Scottish LGPS SAB
10 December 2020

Cessation Issues

The SAB working group on cessation issues presented a report to the SAB meeting in September 2020. The Board considered this, and some points raised by trade union members and remitted the report back to explore how the concerns could be taken on board.

Following discussions, it appears that to change the report would be complicated, but that the concerns could be accommodated if the SAB were to receive the report, with an accompanying acknowledgement of the concerns raised.

Therefore, the joint-secretaries recommend that the SAB accept the report of the subgroup, but also endorse the statement below, and include it in communications by the SAB on this issue:

> "The LGPS exists as a benefit for scheme members, and therefore funds and administrating authorities should not encourage employers to leave the scheme. Legislation exists giving workers certain rights regarding their pensions, and any proposal by an employer to withdraw from the scheme should only be accepted if it is compliant. This includes the statutory guidance issued under section 52 of the Local Government in Scotland Act 2003, available at www.gov.scot/publications/statutory-guidance-local-authorities-contracting/)"

The board is asked to agree that guidance based on this report should be circulated to Funds, and reported to the Minister.

LGPS Scotland Working Group

Report to Scheme Advisory Board

Proposals for Managing Employer Exits from the Scheme

September 2020

Background

An informal working group was established to consider if there was scope to add some additional flexibility in managing exits from LGPS, to identify any Regulatory changes which might be needed and to identify if any best practice across Funds in Scotland could be consistently implemented across all funds. Further details of the working group and the work undertaken by it are contained in Appendix 1.

Proposals

A number of initial proposals were presented to the group by its third sector employer representative members. Details of these, together with summary responses from the administering authority representatives, are set out in Appendix 2. After review and discussion, the following proposals are now recommended to the Scheme Advisory Board.

Proposal 1 – Provide the option to allow bodies to cease all future accrual and operate on a 'closed' on-going funding basis.

The Scheme Advisory Board should**:**

- Seek clarification from SPPA as to the timing and content of any proposed changes to the scheme regulations as a result of its consultation, which was concluded in March 2020, on the impact of changes introduced in 2018 which might facilitate the use of this option.
- Ask administering authorities to give further consideration to the use of this option and ask them to clarify its availability in the review of their Funding Strategy Statements which will take place alongside their 2020 actuarial valuations.
- Consider seeking actuarial advice and/or producing guidance on the use of this option.

Proposal 2 – Fix Cessation Valuation for 90 days

The Scheme Advisory Board should:

- Ask SPPA to clarify whether the existing regulations provide this flexibility, and if not, to amend the regulations.

Proposal 3 – Cessation valuations should be provided by default on all valuation statements

The Scheme Advisory Board should:

- Ask administering authorities to include cessation valuations by default as part of their reporting to employers on the results of the 2020 actuarial valuation and subsequent triennial valuations.

- Ask administering authorities to provide cessation valuations to employers at least annually on request and to explore with their actuaries the desirability of providing these by default alongside accounting valuations.

Proposal 4 – OSCR to review guidance for Trustees in relation to conflicts of interest around participation in LGPS and offer updated guidance / training where necessary

The Scheme Advisory Board should:

- Note this proposal.

Proposal 5 – ICAS to consider updated guidance for auditors around LGPS participation and disclosures

The Scheme Advisory Board should:

- Note this proposal.

Proposal 6 - Legacy liabilities should be dealt with on a consistent basis on entry and exit

The Scheme Advisory Board should:

- Note this proposal and the administering authority response that this is a legacy issue which will largely be addressed by Proposal 1 above.

Proposal 7 - Out-sourced employers should be able to participate in a single LGPS

The Scheme Advisory Board should:

- Note this proposal and that Schedule 4 of the regulations already provides a solution.

Proposal 8 – There should be greater clarity for admitted bodies where guarantees exist on the extent and limitations of these guarantees

The Scheme Advisory Board should:

- Ask administering authorities to engage with admitted bodies on request as to the extent and limitations of any guarantees.

Other areas worthy of consideration

The Scheme Advisory Board should:

- Ask administering authorities to consider alternative and emerging approaches to employer exits to the extent that these are permissible under the regulations and might improve the effective and efficient administration of the scheme.

