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Covenant advisory update:

Developments in the covenant advisory space following TPR's 2017 Annual Funding Statement, and the value the actuarial skill set can bring to this specialism

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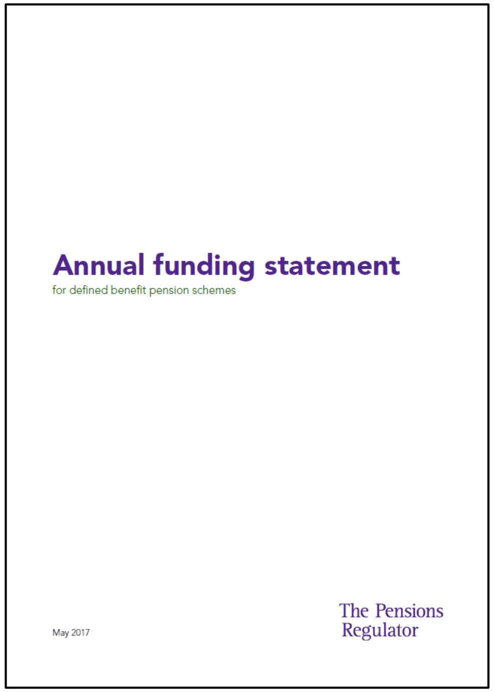
Thursday 7 September 2017

What is covenant?

“The extent of the employer’s **legal obligation**, and **financial ability**, to support the scheme **now** and in the **future**”

Source: 1. ‘Assessing and monitoring the employer covenant’, TPR, August 2015

2017 Annual Funding Statement (AFS)

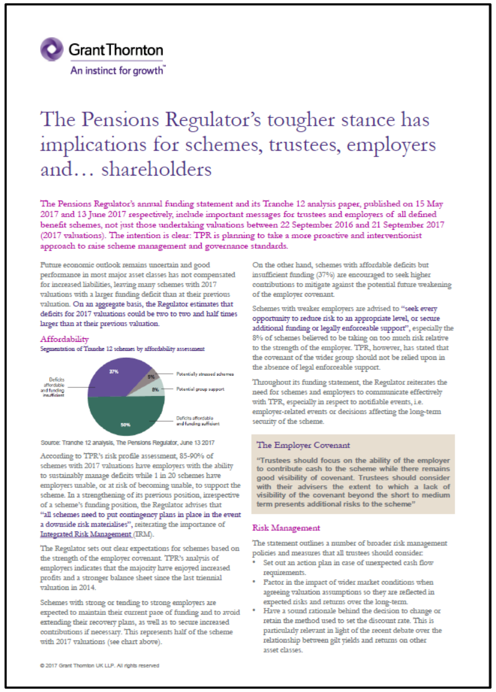


Annual funding statement

for defined benefit pension schemes

May 2017

The Pensions Regulator



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The Pensions Regulator's tougher stance has implications for schemes, trustees, employers and… shareholders

The Pensions Regulator's annual funding statement and its Tranche 12 analysis paper, published on 15 May 2017 and 13 June 2017 respectively, include important messages for trustees and employers of all defined benefit schemes, not just those undertaking valuations between 22 September 2016 and 21 September 2017 (2017 valuations). The intention is clear: TPR is planning to take a more proactive and interventionist approach to raise scheme management and governance standards.

Future economic outlook remains uncertain and good performance in most major asset classes has not compensated for increased liabilities, leaving many schemes with 2017 valuations with a larger funding deficit than at their previous valuation. **On an aggregate basis, the Regulator estimates that deficits for 2017 valuations could be two to two and half times larger than at their previous valuation.**

Affordability

Segmentation of Tranche 12 schemes by affordability assessment

Deficits affordable and funding insufficient 37%
Potentially stressed schemes 5%
Potential group support 8%
Deficits affordable and funding sufficient 50%

Source: Tranche 12 analysis, The Pensions Regulator, June 13 2017

According to TPR's risk profile assessment, 85-90% of schemes with 2017 valuations have employers with the ability to sustainably manage deficits while 1 in 20 schemes have employers unable, or at risk of becoming unable, to support the scheme. In a strengthening of its previous position, irrespective of a scheme's funding position, the Regulator advises that **"all schemes need to put contingency plans in place in the event a downside risk materialises"**, reiterating the importance of Integrated Risk Management (IRM).

The Regulator sets out clear expectations for schemes based on the strength of the employer covenant. TPR's analysis of employers indicates that the majority have enjoyed increased profits and a stronger balance sheet since the last triennial valuation in 2014.

Schemes with strong or tending to strong employers are expected to maintain their current pace of funding and to avoid extending their recovery plans, as well as to secure increased contributions if necessary. This represents half of the scheme with 2017 valuations (see chart above).

On the other hand, schemes with affordable deficits but insufficient funding (37%) are encouraged to seek higher contributions to mitigate against the potential future weakening of the employer covenant.

Schemes with weaker employers are advised to **"seek every opportunity to reduce risk to an appropriate level, or secure additional funding or legally enforceable support"**, especially the 8% of schemes believed to be taking on too much risk relative to the strength of the employer. TPR, however, has stated that the covenant of the wider group should not be relied upon in the absence of legal enforceable support.

Throughout its funding statement, the Regulator reiterates the need for schemes and employers to communicate effectively with TPR, especially in respect to notifiable events, i.e. employer-related events or decisions affecting the long-term security of the scheme.

