LOCAL GOVERNMENT PENSION SCHEME: CHANGES TO THE LOCAL VALUATION CYCLE AND THE MANAGEMENT OF EMPLOYER RISK

A RESPONSE TO MHCLG'S CONSULTATION PAPER

PENSIONS AND LIFETIME SAVINGS ASSOCIATION

ABOUT THE PLSA

We're the Pensions and Lifetime Savings Association; we bring together the pensions industry and other parties to raise standards, share best practice, and support our members. We represent over 1,300 pension schemes with 20 million members and £1 trillion in assets, across master trusts and defined benefit, defined contribution, and local government schemes. Our members also include some 400 businesses which provide essential services and advice to UK pensions providers. Our mission is to help everyone to achieve a better income in retirement. We work to get more people and money into retirement savings, to get more value out of those savings, and to build the confidence and understanding of savers.

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EXECUTIVE SUMMARY

- The PLSA welcomes the Ministry of Housing, Communities & Local Government's (MHCLG's) consultation on changes to the local valuation cycle and the management of employer risk.

- The PLSA is supportive of many of the measures set out in the consultation, including plans to provide more flexibility in exit payments and the proposals to give funds the power to conduct interim valuations. However, we have concerns over the intention to move the local fund valuation from a triennial to a quadrennial valuation cycle.

- We understand the Government's reasoning for aligning the LGPS scheme valuation cycle with that of other public service pensions, and in turn, the logic behind wanting to move the local fund valuation cycle to match. However, given that the LGPS is a funded public pension scheme, holding assets where values and performance fluctuate, regular monitoring and assessments of local funding positions is necessary. As such, lengthening the cycle could lead to a longer period where covenant risk for LGPS funds is not officially reviewed.

- Giving funds the power to carry out interim valuations will provide funds with the power to effectively manage risks. Though we caution that strong governance measures be put in place so employers cannot take advantage of short-term favourable market conditions. The Government's plan to require the Administering Authority to only agree to the interim valuation for reasons set out in the Funding Strategy Statement is therefore sensible.

- The Government has put forward plans to allow exit payments to be spread over time, which will give funds and employers more flexibility. The PLSA supports this proposal, provided that measures are put into place to ensure it will only be done when it is in the best interest of the fund.

- We support the proposal to introduce deferred employer status. The deferred debt arrangement would effectively work as a loan; therefore, effective compliance and enforcement mechanisms are essential. Safeguards must be put in place which detail how the payment is collected, by whom, and whether penalties will be needed in the case of missed payments.

- Planned amendments to the LGPS Regulations 2013 – which intend to specify that Administering Authorities take into account a scheme employer's exposure to risk in calculating the value of an exit credit – is also welcome. However, practical challenges remain in implementation and may have implications for the long-term risk management of the LGPS; proposed changes could add complexity, cost and risk to the LGPS. We suggest that safeguards be put in place, including to ensure that those who may have a financial interest in the outcome of the exit credit assessment are taken out of the review process, and, exit credits should not be permitted to be paid in admission agreements prior to 14 May 2018.

- Proposals to remove the requirement to offer access to the LGPS for new employees from educational employers is contentious. Though removing the requirement may help to ensure the long-term sustainability of the LGPS by reducing the administrative cost and resourcing burden on funds, it could create a "second tier" of employee that could rise to legal challenge, e.g. in light of the McCloud judgement.

- The PLSA supports the view that any policy changes in this area – of LGPS access for new employees of educational entities – wait until the SAB's work on third tier employers is complete and until recommendations, based on robust investigative work, are finalised from the SAB.

BACKGROUND

1. The Pensions and Lifetime Savings Association (PLSA) welcomes the opportunity to respond to the Ministry of Housing, Communities & Local Government's (MHCLG's) consultation on proposed changes to the local valuation cycle and the management of employer risk.

2. The PLSA conducted a survey with its members and consulted with its Local Authority Committee on the proposals set out in the consultation. We welcome many of the Government's proposals in the consultation, including plans to provide more flexibility in exit payments, to spread exit payments and the proposals to give funds the power to conduct interim valuations.

3. However, we are opposed to the Government's plans to move the local fund cycle from triennial to quadrennial. We are particularly concerned over the potential impact the changes could have on the covenant risk for funds as well as how much of an administrative burden implementing the measures could place on funds, especially if interim valuations are needed.

CHANGES TO THE VALUATION CYCLE

4. We understand the Government's reasoning for wanting to align the LGPS local fund valuation cycle (i.e. for consistency with the LGPS scheme valuation and with other public service pension schemes; for supposed greater stability in employer contribution rates; and for a reduction in costs[1]), but we do not believe these arguments are strong enough to justify moving from a triennial to a quadrennial cycle.

