PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

A GUIDE FOR EMPLOYERS PARTICIPATING IN THE LGPS

NAVIGATING ENTRY INTO THE LGPS: FOR LOCAL GOVERNMENT CONTRACTORS

CONTENTS

1. INTRODUCTION

OVER 13,000 EMPLOYERS HELP TO DELIVER LOCAL PUBLIC SERVICES. THESE EMPLOYERS ARE TYPICALLY BUSINESSES, CHARITIES, AND HOUSING ASSOCIATIONS.

If a local authority contract involves the transfer of staff to your organisation under a TUPE arrangement, you will come to participate in the Local Government Pension Scheme (LGPS) as an 'admission body', or will be required to provide a 'comparable' pension benefit.

The LGPS provides a good quality pension for its members. However, participation in the scheme comes with potentially significant financial commitments and administrative responsibilities, including:

- Making regular contributions on behalf of employees and making additional contributions if the scheme is in deficit;
- Facilitating communications with scheme members; and
- Setting up administrative processes for making payments and providing data to the scheme when requested.

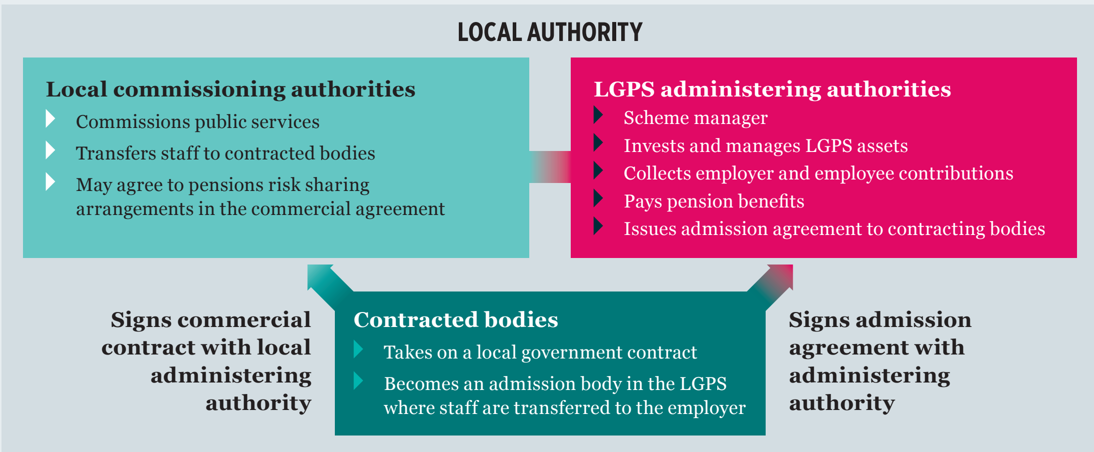
This guidance will help you to obtain a full appreciation of these obligations and any associated risks before entering into a local government contract.

WHAT IS THE LGPS?

The LGPS is a defined benefit (DB) pension scheme for employees working in local government. It is made up of three schemes – the England and Wales scheme and two additional devolved schemes in Scotland and Northern Ireland.

Members of DB schemes are promised a guaranteed pension income in retirement. This means that the financial risk of the scheme's investment falls to you as an employer in the scheme.

The LGPS is governed at national and local level by a number of different bodies[1]. As an admission body, you need to be aware of the relationships between the local commissioning authority and the local administering authorities.



You will engage with the commissioning authority on the terms of the contract you are tendering for ('the commercial contract'); and the administering authority regarding the terms of entry into the LGPS. These terms are governed by an 'admission agreement', a legally binding contract between you, the commissioning authority, and the administering authority.

1 See here for more information about how the LGPS is governed.

HOW IS THE LGPS FUNDED?

The LGPS is funded through the contributions of all employers and employees participating in the scheme. The contributions you pay are valued as an estimate of what the benefits are likely to cost when they are paid. These contributions are then invested to seek a return that can meet the promises made to members.

If the value of the pension scheme assets is not sufficient to meet the promises made to scheme members then the scheme is considered to be in deficit. If you exit the scheme, the cost of meeting the pension scheme liabilities that have accrued during the time of your participation may have decreased or increased. The deficit attributed to admission bodies is calculated at the end of the contract and levied as exit costs.

