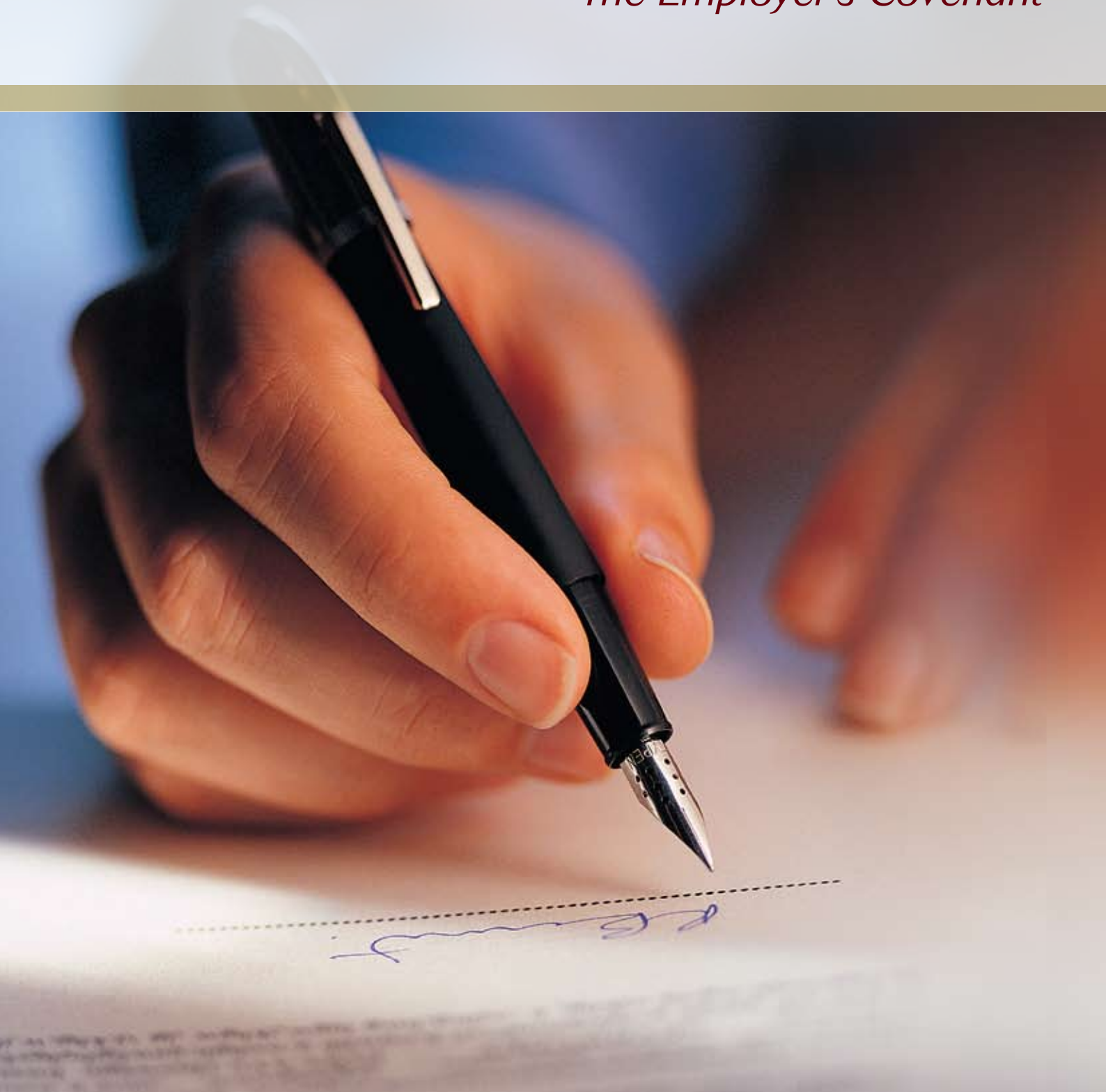




Alexander Forbes

## *The Employer's Covenant*



### The issue

The importance of the employer's covenant has been enhanced by its inclusion in the Pensions Regulator's Code of Practice on Scheme Funding. Section 57 of the Regulatory Code of Practice 03 (Funding Defined Benefits) states:

"It is essential for the trustees to form an objective assessment of the employer's financial position and prospects, as well as his willingness to continue to fund the scheme's benefits. This will inform decisions on both the technical provisions and any recovery plan needed."

