Consultation on Valuation Cycle and Management of Employer risk

June 2019

MHCLG has published a policy consultation setting out proposals to transition the local valuation cycle for the LGPS in England and Wales from triennial to quadrennial; together with proposals to introduce greater flexibility for exiting employers; give HE/FE the option to choose whether or not to admit new employees; and to improve the exit credit provisions to reflect experience since 14 May 2018. This Spotlight sets out Aon's views on the consultation, considering our clients' perspectives (i.e. administering authorities, scheme employers and contractors) and is intended to help stakeholders formulate their own response.

Introduction

The consultation brings together a number of changes, most of which we welcome. The proposal to move the local valuation cycle (which sets employer contributions) from triennial to quadrennial to align with the scheme valuations (carried out by GAD for cost management purposes) has been well trailed although the rationale is weak when considered from a local, funding perspective. MHCLG does, however, appear to recognise this and has proposed a number of potential mitigations, including interim valuations.

The suggested changes to the exit regime for employers and giving greater flexibility and choice for the HE/FE sector in determining whether or not to admit new employees to the scheme were strongly supported by employers and administering authorities during Aon's consultation for the Tier 3 project for the Scheme Advisory Board. The proposals will not be welcomed by everyone, particularly member representatives, but given the strength of feeling of many employers we believe it is important for the issues to be raised and debated openly and transparently, which this consultation should facilitate.

The consultation also proposes to address what has proved to be a material oversight in the introduction of the requirement to repay an exit credit to an outgoing employer, i.e. the failure to allow administering authorities to consider any risk sharing or other arrangements which are not consistent with any surplus being repaid on exit.

Our response to the original consultation on 19 August 2016 made clear the potential complexities associated with pre-existing arrangements, so we are pleased that this is being addressed, although it would of course have been preferable for the issue to have avoided in the first place. Many administering authorities have put exit credits on hold but clarity will be needed on what should happen where exit credits have already been paid but where risk sharing arrangements were in place – will steps need to be taken to reclaim these payments?

This Spotlight sets out Aon's views on the proposals and questions posed in the consultation. We hope it will assist stakeholders in formulating their own responses to the consultation.

The consultation closes on 31 July 2019.

Valuation Cycle

The consultation proposes to move the local valuation cycle (which sets employer contributions) from triennial to quadrennial to align with the scheme valuations which are carried out by GAD.

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 cycle?

We do not agree that the case has been made to move the local valuations from triennial to

quadrennial. The consultation states that this will *deliver great stability in employer contribution rates and reduce costs*.

There are already mechanisms in place to deliver stability of employer contributions via Regulation 62 of the LGPS Regulations 2013 and CIPFA guidance on Preparing and Maintaining a Funding Strategy Statement. In our experience administering authorities do generally make use of various mechanisms available to them to keep contributions stable so we are unconvinced by MHCLG's argument.

We also don't believe the proposals will reduce costs (at least not locally) given:

- it is not clear that auditors will accept accounting figures based on membership data and demographic assumptions which are up to 5 years out of date (so more frequent full valuations may be needed for employer accounting and possibly Fund accounting under IAS26)*
- to the extent that interim valuations are carried out, (noting that a power to carry out an interim valuation is specifically proposed within the document), whether at a whole of fund level or for individual employers, this will increase costs

* the accounting standards require that an employer *shall determine the net defined benefit liability (asset) with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period* and the CIPFA guidance specifically states that this *shall be interpreted to mean that between the formal actuarial valuations every three years there shall be approximate assessments in intervening years* (although it also refers to four years for police and firefighters' pension schemes). It will be important to consider the views of both private sector and public sector auditors as they may have very different viewpoints. It would be potentially embarrassing for MHCLG if NAO's view is that three yearly valuations are required for accounting purposes and this could increase costs overall.

We are not privy to costs charged by GAD for their actuarial work and advice so it is possible that the proposed change would lead to cost savings for MHCLG and/or HMT.

