

Employer Covenant Working Group

Principles of covenant assessment for scheme valuations

A practical guide for advisors, trustees and sponsors

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

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1. Objectives

The Pensions Employer Covenant Practitioner Working Group (the ECWG) was established in May 2012 to provide a forum for employer covenant advisors to discuss best practice and raise awareness. Any reference to 'ECWG' refers to the Employer Covenant Working Group Limited, a Company Limited by Guarantee.

The ECWG's scope and objectives are:

- To discuss technical, legal and regulatory issues, including published guidance, relevant to providing financial advice to clients - trustees, sponsoring employers and other stakeholders - on matters connected with employer covenant.
- To participate in discussion around relevant matters with bodies such as the Pensions Regulator and Pension Protection Fund and, where appropriate, to promote the views of the ECWG with those bodies.
- To act as a vehicle for raising the profile and standards of, and promoting, the employer covenant financial advisory industry generally amongst the pensions community, including trade bodies, regulatory bodies, professional groups and potential clients.

Your attention is drawn to the Important Notice regarding disclaimer and copyright information at Appendix E.

In addition to members of the ECWG, this document has been exposed for comment to a number of organisations, including the Pensions Regulator, the Pension Protection Fund and the Association of Consulting Actuaries.

The purpose of this document is to provide guidance on leading practice principles that underpin independent covenant assessments undertaken by members of the ECWG, for the purposes of informing actuarial valuations.

We expect this guidance will also be of assistance to:

- trustees;
- sponsors and related entities;
- trustee and sponsor advisors; and
- other stakeholders.

While this document focuses on employer covenant in the context of triennial valuations, employer covenant is a key consideration for trustees and employers in a wide range of circumstances. These include covenant monitoring, corporate transactions, distress, scheme mergers, apportionment arrangements and clearance applications.

It is the intention of the ECWG to release further guidance covering other such situations in which covenant assessment is a key consideration.

2. Introduction

Context

TPR's original Code of Practice 3 (February 2006) stated that it was essential for trustees to objectively assess employers' financial positions, prospects and willingness to fund the schemes, in order to inform decisions on technical provisions.

Since then, covenant assessment and associated advisory work has evolved significantly and the environment for UK defined benefit pensions has become increasingly complex.

TPR's revised Code of Practice 3 (CoP3; July 2014) stresses the importance of employer covenant assessment as part of an integrated approach to managing scheme risk and agreeing appropriate valuations and recovery plans. CoP3 suggests that covenant assessment should be proportionate to the scheme's and employer's circumstances and focus on areas that are material to them.

In this context, the ECWG has sought to develop guidance and a series of principles to help guide practitioners, sponsors and trustees in undertaking employer covenant-related work.

In this document, we have set out our views on:

- methodology and suggested approaches to assessing covenant in the context of ongoing valuations;
- how this might impact on a scheme's technical provisions and investment strategy; and
- how employer covenant might be improved/enhanced by the use of, for example, contingent assets or asset-backed funding structures.

This introductory section sets out an overview of some of the key issues and principles developed in this document.

Definition of employer covenant

Employer covenant is defined in CoP3 as representing *“the extent of the employer's legal obligation and financial ability to support the scheme now and in the future”*.

It is our view, expressed in this guidance, that the 'ability to support the scheme' can be distilled further into an employer's ability to put cash (or other assets that can be converted to cash) into a pension scheme when needed.

The focus on cash is crucial for covenant analysis. Funding pensions is ultimately a 'cashflow business' where the inflows come from contributions, investment returns and investment realisations and the outflows are payments of benefits to members and scheme expenses.

Consequently, when analysing the strength of a sponsoring employer's covenant, we are primarily concerned with its ability to deposit cash (or other assets) into the scheme, as and when it is required. This may include:

- payment of contributions for benefit accrual;
- making good any shortfall of assets relative to liabilities calculated on the appropriate basis (funding deficit); and
- making good any further funding shortfall resulting from any downside experience in a scheme's agreed investment strategy.

2. Introduction

Covenant analysis methodology

Section 4 of this document sets out principles and a high level methodology for undertaking assessments of employer covenant for the purposes of triennial valuations.

The underlying principle is that the work undertaken should be sufficient and proportionate to the specific circumstances.

At a high level, assessments should enable trustees to form an objective view on the ability of the sponsoring employers to meet schemes' demands for cash, now and in the future. A proportionate analysis should therefore include:

- Identification of the legal obligations.
- Consideration of the employer's ability to generate cash:
 - immediately (availability of liquid assets/finance);
 - in the short to medium term (trading/cash flow analysis);
 - in the longer term (market analysis); and
 - in the event of distress (structural priority and/or insolvency analysis).

How practitioners choose to express the results of their evaluation (for example, through some sort of valuation methodology or rating scale) is a matter of choice and judgement and this document is not prescriptive in this regard.

Covenant and integrated risk management

In the regulatory framework, employer covenant is inherently linked to both investment strategy and the valuation of liabilities, and consequently any surplus or deficit.

When considering investment and funding strategies, trustees and employers should consider the relative risks and rewards of different options.

The assessment of employer covenant underpins decisions on the level of risk that it is appropriate to take, as it informs an assessment of the ability of the employer to underwrite downside experience.

The level of risk that is ultimately appropriate to accept in any funding or investment strategy is therefore a function of the reward inherent in that strategy and the ability of the employer covenant to underwrite the risks.

In general terms, however:

- A stronger covenant would typically allow more flexibility in determining appropriate investment and funding strategies, as the covenant would be sufficiently strong to repair any downside experience over a reasonable period.
- A weaker covenant would typically limit the appropriateness of riskier strategies, as the employer may not be able to repair downside experience over a reasonable period.

