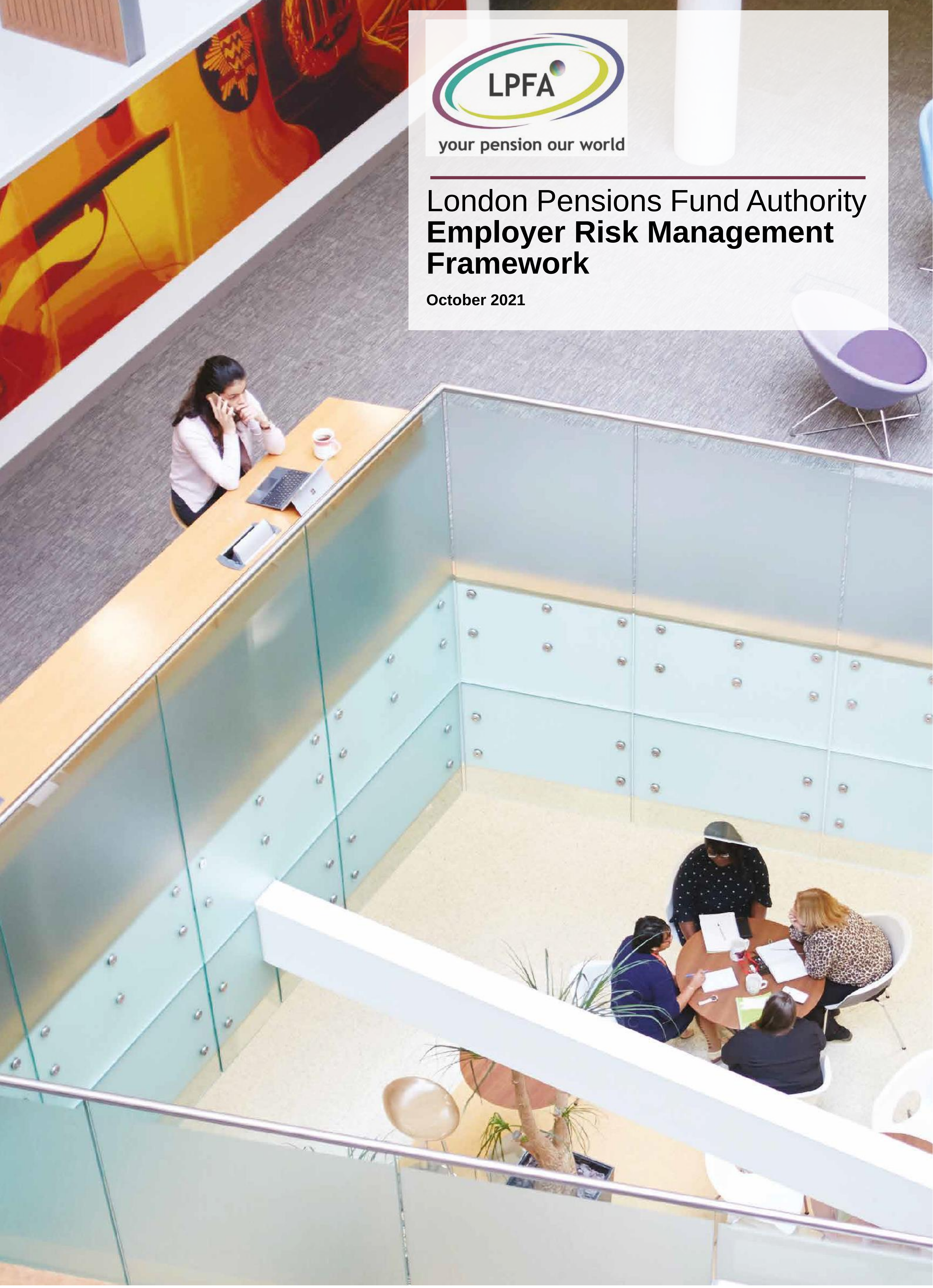

London Pensions Fund Authority

Employer Risk Management Framework

October 2021

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Introduction

1.1 LPFA is proud to serve employers from a diverse range of backgrounds, throughout London and beyond. As well as local authorities and government bodies, LPFA provides pensions for charities, social housing associations, and further/higher education bodies, amongst others.

