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Covenant Facts, Fiction, and First Principles

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Foreword

In 2024, at the inception of the new DB Funding Code, the SPP Covenant Committee issued a short paper, *Covenant perspectives on the DB Funding Code: opportunities, risks and myth busting*¹.

Just over a year later, and with a bank vault worth of experience filled, that includes The Pensions Regulator (TPR) discussions and workshops, we are revisiting some of the myths as well as considering some new ones.

Also, whilst strong scheme funding positions typically persist, and the focus and extent of Covenant support has aligned with that, “first principles” continue to apply i.e. can the legal Covenant underpin the scheme’s risks now and in the future, up to the point where there is no further need for an employer?

Adrian Bourne
Co-Chair, SPP Covenant Committee



¹ SPP Paper, *Covenant perspectives on the DB Funding Code: opportunities, risks and myth busting*, November 2024: <https://the-spp.co.uk/wp-content/uploads/Covenant-Perspectives-on-DB-Funding-Code-SPP-November-2024.pdf>

Key messages

Just over a year into the new DB Funding Code, the landscape has shifted from apprehension to a more nuanced, opportunity-led environment. The "tensions" anticipated at the outset have largely been replaced by a broader menu of strategic options – ranging from traditional buy-outs to innovative run-on structures.

What remains clear is that Covenant is not a "box-ticking" exercise, nor does its relevance diminish as schemes reach low dependency.

Trustees should avoid the temptation to focus solely on Covenant through a compliance lens when the role of the Covenant adviser has evolved, as has recognition of the importance of Covenant in scheme strategy (every end game / strategy involves a covenant decision).

We are no longer just looking at a balance sheet; we are "translating" risk into a shared language that aligns trustees, sponsors, and their advisers.

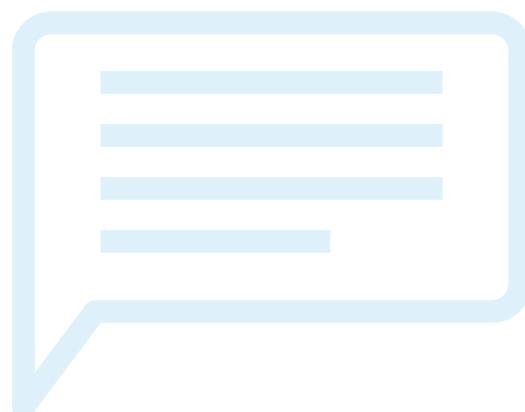
- > **Proportionality is Key:** Covenant advice is being "right-sized," ensuring that the depth of analysis remains commensurate with the scheme's actual reliance on the sponsor. Thoughtful scoping of covenant work is all about meaningful covenant insights that can help inform long-term strategy (with potential upside for members and sponsors), rather than just ticking the regulatory box
- > **Metrics are not Mandates:** While new tests like the 1-in-6-year VaR provide a helpful regulatory baseline, they are not the sole arbiters of risk. Professional judgment and a "broader lens" regarding liquid assets and supportable risk remain essential.

- > **Working together:** the valuation process is much smoother when everyone works together, even if that means sharing caveated numbers and working assumptions. Jointly educating stakeholders on the new regime can also help streamline the process
- > **Wait and See:** In a volatile, dynamic world where every end game strategy involves a covenant decision there may be merit in pausing and retaining flexibility. Rushing into a strategy for the sake of compliance may leave "higher rewards" for members and sponsors on the table.

In summary, the new Regime has affirmed Covenant's enduring relevance, with Covenant Professionals more adept than ever at quickly tuning into a Scheme's needs and providing on-point advice to ensure a balanced outcome for the benefit of all key stakeholders.



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Myth: “Covenant requires significantly more work and advice in the new funding regime”

To some, it may appear that Covenant assessment suddenly became far more complex, burdensome, and advice-intensive with the introduction of the new Funding Code.

However, this perception is largely a myth; in reality, the core nature and purpose of Covenant assessment has not fundamentally changed, and the apparent increase in workload is often a reflection of misunderstanding rather than a genuine change in requirements.

