Grant Thornton Pensions Advisory podcasts

2. Scheme Funding: transcript

Welcome to this series of Grant Thornton's Pensions Advisory podcasts.

In this edition, we will be looking specifically at Scheme Funding and some of the key issues and challenges facing pension scheme trustees, their employers and other stakeholders. To make sense of these issues, I'm joined by my colleagues from the Pensions Advisory team, Phil Green and Jamie MacKenzie, both of whom are very experienced pensions specialists, who've worked for many years on employer covenant and scheme funding projects.

Russell Phil, my first question to you is a very simple one: why do schemes need on-going funding advice?

Phil It's very important that pension schemes understand the risks they have to face. And those risks fall into three categories: you have a risk of something happening to the covenant, there's a funding risk as in how are you going to get the money into the scheme; and the investment risk, as to what's going to happen with the scheme assets.

The regulator has recently brought out some guidance, *Integrated Risk Fund Managing*, and the key there is to try and take a holistic approach to all of these, so look at everything in an overview. And that's quite important because if you think about it, if you've got a weak covenant and the employer can't really afford to pay very much into the scheme, or afford to meet any movements in the investment returns, it's important to make sure that the investment risk and the funding risk are lined up. You don't want an overly aggressive investment policy, which means that you are going to be requiring significant additional funds of money coming through from the employer in future times, if he can't afford it.

So that's one of the circumstances where it's important to understand the risks. You've also got to look at what the covenant is supposed to do. The covenant is supposed to be providing trustees with an understanding of what the ability of their employer is, and that's not just a one-off issue, that's got to be looked at on a regular basis, not just from a monitoring point of view but equally when transactions occur. It's important to understand where you are before the transaction occurs so that you can understand the level of detriment that might be arising from that transaction.

Russell Jamie, a back-to-basics question then, what's involved in a covenant assessment, particularly at the triennial valuation time?

Jamie Covenant assessments vary from scheme to scheme and from employer group to employer group, but it's really a case of horses for courses. The common considerations we see are: who is legally liable so establishing which employers actually support the pension scheme, so which ones are legally obliged because quite often FDs will present to trustee bodies and they will present on a group basis, or consolidated basis. But it’s important for the Trustees to determine exactly which employers really are supporting the scheme and focus on them for their reviews.

Another thing to think about is where these businesses are going? So how are their markets working, are they developing, think about where are they going in the future and trends in relation to that. Also covenant assessment should be forward-looking, thinking about their financial ability now but in the future as well and we base that view of the future on the historics, so we think about how has it performed historically, what have its volumes and profitability looked like in the past and thinking about how achievable budgets have been, have they always been achieved, have they been strong?

Another thing you might think of is the capability of the balance sheet to support the covenant if needed, to actually support the scheme, because usually the scheme is an unsecured creditor so it's important to understand any security that is in place. So where does the scheme rank as a creditor and its priority? Other creditors are typically the banks who might have secured debt so you need to understand how the funds might flow in the event of an insolvency and what would come through to the scheme?

One of them main focuses in the covenant assessment though is to focus on the cash flows rather than just the profit. It's a better measure of the ability of the employer to make contributions to the scheme

Russell I assume the Pensions Regulator gets involved at these kind of times. Do they allow trustees to do these kind of covenant review work themselves?

Phil Well, they do. The requirements of the regulator are that an independent view is formed. If the trustees believe themselves to be sufficiently independent that they can do it themselves, then there's no reason why they have to go out to a third party.

If you look at trustee boards, there's often an awful lot of experience on trustee boards and past knowledge about how the business itself is run, and it's often ridiculous almost to ignore that, so any covenant assessor, even if they are a third party, would tap into that knowledge that the trustees already have. So, any review has to be independent, doesn't have to be third party, but the trustees have got to expect that if they do it themselves, they will be robustly challenged by the regulator because he's very keen to make sure that there are no conflict issues arising, past relationships coming into play between then trustees and previous management, so any covenant review that is not undertaken by a third party is likely to get a bit more of a robust review from the regulator than one that isn't.

Russell And I assume it's just good governance to get things done independently?

Jamie Yes it is good governance to get an independent review. Independent covenant assessors have the benefit of doing this professionally and the considerable experience of looking at all the different situations, so that's a lot that can be brought to the table and add value to a covenant review.

Russell Now I'm aware that the Pensions Regulator and the Pension Protection Fund (PPF) both on a regular basis do distribute information for these kinds of assignments? What are the sorts of things they have been saying?

Phil Actually in the last year there's been a flurry of stuff coming out of the regulator. In 2014 there was the updated Code of Practice on funding defined benefit schemes. In 2015 we had not only the covenant guidance, but also the Integrated Risk Management guidance, which came out in December of last year. As mentioned earlier, that is trying to being a more holistic approach as to how you review the covenant funding and investment risks. So there has been a lot of guidance out there. The PPF on a regular basis puts out guidance in respect of the PPF Guarantee recertification process and it's only going to continue. We are going to see more bits from them this year as well.

