Act now to recover

Pensions Support Index 2021

COVID-19: the move to a fragmented economy

July 2021

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Welcome to PwC's Pensions Support Index 2021

We are delighted to present the 2021 edition of the Pensions Support Index (PSI).

It is now nine years since we launched the PSI. Over that time we have seen sponsors and schemes recover from the impact of the global financial crisis, work through the implications of Brexit and, now, face the challenges posed by COVID-19.

In this edition, we look at some of the key issues facing defined benefit (DB) pension schemes, including an update on the economic landscape, the impact of environmental, social, and corporate governance (ESG) factors on sponsor covenants and the need for sponsors to be agile during periods of sustained disruption.

Please do reach out to one of our team if you would like to have a further discussion about any of the topics covered in this edition of the PSI.

Stephen Soper
Partner

Minesh Rana
Director

Stage 1

Per guidance from The Pensions Regulator (TPR), understand which of the following categories your sponsor fits into:

1. COVID-19 has had limited impact on the business
2. The initial impact of COVID-19 was material but trading has or is recovering strongly
3. Impact of COVID-19 continues to be material

Stage 2

As the UK looks to recover from COVID-19, think through how the new economic environment and trading conditions could impact your sponsor.

Stage 3

Understand the extent to which your sponsor, and the industry it operates in, is susceptible to disruption.

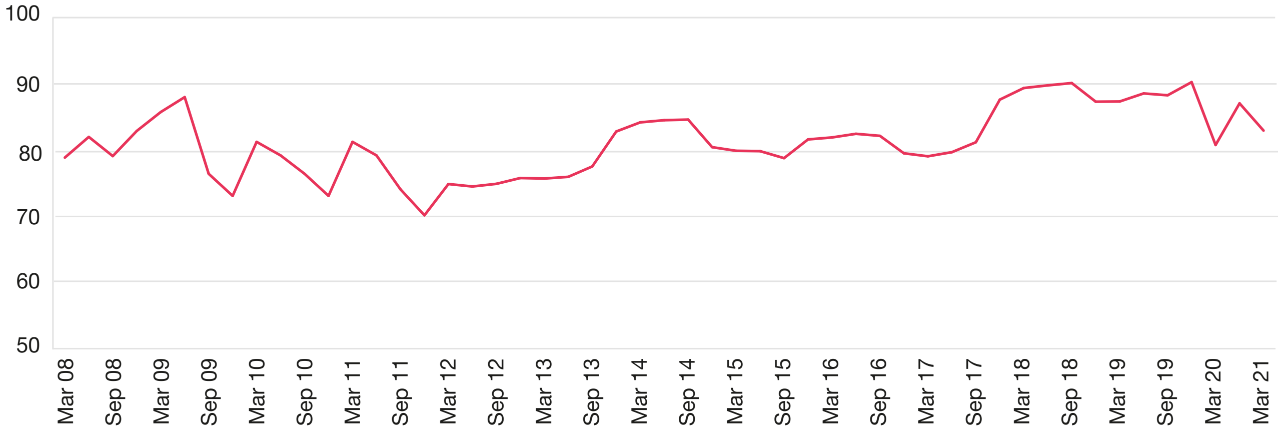
Stage 4

Disruption in action: Understand what impact ESG requirements will have on your sponsor and what steps could be taken to consider the risks and opportunities.

The Pensions Support Index tracks the relationship between the financial strength of the FTSE 350 companies and their defined benefit pension obligations, indicating the overall level of employer support offered to these pension schemes. Rather than just looking at the absolute size of the obligations, we compare the scheme position to the cash generation, profitability and assets of companies supporting their schemes.

The number of weaker FTSE 350 sponsors has more than tripled since June 2020

Figure 1: Total PSI score



The PSI score dropped to 83 in March 2021, reversing the gains seen in the preceding three years. The drop in the PSI score is primarily due to significant hits to profitability and cash generation experienced by many FTSE 350 companies as a result of the pandemic.

The analysis shows there are some companies that continue to be in a good position to support their schemes, with 51% of schemes in the FTSE 350 having a very high score of 95 or over.

However, the percentage of schemes with a score of 60 or lower, which suggests a more limited level of support offered by the sponsor, is now 17% compared to 5% in June 2020. Many schemes will be facing the dual challenge of a material reduction in the level of sponsor support and a substantially increased level of uncertainty.

While liquidity remains tight for many, trustees with weaker sponsors should consider non-cash options as a way of protecting their covenant.

