Briefing

Assessing employer covenant

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Assessing employer covenant is becoming increasingly important for administering authorities in order to manage and mitigate risks to their fund as the number and type of employers participating in the Local Government Pension Scheme (LGPS) continues to grow.

In addition, there have been a number of changes at sector level or as a result of legislation that may have an impact on employer covenant such as the college insolvency regime, the Scheme Advisory Board Tier 3 report and the increased scrutiny from TPR on the LGPS.

In relation to the LGPS, covenant is the ability and willingness to pay the required contributions while participating in the scheme, and any debt at the point of exit. The 2019 valuation gives funds the opportunity to review their participating employers with regard to any guarantees or security in place and the "riskiness" of each employer. In addition to demonstrating good governance and risk management, a covenant analysis also helps funds to categorise employers with a view to developing more tailored funding strategies for employers.

There are different levels of assessment that can be carried out and each fund will have a view of the level of detail that is required.

> The analysis and results of the covenant assessment will need to be available in the next six months to give sufficient time to feed these into your employers' funding strategy so it's important to start work on this soon.

Key benefits of employer covenant assessment:

- increases knowledge of your employers to inform and tailor funding strategy;
- provides management information to prioritise, and engage with, riskier employers;
- identifies riskier employers where you may request security to protect the fund;
- allows increased engagement with employers to help both the employer and the fund to understand the consequences of employer actions; and
- demonstrates good governance and risk management of the fund.

The appropriate approach for each fund will vary 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. For example, a fund that has a lot of small charities, stretched resources and is trying to implement a framework for an actuarial valuation may carry out a high level assessment. Conversely, a fund considering a proposal from a very large employer to extend their recovery period and change their funding approach may require a more detailed review.

Most funds we work with now carry out at least a high level qualitative assessment which allows funds to categorise employers by their characteristics using a simple low/medium/high risk grouping. Many funds are building on this and are using a quantitative assessment based on agreed risk factors which results in a risk score. If a more detailed review is required for some employers then a covenant expert can be used.

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

- Engaging with your employers
- Assessing your employers
- Reducing risk
- Integrating the covenant assessment into the funding strategy

The first two areas are about improving the information held and enabling you to identify and engage with those employers where the fund may want to reduce the risk. The third and fourth areas are about what you can do in practice.

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:

- Carry out an audit of admission agreements to ensure these are fit for purpose and that all parties understand their pension obligations at outset, during participation and at exit. Many of these admission agreements may 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.

- Issue a questionnaire to employers to confirm/provide information. In addition, the questionnaire could have some questions to help determine the employer's ability and willingness to pay contributions.

Assessing your employers

The first step is to decide the level of detail of your covenant assessment – qualitative, quantitative or detailed. 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 based on the 2016 valuation, an updated funding position and cashflow information could be used to do this work ahead of the 2019 valuation.

- **Credit risk score** – use a rating agency, such as Dun & Bradstreet, 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 is relatively cheap.

- **Total risk score** – the qualitative and quantitative assessments can then be combined to estimate a total risk score and to group employers accordingly

Detailed

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

How we can help

We can help with advising on the design of any questionnaires and can carry out a qualitative and/or quantitative assessment to assess the overall employer risk to the fund. We can also provide contact details of covenant specialists who would be able to help if you require a detailed assessment.

Reducing risk

The above assessments will identify any employers where the fund may want to engage with risky employers 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, steps that could be considered are:

- Check whether the employer can get a guarantee from a stronger connected employer, e.g. a council, government department or parent company
- 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
- Manage liabilities and monitor the funding position/membership profile/time horizon of 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 to help funds minimise unrecoverable debts.

Integrating the funding strategy with the covenant assessment

Many funds already do this to some extent. It may be that the recovery period at the 2016 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:

- **More detailed categorisation of employers** - stronger employers have more flexible recovery 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.
- **Tailored investment strategies** - those identified as riskier employers could adopt a 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, with only some initial implementation and more frequent cashflow and asset information required. We'd 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 so contributions will need to increase to achieve this target fund. These additional contributions will help to protect the fund against default over time.

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Benefits for the fund

In summary, the advantages of assessing employer covenant of participating employer within funds include:

1. increases the fund's knowledge of its employers to help minimise the likelihood of unrecoverable deficits through a more tailored funding strategy;
2. provides management information to prioritise risky employers and allows the fund to engage early;
3. identifies any needs to obtain security for riskier employers to protect the fund from unpaid deficit on cessation;
4. allows increased engagement with employers to help both the employer and the fund to understand the consequences of employer actions; and
5. demonstrates good governance and risk management of the fund.

We can provide support at all stages of the process including scoping out the project, reviewing current information, quantifying the risk, helping with actions to reduce the risk and increasing the integration with the funding strategy. Please contact your usual Barnett Waddingham contact if you would like further information.

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:

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