



## **PENSIONS BOARD**

**23 JUNE 2021**

<b>REPORT TITLE:</b>	<b>BOND REVIEW AND INTERACTION WITH COVENANT</b>
<b>REPORT OF:</b>	<b>DIRECTOR OF PENSIONS</b>

### **REPORT SUMMARY**

A number of employers have bonds in place which aim to cover part or all of the value of their termination debt if they exit the Fund and are unable to pay the full debt.

This report sets out the updated risk adjusted approach that has been adopted to review employer bonds with an assessment date of 31 December 2020. This approach takes the covenant of an employer into consideration in order to achieve a balance between reduced risk on the Fund and the burden of cost for an employer. This includes how they will be monitored going forwards to manage the risk of unfunded debts arising in the future.

The report also sets out the measures that have been put in place by the Fund to reduce the overall risk associated with an employer failing to meet their financial obligations to the Fund.

This report contains exempt information. This is by virtue of paragraph(s) 3 of Part 1 of Schedule 12A of Local Government Act 1972 i.e. information relating to the financial or business affairs of any particular person (including the authority holding that information).

### **RECOMMENDATION**

That the Pension Board be recommended to note the completion of the bond review allowing for the covenant-based risk adjusted approach and the ongoing engagement with employers to seek to increase the bond cover.

### **SUPPORTING INFORMATION**

#### **1.0 REASON/S FOR RECOMMENDATION**

1.1 There is a requirement for Members of the Pensions Board to be kept up to date with employer developments and Fund risk exposures as part of their role.

#### **2.0 OTHER OPTIONS CONSIDERED**

2.1 Not relevant for this report.

### 3.0 **BACKGROUND INFORMATION**

- 3.1 A variety of different employer types can participate in the Fund under the provisions of the Regulations.
- 3.2 Within this group of employers, the strength of the employer covenant varies considerably; defined as the ability and willingness of an employer to pay its contributions and fund any debt. The last covenant review took place as part of the 2019 triennial valuation.

#### **Employer exits:**

- 3.3 When an employer exits the Fund without a guarantor, its assets are placed within the lower risk investment bucket. The assets making up this bucket were revised from 31 December 2020 to increase hedging of inflation and interest rate risk.
- 3.4 When an employer exits the Scheme, the Fund must assess the value of any exit debt or surplus based on assumptions consistent with the lower risk investment bucket (as detailed within the Funding Strategy Statement). If an employer cannot pay its debt, then the debt would fall on the remaining employers within the Fund unless the Fund agrees to enter into a Deferred Debt Agreement if the employer remains solvent.

#### **Assessment of the bonds:**

- 3.5 A number of employers have bonds in place, which aim to cover part or all of the value of their termination debt if they exit the Fund and are unable to pay the full exit debt. Alternatively, they would be required to provide security under a Deferred Debt Agreement.
- 3.6 Under the current Termination Policy, the value of the bond required is reviewed by the Actuary on a triennial basis with the latest review based on a calculation date of 31 December 2020. The review has led to an increase in the potential bonds from those that are currently in place. This is mainly due to a fall in bond yields and, consequently, a reduction in the expected return of the lower risk assets which affects the potential value of the termination liabilities in addition to the length of time since the existing bonds were put in place.
- 3.7 As part of the latest bond review, the Fund has moved to a risk adjusted approach, whereby the bond is set with reference to the assessed covenant of the employer. Each employer has been given a covenant assessment of either strong, average, or weak based on the assessment undertaken at the 2019 valuation. Each employer's bond has then been calculated on a set of assumptions consistent with the respective covenant assessment.
- 3.8 Employers assessed to have a 'stronger' covenant, specifically those with a guarantee from another employer in the Fund or a strong financial

balance sheet, will generally be required to obtain a lower bond value than an employer assessed to have a weaker covenant.

- 3.9 Consequently, for employers with a strong or average covenant rating the bond will be set at a level lower than the full termination debt. This is reasonable on the basis that these employers should be able to pay at least part (if not all) the termination debt. There is no guarantee that the bond will cover the actual termination debt as this can vary based on investment market and membership changes at the exit date.
- 3.10 As a matter of course, the potential termination position is reviewed every three years although, if the Fund's view of an employer's covenant changes in the intervening period, the bond requirement may be revised to reflect the perceived risk.
- 3.11 The Fund is in the process of communicating the revised bond amounts to employers and assisting them with any queries or issues that arise.

