Employer Covenant
Practitioners Association

The Employer Covenant Practitioners Association Limited
First Floor, 40 Gracechurch Street, London EC3V 0BT
Telephone: 020 3102 6763 Email: secretariat@ecpa.org.uk

16 April 2024

statementofstrategyconsultation@tpr.gov.uk

The Statement of Strategy Consultation Team
The Pensions Regulator
Telecom House
125-135 Preston Road
Brighton
BN1 6AF

Dear All

Statement of Strategy consultation

The **Employer Covenant Practitioners Association (ECPA)** welcomes the opportunity to respond to the consultation on *Statement of Strategy.*

As an organisation of employer covenant practitioners, we have focused on the questions that are either directly or indirectly referencing employer covenant – and have not therefore responded to all of the questions.

This response should be seen as a collective response from senior industry practitioners and not as a response from any of the ECPA's member organisations specifically.

We have set out below some overarching commentary.

As a general observation it would have been helpful to have sight of the updated covenant guidance or the new DB Funding Code ahead of this consultation and we note that these are not due to be available for a number of months. We see several challenges which we hope the final guidance (on statement of strategy, funding code and covenant) will help clarify. We think it is important that these guidance documents dovetail appropriately.

We also note that the information requested via templates touches on many of the characteristics that good employer covenant advice would cover. However, covenant advice to be used as part of the trustees' funding and investment decisions must take account of the specific complexities of the employer and of the scheme. It should be made clear that the information required as part of submissions is for "regulatory review" purposes, and not to be taken as (or an alternative to) good and proper covenant advice for trustees.

We set out in our question responses some of the specific complexities of providing consistent and complete covenant information. Given this and the importance which trustees will take to submitting information to TPR, we think it is essential that there is sufficient space given with the template to submit explanatory narrative to the numbers provided. You could see this as being consistent with a set of company financial statements, for example, which rely on additional notes to be read and assessed accurately.

We believe that trustees and advisers will want to ensure the appropriate context is provided for their submission. We understand that TPR's initial consideration of the information will be data driven but we believe that if anomalies are identified, this will cover the first stage of inquiry and may save time and resource from a regulatory perspective. We note that there is the opportunity to submit a pdf document to provide further detail on the assessment of maximum affordable contributions, but believe further options are necessary.

We also note that if additional text boxes are not provided, trustees may feel the need to provide additional explanation in other documentation, which might cause further difficulties for TPR.

We understand that the purpose of providing such granular covenant information in the template is to enable TPR, using AI, to identify those schemes for which further investigation or attention is required. It is not clear from the Consultation exactly how such items of data will be used or why these items are particularly relevant.

Subject to further information that we expect will be contained within the anticipated covenant guidance, we continue to have reservations around TPR's concepts of covenant reliability and longevity periods, and the 'reasonably certain' framing embedded in the legislation. Like all estimates of future outcomes, these estimates will naturally rely on subjective assessments of a mixture of qualitative and quantitative evidence, and they are just that – **estimates**. It is vital that the Statement of Strategy allows schemes to frame this accordingly. Asking a covenant adviser, or trustees, to stipulate that covenant reliability and longevity will continue for "at least" X years, as TPR proposes in this consultation, is inappropriate framing which will be a big concern for covenant advisers from a professional liability perspective. It would be comparable to requesting a scheme actuary to stipulate that liabilities will be a maximum of £X, or that the expected return will be at least X% pa. We would ask TPR to consider this definition and framing relative to the time and cost that a corporate auditor incurs in providing a going concern opinion in respect of a period of c.18 months. We suggest a more appropriate framing would be to request trustees' reasonable estimate of covenant reliability and covenant longevity, consistent with the approach taken to actuarial and investment estimates of asset returns and liabilities. We hope this will be clarified within the upcoming covenant guidance.

We now turn to the individual questions asked:

Q1. To what extent do you agree that the proposed approach to submitting covenant information will work in practice for different types of multi-employer schemes?

In our experience, where employers and trustees are fully committed to the process of covenant assessment, and where a professional covenant advisor is engaged to provide support, then sufficient information is usually available to enable a meaningful assessment to be undertaken.

However, information is often imperfect and professional judgement will need to be exercised in order to form an opinion on covenant matters. For example, it is common for financial reporting within groups (where multi-employer schemes are typically found) to be along divisional lines, rather than by entity, or not readily available in a form that would enable straightforward analysis. In these circumstances, deep covenant expertise will be required in order to interpret the information properly and to form a reasoned view of covenant strength, affordability, and capacity to support risk.

Recognising that information can be imperfect, it is important that trustees are given flexibility to take a pragmatic approach to information that is reported. For example, where the employers in a multi-employer scheme comprise a high percentage of a group's trade and assets, it is commonplace to use the group's consolidated information as a proxy for the combined covenant, rather than aggregate individual employers (which may be complex to consolidate and eliminate intercompany positions as a separate exercise). This would seem reasonable and proportionate unless there is an obvious risk of insolvency where more granular analysis would be required.

