

## Part Two - The covenant assessment

**Set out in law for the first time, formal consideration of employer covenant is now a requirement. There are new covenant concepts for you to consider and measure.**

Undertaking a formal covenant assessment will be a step change for many trustee boards. Instead of a single covenant rating, there are a number of new covenant metrics that need to be produced and reported. Assessing covenant early in the valuation process is key; the strength of the employer covenant must be considered in all aspects of the funding and investment strategy, from setting an appropriate long-term objective to choosing a suitable low dependency investment allocation and funding basis, and to developing a journey plan to move to a low dependency funding position.

Trustees should engage with employers early; employer input will undoubtedly be required to allow an adequate assessment to be undertaken. Trustees will need to consider whether they have the expertise to assess the employer covenant or need to appoint a professional adviser, and employers may also wish to consider appointing their own independent covenant adviser.

### What do the regulations and guidance say?



#### Regulatory requirements:

- **Journey plan risk:** As a scheme moves along its journey plan to low dependency, the level of risk that may be taken is dependent on the strength of the employer covenant.
- **Covenant considerations:** An assessment of the employer covenant must consider the financial ability of the employer to support the scheme and any additional contingent asset support. Covenant must be assessed relative to the funding position on the low dependency and solvency bases.
- **Covenant assessment:** The regulations explicitly set out several items to consider including cashflow, future development and resilience of the employer's business, as well as the timeframes over which these should be considered. Covenant strength includes support from any contingent assets that are legally enforceable and will be sufficient to provide that support at such time as it may be required by the scheme.
- **Valuation submission:** Covenant information must be submitted to The Pensions Regulator (TPR) within the scheme's statement of strategy. This includes documenting the covenant timeframes and the value of contingent assets.
- **Reasonable affordability:** Deficits should be recovered as soon as the employer can reasonably afford.



#### Code and detailed covenant guidance:

The code states that covenant should be assessed at least at each triennial valuation. The scope and frequency of any further assessments should be proportionate, considering factors including the scheme's funding level, its maturity, and the level of funding and investment risk within the journey plan.

The code also introduces and provides detailed direction on some key concepts including reliability and longevity periods, reasonable affordability, maximum affordable contributions and supportable risk.

The covenant guidance provides further direction on these concepts including worked examples to illustrate how the assessment of the reliability period and covenant longevity might be undertaken in given circumstances.

In this second part of your FIS Companion, we explore what the regulatory requirements and guidance from TPR might mean in practice for your scheme.

**Our six-part 'FIS Companion' series will help trustee boards and employers approach their first valuation under the new funding regime in a logical, practical order, while highlighting the key considerations for both.**

**1** Setting a long-term strategy

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**3** Scheme investments under the new regime

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**4** The funding valuation and journey plan

Coming soon July 2025

**5** Fast Track versus Bespoke

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**6** Key questions and challenges

Coming soon August 2025



## The covenant assessment: Reliability and longevity



### What's new...

**The single covenant rating (e.g. tending to strong or weak) that was used to describe covenant strength under the previous funding regime has been replaced. In addition to considering forward looking cash flows and prospects, trustees need to consider the timescales over which they can rely on the covenant; this is critical to the pace of funding and the evolution of the journey plan.**

Trustees must consider the reliability period and the longevity period of the employer.

- The **reliability period** is the timeframe during which trustees have reasonable certainty over the employer's cash flow to fund the scheme. Reliability is determined by considering an employer's cash flow and prospects.

TPR recognises that most employers will only have reliability in the short to medium term i.e. three to six years, but this may be extended based on employer-specific circumstances.

- The **longevity period** is the timeframe during which the trustees can be reasonably certain that the employer will be able to continue to support the scheme.

Longevity may be finite for some schemes, for example, if an employer provides a product or service that will no longer be required within a few years, longevity will be limited to this period. TPR considers that for most employers, longevity will not exceed 10 years but that some may be able to demonstrate a longer period. Longevity is determined by an employer's **prospects**.