The new regime focuses on clarity, not complexity. The updated Code requires trustees to articulate their view of Covenant in a more systematic way, and link it clearly to funding decisions. This has been interpreted as meaning “more work” when in fact it is mainly better documentation and transparency. Trustees rightly already engaged with Covenant through employer engagement, financial monitoring, and scenario testing; the new requirements make those conversations and judgements explicit. Good advisers already provided this insight; the regime simply expects it to be clearly recorded.

Myth: “The Funding Code will lead to increased tension between the Trustee and sponsor over the long-term objective”

Just 18 months on and this myth has been properly dispelled! Perhaps in hindsight better to reword “tension” with “opportunity”?!

Helped by the plethora of processes and mechanisms for implementing long term objectives - from traditional buy-ins to more exotic run-ons under the auspices of a new sponsor – noting the “Stagecoach Aberdeen” transaction², never before has there been such a breadth of options for Trustees and schemes to consider. And the market continues to evolve.

The real challenge has become determining what is the best fit for a scheme from such choices, with key influencing factors including Trustee/sponsor motivation, sentiment and risk appetite.

It is important not to forget that there is now a statutory definition of “strength of the employer covenant” which underpins the funding and investment strategy, so clarity on the formal legal position is no longer a “nice to have”.

However, collective experience suggests that a clear understanding and appreciation of the tail risks, supported by a fresh perspective on the range of options now and coming into play can generate a positive mindset for adopting some of the more open-ended end games.

Trustees can be emboldened to adopt a more flexible approach with the Statement of Strategy obligations, recognising the ongoing value in the discussions and not necessarily committing to a strategy now, for the sake of “box ticking”.

Indeed, whilst some recent adverse legal judgments can, and consultations may hint at “new” liabilities that a buy-out could put to bed, those that adopt a wait and see approach, giving adequate time to reflect on multiple moving parts, have the very real potential to reap higher rewards for members and sponsors.

It is a time of opportunity and collaboration between all stakeholders. There are, of course, cases where the new Funding Code creates challenges but, on the whole, advisors and stakeholders are working together to find mutually acceptable solutions.

Myth: “Covenant doesn’t matter beyond low dependency”

In short, yes it very much does!

And in practice, experience firmly suggests that Trustees are benefitting hugely from at the very least a short and regular check-in on Covenant at bi-annual meetings, even where their scheme is low risk and low reliance.

The output may simply confirm what a Trustee already knows, but a third-party professional confirmation and perhaps a broader industry perspective has genuine value; and as much as anything keeping a finger on the Covenant pulse can help when there are more material events or bumps in the road to assess.

Moreover, most Covenant advisers are adept at right-sizing their advice according to the levels of reliance; with commensurate fees and proportionality providing a focus on the big issues of the sponsor, for example, “what moves the Covenant dial?”, is “coming down the road” and providing judgement on real and relevant “what if...” scenarios.

Trustees should work with their covenant advisers to ensure that a proportionate and pragmatic approach is taken, and sponsors will also benefit from taking time to understand what the new regime focuses on. In a very volatile world where the future is impossible to predict, they should not try. Rather, the new funding regime has created an enhanced environment where a more holistic view of a scheme’s risk which can be considered by Covenant assessors, actuaries and investment advisers who are all fluent in the same language.

That language extends to the concept of scheme risk.

² Aberdeen, “Aberdeen to take on Stagecoach group pension scheme” <https://www.aberdeenplc.com/en-gb/news/all-news/aberdeen-to-take-on-stagecoach-group-pension-scheme>

Fact: Value at Risk (VaR) has changed and remains a challenge for some

Historically, the more common approach to risk has been to consider a scheme's 1 in 20, one year Value at Risk (VaR) relative to the Covenant, but this has been reworked to fit with the new regime's fabric.

Now, a 1 in 6, VaR over the length of the reliability period, has replaced the previous concept as the simple regulatory minimum measured against the aforementioned Supportable Risk.

However, the relative haste with which this was included, aligning the VaR period to the reliability period, late in the Covenant Guidance process as compared to the core Guidance has caused some head scratching.