Where consolidated information is not available, aggregation may be appropriate; however, care needs to be taken to avoid double-counting where there is inter-group trading. Care also needs to be taken in scenarios where employers are also guarantors. It is reasonably commonplace for an employer, which supports less than 80% of scheme liabilities, to also be a guarantor. Considering its roles separately has a risk of it (and covenant support) being double counted.

The over-arching objective should be to ensure that, when assessing covenant strength (including free cash flow, affordability and maximum supportable risk etc.), as accurate a picture as possible is formed of the cash flows and other sources of support that are actually available to the scheme, taking into account any limitations in information provided. For multi-employer schemes in group scenarios this should be relatively straight forward but is likely to require professional input.

In many of these multi-employer situations described above, some narrative would seem necessary to explain the data submitted and the assumptions, or assessment, made of an imperfect data set. Further to our comments above regarding narrative text boxes, we believe some ability to provide clarificatory explanations will allow trustees to feel more comfortable with submitting data and also act as a first port of call for TPR analysts, if data anomalies give cause for concern.

For unsectionalised NAME schemes it is likely that each such scheme will adopt a bespoke approach to covenant assessment, which will reflect the number of employers, their different size, nature of activities and availability of information for each employer. Employers to a NAME scheme can often range from very small to very large. Although it may be technically correct to assess overall covenant strength as being strong (reflecting that one or more very robust employers are legally obliged to support all liabilities), it is important that the portfolio of employers is considered both individually and as a whole, so as to better understand covenant risks and affordability of contributions. This will also ensure that employers are treated fairly, and funding agreements take account of differing strengths of covenant across the portfolio.

Registered Office: 10 St James Road Wokingham RG40 4RT
Company Limited by Guarantee Number: 9915768 VAT No. 244657587
Privacy Statement

A challenge for trustees is how to assess covenant strength across a large portfolio (in some cases in excess of 300 sponsors), meaningfully and proportionately. In our experience the use of online portals to collate specific, homogenous information submitted by employers, can make the data collection process relatively straightforward. In such circumstances, even when armed with a large amount of very detailed specific information, a highly bespoke approach is required, which is even less suited to a template submission.

The application of KPIs (based on affordability and balance sheet strength) and use of data analytics tools can then enable the risk profile of the portfolio (including affordability) to be interpreted and sensitised meaningfully and in appropriate detail. Again, we would recommend professional input is obtained.

Q2. To what extent do you agree with the proposal that aggregated covenant information should cover employers that account for at least 80% of scheme liabilities?

Any threshold is somewhat arbitrary but, to the extent some threshold is needed, then 80% seems reasonable subject to the general reporting challenges noted above and below.

However, it is not clear that using such a threshold without other associated scheme data will appropriately capture the inherent covenant risks within a scheme, for example:

- Where a small percentage of scheme liabilities relate to a particularly strong employer and might skew the assessment of maximum affordable contributions; however, this employer might be able to exit the scheme for a de minimis Section 75 debt.

If the same set of employers support a severally liable scheme vs a joint and severally liable scheme, the conclusions on covenant and the ability to underpin risk might be quite different. It would therefore be appropriate for the trustees to confirm that the basis chosen adequately reflects the support in favour of the liabilities on a Statutory Employer or theoretical insolvency basis.

Also, it does not take into consideration contingent protections / contractual protections e.g., guarantees.

As outlined in response to Q1, a more flexible approach outlining the approach to assessing covenant would be preferable, rather than purely providing aggregated information.

Q3. We expect employers to work with trustees and provide the appropriate information. To what extent do you agree that information required will be obtainable to understand the level of risk supportable by the covenant?

Typically, we find employers and trustees work together reasonably proactively and the limiting factor is not the resistance of employers to providing information but either:

- for large, listed groups, there can be real issues around the commercial sensitivity and regulatory restrictions in terms of providing forecast information (especially if the covenant is clearly substantial in the context of the scheme, offering little commercial rationale for needing to provide this information) and the audience is unknown - for example, information which could be classed as insider information; or

- the fact the information does not exist or is unreliable e.g. forecast information is not provided on a statutory entity basis or not produced beyond the current year's outlook. It is not clear what the Regulator's expectations are in these situations.

Understandably, there is a focus on 'cash flows' and it is listed as a proposed information item for 'bespoke' schemes. However, smaller and/or charitable organisations (within NAMES) do not necessarily publish a cash flow statement and some lack internal resource / ability to provide this. It is not clear in which scenarios adjusted EBITDA could be used. In schemes comprising hundreds of these employers, it would therefore not be obtainable (or proportionate) to gather cash flow information (on a historic or forecast basis).

Additionally, for 'bespoke' schemes, the requirement to provide assumed figures for each of the years of the reliability period would create the need for employers to produce forecasts specifically for this purpose (as forecasts in many cases may not extend that far out) or for trustees to create this data by extrapolating the forecast period, which is likely to lead to inaccurate information being submitted or more likely submitting information which is not agreed by the employer. If the trustee is unwilling to submit information which is not agreed with the employer, then lengthy and costly discussions about these figures may be required.

