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Charity Finance Group

Ignorance is never bliss when it comes to the Local Government Pension Scheme

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The purpose of this briefing paper is to set out charities' options for participation in the Local Government Pension Scheme (LGPS) and managing exit payments. This will better equip charities to understand the risks when they bid for public service delivery contracts.

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Introduction

For the unaware charity, the decision to join the Local Government Pension Scheme (LGPS) can have very costly results. However, in this world, knowledge really is power.

It is an increasing trend that local authorities are seeking to outsource many of their services to third parties. Many of these, such as care for the elderly, leisure facilities, housing requirements and youth activities are areas where charities are often best placed to take on those obligations. However, in order to win such work local authorities are required by Fair Deal 2013 or the Best Value Authorities Staff Transfers (Pensions) Direction 2007 to ensure that staff who have transferred to a charity retain a right to earn benefits in the LGPS, even though such membership is not protected under Tansfer of Undertakings (Protection of Employment) (TUPE).

This means one thing for the relevant charity: it must agree to sign an admission agreement and become a participating employer in the LGPS, with all the financial risks that entails.

Sometimes overlooked by charities is that the LGPS is an actual pension fund with assets and liabilities, and therefore the prospect, or at present, the reality of funding deficits that must be made good. This contrasts with the Teachers, Civil Servants and NHS pension schemes, which are all unfunded pension promises, where there is no actual fund, just a contractual promise by the UK Government to meet future pensions via future tax receipts.

Under legislation, a charity participating in the LGPS must pay whatever ongoing funding rate is set by the Fund and, when participation ends, an exit payment is calculated often by reference to a notional cost of buying out the benefit with an insurance company. It is interesting to note that technically, the legislation does not specify how an ongoing or even an exit debt must be calculated. It is therefore very much open to councils and their actuary to set whatever basis they decide.

Therefore, in agreeing to participate, the unwary charity is agreeing to variable ongoing costs and an uncertain, and often material exit payment. Such exit payments can potentially bring the charity into an insolvency situation. Therefore, if a charity does not negotiate a better position with the outsourcing council before the contract commences to mitigate these risks, the charity is very much at the mercy of the Fund actuary and the relevant county council.

Current Context – the Lothian Pension Fund

It is in light of these funding risks that the recent decision by the Lothian has added further uncertainty because of a change they have made in their funding policy.

The policy adopted prior to 2015 by Lothian was:

- That it passed on liability to participating employers for benefits accrued by staff during their employment with the local authority – this meant that a participating charity was liable for any future deficit relating to benefits accrued by staff before they even transferred to the charity. Contributions could increase at the next valuation of the Fund to meet that shortfall;

- They calculated any exit payment (payable by the charity when it ceased to participate in the LGPS or ceased to have active members in the fund) on a higher cessation basis calculated on all liabilities, not just those accrued by the charity during its membership. This means that the charity had to fund a significant difference between the on-going basis (which determined the starting funding rate) and cessation basis.

So broadly, they adopted the standard position.

In 2015, we are told that Lothian took legal advice on its approach for admitted bodies where liabilities were transferred in from another public entity and as a result it agreed to change its policy on exit payments. Interestingly, the new policy sets out that exit payments will be calculated on the on-going basis for both transferred staff and any new staff that join the charity and are enrolled in the LGPS. No details are given as to why the previous approach was not acceptable "legally" and the reasons for change are stated to be based on fairness.

However, it has always been argued by actuaries and lawyers that setting a notional buy-out funding basis on exit was inequitable. The reasoning being that as the LGPS will never wind-up (and so no annuities will be bought), contributing an amount in excess of the ongoing deficit only benefits the other participating employers by reducing the overall ongoing deficit

Background to the LGPS

As mentioned above, because the LGPS Regulations 2013 are not entirely prescriptive about the terms of participation in the LGPS and funding these terms can differ between authorities – particularly liability for accrued benefits and exit payments - with some passing greater liability to a charity than others charities need to consider their approach with each admission agreement they adopt.

Clearly the cost and risk of participation in the LGPS will be a vital factor in any charity's commercial considerations about the value/profitability of entering into the public service delivery contract. In order to accurately price the outsourcing contract the charity needs to fully understand the potential cost and risk and it can be helpful to put these in the context of alternatives for participation when making that assessment of value.

The LGPS is made up of a number of Funds maintained by each local authority in England, Scotland, Wales and Northern Ireland (Administering Authorities) who are each required to set out their specific terms for participation (among other matters) in a Funding Strategy Statement. Charities can also seek to negotiate an alternative to the Funding Strategy Statement - experience tells us this is difficult but not impossible.

