Cambridgeshire Pension Fund   Northamptonshire Pension Fund

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30 July 2019

Dear Sirs,

Local Government Pension Scheme (LGPS): Local Government Pensions Scheme: Changes to the Local Valuation Cycle and the Management of Employer Risk

I am writing to you on behalf of the Cambridgeshire and Northamptonshire Pension Funds to provide our response to the matters covered in the consultation. We have provided answers to those questions of particular concern to the two Funds but would fully endorse the response of our Actuary, Hymans Robertson, concerning questions not addressed in this letter.

<u>**Valuation cycle**</u>

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 valuation cycle?

The Cambridgeshire and Northamptonshire Pension Funds do not agree with this and are of the opinion that the current local valuation cycle remains appropriate to meet the needs of a funded scheme with a variety of employers. Employers have a wide range of funding needs and present different levels of risk to pension funds with some employers only being in the scheme for a relatively short period of time. Each of these characteristics has a direct bearing on the contribution strategy for an employer.

These factors can quickly change making the current contribution strategy inappropriate. Lengthening the period between valuations could increase the overall financial risk to funds if a contribution strategy is no longer appropriate following a change to the financial covenant of an employer, the length of their participation in the fund or their funding need.

This is a particular concern for smaller employers where movements to just one member can have a material impact on each of these factors. However, the Carillion case shows that this can equally happen to large employers too with a significant impact on LGPS funds.

Contrary to the view expressed in the consultation, we do not believe that a 4 year cycle will reduce volatility in contribution rates for employers but could in fact risk the opposite. If funding positions are allowed to drift as a result of a longer valuation cycle, the contribution changes could be sharper than they otherwise would be in a shorter cycle. Contribution rates are already stabilised to some extent and any changes are usually phased in over the valuation cycle to ensure changes are not too sharp for employers. If budgeting certainty is a concern, there are other ways that this can be achieved within the current cycle length.

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

The Funds do not believe this to be necessary and believe that there is benefit in these being separated, preferably with the scheme valuation being carried out prior to local funding valuations. This would allow any subsequent changes to benefits, following a costing review, to be fully accounted for within the ensuing funding valuations.

Aligning the two valuations on a 4 year cycle would not allow fund actuaries to account for changes to the benefit structure in the funding valuation which could exacerbate the risks described in our response to question 1.

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

Yes, if the valuation cycle is to be changed, which we disagree with, the preferred approach for transition to the new cycle seems to be the most sensible approach.

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?

We believe that funds should have this power and that there should be discretion to carry out whole or part fund interim valuations, including for individual employers. This would provide greater risk management within the scheme and allow funds to react more swiftly and appropriately to changing employer circumstances and increased risk exposure for the Fund.

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

We welcome more flexibility to review employer contributions between valuations for the same reasons that we welcome the ability to carry out interim valuations, provided within our response to question 5. We believe that funds should have the ability to review employer contributions of all employer types between valuations. We accept that usually there would be less need to do so for statutory or tax-raising bodies, but through recent experience, there are circumstances where it could be beneficial to review contribution rates for such bodies. During the valuation, contribution strategies are agreed in discussion with employers and based on their circumstances at that time. If there is a material change to those circumstances, it would be helpful to have the flexibility to review the agreed contribution strategy.

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?

We would welcome extra flexibility to spread repayments made on such a basis. Such flexibility would allow smaller employers to manage their exits in an orderly fashion and avoid the risk of becoming insolvent, when their last active member leaves the LGPS or alternatively by being trapped in a scheme where both the continuing in and exiting the scheme are unaffordable. This would be particularly useful for so called “Tier 3 employers” who are particularly at risk of such events and for whom there is usually no form of security protecting the fund.

Such flexibility would also provide a level of protection for all other employers in the fund. In an insolvency situation a fund would only receive a fraction of the total pension debt owed. The proposed flexibility would allow funds to collect pension debt over a manageable period and maximise the amount repaid to the fund by avoiding an insolvency situation, thus reducing the future burden on other employers in the fund.

This flexibility should only be offered, at the discretion of the administering authority (and guarantor where appropriate), based on an assessment of the financial covenant of the exiting employer and/or guarantor. Further, interest should 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.