To some extent, changes in buy-out legislation have tied employers' hands on the willingness issue of funding the scheme. However, employers typically retain a great deal of influence over the rate at which the benefits are funded and their willingness to share information and enter into discussions with the trustees is very relevant.

The strength of the employer's covenant will inform decisions on:

- the level of prudence in the funding target;
- the period over which any deficits should be met;
- the level of investment risk that can be taken with scheme assets;
- investment strategy.

It is clear that different employers will have different covenants, and should take different decisions and implement different actions in each of these areas. This is one of the cornerstones of the new regime that makes it "scheme specific".

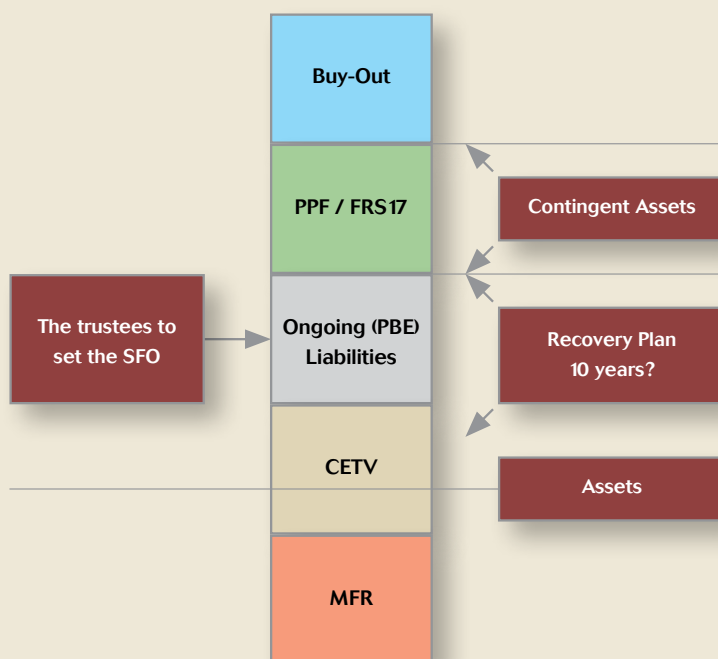
From the trustees' perspective, addressing the issue of the sponsor covenant is an exercise in risk assessment and risk management – i.e. managing the risk that if the employer becomes unable to meet its obligations at some point in the future, the pension scheme will have sufficient assets to pay members' benefits. However that risk is ultimately managed (eg. additional contributions, a charge on business assets or bank guarantees) the starting point has to be a measure of the risk in question.

Trustees are therefore encouraged to think and act in a similar manner to other corporate lenders, such as banks, when assessing the extent to which they should allow the employer to extend its debt to the pension scheme. Like those other creditors, the trustees will have to find a way of balancing their desire for cash now (to improve the scheme funding) with the continued viability

(and hence support) of the employer as a going concern in the long-term.

It is clear that assessing the strength of the employer's support to the scheme is potentially an onerous task – exacerbated by the fact that the strength could change rapidly. It is important therefore that the trustees have a process in place for monitoring and acting upon any changes in a timely manner.

### Illustration of importance of the Employer's Covenant - Relative Scheme Valuations



It is instructive to look at the valuation of a scheme's liabilities from a number of viewpoints. The liabilities can be measured on a number of bases shown here in their usual relative position to one another, but not to scale!

The Minimum Funding Requirement (MFR), all but dead now but still a familiar measure for many trustees.