**We explore the roles of cash flow and prospects in the table below:**

Consideration	Why is this important?	How is this assessed?
<b>Cash flow</b>	<p>The strength of the employer's cash flows will help trustees understand the level of financial support the employer can provide to the scheme.</p> <p>This includes the level of cash that could be paid into the scheme in a downside scenario as well as what deficit reduction contributions (DRCs) are affordable.</p>	<p>Focus on forward looking forecast information, including appropriate downside scenarios.</p> <p>Assessed based upon cash flow expected to be generated by the employer after allowing for reasonable operational and committed finance costs, but before DRCs (or accrual) and other possible uses of free cash.</p> <p>Consider the reasonableness of the forecast assumptions used and any sensitivity to change.</p>
<b>Prospects</b>	<p>An understanding of the employer's prospects will help determine the extent and duration of reliance that can be placed on the employer to support the scheme.</p> <p>The assessment of prospects feeds into the determination of the covenant reliability and longevity periods.</p>	<p>Consider market outlook for the industry the employer operates in as well as the employer's position within that industry. This also includes the diversity of operations, reviewing the employer's strategic importance within any wider group, the corporate strategy, and environmental, social and governance (ESG) strategy as well as more general market commentary.</p> <p>Assess the resilience of the employer including the likelihood of insolvency.</p>





## The covenant assessment: Affordability and supportable risk



### What's new...

**As part of journey planning, trustees need to consider the level of risk in the scheme and whether that risk can be supported by the employer.**

The regulations and the code introduce the following concepts:

<b>Reasonable affordability</b>	<ul style="list-style-type: none"><li>• Under the regulations, deficits must be recovered as soon as the employer can reasonably afford</li><li>• Reasonable affordability should be assessed by reference to an employer's available cash, comprising cash flows and liquid, or readily recoverable, balance sheet assets</li><li>• Trustees must also consider the employer's reasonable alternative uses of cash including investment for sustainable growth, covenant leakage, discretionary payments to other creditors and payments to other DB schemes.</li></ul>
<b>Maximum affordable contributions</b>	<ul style="list-style-type: none"><li>• Defined as the employer's cash flow after adjustments for reasonable alternative uses of cash and DRCs payable to the scheme and other DB schemes sponsored by the employer.</li><li>• To the extent the employer has agreed to pay DRCs from its liquid assets, these amounts should also be included. This will prevent maximum affordable contributions being understated once DRCs are deducted.</li></ul>
<b>Supportable risk</b>	<ul style="list-style-type: none"><li>• Trustees need to consider the employer's capacity to support risk by assessing the maximum affordable contributions over the reliability period that would be available to fund a deterioration in the deficit, and any contingent assets which would be available to fund the scheme in a scheme related stress event.</li><li>• Where contingent assets meet the relevant criteria they can be used to support additional risk taking or a longer recovery plan.</li></ul>

If the assessment of supportable risk shows that the risk in the scheme is unable to be supported, trustees should consider whether to change the funding and investment strategy or seek other forms of covenant support.

Assessment of the supportable risk should allow for investment risk and return and include the impact of a stress test; TPR expects schemes to consider the impact of a 1-in-6 downside level event over the reliability period as a minimum.



**It will be key for trustees to perform covenant assessments early in the valuation process as this is integral to the scheme's journey plan. Trustees will also need to document and evidence how covenant has been assessed and considered as part of the statement of strategy.**

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## The covenant assessment: Contingent asset value



### What's new...

**Covenant strength includes support from any contingent assets that are legally enforceable and will be sufficient to provide that support at such time as it may be required.**

Contingent assets can provide valuable support to schemes who may be unable to rely on employer covenant. Contingent assets could potentially lead to reduced requirements for cash contributions. This may be attractive for employers with considerable assets but minimal ongoing cash flow generation (for example, charitable entities).

To factor contingent assets into the covenant assessment, they must satisfy the 'relevant criteria', meaning they must be:

**Legally enforceable:** This is determined by the terms and conditions of the agreement and by the law. It is important to receive legal advice where reliance is placed on the asset.

**Sufficient to provide support when required, considering:** the scenario in which it can be called upon (e.g. funding triggers or employer insolvency) and the realisable value in that scenario.

