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Briefing note

Employer management in the LGPS

- Funds need to ensure they identify which employers may have issues regarding their plans and ability to pay future contributions
- This information will help put the fund proactively "at the table" for any employers who may experience particular difficulties
- If you're not at the table at the outset then you have little chance to influence and put the fund's case forward, meaning you are always playing catch up…

LGPS funds have been rightly focusing on the impacts on their people, administration and investments, due to the coronavirus pandemic. This note looks at a crucial fourth impact, namely the potential effect on employer covenant and contributions - which are a major source of fund income. Employer covenant is therefore a major risk that funds must effectively manage. The current volatility and uncertainty due to Covid-19 has a twofold impact on both an employer's finances and its pension funding position.

Corporate Insolvency and Governance Act 2020

In addition, on 26 June the Government put into force far-reaching reforms to UK insolvency through the emergency Corporate Insolvency and Governance Act 2020 which allows companies to enter into a "pre-insolvency" position. For the LGPS this means statutory demands for unpaid contributions/cessation debts, calls on some security and winding-up petitions are prevented. As funds are already (in most cases) unsecured creditors, where debts are amongst the last to be paid, this prospect will make it even more difficult for funds to recover debts. By the time action can be taken, it may be too late.

This unintended consequence of the Act, alongside the already increased focus on understanding employer covenant in the current environment, puts even more onus on funds to boost employer engagement, improve covenant information and consider pre-emptive action.

Sector specific considerations

The below sets out some high-level covenant considerations and suggested pre-emptive actions that can be taken by your fund with regards to its employers, split between different categories as follows:

- Councils
- Academies
- Further Education sector
- Contractors
- Charities and other not-for-profit organisations

Councils

For Councils it is not about the fund managing insolvency risk but rather understanding affordability concerns and potential courses of action which have pension implications.

However, recent figures show that income levels for councils are down as much as 10% as a result of lost revenue from lower business rates and council tax, and lower income from sales and fees and charges (for example, from nurseries and leisure centres being closed, lower car parking charges, no local attractions fees, etc). At the same time costs have been higher from Covid-19 response services, purchase of PPE, administering Government grant schemes, etc. What's more, many recent council investments in retail and office space perhaps don't look so promising as the way we live could change so much as a result of the lockdown experience.

There has been some central government relief from cash flow pressures through increased funding, deferred business rates payments, and social care grants paid up front. However, if further central funding is not made available, councils will have to take actions to reduce services / costs in order to deliver a balanced budget.

Fund actions

- Early discussion on contribution expectations in light of possible budgeting difficulty, Section 114 notices and/or possible mergers/restructures
- Discussion on any plans for redundancies and calculation of early retirement costs (and cashflow implications) on various scenarios
- Engagement on outsourced contracts and future delivery plans for these services – particularly with those contractors in difficulty and/or where contracts are due to end in the next 2 or 3 years

Academies

Most academies will continue to see similar levels of income, and principal costs (staff salaries and overheads) will remain largely unchanged. However, there are operational challenges and potentially some impact on earning 'other income' from renting out their halls and facilities for external use.

Fund actions

- Given the large number of academies in most English LGPS Funds, and lower covenant risk associated with this group due to the DfE guarantee, a more general communication inviting engagement might be the best use of fund resources
- Like councils, engagement around outsourced services and future plans
- Whilst each individual academy will only represent a very small part of the fund's overall finances, in combination they can amount to a material segment: funds would be advised to keep track on emerging themes which might affect most of their academies.

Further Education sector

Outside of the tax raising bodies, further education employers to have some of the largest liabilities in the LGPS, with cessation debts which would dwarf any other employer in the fund, other than the largest councils. With no statutory backing, they possibly represent the biggest risk funds must manage.

Universities have predicted huge income drops in the coming academic year as a result of fewer international students (which account for nearly 40% of total fee income in the sector), lost accommodation costs, deferrals expected from some UK students and possible refunds on student fees if distance learning is required. Costs also continue to increase due to higher debt service costs and increased USS and Teachers Pension Scheme contributions. While there is no precedent for liquidation of a publicly funded university, it is explicit in current Government policy that universities can fail and no additional support measures have been announced to date. Similar to Universities, **FE Colleges** will be impacted on enrolment numbers in the short term, particularly if socially distanced learning procedures mean smaller class sizes. As with academies, those impacted most financially may be those that are more reliant on earning 'other income' from renting out their halls and facilities for third party use. Financially distressed colleges may find the approach of merging with stronger colleges an even more difficult process meaning there are less options to explore.

