First Briefing, January 2025: Assessing employer covenant

The Pensions Regulator (TPR) has published updated covenant guidance for trustees of Defined Benefit (DB) schemes.

Consistent with the new DB funding code, the guidance discusses various areas in more detail.

This briefing brings together the key messages.

Trustees and employers should read the guidance in full.

What is the employer covenant?

Let's start by making sure we understand what is meant by the employer covenant, which TPR describes as:

"… the extent to which an employer has a legal obligation and financial ability to support a scheme now and in the future, as well as any expected scheme support from suitable contingent assets."

As a minimum, employer covenant should be assessed at each full actuarial valuation. The covenant assessment will need to be included in the statement of strategy, and unless the scheme is small or low-risk, it will need to provide evidence to support the assessment.

The outcome will help set any recovery plan needed, as well as the level of funding and investment risk that can be supported in the scheme's journey plan.

Areas to consider when assessing covenant

Cash flows and legal obligations

The assessment should consider what cashflow is available from employers with a legal obligation to support the scheme. This should primarily be based on management forecast cashflow rather than historical cashflow information.

Although interactions between the employer and any wider group it belongs to should be considered, TPR notes that no additional investment risk should be taken without a legal obligation (e.g. parent guarantee) from other companies within the same group, i.e. trustees should not assume their support.

The focus should be on the ability of the employer to make cash contributions to the scheme to achieve and maintain full funding.

Covenant reliability and longevity

The assessment of employer cashflow and prospects will help gauge:

- Covenant reliability – How long can you be reasonably certain of the employer's cashflow to support scheme funding needs and investment risk?
- Covenant longevity – How long can you be reasonably certain that the employer will continue to support the scheme?

Contingent assets

Trustees will also need to assess whether they can rely on any contingent asset in place, based on the scheme's legal access and expected realisable value at the time it is likely to be called upon.

Recovery plans

Where a scheme is in deficit, a plan should be put in place to recover this deficit as soon as the employer can reasonably afford it.

When determining reasonable affordability, trustees should consider the employer's available cash and the reasonableness of other alternative uses of cash, including investment in sustainable growth.

If the employer's plan to invest in sustainable growth restricts the funding available to the scheme, trustees should understand how and when the scheme will benefit from supporting this investment and whether other stakeholders are contributing appropriately.

Working together

The trustees and employer will need to work together for this process to work well.

Trustees must engage with the employer at an early stage, and the employer should provide all information required for the trustees to perform their duties. The guidance will help overcome barriers where the information requested is sensitive.

Do you need a professional covenant assessor?

TPR recognises that professional advice will not be required in all cases, with considerations including:

- Do you have the necessary expertise and experience to assess or challenge fellow trustees or the employer on the legal, financial aspects and prospects of the covenant?
- Does the trustee board have full objectivity, for instance if a trustee holds an influential employer role such as finance director?
- Is the scheme highly reliant on the covenant, (e.g. is the scheme large relative to the employer or under-funded, or does its strategy carry a high level of investment risk)?
- Is the covenant complex (e.g. is there a complex legal or operating group structure)?

If trustees decide to perform their own assessment, they should be prepared to explain their analysis and conclusions, if challenged.

Other key points

Proportionality

TPR recognises that the level of detail in a covenant assessment will vary, depending on the situation. Factors to consider include:

- The size of the scheme, both in absolute terms and relative to the size and level of covenant support provided by the employer
- The funding level and investment risk within the scheme's journey plan
- The maturity and expected cash flows of the scheme.

Not-for-profit assessments

The guidance recognises that not-for-profit organisations may work differently from others.

It sets out modifications and extra considerations which may be needed where organisations are reliant on non-commercial operations. Examples include:

- Reputation
- Level of demand for what they do and the strength of their finances
- If they get money from government, how important their services are to national goals
- The chance of merging with a similar organisation instead of closing down if something goes wrong.

Reporting on covenant

As part of the new DB funding code, schemes will be required to submit a statement of strategy, which should confirm whether the covenant has been assessed as adequate or inadequate with regard to the actuarial valuation.

Unless the scheme is small or low-risk, it will be required to provide additional information on the key elements of the covenant assessment.

These include cash flows, maximum affordable contributions, covenant reliability period and covenant longevity period.

These should demonstrate to TPR that the funding and investment risk taken by the scheme is supported by the employer covenant.

Further information

Read TPR's covenant guidance in full.

For further information, please contact your usual First Actuarial consultant.