5. The majority of public service schemes are unfunded, as such, the funded position of LGPS makes it unique. The nature of the funded LGPS position means there is a need for regular monitoring and assessments of funding positions and of the strength of the employer covenant. It should be noted that lengthening the cycle could lead to a longer period where covenant risk for LGPS funds are not officially reviewed – given how quickly the financial covenant of employers can change.

6. The Government states that the move to a quadrennial valuation cycle would "reduce costs". However, it is unclear as to whether this will be the case. Though firms will save

[1] LGPS: Changes to the Local Valuation Cycle and the Management of Employer Risk (Page 8) See here: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/800321/LGPS_valuation_cycle_reform_consultation.pdf

by reducing the frequency of full valuations (and the costs involved), this may be offset by the costs involved in undertaking interim valuations.

7. There is also a question over pensions accounting. Currently, auditors undertake formal actuarial valuations every three years (as per current accounting standards[2]) and use approximate assessments for the intervening years. However, lengthening the cycle may result in auditors being less willing to accept figures based on data which could be up to five years old. This could lead to an increase in the number of full valuations, adding to a fund's costs.

8. The complexity involved in making the necessary changes to move to a quadrennial cycle may also overburden schemes in administration and cost.

9. If the Government does decide to push ahead with the valuation cycle change, we do agree that Approach B to transition to the new cycle is the preferred option. Though Approach A could be seen as less expensive, a five-year gap between valuations could be too long, increasing the possibility that asset value and performance volatility is not being taken into timely consideration for good financial planning.

10. Approach B will provide schemes with a greater flexibility to review and adapt to changing circumstances, particularly when it comes to dealing with uncertainties likely caused by the McCloud judgement; the Employment Tribunal has been tasked with determining the remedy, as such the costs to funds remains unknown. However, we also highlight that Approach B could increase the burden on funds in terms of workload and cost.

DEALING WITH CHANGES IN CIRCUMSTANCES BETWEEN VALUATIONS

11. We support the proposal to give funds the power to carry out an interim valuation in addition to the normal cycle. Interim valuations will be key to ensuring that risks can be monitored and managed in a timely and effective way. Funds will also need to be able to be agile to act quickly to respond to changing market conditions.

12. However, there must be strong governance around this to ensure the valuations cannot be timed to allow employers to take advantage of favourable market conditions. Terms need to be set as to how and when interim valuations can be conducted, along with clear, concise and principles based guidance from a single body to help funds outline the criteria for a valuation, which should be made after consulting their actuary.

13. The Government's proposal to ensure the Administering Authority would need to agree to the interim valuation for reasons set out in the Funding Strategy Statement is sensible.

14. We welcome the proposal to allow a more flexible review of employer contributions between valuations, which will permit funds to help employers to respond to changing

[2] https://www.frc.org.uk/getattachment/69f7d814-c806-4ccc-b451-aba50d6e8de2/FRS-102-FRS-applicable-in-the-UK-and-Republic-of-Ireland-(March-2018).pdf

financial circumstances, which in turn helps to contribute to long-term LGPS sustainability.

15. We believe that it is a practical proposal that each fund should set out the circumstances under which a review of contributions would take place in their Funding Strategy Statement.

16. We agree that SAB guidance will be helpful and appropriate when it comes to ensuring consistency for interim valuations and employer contribution reviews.

FLEXIBILITY IN EXIT PAYMENTS AND DEFERRED EMPLOYER STATUS

17. It should be noted that LGPS exit payments are not calculated on a full buy-out basis. This is because liabilities from the LGPS cannot be transferred to insurance companies.

18. It should also be stated that regulation 64(4) of the Local Government Pension Scheme Regulations 2013[3] currently allows Administering Authorities to agree that the employer can make repayments beyond the effective exit date (although this regulation applies before exit). It is unclear how any of the new regulations from this consultation will interact with this, i.e. the circumstances under which Administering Authorities would be required to agree to spread the payment prior to the exit date or after the exit date.

19. However, we are supportive of the plans to spread exit payments over time, which will give funds and employers more flexibility, provided that measures are put into place to ensure that this would be in the best interest of the fund. The consultation's consideration of a maximum payment period will need further examination, as it may be difficult to have accurate visibility on whether the exit debt could actually be paid in full within a specified period; as such, built-in reviews of the payment period may be needed. Clarity is also required on how the maximum payment period would be determined, i.e. by the Administering Authorities, through guidance or via LGPS regulations.

20. We agree that deferred employer status should be introduced. The deferred debt arrangement would effectively work as a loan; therefore, enforcement will be key. In which case, there must be safeguards in place as to how the payment is collected, by whom, and whether penalties will be needed in the case of missed payments.