**Level of risk exposure:**

- 3.12 For context, the Fund liabilities at 31 December 2020 stand at c£9.2 billion based on the ongoing funding assumptions.
- 3.13 The estimated termination debt in respect of community admission bodies where no bond or guarantee is available to the Fund at that date, stood at £41.3m.
- 3.14 The termination debt in respect of higher / further education bodies where no bond or guarantee is available to the Fund at that date, stood at £176.0m. The Fund took the step to move these employers to the medium risk investment bucket and reduce their deficit recovery period in order to offset the risk posed by the lack of security provided via bonds and the relative covenant strengths.
- 3.15 In addition, there are a number of community admission bodies where the Fund has previously secured a bond, with the current level of bond coverage amounting to £52.4m. However, the bond requirement for the same employers at 31 December 2020 is now £109.1m (compared to the equivalent termination debt of £192.8m which is £83.7m higher reflecting the relative covenant strength of the employers and their ability to pay part of the debt on exit).

The Fund is engaging with the employers concerned to seek to increase the bond coverage. However, the Fund is mindful of the practicalities of asking the employers to increase the level of cover in this difficult economic climate, and the potential detrimental resultant impact to both the employers and the Fund.

**3.16 Further Measures to reduce risk to the Fund**

The Fund has put in place a number of measures to minimise risk having regard to the characteristics of the different organisations:

- The Fund allocates employers to the investment buckets based on the risk they pose to the Fund. This means that the majority of the Community admission bodies, and further education bodies are allocated to the medium risk investment bucket to reflect the increased risk they represent. This mitigates (but does not remove) the potential extreme downside scenarios which could result in increased risk to the Fund.
- All new Community admission bodies, which are not guaranteed by a local authority or public sector body are required to fund on a more prudent basis in order to minimise the risk of an unfunded liability on termination.
- Any community admission bodies that have not provided either a guarantor or bond are required to pay employer contributions at a higher rate in the form of a risk premium loading rate set to target a funding position of 120% of active liabilities.
- Although bonds are the preferred form of security, the Fund is prepared to consider alternatives to bonds including charges on property or other assets, parent company guarantees or escrow type cash deposit arrangements.
- Any Contractor Admission Bodies are required to comply with bond requirements determined by the relevant scheme employer.
- The Fund performs regular reviews of employer covenants, particularly those bodies deemed to be higher risk (e.g. those without a guarantor). Where the Fund notices a significant deterioration in the covenant of an employer, an increased bond may be requested.
- The Fund carries out full triennial reviews of employer bonds in conjunction with the Actuary and advises the other authorities of the requirements in respect of any relevant contractors. However, the funding positions of each employer (including on a termination debt basis) is regularly monitored.

The level of bonds required will be reconsidered following completion of the 2022 actuarial valuation, having regard to the financial position at that time.

#### **4.0 FINANCIAL IMPLICATIONS**

- 4.1 As there are significant shortfalls in most in-force bonds relative to the actuarial assessment of the updated risk exposure, employers will be required to uplift the bond requirements which may be unaffordable in the current financial environment.

#### **5.0 LEGAL IMPLICATIONS**

- 5.1 There are none arising from this report.

## **6.0 RESOURCE IMPLICATIONS: STAFFING, ICT AND ASSETS**

6.1 As the bond increases are significant, in order to determine appropriate uplifts, Fund Officers will be required to engage with employers' Chief Financial Officers. To reach a mutually agreed position it may be necessary to undertake further analysis of the organisation's financial position, which will be conducted under a consistent framework and in compliance with the Funding Strategy Statement.

## **7.0 RELEVANT RISKS**

7.1 The risks are set out in this report, alongside the measures that have been taken to reduce the risks.

## **8.0 ENGAGEMENT/CONSULTATION**

8.1 The Fund consulted with employers during May 2021 on amendments to the Funding Strategy Statement, which included the methodology for determination of bond requirements

## **9.0 EQUALITY IMPLICATIONS**

9.1 There are no equality implications arising from this report

## **10.0 ENVIRONMENT AND CLIMATE IMPLICATIONS**

10.1 There are none arising from this report.

**REPORT AUTHOR:** **Yvonne Murphy**  
(Head of Pensions Administration)  
telephone: (0151) 242 1333  
email: [yvonnemurphy@wirral.gov.uk](mailto:yvonnemurphy@wirral.gov.uk)

## **APPENDICES**

None.

## **BACKGROUND PAPERS**

Mercer Paper Dated 1 June 2021 - Review of Unfunded Liabilities and Risk Assessment.

**SUBJECT HISTORY (last 3 years)**

<b>Council Meeting</b>	<b>Date</b>