TPR's New Covenant Guidance

Key considerations and impacts

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TPR's Covenant Guidance

Top 8 Headlines for Trustees and Sponsors

The way covenant should be considered as part of funding, investment and journey planning has changed with TPR's recent publication of its new Covenant Guidance. Isio Covenant Solutions ("ICS") helps sponsors and trustees understand what the new regulatory guidance means for them.

This overview will help you understand the new key covenant concepts and some of the covenant challenges and opportunities.

We can support by advising on the implications for investment, funding, end game options, risk management and corporate restructuring or transactions.

Top Headlines

Cash flow is King!

Trustees need to assess the employer's 'reasonably certain' cash generation. This will then be the foundation justifying scheme strategy for deficit repair and the level of supportable scheme investment and funding risk.

The prescriptive approach in the guidance sets a higher expectation of how this is assessed and documented.

Covenant Ratings are out, Covenant Reliability and Longevity are in.

These two metrics will underpin journey planning and supportable risk negotiations (see also key concept explanations on page 4)

These judgemental assessments will create a limitation for Scheme strategy. They are likely to be a key area of employer/ trustee debate, so justifying assumptions will be critical.

"Where a scheme is in deficit on a technical provisions basis, a recovery plan should be put in place to recover this deficit as soon as the employer can reasonably afford."

TPR has been prescriptive on how covenant is assessed.

The specific terms and details in agreements will change the recognition and impact on strategy of:

- contingent assets;
- employer investment in growth;
- an employer's "available liquid assets".

Cash flow forecasts and employer prospects will drive the shape of recovery plans and scheme strategy.

Where there is volatility or uncertainty in the forecasts or a lack of forecasts to rely upon, TPR expects an increased focus on eliminating deficits, reducing risk, and obtaining contingent asset support.

Where cash flow projections are unavailable a proportionate, pragmatic approach will be necessary. However, "where there is a high level of covenant reliance in place, it is unlikely to be reasonable to rely on proxies" such as adjusted profit before tax or adjusted EBITDA.

TPR's Covenant Guidance

Top 8 Headlines for Trustees and Sponsors (continued)

Top Headlines

Equitability and fairness remain key concepts through evaluation of "reasonableness of alternative uses of cash".

This will include consideration of investments in sustainable growth, dividends, discretionary creditor payments and contributions to other DB schemes.

Stress testing and sensitising employer cash flows is necessary to assess supportable risk.

This requires a robust commercial understanding of the business, contingent asset values and the risk profiles of both the employer and scheme. Employer input is critical to form a balanced view.

TPR describes that independent covenant advice is necessary where the trustees do not have the necessary objectivity or expertise, where covenant is complex, or where working with incomplete or imperfect information.

Contingent assets are TPR's default mitigation for covenant or funding risk where cash is constrained.

There will be a commercial balance to strike in negotiating proportionate, commercial arrangements within the guidance.

Covenant monitoring is expected at least annually – and not just a verbal update from management.

TPR expects Trustees to conduct regular reviews of employer covenant and contingent asset values.

Once a scheme has reached full funding on a low dependency basis, the focus should be on covenant longevity and any material risks that could lead to the scheme not providing promised benefits to members.

Please contact us if you have any questions.

We are pleased to offer client training and support.

TPR's Covenant Guidance

Key concepts you need to know

The following are the key covenant concepts that underpin TPR's new DB Funding Code and Covenant Guidance.

Isio Covenant Solutions ("ICS") can deliver specialist training to help trustees and sponsors understand the implications and nuance of the new Guidance. We can also provide clients with an initial assessment of what the Guidance could mean for their employer covenant.

Key Concepts

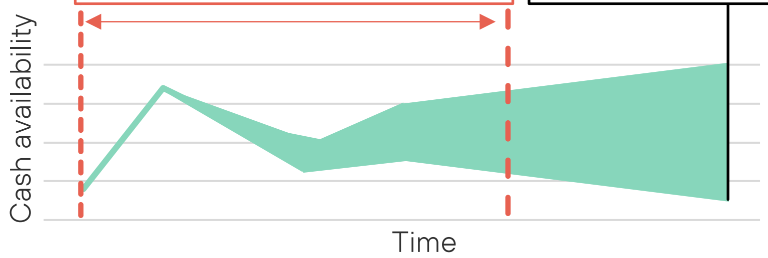
Reliability & Longevity periods

These are new terms and regulatory concepts but not new principles for many schemes. Subjective, informed judgements will underpin the determination of these periods. They will then need to be reported to TPR.

The assessment of Employer Prospects will be a key driver, with relevant factors different for individual schemes, but likely including consideration of some or all of:

Reliability over available cash – typically medium term where there is reasonable certainty of available cash to fund the scheme, e.g. TPR illustration up to 6 years.

Longevity – the maximum period the employer can be reasonably relied upon to support the scheme, e.g. 10-12 years.



