Pension Fund Committee
Meeting to be held on 29 January 2016

Electoral Division affected: None

Lancashire County Pension Fund - Future Employer Risk Management Framework and Approach to Covenant Review

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Executive Summary

During 2015 a detailed covenant review process has been carried out and is now largely completed.

The purpose of this exercise was twofold, prior to the commencement of the 2016 valuation work:

- to specifically assess covenant for the majority of fund employers;
- to devise and implement an ongoing covenant assessment and risk management framework.

Recommendation

The Committee is recommended to approve the proposed risk classification methodology and approach to implementing risk management/security arrangements as set out in the report.

Background and Advice

Within a pensions context the term 'covenant' relates to an assessment of an employer's longer-term ability to meet its financial commitments to the fund. This includes the ability to meet any historic deficit payments due as well as ongoing employer contributions.

Should an employer become unable to meet its commitments, usually because of insolvency, the fund must still meet its pensions obligations to the affected employer's members, and the financial burden of doing so then falls upon other fund employers. Thus it is important to form a view on employers' covenant strength and put in place risk management strategies to reduce any impact of employer default.

2016 Valuation Strategy and Employer Risk

The proposed 2016 valuation approach has been consulted on with employers and one element of this relates to the actuarial treatment of individual employers, specifically how employer risk will be factored into the determination of future service rates and deficit contribution calculations. In essence it is proposed that differential investment strategies be applied to employers, dependent upon their risk profile, with higher risk employers being assigned to a lower risk investment strategy, meaning that there will be more certainty of the strategy delivering the returns required. As a result of this differentiation it follows that different discount factors be applied (high risk = low discount factor) to the actuary's calculations.

This strategy will impact upon higher risk employers in that their future service rate, and deficit calculation, will be higher than it would be had the employer been placed in a lower risk category. It is therefore in employers' interests to engage with the Lancashire County Pension Fund (LCPF) in its risk management approach and provide alternative forms of security where this is requested - in doing so being assigned a lower risk category than would otherwise be obtained.

This report sets out a proposed covenant review framework to be applied for LCPF employers and sets out an approach to managing risk issues arising from the current exercise.

Employer Risk and Security

There are over 200 employers within LCPF, ranging from large taxpayer-backed organisations such as councils, through to small charities with no guaranteed sources of funding. Clearly, some employers present a higher risk than others. Employers are either 'scheduled' or 'admitted': scheduled employers have an automatic right to Local Government Pension Scheme (LGPS) entry, admitted employers don't, and their entry to LGPS arises as a result of being 'admitted' via an Admission Agreement (AA).

LCPF Admission Agreements now specify a requirement for security against default, however older agreements do not, and these older agreements therefore need to be revised and signed-up to by affected employers in order to provide increased protection for the Fund.

The Fund has recently consulted on proposed changes to the admissions process which will limit access in future largely to employers who have a right to entry, largely academies and organisations providing contracted-out services to scheduled employers.

Employers have defaulted on their commitments previously and there remains a risk of further default, although following the review process there is not deemed to be an imminent risk of such. The covenant review process to date has shown that, generally speaking, the riskiest employers are those who have charitable status.

Deficits and Risk Management

The principle source of risk to the fund arises from the existence of individual employers' deficits, rather than an inability to fund future liabilities which haven't yet materialised or accrued; deficits relate to the past rather than the future, and any insolvency or similar affecting an employer reduces their ability to pay off their deficit which is effectively a debt owed to the Fund.

How Risk Can Be Managed

There are five primary tools available to LGPS funds in managing risk:

- obtaining guarantees from existing ‘low risk’ fund employers in respect of other employers’ liabilities;
- an employer obtains an ‘insurance policy’ (known as a ‘bond’) which would pay off liabilities in the event of employer default;
- an employer provides a Charge over land/property which would enable the fund to secure some or all monies due to it in the event of default;
- escrow accounts (where an employer sets aside monies in a specific account controlled by a third party); and
- cancellation of Admission Agreement – this can trigger an ‘exit payment’ due from the employer but its effectiveness depends upon the ability of the employer to meet the exit payment; at the point of exit, a calculation of all outstanding liabilities is carried out, resulting in a demand from the employer of an exit payment which once paid over, absolved the ex-employer of any further funding requests from the Fund.

Employer Type and Associated Risk Profile

The larger employers within LGPS are councils, scheduled bodies who are tax-raising organisations with an implicit ‘government guarantee’ – no council has yet become insolvent, and were any to do so in future, there is perceived to be little likelihood of pension commitments not being underwritten by central government. A second broad category of employers are not scheduled, but are large admitted public sector or quasi-public sector organisations such as universities, Further Education Colleges and housing associations – these do not have as strong an implicit government guarantee as councils, however experience to date across the UK is that where such organisations have failed their commitments have been taken on and honoured by other similar organisations.

The third broad category are admitted employers who do not have any implicit or explicit government guarantee - clearly these present the highest risk, although in membership terms they are relatively small within LCPF.

Covenant Review for LCPF Employers

A comprehensive exercise has been carried out, which involved asking most Fund employers to complete detailed questionnaires. The response rate has been good and this has enabled a clear overview of risk issues to be obtained. Lessons have been learned from this review, and a detailed 'map' of risk issues derived, which provides a platform for ongoing covenant assessment reviews. In the light of this exercise, it is felt that detailed covenant review work in future should be shaped by the resource requirement needed to carry out reviews on an ongoing basis, particularly given that ‘lighter-touch’ reviews can be carried out by analysing publicly available information (such as is available for the housing and university sectors, for example).