1.2 To administer the LPFA Pension Fund effectively, it is important that we identify, assess, and where possible mitigate the risks to which LPFA, and by extension the employers contributing to the Fund, are exposed. One such risk is that individual employers are unable to make payments to the Fund when required, which could ultimately result in other employers needing to pay more. This framework outlines how LPFA identifies, assesses, and manages this risk for the benefit of employers as a whole.

1.3 This framework forms the basis for our engagement with employers. We hope that our transparent approach helps employers to engage collaboratively and constructively with LPFA. Our ultimate aim is to ensure, as far as possible, that:

1) LPFA is able to meet its primary funding objective to pay benefits as they fall due;
2) Employers are not required to pay additional contributions to address deficits created by other employers being unable to make payments to the Fund;
3) Employers are empowered to take positive steps to improve their position within the Fund.

1.4 This framework is not intended to restrict LPFA's discretion. Where appropriate LPFA may depart from this framework based on individual employer circumstances.

Defining the Employer Covenant

2.1 How much reliance can be placed on an employer's ability to support the funding needs of the Scheme? This question lies at the heart of the employer covenant, which is defined by The Pensions Regulator[1] as the:

''Extent of the employer's legal obligation and financial ability to support the scheme now and in the future ''.

2.2 The covenant is therefore about the relationship between the Fund and the employer and, in a certain sense, the relationship between that of a debtor (the employer) and that of a creditor (the Fund).

2.3 Assessing the support available from the employer covenant is a complex process and will involve an appraisal of the covenant across different time horizons and in different downside scenarios (for example, should the scheme's investment strategy underperform and/or the employer's funding deteriorate). Consequently, when assessing the strength of the employer covenant, LPFA will look to consider:

1) Ongoing covenant – the extent to which the employer can continue to make regular contributions to the Fund to pay for benefits being accrued by their employees, and (where necessary) any deficit contributions.
2) Exit covenant – the extent to which the employer could finance any cessation debt that would be payable upon exiting the Fund. Employers are assumed to exit the Fund if they no longer employ any active members (either by winding up or "organically" as members leave service).

2.4 These two perspectives allow us to consider the strength of the employer covenant in the short term (usually dominated by the ongoing covenant) and over the longer term (when the potential for exit can become increasingly likely). Both of these aspects of covenant can change, sometimes quickly, as a result of developments at the Fund or employer level.

2.5 LPFA will look to work with employers in an open and collaborative manner where risks are identified. In turn, LPFA expects employers to engage with the Fund on covenant matters when requested so that both the views of LPFA and those of the employer are given due consideration in the assessment process.

1 The Pensions Regulator – Assessing and monitoring the employer covenant

https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/assessing-and-monitoring-the-employer-covenant

Covenant grades

3.1 The covenant grades that can be awarded to employers are outlined below:

Covenant Grade	
A	Lowest risk
B1	
B2	
C1	
C2	
D	Highest risk

3.2 These grades are used to determine the actuarial assumptions used to calculate each employer's contribution rate. Details of the assumptions adopted for each grade are set out in LPFA's Funding Strategy Statement and are not considered further in this framework.

Identifying risks

4.1 The first step of the framework is to identify those employers that require a covenant analysis. Employers will require an analysis if it is considered possible that they could exit the Fund without having the financial resources to pay any cessation debt that would arise.

4.2 To do this, employers are categorised into their respective sectors. The categories function as a high-level filter for the Fund and allow LPFA to determine if a detailed covenant analysis is necessary.

4.3 Some employers (such as those whose liabilities are guaranteed by government) are assessed as category A because it is not considered possible that they could exit the Fund without the financial resources to pay any cessation debt. These employers are assessed based on their status and a detailed covenant analysis is not carried out.

