Freedom and Choice in the LGPS

Addressee

This paper has been commissioned by and is addressed to Surrey County Council in its capacity as Administering Authority to the Surrey Pension Fund ("the Fund"). It has been prepared in my capacity as Fund Actuary.

Purpose

The purpose of this paper is to investigate the potential funding and cash flow impact of members making use of the new 'freedom and choice' legislation by either transferring their LGPS benefits to a defined contribution (DC) arrangement, in order to have full access to the cash transferred, or by taking advantage of the new trivial commutation limits.

Background – Funding approach

At the 2013 valuation, the assessed funding level (i.e. the assets as a proportion of the value of the past service liabilities) was 72.3% and contributions were set for each employer in the Fund from 1 April 2014 to 31 March 2017.

Full details of the approach taken for assessing contributions are included in the 2013 valuation report (dated 31 March 2014) and the Fund's Funding Strategy Statement (included in the 2014 Annual Report).

Background – Freedom and choice reforms

In its 2014 budget the Government announced measures to give savers more freedom and choice about how they use their pension savings. In particular;

- From April 2015, LGPS members will have the flexibility to **take their benefits as up-front cash via a transfer to a DC arrangement.**
- From March 2014, **the limit applying to the payment of a trivial lump sum increased from £18,000 to £30,000**. This limit applies to the value of a member's pension rights under all registered pension schemes. In addition, planned changes being effected through the Taxation of Pensions Act 2014 mean that from April 2015 **trivial commutation of benefits will be payable from a member's minimum pension age (i.e. currently age 55).**

These reforms may have an impact on the funding position of the Fund and are likely to lead to an increase in the short term outgo.

The reforms have no impact on the cash flow profile of pensioner members, i.e. only active and deferred members in the Fund are able to transfer out to a DC arrangement or take advantage of the higher trivial commutation limits.

This paper does not provide detail on the safeguards in place to protect members considering the option to transfer to a DC arrangement. Further information is provided in our Briefing Note: "*What price freedom*".

Summary

CETV exposure

The maximum exposure to the Fund in respect of possible CETVs over the 2015/16 year is c£1,111m (or c£1,006m on the assumption that all members over age 65 are in receipt of their pension as at 1 April 2015). This can be broken down between active and deferred members as follows;

	Maximum CETV exposure	
	Members over age 54 at 1 April 2015	Members over age 54 and less than age 65 as at 1 April 2015
Active	£811m	£716m
Deferred	£300m	£290m
Total	**£1,111m**	**£1,006m**

Relative to the assumptions underlying the calculation of CETVs, the Fund's valuation assumptions (based on recent market conditions) are currently more *prudent,* i.e. the assessed value of the past service liabilities on the 2013 valuation assumptions is generally slightly *greater* than the valuation of the same benefits for CETV purposes. This means that, on average, each CETV payment will reduce the fund's deficit in absolute terms. The effect on the funding level is negligible (see table on page 7).

Based on the scenarios modelled in this paper, we expect any increase in CETVs to lead to a reduction in the past service deficit. This is due to the difference between the funding assumptions and the CETV assumptions.

The impact of CETVs on the funding position is sensitive to market conditions underlying the ongoing funding basis. A rise in the real gilt yield (all else being equal) will reduce the funding gain arising from CETVs and have a negative effect on the funding level.

Trivial commutation

From April 2015, LGPS members will be able to commute all of their pension benefits if they have reached age 55 and the total value of their benefits (across all registered schemes) is less than £30,000. The rise in the trivial commutation limit (it is currently £18,000) may lead to a higher incidence of trivial commutation pay-outs in the future. Furthermore, the lowering of the age from which members may choose to take a trivial commutation (it is currently age 60) may bring forward the resulting payments.

The table below shows the split of the estimated trivial commutation entitlement over 2015/16 between actives and deferreds.

