BARNETT WADDINGHAM
beyond the expected

Briefing

The proposed changes to the LGPS

Local valuation cycles and exits

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The Ministry of Housing, Communities and Local Government (MHCLG) has recently issued a consultation seeking views on proposals to amend the Local Government Pension Scheme (LGPS) in five key areas.

Where the Olympic rings represent the five different continents of the world, the areas of the consultation also relate to five different areas; the frequency of local funding valuations, interim valuations, exit payments, exit credits and higher and further education membership of the LGPS.

This briefing note follows on from our blog "Is the LGPS to be saddled with a new valuation cycle?" and gives more detail on the proposals and how these could impact the LGPS Funds and participating employers. We hope this helps our clients formulate their own views and response to the consultation which closes on 31 July 2019.

Watch out for further parallels with the Olympics Games!

Moving to quadrennial funding valuations

1 Amend the local Fund valuation cycle of the LGPS from three years to four years

Cycling has been an Olympic sport since the first modern Games at Athens in 1896. Much like the Olympics, valuation cycles have been core to the LGPS since the beginning and it wouldn't be the same without them.

As you may be aware, currently the LGPS is subject to two valuations: 1) local funding valuations carried out by a Fund actuary every three years to assess the financial health of each Fund and set employer contribution rates and 2) a Scheme valuation carried out by the Government Actuary's Department (GAD) as part of the cost cap management process, to ensure the cost of the LGPS remains within a pre-determined cost bracket, in order to protect employers and taxpayers from changes to pension costs.

In 2016 these valuations coincided, but with the LGPS on a three year cycle and the other public service schemes on a four year cycle, this would not always be the case. The Government soon decided that the LGPS Scheme valuation should therefore fall in line with the other public service pension schemes and announced a move to a quadrennial cycle with the next Scheme valuation, to be in 2020. This means the local and Scheme valuations would not coincide again until 2028.

MHCLG has therefore recommended that the local Fund valuations should also be carried out every four years. The mechanism for transitioning to a quadrennial valuation could be by one of the below.

a. Postponing the next valuation until 31 March 2024 and so certifying contributions for five years as part of the 31 March 2019 valuation, which is currently under way; or

b. Effectively continuing the triennial valuation for one more cycle and carrying out a full formal valuation at 31 March 2022, with employer contribution rates certified for two years from 1 April 2023 to 31 March 2025

Comment

The consultation proposes approach b) to provide continuity and greater funding certainty than a five year cycle. We agree with this proposal but it does appear contradictory to the rationale for the quadrennial valuation cycle. This suggests that three years is too short and five years is too long but four years is the right frequency to achieve stability.

It is clear that the main reason for the proposal is to help the Government look at public service pension schemes generally by using the outcomes of each valuation cycle to influence their decision making across the sector as a whole. The consultation also outlines some additional aims of the quadrennial valuation cycle which are set out as greater stability of contribution rates and cost savings. We think it is unclear how these aims will be achieved by this proposal, for the reasons below.

- There is already a considerable amount of work for GAD in carrying out the valuations for the unfunded schemes and creating a bigger peak of work won't help - and could instead potentially delay analysis and results further.

- Through local Fund valuations, Fund actuaries have models and tools to achieve employer contribution stability, as far as possible, and have been doing so for many years. This has not been the case for the other public service pension schemes; e.g. NHS and Teachers' recent hike in contribution rates. In fact, the recent Section 13 valuation of the LGPS carried out by GAD illustrated this point through scenario testing of economic conditions and the impact on employer contributions.

- A Fund will save one valuation fee every twelve years, assuming there are no interim valuations needed (see below)! This is a very small saving relative to other pension scheme costs such as investment and administration. Does this saving outweigh the risks that may result because of less frequent local valuations?

Perhaps it is instead because the valuation cycle would coincide with the Olympic Games? Why wouldn't you want to be aligned with one of the most esteemed cycles in the world?

> The consultation asks whether the LGPS Fund valuations should move to a quadrennial cycle and the risks that need to be considered.

Although we are not against the proposal of the quadrennial valuation cycle, it should be noted that the LGPS is a very different scheme from the other public service schemes. The LGPS is funded and the fifth largest pension scheme in the world, based on assets under management. Given the size of the LGPS, the increasing importance of governance and risk management of pension schemes and the improved efficiency that technology can bring, it seems contradictory to reduce the level of review and monitoring.

On the other hand, pension funding is a long-term game. So we may not be overly concerned about the funding position in the short term, which means a quadrennial valuation cycle may be appropriate.

However, another key difference with the LGPS and other public service schemes is that there are thousands of employers participating in the LGPS, each with their own funding position, contribution rate and funding strategy. There will be a number of employers that require more regular reviews to ensure they are on track to meet all their obligations, either because they have a shorter timeframe in the Fund or because they have a weaker covenant and pose more risk to the Fund. The Fund has a duty to protect the other employers in the Fund and to not do so would be contradictory to good governance, which has become so important to the LGPS in recent years.

