BARNETT WADDINGHAM
beyond the expected

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LGF Reform and Pensions Team
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Dear LGF Reform and Pensions Team

Local Government Pension Scheme: Changes to the local valuation cycle and management of employer risk
Consultation Response

We write on behalf of Barnett Waddingham in response to the above consultation covering the Local Government Pension Scheme (LGPS) in England and Wales. We comment as actuaries and benefits consultants providing advice to the LGPS funds.

By way of background, Barnett Waddingham is a pensions and actuarial firm. Our Public Sector Practice Area provides actuarial, benefits and governance consultancy services, and is the Fund Actuary for 23 of the LGPS Funds in England and Scotland. These Funds include many participating employers of all types.

In addition, we participate in various industry wide technical, Scheme Advisory Board sub committees and working groups, and other groups and meetings concerning the LGPS and its operation and development.

We are therefore experienced in the workings of the LGPS at scheme, Fund and employer level and we have an insight into difficulties and issues experienced by stakeholders in its operation, including in the aspects covered by this consultation.

Our response to the consultation is set out below and we would be pleased to expand, clarify or discuss any of the comments made. Please note that our response reflects our thoughts, experience and knowledge as actuaries and benefits consultants and should not be taken as legal advice.

Summary of response

In summary, we recognise that the Government are trying to provide flexibility to administering authorities to more effectively manage their Funds. Not only are the LGPS Funds very different but there is a huge range of employers who currently participate in the LGPS and therefore there are no "one size fits all" solutions. This is why we agree that there needs to be increased flexibility in the Regulations to help Funds to manage the funding strategies and to help employers to more easily participate in the LGPS.

We welcome many of the proposals made in the consultation around the spreading of exit payments and the introduction of deferred employers but the devil will be in the detail and we would propose guidance for Funds to ensure that these options are used appropriately. This guidance will be a difficult balance between providing sufficiently detailed guidance to be useful but that is also sufficiently flexible to allow Funds to deal with the different scenarios arising while avoiding any unintended consequences.

Although we are not against the move to a quadrennial valuation cycle, we do struggle to see that the two key objectives will be achieved by this change. Firstly, the consultation suggests that the move will provide greater stability of contribution rates and cost savings; stability of rates is already a key objective of the funding valuation and this is already stated in the Regulations. Secondly, with a Fund saving one valuation fee every twelve years, any saving will be offset by the cost of any interim valuations and the potential cost of other calculations that will be required that are currently not carried out (e.g. more frequent valuations to achieve compliance with accounting standards).

With many risk management processes happening in conjunction with the local funding valuations such as investment reviews, employer covenant reviews and strategy reviews, by moving to a quadrennial cycle this change seems contradictory to good governance and risk management, which has become so important to the LGPS in recent years.

Changes to the Local Government Pension Scheme (LGPS) valuation cycle

Question 1 – As the Government has brought the LGPS scheme valuation onto the same quadrennial cycle as the other public service schemes, do you agree that LGPS fund valuations should also move from a triennial to a quadrennial valuation cycle?

Although we are not against the proposal of the quadrennial valuation cycle, it should be noted 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 of pension schemes and with the improved efficiency that technology can bring, it seems contradictory to reduce the level of review and monitoring.

Although pension funding for the scheme as a whole is a long-term game, another key difference between the LGPS and other public sector schemes is that there are thousands of employers participating in the LGPS, who may be participating for much shorter periods of time which would make a quadrennial review inappropriate. These employers all have their own characteristics, funding positions, contribution rates and funding strategies. They will require more regular reviews to ensure that 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.

We do not agree with the proposal that moving to a four year cycle will either achieve stability of contribution rates over the long term or cost savings. The reasons are as follows:

- 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 further delay analysis and results.
- 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 increase in contribution rates, and the consultation notes that in the LGPS there is a risk that changes in employer rates may be greater. In fact, the recent Section 13 valuation of the LGPS carried out by GAD illustrated the potential volatility of contributions through scenario testing of economic conditions and the impact on employer contributions.
- A Fund will save one funding valuation fee every twelve years, assuming there are no interim valuations and save some small fees on providing data to GAD for the scheme valuation. Although this may reduce resource requirements for administering authorities, this is a very small cost saving relative to the other pension scheme costs such as investment and administration and we don't believe this saving outweigh the risks that may result because of less frequent local valuations.