We believe that the rationale would be stronger if the LGPS were only comprised of long-term, secure employers fully backed by taxpayers for which contributions could be set for 4 years without the risk of employer failure with insufficient funds. However, as budget-setting becomes more short-term it's questionable whether those employers would favour contributions being set for 4 years or for more regular reviews. In addition, there are a number of non-taxpayer backed employers, principally community admission bodies and HE/FE scheduled bodies, some of which are increasingly short-term and whose covenant is less strong than the Tier 1 employers.

Many administering authorities have been developing much more robust risk management policies in relation to employer risk and moving to a quadrennial valuation cycle where contributions are only reviewed every 4 years would represent a backwards step. It could even increase costs if it meant interim valuations were carried out every 2 years for these employers.

In addition, as the LGPS is a funded scheme there is an additional element which doesn't affect the unfunded schemes, i.e. investment performance. Whilst administering authorities do set investment strategy on a long-term basis, they also tend to review strategy triennially alongside the actuarial valuation. Less frequent reviews may lead to missed opportunities to refine strategy to maximise the risk/reward trade-off, leading to a cost to employers and taxpayers.

Question 2: Are there any other risks or matters that you think need to be considered, in addition to those identified above, before moving funds to a quadrennial cycle?

Following on from our comments above, we believe MHCLG should consider what evidence is available to support its assertion that the move to a quadrennial cycle would lead to greater stability of contributions and lower costs before proceeding. In particular, we believe it would be prudent to understand employers' and auditors'

requirements in relation to accounting under FSR102 and IAS19.

Our principal objection to the move from triennial to quadrennial valuations is that it may weaken fund governance. Funds following best practice already carry out annual data validation checks and reviews of contributions for short term employers. However, whilst tPR's requirements in relation to data scoring should assist in relation to annual assessments of data quality, if there is no formal requirement for interim valuations the proposed mitigations may have no effect. We consider these points in more detail below in response to questions 5 and 6.

We are aware that the cost management process is under review, but alignment of the scheme and local valuations on a triennial cycle has not proved to be helpful for the 2019 local valuations. A further consideration should therefore be the timing of benefit/member contribution changes following the cost management process, and how these align with local valuation calculations. The aim should be to avoid a repeat of the current situation, where the 2019 valuations are to be carried out without knowing what the benefit structure of the LGPS as at the valuation date will be.

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

We can understand why MHCLG may believe this will be helpful, e.g. that the calculations could be based on the same set of data, but we do not believe that this will bring the hoped for benefits. We are aware that GAD had some material concerns in relation to the quality of the data as at 31 March 2014 (needed to establish the baseline for cost management calculations) and that it was thought that accuracy would have been improved had the date coincided with a local funding valuation. However, if funds are adhering to the new tPR requirements data accuracy should be improved regardless of the local valuation date. To the extent that there are concerns this isn't happening, extending the local valuation cycle may simply make the issue worse, as it will be longer between formal valuation data validation exercises.

In addition, GAD requires the split of membership movements between pre and post-2014 benefits and other data which is not needed for local valuations. It is therefore not clear that aligning the valuation cycle will necessarily improve the quality of the additional data required by GAD.

MHCLG doesn't cite this within the consultation document, but if quality of data is perceived to be an issue, we do not believe that aligning the valuation cycle is the right response.

It will also mean a further year between the cost management calculations and implementation of member contributions or benefit changes which could lead to greater changes to costs and hence more likelihood of the HMT cost management cost being outside of the 2% corridor which triggers member contributions or benefit changes.

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

We agree that approach b) (completion of the 2019 valuation with a three year Rates and Adjustments Certificate followed by another valuation as at 31 March 2022 and a two year Certificate) is preferred to a five year gap between the 2019 valuation and the next.

Approach a) has the disadvantages relating to scheme governance, potential larger changes in contribution rates due to additional intervaluation experience, and accounting implications referred to above, exacerbated by the period being 5 years rather than 4 years.

