Briefing note

Managing and integrating employer risk in funding decisions

This briefing note considers:

- What is meant by LGPS employer risk
- An overview of the different sector risk in the LGPS
- How employer risk can be integrated into funding decisions

In these uncertain and challenging times, it's never been more important to understand and manage employer risk. The 2022 valuations provide an engagement opportunity and natural review point to update employer risk information. By building fuller information on employers, funds can make better informed and robust funding decisions – whether as part of the valuation, when negotiating DDAs or if setting triggers for monitoring/action.

What do we mean by LGPS employer risk?

Employers participating within LGPS funds are all different: they vary by sector, type and size, have differing challenges and gather their funding and income from a multitude of sources. At the highest level, LGPS funds need to understand for each employer:

- What's the employer's ability to meet ongoing contributions?
- How likely is the employer to become insolvent?
- What would be the outcome for the fund on insolvency?

By gathering and assessing the answer to each of these questions, risks can be better managed and informed funding decisions can be made. In addition, the information allows funds to prioritise where time is spent engaging with higher risk employers and potentially exploring options to improve the fund's position.

However, in the current uncertain and changeable environment it's important that risk assessments are forward looking. The next few years' cashflow forecasts and balance sheets can look very different to positions before or during the pandemic.

To help with this process we've summarised the funding priorities, risks and suggested actions for each sector participating in the LGPS without tax raising powers or a central government guarantee.

Overview of the different sector risk in the LGPS

Higher and Further Education Bodies

- Responsible for providing education to students in colleges, universities, sixth form colleges, etc.
- Outside of the tax raising bodies, higher and further education employers have some of the largest liabilities in the LGPS.
- These bodies have been classified as part of the private sector (except FE bodies in Scotland). However, ONS reviews of this classification are planned in 2022/23. Any changes could have significant implications for the covenant of these bodies (see our 60 second summary for more information).
- Funding priorities: currently HE/FE bodies have an obligation to enrol staff in the LGPS and, in general, are expected to participate in the fund for a long time. Therefore, stable and sustainable contribution rates are key. However, some employers within this sector are exploring their pension options and there remains an outstanding consultation that considers removing the obligation to offer LGPS benefits to employees.
- Risks: recent examples of failed bodies, potentially poor outcome for fund if body becomes insolvent, cost of debt servicing, competing stakeholders (eg potential contribution rate changes to the Universities Superannuation Scheme (USS)*), increasing budgetary constraints, reduction in number of international students (which could account for significant portion of total income).
- Fund actions
  - conduct some high-level analysis of key metrics (eg leverage, student numbers, reserves).
  - understand individual circumstances and competing stakeholders.
  - given the typical complexity of these bodies and size of LGPS liabilities, consider specialist covenant advice to gain a better understanding of their position (eg debt ranking, outcome for the fund on insolvency, what security might be available, etc.)

**note that the USS proposed funding package includes pari passu security with new secured debt which mean both rank ahead of LGPS funds if granted.*

Housing Associations

- Responsible for providing affordable homes and providing opportunity for home ownership to various communities.
- Typically, large balance sheets due to housing stock held with a high level of secured debt.
- The Regulator of Social Housing provides useful economic standards and assessment of governance and financial viability.
- Funding priorities: most housing associations participate in the LGPS on a voluntary basis. They are typically closed to new staff joining the scheme and are therefore heading towards an exit date in the short to medium term (when the last employee leaves active service). The objective is to manage their exit.
- Risks: commitments to other (non-LGPS) pension funds, changing Government policies (such as rent reductions), exposure to increased interest costs, increasing running costs (energy, construction and materials), costs associated with meeting Health and Safety standards (eg Grenfell rectification) and other risks associated with development and diversification.
- Fund actions:
  - early engagement is key to understand budget pressures and commitment to the LGPS.
  - gather information now so any request for a Deferred Debt Arrangement (“DDA”) or Debt Spreading Arrangement (“DSA”) can be considered alongside the valuation discussions.

Contractors

- Contractors are admitted to the Fund for a short period of time covering the length of their service contract to ensure any outsourced employees continue to receive LGPS benefits.
- Funding priorities: managed exit to minimise any pension deficit/surplus on cessation.
- Risks: loss of contract, increasing costs (energy, staff), repaying loans taken during lockdown. However, most contractors are now admitted to the LGPS on a 'pass-through' basis meaning that the pension risks remain with the employer who awarded the contract (eg the Council or Academy). Even in instances where a 'pass-though' agreement is not in place, the Awarding Authority remains the ultimate guarantor and therefore the risk to the fund is lessened.
- Fund actions:
  - understand the contracting authorities' intentions as the contract/admission ends (eg insourcing, re-let).
  - discuss any potential exit credit and the decisions required from both parties.
  - review contractors with pass-through arrangements to ensure that costs which are their responsibility are properly assessed (eg strains from redundancy costs, ill health retirements and excessive salary increases).

Charities and other not-for-profit organisations

- Responsible for providing charitable services across a range of different sectors including community support, children's services, public attractions and facilities.
- Typically, reliant on funding, grants, donations, volunteers. Running margins are tight and reserves are usually low.
- Funding priorities: these employers participate in the LGPS on a voluntary basis. They are typically closed to new members joining the scheme (although not always) and are therefore heading towards an exit date in the short to medium term (when the last employee leaves active service). The objective is to have an affordable exit payment.
- Risks: increased running cost, reduced reserves due to use during lockdown, reduction in income from public donations, fundraising events and charity shops, staffing pressures reducing ability to deliver charitable services.
- Fund actions:
  - ensuring the fund is proactively "at the table" for employers who are experiencing difficulties
  - continued engagement is key to understand forward looking viability including current and future budget pressures
  - gather information now so any request for a Deferred Debt Arrangement ("DDA") or Debt Spreading Arrangement ("DSA") can be considered alongside the valuation discussions

Integrating employer risk into funding decisions

We believe that employer risk should feed directly into funding plans, including:

- **Valuation funding parameters** – when setting a contribution plan, the funding target (ie ongoing or low-risk exit assumptions) and likelihood of meeting this target should be set based on the risk of the individual employer e.g. a higher risk employer may be required to have more certainty in their funding plan of reaching their funding target.
- **Employer-specific investment strategies** – where available, an alternative investment strategy from the main strategy may be more appropriate eg a higher risk, well-funded employer may benefit from the lower volatility of a less growth-focussed investment strategy.
- **Entering into DDAs or DSAs** – the results of a covenant assessment help inform the terms of these agreements eg length of plan, required security etc..

Recommended next steps

The 2022 valuation provides an opportunity for funds to leverage the additional engagement with employers by expanding the information held on employers and improving risk management. We appreciate that officer time and resource is at a premium, therefore a proportionate approach is needed. As a first step we can provide sector specific online questionnaires to quickly build solid and comparable information on your employers. This enables focussed further engagement with the required employers, allows robust funding decisions and acts as a baseline for future monitoring. Thereafter, you can decide if a more in-depth assessment is required.

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