2. Introduction

Covenant and integrated risk management

The table below illustrates how the relationship between covenant, investment strategy and scheme funding outcomes may work in practice:

Implied covenant	Potential investment strategy	Comparative discount rate on expected returns basis	Comparative deficits	Comparative investment return and volatility
Stronger	More return-seeking	Higher	Lower	Higher
Weaker	More defensive	Lower	Higher	Lower

Please note that while the table above assumes that a stronger covenant might result in a more return-seeking investment strategy, a stronger covenant would also facilitate a variety of lower risk options, including active de-risking. Ultimately the decision will depend on the trustees' and employers' risk appetites in the context of the scheme's and employer's specific circumstances.

Expected investment returns, funding levels and employer covenant change over time, so it is important for trustees and employers to proportionately monitor these factors to ensure that chosen strategies remain appropriate.

In the event that monitoring highlights a material change, trustees and employers should consider taking action to amend strategies, where appropriate.

Covenant and integrated risk management

To assist with monitoring and taking appropriate action, it may be of assistance for trustees to develop a series of tools or principles as to how to address changes in funding, investment and covenant, in addition to longer term plans or aspirations for the scheme.

Depending on their scope, such plans could set out an assumed 'glidepath' for scheme funding and establish tools and principles to address how the employer and trustees would address any off-plan performance (of the employer, investment returns or adverse variations in other assumptions), whether at future valuations or between valuations.

Weaker covenants will usually offer fewer options for action to address off-plan performance than stronger ones. The scope of any appropriate action will also depend on the extent of contingent or other third party support and its terms.

Further detailed commentary on the role of covenant in an integrated risk management framework is set out at Section 5 of this document.

The table at page 27 sets out example risk management measures for three notional levels of assessed covenant strength - 'strong', 'medium', and 'weak'. It is by no means exhaustive but provides some illustrations of tools that trustees and covenant practitioners can consider in conjunction with other advisors such as investment advisors.

2. Introduction

Recovery plans

Covenant assessment goes hand in hand with the agreement of recovery plans (when appropriate) to fund any valuation deficit and return the scheme to ‘full funding’.

CoP3 states that a “*recovery plan should be appropriate*”, with the affordability of contributions being one factor to consider.

This is a change in language from the previous iteration of the code, which stated that deficits should be repaired as soon as the employer could “*reasonably afford*”.

Employer covenant analysis should form a key factor in trustee and sponsor considerations for what may be appropriate, with relevant factors including:

- the affordability of ongoing contributions, taking into account the employers’ plans for sustainable growth;
- the value, terms and enforceability of any contingent security provided by the employer;
- the ability of the employer to cover downside risk associated with the scheme’s investment strategy; and
- the potential outcome of any employer insolvency event.

Recovery plans are discussed in more detail in Section 6.

Improving employer covenant

In Section 7 we set out some high level options for the improvement of employer covenant.

It is worth noting that every situation is different and the options presented will not be appropriate in all circumstances.

In broad terms, however, the options to improve covenant can be categorised as follows:

- Extension of legal obligation:
 - anything that extends the scope of the scheme’s claim to additional entities or additional assets; and
 - could include guarantees, security (such as fixed charges on property), assets or additional employers.
- Improvement of employers/obligors’ ability to fund the scheme:
 - anything that improves the ability of the current employers/obligors to meet scheme benefits; and
 - could include capital investment, release of security, development of new products/markets over time, growth in market share and profitability.
- Minimise scheme risks:
 - Could include de-risking and liability management plans.

3. Legislation and guidance

Overview

TPR's guidelines on the importance and assessment of employer covenant are set out in the July 2014 document **Code of Practice 3: Funding defined benefits (CoP3)**.

In CoP3, 'employer covenant' is defined as *“representing the extent of the employer's legal obligation and financial ability to support the scheme now and in the future”*.

TPR has also set out its own approach to covenant assessment, based on a segmented approach for the purpose of undertaking its regulatory functions, in the June 2014 document **Defined benefit funding regulatory and enforcement policy (DBFREP)**.

In August 2015 TPR released guidance entitled **Assessing and monitoring the employer covenant (AMC)**, with the aim of providing practical guidance on how to assess covenant as part of an integrated approach to managing scheme risks and monitor the covenant on an ongoing basis.

In addition to the above documents, TPR issues an annual funding statement, which often contains references to covenant. The June 2014 funding statement, for example, emphasised TPR's expectations of trustees to evidence how they have taken a proportionate approach to assessing employer covenant.

Practitioners are expected to be conversant with the body of Codes, Guidance and Statements from TPR, including those listed at Appendix B. As regulatory and market practice continues to develop, practitioners are also expected to keep up to date with the latest approaches and help to develop best practice further.

This guide has been drafted to complement TPR's guidance and provide further insight for advisors, trustees and sponsors on the assessment of employer covenant in practice.

3. Legislation and guidance

Use of advisors

Unlike scheme actuaries for example, employer covenant advisors are not appointed under statute and it is not compulsory for trustees or sponsors to take professional covenant advice. Trustees choosing not to take professional advice should ensure they have the appropriate information, expertise and independence to assess covenant themselves.

However there are circumstances where the provision of external advice is appropriate and encouraged. AMC lists some circumstances in which objectivity and expertise may be insufficient, being:

- the scheme is highly reliant on covenant;
- the covenant is complex; and/or
- the employer and trustees do not have a good relationship.

CoP3 states that *“where appropriate, trustees should seek professional, independent analysis and advice across the employer covenant, investment and funding strands to support their decision making”* and further that *“if trustees elect not to retain independent advisors (for example, to assess the employer covenant) and instead undertake the analysis themselves, they should document why they consider themselves sufficiently equipped, independent and experienced to undertake the work”*.

