PSA21 returns focus to understanding insolvency outcomes

Pension Schemes Act 2021 (PSA21) has returned insolvency analysis to the forefront of many trustee agendas.

The new Contribution Notice (CN) tests introduced by PSA21 formalise how pension trustees should think about corporate transactions in legislation. In particular, the Employer Insolvency Test considers an act or failure to act that "would have materially reduced the amount of the section 75 debt likely to be recovered by the scheme". This will involve quantifying the impact that corporate activity, such as debt refinancing, merger and acquisition activity, or internal reorganisation (such as tax restructuring) may have on the recovery made by a pension scheme in a downside scenario.

As a result, estimating the potential recovery to a pension scheme in the event its sponsor faces distress is now an essential tool in understanding a scheme's position. Any reduction in the scheme's assumed recovery could then be used to inform mitigation negotiations with the sponsor.

However, this can often be a complex and challenging process requiring numerous key assumptions and experience of how such a scenario could develop for a specific sponsor.

To avoid inadvertently breaching the new CN tests, pro-active engagement from sponsors will be required to collaboratively perform this assessment, which is a welcome development from a trustee perspective.

Recognising the importance of insolvency analysis, trustees will need to:

1. Understand and monitor the scheme's return in an insolvency scenario at regular intervals. This can help ensure that the trustee can react quickly to quantify the impact of corporate activity relative to the status quo position;

2. Ensure that an appropriate governance framework is established to ensure the trustee is able to consider corporate activity in the context of the new regulatory environment in a timely manner; and

3. Identify other strategic initiatives that insolvency analysis could support, including LTFT calibration, robust covenant monitoring and contingency planning.

PSA21 will help ensure trustees have a 'seat at the table' during corporate events, but it is now more essential that trustees are familiar with how to utilise insolvency analysis as a strategic and tactical decision-making tool.

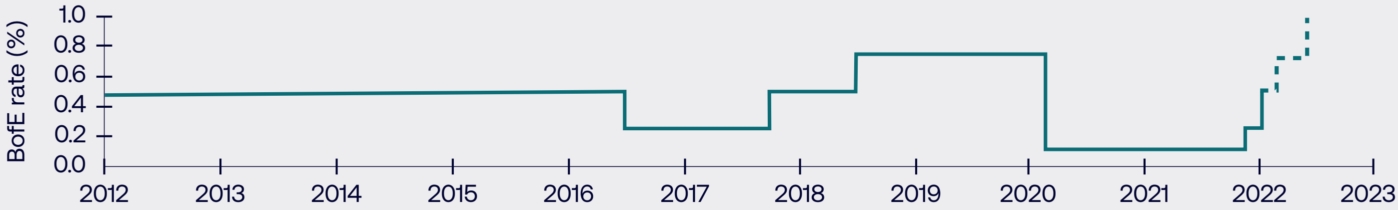
Nick Agius
Director
E: N.Agius@cardano.com
M: +44 (0)7795 636 841

Datawatch: Bank of England interest rates

After almost two years at record low levels of 0.1%, Bank of England (BofE) interest rates have risen twice in recent months – initially to 0.25% in December 2021 and then to 0.5% in February 2022. The interest rate increase was implemented to support BofE's target inflation rate of 2%, noting inflation rose by 5.5% in the year to January 2022 and is expected to peak at 7% later this year.

Increasing interest rates will impact schemes and sponsors alike. Whilst a rise in gilt yields could contribute to reduced deficits, increased finance costs may require sponsors to deleverage and reduce sponsor affordability, thereby having an offsetting impact from a covenant perspective. Uncertainty over the economic and geopolitical outlook means that market volatility is likely throughout 2022 and trustees should continue to monitor the ability of their sponsor to support scheme risks.

BofE historical interest rates and future interest rate expectations



Source: Reuters

Ask the Analyst: How can a business disposal impact the covenant?

A business disposal can significantly impact covenant strength. The size of the impact will depend on the recourse of the scheme to the business being sold; the profitability and assets of that business; the consideration received; and the use of the proceeds.

A sale will typically reduce the size of the covenant as the sponsor becomes smaller, meaning the use of disposal proceeds is often key. Given The Pensions Regulator's (TPR) parallel focus on the equitable treatment of pension schemes, particular attention should be given to proceeds that are used to repay debt or issue dividends, and mitigation may be required in such situations.

Following the introduction of PSA21, increased onus has been placed on companies to demonstrate that a business disposal (or other corporate activity) does not detrimentally impact a pension scheme. It will also increase the need for trustees and sponsors to consider the impact of corporate activity on pension schemes and the need for mitigation.

Nicole Moffat, Analyst, E: N.Moffat@cardano.com

Regulatory developments: The authorisation of the first DB superfund

Consolidation within the defined benefit (DB) pensions landscape is not a new concept, but 'superfunds' are one step closer to becoming a viable end-game option for trustees. Superfunds aim to provide an alternative option for trustees to secure members' benefits at a more affordable price than through an insurer buyout, whilst still breaking the link with the sponsoring employer.

In November 2021, Clara became the first DB superfund to gain TPR approval, paving the way for Clara to start its first scheme transfers and opening the possibility for more superfunds to gain regulatory approval.

But while superfunds may offer an attractive option for some schemes, they will not be appropriate for all schemes. Trustees should consider superfunds in the context of their journey plan and, before proceeding, should satisfy themselves that a superfund transfer provides the best outcome for their scheme members in the context of their covenant and other end-game options.

Sign-up to receive electronic versions of Covenant Quarterly: enquiries@cardanoadvisory.co.uk

Cardano Advisory Limited (formerly Lincoln Pensions) is part of The Cardano Group. Cardano Advisory Limited is registered in England and Wales number 06402742. Registered office: 10 Queen Street Place, London EC4R 1AG. Authorised and regulated by the Financial Conduct Authority.