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 have long argued for powers to amend employer contributions between formal triennial valuations beyond the very limited circumstances currently set out in Regulation 64. We are therefore supportive of the introduction of a broader power to carry out an interim valuation and believe that this is vital to support administering authorities' risk management should local valuations be moved to a quadrennial cycle.

Question 6: Do you agree with the safeguards proposed?

We are aware that previous provisions permitting interim valuations were removed due to concerns about these valuations being timed to enable employers to take advantage of favourable market conditions. We therefore agree with the proposal that the circumstances in which an interim valuation would be carried out should be properly documented within the Funding Strategy Statement ("FSS").

An interim valuation is not defined within the consultation document, but appears to encompass both an approximate update as well as what might more traditionally be viewed as an interim valuation (which would be based on full membership data but may not require updated demographic assumptions)[1]. Of more importance is perhaps what the outcome of the interim valuation might be. Our assumption is that it should be carried out across the fund as a whole, which we would support given that for non-unitised funds this is required to ensure assets are appropriately allocated to employers. However, it presumably does not follow that contributions must be amended for all employers.

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

We believe that more flexibility is already needed to amend contributions between valuations so we welcome proposals to facilitate this. As we have noted on many occasions, it is very unclear how Regulation 64(6) can be used currently given the circumstances appear to be limited to liabilities being higher than expected for active members compared to the assumptions set out in the Rates and Adjustments Certificate by virtue of Regulation 62(8). Any proposals which seek to clarify Regulation 64 must be therefore be a positive step in the right direction.

It will be important to be able to amend contributions more frequently than quadrennially for all non-permanent employers (in practice principally the non-taxpayer-backed, Tier 3 employers). But as the consultation suggests, employer contribution reviews may be needed in other areas too, such as following a merger or take-over and this should be extended to material transfers of staff to or from any employer, whether involving another scheme or employer within the fund.

Our suggestion would be that any proposals should explicitly allow contributions to be changed:

- if an employer closes the fund to new entrants (this can currently be achieved via Regulation 64(4) but an explicit power would be preferable and arguably more transparent), including where one employer within a group or pool closes to new entrants
- if there is a material transfer of staff to or from an employer (noting this has become common in certain sectors, such as movements between MATs, and mergers of colleges and housing associations), or following a material outsourcing or insourcing
- if there is a change in covenant, including but not limited to a material change in the level or source of funding of an employer. (It is important that employers provide such information proactively to funds rather than it being for the administering authority to seek out such information)
- where an employer pays contributions above the level specified in the Rates and Adjustments certificate in any year then arguably remaining deficit contributions should be reduced. However, protections maybe needed to prevent payment of additional contributions to trigger a full review when market conditions are favourable, perhaps by limiting contributions reductions to those justified by the additional payment.

Other situations where contributions should be reviewed should be at the discretion of the administering authority and set out in the FSS.

We are less supportive of the reference to a scheme employer being able to request a reassessment because it believes this would lead

[1] We have formed this view based on the following wording: *it may not be necessary to revisit all of the demographic assumptions and scheme experience*

to a reduction in its contribution rate unless there are safeguards around it, as this provision may lead to employers picking the timing to request such a review, or pay a lump sum deficit contribution to trigger a review, to coincide with favourable market conditions. This would negate MHCLG's objective of stability of contributions and acknowledgement that safeguards are needed to avoid interim valuations being timed to reduce contributions. Therefore, we believe that any provision to allow employers to request reviews of contribution rates should not be so wide ranging that it is open to such manipulation.

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 tools?

We agree that it would be helpful and appropriate for there to be guidance on use of the new flexibilities, whether from CIPFA or the Scheme Advisory Board. If administering authorities' policies on interim valuations are to be set out in the FSS (which seems logical) we don't believe that SAB guidance **in addition to** CIPFA guidance would be helpful. It would be far more practical if all the guidance on the FSS were in the same place, ideally in the statutory guidance referred to in Regulation 58 (which currently refers to the 2012 version of the CIPFA guidance which has been superseded by the 2016 version).