The Employer Covenant

"Trustees should focus on the ability of the employer to contribute cash to the scheme while there remains good visibility of covenant. Trustees should consider with their advisers the extent to which a lack of visibility of the covenant beyond the short to medium term presents additional risks to the scheme"

Risk Management

The statement outlines a number of broader risk management policies and measures that all trustees should consider:

- Set out an action plan in case of unexpected cash flow requirements.
- Factor in the impact of wider market conditions when agreeing valuation assumptions so they are reflected in expected risks and returns over the long-term.
- Have a sound rationale behind the decision to change or retain the method used to set the discount rate. This is particularly relevant in light of the recent debate over the relationship between gilt yields and returns on other asset classes.

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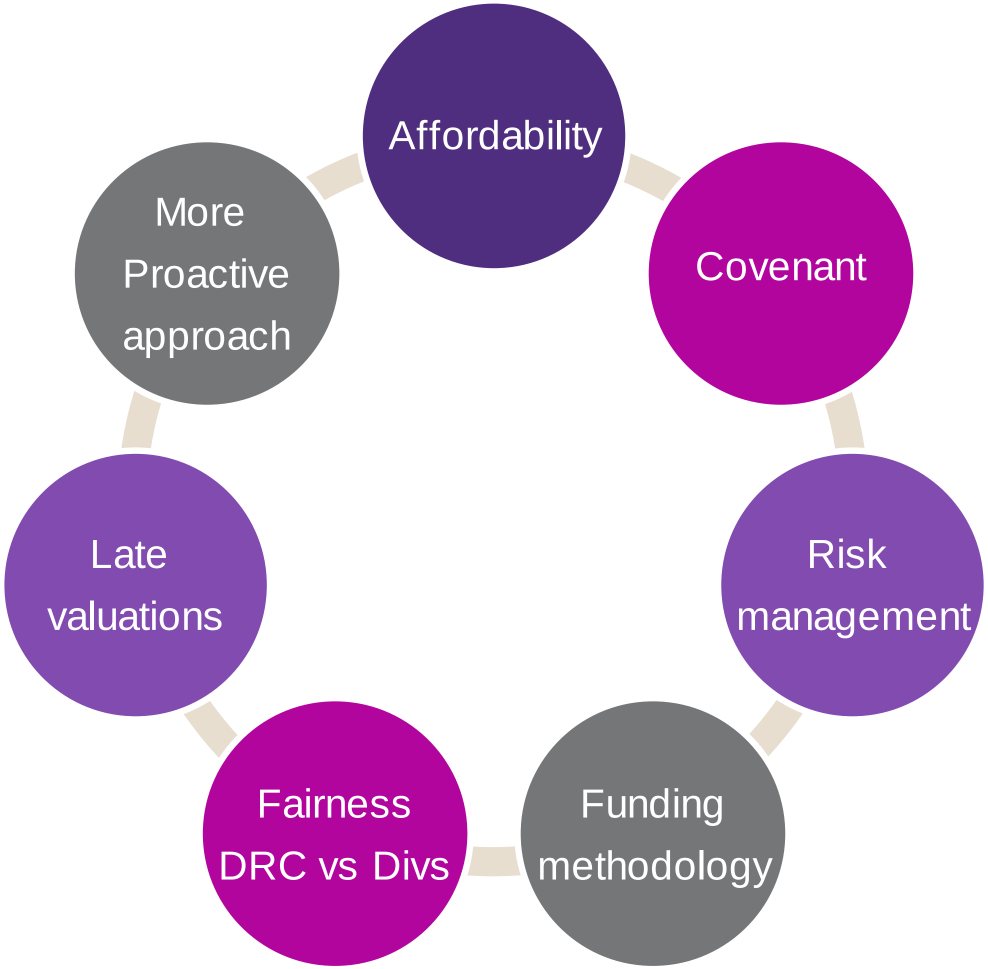
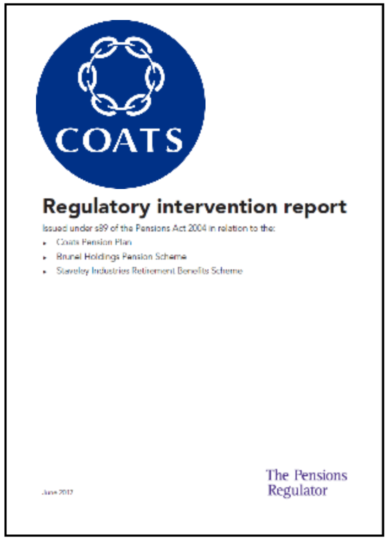


