APPENDIX 7

NORTHUMBERLAND COUNTY COUNCIL PENSION FUND
Pension Fund Panel Meeting 20 September 2019

South Tyneside Council

Pensions Committee

Date: 26th September 2019

Pensions Administration

(for information and discussion)

Report of the Head of Pensions

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- **Purpose of Report**

1. This report briefs the Committee on developments in certain pension administration matters that are LGPS specific and also provides an update on non-LGPS specific matters which are of interest.

2. The Committee is asked to note the report.

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Background

3. This report provides an update to Committee on important pensions administration and governance matters that are of particular relevance at this time. The report is split into 2 main sections, namely:

- Local Government Pension Scheme specific matters; and
- Non-Local Government Pension Scheme specific matters which are of interest. Issues in this section of the report are for information only.

LGPS Specific Matters:

MHCLG consultation – LGPS: Fair Deal – Strengthening Pension Protection

4. In January 2019, MHCLG launched a consultation on a proposal to introduce the concept of Fair Deal in the LGPS. Fair Deal is not new and has applied to other public sector bodies for several years. However, whilst long mooted, this has not previously applied to local authorities or other Best Value bodies.

5. If introduced, Fair Deal will remove the option for staff to be granted access to a GAD certified broadly comparable scheme. Instead, outsourcing 'Fair Deal Employers' (this term will include most Scheduled and Designation Bodies) will be required to provide continued LGPS membership for "Protected Transferees" (a person with LGPS eligibility employed by a Fair Deal Employer).

6. The Fund submitted a response to the consultation on 4th April, a copy of this was included in the Pensions Administration report to Committee in June 2019. The response was largely supportive of the proposals.

7. MHCLG is considering the consultation responses at this time and a response from MHCLG will be expected in due course. Officers will continue to monitor the position.

MHCLG consultation – LGPS: Changes to the Local Valuation Cycle and the Management of Employer Risk

8. At the last meeting, Committee was informed of a consultation by MCHLG called the 'Local Government Pension Scheme: Changes to the Local Valuation Cycle and the Management of Employer Risk'. A verbal update was also provided to Committee, which set out the Officers views at that time, and sought to gain the views of the Committee which could be fed into the response.

9. The deadline for responding to the consultation was 31st July 2019. A copy of the Fund's proposed response was circulated to Committee and Local Pension Board members on 23rd July 2019, to provide the opportunity for members to comment. The final response was then submitted on 30th July 2019 with the approval of the Chair and Vice Chair of the Committee.

10. A summary of MHCLG's proposals (underlined) and the Fund's response (italics) are as follows:

    (i) <u>MHCLG is considering moving the local fund valuation cycle from a triennial (i.e. 3 yearly) to a quadrennial (i.e. 4 yearly) basis.</u>

    We opposed this proposal as MHCLG has not established any real evidence base to support what they claim to be the benefits in switching to a 4 year valuation cycle.

    A 4 year valuation cycle, in many respects, makes sense for large public sector bodies (such as the local authorities); however, the LGPS is now a complex multi-employer scheme with many smaller and financially weaker employers. Moving to a 4 yearly valuation cycle brings increased risks in respect of financially weaker employers and is also a retrograde step from a governance perspective.

    The main drive behind the proposal seems to be a desire, on the part of central government, to align the valuations for all of the public service schemes for comparison purposes. In our opinion, this is a weak rationale, particularly when the risks to the LGPS are considered.

Should MHCLG implement the proposal, they have set out 2 options for local fund valuations in the LGPS in order to align the public service schemes at the 2024 valuation (effective from 1 April 2025):

a) for the current valuation to be for a period of 5 years; or
b) for the current valuation to be for the standard 3 years with a second valuation in 2022 for a period of 2 years.

Whilst we remain opposed to the move to a 4 yearly valuation cycle, we are expressing a preference for option (b) as this is considered the least risky option.

(ii) <u>Introducing additional powers to mitigate the risks of moving to a quadrennial valuation.</u>

The additional powers proposed are:

(a) power for an administering authority to undertake an interim valuation in limited circumstances;

(b) power for an administering authority to require a reassessment of an employer contribution rate to respond to changes in the financial position of the employer; and
(c) power for an employer to require a reassessment of its rate if its liabilities have reduced.

