Greater Manchester Pension Fund

Administered by Tameside Metropolitan Borough

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Dear LGF Reform and Pensions Team,

Local Government Pension Scheme: Changes to the Local Valuation Cycle and the Management of Employer Risk

This response to the consultation named above is on behalf of Greater Manchester Pension Fund ('GMPF'), which is the largest Local Government Pension Scheme ('LGPS') fund in England and Wales with approximately 370,000 members, 600 contributing employers and assets with a value of approximately £24.8bn. This response is drafted from an administering authority perspective.

The consultation makes proposals which GMPF believes have the potential to fundamentally change the operation of the LGPS and its employer base. As a consequence this response is rather long as we have sought to answer what we view as the key questions in some detail.

Whilst we are broadly supportive of several of the proposals, we have overriding concern and objection that Government is seeking to copy many aspects of the regulatory regime in which trust-based multi-employer private sector defined benefit schemes operate. Our view is that the LGPS as it currently stands provides its members with benefits much more cost effectively than comparable trust based schemes, albeit reliable cost comparisons (which should also take into account administration/advisory costs incurred by employers) are almost certainly difficult to obtain.

The key to the LGPS' effectiveness is the relative simplicity of its funding arrangements, which we feel there is a danger of losing via the implementation of these proposals. In particular, we can envisage the level of spend on professional advice by both administering authorities and employers increasing significantly, which given the public-sector nature of the scheme will ultimately be borne by taxpayers.

In addition, implementation of the proposals will likely increase administration workloads for administering authorities that will need to be met via additional resource or diverting resource from other areas.

We would like to draw your attention in particular to our response to question 16 of the consultation regarding the proposals for changes to circumstances under which exit credits can be paid. We do not think this goes far enough in correcting what was in hindsight an ill-thought out amendment made in May 2018. **<u>We believe urgent action is required to correct this fundamentally flawed regulation to prevent expensive and potentially reputation-damaging litigation between exiting employers and LGPS funds.</u>**

Our specific comments regarding each of the questions posed in the consultation are set out below.

Changes to the Local Government Pension Scheme (LGPS) valuation cycle

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 valuation cycle?**
   - GMPF can understand Government's desire to bring the LGPS funds' valuation cycles in line with the other public service pension schemes. However, primarily due to its funded nature, we believe there are several reasons why a quadrennial valuation cycle in the LGPS is less desirable, and we believe the assertion that moving to a quadrennial cycle would provide greater stability in employer contribution rates and would reduce cost is misguided.
   - GMPF's preference is to retain the current 3-year valuation cycle; however we would be comfortable with a 4-year cycle in future if the issues set out in our response to question 2 can be satisfactorily addressed.
   - Moving to a 4-year valuation cycle would increase the divergence of actuarial assumptions made at the valuation from actual experience and mean that when the contributions rates are revised at the subsequent valuation the change in contribution rates for employers are likely to be greater than they otherwise would have been.

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?**
   - Before progressing this proposed change, we think it is imperative that discussions between MHCLG, GAD and the bodies that set the guidance for the audit of LGPS employers take place to establish whether auditors will accept pension accounting disclosures to be based on 4, or potentially even 5 year old membership data. If they will not, then the cost of allowing for membership experience when calculating pension accounting figures will dwarf any savings from moving to a quadrennial cycle.

3. **Do you agree the local fund valuation should be carried out at the same date as the scheme valuation?**
   - We believe this is desirable but not essential. LGPS funds should be taking steps to ensure that their data is of sufficient quality to enable GAD to undertake its calculations at year end.

4. **Do you agree with our preferred approach to transition to a new LGPS valuation cycle?**
   - If quadrennial valuations are implemented, GMPF agrees that MHCLG's preferred option is the least disruptive form of transition to quadrennial valuations. Having a triennial valuation followed by a biennial valuation would make it more likely that assumptions better reflect real life experience, and allow funds to maintain stable and appropriate contribution rates for their employers.

Dealing with changes in circumstances between valuations

5. **Do you agree that funds should have the power to carry out an interim valuation in addition to the normal valuation cycle?**
   - On balance, GMPF is supportive of funds having the power to carry out interim valuations as this will help provide administering authorities with additional flexibility to manage risks that may arise between formal valuations.
   - However, it must be remembered that the funding of defined benefit pension schemes is a long-term project and we would hope that the power to undertake an interim valuation would not need to be used in practice.

