# SPONSOR COVENANT RISK HIGHLIGHTED: THE PAST 25 YEARS COVENANT EXPERIENCE OF THE FTSE 100 INDEX CONSTITUENTS

**Executive summary of key findings**

- As far as Gazelle is aware, this is the first study of its type which looks at the last 25 years pension covenant experience of the companies comprising the FTSE 100 Index in 1985.

- The study is particularly relevant for larger defined benefit pension schemes seeking to evaluate and manage the covenant risks they are likely to face.

- The study is not suggesting that the 'corporate promise' to pay pensions will not ultimately be honoured but it does bring considerable focus on the risk that major pension schemes attached to 'blue chip' companies could well end up in a rather uncomfortable place if history repeats itself.

- Actual default rates may seriously understate the impairment to pension funding taking place. The actual default rate of the FTSE 100 constituents in 1985 has been 7% to date but a much bleaker picture emerges of 26% of these companies experiencing a level of financial stress which was likely to have been materially detrimental to pension funding.

- A main finding of the study is that the exceptionally high incidence of corporate change posed the most risk to covenant deterioration in the study period. Of the FTSE 100 constituents in 1985, 83% experienced one or more major corporate transaction and of these 55% experienced takeover, (nearly half of these by overseas companies), 40% experienced demerger and/or restructuring and 33% underwent substantial merger transactions. Many companies experienced more than one of these.

- Only 11% of the constituents of the FTSE 100 Index in 1985 have offered pension schemes a 'benign' employer covenant experience. This underwrites the importance of employer covenant assessment and monitoring across the board.

- The focus of The Pensions Regulator on formal attachment to historic participating employers would not necessarily have provided "safe passage" for the schemes attached to the FTSE 100 constituent companies if applied retrospectively.

- The tendency of corporate change to cause "downward migration" through corporate structures of the historic participating employers, which provide formal covenant support, may actually be increasing scheme funding risk in spite of compliance with the UK pensions regulatory framework.

- The attachment of pension schemes to historic participating employers may well over time "erode" covenant support by confining it to mature and declining businesses. New growing business units may, for many reasons, fall outside of the historic formal participating employer structure which is left to "wither on the vine".

- The study concludes that The Pensions Regulator may be currently too focused on default outcomes and protecting the Pension Protection Fund compared to the challenges to pension funding presented by corporate and business change.

- The challenges to pension funding identified by this study warrant further consideration of the optimal "blueprint" for covenant support for larger defined benefit pension schemes. Gazelle focuses on three elements which it believes would better address the covenant risks identified in their study:

    - *A form of "perpetual" parent company guarantee that would automatically transcend corporate change and migrate to any new resulting group parent company*

    - *Continuing direct attachment to sufficient assets to recover the assessed outstanding Section 75 pension debt on default with a requirement to supplement assets if they become deficient (but with the flexibility and scope to substitute assets where necessary to fit with changes in corporate structure and strategy)*

    - *Particularly in the absence of a parental company guarantee, a "dynamic" approach to ensuring employer covenant support is not confined to historic participating employer structures comprising old and declining businesses*

**Background**

The assessment of sponsor covenant risk has become a key area of analysis for pension scheme trustees and their advisers. It is increasingly influencing decisions regarding the level of prudence adopted in actuarial assumptions and therefore pension scheme valuations, decisions regarding scheme investment risk exposure as well as the design of scheme deficit repair plans. The Pension Regulator's 2010 Regulatory Guidance sets out an increasingly comprehensive, rigorous and analytical approach to covenant assessment. In due course the measurement of sponsor covenant risk may attract even further attention and prominence from EIOPA-CP-11-006 through which the European Commission have outlined an insurance-based approach which might ultimately require the sponsor covenant to be "valued" as a constituent of corporate balance sheets.

It is therefore of potential concern if the thinking and methodology which has developed and is developing regarding covenant assessment and the measurement of covenant risk is not, at least in part, evidence based. This does not mean that it is incorrect but we believe it would be stronger for drawing on the available evidence and that analysis of this evidence may be extremely helpful in a number of important respects:

- it would give trustees of major pension schemes a clear perspective and context of the extent and nature of sponsor covenant risk their schemes may expect to face before reaching funding self-sufficiency;

- it would provide valuable guidance for trustees and advisers in designing and negotiating protections for their schemes against the principal risks to the sponsor covenant which are historically evidenced and have been experienced to date;

- it could provide background data for developing methodologies for the quantitative measurement of sponsor covenant risk; and

-it would provide a further point of reference to help ensure that the UK's evolving pension regulatory approach is consistent with the specific historic sponsor covenant experience of pension schemes.