What TPR have had to say since AFS

June 2017

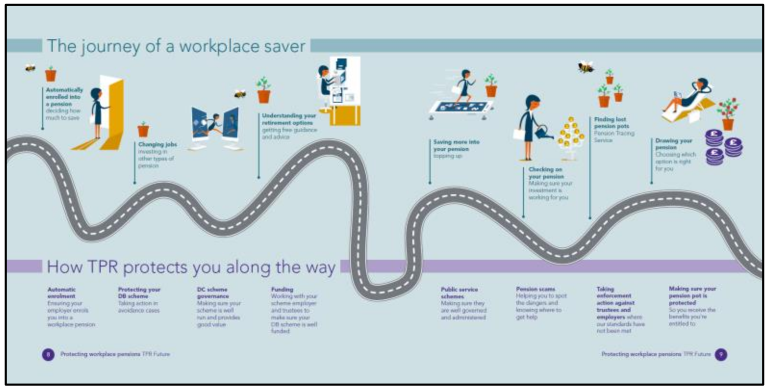


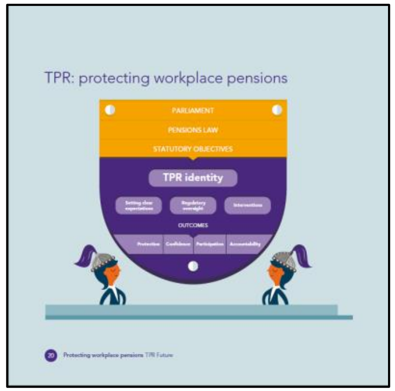
June 2017

June 2017

May - July 2017

July 2017





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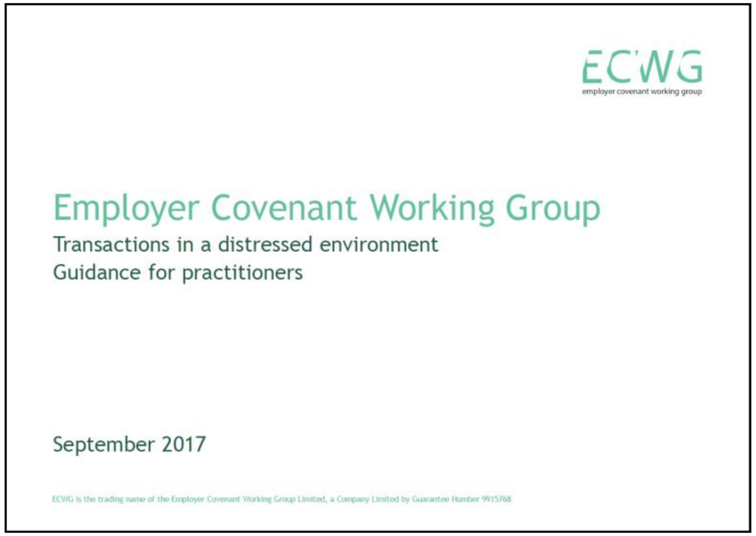
Other publications and press

TATA
TATA STEEL

August 2017

ECWG
employer covenant working group


ECWG
employer covenant working group

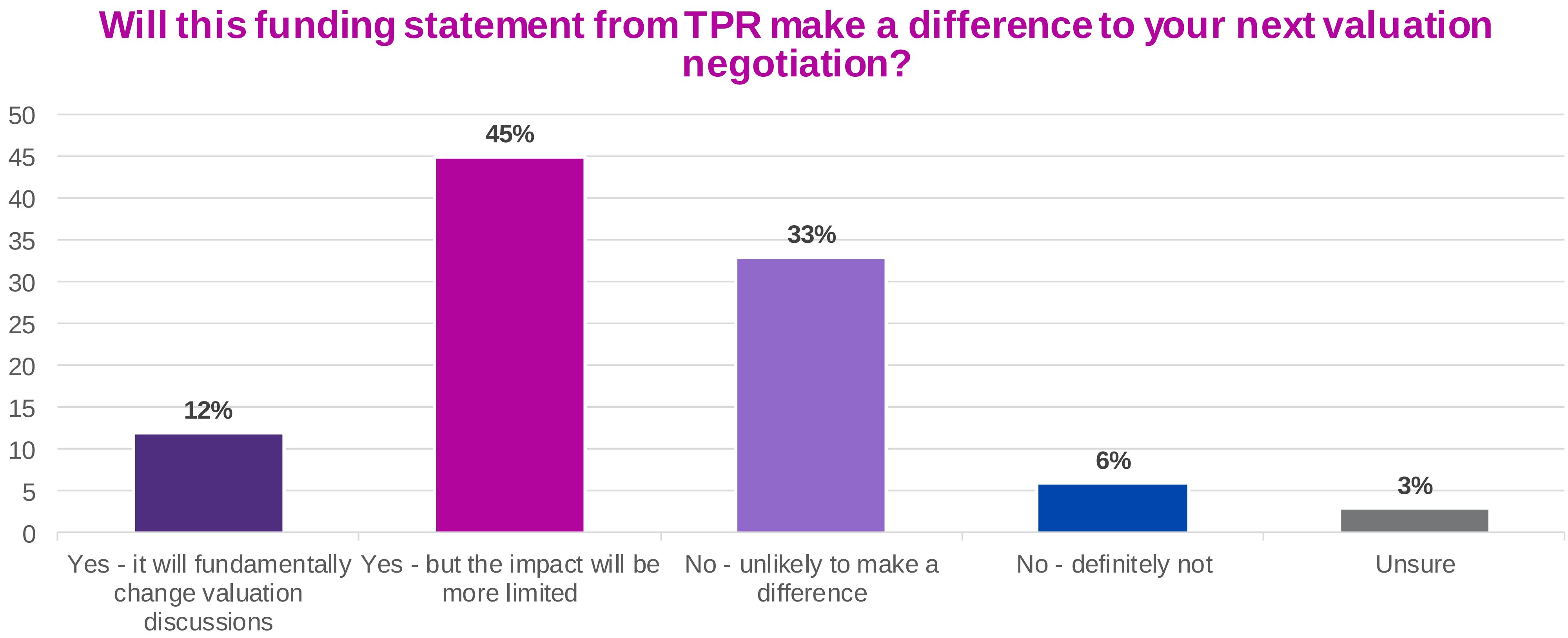
Employer Covenant Working Group
Transactions in a distressed environment
Guidance for practitioners

