



## Covenant Capitalisation

The long term, multi-period nature of defined benefit pensions is a source of much intrinsic strength and stability for the security of the arrangement to scheme members. Unfortunately recent trends in risk analysis and pension regulation, borrowing heavily as they do from banking and insurance risk-based regulation, focus upon the immediate and fail to capture these elements adequately. The result is a disproportionate concern with current funding levels, when these are really only of secondary concern, after the primary risk, sponsor insolvency.

The event of sponsor insolvency creates a real problem for pension schemes in the sense that, now they are orphaned with no possibility of further recourse to their sponsor employer, they are exposed over their remaining life to the risks which were previously borne by that sponsor. This exposure is potentially substantial; if the cost of bulk annuitisation is a fair guide, some 30% or so of total scheme liabilities.

The BrightonRock policy assumes these risks. By entering into this contract, the sponsor is making provision for these risks in addition to the risks of fund asset values being in deficit to fair value of liabilities at the time of sponsor insolvency. The long-term nature of the policy, being for the life of the scheme or sponsor, brings the long-term aspect of the scheme into explicit consideration.

With an annual premium, set for life as an agreed fixed proportion of liabilities, the sponsor employer is creating an unfunded liability to pay future premiums. BrightonRock is the creditor counterpart to this liability. The BrightonRock policy is an asset of the scheme. The value of the policy as an asset of the scheme is determined by the likelihood of sponsor insolvency and the amount necessary to achieve full annuitisation post insolvency<sup>1</sup>, which is full post insolvency risk coverage. This asset increases the level of funding of the scheme, for any level of other assets. The sponsor has capitalised its covenant in this regard without any current funding and this reduces the current contribution cost to the employer sponsor, since lower levels of funding are now required.

The value of the policy varies with sponsor insolvency likelihood and the future other asset surplus or deficit of the scheme's funding, generating the asset's contra-cyclical value characteristics.

The pooling of risks within BrightonRock, where many schemes are covered, results in a lower cost of coverage of the excess post insolvency risk to that faced by any solitary scheme, and is reflected in its premium setting process. The pricing of the BrightonRock policy also considers the likely recovery, if any, on the Section 75 debt, which of course is not reflected elsewhere in scheme or sponsor accounts, which are prepared on an ongoing basis. The result of this premium setting basis is the creation, under most circumstances, of a net asset for the sponsor and scheme combination, the liability arising in the sponsor's accounts will be lower than the asset arising in the scheme's accounts.

This is not a "free lunch", merely optimal financing of a complex liability, with due consideration of the sponsor employer and scheme over the long term.

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<sup>1</sup> The value of the policy may be regarded simply as the sum of the discounted futures values of these.