6. **Do you agree with the safeguards proposed?**
   - GMPF agrees with the proposal that the circumstances in which an interim valuation could be carried out should be documented within the Funding Strategy Statement ('FSS') as this will help manage employers' expectations.
   - We believe the proposal that the decision to undertake an interim valuations should only be made by the administering authority having due regard to the views of their actuary and following consultation with the Local Pension Board needs further clarification. What constitutes 'due regard' to the views of the actuary? From a practical perspective it is hard to see how an administering authority could undertake an interim valuation without the support of its actuary.

7. **Do you agree with the proposed changes to allow a more flexible review of employer contributions between valuations?**
   - The ability to review employer contributions, at the administering authority's discretion, could potentially be a useful tool in managing funding risk for both administering authorities and employers. The consultation suggests employer contribution reviews may be needed following a merger or take-over, but we believe there will be other valid situations where contribution rate reviews could be exercised such as material transfers of staff to or from an employer, whether involving another scheme, LGPS fund or employer participating in the same fund.
   - GMPF welcomes dialogue and engagement from its employers regarding its funding strategy, but we fear that the introduction of a formalised power to allow a review of

contributions might be utilised by employers more frequently than MHCLG may anticipate.

- Consequently, we believe it is vitally important that the ability to determine the circumstances where employer contribution rates can be adjusted should be left to the discretion of each individual administering authority, but with each authority's policy set out transparently in their FSS. This could help avoid spurious requests from employers which would incur costs and/or acting as a drain on fund resources.
- Due to the long-term nature of our defined benefit scheme's funding strategy, unless an employer exit event was expected to occur in the short-term we would not expect GMPF to allow a revision to contribution rates due solely to changes in market conditions or covenant strength.
- Covenant strength is highly subjective, particularly for not-for-profit entities that have no market value or credit rating and frequently rely on funding awards to continue in operation. It is imperative that the administering authority's decision is final in order to avoid any protracted and costly disputes on the appropriateness of contribution rates.

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?**
    - GMPF's view is that it might be helpful for SAB or CIPFA to provide guidance on how the circumstances in which interim valuations can be used are incorporated into the FSS or any equivalent policy document.
    - Any guidance should not be prescriptive in relation to the circumstances in which an interim valuation could be carried out or in relation to the process for triggering an interim valuation. There should be freedom to interpret the proposed regulation changes in a way that helps administering authorities undertake their functions.
    - It should be left to each administering authority in conjunction with its actuary to determine the appropriate circumstances for their fund.

9. **Are there other or additional areas on which guidance would be needed? Who do you think is best placed to offer that guidance?**
    - GMPF does not believe any further guidance is required at this time.

Flexibility on exit payments

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?**
    - Contrary to the consultation wording, our understanding is that there is currently no requirement to calculate exit payments on a *full buy-out* basis. However they are usually, but not exclusively, calculated on a *low risk* basis.

- GMPF is supportive of introducing additional flexibility for employers who are effectively 'trapped' in the LGPS by virtue of not being able to afford their current exit payment and also struggling to meet regular ongoing contributions, therefore placing jobs and other fund employers at risk. However, in practice there are several other risks and issues that need to be recognised.
- By spreading payments an administering authority would forgo the certainty inherent in the one-off exit payment that is currently the norm. There is a risk that an employer might become insolvent whilst in the process of repaying its exit payment, and administering authorities would need to allocate resource and budget on due diligence to avoid taking on any excessive risks.
- In our experience obtaining security from employers such as a charge over property is complex, costly and time-consuming and many employers do not have appropriate assets of remotely sufficient value to make this a worthwhile endeavour. In addition, we generally do not regard the provision of bonds from banks or insurance companies to be a cost efficient solution across the fund as a whole.
- The consultation welcome views on whether it is appropriate to determine a maximum repayment period (such as three years), but for some of the most acute cases it is difficult to envisage the exit debt being paid in full in the foreseeable future and other options may need to be explored. Clarification on whether maximum spreading periods for payment of exit debts will be determined by administering authorities, guidance or the LGPS Regulations would be helpful.
- We can envisage some scenarios where greater flexibility for administering authorities may be unhelpful. For example, it may be difficult to prevent employers prioritising other creditors over the LGPS (bearing in mind the funding of LGPS benefits is not policed by the Pensions Regulator).
- Providing the ability for administering authorities to exercise discretion may allow employers in financial difficulty to blame the administering authority (perhaps publically) for any consequent employer failure should the administering authority elect to receive payment of an exit debt immediately or over a short-period of time.

