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Time horizons and the employer covenant:
the importance of evaluating sponsor longevity as part of a dynamic analysis

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Introduction

Recent corporate distress and harsh economic conditions have highlighted the important link between the duration of defined benefit ("DB") pension schemes and sponsoring employer[2] longevity.

This paper examines the importance of understanding employer longevity as part of the evaluation of the employer covenant for defined benefit schemes; and it examines a range of approaches for assessing it and factoring it into scheme funding and investment decisions.

By way of background, the Pensions Regulator suggests that the employer covenant is *"the extent of the employer's legal obligation and financial ability to support the scheme now and in the future"* [3].

In turn, the Employer Covenant Practitioners Association defines the employer covenant as *"the ability to put cash (or other assets that can be converted to cash) into a [defined benefit pension] scheme when needed"* [4].

These definitions highlight that the employer covenant – in the context of the specific attributes of a scheme, including its funding needs[5] - is reflective of a combination of:

- An employer's legal obligation to support a scheme, perhaps in combination with other forms of contractual support such as contingent assets.
- An employer's financial capacity to do so; and
- An employer's longevity – the time horizon over which the employer might be expected to support a scheme.

This paper focuses in particular on the last of these variables – employer longevity; and it considers, in practical terms how it might be evaluated at a point in time and monitored

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[1] This paper has been prepared by the authors on behalf of the Employer Covenant Practitioners Association ("ECPA"). The ECPA has approved and adopted the contents of the paper.

[2] In this paper, the term "employer" is used as a term which encompasses the legal and financial support which may be provided by multiple entities either as participating employers to a scheme or as providers of contingent support such as guarantees.

[3] See The Pensions Regulator, 'Assessing and Monitoring the employer covenant' (August 2015) 6, available at www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/assessing-and-monitoring-the-employer-covenant.

[4] See: employer covenant Practitioners Association, 'Principles of Covenant assessment for Scheme Valuations: A Practical Guide for Advisors, Trustees and Employers' (March 2016) 4, available at https://ecpa.org.uk/principles-of-covenant-assessment-for-scheme-valuations-a-practical-guide-for-advisors-trustees-and-sponsors/

[5] The Pensions Regulator, n3.

dynamically; and how any evaluation can be used by scheme trustees (and employers) to set appropriate funding approaches, and investment strategies, for a scheme.

Before reaching its conclusions, this paper is ordered as follows: first, it provides background to the importance of employer longevity in the funding of DB schemes; second, it defines employer longevity in the context of scheme funding; third, it comments on how employer longevity can feed into scheme funding decisions; fourth, it considers how employer longevity can be evaluated; and fifth, it considers how longevity can be monitored dynamically – and be coherent with other elements of covenant monitoring, integrated funding and Integrated Risk Management ("IRM") plans.

Background

Most UK defined benefit schemes – but by no means all – are closed to new members; or closed entirely to the future accrual of benefits.

For closed schemes, a key challenge facing trustees is to meet their overall fiduciary obligation to ensure that, absent a scheme buyout, members' benefits are paid over liability run-off periods which are likely to span at least decades - and potentially close to a century taking account of dependents' benefits. For open schemes, there is an additional challenge of delivering secure benefit accrual in a cost-effective and financially efficient way.

The relationship between scheme and employer(s) only ceases on the occurrence of one of four events: a buyout of the liabilities by an insurance company; the transfer of the liabilities to the Pension Protection Fund ("PPF") upon an insolvency of the employer; a transfer of the liabilities to a pension scheme "consolidator"; or, following run-off, through the payment of the last liability to a member and the subsequent winding up of the scheme.

Many schemes and employers cannot – at least in the short term – afford a buyout. The buyout market itself has finite capacity. The consolidator market is in its infancy. And a scheme going into the PPF is unlikely be an optimal outcome for members given benefit curtailment.