In this environment there are likely to be both winners and losers, leading to what has been dubbed as the ‘fragmented economy’.

This divergence is coming at a time of increased focus on ESG and a more robust regulatory regime in the pensions industry. These challenges are in addition to those created through uncertainty due to new COVID-19 variants and continued travel restrictions (at the time of publication).

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The PSI score dropped to 83 in March 2021, reversing the gains seen in the second quarter of 2020.

Employers that have been materially impacted need a clear plan to recovery

Reflecting this caution, TPR has updated its Annual Funding Statement (AFS)

In its recent AFS, TPR provides guidance on what actions trustees could take, depending on the impact that COVID-19 has had on the strength of the employer covenant. The valuation approach taken by trustees will likely vary depending on which of the following categories the sponsor falls into:

1. COVID-19 has had a limited impact on the business

In this category there has likely been no balance sheet weakening and cash flows have remained strong.

We still recommend trustees engage with their sponsor to understand the key factors which led to the limited impact. If the pandemic had played out differently, would the outcome have been the same? TPR is also encouraging trustees to undertake stress testing or scenario planning to ensure alternative future economic environments have been modelled and considered when reviewing sponsors' business plans.

2. The initial impact of COVID-19 was material but trading has or is recovering strongly

For sponsors in this category, the approach is slightly more complex as it depends on the type of impact COVID-19 has had and what the catalyst for the recovery has been. Key areas the trustees may wish to consider to help decide on the appropriate course of action include:

- How reliant was the sponsor on government support, e.g. the furlough scheme?
- Is trade recovering quickly enough to not cause a short-term liquidity problem when government loans are repaid and business rates relief ends?
- What scenario planning has the sponsor undertaken for how to deal with future economic shocks?
- Does the sponsor have a business continuity plan and has it been refreshed in light of the lessons learned from COVID-19?

Stephen Soper
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3. The impact of COVID-19 continues to be material

The third category is where trustees should have real concerns and be proactively engaging on a regular basis with their sponsor. Limited liquidity is likely to mean that affordability is stressed and the trustees could be facing an uncertain medium- to long-term outlook. There is potential for the business to never fully recover.

For trustees who have a sponsor in this category, we note the following considerations:

- What is the realistic long-term viability of the business? What does this mean in the context of the recovery plan?
- Stress testing should be performed on the forecasts, with trustees ensuring they understand the key variables and sensitivities within each model and the extent to which the sponsor has the liquidity available to deal with adverse events.
- Has there been a material deterioration in the covenant and, if so, what additional support needs to be put in place? If liquidity is tight, are there any appropriate non-cash funding options?

At a recent PwC conference, we asked an audience of c.300 people how they think their employer would fare post-COVID-19. 85% said they thought that their employer would be in the same or better position post-pandemic.

