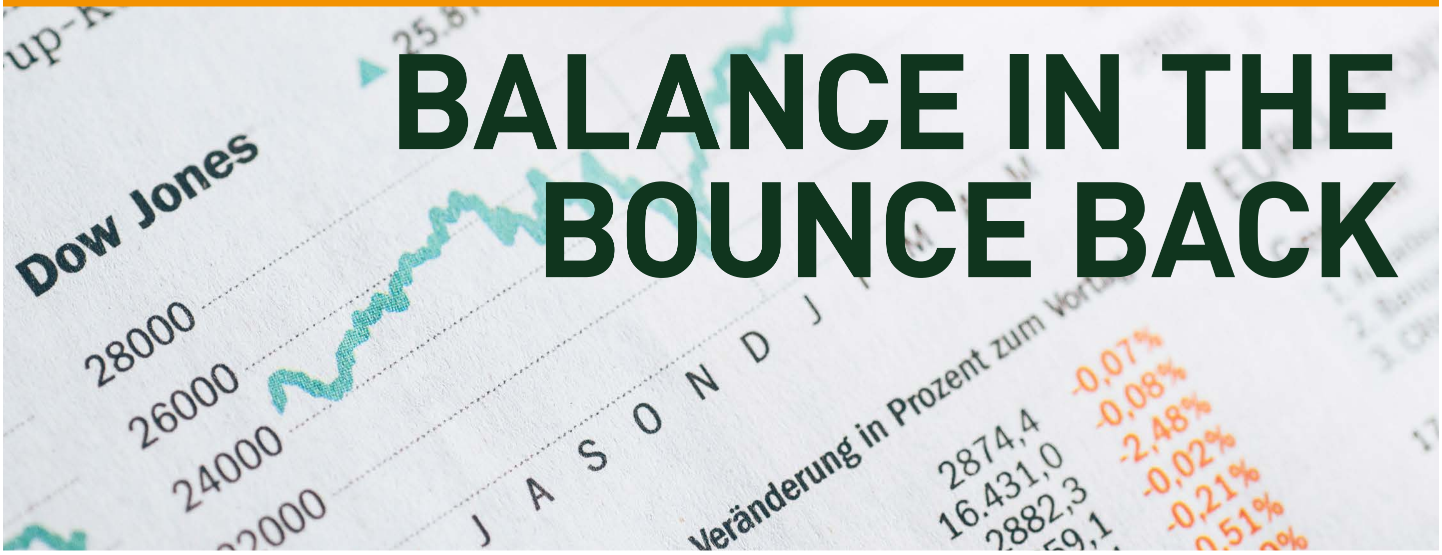
COVENANT QUARTERLY

Q3.2020

LINCOLN PENSIONS' QUARTERLY UPDATE ON COVENANT AND REGULATORY DEVELOPMENTS

BALANCE IN THE BOUNCE BACK



Many sponsors of DB pension schemes have seen an improving situation during Q3. However, the financial implications of lock-down will be long-lasting with an extended period of cost-cutting and strict cash flow management to come. Trustees will need to continue balancing member security with supporting the sponsor through these difficult circumstances.

The shape of recovery we see in the UK will be critical for sponsors in the next 12 months and beyond. Will the recovery be "V shaped" or will we see a slower return to a "new normal"? The behavioural changes we are seeing across the economy, both in terms of consumer preferences and how we all work, are impacting all industries and the demand for sponsors' products and services.

This period represents one of the most challenging set of circumstances possible for Finance Directors. In some cases, trading almost came to a complete standstill during Q2 and it's clear that our economic system is not designed to withstand such scenarios without significant government intervention.

So what can trustees of DB pension schemes, an important creditor, do during this period to protect member benefits?

- Maintain close contact with the sponsor and request regular updates on trading prospects and liquidity;
- Monitor forecast financial information and challenge assumptions, particularly if a sponsor requests reduced deficit repair contributions or other support;
- Where appropriate, be flexible in negotiating funding arrangements with sponsors. This might involve using contingent assets or upside-sharing arrangements, in lieu of more traditional arrangements; and
- Contingency plan for plausible future scenarios. Understand the trustees' "tool-kit" and available levers (across legal, covenant, and investment) and try to mitigate identified gaps.

Patience has been, and will continue to be, required from all stakeholders. The key for trustees will be showing flexibility while taking the steps necessary to protect members.

See our recent webinar:
"Balance in the Bounce Back"

Overleaf: Technical Updates, Ask the Analyst, and Data Watch.

DB PENSIONS HEADLINES THIS QUARTER

- **In June,** TPR launched new guidance for pension consolidators - a significant step in ensuring these models provide a viable end-game alternative for trustees.
- **In June,** the FCA set out measures to reduce conflicts of interest and assist advisors in providing high quality DB transfer advice.