Prior to any of these outcomes, therefore, trustees need to run their schemes in accordance with their fiduciary duties and in line with statutory requirements and regulatory guidance – with a view to meeting the Statutory Funding Objective[6]. Many closed schemes are on some form of "journey plan" to a long term funding target – that target typically being one where the scheme is invested in a comparatively low risk way to meet estimated liabilities discounted at a measure based on a gilts return, not untypically with a margin on top (say, 25-75bps). Open schemes, particularly those that are truly open to new members as well as to future benefit accrual, need to approach their investment and funding strategies differently and efficiently take account of, for example, their distinctly different maturity and cash flow profiles, notably when these schemes are in accumulation rather than decumulation.

In all cases, achieving some measure of Technical Provisions funding is only part of the journey given the ongoing reliance on the employer covenant in the absence of entry into the PPF; a consolidator transaction; the meeting of any final liability to members; or a scheme buyout. Employer longevity is therefore a crucial ingredient of the employer covenant as a key enabler for a scheme meeting its objectives.

Against this backcloth, this paper reinforces how a meaningful assessment of employer longevity to inform efficient funding and investment decisions is an important component of employer covenant assessment - albeit with the inevitable limitation that no-one can predict the future with certainty. Given corporate and market change, such a longevity assessment needs to be dynamic and, in practical terms, regularly revisited by trustees in their covenant monitoring and IRM discussions.

[6] Pensions Act 2004, s 222.

Defining employer longevity

For the purposes of employer covenant assessment, one definition of employer longevity is *"the period during which an employer can reasonably be expected to remain in existence to support a scheme".*

Employer longevity may be thought of in absolute terms – for example, a company may have been in existence for a century or more (implying strong historical longevity); or it may be thought of relative to other participants in an industry. Different industries can themselves exhibit varying levels or cycles of longevity[7].

For scheme funding purposes, however, it is absolute – rather than relative - longevity which is critical given that under the current legislative environment, broadly, a solvent employer is also a requirement for a scheme remaining outside of the PPF.

The importance of employer longevity in scheme funding & investment considerations

The nature of scheme funding involves (i) the determination of an appropriate level of contributions and the setting of an investment strategy to seek to ensure sufficient funds to pay members' benefits as they fall due; and (ii) the consideration of multiple risks, including the risk of the employer(s) (or members) being unable to pay contributions as and when required; scheme investments not delivering the returns anticipated; or liabilities themselves becoming greater than currently expected due to factors such as higher inflation or lower mortality.

It follows that both of these assessments require forming a view of time horizons over which these considerations should take place – and are intrinsically connected to views of employer longevity. On this basis, forming a view of employer longevity is a key ingredient – alongside employer legal obligation and financial capacity – of the concept of the employer covenant.

Trustees need to evaluate where to place the balance of relevant risks (and seek returns) to determine how much risk to assume in each individual element given potential time horizons spanning multiple decades.

Presently, the setting and pursuit of long-term funding targets, where closed schemes achieve a low reliance on the employer covenant by acquiring increasing levels of matching assets, is a key focus of recent regulatory guidance. However, it is crucial to appreciate that funding to the Technical Provisions basis is only a milestone along the scheme's journey plan – and that, as stated in the introduction to this paper, absent a PPF entry, a scheme buyout or consolidator transaction, the scheme will continue to rely on a sponsoring employer until the last member's benefit payment has been made.

Given the importance of assumed extended time horizons in ongoing scheme funding, employer longevity and the dynamic nature of the employer covenant cannot be ignored in the formulation of a financially efficient investment strategy. An appropriate investment strategy will take into account a broad range of factors including scheme maturity and projected liability evolution; the need for liquidity to pay benefits (including the problems of investment market corrections in the decumulation phase); trustee investment beliefs and risk appetites; investment market conditions, asset pricing and expected returns – as well as the ability of the employer to make good any funding shortfall.

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[7] McKinsey & Company note that "*Longevity in a business context, is a relative concept. Some industries more naturally incline to long time frames... [in others] the pace of change tends to be much faster."* McKinsey & Company (2014): "Reflections on corporate longevity".

Interestingly and importantly, as liabilities are paid down and scheme obligations shrink, all other things being equal the strength of employer covenant may actually increase in relative terms.

