Exit Credit Policy

Address and purpose

This paper has been commissioned by and is addressed to London Borough of Tower Hamlets in its capacity as Administering Authority to the London Borough of Tower Hamlets Pension Fund ("the Fund"). It has been prepared by Hymans Robertson LLP (as Fund Actuary) to assist the Fund in developing a policy in respect of exercising its discretion on the payment of exit credits. This paper should not be used for any other purpose.

Introduction

The LGPS Regulations 2013 were recently updated to address issues that emerged as a result of previous changes requiring Administering Authorities to pay exit credits when an employer ceased to be a participating employer while in surplus on their respective exit basis. Previously, the Fund's Actuary would determine the level of any exit credit to be paid. However, the updated Regulations, while still requiring the Actuary to carry out an exit valuation, place the responsibility for determining the level of any exit credit on the Administering Authority, having considered various factors.

Therefore, we recommend the Fund puts in place a policy on how it will make its determination such that:

- A consistent approach is taken between employers and over time; and
- The interests of all parties, including any employer providing a guarantee, are taken into account.

This paper sets out the key considerations the Fund may want to take into account when developing a policy on the payment of exit credits.

New Regulations

The updated regulations that have changed how exit credits are determined are Regulation 62 (2ZAB) and Regulation 62 (2ZC) which are reproduced with our observations below. Please note, we are not lawyers, the Fund may wish to take independent legal advice when considering our interpretation of the Regulations.

Regulation 62 (2ZAB)

An administering authority must determine the amount of an exit credit, which may be zero, taking into account the factors specified in paragraph (2ZC) and must-

(a) notify its intention to make a determination to-

(i) the exiting employer and any other body that has provided a guarantee to the exiting employer under paragraph 8 of Part 3 to Schedule 2 to these Regulations;

(ii) where the exiting employer is a body that has participated in the Scheme as a result of an admission agreement under paragraph (1)(d) of Part 3 of Schedule 2, the Scheme employer in connection with the exercise of whose function it was providing a service or assets; and

(b) pay the amount determined to that exiting employer within six months of the exit date, or such longer time as the administering authority and the exiting employer may agree.

Our interpretation of the above Regulation is that the Fund must notify all parties involved, including any employer providing a guarantee (or some other form of employer financial assistance/support) that a determination as to the level of exit credit will be made. Presumably, this is to allow the interested parties to provide representations as to the level of exit credit to be paid. In addition, the period given to the Fund to pay an exit credit has been extended from 3 months to 6 months compared to the previous Regulation. 6 months can still be a relatively short period of time to finalise the membership data, acquire an exit valuation, allow interested parties to make

representations and for the Fund to make a final determination. Therefore, the Regulation does allow some flexibility where the Fund and the exiting employer can agree an extension to the 6 month period.

Regulation 62 (2ZC)

In exercising its discretion to determine the amount of any exit credit the administering authority must have regard to the following factors-

(a) the extent to which there is an excess of assets in the fund relating to that employer over the liabilities specified in paragraph (2)(a);

(b) the proportion of this excess of assets which has arisen because of the value of the employer's contributions;

(c) any representations to the administering authority made by the exiting employer and, where that employer participates in the scheme by virtue of an admission agreement, any boy listed in paragraphs (8)(1) to (d)(iii) of Part 3 to Schedule 2 to these Regulations; and

(d) any other relevant factors

Considering each of the above points in some more detail:

Point a) the use of the word "extent" here is interesting as it relates to considering the size of the surplus. We do not see this as a relevant factor when determining whether an exit credit should be paid or not. When we carry out an exit valuation we base it on cashflow, investment and membership data provided by the Fund to determine the value of assets and liabilities on the employer's exit date. Therefore, the size of any surplus is a fact in these situations, not a point for consideration and debate. That being said, payment of an exit credit larger than that identified in an exit valuation may result in underfunding as at the exit date increasing risk to the Fund and any employers providing guarantees to exiting employers. Therefore, the exit credit identified in an exit valuation may be viewed as a maximum amount.