One area in which it is unusual for trustees themselves to have expertise is in calibrating their views on covenant in a way that is helpful in providing context for scheme actuaries' advice. Adjectives such as 'strong' and 'weak' have established meanings in relation to covenant.

In the experience of ECWG members, many trustees and sponsors choose to appoint external covenant advisors as best practice,

to ensure covenant issues are considered by an appropriately qualified, experienced and independent professional.

When trustees (or employers) choose to appoint external covenant advisors, the precise output is governed by the terms of reference and scope.

Depending on the circumstances, employers and trustees may expect to receive some or all of the following:

- an independent and robust opinion on employer covenant strength, based on an established methodology in line with TPR guidance;
- assistance in understanding the affordability of contributions and the appropriateness of recovery plans;
- assistance in developing an integrated approach to factoring covenant into actuarial, investment and legal considerations;
- support in negotiations between trustees, employers and other stakeholders;
- an understanding of the likely aims of other stakeholders (including the PPF and TPR) based on first hand experience of similar situations; and
- ongoing covenant monitoring and support, with bespoke assistance in understanding the impact of corporate or scheme events.

If trustees or employers do choose to seek independent professional support, the development of an ongoing relationship should ensure the most cost effective, proportionate and practical advice.

4. Covenant assessment

Introduction

In this section we set out the key elements that clients can expect to be covered in an independent assessment of employer covenant.

In addition, we set out further considerations that may be relevant in specific circumstances.

CoP3 stresses the importance of proportionality in covenant assessment and it may ultimately not be proportionate to undertake a full assessment of all areas (eg detailed insolvency analysis) in all cases.

When engaging independent advisors, trustees and sponsors should ensure they have a full understanding of the agreed scope and the reliance that may be placed on the output provided.

Sections

This section covers the following areas:

- identifying the legal obligation;
- understanding the scheme's position;
- assessing an employer's ability to support the scheme now;
- assessing an employer's ability to support the scheme in future; and
- covenant reporting.

There is also commentary on:

- the importance of cash in covenant assessment;
- the relevance of the wider group;
- proportionality;
- information requirements; and
- multi-employer schemes.

4. Covenant assessment

Identifying the legal obligation

CoP3 states that employer covenant represents an employer's *“legal obligation and financial ability to support the scheme now and in the future”*.

The first part of any employer covenant assessment is therefore to determine the relevant entities to analyse in any assessment of covenant, ie those with a legal obligation (direct or contingent) to support the scheme.

- The assessment should cover sufficient entities to form a robust opinion of covenant. As a minimum, this should include all significant employers and guarantors.
- It may be proportionate to assess the covenant supporting multi-employer schemes within the same financial group on a consolidated basis, provided all significant employers and guarantors are included in the consolidation and the employers/obligors represent a substantial majority of the consolidated group. This will not usually be appropriate for weaker covenants, where generally, structural priorities impacting the scheme as a creditor will be a more important consideration.
- The extent to which structural priorities and insolvency outcomes should be fully understood will depend on the financial health of the group - the greater the risk of distress, the more important it is to understand the position of each employer in isolation and the pension scheme's position as a creditor in each of those employers.
- Scheme deeds and rules may impact the legal obligation, for example where trustees have the power to apportion liabilities (including orphans) between employers, or to set contributions.

4. Covenant assessment

Understanding the scheme's position

Employer covenant assessment is a relative measure of an employer's ability to support the scheme. Consequently it is important to understand the scheme's size, funding level, volatility and ideally, value at risk. Key valuation bases that may be considered are:

- **Technical provisions** - represents an 'ongoing' scenario, but may vary under different covenant strength assumptions. The estimated TP deficit is particularly relevant when considering recovery plan options.
- **S75/solvency** - represents the insolvency/wind-up scenario and therefore relevant when considering asset cover or recoveries and the position of the scheme in distress.
- **Self-sufficiency** - represents a scenario where, in principle, the funding assessment is at a level which assumes the financial risks have been mitigated to the extent that the scheme is not expected to have to rely on the employer covenant. In practice, some advisors may apply the term 'self-sufficiency' more loosely and so some care is needed in its interpretation.

While not typically relevant to employers or trustees in an ongoing situation, understanding the PPF's potential position is necessary in considering restructuring options and distress scenarios.

Covenant assessment should also have regard to VaR and whether the employer can underwrite potential negative experience (over a reasonable period) in:

- investment risk;
- longevity risk; and
- market risks (interest rates, inflation).

The balance between the above risks and covenant is key to an integrated approach to scheme funding.

4. Covenant assessment

Financial ability to support the scheme now

Assessment of financial position

The current financial position of the Employer(s) (ie assets, liabilities and creditor priorities), based predominantly on current and historical financial information.

Typical assessment criteria may include

- Balance sheet ratio analysis, for example:
 - net assets / deficit cover;
 - asset liquidity; and
 - gearing ratios.
- Assessment of asset quality, including dependence on and recoverability of intercompany positions.
- Assessment of finance structure, including security, creditor priorities, guarantees and group treasury.

Cash focus

- Access to cash and cash flows.
- Headroom in facilities and their duration.
- Unencumbered non-operating and liquid assets.

Other potential considerations

- Size of scheme and VaR relative to asset cover and cash flow.
- Fair value adjustments.
- Insolvency analysis.
- Assessment of business enterprise/equity value.
- Restrictions in banking facility agreements on cash or its availability to fund pensions schemes.
- Structurally trapped cash, for example due to exchange controls.
- Assets held in trust, for example in charities and financial institutions.

4. Covenant assessment

Financial ability to support the scheme now (cont'd)

Assessment of financial performance

The current and recent financial performance of the Employer(s) (ie profit/cashflow), based predominantly on historical financial information.