The local administering authority acts as scheme manager and so is responsible for investing and managing LGPS assets, setting employer contribution rates, collecting employer and employee contributions, paying pension benefits as they fall due, and dealing with various other aspects of administration.

The LGPS' funding position has weakened considerably over the last decade. A number of factors, such as increasing longevity and low gilt yields, have contributed to this; resulting in a rising deficit[2].

2 A full set of figures from the latest scheme valuation can be found here.

2. WHAT DO YOU NEED TO KNOW BEFORE ENTERING THE SCHEME?

BEFORE MAKING A DECISION ABOUT TAKING ON A LOCAL GOVERNMENT CONTRACT THAT RESULTS IN ENTERING THE LGPS, YOU NEED TO UNDERSTAND:

- The process of joining the scheme (see Section 3);
- Risks associated with participating in the scheme (see Section 4);
- How these risks might affect your financial prospects and how to mitigate them (see Section 5);
- Your obligations as an employer participating in the scheme and how they could change in the future; and
- Opportunities for negotiating terms of entry, participation and exit.

GOOD GOVERNANCE

You should formalise governance processes to understand and ultimately make decisions about proceeding with becoming an admission body.

Getting this right is critical as you need to be able to assess whether the contract is still viable after taking into account financial commitments to the LGPS. The following steps capture the basic principles of setting up a good governance process.

STEP 1

Check whether or not the commercial contract involves a TUPE arrangement.

STEP 2

Investigate the terms of the standard admission agreement with the administering authority and which of them are negotiable or can be amended alongside the commercial agreement with the contracting authority.

STEP 3

Analyse how the terms of the admission agreement as they stand and possible amendments to them are a risk to the cost-benefit of the commercial contract.

STEP 4

Assess whether, in light of your organisation's risk framework and financial position, the commercial contract and admission agreement is appropriate to take on in its current or an amended form.

WHO IS RESPONSIBLE?

A number of people in your organisation need to be alert to the pension obligations associated with taking on a local government contract.

In the first instance, those responsible for submitting your contract tender need to be aware that local government contracts could include LGPS admission agreements.

Next, the person responsible for identifying the terms of the admission agreement ideally should be someone who has a sufficient ‘pensions vocabulary’. In larger organisations you may have the capacity to train up senior members of your contracting team to find out and interpret essential information from the administering authority. In smaller organisations this may be your finance personnel, chief executive or even an accountant, actuary or legal adviser.

The person responsible for assessing the desirability of the contract will vary. Ultimately, where it involves taking on significant risk, this decision may need to be escalated to your senior executive team or board. They may wish to seek expert advice to make a fully informed decision.

MAKING A DECISION ABOUT PARTICIPATION IN THE SCHEME

A cost-benefit analysis of the contract that factors in LGPS costs, should only form a part of the decision-making process. Other important factors such as your financial position, aims, and what contingency mechanisms you have in place to deal with outstanding liabilities should also be considered.

3. WHAT YOU NEED TO KNOW, AND WHEN, DURING THE TENDERING PROCESS

THE TERMS OF THE ADMISSION AGREEMENT NEED TO BE CONSIDERED AS PART OF THE OVERALL PROCESS OF THE TENDER ALONGSIDE THE TERMS OF THE COMMERCIAL AGREEMENT.

There will be little room to manoeuvre beyond the standard admission agreement issued by the administering authority; however, you will have the opportunity to negotiate risk-sharing arrangements in the terms of your commercial contract with the commissioning authority.

Below we provide an explanation of what you should be thinking about at each stage of the tendering process. It is important to build in time for a series of exchanges between the three main parties. In particular, those you engage with from the commissioning authority may have varying levels of knowledge about the pension implications of the contract they are assigning and so may have to seek external advice.

PRE-TENDER

- Will you be taking on employees who are currently participating in the LGPS?
  - How many?
  - What are their ages, salaries and accrued benefits?
  - On what terms will their liabilities be transferred?
- Do you wish to allow new employees, who work on the contract but are not required to participate, to participate in the LGPS? (This is called an ‘open’ contract.)
- Who will you engage with on pension issues at the administering and contracting authorities?

