Spotlight: Covenant for LGPS Employers

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The ability of LGPS employers to fund their liabilities is critical to ensuring the long term sustainability of LGPS funds and to protect other employers. Administering authorities are increasingly considering covenant, but what this actually means in practice and how it influences funding policy is highly variable. Chris Emmerson takes a look at some of the key issues.

Should you look at covenant?

It is hard to imagine anyone arguing administering authorities should spend significant time and effort assessing the covenant of local authorities and other fully taxpayer-backed employers or academies (despite the potential weakness of the DfE guarantee).

However, other (so-called Tier 3) employers can make up a considerable proportion of an LGPS fund's liabilities – up to 25% in some cases – and by definition they are not fully taxpayer-backed.

We suggest administering authorities' risk management process should include asking following questions:

- What are the ongoing liabilities (and deficit) attributable to Tier 3 employers?
- How does that compare to the payment which would be required on exit? If there is a material gap between the two is that justifiable or sustainable?
- Are we confident the employer will have the funds to pay its obligations to the Fund indefinitely (or for the remainder of its admission agreement)?
- Are we confident that the employer could make good any exit deficit if it were to exit unexpectedly?
- What are the implications of an unplanned exit on the other employers? (It may also be useful to ask how "orphan liabilities" are treated by the Actuary and whether a deficit is allowed to build up on these)

In the vast majority of cases administering authorities are likely to conclude that further consideration of covenant or narrower measure of financial strength will be needed for at least some employers.

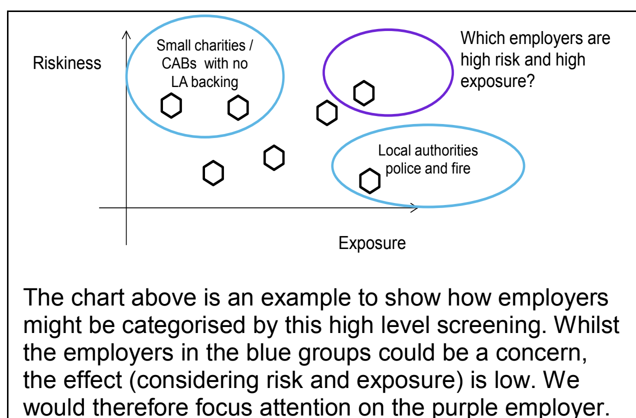
Can you do this yourself?

Whether on cost grounds or due to their Fund actuary not having a genuine covenant capability we are not sure, but there is a trend for administering authorities to assess covenant in a "DIY" manner, relying on their knowledge of the employers and financial situation or plans.

Such a light touch approach used to be common in the private sector. However, the Pensions Regulator ('tPR') has been vocal about its expectation that the analysis should be completed objectively and by persons with relevant knowledge and experience. Where "DIY" covenant assessments have been performed, tPR has seriously questioned the trustees' expertise and independence. Whilst private sector schemes tend to only have a single employer so the risk is arguably more concentrated, administering authorities should ask themselves whether their "covenant" assessment is fit for purpose.

Which employers should you look at?

We usually recommend a high level screening of all employers with a more detailed analysis focusing on the employers who are both high risk and have large LGPS liabilities.



The chart above is an example to show how employers might be categorised by this high level screening. Whilst the employers in the blue groups could be a concern, the effect (considering risk and exposure) is low. We would therefore focus attention on the purple employer.

In our experience two key sectors worthy of consideration are HE/FE institutions and housing associations. The issues for these two groups are different but in summary both generally have:

- no guarantees from tax raising bodies,
- relatively large liabilities within the LGPS, and
- experienced a reduction in their funding or income.

There will of course be other Fund-specific employers to consider too, such as transport companies or other large community admission bodies with no guarantee. Many administering authorities will already distinguish between these employers and tax-raising bodies in their funding strategy. What is less clear is whether their strategy is appropriate and how it relates to the employer's strength of covenant.

How should covenant be assessed?

High level screening can encompass a broad categorisation of employers (e.g. scheduled or admission, open or closed, with or without a guarantee etc), supplemented by credit rating agency information or an analysis of the employer's sources of funding. However, as noted by tPR, it is very difficult to use this information to form an accurate assessment of an employer's covenant (which should include qualitative factors and consider financial strength within the context of an employer's pension obligations, which short-term rating scores fail to do).

In our view the allocation of employers into risk categories based on credit scores alone should not be defined as a 'covenant' assessment in the context of pension scheme funding, and administering authorities should exercise caution if their Fund actuary is labelling it as such. Credit scores are automatically generated based on fixed criteria with limited manual interaction, so lack subjective judgement. They are typically used to assess extending credit to a firm, which would be short term, so are not designed to provide a view on the longer term credit worthiness of a company to support pension obligations (where the maximum exposure is not known). They may not therefore place weight on the metrics more important from a pensions perspective.

An independent covenant assessment will usually consider both the employer's current financial resources and likely future resources, and will consider many factors which will often be beyond the expertise of administering authority officers.

Aon has supported administering authorities by carrying out such assessments for LGPS employers but in practice we recognise that such a detailed analysis is unlikely to be the norm.

Administering authorities need to be aware that there are a variety of options between a "DIY" approach and a full blown private-sector style covenant analysis. Our public sector team is in the privileged position of being able to draw on the expertise of internal covenant specialists. Working with those specialists we have provided a range of different services to categorise and assess employers' financial strength to suit different needs and budgets. Whatever approach is used, administering authorities should ensure their approach is fit for purpose and genuinely contributes to employer risk management within the Fund. In some cases a very light touch approach will do just that. In others, there's a risk it's just a tick box exercise that adds no value.

How should covenant influence funding strategy?

We recognise that some administering authorities will hope to use an employer covenant or risk assessment exercise to justify continuation of their current funding approach.

In many cases that involves a single funding target for all employers with the recovery plan varied to allow for the covenant of an employer. Others ostensibly have a single funding target but contributions are set independently such that it is quite difficult to assess what the underlying funding target actually is for different employers.

We believe the world is moving on and the days of a single funding target for all employers are numbered. Our approach is to align the funding target both to:

- the likelihood of an employer exiting, and
- the funding target which would apply on exit.

We believe that it is more important to set an appropriate funding target and whilst use of shorter recovery period can help, in terms of targeting full funding more quickly, if the funding target is too weak it could leave the Fund exposed to material employer risk.

Consider this simple example:

Ongoing position - £50M surplus

Indicative exit position - £150M deficit

As the employer is in surplus on the ongoing basis shortening the recovery period will actually make the position worse (leading to lower ongoing contributions and an even bigger exit deficit).

Under our approach the ongoing position would be closer to the exit position because either:

- the employer is an admission body whose liabilities will become orphan on exit and we have adopted our "ongoing orphan body basis" which anticipates use of a gilts-based approach to the exit valuation, or
- the employer is not considered to be as financially secure as the taxpayer-backed bodies and hence a stronger ongoing funding target is deemed to be appropriate.

For the latter group a financial risk or covenant assessment can be used to inform (and justify) a suitable funding target.

With improvements in technology and systems, operating multiple funding targets is no longer in the "too difficult pile". As long as administering authorities (rightly in our view) continue to take a low risk approach to exit valuations where there is no successor body within the Fund, varying the ongoing funding strategy to take account of the likelihood of exit makes materially more sense than ignoring the exit position and adopting the same ongoing target for all.

Want to know more?

If you would like to know more about how Aon Hewitt can help you develop your approach to employer risk and enhance your risk management in general please do get in touch.

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