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TECHNICAL UPDATES

Developments in DB funding consultation

Covenant visibility recognised as core concept

Increasingly, rather than just funding to Technical Provisions, trustees are looking at the longer-term journey to a position of "low dependency" on their sponsors.

This is principally the result of the changing regulatory landscape, with TPR's consultation on a new funding code of practice expected to require trustees to set a long-term funding objective, formalise how they expect to reach it, and explain how that strategy is supported by the covenant.

At the heart of this is recognising that covenant changes over time and that visibility over the future covenant will vary from one sponsor to another.

Given these changing dynamics, we have refreshed our covenant rating scale, so that it talks to these longer-term goals for trustees. Our clear guidance on covenant affordability, visibility and reliability will give trustees a strong foundation to build their journey plan on.

ASK THE ANALYST

We answer common covenant related questions

Gavin Ganasalingam,
Analyst

Ask the analyst: What is contingency planning and what does it involve?

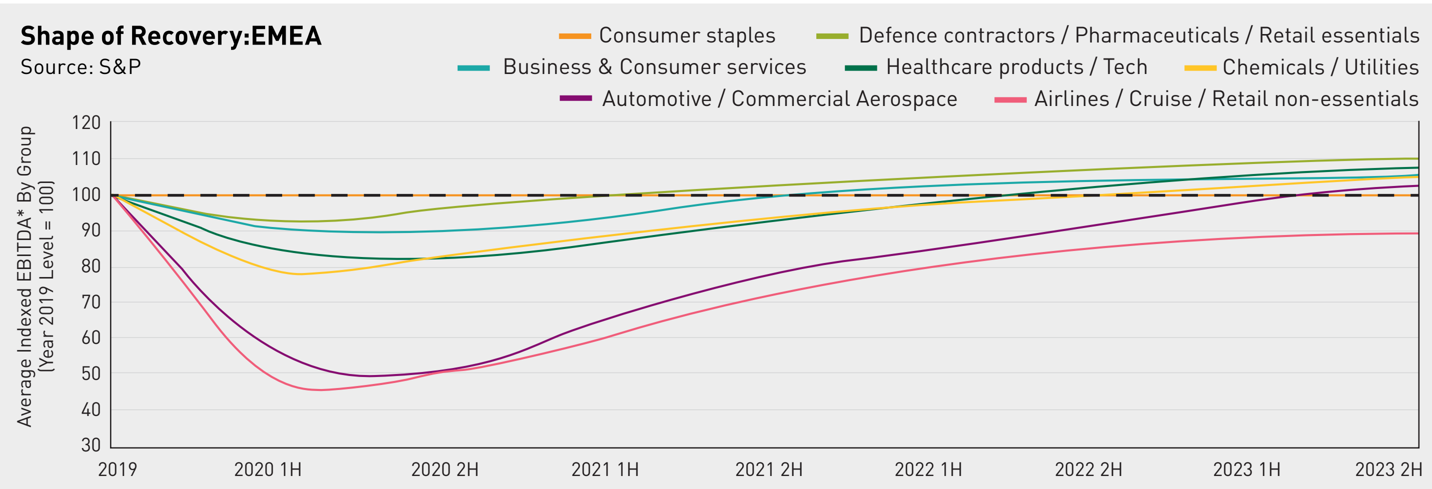
Contingency planning, in a trustee context, is a process of understanding what could go wrong, how those situations can be managed, where the gaps are and what can be done to fix them.

Performing robust contingency planning typically involves trustees and sponsors working collaboratively to understand the covenant and legal support structure, relevant powers under the trust deed and rules, and any other tools the trustees may have to mitigate situations where risks crystallise.

Alongside thinking through what could happen on the investment and funding side, trustees will need to understand the plausible downside covenant scenarios (e.g. distress), and this usually involves leveraging work performed by the sponsor in performing its own contingency planning.

Refreshing contingency plans appears particularly important today, so that trustees can understand any implications of the "new normal" arising out of COVID-19 challenges.

DATA WATCH THE PATH BACK TO NORMALITY



S&P's recent report "The Shape of Recovery: Uneven Unequal, Unchartered" suggests that the path back to normality is unlikely to be swift. The combination of lost output and increasing debt burdens are expected to challenge sponsor solvency over the period to 2023.

S&P modelled seven groups of industries and their EBITDA prospects and concluded that the impact is likely to vary by industry.

Consumer staples, defence contractors, pharmaceuticals and essential retail are not expected to see any material negative EBITDA impact arising from COVID-19. By contrast, airlines, cruise ships and non-essential retailers (amongst others) are not projected to see EBITDA back at 2019 levels until at least 2024

Ultimately, trustees should look to work with sponsors to evaluate their specific prospects whilst keeping in mind the corroborating context of how industries are expected to perform.

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