

TPR publishes updated DB covenant guidance

What you need to know

- Following implementation of the funding and investment strategy regulations and the defined benefit (DB) funding code, The Pensions Regulator (TPR) has released its updated covenant guidance.
- Assessing covenant early in the process will be key for trustees and the first valuation under the new regime will play an important part in setting the long-term strategy of the scheme.
- TPR emphasises proportionality to ensure trustees consider the right level of detail, based on the covenant support provided and the scheme's position. Further insight is provided in the key areas of cash flow, reasonable affordability, periods of covenant reliance, contingent assets and supportable risk.
- The guidance also includes specific considerations for not-for-profit, multi-employer and limited affordability schemes.
- A number of worked examples are provided in the areas requiring trustee judgement, providing trustees with further detail on how covenant should be assessed.

Actions you can take

- **Review the scheme's existing covenant assessment against the new requirements.** Irrespective of the date of your next valuation, covenant assessment is a vital part of setting the scheme's strategy under the new rules and any implications should be considered early.
- **Consider the additional information requirements and begin dialogue with employers,** particularly where further information is required.
- **Review key areas where judgment is required,** including contingent asset support; consider taking legal advice in respect of guarantees.

Key elements of the updated guidance, at a glance

Key concepts	Brief summary of what this means
Reliability period	Timeframe whereby trustees can be reasonably certain that they can rely on an assessment of the employer's cash flows and prospects. TPR considers that most employers will only have reliability in the short to medium term i.e. three to six years however this may be extended, based on employer-specific circumstances.
Longevity period	Timeframe whereby the trustees can be reasonably certain that the employer will be able to continue to support the scheme. TPR considers that for most employers, longevity will not exceed 10 years; some may be able to demonstrate a longer period.
Reasonable affordability	Deficits must be recovered as soon as the employer can reasonably afford. Reasonable affordability should be assessed by reference to an employer's available cash, comprising cash flows and liquid, or readily recoverable, balance sheet assets.
Maximum affordable contributions	Defined as the employer's cash flows after reasonable adjustments have been made for alternative uses of cash and deficit reduction contributions (DRCs) payable to the scheme and other DB schemes sponsored by the employer. To the extent the employer has agreed to pay DRCs from its liquid assets, these amounts should also be included.
Supportable risk	Trustees need to consider the employer's capacity to support risk by assessing the maximum affordable contributions over the reliability period that would be available to fund a deterioration in the deficit and any contingent assets which would be available to the scheme in a scheme stress event.

The finer detail: the guidance in more detail

Identifying employers and their legal obligations to the scheme

Trustees should assess the obligations of each employer and may require legal advice. If an employer is not a statutory employer, it is important to determine its legal obligations to the scheme and therefore whether it is appropriate to take account of the employer when assessing the scheme's covenant. Trustees should also understand their powers under the scheme's trust deed and rules as well as the structure of the scheme e.g. whether it is multi-employer or last man standing.

Assessing cash flow

Cash flow analysis determines maximum affordable contributions and the level of risk tolerable over the journey plan. Trustees should focus on management's forecast cash flow information and review investment in sustainable growth as well as covenant leakage and any other discretionary payments. The reasonableness of the assumptions should be assessed as well as reviewing previous forecasts for accuracy.

Prospects

Assessment of the employer's prospects helps to define the reliability and longevity periods. In assessing prospects, trustees should consider a number of factors including market outlook, the employer's market position, strategic importance within the wider group, diversity of operations and ESG factors, as well as employer resilience and risk of an insolvency event.

Determining reliability and longevity

Reliability and longevity should be periodically assessed at each valuation. The trustees can judge the reliability period through sensitivity of employer forecasts as well as stress testing to understand the employer's ability to withstand downturns.

Contingent assets

To factor contingent assets into the covenant assessment, they must satisfy the 'relevant criteria' i.e. they must be legally enforceable and sufficient to provide the specified level of support when required. TPR considers a guarantor can be treated as a statutory employer when assessing covenant if the guarantee is 'look through'. If a guarantee is not 'look through', the trustees will need to assess whether it meets the relevant criteria and if it can be ascribed a value to support risk.

Recovery plans

Recovery plans should be repaid as soon as the employer can reasonably afford, based on employer cash flows and liquid assets. Recovery plans extending beyond the reliability period increase the risk of the employer not meeting future obligations. Trustees should assess the reasonableness of alternative uses of cash, taking into account the funding ratio and risk on a scheme-by-scheme basis. Additional guidance is provided for schemes with limited affordability.

Determining the covenant inputs to assess supportable risk

Trustees should ensure that both the existing deficit and any potential deficit from scheme related stress events can be covered over the reliability period. In assessing this, they should account for maximum affordable contributions (liquid assets should only be included if they are to fund DRCs over the reliability period) and any accessible contingent asset support.

Monitoring

The trustees should establish a robust monitoring framework including key risks. At a minimum, updates should be annual, with more frequent updates as required.

Find out more

For further information, please get in touch with **Arabella Slinger**, **Elen Watson** or speak to your usual XPS Group contact.



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