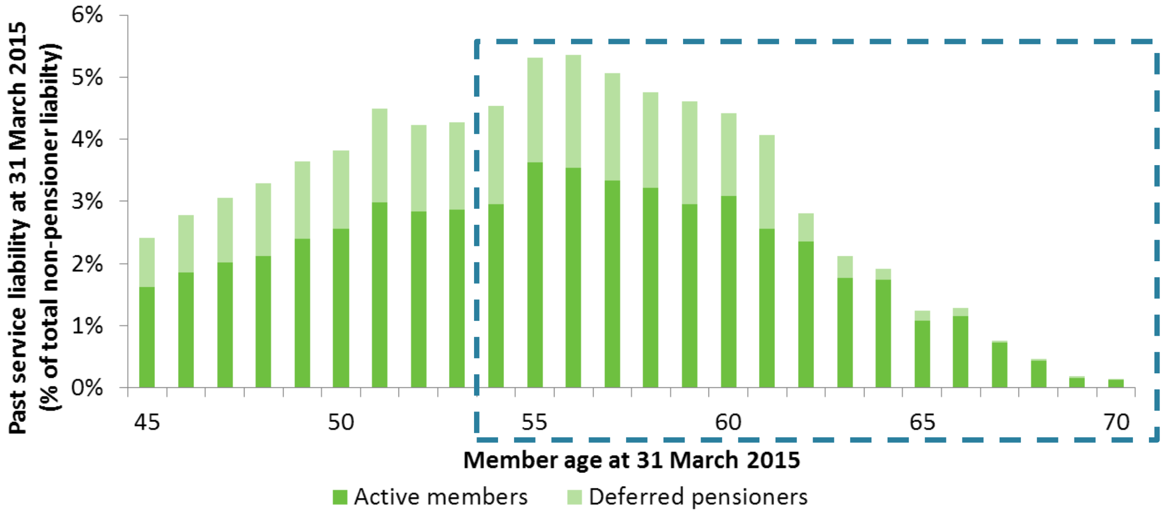
	Estimated trivial commutation entitlement in 2015/16				Eligible members (new rules)
	Old rules	Increase in limit to £30k	Reduction in eligible age	**Total**	
Active	£7.5m	£9.6m	£22.7m	**£39.8m**	**3,738**
Deferred	£12.2m	£10.9m	£30.1m	**£53.2m**	**6,116**
Total	**£19.7m**	**£20.5m**	**£52.8m**	**£93.0m**	**9,854**

Non-pensioner membership profile

Membership data was last provided for the purpose of the 2013 formal valuation. Based on this data, we have identified the members who are able to take advantage of the freedom and choice reforms and estimated the maximum exposure to the Fund of increased cash payments in the short term and the potential funding impact.

Chart 1 below shows the age distribution of the non-pensioner past service liability as at 31 March 2015, based on the 2013 valuation data, service to 31 March 2015 and ongoing funding assumptions as a recent date (31 December 2014).

Chart 1 – age distribution of the non-pensioner past service liability as at 31 March 2015



Notes on Chart 1;

a. It is assumed that all members in the Fund as at 31 March 2013 have the same status as at 31 March 2015. In practice, it is highly likely that some members have left the scheme (and become deferred or transferred-out), retired, or died since the 2013 valuation.

b. The total non-pensioner liability as at 31 March 2015 is estimated to be £2,727m (split £1,901m for actives and £826m for deferreds). The whole fund liability as at 31 March 2015 is assumed to be £4,095m (i.e. the whole fund liability reported in the 31 December 2014 Funding Update.)

c. Actuarial assumptions are based on the approach adopted at the 2013 valuation, allowing for market conditions at 31 December 2014. Further details are included in the appendix.

d. Pension benefits as at 31 March 2013 for active / deferred members have been increased in line with expected pay growth / actual pension increase orders to 31 March 2015.

e. The active liability allows for the expected accrual of benefits from 1 April 2013 to 31 March 2015.

From Chart 1, it can be observed that around 49% of the total non-pensioner liability at 31 March 2015 is attributable to members who will be 55 or over during the 2015/16 financial year (i.e. age 54 or over as at 1 April 2015, as represented by the blue dotted line). This represents around 33% of the whole fund liability at this date.

Broken down by active and deferred status;

- c35% of the non-pensioner liability (or c23% of the whole fund liability) is in respect of active members who will be over age 55 during the 2015/16 year.
- c14% of the non-pensioner liability (or c9% of the whole fund liability) is in respect of deferred members who will be over age 55 during the 2015/16 year.

Cash Equivalent Transfer Values (CETVs)

All non-pensioner members

In the event of a member opting to transfer their LGPS benefits out of the Fund, a Cash Equivalent Transfer Value (CETV) is paid to the receiving DC scheme. The CETV amount is determined in a different way to how we determine the valuation past service liability.

