NextStep®

Guide to cessation for employers in the Local Government Pension Scheme

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PensionsWatch
ACTUARIAL CONTROL SYSTEMS

Introduction

This document sets out some general considerations regarding the consequences for an employer that ceases to participate in an LGPS fund. It is intended to be a useful resource for:

- Employers who may be considering joining an LGPS fund.
- Employers already in an LGPS fund who may be considering outsourcing a service or function to a private contractor.
- Employers who are considering ceasing participation in an LGPS Fund.
- Admission bodies who expect to cease to participate in a fund upon the expiry of their admission agreement.

It should be noted that each employer's circumstances are different, therefore this paper is no substitute for individual, tailored professional advice.

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What is cessation?

Cessation is defined as the situation that arises when an employer ceases to be a Scheme employer. This arises most commonly in the case of admission bodies (e.g. charities and private contractors).

Cessation can pose a major financial risk to any organisation to which it may apply. Typical situations that give rise to cessation are:

- An employer that ceases to have contributing "active" employees, for example employers that are winding down or whose employees can no longer afford the required level of employee contributions and are therefore opting-out of the LGPS.
- An employer that decides it can no longer afford the required level of contributions and wishes to put a cheaper pensions arrangement in place.
- An admission agreement terminates.

  This could be as a result of an admission agreement reaching the end of a fixed term, or may end in other circumstances as set out in the agreement.

The legal framework

Regulation 38 of the Local Government Pension Scheme (Administration) Regulations 2008, as updated by the Local Government Pension Scheme (Miscellaneous) Regulations 2012 describes special circumstances where revised actuarial valuations and certificates must be obtained.

Particularly relevant to the cessation of employers is Regulation 38(1) which sets out that:

- Where an employing authority ceases to be a Scheme employer, the Pension Fund's Administering Authority is required to obtain an actuarial valuation of the liabilities of current and former employees as at the termination date.
- The rates and adjustments certificate must be amended to show the revised contributions due from the employer with a view to providing that the value of the assets of the fund in respect of current and former employees of that body is neither materially more nor materially less than the liabilities of the fund in respect of those employees.

The amendments to the Regulations in 2012 now ensure that requirements above apply to all fund employers, including Scheduled Bodies. Although ordinarily, alternative arrangements are likely to be put in place to ensure the liabilities remain sponsored, for example, by transferring all liabilities to another Scheduled Body within the fund.

What is the main issue?

The above requirements often lead to significant and on occasion completely unaffordable contribution demands from the fund's administering authority. The main reasons why this may be the case are as follows:

- **The cessation valuation uses a different funding target to that of the ongoing funding valuation**

  More specifically, the fund's actuary may use more prudent assumptions in order to value the employer's pension liabilities when compared to those used for regular funding - in particular, future investment returns.

  This is often the main reason why a higher value is placed on the liabilities of the employer which can create or increase the magnitude of a deficit.

- **Adverse market conditions at the cessation date**

  This may lead to a high value being placed on the liabilities (the present value of expected future payments from the fund in respect of the current and former employees of the outgoing employer) and/or a low value of assets being attributed to the employer following a period of poor fund returns.

- **Investment mismatch between assets and liabilities**

  It is relatively rare for administering authorities to offer employers individually tailored investment strategies.

  This can exacerbate the impact above as the value of the assets attributed to the employer does not usually respond in a similar manner to the value of the liabilities under different market conditions.

- **Experience being worse than assumed at the last full assessment of the employer's position for the purposes of setting regular contributions**

  For example, pension increases may have been higher than expected over the period, and/or asset returns may have been lower than expected.

- **The revised rates and adjustments certificate may require that the final deficit be paid as a one-off lump sum, rather than spread over a number of years**

  Administering authorities may agree to settle a cessation debt by means of a series of regular instalments provided they are satisfied as to the employer's covenant. However the situation is complex and may depend on many other factors.

Further points related to these issues are set out below:

Cessation funding targets - what assumptions should be used?

