Bath & North East Somerset Council

MEETING:	**AVON PENSION FUND COMMITTEE**	
MEETING DATE:	**28 MARCH 2014**	**AGENDA ITEM NUMBER**
TITLE:	**2013 VALUATION & ADMISSION BODIES UPDATE**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		

List of attachments to this report:

Exempt Appendix 1 – Community Admission Bodies

Exempt Appendix 2 – Update on Community Admission Bodies

Exempt Appendix 3 – Transferee Admission Bodies

Appendix 4 – List of Academies

1 THE ISSUE

1.1 Following the presentation by the Actuary at the December meeting, the Committee requested a report summarising how the Funding Strategy Statement (FSS) has been applied to different groups of employers in the valuation.

1.2 There are a significant number of “admitted” bodies including Transferee Admission Bodies (TABs) and Community Admission Bodies (CABs) in the Fund. Given the significant pressure on their financial position, the admitted bodies, though small in number and in monetary terms, pose a risk to the Fund in terms of recovering the pension liabilities. This report updates the Committee on the admitted bodies and the Fund’s policy to managing the risk and recovering outstanding debts in respect of these bodies.

1.3 Three specific policy issues have arisen in light of the valuation; the refunding of any surplus of assets over liabilities when Transferee Admission Bodies exit the Fund; the investment policy for employers funded on the corporate bond basis and the Fund’s policy on stopping accruals for eligible members.

2 RECOMMENDATIONS

That the Committee:-

2.1 Notes the report summarising how the FSS has been applied to groups of employers;

2.2 Notes the update on the admitted bodies;

2.3 Agrees the revised approach to implementing the investment policy for certain small employers funded on the corporate bond basis.

2.4 Agrees the amendment to the Fund's policy for stopping accruals for eligible members.

2.5 Instructs Officers to update the FSS to reflect the amended policies as required.

3 FINANCIAL IMPLICATIONS

3.1 There is a significant risk that a few of the CABs may not be able to meet their full liability especially as many of these bodies are primarily funded by local authorities and central government. Where an employer cannot meet their full liability the Regulations allow for the outstanding sum to be recovered from the other bodies in the Fund.

3.2 To put this into perspective, the aggregate deficit of the CABs at the 2013 actuarial valuation was £36m or 4.1% of the total deficit. Over half of this (£21m) relates to one relatively secure entity and a number of the other larger CABs have relatively secure income streams underpinning the deficit.

3.3 The pension liabilities of the TABs are guaranteed by the outsourcing scheme employer (which are typically the unitary authorities) so pose no direct funding risk to the Fund.

3.4 When an employer exits the scheme and the outstanding debt is paid, the Fund resumes responsibility for any deterioration in the funding position at exit. There is no recourse to the former scheme employer.

4 APPLYING THE FSS TO THE 2013 VALUATION

4.1 At the December meeting, the Committee requested further detail of how the FSS was applied to different employers in the valuation. The Regulations require that the valuation is carried out with an effective date of 31 March 2013. Therefore, at a whole Fund level the assets, liabilities and funding position as at 31 March 2013 must be disclosed although the Actuary can state in his report how the funding position has developed up until formal sign off. However, the contribution funding plans i.e. the repayment plan for individual employing bodies can use a number of tools to assist in stabilising any increase in contributions for employers in line with the underlying regulatory requirement for the "desirability of maintaining a contribution rate as nearly as constant as possible". In particular, as new contributions do not come into effect until 1 April 2014, changes in market conditions can be incorporated if the Actuary believes the changes are material and sustainable.

4.2 However, there was one overriding parameter applied across all employing bodies (other than in exceptional circumstances at the discretion of the Administering Authority), within which the use of any tools had to comply; the deficit recovery payments in 2014/15 and beyond could not be lower than the indexed 2010 repayment plan.

4.3 The main parameters or "tools" the FSS permits to stabilise contributions are:

(1) Phasing of the increases in deficit payments and future service rates

(2) Deficit recovery periods

(3) Allowance for Pay restraint

(4) Use of bond yield reversion (observed or anticipated)

4.4 Each employing body's outcome was reviewed and the combined increase in the future service rate (FSR) and deficit payments was taken into account to set the payment plans. Given the large increases in the FSR for some cases (due to the change in the discount rate used and, for some, the minimal savings or extra costs of the new scheme benefit structure) the FSRs were normally phased in over 3 years and in some cases, especially where the new scheme has materially increased costs, over 4 years. Any increase in deficit recovery amounts were phased in over 3 years.

4.5 The FSS has an objective to get all employers to a 15 year deficit recovery period. In general deficit recovery periods have been kept in line with the 2010 plan, i.e. employing bodies have experienced a three year reduction in the recovery period if their recovery period is greater than 15 years.

4.6 The actuary set a long term pay increase assumption of CPI plus 1.5% p.a. (equivalent to 4.1% p.a. for the 2013 valuation based on the long term CPI assumption of 2.6% p.a.). However, with continued pay restraint in the public sector, the Actuary allowed short term pay restraint over the 3 years (equivalent to a total of 1% pa over the period) of the valuation cycle to local authority, town and parish councils and HE/FE colleges on evidence that national pay restraint will apply over the period. As academies can in theory set their own pay awards, pay restraint was not applied to this group of employers or to admitted bodies. In 2010 pay restraint was limited to tax raising employers in line with Government policy.