Typical assessment criteria may include

- Income statement analysis, for example:
 - revenue and profit growth;
 - profit margins; and
 - control of overheads.
- Cash flow analysis, for example:
 - conversion of profit to operating cash flow;
 - capital expenditure; and
 - assessment of free cash flow.

Cash focus

- Ability to generate cash from core operations.
- Cash generated from non-core operations.
- Free cash flow.
- Dividend policy.

Other potential considerations

- Reasonableness of dividend payments.
- Determination of 'free cash flow' available for pension contributions, based on historical performance.
- Capital investment/expenditure, including 'value add' of any investment.

4. Covenant assessment

Financial ability to support the scheme in the future

Assessment of financial prospects - short term (financial analysis)

An assessment of the Employer's immediate financial prospects, based predominantly on forecasts and business plans.

Trustees are entitled to receive information that is necessary for them to carry out their duties. As set out in CoP3, trustees should not be refused information to which they are entitled because of confidentiality concerns, which can be managed.

Typical assessment criteria may include

- Trend analysis.
- Review and/or sensitisation of financial forecasts.
- Review of strategic business plans, including investment plans for sustainable growth.
- Analyst reports, which may include estimated forecasts.
- Debt prices/Credit Default Swap spreads.
- Market and press commentary.
- SWOT/PEST/5-Forces analysis.

Cash focus

- Forecast cash flow (core/non-core operations).
- Restrictions on free cash flow.
- Cash cost of investment plans.
- Proposed dividends.
- Debt service costs.

Other potential considerations

- Regulator's guidance stressing importance of trustees understanding employer plans for sustainable growth.
- Information provision (noting that less information can result in less assurance and lower risk tolerance):
 - use of existing business plans/forecasts (over variable periods), as available;
 - use of broker/consensus forecasts (as available);
 - trend analysis using historical results; and/or
 - restriction of information to sub-committee.
- Proportionality:
 - the value of assessing short-term forecasts in non-stressed situations given the long-term nature of scheme liabilities; and
 - cost versus benefit of sensitising forecasts.
- Management capability and priorities assessment.
- The depth of analysis regarding the validity of assumptions and their application in forecasts will depend on the level of perceived employer credit risk.

4. Covenant assessment

Financial ability to support the scheme in the future (cont'd)

Assessment of financial prospects - medium to long term (market analysis)

Assessment of the wider markets in which the employer operates, to understand potential longer term market trends and issues.

Typical assessment criteria may include

- Market assessment, based on independent reports, surveys, government papers, analyst reports and market commentaries.
- Assessment of market maturity and potential for further growth.
- Competitive position of employer/group (including market share).
- Structural changes, for example global competition, product substitution and changing consumer habits.
- SWOT/PEST/5-Forces analysis.

Cash focus

- Consideration of the potential impact of long term market prospects on an employer's ability to generate cash.

Other potential considerations

- Proportionality - cost/benefit of market assessment.
- Information constraints:
 - long-term business/strategic plan may not be available; and
 - market data may be limited.
- Balance between long term view and current performance (eg business performing well, but in a market facing structural decline).
- While some form of forward looking or market assessment is likely to be required for all leading practice covenant analysis, the depth and level will be determined by scheme specific factors - for example, market analysis may be particularly important in potentially declining markets.

4. Covenant assessment

Covenant reporting

The majority of advisors use a sliding scale, with ‘strong/good’ at one end and ‘weak/poor’ (or ‘none’) at the other. Some advisors use enterprise valuation methodology, potentially alongside a sliding scale approach.

- In practice, scales range from four to eleven increments.
- Some scales assign a numerical grade to rank covenant while others use adjectives (‘strong’, ‘neutral’).

Overall rating is a judgement, based on an overview of key metrics for relevant entities, their circumstances and prospects.

Considerations

While members of the ECWG use a range of scales, the principles underpinning the ‘sliding scale’ approach are broadly consistent.

The approach is generally designed to provide a clear indication of covenant strength, while remaining proportionate and flexible.

A greater level of information and scope allows a more robust assessment.

In our experience, the majority of value for trustees in a professional covenant assessment is provided not with the covenant rating, but from the associated commentary, recommendations and advice around ongoing support.

For trustees facing cost constraints, a proportionate review should provide at least a covenant grading, but the overall conclusions may be less robust with fewer value-adding comments.

Regulator’s scale

TPR has published its own criteria for categorising covenant in its DBFREP, using four ‘segments’: Strong, Tending to Strong, Tending to Weak and Weak. TPR has also published the behaviours it would expect to see from trustees and employers in each segment.

TPR uses its criteria as an initial method to segment schemes and identify those which present higher risks, to help it *“understand risks and develop targeted policies and interventions”*. Its segments are *“not intended to define our expectations for...trustees’ own covenant assessments”*.

While each of the members of the ECWG use their own scale to grade covenant, the broad principles are the same as those outlined by TPR.

A bespoke covenant assessment assists trustees and employers to establish and review appropriate investment and funding strategies, by providing robust analysis and consideration of relevant risks.

While many assessors (including TPR) choose to use segments in their assessment, covenant strength and associated behaviours represent a continuum and it is possible to have stronger or weaker covenants within a particular segment.