There is no prescribed method for determining the assumptions to be used for a cessation valuation. The assumptions are generally considered to be the responsibility of the relevant administering authority, but will tend to be heavily influenced by the advice of the fund's actuary.

One common approach is for the cessation valuation to use low risk assumptions similar to those used by insurance companies when determining the market cost of annuities. The reason for this is to reduce the likelihood that other fund employers will have to pick up the cost of meeting the outgoing employer's liabilities at some point in the future, particularly if experience of investment returns and longevity turn out to be worse than assumed.

The low risk approach usually places a substantially higher value on the liabilities than the approach used in the regular funding valuation (although this may vary from fund to fund).

Where this is not anticipated by the outgoing employer and/or the administering authority this can sometimes cause severe financial difficulties for the employer. Actuaries refer to this as “basis risk”.

Sometimes a cessation valuation may be carried out using assumptions that give rise to a lower value of liabilities when compared to the “low risk approach”. This may occur when a specific fund employer, commonly a letting authority or an employer with a community of interest with the outgoing employer, agrees to sponsor the liabilities of the outgoing employer on exit from the fund. This protects the other employers in the fund and enables a greater degree of funding risk to be reflected in the cessation valuation.

Market conditions

The values placed on an employer's liabilities and share of assets at cessation are typically calculated using assumptions based on market conditions at that particular date (the “cessation date”).

The value placed on assets will normally take into account fund returns since the last valuation of the fund. Therefore if cessation occurs at a time where fund returns have been poor, the employer's share of assets could be lower than expected.

The value placed on liabilities is typically driven by gilt yields. These are used to derive a market view of a low risk investment return and also future inflation. When yields are low, this will increase the value placed on liabilities.

Asset / liability mismatch

The majority of assets in a typical LGPS fund tend to be return-seeking assets such as equities, which are generally considered suitable for matching the liabilities of employers that expect to remain in the fund indefinitely. However, these assets are volatile and do not generally move in line with returns on gilts and, consequently, the low risk value that is typically placed on the liabilities. This is called asset-liability mismatching, and it means that most cessation positions are inherently volatile. Of particular concern to employers is the potential for the value of assets to fall at a time when the value placed on liabilities is high.

This may be a particular problem for employers with fixed terms of participation who cannot choose when they exit. This means that an employer may be left with no option but to leave the fund at a time where the cessation debt is high.

Experience

Irrespective of the funding target in use, there can never be any certainty regarding the day-to-day factors that can affect an employer's assets and liabilities.

A cessation valuation typically requires completely up to date information regarding these factors and so any deviation from what was previously assumed can impact on the overall results. In particular:

- Updated membership data on the employees and former employees of the outgoing employer is normally required. This means that membership movements (retirements, leavers, deaths) since the last valuation are all fully accounted for. Actual experience will almost certainly be different to that assumed. In the case of small employers just one early retirement or death can have a significant impact on the cessation position.
- Fund investment performance data. Investment returns are extremely difficult to predict and will often lead to significant deviations from the expected position.
- Pension increases (based on CPI). Higher than expected pension increases will lead to increased liabilities and vice versa.
- Pay increases awarded to members. Although most of the above factors are beyond the control of any employer, it is important that the employer is aware of the impact of pay awards on pension costs because they directly influence those benefits that are still linked to final salary.

Spreading deficit payments

Another potentially unexpected and significant risk to employers on cessation is that any cessation debt calculated may be deemed payable as a one-off lump sum. This has been common practice in the past.

However, on occasion, greater flexibility may be granted. This might be when the administering authority is satisfied that phased payment is not detrimental to best interests of the fund as a whole.

Where an employer had previously been spreading any deficit payments over a period of years, it may come as surprise when the cessation deficit is requested immediately as a one-off lump sum. Where this is not budgeted for this can cause significant issues, and can even lead to the insolvency of an employer.

Return of surplus

In the relatively rare situation when an employer's cessation valuation shows a surplus of assets over liabilities, the LGPS regulatory environment does not permit this surplus to be returned to the employer. The deficit risk is therefore one-sided – deficits must be paid, but surpluses are not refunded.

