



# Why is assessing employer covenant important?

## For administering authorities

- with the 10,000 employers in the LGPS becoming ever more disparate, a one size fits all approach to funding and investment is no longer appropriate
- some sectors traditionally considered to be "public sector" are no longer classified as such and have no government guarantee
- academy conversions and new ways of delivering services mean local authorities represent a reducing share of the LGPS
- employers are increasingly asking for justification of contributions and details of their exposure to former employers' liabilities
- new national and local governance arrangements are likely to lead to greater scrutiny of funding plans and a focus on covenant assessment

## For employers

- letting authorities need to take a view on bond requirements for admission bodies providing services on their behalf
- guarantors will be interested in the risk of default by guaranteed bodies
- pooled employers ought to be interested in the strength of covenant of other employers in the pool

Aon Hewitt has developed an employer covenant assessment service specifically for the LGPS. This combines our specialist covenant expertise developed over many years of advising trustees and corporates with our knowledge and experience of advising LGPS funds.

Our standard report dovetails with our funding advice and can also be used when considering employer-specific funding strategies. Our high level assessment is a cost-effective and efficient solution for assessing the absolute level and movement in financial strength of a dozen or more employers. A more detailed assessment is available where the circumstances, size of employer or its liabilities (deficit) warrants it.

**Covenant Assessment - ABC College**

**Background**

The Assessing Authority has requested a check for assessment of the covenant of ABC College (the "Employer") in support of the 2015 valuation valuation. The report assesses the covenant as follows:

| Year | Trending to 2014 | Trending to 2015 | 2015 |
|------|------------------|------------------|------|
| 2014 | 17.3             | 18.3             | 17.3 |
| 2015 | 17.3             | 18.3             | 17.3 |

**Information availability**

- Financial report and accounts for the years ended 31 July 2014 and 2015
- Detailed report published on DATE

**Covenant conclusion**

**Summary:**

- Both valuers and employers rate the Employer highly and well above certain market norms (as measured by market data).
- Our most recent inspection report of DATE assessed the Employer as "Outstanding".
- Financial performance, as measured by operating leverage, improved in fiscal 2015 (2015) after a year of operating losses. However, operating leverage is measured 0.34 in 2014 and 0.27 in 2015 with the operating leverage ratio of 0.34 and a 1% response.
- The Employer implemented a staff reduction exercise in fiscal year 2015 to reduce its future cost base. These staff cuts are the main expenditure.
- Cash flow from operating activities increased by 20% in fiscal year 2015 from £100m to £120m due to the Employer's improved operating margin.
- 20% of the Employer's total assets are attributable to financial investments (in a net book value basis), but these assets may not be easily realisable in the short term to cover funding gaps due to the specific nature of the underlying holdings. Also, the Employer may be unable to raise proceeds needed to set up or to the extent of the Employer's total net liability on these assets were funded by grants.
- Looking ahead, the Employer is shifting its teaching emphasis to areas such as (insert text) to minimise the impact of funding cuts, as funding for these areas will be no longer.

**Table of Financial Performance:**

| 2014 | 2015 |
|------|------|
| 17.3 | 17.3 |
| 18.3 | 18.3 |
| 17.3 | 17.3 |
| 18.3 | 18.3 |

**Notes:**

- Operator: The Employer's operating and financial ratios are in support of the valuation. The persons responsible for the valuation are Aon Hewitt.
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**Aon Hewitt**

## When should you seek external help?

| Factor                         |  |  |
|--------------------------------|--|--|
|                                | Light touch OK<br>More likely to be internal | In-depth review needed<br>More likely to be external |
| Corporate structure            | Tax-raising                                  | Non tax-raising                                      |
| Funding                        | Well funded                                  | Badly funded   |
| Materiality                    | Small employer                               | Large employer                                       |
| Investment risk                | Low  | High   |
| Cash flow (sustainable growth) | Unconstrained                                | Constrained  |
| Covenant changes               | Stable                                       | Material employer activity                           |
| Other creditors                | No   | Yes  |
| Sector                         | Stable                                       | Volatile   |
| Employer                       | Cooperative                                  | Uncooperative  |

### Other issues to consider

- Does the administering authority have the necessary expertise, experience and resources?
- Is the administering authority able to take an objective view? For example - what if a committee member also has an important role with the employer?
- Is the administering authority considering offering / requiring different employer investment strategies?
- To what extent does the administering authority already differentiate between employers in its funding strategy?

### Aon Hewitt's LGPS-specific employer covenant assessment can

- complement the administering authority's existing approach
- support a new approach to covenant assessment
- ensure covenant feeds into funding and investment decisions as part of an integrated approach to employer risk management
- assist scheme employers in better understanding their risks



# Employer Covenant Assessment

## Minimising employer risk in your pension fund

Current and future spending cuts have a huge impact on public sector bodies, charities and admission bodies. There have been instances in LGPS funds of multi million pound pension liabilities not being met and falling on other fund employers or Local Authorities and risk of further insolvencies remains high.

LPFA has been recognised within the Pensions Industry for monitoring employer risk. The procedures we follow are in line with the Pensions Regulator covenant guidance and Code of Practice 14 which applies to all Public Sector Pension funds from 1 April 2015.

Monitoring risk in our view is ongoing and not a one off event.

Recommendations to reduce risks will include increased financial monitoring, first charge arrangements and parent company guarantees.

At the 2013 valuation the LPFA fund implemented over £311 million of additional security and guarantees and has received an additional £54 million via additional contribution payments since this date.

Using our sector specific covenant forms and working with key funding agencies and Government Departments we can assist funds in managing your risk.

Risks need to be mitigated early through continual monitoring otherwise liabilities may ultimately be unrecoverable.

The costs of assessing and monitoring are insignificant compared to the potential loss of monies to the pension fund. Active and collaborative engagement with employers may highlight issues at an early stage and reduce overall risk.

## What can be done to manage these risks?

Through regular monitoring, as well as educating and collaborative engagement with fund employers you can improve the risk to your fund.

Examples of this include:

- Obtaining government letters of assurance/ parent company guarantees in relation to pension liabilities of fund employers
- Implementing first charge arrangements.
- Establishing which employers pose a significant risk to your fund
- Preparing reports for Local Pension boards and Pension Committees

## How we can help you?

The London Pensions Fund Authority are able to offer experienced staff that are carrying out annual employer covenant assessments for over 600 fund employers in the LGPS.

We can offer assistance to local authorities and pension committees on the following areas of work:

- Provide sector specific covenant documentation updated on an annual basis
- Carry out covenant assessments and identify key fund risks
- Preparing comprehensive reports on risk to pension committees and Local Pension boards
- Check that legal documentation still appears valid
- Presentations at fund forums on employer risk responsibilities in the LGPS
- Production of newsletters and guides for pension funds on employer risk issues

## Contact us

If you would like more information regarding the services we offer or would like to discuss your requirements with us in more detail then please contact:

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