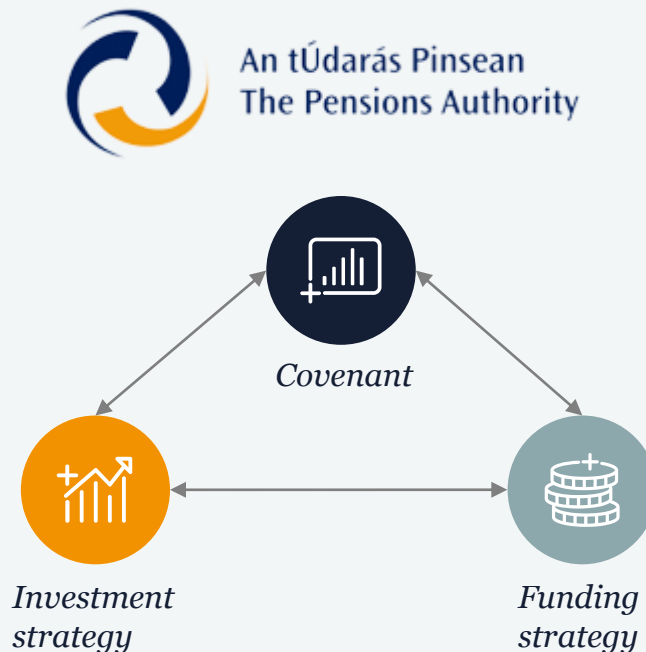


Own-Risk Assessment for Irish defined benefit pension schemes: The importance of assessing the employer covenant

January 2024

- The Pensions Authority's 2021 **Code of Practice for trustees of occupational pension schemes and trust retirement annuity contracts** states that trustees must have a documented **Own-risk assessment ("ORA")** process to identify and assess material risks that threaten the achievement of the scheme's objectives.
- ORAs must consider the trustees' **"evidence-based view of the strength of the employer covenant"**.



What is the employer covenant?

In simple terms, the employer covenant is the employer's **willingness and financial ability to support its defined benefit ("DB") scheme, now and in the future.**

Understanding the employer's financial position and prospects allows trustees to make well informed decisions on scheme funding and investment strategies. This is at the heart of defined benefit **integrated risk management.**

For example, a stronger covenant allows for more flexibility in funding and investment strategies, as this means that the employer is more likely to be able to support the scheme if downside funding or investment events occur. The reverse is true for weaker covenants.

TPA requirements on covenant are underwritten by the law....



The European Union’s Directive on institutions for occupational retirement provision (the IORP II Directive) was adopted in 2016 and

The European Union (Occupational Pension Schemes) Regulations 2021 (“the Regulations”) were signed into Irish Law on 22 April 2021.

Section 64 AL of the Regulations includes the instruction that, when carrying out and documenting the ORA, trustees should include:

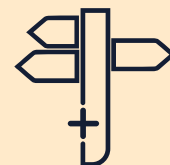
- *“a qualitative assessment of the mechanisms protecting retirement benefits, including, as applicable, guarantees, covenants or any other type of financials support by the employer”*

Client testimonial

“The quality of advice provided by the LCP team is excellent – taking a proportionate approach to considering covenant strength and sponsor longevity risks and integrating these conclusions with specific funding, investment and journey plan recommendations for the scheme”

Colin Richardson
Director, Zedra Governance Ltd

When can an independent covenant assessment help?



The concept of incorporating covenant factors into a scheme’s strategic risk approach will be well understood by trustees of many Irish DB schemes, but may be a relatively new concept to some. Whatever the case, independent advice on covenant can help drive better decisions in lots of situations.

