HOW CAN THE SPONSOR COVENANT BE AFFECTED BY MAJOR ONE-OFF EVENTS?

By Donald Fleming

Tesco, BP and Deepwater Horizon, UK banks and PPI selling – just some of the numerous examples of corporate practices, unforeseen industrial accidents and events which have damaged corporate reputations, created material financial liabilities due to litigation or product claims and, in some cases, precipitated major changes to business models.

DB pension schemes rely on their corporate sponsors to be able to support them typically over several decades. How should the risk of seemingly unpredictable events and the sponsor's ability to repair or address losses caused by such events be viewed from the long-term perspective of the pension stakeholder? We suggest that even if the events cannot be foreseen, it is possible to gauge the potential financial risk to members' benefits through advanced modelling techniques and to help prepare trustees to be as well positioned as possible through scenario planning exercises.

Gauging long-term financial risk to members' benefits

Covenant analysis of the sponsor's financial statements and the business dynamics will help trustees assess the financial impact of major one-off events in the near-term. For instance, there is extensive information available to BP stakeholders about the direct financial costs of the Deepwater Horizon disaster.

For most companies though, the number of macro-economic and business variables limits the value of deterministic forecasts over the very long-term. (An exception would be the regulated utilities sector). This in turn limits the ability to assess longer-term risks to members' benefits – even without a corporate disaster. Adding major one-off events to the mix adds just one more "known unknown". Taking the BP example again, the direct financial effects of settling the legal claims and penalties on BP has only now been settled, some few years after the disaster, while the longer-term opportunity cost and the financial impact of the damage to its corporate reputation (which itself is not captured on the current balance sheet) is very uncertain.

The use of advanced probabilistic modelling techniques (which process a very large number of financial scenarios) is now enabling trustees to consider what would be the impact on pensions risk of a wide range of financial scenarios, including financial stress, even if the triggering event giving rise to this cannot be foreseen.

There is a spectrum of event scenarios, ranging from those with an identifiable event where the financial impact is controlled to those which cause the company to collapse, and any number of events and compounding factors in-between. For example, the effects of a product defect which does not affect safety or reputation might be limited to the financial cost of product recall. At the other end of the scale are apparently strong businesses brought down by events. For example, problems in the wholesale funding markets threatened Northern Rock's liquidity; when combined with failures in board oversight, regulatory intervention and rapid media dissemination of concerns, there was a "run" on the bank.

This also exemplifies the importance of reputation to corporate strength in some industries such as banking. Bank creditworthiness is underpinned by its counterparties' confidence in it – reputational failure can in itself be existential.

Even without collapse, the way in which management reacts to reputational events can lead to reduced profitability and financial strength, as shown by the business and regulatory responses to PPI in the banking industry.

Scenario planning

How can pension trustees plan for events which are inherently unpredictable and dependent on how other parties behave? Just as companies develop their own risk management plans and strategies, so too are some far-thinking trustee boards carrying out exercises to plan how they might react to specific events and how these might affect their view of sponsor covenant risk. The scenarios will of course be highly company and scheme specific; such as, an incident at a manufacturing company's key site. Such exercises are also an opportunity to work with the company's risk management team to understand any plans that the company might have and to improve governance – it is vital to have good communications and decision-making procedures in place.

Surveys of major company boards repeatedly point to reputational risk as being the key area of focus, but also the most difficult for them to assess and to manage. Trustees are not running the company but are exposed to the risk that the company's senior management fails to assess and manage the variety of risks affecting their company, including reputational risk. So it is critical that trustees think about "what if...?"

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