COVID-19: contribution deferral policy

Address and purpose

This paper has been commissioned by and is addressed to London Borough of Tower Hamlets in its capacity as Administering Authority to the London Borough of Tower Hamlets Pension Fund ("the Fund"). It has been prepared by Hymans Robertson LLP (as Fund Actuary) to assist the Fund in developing a policy in respect of the deferral of employer contributions during the COVID-19 lockdown and gradual unwinding of social distancing etc restrictions. This paper should not be used by any other party or for any other purpose.

Introduction

COVID-19 has led to an extraordinary period of lockdown and social distancing measures which has put many employers with LGPS liabilities under considerable financial pressure as their sources of revenue have reduced. This pressure on employers is expected to continue over the short to medium term as Government measures to curb the spread of the infection are gradually lifted and public confidence improves.

In addition, where employers have opted to furlough staff, pay continues to be pensionable (i.e. if a member receives 80% of their pay under furlough, employee and employer contributions are due on this level of pay). However, the Government furlough scheme only compensates employers by 3% of pay towards employer pension contributions (the minimum employer contribution under auto-enrolment rules). Therefore, the balance of employer pension contributions must be found by the employer through other sources which may deplete any cash reserves held by employers, putting their businesses at risk.

The combination of the above is driving an increase in the number of employers across the LGPS enquiring about possible contribution holidays, deferral or temporary reduction of contributions, or exiting the scheme altogether. As a result, the Fund should consider implementing a policy when reviewing these requests to ensure:

- Consistent treatment is applied across employers and over time;
- Employers, guarantors and the Fund understand the risks associated with granting contribution flexibility; and
- The Fund considers appropriate measures to manage the risks where possible.

This paper sets out the key considerations the Fund may want to make in considering a policy on contribution deferment, the requirements the Fund may place on an employer being granted deferment, and a draft policy.

Please note, contribution holidays indicate no contributions are to be paid during the period of holiday. For the purposes of this paper, contribution deferment refers to a delay in the payment of contributions or a temporary reduction to the rates payable.

Key considerations – Regulatory requirements

Our interpretation of LGPS 2013 Regulations 62, 67 and 69 is that every employer must pay, at a minimum, the rates set out in the Fund's Rates and Adjustments Certificate. The timing of said payments are not explicitly addressed, however, they do appear to have to be paid within each 12-month period. Therefore, the Fund does appear to have the flexibility (given any terms in its Funding Strategy Statement) to consider changing contribution patterns paid by employers as long as the total contributions due are paid within the Fund's financial year.

As the Regulations refer to a 12-month period, this naturally limits the period of any deferment (i.e. annual contributions must be paid on or before 31 March each year).

Please note, we do not believe requests for contribution holidays (as opposed to the deferral of contributions) are allowed under the Regulations following a formal valuation. However, under Regulation 64, the Fund may adjust contributions for those employers expected to exit the scheme in the future, to target full funding on the employer's exit basis.

Please note, we are not lawyers and therefore the Fund may wish to take legal advice when interpreting the relevant Regulations when setting this policy. The Fund should also heed LGA guidance which is on its website under FAQs for LGPS administrators.

Key considerations – Fund level

There are a number of risks to the operation of the Fund to consider when setting a policy on deferment, such as:

Cashflow

The Fund relies on contribution income to pay benefits. Granting contribution deferments will affect the cashflows into the Fund, but not the immediate cash requirements to pay benefits. As a result, the Fund will need to consider its overall cash position if flexibility is granted to any particularly large contributors, if significant numbers of employers are granted deferments and the length of time of any deferments. We do not believe this is a reason to deny a request for deferral, however the Fund would need adequate notice to prepare for the potential consequences of deferral on cashflow to mitigate the risk of being a forced seller of assets.

Fund returns

As set out above, regular contributions help the Fund manage its cash position over time which may have a direct impact on the investment/disinvestment of assets. There is a potential for lost return (or gain) due to the timing of investment returns which could be material if the flow of contributions to the Fund is disrupted. This risk largely lands on employers, as any drag on investment returns would be reflected in potentially higher contributions in future.