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

- The introduction of deferred employer status may help some of the 'trapped employers' within the LGPS who cannot afford to pay an exit debt but who equally struggle to afford ongoing contributions. At first glance this option appears to offer an attractive approach for employers to cease accruing benefits which they likely cannot afford to fund whilst avoiding the triggering of an exit debt.
- We believe deferred employer status would be challenging for administering authorities to operate because it would necessitate relatively detailed covenant advice in order to determine whether this option is appropriate for the fund and subsequent covenant monitoring would be required. This is likely to be costly and resource intensive.

- The consultation is not clear on whether deferred employer status would allow the use of ongoing funding assumptions for calculating liabilities i.e. whether a deferred employer is funded consistently to an 'active' employer but without having any active members. If that is the case, it is hard to see why many employers would elect to become an exiting employer and have their liabilities calculated on a more prudent basis (such as full buy-out), when they could opt for deferred employer status which allows them more time to pay their liabilities and ostensibly at a lower overall cost.
- Conversely, if administering authorities' sole concern was to minimise funding risk across its fund as a whole it is hard to see why they would choose any option other than requiring immediate payment in full of an exit debt calculated on a low-risk basis, assuming that the employer has sufficient assets in order to meet this.
- The wording of regulations or statutory guidance will therefore be crucial in order to determine how a compromise may be reached, bearing in mind that the employers with the least ability to pay an exit debt calculated on a low-risk basis will be the employers that are unable to provide adequate security in order to provide comfort to the administering authority that they can ultimately meet their liabilities in full.
- In order to avoid protracted, costly and potentially litigious disputes, we believe it is imperative that administering authorities, acting on actuarial advice are given sole discretion over whether to grant deferred employer status.
- The consultation document only references covenant strength as a factor to consider when offering deferred employer status but we believe there are other factors that administering authorities would wish to consider, such as the quantum of the liabilities and the current funding level.
- The consultation is also not clear on whether to become a deferred employer the original admission agreement would need to be terminated, and a new deferred employer admission agreement be created. Or, whether admission agreements need to be amended to allow the seamless transition to deferred employer status (with the caveat that the administering authority approval is obtained). Typically admission agreements stipulate the grounds of termination (such as the last active member leaving active service) which theoretically ends the employer's participation in that fund. GMPF would welcome further detail on how this transition to deferred employer basis would legally operate.

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 believe there is a risk that employers that utilise deferred debt arrangements would have less ongoing engagement with their administering authority, and funds may need to update some of their processes to ensure a continued effective working relationship with employers that are using this arrangement. Clarity will be required on matters such as whether a deferred employer can exercise employer discretions in the same way as a typical ongoing employer.

- Further clarity on whether it is appropriate to adopt different investment strategies for different employers in the same fund would be helpful. It may be appropriate in order to optimise risk management for deferred employers to have a lower-risk investment strategy than for typical ongoing employers, although we are aware that some administering authorities are reluctant to facilitate this due to a lack of legal clarity on whether it is a vires policy.

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?**
    - GMPF agrees that key obligations and entitlements of parties should be in the regulations. Statutory guidance should not be used to enforce rigidity in the application of the LGPS Regulations as this might inadvertently interfere with the discretion that administering authorities may need to exercise in the undertaking of their functions.

14. **Do you agree options 2 and 3 should be available as an alternative to current rules on exit payments?**
    - We would be comfortable with the introduction of options 2 and 3 as alternatives to current rules on exit payments subject to the regulations being clear that the administering authority, having taken actuarial advice, has the sole power to determine which option is used and the basis of calculation and timing of exit payments.
    - We would need to see the precise wording of amendments to the LGPS Regulations before offering further comment.

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?**
    - We do not believe that the use of statutory guidance is effective, as stated above transparent change to the LGPS Regulations is our preferred approach. Where necessary, or where deficiencies in application arise, SAB guidance may be appropriate. However, day-to-day issues will only arise, if and when, the proposed changes are implemented.