4.4 For other employers a covenant analysis will be required as LPFA will need to determine the extent to which it can rely on financial support as and when such support is needed.

4.5 The sector groupings adopted by LPFA and LPFA's policy for covenant analysis is summarised below:

LPFA Employer Covenant Sector	Covenant Analysis	Covenant Grade
Charities (as regulated by the Charities Commission)	Yes	Variable (A-D)
Further Education Institutions	Yes	Variable (A-D)
Higher Education Institutions	Yes	Variable (A-D)
Independent Schools	Yes	Variable (A-D)
Social Housing Associations	Yes	Variable (A-D)
Contractors (where the admission agreement is underwritten by another LPFA employer)	No	In line with the guarantor
LEA Schools	No	A
Academies	No	A
Government Bodies	No	A

4.6 When an employer has been admitted to the Fund with a guarantor, LPFA will first assess the covenant strength of the guarantor before determining if the Scheme employer requires an additional covenant analysis.

4.7 In categorising employers into their respective covenant sectors, we are adopting a proportionate approach intended to make best use of LPFA's resources, which is ultimately to the benefit of all LPFA employers.

Assessing risks

5.1 Covenant grades A and D represent the extreme ends of the covenant spectrum and are defined in isolation.

- **Category A** employers are those that are understood to present no covenant risk to the Fund. These employers are identified by their close connection to the Government. Employers that do not meet the criteria for category A can achieve this category only if they are guaranteed by a body meeting the criteria for category A or by providing security to LPFA. Further details are set out in section 8 of this document "Actions to improve the employer covenant"

- **Category D** employers are defined as those where in the opinion of an administering authority there are circumstances which make it likely that a Scheme employer will become an exiting employer. LPFA will use this covenant grade in accordance with Regulation 64.4 of the 2013 LGPS Regulations. As category D will only be used in this limited scenario, it does not form a part of the Fund's regular covenant grading framework.

5.2 For employers that do not meet the criteria for category A or D outlined above, LPFA will carry out a more detailed covenant analysis. The main covenant risk that LPFA faces is the risk of an employer exiting the Fund without having the financial resources to pay any cessation debt that would arise in full. When assessing this risk, LPFA considers both the ongoing and exit covenant, which are analogous to the likelihood and consequences of the risk occurring. Ongoing covenant and exit covenant are assessed on a four-point scale, as outlined below.

Score	Ongoing covenant (likelihood of cessation)	Exit covenant (consequences of cessation)
1 (low risk)	The employer is financially strong. The employer's financial strength is sufficiently robust to withstand severe disruptions to operations. The employer's outlook within its sector means that (under normal economic conditions) it could recover from significant disruption in a relatively short timeframe.	Financial failure is likely to result in recovery of over 70% of any cessation debt.
2	The employer is financially stable. Its outlook is generally positive but broader risks in the sector may exist which (if allowed to materialise without mitigation) may weaken the employer's financial strength.	Financial failure is likely to result in recovery of between 50% and 70% of any cessation debt.
3	The employer is financially vulnerable. Financial decline may have led to capital erosion, placing pressure on cash reserves and/or increased the employer's reliance on debt. It may also be that the employer operates in a sector which is highly vulnerable to economic downturn. Whilst there are significant challenges for the business, the employer has a clear strategy plan to improve their financial position.	Financial failure is likely to result in recovery of between 30% and 50% of any cessation debt.
4 (higher risk)	The employer is weak and there are signs of ongoing financial distress which, if continued without mitigation, may mean the employer would be unable to continue as a going concern.	Financial failure is likely to result in recovery of less than 30% of any cessation debt.

5.3 The ongoing and exit covenant scores are combined using the table below to determine the final employer covenant rating.

		Ongoing covenant			
		1	2	3	4
Exit covenant	4	B2	C1	C2	C2
	3	B2	C1	C1	C2
	2	B1	B2	C1	C1
	1	B1	B1	B2	C1

5.4 LPFA uses financial metrics to identify risks. We also recognise that this is a highly complex area and that no one-size-fits-all approach can accurately assess the individual covenant position of employers. Consequently, LPFA combines the use of financial metrics with subjective judgment.

