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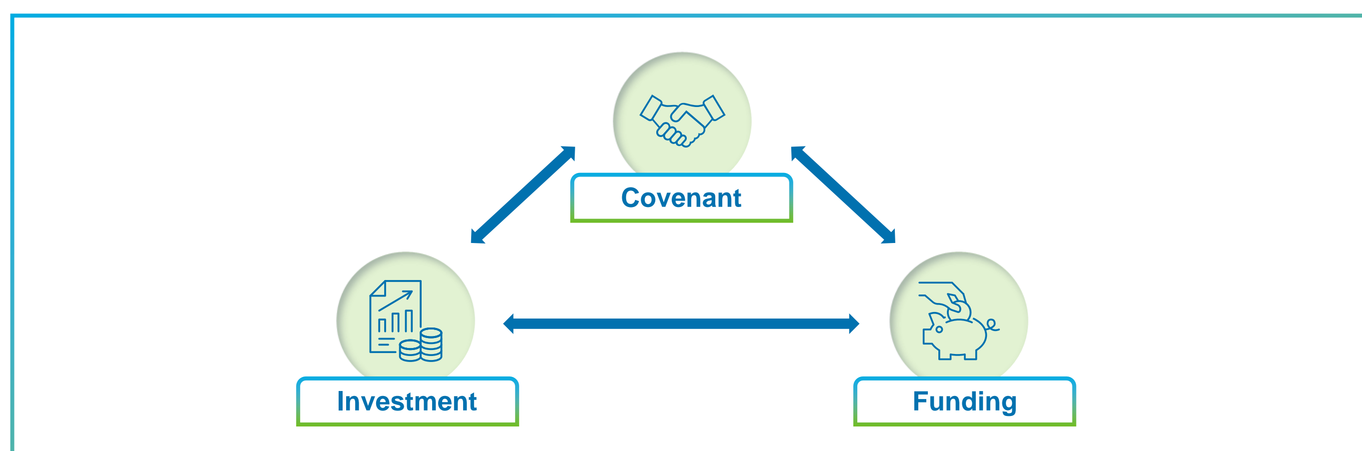
LGPS employer risk management

December 2024

As funds prepare for the 2025 formal valuations, the LGPS landscape looks very different from 3 years ago. On the **funding** side, changes in the economic environment (notably sharp rises in interest rates) have led to improved funding positions and funds are now facing new risks and opportunities. Whilst in the **investment** space, pension policy and the recent ‘Fit for the future’ consultation continues to occupy officer attention. Funds could be forgiven for paying less attention to the third pillar of an integrated risk management framework: employer **covenant.**



Employer risk in the LGPS

In a private sector pension scheme, employer covenant feels well-defined and the risk is clear cut – if the single sponsor fails then the pensions are at risk. In the LGPS the picture is different: a multi-employer scheme, including large tax-raising employers, with protected benefits effectively being backed by the Government.

Nonetheless, employer risk in the LGPS remains important. Not all employers are tax-raising or get funding from the Government, so the risk of default and insolvency remain – albeit the recent extension of the DfE guarantee to further education bodies has significantly reduced the number of ‘riskier’ employers (more on this below).

For all employers, if there are solvency or affordability issues then this presents additional risks that officers still need to navigate, such as the impact on governance, administration or cashflows. **Therefore, assessing and monitoring employer risk remains important in the LGPS.**

Why it is important to consider employer risk in LGPS?

- ✓ **Overview of Fund risk**: a fund is the sum of its parts and understanding the varying employer risks helps you to understand the overall fund risk.
- ✓ **Employer categorisation**: employer risk can inform individual employer categorisation that is evidence-based and transparent, which could determine different funding plans for employers.
- ✓ **Baseline for future engagement**: regular monitoring of employer risk helps you to identify changes in covenant, which may be relevant for decisions supporting employer flexibilities.
- ✓ **Effective administration:** having a full understanding of employer risk allows more effective administration, whether around early negotiation of contribution flexibility or managing an employer exit.

What is the impact of improved funding?

Whilst the recent improvement in funding will lessen the risk that an existing employer leaves behind a funding deficit, assessing employer covenant helps to manage other risks such as administration and liquidity and to ensure good governance.