Exit Credits under the LGPS Regulations 2013

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?**
    - We believe Government should be going much further than the proposed changes to the 14 May 2018 amendments and, at the very least, amending the Regulations to make clear that no exit credits can be paid in respect of admission agreements commencing prior to 14 May 2018.

- We believe it is completely inappropriate for exit credits to be paid in respect of pre-May 2018 admission agreements even if pensions risk sharing arrangements were not in place, as both the opening funding position of the admission agreement and any contract price (applicable to service providers only) would have been agreed at outset on the assumption that no surplus could be paid to the admission body on exiting the LGPS.
- In other words, the asymmetric risk (from the service provider's perspective) that it may be liable for any deficit, but not able to claim any surplus on exit, should already have been factored into the contract price.
- In GMPF's experience, admission bodies that started participating in the fund around the time of stock-market lows, such as 2003 and 2009, currently have strong funding positions and would therefore be more likely to be eligible for an exit credit should they cease participating in the fund. However, this is almost entirely due to good fortune regarding the timing of their entry and exit rather than any action taken by the employer.
- It seems completely incongruous with the desire to manage risk in the LGPS to allow potentially significant sums of money to be paid out to employers who have done nothing more than fulfil the terms of their contract at the pre-agreed price, with the local taxpayer ultimately underwriting both the pension liability and the fulfilment of the contract in the event of employer failure.
- We believe urgent action is required to correct this fundamentally flawed regulation to prevent expensive and potentially reputation-damaging litigation between exiting employers and LGPS funds.
- Whilst we hope our strong views on exit credits (as detailed above) are clear, we also have some specific points to raise in relation to the consultation proposals.
- Firstly, similar to the point made in our response to question 10 of the consultation, contrary to the wording of the consultation, our understanding is that there is currently no requirement to calculate exit credits on a *full buy-out* basis, although that may be the approach taken by most administering authorities and fund actuaries.
- It should be noted that there are a wide range of risk sharing arrangements in existence; it is more complex than simply judging whether pass through has taken place.
- The proposed changes would require administering authorities to adjudicate on what is, in many cases, a contractual arrangement between two employers which the administering authority would not be a not party to.
- The LGPS Regulations stipulate that an exit credit must be paid within three months of exit; however this is likely to be a challenging timescale for a number of reasons, for example the receipt of accurate data and contractual information to attempt to determine the level of risk sharing.
- In addition the Regulations also give members a twelve month window to elect not to transfer their accrued benefits to a new employer. At the point the exit credit is calculated it is therefore not possible to know what liabilities will be subsumed by other

employers in the fund. Liabilities subsumed by other employers may be calculated using different actuarial assumptions compared to those that will be ‘orphaned’.

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

- GMPF’s preference would be for the Regulations to be amended so as not to permit an exit credit to be paid in any circumstances. However, we do not think it is unreasonable to allow exit credits to be paid if all parties are aware of this possibility when the commercial negotiations which give rise to the admission agreement are taking place i.e. post May 2018.
- Again, further clarity on whether it is appropriate to adopt different investment strategies for different employers in the same fund would be helpful. It may be appropriate in order to optimise risk management for employers who are likely to be exiting in the near future to have a lower-risk investment strategy than for typical ongoing employers.

Employers required to offer LPGS membership

18. Do you agree with our proposed approach?

- GMPF appreciates that the financial landscape for further education corporations, sixth form college corporations and higher education corporations in England and Wales has changed considerably in recent years. As a result we believe there is some validity to the argument proposed in the consultation that costs associated with meeting the liabilities of failed educational organisations could fall back on local tax payers, which may be considered inappropriate.
- However, in our view, removing Part 1 Scheme Employer status from further education corporations, sixth form college corporations and higher education corporations whilst still requiring these institutions to offer new teaching staff access to defined benefit pension schemes creates an unfair distinction across the workforce, particularly as non-teaching staff would typically be lower earners.
- On balance GMPF does not therefore support the consultation proposals and believes that these employers should remain as Part 1 Scheme Employers.

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?

- GMPF is not aware of any further equalities impacts caused by the proposals within the consultation other than those outlined in our response to question 18.

Please do not hesitate to get in touch if you wish to discuss any of the matters covered by this consultation.

Yours sincerely,

Sandra Stewart
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Greater Manchester Pension Fund