Point b) relates to the amount of the employer's contributions paid during its participation versus the value of the exit credit. This has been inserted to cover off situations where some short-term employers leave funds with large exit credits due mainly to strong growth on the assets that were transferred from letting authorities which have dwarfed any contributions made by the employer. The concern is that some employers attempt to 'game' the system and, before their contract end date, leave the Fund at a market high to access the exit credit. It is our opinion that, if this has been the intention of the employer, then the value of the exit credit should be adjusted to reflect the value of contributions paid. Such events could be the employer somehow terminating the contract early or triggering insolvency to access the monies to pay other creditors. However, if the employer is leaving as planned at the end of their contract then we would suggest that no adjustment is made to the exit credit. Our reasoning is that if investment returns had been poor and resulted in a deficit, the employer would be asked to pay back this deficit in full. In these situations the employer has been fortunate with the timing of their participation. Note that in arriving at this conclusion, it is our opinion that this viewpoint is the Fund fulfilling its obligations under the Regulations as 'must have regard' to this factor.

Point c) intends to allow any risk-sharing arrangements that sit behind an employer's participation to be taken into account. The Government has said however that there is no onus on the Fund to 'enquire into the precise risk sharing arrangements adopted'. Instead, it will be left to the employer and letting authority/guarantor to explain why the arrangements made by them make payment of an exit credit more or less appropriate. There is a risk that the Fund could get caught up in the middle of arguments between employers over commercial terms that were agreed outside the Fund, leading to higher actuarial, legal and internal management costs, and of course delays to the settlement of cessation valuations. It is worth noting that the amending regulations force the Fund to notify how it intends to deal with the exit credit to both parties ahead of any payment. To avoid the Fund being caught

in the middle of any such debate, we would suggest that the Fund firmly puts the onus on the employer and letting authority/guarantor to agree how any risk sharing arrangement should feed into the calculation of the exit credit and then present this agreed position to the Fund. This could be done via confirmation of which party is responsible for which funding risks (e.g. investment, member experience, assumptions etc). The Fund should still reserve the right to seek further information or ignore such representations based on legal and/or actuarial advice. In the absence of such agreement, the Fund may consider withholding the exit credit until the parties resolve any disputes.

Point d) provides wide ranging scope for the Fund to factor in anything in determining the value of any exit credit. In our mind, the most relevant factors would be:

- **The regulations in force when the contract was priced:** if the contract commenced before 14 May 2018 (i.e. before Exit Credits were payable), then it could be argued that the contract price will have priced in the asymmetric risk in respect of exit deficits and surpluses. Therefore, in the Fund's opinion, it is not fair to the letting authority to pay an exit credit in this circumstance (however, the contractor could challenge how that occurred). This should also apply to contracts which were originally awarded before May 2018 and then were extended or 'rolled over' to a new contract with no changes to the commercial terms. This point would not apply to any new admissions set up after 14 May 2018.
- **The nature of the employer's funding arrangement:** if the employer participated on a full pass-through basis, then the funding risks they were exposed to were limited so it may not be appropriate for them to benefit from the upside risk. Similarly, if the employer's funding strategy has been set at previous valuations in a way that recognises an arrangement with another fund employer (whether that be a formal guarantor, or otherwise), then a similar argument could also be made.
- **Unpaid contributions:** if the employer has not paid over some employee or employer contributions due then these may be deducted from the funding surplus when determining the exit credit. This is obvious in the situation where they have been allowed for in the calculation of the employer's assets at cessation. In the case where they have not been allowed for, the Fund may still want to make this deduction as a penalty for non-payment and to encourage employers to pay contributions on a prompt monthly basis (although this may result in a challenge from the employer).
- **Factors outside the Fund:** if, for example, the employer owed monies to the letting authority in other parts of the contract that was ceasing or owed monies in other contracts with the letting authority, then the Fund may view it as reasonable to deduct these monies when determining the exit credit. The Fund will need to tread carefully in these instances to ensure that the claim by the letting authority is genuine (and correct) and there are no tax or other legal implications. It will also need to consider how it will assess such claims to gain this level of comfort.

