SURREY COUNTY COUNCIL

SURREY PENSION FUND BOARD

DATE: **22 MAY 2015**

LEAD OFFICER: **SHEILA LITTLE, DIRECTOR OF FINANCE**

SUBJECT: **EMPLOYER BODY ADMISSION/TERMINATION GUIDANCE**

SUMMARY OF ISSUE:

The report explains the need for the creation of comprehensive and focused admission and termination guidance for scheme employers, including the option for the Fund to offer a bespoke solution to allow scheme employers to quantify the financial value of pension risk.

RECOMMENDATIONS:

It is recommended that the Pension Fund Board consider the benefits to the Fund of establishing new guidance for scheme employers, which reflects a more structured and focused approach to risk assessment.

REASON FOR RECOMMENDATIONS:

The Pension Fund Board must be aware of the need and requirement for more refined methods of assessing and monitoring risks to the Pension Fund and the part that revised admission and termination terms for scheme employers can play in helping to mitigate these risks. The establishment of new guidance for scheme employers complies with the new code of practice from the Pensions Regulator. The guidance will also include an innovative approach to new scheme employer pension admissions by offering awarding authorities and other scheme employers the option to measure the value of pension risk. This provides an opportunity for the Surrey Fund to lead the way in scheme employer management.

DETAILS:

Background

1 The scheme employer make-up of the LGPS has changed significantly in recent years. Much of this has been due to the increase in outsourcing of the delivery of council services and the high instance of academy conversions and free school start-ups. As a result of this the Fund is now an aggregation of many more scheme employers with distinct financial and funding characteristics. The Surrey Fund includes employers as diverse as local authorities, charities, education bodies, academies and private companies.

2 The proliferation of scheme employers has coincided with additional complexity in the scheme regulations and funding characteristics.

3 Pension provision has a material impact on the balance sheets of scheme employers. As a result, they are now more engaged with pensions and are looking for more bespoke funding and investment strategies as they seek to demonstrate value to their stakeholders.

4 Recent changes in LGPS governance, brought about by the Public Service Pensions Act 2013, means that the LGPS is now regulated by the Pensions Regulator. Within the LGPS a statutory scheme advisory board and local pension boards have been established to assist administering authorities in complying with their regulatory duties. As part of these new governance arrangements, there will be additional scrutiny on risk and deficit management.

5 The increase in numbers of scheme employers and their engagement with pension funds, added to the additional regulatory scrutiny now faced by funds, makes the need for a comprehensive risk assessment of these employers essential.

6 There are a number of key elements to the proposed new guidance for scheme employers. These include:

- a review of policy documentation for admission bodies;
- assessing and monitoring the strength of covenant for employers;
- developing consistent funding and investment strategies.

7 In addition to these key elements, the Fund is uniquely placed to offer awarding authorities and other scheme employers advice and guidance regarding the financial value attributable to pension risk and the options available to them to address this through risk sharing. It is proposed that the Fund should explore offering scheme employers bespoke guidance and advice in this area. This would represent a unique proposition. Details of the scope of this proposition are outlined in the risk sharing framework section of this report.

A review of policy documentation for admission bodies

8 The purpose of admission guidance is to ensure that scheme employers are aware of their responsibilities to the Fund and that the financial risks to the Fund and to scheme employers are identified, mitigated and managed accordingly.

9 Policy documentation included in the admission guidance should be drafted on the basis of the following key principles:

- to ensure the long-term solvency of the Fund as a whole and the solvency of each of the notional sub-funds allocated to the individual employers;
- to help scheme employers recognise, understand and manage their pension liabilities as they accrue within the wider consideration of their business operations;
- to use reasonable measures to reduce the risk to other employers in the Fund and ultimately the council tax payer from an employer ceasing participation or defaulting on its pension obligations;
- to address the different characteristics of the disparate range of employers or groups of employers;
- to maintain long term affordable and stable employer contributions.

10 Admission guidance should include policy documentation which provides scheme employers with a clear framework to enable them to understand and comply with their responsibilities to the Fund. It should allow them to identify the extent of the existing and potential liabilities and the methods by which the Fund may work with scheme employers to mitigate the risks that these liabilities impose. This framework should include:

- allocating assets on entry;
- requirements for bond/indemnity guarantee that is reviewed regularly;
- potentially levying a higher contribution rate; e.g. due to a change in circumstances or covenant strength of a scheme employer;
- having clear termination clauses;
- a range of unambiguous and non-negotiable admission agreements;
- clarification on the terms and repayment of lump-sum events;
- close monitoring of scheme employer deficits when approaching a termination event and adjusting contribution if necessary;
- a clear basis for cessation calculations.

11 It will be necessary to draft or review a full suite of policy documents, including, but, not restricted to admission agreements and admission, cessation and bulk transfer policies.

Assessing and monitoring the strength of covenant of employers

12 As the number of scheme employers in the Fund increases, so does the number of scheme employers raising queries about their willingness to continue their participation in the LGPS and their ability to pay certified contributions.

