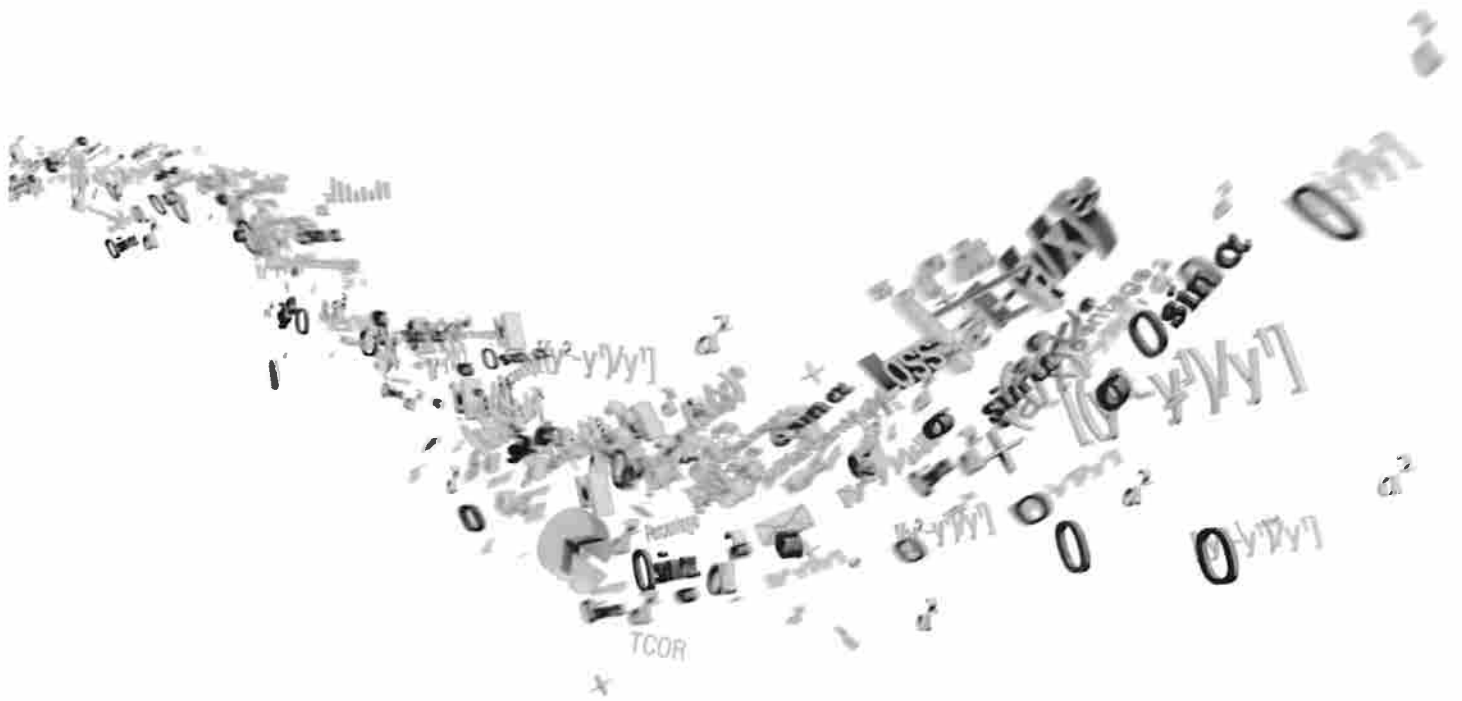


Integrated risk management

Assessing employer risks in the LGPS



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 admission valuation. Aon Hewitt assessed the covenant as follows:

Year	Trending to strong	Trending to strong	Strong
2013	100%	0%	0%
2014	100%	0%	0%

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 median levels (as measured by sector peers).
- Our most recent inspection report of DATE assessed the Employer as "Outstanding".
- Financial performance, as measured by operating leverage, improved in fiscal 2013 (down) after a year of operating losses. However, operating leverage is expected to be lower in 2014 and 2015 with the operating leverage ratio of 1.0x and a 1% response.
- The Employer implemented a staff reduction exercise in fiscal year 2013 to reduce its future cost base. Some staff costs are the main expenditure.
- Cash flow from operating activities increased by 20% in fiscal year 2013 from £100m to £120m due to the Employer's improved operating margin.
- 20% of the Employer's total assets are attributable to franchised investment (in a net book value basis), but these assets may not be easily realisable in the short term to generate liquidity (due to the specific nature of the business). Also, the Employer may be unable to raise proceeds related to the sale of the Employer's total asset base (in the event of a sale) as the Employer's total asset base is not listed on a public market.
- 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.

Financial Data Table:

	2013	2014
Revenue	100	120
Operating Profit	10	12
Operating Leverage	1.0	1.1
Operating Leverage	1.0	1.1
Operating Leverage	1.0	1.1

Other Documents:

- Director Funding Bodies:** A table showing funding bodies for 2014 and 2015, with columns for 'End admission' and 'End Deficit'.
- Notes on scheme:** A section discussing the funding of the scheme and the impact of the 2015 admission valuation.
- Notes on the Employer:** A section discussing the Employer's financial strength and the impact of the 2015 admission valuation.

Aon Hewitt
Employer Liability

When should you seek external help?

Factor		
	Light touch OK More likely to be internal	In-depth review needed 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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