Question 2 - Are there any other risks or matters you think need to be considered, in addition to those identified above, before moving funds to a quadrennial cycle?

We have a few concerns about secondary effects of moving to a quadrennial cycle as follows:

- Many employers have to provide annual accounting disclosures, usually under FRS102 or IAS19. Auditors are increasing their level of scrutiny in their reviews of accounting disclosures. The proposal to move to a quadrennial valuation cycle would result in accounting disclosures being based on an estimated position that is now outdated by up to four years. This estimated position could be materially different from the actual underlying position if a re-valuation was carried out. We are concerned that accounting disclosures based on this estimated position would not meet their requirements. If any additional work or updated valuations are required then this will give rise to additional costs.
- For the accounting figures for smaller employers, there could be material changes in membership over a four year cycle which could invalidate the disclosures on a roll forward approach. This could result in a full funding valuation being required purely to satisfy the auditor's materiality limits and so incur more rather than less costs.
- The valuation cycle is currently an opportunity for Funds to review many of their policies and procedures such as investment strategy, and funding strategy. Less frequent reviews of these important issues could arguably be seen as a weakening in good governance.
- From an administering authority's point of view, they could see a four year cycle as more risky and opt to include more prudence in the actuarial assumptions 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 Fund from increased uncertainty and exposure to risk.
- We have concern over the impact on data quality. The local funding valuation provides a necessary opportunity to improve data quality, and with a move to a quadrennial cycle other pressures could result in less frequent data reviews and a worsening in data quality. Moving to a four year cycle could therefore cause a further increase in the peak of work relative to the current triennial valuation cycle. In addition if

interim valuations were required then administering authorities would see several unscheduled peaks of work, potentially resulting in less reliance being able to be placed on the results of an interim valuation where there is a necessity to use data that has not been fully reviewed.

- We also would suggest that a move to a quadrennial cycle should be considered by the National LGPS Frameworks as the current Framework that the actuarial firms use is the 2016 Actuarial, Benefits and Governance Consultancy Framework. This will be closed in July 2020 and replaced with a new Framework which will last a further four years to July 2024 in theory. This would then mean that Actuarial firms will need to reapply to the Framework in a valuation year which would not be practical as it is not an insignificant piece of work. The timeframe of the Framework should also be reviewed as we understand that it is four years long to cover two valuation cycles but this would no longer be the case with a quadrennial valuation cycle.

Question 3 - Do you agree the local fund valuation should be carried out at the same date as the scheme valuation?

All the public service pension schemes Scheme valuations have now been aligned so that the Government can more easily do a review of public service pensions as a whole and review the scheme for cost cap management purposes.

However, we do not agree that this means that the local fund valuations necessarily need to be carried out at the same time as these are being carried out for a different purpose. We believe that the quadrennial Scheme valuation can happen with a triennial local fund valuation system still in place. For the Scheme valuation to take place all that is required is provision of data to GAD as the Scheme Actuary and we believe that GAD can request this data from Funds for this purpose.

Question 4 - Do you agree with our preferred approach to transition to a new LGPS valuation cycle?

Out of the two options we would prefer option b i.e. to carry out a full formal valuation at 31 March 2022 and certify contribution rates for the two years to 31 March 2025. As set out in our response there are some participating employers where we believe a four year cycle is too long so clearly a five year cycle would exacerbate any stated issues. We note that the consultation proposes option b as its preferred approach in order to provide continuity and greater funding certainty than moving straight to a five year cycle (as under option a). This appears contradictory to the rationale that a quadrennial valuation cycle will achieve more stable contribution rates relative to a triennial valuation cycle.

In addition, given that we are already at the end of July 2019, four months into the twelve months available to complete the valuation, it is arguably too late in the process now to change the approach. We are starting to give employers their results and contribution rates, which will apply for the next three years, as they need to budget for any increases in contributions.

Dealing with changes in circumstances between valuations

Question 5 - Do you agree that funds should have the power to carry out an interim valuation in addition to the normal valuation cycle?

Yes. We welcome the flexibility to carry out interim valuations, regardless of whether the valuation cycle is changed. 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 and that employers may have a short period remaining to potential or actual closure. It's therefore important to allow Funds the flexibility to carry out interim valuations for some, but not necessarily all, employers, and support risk management and governance of Funds and help keep costs to a minimum while adding value to the Fund.

Question 6 - Do you agree with the safeguards proposed?