**Context and data set**

Over 76% of the UK's private sector defined benefit pension schemes are now closed to new entrants *(Source: Capita Hartshead Administration Survey 2010)* but most are unlikely to reach funding self-sufficiency for 20-30 years. It is not yet clear how many of these schemes will be able to transfer their employer specific funding risk exposure to insurers or other regulated buyout providers.

The focus of this paper is the larger UK defined benefit pension schemes and we therefore consider that the most appropriate and easily available data set to analyse is the FTSE 100 Index companies since December 1985 (Appendix I) which provides, in our view, a highly relevant (for larger schemes) and statistically significant data sample experience over an approximate 25 year historic timeframe. In this paper we have sought to categorise and analyse the particular covenant sponsor funding risk highlights of the constituent companies based on publically available data and information.

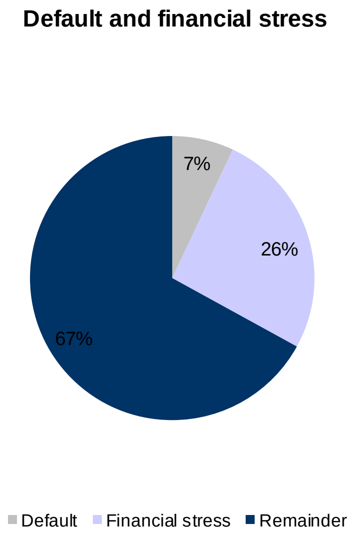
If extrapolated over the next 25 years this experience demonstrates just how much change and therefore uncertainty trustees of large defined benefit schemes can expect to encounter, and in particular what are the most prevalent types of changes and risks they need to monitor and against which they need to protect their schemes.

## Conclusions

### *Default rate and financial stress*

The actual default rate (see definition of default in Appendix II) experience of the FTSE 100 Index companies since December 1985 to the present date is 7/100 or 7%. An approximate comparator is the 7.22% cumulative default rate for BBB rated global corporates over 15 years (*Standard & Poor's Global Fixed Income Research, March 21st 2012).*

*Figure 1*




We have further analysed the FTSE 100 Index (1985) to identify instances of material financial stress (see definition of financial stress in Appendix II). This presents a much bleaker picture with 26% of the FTSE 100 Index (1985) experiencing financial stress since December 1985. We have defined financial stress to only include instances where a serious impairment in pension funding affordability was considered to have resulted or been likely to have resulted. We further consider that many of these instances could well have led to actual default had remedial action or additional financial support not been forthcoming. Indeed the ability to access additional capital or financial support was a recurrent factor in averting default.

The implication is that actual default rates for larger sponsors, such as the constituents of the FTSE 100 (1985) Index, may seriously understate a relatively high incidence of situations with the potential to seriously impair sponsor pension funding from the employer. If the FTSE Index (1985) data set is representative for pension schemes attached to larger companies, then Trustees and their advisers need to be aware that over the remaining life of their schemes, the historical evidence indicates that almost one-third will experience financial stress which either results in a default or a material impairment in pension funding affordability.

Looking behind the actual default experience the two principal factors contributing to actual defaults over and beyond financial stress are the following:

- gradual decline and eventually terminal weakening of the business model (often exacerbated by high leverage): Thorn EMI, Woolworth Holdings, MFI and Habitat Mothercare;
- disastrous acquisitions: British & Commonwealth Shipping, Exco and Ferranti.

Of the 26 instances of financial stress identified in the analysis, it is noteable that 6 related to banks and 2 to insurance companies indicating that pension schemes in these regulated sectors are far from immune from sponsor covenant risk (the former being particularly subject to systemic failure issues.)