Example questions arising, therefore, are whether it is efficient – and in members' best interests – to pursue substantial investment de-risking when staying more "on risk" might actually deliver a buyout of liabilities well in advance of a "low risk" investment strategy; and hence mitigate against an implicit assumed long-term reliance upon employer longevity for many decades ahead. We do not rehearse all the arguments for and against different approaches here – save to record that we believe that they merit in-depth further consideration.

Against the backcloth of the evident importance of employer longevity to scheme funding, what are examples of forces which might mitigate for or against an employer's potential longevity?

Forces driving corporate change

At almost all levels of the economy, disruption caused by changing trends in global competition and technological innovation are creating massive structural changes in markets that can materially impact the financial position and prospects of employers – bringing the need for a clear view around employer longevity into sharp focus. These changes are distinctly different to "event-led" impacts such as the Covid-19 pandemic.

Examples of industries that have experienced significant structural change due to global competition have been the textiles and automotive manufacturing sectors, which in the UK have left a legacy of a number of large schemes with atrophied employers.

In turn, technological change has been extremely rapid in its effect and is accelerating. A "clear and present" example is the technological shift in a number of sectors in response to climate change. Other examples include the shift from film-based photography to digital media. The failure to restructure businesses rapidly to meet evolving technology, whether due to lack of vision or financial constraints curtailing investment, may ultimately result in individual corporate collapses.

Clearly, major corporate change may not merely reflect industrial or macroeconomic forces but also individual management decisions, access to capital, and shifts in management strategy. There are numerous examples of companies which have changed incrementally on an organic basis or through M&A activity. There are also examples of companies which have changed from one sector of the economy to a completely unrelated one as a result of management strategy shift - such as (in the US) Seagram's rapid exit from alcoholic beverages to move to entertainment and media.

While there are instances of companies which have existed in recognisably similar form over decades, the past is not necessarily a reliable indication of the future, and it is more often the case that over the multi-decade lifetime of a pension scheme the corporate employer – or its ownership - will change due to M&A activity, restructuring, change in business model or even liquidation.

A high-level analysis of the FTSE 30 constituents demonstrates this. The FTSE 30 index was originally created in 1935 as an index of large industrial and commercial sector companies whose shares were quoted on the London Stock Exchange. An analysis of its constituents, including those from its inception in 1935, illustrates the extent of corporate change over time, with extensive merger and acquisition activity as well as insolvencies. None of the original constituents has continued in the same form throughout the period. Clearly, this cohort of companies is not necessarily representative of the wider UK economy and the universe of small and medium sized entities (SMEs), a number of which sponsor defined benefit pension schemes.

Given the pace of change affecting markets and businesses, it is suggested that the task of considering corporate longevity cannot be reduced purely to a formulaic or simplistic analysis of a employer's historical financial performance: it requires experienced professional judgement; a forward-looking view; and the application of appropriate strategic and other tools. In the next section, we outline possible tools for corporate longevity assessment.

How can employer longevity be evaluated?

Introduction

In order to take an informed view of how long an employer might survive into the future, employer covenant practitioners will need to consider the employer's strategic and competitive positioning and, in the broadest sense, its resource base. Practitioners will also need to consider the dynamics of the employer's sector – and the factors which drive success or failure in the sector. Taking these and other factors together, we can then consider what factors might mitigate towards the longevity (or not) of an employer in an employer covenant assessment.

Any approach to evaluating employer longevity is likely to encapsulate tools from a broad spectrum of methodologies - from the formulaic (focusing on the output of underlying financial models which can themselves be deterministic or stochastic) to the strategic - and the use of specialist judgement, where consideration is given to wider market, competitive and management dynamics. Using one particular approach in isolation is unlikely to provide a robust conclusion in all circumstances given the multitude of forces and circumstances at play. In practice, an evaluation may draw on multiple techniques.

The limitations of purely formulaic tools

It has sometimes been suggested (for example, in aspects of credit management) that corporate credit strength – and implicitly longevity assessment – can be assessed largely as a quantitative exercise, based around accounting ratio analysis.