Whilst there is logic to it, a scheme's risks are far more dynamic and nuanced than this metric reflects. It is important to recognise that the "metric" is not necessarily the litmus nor decisive test of a scheme's risk profile. Indeed, different investment methodologies can give rise to materially different VaRs and broader scheme risks, including longevity, are not always captured within a single number.

Rather, the Regulatory test can be a reference point to support compliance considerations whilst also thinking more broadly about a scheme's risks, actuarial AND investment for the underlying Covenant.

Risks might be less constrained than say a six-year reliability period and may support a more nuanced and pragmatic view of Supportable Risk, as mentioned by the inclusion where appropriate of the liquid assets referenced below. Equally, it may include a more stringent view of risk for example reverting to the 1 in 20 VaR alongside a 1 in 200 VaR one year!

Myth: "Liquid assets cannot be taken into account when considering what supports a scheme's risk in a scheme stress event"

The new funding regime includes old concepts woven together by new terms – the requirement for a sponsor to be able to underpin a scheme's risks has been around since the dawn of Covenant.

Maximum Affordable Contributions (MAC) and certain types of contingent assets combine to form Supportable Risk, i.e. cashflows that could be applied to support a scheme stress event over its period of reliability.

What if a scheme risk event occurs in year three of say a six-year reliability period?

Cash that has been generated in years 1 and 2 could have been distributed "up the chain" or been pooled in group cash pooling arrangements.

Take for example the UK subsidiary of a Japanese parent. It has never paid a dividend. It has a material cash balance on the group cash pooling arrangement. It has been using this to fund a comprehensive restructuring of its operations and update the business to a new technology. During this period the Company is cashflow negative.

Is it realistic to say that any balance of this could not be drawn upon and applied to a scheme stress event in future funding discussions? And less certain than any future cashflows might?

The apparent inconsistency between treatment of liquid resources in calculating Supportable Risk versus setting a recovery plan needs careful thought to find pragmatic solutions.

Myth: "Assessing a sponsor's prospects is akin to Crystal Ball gazing so why bother?"

The available multi-year data charts and statistics at the fingertips of our actuarial and investment friends are the (mild!) envy of Covenant assessors.

This information deficit fuels the challenge as to how to assess a sponsor's prospects when there is a lack of reliable forecast information, in particular as regards the relevant cashflows when you are seeking to define a "reasonably certain" MAC and reliability period.

Legitimate Employer explanations for the deficit typically focus on a lack of entity information as compared to more relevant regional or business segment information prepared for management eyes.

Peering far into the future is fraught with multiple assumptions and raises the challenge as regards spurious accuracy, which in turn brings the cost benefit test of the work to the fore.

Undeterred by the advantages our learned friends enjoy, Covenant assessors are well versed in working with limited information and balancing compliance obligations with genuinely useful inputs, i.e. where to pragmatically draw the line. Armed with a wealth of experience to calibrate "reasonable certainty", this is an area where professional Covenant assessors offer helpful insight.

An assessment of prospects is not just about setting the periods of reliability and longevity. An initial assessment of the scale of the Covenant to a scheme's deficits and risks supports this and helps to determine where Covenant risk sits in the matrix of risks, and how much of the risk budget should be spent on it.

So for the avoidance of doubt, Covenant in funding and ongoing discussions is relevant regardless of the Bespoke, Fast Track and Low Risk categorisation, but what changes is the degree of relevance, which in turn flexes the scope and budget accordingly.

For example, a simple annual update on a buy-in provider's capital and credentials, can be added to a light-touch sponsor update to give the full Covenant picture, with the latter also helping to retain a view on what might well be the indemnity provider to Trustees if and when the scheme moves to a full buy-out.

This open mindset extends to Covenant and scheme/corporate events too, all of which should continue to be considered on their own merits in line with TPR's Contribution Notice and Material Detriment tests.

Wise Trustees will always set aside a budget for Covenant regardless of the risks!



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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 around 90 corporate members - who collectively employ over 20,000 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 the SPP's Director of Policy & PR, Phil Hall phil.hall@the-spp.co.uk or telephone 07392 310264

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