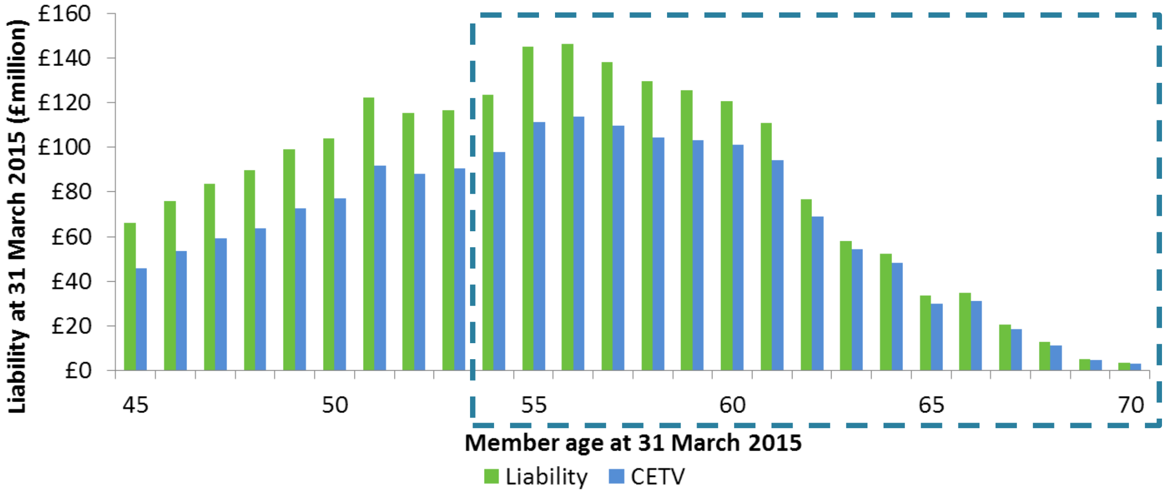
CETVs are calculated based on the guidance and factors provided by the Government Actuary's Department (GAD), dated 28 March 2014. The assumptions underlying the CETV calculation are fixed in nature, i.e. they do not vary in line with any changes to market conditions.

The discount rate adopted at the Fund's 2013 valuation was set equal to the yield on Fixed Interest Government bonds at the valuation date, plus an allowance of 1.6% (the Asset Outperformance Assumption) which represents our prudent estimate of future asset outperformance. Relative to the assumptions underlying the calculation of CETVs, the 2013 valuation assumptions are currently more *prudent,* i.e. the assessed value of the past service liabilities on the 2013 valuation assumptions is generally greater than the valuation of the same benefits for CETV purposes.

In order to assess the potential impact of allowing LGPS members to take their benefits as up-front cash via a transfer to a DC arrangement, I have estimated the value of the past service liabilities of non-pensioner members on the current CETV assumptions. For further details about the assumptions please see the *Data and assumptions* section below.

Chart 2 below shows the split of the estimated non-pensioner past service liability at 31 March 2015 by age and the approximate corresponding CETV.

Chart 2 – Estimated non-pensioner past service liability as at 31 March 2015 and the corresponding CETV



Notes on Chart 2;

a. Notes from Chart 1 apply

b. The active liability and estimated CETV amounts allow for the expected accrual of benefits from 1 April 2013 to 31 March 2015.

c. CETV amounts have been estimated based on the factors and guidance published by GAD for this purpose dated 28 March 2014, the 2013 valuation data and actual pension increase orders to 1 April 2015.

d. A Critical Retirement Age (CRA) of 63 has been assumed in the calculation of CETVs.

From Chart 2 it can be observed that the CETV amount is lower than the value of the past service liability at all ages. Furthermore, the difference between the liability and the corresponding CETV amount is greater at younger ages.

The total CETV value in respect of members who will be 55 or over during the 2015/16 financial year (the bars enclosed by the blue dotted line) is approximately £1,111m. Excluding members aged 65 and over as at 31 March 2015 (on the assumption that their benefits will already be in payment), the total CETV value is approximately £1,006m.

