

South Yorkshire Pension Fund

Policy on covenant assessment and monitoring

Effective date of policy	
Date approved	
Next review	

1 Introduction

The purpose of this policy is to set out the administering authority's approach to assessing and monitoring covenant.

1.1 Aims and objectives

The administering authority's aims and objectives related to this policy are as follows:

- To outline the general approach taken by the fund when carrying out a covenant assessment, including the key risk criteria.
- To outline the process for monitoring covenant strength.

1.2 Background

An employer's covenant underpins its legal obligation and ability to meet its financial responsibilities now and in the future. The strength of covenant depends upon the robustness of the legal agreements in place and the likelihood that the employer can meet them. The covenant effectively underwrites the risks to which the Fund is exposed, including underfunding, longevity, investment and market forces.

An assessment of employer covenant focuses on determining the following:

- Type of body and its origins
- Nature and enforceability of legal agreements
- Whether there is a bond in place and the level of the bond
- Whether a more accelerated recovery plan should be enforced
- Whether there is an option to call in contingent assets
- Is there a need for monitoring of ongoing and cessation funding ahead of the next actuarial valuation?

The strength of employer covenant can be subject to substantial variation over relatively short periods of time and, as such, regular monitoring and assessment is vital.

2 Statement of principles

The assessment criteria upon which an employer should be reviewed includes the following;

- Nature and prospects of the employer's industry
- Employer's competitive position and relative size
- Management ability and track record
- Financial policy of the employer
- Profitability, cashflow and financial flexibility
- Employer's credit rating
- Position of the economy as a whole

Not all of the above would be applicable to assessing employer risk within the Fund; rather a proportionate approach to consideration of the above criteria would be made, with further consideration given to the following:

- The scale of obligations to the pension scheme relative to the size of the employer's operating cashflow
- The employer's obligations to other pension schemes
- The relative priority placed on the pension scheme compared to corporate finances
- An estimate of the amount, which might be available to the scheme on insolvency of the employer as well as the likelihood of that eventuality
- The presence and nature of any guarantee provided by another scheme employer within the fund

3 Policy and process

3.1 Assessing employer covenant

The employer covenant will be assessed objectively and its ability to meet its obligations will be viewed in the context of the Fund's exposure to risk and volatility based on publicly available information and/or information provided by the employer. The monitoring of covenant strength along with the funding position (including on the cessation basis) enables the Fund to anticipate and pre-empt employer funding issues and thus adopt a proactive approach. In order to objectively monitor the strength of an employer's covenant, adjacent to the risk posed to the Fund, a number of fundamental financial metrics will be reviewed to develop an overview of the employer's stability and a rating score will be applied using a Red/Amber/Green (RAG) rating structure.

In order to accurately monitor employer covenant, it will be necessary for research to be carried out into employers' backgrounds and, in addition, for those employers to be contacted to gather as much information as possible. Focus will be placed on the regular monitoring of employers with a proactive rather than reactive view to mitigating risk.

The covenant assessment will be combined with the funding position to derive an overall risk score. Action will be taken if these metrics meet certain triggers based on funding level, covenant rating and the overall risk score.

3.2 Frequency of monitoring

The funding position and contribution rate for each employer participating in the Fund will be reviewed as a matter of course with each triennial actuarial valuation. However, it is important that the relative financial

strength of employers is reviewed regularly to allow for a thorough assessment of the financial metrics. The funding position will be monitored (including on the termination basis) using an online system provided to officers by the Fund Actuary. Employers subject to a more detailed review, where a risk criterion is triggered, will be reviewed at least every six months, but more realistically with a quarterly focus.

3.3 Covenant risk management

The focus of the Fund's risk management is the identification and treatment of the risks and it will be a continuous and evolving process which runs throughout the Fund's strategy. Mechanisms that will be explored with certain employers, as necessary, will include but are not limited to the following:

- Parental Guarantee and/or Indemnifying Bond.
- Transfer to a more prudent actuarial basis (e.g. the termination basis).
- Shortened recovery periods and increased cash contributions.
- Managed exit strategies and bespoke investment strategies in the run up to exit.
- Contingent assets and/or other security such as escrow accounts.

4 Related policies

A summary of the Fund's policy on covenant assessment and monitoring, as they apply to employer groups, is set out in the FSS, specifically "Appendix C6 – Employer covenant assessment and monitoring?".