Wiltshire Pension Fund

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Policy on Employer Covenant Risk

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1 Introduction

The purpose of this policy is to set out the administering authority's approach to assessing employer covenant risks and the impact of employer risks within the funding strategy.

1.1 Aims and objectives

The administering authority's aims and objectives related to this policy are as follows:

- To set out the framework within which the Fund seeks to identify, assess, monitor and mitigate employer risks.
- To provide employers with an outline of factors that will be considered in determining funding strategy, to ensure each employer is treated fairly and with respect to their own circumstances.

1.2 Background

The key risks to the Fund are detailed in Appendix C of the Funding Strategy Statement (FSS). Taking a holistic view on these risks is essential to meeting the Fund's objective of long term sustainability and paying member benefits. Assessing and monitoring employer covenant risk forms part of a robust integrated risk management framework.

The Pensions Regulator defines employer covenant as "*the extent of the employer's legal obligation and financial ability to support the scheme now and in the future*".

Each employer in the Fund presents a different degree of covenant risk to the Fund. If an employer defaults on its obligations to the Fund, the cost is spread amongst the remaining employers. Employer insolvency or cashflow issues can also present the Fund with potential operational or liquidity risks.

To provide protection to all stakeholders (and fairness to employers), it is important to assess and monitor covenant risks, providing mitigation where possible.

1.3 Guidance and regulatory framework

Part 3 of Schedule 2 (para 6) states the requirement for an admission body to carry out *an assessment, taking account of actuarial advice, of the level of risk arising on premature termination of the provision of service or assets by reason of insolvency, winding up, or liquidation of the admission body*.

As set out in Section 5.5 of the FSS the administering authority may require the admission body to provide security, such as a guarantee from the letting employer, an indemnity or a bond.

The Pension Regulator code sets out further guidance on schemes assessing and monitoring covenant and that covenant should be considered when setting funding strategy.

2 Statement of principles

This statement of principles covers the Fund’s approach to employer risk management. The Fund maintains discretion over the application of this policy, but in general:

- Employer risks will be assessed upon a new admission body joining the Fund and may require the body to provide a form of security against certain risks.
- The administering authority will seek to maintain up to date records of security and participation status (eg contract length, guarantors etc.) which may require employers to provide data on request of the administering authority.
- Employer covenant will be assessed triennially as part of the formal valuation, or more regularly depending on the nature of the employer risks or other circumstances.
- Employers may be required to provide financial or management data to support the Fund in carrying out covenant assessments.
- Where data is provided late, or not at all, the Fund may determine that the employer’s covenant is weaker.
- Employer covenant may be used as a factor in determining employer funding strategy, which may result in an employer paying a higher or lower contribution rate.

3 Policy

3.1 Initial employer risk categorisation

There are various employer types that participate within the Fund from different sectors. These can be broadly categorised by those which have tax-raising powers or a government guarantee and those that do not.

Category A (lower risk)

- Local authorities including Police and Fire
- Academies (including multi-academy trusts)

Category B (higher risk)

- Colleges & Universities
- Charities
- Housing associations
- Town & Parish councils
- Contractors*

*Contractors with a guarantee from a Category A employer may be viewed as lower risk as the awarding authority would act as guarantor of last resort.

Note that the above would be an initial categorisation and subject to change following completion of the steps outlined in the remainder of section 3 of this policy.

3.2 Identifying covenant risks

The key employer covenant risks for the Fund to consider are:

1. Ability to make contributions – financial constraints leading to non-payment or underpayment of regular contributions.
2. Likelihood of exit – events leading to termination of the admission, as detailed in Section 7.1 of the FSS.
3. Outcomes in an exit – current pension deficit (on the employer's exit basis) relative to their financial strength. Other considerations include potential additional costs such as redundancy strains.

The administering authority will seek to assess and monitor these risks for each employer, and provide mitigation where possible. Although the primary concern is the default risk posed by (3), the administering authority is also concerned with risks associated with (1) and (2) to protect against other operational risks such as administration and cashflow management.

3.3 Assessment and monitoring of risks

To assess and monitor the risks identified under 3.2, the administering authority will do the following:

1. Maintain an up to date employer database, including key information on contract end dates, guarantors, and other forms of security. Employers may be asked to provide or check information is accurate at regular intervals (eg annually).
2. The administering authority will carry out a pension risk profiling exercise which focuses on quantitative pension risk metrics such as number of active employees, contract period, current deficit on exiting basis, deficit gearing (deficit vs payroll), initial risk categorisation (per 3.1). This exercise will be carried out triennially as part of the formal valuation process.
3. For any employer identified as potentially higher risk under (2), the administering authority will carry out analysis of key financial metrics (past and projected). The employer may be asked to provide data where necessary including completing a questionnaire (with information on cashflow projections, debt facilities, creditors and other financial constraints). This exercise will be carried out triennially as part of the formal valuation process.
4. The administering authority may also request that a covenant specialist carry out further analysis of specific employers or sectors to inform the covenant assessment. This work would consider both quantitative and qualitative analysis, including assessment of governance structures, management and exposure to climate related risks.
5. Based on the analysis carried out under (1-4), the administering authority will categorise employers into three risk categories, high, medium and low (or Red, Amber, Green), based on their covenant assessment.
6. Employer categorisation will be shared with employers and management will be encouraged to engage with the administering authority on the results and funding strategy implications (see Section 3.5).
7. The administering authority may change the risk categorisation after engaging with employers and/or being able to evidence stronger covenant. This could include the provision of additional information by the employer, or carrying out a full covenant assessment by a covenant specialist (depending on the circumstances the employer may be required to pay for the cost of this assessment).
8. Where financial data is provided late, or not at all, the Fund may determine that the employer's covenant is weaker.

