SPENCE

CONSULTATION: LOCAL GOVERNMENT PENSION SCHEME REGULATIONS

Proposed changes to the scheme regulations to implement policies on Fair Deal for staff and Freedom and Choice in Pensions.

May 2016

To:

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Initial comments

We greatly welcome these proposals and the wider consultation. The pension aspects of public sector out-sourced contracts can be complex, however they are undoubtedly additionally onerous due to a complete lack of consistency between Funds in their approach to operating them. This often adds unnecessary costs to the procurement process, can result in less than best value for local authorities and can often be very frustrating for tenderers and Funds alike.

Any drive towards consistency, increased transparency and better communication would be valued.

There are a number of high level issues which I believe need to be addressed to achieve these objectives:-

Inconsistency between Public Sector Schemes – Funded and Unfunded

Steps have been correctly taken to encourage continued participation for staff in their current pension scheme post any procurement exercise, through the extension of access to unfunded schemes such as NHS, Teachers and Civil Service Schemes. However this has resulted in inconsistent treatment between these unfunded schemes and those that are funded, such as LGPS.

Tenderers using unfunded schemes commit to paying the required employer contribution over the term of any contract, but effectively no more. They are in a position then at the end of the contract to exit the Scheme without any cessation liability being due. Within LGPS employers could be subject to an additional liability with an associated deficit amount, reflecting any changes in the funding position over the period of the contract (for the inherited liabilities in Full – see below) and may even be subject to a significantly increased liability and debt reflecting a move to a gilts based cessation valuation basis.

Such an approach clearly results in unfunded schemes looking much more attractive to a contractor than LGPS, if it is possible for them to use these schemes. I believe it would be wholly consistent for LGPS to adopt a consistent 'pass through' process for all tendering work which would result in a more equitable and consistent approach, subject to my additional comments made below.

The Past Service Liability issue

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.

If an organisation is looking to procure a contract for a three year period why should they be burdened by multiple years of past service liabilities accrued by another employer (frequently a Council) and or built up under a former contract. The new contractor has and should have no responsibility for these liabilities.

The current mechanism adopted of notionally assessing the liabilities to be fully funded on an on-going basis' at the outset of the contract is an imperfect solution adopted as a 'quick fix' to look to deal with the issue. Procurers can inherit past service liabilities which dwarf any future service benefit which can be accrued over the term of the contract and become responsible for variations in the value of these liabilities over the contract duration and at the contract end date. The contractor can also become responsible for additional costs as a result of redundancy or ill-health early retirement based upon the full service period and not just proportioned to reflect the contractors period of participation. Attempting to deal with these issues, usually very imperfectly, is achieved via contract negotiation and terms which again adds unnecessary complexity, inconsistency and frustration.

By dealing with this issue properly by segregating liabilities, as is the case in most other large multi-employer schemes, the costs related to past service liabilities would be fairly retained with the employer who accrued them. Future service, over the period of the contract, becomes the responsibility of the new employer. There is therefore much less potential variability in the costs of providing the pension benefits allowing tenderers to better manage pension risk and therefore supply the tendering authority with more competitive and certain pricing. It also removes the issue of potentially multiple cessation options at the end of a contract depending upon whether the contract is renewed or will come to an end.

This increased and unfair risk undoubtedly discourages organisations from participating in the tender process which again is counter productive for the procuring authority.

Fund cessations

The application of a cessation debt on a gilts basis for contractual out-sourcing is wholly inconsistent with other public sector schemes, adopts a basis which does not reflect the usually short term nature of contracting, represents an unreasonable funding premium over the costs that could have been achieved by the contracting authority pre tender and actively discourages participation from contractors resulting in poor outcomes for public service.

A worked example

I've compiled this very simplistic worked example to highlight the issues contractors face. The figures are for representative purposes only and not intended to be LGPS liability specific.

If we look at a member aged 55 and on a salary of £40,000 who will transition to an out-sourced contract for 3 years on 1/7/16. The individual has been working for the Council for over 20 years so their on-going liability at the date of transfer is around £100,000. They will be accruing additional liabilities at a rate of around £5,000 pa over the term of the contract. The Fund is only 90% funded (i.e. equivalent assets of £90,000) so a shortfall of £10,000 at outset. Given this, at the outset of the contract, it would be assumed that the scheme was fully funded and the £90,000 actual assets were notionally viewed as £100,000.