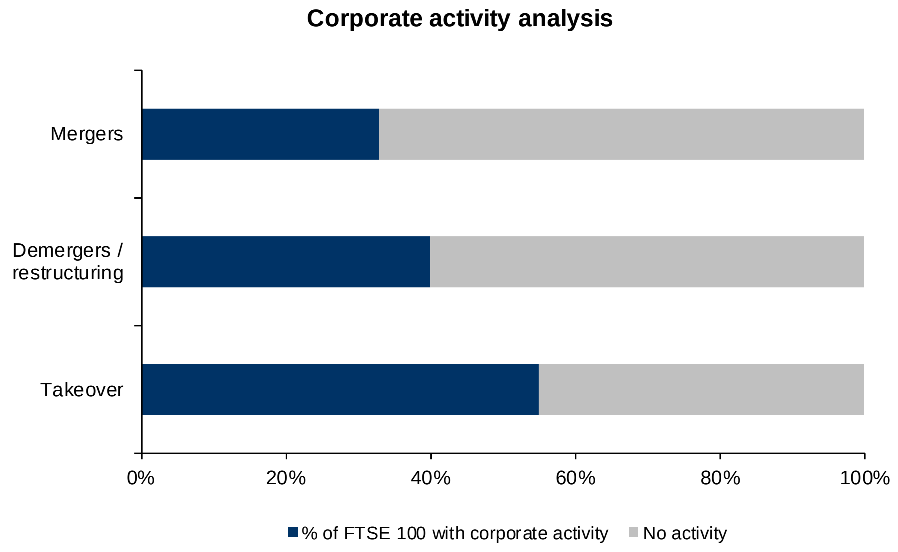
Factors identified in the analysis contributing to financial stress include:

- Material decline in trading (with remedial action including change in management and strategy): M&S, C&W, ASDA, British Aerospace, Granada
- Material decline in trading (leading to takeover): Trafalgar House, Fisons, BHS and Northern Foods
- Overpriced acquisitions: GEC and STC (in particular but evident with other FTSE 100 (1985) constituents)
- Excess debt (followed by debt reduction programmes): ICI and Tarmac
- Private equity leverage combined with decline in trading: Dee Corporation, Thorn EMI
- Financial or operational shock: Allied Lyons (forex losses), BP (Gulf of Mexico).

*Corporate change, M&A and restructuring*

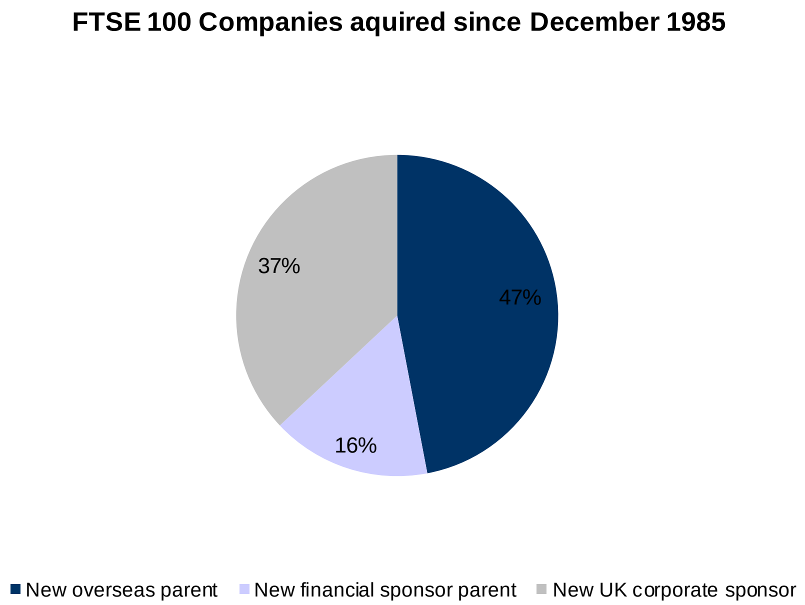
Analysis of the FTSE 100 (1985) constituents highlights a very high incidence of changes in the ownership and structural business composition of corporate sponsors. Our conclusion is that, if the amount of material corporate change experienced historically is extrapolated forward, then pension scheme trustees need to be exceptionally careful that the covenant support for their schemes does not deteriorate as a result.

*Figure 2*




No less than 55% of the FTSE 100 (1985) constituents experienced takeover with nearly half (26) of these ending up owned by new overseas parent companies.
Nine of the FTSE 100 (1985) constituents were financially leveraged by private equity acquirors (financial sponsors). This suggests that perhaps the most prevalent covenant risk exposure for trustees concerns the integration of scheme funding support structures into overseas multinational groups following takeover (and this would certainly accord with Gazelle's pensions advisory experience).

*Figure 3*




Also evident from the analysis is a relatively high incidence of potential impairment in pension covenant support as a result of demergers and major disposal programmes either splitting or downsizing the underlying covenant support provided by the component businesses of the FTSE 100 (1985) constituents. The analysis indicates that 40% of the constituents underwent demergers or restructuring which had the potential to materially alter or impair scheme funding support on a pre versus post-transaction basis.