We don't believe that administering authorities need to have identical policies, noting that this is not compatible with local decision-making nor the diversity of funding levels and employers within funds. However, it would be helpful for funds and employers alike if the *process* by which administering authorities' policies were derived were governed by a single set of principles set out within national guidance.

Assuming that the regulations are permissive and do not contain detailed requirements, both the content and the extent of adherence to the guidance will be important. We would therefore strongly encourage MHCLG to make provision for statutory guidance (which would be automatic if this were provided via the CIPFA guidance on the FSS). We also wonder whether there should be some sort of certification, e.g. within the annual report, that the guidance has been adhered to.

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

We would caution against the guidance being too prescriptive in relation to the exceptional circumstances in which an interim valuation could be carried out or in relation to the process for triggering an interim valuation. It would be helpful for there to be examples but the current uncertainties, including cost management, the outcome of McCloud, and GMP indexation and equalisation, could not have been predicted but might all lead to contributions needing to be reviewed for some or all employers between quadrennial valuations.

We are not sure what is intended by the reference to "*what level of professional advice is appropriate to deliver the interim valuation*". Our assumption is that an interim valuation should not be undertaken without having been signed off by the Fund Actuary. We would be keen to better understand MHCLG's intentions here.

It will be important that it is clear that it is administering authorities and not employers who have the final say on reviewing employer contributions. Employers may request interim valuations for accounting purposes and administering authorities should be able to accede to those requests without then being obliged to review the employer's contributions.

As members of the Institute and Faculty of Actuaries and employed by a firm regulated by the Financial Reporting Council we are subject to the profession's Code of Conduct and Technical Actuarial Standards. Whilst we fully recognise the need for local authorities to demonstrate best value, including in relation to pension fund costs, we would be very uncomfortable if an external party were to dictate what constitutes a "*proportionate level of actuarial advice*" since our work and advice must always comply with our professional standards. In our experience administering authorities are very clear in their requirement to seek best value, and significant cost savings have been achieved via the National

Framework, so we are rather disappointed that MHCLG appears to believe it needs to dictate or somehow limit the level of actuarial advice required by administering authorities.

Other areas which the guidance could cover include:

- Situations it is expected funds should include in their FSS as requiring an interim valuation
- Timescales: "as at" dates for interim valuations, timescales for signing off interim valuations and timing of implementing new contribution rates
- Situations that shouldn't, on their own, trigger an interim valuation

In terms of who is best placed to offer guidance, the key consideration we believe should help determine this is knowledge and experience of administering the LGPS and in particular the limitations of the current approach and potential unintended consequences and pitfalls in implementing any new flexibilities. The ability to develop guidance in a timely fashion should also be considered. We would also note that the guidance could be quite wide-ranging and the organisation which is best placed to provide guidance on interim valuations may not be best placed to provide advice on employer covenant assessments, and vice versa. Finally, as noted in our response to question 8, we think it would be sensible to avoid having CIPFA and SAB guidance which both relate to the provisions of the FSS.

Flexibility on exit payments

There are a couple of potential mis-understandings on MHCLG's part in this section, as follows:

- exit payments from the LGPS are not calculated on a full buy-out basis. This is private sector terminology and not applicable in the LGPS because liabilities cannot be transferred to an insurance company. They are, however, often but not always, calculated on a "low risk", or "gilts" basis, in particular to reduce the chances that ongoing employers will have to meet any future deficits arising on "orphan" liabilities (i.e. liabilities for which no individual employer has future funding responsibility).
- liabilities on exit need not be "significantly higher than their ongoing contributions". The approach Aon takes to ongoing funding is to advise administering authorities to ensure a degree of consistency between how ongoing contributions are set and how exit valuations are carried out, in particular for admission bodies, although affordability and other issues mean that an exit payment can and often does still arise. There are still situations where ongoing contributions are set using a materially higher discount rate which ignores the exit position, particularly now exit valuations can be carried out for scheduled bodies.

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?