Disputes

In the Ministry of Housing Communities & Local Government's partial response to the consultation on Changes to the Local Valuation Cycle and the Management of Employer Risk, any disputes in respect of the Fund's determination should first be routed through the Fund's internal dispute resolution process (IDRP). It is also possible for disagreements to be escalated to the Pensions Ombudsman if the IDRP is not successful in settling matters. The Fund may wish to take independent legal advice on how to apply Regulations 74 to 78 in determining how the IDRP should be applied in these cases. In addition, complaint processes are normally aimed at resolving member disputes, the Fund may wish to review its IDRP to ensure they are capable of handling employer issues.

Recommendations

The introduction of the new Regulations in respect of exit credits puts an onus on Administering Authorities to decide the level of exit credit to pay to exiting employers. Based on our observations, we recommend the Fund consider the following when setting a policy on the payment of exit credits:

- Exiting employers are considered on a case by case basis, but the Fund follows certain principles in order to consistently apply their discretion to pay an exit credit;
- We recommend the maximum value of any exit credits is the surplus identified in the Fund Actuary's exit valuation on the exit basis appropriate to the exit event/employer;
- Admission bodies can terminate their participation in the Fund at any time, whereby scheduled bodies do not have this ability. Therefore, we recommend the Fund's policy differentiates by the type of body involved;
- Where an admission agreement began prior to 14 May 2018 (and commercial terms have not been revised since to allow for exit credits), we recommend the Fund sets the exit credit to nil as the potential for an exit credit would not likely have been priced into tenders for service unless proven otherwise;
- Where guarantees, pass through and risk sharing agreements are clearly set out, we recommend the Fund reflects these in their determination;
- Where the admission agreement ends early, and there are no pass through or risk sharing agreements, we recommend the Fund consider limiting any exit credit to the value of employer contributions paid over the employer's contract allowing for investment returns on those contributions;
- We recommend the Fund policy sets out that any disputes between the exiting employer and the letting employer are settled between those parties without the intervention of the Fund; and
- We recommend the Fund seeks legal and/or actuarial advice when making a final determination.

Based on the above, a draft policy is set out in the appendix to this report.

Reliances, limitations and professional notes

This paper should not be released or otherwise disclosed to any third party without our prior consent. Hymans Robertson LLP accepts no liability to any other party unless we have expressly accepted such liability.

This report proportionately complies with the relevant Technical Actuarial Standards set out below:

• TAS 100 (Principles of Technical Actuarial Work); and

• TAS 300 (Pensions).

Prepared by:-

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For and on behalf of Hymans Robertson LLP

15 May 2020

Appendix – draft policy statement

The below sets out the general guidelines that the London Borough of Tower Hamlets Pension Fund ("the Fund") will follow when determining the amount of an exit credit payable to a ceasing employer in line with Regulation 64 of the Local Government Pension Scheme Regulations 2013 ("the Regulations"). Please note that these are guidelines only and the Fund will also consider any other factors that are relevant on a case-by-case basis. These considerations may result in a determination that would be different if these guidelines were rigorously adhered to. In all cases, the Fund will make clear its reasoning for any decision.

Admitted bodies

1 No exit credit will be payable in respect of admissions who joined the Fund before 14 May 2018 unless it is subject to a risk sharing arrangement as per point 3 below. Prior to this date, the payment of an exit credit was not permitted under the Regulations and the Fund assumes this was reflected in the commercial terms agreed between the admission body and the letting authority. This will also apply to any pre-14 May 2018 admission which has been extended or 'rolled over' on the same terms that applied on joining the Fund.

