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Meg Hillier MP
Chair
The Public Accounts Committee
House of Commons, London, SW1A 0AA

Thursday 18th February 2021

Dear Meg,

PAC Report Managing Colleges' Financial Sustainability: Recommendation 2

This letter is a response to recommendation 2 made in the Committee's report dated 27 January 2021 on the financial sustainability of further education colleges in England. It sets out what the Department has done to assess the pension costs pressures on colleges, and how we have taken account of this assessment in our funding decisions.

Based on an analysis of the Finance Records submitted by colleges since 2016-17, staff costs account for the majority of costs in the college sector, consistently consuming around 64%[1] of all sector income for the past few years. Employer pension costs are driven by staff salary costs and a constitute a considerable portion of college costs, consuming around 9% of sector income. Staff who are employed by colleges are entitled to join the Teacher Pension Scheme (TPS), if they have a teaching role, or the Local Government Pension Scheme (LGPS) in any other role. Membership is not compulsory - individuals can opt out of membership - but auto enrolment rules require all employers above a certain size (including all colleges) to enrol staff in pension schemes unless they opt-out.

Local Government Pension Scheme

The LGPS is a funded multi-employer defined benefit scheme, with 88 separate funds operating across England and Wales. Actuaries to the funds allocate a share of assets and liabilities to the individual employers both in the statutory valuations and on request by colleges for their financial statements, but the scheme assets are held separately from those of the college in separate trustee administered funds. Any individual local scheme will be open to a large number of employers from local government, police authorities and housing associations as well as academy trusts and colleges. As such, risk is pooled and so any loss to the scheme is shared out amongst the remaining members. The actuarial

[1] 63% if staff restructuring costs are removed.

valuations for each employer in the scheme are obtained at least triennially and are updated at each balance sheet date.

The LGPS triennial valuation sets contribution rates in each fund. The last such valuation took place in 2019 and set the contribution rates for the period 1 April 2020 to 31 March 2023. The 2019 review saw all LGPS Funds achieve an improvement in funding position, largely driven by strong asset performance in 2016-17 which carried through to 31 March 2019, and deficit contributions paid by employers over the inter-valuation period.

The amounts charged to colleges' operating costs are the current service costs, including and gains and losses on settlements and curtailments, but in terms of affordability, the call on colleges arises from the actual "cash" contributions paid to the local scheme, comprising both the "normal" contributions based on the rate set by the scheme actuary (usually around 20% of salary costs) and any additional sums to make good a scheme deficit. LGPS schemes have broad power to set whatever deficit reduction contributions they see fit and on occasion seem to have done so without regard to affordability. Colleges have, however, been able to negotiate with their fund to make good these additional contributions through an increased annual contribution rate rather than a one-off payment.

If the actual payments made by a college do not keep pace with the rate at which the scheme charges the college, then the LGPS deficit will rise, though this need not give rise to an issue of affordability in the short term, provided that college can afford to make its scheduled payments.

The college sector has undergone a period of consolidation for the past few years, but the proportion of colleges with a negative LGPS fund balance has remained very consistent: since the academic year 2016-17, substantially all colleges have had an LGPS fund in deficit, with only a handful (typically around 1%) in surplus.

Based on data submitted to the Education and Skills Funding Agency by colleges in their annual finance record, the total of LGPS employer contributions paid by the sector has also been quite consistent over the period:

Note: the 2019-20 college data is still incomplete so we cannot use figures for this year until we have a critical mass

Academic Year	**Number of colleges**	**LGPS employer contributions for the sector £(million)**
2016/17	311	243.4
2017/18	265	241.2
2018/19	244	248.3
2019/20	207	220.1

However, the same period has also seen a steady growth in the size of LGPS fund deficits for the sector:

Academic Year	Highest college LGPS surplus £(million)	Highest college LGPS (deficit) £(million)	Median college LGPS surplus / (deficit) £(million)
2016/17	0.41	(82.69)	(6.97)
2017/18	9.88	(68.41)	(6.07)
2018/19	3.03	(84.48)	(10.68)
2019/20	0.00	(110.56)	(17.48)

It should be noted that, given consolidation, we might expect to see an increase in the size of the average college LGPS deficit since the sector now comprises fewer but larger corporations than it did a few years ago. Further, although there is a wide distribution in the values of college LGPS fund deficits, only a small number have very high deficits. Context is also important.

While LGPS contributions amounted to £248.3 million in academic year 2018/19, total sector income for that year was £6,661 million, so these LGPS payments comprised less than 4% of income.

