HYMANS ROBERTSON

Private & Confidential

LGF Reform and Pensions Team
Ministry of Housing, Communities and Local Government
2nd Floor, Fry Building
2 Marsham Street
London
SW1P 4DF

2 July 2019

Dear Sirs

Hymans Robertson LLP is pleased to provide its response to the policy consultation entitled "Local Government Pension Scheme: Changes to the Local Valuation Cycle and the Management of Employer Risk" published in May 2019 by the Ministry of Housing, Communities and Local Government (MHCLG). We are responding in our capacity as a firm of pension professionals, actively working in the public sector, particularly advising on the Local Government Pension Scheme (LGPS).

The Annex to this letter sets out our formal response to the proposals set out in the consultation.

About Hymans Robertson LLP

Hymans Robertson has grown up with the LGPS. The firm was founded to provide advice to the LGPS in 1921. Alongside our actuaries there is a team of 15 consultants providing investment advice and a team providing benefit and governance advice to our LGPS clients.

Our long history of working with local authorities means that we have developed a real understanding of the challenges they face in the areas covered by this consultation.

We believe that we are well placed, therefore, to respond to the questions posed by MHCLG in this consultation paper.

Yours sincerely

Catherine McFadyen
Head of Public Sector Actuarial, Benefits and Governance
For and on behalf of Hymans Robertson
DD: 0141 566 7784
catherine.mcfadyen@hymans.co.uk

Section 1 - 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 cycle?

No – we believe that 3 years remains an appropriate period. Lengthening the valuation cycle to 4 years does not suit the LGPS for a number of reasons including:

- The LGPS is a multi-employer scheme with many different types of participating employers. Employer circumstances and their financial covenant can change quickly, and lengthening the valuation cycle may expose LGPS funds to greater covenant risk.
- The majority of public service schemes are unfunded. However, the LGPS is funded and holds assets with values and performance that can fluctuate significantly over time. This volatility needs careful and regular management - a longer period puts more pressure on funding strategies, and increases the likelihood of bigger changes to employer contribution rates from valuation to valuation (particularly for shorter term employers such as closed charities).
- A 4-year cycle is longer than the standard 3 years that is applied to funded private sector schemes. The proposal introduces inconsistency in policy on valuation cycles across pension schemes in the public and private sectors without any clear rationale.
- Funds tend to have funding strategies in place already that stabilise contribution rates, commonly for longer term and secure employers. We are not convinced that a 4-yearly cycle will lead to more stability in rates as suggested in the consultation. In fact, as mentioned above, a longer cycle may lead to the funding position drifting over a longer period and therefore a sharper correction to contribution rate being required at the end of the period. This has been observed in the unfunded schemes. Some employers may value an extra year of budgeting certainty.
- Moving to a 4-year cycle, with the use of interim valuations, will also add to the burden of already stretched administration teams. When considering any changes to the current arrangements it is equally important to ensure that administering authorities have the capacity to comply with those changes, at no detriment to their current obligations to scheme members and their dependents.

It is difficult to be certain that moving to a 4 yearly cycle will save costs. This will largely depend on the balance of savings made due to a one year increase to the cycle (saving 1 valuation cost over 12 years) versus the cost of carrying out interim valuations and any other additional employer work required as a result. We are also of the opinion that any cost saving analysis should consider the more substantive possible costs arising from the funding impacts of a delayed valuation as well as costs directly associated with carrying out the valuation process, as well as any interim valuations.

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

The impact on annual pension accounting disclosures should be considered. Actuaries in the LGPS use a ‘roll forward’ approach from the latest formal valuation to estimate balance sheets and other figures in FRS102 and IAS19 reports. This approach helps to control the costs of producing disclosures for employer and avoids the need to carry out a full annual valuation based on fresh data. The downside to the ‘roll forward’ approach is its accuracy –the ‘tracking error’ (i.e. the extent to which the estimated figures deviate from the true figures that would arise if a full annual valuation was undertaken) increases over time. Auditors are increasingly querying the use of a ‘roll forward’ approach to cover a 3 year period, and are likely to be very concerned if this were

lengthened to 4 years. Moving to a full annual valuation would be time consuming, leading to delays in reporting deadlines and significantly higher costs to employers for producing the disclosures.

One other benefit of a more regular valuation cycle is to recognize that a formal valuation is not just about number crunching. It provides a governance opportunity to undertake a 'health check' on the Fund's data and risk management policies, and the metrics provided (cash flows, benefit projections, funding positions etc.) are often used for strategic investment reviews. Increasing the cycle may encourage less governance.

