Lancashire County
Pension
Fund

Employer Risk Policy

March 2023

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Lancashire County Council as administering authority of Lancashire County Pension Fund

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Version Control

0.1	Initial draft	15.08.2022
0.2	Incorporating comments from Mercer	17.08.2022
0.3	Incorporating comments from Financial Consultant and Pensions Technical Lead	22.08.2022
0.4	Review by Mercer	02.09.2022
1.0	Approved by Pension Fund Committee	16.02.2022
1.1	Notifiable events section updated following Funding Strategy Statement Consultation	18.02.2023

Lancashire County Pension Fund

Section 1 - Introduction

This is the Employer Risk Policy of the Lancashire County Pension Fund (the Pension Fund) in relation to the Local Government Pension Scheme (the Scheme), which is administered by Lancashire County Council (the County Council).

Background

The Pension Fund is committed to providing a high quality pension service to both members and scheme employers and the aims of the Pension Fund are to: -

- manage employers' liabilities effectively and ensure that sufficient resources are available to meet all liabilities as they fall due;
- enable employer contribution rates to be kept at a reasonable and affordable cost to the taxpayers, scheduled and admitted bodies, while achieving and maintaining Pension Fund solvency and long term cost efficiency; and
- maximise the returns from investments within reasonable risk parameters taking into account the above aims.

The Employer Risk policy is an important part of the Fund's approach to funding strategy and forms part of the Funding Strategy Statement. The policy has been developed to set out approach to covenant assessment, management of employer risk and funding approaches.

Regulatory developments

Pension Scheme Regulations 2013 require the payment of an exit payment by the scheme employer when the last active member of an employer leaves the Pension Fund, or an employer otherwise ceases to be an employer in the Pension Fund, and the employer was in deficit at the time of their exit.

Recently employer flexibilities were introduced within the Regulations to allow administering authorities to spread exits payments or enter into deferred debt arrangements in certain circumstances. More information on this is contained in the Pension Fund's Admission and Termination Policy.

Section 2 - Employer Covenant

Employers participating in Lancashire County Pension Fund

The Pension Fund is administered on behalf of over 300 organisations ranging from large taxpayer-backed organisations such as councils, through to small charities with no guaranteed sources of funding. Clearly, some employers present a higher risk than others.

The Local Government Pension Scheme is open to 2 main types of employers, 'Scheduled Bodies' and 'Admitted Bodies': scheduled employers have an automatic right to Pension Scheme entry. Scheduled Bodies include County/District Councils and Unitary Authorities, Combined Authorities, Fire and Rescue Authorities, Police and Crime Commissioner, Further and Higher Education Institutions and Academies.

Admitted employers don't have an automatic right to Pension Scheme entry and their entry to the Pension Scheme arises as a result of being 'admitted' via an Admission Agreement. Admission Agreements now specify a requirement for security against default, however older agreements do not, and these older agreements therefore need to be updated.

Employer covenant definition

Within a pensions context, the term 'covenant' relates to an assessment of an employer's legal obligations and longer-term ability and willingness to meet its financial commitments to the Pension Fund. This includes the ability to meet any historic deficit payments and final exit payment due as well as ongoing employer contributions.

Should an employer become unable to meet its commitments, sometimes because of insolvency, the Pension Fund must still meet its pensions obligations to the affected employer's members. Unless there is a guarantor employer within the Fund who would absorb the liabilities, the financial burden of meeting these obligations inadvertently falls upon other Pension Fund employers – these obligations are referred to as orphan liabilities. Thus it is important to form a view on employers' covenant strength and put in place risk management strategies to reduce any impact of employer default.

The strength of covenant depends upon the robustness of the legal agreements in place and the likelihood that the employer can meet them. The covenant effectively underwrites the risks to which the Pension Fund is exposed, including underfunding, longevity, investment and market forces, which impact on the Fund's ability to continue to pay pensions to all members over the long term.

Assessing the employer covenant regularly is important as it enables the Pension Fund to understand the extent to which the employer can afford to support the scheme now and in the future.

Section 3 - Employer risk management

3.1 Identification

It is important to identify those employers that require a covenant assessment. Employers will require an assessment if it is considered possible that they could exit the Pension Fund without having either a guarantor or the financial resources to pay any cessation debt that would arise. To do this in a proportionate manner, employers are categorised into the following two categories:

Category A – Lower Risk – scheduled, taxpayer-backed or with the ability to levy local taxes, government guarantee:

- County, District, and Unitary Councils
- Office of the Police and Crime Commissioner / Lancashire Constabulary
- Lancashire Combined Fire Authority
- NHS-related organisations
- Academies including Multi-Academy Trusts
- Any employer with a Category A guarantor

Category B – Higher Risk – no government guarantee with a risk that liabilities could be orphaned:

- Housing Associations
- Further Education Colleges
- Universities
- Trade Unions
- Charities
- Private schools
- Parish and Town Councils

The focus of employer risk activity is on Category B.