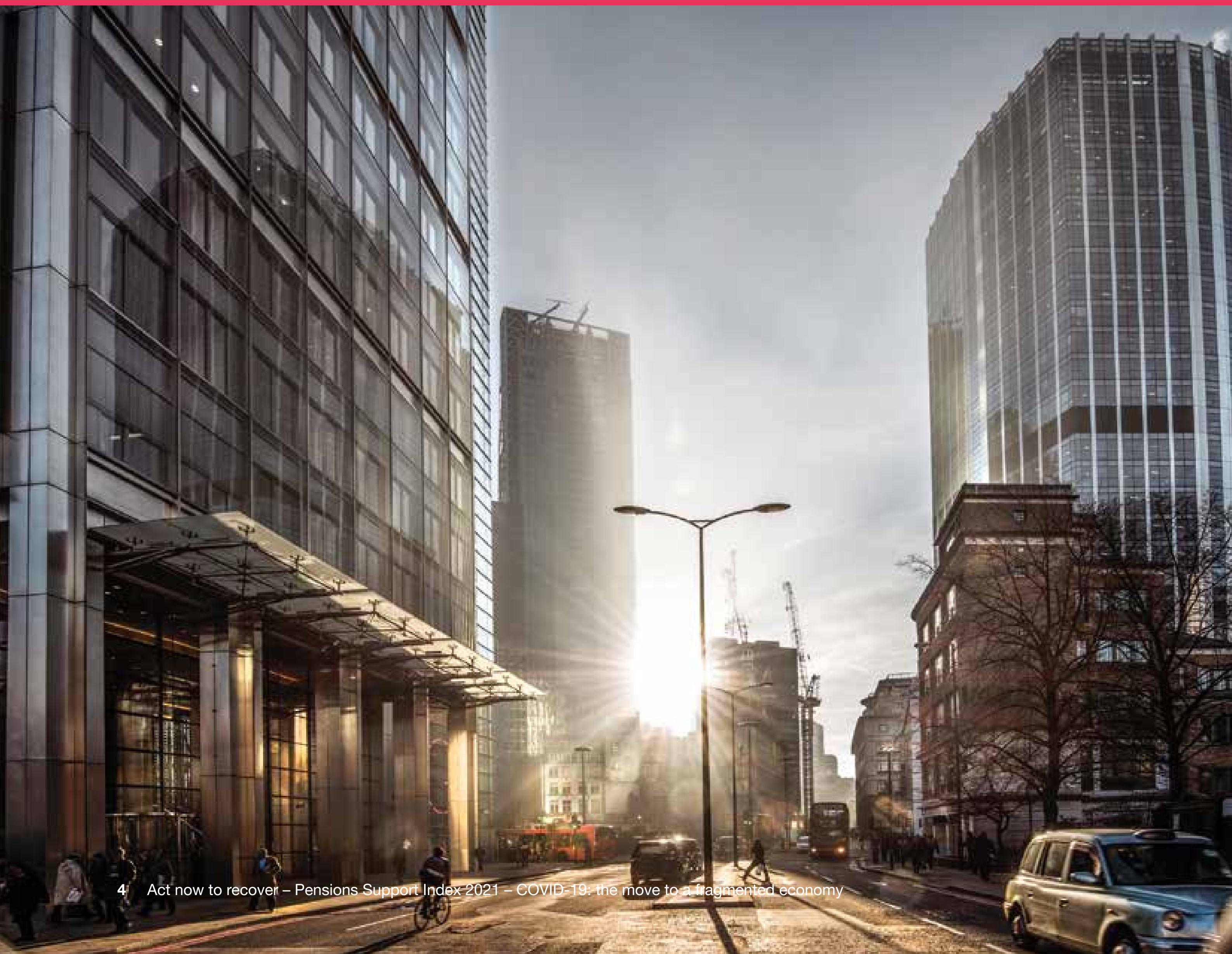
4. While COVID-19 dominates the headlines, there are other broader challenges facing trustees

In this publication we have also drawn on PwC's wider internal expertise to help sponsors and trustees engage and plan for the future.

The remaining articles cover:

- A broader look at the UK economy and what the recovery might look like.
- The role of disruption and the impact it might have on sponsors.
- A look at the role ESG might have in assessing covenant.

The PSI's recovery depends largely on the broader economic environment...



COVID-19 has sent shockwaves through global economies

The full implications of the pandemic are not yet known, but with every lockdown businesses and consumers have demonstrated their ability to adapt, enabling the recovery to get underway. This is good news for pension schemes, particularly those that need to rely on their employer for support and cash contributions.

The extent of any longer-lasting effects of COVID-19 on the UK economy remains uncertain. Much like differing economic theories, the answer depends on who you talk to and the framing of the question. The past year has certainly tested the resolve of many businesses.

As supply chains start to recover and businesses rebuild, this presents an opportunity for trustees to re-engage with sponsors and ensure schemes are treated equitably. As our PSI score shows, the percentage of sponsors whose score is 80 or lower is now 38%, up from 18% in June 2020, which highlights how fragmented the recovery has been.

To assist in this trustees may wish to consider the following in discussions with their sponsor:

- How has the sector your sponsor operates in been impacted by COVID-19?
- Is your sponsor likely to benefit from the release of the pent-up demand?
  - If the answer is yes, then how will the sponsor maximise the benefit of this?
  - If the answer is no, what mitigating measures are being put in place?
- How will continued low interest rates coupled with inflationary pressures impact your scheme and sponsor?
- What modelling has been done on the longer lasting impact of COVID-19 and is the sponsor planning any operational changes to, for example, reduce costs or improve its supply chains?
- Will there be an impact on the company's operations as a result of a shift in work practices?

