Housing briefing, January 2020
LGPS funding agreements

The LGPS 2019 valuation marks an important decision point for housing organisations. As negotiations over future contributions continue, we highlight key issues to be aware of, and report on a number of funding agreements we've already helped put in place.

Organisations in the Local Government Pension Scheme (LGPS) should now have received their provisional results of the 31 March 2019 valuation. Negotiations should already be underway regarding future contribution requirements. It is important to engage with the administering authority as early as possible to find out the options and flexibility available to you.

Although the headline results from the valuation will be your funding deficit and future contribution requirements, employers will also see details of their cessation debt. This debt is usually demanded in cash within 28 days. It is therefore a liability which needs to be controlled and planned for as much as you can. This briefing is similar to our LGPS briefing issued early last year, but updated to report on the success of our clients over recent months in putting funding agreements in place.

More background information on the latest actuarial valuation was provided in our October 2019 webinar – see the 'my bookings' section of our website https://bookings.firstactuarial.co.uk

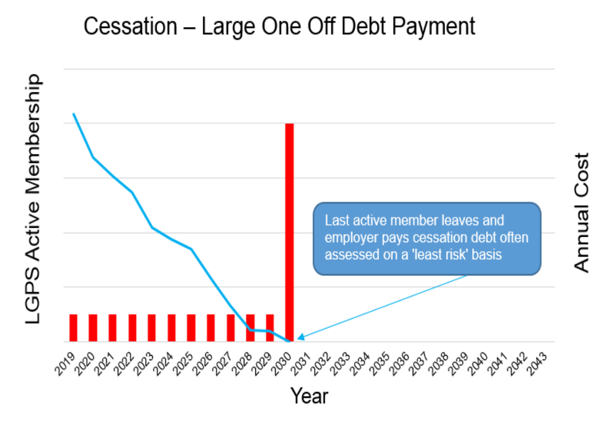
Cessation debts – A reminder

LGPS regulations mean that an employer whose scheme participation ceases (e.g. when its last active contributing member leaves) automatically triggers a cessation debt. This debt is often assessed on a least-risk basis (broadly equivalent to a gilts-based buy-out cost) and can be a significant multi-million-pound one-off cash payment. For employers that have closed the LGPS to new members, this eventual cessation trigger is inevitable.

LGPS funds will often state that the reason for imposing a cessation debt on departing employers is to protect the position of the remaining employers, i.e. ensuring that the liabilities relating to the departing employer can reasonably expect to be funded. This assurance is often achieved by imposing a very prudent least-risk basis for calculating the debt.

Of course, the flip side to being prudent is that there is a high risk that the assets built up following cessation are significantly more than those required to meet the benefits due. In effect, the departing employer pays more, often significantly more than is ever expected to be needed. It's akin to having a large contingency fund for a major building project that is never returned.

The chart below illustrates a typical case where a declining LGPS active membership eventually leads to a significant one-off debt payment being required from the employer. Employers are often required to pay this debt in one financial year, based on timing (and hence financial conditions) over which they have little control.



Funding agreements

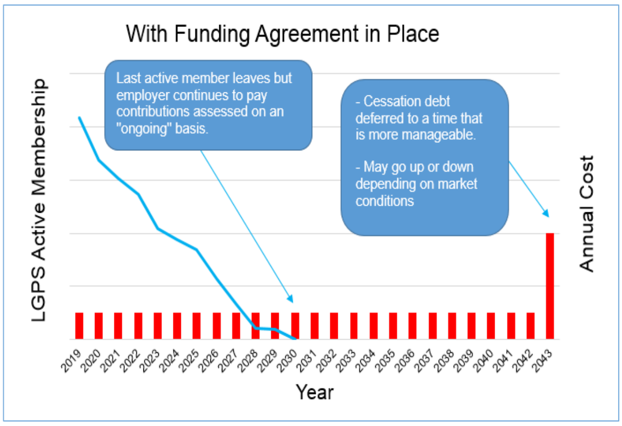
Given the level of cessation debt payments, and their size relative to the standard funding basis, in recent years many LGPS funds have been prepared to negotiate on either the level of the debt or the timing of the debt payment. The results of these negotiations are often formalised by putting a funding agreement in place.

A funding agreement sets out the terms that apply when the cessation trigger occurs. This can give protection to the departing employer and enable payments to be planned for. It is important to stress that an employer putting a funding agreement in place is not trying to avoid its liabilities but is aiming to meet these in a controlled way and at a reasonable cost.

In fact, many funding agreements look to reassess the liabilities over their lifetime, and so the payments reflect the ongoing experience of the membership. Funding agreements can therefore reduce, or even entirely eliminate, the relatively small risk of the cessation debt proving insufficient to meet all the benefits over time. It also gives the employer the ability to spread payments over a reasonable period, rather than as a one-off hit.

First Actuarial is a market leader in helping housing employers arrange LGPS funding agreements, and we have successfully developed innovative solutions for many of our clients.

The chart below illustrates how a cessation debt could potentially be managed. In this example, instead of the cessation debt being triggered when the last active member leaves, it is only triggered (at a much lower level) when the employer decides that it is an optimum time to do so. Before deciding to trigger the debt, the employer would continue to fund any deficit payments required, either on the normal ongoing scheme valuation basis or on an accelerated basis as agreed with the LGPS.



By entering into a funding agreement, the employer will be able to monitor the size of any cessation debt on a regular basis and, if the size of the debt reduces sufficiently, the employer can decide to end the funding agreement at a time of its own choosing with a significantly lower single payment.