The maximum exposure to the Fund in respect of possible CETVs over the 2015/16 year is therefore c£1,111m (or c£1,006m on the assumption that all members over age 65 are in receipt of their pension as at 6 April 2015). Given the uncertainty around the likelihood that members will exercise this option (particularly as different groups could be more likely to do so than others), careful consideration will be required as to how these payments will be financed.

The following section considers the split of the exposure between active and deferred members.

Active / deferred split of CETV exposure

The previous section sets out the maximum CETV exposure in respect of active members and deferred pensioners combined (based on membership data as at 31 March 2013). It could be argued that deferred pensioners are more likely to take advantage of the freedoms, and more likely to do it soon after 6 April 2015, given that they do not need to withdraw from active service (however temporary).

Charts 3 and 4 show the comparison of estimated past service liability at 1 April 2015 and CETV amounts by age, for active members and deferred members separately.

Chart 3 – Estimated active past service liability as at 31 March 2015 and the corresponding CETV

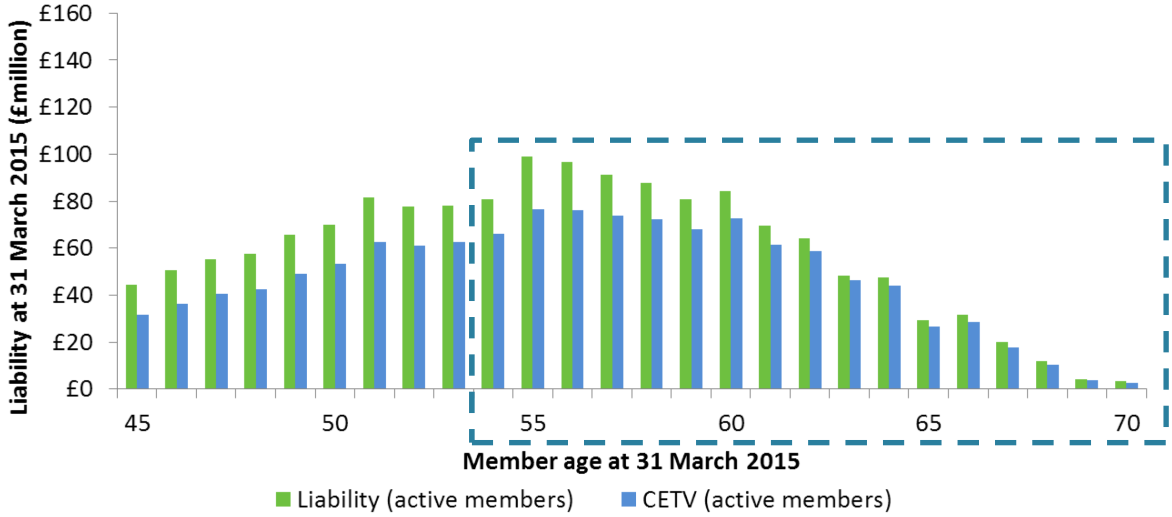
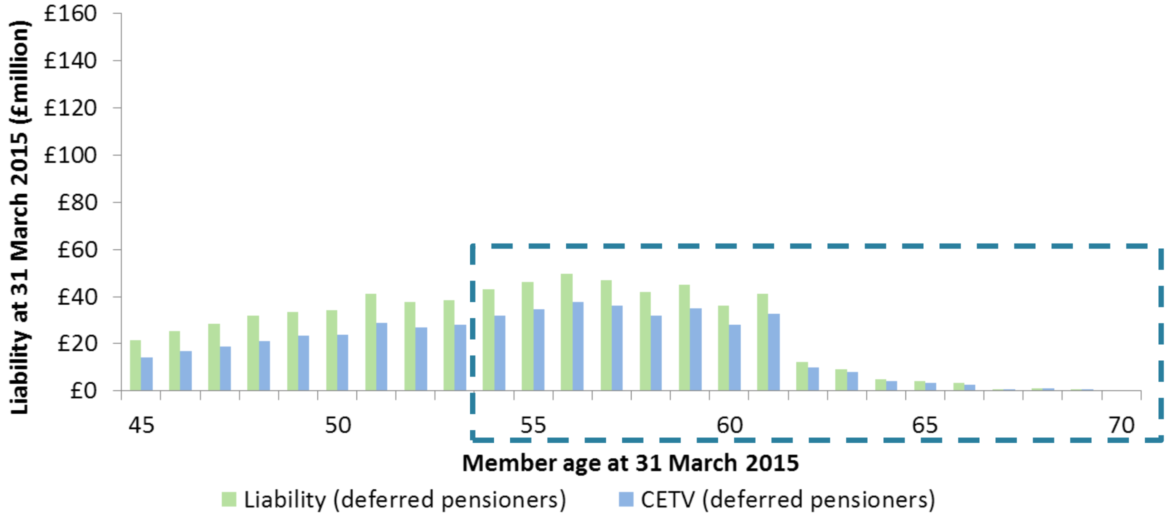