5.5 LPFA will employ a proportionate approach by initially forming a view of the strength of the covenant based on publicly available information, analysed at a high-level. The purpose of this process is to capture trends and emerging risks in the covenant, and to allow LPFA to determine which employers may require a more detailed covenant review.

5.6 In grading the covenant, it should be noted that this is ultimately a matter of judgment, based on a review of key information about an individual employer's circumstances and their position in the Scheme.

5.7 The approach taken when assessing the ''ongoing covenant'' and the ''exit covenant'' are set out below.

Ongoing Covenant

6.1 Ongoing covenant is considered from three perspectives:

- The employer's current and future financial position
- The employer's position within its sector and the outlook for that sector as a whole
- The employer's engagement with LPFA

Financial

6.2 The financial support available from an employer is a key element of the employer covenant. When financial support is assessed in the context of the ongoing covenant, the primary consideration will be the employer's ability to make regular contributions to the Fund to pay for benefits being accrued by their employees, and (where necessary) any deficit contributions.

6.3 Assessing an employer's financial resources is a complex process. Where available, relevant, and proportionate, LPFA will consider the following as part of its analysis –

– Historic resources (as disclosed in annual audited accounts);

– Current financial resources (for example management accounts);

– The employer's group structure and position within the group;

– The employer's trading and balance sheet position, plus financing structure, including material forthcoming events;

– Forecast profit and cash generation, business plans, growth prospects;

– Transactional activity such as mergers, de-mergers, and material acquisitions.

6.4 LPFA will assess the above information with a view to determining how much visibility there is in the covenant and how much reliance the Fund can place on the covenant, given the size of an individual employer's liabilities/funding in the Scheme. LPFA's covenant analysis is not intended to be a critique of an employer's business; rather, it is an assessment of an employer's strength relative to the potential needs of the Fund.

Sector position and outlook

6.5 The importance of sector risks in the employer covenant will be considered against the backdrop of any financial impact such risks could have on the strength of the employer covenant.

6.6 Sector risks can impact employers to differing degrees, and the materiality of the risk may depend both on the employer's covenant strength prior to the crystallisation of the risk and the employer's subsequent response in addressing the risk.

6.7 Examples of sector-based risks that may impact the covenant of LGPS employers include:

- Financial notices of concern from the Education Skills Funding Agency
- Changes to insolvency legislation for employer sectors (for example, the Technical and Further Education Act 2017).
- Changes in Social Housing governance and/or viability grades.
- Changes in the funding and/or security approach of other pension arrangements to which the employer has obligations.
- Regulatory intervention into the activities/finances of an employer.

Employer engagement

6.8 LPFA values the working relationship it has with its employers. When assessing employer covenant, LPFA will work collaboratively on covenant matters so that any covenant concerns can be discussed in an open and transparent manner. This working relationship should be aided by good information sharing between the employer and the Fund.

6.9 Where necessary and proportionate, LPFA may request additional information from employers to support the covenant assessment process. This can include requesting information that is not in the public domain. LPFA expects employers to provide such information where possible. If information is not provided following a request by LPFA, we will expect employers to explain why it cannot be made available.

6.10 LPFA recognises that the employer covenant is a dynamic process which can change quickly and that it is in both the Fund's, and the employers', best interests to work collaboratively on risks identified. If a risk is identified to be of concern, LPFA will look to discuss the risk with the employer so that any strategy plans and/or risk mitigation actions can be included in the covenant analysis. LPFA expects employers to engage with us to manage any covenant concerns identified as part of our assessment.

6.11 If employers do not engage with LPFA to provide information or respond to any concerns that we raise, LPFA may need to make assumptions about the strength of the employer covenant in the absence of full information. In such situations, LPFA will take a prudent approach, which may result in a lower covenant grade being awarded.

