SPPA Consultation The Local Government Pension Scheme (Scotland) Regulations 2018

Response from:

Spence & Partners Limited
The Culzean Building
36 Renfield Street
Glasgow
G2 1LU

Contact: David Davison
david_davison@spenceandpartners.co.uk
Tel: 0141 331 1004
M: 07834 836682

To:

SPPAPolicy@gov.scot

Local Government Pensions Consultation
SPPA Policy
7 Tweedside Park
Tweedbank
Galashiels
TD1 3TE

SPENCE

Date: December 2021

Spence & Partners Limited are submitting a response to this consultation as a Group / Organisation with involvement with LGPS and employers participating in LGPS. We are content that this response is made available to the public and we are happy to discuss the contents with Scottish Government representatives in the future.

We have no substantive comments in relation to questions 1-3 and question 5 of the consultation being content with the proposals. We will focus our response on Question 4.

Question 4 – Further flexibilities for Fund Authorities – these regulations provide further flexibilities for fund authorities in dealing with employers and allow for amendments to an employer's contribution rate in between valuations.

We hugely welcome the proposals to add additional flexibility to the exit process for administering authorities and employers. A framework, such as that proposed, should assist in achieving much needed clarity and consistency. Currently, Funds can adopt hugely varying approaches which result in confusion and expense for the bodies involved in dealing with a myriad of variations of practice. The Suspension process added in the 2018 Scottish Regulations had sought to achieve very similar objectives. However, administering authorities were not confident in the scope and robustness of the Regulations and as a result chose not to implement them in practice.

It has undoubtedly been a long process to reach this point, but the proposed changes to the Regulations should provide a framework to more effectively manage employer exits subject to their fair and consistent implementation by the administering authorities. The introduction of the 2020 Regulations in England & Wales, which provided a framework for Debt Spreading Agreements and Deferred Debt Agreements, have provided a valuable template for change in Scotland. Initial experience from recent engagement with Funds in England to implement exits has been encouraging although not surprisingly Funds have been initially highly cautious in their approach and there have undoubtedly been potential learning experiences from the process which could assist in the roll-out of the Scottish Regulations.

- Initial implementation has been very slow. The England & Wales Regulations were enacted in September 2020. Funds would not initially act on these amendments until supporting guidance was provided by the Scheme Advisory Board. This was not forthcoming until early 2021, which delayed the process by a number of months. Following this, Funds then had to engage with their Actuary and Legal Advisers to design a process which could be incorporated in their Funding Strategy Statements ('FSS'). Having drafted these proposals they then had to be consulted upon by the Fund stakeholders prior to being formally added to the FSS. Some Funds achieved this very quickly, by around April/May 2021. However, at the time of writing, a number of Funds have still not provided their formal process in their FSS.

Recommendation - We are therefore of the view that it would be sensible and speed up the process if Scottish Scheme Advisory Board, and any required SPPA guidance, is prepared in advance (i.e. early in 2022) so as not to delay the implementation process.

- Funds will discuss potential Heads or Terms for an agreement in advance of the FSS being formalised. However, not surprisingly, would not finalise any agreement until this was in place.

  Recommendation – Funds should be prepared to enter into discussions around future options immediately given that it is highly unlikely, given the time required for covenant research, negotiation and staff consultation that any agreement would be completed in less than around 6 months. Employers would also need Funds to reach broad Heads of Terms prior to them consulting with their staff members to ensure an affordable exit is indeed possible. Final details can be refined at the actual exit date within the framework agreed.

- Some Funds have not prepared draft legal documentation at the point of launching their proposals in the FSS. This makes it difficult for exiting bodies to fully understand the implications and consider what areas may potentially be 'negotiable' as part of any arrangement.

  Recommendation – agreements should be prepared in draft form early in the process to allow employers to fully understand their obligations and highlight specific issues to the administering authorities.

Whilst we fully welcome the proposals there are a number of points linked to our response to the 2020 Consultation which we believe need additional clarity:-

Provision of information

It is hugely important that Fund employers are fully aware of the ultimate value of the liabilities they are accruing on a regular basis. If the expectation of the Fund is that an employer will be liable for a cessation liability then it is wholly unacceptable for that employer to be unaware of their responsibilities as has often historically been the case.

The quality of annual information supplied should in our view be more comprehensive. At a consistent date, perhaps linked to the provision of FRS102 information, admitted bodies should be supplied with estimated funding information based upon progress against the funding plan, updated cessation information and details of any material changes which have occurred since the last formal valuation (such a member movements or transfers in / out). This will be particularly important where employers are assessed as being close to cessation or where contributions are likely to vary materially between valuation dates and the extra year of delay could be highly relevant in increasing contribution costs.

The approach could be set at a de minimis level such as the basis applied under the notifiable events framework. Modern technology should make access to this information more straight-forward and not place any additional administrative or financial burdens on the Funds or participants. Indeed some Fund advisers already provide this information on an ad hoc basis.

Revision of the cessation debt basis

Some employers may want or need a more certain solution and may still want to have their liabilities discharged in full. So, they 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 (and therefore remaining employers) benefit disproportionately from cessation payments and a balance needs to be achieved. The Scheme Advisory Board commissioned research from PWC on this specific issue in 2015 which seems to have been completely ignored until very recently other than within some Funds. 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."

The gilts-based approach adopted by LGPS at the point the last member exits is fundamentally at odds with that applied to other UK defined benefit schemes and is resulting in outcomes which do not meet the needs of any of the parties involved.