Russell Key issues to keep in mind, Jamie?

Jamie Just thinking about the new Regulator objective, which came into force in July 2014 to minimise any adverse impact on the sustainable growth of the employer. It's important for Employers and Trustees to think about how they are investing in the growth and the cash flows they are generating. So if an employer plans to invest in sustainable growth and this restricts funds that are available to the scheme, the scheme needs to understand how it will benefit from this investment. Trustees shouldn't accept lower deficit repair contributions to support investment in sustainable growth which sits outside their employer group if they are not going to benefit from it. But it could be the case that the company provides a guarantee to give mitigation for that investment.

And then thinking about Code of Practice, that picks up on what Phil said earlier about an integrated holistic approach to scheme funding and risk management, so it's understanding that the covenant underpins the trustees' approach to investment risk so the level of risk they're targeting, the prudence and the actuarial assumptions and the recovery plan. The Code of Practice was really a refresh of the previous Code of Practice, but it was written in hindsight of what had happened to the Economy, so taking account the credit crunch and how that impacts employers and schemes.

Russell So Phil, what about the other recent guidance that's come out?

Phil The Integrated Risk Management guidance, which came out in December last year we've already touched upon, with the regulator's enforcement of this holistic approach they want trustees to take when considering the three main types of risk which are facing pension schemes: covenant, funding and investment risk.

There was also some covenant guidance that came out last year, in which the regulator recognised that the 2015 cohort was something of an 'unlucky cohort', because of the nature of what the actual investments were doing at that time, deficits were getting greater. That really did imply that one of the things trustees need to think about is affordability and whether or not deficit repair contributions are affordable by employers and if they are not, it opened the way for reducing the deficit repair contributions in the short term, which is a bit of a step forward for the regulator. However they also introduced an idea of maybe more contingent asset security being put in place and some asset-backed funding arrangements, which are something else which have been prevalent in the market these days, to provide some additional support which is being lost by the lower deficit repair contributions.

Russell Does any of this have any effect on PPF certification for example?

Jamie The guidance on that changes frequently and the most recent guidance that has come out is in relation to certifying the 2015-16 Levy year. What changed there is that the trustees need to certify a specific amount they could recover from the guarantor on insolvency. It's called a realisable recovery. We've reviewed a material number of guarantee certifications so it's not quite as simple as saying 'okay, there's a £50 million guarantee and the guarantor has £100 million on its balance sheet, and therefore it can cover that guarantee. It's a case of saying what is that £100 million on the balance sheet there for? They don't usually have it sitting there, it's usually used for working capital, acquisition finance, it might even be connected to their covenants in relation to the amount of debt and cash they hold, so it's a case of thinking about how that would flow through, so it's not just thinking about it theoretically, it's a question of thinking about it practically, how can you demonstrate that the guarantor can pay that amount? The larger the guarantee that's put forward by the employer, the more work that needs to be done to demonstrate that it does cover that.

Russell Finally you mentioned the newer instruments like the use of contingent assets and asset-backed vehicles. What is around, how do those work?

Phil A number of the asset-backed funding arrangements have been put in place recently for everything from cheese to whisky to property. It's quite bizarre but they are out there, property, intellectual property are the more common ones, where you get an income stream from these assets which is effectively pledged to the pension scheme, in lieu of a deficit repair payment or as a back-up or in addition to an agreed Deficit Reduction Contribution schedule. In that way companies are able to ring-fence its assets and get the trustees a little more comfortable with what the level of payments are going to be over a period of time.

The issue always with them is for trustees to really understand what they are signing up to when they agree to them. What are their step-in rights if it all goes wrong, so if for example the employer has to go through some kind of insolvency process, does the asset become an asset of the pension scheme? Is it something they can then sell and get money in from? Or are they really just securitising a future income stream with no proprietary rights over the underlying asset?

Contingent assets are a little more common. Guarantees are probably one of the easiest ways of thinking about contingent assets. Once again your issue there is it's a nice-to-have but you've got to understand what actually it is that you've got and if you are going to be in a recovery scenario, can the guarantor afford to pay the guarantee. This comes back to the recertification of the PPF guarantees, it's all well and good to do a theoretical exercise and say 'it looks as though there's some money there' but in a scenario what's going to happen to that guarantor? Will he really be able to make a payment under that guarantee? So it's really down to the detail of all of this, they are good, they provide additional security to the trustees and they often provide a seat at a table in a future restructuring.

Gentleman, thank you for your time and thanks for joining us. As usual you can find all the information you will need on this complex subject, including a transcript of this podcast, on our web pages at http://www.grantthornton.co.uk/pensionsadvisory