4. Covenant assessment - additional considerations

Covenant analysis and focus on cash

Essentially, for an ongoing (not insolvent) business, there are four sources of cash to consider:

- 1) Cash generated from operations after necessary capex, working capital and other investment and appropriate/proportionate third party obligations ('free cash flow').
 - Other third party obligations may include, for example, payments to lenders, tax authorities and other pension schemes.
 - It is a matter of judgement as to how much of the cash generated from operations should be available to, or paid into, the pension scheme and how much should be available for re-investment within the business (including acquisitions) or returned to shareholders.
 - Other than in unusual circumstances (eg capital intensive industry requiring investment, or financial distress) equitable/proportionate treatment will usually be a key consideration in this analysis. Analysis of employers' sustainable growth plans should help inform trustees as to the extent that cash from operations will need to be reinvested in the business.
 - Crucially, assessment of cash generated from operations will usually be a forward looking evaluation, referencing historic performance by way of background. It follows that making a robust assessment requires a reasonable knowledge of the employer's marketplace, prospective market changes and the employer's competitive position.
- 2) Cash generated from surplus assets not included within the employer/group's core operations.
 - Examples include freehold investment property or other investments which can be realised for cash.
 - How much of any available cash should be allocated to the pension scheme is a matter of judgement.
- 3) Cash generated from contractually-committed obligations of third parties such as guarantors or asset-backed funding vehicles.
 - It is important that such arrangements are only considered to the extent that they will actually generate cash when needed.
 - Risk management options are discussed further in Section 8.
- 4) Cash generated from further borrowings.
 - Includes borrowing capacity and facility headroom where appropriate.
 - May include cash movements as a consequence of Group treasury (eg repayment of internal treasury 'deposits').
 - Consideration should be given to the costs of debt service and finance maturity dates.

4. Covenant assessment - additional considerations

Covenant analysis and focus on cash (cont'd)

In our experience, trustees should be careful before ascribing any value to balance sheet assets which may be difficult to realise into cash.

- Some assets, such as goodwill, may reflect an estimate of future operational cash flow generation ability. This potentially leads to a risk of 'double counting' if trustees were to rely both on these assets and on future cash flows when assessing covenant.
- Other assets are more tangible, and could be more easily realised for value should the business cease to trade. Trustees may be more comfortable in placing value on these assets when assessing employer covenant.

Care should be taken in undertaking any insolvency analysis, ensuring estimated realisations are realistic, taking account of the fact that it is not uncommon for a distressed trading company to have 'burnt through' its asset base prior to insolvency in an attempt to continue to trade. A seemingly healthy balance sheet now could have limited value on any actual insolvency.

Trustees should also be careful as to how much credit is given to any rudimentary balance sheet/pension liabilities analysis.

Relevance of wider group to covenant

There is often an expectation among management and trustees that credit will be given in any covenant assessment for the strength of the employer's wider group. Regulatory guidance is clear that covenant should primarily reflect the legal obligation, so while the strength of the group may be informative as context, it should usually only be taken into account positively to the extent that it:

- is formally committed, for example by guarantee, indemnity or unlimited companies;
- underwrites the credit risk in intercompany debts due to the employer;
- underwrites the value of group investments owned by the employer; and/or
- the wider group is critically dependent on the employer.

The wider group covenant may be relevant as a negative factor, for example where the group is distressed or highly leveraged, leading to prioritisation of cash allocation away from the employer, or where the employer's assets or business has been pledged to support group borrowings.

4. Covenant assessment - additional considerations

Proportionality

CoP3 sets out the following items as potentially appropriate for consideration in covenant assessment:

- Group structure and employer's position within the group;
- Employer's trading and balance sheet position, plus financing structure, including material forthcoming events;
- forecast profit and cash generation, business plans, growth prospects, need for investment and ability to service debt and scheme from cash;
- the nature of the employer's industry and position in the industry, including future trends; and
- an estimate of the return to the scheme as a creditor in the event of an insolvency of the employer(s) or a scheme wind-up.

However, it may not always be proportionate to complete an assessment comprising all areas. Trustees should focus on those aspects of the covenant which are material to the scheme and employer, or where the trustees are not already confident of the position.

A phased approach, with an initial high-level analysis and identification of areas requiring deeper or broader analysis, may be appropriate.

Notwithstanding proportionality, a leading practice approach should include at least some consideration of the future covenant and its likely development over time, rather than focusing solely on historical position/performance.

Multi-employer schemes

The legal obligation of employers under multi-employer schemes can vary, from only being liable for their own portion of liabilities to potentially being liable for all liabilities of the scheme.

For example, under a 'last man standing' scheme, the legal obligation for an employer comprises a direct obligation for its own liabilities (which can include its share of any orphan liabilities), plus a contingent obligation for the remainder of the scheme's liabilities.

When assessing covenant for multi-employer schemes, trustees should ensure they understand the balance of direct and contingent support, together with the likelihood of any contingent support being needed and realised, and factor this into any analysis.

More complex situations, for example where a stronger employer has a smaller proportion of the liabilities or where employers are not associated with one another, are likely to require a greater level of consideration when assessing covenant. This is likely to include:

- the likelihood and mechanics of employer withdrawal;
- the nature and extent of trustee powers; and/or
- the extent of each employer's liability, including orphans.

Trustees should be cognisant of such matters when choosing whether to appoint a covenant advisor and in determining the scope of any such assessment.

4. Covenant assessment - additional considerations

Assessment of sustainable growth

Context

In its guidance of July 2014, TPR provided commentary on how it would implement its new objective to *“minimise any adverse impact on the sustainable growth of an employer”*.

It is worth noting that TPR emphasises that minimising the impact on sustainable growth is a TPR objective, not an objective for other stakeholders such as trustees, employers or the PPF.

Trustees are required to act in accordance with their fiduciary duties (which include acting in the best interest of members), while employers have fiduciary duties to their investors and often in distress scenarios, creditors. However, given the long-term reliance of the scheme on the employer, trustees are generally more likely to meet their objectives if the employer remains strong and viable.

TPR guidance states that *“Trustees should understand the employer’s plans [for sustainable growth]”* and that *“where an employer proposes to prioritise the investment it wishes to make in its business over making funding available to the scheme the trustees should understand how this impacts on the employer covenant”*.

Generally speaking, appropriate investment in the growth of the business of an employer would have a positive impact on covenant.

