Updated Covenant Guidance

Details finally here but proportionality is key

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Introduction

We now have the revised DB covenant guidance from the Pensions Regulator - another project that has been many years in the making, even without a formal industry consultation.

All of the key principles have been well trailed, and a fair amount of detail was already included within the new DB Funding Code, but we now have further expansion and some worked examples for trustees and their advisers to discuss.

For those still relying on a light touch approach to the old four level assessment it will represent a very significant raising of the bar, but many well-funded schemes will be leaning heavily on proportionality to short cut most of the additional expectations.

The updated guidance

There are now nine modules on the Regulator's website:

Covenant guidance | The Pensions Regulator

These cover, in additional depth, all of the areas that are central to the expectations around covenant assessment set out in the new Funding Code. This includes assessing cash flows, analysing prospects, contingent assets, supportable risk, reliability periods and longevity periods.

There is also reinforcement around the key issue of identifying the correct sponsoring employer(s), with legal obligations to the scheme.

The funding code had already specified that *"At a minimum, we expect trustees of all defined benefit (DB) schemes to assess covenant support at each valuation. However, the required depth, and frequency thereafter, of an assessment should be proportionate to the circumstances of the scheme and employer. The approach taken should be documented and trustees should be able to justify why it is reasonable and appropriate."*

The approach set out in the new guidance suggests that the expectations are much more rigorous than many schemes have adopted to date. There is focus for example on challenging the reliability of company forecasts and seeking much greater protection within contingent assets if wanting to rely on them within your funding strategy. Examples show Trustees taking a very different view on reasonable affordability to that presented in company forecasts and potential for some quite challenging discussions with employers as a result.

Indeed, with awareness of these issues having been well trailed with Trustees over the past few years, it may well be that education of employers and helping them to understand the additional financial transparency and discussion that is now expected is the key action to take away from the new guidance.

Broadstone view

At first glance you may be tempted to say there is nothing new here. Given the considerable length of the guidance, that would represent an awful lot of effort for minimal benefit.

However, the challenge for many in assessing covenant has always lain in the detail. As the Regulator is expecting trustees to support their work with detailed answers and granular analysis of cashflows etc. it is important for trustee boards to be able to see how this might actually operate in practice.

Whilst well intentioned, and clearly driven in places by the need to close loopholes identified in historic problem cases, it is hard to read too much without thinking that there is a lot of work involved to meet these expectations. The focus towards best practice also risks dismissing positive steps such as informal parent/group support as worthless, and forcing trustees and employers into more extreme, confrontational positions through the valuation negotiation process.

Small, very well-funded schemes will almost inevitably point to proportionality as a reason to do very little. The challenge will be how less clear-cut cases find a suitable balance between these explicit expectations and a pragmatic solution, whilst maintaining a collaborative and mutually beneficial relationship with the employer.

Find out more

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