EAST HERTS COUNCIL

CORPORATE BUSINESS SCRUTINY COMMITTEE – 11 OCTOBER 2016

LOCAL GOVERNMENT PENSION SCHEME

WARD(S) AFFECTED: All

1.0 Purpose of the Report

1.1 This paper gives an overview of the LGPS, how it's administered locally and the funding of the scheme, how contributions are invested and some of the issues that need to be considered when outsourcing services.

2.0 What is the Local Government Pension Scheme?

2.1 The local government pension scheme (LGPS) is a defined benefit scheme in that its benefits are determined by prescribed Government regulations. The Scheme is a funded scheme, financed by contributions from employees and employers and by earnings from investments. The employee rate is determined by the salary an individual earns in relation to contribution bands set out in the LGPS regulations. The employer contribution is determined by an actuary who values the Fund every three years.

2.2 Up until 2014 the benefits accrued and paid under the LGPS were determined by an individual's final salary and the accrual rate was 1/60th of salary. From 2014 the LGPS changed to a career average scheme (CARE) and the accrual rate was revised to 1/49th. The other main change to the scheme was the increase in the age of retirement from 65 to the state pension age. The accrued benefits earned under the old final salary scheme were also protected for employees.

2.3 The table below compares East Herts DC's scheme membership to the whole Fund.

	Active members		Deferred members		Pensioners		Total
	No.	%	No.	%	No.	%	
East	374	32%	314	27%	476	41%	1,164

Herts DC							
Whole Fund	35,384	37%	35,835	37%	24,776	26%	95,995

This indicates that East Herts DC has a more mature profile, with a greater proportion of pensioner members when compared to the fund as a whole.

Since 2010, East Herts DC has paid a stabilised employer contribution rate. Stabilisation is a mechanism whereby year on year variations in the employer contribution rate are kept within a pre-determined range, thus allowing those employers' rates to be relatively stable. In general, stabilisation is only appropriate for employers with tax raising powers, who are open to new entrants, and are long term scheme employers who are deemed to have a strong employer covenant.

The following table shows the contribution rate and deficit payments currently paid by East Herts DC as certified at the 2013 Valuation. The unstabilised rate that would be payable by East Herts DC is also shown.

	Current rate (stabilised)	Theoretical rate (unstabilised)
Future Service Rate (ongoing benefits)	16.6% of employer payroll	18.9% of employer payroll
Deficit recovery repayment rate (spread over 20 years)	£600k p.a.	£1,092k p.a.

3.0 Governance and Administration

3.1 The LGPS is administered locally by Hertfordshire County Council which has delegated this function to the Pension Committee. The Pension Committee is made up of Ten County Councillors who have voting status and three non-voting district councillors. Other attendees at the Pension Committee are a Unison representative who attends as an observer as well as a Chief Financial Officer from the District Councils.

The Pension Committee is responsible for the following functions:

- Administration of the LGPS;
- Approving the investment strategy and funding strategy;
- Set performance objectives for the Fund and monitor performance of investment management; and
- Ensure compliance with LGPS regulations.

3.2 The Pension Committee is supported by officers and a number of consultants which include the scheme actuary as well as the scheme investment consultant, The Pensions Act 2014 introduced a change in governance arrangements for LGPS funds with the introduction of the local pension boards. The role of the pension board is to assist the pension committee in ensuring compliance with the LGPS regulations and that due diligence has been followed in the decisions made by the Pension Committee. The Pension Board is made up of a total of eight employer and employee representatives. This includes District Council representatives.

3.3 On a national level the Pension Regulator now has oversight of all public sector pension schemes including the LGPS and has issued a Code of Practice for Funds to follow and can issue penalties for failure to comply with regulations. In addition the Scheme Advisory Board for LGPS provides advice and support to the Secretary of State on such matters as the overall cost of the scheme and governance.

4.0 Funding and Valuation

4.1 The LGPS regulations require each LGPS Fund to be valued every three years to measure the liabilities and assets in the Fund, the funding level of the Fund; the valuation also determines the individual contribution rates paid by each employer. The Fund is currently being valued by the Scheme actuary, Hymans, as at 31 March 2016 and individual employer results will be available from November 2016.