Where the Administering Authority is not the contracting authority – for example the county council may be the Administering Authority but the borough council is outsourcing the service – there may also be scope to reach agreement with the contracting authority to mitigate some of the liabilities transferred in accordance with a Funding Strategy Statement.

Key terms for the purposes of this note

Exit payment – the amount required to bring an existing charity’s share of the Fund to 100% funded when it ceases to participate in the Fund or ceases to employ active members in the Fund. The cost can be calculated on an ‘on-going’ or ‘cessation’ basis.

On-going basis – the cost of providing the LGPS benefits assuming payments from the charity calculated over the lifetime of the employee.

Cessation basis – the cost of providing the LGPS benefits assuming payments from the charity calculated over a shorter period of time (e.g. the date that the charity ceases to participate in the LGPS). This will give rise to a higher contribution rate than the on-going basis.

Regulations - the Local Government Pension Scheme Regulations 2013 (and references to a Regulation in this note are to the Regulations).

What charities need to know about the LGPS

1. How does a charity get certainty regarding its ongoing contribution?

Regulation 62 requires the Administering Authority to obtain an actuarial valuation of the Fund every 3 years. In the process they must determine the contributions payable by each employer, based on actuarial advice and taking into account the cost of future accrual so as to secure the solvency of the Fund (Regulation 62(5)) – and the amount by which this should be increased or reduced by reason of any circumstances peculiar to that employer (Regulation 62(7)).

The problem

Charities have no control over the assumptions used by the actuary, the investment strategy or actual experience. Charities do have control over certain factors such as wage increases, preferential early retirement terms or redundancy. This lack of control gives rise to uncertainty in the contribution rate that will apply after each 3 year valuation.

Possible Solutions include

Fixed rate contributions

- Administering Authorities can agree a fixed rate contribution that does not change over the life of the contract. This means that the charity does not bear any of the risk of adverse experience generating a shortfall in funding.

- This transfer of risk means that contribution rates are commonly higher than the standard contribution rate.

- The flipside to this arrangement is that if there is an improvement in funding levels, the charity would not benefit from this, although it has the advantage of being able to budget for fixed liabilities and therefore contract pricing becomes easier.

Cap and collar arrangement

- The Administering Authorities can agree a maximum and minimum contribution rate and the charity pays the prevailing rate, subject to those caps and collars.

- The charity benefits from a degree of certainty but the utility of the contribution minimum and maximum depends on how widely they are spread and whether they will actually bite.

The risks of Regulation 64(4) - the odd Provision

- Regulation 64(4) permits an Administering Authority to increase the contribution rate payable by a charity where, in its opinion, there are circumstances which make it likely that the charity will cease to participate in the LGPS or will cease to have active members in the LGPS in the future. The increase will be intended to ensure that any

exit payment will be paid by the date on which the Administering Authority thinks that this will happen.

- The use of this power, which is becoming more common, will depend on whether an exit payment is in fact due and whether a fixed rate contribution has been agreed. However, for those charities who pay contributions at the assessed rate and who are liable for an exit payment, this could have a significant impact on their immediate liabilities, perhaps at a time when they are not best placed to pay them.

- There is an increasing divergence amongst Administering Authorities, with some setting out clear terms for when this approach would apply, while others do not do so. Where this is unclear charities should seek confirmation about past practice and its intended use. The interaction of this power and any agreement on contribution rates in an Admission Agreement should be carefully considered.

2. Must the charity take on responsibility for funding past benefits of transferring members at the start of the contract?

No, not always. When a charity starts to participate, the Administering Authority will carry out a calculation to determine the applicable rate of future contributions. There are a number of variables to this calculation including: the assumed funding level of the Fund, the investment strategy adopted by the Administering Authority and the extent to which the charity is required to assume liability for benefits accrued by transferring staff prior to their transfer to the charity. Traditionally, it is assumed that the new employer will take full responsibility for all transferring staff's prior benefits. In other words, the current employing council is seeking to move the funding liability from itself to the charity. This seems a very unfair situation.

The problem

Administering Authorities are free to transfer liability for past accrual of benefits to the charity and therefore any deficit in respect of those past accruals. This means the charity would become liable not only for the cost of benefits earned while it is employing staff in the LGPS, but could also be liable for:

- Immediate payment of 'deficit contributions' to reduce an existing shortfall (for example, if the Fund is 90% funded at the point of participation and this is the basis on which contributions are calculated).

- Funding shortfalls that develop in the future in respect of those pre transfer benefits due to differences in reality and actuarial assumptions (for example if the Fund is 100% funded on an on-going basis at the point of contracting but at the next valuation is only 95% funded).

Possible solutions include

Negotiate an assumption of 100% funding whereby:

- The Administering Authority assumes that the Fund is 100% funded on an ongoing basis for historic liabilities (notwithstanding the actual funding level of the Fund is less than 100%).