September 2017

ECWG is the trading name of the Employer Covenant Working Group Limited, a Company Limited by Guarantee Number 9915768

September 2017

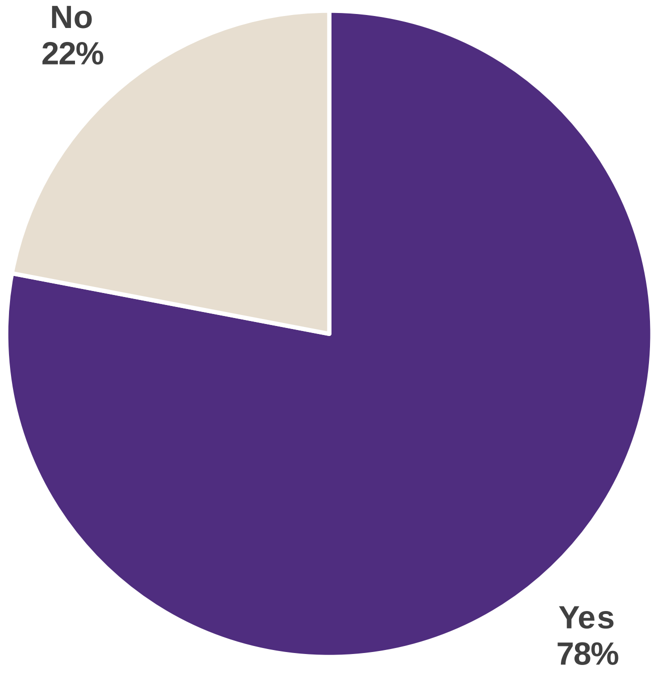
What trustees have had to say since May 2017



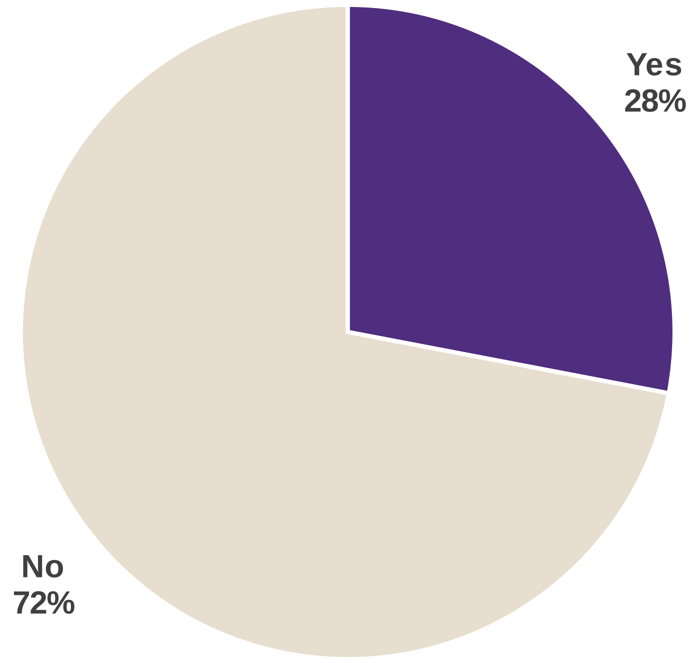
Source: 1. Grant Thornton survey, July 2017

What trustees have had to say since May 2017

Do you have an Integrated Risk Management (IRM) framework in place?

