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Covenant Quarterly
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Discover: AI powered covenant

Complexity and cost often put traditional covenant assessments out of reach for smaller schemes or scheme sections. This can be a problem given the importance of covenant to member outcomes, increased focus from The Pensions Regulator (TPR) on covenant, and draft DWP legislation requiring trustees to assess covenant strength.

Data and modern artificial intelligence techniques can be a solution for this problem, providing the type of high-level covenant input and analytics more appropriate for these smaller schemes or scheme sections. Such an AI covenant tool should:

1. Start with a comprehensive database of covenant assessments and all the variables underlying each covenant rating, and use machine learning to analyse which factors are typically the key drivers and need to be considered for a streamlined approach;

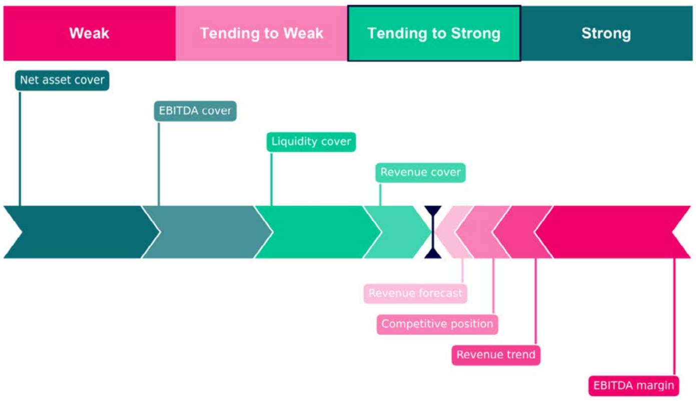
2. Use a model to replicate rating classifications not only based on quantitative metrics, but also the forward-looking qualitative metrics that are crucial to understanding covenant strength; and

3. Illuminate the 'black box' AI model, to provide not only a covenant rating, but also identify the underlying drivers – these are often key to informing next steps, negotiations, or monitoring.

At Cardano, we have followed such an approach to develop Discover – our AI powered covenant analytics solution. Discover provides an employer covenant rating, examines the main drivers underlying the rating, benchmarks rating metrics, and provides corresponding recommendations.

Discover has been designed for schemes with assets less than £50m and simple covenant structures, or for sectionalised or non-associated multi-employer schemes, including local government pension schemes (LGPS).

Discover provides covenant ratings and rating drivers



Launching Discover is a significant and exciting step towards modernisation within the pensions industry, harnessing our wealth of data (capturing 300+ years of combined covenant experience) with new technology to build cost-effective tools and solutions for schemes. Discover gives comfort that employer covenant views have been externally validated, supports triennial valuations, scheme return submissions, ongoing monitoring, and can also be utilised to explore 'what-if' scenarios, for example, an improvement in a sponsor's trading or an increase in its debt.

Find out more on covenant analytics or Discover, here.

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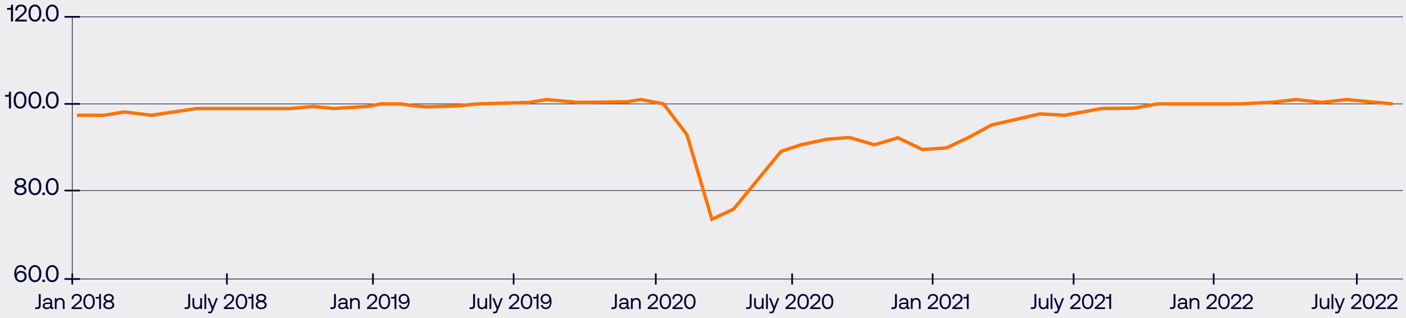
Datawatch: UK GDP trends

Monthly GDP



The UK economy has steadily recovered from the economic impact of the COVID-19 pandemic with economic growth observed in 2021 and forecast for 2022. However, market consensus indicates that GDP is expected to stagnate in 2023 and GDP fell by 0.6% during September 2022. A near-term recession appears increasingly likely and the Bank of England has warned that the UK risks being plunged into the longest recession in 100 years.

