London Pensions Fund Authority

Interpreting your Covenant Assessment – A guide for Employers

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This document is designed to help you understand the LPFA Employer Covenant Assessment.

We carry out the Employer Covenant Assessment (the Assessment) in line with our Employer Risk Management Framework, which explains why we assess Employer covenant and our general approach.

Please see the contact details at the end of this document if you would like to discuss any aspect of the Assessment.

Section 1: General

1.1 What is Employer covenant?

Employer covenant is defined as the extent of the Employer's legal obligation and financial ability to contribute to the LPFA Pension Fund (the Fund) now and in the future. In other words, it is a measure of the confidence we have that the Employer will be able to make contributions to the Fund.

1.2 Why is LPFA assessing Employer covenant now?

We monitor Employer covenant as an ongoing process but every three years we carry out a more detailed assessment to help inform the actuarial valuation. A short summary of the valuation process is available on our website.

1.3 What covenant grades can be awarded to Employers?

LPFA uses six covenant grades, which are outlined below:

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

Covenant grade A is awarded to Employers that are government bodies or are guaranteed by government. Employers that do not meet the criteria for grade A can only achieve this grade if they are guaranteed by a body meeting the criteria for grade A or by providing security to the Fund.

Covenant grade D is awarded to Employers where, in the opinion of LPFA, there are circumstances which make it likely that an Employer will stop participating in the Fund.

Where Employers don't meet the criteria of covenant grade A or D, we carry out an assessment to award a grade from B1 to C2.

1.4 How does LPFA decide what grade to award?

We consider the Employer's financial position from two perspectives:

- **Ongoing covenant – see Section 2: Understanding the ongoing covenant**

  This is 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.

- **Exit covenant – see Section 3: Understanding the exit covenant**

  This is 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 by Members leaving service.

Each of these factors are rated from one (lowest risk) to four (highest risk) and combined to determine the covenant grade using the table below:

		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

1.5 How does the covenant grade affect Employer contributions?

The covenant grade determines the discount rate that is used for the Actuarial Valuation (Valuation). A higher risk covenant grade will result in a lower discount rate being used for the 2022 Valuation. A lower discount rate means less reliance will be placed on future investment returns, resulting in higher contributions being required from the Employer. These higher contributions are intended to address the risk that the Employer might not be able to make contributions to the Fund in future.

Our Funding Strategy Statement (FSS) sets out the discount rate for each covenant grade. It also details our approach to setting contributions, including managing any surplus or deficit.

1.6 What can I do to improve my organisation's covenant grade?

Our Employer Covenant Assessment is preliminary and could change for three reasons outlined below.

– **Security or a guarantee could be provided**

  The covenant grade can be improved by providing LPFA with security over the Employer's assets or a guarantee from a parent company or government body. The covenant grade awarded depends on the amount of security offered. The current security coverage is shown on the assessment for Employers that already have security in place.
  See **Section 4: Understanding the security coverage** for more details.

Level of security	Covenant grade
At least 70% of the cessation deficit at 31 March 2022	A
At least 55% of the cessation deficit at 31 March 2022	B1
At least 40% of the cessation deficit at 31 March 2022	B2

Our Employer Risk Management Framework gives more detail about the process of providing security.

Please see the contact details at the end of this document if you would like to discuss this possibility.

– **More information could be provided**

  The preliminary covenant grade is based on information available to LPFA when the assessment was prepared. This usually means that it is based on publicly available information. If more detailed or up-to-date information is available, we would be happy to take it into consideration. This might affect the covenant grade.

Please see the contact details at the end of this document if you would like to provide further information or to discuss how we have interpreted your financial statements.

– **The cessation deficit will be revised**

  The amount of the cessation deficit at 31 March 2022 is an important element of how we assess the exit covenant (see **Section 3: Understanding the exit covenant**). The preliminary covenant grade is based on an estimate of the cessation deficit. As part of the valuation, the Fund Actuary will update the cessation deficit to reflect more up-to-date membership data and actuarial assumptions. This updated cessation deficit is expected to be provided in the autumn and we will contact you if it affects your covenant assessment.

1.7 What does "security coverage" mean?

The security coverage compares the value of this security (i.e. the amount LPFA would be entitled to on the Employer's insolvency) with the LPFA cessation deficit (i.e. the payment that LPFA would require on the Employer's insolvency).

Section 2: Understanding the ongoing covenant

2.1 What does the ongoing covenant rating mean?

Ongoing covenant is 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 any deficit contributions where necessary.

We assess the ongoing covenant rating on a four-point scale:

Rating	Ongoing covenant definition
1 (lower 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.
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.
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.
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.

2.2 What does LPFA consider when deciding the ongoing covenant rating?

The ongoing covenant rating is selected based on the professional judgement of our Employer Management Services team. We consider four aspects when determining the ongoing covenant rating and provide a summary of each one in the assessment document.

– **Financial Position**

We review available financial information and make a judgement about how much reliance the Fund can place on the covenant, given the size of an individual Employer's liabilities/funding in the Scheme. In assessing the financial position our focus is on the Employer's ability to make regular contributions to the Fund – our assessment is not intended to be a critique of the Employer's business.

In the first instance, we review the Key Risk Indicators which are calculated based on audited financial statements. We supplement this with a more detailed review of audited financial statements to identify any major risks to the organisation. Unless otherwise stated, our analysis is based on publicly available information.