We have maintained our opposition to the proposals in section 1 and do not think the proposals in section 2 fully mitigate the risks to the LGPS posed by moving to a 4 year valuation cycle. Nevertheless, we would welcome the introduction of the additional flexibilities set out at (a) and (b), even if the valuation cycle remains at 3 years.

We are opposing (c) on the basis that this could create an administrative burden for the Fund and employers may also look to exploit this power when markets are performing well in order to seek a lower contribution rate.

(iii) Introducing additional flexibilities in recovering exit payments.

The additional flexibilities proposed are:

(a) a power for an administering authority to agree to an exit payment being recovered over a period of time; and
(b) introducing the concept of 'deferred employer' status in the LGPS so that an employer can exit, but still contribute to the Fund.

Provided sufficient security is in place, we are supportive of (a) and not necessarily opposed to (b), but query whether (b) is necessary given the power contained in (a). Our main issue with 'deferred employer' status is that a deferred employer may never have a true exit date. This then creates additional administrative burden for the Fund and additional costs.

(iv) Proposals for an administering authority not to repay an exit credit (i.e. a surplus when an employer leaves the Fund) where risk sharing provisions between an outsourcing employer and a contractor meant the contractor did not bear the pensions risk.

We fully support the sentiment underlying this as some very inequitable situations have arisen in the LGPS. We have managed to avoid this in TWPF and our new Exit Valuation Policy (approved by Committee in September 2018) has assisted in this regard.

The problem with the proposals is that they could effectively impose a duty on us to review contractual documentation that we were not a party to and then require us to make a determination on the intention of the parties as set out in the contract. This brings with it a risk of criticism, appeal and possible legal proceedings against the Fund.

Whilst we fully support MHCLG in seeking to address the problems experienced in the LGPS with respect to exit credits, the proposed solutions are flawed.

(v) Proposals for colleges and universities to be able to close LGPS eligibility for future recruits (existing staff are to be protected).

We have opposed this proposal as it is not good for the Scheme. Our colleges and universities are large scale employers and, should they close membership, the active membership of the fund will fall which would impact cashflows and likely bring forward the date the fund matures.

11. Now that the consultation deadline has passed, it is for MHCLG to consider the representations received before MHCLG makes any determination on how to proceed. Officers will monitor the position and keep Committee updated.

Ongoing Consultation – Guaranteed Minimum Pensions

12. In a number of earlier reports the Committee has been advised that in February 2017 the Fund responded to an HM Treasury ("HMT") consultation on options for how the Guaranteed Minimum Pension element of pensions paid to those members who will reach state pension age on or after 6th December 2018 should be indexed. Since then members have been provided with an update at each meeting.

13. In January 2018, HMT published its response to this consultation. This acknowledged that it is a complex area and more time is required to identify a long term solution. As a result, it will now extend the existing interim solution, covering those members of public service schemes reaching state pension age between 6th April 2016 and 5th December 2018 to those that reach state pension age on or before 5th April 2021. Further time will then be taken to identify the longer term solution.

14. The interim solution increases the value of liabilities in the LGPS, though this increase is not generally material and the Fund Actuary did not need to review employer contributions before the 2019 valuation.

15. It is expected that further consultation will take place, but to date no further progress has been made. The Committee will be kept up to date on this matter.

SAB Review - Academies

16. The Scheme Advisory Board ("SAB") has commenced a review of the participation of existing academies and commissioned PwC to investigate these issues and prepare a report.

17. The report, which was released on 17th July 2017, made no recommendations but set out three broad types of approach or mechanisms to try and resolve these issues. These are:

    - non-regulatory measures within the LGPS
    - regulatory measures within the scheme, and
    - measures outside of the LGPS, including through primary legislation.

18. The SAB review has been split between a funding working group and an administration working group. Work on the administration working group was put on hold due to competing work pressures; however, this has now been lifted and work on this is to resume.

19. Officers will continue to monitor the position and update Committee accordingly.

SAB Review – Tier 3 Employers

20. In addition to the review noted above, the SAB has also commissioned some work in respect of "Tier 3 employers" in the LGPS.