Exit covenant

7.1 An employer's obligations to the Fund go beyond the payment of ongoing contributions. In accordance with the LGPS 2013 Regulations (Regulation 64) ,when an employer exits the Fund LPFA will obtain an actuarial valuation of the liabilities of the former employer, and may subsequently obtain a revised rates and adjustment certificate showing the exit payment (or "cessation debt") due from an exiting employer.

7.2 Details of the approach taken to managing cessation debts are set out in LPFA's Funding Strategy Statement. These details are not considered further in this framework, except to note that cessation debts are frequently much larger than ongoing contributions.

7.3 When determining the strength of the exit covenant, LPFA will assess the extent to which the employer could finance any cessation debt that would be payable upon exiting the Fund. When making this assessment, LPFA is mindful that the cessation debt could be triggered by the wind-up or insolvency of the employer. In this circumstance, it is possible that the employer's financial resources could be lower than those currently available.

7.4 Where relevant and proportionate, LPFA may consider the following when assessing the employer's ability to finance any cessation debt:

- Cash generated from operations, though noting that this could be significantly weakened in the run-up to an insolvency event.
- Tangible balance sheet assets (e.g. property, which can be pledged as security or can be converted as cash for LPFA)
- Any liabilities or charges placed on the employer's assets that would rank ahead of LPFA in a wind-up scenario.
- Any restrictions placed on assets (for example, permanent endowment restrictions).
- Future plans for capital investment/expenditure, including the value added to the covenant from such plans.

7.5 The estimated level of financial resources will be compared with the estimated cessation debt to assess the proportion of the debt that might be recovered. This will determine the employer's exit covenant score.

7.6 Taking this approach towards assessing the exit covenant will allow LPFA to discuss any concerns we have with employers before an employer exits the Fund.

Actions to improve the employer covenant

8.1 There are two main approaches that employers can adopt to provide additional covenant support and hence improve their covenant rating. These are:

- Guarantees; and
- Providing security to LPFA.

Guarantees

8.2 Where legally binding guarantees are provided from a related organisation, LPFA will assess the employer's covenant based on the characteristics of the guarantor. Where the guarantor meets the criteria in paragraph 4.5 to be regarded as covenant category A, no further covenant analysis will be required.

8.3 Guarantees could be awarded by, for example, Government departments, tax/levy raising bodies, schools/academies, or private entities.

Security

8.4 LPFA has implemented a security framework to allow employers to improve and stabilise their covenant rating, while simultaneously improving LPFA's risk profile. This framework allows employers to achieve an improved covenant rating if security can be provided to LPFA. The framework is set out below.

Security level	Covenant Analysis
At least 70% of the cessation debt at the most recent actuarial valuation	A
At least 55% of the cessation debt at the most recent actuarial valuation	B1
At least 40% of the cessation debt at the most recent actuarial valuation	B2

8.5 LPFA will engage with any employers that wish to explore the possibility of putting security in place.

Types of security

8.6 There are a number of different security types LPFA can establish with employers. These include:

- **Bonds** – either through a bank or third-party insurer.
- **Charges** – either on property, assets, or investments. LPFA would expect to take a first charge on the asset offered but can also take second charges where appropriate.
- **Escrow** – either cash or investment.

8.7 The above is not an exhaustive list of the types of security that can be implemented with employers. Any security proposal from an employer will receive due consideration from LPFA.

Review of security

8.8 Depending on the type security that is offered by employers, LPFA may need to periodically review the security to confirm that the value of the asset is still at the level required.

8.9 If, following a review, the value of the security has fallen below the amount necessary to maintain a particular covenant grade, LPFA will engage with the employer to ensure that the security's value is brought up to balance. If an employer's covenant has also deteriorated, then LPFA will also look to request an updated valuation report (where applicable) to review the value of the security.

8.10 When additional security cannot be implemented by an employer to maintain their current covenant grade, LPFA may consider reverting to the covenant grade that would apply if no security were in place, or another grade if appropriate. LPFA will engage with the employer to consider available options for strengthening the covenant before implementing a lower covenant grade.