Finally 33% of the constituents participated in a substantial merger transaction which changed the profile and nature of the covenant support structure compared to previously. While in some cases this may have actually strengthened the covenant, in others the process of integration may equally have weakened covenant support.

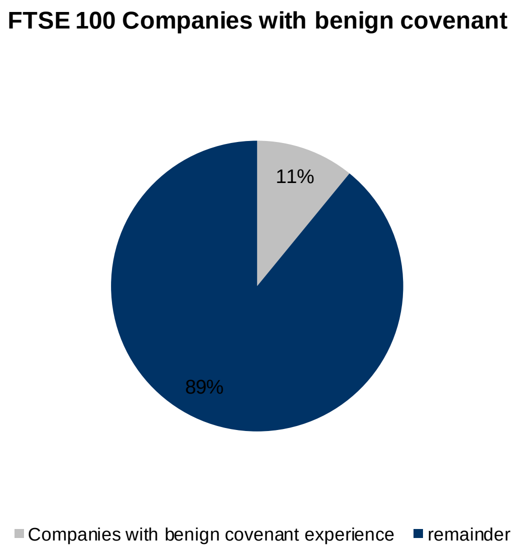
It is perhaps beyond the remit of this paper to discuss why corporate change has been so prevalent since 1985. However the following observations appear pertinent:

- a large number of the takeovers and mergers reflect the consolidation of market positions on an international basis ; and
- a large proportion of demergers, restructuring, downsizing and disposal activity related to the demise of the diversified conglomerate model and pressure for more focused business strategy by activist investors, supported by other shareholders (themselves often ultimately pension funds).

*Incidence of benign covenant experience*

Finally it is perhaps worth highlighting the number of FTSE 100 (1985) constituents which experienced a benign covenant experience. The analysis indicates that only 11% of the constituents do not exhibit material incidences of default/financial stress or corporate change. Of these 2 are property companies without material pension schemes.

*Figure 4*



This statistic serves to underline the importance for the trustees of pension schemes attached to larger corporate sponsors, whether with investment grade credit ratings or not, of monitoring and regularly assessing sponsor covenant risk.

**Implications for advice and the UK pensions regulatory framework**

One of the most concerning questions highlighted by this analysis is whether there is an optimal design for covenant support which would have allowed larger pension schemes to navigate through the quantum and types of covenant risk exposures experienced by the FTSE 100 (1985) constituents over the last 25 years. Such a covenant support design would need to reflect and protect schemes attached to larger corporates from the likely incidence of default and financial stress as evidenced from the historic analysis as well as the highly probable incidence of major corporate change which is considerably more prevalent as a risk than administration or insolvency.

In particular it is questionable whether The Pension Regulator's current emphasis and focus on the formal attachment of schemes to the existing participating employer(s) would have provided "safe passage" for schemes supported by the FTSE 100 (1985) if applied retrospectively? In support of TPR there is certainly a strong case for striving to ensure that the historic informal company funding support that many of these schemes enjoyed is formalised. However given the high prevalence of corporate change the missing step is perhaps ensuring that formal support is at parental company level and then passes through to any new successor group parent company resulting from corporate changes. Otherwise formal responsibility for scheme funding is at high risk of being pushed down the corporate organisation chart if kept confined to historic participating employers which more than likely will be integrated and restructured over time. Experience indicates that downward migration of covenant support has been prevalent, especially in respect of takeovers, but establishing the factual extent of this has not been attempted by this study and would require information not publically available.

If this is the case, then *the overall level of scheme specific employer funding risk facing trustees may actually be increasing* despite compliance with the UK pension regulatory framework and The Pension Regulator's guidance. This might indicate that The Pensions Regulator needs to focus more on the challenges to pension schemes presented by corporate change and less on default outcomes and on protecting the Pension Protection Fund.

A further issue with The Pension Regulator's emphasis and focus on the formal attachment of schemes to the existing participating employer(s) is that it risks pension schemes becoming isolated with older, mature or declining parts of the business over time whereas new corporate entities outside of the historic participating employer group may contain the growing parts of the business which may be better able to support the future affordability of pension scheme contributions. There is perhaps an implicit "trade-off" in the current pension regulatory guidance between attaching pension schemes to asset rich but older businesses to enhance recovery for schemes on default and accessing newer growing business units which may be better able to afford future pension fund contributions. If the covenant is not "dynamic" it may wither on the vine.