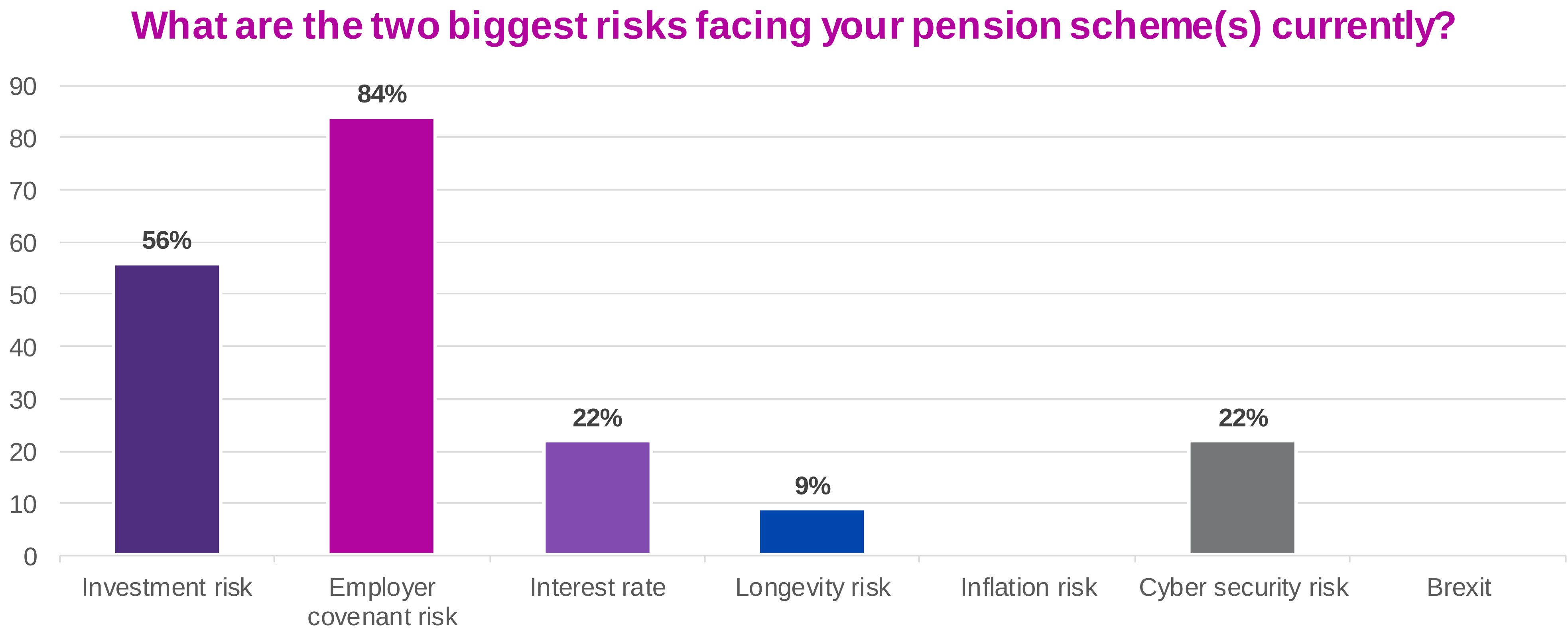


If so, does your IRM framework have agreed legally enforceable contingency plans?



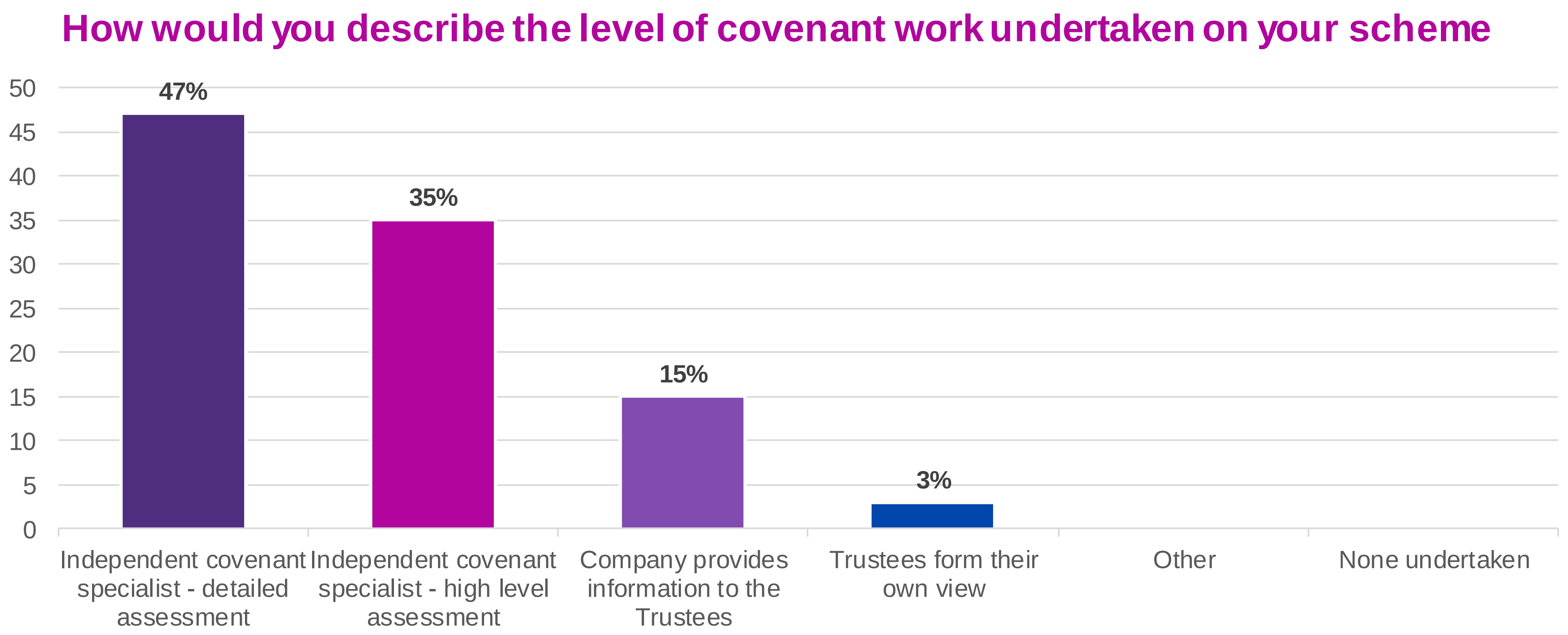
Source: 1. Grant Thornton survey, July 2017