Administrative complexity

If a material number of employers were to be granted deferment, there will be a potential uptick in administrative complexity due to the increased interaction with affected employers, reconciliation of irregular contribution patterns with expectation, and cash management as set out above. While we do not believe this should be a barrier to granting deferment, the Fund should be aware of the potential risks in terms of officer time and effort.

Key considerations – Employer level

Certain risks in respect of the employers themselves should also form part of the Fund's considerations in setting any policy on contribution deferment. Many of these considerations look to protect the Fund from taking excess risks.

Covenant & solvency

In order to protect the Fund (and any Fund employer providing a guarantee), the Fund should be satisfied that employers requesting deferment will likely continue as a going concern (i.e. they will eventually have the ability to meet contributions in future). Alternatively, if there is an increased risk of failure, the Fund should seek assurance that any exit debt is likely to be met. The Fund can gain assurances on covenant and future solvency through a number of approaches:

- Requiring employers to set out why the request is being made (i.e. liquidity constraints) as well as supporting evidence that they have a clear business plan to emerge from their current position;
- Obtaining written assurance that the employer's other financial obligations are suspended for the period of deferment (e.g. dividends and other shareholder returns are suspended);

- Obtaining written assurance that the Fund is being treated consistently with other creditors and pension arrangements where the employer has obligations (i.e. whether any private sector schemes in which the employers participate are granting concessions);
- Obtaining written evidence that the employer is actively considering other means of preserving liquidity as well (e.g. through the Government's furlough or business loan schemes);
- Requesting a covenant assessment be carried out on the employer to determine their ongoing viability, the affordability of increasing contributions in future and potential recovery of exit debts should the employer go into administration; and/or
- Requiring the employer to provide (further) security to the Fund through bonds, guarantees or a charge on disposable assets.

Interest

When calculating employer contribution rates, there is an implicit assumption that contributions will be paid uniformly throughout the year unless otherwise instructed or noted in the Rates and Adjustments Certificate. Therefore, it is assumed the contributions over the year will attract roughly a half year's expected return on investments. If an employer defers their contributions, this assumption no longer holds. As a result, the Fund should consider whether interest should be charged due to the deferral of contributions, especially if deferral is for longer periods. For ease of administration, the Fund may waive this for short periods of deferment.

Redundancy

Employers may need to restructure to ensure their ongoing viability. This may result in redundancies and the associated strain costs where members are aged 55 or older. The Fund may want to consider whether it is appropriate to agree to a deferral request during a period when an Employer is incurring additional liabilities and pension costs.

Guarantors / letting employer

As set out above, if deferment is not granted, employers that may otherwise be viable could be forced into administration (noting that it would be the cumulative effects of public and Government responses and employer creditors that would tip an employer into insolvency). In the event of an employer exiting the scheme, the Fund may need to call on any guarantor where an exit debt exists. In addition, the guarantor is often directly involved in the contract for services or funding of the employer. As a result, the Fund should consider whether to take the opinion of any employer providing a guarantee into account when determining whether to grant a deferral.

Employee contributions

Employee contributions are deducted from payroll, therefore, these <u>must</u> continue to be paid over to the Fund monthly, regardless of any decision on the deferral of employer contributions. This is a strict regulatory requirement.

Recommendations

We do not believe requests for lower contribution rates or contribution holidays are allowed under the Regulations (noting potential changes under review of Regulation 64 could possibly result in reducing contributions for employers planning to exit the Fund). However, given the extraordinary circumstances associated with COVID-19, we recommend the Fund considers all requests for deferral of employer contributions. In considering deferral, the Fund should take several steps to protect itself, guarantors and any other employers in the Fund including:

- Limiting the period of deferral to a maximum of 3 months. Following the 3-month period, extensions may be granted on a monthly basis, however, it should be made clear that the annual total contributions must be paid by 31 March and interest may apply;

