Report To:	**GREATER MANCHESTER PENSION FUND LOCAL BOARD**
Date:	19 January 2016
Reporting Officer:	Peter Morris – Executive Director of Pensions
Subject :	**EMPLOYER COVENANT**
Report Summary:	The Fund can generally take a long-term outlook due to the ability of the Fund's participating employers to ultimately make good any deficits that emerge from time to time. This ability is often referred to as the 'employer covenant'. This report provides a high-level analysis of the Fund's employer covenant with the aim of highlighting any weaker sectors and employers where the Fund is potentially exposed to a material employer cessation risk and where further analysis should be undertaken.
Recommendation:	To note the content of the report.
Policy implications:	None.
Financial Implications: (Authorised by the Section 151 Officer)	If an employer fails whilst its sub fund is in deficit then there is the potential for other employers' contribution to increase to meet any shortfall.
Legal Implications: (Authorised by the Solicitor to the Fund)	The Fund can mitigate employer covenant risk by requiring additional security that can take the form of a parent company guarantee, a charge over assets of the company and/or a bond or other guarantee. However, there will always be some covenant risk and this is best managed through the policies adopted in determining admission as an employer.
Risk Management:	A key risk when administering the LGPS is that an employer fails whilst its sub fund is in deficit. As the mix of employers in the Fund becomes increasingly complex it is important to review and strengthen the measures in place to identify any employers with a material risk of failure and consider measures to mitigate the risk to the Fund.
ACCESS TO INFORMATION:	**NON-CONFIDENTIAL** **This report does not contain information which warrants its consideration in the absence of the Press or members of the public.**
Background Papers:	For further information please contact Euan Miller, Assistant Executive Director – Funding and Business Development. Telephone: 0161 301 7141 e-mail: euan.miller@tameside.gov.uk

1. INTRODUCTION

1.1 In order to target long-term affordability, the Fund invests predominantly in 'return-seeking' assets. The market value of these assets will be relatively volatile in the short to medium term, but the Fund can take a long-term outlook due to the ability of the Fund's participating employers to ultimately make good any deficits that emerge from time to time. This ability is often referred to as the 'employer covenant'.

1.2 At the whole fund level the covenant is strong due to the participation of the 10 local authorities, the National Probation Service, plus other employers with tax-raising powers. However, there are employers participating in the Fund that are not as financially strong and if any of these employers were to fail whilst their sub-fund was in deficit, this would likely result in additional costs for other employers.

1.3 As the mix of employers becomes increasing complex it is becoming more important to analyse covenant at the individual employer level and to take steps in order to minimise the Fund's exposure to the risk of individual employer failure.

1.4 This report provides a high-level analysis of the Fund's employer covenant with the aim of highlighting any weaker sectors and employers where the Fund has material exposure.

1.5 The analysis in this report is based on the results of the Fund's 2013 actuarial valuation. Detailed consideration of employer covenant will be undertaken as part of the 2016 actuarial valuation process.

1.6 The Pensions Regulator's Code of Practice #14 – Governance and Administration of Public Service Pension Schemes, recommends that, where relevant, schemes should put in place systems and processes for making an objective assessment of the strength of an employer's covenant (which should include analysis of their financial position, prospects and ability to pay the necessary employer contributions).

2. GMPF EMPLOYER COVENANT

2.1 Chart 1 of **Appendix 1** to this report shows the split of liabilities in the Fund (as at 31 March 2013) between the 10 Greater Manchester local authorities and other employers.

2.2 At 31 March 2014, 77% of the Fund's liabilities are in respect of local authority pools. Of the remaining 23%, this is split between other sectors considered lower risk (10%), which include the fire service, Greater Manchester Probation Trust, academy schools and sectors considered higher risk (13%).

2.3 Note that these figures are prior to the probation service transfers taking effect. Probation liabilities now make up around 20% of the Fund.

2.4 The classification between lower risk and higher risk is largely subjective based on officers' current understanding of the treatment of LGPS liabilities on employer failure; in particular whether any deficit is 'crystallised' or passed directly on to a successor organisation. This understanding will develop over time as experience emerges across the LGPS.

2.5 Chart 3 of **Appendix 1** shows a split of liabilities by employer type within what we currently see as the higher-risk sectors.

2.6 Within the higher risk sectors, employers do not necessarily pose a potential risk to the Fund and where possible, the Fund has historically taken steps to minimise any risk via obtaining additional security such as a local authority guarantee or a bond covering an individual employers' liabilities. In addition, where there is a perceived material funding risk, the Fund looks to recover any deficit over a shorter period of time, therefore the liabilities of these employers are often relatively well funded.

2.7 Chart 2 of **Appendix 1** summarises, for the higher risk sectors, the level of security provided in respect of individual employers.

High security – Employers' who are not pooled with a Local Authority, but where a Local Authority guarantees the employers' liability to the Fund

Medium security – Employers who satisfy one of the following criteria:

- A bond is in place covering a material proportion of the employers' cessation deficit
- Part of a pool with at least one other employer with a Local Authority guarantee (although note that this does not necessarily protect against a deficit being crystallised on an employer within the pool failing)
- Parent company guarantee (i.e. guarantee not from a Local Authority)

Low security – Employers which do not meet the criteria for high or medium security

2.8 Chart 4 of **Appendix 1** summarises the split of liabilities, at the whole fund level between those considered to provide high security, medium security and low security. Around 84% of the Fund's liabilities are considered to be highly secure.

2.9 A significant proportion of the low security liabilities relate to Scheme Employers, where the Administering Authority does not have discretion to refuse or make conditional their employees' access to the Fund and obtaining security is therefore more difficult. Examples of these employers are Further Education Colleges and certain universities.

2.10 Even if no bond or guarantee is in place, meaning that the employer is classified as low security in the analysis, in an insolvency scenario the Fund, along with other creditors, would generally have a claim on the employers' remaining business assets and therefore may be able to recover at least part of any unpaid deficit.

2.11 The balance sheets of Fund employers can vary significantly, for some employers, such as housing associations can have substantial fixed assets, where many employers that are primarily service providers often have negligible assets on the balance sheet. Where liabilities are material, an analysis of employers' balance sheets will be carried out as part of the 2016 valuation process.

3. NEXT STEPS

3.1 Consideration of employer covenant strength will form a key part of the 31 March 2016 actuarial valuation process.

3.2 Specific actions during the valuation process are likely to include:

- Categorisation of employers into different risk categories, following a similar methodology to that used in the analysis for this report. This will include reassessing the risks of different sectors (e.g. stated Government policy and funding).
- For employers deemed to be of higher risk, analysis of employers' balance sheets to estimate the Fund's outcome in a hypothetical insolvency scenario.
- Consideration of further steps the Fund could take to reduce exposure, e.g. fund on more prudent assumptions, implementation of bespoke lower-risk investment strategies, seek additional forms of security, such as a charge over assets.

3.3 Going forwards, the Fund will provide Local Authorities on an annual basis with details of the employers for which they act as guarantor.

3.4 The Fund will continue to share knowledge and experience in this area with other funds as appropriate.

4. RECOMMENDATIONS

4.1 The Board is asked to note the report and provide any advice as appropriate.