Whilst such a methodology has some background in academic theory[8], and attempts have been made to identify a formula that has *a priori* predictive ability, it is worth noting that despite the development of various credit risk models, there is currently no single credit rating model which is universally agreed to have absolute predictive power for determining corporate failure.

Credit scoring and probability of default models can be effective portfolio management tools, to provide an indication of portfolio credit quality strength and speed and direction of change across a large number of data points, but their application to single credits / single employers is of limited predictive value.

Part of the reason for this lack of a single accepted model is due to the limitations of the formulaic approach. The data used to support these models is either historical or based on forecasts, which, in turn, are built on assumptions that can materially change depending on micro or macro-economic conditions. For example, the impact that the Covid-19 virus has had on a substantial number of markets or businesses, such as in the transport or hospitality industries.

Stochastic modelling approaches have also been developed in an attempt to address such limitations.

[8] For example, the work of Edward Altman sought to predict bankruptcies by using a form of multivariate discriminant analysis to identify key accounting ratios associated with corporate failure - the eponymous "Z" score. Altman's work pioneered academic interest in developing quantitative models to detect financial distress and the world of credit management has since evolved through such diverse approaches as logit models and artificial intelligence networks.

Broader approaches

An alternative to a purely formulaic approach is to consider financial and other forecasts alongside more qualitative information - for example, an evaluation of a company's strategic positioning in its marketplace. Key areas of focus may include an assessment of what is happening in the employer's markets[9]; an evaluation of management's track record in steering a company through financial crises; or how a company utilises both its scale and existing resources to invest and survive. Crucially, understanding whether people who have been heavily influential in an employer's performance – such as key members of a successful and dynamic management team – have recently left the business may be informative around potential problems emerging given the proven importance of strong management teams in sustained corporate success.

These factors may span a longer time horizon than that considered in financial and other information available to Trustees. They may therefore potentially help to provide a view of the covenant more compatible with the timeframes over which schemes need to be supported by their employer. Indeed, consideration of factors such as strategy, markets and management ability can enhance and strengthen the use of quantitative techniques when assessing an employer's longevity.

Recognising that the employer covenant and its assessment is multi-faceted, the quantitative, strategic and other aspects of covenant evaluation should be interwoven so that the covenant adviser develops a comprehensive view of an employer's financial strengths, strategic positioning, and outlook – albeit, these and other factors will need to be monitored and reappraised dynamically given market and other changes (a key point discussed further below).

There are a number of useful analytical tools that can be utilised when undertaking the non-financial aspects of an assessment, including:

1) **SWOT analysis** – historically credited to Albert Humphrey[10], SWOT analysis aims to identify the strengths, weaknesses, opportunities and threats (both internal and external) to assess holistically a company's or project's strategy and market positioning.
2) **PESTLE** - PESTLE sets out six macro-economic environment categories that could impact a business, including: 1) Political (e.g. Government in power); 2) Economic (e.g. GDP, exchange rates); 3) Social (e.g. demographics, changes in buying habits); 4) Technological (e.g. changes in technology such as renewable energy); 5) Legal (e.g. changes to legislation) and 6) Environmental (e.g. climate change, reducing natural resources).
3) **Porter's Five Forces** - Developed by Michael Porter of Harvard University[11], this is an analytical model that looks to evaluate the forces governing competition in an industry by considering: 1) Supplier Power; 2) Buyer Power; 3) Threat of new entry; 4)Threat of substitution. These four forces feed into Porter's fifth concept of (competitive) Rivalry.

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[9] Note that Pensions Regulator guidance, n3, suggests a consideration of *"the markets in which the employer operates, the medium and long-term outlook for those markets and the employer's competitive position in those markets."*

[10] Note that the specific origin of SWOT analysis is unclear but is conventionally associated with Humphrey's work.

[11] "How competitive forces shape strategy", Michael E Porter, Harvard Business Review, March 1979.