4.2 When determining the contribution rate for an employer body the actuary will look at the covenant of each employer and take into consideration the following:

- Tax raising powers

- Type of employer body
- Open or closed to new entrants
- Guarantor in place
- Funding position/size of liabilities.

4.3 As scheme manager/administering authority for the Hertfordshire Fund, the County Council will work with the scheme actuary to set assumptions for the discount rate (used to measure the liabilities), future pay growth, ill-health retirement, inflation and various other assumptions such as longevity. The actuary will set contribution rates for each employer body for a period of three years. The Funding Strategy aims to ensure a fully funded position by 2033 i.e. over 20 years.

4.4 The funding level of the Hertfordshire Fund, when last valued in March 2013, was 82%, compared with 79% for East Herts DC. This was an improvement from 2010, when both the Fund as a whole and East Herts DC were 74% funded. The difference in the improvement in funding level largely reflects differences in membership profile and experience over the valuation period. For example, the actual contributions paid vs the cost of future benefits accrued by members has not been as positive for East Herts DC than for the fund as a whole.

5.0 Investment Strategy and asset pooling

5.1 The Pension Committee is responsible for setting the overall investment strategy for the Hertfordshire Fund. The Committee works with officers and receives advice from an external investment consultant, Mercer, in setting the investment strategy for the Fund,

5.2 The investment strategy will look to seek the best level of return, within an acceptable level of risk and will be diversified across a number of asset classes. One of the main objectives of the investment strategy is to ensure over the long term that there are sufficient assets to pay benefits. In addition it will look to achieve a long term rate of return which assists in controlling the level of employer contributions.

5.3 The Pension Committee will set benchmarks for each of its investment managers and will monitor the performance of each manager against these benchmarks. The Fund employs a number of different managers who manage assets classes such as bonds, equities, property, private equity, and alternative investments. The Fund had a total of £3.6bn in assets at the 31st March 2016.

5.4 **Asset Pooling –** Over the last 10 months the Government has asked LGPS schemes to put forward proposals to pool assets with the objectives of reducing the overall cost of investment management through economies of scale and to also increase the capacity to invest in infrastructure. The Hertfordshire Fund is working with other Funds in the South East and East of England known as ACCESS and has put forward its pooling submission to Government. If approved the ACCESS pool will have a regulated investment company managing over £35bn of assets. The estimated savings by year 2033 for the ACCESS group of 11 funds will be circa. £26.5m per annum.

6.0 Outsourcing and Pension Protection.

6.1 Councils have over the years moved away from in-house service delivery to delivering services through arm's length companies or outsourcing to third party contractors. Examples of such services will be leisure services, IT services and street cleaning and waste management. This section will look at outsourcing and continued admission to the LGPS.

6.2 **Pensions Protection**

When transferring staff to another service provider or arm's length company, the outsourcing body must consider the pension protection that applies to any transferring staff. Currently these protections are provided under 'the Best Value Authorities Staff Transfers (Pensions) Direction 2007'. These regulations are due be replaced and the current draft amendments propose transferring staff categorised as "protected transferees" with a continuing right to membership of the LGPS. Any outsourcing Council setting up a new entity to deliver services would be able to close the scheme to new employees but not to staff who transfer directly from the Council.

6.3 **Providing new pensions arrangements for staff**

If the Council close the scheme to new entrants for an outsourced provider or arms-length company then the new provider would need to provide pension arrangements that comply with the automatic enrolment provisions contained within the Pensions Act 2008. This means that for new employees the provider will need to put in place alternative pension scheme arrangements. Among the things that will need to be considered are:

- Which staff will be designated to join the LGPS;
- The cost envelope within which the Provider wishes to provide pension benefits- reflective of any contract costs; and
- Automatic enrolment legislation - the Provider would need to develop a separate strategy for communicating and implementing automatic enrolment in respect of those non LGPS members.

6.4 **HR and workforce issues**

For individuals there are a number of protections which allow them continued access to the LGPS when outsourcing services. In addition, auto-enrolment has been introduced which means that employers must enrol workers into a work placed pension scheme if they are between 22 and state pension age and earn over £10k.