21. Broadly speaking, Tier 3 employers are those employers which: (i) have no tax raising powers, (ii) are not backed by an employer with tax raising powers; or (iii) are not an academy.

22. It is understood that the SAB is seeking to identify the potential funding, legal and administrative issues and liabilities relating to Tier 3 employers.

23. SAB has established a small working group to review concerns expressed by Tier 3 employers and the ways in which they may be resolved. The working group is tasked with reporting back to the SAB with a set of recommendations for further consideration. At the current time, no changes are expected in advance of the 2019 valuation.

24. The latest MHCLG consultation which covers potentially removing the 'requirement' for further education corporations, sixth form college corporations and higher education corporations in England to offer new employees access to the LGPS, is understood to have its roots in this review.

25. The Committee will continue to be updated on this matter

SAB Review – Good Governance in the LGPS

26. In 2014/15 the SAB commissioned a project to look at the issues and challenges of potentially separating the pensions function of LGPS administering authorities from their host authorities.

27. The review centred on the potential conflicts of interest that can arise. The view was expressed that, in principal, the greater the separation between the Pension Fund and the employers, the lesser the risk there is of a conflict arising.

28. Whilst a report was produced by KPMG on this subject no firm decisions were taken on how to progress and the initiative was largely put on hold as the SAB prioritised other areas of work such as pooling and academies.

29. In 2018/19 the SAB restarted this initiative and following a tender exercise appointed Hymans Robertson to assist with the project on the "good governance of the LGPS". As part of its role, Hymans undertook a survey with a limited range of stakeholders. Amongst other things, views were sought on the following governance models:

Model 1 – Improved practice: Introduce guidance or amendments to LGPS Regulations 2013 to enhance the existing arrangements by increasing the independence of the management of the fund and clarifying the standards expected in key areas.

Model 2 – Greater ring fencing of the LGPS within existing structures: Clearer ring-fencing of pension fund management from the host authority, including budgets, resourcing and pay policies.

Model 3 – Joint Committee (JC): Responsibility for all LGPS functions delegated to a JC comprising the administering authority and non-administering authorities in the fund. Inter-authority agreement (IAA) makes JC responsible for recommending budget, resourcing and pay policies.

Model 4 - New local authority body – an alternative single purpose legal entity that would retain local democratic accountability and be subject to Local Government Act provisions.

30. Hymans recently completed its report for SAB and a link to the report was initially sent to Committee members on 31st July 2019 and was followed up on 12th August with further details and a summary of the report. It can be noted from the report that the survey responses showed the most favoured governance model of those listed above was Model 2. Model 2 is the most closely reflective of the arrangements South Tyneside Council operates for Tyne and Wear Pension Fund.

31. Following the survey, Hymans made a number of recommendations for SAB to consider in order to improve governance in the LGPS. The recommendations can be summarised as follows:

I. To take an 'outcomes-based' approach to governance in the LGPS with minimum standards rather than a prescribed governance model. Hymans considers it preferable to specify what outcomes are desired so individual administering authorities can then set their own governance procedures. Hymans does not view prescribing a 'one size fits all' governance model as appropriate for the LGPS.

II. The 'outcomes based' approach should include:

(a) robust conflict management, including clarity on roles and responsibilities for decision-making;
(b) assurance on sufficiency of administration and other resources (quantity and competency) and appropriate budget;
(c) explanation on employer and scheme member engagement and representation in governance; and
(d) regular independent review of governance – this should be based on an enhanced governance compliance statement which should explain how the required outcomes are delivered.

III. Enhanced training requirements for s151 officers and Pensions Committee members (the requirements for Committee members should mirror those for Local Pensions Board members).

IV. For central guidance to be updated to be more applicable for the modern day LGPS.

32. Overall, there is nothing within the Hymans report which proposes anything revolutionary from a TWPF perspective. Nevertheless, the report has made recommendations only and the final outcome may yet differ from what is listed above.

33. For the next stage of the project, SAB has again invited Hymans to continue to provide support. Two working groups are to be established, one to focus on defining good governance outcomes and the guidance needed to clearly set them out and the other working group to focus on options for independent assessment of outcomes and mechanisms to improve the delivery of those outcomes. Both working groups are to comprise a wide range of stakeholders within the LGPS and the working groups are to report back to SAB at its next meeting in November. The proposals SAB considers recommending to MHCLG will be consulted on before SAB formally reports back to MHCLG.

