

Engaged Investor – London Forum

Demystifying the Employer Covenant

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Introduction

Speaker



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Before joining Gazelle, he worked for Standard & Poor's running the rating agency's sponsor covenant business. Prior to this, he worked as a consulting actuary for both Mercer and Watson Wyatt. He participated on the Sponsor Covenant Working Party of the Institute of Actuaries.

The sponsor covenant: introduction

What is the sponsor covenant?

Common definitions

- Willingness and ability of the sponsor to fund the pension scheme
- Employer's credit strength

“the extent to which trustees can rely on contributions from the employer”

What's the big deal?

- Sponsoring employers can go bust leaving insufficient assets in the pension scheme to pay members' benefits
- No employer, no more contributions

What about the Pension Protection Fund?

- PPF designed to pay benefits where employer becomes insolvent
- Benefits not paid at full levels



Important to understand the strength of the employer and plan ahead

The sponsor covenant, funding and investment

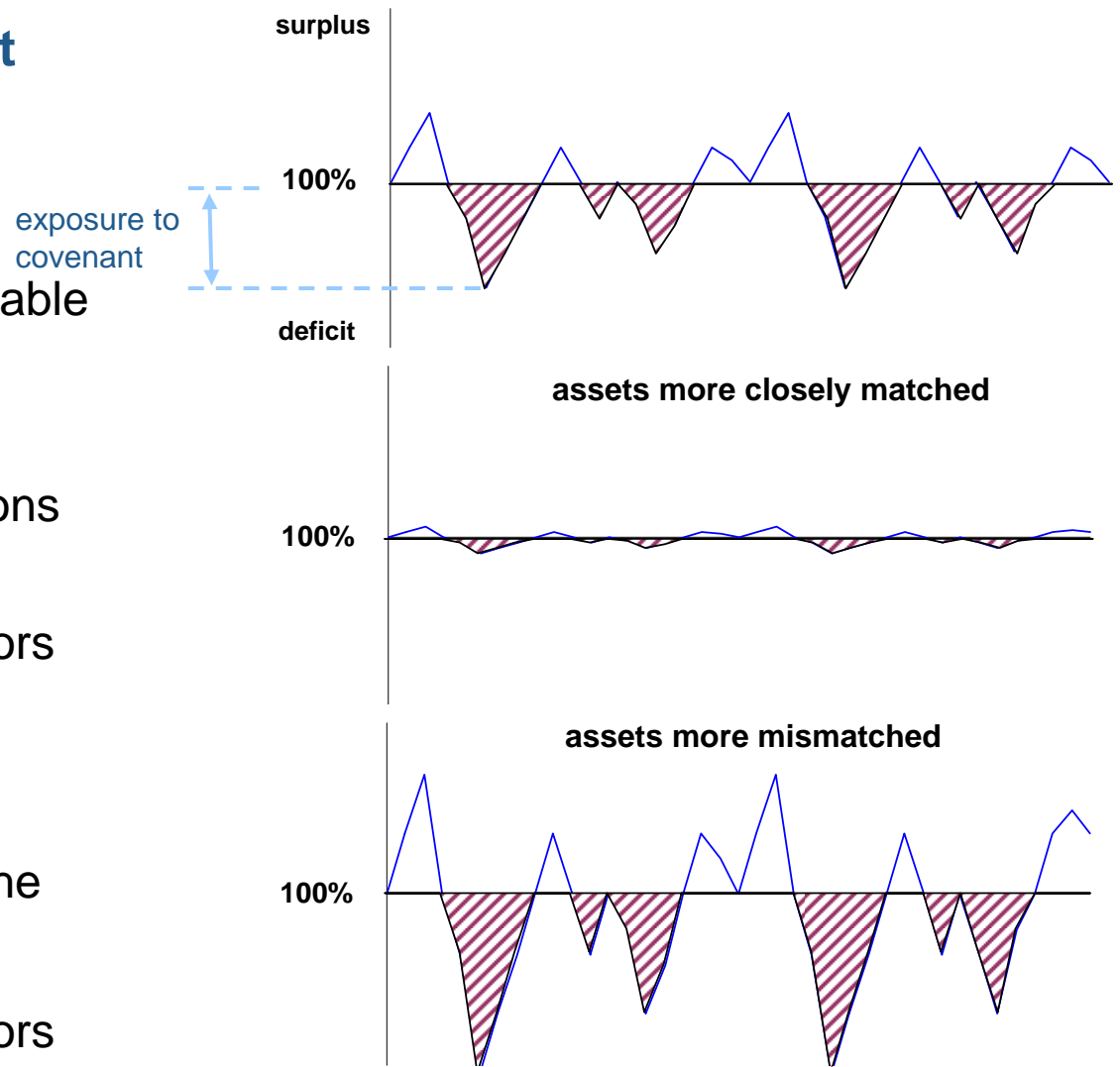
How does the sponsor covenant link to funding and investment?

