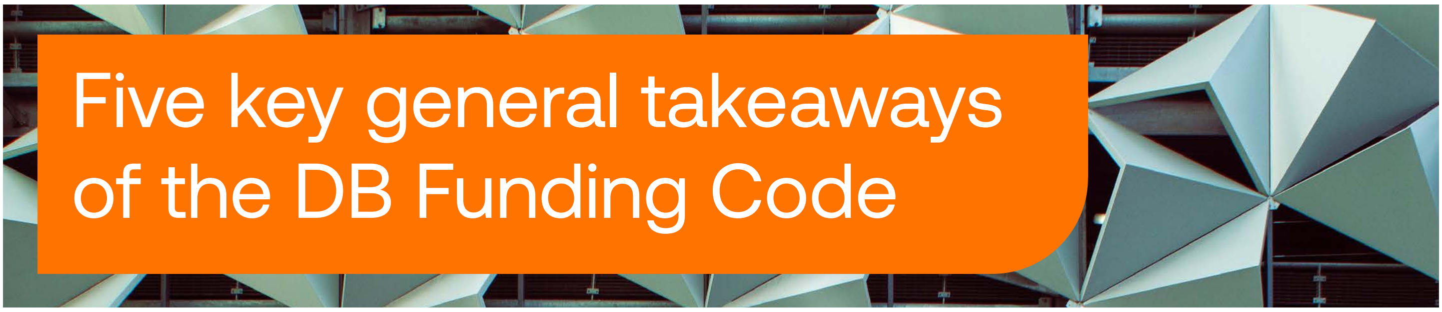
Covenant Quarterly
Q3 2024



Five key general takeaways of the DB Funding Code

The Defined Benefit (DB) Funding Code was finally laid in Parliament on 29 July 2024, providing the industry with helpful visibility over its contents ahead of 22 September 2024 – the date after which valuations will need to abide by the new Funding and Investment Strategy Regulations (the "Regulations"). We have set out five key general takeaways of the Funding Code below.

1. **An understanding of covenant remains absolutely vital regardless of funding levels –** The Funding Code reflects the new legal requirement for trustees to consider covenant as part of setting a scheme's funding and investment strategy. Employer covenant should underpin a scheme's ability to meet its funding objectives and manage risks effectively, helping to determine the journey plan and appropriateness of a valuation basis (i.e., Fast Track or Bespoke). Further, the consideration of covenant extends beyond the point of full funding on a low-risk basis – low dependency on covenant does not mean no dependency.

2. **Covenant approach updated with some new concepts –** The Funding Code sets out what an assessment of covenant should consider (cash flow, contingent assets and employer prospects), how it should be considered (relative to the scheme's funding position and level of funding and investment risk) and when it should be considered (at each valuation, with regular monitoring in the interim, and on a light-touch basis beyond the point of full funding on a low risk basis). The Pensions Regulator (TPR) has also introduced two new concepts – the period of covenant reliability (informing the recovery plan length and period over which higher investment and funding risks can be taken) and the period of covenant longevity (informing the transition to low dependency).

3. **Long-term planning is the name of the game –** The Regulations have now made it a legal requirement to put in place a long-term strategy, agreed with the employer, that targets full funding on a low dependency basis by the time the scheme is "significantly mature". The definition of "long-term planning" extends from agreeing how to provide benefits over the long-term (the "long-term objective") to setting a low-dependency funding target and formulating a journey plan that reflects covenant strength and scheme maturity.

4. **Valuations will follow the twin-track approach as expected –** The Funding Code confirms the use of the twin-track approach for scheme valuations, broadly in line with that set out in the December 2022 consultation. Trustees will choose between "Fast Track" and "Bespoke" – whichever approach is used, it must be consistent with the funding and investment strategy set as part of the longer-term planning process and supported by the assessment of covenant.

5. **"Documentation, Documentation, Documentation" –** The Regulations have introduced a new requirement to prepare a written Statement of Strategy which records a scheme's funding and investment strategy and various other supplementary matters. Trustees will likely require input from advisers when it comes to the data to be submitted to TPR as part of the Statement of Strategy. It will be important to keep focus on the purpose of covenant and the risks to covenant amidst this ever-increasing administrative burden.