34. Officers will continue to monitor the position and update Committee accordingly.

Cost Management Review / McCloud

35. A cost control mechanism was introduced in public service pension schemes following the Hutton review. The aim was to provide protection against unexpected changes in pension costs.

36. In the LGPS, the cost cap mechanism is complicated by the fact that there are two control mechanisms in place. Both are complex and work in similar ways but are not identical to each other. The cost review mechanisms are run by:

    (i) Scheme Advisory Board (SAB) – this is non-statutory and is intended to give an 'early warning' of any changes to costs; and

    (ii) Her Majesty's Treasury (HMT) – this is the statutory cost cap, and 'trumps' the SAB version. Proposed changes from the SAB exercise can however, be taken into account by the HMT process when considering their exercise.

37. Both caps have a 'target cost' (determined using Government Actuary's Department (GAD) assumptions) and the underlying legislation requires action to be taken if the target under the HMT cost cap is breached by 2% of pay e.g. if the target was 19.5% of pay, a breach would occur if the cost fell to less than 17.5% or rose above 21.5%. The action involves changes to the benefit or employee contribution structure to bring the cost back to the target cost.

38. As noted above the SAB calculation is intended as an early warning mechanism and as such takes place in advance of the HMT calculation.

39. The outcome of the SAB calculation was a total Scheme future service cost of 19%, against a target of 19.5%. The reduction in cost is believed to largely be attributable to a lower than assumed increase in life expectancy.

40. Consequently, the SAB considered changes to the benefit package and contribution rates to bring the cost back to the target level. It made a proposal to Government which included:

    - removing Tier 3 ill health benefits with eligible members to receive Tier 2 instead;

    - the introduction of a minimum death in service benefit of £75,000;

    - enhanced early retirement factors for members active on 1 April, applied to all service;

- some amendments to the employee contribution rates at the lower salary levels and others to address tax anomalies.

41. It was estimated that these changes would add additional costs on average of around 0.9% of pay. The above changes, subject to agreement by Government and following a consultation exercise, were initially expected to be introduced with effect from 1 April 2019.

42. In advance of this agreement, the LGA and SAB recommended that steps be taken to prepare for these amendments. Consequently, the Fund wrote to Scheme employers and recommended that steps be taken to prepare for changes to the Scheme with effect from 1 April 2019.

43. Despite the direction of travel previously appearing clear, an unexpected complication arose in the shape of the court cases of McCloud and Sergeant (collectively referred to as McCloud).

44. The McCloud case related to transitional arrangements in the Judges' Pension Scheme that were alleged to amount to age discrimination. If the claimants were successful in establishing the transitional arrangements amounted to age discrimination, this would result in additional pensions liabilities being incurred.

45. Although neither McCloud nor Sergeant directly related to the LGPS, the judgement was considered to be of relevance to all public service schemes. On this basis, Central Government suspended the Cost Cap Review pending the outcome of McCloud.

46. On 20 December 2018, the Court of Appeal upheld the claimants' action and found that the transitional arrangements did result in age discrimination. Central Government sought leave to appeal to the Supreme Court, but, on 27 June 2019, the Supreme Court refused the Government's application. Consequently, the decision of the Court of Appeal stands and the transitional protections provided in the Judges' Pension Scheme and the Firefighter's Pension Scheme are legally classed as age discrimination.

47. On 15 July 2019, HMT confirmed expectations that the McCloud judgement will be treated as applying to all public service schemes. This means that additional liabilities will arise for employers in the LGPS, although the level of impact is not yet known. The timing of this development is unfortunate given LGPS funds are undergoing the triennial valuation.

48. Officers have discussed the position with the Fund Actuary, Aon. It is accepted that some allowance needs to be made for McCloud in the 2019 Valuation, but, at the time of writing, discussions remain ongoing with Aon on how best to allow for the court judgement and the resultant increase in liabilities.