Costs and charges

8.11 Any security that is offered by an employer to LPFA will need to be executed by way of legal agreement. This will incur legal fees that may be recharged to the employer.

8.12 A security case may also incur actuarial fees as well as LPFA staffing costs that may be recharged to the employer. Employers will be expected to sign a memorandum of understanding confirming their acceptance of the fees a security case may incur before any work is started to execute a security asset.

Monitoring

9.1 Effective risk management is an on-going process. The strength of an employer's covenant can change quickly and whilst some changes may be temporary and of little concern to LPFA, other changes may be longer-lasting and can potentially impact LPFA's view of the strength of the covenant.

9.2 LPFA carries out a full covenant assessment to inform the funding valuation, which is carried out by our Fund Actuary every three years. It is especially important that employers provide information to LPFA to assist with this process. Regular reviews will also be carried out annually between valuations and will be informed by any additional information that employers are in a position to provide.

9.3 Following each annual covenant review LPFA will contact those employers where the process has identified any area of concern.

9.4 Each year, employers will be asked to advise LPFA of any material events that have occurred during the past year or are likely to occur over the coming year. Example of material events of interest to LPFA include –

– Change in an employer's ownership or group structure

– Acquisitions or disposals of businesses or subsidiaries

– Expiry, loss, or acquisition of a significant revenue stream

– Issue of additional security or guarantees

– Breach of any banking covenants

– Any adverse change in the policy of a competing creditor leading to a material call on an employer's available cash and/or assets

9.5 LPFA will also monitor the covenant through press searches and on filings at Companies House. If a material covenant event is identified by LPFA then we will engage with the employer to discuss our concerns.

9.6 In some cases, LPFA may wish to engage more frequently with employers, especially where specific covenant concerns are identified. In such situations LPFA will seek to agree a proportionate programme of engagement with the employer.

9.7 The table below summarises LPFA's approach to covenant monitoring:

Timing	Employers	LPFA
Every three years, at actuarial valuations	• Provide information if requested by LPFA • Advise of any material events that have occurred over the preceding year or expected to occur over the coming year	• Carry out proportionate covenant assessment for all employers. • Inform employers of their formal covenant grading. • Engage with employers where LPFA identifies opportunities to improve covenant rating.
Every year, except at actuarial valuations	• Provide information if requested by LPFA • Advise of any material events that have occurred over the preceding year or expected to occur over the coming year	• Carry out high-level covenant assessment for all employers. • Inform employers of their interim covenant grading. • Engage with employers where LPFA identifies opportunities to improve covenant rating, or where covenant rating has deteriorated significantly.
As required, where covenant concerns are identified.	• Provide information if requested by LPFA • Engage as necessary with LPFA officers	• Engage as necessary with employer
Monthly	• Address any concerns raised by LPFA	• Search press articles and filings at Companies House. • Engage with employer to discuss concerns if a material covenant event is identified.

Decisions and disputes

10.1 Whilst the details of the employer covenant will be based as much as possible on objectively verifiable data, the conclusions drawn from the covenant review will involve subjective judgment, reflecting LPFA's perception of the risks identified.

10.2 A feature of the above assessment process is that LPFA will need to form a judgment on the likelihood of an employer exiting the Fund and the impact of such an exit occurring. In assessing employer covenant LPFA may need to take decisions that the employer disagrees with or is dissatisfied with. This reflects the fact that LPFA and Scheme employers have different objectives and tolerances for risk. It is therefore possible that LPFA and an employer may disagree about the materiality of a risk identified in the covenant assessment.

10.3 LPFA's preference is that such disagreements should be resolved by way of mutual discussion between the employer and LPFA.

10.4 If a disagreement cannot be resolved by way of further discussion then LPFA may request a review the covenant by an external covenant assessor.

10.5 Any costs involved in commissioning an independent covenant review would need to be met by the Scheme employer in full. We also note that LPFA is not bound to accept the findings of any such external covenant review.

Review of the policy

11.1 This framework will be reviewed from time to time and at least every three years.