Beyond the horizon

Summary
• The Pensions Regulator's DB Code of Practice consultation document puts covenant visibility at three to five years. This has led to concerns of covenant reliance being watered down. TPR has clarified that is just promoting trustees looking at a range of future scenarios as good risk management.
• While it is recognised that looking at covenant beyond five years can be difficult, trustees tend to look at employer covenant strength in relation to the maturity of the scheme. Covenant visibility is also dependent on the sponsor's business sector, so a one-size-fits-all approach is difficult to achieve.
• A change to the covenant regime may impact the sponsor/trustee relationship and effect investment strategies.
• Trustees also consider other long-term, low-visibility risks to the scheme, such as investment returns and member longevity. However, employer covenant visibility is considered the greater risk.
• A second TPR consultation document, addressing concerns from the first consultation is due in the second half of the year.

The Pensions Regulator's proposal that covenant visibility is only three to five years for most schemes has caused concerns that reliance on the covenant may be watered down. Laura Blows considers the implications of a change in covenant emphasis and how schemes determine covenant time horizons

The Pensions Regulator's (TPR) DB funding code proposals has been subject to much debate, particularly with regards to its fast track or bespoke funding options. But the code's viewpoint on the time horizon of employer covenant visibility has also generated conversations.

While the *DB Funding Code of Practice* consultation document does not contest that trustees of schemes with stronger employer covenants can afford to take more risk and so assume higher investment returns, it states that it thinks it is "inappropriate to assume indefinite reliance on the covenant" and instead "this should be limited to the period over which there is good covenant visibility". The document proposes that "for most schemes, practical considerations will limit visibility to three to five years (and sometimes less)".

Concerns and clarifications

In January, TPR released its interim response to the *DB Funding Code of Practice* consultation. While there was general support for the principles and regulatory approach proposed in the consultation, it noted concerns that the three-to-five-year covenant visibility expectations may result in the reliance on the covenant being watered down, as well as what a greater trustee focus on covenant visibility would mean for schemes' ability to rely on covenant beyond the medium term.

Some respondents may have been taken aback, Aon partner and head of the covenant team, Aidan O'Mahony, says, because "the implication that you only have covenant visibility for three to five years may mean schemes need to start de-risking or being more conservative with investments earlier than expected – and if you have an open or immature scheme, why on earth would you automatically limit your investment risk and expected returns".

Stoneport Pensions head of covenant, Jacqui Woodward, agrees that the concerns stated in the consultation's interim response arose from the perception that TPR was pushing a de-risking agenda for both closed and open schemes.

"In fact, under the bespoke regime as set out in the consultation it is perfectly possible, and right, that you can take account of the employer covenant beyond five years," she explains.

Speaking at the recent PLSA 2021 Investment Conference, TPR executive director of regulatory policy, analysis and advice, David Fairs, stated that there may have been confusion about the regulator's intentions.

"We have said that covenant horizons are only visible for a period of three to five years and some people have interpreted that as that you can't take any account of it after that period. But that really was not what we were saying," he clarified.

"We are saying that if the covenant horizon is only clearly known for three to five years, doesn't it make sense, as part of good risk management, to look at what happens beyond that three-to-five-year period, if there was some deterioration in the covenant?"

Speaking to *Pensions Age*, Fairs adds: "In many cases it is not possible to predict what the covenant will look like in the longer term. Covenant strength can remain unchanged for a number of years but can also reduce relatively fast or, in extreme examples, disappear entirely very quickly.

"We are not suggesting the employer covenant will necessarily weaken in the longer term but, given trustees have no certainty it won't, it is prudent to look at potential outcomes if the covenant deteriorated and what that would mean for the scheme. Looking at a range of future scenarios is just good risk management. From that, it might be appropriate for trustees to assume less reliance on the covenant beyond the medium term to avoid taking on more risk than the scheme can support."

Time horizons

The Employer Covenant Practitioners Association (ECPA) does not think five years should be regarded as an absolute limit for covenant visibility, "given the wide range of realistic potential sponsor longevity horizons, which is entirely situation-specific", its spokesperson says.