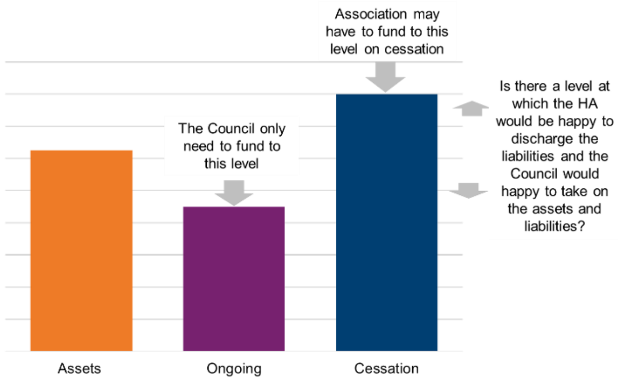
So what's in it for a council? The council is only ever concerned with the ongoing funding position. So if they take on a section of the LGPS with an ongoing surplus, the council could potentially use this surplus to reduce its own contributions in the future.

Subsumption agreements

Increasingly, we are seeing housing associations and councils discussing an agreement whereby the council assumes responsibilities for the association's LGPS assets and liabilities, perhaps in return for a one-off payment to the LGPS and/or council.

The benefit to the association of such an agreement is that they can cease participation in the LGPS at a lower cost than that of a typical cessation debt.

So, what's in it for a council? The council is only ever concerned with the ongoing funding position. So, if they take on a section of the LGPS with an ongoing surplus, the council could potentially use this surplus to reduce its own contributions in the future. There can also be more altruistic motives if it can be shown that the transfer puts the housing association in a stronger position to invest in the local community, for example.



This leads to the question – what is the risk to the council of taking on a section that is in surplus on an ongoing basis but in deficit on a least-risk basis? We have developed unique modelling tools to advise either party on the risk involved, to support these negotiations. Our experience shows that this type of arrangement really can be a win-win for all parties.

Types of funding agreement – How First Actuarial has helped its clients

Set out below are a few examples of LGPS funds where we have negotiated agreements for our clients, with a brief explanation of the terms of the funding agreement that has been put in place.

Home Counties (West) LGPS Fund – In advance of the last active member leaving the fund, a funding agreement was agreed and put in place which effectively defers payment of the least-risk cessation debt indefinitely (with simply normal funding requirements ongoing even after active membership ceases). This was based on the clear financial strength of the employer, evidenced by accounting information and agency ratings. The Fund was happy to agree to this without any physical security being put in place.

This could be described as the holy grail of funding agreements. It did not tie up any capital, it avoided significant debt payments in one year, and it gave the employer the flexibility to wait for the optimum time to pay its debt.

We have now used the same terms as this agreement for three different funding agreements. The first of these was set up four years ago, with the employer monitoring its funding position and recently electing to pay the debt at a fraction of the original amount.

London LGPS Fund – For a number of London-based funds we have negotiated agreements similar to the funding agreement referred to above. However, each LGPS fund is different and can adopt different policies. In general, this has meant that some form of security is required to underpin the agreement. This could be a charge for non-housing stock assets, cash escrow account or a bond. However, other types of security are permitted.
Note: A charge over social housing stock is now theoretically allowed, but in our experience the vast majority of housing associations would not want to go down this route.

Southern LGPS Fund – Again, in advance of the last active member leaving the fund, a funding agreement was put into place which meant that the employer is only required to pay the excess of the cessation debt over the ongoing funding debt when the last active member leaves. The remaining debt is then paid over an agreed period.

Home Counties (North) LGPS Fund – Often the original council is acting as a guarantor to the employer's participation in the LGPS. This means that it is already standing behind the employer both to support its participation in the LGPS and as a partner in the work being carried out in the community. With this type of working relationship, subsumption agreements can work well. In this way, no cessation debt is ever payable, and the employer retains valuable cash to invest in the community.
See our case study to find out how we successfully negotiated this transfer of assets and liabilities for our client, while allowing the remaining employees to continue to participate in the Fund. A win-win for all involved.

West Midlands LGPS Fund – This was one of the first funding agreements seen in the UK, and First Actuarial was instrumental in negotiating terms. The agreement deferred payment of the least-risk cessation debt indefinitely, with the employer continuing to fund past and future benefits on an ongoing basis. In return for deferring this payment, security is currently being phased in and will then be phased out once the cessation debt starts to reduce the cessation debt.

Government consultation on LGPS exit payments

Last year, the government began a consultation process on a number of matters relating to the LGPS. These include:

- Moving from the current 3-year valuation cycle to a 4-year valuation cycle
- Several measures aimed at mitigating the risks of moving from a three-year to a four-year valuation cycle
- Proposals for greater flexibility on exit payments from LGPS
- Proposals for further policy changes to exit credits
- Proposals for policy changes to employers required to offer LGPS membership.

First Actuarial has provided a full response to this consultation, available in this briefing.

In our view, the most interesting part of the consultation relates to greater flexibility on exit payments. Government is considering whether the common practice of automatically calculating cessation debts on a least-risk basis should be relaxed in future, provided employers can demonstrate sufficient financial strength. We support the direction of this consultation, and have suggested further improvements which we believe are also important.

We now await further updates from Government and potentially a change in legislation. We will keep you updated on the outcome and how this will affect you.

How First Actuarial can help

First Actuarial provides independent advice to more SHPS employers than any other firm.

If you would like to discuss any of the areas explored in this briefing, please contact your usual First Actuarial consultant or any of the First Actuarial Housing team below:

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