It is likely that the majority of employers will not face a binary decision between investment and the payment of appropriate contributions to the scheme, with cash flows sufficient to fund both investment and pension obligations.

However, in some circumstances, employers may seek to reduce or defer what would otherwise be appropriate contributions to a scheme on the basis that cash is required for investment purposes.

This may result in a longer recovery period than might otherwise be appropriate.

In these circumstances, trustees should ensure that they undertake an assessment of the employer’s plans for sustainable growth to ensure that all stakeholders are contributing appropriately. The level of detail that trustees should apply to this assessment will depend on the extent to which deficit repair contributions are being constrained, the level of risk taken on by the scheme and other relevant scheme/employer circumstances.

Investment that is not justified in the context of achieving sustainable growth could be unsupportable as a reason to agree a restriction/deferral of contributions.

4. Covenant assessment - additional considerations

Assessment of sustainable growth (cont'd)

Assessment of sustainable growth plans

Employers should be prepared to provide information on growth and investment plans to trustees in order to inform the assessment of employer covenant.

We would anticipate this information being provided together with employer forecasts and business plans, with any additional information about significant or material one-off investments, such as the timing and quantum of its impact on covenant and affordability, being provided on an ad hoc basis.

Key considerations for trustees will include:

- cost of investment (whether the cost of the proposed investment has a material impact on covenant and/or affordability in the short term);
- outcome from investment (the anticipated outcome of the investment, its timing and its effect on covenant);
- reasonableness (to what extent the investment plans look reasonably likely to achieve the indicated outcome);
- quality of information (whether information provided by the employer is of sufficient depth and quality for the trustees to take comfort from it);
- materiality (whether the investment is material in the context of covenant); and
- the extent to which other stakeholders are contributing to the growth plans, for example shareholders foregoing dividends.

Further considerations

Trustees should be mindful of the risks that speculative investment (for example in an unproven product or market) may have on covenant. In particular, where an employer's business or market is in long term decline, trustees should take care to ensure they are comfortable that the longer term position of the scheme is not being compromised by high risk investments, or an unrealistic assessment of the impact of investments on growth.

Where investment plans restrict the ability of an employer to meet contributions in the short term, trustees and employers should consider working together to agree a commitment that the scheme shares in any upside from the investment once the outcome is achieved.

If contributions are restricted on the basis of planned investments that do not ultimately materialise (for example planned acquisitions), advance consideration should be given to the potential for a share of unutilised funds to be paid to the scheme.

As with any affordability constraint, trustees should consider whether contingent assets (or some other form of covenant enhancement - see section 7) may provide protection for the scheme's members.

If trustees are uncertain whether investment plans will have a material impact on covenant or whether the expected outcome of any investment plan is 'reasonable', independent advice may be required.

4. Covenant assessment - additional considerations

Information requirements

CoP3 emphasises the importance of collaborative information sharing. Trustees are entitled to receive information that is necessary for them to carry out their duties. As set out in CoP3, trustees should not be refused information to which they are entitled because of confidentiality concerns, which can be addressed through confidentiality agreements or the establishment of empowered sub-committees.

We set out below the minimum and preferred information requirements likely to be required in any independent assessment of covenant.

Further information may be necessary depending on the specific circumstances.

Trustee/Scheme information

Minimum:

- latest scheme return;
- most recent valuation, schedule of contributions and recovery plan; and
- any available formal valuation updates, post-valuation.

Preferred:

- up to date valuation estimates on technical provisions, self-sufficiency, s75/solvency and PPF bases;
- previous covenant assessment;
- latest available PPF levy assessment; and
- any available VaR analysis.

Employer information

Minimum (for all employers):

- last three years' financial accounts;
- Group structure;
- confirmation of employer financing structure, including facility terms, duration, security, guarantees and details of intercompany debt and treasury arrangements;
- high level commentary from management on investment plans for sustainable growth and dividends; and
- an indication of impending events that may impact covenant, such as corporate transactions or refinancing.

Preferred:

- intercompany debt matrix;
- short/medium term integrated forecasts (one to five year, depending on availability); and
- medium/long term business plan/strategy.

Market information (to the extent obtainable)

- recent news commentary;
- analyst reports;
- market/industry reports; and
- credit ratings, credit default swaps (CDS) and debt price information.

5. Covenant and integrated risk management

Generally, a stronger covenant should allow more flexibility with investment strategy and permit greater risks to be taken in pursuit of returns if that is consistent with the trustees' and employer's risk appetites and the ability of the employer to repair downside experience over a reasonable period.

Consideration of investment strategy is particularly important where a larger scheme is supported by a weaker employer, which is unable to cover downside risk over a reasonable period.

Regulatory guidance stresses the importance of trustees taking an integrated approach to risk management, addressing the three key risk areas of covenant, investment and scheme funding. CoP3 emphasises the links between covenant and investment strategy, stating that:

- *“trustees should place emphasis on setting investment principles that are appropriate to the scheme and employer's situation (now and in the future)”;*
- *“the trustees should be satisfied that the investment strategy is consistent with [their] assessment of the employer covenant and its plans for sustainable growth”;*
- *“trustees should be mindful of the impact that downside [investment] underperformance has on the likelihood of members receiving their promised benefits and any strain it would place on the employer covenant”;* and
- *“the higher the level of investment risk...the greater should be the trustees' focus on the level of employer covenant to support it”.*

It is clear from the guidance presented opposite that covenant is the lynchpin underwriting the appropriateness of trustee and employer decisions on investment and funding strategies.

When considering investment and funding strategies, trustees and employers should balance the relative risks and rewards of the different options available with the risk that any downside experience may ultimately need to be supported by the employer.

It is therefore important that trustees have a good understanding of the risks that may crystallise in any given funding or investment strategy and the extent to which downside risks can be supported by the employer covenant over a reasonable period.