Against the backdrop of improved funding positions, funds may now also be facing new questions and challenges from employers on options, such as:

- requests for tailored employer investment strategies;
- requests for flexibility on contribution rates; and
- exit credit payments due to employers exiting with a funding surplus.

Having a framework to assess employer risk is an effective way of managing these challenges.

Sector highlights

The improvement in funding is good news, however employers continue to face a variety of challenges in the current environment. Higher inflation, interest rates and pay awards, amongst other pressures, are impacting organisations.

Councils

As tax-raising, government backed employers, the ‘covenant’ of this group is not in question. However, understanding and engaging on affordability is a key risk for funds to manage, especially given the importance of this group to the cashflow position of the fund – and the current environment remains a challenge:

- **Budget deficits** – many councils are forecasting budget deficits, with reductions in government grants and higher demand for services such as housing and children’s services.
- **Debt service costs** - higher interest rates means that the cost of servicing debt has also increased.
- **Equal pay awards** – a number of councils have also been affected by equal pay claims settlements.

Several councils have issued s114 notices as a result of these pressures and others are expected to follow suit. Whilst the payment of LGPS pension contributions should be unaffected (as a statutory function of the council), the budgeting pressures and additional scrutiny this brings is clearly something that funds need to manage carefully.

What actions should funds take?

- **Contribution modelling**: Funds can carry out contribution modelling now to set rates for the 2025 valuation (i.e. with effect from 1 April 2026). Councils will be setting budgets and considering medium term financial planning, and an early indication of rates will be valuable.
- **Cashflow impact**: Understanding the impact of contribution reductions for this group on the fund’s cashflows will give officers time to plan effectively – especially as many funds’ current net cashflow positions would be very sensitive to contribution reductions.
- **Early engagement**: Officers should engage with these employers now to set expectation ahead of the 2025 valuation and to flush out any affordability concerns or other issues such as workforce planning.
- **Investment strategy options**: Many funds are considering investment strategy options at this valuation and should seek views from this group on risk preferences.

Further education bodies

In November 2022, ONS announced the reclassification in England of FE colleges, sixth form colleges and designated institutions to the central government sector.

This change had immediate implications for the funding and operation of these bodies. However, the biggest question mark for LGPS funds was whether the DfE guarantee would be extended to this group. This question has now been answered with the recent announcement of the extension of the DfE guarantee to further education bodies.The presence of a guarantee for these bodies is clearly a positive outcome for funds as it mitigates the covenant risk. However, as with any such material change, there are some areas for the Fund to work through.

What actions should funds take?

- **Impact on funding strategy**: FE bodies should now be viewed as lower risk (on a par with academies). Funding strategy should be considered for these employers to reflect this change. For many funds this may mean a change in the funding time horizon or less prudence in funding (eg via the contribution rate likelihood of success measure).
- **Review contribution rates**: Regulation 64A allows funds to review contribution rates between valuations where there has been a significant change in covenant. Funds should consider whether it is appropriate to carry out a review to change contribution rates with effect from 1 April 2025 (noting employers may also initiate this request for a review).
- **Early engagement**: Whether reviewing contributions or not, funds should seek to engage with these employers now to recognise the implications of this change and set expectations for the 2025 valuation.
- **Contribution modelling**: Funds may also consider whether it is now appropriate to include this group within ALM exercises being carried out to help set contribution rates. This modelling is typically used for large, long-term secure employers to help funds consider wider factors such as longer-term stability and affordability of contributions.
- **Affordability assessments**: Whilst the guarantee reduces the risk to funds on employer insolvency, many of the pressures facing this sector remain. Funds may consider carrying out a high-level assessment of affordability (by reviewing net operating cashflows) which may be a factor in setting rates at the 2025 formal valuation.

Higher education bodies

Higher education bodies (i.e. Universities) have no formal guarantee. They continue to pose a significant risk to funds with large liabilities and various challenges impacting their sector.

Increased costs:

- The Teachers' Pension Scheme (TPS) contribution rate has increased to 28.7% of pay.
- Higher borrowing costs due to rising interest rates.
- Higher wage growth due to rising inflation, cost of living and industrial action.

