Forward looking approach, putting you in the driving seat
Innovative employer covenant support from Deloitte
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Introduction

It is critical for stakeholders of defined benefit pension schemes to understand the businesses that support them. This includes assessing the strength of the employer’s financial position and prospects as well as its legal obligation to fund the scheme’s benefits (known as the ‘employer covenant’) and understanding the impact of employer or scheme events on the scheme’s position. This is especially important in the current environment, with pensions legislation and guidance issued by the Pensions Regulator (“TPR”) constantly evolving.

What we do
Our market leading dedicated team provides a tailored solution with integrated sector expertise, ensuring that our clients’ specific requirements are fully identified and addressed with the focus on developing a cost efficient approach. We are at the forefront of providing a proactive, forward looking approach to managing employer covenant risk.

We robustly support our client’s interests, while recognising the employer-trustee relationship is on-going and long term, benefiting from a pragmatic, consensual approach.

Our key services are:

How we can help
Our team harnesses the unparalleled breadth and depth of expertise from across Deloitte:

- business review, insolvency outcome and sector analysis – our covenant team has a background in restructuring and corporate insolvency. Our broad sector expertise gives us the ability to focus rapidly on the core business and market issues facing the employer; and

- actuarial and investment input from Deloitte Actuarial and Pensions Services – bringing capability to link covenant assessment conclusions to scheme valuation assumptions, analysing the impact of changes in covenant on investment strategy, and designing deficit financing solutions. True integrated risk management.
Market practice and commentary from the Regulator has created an expectation that trustees will actively monitor the strength of the employer covenant. However, trustees do not necessarily have a background in finance and, where they do, there may be a perception of a conflict of interests between their roles for the Company and as a trustee, making assessing and monitoring the performance of the business a challenge.

For schemes with a funding deficit, covenant assessments frequently include an evaluation of the affordability of deficit contributions. This is described in more detail on the following page.

“I found their advice to be commercial, pragmatic and communicated in a clear and concise manner that met the clients' different needs.”

Client quote

We help navigate this process by providing independent advice covering:

### Scheme funding – the triennial valuation process

- assessing the strength of the employer covenant, summarising findings in clear, straightforward terms;
- our four point rating scale facilitates read across to the four point scale used by TPR and easily compatible interaction with the scheme actuary/funding assumptions;
- suggesting ways to improve the covenant;
- linking covenant advice with funding and investment assumptions, ensuring the risks being taken within the scheme's investment strategy are consistent with the strength of the covenant;
- identifying key risk areas for monitoring as part of an integrated risk management approach; and
- assisting with the dialogue with other pension stakeholders, including negotiation support.

### Ongoing Monitoring

- working with the trustees to develop a tailored monitoring dashboard to simplify and improve the effectiveness of employer covenant monitoring;
- recommending trigger levels to rapidly highlight areas of concern and identifying possible trustee responses;
- providing regular or ad hoc covenant monitoring update reports; and
- designing and delivering training to assist trustees in fulfilling their ‘Trustee Knowledge and Understanding’ (TKU) responsibilities and enabling them to respond rapidly to future events that may impact employer covenant strength.
Employer covenant assessment

Case study

We advised the trustees of a scheme sponsored by the UK subsidiaries of a European group with a significant funding deficit. We developed a collaborative, cost effective approach, working alongside the trustees and their other advisors. Our work in helping the trustees understand the impact on the covenant of various deficit mitigation scenarios led to a significantly enhanced funding and guarantee package being negotiated with the employer.

We provided full triennial employer covenant assessments, recovery plan negotiation support and annual monitoring updates. We have also considered the impact of several corporate transactions on covenant strength and investigated the suitability of a range of additional asset support.
Affordability evaluation and recovery plan negotiation

Trustees of schemes in deficit typically ask us to evaluate the affordability of deficit contributions at the same time as assessing covenant. However, in cases where the trustees already have a good understanding of covenant, we are sometimes asked to evaluate affordability in isolation.

In either situation, we provide robust support to our client, drawing on our extensive experience in these areas:

**Affordability assessment**
- reviewing the employer’s cash flow projections to assess surplus cash available for pension contributions reflecting on the employer’s plans for sustainable growth;
- identifying other potential constraints on affordability; and
- suggesting a reasonable range of affordable contributions, taking into account an appropriate level of headroom.

**Recovery plan negotiation**
- working with the scheme actuary and investment manager, develop an appropriate recovery plan to eliminate the deficit over a reasonable time period with regard for the principles outlined in the Pensions Regulator’s annual funding statements;
- comparison of deficit recovery payments with employer dividend levels; and
- support through negotiations and provision of further analysis as required.

**Alternative funding solutions**
- provide suggestions for alternative funding solutions, such as additional security or asset backed contribution structures; and
- support in the negotiation and implementation of these structures.
Affordability evaluation and recovery plan negotiation

Case study

Our client was the trustee board of a large pension scheme sponsored by a UK financial institution. Although the trustees had an excellent understanding of the employer covenant, they had reached an impasse with the employer on recovery plan length and consequentially sought our advice around the affordability of deficit contributions. Our analysis reflected the employer’s earnings outlook and constraints imposed by requirements to meet minimum levels of regulatory capital. Our clear, objective analysis provided the trustee board with additional leverage in negotiations with the employer, enabling them to reach a favourable outcome while maintaining a positive ongoing relationship.
Corporate transaction support

The Pensions Regulator requires trustees to understand the full effect of any corporate transaction on the employer covenant. Examples include mergers, acquisitions, disposals, reorganisations, debt restructuring or return of capital to shareholders. Frequently transactions also encompass changes to the structure of the scheme, such as employment cessation events, flexible apportionment arrangements or deferred debt arrangements, changes to guarantee and security packages.

