Business Services Association
130 Fleet Street,
London.
EC4A 2BH

BSA – The Business Services Association

MCHLG – Local government pension scheme: changes to the local valuation cycle and management of employer risk

Background

The Business Services Association – the BSA - brings together those who are interested in delivering efficient, flexible and cost-effective service and infrastructure projects across the private and public sectors. A list of our members is attached as an Annex. They include large and small businesses, charities and social enterprises.

The sector includes ICT, facilities management, construction and infrastructure provision and other project delivery. 70 per cent of services are provided business-to-business and 30 per cent for the public sector. The sector employs 3.3 million people across the UK, accounting for around 1 in 10 jobs. As such it is an important driver of inclusive economic growth across every region and community.

The BSA represents many employers who participate in the Local Government Pension Scheme (the "LGPS"). Almost all BSA members who participate do so as tier 4 members, or admission bodies. Our response is based on the concerns of those employers.

Question 1 – As the Government has brought the LGPS scheme valuation on to 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?

The complexities of having and operating a split valuation cycle (effectively meaning that the valuation cycles would only align every 12 years) will introduce uncertainty and potentially anomalous results – for example, if the Scheme valuation took place on a day when markets were falling and interest rates were low but the local valuation took place when interest rates had increased and markets recovered and were increasing.

Consequently, as the decision appears to have been made that the Scheme valuation is to move to a quadrennial basis, there is no commercial sense to not moving the Fund valuation to the same basis.

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?

As alluded to later in the consultation, the issues around an administering authority taking a conservative approach to funding as the risk falls over a longer period of time and the monitoring and cost consequences all could lead to additional costs and expense for Scheme employers (particularly tier 4 scheme employers).

Additional concerns include:

• Additional investment risk – unless careful monitoring of employer covenant and a proper alignment of investment risk on an ongoing basis is established, the investment risk relative to economic and demographic changes could create mismatches between assets and the liabilities they are supposed to fund.

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• Valuation risk – the longer the valuation cycle, the less prudent a mark-to-market approach to valuing the Scheme (and the Fund) appears. Taking a "snapshot" of the market value of investments on one day in a four-year cycle prospectively increases volatility and makes risk a higher factor than over, say a three or a two-year period. This is manageable in unfunded schemes where the mark-to-market assessment is against some form of indices of index-linked gilts – this is far more complex when assessed against the market value of a range of growth and matching asset portfolios. Unfortunately, it is the Scheme employers who will bear this additional risk. Such risks could easily be assessed by use of 'actuarially pooled' admission agreements (as are currently used) whereby the transient membership of an Admission Body does not interfere with the long-term funding approach used in the underlying scheme employer pool, and which integrates well with a 4-year valuation cycle.

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

Yes.

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

Of the two methods proposed, this would appear to carry the lower risk.

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

Whilst the ability of a Fund to carry out a valuation between the quadrennial cycles is, on the face of it attractive (particularly for administering authorities) there need to be suitable checks and balances in place to stop this being abused or administering authorities taken "Knee-jerk" reactions to, say, a bear market and seeking a wholesale review and increased funding rates.

Whilst the proposal to only permit a revised valuation on the direction of the Secretary of State, we will need to understand more fully the "…certain protections" referred to in the consultation.

Further, prior to the changes put in to force in 2012, the LGPS regulations permitted an employer to invoke a valuation which was a valuable tool for employers in managing their liabilities under the LGPS, the removal of this has tilted the position in favour of administering authorities often to the detriment of the Scheme employer. We recommend that this option should be reinstated as part of the new regime.

Question 6 – Do you agree with the safeguards proposed?

Please see response 5 above.

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

There need to be safeguards for employers to prevent knee-jerk actions by authorities imposing on those employer's unreasonable contribution requirements.

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Generally, sensibly constructed flexibilities will be welcomed but we would want to see more detail before we are able to comment fully.

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?

Whilst there are areas where SAB guidance would be appropriate, our concern is that such guidance would be simply that – guidance with no imperative on administering authorities to follow such guidance.

In our view, there are areas of operation which, if they are not specified in the legislation should be subject to statutory guidance issued by the Secretary of State as opposed to the SAB as this will carry more authority and administering authorities should be required to follow such guidance.

There also needs to be some consistent approach across administering authorities to the use of bonds, indemnities and guarantees. When the admission of commercial employers started in 1999, the bond or indemnity was purely to protect the transferring authority against the prospect of a strain payment becoming due for staff over the age of 50 (now 55) who became redundant on the insolvency of the admission body. This has changed over the years and we have seen, at the extreme, administering authorities seeking to cover the full value of the buy-out cost for all transferring employees through the bond, indemnity or guarantee. Guidance should be issued on the proper use of bonds or indemnities.

