Employer covenant: A new dawn

Summary
- Increased funding levels across the DB landscape has prompted a shift to a longer-term view on the role of the employer covenant.
- Recent regulation has placed covenant at the heart of investment strategies, underscoring its significance.
- Recent market innovations, such as superfunds, have provided schemes with weaker sponsors more options when it comes to the DB endgame journey.
- Maintaining a close relationship between trustees and sponsors and working towards the same goal is key to navigating covenant considerations.

Market shifts, including increased funding levels and new regulations, are prompting DB schemes to reassess the role of the employer covenant in their endgame strategies

The employer covenant – the employer's legal commitment and financial ability to support their DB scheme now and in the future – has long been a cornerstone of DB pension scheme security.

Its significance has further grown since The Pensions Regulator's recent update guidance for trustees on assessing employer covenants. Not only does this guidance represent the final piece in the new DB funding regime introduced earlier last year, it also underscores the regulator's heightened focus on the covenant's role.

Impact of improved funding levels

As funding levels for DB schemes have increased, trustees and sponsors now have greater confidence in the financial stability of their schemes. This has led to shift from a reactive approach – focused on addressing immediate funding shortfalls – to a more forward-looking strategy.

This change has also been reflected in how schemes are looking at covenant. BESTrustees professional trustee, Zahir Fazal, says there is a greater recognition of the need to consider a longer period, which has created a much more sophisticated assessment of the covenant now.

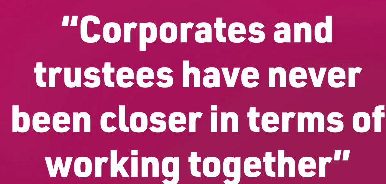
"What is the strength of the company? What is the affordability? What is its cashflow? What is it likely to be X years in the future? Now whether that X is three or six or 10 years is up for debate, but it's certainly a much more forward-looking curve," he says.

Clara Pensions chief transaction officer, Matt Wilmington, agrees that trustees must look beyond the current state of the covenant and funding levels, considering how they may evolve over the long term. This shift in perspective has further highlighted the growing importance of the covenant.

"We're in a relatively new world of scheme funding looking good. It's not been that long since it wasn't looking very good. Shock events could move either way. So, it remains absolutely critical in trustee and corporate thinking in terms of looking after the members," he says.

While improvements in funding levels may have reduced near-term requirements of the covenant, XPS Group head of covenant advisory, Arabella Slinger, adds that the advent of the funding and investment strategy regulations, together with the funding code and covenant guidance, has emphasised its significance for DB schemes and their approach to their strategic journey.

"The regulations have put covenant at the heart of the scheme's journey in



terms of how much risk you can support and which investment strategy your scheme should be running. Start at the end and work backwards – where do you want to get to, how quickly do you need to get there, and what level of risk you can support along the way. All of that hinges on covenant," she says.

Approaches for weak versus strong covenant

With the influence of the covenant strength on how DB schemes approach their endgame journey remaining strong, schemes with a strong covenant continue to take a different approach compared to those with a weaker covenant.

Although funding levels have improved, weak covenants persist. In fact, PwC head of employer covenant, Mark Jennings, notes that the market remains particularly difficult and is likely to stay that way in the coming years, particularly with the impact of the National Insurance increase from the last Budget. This will significantly affect many businesses, meaning that a considerable number of schemes with weak covenants are still in play.

Wilmington says that schemes with a weak sponsor did not use to have many options in terms of their approach to endgame journeys.

"In the past, the options weren't very varied. They could really sit and wait, or they could move to an insurer. But if a sponsor has a weak covenant, it's unlikely to have the funding available to be able to get it to insure if it isn't already there," he says.

However, in recent years, particularly since the significant changes that came about from the liability-driven investment (LDI) crisis, the pension market has seen a wave of innovation,

which has been positive for schemes with weak sponsors.

"The weaker schemes, with employers that can't support them, are now able to assess a range of options with the advent of consolidators, like Clara, and different capital-backed options with the key being to understand what they do and do not provide," Slinger says.

Jennings agrees, adding that schemes with weak covenants also have the option of going to the insurance market and buying out, as well as doing insurance risk transfers.

Indeed, Clara's first two transactions with Sears and Debenhams proved the role of superfunds providing additional benefits and security to schemes that didn't really have a sponsor at all, according to Wilmington.

"For schemes with stronger covenant, it's a little bit different and makes decision making easier because you have the option of running on and being able to rely on that sponsor covenant as a long-term protection piece," Wilmington says.

While covenant strength provides flexibility, Wilmington notes that with the success of more recent market innovations has led even some schemes with strong sponsors to explore options from insurers and superfunds, which can provide real capital.

In fact, Clara's third and most recent superfund transaction with Wates Group demonstrated this, as this transaction marked the first transaction completed with an active sponsor.

Navigating covenant considerations

With the shift in focus to long term and increase in options available for both schemes with a weaker covenant and stronger covenant, the importance of the relationship between trustees and sponsors has been heightened.

Fazal emphasises the importance of maintaining the relationship, despite challenges that might arise.

"Yes, there will be tensions and differences of opinion, but if you can establish that you're looking to the same goal, and that's to look after the members and fulfil the pension promise, but closer you can work together the better," he says.

This relationship is particularly important now because going forward there will be quite a significant change in the way assessors view the covenant therefore the information requirements from the company are going to be perhaps more demanding and more forward-looking, he adds.

Fortunately, over the past few years trustees and sponsors have been working closer together more and more, especially as they recognise that they are working towards the same goal, Jennings adds.

"Corporates and trustees have never been closer in terms of working together. One of the reasons for that is everybody recognises they usually get a better result if everybody's working together to achieve the same aim," he says.

Wilmington agrees, adding that working towards the same goals remains the case no matter how strong the covenant is.

"Some ambitions are aligned in that the trustees have a fiduciary duty to make sure that members are paid but it's kind of easy to forget that even a weak sponsor wants to make sure everybody's pensions continue to be paid. So actually, interests are very much aligned from with a weak sponsor. Interests are very much aligned with a strong sponsor as well," he says.

Written by Niamh Smith, a freelance journalist