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Dear Frank

Pension Payments in Advance

Further to our discussion last week after the Audit and General Purposes Committee and my subsequent email about your proposals to make deficit funding payments to the Oxfordshire Pension Fund, due originally to be spread over the next three years, as a single payment in April 2014. As the sums involved are likely to be significant and the law in this area is complex, we felt it would be helpful to set out our position on this matter in advance of the transaction taking place. You will understand, however, that it is not the external auditor's role to comment definitively on the lawfulness of transactions in advance and we cannot fetter our discretion by doing so.

As such a transaction is being considered by a number of councils across the country, the Audit Commission has obtained legal advice on this matter which it is sharing with auditors. This advice is included in the appendix to this letter. It was based on consideration of legal arguments put forward by one particular authority but the same general principles are likely to be applicable to all authorities. You should note that this advice was obtained by the Commission and does not therefore necessarily represent Grant Thornton's formal view.

We would wish to draw your attention to two particular areas in the advice:

- the view that the early cash payment can only be made if the actuary has issued a Rates and Adjustments Certificate which reflects this (so that the cash payment made is in accordance with the Certificate).
- the view that the amount payable for the year, if an early payment is made, is the full three-year amount and therefore that the General Fund needs to be charged this amount all in the first year.

Given the complexity of the law in this area, we strongly recommend that any council planning on making an early payment obtains its own detailed legal advice. Where councils have already obtained legal advice, they should review this advice to ensure that it addresses the issues raised in the Audit Commission's advice and in particular the two issues outlined above.

Once you have obtained or updated your legal advice, we will consider in the light of this advice whether or not we need to obtain specific legal advice pertaining to your particular

circumstances. We will also consider whether we need to exercise any of our powers under the Audit Commission Act 1998.

We appreciate that time is short given the proposed timing of the transaction. Given this, and the possibility that we may have to reconsider our position at any stage until the relevant year of audit is closed, should we receive new information or should there be any formal challenge (for example from local electors), we also recommend that, prior to committing to such an advance payment, you consider how you would reverse the transaction if necessary. This may be in relation to the timing of the charge to the General Fund or the cash transaction itself.

Please do not hesitate to contact me if you think a further discussion would be helpful at this stage.

Yours sincerely



PP

John Golding
Partner
For Grant Thornton UK LLP

Appendix – legal advice obtained by the Audit Commission

1 Introduction

You have asked for our advice in relation to the legality of local authorities making early payments into their pension funds. In order to secure savings and reduce risk,¹ a number of local authorities are considering paying the Local Government Pension Scheme (LGPS) deficit contributions for the next three financial years as a lump sum on 1 April 2014, rather than paying in monthly instalments. These payments are made in order to reduce the deficit in the pension funds. The “normal” contributions (ie contributions that fall due for each year to ensure assets are enough to cover potential liabilities) are made in monthly instalments as usual. The proposal in the example we have seen, is to make a cash payment of around £30 million on 1 April 2014 to reduce the deficit. This will then be charged to the General Fund on a yearly basis, in three roughly equal sums.

- 2 We understand, that as an accounting practice it is sometimes appropriate to pay cash and defer the charge to the General Fund. In this particular case, however, the charge to the General Fund is determined by the Code of Practice on Local Authority Accounting and the 2003 Local Authorities (Capital Finance and Accounting) (England) Regulations 2003

3 The Code of Practice on Local Authority Accounting

The Code of Practice on Local Authority Accounting (“the Code”) sets out accounting requirements that local authorities must follow. In England and Wales, the Code constitutes a ‘proper accounting practice’ under section 21(2) of the Local Government Act 2003 and Regulation 31 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003.