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

We do think that other guidance would be welcomed, and in particular in relation to the following questions about valuing exit contributions and how exiting employers should be treated on the ending of an admission agreement.

Clearly, the correct persons to offer that guidance, some of which should, again be statutory guidance, would be the Secretary of State and the Government Actuary's Department.

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?

The current basis for calculating and levying exit contributions is not fit for purpose in many cases.

In the private sector, exit debts are calculated in accordance with a specified methodology in accordance with section 75 of the Pensions Act 1995 and the Occupational Pension Scheme (Employer Debt) Regulations 2005. The same constraints are not imposed on the LGPS actuaries who have a very "free-hand" to determine what they assess "full buy-out basis" means. This is clear schism between the two funding regimes and there should be put in place some form of guidance (as a minimum) or statutory guidelines (similar to the section 75 regime) to ensure consistent actuarial practice across the administering authorities.

Further, for tier four employers, when an admission agreement comes to an end, many of the staff are transferred to a new supplier and will continue in the Scheme on an ongoing basis. To seek to

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levy a buy-out contribution amount on an outgoing employer – whether through deferred employer provisions or otherwise – for these continuing active members is both unfair and uneconomic. Whilst there is no doubt such employers should fund deferred and pensioner liabilities on a buy-out basis (as ongoing contributions will not be paid for these categories of member) contributions for active members who transfer will continue to be paid on the prescribed ongoing basis by the incoming supplier so double counting their liabilities is perverse and unreasonable.

There is inherent protection against surplus and deficit positions in the unfunded NHSPS and PCSPS arrangements for admitted bodies following New Fair Deal in 2013, so this consultation seems the ideal opportunity to bring consistency to the entire public sector pension outsourcing position through the use of 'actuarially pooled' admission agreements, or their equivalent. If employer covenant remains linked to the underlying scheme employer, as do funding and contribution plans, then this brings consistency with the overall responsibility that employer has to its outsourced employees and those services. Linking covenant assessment and funding plans to the short-term nature of private sector contracts disrupts the LGPS funding plan, complicates matters and at worst serves to create a risk premium in transactions, which will only ever be lost to the scheme employer through contractor-charges, and which in many cases (due to prudent risk-pricing approaches), will never actually go into the LGPS, thereby being lost to authority control and generating excess profits for contractors.

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

Broadly we do agree with the introduction of deferred employer status into the LGPS.

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?

As set out earlier in our response, we are concerned at the lack of consistent structure for the funding of the LGPS; there is no statutory funding objective nor any equivalent to the section 75 regime in the private sector.

Consequently, we are concerned at your comment "…we have considered and rejected the option of setting [such] a minimum level of funding." Once again this leaves the assessment of liabilities in the hands of the actuaries to the funds who each use differing approaches to assessing the level of debt. If funding assessment remains focused on authorities this could harmonise valuation approaches across the entire LGPS, leading to more efficient processes, increased consistency and lower management fees.

We continue to believe that, just as there should be some statutory mechanism for calculating an exit contribution equivalent to the section 75 regime for private sector organisations, there should also be some statutory safeguards to protect employers from arbitrary deferred debt calculations.

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 with putting the key elements of deferred employer debt provisions into the Regulations and we would welcome that being backed up by the flexibility of statutory guidance.

The difficulty with allowing a substantive element of the regime at the funds' discretion is the inconsistency with which different funds apply their discretions. We already see a wide diversity of

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how funds interpret the regulations and how their actuaries value liabilities on certain events. This inconsistency needs to be minimised if employers are to have any confidence in the deferred employer debt arrangements.

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

In practice, some of the more progressive LGPS funds take the view that, as option 2 is not currently prohibited by the LGPS Regulations, then they have been able to offer option 2 and have done so for some time.

However, we agree that more flexibility around exiting fund is preferable.

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?

In the body of section 3.2 you pose the challenge "We expect that statutory or Scheme Advisory Board guidance will be necessary in addition to a change to regulations and welcome views on which type of guidance would be appropriate for which aspects of the proposals."

In response to this challenge we confirm that we also see a need for guidance to maintain flexibilities and think the following should be subject to the following guidance:

Regulations Statutory Guidance SAB Guidance

Deferred debt arrangement framework to be set out in the regulations Statutory guidance should be issued around the valuation bases for deferred employer debt and for the calculation of exit contributions. SAB guidance should be around the proper interpretation of the regulations and when and how each of the alternative exit strategies set out in 1, 2 and 3 would be appropriate with fund discretion on when to use each strategy.