Where the covenant is weaker, it is likely that fewer strategic options will be considered appropriate.

5. Covenant and integrated risk management

The linkage of covenant with actuarial liabilities and investment strategy

Under the UK scheme specific funding regime, trustees and their advisors have the option to value the pension liabilities using a discount rate which reflects the anticipated return on the scheme's assets ('expected-return approach') or the yield available on government or high quality bonds. The discount rate must be chosen prudently, and the appropriate margins for prudence relative to the scheme actuary's best estimate calculation should reflect the size of the funding requirements which may emerge (ie level of risk) and the strength of the employer covenant.

Depending on assumptions and scheme characteristics, there is therefore likely to be a close linkage between the employer covenant, investment strategy and the valuation of liabilities (and consequently any surplus or deficit).

If we consider an expected returns basis of liability valuation, it may be that the more risk that is accepted in a scheme's investment strategy due to higher expected returns, the higher will be the discount factor used to value liabilities and the lower any deficit (or higher any surplus) arising. However, with this expected return comes higher risk and potentially greater volatility which may need to be made good in the future.

Conversely, on an expected returns basis, a defensive investment strategy would result in:

- comparably lower returns (and discount rates);
- higher liabilities; and
- probably, lower volatility/VaR.

In summary, generally speaking:

- a stronger covenant potentially allows trustees to choose to take more investment risk in pursuit of higher returns, where the covenant is sufficiently strong to repair any downside experience over a reasonable period.
- a weaker covenant potentially limits the trustees' ability to take risks, as the employer may not be able to repair downside experience over a reasonable period.

This can be summarised in the table below:

Covenant	Potential investment strategy	Comparative discount rate on expected returns basis	Comparative deficits	Comparative investment return and volatility/VaR
Stronger	More return-seeking	Higher	Lower	Higher
Weaker	More defensive	Lower	Higher	Lower

In assessing covenant, it is important for trustees to consider the interaction between the availability of cash (and its timing) from the employer or a contractually-committed third party and the scheme's investment strategy and associated volatility.

Trustees and covenant advisors should therefore work closely with actuaries and investment advisors to identify whether the assessment of covenant 'fits' with the scheme's investment strategy and assessment of actuarial liabilities and if not, why not and whether change might be appropriate.

5. Covenant and integrated risk management

Use of VaR analysis

VaR analysis is a method of estimating the potential range of scheme funding outcomes at certain levels of probability and over a certain period of time.

It can be used to assist trustees in understanding the strain that may be placed on the employer covenant in the event that downside outcomes are experienced.

Following regulatory guidance, leading practice covenant assessment would generally include some element of consideration for downside experience being borne out. Where available, VaR analysis is one way to achieve this.

Please note that while we have referred to VaR throughout this document, there are other methods to measure risk/volatility that could also be used to inform covenant assessment such as scenario and stress testing. No single risk measure is perfect and the approach adopted should be proportionate to the circumstances of the scheme.

If using VaR, care should be taken to reconcile the typically short-term nature of VaR analysis with longer term considerations around affordability and recovery plan length.

Risk appetite

When making decisions on investment and funding strategies, trustees should generally consult with the employer to understand the employer's, as well as their own, appetite for risk.

While a stronger covenant allows more flexibility to take risk, in circumstances where there is limited appetite to do so, a stronger covenant can also facilitate de-risking strategies, for example by allowing trustees to accelerate any planned de-risking through additional contributions.

Monitoring and risk management

Trustees make strategic choices based on assessed covenant strength, funding levels and investment returns, all of which change over time. Consequently it is important to actively monitor (on a proportionate basis) these factors to ensure chosen strategies remain appropriate.

In the event that proportionate monitoring highlights a material change, trustees should consider taking action to amend strategies, where appropriate.

Some examples of tools available to trustees to manage risks are presented in the table on the following page.

5. Covenant and integrated risk management

Risk management tools

Set out below are illustrative examples of potentially appropriate risk management tools for associated covenant strengths.

Notional covenant strength	Commentary	Example risk management tools
Strong	Relative to the pension scheme, practically unlimited cash available if needed - 'high optionality'. This might be the case for a very substantial, stable and profitable company operating in a stable market sponsoring a comparatively small scheme.	<ul style="list-style-type: none"> • Risk management tools are likely to be of lower importance - off-plan performance can be addressed at next triennial valuation. • However, there is no reason for the employer and trustees not to consider risk management tools such as investment derisking if they consider it appropriate.
Medium (potentially with some degree of third party support)	Some additional cash available to fund a pension scheme over and above that already committed by way of future accrual/deficit repair - 'medium optionality'.	<p>Risk management tools may include the following:</p> <ul style="list-style-type: none"> • ongoing monitoring; • additional contributions; • performance related recovery plans; • contingent asset support; • closure to accrual; • restrictions on certain corporate actions without trustee consent; • investment de-risking; • adjustments to third party guarantee terms (quantum/duration) under certain circumstances; • cash draw-downs from guarantors under certain trigger events; and • dividend or bonus restrictions.
Weak	Limited, if any, additional cash available to fund a pension scheme - 'low optionality'.	<p>As above, plus:</p> <ul style="list-style-type: none"> • monitoring of the scheme's position as a creditor and potentially making overtures to the company for the scheme's position to be protected; and • crystallisation of the scheme's position.

6. Agreeing a recovery plan

Appropriateness

The work undertaken to assess employer covenant forms a key part of agreeing any recovery plan.

CoP3 states that a recovery plan “*should be appropriate*” and factors that trustees should consider include the following items informed by the trustees’ assessment of the employer covenant:

- the affordability of ongoing contributions, taking into account the employer’s plans for sustainable growth;
- the value, terms and enforceability of any contingent security provided by the employer;
- the potential outcome of an employer insolvency event; and
- the ability of the employer to cover downside risk associated with the scheme’s investment strategy (as informed by VaR or equivalent analysis).