As experienced employer covenant advisers, we are adept at taking account of such practicalities and gaining sufficient and appropriate evidence to form the basis of covenant advice. It would be beneficial to include a narrative text box, or to attach a separate pdf, explaining such approaches and why these are deemed sufficient in the circumstances.

Q4. To what extent do you agree that the covenant information we propose to request for Bespoke and Fast Track valuation submissions is reasonable and proportionate?

As noted above, the information requested touches on many of the characteristics that good employer covenant advice would cover. However, covenant advice to be used as part of the trustees' funding and investment decisions must take account of the specific complexities of the employer and of the scheme. It should be made clear that the information required as part of submissions is for "regulatory review" purposes, and not to be taken as (or an alternative to) good and proper covenant advice for trustees.

Key covenant characteristics for more complex schemes e.g. large, open to new members and open to future accrual or multi-employer, may well cover much, but not necessarily all, of the information requested. They are however also likely to include important other information which is not covered here e.g non-credit-related characteristics for not-for-profit organisations or employers who benefit from specific legislative, contractual, or other structural support from Government or other public sector bodies.

It would be beneficial to include a narrative text box, or to attach a separate pdf, explaining such approaches and why these are deemed sufficient in the circumstances.

In general, however, we would note again it is difficult to comment on the information requested without reviewing the updated DB Funding Code and associated covenant guidance. For example, the requirement to provide liquid assets, after adjusting for working capital, is a difficult task without guidance: it is not clear what would constitute liquid assets or reasonable working capital in this context. These concepts are likely to vary depending on the specific circumstances of individual employers. It is implied in the Consultation that this information will be used to assess affordability, but we note that liquidity alone does not necessarily translate into affordability, particularly where there is a need to maintain certain metrics for credit scoring / rating purposes, or to provide flexibility for downside employer events. This would be another area where the use of explanatory text boxes would be helpful.

Registered Office: 10 St James Road Wokingham RG40 4RT
Company Limited by Guarantee Number: 9915768 VAT No. 244657587
Privacy Statement

With respect to this specific question, if the purpose of the information is to support TPR's regulatory approach between Fast Track and Bespoke, then the principle that schemes on Fast Track should submit less covenant information is a reasonable requirement. We also support the idea that trustees should still be required to confirm that they have assessed covenant, even where the Fast Track approach is being adopted. This is on the basis that even Fast Track would not necessarily be appropriate for all covenants, and that there continues to be covenant reliance in Fast Track and in the period beyond reaching full funding on a low dependency basis.

We consider the information requested in relation to contingent assets to be reasonable, although we note that requesting the amount of the contingent asset value being relied upon for each purpose is likely to be difficult. This is because there might not be direct matching and this may not reflect the complexities of some structures, particularly where there are multiple contingent protections in place which may be looked at, at the time of submission.

We note that there are 30 discrete pieces of covenant information that are required for Bespoke valuations and 9 for Fast Track. We note also that the information required for Fast Track will still require much of the analysis to be done (albeit not submitted) which will still require time and potentially cost.

At present it is not clear whether those schemes that are both post the point of low covenant dependency and past the Relevant Date will be required to provide a lower, more proportionate response on these covenant items than those who are pre the Relevant Date. It would feel appropriate that those past both these points have a lower burden of evidence.

The limitations to disclosing alternative uses of cash only to those Bespoke schemes with recovery plans over 6 years would imply the Regulator is happy with a recovery plan of 6 years, even for very strong employers with immaterial deficits.

We note, as outlined above, some of the more detailed information requested for Bespoke schemes may not be available e.g., the information to support assumed figures for maximum affordable contributions for each year of the reliability period (as outlined at Q3) and it may be costly and disproportionate to produce such information.

In summary, we welcome the requirement for schemes to submit covenant information as evidence that the trustees have appropriately considered the support the employer covenant provides. We also understand why TPR wants to pursue a data-led approach, **but we strongly advocate that provision should be made for clarification to be provided if sponsor data does not exactly conform to the template requirements.**

We also continue to have concern about whether TPR guidance will be appropriately joined up and will provide sufficient flexibility for different scheme and sponsor specifics and we would recommend that an opportunity is given for the industry to consider all guidance in the round.

Registered Office: 10 St James Road Wokingham RG40 4RT
Company Limited by Guarantee Number: 9915768 VAT No. 244657587

If you want to discuss the contents of our response as part of your ongoing stakeholder engagement process, we would be delighted to do so. You can contact me on guy.mander@rsmuk.com or on 07779 644275.

Yours faithfully

Guy Mander

Chair

On behalf of the Employer Covenant Practitioners Association

Registered Office: 10 St James Road Wokingham RG40 4RT
Company Limited by Guarantee Number: 9915768 VAT No. 244657587
Privacy Statement