

Assessing and allowing for employer covenant

RISK | PENSIONS | INVESTMENT | INSURANCE



Assessing employer covenant is becoming increasingly important. The number and type of employers participating in the LGPS is continuing to grow and it has fallen to you, as administering authorities, to manage and mitigate the risks this poses to your fund.

Employer covenant is the ability and willingness of an employer to pay the required contributions to the scheme including any associated debt at the point of exit. A covenant analysis can help you categorise employers with a view to developing more tailored funding strategies for employers. It also helps demonstrate good governance and risk management.

The 2022 valuation gives you the opportunity to review your participating employers with regard to any guarantees or security in place and assess the “riskiness” of each employer, to ensure

contributions are set appropriately. This note sets out further information to help you determine an appropriate approach to employer covenant analysis for your funds and options for incorporating this into your 2022 valuation results.

In order to incorporate the results of a covenant assessment into the 2022 valuation, these will need to be available ahead of the valuation date. It is therefore important to consider this now.

Why you should care about employer covenant:

- You will make better, more informed decisions relating to funding and investment strategy such as:
 - Are the employers in aggregate able to support the current level of investment risk?
 - Is the current level of prudence in the funding strategy appropriate?
 - Would the fund benefit from some employers being subject to a more tailored funding strategy (e.g. higher individual prudence levels) so that stronger employers are not subsidising them?
- You can take appropriate actions to reduce risks (e.g. guarantees, additional security) where you have identified employers with high risk of unrecoverable deficits.
- Your employers can better understand the consequences of employer actions and engage with you to understand what they can do to improve their risk standing within the fund.
- You can demonstrate good governance and risk management of the fund.
- The new “employer flexibilities” amendments to the regulations allow funds to increase contributions levels when the covenant of an employer changes, and to offer exiting employers options such as debt spreading or deferred debt agreements. A covenant assessment framework will help inform you when the use of such options may be appropriate.

Covenant-related advice can broadly be broken down into the following four areas:

- engaging with your employers
- assessing your employers
- reducing risk
- integrating analysis into the funding strategy

The first two areas are about improving the information held and enabling you to identify and engage with those “risky” employers. The third and fourth areas are about what you can do in practice to reduce the risks to the fund and your employers once you know what those risks are. These four areas are considered further below.

Engaging with your employers

It is important for funds to have robust and comprehensive information on their employers. However, employers may not always provide all the relevant information to administering authorities. Some steps to improve this information are:

- **Carrying out an audit of admission agreements.** Ensure these are fit for purpose and that all parties understand their pension obligations at outset, during participation and at exit. Many admission agreements will have been drafted some time ago. As there have been a number of LGPS regulatory changes over the years, a review and redraft of these agreements would evidence good governance and best practice risk management.
- **Issuing a questionnaire to employers to confirm/provide information.** The questionnaire could also include questions to help determine the employer’s ability and willingness to pay contributions.

Assessing your employers

The appropriate approach to assessing employer covenant will vary for each fund, depending on factors such as:

- the balance of the types of employers in the fund;
- the size of the potential risk;
- how much capacity the fund has to do some of this work internally; and
- the purpose of the particular exercise.

The first step is to decide the level of detail of your covenant assessment – qualitative, quantitative or comprehensive.

If your fund has a lot of small charities, stretched resources and is trying to implement a framework for an actuarial valuation, a high-level assessment may be appropriate. Conversely, if your fund is considering a proposal from a large employer to extend their recovery period and/or change their funding approach, this may require a more comprehensive review. Further detail on each is given below.

Qualitative

Use employer characteristics and information to categorise employers into risk groups. This includes type of employer and sector, open or closed employer, guarantee/security, pooled or individual, and time horizon in the fund.

Quantitative

- **Pension fund risk score** - analyse pension information such as the ongoing funding level and cessation position, maturity, net cashflow and contribution levels. An estimate of the updated funding position based on the 2019 valuation and recent cashflow information could be used to do this work ahead of the 2022 valuation.
- **Credit risk score** – use a credit rating agency to gather and analyse detailed financial and non-financial information. This will provide additional information on a number of different measures including a failure score and risk indicator which assess the risk of failure to pay or paying late. This requires little work from the administering authority and can be relatively low cost.