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

This proposal puts too much emphasis on the subjective judgement of a party not associated with any service provision but with a financial interest in the outcome of the decision.

In our view, there should be an independent body, perhaps a sub-group of the SAB – established to determine whether a scheme employer has been exposed to a level of risk where there is insufficient evidence to allow the parties to determine the question between them.

This approach would avoid any possibility of the decision being made by an interested, albeit third, party and would drive the avoidance of bad behaviours from either of the two contracting parties involved.

There also needs to be greatly increased clarity about what is meant by risk. The phrase 'pass through' is often used, but inaccurately, as it means that LGPS costs are not priced, but simply passed through to the client. Many contracts which are considered to operate 'pass through' are not actually such, and use a best-estimate pricing approach for LGPS costs, with the ability only to pass through certain variations in costs such as contribution rates and deficits, whilst exposure to many other risks is retained. These cover demographic risk (lower than expected churn/retirement) redundancy capital costs, ill-health retirements, bond costs and client default (where authorities challenge the legal interpretation of even the most legitimate of protections).

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

In the consultation you refer to "pass-through". The BSA, along with the CBI and a number of the unions in 2008/2009 met with the MHCLG to determine whether it would be appropriate to introduce statutory pass-through into contracts for services with Best Value Authorities. The proposals ranged from including some form of pass-thorough into the regulations to the introduction of statutory guidance setting out the terms for pass-through. There is already considerable evidence present within the various LGPS arrangements of actuarially pooled admission agreements delivering the lowest contribution rate with the highest covenant strength, simplest of delivery models and removal of virtually all risk-premiums. This concept is not new but has been in place for well over a decade.

The lack of engagement by the Local Government Employer's organisation meant that only a non-statutory "advisory" paper was issued by NHCLG in 2009.

The consequence of this failure to agree is that "pass-through" now has many different forms and meanings so to take an approach which deals only with "pass-through" will disadvantage many scheme employers if their "pass-through" is not in the form as you currently envisage.

Similarly, some funds use "sub-sumption" as their model, would this fall into the definition of "pass-through" for the statutory amendments?

How would "cap-and-collar" arrangements be dealt with under the new regime? Would there be some form of sliding scale by which the amount of risk and so the entitlement to a level of exit credit be determined?

Even here it should be noted that many contractors will automatically price the cap differential as a risk premium to ensure coverage where necessary, leading to the acceptance of risk by the contractor generating further potential for profit, rather than a true limited risk-share.

This proposal needs further work to determine how best to protect contracting authorities who have assumed risk (albeit for their own prospective financial benefit) and contractors who have priced competitively for the benefit of local taxpayers.

Question 18 – Do you agree with our proposed approach?

Not applicable to BSA members.

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

Not applicable to BSA members.

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List of BSA Members, July 2019

3SC
Accenture Plc
AECOM
Amey Plc
ARAMARK Ltd
Atkins
Atos
Baachu
Balfour Beatty Plc
BAM Construct UK
Barclays Corporate
Bellrock Ltd
Bevan Brittan LLP
Bouygues Energies and Services
BT Group Plc
Capita Plc
Catch 22
CBRE Ltd
Change, grow, live
Clyde & Co LLP
CMS Cameron McKenna Nabarro Olswang LLP
Community Models
Compass Group Plc
Connect Assist
Corndel Ltd
CSG
Cyber Prism
David Macbrayne Ltd
Deloitte
DWF LLP
Elior UK Ltd
ENGIE UK & Ireland
EY LLP
Fujitsu UK
G3 Systems Ltd
G4S Plc
HP
IBM
Incentive FM
Ingeus
Interim Partners
Invicti
Interserve Plc
ISS UK Ltd
KBR
Kier Group Plc
KPMG LLP
Maximus UK Ltd
Mears Group
Mitie
MTC
NatWest
NCG
New Street Executive Search
OCS Group UK Ltd
P3
Pinsent Masons LLP
PricewaterhouseCoopers UK
Robertson FM
Salisbury Group
Seetec Group Ltd
Serco Group Plc
Sharpe Pritchard LLP
Shaw Trust
Sodexo Ltd
Sopra Steria Ltd
Space Solutions
Spend Network
Strictly Education
TerraQuest Solutions Ltd
The Challenge
The Gap Partnership
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Wand Consulting
Wates Group
Willmott Dixon