In addition, many employers have to provide annual accounting disclosures, usually under FRS102 or IAS19. As you are no doubt aware, auditors are becoming increasingly academic in their reviews of accounting disclosures. It remains to be seen whether a four year roll forward would meet their requirements. There is a risk, particularly for smaller employers, that material changes in membership over a four year cycle could invalidate the disclosures on a roll forward approach. This could result in a full valuation being required purely to satisfy the auditors' materiality limits and so incur more rather than less costs.

From an administering authorities' point of view, they could see a four year cycle as more risky and opt to include more prudence in the actuarial basis used to value employers' liabilities and to calculate their contribution rates. As a result, this could inadvertently lead to higher ongoing costs to protect the administering authority from increased uncertainty and exposure to risk.

2 Ability to carry out interim valuations to deal with changes in circumstances between valuations

In 1924 the Olympic committee decided that waiting four years until the next Olympics was too long and introduced the Winter Olympic Games. This meant that for all those Olympic fans out there they no longer had to wait four years for the next Games. However, if you were only interested in the Summer Olympics and who was going to win the 100m sprint, you still only needed to tune in once every four years.

Similarly, the consultation acknowledges that as a result of a longer valuation cycle, there are some Funds who would not be willing to wait four years for the next valuation and so have introduced the option of an interim valuation. A four year cycle can expose Funds to potential risks of a greater change in assets and/or liabilities, resulting in greater changes in employer contribution rates following valuations.

Fortunately, the MHCLG has proposed the following which will, at least in part, mitigate these risks.

- Allow Funds to carry out an interim valuation for all employers. To limit the risk of employers cherry picking the valuation date, the funding strategy statement (FSS) would set out the conditions required to be satisfied to trigger an interim review.
- On application, the Secretary of State could agree to an interim valuation in exceptional circumstances not covered in the FSS and would also have the power to enforce an interim valuation of a Fund.
- Allow Funds to change contribution rates for individual employers (increasing or reducing) under certain conditions as set out in the FSS.
- The Scheme Advisory Board will be invited to provide guidance on a number of areas to support revising the Fund's FSS.

Comment

We welcome the flexibility to carry out interim valuations, regardless of whether the valuation cycle is changed, but in our view this would be essential if we did move to a quadrennial cycle.

> As stated in the consultation, we agree that it is important to review and amend contribution rates for some scheme employers and many admitted bodies, given the different funding strategies.

It's therefore important to allow Funds the flexibility to carry out interim valuations for some, but not necessarily all, employers, and help keep costs to a minimum while adding value for the Fund.

We also agree that by setting out in advance the conditions that trigger an interim valuation, this should provide some safeguards. However, the devil will be in the detail and the conditions that allow an interim valuation will need to be wide enough to ensure Funds can trigger when necessary, while on the other hand avoid having to carry out interim valuations too frequently. This will be a difficult balance to achieve, particularly as consistency across Funds, to some extent, will also be desirable. Providing some guidance should be helpful but it will depend on the guidance! Funds may also want to discuss the approach with their Fund actuary as both parties will have Fund and employer specific knowledge which may impact the conditions that would be set for that Fund. It would be sensible if any guidance did not exclude that option.

Allowing more flexibility in the regulations to review contribution rates for individual employers is something we have been championing for a long time now. Under the current regulations it is difficult to change contribution rates outside of the triennial valuation cycle but the proposals would relax these requirements. However, the proposal only talks about a review if liabilities have increased substantially. We would argue this needs to work both ways and should also be subject to review if they decrease substantially. This is touched upon in the consultation but only with regards to which party should pay for the review and so needs to be more comprehensive and have greater clarity.

One final concern is on data quality. Funds work hard to provide the fund actuary with good quality data for the triennial valuation, but this usually requires a peak in work. It's possible data quality, for actuarial valuation purposes, dips between quadrennial valuations which would impact results and good decision making when an interim valuation was needed.

3 Allow more flexibility for exiting employers when making exit payments

The consultation proposes that scheme employers that are leaving the LGPS and triggering an exit payment no longer have to sprint to the finish line and could be allowed to spread the exit payment over a period of time.

The proposal will allow employers to be treated more like long distance runners by allowing them to maintain speed and defer making any payment and be treated as an ongoing employer if there is an ongoing commitment to meet existing liabilities. Of course all employers would still be encouraged to make a sprint finish where appropriate.

> Currently, it is common for Funds to determine and request the exit payment from the exiting employer as a single payment shortly after the exit date.

The proposal addresses the issue of the "too expensive to stay in, too expensive to get out" problem that many employers face, particularly where employer contributions have been on an ongoing basis but the exit payment has been calculated on a full buy-out basis. The proposal follows the model adopted by the Scottish Public Pensions Agency which allows a Fund to adjust employer's contributions to target a fully funded position by the exit date.

This proposal would also bring the LGPS into line with the private sector where deferred debt arrangements are often possible, allowing the exiting employer to defer payment if certain conditions are fulfilled.