No matter the position of your scheme, it is important to get up to speed on the key new requirements ahead of further detail coming later this year in the form of the covenant guidance and final Statement of Strategy details.

It would be easy to get bogged down in the detail of meeting regulatory requirements and miss what is really important. As we celebrate the 20th birthday of the covenant industry (20 years on from the Pensions Act 2004), we have found it helpful to reflect on the lessons of the past, and how this informs our future approach. Click here to watch a short video: **20 Years of Covenant: Past Lessons. Present and Future Considerations**

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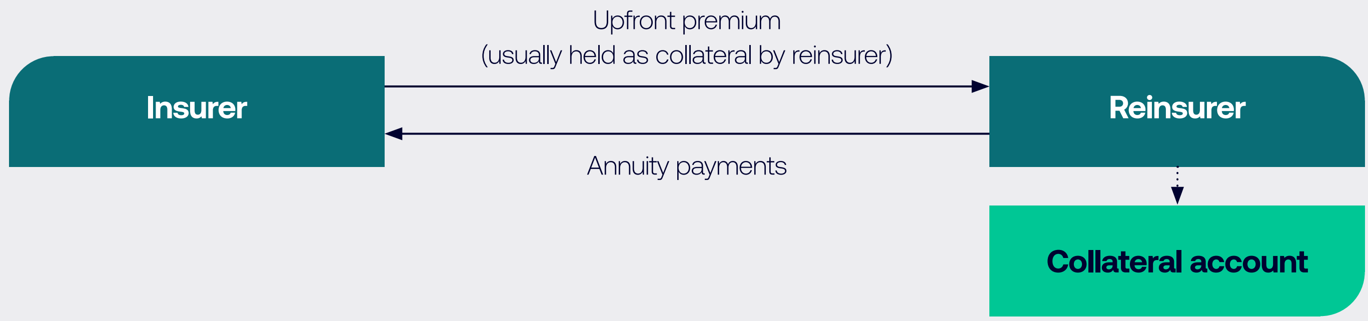
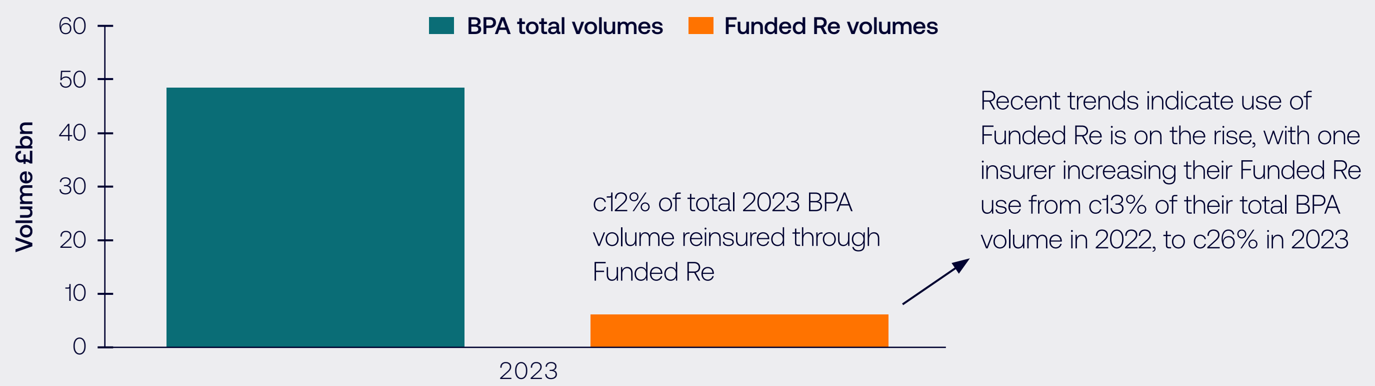
DataWatch:
Funded Reinsurance in the pensions industry

Funded reinsurance (Funded Re) has been a hot topic in the bulk annuity market for the last couple of years. Funded Re involves an insurer transferring a portion of a bulk annuity transaction premium to a reinsurer, thereby reinsuring the associated longevity and asset risk – essentially, it's a collateralised buy-in between an insurer and a reinsurer.



