Tel: 020 8213 2739

E-Mail: neil.mason@surreycc.gov.uk

Our Ref: Insolvency regime for Sector employers
Your Ref:

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SURREY
COUNTY COUNCIL

Benjamin Dance
Department for Business, Innovation and Skills
Vocational Education Directorate
Orchard 1
2nd Floor
1 Victoria Stree
London
SW1H 0ET

4 August 2016

Dear Benjamin,

RE: Consultation on Developing an Insolvency Regime for Further Education and Sixth Form Colleges

Surrey County Council (Surrey) welcomes the opportunity to respond to the Government's consultation *Developing an Insolvency Regime for Further Education and Sixth Form Colleges* (the FE sector).

Surrey is the Administering Authority for the Surrey Pension Fund (the Fund) as part of the Local Government Pension Scheme (LGPS). The Fund has assets of over £3billion and includes more than 200 employers, 18 of which are FE sector employers.

The employer funding strategy of the Fund

The consultation correctly identifies the LGPS as a defined benefit scheme. Member benefits are protected by statute and ultimately the local council tax payer.

Although investment returns and market conditions have a direct relationship to the valuation of the assets and liabilities of the Fund and the funding strategies for all employers, there is no corresponding relationship between these investment returns and benefits payable to members, as stated in paragraph 111 of the consultation document:

"111. The LGPS is a defined benefit scheme with benefits payable from the scheme based on the amount of money paid in, the returns achieved on that investment and the market conditions at force at the time that the benefits become payable."

The Fund manages assets and employers within its administration in accordance with its fiduciary duty. It also complies with its statutory obligations as laid out in the *Public Sector Pensions Act 2013*, which are applied through Funding Strategy Statement, namely:

The Public Sector Pensions Act (Section 13, (2), Employer contributions in funded schemes

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"Scheme regulations must provide for the rate of employer contributions to beset at an appropriate level to ensure—
(a) the solvency of the pension fund, and
(b) the long-term cost-efficiency of the scheme, so far as relating to the pension fund."

As part of the Fund's fiduciary duty it considers the relative covenant strength of all scheme employers and designs an appropriate matching funding strategy. For example, an employer in the Fund that has tax raising powers would be considered to have a stronger covenant than one which does not. This translates in to the relative risk that the Fund would consider that these respective employers pose to all other employers in the Fund, as the LGPS is a 'last man standing' arrangement. In simple terms, an employer that is considered less secure could have a shortened deficit recovery period with the implied escalated employer contributions.

Since the increased independence of employers within the FE sector and the removal of the exceptional funding support (EFS) regime from the government, the Fund has been forced to reassess its funding strategy for this cohort of employers.

Developing an insolvency regime for the FE sector

Surrey supports the government's proposal to develop a solvency regime for the FE sector. No such regime currently exists and LGPS Funds are forced to rely on the limited and unsatisfactory assumption that, should a FE sector employer fail, neighbouring FE sector employers would take them over and inherit their pension assets and liabilities.

We have considered the relative merits of the insolvency options outlined in the consultation. We have also identified the main concerns for the Fund in potentially being classed as an unsecured creditor. We propose some solutions that would allow the Fund greater flexibility in dealing with FE sector employers, thereby reducing the financial pressure on these employers and protecting the interests of tax payers.

Paragraphs 39 to 57 of the consultation provide details of the proposed insolvency regime, with the stated intention of mirroring the *Insolvency Act 1986*. We will consider each aspect of this proposed regime from the view of the protection it may afford the Fund under the following arrangements:

- Company voluntary arrangement.
- Administration.
- Compulsory or voluntary liquidation.

Company Voluntary Arrangement (CVA)

We believe this could provide some protection to the Fund, as it would enable the possibility of a negotiated settlement with the FE sector employer while it looks to restructure and with the hope of it continuing as a going concern. Any agreement would need careful legal consideration.

Administration

Administration could ultimately lead to the winding up of the FE sector employer, with the Fund being an unsecured creditor and potentially recovering little or no cessation debt payment. A positive of administration is that the process could take up to 12 months to complete, which could allow a period during which a form of repayment could be negotiated.

Compulsory or voluntary liquidation

This would be the least desirable outcome for the Fund. The Fund would be an unsecured creditor and last in line for the recovery of assets relating to unpaid debts.