Chart 4 – Estimated deferred past service liability as at 31 March 2015 and the corresponding CETV



Notes on Charts 3 and 4;

a. Notes from Chart 2 apply

These charts show that the maximum CETV exposure is split approximately 70%/30% between active members and deferred pensioners. In addition, the difference between the past service liabilities and CETV amounts is slightly smaller for deferred pensioners. This reflects the assumption that deferred pensions are increased at a lower rate (CPI) than active members' salaries (salary growth).

The maximum CETV exposure over 2015/16 of £1,111m (or £1,006m in respect of members less than 65 at 1 April 2015) can be broken down between active and deferred members as follows;

	Maximum CETV exposure	
	Members over age 54 at 1 April 2015	Members over age 54 and less than age 65 as at 1 April 2015
Active	£811m	£716m
Deferred	£300m	£290m
Total	**£1,111m**	**£1,006m**

Funding impact

The funding level as at 31 December 2014 was estimated to be 73%, as noted in my funding update (Navigator) report as at 31 December 2014. Taking into account the potential CETV exposure calculated above, the table below shows the potential funding impact of members choosing to take a CETV, under the following scenarios;.

1. 75% of deferred members over age 54 (at 1 April 2015) take a CETV over the 2015/16 year;
    a. Active take-up rate of 50% (over age 54 at 1 April 2015)
    b. Active take-up rate of 10% (over age 54 at 1 April 2015)
2. 25% of deferred members over age 54 (at 1 April 2015) take a CETV over the 2015/16 year;
    a. Active take-up rate of 50% (over age 54 at 1 April 2015)
    b. Active take-up rate of 10% (over age 54 at 1 April 2015)

All figures in £m	1a 50% actives 75% deferreds	1b 10% actives 75% deferreds	2a 50% actives 25% deferreds	2b 10% actives 25% deferreds
Funding position pre-transfer;				
- Liabilities	4,095	4,095	4,095	4,095
- Assets	3,006	3,006	3,006	3,006
- Deficit	1,089	1,089	1,089	1,089
- Funding Level	**73%**	**73%**	**73%**	**73%**
Assumed CETV payments;				
- actives	406	81	406	81
- deferreds	225	225	75	75
- total	**631**	**306**	**481**	**156**
Past service liability transferred;				
- actives	478	96	478	96
- deferreds	291	291	97	97
- total	**769**	**387**	**575**	**193**
Funding position post-transfer;				
- Liabilities	3,326	3,708	3,520	3,902
- Assets	2,375	2,700	2,526	2,850
- Deficit	951	1,008	994	1,052
- Funding Level	**71%**	**73%**	**72%**	**73%**

The funding assumptions are (currently) more prudent than the CETV basis which means that, in every scenario, the fall in liabilities is greater than the fall in assets. However, the difference is relatively small so the *percentage* fall in assets is greater. This means that the past service deficit falls but so too does the funding level.

It is assumed in the above figures that CETVs are paid in respect of an equal cross section of the fund's active and deferred membership. If CETVs were concentrated amongst older members, where the difference between CETV and liability amounts is smaller, the deterioration in funding level would be slightly greater and the reduction in the deficit would be smaller than that shown. Similarly, it is possible that individual CETVs paid in respect of individual members (in particular, younger members) may lead to both an even greater reduction in deficit and an improvement in the funding level.

