THE SOCIETY OF PENSION PROFESSIONALS
making pensions work

Covenant perspectives on the DB Funding Code:
opportunities, risks and myth busting

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Foreword

In August 2024, the Society of Pension Professionals (SPP) Covenant Committee produced a practical guide to the new DB Funding Code[1], explaining duties and requirements.

The Covenant Committee is keen to ensure pension professionals are not just aware of new requirements but also have an understanding of the many potential risks and opportunities that the new DB funding regime has created.

Many of these risks and opportunities can be linked to a number of common misconceptions or "myths" related to the detailed theory within the DB Funding Code or the way in which it will be applied in practice.

As our industry moves to apply the DB Funding Code theory in practice, this short paper looks to shed light on the various potential risks and opportunities by "busting" some of the myths along each stage of a scheme's funding and investment strategy journey, with a view to making life under the new regulatory framework as smooth as possible.

Jane Evans,
Immediate past Chair, SPP Covenant Committee

1 The DB Funding Regime: a practical guide to the new DB Funding Regime, August 2024: https://the-spp.co.uk/wp-content/uploads/SPP-DB-Funding-Regime-15.8.24-1.pdf?v=2001

Stage 1: Setting the long-term funding and investment strategy

Myth: "Covenant doesn't matter beyond low dependency"

Avoiding the misconception that "Covenant doesn't matter beyond low dependency" is essential. The Regulations and Funding Code place a great deal of focus on getting to a position of full funding on a low dependency basis. The journey beyond this point (whether running on or getting to the point of transferring to an insurer) is not mentioned in the Regulations and only briefly mentioned in the Funding Code as part of setting and agreeing the Long-Term Objective.

The Pensions Regulator (TPR) included the following paragraph in the Funding Code to remind us that covenant is the ultimate underpin and that risks remain even at low dependency: "As the regulations require trustees to target low dependency on the employer, not no dependency, even schemes that are fully funded on a low dependency funding basis at and after the relevant date remain exposed to covenant risk if funding levels deteriorate or if there were to be an unexpected employer insolvency event.". However, this one paragraph does not, in isolation, eliminate the risk that stakeholders become unduly focussed on reaching the low risk basis to the extent that the journey beyond and the support required/provided by covenant over that period is under-considered – tail risks will continue to exist until the final member payment is made.

Myth: "Schemes with good funding levels and/or low funding and investment risk don't need to look at covenant at all"

The Code states that "Trustees of schemes that have one or more of the following characteristics should be able to conclude that the risks being run are supportable without much analysis or a detailed covenant assessment, provided no material concerns with the scheme's covenant longevity are identified.

- The size of the employer is very large in comparison to the size of scheme.
- The scheme is already well-funded on a low dependency funding basis, solvency basis, or both.
- The journey plan relies on only a small amount of funding and investment risk being taken in the period before their relevant date."

In isolation, this specific wording could potentially set a low bar for covenant assessment in such circumstances ("covenant complacency"). However, the Code is clear that trustees will need to carry out a fuller assessment of the covenant and a more detailed analysis of the level of risk to allow for in the journey plan. Similarly, the Statement of Strategy requires trustees to confirm that "the strength of the employer covenant [is] adequate by reference to the actuarial valuation to which the funding and investments strategy relates?", which will be difficult to confirm without having done a proportionate level of analysis. The move towards a more principles-based, rather than prescriptive, approach regarding covenant analysis is helpful in allowing a proportionate approach to this analysis.

Myth: "There's no need to prepare for risk transfer until the employer is ready"

The need to have a long-term objective for the scheme agreed and documented could have employer group accounting implications, particularly for any schemes with employers with US parent entities. A stated aim of buy-out could cause some accounting headaches. This may mean that those employers will be more likely to choose "run on" as their stated Long-term Objective, at least up until the point that they actually want to transfer to an insurer. A sharp pivot from "run-on" to insurer might result in compressed timescales for transacting. This points towards trustees considering carrying out good housekeeping steps (e.g. data analysis and cleansing) and strategic planning regardless of the agreed long-term objective, in order to be ready at short notice if required.

Myth: "The Funding Code will lead to increased tension between the trustee and sponsor over the long-term objective"

The door is open to engage with employers on a longer-term plan – the requirement to agree the Funding and Investment strategy with the employer should be seen as a helpful and important opportunity to engage with an employer on its longer-term plans for the scheme in the context of its own longer-term business strategy. As a topic that an employer can sometimes seek to avoid discussing in detail for a variety of reasons e.g. focus on triennial valuation or lack of bandwidth to consider in the required level of detail within the business. This could be something to take advantage of.

