First Actuarial's response to the Ministry of Housing, Communities & Local Government's policy consultation "LGPS: Changes to the local Valuation Cycle and the Management of Employer Risk"

First Actuarial is a consultancy providing pension scheme administration, actuarial and consultancy services to a wide range of clients across the UK. Our clients' pension schemes range in size from £0.5 million to nearly £5 billion in assets and cover a number of sectors including manufacturing, financial services, not for profit organisations and those providing services previously in the public sector. We advise trustees, employers and unions.

First Actuarial advises many private employers participating in the LGPS. Many of these are housing associations who are Community Admission Bodies. But we also advise some charities, Transferee Admission Bodies and Designated Bodies. We have a team of consultants working with these employers. The whole team has had opportunity to give input to this consultation response.

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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?

No.

Pension schemes are by their nature very long term. There is no need to fine tune contributions frequently – particularly with schemes open to accrual where there is often an in built balancing mechanism. For example if asset values are very low, this may make the past service position appear worse but it will mean that contributions for future service can be lower because they are invested in lower priced assets.

Employers value having stability of pension contributions. They need to know what to factor into their business plans. We believe that employers would generally dislike the possibility that a valuation might be called part way through an inter-valuation period and change their contributions again only a short while after the contributions were last adjusted.

We note that pension scheme advisers could be the major beneficiaries of a move to allowing interim valuations and would ask whether local or national taxpayers would receive value from this.

Question 6 – Do you agree with the safeguards proposed?

No.

In the private sector, if pension trustees want to call an early valuation, they would usually do so with the agreement of the sponsoring employer. We note that there is no proposal for employers' consent to an early valuation of their membership of the LGPS. Employers in LGPS are ring fenced from each other, unless they are in a pool. It would be possible in principle to carry out an early valuation only in respect of those employers, or pools, which consent to it.

If the MHCLG is not persuaded that a 4 year interval between fund valuations is a safe interval, then it would be better to stick with the current 3 year interval. Better to have regular 3 year valuations than to have regular 4 year valuations plus occasional unexpected valuations in between.

Employers might welcome regular 4 year valuations, in combination with no power to hold an interim valuation, because it would give them a longer period of known contributions to put into their business plans.

Of course there is nothing to prevent employers from seeking an approximate update to the previous valuation to get an understanding of the direction of travel.

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

No.

One of the scenarios posed in the question is that of a declining employer covenant, where the proposed reaction is "to protect other employers in the scheme or the solvency of the fund itself" by a "change in the deficit recovery plan and/or funding target level".

We do not agree that it is appropriate to seek higher contributions at the same time as an employer is having difficulties. This begs a question about the original funding target. If the original funding target is insufficient to give comfort about the prudence in the funding plan in the event of a weakening employer, then the original funding target was inappropriately set in the first place. When the employer has become weak is not an appropriate time to increase contributions.

We reiterate our opinion that stability of contribution is valued by employers. The period between valuations should be set at a length that MHCLG believes is reasonable for contributions to be fixed between valuations. There should not be a mechanism for a review of contributions between valuations, except possibly with the employer's consent.

Flexibility on exit payments

We have some important things to say on this section which are not the subject of any of the consultation questions. Before turning to the questions, we comment on some statements in the consultation document.

3.1 paragraph 1 "We know that some smaller and less financially robust employers are finding the current exit payment regime in LGPS onerous."

The exit payments required by many LGPS funds are onerous regardless of the size or financial robustness of the employer. A so called "least risk" deficit, one calculated using the gilt yield as the discount rate, would be onerous to any employer of any financial strength, if the large majority of the employer's employees are accruing pension in LGPS.

The possibility of an exit payment does trap employers into continuing accrual in LGPS.

3.1 paragraph 2 "These problems arise because the employer debt is calculated at full buy out basis."