What trustees have had to say since May 2017



Source: 1. Grant Thornton survey, July 2017

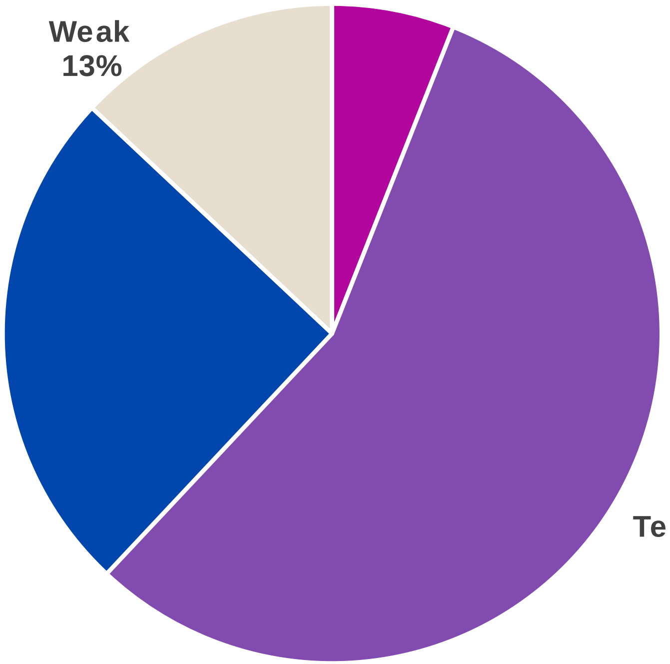
What trustees have had to say since May 2017



Source: 1. Grant Thornton survey, July 2017

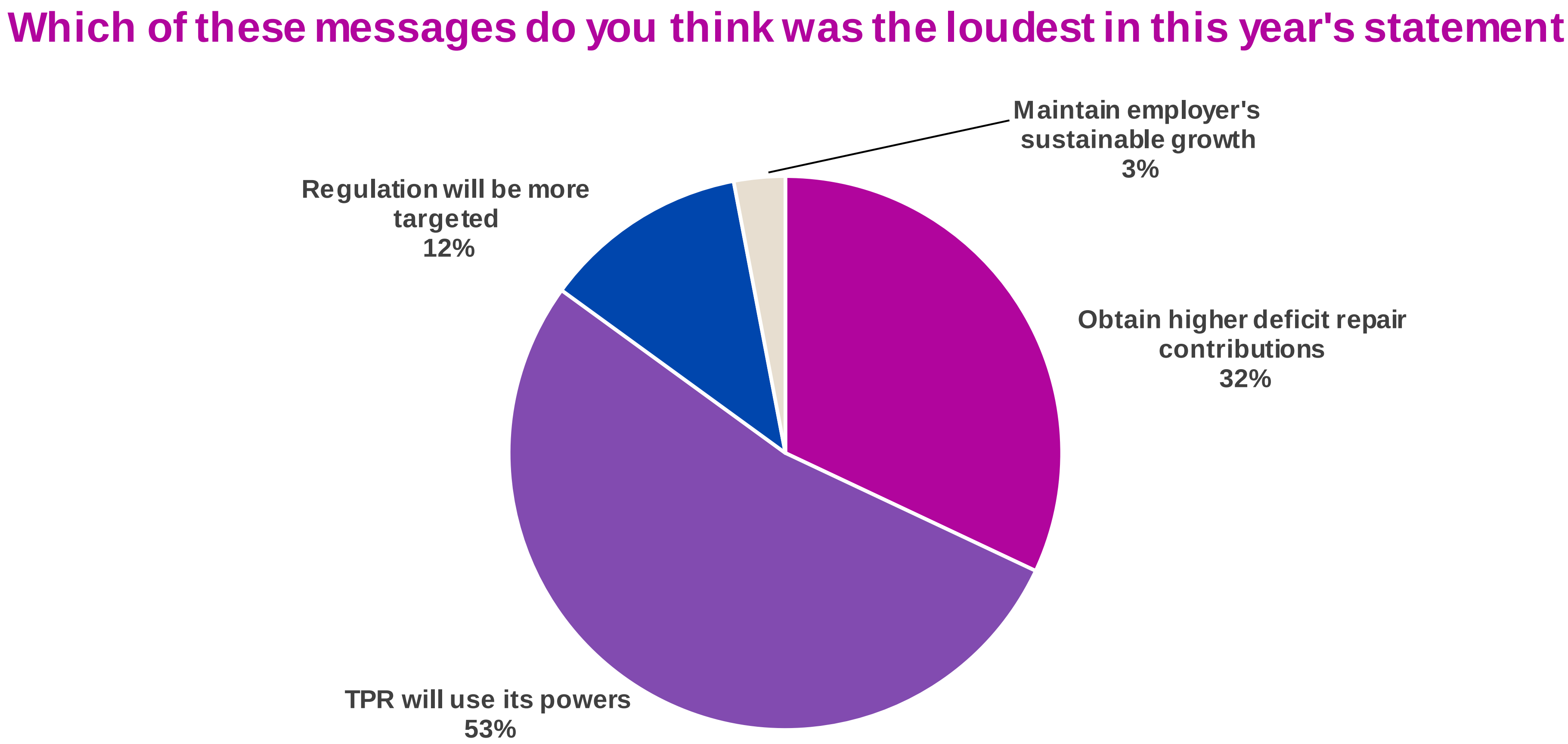
What trustees have had to say since May 2017

Which of the following best describes your covenant grading at your last valuation



Note: 1. N/A – Did not undertake a covenant assessment at last valuation – 0% of respondents
Source: 1. Grant Thornton survey, July 2017