4) **The Resource-Based View (RBV)** – RBV is (in part) attributed to a paper by Birger Wernerfelt[12] and to a 1991 paper by Jay Barney entitled "Firm resources and Sustained Competitive Advantage". At its core lies the question of how a firm can use its resources to compete. Barney considered whether a firm may have "VRIN"[13] resources - and whether it can exploit them. "Resources" can include tangible assets, intangibles, talent etc. The VRIN acronym comprises: 1) Valuable – are the available resources a source of competitive advantage; 2) Rare – do the resources deliver a unique strategy to provide a competitive advantage when compared to the competing firms; 3) Imperfectly Imitable – resources will support sustained competitive advantage if competing firms cannot obtain them and, 4) Non-substitutable - resources should not be able to be replaced by other strategically equivalent valuable resources.

In addition to the different analytical and assessment tools discussed above, there is clearly a range of other factors which can be considered when seeking to establish an employer's potential longevity including, but not limited to, its access to capital (recognising that lenders and other equity investors may have sectorally-based capital allocation strategies); business structure and strategy; dividend and cash retention policies; and management experience and track record.

The dynamic monitoring of covenant, including employer longevity

Introduction

Notwithstanding the value of the types of analysis referred to above, using a variety of analytical methodologies will only provide a view of an employer's longevity at a single point in time. The conclusion of the evaluation could alter materially and quickly - highlighting the need for the evaluation and monitoring process to be dynamic, with regular monitoring of the employer's business and its market, to take account of changing economic and market conditions.

The ability to monitor longevity and other risks dynamically – and not just once every three years - matters because changes can occur rapidly and have permanent effects on the employer's ability to meet its obligations to a scheme in full.

The nature of industries and ownership structures

As discussed previously, various industries and ownership structures will have different life cycles and will have naturally longer or shorter life spans. This can be considered in a tailored longevity assessment and monitoring approach.

For example, a family-owned firm, where longevity may be an objective *per se*, may be run so as to target a longer life span, albeit with potentially lower returns, compared to a highly leveraged investment being run for high returns – and where off-plan performance may lead rapidly to a potential insolvency event such as a default in credit agreements.

Likewise, technology-based companies may tend to have shorter business life cycles due to technological change and obsolescence than, say, professional services firms where long-term expertise and relationships built on trust and continuity are essential parts of the business model. Focusing on the pipeline of drugs in development may provide much more insight into the long-term prospects of a pharmaceutical company than year-on-year historic changes in turnover.

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[12] "A Resource-Based View of the Firm", Birger Wernerfelt, Strategic Management Journal, Vol 5, No2, April-June 1984.

[13] Sometimes known as VRIO, with the "O" standing for "Organised to capture value", e.g. "Is a company well organised to capture the value of its resources"?

One categorisation of markets is to allocate them into permutations of “predictably steady” (such as monopolistic utilities); “cyclical” (such as consumer facing businesses); and those in structural change (such as those faced with global competition or product substitution due to technological innovation). These conditions often drive different financing structures. “Steady state” companies can – subject to financial performance - in general, safely stand relatively high gearing (subject to interest rate hedging). Companies in cyclical sectors may require more of an “equity buffer” to iron out peaks and troughs in trading. Those operating in industries in structural decline may be “run for cash” to reduce debt unless they can be repositioned to thrive in a changing environment.

Understanding these different drivers and influences is important because it informs the make-up of a sensible assessment and monitoring package needed to deliver a dynamic covenant evaluation and monitoring process.

Other drivers for dynamic monitoring

In addition to understanding and monitoring employer longevity, there are a number of other reasons why active covenant monitoring is important. Three of these are highlighted below. Each of these reasons shows how careful, dynamic monitoring can inform trustees’ view of the covenant generally; and, in so doing, signal potential threats to assumed longevity.

One reason for dynamic monitoring is driven off the nature of the relationship between the scheme and its employer. Unlike other commercial and financial creditors that have diverse portfolios of credit exposure for which they are rewarded, and who can trade in and out of positions to manage their risk, pension funds generally have concentrated exposure to sponsoring employers with (absent a surplus) no upside for the risk they are taking beyond the limit of achieving full funding - provided the employer remains solvent. It may, therefore, be even more important for trustees than for other creditors to engage proactively with employers over time to understand developments in their concentrated exposure to these employers.