This is not true. The exit deficit is calculated on the buy out basis from a multi-employer scheme in the private sector, but this regulation does not apply to the LGPS. The basis of calculating an LGPS exit deficit is determined by each LGPS fund and is usually set out in their Funding Strategy Statement.

Many LGPSs use a so called "least risk" basis, which uses the yield on gilts as the discount rate, but not all do. Some LGPSs use the ongoing valuation basis (particularly if the employer joined the LGPS with an asset credit equal to the ongoing value of the active members' liabilities).

The regulations state that a debt is triggered when, for example, the last active member leaves. However, the regulations do not specify how this debt is calculated or how it has to be paid.

By definition, debts assessed on a 'least risk' basis have a high probability of the employer paying significantly more than is actually needed to provide the promised benefits in the LGPS. This excess money is effectively credited to other employers. This type of 'cross subsidy' is inevitably one sided to the benefit of the Scheduled Bodies continuing to participate in the LGPS.

3.1 paragraph 3 "The current regime is designed to protect those scheme employers who remain in the scheme when one or more employers have ceased to employ active members and who may be left with orphan liabilities."

One problem with the current operation of the LGPS is that an employer with zero active members is deemed to be terminating all future liability to contribute. This is an unnecessary and inappropriate conflation of two separate issues:

1. The decision to terminate benefit accrual in LGPS, and

2. The decision to terminate all future liability to contribute to LGPS.

It would be much better if these two employer decisions were kept separate. That is:

1. An employer who decides to terminate benefit accrual can remain liable to pay deficit contributions on the usual ongoing funding basis.

2. An employer who wishes to terminate all future liability to contribute can do so by paying the exit deficit. It might be reasonable to charge a premium above the standard ongoing funding basis in return for release from the obligation to contribute, that is, the exit deficit might be calculated on a more cautious actuarial basis than the ongoing valuation. However, a least risk basis is not necessarily appropriate for this purpose.

It is not obvious that merely deciding to terminate benefit accrual should change the basis of calculating contributions. If an LGPS is satisfied with its ongoing basis of funding while an employer has active members, it is arguable that the same ongoing basis should remain satisfactory after an employer has terminated accrual. Nothing else has changed, closing to accrual does not damage an employer's financial strength, in fact it might marginally improve it.

3.1 paragraph 5 "… the time is right to bring LGPS more in line with wider practice in the private sector."

Private sector practice is not necessarily a model for the public service.

For example, the buy out basis termination deficit in the private sector is not a model for the public service pension schemes. The LGPS will never be insured, therefore the buy out basis is irrelevant.

The private sector regulation which requires an employer which ceases to have active members in a multi-employer scheme to pay a cessation deficit is not a good model to follow. This model has caused serious difficulties in the private sector, especially in industry wide schemes such as the Plumbing Industry Scheme.

The policy of charging a "least risk" deficit upon the last active member leaving service in LGPS also causes grave problems.

As mentioned above, it is better to keep separate the decision to terminate accrual and the decision to terminate liability to contribute. The private sector is moving in this direction with the innovation of Deferred Debt Arrangements.

3.2 final paragraph "… we propose that the exit payment in these circumstances [spread exit payments] would continue to be calculated as now on a full buy out basis."

Exit payments are not necessarily calculated on a full buy out basis nor should they be.

The basis of calculating exit payments needs careful consideration. There needs to be flexibility. As we explain below, the method of calculation of the exit payment may reasonably depend upon market conditions and upon the terms on which an employer was admitted to the LGPS.

"Least risk" basis

Many LGPSs use a so called "least risk" or "gilts" basis for calculating a cessation debt. This is a valuation using a gilt yield as the discount rate. The premise of such a valuation is that the benefits will be provided from investment in gilts. This premise needs examination.

An allocation to gilts in the investment strategy should be determined objectively. It should not merely be assumed that the allocation is "all gilts". A rational allocation to gilts would consider:

- The pattern of cash flow in and out over time
- The expected return on gilts and "growth assets"
- The scope for losses on growth assets vs the lost expected return from investment in gilts.

