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CONSOLIDATION OF DEFINED BENEFIT SCHEMES

DISCUSSION DOCUMENT PRODUCED BY THE EMPLOYER COVENANT WORKING GROUP LIMITED (ECWG)

1. BACKGROUND

As part of the DWP's white paper, Protecting Defined Benefit Schemes, there is a proposal to consult on a framework and authorisation regime for the creation of Superfunds; vehicles for the consolidation of defined benefit (**DB**) pension schemes. In this context the DWP has asked for the ECWG's views on a series of questions, being:

- How could a potential gateway to stop those who can afford buyout from entering a superfund work?
- What would trustees need to consider when assessing whether to transfer to a superfund in relation to the employer covenant?
- Does the employer covenant advice market have the capacity to provide this advice and how likely is it that trustees would be able to understand the information?
- How could you assess the covenant of superfunds?

2. OBJECTIVES

This discussion document is intended by the ECWG to assist the DWP in understanding leading market practice in assessing employer covenant, the commercial principles to consider in deciding whether a proposal to change the covenant available to a scheme is in members' interests and, with these as context, answer the above questions.

3. APPROACH

We have not originated any specific research in producing this document and have relied principally on our own practical experience and the following key documents:

- DWP white paper, Protecting Defined Benefit Schemes (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attach ment_data/file/693655/protecting-defined-benefit-pension-schemes.pdf) (**White Paper**)

- ECWG - Principles of covenant assessment for scheme valuations - a practical guide for advisors, trustees and sponsors (http://ecwg.co.uk/docs/ECWGPrinciples.pdf) (**POCA**)
- ECWG – Principles of risk management (https://ecwg.co.uk/docs/ECWG%20-%20IRM%20final%20May%202018.pdf) (**PRM**)
- ECWG - Transactions in a non-distressed environment (https://ecwg.co.uk/docs/Transactions%20in%20a%20non-distressed%20environment%20-%20final%20(December%202016).pdf) (**TNE**)
- ECWG - Transactions in a distressed environment (https://ecwg.co.uk/docs/170825%20Final%20v2%20-%20Transactions%20in%20a%20distressed%20environment%20Guidance%20for%20practitioners%20(003).pdf) (**TDE**)
- PLSA DB Taskforce paper 'the case for consolidation' (https://www.plsa.co.uk/portals/0/Documents/0622-The-Case-for-Consolidation.pdf) (**CFC**)
- The Pensions Regulator's Code of Practice 3 – Funding Defined Benefits (http://www.thepensionsregulator.gov.uk/docs/code-03-funding-defined-benefits.pdf) (**CoP3**)

The document is divided into the following main sections:

- Employer covenant, how it is assessed and how the assessments are used
- Principles of assessing the impact of changing covenant
- Understanding and assumptions regarding the operation of Superfunds
- Application of covenant assessment principles to Superfunds
- Summary and conclusions

4. EMPLOYER COVENANT, HOW IT IS ASSESSED AND HOW THE ASSESSMENTS ARE USED

The POCA document sets this out in some detail but in summary:

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'.

CoP3 has the following to say about understanding risks over time:

'Trustees should seek to understand the risks across the employer covenant, investment and funding strands. In particular trustees should understand the extent of the scheme's reliance on the employer covenant over time on the basis of a range of plausible future scenarios. These scenarios should capture investment risk, the impact of potential or actual maturing of the scheme and the impact of the contribution patterns which are proposed for the scheme (and the risks to those contribution patterns) compared to the employer covenant available under various scenarios. This is because the employer underwrites both the short- and long-term risks to which a scheme is exposed.'

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.

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

- Identification of the legal obligations;
- Consideration of the funding position of the scheme and its potential volatility;
- 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).

Practitioners typically express the results of their evaluations through some sort of valuation methodology or rating scale.

In the regulatory framework, employer covenant is inherently linked through 'Integrated Scheme Funding' (see the PRM document) 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. It is important to both trustees and corporates to achieve funding strategies in which the key risks of covenant, investment and funding are compatible with one another, reflecting risk appetite and subject to risk capacity. 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, high return-seeking strategies, as the employer may not be able to repair downside experience over a reasonable period.