The Code follows International Accounting Standard Board approved accounting practice, except where it is necessary to depart from these due to specific statutory requirements. One such instance occurs in relation to accounting for costs relating to pensions. Paragraph 6.4.3.39 of the Code reads:

“The amount that shall be charged to the General Fund for providing pensions for employees is the amount payable for the year in accordance with the statutory requirements governing the particular pension schemes or funds in which the authority participates.”² ”

The effect of this is that the General Fund must be charged for the amount of local authority pension contributions for a particular year (i.e. annually), in accordance with relevant statute. The question is, what constitutes “the amount payable for the year in accordance with the statutory requirements.” Appendix B to the Code refers only to the Local Authorities

¹ Savings are achieved as a result of the higher rates of interest under LGPS, compared with the lower ones available under the Treasury Management Strategy, which appears to be how matters are currently conducted. The case study provided suggests that the risk involved in making a lump sum payment in advance are lower than investing under the Treasury Annual Investment Strategy.

² The paragraph continues: “Where this amount does not match the amount charged to Surplus or Deficit on the Provision of Services for the year under the Code, the difference shall be taken to the Pensions Reserve.” I am instructed that this sentence is not relevant for present purposes.

(Capital Finance and Accounting) (England) Regulations 2003, and subsequent amending legislation (in respect of England).

4 Local Authorities (Capital Finance and Accounting) (England) Regulations 2003

The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (“the 2003 Regulations”) makes provisions on capital finance and accounts under Part 1 of the Local Government Act 2003. This includes Regulation 30, which provides:

“For a financial year beginning on or after 1st April 2004, a local authority shall charge to a revenue account an amount equal to the retirement benefits payments and contributions to pension funds which are payable for that financial year in accordance with the [statutory requirements mentioned in] regulation 4(2).”

Regulation 4(2) provides:

“(1) Liabilities for retirement benefits appropriated to a pension reserve in accordance with proper practices are liabilities specified for the purposes of section 7(3)(c)³.

(2) For the purposes of paragraph (1) and regulation 30, ‘retirement benefits’ means benefits payable pursuant to [statutory requirements under an arrangement accounted for as a defined benefit pension plan or as other long-term employee benefits (as defined in accordance with proper practices)].”

Proper practices are set out in the Code, as approved by Regulation 31: in other words, it is still necessary to have regard to further legislation in order to consider what “pension funds which are payable for that financial year” means (and whether this could include the proposed annual lump sum deficit repayment amount.

5 Local Government Pension Scheme (Administration) Regulations 2008

The Local Government Pension Scheme (Administration) Regulations 2008 (SI 2008/239) (“2008 Regulations”) set out provisions relating to the administration of the Local Government Pension Scheme. Regulation 39 provides:

“(1) An employing authority must contribute to the appropriate fund in each year covered by a rates and adjustments certificate under regulation 36⁴ or 38⁵ the amount appropriate for that authority as calculated in accordance with the certificate and paragraph (4).

(2) During each of those years an employing authority must make payments to the appropriate fund on account of the amount required for the whole year.

(3) Those payments on account must—

(a) be paid at the end of the intervals determined under regulation 42⁶; and

³ Section 7(3)(c) of the LGA 2003 allows the Secretary of State to make provision for a description of a liability which does not constitute a qualifying liability for the purposes of provisions on “credit arrangements”, and has done so here in respect of liabilities for retirement benefits.

⁴ Actuarial valuations and certificates

⁵ [38 Special circumstances where revised actuarial valuations and certificates must be obtained]

(b) equal the appropriate proportion of the whole amount due under paragraph (1) for the year in question.

(4) An employer's contribution for any year is the common percentage for that year of the pay on which contributions have, during that year, been paid to the fund under regulations 18 (contributions during child-related leave), 19 (contributions during reserve forces service leave) or 21 (contributions during absences with permission) or regulation 3 of the Benefits Regulations (contributions payable by active members) by employees who are active members, increased or reduced by any individual adjustment⁷ specified for that employer for that year in the rates and adjustments certificate.

(5) The common percentage is the common rate of employer's contribution specified in that certificate, expressed as a percentage.

(6) Where an employee—

(a) is treated under paragraph (4) of regulation 18 as if he had paid contributions; or

(b) has paid contributions during a period of maternity, paternity or adoption absence (within the meaning of that regulation),

the pay on which the common percentage is calculated is the pay the employee would have received if he had not been absent.”