Yes.

We agree that by setting out in advance the conditions that trigger an interim valuation, this should provide some safeguards. However, this in itself may cause difficulties if the conditions set out in the FSS are too flexible/not flexible enough. The safeguards would need to be carefully set so that Funds could easily trigger an interim valuation when necessary, whilst not being required to carry them out too frequently. This will be a difficult balance to achieve, particularly as consistency of approach 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, relating to the funding and investment strategy, which may impact the trigger conditions that would be set for that Fund. It is important that any guidance does not exclude that option.

Question 7 – Do you agree with the proposed changes to allow a more flexible review of employer contributions between valuations?

Yes. 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 and so we are keen to see more flexibility here given recent volatility in markets, the range of funding strategies, the increased activity across employers (e.g. mergers or exits) and the increased accessibility to information (e.g. covenant assessment). The Regulations as they currently stand permit a review of contributions if liabilities have increased substantially.

We think the ability to review contributions should be available to the administering authority whether a deterioration or an improvement to the funding position has occurred, with consideration of the employer covenant. The consultation does introduce this idea in that a reassessment of the contribution rate may occur where it is believed that liabilities have reduced. However, the detail of the wording is important as it proposes the ability for an employer to request a reassessment of its contribution rate; this raises a potential risk of Funds receiving lower than anticipated contributions if there are many employers requesting contribution reassessments in order to try to reduce their payments into the Fund. Therefore there should be sufficient restrictions around the review of contributions within the FSS to protect the Fund (without reducing the flexibility that this ability should bring).

Question 8 – Do you agree that Scheme Advisory Board guidance would be helpful and appropriate to provide some consistency of treatment for scheme employers between funds in using these new tools?

Yes.

We would expect that any policies in place for funds using these tools should be set out in the FSS and therefore guidance would be helpful to ensure consistency of approach.

There is some risk of Funds putting in place a policy that may get triggered at inappropriate times, when a review is unnecessary, or not triggered when it would be appropriate to do a review but the Fund's policy does not allow them to. We recognise that Funds will want to have different policies but it would be useful for there to be some guidance on the process of designing a policy.

We think that guidance is only needed from one party so that all the guidance is in one place and the Scheme Advisory Board is the obvious choice. We would also suggest that existing guidance such as the guidance on preparing a Funding Strategy Statement, historically provided by CIPFA, is consolidated under the Scheme Advisory Board guidance.

Question 9 – Are there other or additional areas on which guidance would be needed? Who do you think is best placed to offer that guidance?

Yes.

We would suggest that any interim valuation is only undertaken by the Fund Actuary to keep costs to a minimum for the Fund and we would like this to be clear.

Flexibility on exit payments

Question 10 – Do you agree that funds should have the flexibility to spread repayments made on a full buy-out basis and do you consider that further protections are required?

Yes.

There are two aspects to this proposal. In fact, we understand that the regulations currently allow a repayment schedule and that there are a number of these arrangements in place already with an agreed repayment schedule for financially struggling employers. Demanding full and final payment in a single cash sum achieves little if the exiting employer is forced into insolvency and the Fund doesn't receive any payments. However, what we understand is not currently possible, is the ability to review the cessation valuation at a later date and revisit the repayment schedule which is something that we have been championing for a long time. We imagine that this proposal will be well received by administering authorities to provide more flexibility in order to achieve more optimal outcomes.

We note that the consultation refers specifically to scheme employers and the full buy-out basis and we would like more clarity from MHCLG on this reference. There are of course other employers that exit and other bases for determining the exit payment. Clarity on whether the proposal deliberately only covers scheme employers on a full buy-out basis or will Funds be able to apply this principle to all employers and adopt a basis appropriate to the circumstances for the exit valuation. The terminology is not necessarily appropriate here as a "buy-out" basis suggests that the liabilities will be bought out by an insurer, which is not possible under the Regulations. The terminology we would use for an exit valuation on a similar basis would be a "gilts" basis or a "minimum risk" basis.

Although in general we would not expect administering authorities to want to make use of this option where the exit payment for ceasing employers is valued on an ongoing basis, we would still like to see this option to be available in all circumstances with the administering authority having the power to decide whether to allow this flexibility. For these employers (which will be mainly contractors) we would still expect the administering authority to seek full and final payment as a single lump sum as a default. However, there may be circumstances where this is appropriate, e.g. if an employer (contractor) ceases but starts a new contract in the same Fund and with the same letting authority, the contribution requirements and the bond for the new contract could be set taking into account any previous deficit.

