Employer risk strategy

Purpose

This paper is addressed to Croydon Council in its capacity as Administering Authority to the London Borough of Croydon Pension Fund ("the Fund"). The purpose of this paper is to outline work relating to employer risk strategy including assessing and monitoring the financial strength of employers participating in the Fund. The Pensions Committee is asked to consider this paper and approve this work to ensure a more considered strategy to employer risk management in the Fund.

Overview

The LGPS has changed significantly in recent years and continues to change. There are now far more employers participating in the Fund and these employers are far more diverse, covering local authorities, charities, education bodies, academies, 'arms-length' organisations such as mutual trading companies and private sector contractors. There is more scrutiny on the LGPS and an increased level of governance, with the introduction of the Fund's Pensions Board, and a focus on managing deficits more effectively.

The Fund has a duty to ensure that each employer pays for its own benefit obligations in the Fund, and to minimise cross subsidy between employers. To do this it needs to set contribution rates that recognise the financial strength of the employer, and reduce the risk upon employer cessation of the Fund being left with an unpaid debt.

In addition, employers are now more engaged and knowledgeable about pension issues due to increasing costs and the need to demonstrate value to stakeholders. Employers are looking to the Fund to provide more bespoke solutions and options in relation to funding and investment strategies, as admission arrangements get more varied and complex.

Legislative requirement

The Pensions Regulator is now actively involved in oversight of the LGPS. It issued a Code of Practice on the "Governance and administration of public service pension schemes" in April 2015. Paragraph 114 of the new Code of Practice states:

Where relevant, schemes should put in place systems and processes for making an objective assessment of the strength of an employer's covenant (which should include analysis of their financial position, prospects and ability to pay the necessary employer contributions).

This is particularly relevant for the LGPS given the diverse nature of the participating employers.

Implementing an employer risk strategy framework

To improve the Fund's governance and provide the basis for agreeing better outcomes for employers and the Fund, the following areas of work are proposed in the run up to the 2016 actuarial valuation, from which revised employer contribution rates come into effect on 1 April 2017.

Date	Work required
End Sept 2015	Results of Academies' contribution rate consultation fed into employer risk framework
Autumn 2015	Work with Officers (see Appendix): • develop risk matrix to produce an objective risk score for each employer in the Fund; • develop and issue questionnaire to be completed by employers; • obtain a credit score from a credit rating agency such as Experian; • calculation of 'early indication' employer 2016 valuation funding position and contribution rates; • categorise employers based on this information to inform funding and investment strategy; and • consider case for implementing individual employer investment strategies.
Jan 2017	Early engagement with employers ahead of 2016 formal valuation
Aug-Oct 2016	Calculation of 2016 actuarial valuation results, including employer funding positions and contribution rates
Sept 2016	Whole Fund valuation results, and approach to setting individual employer contribution rates approved in principle by Committee
Nov 2016	Communication of draft employer funding positions and contribution rates
Dec 2016	Employer forum and surgeries with Actuary
Jan 2017	Consult on Funding Strategy Statement with employers as required by LGPS Regulations
Mar 2017	Final Funding Strategy Statement, valuation results and contribution rates approved by Committee
Apr 2017	New contribution rates for employers come into effect

Next steps

The work outlined above would result in a comprehensive framework for employer risk strategy and managing deficits which will ensure better outcomes for the Fund and its employers. This work is being carried out by many LGPS funds ahead of the 2016 valuation and would demonstrate that the Fund has a system in place to manage and mitigate employer risks.

The Pensions Committee is asked to grant its approval to carry out the work detailed in this paper.

Richard Warden

Fund Actuary
For and on behalf of Hymans Robertson LLP
03 August 2015

Appendix

1 Assessing and monitoring employer covenant

Background

With the number and diversity of employers participating in the Fund and the more complex pension arrangements arising, it is becoming increasingly important to assess and monitor the ability and willingness of employers to meet their pension obligations. The Fund is experiencing an increase in the number of employers raising issues about their ability to pay the certified contributions and their willingness to continue participation in the LGPS. This is likely to lead to more defaults on debt unless employer covenant is monitored regularly throughout the term of any admission agreement and, where considered necessary, appropriate remedial action taken to safeguard all employers within the Fund.