Appendix 1

Working Group

The working group consisted of:-

- Iain Coltman and Kim Linge of Scottish Public Pension Agency
- Doug Heron – Chief Executive of Lothian Pension Fund
- Richard McIndoe – Director of Strathclyde Pension Fund
- Kenneth Ferguson – on behalf of The Robertson Trust and Scottish Grantmakers
- Christine Scott – Institute of Chartered Accountants of Scotland
- David Davison – Owner / Director – Spence Consulting Actuaries

The working group also benefitted from input from OSCR, the Office of the Scottish Charity Regulator.

Financial modelling was carried out by Spence on behalf of the Robertson Trust and the MacRobert Trust based upon publicly available financial information to seek to identify the quantum of risk from charitable admitted bodies in Funds and how that risk exposure may change on conversion from an 'on-going' funding method to an accounting and also 'gilts-based' cessation method and this information was shared with the Group.

The research clearly identified a significant risk both to further accrual of liabilities and on Fund exit. It also identified the likelihood of cessation issues increasing for Funds over the short to medium term as admitted bodies who are closed to new entrants move to having no active participants and therefore triggering a cessation. It was therefore recognised that there was a need to effectively manage this transition.

The research figures were compiled pre the COVID19 pandemic which, especially given that the Scottish LGPS Valuation cycle is at 31 March 2020, is likely to significantly exacerbate the position.

Spence, ICAS and Kenneth Ferguson were therefore asked to provide some proposals for change which could be considered by the Scottish Funds and the Scottish Scheme Advisory Board.

Appendix 2

Detailed Proposals and Administering Authority Response

Proposal 1 – Provide the option to allow bodies to cease all future accrual and operate on a ‘closed’ on-going funding basis

The Regulatory changes implemented in 2018 provided a framework for Funds to offer employers more affordable exits from Funds which would not only be in their interests but to the wider benefit of the Funds and other employers. It gave the Funds flexibility to design these exit terms rather than them being prescriptive. However, to date there has been very limited usage of these revised Regulations.

The Regulatory revisions were primarily looking to deal with the issue that many employers find themselves in a Hobson’s choice scenario where they cannot (or believe they should not) continue to accrue benefits but cannot afford a gilts-based cessation to exit. This leaves them trapped in Funds, continuing to accrue benefits they cannot afford which is neither in their interests or that of other employers in the Fund. The priority here is to find an affordable mechanism to allow charities to close of future accrual to limit risk and to allow resources to be focussed on paying down the accrued liability rather than building additional liabilities.

Remind

We believe that implementation of a ‘closed’ on-going membership category via the use of the ‘suspension’ Regulations is a pragmatic solution which would allow this to happen and set employers on a path to an affordable exit. This is an approach which completely mirrors the approach adopted in non LGPS UK defined benefit schemes.

We recognise that there needs to be a balance between security, investment, funding and affordability and would be interested to see proposals how these could operate in practice. We are of the view that some additional margin for prudence could be adopted as part of the actuarial methodology.

Information was shared with the group showing how some Funds in England are already adopting this approach, despite their Regulations not providing similar levels of flexibility as those applicable in Scotland. The options were provided based upon advice from one of the leading actuarial firms who provide advice to a number of Funds in Scotland.

We understand that there may need to be some further updates to the 2018 LGPS Scotland Regulation required however understand that such revisions have been confirmed to SPPA as part of the 2020 Consultation exercise.

Administering authority response:

- No guidance was provided as to how the additional flexibility permitted by the 2018 changes might be used. The changes might facilitate use of the option described but it is not clear whether that was the intention or how ongoing contribution rates would be calculated for a ceased employer.

- There are extant flaws in the 2018 regulations which currently inhibit their use in this way, albeit it is understood that SPPA is addressing these.

Detailed Proposals and Administering Authority Response

- The approach described above has been offered to some exiting employers but declined on the basis that it would mean that the employer would continue to run funding risk for an indeterminate and potentially very long period, and might ultimately pay more. Many employers may prefer the certainty offered by other approaches which fix the liability at the exit date. These approaches have been used successfully to date to manage many employer exits.

- This approach also exposes the Fund to continuing employer covenant risk unless security can be obtained. It may be appropriate in some scenarios but will not be in others and should not be viewed as a panacea.

- Once the regulations are amended, there should be greater scope for administering authorities to offer this approach. Authorities will have the opportunity to consider it further when they update their Funding Strategy Statements alongside their 2020 actuarial valuations.

- The LGPS in England and Wales is now introducing changes to include provision for the option of a Deferred Debt Arrangement for exiting employers. The proposals include much clearer definition of how the arrangement might be applied than has previously been the case in Scotland.