1. Market outlook
2. Employer's market position
3. Resilience of the employer
4. Diversity of operations
5. Future development of the employer's business (incl ESG)
6. Risk of employer insolvency

Supportability Principle

The level of funding and notional investment risk should be set in line with the level of available covenant support and the maturity of the scheme.

Available Cash

All cash and liquid assets available at the time of agreeing the recovery plan. This is used to determine Deficit Repair Contributions (DRCs) and fairness through consideration of reasonable alternative uses of cash.

Reasonable Affordability

TPR prescribes the following approach to determining reasonable affordability of deficit repair contributions.

Consideration 1	Consideration 2	Consideration 3
Employer's Available Cash Flow	Reliability of Employer's Cash Flow	Reasonable Alternative Uses
• Cash flows; and • Liquid assets	• Trading and working capital cycles • Certainty of cash flow • Stress testing and sensitivities	• Investment in sustainable growth • Covenant leakage; and • Discretionary payments to other creditors.

Where a third party has provided a 'look-through' guarantee, trustees should additionally assess reasonably affordability of DRCs from the guarantor. 'Look-through' is a new concept under the guidance, and TPR has detailed 7 conditions which need to be met for the guarantee to qualify.

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Key concepts you need to know (continued)

The following are the key covenant concepts that underpin TPR's new DB Funding Code and Covenant Guidance.

Key Concepts

Maximum affordable contributions

The employer's cash flows that could and would be available to the scheme if there was a scheme stress event, and therefore when an increased deficit would need to be rectified through cash payments to the scheme.

Recovery plan

A **TP deficit** must be repaired as soon as the employer can reasonably afford. In determining DRCs under a recovery plan, the trustees **must** consider an employer's sustainable growth investment and may consider:

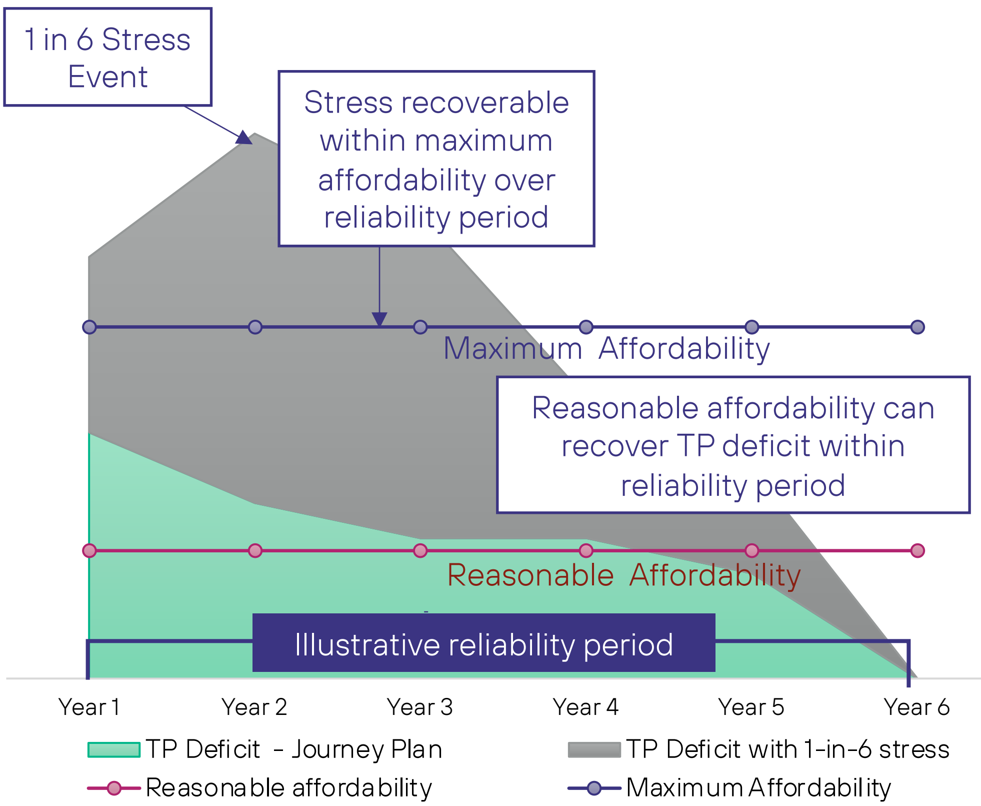
- Post valuation experience
- Reasonable affordability
- Investment outperformance

Supportable risk should be considered separately for both during, and after the reliability period.

During the reliability period, the key determinants of supportable risk are the maximum affordable contributions **over the reliability period**, and contingent asset support **which would be accessible**.

After the reliability period, there is increased uncertainty over cash flows, so becomes a more qualitative assessment. The guidance states that risk after this point would need additional support, with a focus on contingent assets.

This again highlights the importance of the assessment of the covenant reliability period.



Our Covenant experts are on hand to discuss how this new guidance and approach is relevant for you and your scheme.

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