Please contact us if you can provide additional information that you believe could affect our understanding of the Employer's ability to make contributions in future.

– **Sector outlook/Employer position**

The Employers that participate in the Fund represent a wide range of sectors. Employers may be subject to risks and pressures related to their sector and their position within it.

The importance of sector risks is considered against the backdrop of the financial impact such risks could have on the Employer's ability to contribute to the Fund. The Employer Risk Management Framework outlines some examples of sector risks that might be relevant.

– **Climate analysis**

Risks relating to climate change have the potential to affect the Employer's ability to contribute to the Fund in future. We have partnered with Cardano, a specialist covenant adviser, to help us understand how physical and transition risks might affect Employer covenant.

The analysis of physical risk focusses on flooding risk and how this might develop in future. The analysis of transition risk is assessed at a sector level to consider risks that the sector as a whole might face during the transition to a low-emission economy.

– **Engagement**

We rely on high quality engagement with Employers to provide information when necessary and to manage participation in the Fund more broadly. We work collaboratively with Employers so that covenant can be discussed in an open and transparent manner.

If Employers do not engage with us to provide the information we need, we may need to make assumptions about the strength of the Employer covenant in the absence of full information. In such situations, we will take a prudent approach, which may result in a lower covenant grade being awarded.

2.3: What are the key risk indicators?

The key risk indicators are accounting ratios calculated based on figures taken from Employers' audited financial statements. We use them to inform our decision making when considering the ongoing covenant rating, but they are not the sole deciding factor. A definition of each key risk indicator and an explanation of colour coding is provided below.

		Colour coding			
Key Risk Indicator	**Definition**	**Lowest**	**Low**	**Moderate**	**High**
Pension burden	Pension deficit divided by net assets (before deducting pension deficit)	0%	0% to 20%	20% to 30%	>30%
Affordability of pensions	Net surplus divided by pension costs	>10	7 to 10	3 to 7	<3
Growth	Income this year divided by income last year	>2	2 to 1.5	1.5 to 1	<1
Financial performance	Net surplus divided by total income	>7%	5% to 7%	3% to 5%	<3%
Sustainability of funding	EBITDA divided by interest cost	>2	1.5 to 2	1.5 to 1	<1
Gearing	Total borrowing divided by total net assets (before deducting pension deficit)	<20%	20% to 40%	40% to 60%	>60%
Acid ratio	Liquid current assets divided by total current liabilities	>1	0.8 to 1	0.6 to 1	<0.6
Current ratio	Total current assets divided by total current liabilities	>2	1.5 to 2	0.8 to 1.5	<0.8

Section 3: Understanding the exit covenant

3.1 What does the exit covenant rating mean?

Exit covenant is an assessment of how much LPFA could recover from the Employer on insolvency, relative to the needs of the Fund.

We assess the exit covenant rating on a four-point scale:

Rating	Exit covenant definition
1 (lower risk)	Financial failure is likely to result in recovery of over 70% of any cessation deficit.
2	Financial failure is likely to result in recovery of between 50% and 70% of any cessation deficit.
3	Financial failure is likely to result in recovery of between 30% and 50% of any cessation deficit.
4 (higher risk)	Financial failure is likely to result in recovery of less than 30% of any cessation deficit.

3.2 What is the cessation deficit?

The cessation deficit is:

– the value of the pension liabilities in respect of the Employer, calculated on a minimum risk basis,

  minus

– the value of the pension assets in respect of the Employer.

Details of the approach taken to calculating the value of the liabilities on a minimum risk basis are included in our draft Funding Strategy Statement which was recently issued to Employers.

Under the LGPS Regulations 2013, when an Employer stops participating in the Fund the cessation deficit may need to be paid. The exit covenant is an assessment of how much of the cessation deficit the Employer is likely to be able to pay in an insolvency situation. We assess this by calculating the "estimated coverage of cessation deficit".

3.3 What is the estimated coverage of cessation deficit?

This is a percentage estimate of the proportion of the cessation deficit that could be recovered on insolvency.

It is calculated as:

– the amount of assets that might be available to pay LPFA and equal-ranking creditors on insolvency (the estimated assets available on exit),

divided by

– the amount of liabilities (including the cessation deficit) that rank equal with LPFA on insolvency (the estimated liabilities to be met on exit)

3.4 How do you calculate the estimated assets available on exit?

We take a three-stage approach to calculating this amount:

– We consider the book value of the Employer's tangible assets as taken from audited financial statements. These are the assets that we assume retain value on insolvency. We assume that any intangible assets lose all value on insolvency.

– We reduce the book value of these tangible assets to reflect that they might lose some value on liquidation. We do this by multiplying the book value by an assumed recovery rate, which varies depending on the type of asset. This results in the total assumed recovery value of the assets.

– We deduct any secured borrowings that rank ahead of LPFA. These are assumed to be paid in full before any assets are available to pay the cessation deficit.

This results in an estimate of the level of assets that might be available to pay LPFA and other equal-ranking creditors on insolvency.

3.5 How do you calculate the estimated liabilities to be met on exit?

This is the sum of all liabilities that are assumed to rank equally with the LPFA cessation deficit on insolvency. It includes:

– The estimated LPFA cessation deficit.

– The value of any other defined benefit pension deficits disclosed in the financial statements.

– The value of any other creditors, except for secured borrowings that have been deducted from the estimated assets available on exit.

If you would like to discuss anything concerning Employer Covenant Assessments, please contact the Employer Management Services team using the following details:

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