Funding

- Defined benefit deficits are unavoidable
eg investment, longevity costs
- Rely on employer to remedy
- Employer can only make contributions while in business
- Expect trustees with weaker sponsors to remove deficits more quickly

Investment

- The greater the deficit the greater the exposure to the covenant
- Expect trustees with weaker sponsors to be invested more conservatively



The sponsor covenant: funding

What does The Pensions Regulator expect?

TPR: Code of Practice 03 Funding Defined Benefits (Feb 2006)

- **Approaching the valuation process**

“ 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 (the employer’s covenant). ” (para 57)

- **Matters to take into account when preparing a recovery plan**

“ Trustees should aim for any shortfall to be eliminated as quickly as the employer can reasonably afford . ” (para 101)

- **Actuarial valuation assumptions**

These should be set prudently – TPR has indicated that this will depend on the strength of the covenant.

The sponsor covenant: actuarial valuations and funding

Recovery plans

- Weaker employers pose greater risk to members
- Weaker employers pose greater risk to PPF

➡ **The weaker the employer the more concerned trustees will be about deficits**

BUT:

- Weaker employers will find it harder to make additional contributions
- Will not usually be in the interest of trustees to push employer too hard

➡ **Need to balance managing risk with what employer can reasonably afford**

Assumptions

- If employer becomes insolvent then trustees will need buy out cost
- Funding on buy out might be excessive for stronger employers

➡ **The weaker the employer the more trustees should look at buy out basis**

The sponsor covenant: clearance and corporate events

What is clearance?

TPR: Revised clearance guidance (consultation Sept 2007)

- TPR has powers to prevent employers taking actions that weaken pension scheme
- 'Type A event' – an event that detrimentally affects pension scheme
- Contribution Notices – deliberate act, not in good faith
- Financial Support Directions – makes company responsible for pension scheme
- Clearance is voluntary
- There are additional criteria for Financial Support Directions
- Department for Work and Pensions is currently consulting on changes
- Will mean broader application for CNs and FSDs – eg no good faith criterion



Clearance is a process whereby companies can advise TPR of a forthcoming event and obtain a statement that TPR will not use its powers

Assessing the covenant: different stakeholders

Banks and bondholders (lenders)

- Interest payments need to be met
- May have more senior position on insolvency than pension scheme

Shareholders

- Company ultimately responsible to shareholders
- Dividends can be withheld but risky
- Will usually have lower position than pension scheme on insolvency

Active members

- Have stronger interest in maintaining healthy employer
- Could lose employer and pension

Other members

- Primarily concerned about security of pension
- Might be more inclined to consider insolvency recovery
- Pensioners have less opportunity to make up for pension shortfall

compete with pension scheme for both cash and insolvency proceeds

trustees may need to balance members' interests

Assessing the covenant: getting started

When to look at covenant

- As part of an actuarial valuation (SSF regulations – recovery plans, assumptions).
- Monitoring – ie between valuations, keeping trustees informed.
- Specific events – business sale or purchase, refinancing, restructuring

Scheme and corporate structure

- Who is sponsoring employer(s)? Not necessarily principal employer.
- Support from parent group? Cannot automatically rely on strength of the parent.

Employer involvement

- Covenant analysis usually more effective if employer involved.
- Regular updates from employer very useful.
- Need to consider objectivity and trustee conflicts of interest.

Information available

- Information on public companies can be considerable.
- D&B/PPF score - limitations.
- Can be complicated – consider need for professional help.

Assessing the covenant: finding a solution

Where cash is not available or not desirable:

Support arrangements

- Support guarantee from strong parent or other group entity.
- Make sure it's from the right company.

Contingency planning

- Cannot rely on recovery values on insolvency – likely to be low.
- About 5% according to Association of Business Recovery Professionals.

Alternatives to cash

- Contingent assets – asset charges can provide equivalent level of security to cash.
- Letters of credit – can be expensive where employer not strong.
- Escrow accounts – where employer concerned about tying up capital

Case studies

Case 1

- Loss-making employer.
- Finding cash payments difficult.
- Tax concerns on contributions given company not profitable.

➡ **Contributions paid to escrow account – Company could get surplus**
‘Negative pledges’ used to keep trustees informed and consent for disposals

Case 2

- Loss-making employer / contributions very difficult
- Options very limited given banks had first charge over most assets
- Terms of other borrowings very prescriptive

➡ **Second charge over assets**
‘Negative pledges’ used to protect charge