

It is now 20 years since the Pensions Act 2004 came into force and the words ‘employer covenant’ became part of the DB lexicon.

Over the past two decades the employer covenant advice market has evolved from an uncertain start into a core pillar of integrated risk management, with many DB trustees now regularly receiving external advice to inform valuations, monitor sponsor performance and assess the impact of corporate events.

Covenant advisers regularly participate in consultations with The Pensions Regulator (TPR), Department for Work and Pensions and other governing bodies. Many actively participate in industry groups like the Society for Pension Professionals and even have their own professional body – the Employer Covenant Practitioners Association – with more than 20 member firms.

In short, covenant assessment has become a critical element of effective DB management – a reality that is now enshrined in both legislation – the Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024 – and TPR’s new funding code, which together put the employer covenant at the heart of the funding framework.

And yet...

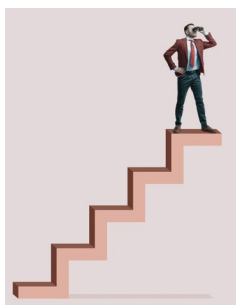
...this moment of recognition for the employer covenant industry comes at a time of great change in pensions.

In particular, the dramatic and sustained rise in UK gilt yields (from less than 1 per cent in 2021 to more than 4.5 per cent today) significantly improved funding levels, particularly those with fewer hedged assets.

At the same time, the new funding code emphasises the importance of proportionality in assessing covenant, particularly with reference to scheme funding. Whilst all trustees will be required to assess covenant under the new framework, the new code recognises

The future of covenant assessment

➤ **Employer Covenant Practitioners Association chair, Luke Hartley, explores the continued importance of the employer covenant throughout this period of great change**



that the extent to which schemes rely on covenant (e.g. for contributions) varies on a scheme-specific basis. Taken together with

TPR’s ‘fast track’ principles – that if met, result in a reduced level of regulatory oversight – the focus of covenant assessment for many trustees may change, moving away from short-term affordability towards a more holistic assessment of sponsor prospects and ability to underwrite downside risk.

Improved funding has also put many schemes within sight of their ‘endgame’ with trustees actively considering the long-term options for members. While we have seen record numbers of buyouts in recent years, an ‘ASAP’ risk-transfer to an insurer is not the only game in town. The first ‘superfund’, Clara Pensions, has now completed several deals and new providers are expected to enter the market. More widely, many trustees are considering run-on strategies as they address historical data issues, illiquid investments or even contemplate surplus release flexibilities set out in the Pension Schemes Bill.

So what does all this mean for the employer covenant?

The legislative and regulatory requirement to assess covenant has never been greater, yet trustee and sponsor

needs are changing as funding improves and new flexibilities are presented.

Accordingly covenant assessment is evolving, with advice becoming more tailored to the circumstances of the sponsor, scheme and its funding journey.

While many trustees will continue to require support in assessing the affordability of contributions or the impact of corporate events, others will be looking to understand the ability of their sponsor to underwrite their agreed run-on strategy, or the relative merits of various risk transfer options versus current sponsor support. To maximise the benefit of covenant advice, trustees and sponsors may wish to consider:

- working with your advisers to agree how covenant advice can be focused on the areas of greatest benefit, such as short-term affordability or sponsor longevity;
- taking the time to critically consider scheme specific objectives and risks, and considering the extent to which these are supported by covenant; and
- moving away from “how strong is my covenant?” to questions such as “does covenant underwrite the risk in the journey plan?” or “what risks are facing the sponsor over the next five years?”.

The covenant industry is already embracing this new approach; supporting its clients as trusted advisers and helping them to navigate new regulations, complex funding journeys and multifaceted corporate events.

➤ **Written by Employer Covenant Practitioners Association chair, Luke Hartley**