4.7 Depending on the drivers of the valuation outcome, the length of expected participation in the Fund and the strength of employer covenants, the Actuary will advise accordingly which of these tools he considers to be more appropriate to use, if at all. A key driver of the increase in deficits at 31 March 2013 was the assessment of the liabilities which is based on government bond yields with an allowance for the expected asset returns on the Fund's investment portfolio. Given the assessment was a point estimate at 31 March, consideration was given to whether this was a fair representation of the long term bond market position. After analysing various economic indicators and considering how markets had moved from 1 April 2013 he advised that incorporating a degree of yield reversion into certain employers' funding plans was reasonable and appropriate, where it was necessary to stabilise contribution requirements. **It should be noted that the declared deficit and funding position at 31 March 2013 at the whole Fund or individual employer level will not reflect any allowance for yield reversion, although the effect will be noted in the Actuary's formal report.**

The level of yield reversion depends on a number of factors which includes the level of expectation of interest rate changes already factored into the markets. Between 31 March and 31 August some reversion in yields was

observed as they had increased by 0.4% per annum. Market yields have remained at similar levels since then.

4.8 Academies have been treated as individual employers and their FSR and deficits reflect their own experience since inception and the profile of their members. Therefore their FSR in particular will diverge from that of their former LEA. The deficit recovery period has been set in line with that of the former LEA (the policy set when converted to academy status). As a result of individual experience the changes in deficit payments have varied. The FSS has taken the Letter of Guarantee from the DfE into account in the valuation. Appendix 4 lists all the current academies in the Fund for information.

4.9 The parameters used to determine the contribution rates for the TABs have been agreed with the outsourcing employer as there may be implications for the commercial contract. From the Fund's perspective, the outsourcing employer is the guarantor of last resort so it is appropriate for them to have some influence over the parameters under Fund policy.

4.10 CABs guaranteed by scheme employers usually have the same recovery period as the outsourcing employer unless the guarantor instructs otherwise.

4.11 CABs that do not have financial guarantees are assessed on a case by case basis, with a balance required between protecting the Fund and ensuring the employer remains financially viable. Where there are significant assets or other financial resources owned by the employer, the policy is to use the on-going concern basis for determining the funding plan i.e. in line with the other employers in the Fund. Where appropriate the Fund will seek a "charge" on those assets to improve financial security for the Fund. This is an on-going process within the risk management framework. For those bodies without significant assets/resources, the Fund's policy is to move to the corporate bond basis wherever possible. The intention is to give better stability in terms of outcomes for the Fund and employer but at a higher target contribution level.

4.12 To summarise:

Group	Recovery period (years)	Average FSR	% of Fund deficit
Unitary Authorities & Fire	20	14.1%	80%
Universities	20	13.9%	8%
Colleges	17	14.2%	4%
Academies	20	14.7%	4%
Parish/Town Councils & designating bodies	16	17.2%	0.2%
CABs	24	18.0%	4%
TABs	8	18.9%	0.3%
Overall Fund	20	14.3%	

Note: Recovery period weighted by deficit value

5 ADMITTED BODIES UPDATE

5.1 There are presently 22 CABs plus 3 controlled entities in the Fund. These bodies can take various forms but one common feature is that their funding generally comes from the public sector. The security of the funding sources varies which means that, in terms of being able to meet their pension liabilities, some bodies pose a greater risk to the Fund than others.

5.2 All CAB admissions to the Fund must be approved by the Committee. Since December 2005 the Fund's policy is to only admit a body seeking admission to the Fund as a CAB if it is guaranteed by a Scheme Employer or a bond is put in place to protect the Fund.

5.3 The Fund has an on-going process in place to monitor the financial strength of the admitted bodies. This process feeds into the valuation in determining the level of contributions set. The reduction in funding from public sector bodies has exacerbated the financial situation for many of these bodies, making it more difficult for them to manage increases in contributions. Exempt Appendix 1 summarises the key financial and valuation data for the CABs. Exempt Appendix 2 updates the committee on the risk management measures taken by the Fund in respect of individual CABs in more detail.

5.4 There are 38 TABs in the scheme whose pension liabilities are guaranteed by the outsourcing scheme employer. TABs are usually private sector companies where there is a commercial contract in place between them and the outsourcing employer. Some TABs have a bond in place to protect the outsourcing employer in the event of insolvency of the TAB.

5.5 Exempt Appendix 3 summarises key financial and actuarial data of each TAB showing the actuarial position at the 2013 valuation.

6 INVESTMENT POLICY FOR EMPLOYING BODIES FUNDING ON THE CORPORATE BOND BASIS

6.1 For some admitted bodies with no guarantee, the Fund uses the corporate bond funding basis in order to better manage their exposure to investment risk and therefore volatility of funding requirements. The assets backing these liabilities are corporate bond assets held by the Fund. The intention is that the employer pays higher contributions but receives increased certainty over its future funding position and hence a more stable contribution requirement.