We have not attempted to analyse the pace of change in the underlying businesses of the FTSE 100 (1985) constituents their product or service lifecycles, or the impact of the recent high rates of technological change and the emergence of lower cost international manufacturing centres inter alia. We would however suggest that such analysis of business change, as well as corporate change, would further indicate that a narrow formal attachment of schemes to their original participating employer groups alone could increase risks for pension scheme funding on a medium to long term perspective. In any event much of the corporate change identified may well reflect the pace of underlying business change over the period since 1985.

Gazelle's view on the optimal "blueprint" covenant support for larger UK pension schemes is for a 'perpetual' parental guarantee which would automatically transfer on to any new group parent company and therefore transcend and survive takeovers, mergers and corporate restructuring. However this may still not provide sufficient protection for pension schemes where the parental guarantee has migrated on takeover to an overseas company in which instance a poor or uncertain recovery under overseas insolvency jurisdictions could still result. In these cases we believe the optimal "blueprint" covenant support should comprise a parental guarantee together with continuing direct attachment to the UK assets which originally supported the scheme, or the substitution of at least equivalent assets, supplemented, if these become deficient on an insolvency analysis, by additional assets or other security. This may appear to be "belt and braces" but it would in our view deal effectively with the experience of the FTSE 100 (1985) constituents as analysed and in particular corporate change. It is debatable whether a 'belt and braces' approach should be prescriptive or whether it would be practical to apply it. However it would appear from the study that without this additional funding risk may be involved which needs to be acknowledged

The current 'clearance' based system for corporate transactions remains voluntary with the company deciding whether it wishes to seek clearance from the Pensions Regulator or not. If corporate change is indeed the major source of funding risk to larger pension schemes, the current system not prove commensurate to the task.

**Qualifications of the analysis**

We have not attempted to analyse what has actually happened to the original participating employers of the FTSE 100 (1985) and the pension schemes they supported. Such a study would require confidential data which might be sensitive for employers if it indicated a material deterioration in covenant support before the 2004 Pensions Act was introduced. It would undoubtedly shed more light on the issued raised in this paper.

Finally we accept that the analysis contains a level of interpretation of specific historic company information in order to aggregate and categorise data. We have however provided clear definitions of the categories we have used in Appendix II. In particular we have selected a narrow definition of financial stress and applied it only to instances where we consider the potential impact on pension scheme funding was or could have been materially detrimental. We suspect that access to non-public information sources would result in an expansion in the number of cases of financial stress recorded.

**Appendices**

I - Constituents of FTSE 100 Index at 31st December 1985

II - Definitions used in the analysis table for FTSE 100 Index

**Appendix I - Constituents of FTSE 100 Index at 31st December 1985**

**Table H—Constituents of the F.T.–S.E. Index immediately after the 31 December 1985 changes—with Equity Market Capitalizations on that day**