21. The Government is proposing that the concept of Deferred Debt Arrangements recently introduced by DWP into private sector pension schemes be incorporated into the LGPS via Deferred Employer status. While well-intentioned, it could introduce excessive complexity into the LGPS, particularly in how an Administering Authority should adjust their funding strategy to deal with the changes, and how it will be regulated. As such, comprehensive guidance would be needed to ensure transparency and consistency in practical application.

22. We agree that only the key obligations and entitlements of parties should be in the regulations. However, robust and comprehensive guidance will be needed to ensure

[3] http://www.legislation.gov.uk/uksi/2013/2356/made/data.pdf

transparency and consistency. Scottish regulations refer to targeting exit debts before reaching exit; this should be referenced in guidance in order to avoid cliff edges.

23. We believe option 1 is a good option for both funds and employers when employers can afford a clean break. Options 2 and 3 should be made available as alternatives to the current rules on exit payments. The arrangements would offer greater flexibility for both funds and employers, providing practical solutions to employers who cannot afford to make a clean break without posing undue risk to the fund. However, these options should only be available where the employer has a strong covenant to fulfil the obligations. Robust guidance will also be needed to ensure consistency in when these options should be made available and how exit payments are calculated.

EXIT CREDITS UNDER LGPS

24. We support the Government's intention to amend the LGPS Regulations 2013 to specify that Administering Authorities take into account a scheme employer's exposure to risk in calculating the value of an exit credit. However, there are potentially large challenges to consider, particularly when it comes to practical implementation and may have implications for the long-term risk management of the LGPS.

25. The plans could add complexity, cost and risk for Administering Authorities. Difficulties could arise as the Administering Authority is likely not to be involved in the decisions over the pension risk sharing agreement between the employer and a contracted employer on LGPS pension benefits or on the contractual and commercial agreements; there could be a significant variation in terms of pension risk sharing and the robustness of written agreements in place; risk exposure can be a matter of judgement and vary in each contract; how the exit credit valuation is "adjusted" to reflect the risk could vary substantially across employers and funds as a result.

26. All of these introduce inconsistencies in exit credit calculations across funds, which then become more difficult to monitor and review over time from a governance and good practice perspective. The Administering Authority could also find, given the reasons stated in the previous paragraph, that it is challenging to enforce adjustments to exit credits.

27. If the proposals go ahead, funds will need to undertake additional work to assess employer risks and to justify the calculation of any lower credit. This will likely lead to significant additions to workload and cost, which means that the timeframes in which exit credits must be paid must also be thoroughly considered.

28. Monitoring the deferred debt arrangement on an ongoing basis will therefore be needed, along with guidance which explains how it can be done to ensure consistency and to avoid hazards when it comes to determining risk.

29. Safeguards must be in place to ensure that those who may have a financial interest in the outcome of the exit credit assessment are taken out of the review process; the assessment should be done by an independent reviewer, especially as risk assessments carry a subjective element to it.

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30. It should be noted that the consultation proposes that the change would be retrospective to 14 May 2018, which has the potential to create issues for funds that have already paid out an exit credit to employers.

31. We believe that the Government should go further, and look to amend the Regulations to clarify that no exit credits can be paid in admission agreements which began prior to 14 May 2018. Admission agreements made before this date had opening funding positions and contract prices (applicable to service providers only) agreed at the outset with the assumption that no surplus could be paid to the admission body on exiting the LGPS. As such, if payment of exit credits for agreements made before 14 May 2018 are allowed, funds may have to pay out potentially large sums to employers who have simply fulfilled their obligations. This may also stand contrary to the aim of long-term sustainability of – and risk management in - the LGPS. Our members have also expressed concern that if Regulations are not amended, there is the potential for expensive and complex litigation between exiting employers and LGPS funds.

EMPLOYERS REQUIRED TO OFFER LGPS MEMBERSHIP

32. There are reasons to both support and to be wary of this set of proposals. There are views from our membership that approve of removing this requirement to offer access to the LGPS for new employees from educational employers, as well as those that do not.

33. The administrative cost and resourcing burden from the growing number of employers in recent years is a live issue, and this could be a way to help introduce a way to help ensure the long-term sustainability of the LGPS.

34. However, there are compelling reasons to refrain from pursuing these proposals at this time. For one, there are lessons that should be learned from the recent McCloud judgment. Drawing a line like this on who should and should not be offered access to the LGPS seems to create an arbitrary boundary, similar to the ones argued against by firefighters and judges in the McCloud case. It creates a "second tier" of employee that could rise to legal challenge. Concerns over cash-flows for LGPS funds have also been raised.

35. Additionally, the SAB commissioned in 2018 a project ("Tier 3 project") looking at this particular issue of the impact of the status of higher and further education entities on the LGPS.

36. Overall, the PLSA supports the view that any policy changes in this area wait until the SAB's work on third tier employers is completed and until recommendations, based on robust investigative work, have been finalised from the SAB.

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