3.2 Termination of Fund participation

To reflect the fact that the liabilities of Category B employers will be orphaned when they exit the Fund, and so fall to all remaining employers, the exit payment for these employers is assessed using more prudent assumptions than those used for ongoing funding. This is to provide protection to the other employers by reducing the likelihood that they will need to provide additional funds to meet the exiting employer's obligations.

The full details of the approach on termination is covered in the Pension Fund's Admission and Termination Policy.

3.3 Covenant assessment

As mentioned above, assessing the employer covenant regularly is important. In line with this policy, Category B employers will undergo a regular assessment of covenant by the Fund.

The scope of conducting a covenant assessment is summarised below:

- Quantitative analysis of past financial performance including income, balance sheet and Cashflow;
- Quantitative analysis of forecast financials, profitability and cash flows;
- Commentary of the qualitative factors impacting and sectoral analysis including commentary on key trends/ future trends that may impact the employer in the Pension Fund; and
- The employer's group structure and position within the group.

The Pensions Regulator regards employer covenant as one of the cornerstones of the defined benefit scheme risk spectrum that must be considered and regularly monitored. Covenant strength can change rapidly, and both LGPS and employers will want to ensure they have measures in place for remediating a concern.

The table overleaf summarises the results into three covenant ratings. The main purpose of the covenant assessment is to identify the higher risk employers (the bottom group), so that the Pension Fund can consider whether action needs to be taken in these cases. Once an employer has been assessed, the appropriate funding approach will be applied – see appendix (Funding approaches).

Covenant Rating	Funding Approach	Definition
(Green)	Outcome B (unless bond/security put in place – see mitigation section)	**Good financial position to support pension contributions and likely to be able to support pension deficits but no explicit government backing.**
(Amber)	Outcome B (unless bond/security put in place – see mitigation section)	**Good financial position with minor indication of concern to support pension deficits in the foreseeable future.**
(Red)	Outcome B (unless bond/security put in place – see mitigation section) + additional engagement on options to manage risk*	**Poor financial position with indication of concern to support pension deficits in the foreseeable future.**

* the focus here will be on actions that can be taken to limit the risk to other Pension Fund employers, and may extend to funding for termination over a short period – see para 3.6-Funding for termination overleaf.

3.4 Monitoring

The strength of employer covenant can be subject to substantial variation over relatively short periods of time. As such, regular monitoring and assessment is important to identify increasing exposures to risk - some changes may be temporary but others may be long-term and impact on strength of the covenant.

Covenant assessment will be undertaken every three years to align with the actuarial valuation. The Pension Fund will also aim to undertake regular reviews - potentially annually between valuations – for some employers depending on their individual circumstances.

This is subject to notifiable events (see para 3.7 overleaf).

3.5 Mitigation

This policy focuses on the use of funding based measures to increase contributions for employers that are assessed as posing risk to the Pension Fund. Employers in Category A are assumed to pose minimal risk to the Fund due to their taxpayer backed status, so the focus is on those in Category B. The Pension Fund will adopt stronger funding measures for these employers as default, with consideration of further specific measures for those identified as having a weaker covenant. Further detail is provided in the appendix.

The Fund's preferred approach is to increase security through a more prudent funding approach. The "standard" funding approach applied to Category A employers is to target full funding (i.e. no deficit) on the Pension Fund's ongoing assumptions over a reasonable timeframe. The more prudent funding approach will result in higher contributions. The rationale for this is that higher contributions will align more closely to the exit payment for Category B employers, and so improve funding positions and reduce the size of any potential unfunded exit debt should the employer leave the Fund.

However, employers may instead be able to provide security (see below) to cover unfunded exit debts and would, in return, be given treatment similar to a Council.

There are five primary tools available to the Pension Fund in managing risk:

- obtaining guarantees from an entity in respect of other employers' pension liabilities. Guarantees from a Category A employer or Government departments or tax/levy raising bodies would see the employer in question moved to Category A. However, the Fund may also consider the value of guarantees awarded by private entities (for example a parent company);
- an employer obtains an 'insurance policy' (known as a 'bond') which would pay off Pension Fund liabilities in the event of employer default;
- an employer provides a Charge over land/property/asset which would enable the Pension Fund to secure some or all monies due to it in the event of default;
- escrow accounts (where an employer sets aside monies in a specific account controlled by a third party); and
- cancellation of Admission Agreement – this can trigger an 'exit payment' due from the employer but its effectiveness depends upon the ability of the employer to meet the exit payment. However, employer flexibilities can be used in certain circumstances.