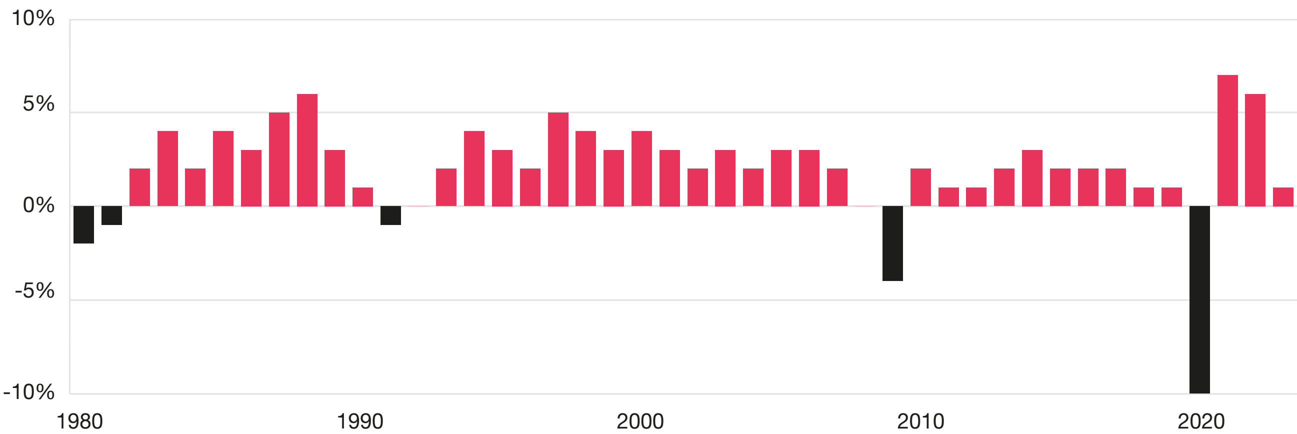
> “
> If I had to summarise the diagnosis, it's positive but with large doses of cautionary realism.
>
> **Andrew Bailey, Governor of the Bank of England**

Total insolvencies are down, but is this the calm before the storm?

In February 2021, the Office for National Statistics' preliminary data showed annual GDP in 2020 suffered the largest decline in more than 300 years, contracting by almost 10%. In March 2021, UK GDP was 6% below its pre-pandemic levels and, while a slight improvement was seen in April, it remains down 4%.

However, in May 2021 the Bank of England released new forecasts. They predicted that the UK economy will grow at its fastest rate in more than 70 years, expanding by 7.25% in 2021, as shown in the chart below.

Figure 2: International Monetary Fund, World Economic Outlook Database, April 2021



Source: International Monetary Fund, Bank of England

Despite the challenges of 2020, government data shows the number of registered company insolvencies in April 2021 was 925, 22% lower than the same month in 2020 and 35% lower than the number registered two years previously. Insolvencies have actually been on a negative trend since January 2019 and significantly lower than the c.1,600 monthly average seen in 2009 after the global financial crash. As the government starts to unwind the support measures put in place, could this lead to a significant increase in corporate distress?

Figure 3: Insolvencies

Source: Insolvency Service

The fragmented economy

The Office for Budget Responsibility estimates that households have accumulated a stock of excess savings of around £180 billion since the start of the pandemic. This is waiting to be unleashed into the economy.

How these savings will be deployed is yet to be seen. But it is likely those operating in the more discretionary sectors of the economy will do well.

The potential for an uneven recovery means there are likely to be both winners and losers, leading to a 'fragmented economy'.

Caution continues to hold sway

Economists still express caution over the extent to which this pent-up demand could be tempered by job uncertainty and general hesitancy across the economy. The full impact of winding down government support mechanisms is yet to be seen; however, we are unlikely to see a completely smooth transition of furloughed workers back to their old jobs.

Uncertainty also exists regarding the outlook for inflation. Inflation could peak at around 2.8% this year before returning to target in the next few years, but is unlikely to follow a smooth path in the coming months.

We expect the Bank of England to continue prioritising the recovery with low interest rates, over reducing inflation.

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...but there are other threats to the recovery

How susceptible to disruption is your sponsor?

Since the concept of 'employer covenant' was first applied to a pensions context back in 2004 there have been relatively few changes to the way in which we assess the strength of the employer covenant. Over recent years, there has been greater consideration of some newer areas such as ESG and the covenant horizon, i.e. how long a scheme can reasonably rely on support from its employer.

However, to date these have only had a marginal impact on the methodology used to assess covenant and there is a risk that we are missing a bigger issue. For example, should we instead be considering anything that could disrupt the ability of sponsors to support their obligations to schemes?

