

PENSION FUND COMMITTEE – 5 JUNE 2015

MANAGEMENT OF PENSION FUND DEFICITS

Report by the Chief Finance Officer

Introduction

1. In May 2014, Brandon Lewis MP the Minister responsible for the LGPS at that time wrote to the Shadow Scheme Advisory Board asking the Board to consider and make recommendations on innovation with respect to fund deficits. Since that time, the Board has produced a number of papers on the management of pension fund deficits.
2. This paper highlights the key aspects of the Board's work and considers the implications for this Committee.

National Picture

3. The work of the Shadow scheme Advisory Board has been supported by work commissioned from PwC. Key amongst the findings is that the current picture on fund deficits is clouded by the variations in the way that fund deficits are calculated. The nationally reported deficit for the LGPS as a whole at the 2013 valuation was £47bn. This compared to a figure of £37bn at the 2010 Valuation.
4. However, PwC commented that the average discount rate applied by fund actuaries in the 2010 valuations was equivalent to CPI plus 3.2%, whereas under the impact of quantitative easing, this had dropped to CPI plus 2.5% for the 2013 Valuations. If the deficits had been calculated on a standardised basis across both Valuations (PwC took CPI plus 3% which is the standard approach taken by the Government Actuary Depart (GAD) when valuing the unfunded public schemes), then the overall deficit would in fact have fallen between 2010 and 2013 from £42bn to £24bn.
5. The PwC work also identified that the reported deficits varied depending on the individual fund actuaries, with both Aon Hewitt and Barnett Waddingham producing reports with higher discount factors and therefore smaller deficits than Hymans Robertson and Mercers.
6. A key initial recommendation from the Board is therefore for a standardised approach to be taken by all actuaries from the 2016 Valuations, to ensure all Funds report deficits calculated on a standardised basis. Fund Actuaries will be allowed to continue to tailor the financial assumptions when completing the valuation to produce employer contribution rates, but the separately reported

results on a standard basis will allow the Board, and individual funds to compare the position across funds, and direct any action to where it is most needed.

7. Other key issues identified by the Board and the work of PwC include:
 - The benefit of showing all deficit payments as a cash sum
 - The need to be clear on employer covenants
 - The need for greater flexibility around cessation payments
 - The need to ensure that the valuation, funding strategy statement, deficit recovery period and investment strategy are consistent
 - The potential requirement to set a minimum employer contribution
8. Amongst these issues, the issue of setting minimum employer contribution rates is likely to prove to be the most contentious, and the Board are likely to undertake further consultation on this point before making any recommendations to the Secretary of State. Whilst there is a clear need to avoid the situation of the 1980's and 90's where deficits rose when some funds took contribution holidays, it is unclear whether there is a fair and consistent method of setting minimum rates whilst taking into account the differences in local situations.
9. The only other key point made by the Board, is that the issue of fund deficits will not be addressed by simply focussing on scheme costs. The total costs of the scheme as measured by the second Annual Report for the LGPS are in the region of £0.5bn to £0.6bn, just over 1% of the total reported fund deficit of £47bn. As such, deficits will only be addressed by improving investment returns and/or further increases in contributions.

Oxfordshire Position

10. The position in Oxfordshire is not felt to be out of line with that elsewhere, accepting the lack of standardised data makes that judgement a difficult one to confirm. The deficit at the last Valuation was £329.7m which gives a funding level of 82%.
11. Along with other Barnett Waddingham clients, the discount rate applied at the 2013 Valuation was higher than average for all funds, at 5.8%, or 3.1% above the actuaries assumed level for CPI. The PwC chart of all Funds places the Oxfordshire Fund at the average funding level for Barnett Waddingham clients, whilst using a lower discount rate than the average used by Barnett Waddingham.
12. The key issue identified by the Board is whether the investment strategy can realistically deliver the returns required to eliminate the deficit over the stipulated deficit recovery period. There is nothing in the compiled figures to suggest that this is not the case at present.
13. A key issue that this Committee needs to consider is the extent to which the investment strategy is consistent with the liability profile. At the present time

the Fund is receiving on average £1m more a month in contributions than it is paying out in pension benefits. This allows the Fund to focus the investment strategy on delivering returns to close the deficit, without having to make allowance in the strategy for sufficient cash returns to pay pensions.

14. The Committee have not though previously undertaken any in depth analysis of this cash flow position to determine when the situation will move to the cash negative position a number of funds have found themselves in. It also follows therefore that more work needs to be undertaken in considering how the current investment strategy will support the payment of liabilities over the medium term, and therefore the strength on the current deficit recovery plan.
15. It is therefore recommended that the Committee asks the officers to work with Barnett Waddingham to produce a detailed analysis of the Funds predicted future payments of pension liabilities and cash flows. This work will also involve liaison with the major fund employers to understand their future plans in so far as how they relate to future LGPS membership e.g. major out-sourcing proposals, or reductions in service provision
16. This Committee has already incorporated other aspects of the Board's suggestions in respect of fund deficits. Almost all employers now pay their deficits by way of a cash contribution (so that it is not impacted by variations in active membership). The only exceptions are the County Council and the City Council where the deficit contributions are still set as a percentage of pensionable pay.
17. The Committee has also implemented a review of the financial covenant of the employers within the Fund, and received the first report at its March meeting. It is important to recall that 83% of the total fund deficit fell to the County, City and District Councils, with a further 14.7% falling to Brookes University, the colleges and the academies, and 2.2% falling to the transferee admission bodies which are in turn under-written by one of the scheduled bodies.
18. At the present time therefore, the available information suggests that the fund deficit is in line with those elsewhere, and can be eliminated over the deficit recovery period through maintaining the current investment strategy. The vast majority of the deficit is allocated against the major scheduled employers, such that the repayment is under-written by the tax payer, or the Department for Education.
19. It is though clear that the Committee would benefit from greater transparency over its future cash flow projections, which would provide an improved basis for monitoring the deficit repayment plan as well as a basis for the review of the current investment strategy and asset allocation to ensure these remain appropriate in light of the expected liability profile.

RECOMMENDATION

20. **The Committee is RECOMMENDED to:**

- (a) note the report;**
- (b) ask officers to work with the Fund's Actuary, Barnett Waddingham, to provide a detailed cash flow forecast based on assumed pension liabilities, and known plans of the main employers; and**
- (c) provide reports to future meetings of this Committee setting out the cash flow projections, and any implications for the current investment strategy and asset allocation.**

Lorna Baxter
Chief Finance Officer

Background papers: Nil
Contact Officer: Sean Collins, Service Manager, Pensions, Insurance & Money
Management, Tel: (01865) 797190

May 2015