Sackers

DB funding – TPR publishes covenant guidance

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Introduction

Hailed by TPR as the "last piece of the jigsaw to help schemes carry out valuations under the new DB funding code", yesterday TPR published its revamped covenant guidance ("the Guidance"). Building on the detail in the DB funding code ("the Code"), the Guidance sets out how trustees should go about assessing and monitoring the employer covenant under the new regime.

Key points

- Defined in pensions legislation for the first time by the Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024, "employer covenant" takes account of the employer's financial ability to support the scheme having regard to its legal obligations.
- With the Code having come into force on 12 November 2024, the Guidance dissects the various components involved in assessing employer covenant (eg cash flow, prospects, reliability period, covenant longevity, and contingent assets), with each having its own section. Several worked examples are included, covering "areas of covenant assessment that require the highest level of judgement from trustees".
- In line with the Code, there is an increased focus on proportionality, with TPR expecting trustees "to review whether their existing covenant analysis is focused in the right areas", especially if there has been "a significant change" in the scheme's funding position in recent years.
- Acknowledging that for many schemes the Guidance will simply "bake in best practice", TPR nonetheless expects all trustees to read applicable sections "in full" and to "make sure their members are protected". The Guidance will also be of interest to DB scheme employers and advisers.
- Whilst TPR is not formally consulting on the Guidance (as had been expected), it has said that it may revise the Guidance "when needed and include industry feedback".

Identifying employers

The Guidance includes a section on identifying the scheme's employer(s) and assessing the "nature and extent" of their legal obligations to the scheme, noting that this is "a complex process and may require legal advice". Trustees are urged to understand their scheme's balance of powers, including who holds the power to amend the scheme, wind up the scheme and trigger a section 75 employer debt, as well as who sets the level of ongoing and deficit repair contributions ("DRCs").

Where an employer's financial performance is "heavily dependent" on a third party, the wider group or a group obligation, this should also be considered. For trustees of multi-employer schemes, where it is not proportionate to assess each employer, the Guidance offers alternative approaches, including pooling employers into sub-groups with varying levels of review for each, considering the aggregate performance and position of all the employers, or focusing on the employer(s) with the largest share of the scheme's liabilities.

TPR also provides helpful input on assessing "last man standing multi-employer schemes", formally segregated multi-employer schemes, and partial wind-up provisions for multi-employer schemes.

Key components of assessing covenant

With TPR stressing the importance of understanding that the risk being taken "on the journey plan to their low dependency target" is supportable by the employer, some of the key areas involved in assessing an employer's covenant are:

Cash flow

The Guidance sets out what trustees should consider when assessing the cash flow of employers (and non-employers) who have a legal obligation to financially support the scheme, and includes a number of worked examples. When assessing cash flow, trustees should primarily focus on forward-looking forecast information, using historical information to help evaluate its accuracy and reliability.

An employer's "cash flow" is essentially what is left as "free cash" after taking account of reasonable operational and committed finance costs (eg utility costs, essential maintenance, and staff costs), but before DRCs to the scheme or other possible uses of that cash. The other uses might include investment in the employer's sustainable growth, payments that result in covenant leakage (eg dividends and intercompany transactions) and discretionary payments to other creditors. The Guidance considers the possible impact on cash flow of these factors, plus the level and type of any borrowing, and the implications of being part of a wider group.

Prospects

This section of the Guidance is designed to help trustees understand the **"**extent and duration of reliance" that can be placed on employers continuing to provide sufficient scheme support, and highlights the risks involved in that support deteriorating. Factors to consider when assessing prospects include market outlook, employer market position, diversity of employer operations, ESG risks, resilience and risk of insolvency.

Trustees should generally request the information needed here from the employer's management, but may also have to consider supplementing this with information from other sources, such as market outlook reports and market data.

Determining the reliability period and covenant longevity period

This involves considering the:

- reliability period – the period over which trustees have reasonable certainty about the employer's available cash flow to fund the scheme (generally three to six years for "most" employers)
- covenant longevity – how long trustees can be reasonably certain that the employer will be able to continue to support the scheme.

The Guidance includes detailed examples illustrating how the assessment of the reliability period and covenant longevity should be undertaken, emphasising the need for stress testing where "material risks" to the employer's prospects and covenant are identified.

Contingent assets

As a minimum, TPR expects trustees to reassess the value of contingent assets at each valuation, or more frequently if appropriate for the scheme's circumstances, and to have in place processes to monitor any potential deteriorations in the asset value in the interim period. Whilst this may be a fairly well-trodden path for some, the Guidance looks in detail at how to approach ascribing an appropriate value to a contingent asset and how to evidence that it is "sufficient to provide the specified level of support when required".

But the process for valuing contingent assets looks altogether more complex, granular and onerous than it is currently, so it will be interesting to see how covenant advisers approach this in practice.

Determining the covenant inputs required to assess supportable risk

The Guidance details how to determine the appropriate covenant inputs needed to assess whether the level of risk being run in the scheme's funding and investment strategy is supportable by the covenant. It outlines how to calculate "maximum affordable contributions" and other considerations to be borne in mind, including look-through guarantees, payment of DRCs by an entity other than the employer, as well as the impact of an employer sponsoring more than one DB scheme.

Monitoring covenant

Unsurprisingly, TPR expects trustees to monitor the covenant throughout the scheme's lifetime. Steps involved in a robust and proportionate monitoring framework include:

- identifying key covenant support risks – such as loss of a key customer / supplier, breach of banking covenants, technology or market changes, or reputational damage
- setting tolerance thresholds for each key risk identified – each indicator could have more than one threshold, eg "soft" or "hard" thresholds reflecting the severity of the breach and the strength of the action to be taken, and
- agreeing proportionate actions to be taken if thresholds are breached – eg obtaining additional and more frequent information, engaging covenant advisers, de-risking the investment strategy or calling an out of cycle valuation.

The frequency and depth of monitoring are likely to change over time, but trustees must be able to justify their approach and document decisions taken. TPR also expects that, as a minimum, "a full review of the monitoring framework should be completed as part of the scheme valuation process".

Information required for effective monitoring includes publicly available information, analyst reports (if available), as well as employer information such as management accounts, metrics and forecasts. As TPR regards a “good working relationship with management” as key, information-sharing protocols and contingency plans will also be important.

What’s next?

TPR plans to launch a new digital service for submitting funding documents in spring 2025. In the meantime, schemes have been advised to hold off submitting their statements of strategy until this service is up and running, with TPR providing comfort that it will not treat this as a breach of the funding requirements.

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