In certain circumstances where TPR considers the event to be materially detrimental to the covenant, it can use its anti-avoidance powers to sanction parties involved in the transaction.

We have significant experience in this area and can support clients by:

- understanding the impact of the event on the employer covenant and the scheme’s position, including any ‘material detriment’;
- considering the appropriateness, level and nature of any mitigation required;
- considering potential availability of TPR anti-avoidance powers;
- suggesting alternative transaction structures to minimise the employer covenant impact; and
- providing support through negotiations and, potentially, TPR’s clearance process.

“The team engaged rapidly, and completed the project in compressed timetable. They demonstrated extensive transaction experience and capability, enabling them to form a rapid opinion allowing transaction to close in line with timetable.”

Client quote
**Case study**

Our covenant assessment identified that the employer had recently disposed of a key subsidiary to another entity in the wider global Group with consideration in the form of an intercompany loan note. This reduced the employer’s profitability to below the existing level of deficit contributions.

We performed a full evaluation of the transaction. It was key to establish whether the consideration was at fair value, and whether the purchaser had sufficient liquidity to settle the intercompany loan note on demand.

We concluded that the transaction was detrimental to the employer covenant and supported our client in agreeing additional prudence in the actuarial valuation assumptions and in obtaining a parent company guarantee.
Restructuring support

It is often the case that a defined benefit pension scheme is a significant or even the largest creditor when we are called in to look at a business that is transforming or experiencing financial distress. Considered in conjunction with the Pensions Regulator’s anti-avoidance powers, having a strong grasp of the issues and obligations pertaining to the scheme, as well as a range of appropriate solutions, is essential for all stakeholders during a restructuring process.

We have considerable experience providing advice and support to trustees in a broad range of situations. Our work typically incorporates some or all of the work streams below:

- Critical test and challenge of employer forecasts to establish realistic scheme affordability.
- Innovative approaches to address the scheme’s deficit, including asset-backed structures.
- Understanding the impact of a restructure, for instance clarifying if the divestment of a group company adversely impacts the covenant position.
- Preparation for and support during meetings with TPR/PPF.
- Stakeholder, industry and sector analysis.
- Developing estimated outcome analysis to establish potential returns to different creditors in the event of insolvency.
- Assessing affordability of the scheme, funding levels and eligibility for PPF entry, including via a Regulated Apportionment Arrangement.

“They provided clear advice [and] identified historical events detrimental to covenant which was invaluable in supporting the trustee’s discussions with the employer. They then helped the trustees understand key risks to covenant associated with proposed future restructuring.”

Client quote
Case study

We advised the pension trustees to a scheme which had grown in scale relative to the profitability of the employer. After a period of negotiations during which we advised on the affordability of deficit contributions, and a further downturn in trading performance, it became apparent that a conventional funding solution was not obtainable.

We supported the trustee during extensive discussions with the employer, TPR and the PPF which ultimately led to the scheme entering the PPF via a Regulated Apportionment Arrangement.
PPF Guarantee analysis

Each year, the PPF updates its approach to certifying guarantees provided to a scheme for the purposes of reducing the annual PPF levy payments required. The process have become more detailed and prescriptive with each iteration.

Schemes are required to certify the amount that they are reasonably satisfied the Guarantor could meet in the event of the employer’s insolvency, and:

• for schemes where recognition of the guarantee would result in a levy saving of at least £100,000, the trustees are required to obtain a pre-certification report from a professional advisor;

• schemes where the levy saving is less than £100,000 do not need to provide a pre-certification report but they are recommended to keep comprehensive records to support their certification.

Each year the PPF samples a proportion of these guarantees for detailed review to ensure the scheme has complied with the PPF’s requirements.

It is therefore essential to ensure the guarantee amount certified is supported by robust analysis to withstand PPF scrutiny.

We use our extensive and unrivalled knowledge of the PPF’s certification requirements and process to help trustees navigate the changing requirements by:

• reviewing existing PPF guarantees for the annual trustee certification process, to ensure this will stand up to PPF scrutiny;
• identifying potential guarantors;
• calculating the appropriate “realisable recovery“ amount to certify, and the potential saving in levy payments;
• assessing suitability against the latest PPF rules; and
• supporting the client in responding to queries raised by PPF.
PPF Guarantee analysis

Case study

By 2018, we had reviewed over 100 guarantees to assess compliance with PPF criteria. We undertake these assessments by considering the impact of the employer’s insolvency on the guarantor, in addition to reflecting on financial and operational dependencies. We then analyse the guarantor’s financial performance and position to assess whether it would be able to meet the certified amount.
Skilled Person/Expert Witness

There are times when an independent, objective view is required on a specific point and a Skilled Person is required to provide an assessment of the situation. This can either be imposed upon trustees or an employer by TPR through the use of its powers, or may be appointed voluntarily, prior to powers being exercised.

In the context of legal action this professional opinion is provided, in court, by an Expert Witness.

We have extensive knowledge and experience of the scheme funding regime and provide expert services in employer covenant, restructuring and insolvency situations.

This awareness and understanding means that we are often called upon to represent our clients to robustly support them in negotiations.

“They demonstrated knowledge of the regulatory regime, carefully considering TPR's moral hazard powers, and a pragmatic approach”.

Client quote
Case study

Our client appointed us an Expert Witness to assess the strength of the covenant supporting a major public sector pension scheme and the affordability of deficit contributions.

As the employer was run on a not-for-profit basis, in assessing affordability we needed to identify various budgetary flexibilities that could potentially be used to release funds for deficit contributions. Our work reflected the complex inter-governmental funding structure and considered the feasibility and implications of amending expenditure plans.
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