While the language of the revised CoP3 has moved away from ‘affordability’ being the key driver of a recovery plan, it remains an important aspect to consider - particularly in cases where the scheme is heavily reliant on contributions to recover any shortfall (eg covenant is weaker and the trustee has adopted a conservative investment strategy).

It is important to recognise that covenant may deteriorate over time and therefore generally shorter recovery plans involve less risk.

Trustees should remain cognisant that in the context of an ongoing scheme, the employer will be required to cover ongoing contributions and expenses in addition to any agreed recovery plan.

Assessment of affordability

Key considerations in the assessment of affordability are set out below:

Maximum affordability is typically based on:

- assessment of forecast free cash flow (based on forecasts, or trend analysis); and
- available liquidity (ie surplus cash reserves plus available finance).

Assessing affordability involves judging whether the priorities for the allocation of cash are fairly and reasonably balanced:

- appropriate investment in the employer’s business for ‘sustainable growth’ should be covenant enhancing;
- there may be competing priorities for cash; and
- a high-level affordability assessment may not take account of business strategy.

Other potential considerations around affordability may include:

- use of liquidity/finance to meet scheme contributions;
- consideration of wider market issues and long term ability to generate cash;
- level of risk/reward in employer investment;
- linkage of recovery plan to performance goals and/or dividends; and
- Shared cost schemes, which may have specific considerations including member affordability.

7. Improving covenant

A key question often asked by trustees and sponsors is how can covenant be improved and what benefits might this bring?

The second question can be answered easily:

- for trustees, covenant improvement enhances the security of members benefits, so is consistent with acting in members' best interests; and
- for sponsors, covenant improvement enhances the likelihood that the employer will meet its legal obligation to scheme members and in addition can allow trustees to exercise greater flexibility when setting technical provisions, which may reduce cash funding requirements in appropriate circumstances.

The first question can only be answered on a case by case basis. However, some potential options are set out opposite, grouped into four categories:

- extension of legal obligation (ie extend the covenant to a greater number of employers, or improve the scheme's relative position compared to other creditors);
- improvement in ability to support the scheme (ie improve an employer's position, performance or prospects);
- minimising the risk of covenant deterioration (ie preserve an employer's position, performance or prospects or the scheme's position vis a vis other creditors); and
- minimising scheme risks (ie better governance to reduce the reliance placed on the employer).

Extension of legal obligation;

- guarantees (including PPF compliant guarantees);
- asset backed funding structures;
- additional employers;
- security; and
- assignment of intercompany debts.

Improvement in ability to support the scheme:

- transfer business into the employer;
- equity investment in the employer/business;
- release of security;
- use of asset-backed funding structures to regulate cash flow;
- refinancing (improvement to free cash flow);and
- new products/markets.

Minimising risk of covenant deterioration:

- dividend/share buy-back restrictions; and
- negative pledges.

Minimising scheme risks - risk management tools:

- de-risking investment strategy; and
- liability management.

Glossary of terms



Glossary of terms

5-Forces	- a framework to analyse level of competition within an industry, comprising buyers, suppliers, new entrants, substitutes and competition	EV/Enterprise Value	- going concern value on a debt free, cash free basis
AMC	- TPR guidance document entitled “Assessing and monitoring the employer covenant” dated August 2015	Free Cash Flow	- operating cash flow less necessary business maintenance payments including Capex, interest, some investments and tax payments but before scheme contributions.
Capex	- capital expenditure	Important Notice	- The Disclaimer and Copyright information detailed in Appendix E
CDS	- Credit default swaps	PEST	- Analysis tool based on political, economic, structural and technological factors
CoP3	- TPR’s Code of Practice 3: Funding defined benefits, as revised in June 2014	PPF	- Pension Protection Fund
DBFREP	- TPR guidance document entitled ‘Defined benefit funding regulatory and enforcement policy’, dated June 2014	S179	- section 179 of the Pensions Act 2004 (the basis for the PPF deficit)
EBITDA	- earnings before interest, tax, depreciation and amortisation	S75	- deficit calculated pursuant to section 75 of the Pensions Act 2004 (the basis for the buyout deficit)
ECWG/we	- the Pensions Employer Covenant Practitioner Working Group	SWOT	- Analysis tool based on strengths, weaknesses, opportunities and threats
Employer	- the employer of a scheme, against which the scheme’s obligations lie	Structural priority	- the concept that some creditors effectively rank ahead of others by virtue of the position of their claim in a group structure and proximity to assets eg with a claim in an asset owning entity, rather than a holding company
EOS	- estimated outcome statement		

Glossary of terms

- TP - Technical provisions (the basis for the 'ongoing' deficit)
- TPR/the Regulator - the Pensions Regulator
- VaR - Value at risk, being the potential downside to scheme funding over a defined period of time at a defined level of probability

Other useful guidance

B

Other useful guidance

TPR publications

'Assessing and monitoring the employer covenant' - www.thepensionsregulator.gov.uk/guidance/guidance-assessing-monitoring-employer-covenant

'Code of Practice 3: Funding defined benefits' - www.thepensionsregulator.gov.uk/code3

'Asset-backed contributions' - www.thepensionsregulator.gov.uk/abc

'Identifying your statutory employer' - www.thepensionsregulator.gov.uk/docs/identifying-your-statutory-employer-statement

'Multi-employer schemes and employer departures' - www.thepensionsregulator.gov.uk/multi-employer

'Abandonment of DB pension schemes' - www.thepensionsregulator.gov.uk/abandonment

'Clearance' - www.thepensionsregulator.gov.uk/clearance

TPR's annual statements - www.thepensionsregulator.gov.uk/statements

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