Barnett Waddingham LLP

The appropriate approach for each LGPS 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 will need a different approach and different type of external support than a Fund that is examining a proposal put forward by a very large single employer that is going through a restructuring and wants to significantly extend their recovery period and change their funding approach.

We would suggest that covenant-related advice can broadly be broken down into the following four areas:

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

The first two areas are really about improving the information held and enabling you to identify the employers that need to be engaged with. The third and fourth areas are about what you do with that information.

Understanding your employers
This is an area that Barnett Waddinham has helped various Funds with. This essentially involves adapting best practice in various areas so that, for example, you have a robust employer database and you might also carry out a mini-audit of your admission agreements to make sure that they are doing what they are supposed to (e.g. there are sometimes issues with old community admission agreements). The first step in this would be to arrange a time for Barnett Waddingham to come to your office to have a discussion about what areas you'd like to be covered.

Assessing your employers
We do not directly assess employers' covenants i.e. we do not offer a service whereby we say that one employer is stronger than another.

We can, however, interpret the results and combine these with funding information to quantify the overall risk to the Fund i.e. the covenant assessment tells you how likely an employer is to default and we can estimate or calculate the cessation deficit so that you know what the effect would be on the Fund if they did default. I'll come back to this but first, I thought it would be useful to set out some of the different types of covenant assessment.

- You can simply use the employer type or sector e.g. councils are less likely to default than housing associations. This gives a simple breakdown so that you might then take a different approach for the various types of employers.
- You can use credit scores. These are usually solely based on public information and their main advantages are that they are relatively cheap and they exist for most employers in the UK. The problems with them are that they are fairly simplistic, no judgement is applied and they are not designed specifically for pensions purposes.
- You can use a framework designed for your Fund or for pension schemes generally. This approach might involve an annual questionnaire so that you can ensure, for example, that you are told when employers take out a charge on their assets (although such checks may already be part of your process). The difficulties with this approach are ensuring that you have enough resources to monitor the employers in this way and this gets trickier the

further you take this approach. For example, if you start using the financial information in the accounts to develop a scoring system, this takes a lot of expertise for it to be appropriate and consistent between employers. You could also open yourselves up to challenge if an employer does not agree with their score.
- 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.

We regularly carry out exercises for Funds where we obtain their credit score from Dun & Bradstreet and combine it with their cessation deficit to produce a report which identifies where the risk lies and we have been asked to do a number of these as part of the 2016 valuations. The cost is in the region of £5k plus VAT (it depends on the number of employers) and it's in a format that can be presented to your committee.

We can help with advising on the framework and reviewing the design of any questionnaires. We cannot advise on a scoring system but we can put you in touch with covenant specialists who would be able to help. For example, one Fund has appointed a covenant specialist and they are planning on holding a number of workshops with employers to help their understanding before they design the framework in more detail. The LPFA have designed a framework for their employers and they are keen to share their experiences and knowledge with other LGPS Funds.

<u>Reducing risk</u>
The previous two areas help with this objective as they may identify issues that you were not previously aware of and that can lead to discussions with the employers and we would be happy to be part of these discussions if it was helpful. Similarly, it might help to identify policies or admission agreement wording that could be improved.

If an employer is identified as posing a risk, steps that could be considered are exploring whether it's possible to obtain or increase security, whether it's possible to get a guarantee from a stronger connected employer (e.g. a council or Government department), reviewing any bond amount and putting in more monitoring procedures such as regularly checking their number of active members or requesting quarterly updates/meetings.

Increased employer engagement helps employers to understand the consequences of their actions and to help Funds minimise unrecoverable debts.

<u>Integrating the funding strategy with the covenant assessment</u>
The Oxfordshire Pension Fund already does this to some extent. The recovery period at the 2013 valuation for councils was 25 years whereas the Small Admitted Bodies pool (generally charities and trusts) was only 10 years.

It would be possible to extend this so that you categorise employers. For example, you might have Category A which is all bodies with tax raising powers, Category B which is other employers which are deemed to be low risk and Category C which is the employers identified as medium or high risk. The higher categories would have longer deficit recovery periods and Category C employers could get "promoted" to Category B if they put in place security or show that their risk has fallen. Similarly, Category B employers might get moved down to Category C but these are the tricky cases as these employers are possibly the ones that would struggle the most with an increase in contributions at the next valuation so it's important to design a system that is not too inflexible.

Other approaches that have been taken in the LGPS include
- Different investment strategies for different employers. Those that are identified as riskier employers might only be allowed to invest in lower risk investments. The approach usually used for this approach is to unitise the assets between employers and this leads to

considerable extra administration work. We'd be happy to discuss this in more detail but it would be a fundamental change to the way that the Fund operates.

- Different discount rates for different employers but still keeping the same investment strategy for all employers. Using more prudent assumptions for riskier employers means that they need to have more assets for a given set of liabilities and these extra assets are the protection the Fund has against unexpected default. The practical effect in the short to medium term is an increase in contributions i.e. it's reasonably similar to having a shorter deficit recovery period.

In summary, the advantages of carrying out this work include that increasing the Fund's knowledge of its employers can help it to plan and prepare and to minimise unrecoverable deficits. It provides management information to prioritise employers with which to engage. Increased engagement with employers can help both the employer and the Fund to understand the consequences of their actions, for example the potential for deficits to crystallise, to identify opportunities to increase employer security, to increase efficiency and to reduce costs.

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.