A recession will have a number of material impacts for sponsors; particularly those in cyclical industries that are exposed to increased risk in recessionary environments. Such sponsors are likely to face a liquidity strain which may restrict their capacity to fund pension obligations. Concurrently, businesses may be required to restructure their operations and defer capital expenditure which is likely to hinder near-term growth. We therefore recommend close engagement with your sponsor to fully understand the implications of these developments over the months ahead.

Ask the Analyst: How should I be thinking about covenant in the context of recent gilt yield volatility?

The recent and unprecedented movement in gilts yields, in response to the 'mini budget' on 23 September, resulted in a major liquidity crisis for the majority of UK DB pension schemes. In a bid to maintain hedges, liquid assets (both matching and growth) were sold to meet collateral calls required under Liability Driven Investment (LDI) strategies.

Despite intervention by the Bank of England to stabilise markets, some schemes had their hedges cut and funding levels were impacted. Whilst investment strategy and scheme liquidity are top of the agenda for many trustees right now, covenant remains the ultimate underpin for all scheme risks and therefore needs to be considered.

A decision taken to reduce scheme leverage of unfunded schemes will likely necessitate a reduction in growth assets; this will result in increased reliance on the covenant, either through a requirement to extend the journey plan or to pay increased contributions.

As the markets begin to settle, now is the time you should reflect on how your scheme was impacted by recent events. This knowledge should then be leveraged to future proof your scheme; in this context, we recommend trustees take the following steps:

1. Consider the covenant when making difficult decisions. The trade-off between a higher growth investment strategy and longer-term covenant reliance needs to be considered.

2. Consider whether your sponsor could help you with future liquidity requirements, particularly in relation to illiquid assets. Given the depleted economic outlook, we recommend that these conversations are started early and factored into any downside scenario planning.

3. Plan for the future. Sponsors will want reassurance that LDI strategies are fit for purpose, particularly if they were called upon to provide funding. Consider a Cardano LDI Healthcheck. Recent events provide an opportunity to reflect on your journey plan and investment strategy, both in the context of risk and liquidity.

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Regulatory developments: Covenant front and centre within draft Occupational Pension Schemes Regulations 2023

The draft regulations introduce a number of concepts and requirements that schemes should prepare for ahead of implementation in Autumn 2023. Some of the most significant points worth noting within the draft regulations include:

1. **Covenant:** A definition of covenant is now included within legislation; it will now be a legal requirement for the requirement for funding and investment strategies to be set, first and foremost, with reference to covenant.

2. **Statement of strategy:** This approach to funding and investment will need to be set out in a statement of strategy to be written by the scheme chair and submitted to TPR no less frequently than at each valuation.

3. **'Significant maturity':** The regulations formalise the idea of longer-term thinking that has been set out in regulatory guidance for some time, with all schemes expected to reach full funding on a low dependency basis by the 'relevant date' – which means the point of 'significant maturity'. While the specific date for 'significant maturity' will not be specific in the regulations, it was noted in the consultation that a 12 year duration is understood to be set out in the draft revised Code of Practice. This is at the lower end of the 12-14 year bookends provided in the Funding Code consultation in 2020.

4. **Recovery plans:** Trustees, when determining whether a recovery plan is appropriate, will be expected to follow the principle that 'funding deficits should be recovered as soon as the sponsoring employer can reasonably afford' as part of relevant considerations for recovery plans.

A scheme's journey plan sets out the path to achieve its end goal, while integrated risk management (IRM) refers to the need for trustee decision making to consider risks across covenant, investment, and funding. The draft regulations outline the need for trustees to set a defined journey plan to a point of low dependency on the employer covenant by the time a scheme reaches significant maturity. We believe this is the right thing to do in terms of seeking to support trustees and employers in planning their scheme funding over the longer term. We are also supportive of the intention to improve risk management through covenant-driven investment and funding strategies, and a long-term objective of reducing reliance on covenant.

It is essential that as part of any shift to longer-term planning, a clear understanding of how covenant can underwrite contributions and investment risk is obtained. This should supplement an understanding of how covenant visibility shapes an appropriate balance of investment return and contributions over the period to the scheme's long-term objective. A scheme will remain reliant on its sponsor far beyond the point of low dependency, so a meaningful view of covenant reliability over the long-term is also fundamental to longer-term thinking.

Once the journey plan is set, scenario planning is key to effective risk management, so trustees can remain vigilant to potential downside risks and be ready to adjust the scheme's strategy if circumstances change.

While it is our understanding that well-run schemes, making sensible funding and investment decisions, are not expected to have to make big changes, there are some potential unintended consequences of the draft regulations and we will see whether DWP adjusts the final version based on market-wide feedback. Ahead of then, look out for the upcoming Funding Code of Practice consultation due out before the end of the year!

For more detail, see our full response, including consultation submission, **here**.

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