So let's assume we're 3 years down the line. The total notional liabilities should be £115,000 but in reality they've increased as a result of market conditions by 10% to £126,500 and unfortunately the asset value including contributions is still £100,000. There is now a deficit of £26,500 (scheme funded to around 80% on an on-going basis). Now no-one would argue that the contractor should have to fund the liability for the period of the contract in full i.e. the £15,000, now valued at £16,500. This, given the scheme is 80% funded would leave a shortfall of £3,300. But why should the contractor have to fund the balance of £23,200 when these liabilities have nothing to do with this contract or that contractor?

In addition the position could be worse as if the contract came to an end and wasn't renewed the Fund could chose to look for a cessation debt (unless any alternative agreement was reached at out set). The likely cessation liabilities would be around £180,000 leaving a shortfall of £80,000 payable by the contractor. How can this possibly be equitable? Why should the original employer who accrued these liabilities suddenly lose responsibility for them? Equally why would any new contractor wish to take them on knowing that they're effectively assuming liabilities from another unconnected employer?

As if that wasn't bad enough, if the funding position had deteriorated pre an actuarial valuation which was happening within the 3 year contract period this could result in higher contributions, again based on the whole of the liabilities.

As the member is over 55 if the contractor looked to make him redundant there would be strain on fund costs payable as the member would be entitled to their pension at NRD undiscounted payable at 55. The contractor would be liable in full for these costs (again unless any alternative arrangement was agreed at outset) and they could run in to £10's of thousands. This is the result despite the fact that they were only responsible for about 13% of the total liabilities. Similarly they could be responsible for ill health early retirement strain costs.

Dealing with all this as part of any contractual negotiation is unnecessarily complex, time consuming and costly, and even then can still result in inequitable outcomes.

Being able to accurately allocate liabilities by employer service to more effectively deal with legacy past service benefits would greatly simplify the whole process, make it fairer and more cost effective for all as well as being likely to produce much better outcomes for the procurer. This, in conjunction with a consistent pass through mechanism on these accrued contractual liabilities, would greatly improve the tendering process.

Questions

Specific commentary on some of the points raised in the consultation.

Point 5 – Draft Regulation 6

The approach adopted by Funds of using the 50/50 option as something of a cash cow, by requiring employers to maintain their full contributions, despite a lower benefit accruing and a lower employee contribution being paid. This is particularly material with short term contracts. Contractors have been discouraged from promoting this option to their staff given that there is no immediate cash benefit

Point 10 – Draft Regulation 11

This is effectively transferring the risk of reduced benefits completely to the member and away from the Funds and while it may make the administrative running of the scheme simpler I have a concern that such a move could be contrary to the interests of the vast majority of members who find themselves in this circumstance.

Very clear instructions, information and guidance would need to be provided by the Fund to the member and even then a change this material could need the individual to take independent advice with an associated cost.

Point 14 – Draft Regulation 15

While I welcome the addition of exit credits to be paid to employers where they have over-funded their LGPS liabilities as it means contractors can , if they chose be more conservative in terms of funding their liabilities in the knowledge they will have any excess returned. In reality if gilts-based cessation valuations continue then the change is completely ineffectual as the circumstance is unlikely ever to arise as even material improvements to the on-going funding position are unlikely to be enough to see an employer over-funded on a gilts based cessation basis.

Point 15 – Draft Regulation 16

The use of employer exemptions to standard practice is unnecessarily complex. There should be a standard default position and if employers chose to move away from the default it should be clearly identified what the likely implications are and their potential costs. Having done this, employers should be liable for all costs of this type.

We welcome the other proposals made and particularly points 7, 11 and 28.

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- 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 and has a regular blog on Civil Society website (on which he has written extensively on Growth Plan). 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, and is a co-author of PLSA's local government pension scheme guides.

- David was involved on a DWP working party established by former Pension Minister Steve Webb to look at multi-employer pension schemes issues.