### Examples of contingent assets

- Charges over cash or property
- Letters of credit and bank guarantees
- Guarantees (including parent company guarantees)
- Contingent funding mechanisms (which allow for cash to be paid into the scheme based on pre-agreed triggers)

Asset backed contributions should not be used to take additional funding/investment risk as they are typically already used to increase the scheme's asset position.

### Further details on guarantees

Guarantees provide a scheme with legal recourse to a party other than its employer in a pre-defined situation. This is a common type of contingent asset that many schemes benefit from. The code sets out how guarantees should be valued and distinguishes between look through and non-look through guarantees, with further examples provided in the guidance.

Definition	Implications for covenant assessment
<b>Look through guarantee</b>	
<ul style="list-style-type: none"><li>• Legally binding clause to look through to the guarantor for affordability</li><li>• Replicate the obligations placed on a statutory employer</li><li>• Trustees able to claim against guarantor for all monies owed by the employer to the scheme without restrictions or qualifications once a trigger event has taken place</li><li>• No time limit and cannot be revoked without trustee agreement</li><li>• No onerous conditions attached</li><li>• Includes an information sharing protocol</li></ul>	<ul style="list-style-type: none"><li>• Guarantor can be considered in determining covenant reliability and longevity and its cashflows used to support additional risk</li></ul>
<b>Non-look through guarantee</b>	
<ul style="list-style-type: none"><li>• Does not include specific contribution mechanism</li><li>• May be limited in time or value or contain other restrictions</li></ul>	<ul style="list-style-type: none"><li>• Could be used to justify a longer reliability or longevity period, but unlikely to be taken into account for supportable risk unless trustees can ascribe a value with reasonable certainty to the level of support it can provide when required</li></ul>





## The covenant assessment: Journey planning and proportionality

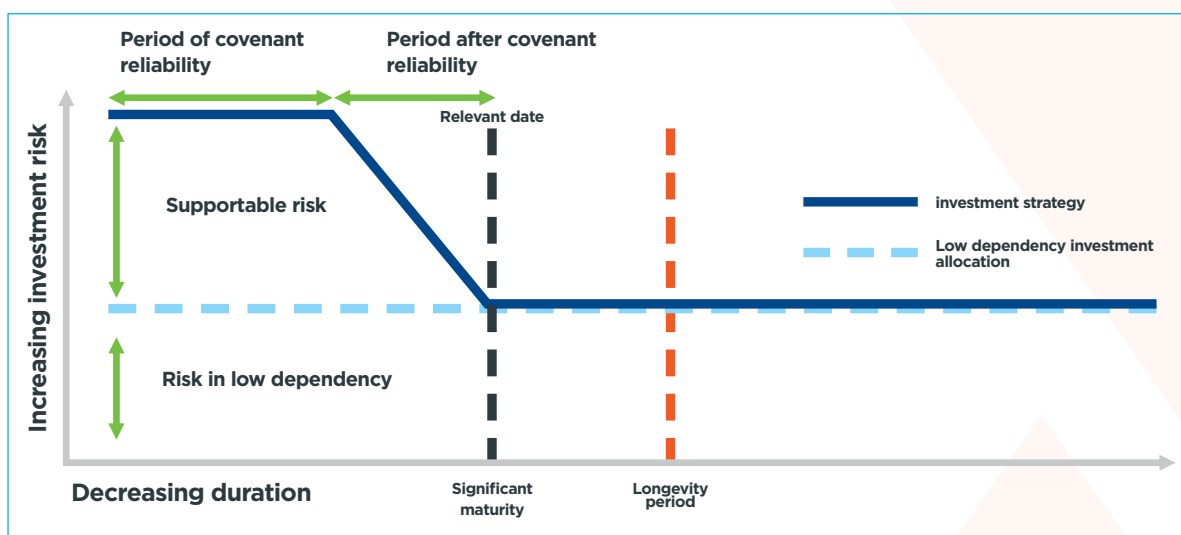


### What's new...

**Trustees must reflect employer covenant in their journey plan. Naturally, as a scheme approaches its relevant date, its reliance on the employer will need to reduce.**

Covenant should be a key consideration within the journey plan. The differing characteristics of each scheme and its employer covenant will mean that the shape and timeframe of the journey plan to low dependency will vary.