Gilt investment provides a guaranteed income, but the income is guaranteed to be low. Gilts might be good for the mitigation of disinvestment risk in the shorter term, but in the longer term growth investments have a high probability of returning more than gilts, even if growth investments were to suffer a market down rating.

A rational plan for running off a closed section of the scheme might assume investment in gilts for the shorter term and investment in growth for the longer term. This plan could then be the basis of calculating the termination deficit.

The basis of admission

The basis of termination should be commensurate with the basis of admission.

Were a Community Admission Body to terminate liability to contribute, the principle should be that the basis for calculating the pension assets to be transferred away from the CAB is commensurate with the basis on which pension assets were transferred to the CAB on its admission.

For example, many CABs were admitted to LGPS with an asset credit for their inherited pension liabilities equal to 100% of the ongoing value. Were such a CAB to terminate its liability to contribute, it is only fair that the cessation payment to the LGPS is also calculated on an ongoing valuation basis.

Were the transfer of liability to the CAB to be calculated on an "ongoing" basis, but the transfer of liability back to the scheme to be calculated on a "least risk" basis, that would be grossly unfair to the CAB. Regrettably, this is what is done by many LGPSs.

If it is true that the price of transferring liability from one body to another is a "least risk" basis (and we could debate that) then the liability should not have been transferred from the council to the CAB on its admission by credit of an "ongoing" value of liabilities.

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?

There would be less need to create regulations governing the flexible payment of a cessation deficit were the cessation deficit more reasonably calculated in the first place. Before considering the need for flexibility of payment of an onerous cessation payment, we recommend that consideration is given to the basis of calculation of the cessation payment.

Exit payments are not calculated on a full buy out basis nor should they be.

Many LGPSs use a discount rate equal to the yield on long dated gilts to calculate the cessation deficit. A problem with this at the present time is that gilts have a yield of *minus* 1.9% real. It makes little financial sense to pre-fund pension payments via an asset guaranteed to lose 1.9% pa in real terms. £1 contributed in respect of a 45 year old is worth 51p in real terms when spent on a pension payment at age 80.

It is likely that “growth” assets will produce a positive real return in the long run. The likelihood of growth assets producing a performance as low as -1.9% pa real is very small, let alone a performance materially worse than -1.9% pa.

A cessation deficit calculated on a gilt yield basis is excessive. A rational analysis of when to invest in gilts, taking into account net cash flow, diversification, the risk of growth market falls and the opportunity cost of not investing in an asset of higher expected return, would conclude that the benefit of investing in gilts to protect against risk is limited to a short period only, in current market conditions.

We recommend that it is considered whether a floor be placed on the discount rate for calculating cessation deficits. For example, nil real return relative to RPI. It is highly likely that “growth” assets will produce a positive real return. A deficit calculated on a nil real return basis will still protect other employers in the LGPS.

The premise of a cessation payment is that it is the payment to terminate all future liability. Allowing a period of time to make a cessation payment is an erosion of this premise. It would seem reasonable for the period of payment of a cessation deficit to be somewhat shorter than the period of payment of an ongoing funding deficit.

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

Yes.

We recommend that a deferred employer is required to fund its liabilities in the LGPS on the same basis as it would were it to have active members i.e. on the usual ongoing valuation basis.

We recommend that ceasing to have active members is not treated as a trigger for ceasing liability to contribute.

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?

We do not recommend copying the approach in the private sector. This approach can be improved upon for the LGPS.

Regulation would be much simpler were it to distinguish between:

1. The decision to terminate benefit accrual in LGPS, and
2. The decision to terminate all future liability to contribute to LGPS.

Employer has only decided to terminate accrual

Sections 3.3(iii) and (iv) outline an unnecessarily complex approach. The system can be as simple as a deferred employer which has only decided to terminate benefit accrual being allowed to continue to fund its liabilities on the LGPS's usual ongoing valuation basis. Nothing else needs to be done.

