Pensions Committee

2.00 p.m., Wednesday, 30 September 2015

Funding Strategy – Employer Appeals

Item number	5.6
Report number	
Executive/routine	
Wards	All

Executive summary

This report advises Pensions Committee of the key issues which have been raised by the appellants and provides responses to those matters arising. It recommends changes to the Funding Strategy Statement, in relation to funding of liabilities transferred from another employer within the Fund and the frequency of payment of past service deficits.

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Report

Funding Strategy – Employer Appeals

Recommendations

That Committee should:

1.1 Invite the Pension Board to raise any relevant matters or concerns which the Committee should consider;

1.2 Note this report;

1.3 Note that a further report by the Chief Operating Officer, Deputy Chief Executive, recording the determinations of the employer appeals against the Funding Strategy is provided at item B1;

1.4 Note that a further report by the Chief Operating Officer, Deputy Chief Executive, on those employers who propose to cease membership of Lothian Pension Fund is provided at item B2;

1.5 Agree to amend the Funding Strategy Statement to provide that where an employer has been admitted to the Fund arising from the transfer of members of staff from another scheme employer and the ceding employer is in agreement, then funding, including cessation, should be on the ongoing basis. This is subject to consultation responses from the Fund employers, an oral update of which will be provided to Committee;

1.6 Agree to amend the Funding Strategy Statement to stipulate that employer contributions in respect of Past Service Deficit, which are expressed as a minimum fixed monetary sum, are payable on a monthly basis, that is one twelfth of the annual total. This is subject to consultation responses from the Fund employers, an oral update of which will be provided to Committee.

1.7 Note that the basis of cessation valuations has been considered by the Scheme Advisory Board and agree that the Fund will take cognisance of any guidance in due course.

Background

Context of employer appeals

2.1 Pensions Committee, at its meeting on 25 March 2015, considered a report by the Director of Corporate Governance, which proposed a revised Funding Strategy Statement for the 2014 Actuarial Valuation. A key change to the funding strategy was as follows:

2.2 “Overall the Fund adopts a long-term investment strategy, aiming to maximise the investment return within reasonable and considered risk parameters and hence minimise the cost to the employer. However employers (with the exception of Transferee Admitted Bodies) who are closed to new members and have less than 5 active members, or are expected to leave the Fund within two valuation periods (6 years), will be assumed to be invested in lower-risk investments i.e. index-linked government bonds. This aims to reduce the degree of short-term change in employer contribution rates in the period prior to the employer leaving the Fund and hence manage risks for both the individual employer and for the Fund as a whole.”

2.3 Whilst fully endorsing the proposed funding strategy as a prudent measure to protect the interests of Lothian Pension Fund and its employers, Pensions Committee also recognised that the lower-risk investment contribution strategy may have significant cashflow implications. Accordingly, the revised Funding Strategy Statement was approved with the addition of the following:

Appeal criteria

2.4 ‘If there are specific circumstances where an employer may assert that the lower-risk funding strategy would place its future existence in jeopardy and therefore a less prudent funding strategy should prove advantageous to Lothian Pension Fund and the employer, then an appeal may be submitted to Lothian Pension Fund no later than 15 months after the date of the actuarial valuation. An appeal should include an alternative funding proposal recognising the need for the employer to meet their pension liabilities. Any such appeal would be considered by the Director of Corporate Governance (now Chief Operating Officer, Deputy Chief Executive) in consultation with the Convenor of the Pensions Committee, Convenor of the Pensions Audit Sub-Committee and the Independent Professional Observer and the decision reported subsequently to the Pensions Committee. In order for any appeal to be upheld, support from any respective ‘aligned body’ or guarantor would be required, together with approval of the Fund’s Actuary. Should such appeal be successful, then a revised ‘Rates and adjustment certificate’ would be issued. Pending determination of any appeal, the actuarial valuation ‘rates and adjustment certificate would remain applicable’.

2.5 An update on the progress of the appeals was provided to Pensions Committee, at its meeting on 24 June 2015, in the report “Funding Strategy Employer Appeals and Cessations”.

Main report

3.1 Of the 27 employers affected by the change of funding approach, 14 submitted an appeal by the due date of 30 June 2015.

3.2 Of those 14 employers, 6 propose to close their membership of the Local Government Pension Scheme (LGPS) to future benefit accrual, as soon as is possible, and thereby exit the scheme. A formal cessation valuation would be calculated by the Fund Actuary at the relevant date(s). If an employer wishes to pay the cessation debt over a period longer than 5 years, this requires Pensions Committee approval.

3.3 Specific coverage of the appeal submissions is provided in separate reports to this meeting of the Pensions Committee. These are shown as “B Agenda” items in order to respect the confidentiality of the employer submissions and financial forecasts.

3.4 This report advises of general issues which have been raised by the appellants and provides responses to those matters arising.