A further risk which should be considered is that the full funding valuation is often the prompt for a full review of data held and an opportunity for data reconciliation and cleansing. Less frequent valuations may therefore be detrimental to data quality.

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

We don't believe that this is essential.

Ideally, we think that the 'as at' date of the scheme valuation should be ahead (by perhaps a year?) of the local fund valuations. This would allow time for:

- the Government Actuary's Department (GAD) to gather the necessary data and do the calculations;
- discussion to take place on the results with the various national oversight bodies;
- agreement to be reached over any changes to the benefit structure or employee contribution rates to get the cost of the scheme within the +/- 2% of pay corridor; and
- software providers to make the necessary changes to systems and for those changes to be fully tested ahead of the effective date.

This should avoid changes to benefits or employee contributions being implemented retrospectively and allow time for administration and valuation systems to be updated to reflect the correct structure for the local valuations.

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

Yes, and notwithstanding the points made in response to Question 1, approach (b) is our preference. We would rather avoid the 5 year period under (a) for the reasons outlined above.

Section 2 - 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, this power is needed. LGPS funds have a diverse range of sponsoring employers, and they bring varying degrees of risk. Many funds already closely monitor employer funding positions between valuation dates, particularly for short term contractors or closed bodies close to exit, and use the results to align contribution rates with funding targets. Giving funds full power to carry out an interim valuation and amend the Rates and Adjustment certificate under a wider range of circumstances than the current Regulations allow would be welcome from a risk management perspective.

The consultation is not specific on whether an interim valuation refers to the whole fund only, or if it could be applied only to certain employers. A whole fund valuation would normally require full up-to-date membership data and would be more time consuming and onerous than a valuation undertaken using an approximate 'roll-forward' approach. We think it would be sensible for funds to have the discretion to do an interim valuation at either whole

fund or specific employer level (on an approximate basis or otherwise), with the decision depending on the reasons for undertaking the valuation.

Question 6: Do you agree with the safeguards proposed?

We agree that safeguards should be put in place to ensure that the power to do interim valuations is being used appropriately by funds and employers. Regulations and statutory guidance on protections is also welcome to ensure that there is some consistency across funds – this will be important for employers that participate in multiple LGPS funds. Whilst the Local Pension Board isn't a decision-making body in the LGPS, it does have an oversight role to ensure that funds are complying with legislation and regulations and to hold the Pension Committee to account. The proposal to consult with the Board should provide comfort to funds and employers that due process is being followed.

We note the proposal for the Secretary of State (SoS) to have the power to require an interim valuation on representation from scheme employers. It would be helpful for funds to understand the factors that the SoS may take into account before using this power – funds will be keen to avoid 'moral hazard' situations where employers lobby for a valuation to take advantage of favourable market conditions.

Consideration also needs to be given to the administrative burden of providing data for interim valuations, particularly where requested by scheme employers. If the scope for requesting and agreeing to interim valuations is not clearly defined such requests could be an unwelcome distraction and divert attention from the delivery of administration services to scheme members and their dependants.

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

We welcome the ability for funds to deal more flexibly with employer contributions between valuations, as the current Regulations only allow for limited circumstances. We believe that this principle should apply to all employers and include contribution rates that apply in the period after cessation (where such arrangements have been agreed).

The consultation makes a clear distinction between low risk employers (generally statutory or tax-raising) and other employers that are subject to covenant risk. Whilst we accept that the need to review contribution rates between valuations for the former group is likely to be smaller than for the latter, there may be occasions where a review is desirable e.g. where a Machinery of Government change has a material impact on a low risk employer's membership, or where a low risk employer outsources large numbers of staff to another body.

Due to 'moral hazard' – see our response to question 6 above - we have reservations about the proposal for an employer to request a reassessment of its rate because it believes that it would result in a reduction. However there can be occasions where this would be a valid request e.g. where an employer injects an immediate capital sum into the Fund to reduce future ongoing contribution commitments.

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 think (statutory) guidance would be helpful to ensure some consistency across funds around the process and reporting. It would also be helpful if such guidance were to cover the tests that would need to be met in order for a scheme employer to request an interim valuation itself from the SoS. Any guidance however needs to recognise local circumstances and funding plans, and not fetter the ability for funds to carry out interim valuations in line with their own FSS's.

We suggest that a principles-based approach to guidance would be preferable to a prescriptive approach, and give funds the discretion to demonstrate compliance using methods that work for their own circumstances and employers.

We note that little guidance (other than the CIPFA guidance mentioned in the consultation) is in place about the principles that should apply to full valuations. It seems odd that SAB guidance should be created for interim valuations and yet be missing for full valuations, and we suggest that any guidance should cover both types of valuation, and point out how the process and reporting may differ.

