New Covenant Guidance

What does it mean in practice?

Cardano a business of Marsh McLennan & Travers Smith

Joint Meeting: Association of Consulting Actuaries & Association of Pension Lawyers

Introduction

Your speakers

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Agenda

1. Overarching regulatory framework
2. Covenant assessment framework
3. Prospects
4. Cash
5. Contingent assets

The final piece of the jigsaw…

So now we have the framework

PSA 2021 and FIS Regs 2024 create legal obligations…

…whereas the Funding Code and Covenant Guidance generally don't

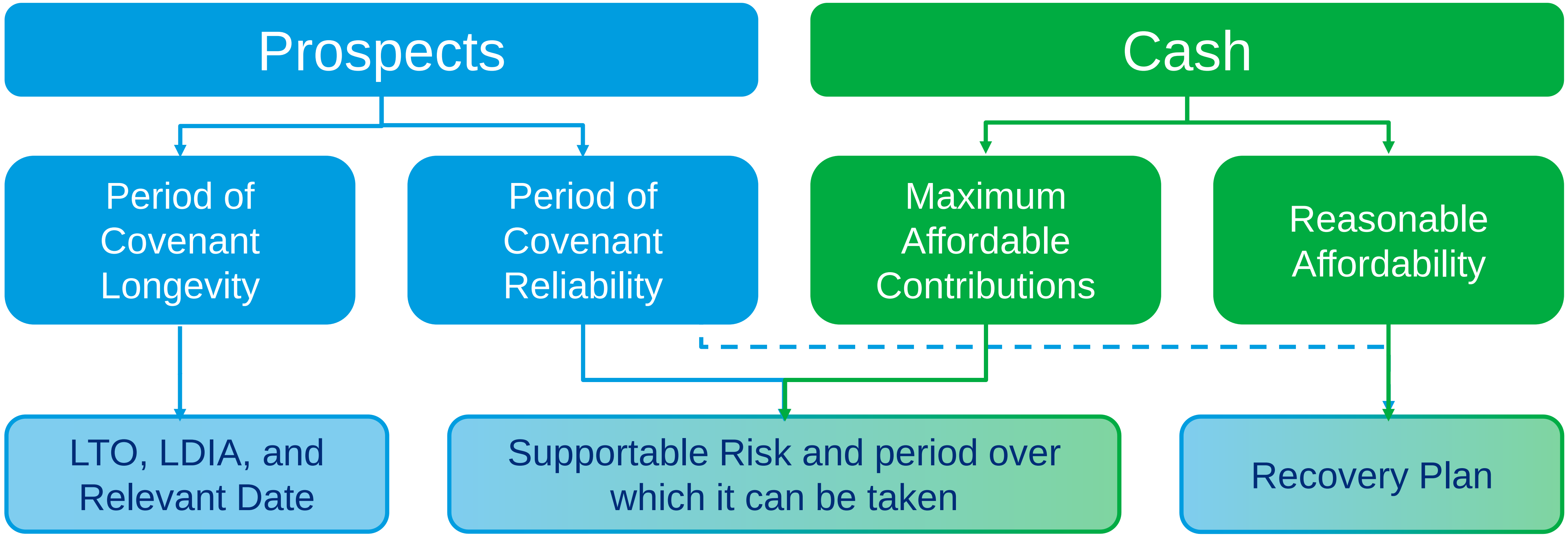
So, what's new???

Does not re-invent the wheel, but….

…there are a number of new elements that will:

- Require a **refocus** in the way trustees and advisors assess covenant strength and document their findings
- Add **complexity** and **judgement**
- Require **closer working relationship** with management
- Require advisors to be **joined-up**

Covenant assessment framework



Contingent assets: *could impact any of these depending on nature*

Prospects: Period of Covenant Reliability

c.3 to 6 years for the average employer

Examples: renewal of large contracts, refinancing risks, high divergence between forecast scenarios

Key risks leading to reasonable certainty ending

Short to medium term prospects

Market outlook

Strategic importance for wider group

Balance sheet resilience

Consider historical accuracy of management forecasts, appropriateness of assumptions, managing year-on-year variances

Reasonableness of the employer’s cash flow forecasts

Prospects: Period of Covenant Longevity

c.10 years for the average employer

In this case, longevity could be defined as "at least x years"

Inability to look forward with reasonable certainty can be the limiting factor

Market outlook and employer market position

Diversity of employer operations

ESG

Balance sheet resilience

Key risks which could cause longevity to have a set 'end date'