Source: Cardano

The use of Funded Re has increased significantly in recent years, although detailed public disclosure on the level of use remains limited. Of the £49bn of total bulk purchase annuity (BPA) business written in 2023, c.£6bn (12%) was reinsured through Funded Re. Whilst concrete numbers on the level of use in 2022 is unclear, it will likely have been significantly lower.



Funded Re can help an insurer manage its capital position and asset sourcing, but they are bespoke and complex structures and come with meaningful risks which require careful management. The Prudential Regulation Authority (PRA) has recently issued a policy statement on Funded Re – in the eyes of the insurance regulator, UK BPA insurers need to improve the way they manage the risks associated with their use of Funded Re. The PRA's policy statement includes a comprehensive and stringent set of expectations on how it expects insurers to manage these risks. The PRA has made it clear that if insurers do not comply with these expectations it will not shy away from stepping in - for example, to restrict the use of Funded Re, or to force insurers to set aside more capital. Insurers have until 31 October 2024 to submit information to the PRA to allow the PRA to determine if the insurers are deemed to be compliant.

In using Funded Re, the member benefit underpin is transferred away from the 'fronting' insurer and across to the reinsurer. Given insurers' increased use and the level of risks associated with Funded Re structures, any pension scheme looking to do a buy-in with an insurer should undertake a financial strength review of their selected insurer to understand whether the insurer intends to use Funded Re (and how the risks are managed).

Ask the Analyst: Marrying Artificial Intelligence (AI) and the human touch

While the risks and benefits of widespread AI adoption can be debated, there are many opportunities presented by recent improvements in the quality and accessibility of AI that could help to evolve the DB pensions landscape. Staying ahead of this curve, we've developed Discover. Discover provides a dynamic solution to a suite of industry professionals by using AI capabilities to provide assessments and monitoring of covenant in an efficient and proportionate way.

We believe that AI can be deployed to reduce the administrative burden of running DB pension schemes, and we are actively working with our client base to leverage these advantages to help achieve operational efficiencies and cost savings, while ensuring that good governance does not suffer as a result.

AI tools, like Discover, are changing how covenant advice can be delivered, but the importance of human relationships in the industry remains paramount in order to provide the contextual overlay to help trustees' understanding of covenant.

Recognising this, we've begun actively facilitating team events with industry professionals to discuss developments around AI, recent changes to DB pensions regulation and more general covenant matters. These events serve the purpose of building and developing our relationships across the industry, which remain essential for trust and collaboration across the sector, while also providing an enjoyable setting that computer generated reports and AI cannot (currently) provide.

The integration of AI into our advice, while maintaining a human approach both embraces the new and retains the strength of the old.

Thomas Oke
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Regulatory developments: TPR's Superfund Guidance

TPR released updated guidance in July which represents a major step forward in the developing market for Superfunds (and Capital Backed Arrangements), which provides important new options for companies and trustees looking to provide better outcomes for their members in a cost-effective way.

In its new guidance, TPR has:

1. taken action to address some of the aspects of the Superfund guidance that inhibited the development of Superfunds; and
2. opened up new flexibilities for trustees facing difficult decisions when their sponsor becomes insolvent

The guidance gives clarity on allowing a Superfund to distribute returns to its investors (akin to how an insurer would pay dividends to shareholders) which should improve pricing for pension funds, while also making the structure more appealing to a wider range of investors. This will need regulatory oversight and strong governance, but it could encourage entrants into the market and increase competition.

TPR has also seen merit in relaxing the capital requirement for capital backed providers / Superfunds looking to rescue pension funds from the Pension Protection Fund (PPF). TPR is effectively giving trustees more tools to manage employer insolvency risk. In practice, with the number of cases entering PPF assessment at record lows, our sense is this move could end up supporting the contingency plans that enable trustees to run-on their pension schemes.

There are still some areas in the guidance which require further consideration, particularly how the discount rate for Superfunds' technical provisions is set and reviewed. There also remains the wider question of the different regimes insurers and Superfunds operate under which can make it hard for trustees and companies to compare the two routes. Overall, TPR has reaffirmed its support for industry innovation with this guidance that is likely to accelerate the pace at which the DB pension fund market consolidates. Aspects of the guidance remain a work in progress and require further discussion, but it's a positive step for the industry as whole.

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