Our understanding is that this is already possible, given that the LGPS in England and Wales has an identical provision to Regulation 61(6) in Scotland – Regulation 64(4), although as this regulation applies before exit it is not clear how it interacts with Regulation 64(2). Administering authorities we advise regularly use this provision to review contributions for short-term employers between formal triennial valuations. However, we are not aware that it is widely used to permit spreading exit payments, often on the grounds that for most community admission body exits there are real concerns about whether the body will continue to exist for long enough to make spreading a justifiable approach for the fund.

The consultation refers to use of legal side agreements but in our experience use of legal side agreements has been aimed at achieving a solution akin to the deferred employer route rather than to simply spread the exit payment.

That's not to say that we are dismissive of the suggestion of additional flexibility and are of the view that the current regulations are unclear and could be improved upon. Further, in situations where secure scheduled bodies exit leaving orphan liabilities this flexibility may be useful (e.g.

it was the approach taken following the magistrates transfer to the PCSPS).

Finally, it would be useful if MHCLG could clarify that it is not their intention to consider encouraging the spreading of exit payments in circumstances where liabilities are not being valued on a low risk/gilts basis, i.e. a weaker ongoing funding target is being used in the exit valuation. From an administering authority perspective we would not typically be supportive of extending flexibility in such cases since, particularly where the exiting employer is a contractor, it is not obvious that any bond would cover payment of an exit debt in instalments and hence spreading the payment would automatically increase risk for the fund/other employers.

However, scheme employers and contactors may have a different view and are likely to want the flexibility to spread repayments over a suitable period, in which case a maximum spreading period for the LGPS as a whole could be helpful in order to provide consistency across funds. The consultation uses a 3-year period as an example and this could be a suitable maximum timeframe.

The greater the disconnect between the ongoing funding basis for determining employer contribution payments and the basis used for the exit valuation the greater the rationale for permitting the spreading of the exit deficit since this could be significant and not accounted for in contractors' budgets.

Administering authorities may feel more comfortable allowing contractors (and other admission bodies) to spread exit payments if appropriate security is in place, e.g. a bond or continuation of the guarantee provided by the letting authority.

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

Yes. We have previously suggested similar provisions to those introduced in the private sector would be useful for the LGPS as set out in our Spotlight dated May 2017. Feedback from administering authorities and employers during the evidence gathering for the Tier 3 review has strengthened our view that such provisions would be helpful.

As ever, the devil will be in the detail and it will be important for any proposed regulatory provisions and associated guidance to be robust and subject to a further, detailed consultation. We would be particularly keen to ensure that any regulatory changes flow through to Regulation 62 and other relevant regulations.

We would also observe that if a deferred debt arrangement can only be entered into when an employer "has just, or is about to become an exiting employer" this make may it more difficult for administering authorities to develop their funding strategy to cope with the possibility of these arrangements. Employers not admitting new entrants may wish to have clarity years in advance of their potential exit that they will be able to continue to participate as a deferred employer and may be hoping to reduce certified contributions as a result. Given the uncertainty of the timing of any exit and the employer's covenant at that point, it may not be prudent for administering authorities to reduce employer contributions in anticipation of them becoming a deferred employer. Thus whilst it will assist in reducing the effect of a one-off exit payment being required, it may not have the desired effect of reducing ongoing contributions in the meantime.

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?

We agree that any deferred employer arrangements need to include safeguards for the administering authority. We have seen legal side agreements which appear to commit the administering authority to continue to adopt "an ongoing basis" (i.e. the funding target adopted for local authorities) during the period of the agreement which appears to significantly favour the employer to the detriment of the fund (the only benefit to the fund being that there is an ongoing employer which would meet future funding risks). If the employer had sufficient resources at the point of exit to pay a gilts basis exit valuation entering into such an agreement would, in our view, represent poor risk management by the fund.

However, viewing the proposed changes through the lens of a contractor/other employer we can see

that being able to request deferred status may be beneficial and justifiable in certain circumstances. Assuming letting authorities support that view (noting that if the deemed employer route is implemented there may be far fewer transferee admission bodies exits in future), the option to spread exit payments could be made available for employers to request as long as suitable guidance is provided to administering authorities on how to assess such requests.