A second reason for undertaking dynamic monitoring is that without this, trustees would not have the opportunity to discuss the covenant frequently enough with the employer’s management team outside of the triennial review cycle. Schemes are often unsecured creditors when banks, for example, may have secured positions. Bankers and suppliers are often able to act decisively at the early stage of business difficulties given “early warning signs” such as lending covenant tightness or the tightening of payment terms, which Trustees are often unable to do if they do not get access to equivalent or better information.

A third reason for dynamic monitoring is that by spotting an issue early and discussing it with the employer’s management team, early remedial actions can be proactively taken by trustees, thereby ensuring they are not placed into circumstances where sub-optimal positions have to be agreed in the face of limitations of both time and information in order that the employer can avoid financial distress (or insolvency). Once an employer gets into financial difficulty, time and funding is obviously constrained and the options for trustees to ask for more cash, increased asset cover or seek other concessions that could otherwise have improved the employer’s covenant and reduced further cash leakage are often limited. In effect, by being the last stakeholder to have an in-depth conversation with the employer due to the triennial nature of the valuations, trustees may be put in the position where obtaining more support from the employer may not be an economically viable option when the request comes too late - after the employer has hit real problems and it simply may not be able to provide further scheme funding given the demands of other stakeholders, such as lenders, upon whom it needs to rely for survival.

Dynamic monitoring as part of a package of measures

Dynamic monitoring should, therefore, ideally be part of a package of measures, pre-agreed with the employer, that enables trustees to obtain more support from the business in good times and rely on pre-agreed triggers against set KPIs when business performance or the

scheme's funding position worsens. It should form part of trustees' IRM approach, informing their choice of investment strategy.

Where possible, pre-agreed triggers should be based on specific events or conditions – such as acquisitions, disposals of assets, dividends or *in specie* distributions.

For example, a package might include a measure that if the ratio of net debt to EBITDA falls to a pre-agreed trigger level, the ability of the employer to pay dividends is curtailed until a pre-agreed level of funding is achieved. In effect, this would be akin to setting "covenants" (in the banking sense) to protect the scheme against a deterioration in the covenant strength of the employer before it is too late for the trustees to do anything about it. In addition, such measures could reduce cash leakage via dividends or management fees into wider corporate structures when the employer is part of an international group of companies.

Features of a dynamic monitoring process

We highlight three principal features of a dynamic monitoring process, being: (1) an appropriate frequency of reviews; (2) the use of appropriate KPIs and limits/triggers; and (3) the effective use of an early alert system to ensure that the variations in an employer's covenant strength are reflected in good time in the Trustees' funding and investment approach and strategy.

Frequency of reviews

Rating agencies, banks and bond analysts set risk-adjusted frequencies to their reviews and use triage systems to avoid creating excess workload when all that is required is spotting outliers early enough.

Under this approach, firms may be categorised based on:

a) Their industry: for example, it may be appropriate to review steel makers quarterly because prices and volumes change very fast whereas supermarkets could be reviewed twice yearly, such as after post-Christmas trading levels are known; and / or

b) Their credit quality: reviews for high yield issuers are undertaken more frequently than for investment grade issuers because their path to default can be so much faster - quarterly as opposed to annually, for example.

In essence, businesses operating in certain industries or with higher risk credit structures are likely to require a more much intense and focused system of monitoring to ensure their underlying financial position and expectations are understood in a timely fashion.

Use of appropriate KPIs and how to calculate them

Industry specifics and the drivers behind an employer's business model and financial policy may also dictate the KPIs which should be considered to ensure an effective monitoring protocol is in place – particularly when monitoring employer longevity.

In addition to the usual "banking covenant metrics" of debt to profitability, interest coverage and liquidity headroom, business-specific operational early warning measures should also be considered – driven off factors which may be informative about short or medium term threats to employer longevity. For example, these might include the churn rate of customer contracts for mobile phone companies; occupancy rates for hotels; or changes in underlying raw material prices for many manufacturing businesses.