6.5 **Funding and Investment implications**

Generally when the Council undertakes a TUPE transfer of staff to a new provider, it will pass assets of equal value to the liabilities to the new provider. The Council will retain the existing past service deficit up to the date of transfer. The Council will therefore still be required to make contributions to meet the deficit, and whilst its net liability in monetary terms will remain the same, the funding level will reduce and contributions payable by the Council will be a significantly higher percentage of the reduced payroll.

A Council that outsources a significant proportion of its workforce will see the maturity profile of their element of the Fund increase dramatically and quickly; this means that the number of active contributing members will be significantly less than the number of deferred and pensioner members. The Council could experience a cash flow negative position in that more benefits will be paid out than contributions received from active members. For a Council who has a funding gap in their pension fund i.e. deficit then this will mean it will be required to pay in more in the form of its employer contribution.

7.0 Lump sum contributions

7.1 As well as paying contributions to ongoing benefits (future accrual) and certified annual deficit repayment, an employer body can make additional lump sum payments to the Fund towards their deficit or lump sums in advance. In March 2014, East Herts DC paid an additional £1,008k to the Fund in order to stabilise its annual deficit repayment at £600k for the 4 year period from 1 April 2014 to March 2018. East Herts DC also paid an additional £1,000k in March 2016 which will be reflected in the Councils funding position at the 2016 Valuation.

7.2 There are potential benefits and risks to an employer of paying a large lump sum to the Fund which are set out in the table below:

Benefits	**Risks**
In financial terms, if investment returns are higher than the interest earned by the contributions elsewhere, bank deposit account for example, then there is a benefit to the employer.	If investment returns are negative then this could dampen the financial benefits of the lump sum payment to the Fund; and
Assuming fund investment returns are positive then there is an economic benefit in paying large contributions sooner so that additional investment returns are made on the lump sum;	In general, the arrangement involves taking cash from other potential uses by the employer body. Such alternative uses may be considered more important or valuable to the employer.
In effect, the employer is benefitting from a reduction in the annual amount of interest paid on the debt owed to the Fund if the employer has a deficit; and	
The principle objective should be to reduce the overall deficit as quickly as possible. If the	

employer pays a lump sum in addition to the certified contributions then this can be used to reduce the overall deficit, or could use the additional contributions as a means to reduce their future certified deficit contributions.	

7.3 The example below provides two options that East Herts District Council (EHDC) could consider when paying a lump sum into the Fund. These examples have been calculated by the Actuary, based on a nominal lump sum contribution of £1m.

Option 1 – paying contributions as a lump sum in advance instead of regular contributions

Lump sum amount	**Additional interest**
£1.0m	**£62k**

The interest saved by paying in contributions as a lump sum in advance rather than spread throughout the year has been calculated using the valuation discount rate of 4% p.a. and assumes that the payment is made on the 31 March 2017. If the payment is made later then the additional amount of interest earned will reduce by around £3.3k per month. This is based on fund performance being in line with expectations.

Option 2 – paying an additional £1m into the Fund towards the deficit

Additional contribution	**Value**
£1.0m	**£2.2m**

The additional value to East Herts DC's funding position of paying in an additional £1m over and above the level of the annual actuarial assessment has been calculated using the same discount rate as option 1. If fund investment returns perform in line with the Fund actuary's expectations over the next 20 years, the value of the £1m payment would be approximately £2.2m and would reduce the deficit by this amount. However, if the markets were to perform poorly then the effect of the additional £1m payment would be diminished.

8.0 Summary

8.1 The LGPS is a funded pension scheme which is funded by contributions by both employers and employees. The employers' contribution is determined by an actuarial valuation which takes place every three years and the contributions paid by employees are prescribed by regulations. Contributions are invested through the Fund's investment strategy in a number of asset classes to deliver returns/income to meet current and future pension liabilities.

8.2 The Government has instigated a number of reforms to improve the governance of Public Pension schemes including the LGPS, reduce the cost of pensions to the employer by changing the scheme to a CARE scheme and linking the age of retirement to state retirement age; and introducing asset pool to reduce the overall cost of investment management.

<u>Report Author:</u> Patrick Towey (Telephone: 01992 555148).