New DB funding (covenant & investment!) regime

Preparing for the new covenant requirements – key actions for trustees and how LCP's Covenant team can support you

October 2024

The Pensions Regulator's new funding code has (finally!) been laid before parliament and we now know most of the details of the new funding regime, which is set to be the biggest shake up in DB pension scheme valuation discussions for almost 20 years. There are **new covenant-related requirements** that trustees will need to consider, very soon in some cases, with the new regime applying to all funding valuations with an effective date on or after **22 September 2024**. This summary focuses on the new covenant requirements as **more in-depth covenant assessment will be required for many,** with an emphasis on the employer's cash flows and future prospects. **Trustees will need to report to the Regulator their conclusions about the ability of the covenant to underwrite scheme risks, and in some cases will need to provide detailed information on specific covenant metrics**.

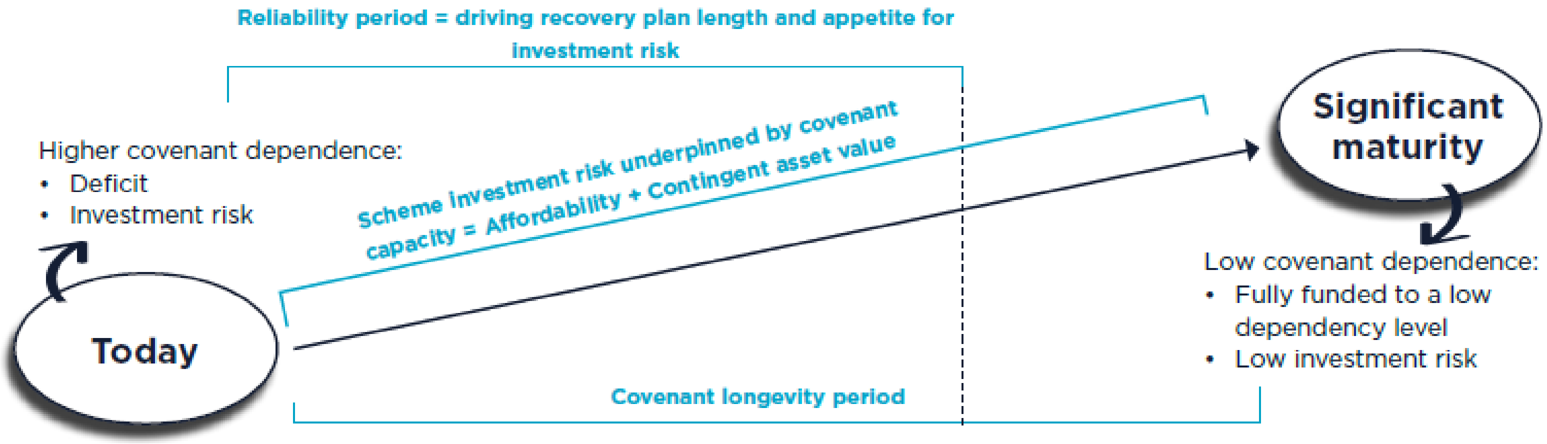
Covenant headlines of the new funding regime

- Covenant is defined in law – and so is the requirement for trustees to assess it when preparing their scheme's "funding and investment strategy".
- Key principle is that scheme risk should be supportable by the sponsor's cash flows and contingent assets – therefore both must be assessed.
- If there is a funding deficit it must be recovered as soon as the employer can reasonably afford – this is also in law now and needs assessment.
- Covenant information must be submitted to TPR with the scheme's Statement of Strategy – this will be a significant new requirement for some schemes.