Comment

In fact, we understand there are a number of these arrangements in place already where Funds have applied some common sense to agree a repayment schedule with financially struggling employers. Demanding full and final payment achieves little if the exiting employer is forced into insolvency and the Fund doesn't receive a payment anyway. It is likely this proposal will be welcomed by Funds and their advisers to provide more flexibility in supporting Funds and their employers to achieve optimal outcomes.

Interestingly, the consultation refers specifically to "scheme employers" and "a full buy-out basis". There are of course other employers that exit and other bases for determining the exit payment! It is unclear whether the proposal, therefore, is deliberately only covering scheme employers on a buy-out basis or whether Funds will be able to apply this principle to all employers.

Although this proposal will be welcomed, it is important to consider any unintended consequences. Funds will still need to ensure that other employers are protected and therefore under what circumstances it is in the best interests of the Fund and other employers to apply this approach. Funds will also need have a policy on the repayment period and whether additional security and/or protections are required.

4 Clarify under what circumstances an exit payment should be made to a ceasing employer

Exit credits were introduced in the amendments made to the LGPS Regulations 2013 from 14 May 2018. Where an active employer left the Scheme, they would be entitled to an exit credit if their actuarial assessment upon leaving showed a surplus funding position. This idea was welcomed but it introduced a number of unforeseen complexities that this consultation proposes to deal with.

Sticking with the Olympic analogy, pass-through employers can be compared to a relay team. The baton (the liabilities in this case) gets handed from employer to employer as each contract passes on to a new contractor. Although the employer will pay contributions as they carry the baton, ultimately the baton gets passed on to the next employer. For these types of employers there are some that arguably never take on the funding risk and so should not be entitled to an exit credit.

Comment

We agree with this idea where it can clearly be demonstrated that the employer had no exposure to risk. However, the key question here is "how can the letting authority ensure that this is demonstrated for historic agreements?"

This issue should also be considered in relation to the other recent consultation on Fair Deal which suggests use of the deemed employer approach, where new employers can participate in the Scheme on a pass-through basis with the ceding employer being the deemed employer, who would retain responsibility for the liabilities. This would make it easier to demonstrate that the scheme employer had no exposure to risk and we would support this proposal.

The consultation proposes that this change would be retrospective to 14 May 2018, which creates issues for Funds who have already paid out an exit credit to employers who may fall into this category. It will not be easy (if even possible) for Funds to receive a refund.

5 Relax requirements about FE colleges, sixth form colleges and HE corporations offering LGPS benefits to new joiners.

Being a finance director at a FE College must be similar to being an Olympic 400m hurdler. Not only do you have to sprint around the track to keep up with the pace (of funding), you also have to deal with all the obstacles that being a hurdler involves - and then still have to sprint to the finish line on cessation.

MHCLG has recognised there are a number of hurdles that further education and higher education sectors must clear, together with the financial pressures of participating in the LGPS.

The consultation proposes to allow these employers to stop offering LGPS membership to new non-teaching staff.

> Combined with the proposed additional flexibilities around managing exit payments, MHCLG appear to be trying to make it easier for colleges to manage their financial risk exposure to the LGPS and control costs.

As many of these employers are categorised as Tier 3 employers, at the moment they could be exposed to a significant cessation debt if their participation in the Scheme ended. As mentioned above, the recent problem for some has been that they can't afford to stay in but they also can't afford to leave.

Comment

In principle we suspect that this proposal will be welcomed by some colleges. It might be one less financial hurdle they need to jump over, but this could open up a two tier work force and views by employees of perceived unfairness, so this should be carefully managed. It could also create problems in future college mergers if one party offers LGPS membership and the other does not. Of course, offering LGPS membership would still be possible but the proposal gives employers the flexibility to manage their own risks by removing the strict requirements.

Please note that this proposal is only for employers in England at this stage. The Welsh Government does not propose to make these changes to the regulations.

Final comments

There are a number of similarities when comparing running the LGPS with the new sports being introduced at the Tokyo 2020 Olympics and it's important that the outcomes of the consultation do not prohibit us from achieving the key aims below.

SPORT CLIMBING

More protection is offered than in traditional climbing. With LGPS Funds achieving strong investment performance and getting increasingly close to being fully funded, with some already there, taking steps to protect that position, monitor regularly and make changes as necessary is a key objective.

KARATE

There are many different forms of karate and practitioners. The LGPS Funds are also very different and a one-size fits all is not appropriate. It is important that Funds are allowed flexibility to manage funding strategy and risk appropriately for their circumstances.

BASEBALL

In baseball, the first objective is to get your players safely on a base. Keeping your Fund safe demonstrates good governance and attention to detail in many different areas will help achieve this.

SURFING

It's all about balance and stability and Funds need the powers to ensure the financial stability of the Fund and balance this with the affordability/stability of employer contributions.

On the whole, we support many of the proposals in the consultation but we would encourage you to consider some of the issues we have raised and respond to the consultation which is open until 31 July 2019.

We would be more than happy to discuss any of the proposals with you in more detail, so please do get in touch with your usual Barnett Waddingham contact for more information. Alternatively get in touch via the following:

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