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Sensitivity to a rise in the discount rate

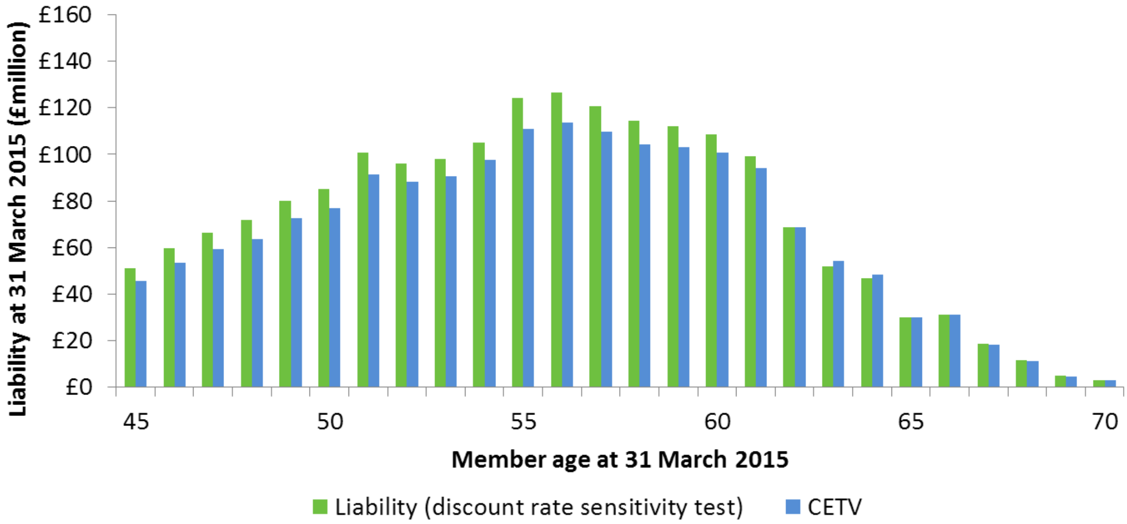
The assumptions underlying the factors used to determine CETVs are fixed in nature, i.e. they do not vary in line with changes in market conditions. The funding assumptions are set relative to market conditions at the calculation date meaning that the assessed past service liabilities can vary from time to time in line with changes to market conditions (in particular the yields on government bonds).

Based on recent market conditions, the ongoing funding assumptions underlying the valuation of the past service liability are collectively more prudent than the CETV assumptions, meaning that we expect the funding deficit to fall in absolute terms as a result of transfers-out on a CETV basis (as shown in the previous section).

Future changes to market conditions may lead to the assessed CETV values being higher than the value of the past service liabilities on the funding assumptions. In particular, this may happen in the event of a substantial increase in Government bond yields, with no corresponding increase in implied inflation (i.e. an increase in the real discount rate).

To investigate the sensitivity of the results to changes in market conditions, we have estimated the past service liabilities as at 31 March 2015, based on a 1% p.a. higher real discount rate. All other assumptions are the same as before. This is shown in Chart 5 below.

Chart 5 – Estimated non-pensioner past service liability as at 31 March 2015 (discount rate + 1% p.a.) and the corresponding CETV



Notes on Chart 5;

a. Notes from Chart 2 apply.

b. Liabilities have been calculated using 31 December 2014 financial assumptions with the real discount rate increased by 1% p.a.

We can clearly observe from this chart that a higher real discount rate (1% p.a. higher than before) significantly reduces the difference between past service liabilities and CETVs. We can also see that CETVs slightly exceed the value of the past service liabilities at higher ages (over assumed retirement age).

Consequently we would expect deficits to fall as a result of members taking a CETV from the Fund.