Comprehensive

A comprehensive covenant assessment can be carried out by a specialist firm. This can be fairly expensive, so it is likely to be appropriate for specific cases rather than for regular monitoring of all employers.

How we can help

Most LGPS funds we work with carry out some form of qualitative assessment which allows them to categorise employers by their characteristics using a simple low/medium/high-risk grouping. Many are building on this and using a quantitative assessment to assign a risk score to each employer. Covenant experts have also been used by some funds to provide a more detailed review of individual employers.

We can help with advising on the design of any questionnaires and can carry out a qualitative and/or quantitative assessment of overall employer risk to the fund. We can use the results of the 2019 valuation for a quantitative assessment now, ahead of the 2022 valuation. We can also provide contact details for a number of covenant specialists who would be able to help if you require a comprehensive assessment.

Reducing the risk

The above assessments will help identify risky employers that the fund may wish to engage with and we would be happy to be part of these discussions as required. The assessment may also help to identify policies or admission agreement wording that could be improved and avoid protracted discussions further down the line.

If an employer is identified as posing a risk to the fund, the following steps could be considered:

- check whether the employer can get a guarantee from a stronger connected employer e.g. a council, government department or parent company. In our experience, it's far more likely a connected employer would act as guarantor while the employer is a participating employer in the fund;
- obtain security through a first charge on the employer's assets, such as property, to cover an agreed level of deficit. This will require a legal side agreement to set out the details of the security;

- review the bond amount or put a bond in place if there is not one already; and
- manage liabilities and monitor the funding position/membership profile/time horizon of the employer regularly to agree an affordable contribution plan that targets a fully funded position at the end of participation. This is even more important now that employers are entitled to an exit credit.

Increased employer engagement helps employers to understand the consequences of their actions, and helps funds minimise unrecoverable debts.

Integrating with the funding strategy

Many funds already do this to some extent. It may be that the recovery period at the 2019 valuation for bodies with tax-raising powers was longer than for other employers and this is a simple example of integrated risk management.

More detailed approaches that have been taken in the LGPS include:

- **Extra detailed categorisation of employers** - stronger employers have more flexible contribution plans. This can also encourage employers to put in place security arrangements with the fund or reduce their risk in other ways to achieve a higher category and get more flexibility with their funding strategy. We can draft a template letter that the fund can populate for those employers who may be interested in this option.

- **Tailored investment strategies** – for those identified as riskier employers, the fund could adopt a notional lower risk investment strategy. This leads to lower expected returns and so a higher contribution. Our standard approach to tracking employer assets easily enables this, and we would be happy to discuss this in more detail.
- **Different discount rates** – keeping the same investment strategy for all employers, but using more prudent assumptions for riskier employers, will result in a higher target fund and higher resulting contributions. These higher contributions will help to protect the fund against default over time. It is likely that these employers have a higher funding target on cessation, so this approach means the higher funding target is achieved over time rather than at cessation.

The second and third options above are similar ways of achieving the same thing, which is to increase the likelihood of having enough money to pay all the future benefits, but will not guard against the immediate default risk and potential debt that arises.

Next steps

We recommend that you consider this ahead of the 2022 valuation so an appropriate approach can be implemented.

We can provide support at all stages of the process, including:

- scoping out the project
- reviewing current information
- quantifying the risk
- helping to reduce the risk

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

✉ publicsector@barnett-waddingham.co.uk

☎ 0333 11 11 222

www.barnett-waddingham.co.uk

Barnett Waddingham LLP is a body corporate with members to whom we refer as "partners". A list of members can be inspected at the registered office. Barnett Waddingham LLP (OC307678), BW SIPP LLP (OC322417), and Barnett Waddingham Actuaries and Consultants Limited (06498431) are registered in England and Wales with their registered office at 2 London Wall Place, London, EC2Y 5AU. Barnett Waddingham LLP is authorised and regulated by the Financial Conduct Authority. BW SIPP LLP is authorised and regulated by the Financial Conduct Authority.