Fund actions

- Conduct some high-level analysis on FE bodies of key metrics:
  - Leverage – is the body highly leveraged (liabilities / net assets) e.g. around 7% of Universities have leverage over 3.0x
  - International students – does the body have a high proportion of international students (ie. non UK and non EU) e.g. over 25%
  - Reserves – are reserves low, indicated perhaps by net assets per student (to take the size of university into account) e.g. 15% of Universities have less than £5k of net assets per student
  - Income vs expenditure - Does the body have a history of net expenditure rather than net income in recent years?
- Consider commissioning independent covenant assessments for any employer (or group of employers) of particular concern to gain a better understanding of their position. For example:
  - Understanding the fund's debt ranking and likely recovery rate on insolvency and what security might be available to improve the fund's position as an unsecured creditor.
  - Testing the affordability of increases to employer contributions required as a result of adverse market conditions and/or weakening covenant
- Keep an eye on implementation of recommendations coming out of the Augar review on Government support for the sector and the 2020 USS valuation contribution requirements
- Begin a dialogue about the possibility of obtaining security from the employer (this is potentially more urgent with university employers as the USS looks set to do likewise as part of their 2020 valuation)
- Consider if the overall investment strategy of the fund is still suitable for bodies with weaker covenants

Contractors

Some contractors will have helpful access to continued service payments from Letting Authorities and Government support measures including furlough payments and guaranteed business loans. However, many may have limited or no access to these and any loans taken will need to be repaid. Smaller contractors and local businesses typically operate on very thin margins, therefore, even with reduced staffing costs, an extended period of no (or reduced) income could cause irreparable damage.

Fund actions

- Proactive discussion with contractors and their Letting Authority will be important to understand the contractor's ongoing viability, remind them of their respective responsibilities and to understand the intentions as the contract/admission ends (noting that this could be earlier than expected as a result of redundancies, service delivery changes, etc)
- Ensure the contractor and its Letting Authority are well informed on current funding positions.
- Consider if contribution rates require to be reviewed as a result of market conditions impacting on potential cessation exit credits/debts. Where appropriate, discuss any potential exit credit and the decisions required from both parties.
- Ensure guarantee and bond arrangements are still in place, and cover is sufficient to protect against the current risk.
- Review contractors with pass through arrangements to ensure that costs which are their responsibility (for example, strains from redundancy costs, ill health retirements and excessive salary increases) have been monitored and collected alongside regular contributions.
- Mandate or strongly suggest the use of pass through admission arrangements for new contractors

Charities and other not-for-profit organisations

Whilst every charity will be impacted in different ways, the National Council for Voluntary Organisations (NCVO) estimated that the income of charities fell by £4bn over the first 12 weeks of lockdown. For example, this can result from funding raising events being cancelled, charity shops and attractions being closed, lower voluntary donations, etc. This is likely to only have been partially replaced by Government support schemes including a business rates holiday, £750m emergency fund and through access to furlough.

Fund actions

- Write out to all charities inviting further engagement with the Fund and setting out:
  - A reminder of their responsibilities as part of continuing participation in the Fund and what was agreed as part of the last valuation;
  - details of how the Fund will be monitoring and managing their funding and risk;
  - a schedule outlining each employer's latest estimated funding and cessation position; and
  - a request for key financial information and details of any material events since the last valuation which materially affect the financial position or prospects of the organisation.
- Consider discussion with the council(s) in the fund to investigate if a guarantor arrangement could be provided. For example, as many charities may have a surplus on the ongoing participation basis (despite being in deficit on a cessation basis), guarantor support might be more forthcoming. This could allow the charity to (i) cease accrual, (ii) use an alternative staff pension arrangement (e.g. Defined Contribution) going forward and (iii) continue in business (perhaps providing a valued local service that the council would otherwise have to provide themselves).
- Housing associations will have their own specific challenges from the impact of housing prices and demands to consider. There would be merit in conducting a separate engagement exercise with any you have in the fund.

Governance

We suggest that you ensure your Pensions Committee and Local Pension Board are informed on how employers are being engaged and managed, including an update on the latest employers under closer observation.

Here to help

With the focus in most LGPS funds through the pandemic rightly being on administering benefits and strengthening governance, the crucial contribution income will depend on effective and comprehensive management of employer risk. Do get in touch with your usual Hymans contact if you would like to discuss next steps and prioritisation.

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