

Can employers avoid paying too much by leading on the covenant assessments?

The new covenant guidance and how this impacts journey planning provides an opportunity for employers to take control of the covenant assessment process. Employers who familiarise themselves with the new guidance can present a covenant picture to trustees for an optimal valuation outcome, resulting in a long-term strategy that better aligns the objectives of the employer and scheme.

This edition of XPS Express is the **fourth in a series on setting long-term strategies** - read part **one**, **two** and **three**.

At a glance

Employers have an opportunity to take control of the covenant assessment process as part of the crucial first valuation under the new regime, to present a picture to the trustees to set a long-term strategy for better outcomes.

A lack of engagement may result in higher contributions; employers can no longer afford to be passive in the process.

When using its powers for non-compliance, The Pensions Regulator will consider the covenant guidance, containing examples of covenant assessment.

Key new concepts include reliability period, over which risk is taken and deficits funded, and longevity period, which impacts time to funding on low-risk measures.

New covenant concepts

Time horizon	• Reliability period
	• Longevity period
Cash	• Reasonable affordability
	• Maximum affordable contributions
	• Supportable risk
Contingent assets	• Look through guarantee

See next page on how these concepts feed into valuation outcomes and journey planning.

Key risks for employers

Area	Key risks
Lack of information	Trustees may make more prudent assumptions resulting in higher funding requirements.
Value of contingent assets	Some contingent assets (e.g. without a funding trigger or non-look through guarantee) may not be sufficient, leading to de-risking and higher contributions.
Recovery plan length	Strong affordability and provision of a look through guarantee may result in a shorter recovery plan.

Actions employers should take

- 1. Take covenant advice. Start an early dialogue with trustees,** especially where the new requirements may lead to them taking a different view.
- 2. Prepare information for covenant assessment,** including clear financial forecasts and cash flow items. Consider sharing your view of the covenant with the trustees.
- 3. Review key areas where judgement is required,** including covenant reliance periods and contingent asset support; consider taking legal and covenant advice on guarantees.

XPS can provide you with a 'health check' to flag any potential issues early.

What the new covenant guidance means for you

The first valuation under the new regime will be critical for many employers as it will determine the strategy for the scheme going forwards and, once the strategy is set, it may be more difficult to change course.

We have shown two illustrative examples below on how engagement and information provision on covenant could feed through to very different valuation outcomes and long-term strategies.

	Lack of engagement 	Proactive engagement 
Covenant assessment outcome	Insufficient information results in more prudent assessment by trustees: • Reliability period: 3 years • Longevity period: 6 years • Supportable risk: £30m	Appropriate information sharing allowing for a more representative assessment: • Reliability period: 6 years • Longevity period: 10 years • Supportable risk: £70m
Valuation outcome	Deficit: £30m Recovery plan length: 3 years Implied contribution: £10m p.a.	Deficit: £20m Recovery plan length: 6 years Implied contribution: £3m p.a.
Long-term strategy	Investment strategy: gilts+1.5% derisking to gilts+0.5% by year 6	Investment strategy: gilts+2.0% derisking to gilts+0.75% by year 10

Your covenant checklist:

To maximise the assessment of your reliability and longevity periods, and supportable risk, employers should:

- ✓ Provide cash flow forecasts, including supporting evidence for assumptions
- ✓ Highlight your ability to address downside risk
- ✓ Clearly outline all planned alternative uses of cash and rationale
- ✓ Review any guarantee to understand value it provides and consider a look through guarantee or other contingent assets

We can help you understand:

- How trustees might view the covenant
- Where the key areas of discussion are likely to be
- How you can best present your case to the trustees to achieve the best valuation outcome

Upcoming valuations present a **significant opportunity for employers** to engage on their long-term strategies and align them with the wider corporate objectives.

Find out more

For further information, please get in touch with **Kelvin Xu, Charlotte Yuen or Dan Auton** or speak to your usual XPS Group contact.



Kelvin Xu
Partner, Covenant

 kelvin.xu@xpsgroup.com



Charlotte Yuen
Senior Consultant

 charlotte.yuen@xpsgroup.com



Dan Auton Head of
Corporate Solutions

 dan.auton@xpsgroup.com

© XPS Group 2024. XPS Pensions Consulting Limited, Registered No. 2459442. XPS Investment Limited, Registered No. 6242672. XPS Pensions Limited, Registered No. 3842603. XPS Administration Limited, Registered No. 9428346. XPS Pensions (RL) Limited, Registered No. 5817049. XPS Pensions (Trigon) Limited, Registered No. 12085392. Penfida Limited, Registered No. 8020393. All registered at: Phoenix House, 1 Station Hill, Reading, RG1 1NB.

XPS Investment Limited is authorised and regulated by the Financial Conduct Authority for investment and general insurance business (FCA Register No. 528774).

This communication is based on our understanding of the position as at the date shown. It should not be relied upon for detailed advice or taken as an authoritative statement of the law.