The Cash Equivalent Transfer Value (CETV) basis, used to calculate transfer values (TVs) and determine if there is scope to reduce transfer values.

The Ongoing or Technical Provision valuation, which we term the Prudent Best Estimate (PBE) valuation, used to determine the funding and the Recovery Plan.

The Pension Protection Fund (PPF) valuation for determining the PPF levy and FRS 17 (or IAS 19) for determining how the scheme is reported in a company's accounts.

Finally the highest of them all, the Buy Out liability, the amount an issuer would require to take on the all the scheme's benefits.

The Pensions Regulator would like the trustees to set the Statutory Funding Objective (SFO) as high on this chart as possible, preferably at about the same level as the higher of FRS 17 and PPF.

Being a scheme specific measure, the trustees are required to set the SFO at what they consider a prudent level.

## Ways of gathering information

We have set out below various methods trustees can use to assess the strength of the employer's covenant. Firstly, a few cautionary notes:

- Any assessment of the credit quality of a scheme sponsor is inevitably inexact and therefore will itself be subject to uncertainty.
- Models for statistical risk tend to be indicative because they are limited by the amount of historical statistical data.
- Unforeseen contingencies are (by their nature) not modelled and therefore models tend to understate risks, especially large risks.

### Credit Rating

These are offered by specialist credit rating agencies like Standard & Poors and are risk-based measures of a sponsor's financial strength. These are designed to provide creditors with an initial measure of the financial strength of the sponsor and indicate the risk that the sponsor will fail to meet its obligations over the short, medium or longer term.

The company may be required to pay the credit rating agency a fee to provide the rating. Negotiations between the company and the credit-rating agency may be necessary, including complying with requests to provide information that is not publicly available, in order to arrive finally at a rating that satisfies the company's view of its business. An implication is that the company may withhold adverse information that is not yet in the public domain in order to achieve a higher rating.

This method is relatively cheap and is considered by most to be the principal assessment of credit quality risk. However, not all companies have full credit ratings.

Trustees looking at addressing scheme deficits will need a risk measure that covers a number of years not just the short term. Fortunately the financial markets have been using credit ratings to do just this for many years into the future. In the same way,

trustees can use ratings and historical default data to appreciate the risk of a company not meeting its obligations over the life of a recovery plan. They can then decide on an acceptable level of confidence that their sponsor will not default and construct their funding plans accordingly.

### Pension Protection Fund (PPF) Failure Scores

The Trustees may also use the employer's "Failure Score" (given by Dun & Bradstreet to calculate the PPF levy) to assess the strength of its covenant. However, it is becoming clearer to trustees and advisers that the PPF Levy information has only limited usage for sponsor covenant assessment. Essentially, this information is designed to assess the insolvency risk over one year rather than the likelihood of the sponsor defaulting a number of years into the future.

Unfortunately, the PPF's insolvency risk measures something other than the ability of the sponsor to meet its financial obligations. According to the PPF website, the "Failure Score" is the probability that an organisation will "cease operation without paying creditors" within the next 12 months. This is inappropriate for deciding on funding rates and recovery periods for several reasons:

- For the majority of pension schemes, the deficit funding period will exceed 12 months.
- Insolvency scores cannot accurately be extrapolated over a typically long deficit funding period because risk is not constant over time.
- Typically, businesses cease trading at the end of what can be a prolonged period in administration. Scheme funding normally ceases when the sponsor first enters administration. Therefore, the insolvency score is unlikely to reflect the period over which the scheme will receive sponsor contributions.

Credit ratings on the other hand are a measure of default risk through time and are a better assessment of the risk that a company fails to meet a financial obligation such as funding contributions.

## Independent Business Reports (IBR)

Independent firms of accountants usually provide IBRs. Currently they are typically commissioned for a specific business purpose, rather than being used as a general monitoring tool. Advice will often involve an analysis of the expected profitability of the business over the next few years often focussing on the short-term cash flows that are anticipated or the value of the company on break-up.