Also, the assumed longevity of many, but not all, sponsors can well exceed five years – and implicitly has to for the scheme to deliver its benefits to members. "Reliance on the covenant afforded by the employer is likely to be required for a period significantly longer than the period of the payments arising under an agreed recovery plan," the spokesperson explains.

However, the regulator's view of a three-to-five-year timeframe being appropriate is still broadly in line with views across the pensions industry, Sackers associate director, Nigel Cayless, says. "Despite the uncertainty created by the pandemic, not to mention Brexit, which could make it harder to assess employer covenant over the longer term."

So how can trustees determine what might just be short-term blips to the employer covenant, and what may actually damage it three to five years down the road, or beyond?

According to O'Mahony, TPR is rightly acknowledging that it can be difficult to project three to five years ahead, "or even three to five months for financial forecasts currently – but it doesn't turn good companies into bad companies when you have a downturn", he adds.

DHL Trustees chair, Peter Flanagan, echoed this viewpoint at the PLSA Investment conference, stating that "low visibility does not equate to no covenant".

When considering covenant timeframes, "as a trustee I would typically want to consider covenant in the context

of the life of the scheme, which can be several decades", Dalriada Trustees professional trustee, Keith Hinds, says.

"I believe the regulator recognises the greater chance of accuracy in shorter-term forecasts and the challenges around accurately predicting longer-term financial performance of sponsors, hence the comments around consideration and preparedness for off-forecast performance in the longer term."

HS Sole Trustees director, Ray Martin, agrees that it is important for trustees to consider the strength of the employer covenant in the context of the period it will be needed.

"The stronger the funding level and the funding basis then the less reliant the trustees are on the covenant and the shorter the period they need to consider in assessing it. However, if there is a weak funding position the trustees need to consider the strength of the business supporting the pension scheme over many years, even multiple decades," he explains.

To consider this long-term covenant strength, Hinds suggests that trustees would want to receive a range of information from their covenant adviser, such as the sponsor's competitive advantages and disadvantages, scope for technical innovation and disruption, the level of re-investment in the business versus distributions to shareholders, access to capital for investment in the future and sector positioning.

"When we start analysing sponsor covenant we start with their sector," O'Mahony says. "For instance, if the sponsor is a regulated utility why would you have a three-to-five-year view when your utility returns are predictable over a 30-year horizon?"

PLSA head of DB, LGPS and investment, Tiffany Tsang, agrees that it is evident that visibility or long-term confidence for employer covenant varies significantly between industries.

"Some employers may have extended covenant visibility (over 10 or 20 years), such as in the higher education sector," she says, "while some, such as retail, may not have visibility much further than 12 months. As a result, it is important that the future funding code reflects these variations and does not by design or accident result in a one-size-fits-all approach."

Implications

If trustees did need to de-emphasise reliance on the employer covenant, be it due to regulator attitude, sector risk or other reasons, what implications may this have?

One area it may impact is the sponsor/trustee relationship.

"Having spent the past 10 years or so fostering collaborative relationships between sponsors and trustees, framing any discussion on sponsor strength in this way *[that trustees can only consider employee covenant visibility to be about five years]* is only going to serve to heighten emotions and weaken those important relationships," Woodward warns.

"There could well be a tension between the needs of the sponsor to invest in its business and the funding needs of the scheme to reach a funding target within five years," the ECPA spokesperson adds. "This will require an open and constructive dialogue between trustees and sponsor."

One query raised at the PLSA Investment Conference was whether assuming a clear covenant horizon of five years or fewer may result in a different pattern on investment risk-taking – such as taking 'high' levels of investment risk in the first five years while the covenant is clearly visible and then de-risking to a low risk, low dependency portfolio.

However, according to O'Mahony, "it is hard to have a fixed date, to say five years from now come hell or high water that we'll have fully de-risked; that's too dogmatic and unachievable".

Over the past 10-15 years, there has been a significant shift towards investment de-risking as DB schemes have matured and aimed to match assets and liabilities, so the majority of schemes are not particularly seeking higher-risk investments, Tsang points out.

"There is a risk of taking too prudent a view on longevity and causing excess strain on the sponsor through high cash contribution requirements to support a low-risk investment strategy," the ECPA's spokesperson says. "This may in turn weaken the sponsor. A balance needs to be struck."