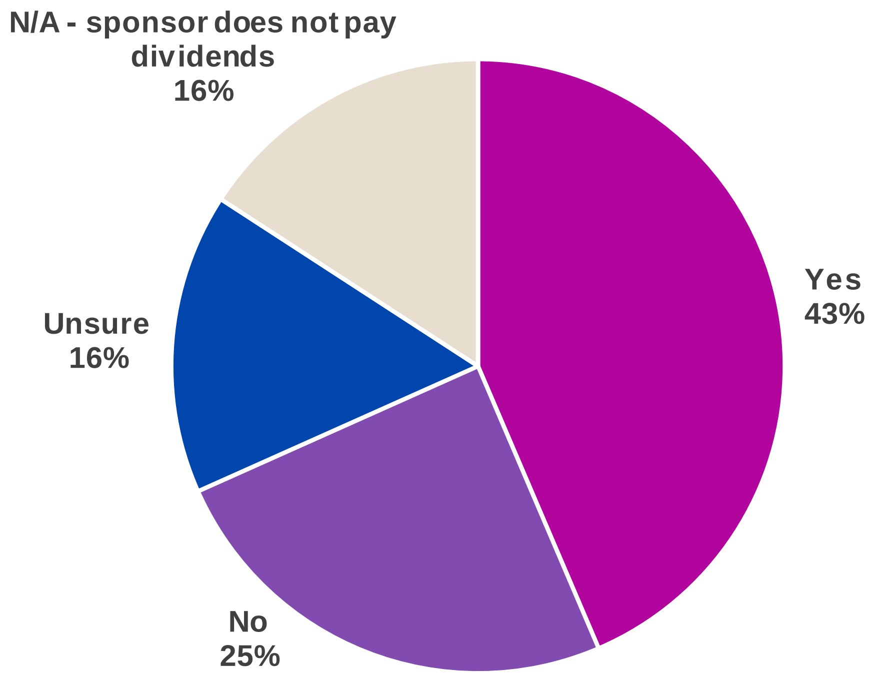
What trustees have had to say since May 2017



Source: 1. Grant Thornton survey, July 2017

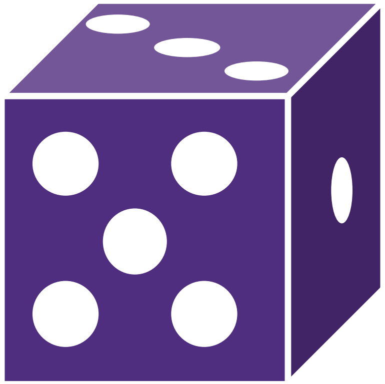
What trustees have had to say since May 2017

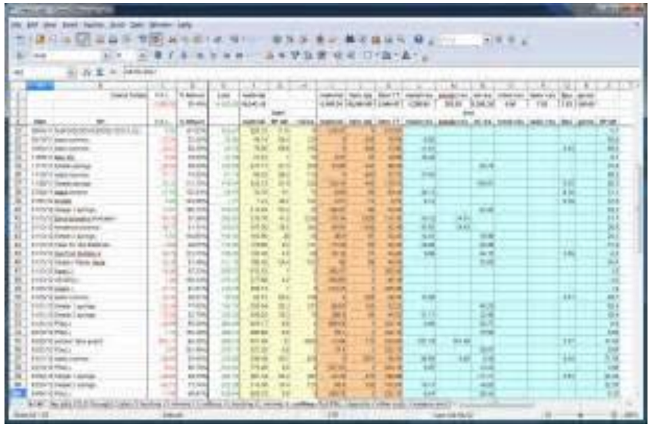
Does your scheme employer typically pay dividends great than the level of deficit repair contributions

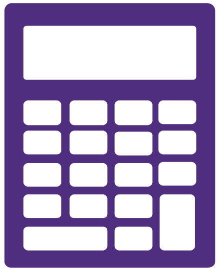


Note: 1. N/A – scheme is not in deficit – 0% of respondents
Source: 1. Grant Thornton survey, July 2017