Myth: "A solvency surplus must be considered through the same lens as the low dependency investment allocation"

The low dependency investment allocation (LDIA) requirements within the Funding Code do not apply in relation to the treatment of solvency surpluses. This does, therefore, represent an opportunity that should drive a lot of careful thought and structuring. Trustees and employers should look to assess the potential opportunity that a surplus offers for schemes, their members and the supporting employer(s).

Related to this, it is unclear how the Code is going to tie into policymakers repeated emphasis on the need for pension schemes to invest greater sums in UK productive assets. This appears to be both a risk and an opportunity, both for the government not to miss the opportunity to help meet its policy objective by securing an important pillar of investment for the UK economy, and for trustees not to be pushed towards inappropriate investment decisions and to invest in quality assets that are matched to the scheme's risk profile.

Stage 2: Triennial valuation – Fast Track or Bespoke

Myth: "Covenant is not relevant in Fast Track"

The lack of covenant metrics within the Fast Track (FT) criteria could give the impression that covenant is not relevant. However, trustees are still required to consider covenant by law and, ultimately, if a scheme's sponsor fails, the FT route does not protect members from a funding shortfall. In practice, the FT route will include reliance on covenant for contributions and an ongoing risk underpin, and the Statement of Strategy will require trustees to answer a specific question as to whether the covenant is "adequate" for the valuation. Trustees will not be able to answer this question without having considered covenant in a proportionate way.

Myth: "Covenant detriment doesn't matter as long as the scheme is in Fast Track"

There is a risk that employers use the scheme continuing to be in FT as a rationale for why a transaction/M&A/sale/disposal is not detrimental. In practice, the Valuation and Events regulatory frameworks are separate and the impact of an event on covenant should be considered on its own merit in line with TPR's Contribution Notice and Material Detriment tests. From a funding and investment strategy perspective, the impact of an event should also be considered on the ability of the covenant to support the strategy previously agreed with the employer.

Stage 3: Governance and Documentation, including the Statement of Strategy

Myth: "The need for all schemes to submit significant amounts of data to the Pensions Regulator is a significant and pointless task given lower average scheme risk levels, and could lead to increased tension with the sponsor"

In this new world of "big data", there is an opportunity for the regulator to have a clearer picture of the DB scheme universe, which should provide a platform to be more informed when it comes to industry-wide regulatory initiatives, as well as to be more targeted and pragmatic in its direct engagement with schemes. This should benefit schemes as well as the regulator itself.

There is scope to be pragmatic in the information provided (e.g. "at least x years" for periods of Covenant Reliability and Longevity) but this will require thought and engagement.

Myth: "Meeting Funding Code requirements is 'job done' regarding covenant"

The Statement of Strategy introduces the requirement to consider a number of covenant-related concepts (including Covenant Reliability and Covenant Longevity) and submit this information to TPR. However, this requirement does not necessarily mean that by following that process (including providing the required information) trustees will have adequately or appropriately considered the extent to which covenant supports their specific situation and strategy.

At every stage, trustees should be considering not only "what do we need to submit to the Regulator to satisfy their need for information" but also "what analysis will contribute to decisions that lead to the best outcome for members." In some cases this might be one and the same, but in many cases there will be analysis that goes above and beyond the minimum regulatory requirements that will lead to improved member security.

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About The Society of Pension Professionals

Founded in 1958 as the Society of Pension Consultants, today SPP is the representative body for a wide range of providers of pensions advice and services to schemes, trustees and employers. These include actuaries, accountants, lawyers, investment managers, administrators, professional trustees, covenant assessors, consultants and pension specialists.

Thousands of individuals and pension funds use the services of one or more of the SPP's members, including the overwhelming majority of the 500 largest UK pension funds.

The SPP seeks to harness the expertise of its 85 corporate members - who collectively employ over 15,000 pension professionals - to deliver a positive impact for savers, the pensions industry and its stakeholders including policymakers and regulators.

Further information

If you have any queries or require any further information about this discussion paper, please contact SPP Head of Policy & PR, Phil Hall phil.hall@the-spp.co.uk or telephone 07392 310264

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