Covenant assessment is more prescriptive in the new funding regime

- Trustees will need to identify key covenant features such as an employer's **free cash flow**, **maximum affordable contributions**, and its covenant **"reliability"** and **"longevity"** periods. It will be important to evaluate each of these as they all influence the level of risk that can be taken in a scheme's funding and investment strategy and over what time period, and the recovery plan if there is a funding deficit.
- Deficits must be repaired **"as soon as the employer can reasonably afford"**, taking account of the employer's planned investment in its own sustainable growth. This will mean trustees understanding what is reasonably affordable. It could mean contributions need to be increased, and in some situations where affordability is constrained, the employer may need to adjust its business plans including reducing dividends and other 'covenant leakage'.
- **Contingent assets** must be legally enforceable and trustees need to assess their value considering the situations in which they could be called on, eg in employer distress or even insolvency.
- **Assessment of guarantees** has been tightened up and their legal terms may need to be revisited.
- There are two routes for TPR to assess valuations – **Fast Track** or **Bespoke**. Fast Track is a regulatory filter, under which if you pass various tests (eg relating to your technical provisions and recovery plan length), you can expect limited regulatory scrutiny. Bespoke is an equally valid route but you must justify your approach.
- **If the Bespoke route is taken**, TPR will request details of the trustees' approach to covenant assessment, including key financial information to confirm scheme risks are adequately supported and whether any independent advice has been taken.
- TPR is currently updating its **covenant guidance** to support the new requirements. This is expected to be issued for consultation towards the end of 2024.

Covenant is important throughout a scheme's journey to its long-term target and beyond



What the code says:

Covenant reliability – period over which trustees can be reasonably certain of the employer's cash flow to support the scheme (TPR has said usually three to six years).

Covenant longevity – how long the trustees can be reasonably certain (based on information available at the time) that the employer will be able to continue to support the scheme (TPR has said usually up to 10 years).

LCP's Covenant team can support you in navigating the new funding regime

- Whether this is your first time considering independent covenant advice, or you are looking to adjust the scope of your covenant advice given the requirements of the new funding regime (or even because of recent changes in your scheme's funding position), LCP's Covenant team can provide effective and proportionate support.
- A new regulatory regime can put stresses on trustee and sponsor relationships, we work collaboratively to ensure all parties are aware of the new requirements and options for how they can be met – even when this may be challenging.
- LCP is uniquely placed to advise you on the new requirements given our deep regulatory insight. Helen Abbott, a partner in the Covenant team, was a lead covenant specialist at TPR for seven years until 2020 and she worked on the development of the new funding regime.
- Also, in 2023 David Fairs joined LCP from TPR where he was Executive Director of Regulatory Policy, Analysis and Advice and lead the work on the new DB funding code.
- We can provide trustee board training to get you up to speed on all the new requirements.

Key covenant actions for Trustees

Determine the scope of your covenant assessment ahead of your next valuation

- Liaise with sponsors on information required – in most cases more will be needed to meet the new requirements.
- Identify key covenant metrics that will need to be reported to TPR.
- Ensure appropriate covenant advisers in place to provide support.

Assess new covenant metrics and feed covenant factors into discussions on the scheme's funding and investment strategy

- Consider covenant reliability and longevity periods and check the covenant can adequately support scheme risks – if not your funding and investment strategy may need to be amended.
- Is contingent asset support in place or needed?

Determine if your scheme is likely to take the Bespoke route when submitting its valuation

- Bespoke valuations will need to evidence how scheme risks are supported – additional information will need to be submitted to TPR to support the approach taken, including confirming whether the trustees have taken covenant advice.

Undertake a 'health check' on your contingent assets

- Contingent assets form an important element of covenant support for many schemes.
- Trustees need to be confident that their contingent assets will be able to provide the support assumed in the scenario in which they are likely to be called on – they need to be appropriately valued and legally binding.
- We can undertake an assessment of how your current arrangements stack up to the requirements of the new regime and what amendments may be needed.
- We can also review what new contingent assets may be available from the employer or wider group.
- TPR has particularly tightened up its expectations of how guarantees should be assessed, introducing the new concept of a 'look through' guarantee which mirrors the obligations of a scheme's employer. Many existing guarantees will not meet this criteria.
- If the scheme is taking a Bespoke route with a high degree of reliance on a contingent asset to underwrite scheme risks then significant information will need to be submitted to TPR with the Statement of Strategy – we can help you with these new requirements.

Related events and resources

[The new funding code – the final details and what it means for you](#)

[Securing the future – the expanding role of the employer covenant](#)

[Contingent Funding in the New Pensions Era](#)

- Summary of the Fast Track requirements
- Action list for trustees
- Action list for sponsors

The final regulations set out the legal framework and the new Code covers TPR's interpretation and guidance. Our News Alert summarises key actions and the new funding regime. You can also read our summary of the Fast Track requirements here.

Want to find out more?

If there's anything further you'd like to ask, please get in touch with your usual client contact, or one of our covenant exp erts.

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