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?

We are struggling to understand the comments in the consultation about professional advice i.e. *what level of professional advice is appropriate to deliver the interim valuation, and what comprises a proportionate level of actuarial and professional advice*. The Regulations make it clear that the Fund Actuary is responsible for undertaking full valuations. Actuaries are bound by professional standards and a code of conduct, and have experience of providing advice that is proportionate to the work being undertaken. The fact that a valuation is interim rather than full does not take away the need for professional advice; the actuary would apply professional judgement over the amount of advice needed under either approach.

As mentioned in our response to Q8, we are keen to see a principles-based approach to guidance. The consultation sets out some potential areas that the guidance might cover – it would be useful if this could also include:

- the minimum levels of reporting expected
- timescales around the process
- an indication of the circumstances that may or may not 'trigger' the need for an interim valuation, particularly if requested by a scheme employer

Section 3 - 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?

It should be noted that the Regulations as they currently stand do not subscribe any one basis for valuing exit debts and in practice, these can differentiate materially between different types of employer and between funds. Funding strategies are set locally and any suggestion that there is (or could be) a standard exit basis would not be welcome. We are not aware of any cessations being carried out on a full 'buy-out' basis as can happen in the private sector. However, we do believe that additional flexibilities would be helpful in constructively managing the exit of any employer, independent of the basis of the exit valuation.

Regulation 64(4) already offers the flexibility for Administering Authorities to agree the repayment of deficits beyond the effective exit date if the agreement takes place while the employer still employs active members of the scheme. The timing of an exit event and the magnitude of any exit debt may not be known until well after the exit event. Therefore, we would welcome any clarification in the Regulations to extend this flexibility to exited employers. This would require an examination of how Regulation 64(4) interacts with 64(2).

Any change to allow repayment of exit debts to the Fund increases the level of risk faced by remaining employers. To manage the additional risks involved in extending this ability, we would suggest:

- This is at the discretion of the Administering Authority (and the guarantor where appropriate), allowing them to make a judgement on the covenant of the underlying employer;
- There is a maximum period for repayment, we suggest this is left as a local decision and included in the funding strategy statement or cessation policy (where applicable);
- Interest be charged at an appropriate rate; and
- The Administering Authority should have the ability to request additional security be put in place during the repayment period.

We would also encourage consideration be given to the interaction of these changes with suspension notices under Regulation 64(2A) and the extension of asymmetries where exit credits are identified (these must be paid within 3 months of an exit event whereas we may be giving years to repay exit debts).

Questions 11 and 12: Do you agree with the introduction of deferred employer status into LGPS? 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 agree with the introduction of a deferred employer status and the approach to deferred employer debt arrangements. However, we would suggest that a significant deterioration in covenant is enough to trigger termination (there should not be an attaching other 'relevant event').

As set out in our answer to Question 10, there is the potential to simplify the Regulations by eliminating the need for suspension notices. Funds could instead apply deferred employer status to an employer where active members may join the scheme in future, with a relevant event for suspension of deferred status being the employer having new active members (as currently suggested). Consideration could also be given to extending this option where an exit credit is identified (there may be circumstances, such as accounting advantages and where new active members may join the scheme, where an employer in credit may which to extend their exposure to the scheme).

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?

We agree only the key obligations and entitlements of parties should be set out in the Regulations. Careful consideration should be given to any supporting guidance and whether this is statutory in nature. In particular, funds are not required to follow guidance issued by the Scheme Advisory Board. Therefore, where there is desire for commonality of approach across Funds, this should be detailed in statutory guidance from the Secretary of State. Any commonality must be balanced with local funding strategies and therefore any guidance should have significant input from LGPS practitioners throughout the drafting and consultation stages.

Question 14: Do you agree options 2 and 3 should be available to current rules on exit payments?

We agree options 2 and 3 should be available as alternatives to the current rules on exit payments. However, as set out in our response to Questions 10, 11 and 12, careful consideration should be given to the need for suspension notices under Regulation 64(2A) and the extension of asymmetries where exit credits are identified.

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?

The additional options for managing exits could increase the overall administration costs of the scheme for both employers and administering authorities (whether in relation to actuarial fees or the time required from officers to consider and monitor proposals). Therefore, we believe there needs to be some level of statutory guidance in terms of the interpretation and application of the new Regulations. A balance will need to be struck between compulsion to ensure a consistent interpretation of the Regulations and the ability of funds to manage their own funding and employer risks. We would strongly encourage any guidance to go out for full public consultation.

Section 4 - 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?