The effect of Regulation 39 of the 2008 Regulations is that local authorities must contribute “the appropriate amount” to the appropriate fund each year covered by a rates and adjustments certificate. The “appropriate amount” is that “calculated in accordance with the certificate and [regulation 39] paragraph (4).”

A “rates and adjustments certificate”, which will be prepared by an actuary,⁸ is defined in Regulation 36(4) as a certificate specifying:

“(a) the common rate of employer's contribution; and

(b) any individual adjustments,

for each year of the period of three years beginning with 1st April in the year following that in which the valuation date falls.”

Under Regulation 36(5), the common rate of employer's contribution is “the amount which, in the actuary's opinion, should be paid to the fund by all bodies whose employees contribute to it so as to secure its solvency, expressed as a percentage of the pay of their employees who are active members.”⁹ This

⁶ Under regulation 42, every employing authority must pay to the appropriate administering authority on or before such dates falling at intervals of not more than 12 months as the appropriate administering authority may determine the amounts deducted from a number of sources, including the pay of its employees. There is no mention of deficit payments.

⁷ Under Regulation 36(7), “an individual adjustment is any percentage or amount by which, in the actuary's opinion, contributions at the common rate should, in the case of a particular body, be increased or reduced by reason of any circumstances peculiar to that body.”

⁸ Regulation 36(1)(c).

⁹ Under Regulation 36(6): “The actuary must have regard to—

(a) the existing and prospective liabilities of the fund arising from circumstances common to all those bodies;

definition suggests that in terms of the common rate of contribution on the certificate, deficit payments and normal contributions could both be considered as part of the common rate of contribution. Where the actuary considers it appropriate to contribute amounts to the fund to reduce the deficit using the common rate (rather than by making individual adjustments), this is included with the normal amounts that are paid to sustain the fund (by virtue of Regulation 39(4), subject to adjustment by the certificate). Both amounts would then be expressed together as a percentage of the pay of their active member employees.

Under regulation 36(7) *“An individual adjustment is any percentage or amount by which, in the actuary's opinion, contributions at the common rate should, in the case of a particular body, be increased or reduced by reason of any circumstances peculiar to that body.”* This appears to give the actuary a wide discretion to alter the common rate of contribution, as this rate may be adjusted by reason of *any* circumstance particular to the local authority. In other words, although deficit payments could be taken together as part of the common rate of contribution (to secure the solvency of the fund), they could equally be accounted for by individual adjustments to the common rate, provided they could be justified by circumstances peculiar to the local authority.

Regulation 39 requires a yearly contribution to the appropriate fund (the pension fund) of the *“amount appropriate for that authority as calculated in accordance”* with the rates and adjustment certificate, which sets out, as far as I can see, no more than a common rate of employer's contribution (in general terms, a percentage of employees' pay, but subject to the actuary's discretion to secure the solvency of the fund) and any individual adjustments upwards or downwards, that is by *“any percentage or amount”* which should have effect, for each year of the three year period.

The case study includes a draft rates and adjustment certificate, which sets the common rate of the employer's contribution at a given percentage. However, it provides that contributions are payable in monthly arrears *“unless otherwise noted in a separate agreement with an individual employer, and the contributions in the attached schedule take account of any such agreements.”* The first legal advice that we have seen takes this to authorise the use of a single upfront payment although there is no real analysis of why they think this suffices in law or how this relates to the various provisions. Perhaps it is being argued that this provision is an *“individual adjustment”*.

However, we cannot see how the actuary is empowered to provide for an agreement outside of the scope of the certificate to have any effect on the way that the required calculations under the legislation work. The second legal advice¹⁰ provided seems to suggest that such an agreement is determining the *“appropriate proportions of the whole amount due for the year”* payable by the local authority under Regulations 39(2) and (3). These amounts are said to have been agreed between the local authority and the actuary as appropriate proportions of the whole amounts due and, at the end of three year period covered by the rates and adjustment certificate, the amounts paid will equal the total amounts detailed on the certificate.

