Covenant Quarterly
Q4 2021

Looking beyond the rating – an early New Year's resolution

What is the purpose of a covenant assessment? Whilst the first task is to provide a robust rating for the covenant, it's the "so what" that really matters.

As schemes become more mature and look towards their long-term objective, the covenant rating becomes less of a needle-mover on technical provisions assumptions, and trustees need to look beyond a point-in time rating to see the real benefits.

For instance, covenant should be at the heart of a scheme's journey plan and trustees should be asking themselves:

- "Does the journey plan make sense given my sponsor's ability to fund contributions;" and
- "How does the longevity of my covenant support investment risk over time? If not, what should we do differently?"

Furthermore, while there are many factors influencing member outcomes, covenant is the ultimate underpin. If the covenant fails, members miss out. If it endures, members will likely receive their benefits in full.

With that in mind, covenant should be a key part of trustees' risk management frameworks with best practice governance meaning that:

- Plausible downside scenarios should be assessed for their impact and likelihood;
- Potential mitigating actions to take now, and/or in response, should be identified; and
- A covenant monitoring framework must be calibrated for these downside scenarios to provide time for a response.

Monitoring is not just a numbers game. With so much social and economic change on the horizon, looking through the financials to the underlying opportunities and risks facing the sponsor is now more important than ever.

Why not set a New Year's resolution to make the most out of your covenant assessment, stay on top of the key risks and refresh your covenant monitoring framework for the challenges that 2022 will bring.

In the meantime, the team at Cardano wish you and your loved ones an enjoyable festive break.

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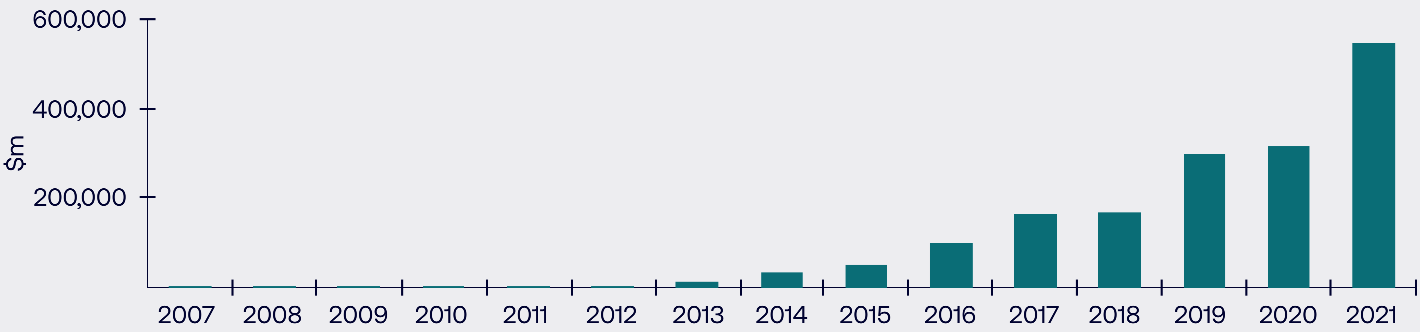
Lincoln Pensions is now Cardano Advisory.
Our teams continue to work closely with our clients to provide expert advisory services to schemes, sponsors and other key stakeholders on covenant, sustainability and pensions corporate finance matters.

Datawatch: issuance of green bonds

The issuance of green bonds has soared in recent years, reflecting the increased prevalence of ESG matters on the corporate agenda. Increased demand for green bonds has corresponded with pricing pressures as they typically trade at a premium relative to their conventional counterparts, implying cheaper finance costs for borrowers.

The increased prevalence of green bonds could contribute to a reduction in finance costs for sponsors making qualifying investments with the proceeds. At the same time, trustees should weigh up whether green bonds have a role in their portfolio, recognising the potential premium they attract.

Issuance of green bonds



Ask the Analyst: What does rising inflation mean for pension schemes?

A rise in inflation is likely to have an immediate impact on pension schemes as members with inflation-linked benefits will receive higher pension increases. The extent to which schemes' funding positions are affected by changes in inflation is largely driven by how closely matched or hedged their investment strategies are. Where schemes have not fully hedged in line with their liabilities deficits may rise, increasing covenant reliance on the sponsor.

In addition to potentially contributing to scheme funding pressures, rising inflation will increase costs for many businesses. In circumstances where costs cannot be passed on to customers, pension contributions may become less affordable for sponsors in periods of high inflation.

As we draw towards the end of the year, trustees should consider their scheme's and sponsor's exposure to rising inflation, and the implications this may have for covenant and funding.

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Regulatory developments: Plans for the UK to be the first net zero financial centre

The UK Chancellor recently set out plans for the UK to be the world's first net-zero aligned financial centre, calling for other countries to follow suit. As part of this initiative, it has been announced that $130 trillion (c.40% of global financial assets) is being aligned with the climate goals of the Paris Agreement.

There will be new requirements for UK financial institutions and listed companies to publish their net zero transition plans that detail how they will adapt as the UK moves toward net zero by 2050. A taskforce is being established to set a science based "gold-standard" for the plans and ensure disclosures are substantive and not merely a marketing platform for businesses.

Sustainability is becoming an increasingly prominent covenant consideration and enhanced disclosure requirements for sponsors is a welcome development.