What is Employer Covenant?

Employer covenant is defined as the “ability and willingness” of the employer or scheme sponsor to support the pension scheme through contributions. We should consider and assess each of these separately.

We need to assess the ability of each employer to:

1. Pay regular contributions at the level required to fund new benefit accrual in the LGPS
2. Pay contributions towards any existing deficit or any deficit that arises as a result of adverse experience
3. Meet the costs of any lump sum payments that arise as a result of participation in the LGPS, including ill health retirement or redundancy strain costs.
4. Meet the costs of any final settlement of liabilities that may be required as a result of ending participation in the LGPS.

We need to assess the willingness of each employer to fund LGPS benefits on behalf of their members including:

1. Reasons for employer participation in LGPS, e.g. legislative requirement, contractual requirement
2. Employers’ time horizon for participation in LGPS
3. Employer’s attitude to valuation funding level and deficit
4. Employer’s attitude to pensions accounting issues including balance sheet and revenue account
5. Employer’s view on contributions levels and contribution volatility.

Purpose

The purpose of assessing employer covenant is to:

1. Quantify the financial risk to which the Fund is exposed by employers, individually and in total.
2. Take actions to minimise the financial risk to the Fund through employers being unable to meet the costs of participation in the Fund, firstly by establishing appropriate funding objectives for each employer and putting in place a funding and investment strategy that maximises the employer’s chance of meeting these objectives and secondly, by establishing the appropriate levels of security for the Fund in the event that an employer cannot meet its obligations.

This can be carried out in many ways, including:

- Regular reviews of the employer funding level;
- Regular reviews of the potential risk and financial debt on early termination (including redundancy costs);

- Assessment and review of covenant through a number of metrics and development of a risk score. Employers can be categorised based on these metrics (e.g. deficit, time horizon, gearing ratio, cash flow position etc) and their potential financial impact to the Fund.
- An assessment of covenant by a credit rating agency (such as Experian) where this is available for employers. Due to the number of employers in the LGPS this can be obtained at low cost due to economies of scale.
- Assessment against actuarial assumptions in areas such as pay growth;
- Requirements on the admission body to notify changes in their circumstances;
- Regular assessment of the strength and value of any security put in place by the employer (e.g. bond, parent company guarantee, first charge on assets, escrow account);
- Checks to see whether an employer has failed to notify the Fund of relevant changes (e.g. closure to new entrants).
- Issue a questionnaire to determine the employer’s ability and willingness to pay

2 Developing consistent funding and investment strategies

We have already developed a more comprehensive and tailored funding strategy in recent years to enable better informed decisions during the formal valuation process. One example is that the Fund uses asset-liability modelling to set less volatile (stabilised) contribution rates for tax-raising bodies by stress testing those rates against a range of possible economic conditions over the long term.

This modelling exercise, which was adopted at the 2013 valuation for tax raising bodies, can be extended to all employers in the Fund based on the employer covenant work detailed above and allowing for the specific time horizon of each employer.

It works by setting a higher funding target for those employers with poorer covenant and that represent a greater financial risk to the Fund. The higher funding target is measured through an increased likelihood of achieving a fully funded position. For example:

- Low risk employer (e.g. University) – 66% likelihood
- Medium risk employer (e.g. contractor) - 75% likelihood
- High risk employer (e.g. charity) – 85% likelihood

The actual likelihoods used in practice would be discussed and agreed as part of the valuation discussions.

The Fund currently applies a single investment strategy to all of its employers. It may wish to review this approach once the employer risk strategy exercise has been completed for certain groups of employers e.g. for closed bodies that have a much shorter time horizon than other employers (such as the Council which is also are open to new entrants).