We advise against building in a covenant test for eligibility to a deferred debt arrangement. We advise against using a deterioration of covenant as a trigger for withdrawal of a deferred debt arrangement. This will put LGPSs in the difficult position of withdrawing a DDA from a financially deteriorating employer and pushing the employer into insolvency. We think it better to be satisfied with the prudent funding established in the ongoing valuation basis and to dispense with the employer covenant assessment.

Such tests are not usually applied to employers with active members. Ceasing to have active members is not sufficient reason to introduce covenant tests, for an employer not seeking to terminate liability.

Employer has decided to terminate future liability to contribute

Ideally this is triggered at the employer's option and is not triggered merely by having no active members.

If the termination is triggered by the employer, then the employer should only make that decision if it can afford the termination debt. If it cannot, the employer can instead continue its liability to contribute and fund its liabilities on the usual ongoing actuarial basis over the usual deficit repayment period allowed by the LGPS.

The premise of a cessation payment is that it is the payment to terminate all future liability. Allowing a period of time to make a cessation payment is an erosion of this premise. It would seem reasonable for the period of payment of a cessation deficit to be kept short. If the period of payment is short, the assessment of the financial strength of the leaving employer need only be done once, at the point of setting up the deferred debt agreement. The repayment terms can be loaded for the risk of default. That is, the periodic payments are not only increased for the time value of money, but also increased to cover the risk of default.

The employer can then choose between:

- Continuing liability on the ongoing basis
- Termination of liability to contribute in a deferred debt arrangement including a loading for default risk
- Termination of liability via a one off payment.

This will keep the system simpler than the complex outline proposals in the consultation paper.

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?

No mention is made of the role of an Admission Agreement in delineating roles and responsibilities. Ideally, all admission agreements would have clear statements about matters such as the basis of calculation of a cessation deficit and the role of a guarantor. Unfortunately, few admission agreements for community admission bodies are explicit about these things, but some are. New regulation should not override existing admission agreements.

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

If the decisions to terminate accrual and to terminate liability to contribute are kept separate, as we recommend, option 2 is not entirely necessary. However, the introduction of option 2 could be a helpful thing to do.

If the decisions to terminate accrual and to terminate liability to contribute are kept separate, as we recommend, the requirement that the "scheme manager was confident that it [the employer] would fully meet its obligations" can be dropped where an employer is terminating accrual but not liability to contribute. In this circumstance, the employer should carry on contributing on the usual ongoing funding basis.

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?

Fundamentally, employers should be encouraged to provide pensions, not discouraged from doing so. The regulations governing LGPS should create a regime in which employers can gladly sponsor pensions in LGPS.

Administering authorities should aim to work in partnership with the employers in the LGPS funds. The nature of the services that both Community Admission Bodies and Transferee Admission bodies provide mean that it is in the interest of all parties for a collaborative approach to be taken.

LGPS funding should enable employers providing services in the community to pay a 'fair cost' for LGPS benefits with the aim of sustaining both the employer and the LGPS fund. In the long run this will also benefit members who will be more likely to be offered a good quality pension.

We believe that Administering Authorities should be given the flexibility to negotiate scheme funding with the employers that participate in the LGPS. Accordingly, at a high level, guidance should simply state the variety of options available rather than being prescriptive. The key principle being to disentangle the decision to cease active benefit accrual with the decision to terminate all future liability to contribute.

SAB guidance might be useful on the calculation of cessation deficits. One principle should be that the cessation deficit calculation should be commensurate with the credit when an employer first joined. For example, if an employer received pension liabilities for transferred staff which were funded at 100% on an ongoing basis, then the basis of cessation should also be an ongoing basis. The SAB could provide guidance on a cessation deficit basis which provides prudent funding for the discharged liabilities using rational cash flow driven investment principles. Such a basis would not be as extreme as a gilts basis, in current market conditions.