INVITATION TO TENDER

During the tender process you should request the following information:

- Guidance for admission bodies (where available);
- An example admission agreement with an indicative contribution rate;
- The latest actuarial valuation of the fund;
- The commissioning authority’s policies on pensions risk-sharing;
- Whether a bond or indemnity is required; and
- Your exposure to additional costs that could arise due to redundancy, ill health and death in service of the transferred employees.

SUBMISSION TO TENDER

When submitting your bid for the contract, the price should include a prudent, risk-adjusted measure of the costs of providing the service that includes the cost of LGPS participation[3].

CONTRACT AGREED WITH THE COMMISSIONING AUTHORITY

Any risk-sharing with the commissioning authority should be agreed at this phase (see Sections 4-5).

ADMISSION AGREEMENT AGREED WITH THE ADMINISTERING AUTHORITY

The admission agreement and all of the paperwork relating to being set up as a new employer in the fund should be completed at this time. Although this and the previous stage are ordered sequentially, in practice they need to be considered alongside each other from the start of the contract.

3 NAO guidelines state that contracts should cover core costs and, for charities, that donations shouldn't be used to cover the costs of delivering a statutory service.

4. RISKS FOR ADMISSION BODIES PARTICIPATING IN THE LGPS

THE MAJOR UNFORESEEN COSTS THAT MAY COME WITH LGPS PARTICIPATION ARE:

- Increases in contributions during the term of the contract;
- Exit costs – what the fund requires at the end of the contract; and
- Unexpected increases to staff remuneration, which have a knock-on consequence for contributions during the term of the contract.

INCREASES TO CONTRIBUTIONS

There are a large number of variables that determine the cost of benefits as they accrue, including:

- Economic conditions;
- The investment profile of the fund assets;
- The current membership of the scheme; and
- Longevity projections for scheme members.

The interplay of these variables, and changes in them over time, can lead to substantial changes in employer contributions over the term of your contract. By law, the fund will undergo an actuarial valuation every three years to assess how these factors will affect contributions. However, there are circumstances where such a valuation can be brought forward outside of this cycle – most admission agreements will indicate this.

During the valuation the actuary will recalculate:

- The past service contribution rate – in relation to the deficit or surplus; and
- The future service contribution rate – in relation to the current estimated cost of providing the benefits promised in the scheme.

To make your liability for the past service liabilities of transferred employees clear to you, admission agreements will state that, on the date of your contract commencing, your participation in the scheme starts as '100% funded'. This term can be misleading, so it is important to understand what it does and doesn't mean.

When employees are transferred to you, the fund will assess whether there is a deficit relating to the funding of the scheme for those employees. If the scheme is in deficit, being 100% funded means that you are not responsible for the deficit that has arisen before you took on those employees. However, you do take on the liabilities relating to those employees, which can change over time. You will be responsible therefore for any changes to the deficit that arise from the commencement of the contract in relation to those past service liabilities.

For example if the employees' notional scheme is £5 million in deficit when you start the contract, then you won't be liable to pay extra contributions to ensure those past service liabilities are fully matched. If however, on the next valuation, that £5 million deficit has grown to £6 million, then, unless you have negotiated another arrangement, you will be liable for the extra funding gap that has arisen in relation to those employees' past service liabilities over the course of your contract – an extra £1 million.

Changes in these liabilities will, in turn, be reflected in your contribution rate and any exit costs payable at the end of the contract.

COVENANT ASSESSMENT

Your contribution rates will be affected by the administering authority's view of your 'covenant'. This is your financial ability to support your obligations to the scheme now and in the future.

You should have the capacity to feed into discussions about the covenant strength allocated to you[4]. It is important that you understand the rationale behind your allocated covenant strength, what this means for your participation in the scheme, and what factors will improve or worsen your position. Higher contributions will be required from an employer with a 'weak' covenant, because the administering authority has concerns about weaker employers' ability to pay if the deficit increases.

EXIT COSTS[5]

Exit costs are paid when you cease to participate in the scheme, and have the potential to be very high.

You are deemed to exit the scheme, known as a 'cessation event', when:

- the commercial contract has ended;
- Your last 'active' member (ie. members that are still accruing benefits) leaves the scheme; or
- You undergo an insolvency event so no longer employ any active members in the scheme.

There are also some situations where a corporate restructure (eg. a merger or an acquisition) results in an effective cessation event, because a new entity employs the members.