49. A verbal update will be given on this at Committee.

Non LGPS Specific Matters

Public Sector Exit Payments Cap

50. The Small Business, Enterprise and Employment Act 2015 introduced the concept of a 'public sector exit payments cap'. The legislation provides that exit payments to be paid to a person are not to exceed £95,000. The 2015 Act provided the overarching principles of how the exit cap was to operate, but the detail was to be prescribed in regulations that were expected to soon follow.

51. This matter was very topical in 2015 and 2016; however, following the referendum on EU membership, the matter was placed in abeyance as 'Brexit' dominated central government's attention.

52. After several years of inactivity on the public sector exit payments cap, HMT launched a new consultation on this matter in April 2019. Included in the consultation were draft regulations called 'The Restriction of Public Sector Exit Payment Regulations 2019' (the "Exit Cap Regulations 2019") which provided most of the detail on how the exit cap regime will operate from an employer's perspective. The consultation posed 8 specific questions all targeted at employers, not administering authorities.

53. Under the Exit Cap Regulations 2019, it is proposed that the exit cap will be phased into the public sector, but local government is covered by phase 1. The exit payment cap is to remain at £95,000 despite the passage of 4 years (i.e. it is not index linked) and the exit payment amount is determined by the accumulation of the following:

    - redundancy payment(s);
    - any payment to offset an actuarial reduction to a pension arising by virtue of early retirement (we refer to this as a 'strain on the fund' cost);
    - any payment made pursuant to an award of compensation under the ACAS arbitration scheme or a settlement or conciliation agreement;
    - any severance payment or ex gratia payment;
    - any payment in the form of shares or share options;
    - any payment on voluntary exit;
    - any payment in lieu of notice due under a contract of employment;

- any payment made to extinguish any liability under a fixed term contract;
- any other payment made, whether under a contract of employment or otherwise, in consequence of termination of employment of loss of office.

54. As can be seen from the above, the list of what can contribute towards the exit payment cap is extensive. Of particular interest to the Fund is that 'strain on the fund' costs are included towards the cap. In this context, it should be noted that strain on the funds costs alone can exceed £95,000. It can also be noted this is not just in respect of higher earners. Strain on the fund costs can also exceed this amount for members with long periods of membership.

55. Despite the subject matter of the consultation being largely employer issues, Officers submitted a response, in agreement with the Chair and Vice Chair of the Committee on 3 July. Details of the proposed response were emailed out to the Committee and the Local Pension Board on 1st July 2019. A summary of the response is as follows:

- in respect of the LGPS, further clarity is needed on the methodology for calculating partial reductions to benefits;
- consideration should be given to standardising the calculation of strain on the fund costs across the LGPS to avoid inconsistencies across the Scheme;
- the Exit Cap Regulations 2019 should not be implemented until the requisite amendments have been made in the LGPS Regulations;
- concern has been expressed that relatively low earners may be caught by the cap, provided they have sufficient long service.

56. It is now for HMT to consider the consultation responses before HMT decides how to proceed with the exit payments cap. Officers will monitor the position and update Committee accordingly.

Repayment of public sector exit payments (also referred to as "clawback")

57. As well as the public sector exit payment cap, the Small Business, Enterprise and Employment Act 2015 allows for the introduction of a mechanism for the repayment of some or all of qualifying exit payments to be repaid by high earners (i.e. those earning £80,000 or more) should they return to public sector employment within 12 months.

58. Consultation occurred on this proposal in 2015, but this continues to be held in abeyance. Unlike the public sector exit payments cap, the “clawback” provisions are not being progressed at this time.

Competition and Markets Authority (CMA) – Review of Investment Consulting and Fiduciary Management

59. Recently the CMA published a report following a review of the investment consulting and fiduciary management markets. Earlier the CMA had set out a draft Order, setting requirements for the appointment and governance of fiduciary managers and for pension funds to set objectives for their investment consultants. Although the draft Order did not impact on the LGPS, the final Order, published on 10th June, does now extend to the LGPS.

60. As the Fund does not have any fiduciary manager appointments, this part of the order is not relevant, however, the requirement to set formal objectives for the Fund’s investment consultant (Hymans Robertson) does apply. The Fund has six months to comply with these requirements.

61. Discussions are taking place with Hymans Robertson on how best to comply with this new requirement. A fuller report will be brought back to Committee in November 2019.

Recommendation

62. The Committee is recommended to note the report.

26th September 2019