of credit or asset-backed contributions)
- Guarantees from other entities in the sponsor's group
- Commitment not to perform certain acts without agreement or consultation with the trustees
- Improving the scheme's insolvency priority.

The strength of the employer covenant can change quickly so it is important to monitor it regularly. This will enable prompt and effective action when downside events occur. The frequency of monitoring will depend on both the availability of information and the level of the scheme's reliance on the covenant.

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The regulatory and legal agenda

We are seeing major legal and regulatory developments in the pensions arena. The long-awaited Pension Schemes Act received Royal Assent in February 2021 and, during 2020, TPR completed a first consultation on its draft Funding Code for DB schemes (although the new Funding Code is not now expected before the end of 2022). These could result in far-reaching changes and implications for trustees and sponsors. For DB schemes, tPR regards employer covenant as one of the critical elements of the risk spectrum that must be considered and regularly monitored.

Additionally, accelerated by the COVID-19 pandemic, the Corporate Insolvency and Governance Act (CIGA) received Royal Assent in August 2020 and has some important consequences for schemes.

The Pension Schemes Act

The Act includes changes to rules on scheme funding and introduces new powers for TPR. It has attracted some controversy, particularly in relation to criminal sanctions that TPR will be able to impose, that could extend to action against pension scheme trustees. There are concerns around the scope of such sanctions and the potential impact on a wide range of corporate activity scenarios. Guidance is expected from the Department for Work and Pensions in the autumn of 2021.

The Pension Regulator's Defined Benefit Funding Code

The biggest shake-up in DB funding for more than a decade, the Funding Code, will have implications for most DB schemes in the UK. Its key aims are to implement measures which will 'optimise' scheme funding in the wake of several high-profile corporate failures. This will be accompanied by new and improved regulatory powers for TPR to intervene when expectations are not met.

TPR has stated that the Code will enable it to target its resources more efficiently and effectively, whilst embedding good practice across the industry. To comply, schemes will follow one of two routes to compliance – Fast Track or Bespoke.

Many schemes may well find that their current funding and investment plans fit well with the Code, but all trustees and sponsors will, to a greater or lesser extent, need to demonstrate more clearly that a plan is in place and the risks they are running can be supported by the sponsoring business.

Trustees and sponsors are watching closely for more details on what form the new framework and powers will take. TPR has confirmed that a second consultation will take place in the second half of 2021 with implementation of the Code being likely in 2022.

The Corporate Insolvency and Governance Act (CIGA)

CIGA has brought in significant changes to UK restructuring and insolvency practice. It impacts the restructuring of distressed companies, in particular those affected by the coronavirus pandemic. This has a knock-on impact on the way DB pension schemes are funded, so affects the actions trustees can and should take.

CIGA is likely to impact the assessment of employer covenant and, in particular, the value placed on any securities, which could well be diluted. Action should be taken to review any current contingent assets to address any weakening of protection.

The sponsor and trustee relationship

In an ideal world, a collaborative relationship between sponsor and trustee is a key intangible asset for any scheme. In reality, many factors can create tensions and are exacerbated by differing objectives, priorities and pressures.

Complex corporate structures can mean that the relationship is not straightforward. For example, the sponsor of the scheme may not be the employer and there may be an overseas parent company. Corporate events such as mergers and takeovers can result in changes and stresses that trustees must navigate carefully.

TPR's expectations are that the parties should work openly and collaboratively. In particular, trustees should be provided with the information necessary to make an informed assessment of the covenant over time. A governance and reporting framework should also be in place so that both sides are clear what their disclosure obligations are, so that surprises on either side will be minimised. As schemes are typically a material creditor of the sponsor, trustees should act like a bank creditor and expect similar treatment to the sponsor's banks in terms of information provision.

Recent legislation, particularly the Pensions Act and the Corporate Insolvency and Governance Act, aim to add additional protections to schemes and are designed to lead to increased engagement from sponsors. New powers have also been created to pursue criminal behaviour - by both corporates and trustees – causing some concern over how these will be exercised in practice.

Key tools for developing a productive relationship include:

Regular communication and transparency, using an open-book approach, leading to greater mutual understanding

- Information sharing protocols to ensure confidentiality concerns are addressed
- Regular quarterly or half-yearly reporting

Concluding points

Managing covenant risk is central to most schemes in achieving their long-term objectives and, ultimately, to securing members' benefits.

Covenant evaluation involves a robust assessment of the sponsor's likely future profitability and cash flow, taking account of the outlook for the business, the market in which it operates and the position of the scheme relative to other stakeholders.

By establishing the baseline covenant and highlighting potential risks, trustees and sponsors can determine the key areas to monitor and agree protections that can maintain or even enhance the covenant.

Increasing legal and regulatory focus on covenant means that trustees are expected to have:

- A detailed understanding of the sponsor covenant, both on a business as usual basis and in the event of a range of potential scenarios
- A high degree of collaboration with the sponsor as a basis for agreeing how the trustees and the sponsor will react to those scenarios, together with a shared vision for the long-term position of the scheme.

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Penfida is a leading covenant advisory firm and the PMI's Academy Partner.

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