Whichever insolvency arrangement is pertinent to a FE sector employer, the Fund does seek assurance from the government that it would not be permissible or possible for this employer to engineer an insolvency in order to release itself from its pension obligations, only to then start-up again immediately as a new education establishment.

Special Administration Regime (SAR) and Transfer Schemes

The Fund welcomes the proposal for a SAR, as it does provide the facility for negotiating an equitable solution for the Fund, whether this be through a merger with another FE sector employer or by the restitution of the financial viability of the FE sector employer.

The Fund seeks assurances from government that ongoing pension obligations would be honoured during any period of SAR.

A SAR is clearly not a panacea for the Fund and there remains a risk that neither a merger nor rescue may be possible, again leaving the Fund as an unsecured creditor.

In addition in the incidence of a Transfer Scheme being implemented the Fund seeks assurance this would not override any third party right; e.g. a first charge on FE sector employer assets held by the Fund.

Mitigation of risk to the pension Fund

A crystalisation of the pension debt for FE sector employers (potentially using a prudent discount rate) is not desirable for FE sector employers, the Fund or the government. However, without government support of FE sector employers, and within the existing statutory framework, the Fund has no alternative but to review its funding strategy for FE sector employers in light of their respective strength of covenant. It is possible that a revised funding strategy could have the effect of undermining the financial position of a hitherto viable FE sector employer.

We assert that there are three clear ways by which the government can support the Fund and local taxpayers, whilst simultaneously providing further education and sixth form colleges with an opportunity to flourish:

1) Liaise with colleagues in the Department of Communities and Local Government (DCLG) to revise the LGPS regulations and enable the mandating of security from FE sector employers.
2) Remove FE sector employers from the LGPS.
3) Provide a pension liability guarantee for FE sector employers.

1) Revising the LGPS Regulations

Further education and sixth form colleges are defined under the LGPS regulations as Schedule 2, Part 1 employers. Schedule 2, Part 1 employers are statutorily obliged to offer eligible employees access to the LGPS.

Schedule 2, Part 3 employers (admission bodies to the LGPS) must provide an indemnity of bond, approved by the administering authority, if they pose a risk of premature termination. This requirement does not exist for Part 1 employers.

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If the DCLG were to revise the LGPS Regulations to require further education and sixth form colleges to provide adequate security, this would enable Funds to have more flexibility with FE sector employers, who have put this security in place when formulating recovery plans. This would enable them to benefit from more stable and affordable contribution rates.

We believe it would be very constructive if the government could work inter-departmentally to explore this option.

2) Removing FE sector employers from the LGPS

The government could mitigate the ongoing LGPS challenges faced by FE sector employers by removing their eligibility for the LGPS and perhaps enrolling them in one of the unfunded public sector schemes; e.g. the Teachers Pension Scheme.

This would obviously trigger an immediate crystalisation event and an agreement would need to be reached between Funds and the government regarding an equitable cessation valuation.

3) Providing a pension liability guarantee for Sector employers

If the government were to offer a guarantee to fund pension liabilities in the event of a FE sector employer insolvency, this would have the immediate effect of strengthening the covenant of this cohort of employers in the LGPS. This would give the Fund even greater flexibility with FE sector employers when formulating recovery plans and setting contribution rates than if FE sector employers offered their own form of security, as detailed previously.

There is an obvious precedent in the guarantee that has been offered for academy schools in the LGPS by the Department of Education. This has allowed the Fund to keep deficit recovery periods and contribution rates broadly the same for academies as that which they experienced when under local authority control.

Surrey welcomes the plans to introduce an insolvency regime for the FE sector and recognises that this builds positively on the Area Review initiative launched in July 2015.

However, we have highlighted some of the significant concerns that we have regarding the potential risks that are presented to the Fund by the FE sector's continued participation in the LGPS. We have also provided details of the action that the Fund is obliged to take as part of its fiduciary duty and how this could potentially negatively impact the finances of employers in the FE sector.

We hope that the government will respond positively to our proposals which allow some of the concerns to be allayed and look forward to working constructively in the future to the benefit of the Fund, the FE sector and taxpayers.

Yours sincerely

Sheila Little
Director of Finance