Sponsors which fail to respond to disruption with agility and innovation may find themselves being left behind as the rate of change across industries increases. Those which embrace change will likely succeed and could become the established market leaders of the future.

Agility

Trustees need to consider how agile their sponsor is and its ability to cope with disruption when considering the future covenant. We have worked with experts from across PwC to consider how trustees can get a sense of a sponsor's agility as a way of dealing with disruption.

> It isn't where you came from; it's where you're going that counts.
>
> **Ella Fitzgerald**

Agile sponsors will fare better in this new environment

Strategy

Assessing sponsors' business plans and the likelihood of success is key to determining the longevity of the covenant. This will be increasingly important when the new DB funding code comes into effect, although that is now not expected to be until late 2022.

- How agile is the sponsor's strategy? Can it respond to signals that disruption is coming, or is it locked in for the next five years?
- How focused is the sponsor on driving new areas of strategic growth?
- Has the sponsor got the capabilities it needs to grow? Are there any key gaps?

Process

Virtually all of TPR's recent covenant guidance has referred to the importance of scenario analysis and contingency planning to help Trustees assess key risks facing the employer and what actions they would need to take in the event that one or more of those risks materialises.

- Is the sponsor focused on looking backwards at risk? Or is the risk analysis of the sponsor forward-looking and data-driven?
- Is the sponsor's cost base fixed and rigid, or can it be dialled up or down to meet demand?
- How quickly can the sponsor get new products to market?

Technology

Our clients are increasingly demanding better use of technology. They now require access to real-time insights into the strength of the covenant, to ensure they have the information they need to make critical decisions. The same thought process can be applied to sponsors with the need to leverage increasingly sophisticated technology applications to stay ahead.

- How often does the sponsor update its technology? Is it constantly evolving using cloud architecture, or reliant on cumbersome whole system upgrades?
- Is technology a growth driver or a cost centre?
- Is your sponsor appropriately addressing the ever increasing risk from cyber threats?

People

One area of our lives which looks like it has been permanently changed is the way in which we work. Gone are the days of everybody being expected to be in the office all or most of the time; most surveys indicate that the majority of employees would like to work from an alternative location at least some of the time (where this is feasible).

- Do the sponsor's employees have the skills needed to fulfil the sponsor's future strategy?
- Does the sponsor have a diverse workforce that can bring a range of views to the table?
- How will changing work patterns and hybrid working impact your sponsor?

Organisation

There is an unprecedented level of deals taking place at the moment, from major transactions between multinational conglomerates to M&A activity in the <£5m EBITDA market. We believe that one of the key drivers of this is corporates looking to focus on their strengths and dispose of non-core businesses to allow them to focus on their post-COVID strategy.

- To what extent is the sponsor's operating model aligned with its corporate and innovation strategy?
- Is the sponsor focused on its core capabilities, or hampered by non-core assets?

"There is an unprecedented level of deals taking place at the moment, from major transactions between multinational conglomerates to M&A activity in the <£5m EBITDA market.