From a cash flow perspective, the proportionality of dividends to deficit repair contributions and/or free cash flow is becoming increasingly prominent, particularly given trustees' and the Pensions Regulator's recent focus on cash leakage from employers.

Clearly, excess dividends may threaten the longevity of the employer's covenant if, for example, insufficient resources are retained in the business to invest in necessary technological or other change. Further, if a business is effectively in run-off and its pension scheme is underfunded, then the cash flow generated should be prioritised towards DRCs, rather than dividends, given the nature of the scheme as a creditor claim.

The effectiveness of stated KPIs is significantly weakened if the methodology of their calculation is not strictly defined, with appropriate amendment allowed to ensure the underlying methodology remains appropriate and consistent across different accounting periods. The devil really is in the detail of the calculations: on an ongoing basis KPIs may be at risk of "unintended consequences". For example, companies may add back exceptional items to their EBITDA KPI calculations. Whereas this may provide a more "maintainable" metric of a business's underlying operational performance, the adding back of exceptional costs may in practice mean that the true profitability is in fact overstated. The choice of actual or rolling averages for metrics will be dependent on the nature of the business: although rolling averages are by nature slower to reveal trends, they do avoid triggers being breached due to one-off events, or seasonal effects that self-correct in the following period.

During 2020, many businesses adjusted their reported EBITDA to take account of the impact of the Covid-19 pandemic, thereby smoothing out, in an artificial way, the very real impact of the lock-down on both profit and cash flows. In some cases, figures from the prior year were used to negate the impact of the Covid-19 pandemic on financial covenant testing.

Given the technical and detailed nature of the monitoring of KPIs, it is highly recommended that trustees consider seeking the support of professional advisors in planning, documenting, implementing, and progressing the monitoring process.

Effective use of early alert systems

Undertaking a regular review of KPIs and other information that provides trustees with an early understanding of changes in the underlying covenant afforded to their Scheme by an employer is clearly helpful - in particular, early warning of material off-plan performance; or material market or other shifts prospectively affecting longevity.

The notion of using embedded "banking style covenants" or similar metrics within covenant monitoring is one effective way of ensuring that trustees become aware of possible short-term performance-related issues early. However, in addition to short term measures, trustees need to consider metrics or other factors which might signal changes to assumed longevity.

For these early warning mechanisms to be truly useful and effective, trustees can consider seeking a pre-agreed set of actions with the employer that give rise to either changes in the scheme's funding and/or investment strategy; or allow for additional support to be provided by the employer should pre-determined changes arise in the covenant or funding of the scheme.

These pre-agreed events could include, but are not limited to, some or all of the following – amongst numerous others:

- Additional funding or contingent assets to be provided by the Employer if the covenant is determined to have reduced consistently over an agreed time period.
- Constraints on dividends.
- Undertaking "buy-ins" of cohorts of liabilities to "lock-in" improved funding levels.

- Changes to the underlying investment strategy to de-risk the investment portfolio once certain funding levels are achieved.

Conclusions

This paper has demonstrated the fundamental importance of the evaluation of employer longevity, and the dynamic monitoring of it as part of broader covenant monitoring, in the efficient funding of UK defined benefit pension schemes.

It draws attention to the very considerable time horizons over which employers usually need to survive, absent a scheme buyout or consolidator transaction, to ensure that members' benefits are paid in full.

With appropriate professional advice from experienced practitioners – and using the tools and techniques referred to in this paper – it should be possible to form a sound, working view of corporate longevity in the short, medium and long term. However, having formed this view, the paper illustrates the importance of monitoring the position closely and dynamically; and putting in place measures to be ready to respond to both off-plan performance or one-off events or transactions.

Crucially, the paper highlights the distinct limitations of using a purely formulaic approach to covenant assessment in isolation: indeed, the failure to identify potential changes to corporate longevity assumptions by not forming a rounded forward-looking view, supported by experienced professional judgement, could be disastrous given the nature and importance of scheme funding decisions and the time horizons underpinning them.

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