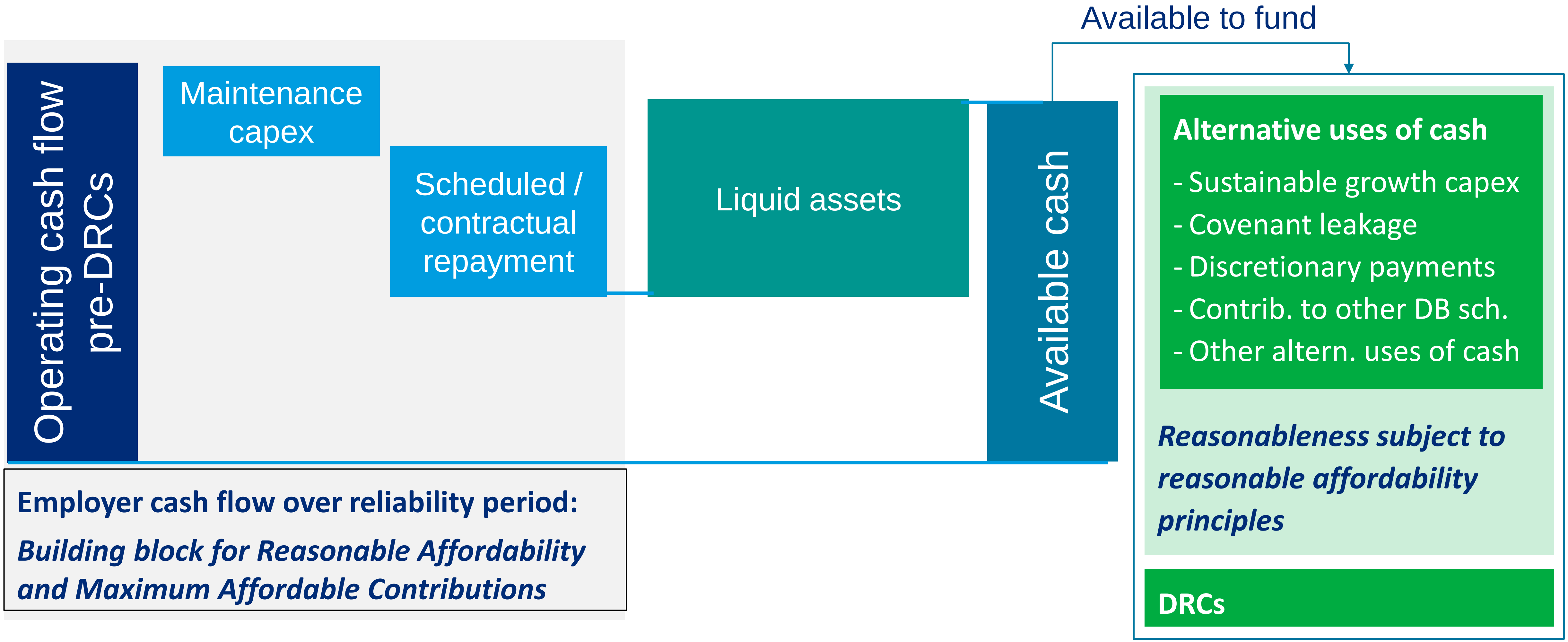
Legislative changes

Technological innovation

Expected change in market conditions

Medium to longer term prospects of employer and industry

Cash: Reasonable affordability



Note: The above refers to the employer(s); in case of a look-through guarantee, to the guarantor as well (attention to any double counting)

Cash: Reasonable affordability principles

1. Investment in the employer's **sustainable growth may be reasonable** if trustees are confident of the resulting benefit