Instead of taking the five-year proposal literally, O'Mahony suggests trustees see it as recognising that most DB schemes are maturing quickly, "so it makes sense to get the scheme to as low a risk as possible before scheme cashflows potentially become negative".

This is not a new idea, Cayless adds, as understanding the covenant should always underpin the trustees' approach to the level of investment risk and scheme funding.

"The key questions for trustees are, does your covenant support the risk your scheme is running and are you considering the time you have for investments to repair any damage (ie how mature is your scheme)?," he says.

Whilst it is useful to have some level of prescription in TPR's approach, "it is important to recognise there is no 'one-size fits all' solution. Schemes will be looking at strategy for the long term, or with their endgame in mind, so context will be critical", Tsang adds.

A unique risk?

Context is clearly critical and employer covenant is not something considered in silo when managing the scheme. Trustees must consider a number of other factors, such as investment risk and longevity predictions, both of which are also difficult to predict long term with any accuracy. So what makes determining the time horizon of the employer covenant unique?

According to Flanagan, speaking at the PLSA Investment Conference, "many I spoke to during the consultation also felt that covenant visibility was no worse than

that of investment return, inflation or mortality. All of which require long-term assumptions well past the time there is any certainty of outcome".

Whilst these other risks, such as investment and mortality, are very long term they are supported by the covenant and thus, as long as the covenant remains sound, they should be manageable, Woodward says.

"The key issue with the covenant is that it can go to zero. Members may live longer but not forever – the covenant, however, can completely disappear."

The issue of *[covenant]* longevity is very important, the ECPA spokesperson says, "but there is a risk that problems with forming a medium- or long-term view can be overplayed".

"As the ECPA recommends in its paper on sponsor longevity, longevity can be evaluated – but then dynamically monitored (just like other aspects of scheme funding such as investments). Trustees should look to form an understanding of sponsor longevity as part of their covenant assessments in the same way that they consider asset and liability modelling and scenario analysis."

O'Mahony contrasts employer covenant risk with bank lending – "they have the security to lend to thousands of companies, so if a few go bust, it doesn't really matter. For a pension scheme, it only has the one employer, so if that employer goes bust that's a big deal; the concentration risk for the scheme is huge".

According to O'Mahony, the issue with just considering covenant visibility as three to five years is if you think about the big pension failures in recent years, BHS and Carillion, "their problems were not that they couldn't see three to five years ahead; there were other issues going on".

So, the question is why is covenant so important?, he asks. "The answer is because the scheme isn't fully funded. If all schemes were fully-funded on a low-risk basis you wouldn't care if they were attached to regulated utility company or high street retailer."

Change ahead?

As a general trend, O'Mahony can see the need for a more robust probing of the covenant and being more aware of the potential instability and longevity of sponsors, "but you can hardly say that's an amazing new trend that's only been discovered in the past year".

He expects TPR's three-to-five-year covenant visibility proposal to be 'softened' as "if it is ratified, it would have huge implications, with changes such as more demand for gilts, an equity dump, bigger calls on cashflows, potentially pushing employers into insolvency, and the need for contingent assets".

Instead, he "wouldn't be surprised if the final DB funding code goes back to highlighting how the sustainable growth of the employer is also important, that sector views are important and that the maturity of the scheme needs to be considered – a more nuanced approach".

Flanagan also stressed at the PLSA conference that any changes to the covenant regime "must be proportionate".

We will find out how proportionate any changes will be in the second half of the year, which is when the regulator says its second DB funding code consultation will be released. It will feature a full summary of the responses to its first consultation, and the approach taken in light of these responses.

"As part of our DB funding code consultation we are considering this issue *[of covenant time horizons]* and plan to set out ideas of how it might be incorporated into fast track while leaving room for trustees to explain longer-term visibility through bespoke," Fairs says.

This second consultation will likely be eagerly received, as, Woodward says, "TPR appears to have fallen into a philosophical quandary by trying to formally define covenant visibility similar to the Schrodinger's Cat paradox – will the sponsor still be around in five years or not or both? The answer is likely both for most sponsors – it will be around but not in its current form".

Written by Laura Blows