Although we welcome this proposal, 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 to apply this approach. Therefore we suggest that it is required for administering authorities to have a process set out in their FSS around when this option should be available.

Without too many restrictions we would agree that a maximum time limit could be enforced (perhaps along with a recommendation for this to be in line with the triennial or quadrennial valuation cycle) but ultimately, the length of this time limit should be a local fund decision. Funds would also have the power to reduce this time limit as appropriate, but again their policy to this should be set out in their FSS.

Any spreading on payments may be contingent on the employer offering a form of security to the fund, but again this would need to be included in their FSS.

We also note that you reference Regulation 61(6) of the LGPS Scottish Regulations as a good idea to implement in England and Wales but we would note that this option is already available under Regulation 64(4) in the Regulations in England and Wales and is already being made use of by Funds. Furthermore, this suggestion also doesn't necessarily address the issue of managing exiting employers as it would target employers who are still participating in the scheme before exit, rather than after an employer has exited the Fund.

Question 11 – Do you agree with the introduction of deferred employer status into LGPS?

Yes.

Although we would like to see this option being made available for all employers rather than those "just, or is about to, become an exiting employer", as it could be a useful risk management tool for helping employers to plan their exit from the Fund in other scenarios, particularly those employers who have closed to new entrants who may be concerned about what happens when they no longer have any active members.

However, we would be happy for this option to be available for all types of employers, we would still expect the default position for employers exiting on an "ongoing" basis to be a full and final exit payment. We see this option being used for employers whose exit payment is valued on a "minimum-risk" basis. We would also expect the employer to provide some additional form of security in line with the local Fund's policy for allowing this arrangement to take place in the Fund.

There will need to be careful guidance for administering authorities encouraging them to have a clear policy set out in their FSS about how different types of employers may use this option. There may be circumstances where the Fund still wants to seek full payment of an exit debt on a "minimum-risk" basis if there is concern over employer covenant etc.

Question 12 – Do you agree with the approach to deferred employer debt arrangements set out above? Are there ways in which it could be improved for the LGPS?

Yes.

We think that implementation of this option would need to be carefully managed by MHCLG as well as local Funds and therefore we suggest guidance is provided about what information should be included in the FSS.

We agree that there needs to be a policy setting out what events could trigger the end of the deferred employer debt arrangement and agree with those listed in iii).

If an arrangement was ended early then it would need to be clear whether any remaining payment due would be based on an up to date cessation valuation or whether it would be based on the pre-agreed funding plan. The consultation refers to "regular actuarial valuations" but it would need to be agreed what this remaining payment would be based on and whether it could be revisited on any date. There should be some control around this to avoid the extreme situation of an employer asking for a valuation too frequently.

For any current arrangements of this type we recommend that there is also a legal agreement in place and we would like to see this recommended for any deferred debt arrangement put in place.

Question 13 – Do you agree with the above approach to what matters are most appropriate for regulation, which for statutory guidance and which for fund discretion?

Yes and No

In terms of documentation and legal requirements of the actual deferred debt arrangement itself, we would like this to be included in the Regulations as per the admission agreement (set out in Part 3 of Schedule 2 (9)) to ensure consistency. This would be in addition to the key obligations and entitlements of the parties which we agree should be set out in the Regulations.

Due to the number of things that we would expect to see in the FSS as detailed in our answer to question 10 and 11 then we would expect there to be guidance around this to help a consistent approach being taken by administering authorities. We would prefer guidance from SAB rather than statutory guidance so that Funds are able to take their own view around an appropriate approach which can then be tailored to each individual circumstance. Ultimately, offering this option to employers should be a Fund discretion and we feel that any guidance would then need to be supplemented with the CIPFA guidance around writing the FSS and therefore the FSS guidance from CIPFA should also be updated.

Question 14 – Do you agree options 2 and 3 should be available as an alternative to current rules on exit payments?

Yes.

We believe that some funds already allow the approach detailed in option 2 assuming that the cessation payment is not revisited (as noted in our response to question 10 above). We would welcome clarity on this within the Regulations as we are aware that not all funds or legal advisers share this view.