- The Administering Authority agrees it will continue to ensure that the 100% funded position as the assumed starting point at all future ongoing and exit valuations but the charity remains liable for adverse experience generating a shortfall after the contract starts (such as material increases in salary/redundancy).

Fixed rate contributions and collar and cap arrangements will also be helpful.

3. Can the charity avoid potentially material exit payments?

This is the critical one. The Regulations require the Fund actuary to "obtain an actuarial valuation as at the exit date of the liabilities of the fund in respect of benefits in respect of the exiting employer's current and former employees" (Regulation 62(2)(a)) and a "revised rates and adjustments certificate showing the exit payment due from the exiting employer in respect of those benefits" (Regulation 62(2)(b)).

The exit date will be the date that the public service delivery contract comes to an end or the date that a charity ceases to have active members in the Fund if earlier (Regulation 64(1)(b)). It will also happen where there is breach by the charity of the terms of the Admission Agreement which sets out the terms of its participation in the LGPS.

The problem

- The Administering Authority decides whether any exit payment should be on an 'ongoing basis' or a 'cessation basis'. If the cessation basis is used a charity can be left with a significant increase in its liabilities, potentially at a time when it is in a poorer position to pay it (for example because it has just lost a material contract).

- The Administering Authority can determine the extent of the liabilities which must be covered by an exit payment (for example, whether it should be in respect of a funding shortfall or other costs that are within the control of the charity, such as redundancy costs), or whether such a payment will be due at all.

- The Administering Authority can also determine the time period for payment of that obligation and can spread the financial burden on the liable charity or effectively require payment on demand.

Possible Solutions Include

Fixed rate contributions

- Even where fixed rate contributions apply, the law will still impose on obligation on the exiting employer to pay the exit payment under Regulation 62. It is not uncommon to agree that an outsourcing employer will indemnify the exiting employer against the full exit debt where fixed rate contributions are agreed. Liability will commonly remain for the charity in respect of costs incurred by the charity as a result of redundancy, higher than expected wage increases or benefit augmentations granted by the charity etc but the material element of an exit debt will have been transferred to the relevant council.

Spreading the exit payment obligation

- If the charity does have an exit payment obligation and no indemnity, an Administering Authority could instead agree to give notice to suspend that liability for a period of up to 3 years. This can be done if, in the reasonable opinion of the Administering Authority, the charity is likely to have one or more active members contributing to the fund within the time specified in the notice (presumably up to 3 years).

- This is a new flexibility introduced by the Regulations and it seems more likely that this would be used where an outsourcing agreement is still in place but the original employees have left employment. It could also be beneficial for charities where a contract ceases but outsourcing work is a regular business occurrence and it has a commercial relationship with a particular Administering Authority (or authorities). While one contract may have come to an end there may be sufficient precedent for both parties to recognise that a new one is likely to start within a certain timeframe.

- The Regulations are not clear as to whether the exit payment must be made after the agreed period or whether the employment of employees participating in the LGPS is sufficient to cancel the need for an exit payment until that next contract expires. We think it likely that the debt is treated as never having arisen and therefore when cessation happens at a later point, a new debt would be calculated at that point in time.

Open and closed contracts

- Participation of the charity in the LGPS will be on either an open basis, where new employees taken on by the charity after the original transfer are entitled to join the LGPS (if providing the relevant “services” covered by the contract), or a closed basis, where only a pre-determined group of employees who are either in the LGPS or eligible to join at the point of transfer, will be permitted to join.

- Closed contracts clearly limit funding risk but charities must be careful not to cease to employ active members and so inadvertently trigger an exit payment unless covered by an indemnity. There are also technical legal arguments about whether ceasing to employ an active member would trigger the exit payment liability in certain circumstances. If in doubt legal advice should be sought.

Closing comments

Outsourcing councils are under no obligation to adopt a LGPS funding strategy that does anything other than protect the financial interests of the council itself. Without careful consideration of the potential risks and options, a charity can be left with escalating costs during participation and the possibility of a large debt at the end of the outsourcing contract, perhaps at a time when it is least able to pay.

There are possible ways to control LGPS costs during participation and when participation ends but this must be negotiated with the outsourcing council before entering into the admission agreement. Knowledge is key in these circumstances and ignorance almost certainly won't lead to bliss.

Whatever you do agree with the Council and/or the Pension Fund, it is imperative that the agreed matters are properly documented in the Admission Agreement or the outsourcing agreement setting out the terms of participation of the charity and proper legal advice will often be essential in documenting those terms and negotiating the approach adopted.

The comments in this briefing note are not intended to constitute legal advice. We strongly recommend that you obtain professional advice before entering into a LGPS admission agreement.