Assuming a Government guarantee cannot be provided, the default security will be bonds. However, in certain circumstances the Fund may consider the other options. Where other options are applied, any costs (for example the adviser costs related to assessing the value of a parent company guarantee) will be met by the employer.

3.6 Funding for termination

The above assumes Category B employers, while posing a risk to some degree, intend to continue in the Fund in the short to medium term.

However, where they are likely to exit in the short / medium term, or the level of risk is perceived to be higher, employers might have to fund for termination over a much shorter period where the Fund believes exit will occur shortly. The Pension Fund will identify relevant employers as part of valuation (e.g. fixed end date in the Fund, closed employers with older membership) or consider whether there are any weaker employers to include (e.g. more likely to terminate through insolvency) based on the results of the covenant review.

3.7 Notifiable Events

While monitoring is covered above, the Fund cannot identify all issues that might affect an employer's covenant in real time. Therefore, employers are required to notify the Fund of any corporate activity or changes which could materially impact the covenant.

A notifiable event is any event or circumstance that, in the judgement of the Fund, could materially affect an employer's continued participation in the Fund, ability to pay contributions, or cover their exit debt.

Typical events that should be notified would include:

- Significant changes in the employer's membership / liabilities. This would include, for example, restructuring (involving significant staffing changes), significant outsourcings / staff transfers, mergers, significant redundancy exercises, salary awards, ill health retirements, member withdrawals from the Fund, concerns of fraud that may include pensions aspects
- Significant changes to the employer covenant. This would include, for example, reduced affordability of contributions, significant reduction in funding, provision of security to other parties, impairment of security / change in bond, sale or transfer of significant assets, any payment defaults, potential insolvency
- Other significant changes in circumstances. This would include, for example an acquisition by another organisation, winding down / ceasing to trade, change in business model, relevant legal proceedings against the employer

On notification, the Fund will discuss the circumstances with the employer, and consider whether a change in funding approach (see Appendix) or other action is appropriate.

If an employer has any doubts as to whether an event is significant, please contact the Fund who will be happy to provide guidance on this.

Where an employer does not inform the Pension Fund of an event that is relevant in the Pension Fund's view, then the Fund may in extreme circumstances make changes to the funding approach or take other actions without discussion and/or consent of the employer in order to protect the Fund (although we would always look to engage with employers in a collaborative manner, and so would expect such instances to be very rare in practice).

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Section 14 - Future Review

This policy will next be reviewed in detail as part of the next triennial valuation due 31 March 2025. Key principles will be reviewed and monitored on an annual basis and updated following consultation and as a matter of course in the event of significant change in scheme regulation and guidance.

The Pension Fund may, where appropriate, depart from this policy depending on the individual circumstances of an employer.

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Appendix 1 – Funding approaches

The approach to funding - for employers falling within scope of the Employer Risk Policy - focuses on the use of funding based measures to target higher contributions where appropriate in order to reduce risk to other employers. These will typically involve the use of more prudent actuarial assumptions, which will result in both a higher "funding target" (the level of assets the employer is targeting in the Fund) and so potentially higher deficit contributions, and higher future service contributions (covering new benefits earned). Further detail is in the mitigations section.

The funding approach focuses on employers that do not have a taxpayer guarantee – Category B employers – where the risk of unfunded exit debts is greatest. For Category B employers there are two potential outcomes:

- Outcome A – the employer provides sufficient security (see the mitigations section above) to cover any potential exit debt
- Outcome B – no such security is provided

The funding approach in each circumstance is as follows:

Covenant Rating	Category A employers*	Category B employers One of the following outcomes:	
		Outcome A	Outcome B (default)
Bond / security	No*	Yes**	No
Funding target	Standard	Standard	Higher
Future service rate	Standard	Standard	Higher
Deficit recovery period	Standard	Standard	Potentially shorter
Surplus offset allowed?* **	Yes	No	No
Alter if close to exit******	No	Optional	Optional

* These employer are not subject to regular covenant assessment. Note that some contractors may be required to provide a bond on admission, but this is to protect the guarantor employer

** The base position is that the bond / security should cover the potential exit debt in full, including any redundancy strains, but depending on individual circumstances some combination of partial security and / or reliance on covenant may be sufficient (subject to agreement of the Head of Fund)

*** Category A employers who have a surplus in the Fund may be allowed to use this to reduce their future service contributions via "surplus offsets". This will not be the case for Category B employers (unless they have a surplus relative to their exit debt)

**** If an employer is close to exit and there is no bond then the Fund might take further steps – for example requiring the employer to Fund for the exit debt (usually meaning much higher contributions than even the right hand column above)

Note – for Town/Parish Councils, deficit recovery plan and surplus offset allowed will be considered based on individual circumstances.