| *Position* | *Company* | *Capitalization (£m)* | *Position* | *Company* | *Capitalization (£m)* |
|---|---|---|---|---|---|
| 1 | British Telecommunications | 13920·0 | 51 | Sun Alliance & London Insurance | 1025·5 |
| 2 | British Petroleum | 10211·9 | 52 | B.E.T. | 992·9 |
| 3 | "Shell" Transport & Trading | 7325·1 | 53 | Whitbread | 977·8 |
| 4 | Glaxo Holdings | 5690·1 | 54 | United Biscuits (Holdings) | 966·9 |
| 5 | Imperial Chemical Industries | 4929·6 | 55 | Reckitt & Colman | 963·7 |
| 6 | Marks and Spencer | 4655·8 | 56 | Commercial Union Assurance | 949·4 |
| 7 | BAT Industries | 4616·6 | 57 | Racal Electronics | 913·2 |
| 8 | General Electric | 4373·5 | 58 | Hawker Siddeley Group | 910·4 |
| 9 | B.T.R. | 4165·3 | 59 | Rank Organisation | 882·7 |
| 10 | Cable and Wireless | 3631·3 | 60 | Thorn E.M.I. | 859·3 |
| 11 | Barclays | 3271·2 | 61 | Woolworth Holdings | 859·0 |
| 12 | Grand Metropolitan | 3075·9 | 62 | Pearson | 858·6 |
| 13 | Hanson Trust | 2817·2 | 63 | Consolidated Gold Fields | 844·3 |
| 14 | Beecham Group | 2711·5 | 64 | Dixons Group | 827·9 |
| 15 | J. Sainsbury | 2606·5 | 65 | Cadbury Schweppes | 823·7 |
| 16 | National Westminster Bank | 2497·3 | 66 | Reed International | 819·4 |
| 17 | Prudential Corporation | 2339·4 | 67 | Smith & Nephew Associated | 815·8 |
| 18 | Unilever | 2209·9 | 68 | Royal Bank of Scotland Group | 754·3 |
| 19 | Bass | 2144·8 | 69 | Hammerson Property Inv & Dev | 739·9 |
| 20 | Great Universal Stores 'A' | 2046·5 | 70 | Blue Circle Industries | 737·4 |
| 21 | Imperial Group | 1928·3 | 71 | Redland | 730·2 |
| 22 | Boots | 1912·7 | 72 | Courtaulds | 728·3 |
| 23 | Royal Insurance | 1888·3 | 73 | M.E.P.C. | 703·3 |
| 24 | Allied-Lyons | 1834·6 | 74 | British Home Stores | 695·0 |
| 25 | Distillers | 1797·7 | 75 | Rowntree Mackintosh | 695·0 |
| 26 | Lloyds Bank | 1727·9 | 76 | Pilkington Brothers | 691·9 |
| 27 | ASDA-MFI Group | 1626·1 | 77 | Argyll Group | 690·6 |
| 28 | Rio Tinto-Zinc Corporation | 1602·9 | 78 | B.P.B. Industries | 682·6 |
| 29 | Sears | 1600·6 | 79 | Willis Faber | 672·5 |
| 30 | Burton Group | 1539·9 | 80 | British & Commonwealth Shipping | 671·8 |
| 31 | Land Securities | 1510·2 | 81 | Standard Chartered | 664·3 |
| 32 | Dee Corporation | 1259·6 | 82 | Ladbroke Group | 656·7 |
| 33 | Plessey | 1248·5 | 83 | Guest Keen & Nettlefolds | 622·2 |
| 34 | B.O.C. Group | 1243·9 | 84 | Ferranti | 620·4 |
| 35 | Trusthouse Forte | 1216·9 | 85 | Northern Foods | 606·2 |
| 36 | General Accident Fire & Life Assurance | 1210·8 | 86 | Jaguar | 606·0 |
| 37 | Trafalgar House | 1190·4 | 87 | English China Clays | 567·8 |
| 38 | Tesco | 1180·2 | 88 | Abbey Life Group | 560·0 |
| 39 | British Aerospace | 1175·1 | 89 | S.T.C. | 546·0 |
| 40 | Tarmac | 1169·7 | 90 | Ultramar | 545·6 |
| 41 | Guardian Royal Exchange | 1144·1 | 91 | Habitat Mothercare | 542·7 |
| 42 | Reuters Holdings 'B' | 1136·7 | 92 | Granada Group | 520·6 |
| 43 | Legal and General Group | 1126·1 | 93 | Globe Investment Trust | 514·0 |
| 44 | Peninsular & Oriental Steam Navigation | 1117·2 | 94 | Harrisons & Crosfield | 502·0 |
| 45 | Fisons | 1062·7 | 95 | Scottish & Newcastle Breweries | 497·2 |
| 46 | Sedgwick Group | 1061·9 | 96 | Exco International | 491·7 |
| 47 | Britoil | 1045·1 | 97 | Smiths Industries | 490·0 |
| 48 | Midland Bank | 1038·3 | 98 | Bank of Scotland | 486·7 |
| 49 | Associated British Foods | 1036·5 | 99 | Sun Life Assurance Society | 462·6 |
| 50 | Guinness | 1030·9 | 100 | B.I.C.C. | 462·0 |

**Appendix II - Definitions used in the analysis table for FTSE 100 Index**

*Default*
Bankrutcy, insolvency or administration of all of, or a substantial part of, the business of a FTSE 100 constituent company as it was originally comprised in December 1985.

*Financial Stress*
An event or events giving rise to one or more of the following by a FTSE constituent company: (i) the need for additional capital support; (ii) the need for debt refinancing (including banking nationalisation) ;(iv) a materially detrimental reversal in trading performance ; (iv) a material financial loss (arising from accounting irregularity, operational issues or external factors)

*Takeover*
A successful public offer for a FTSE 100 constituent company or the acquisition of the majority of the business(es) comprising a FTSE 100 constituent company in a private transaction.

*Demerger or restructuring*
The demerger or split into separately owned component businesses of a FTSE 100 constituent company, or disposals representing a material part of the business of a FTSE 100 constituent company or a significant reorganisation of the corporate structure or listing.

*Merger*
The merger of a FTSE 100 constituent company with a separate business of similar size whether effected by way of a share exchange, acquisition or “Newco” structure.