Under 2 and 3 it would need to be clear within each arrangement whether the value of the debt would be revisited at a later date (e.g. due to market changes or member experience). Any agreement would also make clear that under these options, the employer would need to make a final deficit payment, if appropriate, when they formally leave the scheme and how and when this would be valued.

Question 15 – Do you consider that statutory or Scheme Advisory Board guidance will be needed and which type of guidance would be appropriate for which aspects of these proposals?

Yes.

As detailed in our response to question 13, we would recommend that Scheme Advisory Board guidance is issued as Funds will need to think about repayment periods and whether additional security and/or protections are required.

Exit credits under the LGPS Regulations 2013

Question 16 – Do you agree that we should amend the LGPS Regulations 2013 to provide that administering authorities must take into account a scheme employer's exposure to risk in calculating the value of an exit credit?

Yes.

We agree with the proposal that when it can be clearly demonstrated that the employer has had no exposure to risk they should not be entitled to an exit credit. However, the key question here is around the demonstration and how the letting authority can ensure that this is clearly demonstrated for historic arrangements.

It is worth noting that there is a range of risk-sharing arrangements between authority and employer that we are aware of, not just pass-through. There are cap and collar arrangements (where the employer is responsible for costs that fall into a pre-determined band), arrangements where the employer only pays for certain costs (e.g. death in service costs) or is responsible for a certain share of the liabilities only. The Regulations should enable the flexibility for administering authorities to only pay out a share of exit credit appropriate for the level of risk taken by the exiting employer. In particular, one option may be to cap any exit credit. This cap could be equal to the contributions paid by the employer together with investment returns on these contributions over the lifetime of the employer's participation in the LGPS.

There are also a significant number of arrangements where there is a guarantor in place, who would be responsible for picking up any future liabilities of an employer if they left the Fund. For these arrangements we value their cessation liabilities on an "ongoing" basis rather than a "minimum risk" basis in acknowledgement that the exiting employer is passing the responsibility (and risk) of these liabilities to the guarantor.

It is in this latter situation that we have seen many issues around exit credits arising since their introduction in 2018. For example, market movements in one case led to an employer being entitled to an exit credit which was higher than the total of the actual contributions they had paid in. In another case we had a contractor with two admission agreements with one in surplus and one in deficit where under the current Regulations, we had to look at their results separately, Pooling these results would reduce risk to the Fund.

Question 17 – Are there other factors that should be taken into account in considering a solution?

Yes.

The consultation proposes that this change would be retrospective to 14 May 2018, which creates an issue 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, if certain circumstances would result in a change in the exit valuation.

Guidance should be in place for new arrangements and the admission agreement should have sufficient detail to ensure all parties know what their obligations are on exit and all parties are comfortable with the potential outcomes. For new arrangements an assessment of risk could be documented in the admission agreement about how much risk the new employer is taking on.

The 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.

There could be additional costs that could be incorporated into a cessation valuation. At the moment no allowance is made for anything in addition to the value of the liabilities and the costs of potential early retirement strains (although only on a minimum risk basis) and therefore we could include an appropriate expense allowance to pay for actuarial and other external advice.

Employers required to offer LGPS membership

Question 18 – Do you agree with our proposed approach?

In principle we believe that this proposal will be welcomed by some employers in this sector. However we also believe that this proposal will not be welcome by members and there will be a mixed view from administering authorities.

These types of employers make up a significant proportion of liabilities in some Funds as well as a large proportion of the active membership and accordingly, the cashflows coming into the Fund. Therefore for some Funds, this new approach could lead to a review their investment strategy.

We are aware of many scenarios where these types of employers are trying to manage their participation in the Fund by using the current options available, however some of the other suggestions in this consultation could help these employers to manage this, e.g. deferred debt arrangements and flexibility around exit payments, without the need to remove the requirement for these employers to offer LGPS membership.

This approach could cause difficulties for future college mergers if one employer offered LGPS membership and the other did not.

Question 19 – Are you aware of any other equalities impacts or of any particular groups with protected characteristics who would be disadvantaged by the proposals contained in this consultation?

Yes.

This could create a two tier work force with potential for equal pay issues so it would need to be carefully managed if implemented by an employer with appropriate legal advice obtained.

There may be some academies who converted from sixth form colleges who may seek the same level of flexibility who would not currently fall into this category. Guidance may be needed for these employers who have not yet converted to make sure that they understand the risks and options available to them.

If you have any questions on the above please contact us.

Yours sincerely

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