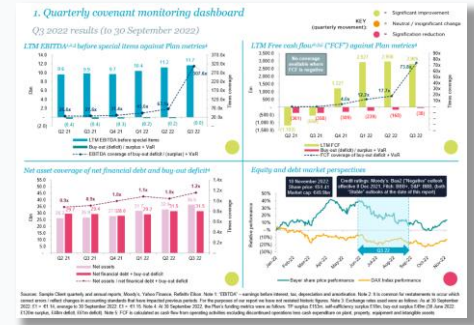
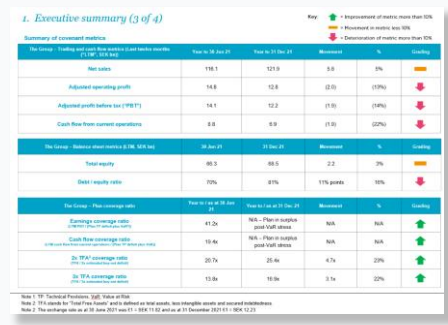
Business as usual situations	Event-related situations
Covenant reviews for ORAs	Assessing changes to the covenant that occur through corporate transactions (eg mergers & acquisitions)
Covenant reviews to support triennial valuations	Assessing the impact of refinancings
Support in negotiations with employers	Support through employer distress and restructuring
Covenant monitoring	Covenant advice where schemes are restructured
Trustee training	
ESG risk assessments and assistance with Taskforce for Climate-related Disclosure (“TCFD”) projects	

How we can help

What does a covenant assessment usually cover?

We tailor our advice to the needs of our clients, but the following are important factors to consider in all assessments:	
Legal support structure	Trustees need to understand which companies have a legal requirement to support the scheme and the extent of these obligations. Trustees also need to understand if any contingent support is in place, eg guarantees from other companies and / or legal pledges over assets.
Scheme characteristics	The level of potential covenant reliance needs to be understood so that trustees can assess the level of financial support that may be required from the sponsor. Important things to understand include the extent of any deficits, the level of downside financial risk being run by investment strategies and the period over which a scheme may be reliant on the employer.
Cash flows available to support the Scheme	Trustees need to assess and employer's historic and projected trading and cash flow performance to understand how much cash could be generated to provide support to the scheme, if required. It is also important to understand the key assumptions that are used in any set of forecasts and to understand the competing demands for an employer's cash.
The availability of financial resources	Balance sheet strength is an important facet of covenant review, and in particular understanding the composition of assets and liabilities, how liquid / realisable key assets are and how resilient the employer could be to stress events.
Prospects and covenant longevity	Trustees should assess prospects for an employer by understanding its sector risks and opportunities, and how a business stacks up against its competitors. Trustees should consider this in tandem with the extent of potential covenant reliance noted above to assess whether the two are well matched.
Risk rating and recommendations	We provide trustees with an assessment of how strong we think a covenant is on our four-point gradings scale, and provide bespoke recommendations to trustees based on the characteristics of the scheme and the risk profile of the employer

Reporting and proportionality



Our client deliverables will typically be concise reports which use intuitive visuals to make key messages clear to the reader. We are always delighted to present our findings at trustee meetings so we can bring out the key points and take questions.

Through our years of experience of providing covenant assessments to clients we know that one-size does not necessarily fit all and that the precise scope of work for a covenant review will be proportionate to the extent of the risks faced by both the employer and the scheme.

However, whilst some trustees may wish to engage in more in-depth analysis, we recognise that some will want to adopt a more high-level approach which hones in on the key building blocks of their employer covenant.

Recognising this, where a light touch assessment is appropriate we have developed a streamlined covenant report which can be provided for a fixed fee in most cases.

Why LCP



Integrated advice specialists



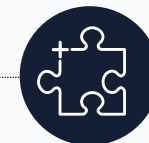
Collaborative and jargon free reporting



Strong understanding of Irish DB regulation



Experience of advising Irish DB schemes on covenant



Advice tailored to client requirements



Market leaders in the UK DB arena

Case Study #1 – ORA assistance

In 2021 Helen Abbott was appointed by the Trustees of a large Irish DB Scheme with an employer in the banking sector, in order to assist them in identifying key covenant risks in the context of the Scheme's 2021 valuation.