9. Where an employer can provide any additional form of security (such as security over an asset), the administering authority may view the employer covenant to be stronger.

3.4 Frequency of monitoring

A full review of employer covenant will be carried out triennially as part of the formal valuation process. More regular updates may be required depending on circumstances, including:

- **Employer database -** will be reviewed annually to ensure the information is accurate and up to date. This will include a review of bond status and employers may be required to provide evidence that forms of indemnity remain in place and are up to date.
- **Higher risk employers -** may be asked to provide financial information via a questionnaire annually, as part of an annual review process. If there is judged to be a material change in covenant there is provision for contributions to be reviewed in line with the fund's contribution review policy (see Wiltshire Pension Fund policies)
- **Employer approaching exit -** such as employers with contracts due to end before the next formal valuation, or those with few active members will be monitored more regularly. The administering authority will monitor these employers annually (or more frequently) using pension risk metrics, including monitoring the active membership and the funding position on the employer's exit basis. The administering authority will continue to engage with these employers as they approach exit to help manage the exit and ensure the employer is aware of their pension obligations and the exiting process.
- **Changes in economic or regulatory environment** – may require the administering authority to carry out ad-hoc reviews of employer covenant - recent examples include the Covid-19 pandemic or the reclassification of colleges.

3.5 Risk mitigations and impact on funding strategy

The Fund will seek to manage employer risks appropriately to protect stakeholders and ensure fairness to employers. Forms of risk management include:

- **Provision of security** – as outlined in Section 5.5 of the FSS, the administering authority will seek to obtain a form of security from bodies upon admission. Some employers may also provide security (such a charge over an asset) during their participation to evidence stronger covenant and enable more flexibility in funding strategy. As part of ongoing risk assessments, the Fund will also seek to ensure that bonds and other forms of security are up to date and maintained for the appropriate level of indemnity.
- **Guarantees** – certain employers participating in the Fund may have a guarantee from central government, a parent company or another employer within the Fund. The administering authority will seek to ensure that information relating to these guarantees is accurate and up to date. This may require employers to provide evidence such as risk sharing agreements or a copy of guarantees.
- **Insurance** (and other forms of risk transfer) - where appropriate, employers (or the Fund on behalf of employers) may also take out insurance against certain risks (such as ill health early retirements).
- **Termination policy** – employers with no guarantee will exit the Fund on the Fund's cessation basis (as described in Appendix D5 of the FSS). Where an employer is seeking to enter into a post cessation funding arrangement (such as a deferred debt arrangement), the Fund will consider the employer's covenant in agreeing to or in setting the terms of the arrangement.

- **Contribution policy** – while participating in the Fund, the administering authority will consider employer covenant when determining funding strategy and the level of employer contributions (and any flexibilities afforded).
    - **Funding target** – contributions may be set to target full funding on an employer's cessation basis, to minimise the risk of underfunding on exit. Where a higher risk employer is approaching exit (eg few active members or approaching contract end date), the administering authority may begin to transition the funding target towards the exit basis.
    - **Time horizon** – a shorter funding time horizon may be adopted for higher risk employers when setting contributions.
    - **Likelihood of success** – a higher likelihood of success may be adopted for higher risk employers when setting contributions.
    - **Contribution flexibility** – employer covenant will be a factor when considering contribution flexibility, such as phasing of contribution increases or whether a reduction in contributions as a result of any funding surplus can be allowed. For example, employers with weaker covenant may be required to pay a minimum of the Primary Rate (cost of accruing benefits).

The administering authority will aim to provide all employers with a clear framework of how employer risk categorisation will be used in setting funding strategy, as detailed in section 2.2 of the FSS. However, the Fund has ultimate discretion over the application of this policy and associated funding strategy.

4 Related policies

The fund's approach to setting regular employer contribution rates is set out in the Funding Strategy Statement, specifically "Section 2 – How does the fund calculate employer contributions?".

The treatment of new employers joining the fund is set out in the in the Funding Strategy Statement, specifically "Section 5 – What happens when an employer joins the fund?"

The treatment of employers exiting the fund is set out in the in the Funding Strategy Statement, specifically "Section 7 – What happens when an employer leaves the fund?"

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