Where there is no successor body agreeing to take on the liabilities, or no guarantor in place, cessation or exit debts are generally calculated using more cautious assumptions (known as a 'risk-free' basis) than the basis used to calculate the cost of providing pensions for your employees, resulting in higher liabilities. This basis is employed to minimise the risk that deficits attributable to members of departing employers inadvertently fall onto other employers as 'orphan liabilities'.

BONDS AND OTHER SECURITY

To mitigate the risk that employers won't be able to honour their commitments to the scheme, many administering authorities will ask for some form of indemnity against an inability to pay, such as a bond, security or a parent guarantee.

Different administering authorities apply different policies regarding what the bond is designed to cover. Some simply cover the costs of any likely redundancy payments on early termination. Others may go far wider and cover exit costs.

Bonds can be expensive to provide and may have a negative impact on your sponsor's balance sheet. Companies are not always willing to provide bonds readily; particularly if they already have a number of other bonds in place.

4 The Pensions Regulator provides helpful guidance on covenant assessment for private pension schemes – many of the same principles apply to employers participating in public service pension schemes.
5 Please see our 'managing exit' guidance for further information.

COST OF REDUNDANCIES, ILL HEALTH AND DEATH IN SERVICE

When an employee is made redundant or suffers ill health, they may be eligible for early retirement benefits from the LGPS. If an employee dies in service then their beneficiaries are due a sum that is a multiple of their salary.

When these events occur, you may need to pick up the increased value of the benefit earned over the member's total service. Some administering authorities make their own insurance provisions for these purposes so that the employer rate includes a small amount intended to cover these costs.

Most commissioning authorities will require you to pay for any increase in costs due to redundancies or greater-than-expected numbers of early retirees separately – and so where you are planning redundancies, it is important to factor in this cost.

5. MITIGATION OF RISKS

THERE ARE MANY WAYS TO LIMIT YOUR EXPOSURE TO RISKS FROM PARTICIPATING IN THE LGPS. THE MOST IMPORTANT THING TO REMEMBER IS THAT ONCE YOU ARE AN EMPLOYER IN THE LGPS, THE REGULATIONS, THE COMMERCIAL CONTRACT AND THE ADMISSION AGREEMENT WILL CONTROL YOUR RELATIONSHIP WITH THE LGPS.

To the extent that you can mitigate risks, it will be through the commercial contract. Different commissioning authorit ies have different policies on which risks they are willing to cover for admission bodies.

Some common risk mitigation measures are described below:

- Unless you have an agreement with the administering or contracting authority to the contrary, you are responsible for all past service liability which includes pensionable service accrued prior to you taking on the contract. You may want to ensure that you are isolated from this funding risk. You should discuss with the commissioning authority options to remove responsibility for any past service liability accrued before the start of the contract.
- You should seek to have liabilities dealt with on a consistent (actuarial) basis on joining and exiting the scheme in order to avoid unexpected exit costs.
- If you have agreed to assume the risk for pre-contract past service liability then care should also be taken over the actuarial basis used to calculate this. Even if there is no funding volatility over the course of the contract, pre-contract liability could be calculated on a higher basis at exit.
- Some funds will allow the costs arising from ill health retirements and deaths in service to be smoothed through your ongoing contributions or, especially for small contractors, shared among a pooled group of similar employers. The default position is for these additional costs to be levied by a single payment.
- Costs arising as a result of redundancy are generally considered an employer decision rather than a risk to be shared. However, there may be some room to discuss how costs arising very early in a contract are handled.
- It may be possible to request that the contracting authority pays any excess should contributions exceed a stated ceiling. This is known as a 'pass-through' arrangement.
- A more sophisticated arrangement is a 'cap and collar' arrangement where the contracting employer agrees to pay contributions only if they are within a certain range. If they fall outside this range, adjustments are made to the contribution rate.
- You can agree to restraints on your own behaviour or options so as to reduce risk of increasing liabilities. A commissioning authority may agree to retain certain risks if the contractor takes responsibility for matters affecting pension liabilities under its control, such as excessive pay awards.

NOTES

Pensions and Lifetime Savings Association
Cheapside House,
138 Cheapside,
London EC2V 6AE

T: 020 7601 1700
E: plsa@plsa.co.uk

www.plsa.co.uk

May 2016