We provided the Trustees with detailed conclusions around the affordability of contributions, the ability of the employer to support downside shocks, and potential risks to the future strength of covenant.

Further recommendations were provided to the Trustees on the usage of contingent assets and potential value sharing mechanisms to help them to achieve a good outcome in their negotiations with the company.

In 2023 Helen has been re-engaged by the Trustees to assess the employer covenant for the purpose of their ORA for the Scheme.

Case Study #2 – Focus on investment risk

A set of Irish DB Trustees appointed Jon Wolff to assist them with work they were undertaking to review the appropriateness of the risk that was being taken in the Scheme's investment strategy.

At first we took time to understand the Scheme's funding and investment characteristics so that we could assess the level of financial support that may be required from the employer, given the downside risk in possible investment strategies that the Trustees were considering.

Once this was understood we conducted a detailed assessment of the employer's financial and business risk in order to assess the scale of its potential cash flows and liquidity available to support pension scheme risk, after taking account of the cash needs of other stakeholders (eg internal investment requirements, trading and debt obligations and shareholder returns). We presented our findings to the Trustees at an investment sub-committee meeting.

Awards



WINNER

Sponsor Covenant / IRM Adviser of the Year
Lane Clark & Peacock



SPONSOR COVENANT PROVIDER OF THE YEAR

We are currently recognised as industry leaders for our approach to working with key DB pension scheme stakeholders. We were delighted to be awarded the 2023 UK Pensions Age **Sponsor Covenant Provider of the Year**. This accolade followed closely from being recognised as the UK Professional Pensions **Sponsor Covenant and IRM Adviser of the Year** in 2022, reflecting our commitment to delivering excellent outcomes for our clients.

“LCP was a clear winner, for “showcasing its impressive dedication to the covenant arena, and being in tune with the different ways a sponsor covenant provider can and should assist its clients, at whatever stage of the pensions journey they may be”

Pensions Age Judging Panel

An overview of LCP's senior covenant team

To find out more about LCP's Covenant & Financial Analysis Services team and read our latest insights, please visit us [here](#).



Jonathan Wolff FCA

Partner, Head of Covenant & Financial Analysis

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Jon heads up LCP's Covenant & Financial Analysis team having joined the firm in 2016. He is a qualified accountant, has more than 15 years' experience in covenant advisory and has a background in corporate restructuring. Jon undertook a secondment to the UK Pensions Regulator in 2013 and has experience of advising large Irish DB schemes on covenant matters.



Helen Abbott FCA

Partner

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Helen joined LCP in 2020 from the UK Pensions Regulator. She maintains a keen interest in regulatory developments and supporting clients to adapt to these changing requirements. Helen has over 15 years' experience in covenant advisory and a background in restructuring. She has also advised Irish DB schemes on considering how covenant feeds into their ORAs.



Francesca Bailey ACA

Partner

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Fran leads on the development of how covenant fits into LCP's integrated risk advice. Alongside her role helping clients understand their covenant risks in the context of their longer-term pensions strategies, she also runs LCP's insurer financial risk review offering. She is a chartered accountant and was Highly Commended in the UK Consultant of the Year category at the 2021 Rising Star Awards.



James Silber ACA

Principal

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James joined LCP team in 2022 having spent 8 years in the employer covenant department at a large accountancy firm. He has provided covenant advice for several of the UK's largest pension schemes and also brings experience of complex distressed restructuring deals. James was seconded to the UK Pensions Regulator as a Business Analyst in 2017.



John Parnis England ACA

Principal

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John is a covenant advisor who leads assignments and is an expert in assessing how climate risks and opportunities impact upon a scheme's covenant and ultimately upon journey plans. In particular he is the key liaison between the LCP Covenant & Financial Analysis team and LCP Delta, our in-house experts on the energy transition.

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