As well as the provisions set out in 3.3(iii) of the consultation document, we would like to see provisions that

- termination could be triggered on significant deterioration of covenant without an associated insolvency event, as by that point it could be too late to recover the full remaining exit debt
- either the employer or the fund can trigger termination without agreement of the other party providing that this then leads to an exit valuation being carried out

As we have previously mentioned to MHCLG officials and colleagues at LGA, there is a difference of opinion between administering authorities as to whether or not operating different investment strategies for different employers is consistent with the LGPS Regulations. Where deferred debt arrangements are being entered into, and the liabilities will become orphan when the arrangement ends (we think it unlikely administering authorities will wish to enter into open-ended agreements), a "flight plan" approach whereby the funding and investment strategy are regularly reviewed in light of the longer-term target of being fully funded on a gilts basis may be appropriate, particularly for larger employers. In order to ensure consistency of understanding of what is possible within the Regulations, it would be useful if specific reference could be made to an alternative investment strategy being permitted for deferred employers. This may be of benefit to both the fund and employer in terms of risk management.

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?

Whilst we agree that key obligations and entitlements should be in Regulations, we think that it would be useful for the Regulations to list the considerations which must be included in any deferred debt arrangement, like the list of matters to be included within an admission agreement in Part 3 of Schedule 2. This would ensure greater consistency as well as providing a minimum standard for such arrangements.

Ultimately it should be for administering authorities, having taken appropriate advice, to weigh up the risks and competing interests of stakeholders so we agree that these matters should be for fund discretion. However, if SAB guidance is only "advisory" the risk will remain of some administering authorities entering into arrangements without as thorough an assessment or understanding of the various risks as would be best practice. As these proposals represent a material shift in how employer exits are dealt with, we believe the guidance should be statutory rather than advisory. It should be noted that a deeper risk analysis does not imply a more risk averse approach leading to infrequent use of deferred employer arrangements. Such analysis could in fact provide administering authorities with the confidence to enter into such arrangements. Statutory guidance could therefore be in the interests of exiting employers if it results in more administering authorities being willing to enter into deferred employer arrangements. Given changes to the Regulations implemented earlier this year we note that it seems that only the Secretary of State can issue statutory guidance. We are not sure if that was intended to preclude SAB from developing guidance which is then adopted and issued by the Secretary of State; it would be useful if MHCLG could confirm.

In any event, regardless of who is responsible for the guidance we would strongly suggest that it is developed in collaboration with LGPS practitioners who have experience of implementing legal side-agreements. SAB's approach of using appropriately skilled working groups to take forward initiatives has generally worked well but we believe it is absolutely vital here if the detailed policy is to be provided in guidance and it is to be effective and operate as intended.

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

As noted above our view is that 2 is already available but further clarity on the regulatory provisions and implementation would be welcome.

We also agree with the introduction of deferred debt arrangements, albeit with strong safeguards for funds and supporting guidance to ensure greater consistency, whilst retaining local discretion.

Question 15: Do you consider that statutory guidance or Scheme Advisory Board guidance will be needed and which type of guidance would be appropriate for which aspects of the proposals?

As noted above we believe that guidance is needed and in relation to the deferred debt provision in particular, that it should have statutory force rather than be advisory only.

Exit credits

We are not dismissive of the concept of introducing symmetry between surpluses and deficits on exit and understand the earlier changes were intended to address the concerns of employers that they would pay for a deficit but couldn't benefit from a surplus.

However, in our response to the previous consultation we did highlight that a blanket change affecting all exits could lead to material problems and issues with **existing** admissions and in particular risk sharing and other arrangements between the contracting parties. We therefore welcome proposals to try to address those issues.

However, we are concerned about MHCLG's assertion that "an exit credit may be payable if..., the employer is in surplus on a full buy-out basis". That is not our understanding of the regulatory changes implemented with effect from 14 May 2018, noting that the Regulations do not prescribe the approach to use in valuing liabilities on exit.

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?