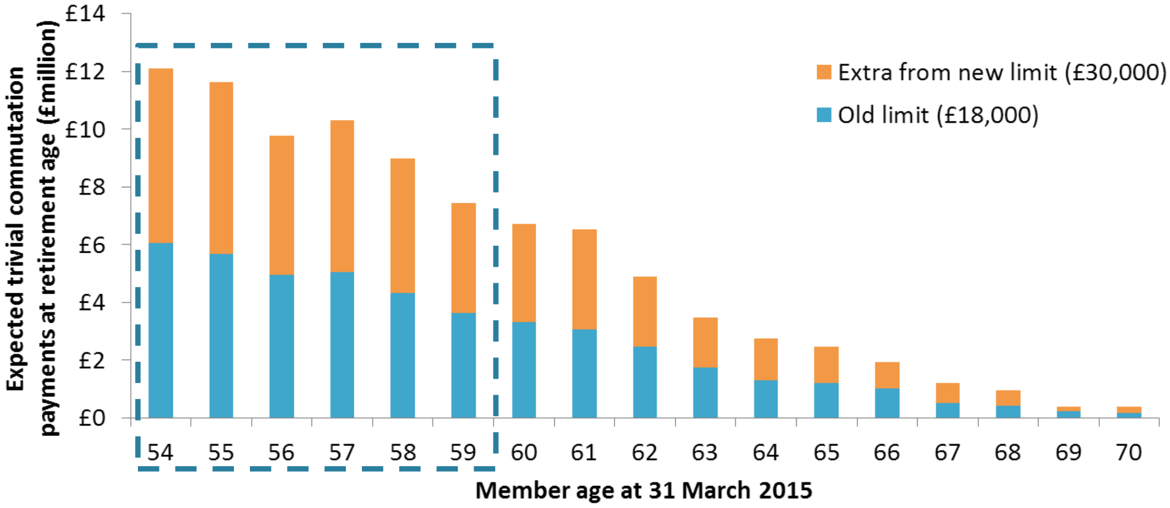
Members eligible for trivial commutation

All non-pensioner members

From April 2015, we understand that LGPS members will be able to commute all of their pension benefits if they have reached age 55 and the total value of their benefits (across all registered schemes) is less than £30,000. The rise in the trivial commutation limit (it is currently £18,000) may lead to a higher incidence of trivial commutation pay-outs in the future. Furthermore, the lowering of the age from which members may choose to take a trivial commutation (it is currently age 60) may bring forward the resulting payments.

Chart 6 below shows the maximum trivial commutation payments at retirement, based on the old limits (£18,000 – blue bars) and the additional maximum entitlement arising as a result of the new limits (£30,000 – orange bars).

Chart 6 – maximum trivial commutation payments at retirement date (age 60)



Notes on Chart 6;

a. Pension benefits as at 31 March 2013 have been increased in line with actual pension increase orders to 1 April 2015.

b. It is assumed that members have no pension entitlement in other registered schemes. In reality, members with entitlements in more than one scheme may have a total pension amount which exceeds the trivial commutation limit and may therefore not be eligible.

c. Trivial commutation amounts have been estimated based on the factors and guidance published by GAD for this purpose dated 28 March 2014. Revised factors reflecting the ability to take a trivial lump sum from age 55 have not yet been issued by GAD.

d. This chart does not allow for any retirements that have occurred since the 2013 valuation. The trivial commutation exposure at later ages 60 is therefore likely to be overstated.

e. In determining the maximum exposure to the Fund, it is assumed that all members with an assessed pension pot value in the Fund of less than £30,000 take up this option.

It can be seen from Chart 6 that the upcoming changes to the trivial commutation rules may lead to a significant increase in the amount paid out by the Fund in the short term.

The estimated trivial commutation entitlement emerging in respect of members reaching the limit in 2015-16 is around £93.0m (the sum of all bars above). This can be broken down as follows;

- Prior to the freedom and choice reform, only members over age 60 were eligible to take a trivial lump sum if the value of their benefits was less than £18,000. **Under the old rules**, the total trivial commutation entitlement in 2015/16 was around £19.7m (i.e. the blue bars for those aged 59 and over).
- The **increase in the trivial commutation limit** (from £18,000 to £30,000) **in isolation**, leads to an increase in the maximum trivial commutation entitlement in 2015/16 of around £20.5m (i.e. the orange bars for those aged 59 and over.

- The change in the **age at which members are eligible** for trivial commutation (from 60 to 55), leads to an increase in the maximum trivial commutation entitlement in 2015/16 of around £52.8m (i.e. blue and orange bars in the blue dotted box).

The impact of the rise of the trivial commutation limits on the Fund’s projected benefit outgo is clearly significant. Under the old limits, there may have been 3,405 members to be entitled to trivial commutation over 2015/16. Under the new rules, we estimate 9,854 members may qualify for trivial commutation in the 2015/16 year (assuming that the value of any other pension entitlement in other schemes doesn’t take the member over the £30,000 threshold).

As with the CETVs in the previous section, the likelihood to take up the trivial commutation option may be very different between active and deferred members. In particular, deferred pensioners may be more likely to take advantage of the lowering of the qualifying age given that they do not need to withdraw from active service (however temporary).

The table below shows the split of the estimated trivial commutation entitlement between actives and deferreds.

