**New DB funding (covenant and investment!) regime**

# *Covenant action list for trustees: check your covenant support stands up in the new regime*

**February 2023**

In December 2022, The Pensions Regulator (TPR) published its draft Code of Practice on DB funding. This is the biggest shake up in DB pension scheme strategy for almost 20 years and there is a lot for trustees and also employers to consider.

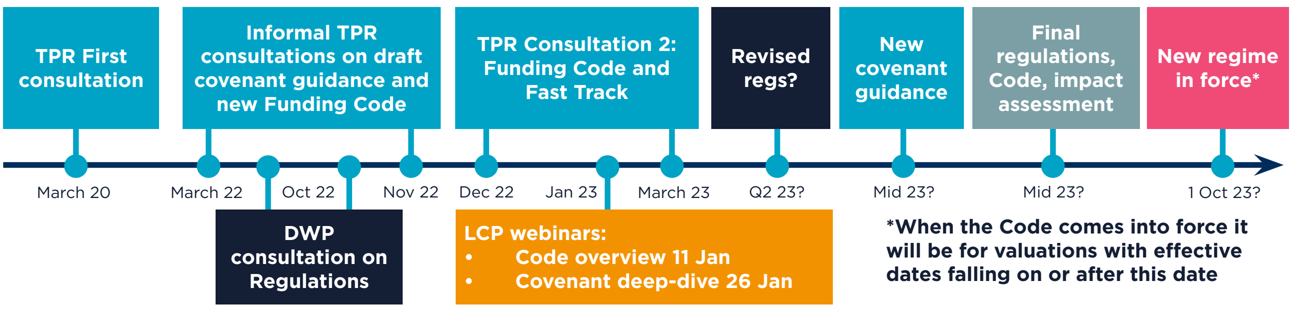
To help, our News Alert includes an overview of the Code consultation, our 11 January 2023 webinar walks through the detail and what it may mean in practice, and our 26 January 2023 webinar focuses on the new covenant requirements. We have also produced an action checklist to help you navigate the new regime as a whole.

This note focuses on the covenant related aspects of the new regime because it's clear that for many trustees a much greater focus on covenant strength will be required, including taking a more in depth view of an employer's future prospects.

## *Actions now – a 'covenant health check'*

- Confirm your legal covenant structure – which entities are the scheme's employers (and guarantors – see below) and what is the extent of their obligations. Eg in multi-employer schemes, what proportion of liabilities is each employer responsible for?
- What cash flows are being generated by your employer and for how long are these 'reliable'? This 'reliability' period is key in the new regime – it influences the investment risk your scheme can take, recovery plan length, and for open schemes what allowance can be made for new accrual.
- Take a view on likelihood of insolvency and what additional work may be needed to understand the impact.
- Consider carefully the terms of guarantees – do they meet the criteria of a 'look through' guarantee (being the gold standard under the new regime)? Most won't without some updates. What additional comfort does the guarantee provide – when can the support of the guarantor be called on and how strong is its ability to stand behind its commitments in those circumstances, which may be in a scenario where the employer has failed?
- Does the scheme have any other contingent assets in place? Is the legal route to access these clear and what could they be worth in the event they are called?
- Is the scheme being treated fairly (based on the draft Code wording) compared to the employer's other stakeholders or should steps be taken to address covenant leakage?
- Are your information sharing processes fit for purpose to meet the requirements of the new regime, in particular looking at employer prospects?
- If covenant advice is needed for the first time, or the current level of advice needs to be expanded, appoint appropriate advisors and start planning the work (you will probably need to comply with the principles of the new covenant guidance expected later in 2023 even if your next valuation isn't until later).

## *The timeline to the new regime*



## Actions at your scheme's first valuation under the new regime

- Kick off covenant work early and liaise with sponsors on the information required.
- Analyse employer forecasts and conclude on free cash flows potentially available to support the scheme.
- Establish covenant visibility, reliability and longevity periods.
- Consider covenant in the context of **integrated risk management:**
    - Covenant – based on cash flows, covenant reliability period and contingent assets, what level of risk can the covenant support?
    - Funding – what is your scheme's 'duration' and when do you expect the scheme to reach significant maturity? Is your covenant reliability period and deficit recovery plan consistent with this time frame?
    - Investment – is there sufficient headroom in affordability or through committed contingent assets to underwrite investment risks?
- Does the covenant need to be enhanced to underwrite scheme risks? If so consider guarantees or other contingent assets (or take action to reduce risk).
- If there is likely to be a large impact on your sponsor's business (eg more pension contributions, additional other support for the scheme, and/or new constraints on business activity), start a dialogue with the sponsor on this ASAP.
- Prepare covenant information to be disclosed in the Statement of Strategy.
- Fast Track versus Bespoke – which approach do you expect to follow? If Bespoke, consider what additional work and supporting documentation will be required on covenant.

## Related events and thought leadership

Webinar: The new DB funding code – the good, the bad and the (potentially) ugly

11 January 2023

Webinar: The new DB funding code – a whole new world for covenant advice

26 January 2023


On point paper: Missing the target: How over rigid pension scheme funding proposals could have unwelcome consequences

## Want to find out more?

If you would like further information, please contact your usual LCP adviser or one of the people below.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