We agree that changes are required to remove the unintended consequences of the 14 May 2018 amendments. However, it is worth noting that there is a very wide range of risk sharing arrangements in place so it is not as simple as saying that if pass through is in place no exit credit is payable. In addition, by putting the onus on the administering authority, the fund will then be adjudicating on what is, in many cases, a contractual arrangement between two employers.

For example, where a cap and collar arrangement is in place there has clearly been risk sharing but it is not the case that the contractor has borne no risk. We assume it is not MHCLG's intention for partial exit credits to be paid? That could be extremely difficult to implement and would likely lead to disputes between employers as to how much risk had been taken and hence how much of any surplus should be repaid.

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

There are a number of ways in which an employer may bear less pension risk:

- Risk sharing arrangements that split pension risks between the two employers including cap and collar arrangements or where specific risks (e.g. excessive pay increases) are left with the employer
- There are different types of "pass through" arrangement – the employer may pay a fixed contribution rate or pay the awarding authority's contribution rate for the duration of the contract, and in this latter case some pension risk is being borne by the employer as their contribution rate will fluctuate
- In order to prevent costs increasing on outsourcing it is common for scheme employers to offer a commitment to absorb any assets and liabilities after the contractor exits the fund (often after the contractor has made good any exit debt). In such cases the exit valuation (and other valuations) would typically be carried out on the ongoing funding target used for the awarding authority, i.e. a

weaker basis than that used where orphan liabilities are left in the fund. While not conventional risk sharing, it could be argued that a contractor in this situation is benefiting from the arrangement so should be viewed as bearing less pension cost/risk.

As the contract price and other terms and conditions will have been determined on whatever basis was agreed at the outset, we believe a better solution than requiring an assessment of the extent to which the contractor has borne any risk would be to amend the Regulations so that no exit credits are payable for transferee admissions entered into before the date of the regulatory changes. As noted above, we suspect that trying to determine how much risk the contractor has taken will be very contentious and it is not clear that the administering authority is best placed to determine this where the risk sharing arrangement is documented outside of the admission agreement in a contract to which the fund is not party.

Alternatively (and this would have broadly the same effect in most cases) the changes could state that the administering authority can determine (as part of its funding strategy) that an exit credit is only due for existing admissions if the contractor is in surplus on a low risk/gilts basis on exit. This would be comparable to the private sector situation where payment of surplus on exit is only permitted if the assets attributable to the exiting employer exceed the estimated cost of the liabilities on a 'full buy out' or 'self sufficiency' approach (plus estimated administration and other costs).

Other factors to take into consideration could include the costs of administering the exit. For example, would it be appropriate for those costs to be deducted before an exit credit is paid so that the other employers do not have to pick up the tab where there has been material additional work or external advice required by the fund?

Employers required to offer LGPS membership

Question 18: Do you agree with our proposed approach?

Based on the feedback of many (but by no means all) HE/FE sector representatives during our data gathering for the SAB's Tier 3 review we agree that many in the sector will welcome the ability to control pension costs.

It is a policy decision for MHCLG on which employers must and which can participate in the LGPS but given the changes in the sector it does now appear arguable that HE/FE is not "public sector" and hence should not be required to admit new members.

If such changes were to be made we would suggest that:

- closing the scheme to new members should be facilitated via an admission agreement rather than a move to Part 2 of Schedule 2 (designating employers) since there is then a contractual agreement between the fund and the employer which governs the employer's participation. Thought would be needed as to the other requirements of admission bodies (e.g. the guarantee requirements) since not all of these would be relevant to the HE/FE sector
- consideration should be given to the treatment of sixth form academies since we assume they will not be given similar flexibility – whether or not this is an issue will depend upon whether it is likely that there will be further conversions from sixth form colleges to academy status

Employers should also be aware that choosing this approach may not immediately reduce their pension costs. Indeed contributions may even increase in the short term, as administering authorities are likely to want to recalculate the employer contribution rate, allowing for the fact the employer is now closed to new entrants and potentially altering the funding basis to reflect the shorter term nature of the participation of the employer.

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