	Estimated trivial commutation entitlement in 2015/16				**Eligible members (new rules)**
	Old rules	Increase in limit to £30k	Reduction in eligible age	**Total**	
Active	£7.5m	£9.6m	£22.7m	**£39.8m**	**3,738**
Deferred	£12.2m	£10.9m	£30.1m	**£53.2m**	**6,116**
Total	**£19.7m**	**£20.5m**	**£52.8m**	**£93.0m**	**9,854**

Next steps

Potential areas to consider as next steps include:

- **Investment strategy**: consideration of impact due to increased transfers and trivial commutation on cash flow management
- **Including scenarios in 2016 valuation modelling**: depending on the uptake of transfers and trivial commutation there could be an impact on the long term stabilisation modelling. The scenarios modelled ahead of the 2016 valuation can include allowance for increased transfer and trivial commutation activity. Unless there is a very significant take up of the options contained in this paper we would not expect a material short term impact on employer contribution rates.
- **Informing the committee of potential impact**
- **Freedom and Choice communications**
    - Altering members to changes
    - Updating retirement packs and benefits statements
    - Employer engagement
- **Transfer quote activity**: Planning for increased transfer quote requests and the impact on administration
- **Safeguard policy:** drafting a safeguard monitoring policy in relation to Reduction of Cash Equivalents Regulations 2015

Reliance and Limitations

This paper has been prepared solely for the use of the Fund. This document should not be released or otherwise disclosed to any third party without our prior consent, in which case it should be released in its entirety. Hymans Robertson LLP accepts no liability to any other party unless we have expressly accepted such liability.

The estimated CETVs provided in this paper are no substitute for actual CETV amounts that should be determined as and when required in line with GAD guidance.

This paper does not form advice to any of the members of the Fund in relation to transferring benefits. Members thinking of transferring benefits or taking a trivial commutation lump sum should seek further advice from a qualified professional, for example an Independent Financial Advisor.

The following Technical Actuarial Standards[1] are applicable in relation to this report:

- Pensions TAS
- TAS M - Modelling
- TAS R – Reporting; and
- TAS D – Data.

This report complies with each of the above standards.

[1] Technical Actuarial Standards (TASs) are issued by the Financial Reporting Council (FRC) and set standards for certain items of actuarial work, including the information and advice contained in this report.

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HYMANS ROBERTSON LLP

This report and the 2013 valuation final results report dated 31 March 2014 comprise the aggregate report for this advice, in accordance with TAS R.

Prepared by:-

Barry McKay

Barry McKay FFA

01 May 2015

For and on behalf of Hymans Robertson LLP

Appendix 1

Data and assumptions

Data

The member data used in this analysis was that supplied for the purposes of the 2013 formal valuation. This is summarised in the table below.

	Number	Actual pay/ pension (£000)
Total employee membership	29,772	489,043
Total deferred membership	30,189	36,797

The deferred pension shown includes revaluation up to and including that granted by the 2013 Pension Increase Order.

Please note that the data used may not be an accurate reflection of the current non-pensioner membership. In particular, I have not adjusted the data to allow for new entrants, new deferrals, deaths and retirements since the 2013 valuation. The only way to capture the actual experience of the Fund since the 2013 valuation would be to consider this exercise based on updated data at a recent date.

Assumptions

The demographic assumptions used to calculate the liabilities on the 2013 valuation basis are described in detail in the 2013 valuation final report, dated 31 March 2014.

The financial assumptions for the past service liabilities calculated in this report were based on market conditions as at 31 December 2014, as summarised below.

	31 March 2013	31 December 2014
	% per annum	% per annum
Gilt yields	3.0%	2.4%
Asset outperformance assumption	1.6%	1.6%
Discount rate / investment return	4.6%	4.0%
Salary increase	3.8%	3.7%
Pension increase (CPI)	2.5%	2.4%

The CETV and trivial commutation amounts have been determined in line with the following guidance issued by the GAD.

- Individual Incoming & Outgoing Transfers (dated 28 March 2014)
- Trivial commutation (dated 28 March 2014)

It should be noted that we are making no estimate about the likelihood of members choosing to take up the option of transferring to a DC scheme or trivially commuting all of their LGPS benefits as there is currently no evidence on which to base such an estimate. I am happy to consider this further if required.