The covenant review exercise has identified some high risk employers and enabled a framework to be proposed which will focus largely on managing higher risk employers proactively, with a more passive approach applied to lower risk employers but which will provide a methodology to maintain a watching brief and early warning system to identify and mitigate any emerging risk issues.

Some employers, despite several attempts, have not engaged with the covenant review exercise and it is proposed that, in the absence of any supporting information, such employers be categorised as high risk; note however that this suggested approach would apply only to certain organisations (categories B and C - as outlined below).

The Fund will engage with higher risk employers with a view to them providing adequate security before December 2016, thus enabling them to benefit in terms of their risk classification and treatment within the valuation process.

As a first step, employers will be required to sign up to a new admission agreement (AA) which explicitly states a requirement to provide security should that be required. Following the signing of a new AA, attempts will be made to put in place security measures as necessary, and in a way which will be tailored to each employer’s particular circumstances. Employers who do not wish to provide security or engage with the Fund will be required to consider whether they wish to remain as an (admitted) employer within LCPF.

Proposed Covenant and Risk Management Process

It is proposed that employers are classified both objectively and subjectively; objectively by organisation type, subjectively by looking at all relevant aspects of an employer's finances and future prospects.

Objective Classification of Employer

Employers will be grouped by type of organisation as follows:

Category A – Lowest Risk – scheduled, taxpayer-backed or with the ability to levy local taxes, implicit government guarantee:

- County, District, Unitary, Parish and Town Councils
- Office of the Police and Crime Commissioner / Lancashire Constabulary
- North West Inshore Fisheries Conservation Authority
- Lancashire Combined Fire Authority
- NHS-related organisations
- Academies including Multi-Academy Trusts
- Other employers who provide security in excess of deficit plus unfunded liabilities
- Any employer with a category A guarantor

Category B – Higher Risk – Large public sector, (generally) admitted bodies, no or weaker implicit government guarantee:

- Housing Associations
- Further Education Colleges
- Universities
- Any employer with a category B guarantor

Category C – Highest Risk – no implicit government guarantee, admitted bodies:

- Trade Unions
- Charities

- Private schools
- Any employer with a category C guarantor
- Any employer not in category A or B

Subjective Categorisation of Employer

These would be applied to categories B and C only and would be ‘scored’ by:

(Category B) keeping a watching brief on employers’ financial/socio-economic/political environment via a process reliant on publicly available information; **(Category C)** carrying out annual detailed covenant review via questionnaire and proactive liaison with employers.

Employers' risk profile will be subjectively classified using a ‘traffic light’ system:

Red – highest risk, immediate action required

Amber – lower risk, watching brief and potential medium term action required

Green – lowest risk, ‘light-touch’ review unless specific concerns arise

The 'traffic light' classification will be formed largely by carrying out analyses of data, financial accounts, annual reports and discussions with employers. The data analysis methodology and findings will be made available to employers, who will be offered the facility to challenge, if necessary, the Fund’s review methodology and conclusions. The table below sets out the results of this analysis across the current client base:

The table below shows the number of employers grouped by risk category

Employer Objective Category	Subjective amber	Subjective green	Subjective red	Totals
A	n/a	n/a	n/a	87
B	25	73	2	100
C	4	4	15	23
Totals	29	77	17	210

The table below shows the number of members grouped by their employer's risk category

Employer Objective Category	Subjective amber	Subjective green	Subjective red	Totals
A	n/a	n/a	n/a	129,187
B	10,288	3,890	2	14,180
C	11,234	2,156	686	14,076
Totals	21,522	135,233	688	157,443

Key Points Arising from Proposed Classification System

- complies with The Pensions Regulator's best practice guidance;
- proactively manages risk with a view to minimising resource input to covenant process;
- all employers in categories B and C are able to obtain Category A status (by provision of adequate security);
- improves communications/liaison/support for employers; and
- over the medium term the aim will be to have no Category C employers.

Next Steps

Consultation/negotiation with individual high risk employers has already commenced; the process tends to be complex and time-consuming, requiring employers to implement changes (such as agreeing to a land charge) which from their perspective could potentially be seen as impacting negatively upon their ability to achieve organisational goals. Each employer faces a different set of circumstances in terms of finances, future prospects, funding etc. and as such there is no defined model for engaging and ultimately reaching agreement.

Whilst the use of differing investment strategies (and therefore discount factors) will likely form a key part of the 2016 valuation strategy, it is not yet possible to determine the interplay between actuarial assumptions, risk and investment prospects, and as such the impact of differing discount factors cannot yet be modelled or otherwise exemplified; as the valuation proceeds the final position will become clearer. This means that in attempting to reach agreement with employers during 2016, employers may not be able to fully understand the financial implications of not coming to an agreement with the Fund in terms of providing additional security.

Consultations

A formal consultation, with Fund employers, in respect of the 2016 actuarial valuation, has been completed recently and will be reported to the next meeting of the Committee.

Implications:

This item has the following implications, as indicated:

Risk management

The recommendations contained within this report are intended to mitigate and manage risk where possible.

Local Government (Access to Information) Act 1985
List of Background Papers

Paper	Date	Contact/Tel
N/A		

Reason for inclusion in Part II, if appropriate

N/A