It should be noted that, in addition to their regular annual payments to their LGPS funds, an increasing number of colleges have faced demands from their schemes for “top up” payments to make good deficits that have arisen in past periods. In the main, rather than meet these one-off payments with a single lump sum, colleges will agree with their fund that the sum required is recovered by means of an increase in their regular annual payments over a period of years, with only a small number of colleges actually making these payments as a lump sum. For instance, in 2018-19 in addition to the £248.3million paid as regular payments, around £2.5million was paid in lump sums. However, this figure underplays the extent of these additional payments, the majority of which are blended with their normal annual payments. Early ESFA modelling suggests that around 20% of the annual payments to LGPS funds by colleges is to cover the cost of these additional payments. The ESFA is planning to do a great deal more work on this subject, gather further information on these payments and work with the sector to improve reporting transparency in this area.

LGPS funds collectively may be regarded as the sector’s single biggest creditor. The rise in college LGPS deficits is concerning as it points to both an upward pressure on employer contribution rates themselves (as well as additional deficit repair charges). However, the next LGPS triennial review is not due to take place until the next spending review period and so the Department is unable to make any commitment to cover any additional costs at this point. The ESFA’s work with the sector and the triennial valuation mean that there will be some developments in this area and we will keep the Committee informed of these should it indicate that it wishes to be kept up to date.

Teachers’ Pension Scheme

The Teachers' Pension Scheme (TPS) is the defined benefit pension scheme provided by colleges to their teaching staff. It is an unfunded (or notionally funded) contributory, final salary public service occupational pension scheme. Like many other public service schemes, TPS operates on a “pay-as-you-go” basis, with employer and employee contributions paid to HM Treasury which, in turn, pays out pension benefits, netting off the contributions received.

The TPS may be thought of as “notionally funded” because periodic valuations are carried out every four years by the Government Actuary’s Department as though there was a fund, and both employer and employee contributions are set on the basis of these valuations. As such, while the risk of the affordability of the contributions is a matter for colleges, the risk of non-affordability of scheme benefits falls on the Treasury, not colleges themselves. This situation may be contrasted with that of LGPS where, because of the wider range of employer types and local administration, there is more exposure to risk and scheme viability is not “guaranteed” by the state.

The last TPS valuation report was published in March 2019 and it concluded that the employer contribution rate would increase from 16.48% to 23.6% of contributory pay with effect from 1 September 2019.

As a result of the increase in employer contributions, the Department consulted on whether or not to provide funding to those in the Further Education sector required to offer TPS to meet these additional costs. Consequently, the Department has met the additional employer contributions since September 2019. The Department is providing £129 million for these costs in the 2020-21 academic year and is committed to providing funding until the end of the 2021-22 academic year. Decisions on future funding are for a matter for the spending review.

The McCloud judgement

In December 2018, the Court of Appeal ruled that the government’s 2015 public sector pension reforms unlawfully treated existing public sectors differently based upon members’ age on 1 April 2012. The judgement came after two Employment Tribunals concerning the pensions of Judges’ (McCloud) and Firefighters’ (Sargeant) respectively. The court ruled that in these two cases the Government failed to demonstrate that the transitional protection arrangements were based upon a legitimate aim.

This ruling was appealed by the Government, but the appeal was rejected in July 2019 and the cases were remitted to Employment Tribunal remedy hearings. The issues are complex, but the overall idea is to extend the protection to all people who were in the scheme in 2012 (i.e. to allow them final salary benefits rather than average salary benefits). Once final decisions are made, an assessment will be required for the impact on college finances, but only as one additional factor in the ongoing determination of scheme liabilities and contribution rates.

Summary

The requirements for Education Skills Funding Agency to assess the affordability of pension pressures in the college sector sits within the wider context of its obligation to assess the financial health of colleges more broadly. The Agency has a well-established and widely understood methodology for assessing the financial health of all colleges that takes into account their ability to generate surplus income, their ability to meet short-term commitments and the extent of their borrowings. This is supplemented by an approach to financial planning that requires colleges to produce multi-year budgets, and an independent external audit of college financial statements that incorporates (implicitly) a professional opinion on the ability of any college to remain a going concern.

While the accounting treatment of pensions within college accounts is rather complex, the issue of affordability is essentially one of whether a college can meet its current and future fund contributions. In the case of both TPS and LGPS, contribution levels are determined externally by means of an actuarial review process that takes place on either a 3 or 4 year basis This means that we have relative stability for a number of years and advance warning of when rates may need to change. When contribution rates to TPS rose substantially following the last TPS review, DfE acted accordingly to mitigate the impact of the increased contribution of colleges financial sustainability. The trend for LGPS fund deficits to increase across the sector suggests that there will be an upward pressure on LGPS contribution rates too. However, as the McCloud ruling shows, this is an area of relative uncertainly and one which we keep under ongoing review.

I hope this is helpful to the Committee.

SUSAN ACLAND-HOOD
PERMANENT SECRETARY