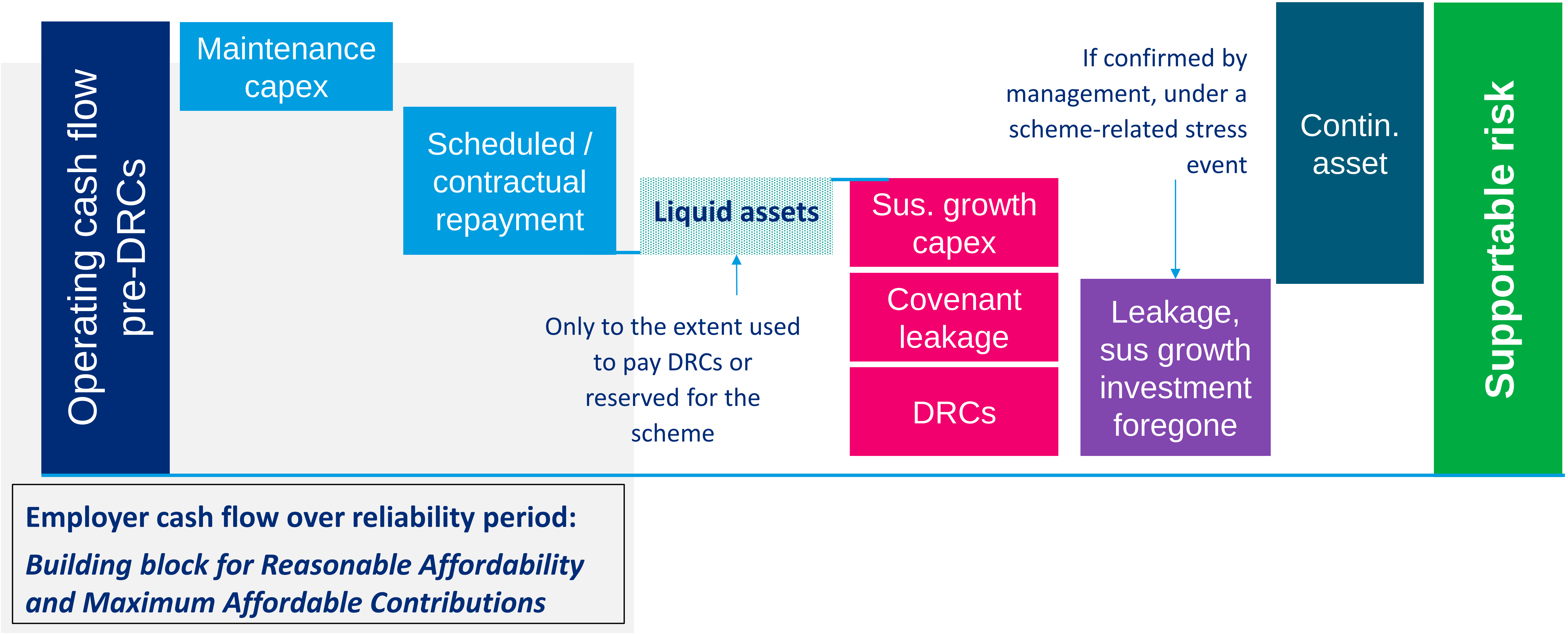
2. The **lower the funding ratio / the more funding risk, the less reasonable** are discretionary payments or covenant leakage

3. **Discretionary payments or covenant leakage less reasonable** when result in recovery plan longer than reliability

4. The **more mature the scheme, the more need for cash** to be paid to the scheme in the near term

5. **Allocation of cash between DB schemes** sponsored by the employer should be **fair**

Cash: Maximum Affordable Contribution and Supportable Risk



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Contingent assets: overview

Decreasing value in context of Funding Code

New gold standard

1 Look through guarantee

Treat guarantor as employer:

- ✓ Increase Supportable Risk
- ✓ Increase Reliability Period
- ✓ Increase Reasonable Affordability (expect shorter Recovery Plan)

2 Contingent assets that offer quantifiable improvement to supportable risk

- Security
- Keep-well provisions
- Pre-insolvency triggers
- Contingent funding

3 Contingent assets that allow extension of recovery plan

- Can go beyond reliability period subject to access and projected value

4 Contingent assets that allow a marginally more optimistic view

- E.g. Reliability period at upper end of estimated range for employer

5 Informal support

- Not expected to support additional risk

Need to be reasonably certain of value (in circumstances in which contingent asset will be called) and ability to access value to help the scheme achieve objective of reaching Low Dependency by the Relevant Date

So what does that mean for "traditional" PPF-compliant s75 guarantees…?

Contingent assets: look through guarantees

Underpin for the full s.75 deficit	Missed DRCs	Evergreen
No onerous conditions attached	Legally enforceable	Information sharing protocol
Legal mechanism enabling you to look through to the guarantor's cashflows when setting contributions		

Historically, guarantees that look like this are **rare**

Potentially **very different prospect** for the guarantor if more money will have to be paid to the trustee more quickly

The legal mechanism **isn't explained in the Guidance** – it's up to the lawyers to work out what is appropriate and different solutions may be needed in different circumstances

Wrap up

This is important new guidance…

- Which is designed to drive **new practice**
- Trustees and employers will want to consider a **proportionate response**
- It will be instructive to see how **good practice develops**
- However, some may need to **respond more rapidly**
- As always, the **key is joined-up advice**

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