Therefore, covenant strength is assessed not just in relation to the size of the funding deficit at any given time but also the overall risks in the scheme relative to the employer and how these may play out over time, which can be critical to the assessment of future corporate viability. This is because, while schemes themselves are rarely, directly the sole triggers for corporate insolvency, they can act as an impediment to raising the capital required to maintain and grow business operations, causing gradual decline.

5. PRINCIPLES OF ASSESSING THE IMPACT OF CHANGING COVENANT

Typically, as set out in the TNE, significant changes to covenant arise as a result of corporate transactions, such as leveraged buy-outs, sales/purchases of subsidiaries, refinancing etc. Also scheme splits and mergers also give rise to similar considerations. Given that an understanding of the employer covenant is the foundation for investment and funding strategy, it follows in general that when covenant changes consideration needs to be given to whether:

- there is a material change to the support provided to the scheme;
- it is in members' interests;
- any mitigation is required to address any adverse change; and
- investment strategy, funding assumptions and recovery plan need to be adjusted post transaction.

The above 'before and after' analysis is routinely carried out by employer covenant advisors and, in the view of the ECWG, the principles apply equally to whether transferring members to a Superfund is appropriate. The specifics will however be somewhat different and, before going on to address these, we set out in the next section our broad understanding and assumptions as to how Superfunds are expected to be structured and operate.

7. UNDERSTANDING AND ASSUMPTIONS REGARDING THE OPERATION OF SUPERFUNDS

We have taken as our model the 'Model 4' proposals set out in the CFC. 'In essence:

- Employers would pay a fee – either upfront or in the form of secured debt – to substantially reduce scheme underfunding and discharge themselves from responsibility for the scheme.
- If the trustees of the scheme agreed, following consultation with members, the scheme and all its assets and liabilities would be transferred to a Superfund.
- Members' benefits would be aligned to a common Superfund structure. Negotiations between sponsor, trustees and consolidator agree an actuarially equivalent conversion to the Superfund benefit structure.
- Superfunds would be authorised and supervised by TPR and would demonstrate the highest standards of governance.
- The Superfund would be managed to and maintained at a funding level which gives members greater prospects than now of receiving their benefits, and is less expensive to access than buyout.'

The CFC anticipates that the Superfund target market would be schemes with a mid-range covenant because employers with strong covenants should be able buy out their liabilities with FCA regulated insurers and those with weak covenants would be unable to afford the Superfund premium and may ultimately need to fall back on the PPF. However, there may be situations in which weaker employers could access Superfunds through third party funding from e.g. shareholders or a wider group.

8. APPLICATION OF COVENANT ASSESSMENT PRINCIPLES TO SUPERFUNDS

The above Superfund model involves the removal of support of the sponsoring employer in exchange for a level of support that is expected to be better than that of the employer but is cheaper than an insurance buy-out and falls short of the ‘gold standard’ level of assurance provided by FCA regulated insurers. This implies that, bearing in mind members’ interests, for schemes to qualify for the Superfund route, their employers should be facing some degree of stress (which may involve considerations set out in the TDE) and there should be a significant level of doubt that members’ benefits could ultimately be bought out with an insurer. As schemes generally deliver benefits over many decades, this involves taking a long-term view of scheme funding, associated risks and how the existing employer covenant is likely to play out.

For a scheme to qualify, the outcome of the ‘before and after’ assessment should be that members would be better off in the Superfund environment, which could involve permutations of:

- A low level of confidence that the Scheme would be in a position to buy out in the foreseeable future;
- A higher/full level of funding in the Superfund;
- A lower/minimal level of investment risk;
- Either expected non-reliance by the Superfund on covenant (through full funding and de-risking on a conservative basis) or a level of committed capital headroom in the Superfund ‘sponsor’ (or through robust third-party guarantees) that is reasonably expected to be able to absorb adverse volatility in investments and estimates of liabilities with significantly greater confidence than the departing employer;
- Immaterial credit risk to the Superfund, which could arise through deferred entry premium payments or reliance on guarantees;
- Limited exposure to profit taking by the providers of capital;
- PPF eligibility as a fall back, e.g. in case a market or mortality shock undermines the Superfund.