- Evidence of the ability to resume contributions is provided. This may come from the employer as part of its business planning or from a covenant advisor;
- Evidence the LGPS is not the only avenue being used to preserve cash (e.g. dividends are suspended, concessions are being sought from other creditors and pension funds, employers are using or considering whether to use the Government's furlough and business loan programs, employers are considering other means to raise or preserve their cash positions);
- Evidence of discussions with their letting employer or any employer providing a guarantee. Where there is no guarantor, additional security should be sought;
- For speed of decision, a named Officer (rather than the Pension Committee) is delegated to approve requests; and
- Consider whether it is appropriate to report on employer contribution deferrals (those considered, accepted or rejected) to the Pensions Committee and Pensions Board.

Based on the above, a draft policy is set out in the appendix to this report.

Reliances, limitations and professional notes

This paper should not be released or otherwise disclosed to any third party without our prior consent. Hymans Robertson LLP accepts no liability to any other party unless we have expressly accepted such liability.

This report complies with the relevant Technical Actuarial Standards set out below:

• TAS 100 (Principles of Technical Actuarial Work).

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For and on behalf of Hymans Robertson LLP

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Appendix – draft policy statement

COVID-19 – Policy on the deferment of employer contributions

As a result of Government policies to manage the spread of COVID-19, many employers are experiencing a severe impact on their immediate and ongoing revenues. The London Borough of Tower Hamlets Pension Fund ("the Fund") recognises the challenges this may bring in respect of meeting employer pension costs over the shorter term. This document sets out the Fund's policy on granting flexibility in respect of the payment of employer contributions during these unprecedented times.

The Fund is restricted by the LGPS Regulations in granting flexibility as there are limited circumstances where contribution rates certified in the Rates and Adjustments Certificate can be amended. In addition, the Regulations require that employer contributions in line with the Rates and Adjustments Certificate must be paid within each 12 month period. As a result, the Fund is not able to consider reducing contributions or granting contribution holidays to employers. However, the Fund is able to consider the deferral (or temporary reduction) of employer contributions whereby an employer delays payment of employer contributions at the full rate for the current year that are owed to the Fund.

The Fund will only consider deferral where an employer makes a formal request. All other circumstances will be considered as late payments to the Fund and handled in accordance with the Fund's administration policy. In making a request for deferral, the Fund requires:

- A clear business case and rationale for the request, including evidence that the employer will likely be able to meet the deferred contributions at the end of the deferment period;
- Assurances that other financial obligations, such as dividend payments, will also be suspended during the period of deferral;
- Evidence the employer is seeking relief from other creditors, including any other pension arrangements, to ensure the Fund is being treated consistently; and
- Evidence of discussions with their letting employer or any employer providing a guarantee.

Failure to provide the above will result in the Fund being unable to provide a deferral of contributions.

The request and accompanying evidence will be considered on a case by case basis and, if successful, would be approved by Neville Murton, the Section 151 officer with responsibility for the Fund, after the Fund has taken covenant, legal and actuarial advice. The Fund will also consult with any associated employer that is providing a guarantee to the employer seeking deferral. The Fund will respond to a request for contribution deferment as quickly as possible and usually within a 21 day period. Employer contributions should be remitted as usual during the period that a deferment request is being considered.

Where a request for deferral is not approved in the first instance, the Fund may require additional evidence or security to reconsider the request. There is no explicit appeals process for contribution deferment requests. If an employer feels they have been treated unfairly by the Fund, they may refer to the Fund's standard complaints and Internal Dispute Resolution Procedure (IDRP) processes.

Where a request for deferral is accepted, employers will be able to defer contributions for up to 3 months. Following the 3-month period, 1-month extensions may be granted on request subject to submission of updated evidence of the employer's financial position. Extensions cannot go beyond 31 March 2021 at which point annual employer contributions for the whole 2020/21 year are due in full. Where contributions are not received in full by 31 March 2021, the Fund has a statutory obligation to consider reporting the failure to make employer contributions to the Pensions Regulator.

It should be noted that employee contributions should be remitted as usual during the period of deferment, and are unaffected by the employer's decision to request (or not) any deferral.