Below is an illustrative journey plan demonstrating how the level of risk can evolve based on covenant characteristics and should reduce over time as the scheme approaches significant maturity.



### What is proportionate?

TPR emphasises proportionality to ensure trustees consider the right level of detail in the covenant assessment, based upon the covenant support provided and the scheme's position. It is reasonable for a scheme with minimal covenant reliance to take a light-touch approach compared to a scheme with greater reliance.

TPR has outlined its expectations regarding proportionality, and examples are summarised below.

#### Examples where a light-touch assessment may be appropriate

- The scheme has fully bought in with an insurer
- The scheme is fully funded on its low dependency basis, noting that a scheme does still remain exposed to covenant risk if funding levels decline or there is an employer insolvency event
- The size of the employer is very large in comparison to the scheme
- The journey plan relies on a small amount of funding and investment risk being taken before the relevant date

#### Examples where a more involved assessment may be appropriate

- The scheme has a funding deficit
- Covenant has not been formally assessed previously
- The trustees have concerns about the viability of the sponsoring employer

Ultimately, trustees have discretion in determining what is proportionate, but they should be able to justify their approach when required. Trustees should also take a proportionate approach to documenting explanations in the statement of strategy taking into account the size, maturity and funding level of the scheme as well as the level of investment risk. Where there is greater risk and complexity, a greater level of detail and explanation will be required.





## The covenant assessment: Next steps

### Checklist for trustees

#### Engage early



The more formalised covenant requirements will mean additional support from the employer is required. Starting conversations before (or shortly after starting) the valuation process is key.



Information should be obtained from the employer in order to assess covenant.

#### Be proportionate



Trustees should consider how proportionality looks in the context of their scheme.

#### Agree who will undertake the assessment



Trustees should consider whether they have the expertise to assess the employer's covenant; if they do not, then professional covenant advice should be sought.



Trustees who have already appointed a covenant adviser should engage with them to understand how their approach has developed due to new regulatory environment.



If trustees do not appoint a covenant adviser, they will need to adequately document how they have assessed covenant and reached their conclusions.

#### Reflect covenant in your journey plan



If trustees are unable to obtain sufficient covenant information, prudence and safeguards will need to be built into the journey plan.



For schemes that are fully funded, trustees should still ensure the employer can financially support the scheme in the event of downside scheme risks crystallising.



Review contingent assets and how they are being factored into your covenant assessment.



Consider the certainty of cash flows and the period over which these can be relied upon.

#### Document the process



Ensure that sufficient analysis is performed to support documenting the covenant in the statement of strategy.







## The covenant assessment: Next steps

### Checklist for employers

#### Engage early and provide information promptly



Review the new guidance and consider how elements of the covenant can be presented to promote understanding and better align the objectives of the employer and the scheme.



Employers are required to support trustees with the information needed to undertake their covenant assessment, including cash flow forecasts and supporting assumptions. Insufficient information may result in a more prudent assessment by the trustees.

#### Be prepared to engage in discussions on cash flow usage and capacity to support risk



The reasonableness of the employer's proposed use of free cash flow for purposes other than funding the scheme or supporting risk, and the employer's ability to adapt its plans, will influence the pace and quantum of funding required. An early discussion clarifying the employer's plans will help to align expectations.

#### Consider the role of contingent assets



Review any guarantees or other contingent assets to understand the value they provide and consider taking legal and covenant advice on guarantees.

#### Discuss strategy with your advisers



Consider whether to engage an independent covenant adviser to support the successful presentation of the employer's covenant position to the trustees.



Employers will also need to familiarise themselves with the new guidance. We believe the first valuation under the new FIS regime represents a significant opportunity for employers to engage with the trustees on their long-term strategies and align them with the wider corporate objectives.

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## Find out more

To discuss any of the issues covered in this edition, please get in touch with **Bessie Hamilton**, **Pauline McConville** or **Kelvin Xu**. Alternatively, please speak to your usual XPS contact.

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