Actuarial skill set in respect of covenant







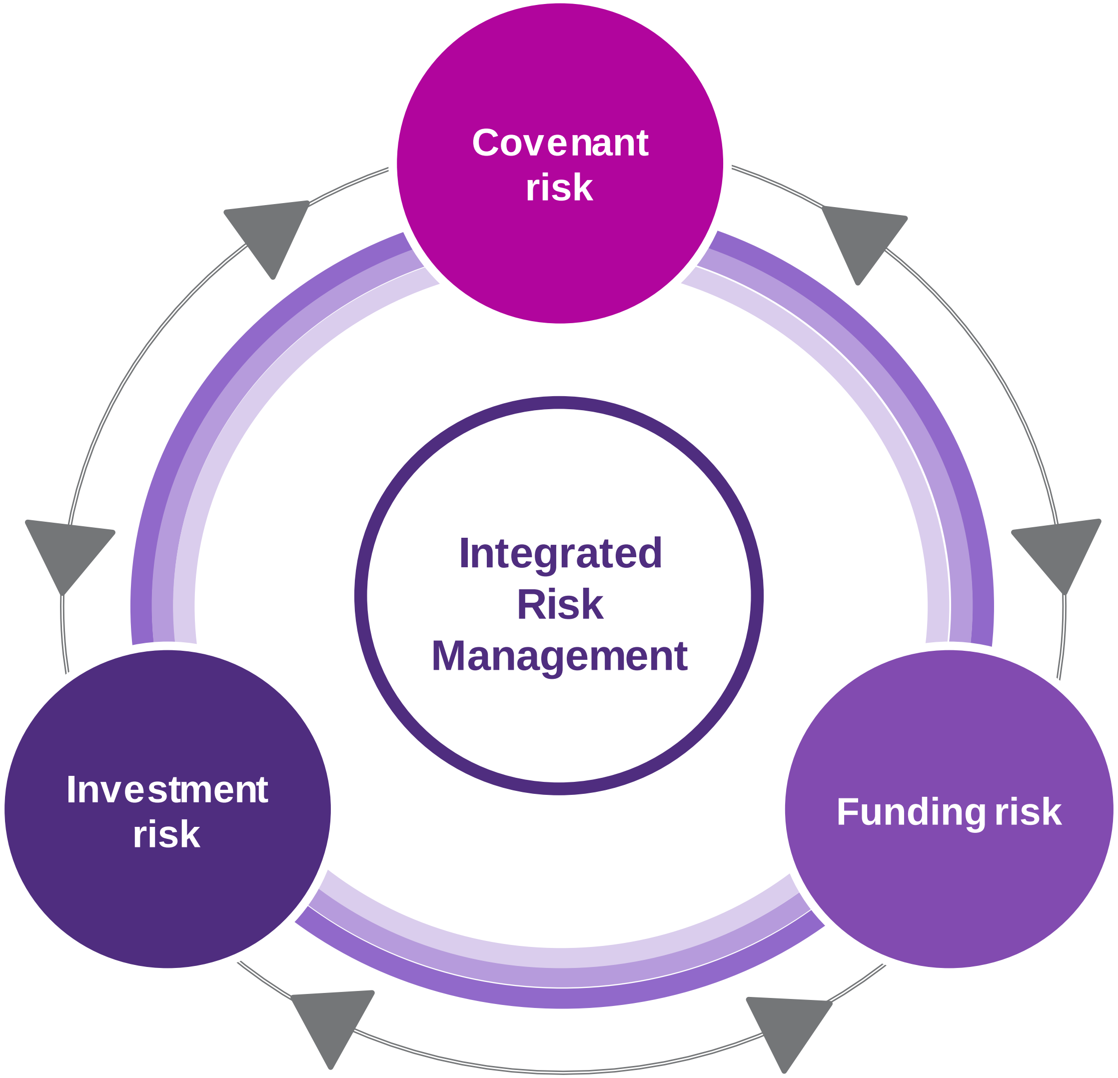
Strong

Tending to strong

Tending to weak

Weak

Integrated Risk Management (IRM)



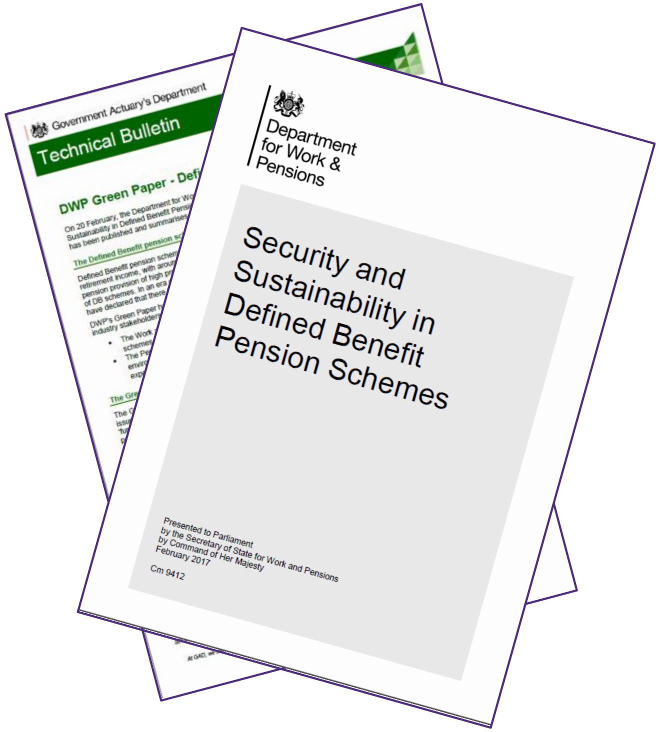
The importance of risk management

“over the longer term, the only alternative to risk management is crisis management-and crisis management is much more expensive, time consuming, and embarrassing”

Source: 1. Grant Thornton
2. James Lam - Enterprise Risk Management, from Incentives to Controls 2003

Looking ahead to the future

DWP Green Paper



DWP White Paper
(expected late 2017)

“This must be one of the ‘greenest’ green papers in living memory”

Steve Webb, Former Pensions Minister 2010-15, 7 February 2017

Looking ahead to the future

DWP Green Paper consultation

Consolidation to provide small schemes with scale (voluntary? government-run?)

Widen the criteria for Regulatory Apportionment Arrangements

Encourage schemes to move from an RPI-based to a CPI-based inflation measure

More Information-gathering powers

More powers to TPR to inflict punitive fines on employers not meeting their obligations

Proactive compulsory clearance of certain corporate activities that could be materially detrimental to a scheme's funding position

Any questions?

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Article on TPR's 2017 Annual Funding Statement

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