Proposal 2 – Fix Cessation Valuation for 90 days

The current cessation valuation process results in uncertainty for exiting employers and Funds. The employer may have requested indicative figures a number of months prior to this so figures could vary materially over that period with an exit appearing affordable but then market movements making it unaffordable.

In addition, an exiting employer and Fund agree an exit date and the cessation valuation will be calculated based upon market conditions at that date. It may take a couple of months for the final figures to be available. This creates a greater risk as the employer will have elected to exit but they are effectively taking a decision on an exit value ‘blind’ with no awareness of what the market conditions, and therefore the exit debt, will be at that date and therefore if it remains affordable.

The process can also result in multiple reports being required with associated advisory costs for the Fund.

A good template process which could be adopted is that used for member transfer values. These issues are resolved on individual transfers by ensuring any transfer value offered is guaranteed for a period of 3 months. This provides certainty on both sides. The initial timing of the cessation debt calculation is important as ideally it should leave enough time to complete any required consultation to allow the employer to exit within the specified period.

The way that ‘re-quotes’ are managed within the individual transfer process is that one quote is available within a 12 month period free of charge and any re-quotes would then be charged for. This could be at a ‘premium’ rate to avoid multiple quotations. This could discourage frequent re-quotes. Funds could

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potentially limit the number of re-quotes within a prescribed period e.g. 150 days. Funds should have some discretion around this to account for circumstances where a re-quote was necessary, for example due to a consultation delay. Ultimately if exit terms are based on gilt yields at the day of exit any re-quote will still be based on market conditions at that date.

Funds and SPPA need to consider if any changes to LGPS Regulations are required or if this discretion already sits within the existing powers?

Administering authority response:

- The regulations require the actuarial valuation of the liabilities to be carried out as at the exit date. Exit date is not defined but would appear to be the date of last member participation in the scheme. SPPA could be asked to define exit date and/or add "or such other date as may be agreed".

- This should be less of an issue where the "closed ongoing" funding approach set out at proposal 1 is adopted as the cessation debt will be suspended and may never require to be paid.

Proposal 3 – Cessation valuations should be provided by default on all valuation statements

Organisations need to be more aware of and better understand their cessation risk so providing them with these figures more regularly, and indeed prominently, would be of huge benefit. We have seen Funds provide indicative cessation with annual accounting figures and believe this would be a valuable addition however we would be open to proposals from Funds how this figure can be provided more frequently.

Administering authority response:

- Provision of cessation figures alongside triennial valuation results is already best practice and widely adopted by funds.

- Many funds also provide regular updates on request.

- For many employers, annual updates are not required or relevant and should not be provided by default.

Proposal 4 – OSCR to review guidance for Trustees in relation to conflicts of interest around participation in LGPS and offer updated guidance / training where necessary

As part of the discussions there was concern expressed that conflicts of interest among charity boards and the executive team may be a barrier to good governance and prevent charities reaching a natural conclusion that the costs for the scheme are unaffordable and the risks are too great.

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The Group's view was that there was a role for OSCR in ensuring that Charity Executives and Trustees are fully aware of these conflicts and have had guidance (and if necessary training) in how best to manage them.

OSCR to consider and make suitable proposals.

Administering authority response:

- The employer side has sometimes given the impression that admitted bodies have been compelled to join the scheme as a result of local authority outsourcing. In reality, historic reasons for joining vary greatly but employers often joined in order to recruit senior management or to allow existing senior management to participate. This may give rise to conflicts of interest.

Proposal 5 – ICAS to consider guidance for charities and their advisers around participation in multi-employer schemes and related accounting matters

ICAS should consider preparing guidance for charities and their advisers around participation in multi-employer schemes and related accounting matters, including whether this guidance should focus specifically on LGPS participation. The guidance could cover the likely immediacy of a gilts-based cessation trigger, such as on a reduction of active members below 5 (and particularly when less than 2) and the associated impact on the going concern basis of accounting and the impact of underlying guarantees.

Administering authority response:

- This a matter for ICAS but does appear to have some merit.

Proposal 6 - Legacy liabilities should be dealt with on a consistent basis on entry and exit

The current practice within LGPS of re-allocating all past service liabilities to the latest employer is wholly inequitable and inconsistent with the approach adopted in all other UK defined benefit schemes. We are of the view that each employer should be wholly responsible for the liabilities they build for their staff whilst they are in their employment. Currently any legacy liabilities are transferred to the most recent employer on an 'on-going' valuation basis however charities are forced to settle these liabilities on a gilt-based cessation basis should they exit a scheme. This has the effect of passing significant additional liabilities to charities which make exits even more unaffordable.