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

Yes, we agree with the introduction of deferred employer status into the LGPS, this would be a useful flexibility for funds for similar reasons to those set out in question 10 and agree that this would be particularly helpful for smaller employers.

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

Yes, the extra flexibility would be welcome. With all three options available to employers an argument could be made that the need for suspension notices is redundant. An employer could simply become a deferred employer until they have a new active member.

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?

Statutory guidance would be useful but a balance needs to be struck with the ability of funds to manage their own funding and employer risks and to account for other local considerations when taking decisions.

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?

Yes, we feel very strongly that this should be the case. Risk and reward should flow in the same direction and it is clearly inappropriate for an exiting employer to receive an exit credit when they would not be expected to pay an exit debt.

Furthermore, it should be clear that where the pension risk is held by a non-exiting employer, no exit payment should made to any employer, particularly to an ongoing employer with an existing deficit. It would clearly also be inappropriate for a fund to release monies to such an employer. We therefore agree with the proposed wording that, in such circumstances, the exit credit should be calculated as nil.

The liabilities and corresponding assets would be pooled with the scheme employer holding the pension risk and therefore, all else being equal, would reduce their deficit which, in our opinion, is a sensible approach.

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

We are of the view that the exit credit regulations should only apply to new admissions.

For admission agreements entered into prior to the introduction of exit credits, all parties would have entered into admission agreements with an understanding that no exit payment would be made on exit, if a surplus existed. Consequently, as the regulations did not allow it, most risk sharing agreements will be silent on provisions if a surplus exists at the end of the contract. As a result, legal opinion may be required when reviewing risk sharing agreements for cessation cases. If the regulations had existed at the time, a surplus scenario would be explicitly covered within the risk sharing agreement, removing the need for a legal opinion.

Further, had the legislation been in place when such a body joined the LGPS, it may have changed how they were treated throughout their time in the LGPS. The introduction of exit credits effectively changed the risk these employers posed to ceding authorities which may have resulted in significantly different treatment throughout their time in the LGPS.

We are also of the opinion that the current time constraints placed on funds within which an exit credit must be paid is extremely onerous. This is a very short time frame within which a fund must collect required data from an employer to assess their final position, commission and receive a valuation, release assets (in an orderly manner to minimise the cost of doing so) and obtain the required local treasury sign off to release payment. If funds are required to take account of risk sharing arrangements when calculating an exit credit, as we agree they should do, this will certainly make it impossible to meet the three month deadline. Especially if legal interpretation of commercial agreements is required.

We are of the opinion that a longer time frame should be implemented

Employers required to offer LGPS membership
Question 18 – Do you agree with our proposed approach?

We accept that there is certainly justification for considering the nature of participation in the LGPS by the further and higher education sectors. However, we would have concerns over the increased risk to funds, if the statutory obligation to offer LGPS membership were removed.

Giving protected status to existing employees is comforting and in our view a fair and sensible approach. However, if such a body were to close the scheme to new entrants, a cessation event would become inevitable through natural staff turnover. It is not uncommon for the liabilities of these bodies to be worth tens of millions of pounds and if such a body were to cease participation in the fund, it is likely that a large deficit would be payable. Given the current financial concerns within the industry, this would increase the risk of insolvency situations and the liabilities being subsumed by all other employers in the fund.

Further, such a proposal would likely increase the costs of participation in the fund for this type of employer. Currently, they are treated similar to other scheduled bodies, as they are viewed as long term employers. If such bodies were no longer required to offer LGPS membership, this would change how funds view them and given the removal of government backing, these bodies would become similar to smaller tier 3 employers, but with much larger liabilities and therefore higher risk and contribution strategies would be need to reflect their high risk status potentially leading to higher contributions.

Any change to the status of these bodies in the fund would need to be alongside changes to the flexibility available to administering authorities in dealing with ceasing employers and employer debt. However, the high risk nature of these employers could still make long term repayment plans difficult to justify without additional security, which could further increase costs for these bodies.

Yours faithfully

Mark Whitby FPMI, CPFA
Head of Pensions
LGSS
On behalf of the Cambridgeshire Pension Fund and Northamptonshire Pension Fund