

# Integrated risk management

## Assessing employer risks in the LGPS



Copyright © 2017 Aon Hewitt Limited. All rights reserved.  
aon.com

Aon Hewitt Limited is authorised and regulated by the Financial Conduct Authority.  
Registered in England & Wales No. 4396810

Registered office:

The Aon Centre | The Leadenhall Building | 122 Leadenhall Street | London | EC3V 4AN

This report and any enclosures or attachments are prepared on the understanding that it is solely for the benefit of the addressee(s). Unless we provide express prior written consent no part of this report should be reproduced, distributed or communicated to anyone else and, in providing this report, we do not accept or assume any responsibility for any other purpose or to anyone other than the addressee(s) of this report.

# Why is assessing employer covenant important?

## For administering authorities

- with the 10,000 employers in the LGPS becoming ever more disparate, a one size fits all approach to funding and investment is no longer appropriate
- some sectors traditionally considered to be "public sector" are no longer classified as such and have no government guarantee
- academy conversions and new ways of delivering services mean local authorities represent a reducing share of the LGPS
- employers are increasingly asking for justification of contributions and details of their exposure to former employers' liabilities
- new national and local governance arrangements are likely to lead to greater scrutiny of funding plans and a focus on covenant assessment

## For employers

- letting authorities need to take a view on bond requirements for admission bodies providing services on their behalf
- guarantors will be interested in the risk of default by guaranteed bodies
- pooled employers ought to be interested in the strength of covenant of other employers in the pool

Aon Hewitt has developed an employer covenant assessment service specifically for the LGPS. This combines our specialist covenant expertise developed over many years of advising trustees and corporates with our knowledge and experience of advising LGPS funds.

Our standard report dovetails with our funding advice and can also be used when considering employer-specific funding strategies. Our high level assessment is a cost-effective and efficient solution for assessing the absolute level and movement in financial strength of a dozen or more employers. A more detailed assessment is available where the circumstances, size of employer or its liabilities (deficit) warrants it.

**Covenant Assessment - ABC College**

The Administering Authority has requested a desk top assessment of the covenant of ABC College (the "Employer") in support of the 2016 actuarial valuation. Aon Hewitt assesses the covenant to be:

**Weak**    **Tending to Weak**    **Tending to Strong**    **Strong**

**Information availability**

- Financial report and accounts for the years ended 31 July 2014 and 2015
- Latest report published on DATE

**Covenant conclusion**

**Strengths:**

- Both students and employers rate the Employer highly and well above sector's median score, as measured by (Brexit) here.
- Latest's most recent inspection report of DATE assessed the Employer as "Outstanding".
- Financial performance, as measured by operating surplus, improved in fiscal 2015 (Eum) after a years of operating losses. However, operating surplus is expected to be lower in 2016 and 2017 with low operating surplus margin of 0.4% and 0.1%, respectively.
- The Employer implemented a staff reduction exercise in fiscal year 2015 to reduce its future cost base, since staff costs are the main expenditure.
- Cash flow from operating activities increased by xx% in fiscal year 2015 from Ex.um to Ex.um due to the Employer's improved operating surplus.
- xx% of the Employer's total assets are attributable to freehold properties (on a net book value basis), but these assets may not be easily realisable to meet obligations to creditors (including LGPS) due to the specialist nature of the teaching buildings. Also, the Employer may be unable to retain proceeds related to Ex.um of the Ex.um of the Employer's land and buildings as these assets were funded by grants.
- Looking ahead, the Employer is shifting its teaching emphasis to areas such as (insert details) to minimise the impact of funding cuts, as funding for these areas are to be protected.

**Table: Exit Liabilities**

Exit Liabilities	Exit Deficit
17.3	8.2
13.3	7.3

**Table: Performance Metrics**

	2016	2017
0.2	0.1	
0.2	0.3	
1.6	1.5	
1.6	1.0	
2.0	1.5	
3.3	3.3	

**Table: Financial Summary**

	25 May 2012	31/03/2016
Outstanding-1		
Outstanding-1		0.2x
Outstanding-1		2.3x

**Footnote:** Covenant is the employer's legal obligation and financial ability to support [the] scheme. (Source: The Pensions Regulator)

**Aon Hewitt**  
Empower Results<sup>®</sup>

## When should you seek external help?

Factor		
	Light touch OK More likely to be internal	In-depth review needed More likely to be external
Corporate structure	Tax-raising	Non tax-raising
Funding	Well funded	Badly funded
Materiality	Small employer	Large employer
Investment risk	Low	High
Cash flow (sustainable growth)	Unconstrained	Constrained
Covenant changes	Stable	Material employer activity
Other creditors	No	Yes
Sector	Stable	Volatile
Employer	Cooperative	Uncooperative

### Other issues to consider

- Does the administering authority have the necessary expertise, experience and resources?
- Is the administering authority able to take an objective view? For example - what if a committee member also has an important role with the employer?
- Is the administering authority considering offering / requiring different employer investment strategies?
- To what extent does the administering authority already differentiate between employers in its funding strategy?

### Aon Hewitt's LGPS-specific employer covenant assessment can

- complement the administering authority's existing approach
- support a new approach to covenant assessment
- ensure covenant feeds into funding and investment decisions as part of an integrated approach to employer risk management
- assist scheme employers in better understanding their risks

## Contact Information

If you would like further information from Aon Hewitt, please contact your usual consultant or alternatively and adviser from the Covenant review team:

### Public sector team contacts

**Alison Murray**

+44 (0)117 900 4219

alison.murray@aonhewitt.com

**Joel Duckham**

+44 (0)117 900 4425

joel.duckham@aonhewitt.com

### Covenant Review Specialists

**Aidan O'Mahony**

+44 (0)207 086 9230

Aidan.omahony@aonhewitt.com

## About Aon Hewitt

[Aon plc](#) (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

Nothing in this document should be treated as an authoritative statement of the law on any particular aspect or in any specific case. It should not be taken as financial advice and action should not be taken as a result of this document alone.