13 The strength of the employer covenant represents a measurement of scheme employers “ability and willingness” to pay contributions.

14 The new guidance to scheme employers will include details of how the Fund proposes to systematically assess the ability and willingness (or strength of covenant) of scheme employers to pay contributions. This will include the following:

- ability: to pay regular contribution towards new or accrued benefits, to meet the costs of lump-sum payments and to make a final settlement when ceasing participation in the Fund;
- willingness: legislative or contractual obligation, or attitude to pension funding.

15 Assessing the employer covenant allows the Fund to identify and quantify the financial risk to the Fund posed by an individual or group of employers. If financial risk is identified, the Fund can take mitigating action. This could include putting in place specific Funding strategies and appropriate levels of security to protect the Fund in the event of default.

16 The assessment will include various activities, including, but not restricted to:

- regular reviews of employer funding levels, termination risk, actuarial assumptions compared to actual salary growth;
- assessment and review of covenant by a number of metrics to establish a risk score (e.g. deficit, time horizon, gearing ratio, cash flow); this could also be by reference to credit rating agency checks;
- regular reviews of bonds or guarantees

- checks against scheme employer compliance with the regulations and the Administration Strategy (e.g. are reporting standards being met, or is the scheme employer notifying the Fund of material changes).

Developing consistent Funding and investment strategies

17 The Fund already provides different Funding strategies for employers with tax raising powers, allowing a stabilisation of contribution rates. As part of a consistent approach to risk assessment, including policy and covenant reviews, the Fund could look to match funding targets to the overriding risk assessment of scheme employers.

18 Such matching would allow the Fund to set a higher funding target for those employers with a poor covenant and higher risk of default. The higher funding target is set through an increased likelihood of achieving a fully funded position. A simple example of this is as follows:

- Low risk employer = 66% likelihood
- Medium risk employer = 75% likelihood
- High risk employer = 85% likelihood

19 The matching of funding targets to risk assessed covenant strength could inform a selection of bespoke investment strategies. The different investment strategies would feed in to valuation assumptions and be linked to the calculation of contribution rates.

A pension risk sharing framework

20 When admitting new contractors to the Fund, the standard assumption is that the new scheme employer will start on a “fully funded” basis, with assets at the outset notionally set equally to the value of transferring past service liabilities. In effect, the new scheme employer would have no deficit at outset.

21 The opening contribution rates are set to provide the cost of future service benefits and then reviewed at every formal valuation date to allow for a readjustment of contributions to match assumptions and market conditions; and producing the commensurate surplus or deficit.

22 When the contractor reaches the end of the contract, a cessation valuation is carried out and any deficit is levied on the departing scheme employer.

23 As already noted, there has been an increase in sophistication of scheme employers and this has lead to a re-examination of the pension risk attributable to the “fully funded” approach.

24 There are a number of risk sharing options that can allow the awarding authority to exchange the retention of some or all of the pension risk for a reduced contract price.

25 As risk sharing arrangements become more common, it is important that awarding authorities and new scheme employers understand the risks they are taking on. Failure to do can lead to covenant strength issues and the risk of awarding authorities having to fund deficits.

26 The Fund believes that it is important and demonstrates good governance for clear information regarding the specific costs attributable to risk sharing arrangements to be available to awarding authorities and new scheme employers.

27 It is proposed that the Fund offer, where appropriate, an assessment which provides high level financial information to allow better decision making and to assist in delivering best value in public procurement, through the consideration of the impact of pension risk sharing arrangements. This could include:

- the adequacy of any fixed, capped or collared contribution rate;
- the likelihood of the new scheme employer being fully funded at the end of the contract;
- the impact on the contract price of any risk sharing arrangement;
- the measure of potential deficit at the end of the contract which the contractor would be obliged to meet.

28 There is currently no standard offering of this type of risk sharing assessment solution. The development of a new approach provides the opportunity for the Surrey Fund to establish itself as the market leader in employer management.

CONSULTATION:

29 The Chairman of the Surrey Pension Fund Board has been consulted on the report.

RISK MANAGEMENT AND IMPLICATIONS:

30 Risk related issues are contained within the report, most notably the assessment of the strength of scheme employer covenant.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

31 The costs of developing the guidance will be investigated and reported in future Board reports.

DIRECTOR OF FINANCE COMMENTARY

32 The Director of Finance will ensure that all material, financial and business issues and possibility of risks will be considered when a final report is presented to the Board.

LEGAL IMPLICATIONS – MONITORING OFFICER

33 Legal implications or legislative requirements associated with this initiative will be addressed in future Board reports.

EQUALITIES AND DIVERSITY

34 There are no equalities or diversity implications associated with this report.

OTHER IMPLICATIONS

35 There are no potential implications for council priorities and policy areas.

WHAT HAPPENS NEXT

36 The following next steps are planned:

- A further report presented at a future Board meeting.

Contact Officer:
Phil Triggs, Strategic Finance Manager (Pension Fund and Treasury)

Consulted:
Surrey Pension Fund Board Chairman

Annexes:
None

Sources/background papers:
None