Principles for repayment of pension liabilities

3.5 At the outset, it may be considered helpful to summarise the key tenets held by the Fund for the repayment of liabilities:

a. Liability for pension benefit obligations is the responsibility of the employing organisation.

b. Affordability of pension contributions to the employer is a paramount concern for all parties.

c. Best interests of the “aligned body”, (i.e. that which will be liable for the pension liabilities if the employer is unable to pay), in mitigating the risk of employer default are served by the employer continuing to exist to meet pension obligations in full.

d. Suitable protections to the Fund and aligned body should be incorporated in any such repayment schedule, e.g. security over assets, future revenues and capital receipts.

General issues raised by the appellants:

Admission basis – wording of legal documentation

3.6 Under the Scheme regulations, the City of Edinburgh Council and predecessor authorities has, as administering authority been able to admit certain bodies to the Local Government Pension Scheme. This is done by way of a legal document, an ‘Admission Agreement’ which sets out the terms of the admission. Most of the Admission Agreements include the following clause: “The Admission Body shall pay to the Authority in respect of each person admitted in the benefits of the Fund in accordance with the terms of this Agreement and for so long as such person remains an eligible employee such monthly sum representing the relevant monthly pension contributions of the person concerned and the Admission Body as would have been paid in to the Fund by the Authority and that person had he been in the direct service of the Authority, adjusted by any increase or reduction which may be certified by the Fund's Actuary."

3.7 Some appellants have stated they have received legal advice that the 'purpose and intention' of this clause was to place each admission body on an equal footing with the administering authority. Further, they have stated that the terms of the Admission Agreement cannot be adhered to unless the Administering Authority and the Actuary when setting contribution rates have taken into account any circumstances particular to the admission body. As such, appellants have requested clarification as to whether or not the Actuary has or has not taken into account an individual adjustment by any percentage or amount by which in the Actuary's opinion, contributions at the common rate should be increased or reduced by reason of any circumstances peculiar to the organisation.

3.8 The Fund disputes the stated purpose and intention. The Fund has sought legal advice on the relevant clause. The advice received confirms that contributions are payable by the employing bodies, but more importantly that those contributions can be increased or reduced as may be certified by the Fund's Actuary. The purpose and intention of the clause is not to place the employing body on an equal footing with the City of Edinburgh Council. The wording "adjusted by any increase or reduction which may be certified by the Fund's Actuary" makes it clear that the contributions payable by each employing body may be different from the contributions payable by the City of Edinburgh Council. The contribution rates for these organisations, as set out in the Rates and Adjustment certificate, (Appendix G of the Lothian Pension Fund 2014 Actuarial Valuation report), are based on the individual circumstances relating to each employing body. Individual employer contributions have applied in the Fund since 2005.

3.9 One appellant was admitted to the Fund many years prior to the others and as such the wording in its agreement is slightly different. The Fund's position, however, is that the same principle applies.

Admission basis - staff transfer

3.10 Three employers are disputing the treatment of liabilities of employees who were previously employed by other organisations (councils) in the Fund.

3.11 Lothian Pension Fund has sought specialist legal opinion on the admission of employers following staff transfer from another Fund employer, this being prior to Transferee Admission Bodies being established by previous Regulations. This advice has confirmed that the basis of admission is not relevant for current scheme funding and employer contribution purposes. The Fund and the Fund Actuary must treat each admission body on an individual basis when deciding on the appropriate funding approach.

a. Employers have an incorrect perception of the treatment of liabilities when these were transferred between employers. Appellants asserted that they received no credit of any assets in respect of liabilities accrued prior to their admission. This assertion is incorrect. In 2002, when bespoke employer funding arrangements were put in place, each recipient employer received 96% funding on an ongoing basis (96% being the overall funding rate at the time). This arrangement, however, does serve to highlight the inconsistency of the allocation of assets on the ongoing versus the cessation basis. For those employers admitted to the Fund owing to the transfer of members from another Fund employer, and the ceding employer has agreed to the treatment of the employer as a Transferee Admission Body for funding purposes, , it is therefore considered that a cessation basis on the ongoing basis, akin to the treatment of Transferee Admitted Bodies, would be appropriate. An amendment to the Funding Strategy Statement would be required to affect this change.

Gilts basis for funding and cessation valuations

3.12 All organisations have objected to the gilt discount rate being used in the cessation valuation and representations have been made directly to the Scottish Government on this matter.

3.13 Various appellants disputed the lower risk contribution and investment strategy which the Fund assigned to those employers in the period close to exit, or at higher risk of an impending cessation event. For example, “There is the prospect that the last member may not retire, triggering a cessation event, for (a number of) years...we are of the view that a move to a gilts based valuation at this point imposes an excessive burden ... given that continuing to invest over this period will in all likelihood reduce the ultimate cost of providing for the liabilities”.

3.14 As previously advised to Committee, the principles of cessation valuations, namely the crystallisation of pension liabilities when there are no more active members, are receiving attention nationally across the LGPS. Indeed, the Scheme Advisory Board for the LGPS in England and Wales commissioned a review of cessations and the management of the exit of employers from funds. A report entitled “Deficit Management in the LGPS” was produced by consultants, dated 3 July 2015. It is emphasised that, at this stage, this represents only one opinion and remains under consideration by the Board.