Reduced income:

- Tuition fees have been capped at current rates since 2017 which has squeezed finances. However, the Government has announced that the cap will be increased by 3.1% next year to provide some relief.
- Changes to international student visas have negatively impacted finances and universities' ability to offset funding deficits.

Across the LGPS there are several universities reviewing their LGPS pension arrangements in response to these cost pressures.

What actions should funds take?

- **Risk assessment**: Given the size of liabilities and potential impact, funds should carry out a high-level risk assessment to better understand the financial position of each organisation – such as net assets / net cashflows relative to LGPS liabilities / contributions or information on other creditors.
- **Funding strategy**: Funds should seek to categorise the risk for employers and reflect this varying risk fairly in funding plans, e.g. target a higher likelihood of success for 'riskier' employers.
- **Security**: Funds should engage with these employers on security, noting they can offer greater flexibility in funding or investment options to employers who are able to provide security.
- **Engagement**: Funds should engage with this group now on the above, and to also understand their commitment to longer-term LGPS participation (or otherwise).

Housing associations & charities

Although every employer is different, similar challenges are affecting these sectors, with the common threads of higher costs and strained income. The recent improvements in LGPS funding have led to many of these organisations reviewing their LGPS participation.

What actions should funds take?

- **Risk assessment**: Funds should carry out risk profiling / risk assessments to better understand and categorise the employer risk for setting appropriate funding plans. Financial risk assessments may be more relevant for larger organisations with greater LGPS liabilities.
- **LGPS participation**: Funds should engage with employers now to understand their position and intentions. Many charities may now be fully funded on a fund's cessation basis and the fund may deem it appropriate to proactively engage with employers around their options (e.g. exit at no cost).

Other employers

Given the changes in the economic environment since 2022, and some of the challenges described above, we expect funds will experience increased levels of engagement at the 2025 valuation from these groups. As part of a holistic employer risk review, we would encourage funds to actively seek engagement with all employer groups, including:

- **Academies**: the DfE guarantee limits the solvency risk of this group. Nonetheless, they represent the largest number of employers in the LGPS and there will be a variety factors to understand, such as affordability or contract outsourcing – which can impact administration and cashflows.
- **Contractors**: with the majority of new contracts being admitted under 'pass-through', the risk posed has significantly lessened. Furthermore, many of the older admissions may now have a funding surplus. Therefore, the focus for this group may be more around housekeeping (eg keeping records up to date on bonds and contract end dates) and understanding the impact of potential exit credits. Where non-pass-through contractors are due to exit the scheme before the next valuation (and are in surplus), funds should consider if it is appropriate to review or suspend contributions (under Regulation 64a).
- **Town & Parish councils**: these employers typically have very small liabilities, meaning the solvency or cashflow risk is limited. However, contribution affordability or employers seeking to exit the scheme are often on the agenda meaning engagement is important.

What can funds do to manage employer risk?

All funds should establish an **employer risk management framework** which documents how employer risk is assessed and monitored. This will help funds to recognise employer diversity in a fair and transparent way and supports governance best practice. This framework should include:

- **Regular review of information**: including contract dates, guarantor status, security arrangements etc.
- **Employer risk categorisation**: establish an approach to risk categorisation of employers. This may be lighter touch for some employer groups (e.g. academies) or involve seeking more information from perceived 'higher risk' groups via a high-level risk assessments.
- **Set frequency of monitoring**: which may vary depending on circumstances, e.g. higher risk employers or employers approaching exit.

Funds should also seek to mitigate employer risk where possible. Effective risk mitigations include:

- **Indemnity**: traditional measures of managing employer risk remain valuable, such as security, guarantees and insurance.
- **Funding (and investment) strategy**: flexing the approach to funding plans such as targeting higher levels of prudence or alternative investment strategies for riskier employers.
- **Engage with employers**: as simple as it sounds, engagement can also be an effective tool. Funds should seek to engage with employers ahead of the valuation to raise awareness and understand employer pressures and preferences.

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How can we help?

Valuation preparations are well underway across the LGPS and we have been working closely with funds to support discussions and actions with employers. Please speak to your Fund Actuary for further details on how we can help you with your own preparations. A variety of support options are available to supplement officer knowledge.

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