A recent example of this was a small charity who decided to employ their council contact for a couple of years pre-retirement and in doing so inherited 37 years past service and effectively an additional £260,000 of cessation liabilities. These liabilities are transferred by default without the receiving employer being aware of them or their impact.

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The vast majority of these liabilities go from Councils (or other public entities) to 3rd sector organisations. Had they remained with the Council a gilts-based cessation liability would never be due. In addition Funds allowing these transfers are weakening the covenant of their schemes as a whole as benefits backed by public entities have a stronger covenant than that provided by a 3rd sector organisation.

The public entity should be made to re-allocate these liabilities on an on-going basis on cessation. This will have nil to a negligible impact on the public body as these liabilities would be valued on an on-going basis in any case.

We are aware that one Fund have pioneered a solution in this area which has been incorporated in their Funding Strategy Statement ('FSS'). This recognises that where an organisation has evolved out of a public entity, and that entity accepts the prior liabilities, any cessation debt would be calculated on an on-going rather than gilts cessation basis. This recognises that the transition of historic liabilities has not been recognised on a gilts basis so it is inequitable for the last employer to have to pick these up on this basis. We would contend that this is an overly generous solution as it doesn't reflect the liabilities accrued for staff other than those transferred or for those built up by the admitted body subsequently. We would want to see something more equitable but having a wider application.

Historic liabilities can be transferred to the later employer in a number of ways not covered by the referred to Fund FSS. For example, a new entity can be established and then staff gradually transferred from a public body (or numerous bodies), staff can transfer liabilities in or employers may have undertaken outsourced public contracts many years ago prior to the current TAB / pass through provisions being in place. The impact is exactly the same regardless of the originating location or timing of the transfer. In these circumstances the latest employer automatically, under the Regulations, has to accept these liabilities and won't even be made aware of them. All these liabilities will be transferred in on an on-going basis but on exit will be assessed on a gilts cessation basis so effectively the last employer is picking up additional liabilities from a prior employer.

We are also of the view that there should be a classification of admission in LGPS which allows central government and other public entities (e.g. NHS, Civil Service, Armed Forces etc) to participate to allow them to more cost effectively provide guarantees and to accept historic liabilities. Currently if central government, for example, provides an admission body with a guarantee, unlike the local government, where liabilities can be re-allocated, central government would have to actually settle any gilts-based cessation amount levied which is a direct cost to the public purse. Participation in LGPS would mean that these entities could be considered continuing employers and fund based upon on-going and not gilts-based liabilities which would be much more cost effective and a better use of public money. It would also mean that these entities would be more likely to accept liabilities where there was a clear case to do so again improving the covenant of the scheme as a whole.

Administering authority response:

- Although the LGPS is no longer a final salary scheme, the majority of liabilities continue to be based on final salary. This is controlled by the final employer, hence that employer is responsible for funding the liabilities.

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- It is also that employer's decision to exit the scheme which triggers the debt and the consequent change of basis from ongoing to cessation.
- Where a local authority or other guarantor accepts the prior liabilities, the cessation basis is effectively nullified as the liabilities can be funded on an ongoing basis alongside that employer's other liabilities.
- This is largely a legacy issue. Admission requirements have been much more stringent in recent years than previously, and administering authorities have made greater use of pass-through arrangements and guarantors.
- Proposal 1 also has the potential to address this issue as, although exits will be calculated on a cessation basis, they will not necessarily be funded on that basis.

Proposal 7 - Out-sourced employers should be able to participate in a single LGPS

We are also of the view that organisations performing out-sourced contracts should be permitted to participate in one LGPS to cover all of their contractual arrangements as this would add simplicity to the process and limit cessations. A more consistent and transparent process would be required to manage this evolution.

Administering authority response:

- Schedule 4 of the regulations already facilitates this and is currently being used by Visit Scotland to consolidate its liabilities from all 11 Scottish funds into just one.

Proposal 8 – There should be greater clarity for admitted bodies where guarantees exist on the extent and limitations of these guarantees

There is often material uncertainty for charities participating in LGPS whether any form of guarantee over their membership exists and if it does the robustness and enforceability of that guarantee. Clearly within Funds the risk exposure of admitted bodies is mitigated where guarantees have been obtained so they equally should be concerned by the robustness of any guarantee.