It should be noted that the Regulations as they currently stand do not subscribe any one basis for valuing exit credits and in practice, these can differentiate materially between different types of employer and between funds. Funding strategies are set locally and any suggestion that there is (or could be) a standard exit basis would not be welcome. We are not aware of any exit valuations being carried out on a 'full buy-out' basis as can happen in the private sector. However, we agree the Regulations should be amended to take account of a scheme employer's exposure to risk when calculating an exit credit.

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

Our concerns around exit credits go beyond contractors with risk sharing agreements. The use of pass through and risk sharing agreements has grown in prominence, however, there are still a significant number of former transferee admission bodies where risk sharing does not apply. The funding strategy of these employers, from the allocation of assets to cover past service liabilities at their date of joining to their ongoing contributions and bond requirements, were predicated by the Regulations and Funding Strategy Statements that were in force at the time they joined (and any subsequent formal valuations). The introduction of exit credits effectively changed the risk these employers posed to ceding authorities which would have may have resulted in significantly different treatment throughout their time in the LGPS. As a result, we strongly believe that exit credits should not be applied retrospectively to any contracts that were in force prior to 14 May 2018, whether on a risk-sharing basis or otherwise. In other words, the exit credit regime should only apply to new contracts that were set up from 14 May 2018 onwards.

There are a wide range of risk sharing agreements in existence in the LGPS, many of which may be made without the knowledge of administering authorities. The requirement for the administering authority to be satisfied the provider has not borne <u>any</u> risk is an extremely high hurdle given the nature of these arrangements (i.e. would an arrangement where the guarantor takes on all the pension risks with the exception of say excessive pay increases fail this test, even if pay awards were sensible?). Putting the onus on the administering authority to carry out this additional function may significantly increase costs (either through external consultancy or internal time of officers) as agreements are likely to be legal agreements that may need professional interpretation. The risk of challenge of any decisions would be material.

The 3 month timeframe on which to pay an exit credit remains overly onerous and will be exacerbated by this change. We would expect administering authorities to make a determination on whether the service provider has not borne any risk prior to instructing an exit valuation. It is questionable, especially where interpreting potentially complex legal agreements, that this could be done within 3 months. In addition, if further flexibilities are added to manage exit debts, you could face a situation where you have to return a surplus within 3 months of an exit date, but deficits may not be recovered for a number of years. Therefore, we believe the 3 month limit on exit credits is asymmetric in favour of employers and consideration should be given as to whether it remains appropriate.

Section 5- Employers required to offer LGPS membership

Question 18: Do you agree with our proposed approach?

It is a policy decision to allow higher and further education bodies to close to new entrants. We are aware that some bodies are struggling to meet the cost of participating in the LGPS, and recent changes in the sector (as outlined in the consultation) do raise questions about their ongoing treatment as 'scheduled bodies' under the Regulations.

It is not uncommon for the LGPS liabilities of these bodies to be worth tens of millions of pounds. We expect funds to keep in close touch with these employers and regularly monitor their financial strength, and wherever possible seek security to reduce the risk of unpaid liabilities falling on other employers in the event of insolvency. Those bodies that close to new entrants may well see their pension costs increase in the short term as exit funding strategies are agreed between funds and employers. The extent to which total employer pension costs in the medium to longer term rise or fall will depend on the type of pension arrangement that employers put in place for new entrants to replace the LGPS.

Employers that use this proposal would create a two-tier work force in terms of pensions provision. There will be a need to monitor and ensure that promises are kept to those members currently in the LGPS i.e. that they are not induced out of the LGPS. The accompanying legislation should make it clear where that responsibility lies and the possible penalties for non-compliance.

Section 6 – Public sector equality duty

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?

We would agree that in relation to sections 1 to 4 of the consultation document there should be no equality issues to consider, given that member benefits and contributions would not be impacted by any eventual outcome from this consultation exercise. We assume that the current safeguards in relation to ongoing entitlement to member benefits would not be impacted on any relaxation of recovery of exit payments (i.e. it would fall to the Fund to make payment of benefits where it has not been possible to recover some or all of an exit payment and the remaining liability is spread across remaining employers with active members).

In relation to section 5 the consultation document refers to the fact that "It will be up to each institution to consider the potential equalities impacts when making their decision on which, if any, new employees should be given access to the scheme.". Our concern would be whether such institutions may seek to offer inducements to existing active scheme members to opt to leave the scheme in order to accelerate their departure from the scheme as a whole. Appreciating that such action would be unlawful and counter to the requirements of automatic enrolment provisions there is a risk that such actions could be taken, disadvantaging existing active members