2 No exit credit will be payable to any admission body who participates in the Fund via a pass through approach.

3 The Fund will make an exit credit payment (if any) in line with any contractual or risk sharing agreements which specifically covers the ownership of exit credits/cessation surpluses or if the admission body and letting authority have agreed any alternative approach (which is consistent with the Regulations and any other legal obligations). This information, which will include which party is responsible for which funding risk, must be presented to the Fund in a clear and unambiguous document with the agreement of both the admission body and the letting authority within one month of the admission body ceasing participation in the Fund.

4 If there is any dispute from either party with regards interpretation of contractual or risk sharing agreements as outlined in 3, the Fund will withhold payment of the exit credit until such disputes are resolved.

5 The Fund will also consider any representations made by the letting authority regarding monies owed to them by the admission body in respect of the contract that is ceasing or any other contractual arrangement between the two parties. The letting authority must make such representations in a clear and unambiguous document within one month of the admission body ceasing participation in the Fund.

6 Where a guarantor or similar arrangement is in place, but no formal risk-sharing arrangement exists, the Fund will consider how the approach to setting contribution rates payable by the admission body during its participation in the Fund reflects which party is responsible for funding risks. This decision will inform the determination of the value of any exit credit payment.

7 If the admission agreement ends early, the Fund will consider the reason for the early termination, and whether that should have any relevance on the Fund's determination of the value of any exit credit payment. In these cases, the Fund will consider the differential between employers' contributions paid (including investment returns earned on these monies) and the size of any cessation surplus.

8 The decision of the Fund is final in interpreting how any arrangement described under 3, 5, 6 and 7 applies to the value of an exit credit payment.

9 If an admitted body leaves on a gilts-exit basis (because no guarantor is in place) as set out in the Funding Strategy Statement, then any exit credit will normally be paid in full to the employer.

Scheduled bodies and resolution bodies

1 Where a guarantor or similar arrangement is in place, but no formal risk-sharing arrangement exists, the Fund will consider how the approach to setting contribution rates payable by the employer during its participation in the Fund reflects which party is responsible for funding risks. This decision will inform the determination of the value of any exit credit payment.

2 Where no formal guarantor or risk-sharing arrangement exists, the Fund will consider how the approach to setting contribution rates payable by the employer during its participation in the Fund reflects the extent to which it is responsible for funding risks. This decision will inform the determination of the value of any exit credit payment.

3 The decision of the Fund is final in interpreting how any arrangement described under 1 and 2 applies to the value of an exit credit payment.

4 If a scheduled body or resolution body becomes an exiting employer due to a reorganisation, merger or take-over, then no exit credit will be paid.

5 If a scheduled body or resolution body leaves on a gilts-exit basis (because no guarantor is in place), then any exit credit will normally be paid in full to the employer.

General

The Fund will advise the exiting employer as well as the letting authority and/or other relevant scheme employers of its decision to make an exit credit determination under Regulation 64.

Subject to any risk sharing or other arrangements and factors discussed above, when determining the cessation funding position the Fund will generally make an assessment based on the value of contributions paid by the employer during their participation, the assets allocated when they joined the Fund and the respective investment returns earned on both.

The Fund will also factor in if any contributions due or monies owed to the Fund that remain unpaid by the employer at the cessation date. The Fund's default position will be to deduct these from any exit credit payment.

The final decision will be made by Neville Murton, the Section 151 officer with responsibility for the Fund, in conjunction with advice from the Fund's Actuary and/or legal advisors where necessary, in consideration of the points held within this policy.

The Fund accepts that there may be some situations that are bespoke in nature and do not fall into any of the categories above. In these situations, the Fund will discuss its approach to determining an exit credit with all affected parties. The decision of the Fund in these instances is final.

The Fund will advise the exiting employer of the amount due to be repaid and seek to make the payment within six months of the exit date. In order to meet the six-month timeframe, the Fund requires prompt notification of an employer's exit and all data and relevant information as requested. The Fund is unable to make any exit credit payment until it has received all data and information requested.

If the exiting employer or letting authority wishes to dispute the determination of the amount of an exit credit, this must be routed through the Fund's internal dispute resolution process in the first instance.