3.15 The Scheme Advisory Board for the LGPS in Scotland is expected to undertake a similar review and any guidance resulting from that the review will be considered in due course by the Fund.

3.16 The Fund Actuary remains strongly of the view that, for employers lacking any strong financial covenant (and whose admission did not arise exclusively from the transfer of staff from another scheme employer), it would not be appropriate for the Fund to contemplate any relaxation of the funding bases for cessation valuation, namely using a UK Government bond derived discount rate together with an allowance for mortality improvements. Such a degree of prudence is required in order to protect the interests of the aligned body and/or the remaining employers within the Fund. This stance is entirely consistent with the approach taken by the majority of LGPS administering authorities across the United Kingdom.

3.17 Committee should also be aware that the Scottish Government issued a consultation on amendments to the Local Government Pension Scheme (Scotland) Regulations 2014 on 1 September 2015. One amendment proposes to provide a grace period of up to three years before a cessation debt payment is required by the fund actuary. This can be applied where an employer has no active members in the scheme and the administering authority believes that the employer is likely to have one or more active members contributing to the fund within the period specified in the suspension notice. A new regulation 25A regarding employer contributions for historic liabilities is proposed to be inserted into the transitional regulations. The new regulation allows flexibility regarding the time period over which cessation debts are paid. At the time of writing, these amendments are being considered by officers and the Fund actuary and a verbal update will be provided to Committee.

Employer contributions 2015/16 to-date

3.18 Pending determination of the appeals, a number of employers have continued to make employer pension contribution payments for 2015/16 at the previous year's rates, rather than the required minimum contribution, as certified by the Actuary, for the actuarial valuation 2014. This matter will be pursued further with the relevant employers.

Minimum Contributions

3.19 The financial position of some employers showed that the contribution rates as certified in the 2014 Actuarial Valuation were indeed unaffordable.

3.20 In consideration of the appeals and the determination of any revised contributions, the future service rate on the gilts basis is considered to be the minimum contribution in order to ensure that the accrual of new benefits does not increase the deficit on the cessation basis.

Funding Strategy Statement – Past Service Deficit

3.21 Employer contributions, as calculated by the Fund Actuary, comprise two elements:

- An estimate of the cost of benefits accruing in the future, referred to as the "future service rate", which is expressed as a percentage of payroll and;
- an adjustment for the solvency of the Fund based on the benefits already accrued. If there is a surplus, there may be a contribution reduction; if there is a deficit there may be a contribution increase. For all employers, contributions to

cover any Past Service Deficit are expressed as a fixed monetary sum, rather than as a percentage of payroll.

3.22 Whilst the overwhelming majority of employers are paying the past service deficit contribution on a monthly basis, that is one twelfth of the annual fixed monetary sum, it has come to the attention of the Fund that there may be unintended scope for an employer to interpret that it may defer payment of the total past service deficit contribution up to the last day of the financial year. The Fund Actuary has confirmed that such interpretation would not be in accordance with his intention.

3.23 Accordingly, it is recommended that Committee should consult with employers on the proposal that the Funding Strategy Statement should be amended to stipulate that the past service contribution should be paid monthly on a proportionate basis.

Funding Strategy Statement – Amendments

3.24 The proposed amendments noted above (change to cessations for employers admitted to the Fund owing to the transfer of members from another Fund employer and the frequency of deficit payments) have been subject to formal employer consultation from 17 September. A verbal update on the consultation responses will be provided to Committee. Subject to responses, Committee is asked to approve the changes to the Funding Strategy Statement.

Measures of success

4.1 This report seeks to ensure the sustainability of the Lothian Pension Fund, recognising the affordability constraints faced by its employer membership.

Financial impact

5.1 None directly arising from this report, although the determination of any employer appeal against the funding strategy has obvious financial implications for Lothian Pension Fund. Similarly, any spreading of a deficit payment on cessation of an employer will also be of consequence. Both these aspects are directly addressed by the separate reports on the “B Agenda”.

Risk, policy, compliance and governance impact

6.1 The risk that any individual employer is unable to fulfil its financial obligations to meet pension liabilities is addressed by the Fund’s Funding Strategy Statement. This report proposes suitable amendments to the Funding Strategy Statement.

Equalities impact

7.1 There are no adverse equalities impacts arising from this report.

Sustainability impact

8.1 There are no adverse sustainability impacts arising from this report.

Consultation and engagement

9.1 The Fund has engaged in extensive consultation and dialogue with its employers over the changes to its funding strategy and the appeals process. Similarly, there has been full engagement with employers regarding the implications of cessation of LGPS membership.

9.2 During consideration of the appeals, consultation has also been undertaken with the Convenor of the Pensions Committee, the Convenor of the Pensions Audit Sub Committee and the Independent Professional Observer.

9.3 Changes to the Funding Strategy Statement are subject to consultation with employers.

9.4 The Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading/external references

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