A key component of any before and after assessment, which for example sometimes arises in the ‘members’ interests’ test in flexible apportionment arrangements (**FAA**s), is a comparison of the benefit to the employer and/or its wider group vs what it’s paying as a premium (or in mitigation). If the increase in the value of the group from severing its links with the scheme significantly exceeds the premium (mitigation) being paid, it may indicate that the transaction is not fair or in members’ interests.

It is worth noting that, as with the PPF, there is ‘moral hazard’ to bear in mind. It may be that, at a point in time, a scheme would qualify for Superfund entry but, with a view to minimising the cost of employer separation, its journey there could have involved:

- Purposeful or reckless suppression of covenant e.g. through excessive dividends or intra-group charges;

- Minimisation of contributions over time, giving rise to adverse experience from an inappropriately high-risk investment strategy.

This is partly a consideration for scheme funding regulation by tPR but also could be relevant for the trustees and their advisors, for example if the employer is part of a wider group and a better outcome might be achievable through the exercise by tPR of its CN or FSD powers.

Thought needs to be given to the sources of funding for the Superfund entry premium. While the direct, legal covenant of the employers in a group may of itself be insufficient to fund a buy-out, there is the question of whether the wider group could pay more than the entry premium and actually buy out the scheme. If a group is funding the premium, could they and should they, depending on the circumstances, actually pay more?

9. SUMMARY AND CONCLUSIONS

There are therefore many considerations in assessing whether the Superfund route is appropriate, which interact and involve the application of experience and judgement. With this in mind our answers to the questions posed by the DWP are as follows:

Q - How could a potential gateway to stop those who can afford buyout from entering a superfund work?

A – We assume by the term ‘gateway’ the DWP is referring to some kind of formulaic test (such as the ‘insufficiently resourced’ test for financial support directions) to determine whether a scheme might qualify for Superfund entry. Our view is that the issues are sufficiently complex and the possible scenarios so varied that any formulaic approach is likely to lead to perverse outcomes. A principles-based approach, relying on professional assessment, considering the specific circumstances of a situation, is more likely to achieve appropriate outcomes. We also believe that independent covenant advice is necessary and should be compulsory because, in our experience, trustee boards do not usually have the capacity, experience or independence to form a view on such significant and complex events.

Q - What would trustees need to consider when assessing whether to transfer to a superfund in relation to the employer covenant?

A – As set out under section 8 above, but in summary whether, in the circumstances, the transfer would be in members’ interests.

Q - Does the employer covenant advice market have the capacity to provide this advice and how likely is it that trustees would be able to understand the information?

A – We are confident that the market has the capacity on the assumption that there would be no ‘opening of the floodgates’, which would need to be caused by a combination of:

- Very relaxed entry requirements (which in some cases would probably not be in members’ interests); and
- The quick establishment of Superfund vehicles with massive capital capacity.

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Trustees are generally drawn from a wide range of backgrounds and some may struggle with the concepts, but no more than in say a routine scheme funding negotiation or in a corporate transaction. It is the job of covenant and other scheme advisors to make their advice as accessible as possible and it is part of the ECWG's role to provide support and guidance to practitioners to this end. In our experience, with suitable advice, there is usually a sufficient level of understanding amongst trustee boards to make robust decisions, but if in particular situations there is not, there is a community of professional trustees available to supplement capabilities. The DWP may wish to consider making a condition of transfer the appointment of an independent professional trustee.

Q - How could you assess the covenant of superfunds?

A – The assessment of Superfund covenant would follow the principles set out under section 8 above.

We welcome the opportunity to present our thoughts on this important matter and would be pleased to discuss the thoughts in this document and contribute to any ongoing debate.

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