These reports are comprehensive in their coverage but can be expensive; fees can typically mount up to five or even six figures. For companies that are battling in tough markets, it may be that trading conditions change rapidly, and that trustees fall into a cycle of regular reviews. Hence, trustees should be aware of the potential costs bearing in mind all the other pressures now put on defined benefit schemes.

## Employer Covenant Consulting Services

As one might expect in an area of expanding interest, a number of firms market their services in a manner tailored to trustees' needs. These companies tend to have backgrounds in corporate finance analysis, such as insolvency practitioners and corporate restructuring specialists. Their services are designed to focus on the issues with which trustees must grapple under the new scheme-specific regime and can be as rudimentary or as comprehensive as the trustees desire – e.g. covering each of the assessments outlined above, and extending as far as negotiations with the company on the trustees' behalf once this information has been gathered. If necessary, we can supply details and comments on a range of potential providers of these services.

## Questioning of Employer

An alternative and more cost-effective method would be simply to ask the employer questions that would help Trustees get a better understanding of the strength of the employer's business and its plans for continuing to support the pension scheme. These questions could relate to future business plans, debt structure, cashflows, unencumbered assets, proposed company investment projects and risk from competitors.

Questioning the employer may not give the trustees a perfect understanding of the employer's ability to honour its commitment to the pension scheme in the future. However, questioning the employer could certainly act as a foundation from which trustees can decide whether or not further information is needed.

Consideration of affordability is important – too onerous a contribution schedule could increase the likelihood of the employer's demise. A danger here is that it would be easy to conclude that if the sponsor cannot afford the contribution suggested by a risk-based approach that the covenant debate has ended.

Affordability is not a measure of risk – the companies might currently produce strong cash flows but still have a high risk of default because of the industry they operate in or the threat from competition. It is also a somewhat slippery concept – is a contribution not affordable because it would mean reducing dividends to shareholders?

Affordability is one important factor that trustees will need to consider before other options are explored.

However, the risk of default still needs to be assessed and managed even if higher contributions are not currently possible.



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## Our recommendations

Our recommendation is for trustees first to question the employer about its ability and willingness to pay members' benefits in the future. We have created a questionnaire to assist this process. The responses should then inform the decision on whether further investigation is needed i.e. if a third party should be consulted.

We recognise that trustees may initially feel uncomfortable asking these questions, and employers could feel that the trustees are straying into areas that do not concern them. However, we believe that by discussing these and similar questions, both parties will increase their understanding of the pension scheme issues. The atmosphere of co-operation and mutual trust that this process engenders is likely to be beneficial to the future management of the scheme.

In recommending an interrogative approach, we are not suggesting that the issue will be easy for trustees to resolve. For some, the only option may be to take expert advice on whether the sponsor has a future at all. For companies with uncertain futures, trustees are likely to be particularly sensitive where total contributions are insufficient to cover the increase in liabilities on a buy-out basis.

It will also be important to update regularly the trustees' view of the employer's covenant strength. Trustees should not assume that they will have time to act or that they will be able to obtain more security from the employer when they become aware of deterioration of the employer's covenant. An undertaking from the employer to the trustees to inform them of changes in company control, creditor priority, breaches of loan covenant or planned returns of equity to shareholders would help the trustees carry out their duties. In the event that the employer's covenant shows signs of weakening the trustees may need to act quickly.

Some risks may be correlated. For instance, a fall in the stock market may be correlated with deterioration in trading conditions, which could mean that the employer's covenant deteriorates at the same time as the funding position of the scheme becomes worse.

In spite of the importance attached by the Pensions Regulator and the industry generally to this topic, thinking on the appropriate processes and the possible implications of the assessments is still developing.

## Independent Assistance

If you need to discuss any issues raised here or those specific to the quality of your own scheme sponsor's covenant our actuarial services team will be pleased to help.

Please call either:

**Jayanti Sojitra - 0161 242 8311**

**Alan Carey - 020 8686 0660**

**Reno Blake - 020 8253 7945**





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