Planning for cessation

Where exit from the fund is expected (perhaps as a result of an admission agreement reaching the end of its term), the fund should ideally be helping to prepare the employer for exit, and setting its regular valuation assumptions accordingly.

This is to reduce the risk of the value of the assets of the fund in respect of current and former employees of that body being materially more or materially less than the anticipated value of the liabilities of the fund in respect of those employees at the date the admission agreement is to end. However, the extent to which this can work in practice is somewhat limited if a matching investment strategy is not also implemented for the employer in question.

Regulation 38(4) of the Local Government Pension Scheme (Administration) Regulations 2008 has been subtly amended by the Local Government Pension Scheme (Miscellaneous) Regulations 2012 to encourage its use for the purpose of readying employers for planned exit from the fund.

Effectively the regulation encourages more frequent valuations to monitor the funding position and amend the contribution rates where required. However this practice is not mandatory and it remains to be seen whether the regulation will be used more regularly as a result of this change.

Risk sharing

Further complications may arise where a risk sharing agreement is in place between two employers in the fund (usually a letting employer and an admission body who is providing services on behalf of the letting employer following a successful tender). This would commonly protect the admission body for some of the pension risk that is deemed outside of its control, and can bring more stability to the admission body's cessation position.

How is cessation risk best managed?

Cessation risk is a real and potentially highly significant issue for many LGPS employers.

PensionsWatch actuaries have had many years of experience in dealing with cessation valuations, from both a fund and employer perspective and we advocate a pro-active approach.

- **Fully understand the cessation framework as it would apply to your organisation**

  We recommend that employers who are concerned about the impact of cessation contact us to discuss the issues and their own particular circumstances in more detail.

  Where a potential admission body has not yet joined the LGPS they may wish to discuss risk-sharing agreements with us to learn more about how they can mitigate any future cessation risk.

- **Confirm the approach taken by the administering authority as regards the cessation valuation**

  The Funding Strategy Statement (FSS) published by each LGPS fund may describe the approach taken on cessation, however this may not always contain the required level of detail.

  PensionsWatch can conduct enquiries on an employer's behalf, on a no-names basis as required.

- **Consider the merits of requesting a bespoke investment strategy**

  Although relatively uncommon, some administering authorities are open to the suggestion of maintaining bespoke investment strategies for individual employers.

  Perfect matching is not technically possible, however, a significant element of market risk can be removed by adopting a more matched investment strategy. Clearly, however, timing is critical and so the employer will not wish to "lock in" to any particular position until the financial conditions are appropriate – routine monitoring of the cessation position can help with this decision.

- **Regularly monitor the estimated cessation position**

  PensionsWatch has developed the NeXtStep web-based platform to be capable of providing monthly cessation debt estimates as a fully inclusive part of our fixed-price package.

- **Formulate an exit strategy**

  Proactive employers may wish to discuss potential exit scenarios long in advance of any decision. Informed decision making will require continuous monitoring of the cessation debt so the employer can be in a position to determine when market conditions are most favourable.

  Employers should also consider covenant issues as it is likely to have a significant bearing on any settlement terms that may be agreed with the administering authority.

Risk sharing agreements for new admission bodies

PensionsWatch actuaries have advised both admission bodies and letting authorities regarding commercial side agreements covering the sharing of pension risks, including the position on cessation. Typically such agreements are drawn up in consultation with the employer's legal adviser and sit outside of the formal admission agreement.

Actuarial input is vital in ensuring that the precise legal wording accurately reflects the intentions of both parties. This helps employers to understand and manage their cessation risk before they sign the admission agreement.

Finally, where an employer is considering participating in an LGPS fund, we suggest that they do not proceed before they understand the risk surrounding any subsequent exit from the fund. PensionsWatch actuaries have the skills and experience to help to guide employers through this sometimes overlooked and often misunderstood area of pensions risk.

Questions?

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