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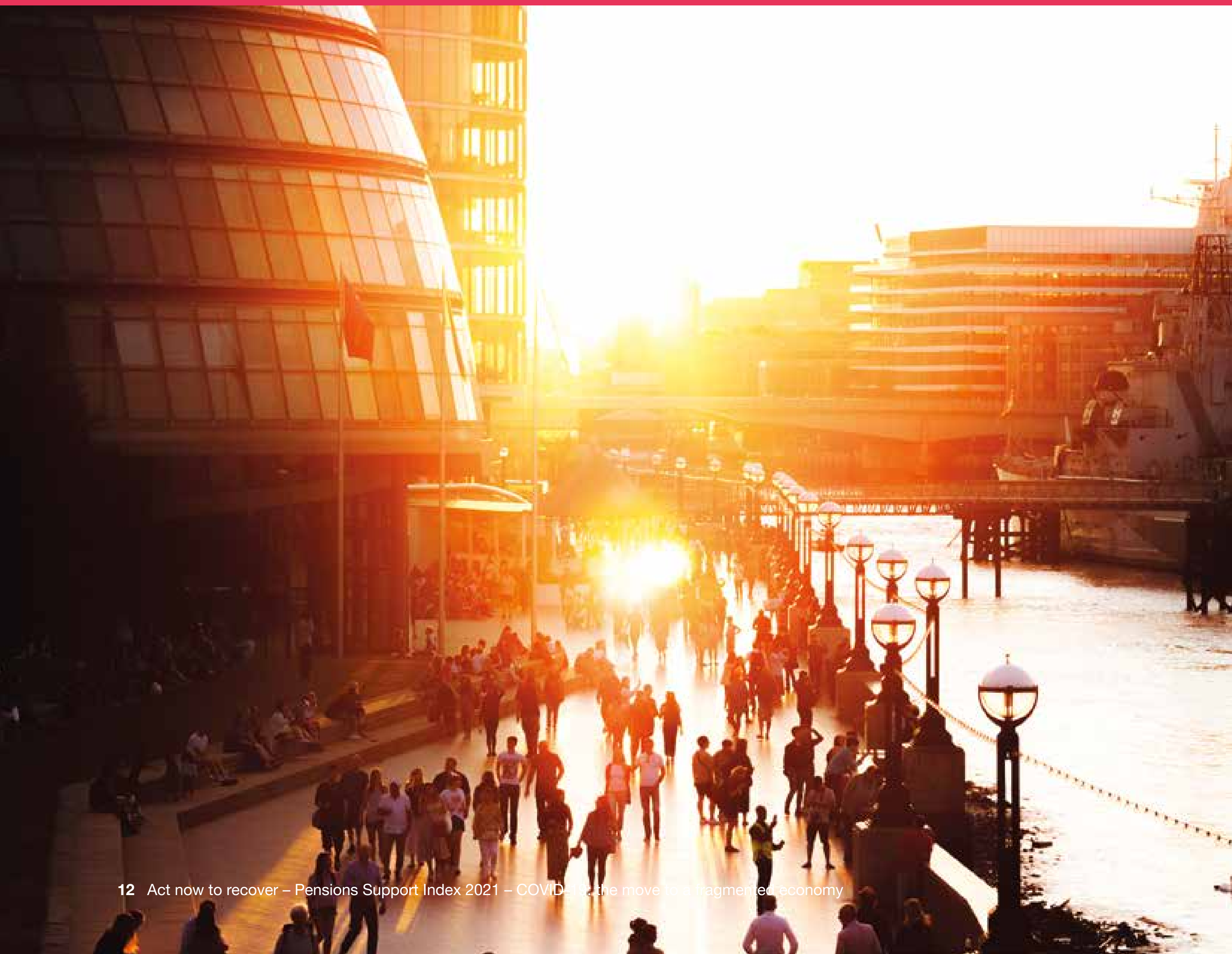
Disruption in action



Is climate change a bigger employer covenant issue than COVID-19?

As the green shoots of recovery appear, businesses will also be refocusing on longer-term trends and focus areas such as ESG. As trustees are long-term stakeholders, this pace of change presents a challenge. Trustees are likely to need to consider:

- Is there an existential threat to the long-term prospects of their sponsoring employer?
- Does their employer need to invest to evolve and diversify, and what does this mean for cash availability for contributions to the scheme?
- How do the trustees consider the above, engage with their employer and consider these challenges in a way that is consistent with their strategy for the scheme?

To help break this down and support trustees in exploring these issues, we set out five different drivers that trustees can consider in relation to ESG and the long-term impact on covenant:

1. Different sectors have different levels of exposure, but all are impacted

Much of the climate debate has started with sectors like oil & gas where the exposure is clear, but both energy transition and physical risks will have an impact across the board. In addition to direct employer exposure, long term success will need consensus with customers and suppliers to grasp opportunities as well as protecting value.

2. Management perspective on ESG

There is a wide range of attitudes amongst management teams and investors. Some are leading the charge to implement an energy transition strategy, such as reducing carbon emissions in their energy supply and vehicle fleets.

Others are taking a 'wait and see' approach and could risk being left behind or facing increasing costs. For example, the emission trading system where prices have tripled over the last three years.

3. Is appropriate governance in place?

An increasing number of companies are setting net zero targets, but the substance and governance behind them is the vital piece of the puzzle.

In June 2021, the government announced it has adopted the Task Force on Climate-related Financial Disclosures (TCFD) requirements for the pension industry. While TCFD only relates to climate change, the government is also looking at social and corporate governance aspects.

Trustees therefore need to be considering all aspects of ESG, not just climate change, especially in light of the new Own Risk Assessment requirements which are being introduced under the UK Corporate Governance Code (formerly known as the Combined Code).

