A level playing field?

With employer covenant assessments taking many different approaches, should there be stricter guidelines about what goes into them, and how is the regulator keeping check of employer covenant?

Summary
- Should there be stricter guidelines around what goes in to measuring such an important part of a pension scheme's risk management?
- How is The Pensions Regulator looking at employee covenant?
- There might be advantages to taking a range of different approaches.

Employer covenant assessments give pension trustees an indication of the strength of their sponsoring company and are vital to inform a recovery plan for the scheme.

However, these assessments or reviews can be conducted by many different firms, each of which come to their own conclusions about covenant strength, leading to questions around an unlevel playing field and potential conflicts of interest.

Differing views

Aries Insight director, Ian Neale, says there are essentially two parts to the employer covenant – the employer's legal obligations to the scheme, and its financial position, both current and prospective.

"The framework of the former is fairly well defined and partly common to all UK trust-based occupational pension schemes, although the balance of powers between employer and trustees will vary between scheme trust deeds and rules," he said. "Much less objectively determinable, despite efforts to enforce adherence to accounting standards, is the latter."

Published accounts are not necessarily a reliable guide to a company's current financial position, and even less to the future, according to Neale. So, he says: "Covenant assessments have to focus on the employer's ability to contribute cash to the scheme when required now and in the future: affordability is a key determinant of covenant strength."

In some cases, this might mean covenant strength can be open to interpretation and therefore lead to wildly different results between one company offering an employer covenant assessment and another company offering the same service.

However, XPS Pensions Group head of covenant advisory services, Lorant Porkolab, does not think this is a common issue.

"While at first it may appear that different covenant advisers can easily arrive at very different conclusions regarding the strength of support available to a pension scheme, the actual consistency between advisers in this area is pretty large and this has considerably increased over the past decade or so," he notes.

He explains while there is no single universally accepted methodology or rating system, The Pensions Regulator's (TPR) guidance sets out "fairly clearly" the requirements and the framework for covenant assessments.

Porkolab adds that different views on the same covenant by different advisers could also be explained by the various perspectives the assessment was carried out from, and even the purpose of the assessment.

"The strength of the covenant may appear differently from the perspective of the employer than from that of the trustees," he says. "While the financials are exactly the same, the risk tolerances and risk-return profiles of these two sides can be very different. Not necessarily always, but employers' covenant assessments often indicate a stronger support available to the scheme than how it appears from the trustees' perspective."

EY associate partner, transaction advisory, James Berkley, agrees, saying that certainly among the bigger employer covenant advisers, while they might have different methodologies, they broadly reach similar conclusions.

For many in the industry, the lack of consistency in assessing employer covenants is generally considered a positive. It allows for some nuance in the reviews, rather than the advisers simply coming to a single score or rating.

Berkley says: "I think covenant reviews tend to look at similar areas and tend to consider similar facts. They might then present that in different ways and have slightly different ways of looking at things, but I don't think you want covenant reviews to be too standardised.

"What trustees and companies are paying for is a bespoke review which takes into account those complexities and those differences and therefore it's right there should be some flexibility in their analysis, for covenant advisers to focus on what is considered to be most important in a specific situation."

Regulator concerns

One area of concern for the regulator is in instances where companies have conducted their own covenant assessment.

Aon partner Aidan O'Mahony, said: "If the finance director carries out the covenant assessment of his own company, what do you think he is going to find? A stronger covenant means payments to the scheme are lower and the deficit needs to be shrunk at a slower rate. TPR found there are blatant conflicts there."

He added that often, when a covenant has been self-assessed as strong, once it has been reassessed, it is found to be weak or tending towards weak. As an example, in a case study published by TPR, it found "a significant covenant risk" at one scheme.

TPR stated: "Sales and profitability were deteriorating, and the covenant advice had been drafted by an in-house finance expert and not by an independent covenant adviser. The in-house finance expert had rated the covenant as strong".

But this should not be an issue for schemes and their trustees if they use an independent covenant adviser.

O'Mahony adds it is important for companies to work with reputable agencies that will "give a thorough check-up, rather than just carry out an audit of the company accounts".

RSM UK restructuring advisory partner and member of the covenant assessment services team, Donald Fleming, says: "It's not uncommon for pension schemes to say *[to covenant assessment firms]*, 'how would you map your rating onto where the regulator is?'

"My response to that is, the regulator is looking at it across the landscape – they're looking at it from the standpoint of the regulator looking at risk to the system."

Fleming adds: "While covenant practitioners are dealing with the specific relationship between the scheme and its sponsor and trying to analyse where covenant risk is in that precise scheme-specific situation."

The need for varied approaches

While he says he would expect TPR and covenant practitioners to be in the same territory "as a sense check", there is no need for them to be "precisely the same" when it comes to identifying covenant risk "because they're doing different things".

But could standardising the way covenant assessments are conducted and published help to iron out any discrepancies in the industry?

"TPR's publications, such as the guidance on covenant, clearance, the code of practice and various statements, ensure a certain level of standardisation and consistency across covenant assessments these days," Porkolab notes.

"Too much 'standardisation', or a more formulaic approach, would potentially represent a larger risk, as the strict rules may put trustees and practitioners in a 'straight jacket' – not allowing them to consider and capture the less usual covenant issues and scenarios, which may be critical."

Berkley says the make-up of boards of trustees has changed and, as a result, they have required ever-greater detail from employer covenant assessments, rather than a simplification of the process.

"When these were started in 2004-05 it was helpful to trustee bodies that had quite a broad range of skills making them up, that actually there was a relatively simple conclusion and that was generally done through bucketing the employer covenant into various areas," he comments.

But Berkley says trustees are now "very financially literate, and they are demanding deeper and different analyses".

"I would say now that the focus is moving away from a one-off rating, and saying the covenant is this, and I think it is now moving much more towards the advice that goes around it," he adds.

For O'Mahony, a standard methodology would not be beneficial to the industry, as he says it might end up "being something wishy washy or gamed as people tried to turn it into a maximum standard and do nothing more".

Fleming has not seen demand from schemes for a uniform assessment, and in his role as chair of the Employer Covenant Practitioners Association – the body representing the member firms which focus on covenant assessment – he says there is no initiative, at the moment, to standardise.

"In practice, the covenant market works in broadly a similar methodology. I think that's where the judgment lies is that people choose different firms. It's less about the methodology and the covenant grading, and more about the fit that the individual and the firm will have with their client," he notes.

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