Summary

• In an ever-changing world, pension schemes have a complex challenge of assessing their company's future trajectory.
• In terms of employer covenant, there are winners and losers, with no underlying theme.
• It is important for schemes to make contingency plans, and maintain good relations with the scheme sponsor.
• There is a general direction of travel of a greater emphasis on understanding the covenant better.

Navigating the uncertain world

In an unpredictable world, pension funds have a complex challenge of assessing their employer covenant, but more schemes are placing an emphasis on understanding employer covenant. Louise Farrand reports

Fifteen years ago, BHS was a thriving high street mainstay, and outside the construction sector, few people had heard of Carillion. BlackBerrys were the smartphone of choice, and iPhones existed only in Steve Jobs' imagination.

The world we took for granted back in 2003 has been transformed and the future is incredibly uncertain, with so much yet to be invented, negotiated and decided. As a result, defined benefit (DB) pension scheme trustees have a difficult task on their hands. They must assess the strength of their sponsoring employer in the knowledge that even their most educated guesses about the company's future trajectory could turn out to be flawed.

A heady combination of Brexit plus broader macroeconomic and geopolitical instability is fuelling the uncertainty. "We are living through the sort of turmoil you see perhaps once in several centuries," says ITS' managing director, Chris Martin. The professional trustee adds: "Whoever you ask says confidently that they are planning for Brexit, but there is not much clarity on what that means."

Meanwhile, we could be in line for a market correction. "In my personal view, we are nine or 10 years into a strong economy. Some might call it a bull market, which suggests there is likely to be a correction at some point. It is just a question of when that correction occurs and what is the trigger," says Lincoln Pensions' managing director, Alex Hutton-Mills. "If I were guessing, I would say that the trigger is more likely to be geopolitical – I think we are just going to wake up one day and things will be different."

In such an uncertain environment, experts across the board agree that it is impossible to generalise about the state of employer covenants for UK plc. "Whatever the macroeconomic trends are, they affect employer covenants in different ways. Some sponsors are enjoying the current environment of uncertainty and others can feel some very strong headwinds," says Martin.

"It is such a scheme-specific thing," agrees Redington's head of defined benefit, Dan Mikulskis. "Clearly it is top of mind for schemes. It goes without saying that everyone is focused on Brexit as a potential effect on the covenant over the next few years."

Winners and losers

When PwC partner, Jonathan Land, first started producing PwC's Pensions Support Index in 2006, he never expected to still be publishing it in 2018. Although the index, an annual measure of pension scheme covenant strength within the FTSE 350, shows a return to pre-recession levels in 2017, there are still winners and losers, says Land. "I thought I would just start doing it for a few years and then we would be sorted … In 2007 it plummeted. But we have seen overall support has come back as a result of economic performance improving and money going back into schemes."

Land adds: "There is a polarisation. Trustees who de-risked are doing fine. Those who didn't because the sponsor very often wasn't strong enough have had a double whammy: the deficit has got larger, the sponsor hasn't got stronger, and not enough money has gone in. People who have done well have done well, and people in unfortunate situations have seen them get worse."

Law firm Sackers' partner Vicky Carr says: "The retail sector is having a hard time at the moment, but other areas are doing well. We see a broad spectrum of covenant strength across our clients. You can't necessarily put a theme on it."

Trustees cited covenant as the biggest risk to their scheme in PTL's quarterly DB risk survey, which was published in May 2018. In an uncertain world, how can trustees assess covenants effectively?

Build up a clear picture

"For trustee boards that don't take covenant advice, if they are concerned about covenant then it probably makes sense for them to seek advice from a professional firm," says Carr.

She adds: "It is key to get information from the employer, so you really get a good understanding of what's going on. The employer knows its business the best so the more information the trustees can get about what the employers perceive is the risk to their business, the more information trustees can build about what they should be concerned about."

Stress testing the pension scheme is also helpful, suggests Mikulskis. One in eight FTSE 100 companies with DB obligations could struggle to meet their commitments to members in a distressed scenario, according to The Worry Index 2018, a risk index produced annually by Redington and Cardano.

Trustees should regularly revisit their covenant assessment, says Martin. "Most covenant reviews now are not once every three year, set piece reviews. Proper covenant assessment is a living, breathing part of integrated risk management and trustees should be thinking about it at every trustee meeting and frankly, in between."

Make contingency plans

Concerned trustees should put in place contingency plans for what happens if the risks that they are worried about do materialise, says Carr. She explains: "They can range from a legally binding document that says if a certain event happens we will do this – for instance pay more cash into the scheme – to contingent assets, which are designed to protect against risks that trustees are concerned about, whether that might be a covenant event, which might give trustees comfort that if things do go wrong they would have something tangible there to call on."

There are a range of measures trustees can take in response to changes in the employer covenant, says Mikulskis. These include seeking higher contributions or exploring asset-backed security measures, adjusting the time horizon over which they plan to achieve their objectives for the scheme, adjusting their investment return objectives to be more aggressive or conservative, or changing the end game target. On the latter, he says: "You might go from thinking about self-sufficiency to deciding you don't think the sponsor can stand behind that now, so to aim for buyout instead."

Good relations

Staying on good terms with a scheme sponsor is all-important but can be challenging in sometimes stressful situations. Be pragmatic, says Mikulskis. "There can be situations where *[trustees and sponsors]* have quite a collaborative attitude, particularly where sponsors see trustees are prepared to use all the available levers in different ways, rather than just a one-way street where everything is being locked down. The sponsor is likely to be more amenable if there are allowed to be trade-offs and trustees are prepared to look at pensions security in the round, rather than just trying to extract higher pension contributions."

Generally, where disagreements arise is when trustees and the sponsor have not got a common understanding of the facts, says Land. A covenant review can help them to sing from the same hymn sheet. "Most finance directors and trustees I meet are fairly sensible, but where they are not agreeing is because they are looking at it from different perspectives."

It's also important that the scheme's advisers work effectively together, says Martin, who suggests getting advisers together before a full trustee board meeting to make sure they have negotiated solutions to any disagreements and are prepared to present a full range of options to the trustees. "I want everyone singing from the same hymn sheet, not three groups of advisers coming at it from different perspectives because that sows chaos."

Times are changing

Awareness is growing among trustees but isn't universal yet, says Hutton-Mills. "The first code of practice on scheme funding came out in 2006. Covenant was mentioned nine times in that first code of practice and in the 2014 version it was mentioned 96 times. There is a direction of travel that shows there is emphasis on understanding the covenant better, which has been driven by the regulator. That has been manifested at the larger end of the market and at the smaller end of the market where there is stress. It definitely hasn't permeated through the whole market and there are still schemes that are DIYing on their covenants."

Meanwhile, Land hopes that in five to 10 years' time, the Pensions Support Index won't be needed any more. "I expect there will be a gradual trending upwards over time – in five or six or 10-years' time I won't need to do this anymore. But there is still a very long tail of pension obligations, which we are going to be dealing with for probably another 20 years. So, while I anticipate a gradual trending upwards, there will also be a polarisation of some companies that are really struggling and some that are doing better. Look at how technology is changing companies: business models are changing all the time and if you are stuck with a DB scheme in a business where fundamentally the economics have changed, that is problematic."

Written by Louise Farrand, a freelance journalist