> "We have to look at ESG not only as a threat but also as a significant opportunity.
>
> **Henry A. Fernandez, chairman and CEO of MSCI, US**

Trustees have a key role in driving the ESG agenda with sponsors

4. A covenant assessment giving a longer-term view

Covenant visibility over the longer-term has always been challenging but the approach of focusing on key strengths and risks applies equally to ESG considerations.

Exposure can often be evaluated by identifying milestones and future changes, for example regulatory deadlines and net zero targets of governments or customers. Significantly, action is being taken. Transactions have occurred where groups are divesting of operations which are more exposed to climate change.

5. Longer-term covenant interaction with scheme strategy

Integrated risk management is a subject in itself, with longer-term covenant visibility and risks linking to decision making around valuations, length of recovery plans and investment strategy.

Monitoring of longer-term covenant risk can significantly enhance decision making. Even if visibility is limited to a year or two, provided it is regularly refreshed through focused monitoring, benefits will still be realised.

Developing a greater understanding of scenarios and the formulation of contingency plans is therefore a useful tool to think about potential outcomes.

Ultimately trustees should be seeking covenant diversification, down side protections or accelerated de-risking, if risks around longer-term covenant are not addressed by management's strategy.

While clearly not exhaustive, these are some of the reasons that ESG needs to be high on the agenda for both the scheme and the sponsor.

We expect part of this recovery to be transaction-led, and we are already seeing transaction demand and valuation multiples being impacted by ESG considerations and climate change in particular.

The pace of change required means those who proactively plan for these changes will be best placed to support their pension schemes for many years to come. Trustees have a role as a major stakeholder in providing challenge and making sure these factors are a key part of a sponsoring employer's strategy.

> "At our recent Pensions & Restructuring Lawyers Event, more than 50% of lawyers said that ESG should be a key risk in assessing the long-term covenant.

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Our Pensions Employer Covenant & Restructuring team

Pension Covenant Adviser of the Year for 2008, 2010, 2011, 2012, 2013, 2014, 2015, 2017, 2019, 2020 and 2021

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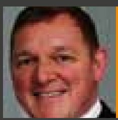

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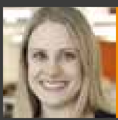

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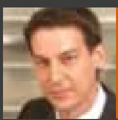

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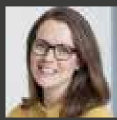

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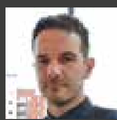

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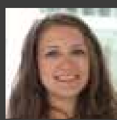

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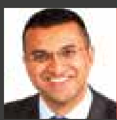

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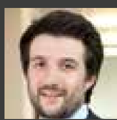

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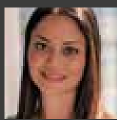

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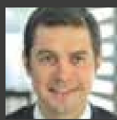

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Methodology

The Pensions Support Index tracks the relationship between the financial strength of the FTSE 350 companies and their defined benefit pension obligations, indicating the overall level of employer support offered to these pension schemes. Rather than just looking at the absolute size of the obligations, we compare the scheme position to the cash generation, profitability and assets of companies supporting their schemes.

The PSI should not be viewed as a replacement for an employer covenant review or other professional advice.

Index scores – Definitions and characteristics

Similar to the FTSE indices, our Index tracks average performance, in this case the ability of FTSE 350 companies with DB pension schemes to support their associated DB pension obligations, and again, like the FTSE, performance within the Index itself varies considerably.

Index scores	Definitions and characteristics
More than 90	Indicates that the legacy DB pension issue in the UK has been largely addressed and for an individual company this is likely to indicate that the company can comfortably support its pension obligations.
75 – 90	Indicates that the majority of companies will have addressed their pensions issues. However, there will be a need for continual monitoring of individual employers. This is because some companies could be vulnerable to a decline in their score should the recovery from the pandemic not be smooth or if there are significant one-off events (e.g. a corporate transaction or restructuring) which could significantly change the level of support available to the scheme.
50 – 74	Indicates that the majority of companies will still be able to meet their pension obligations as they fall due. However, there will be a proportion of schemes which are large relative to the size of their sponsoring employer. For these schemes there is material risk to members' benefits and setting out a longer term plan for the scheme will be key.
Less than 50	Indicate that there are many schemes where there is a risk of a cut in members' benefits resulting from the failure of the sponsoring employer. For companies and schemes in this position, there will be a need to consider the broad range of options available to address the pension obligations that the company is exposed to and to understand what steps can be taken to secure members' benefits.

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