Gilt yields have been highly variable over the past 2-3 years, resulting in huge variations in any cessation debt payable. We have recently witnessed one admitted body which was quoted around £350,000 in December 2019, £650,000 in July 2020 and £10,000 in February 2021. The employer was very nearly forced to accept the £650,000 figure as the last remaining member was considering retirement but fortunately chose to remain until February 2021. This highlights the ludicrous nature of the gilts based approach. None of these so called 'answers' are correct as the vast majority of Funds do not invest exiting employers in gilts and for any that do this highlights why they need to reconsider their approach.

We are already witnessing a move away from the pure gilt-yield methodology in a couple of Scottish Funds, as well as some Funds in England, with two advising actuarial firms recommending a revision of approach. These Funds have adopted a probability type approach (90% or 80%) which is allowing a marginally higher discount rate to be used resulting in lower cessation liabilities and deficits (consistent with our previous proposals and those outlined by PWC). This represents a more equitable sharing of risk between the employer and Fund and is likely to encourage more employers (or make it more affordable for employers)

to select a cessation repayment option with the associated certainty of cost rather than a deferred debt approach.

We would like to see this approach more consistently rolled out across Scottish Funds to avoid a cessation lottery.

Security

Funds need to understand how security might be used as to date the approach to considering options has been counter-productive.

The current approach has seen some LGPS view cessation or deferred debt agreements as an opportunity to extract as much security as possible rather than focussing on the big picture of limiting future accrual and paying down liabilities. Individual employers have therefore been unable to avail themselves of the option as the focus has been on the cessation debt covered by large levels of security. There needs to be a balance between security, investment, funding and affordability.

We struggle to reconcile the logic of demands for high levels of security to allow for an end to future accrual. Why is it acceptable for Funds to allow accrual of additional future service liabilities with no security over these or the accrued liabilities and yet when there ceases to be any further accrual and historic liabilities are reduced by future contributions there is a clamour to get security? It is clear in this scenario that the risk with cessation of future accrual is lower.

By adopting such a security focussed approach, far from protecting themselves and other employers, Funds are in fact placing them at greater risk, forcing employers to build additional liabilities which they can't afford and trapping them in schemes. We therefore believe that employers should be able to continue to participate on a DDA basis with security required only on any additional risk over that which is already inherently held within the Fund without security. Should it be possible to provide security, this should provide Funds with the option to improve discount rates and therefore reduce funding costs.

Funding periods

It also seems counter-productive to set funding periods which are either too short as they are unaffordable or too long because employers cannot reasonably commit to funding them. In our view the focus should therefore be on setting affordable future contributions to manage the actual costs of pension provision. We recognise that there may have to be some margin payable as a closed employer, but this should be reasonable and reflect the actual risk.

We believe that improving delivery and better managing risk is not just about extracting the maximum amount from employers when they leave a Fund, but about taking a more holistic view to manage Funds and protect employers in a fairer and more consistent way.

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

The inability of LGPS to be able to identify and allocate past service liabilities between employers, apparently only being able to allocate it to the latest employer, is an issue that remains the 'elephant in the room' causing untold additional complications as well as being patently unfair.

LGPS has consistently ignored the issue of legacy liabilities and their impact on cessation debts. Lothian Pension 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 Lothian FSS. For example, a new entity can be established and then staff gradually transferred from a public body, 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. 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. A recent example we witnessed 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 without having been made aware of this.

This is wholly inequitable and the original employer should not have the option to reject these liabilities built up on an employees service with them. 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 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 for the public purse. It would also mean that these entities would be more likely to accept liabilities where there was a clear case to do so.

LGPS to audit all guarantees and to ensure they are comprehensive, up to date and all bodies fully understand their obligations

While Funds claim to pursue routes in the name of protecting other employers participating in the Funds, we believe that this is far from the universal case. The risk exposure of some admitted bodies is mitigated in Schemes where guarantees have been obtained. However, our experience is that some Funds adopt a relatively lax approach to the pursuit and maintenance of these guarantees often meaning that there is confusion about their robustness and enforceability. We have witnessed this in a number of areas:-

- Funds have not looked to effectively deal with 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 clearly not guarantees and would be unenforceable. The decision to permit access on this basis places other employers in the Fund at 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.

We believe that the above issues highlight a fundamental conflict of interest issue as Funds need to have difficult discussions with their local authorities employers.

This creates uncertainty and risk, and also for those employers affected, impacts on their FRS disclosures and therefore financial position. We believe that Funds need to adopt a more robust governance standard in this regard and should audit all employers and ensure that where guarantees are identified these are robust and enforceable.

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.

About Spence & Partners Limited

Spence & Partners is a specialist actuarial practice primarily focusing on providing advisory services to DB scheme trustees and employers. Our business employs over 200 staff, with a turnover in excess of £20m and has offices in Glasgow, London, Manchester, Bristol, Birmingham, Leeds and Belfast. Spence have been providing focussed actuarial and pensions advice in the charitable sector for over 18 years and have worked with in excess of 500 charities and not-for-profit organisations throughout the UK.

Owner/Director David Davison heads the third-sector practice and he has built up very considerable experience working with charities and other not-for-profit bodies participating in the LGPS and other multi-employer schemes.

David is a regular contributor on pension issues for charitable publications. David is a member of the Institute of Chartered Accountants in Scotland Pensions Group, provides specialist pensions support to Charity Finance Group co-authoring their 'Pensions Maze' publication, is a co-author of PLSA's local government pension scheme guides and is on PLSA's local government pension scheme working group.

David worked with ICAS and the Scottish Public Pension Agency to assist with the revisions to the Scottish LGPS Regulations in 2018.