We do not consider that the 2008 Regulations allow for such an interpretation. Regulation 39(2) is clear that during *each* of the three years under the certificate, the local authority *“must make payments to the appropriate fund on account of the amount required for the whole year”* (emphasis added). If the certificate contains deficit payments in each of the three years, then

- (b) *the desirability of maintaining as nearly constant a common rate as possible; and*
- (c) *the current version of the administering authority's funding strategy statement mentioned in regulation 35.”*

¹⁰ Undated, but titled: “summary of legal issues relating to XX Council's proposal to pay pension deficit recovery amounts upfront”.

these must be paid to the pension fund each year. Under Regulation 39(3) they must be paid at the intervals calculated in accordance with Regulation 42 (at intervals of not more than 12 months), and equal the appropriate proportion of the whole amount due under the certificate “for the year in question”. Again, if the certificate contains deficit payments for each for the three years, we would suggest that Regulation 39 does not leave room for these not to be paid (it is not clear on basis an agreement to pay these not in the year in question would be valid, and the point that the overall amounts are the same does not address this).

Another argument raised by the second advice we have seen is that the phrase “*calculated in accordance with*” in Regulation 39(1) does not mean “*the amount stated on the certificate*”, and as long as the contributions to the pension fund are calculated in accordance with the principles applied in calculating the figures in the certificate, there is no need for the two amounts to match. Over the three years the payments to the pensions fund in the one upfront deficit payment will match the total of the three certified amounts representing the deficit. I consider this to be stretching the meaning of the phrase “calculated in accordance with”, and that a plain reading would be more appropriate. On such a reading, the amount that must be contributed to the pension fund is the figure that is determined by the certificate, arrived at through the principles set out in Regulation 36. I would suggest that the amount that must be contributed each year under Regulation 39(1) is fixed by the certificate and Regulation 39(4), and there is no scope for arguing that different contributions can be made simply because the figures at the end of the three years are the same (in any event, it is difficult to see how contributions for the deficit payments in year one but not years two and three could be said to have been calculated in accordance with the certificate, when the certificate details the deficit payments spread out over the three years).

There is the further difficulty with this argument that arises from regulation 39(3)(a) and its reference to regulation 42. The intervals referred to in regulation 39(3)(a), are further to regulation 42 determined by the “appropriate administering authority, not the actuary or the local authority. Arguably, regulation 39(3) requires all of the payments on account in any year, to be made at the end of the intervals so determined.

Under Regulation 39, the local authority must contribute to the pension fund in each year the amount set out in the rates and adjustments certificate. Although the common rate of contribution should remain as nearly constant as possible for each of the three years,¹¹ the individual adjustments could be used to effect the upfront payment of the amounts used to reduce the deficit. In other words, the common rate of contribution will remain the same throughout the three year period, but the individual adjustments will show an increase in the first year to cover deficit payments that would have otherwise been paid over three years, followed by a decrease for the second two years such that the rate is fixed at the common rate of contribution and only normal contributions are made. The relevant circumstance particular to the local authority to justify the increase and decrease is that it is economically prudent to pay the deficit payments upfront. The case study notes that the upfront payment mechanism is consistent with the principles behind the Regulations and the Code, by allowing a smooth contribution rate as possible and to minimise the volatility of amounts charged to the General Fund.

The potential difficulty with this of course, is that both the Code and the 2003 Regulations require that the General Fund is charged for the amount of employee pension benefits “*payable for the year in accordance with the statutory requirements.*” This means that the General Fund must be charged with the amount each year set out in the rates and adjustments certificate.

¹¹ Regulation 36(6)(b).

The proposal is to pay the deficit contributions upfront, but to charge them over three years. This practice would not seem to be in accordance with the Code and 2003 Regulations. Were the rates and adjustments certificate to set out an upfront payment of the deficit in the first year, followed by no such payments in the further two years (but the normal contributions being paid under the common rate of contribution throughout the three years), these amounts would have to be charged to the General Code as the amount payable for each year in accordance with the statutory requirements.

Ends