Some examples of uncertainties are:-

– Employers who clearly joined as transferee admission bodies but were early adopters so admission agreements pre-dated TAB status.
– Employers being permitted to join Funds based upon 'letters of comfort' which are not guarantees and would likely be unenforceable if called upon. These agreements impact on Fund covenant and therefore place other employers in the Fund at increased risk.
– Guarantees of last resort which cover bodies only if they are unable to pay providing for material unquantified risk
– Guarantees not robustly pursued from local authorities or updated to more recent legal versions.

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We believe that Funds should audit all employers and ensure that where guarantees are identified these are robust and enforceable.

Administering authority response:

- Funds will have their own arrangements for review of covenants and guarantees. It may not be easy to re-negotiate existing guarantees or obtain new ones.
- Where an admitted body is relying on the protection of a guarantee, there must be some onus on that body to ensure that the guarantee exists, and ascertain its terms and enforceability.

Other areas worthy of consideration

Watford Community Housing

LGPS should also consider a wider range of options such as that implemented recent by Hertfordshire LGPS and Watford Community Housing where there is a clear public benefit.

3rd Sector Amnesty

Some Funds have been prepared to allow 3rd sector organisations to exit on an on-going basis for a limited period to allow the Fund to better manage the risk of on-going accrual. This protects public services and as liabilities are re-allocated to the Council provide minimal additional risk providing they are at least fully funded on an on-going basis.

'Gilts-based' cessation

We believe that the implementation of a 'closed' on-going basis to a great extent makes revisions to the cessation debt calculation methodology less pressing however some employers may want or need a more certain solution so may still want to have their liabilities discharged in full so would require a cessation debt to be calculated.

We believe that departing employers should pay a risk premium to those employers remaining in the scheme however the current gilts-based approach is excessive and means that over time Funds benefit disproportionately from cessation payments and a balance needs to be achieved. The Scheme Advisory Board in England commissioned research from PWC on this specific issue in 2015. That report commented:-

"We recommend that Funds should not be permitted to use very onerous assumptions for exit bases. One way to achieve this would be to require that the discount rate applied should not be stronger than CPI plus 1.0% or plus 1.5%. This would be the maximum strength exit basis. The range suggested is consistent with cautious investment policies but not zero risk investment policies."

We do not question the need for some form of security / prudence margin to be applicable for exiting employers however are of the view that 100% gilts based

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is excessively prudent and a more reasonable balance could be achieved. The PWC Report referred to above also suggested the use of Liability Driven Investments which could increase the 'secure' discount rate which could be used thereby reducing exit payments and making exit more affordable.

We believe that cessation debts should be linked to the investment approach actually adopted by the Fund and to the specific membership of the employer (i.e. a longer duration of liabilities could increase the discount rate and lower the required cessation payment again making exit more manageable. Funds could also have the option to consider using smoothed returns over a period to achieve more equitable results and the ability to use a margin over the on-going liability rather than a gilts cessation basis.

Not only do Funds currently benefit from the gilts-based cessation they also benefit from member movements as deaths, transfers or retirements can all reduce liabilities over time from those on which the cessation payment was based. An example of this we have witnessed recently was where a charity was looking to exit and while this was being negotiated a member of staff transferred out reducing the cessation debt by over £160,000. This is a one way bet for the Funds on exit and it is not considered as part of any assessment.

In our view LGPS needs to more realistically define risk, as currently this only really focusses on the risk of default and doesn't really assess the material risk of future accrual, particularly for organisations with a weak covenant. It could be argued that the greater risk here lies with an employer continuing to accrue further liabilities which they may be unable to afford, which places other employers in the Fund at risk. It must be better for the employer, and the other employers in the Fund, for an employer to be paying all its future contributions to pay down a past liability than to be building a further liability. For example, have Funds carried out an assessment of the increasing growth of liabilities in comparison to covenant strength or an assessment of the likely level of default.

We recognise that the approach adopted by LGPS needs to be supported by professional advice. We would however ask that the approach is reviewed to ensure it is 'fit for purpose' or if more equitable approaches could be adopted.

Administering authority response:

- Each of these proposals may have some merit and should be considered by administering authorities where they might be appropriate.

- However, as acknowledged above, the implementation of a 'closed' on-going basis to a great extent makes revisions to the cessation debt calculation methodology less pressing.

- Administering authorities' first objective in managing exits is to protect the interests of the remaining employers in the Fund. The current methodology and gilts basis remain the best and most consistent way of achieving this.