6.2 However, given the large shift in bond yields over 2010/13 this approach, adopted to achieve stability, has led to a divergence in contribution requirements. The current practice adopted can lead to a mismatch in assets and liabilities as the assets are invested in corporate bonds that, in most cases, have a shorter duration than the liabilities. When bond yields change materially (as has been the case in the extreme since the 2010 valuation) this mismatch leads to significant shifts in the funding position and therefore contribution requirements. A more practical approach to achieve stability of contributions is to use a "notional" corporate bond investment return that would exactly match the movement in past service liabilities between valuations with any difference between that return and the actual return from the Fund's corporate bonds being absorbed by the Fund.

6.3 At the time the Corporate Bond basis approach was adopted the Actuary advised that using a notional return would provide “investment risk stability” but would lead to a certain level of cross subsidy between employers. Therefore, at the time, the decision was taken not to use notional returns in order to minimise a degree of “cross subsidy” within the Fund.

6.4 The bodies funded on the corporate bond basis account for less than 0.5% of the Fund’s assets and consist of small charities (0.06% of assets) and commercial entities or bodies with significant asset backing (0.4% of assets). It is proposed to adopt the notional investment return approach for the small entities where there are no other contingent assets available to protect the Fund in the event of insolvency. The cross subsidy impact of using the notional strategy for these employers is de-minimis in the context of the Fund as a whole and has the real advantage of better “risk” management for these employers which in turn reduces the ongoing governance requirements somewhat. Officers will investigate with the Actuary whether there are more suitable term matching funding strategies for the other commercial entities to achieve the key objective of greater funding stability for these employers.

6.5 The Committee is asked to approve the revised approach to implementing the investment policy for the smaller employers that are funded on the corporate bond basis from this valuation onwards.

7 POLICY FOR REFUNDING SURPLUSES WHEN TAB CONTRACT TERMINATE

7.1 In the 2013 valuation, a number of TABs have a surplus funding position. The Fund’s policy is to repay the surplus over the period of the commercial contract until expiry through an offset in the contribution rate. The regulations do provide limited flexibility to the Fund in relation to surpluses (and deficits) on exit.

7.2 The LGPS Regulations were recently amended on 10 February 2014 (with retrospective effect from 1 April 2012) which does make some changes in this context. Having received advice from the Actuary about this, the Fund is obtaining legal advice as to what precisely the new regulations permit. If the Fund’s policy needs to be amended as a result of this advice, it will be brought to Committee at a future meeting.

8 FUND POLICY ON STOPPING ACCRUALS FOR ELIGIBLE MEMBERS

8.1 The Fund has in the past received a number of requests from community admission bodies to close the scheme to existing members and for the employer to exit the scheme. Legal opinion was sought which is summarised follows:

(1) The Regulations do not prevent a community admission body from closing the scheme to new accruals.

(2) However, it is only permitted if it is allowed in the admission agreement.

(3) If not permitted in the admission agreement, then the admission would have to be amended by:

a) Restricting the eligibility conditions so that all eligible employees automatically cease to be eligible; or

b) Terminating the agreement if the parties make a provision about termination under such circumstances.

8.2 The Fund's admission agreements do not include provision for admission bodies to stop accruals for eligible members nor do they have a provision allowing termination in those circumstances. Any amendments to the admission agreement to stop accruals for eligible members will therefore require the agreement of the Fund.

8.3 The Fund's policy is to agree to the ceasing of accruals for eligible members having considered the following:

(i) whether the increase in the funding risk of the other employers Fund is material and manageable (as the other employers in the Fund assumes responsibility for any deterioration in the deficit once an employer has exited the scheme);

(ii) Whether the Fund has a duty of care to the members affected.

8.4 When an employer exits the Fund, the Regulations allow the Fund to demand immediate full payment of the outstanding deficit on termination valued on the exit basis.

8.5 Following the 2013 valuation the cost of providing LGPS benefits for a number of admission bodies has become financially unviable given the reduction in their income streams. If these employers are unable to pay the contributions required then at the next valuation, everything else being equal, their deficit will have increased. In order to protect the Fund and keep these organisations financially viable, the recommended option is for them to leave the scheme and stop accruing liabilities (subject to the employing body resolving employment and contractual issues with affected staff). A payment plan would be agreed to ensure the maximum repayment of deficit to the Fund whilst enabling the organisation to remain financially viable. The alternative of not allowing this would likely be the insolvency of the employer and crystallisation of deficits, recovering a far lesser sum.

8.6 The Committee are asked to agree to amend the current policy to allow community admitted bodies to exit the scheme if continuing in the scheme would make the organisation financially unviable where this can be evidenced.

9 RISK MANAGEMENT

9.1 A key risk to the Fund is the inability of an individual employer to meet its liabilities, especially when it ceases to be an employing body within the Fund. Assessing the strength of an employing body's covenant is a crucial component in managing the potential risk of default to the Fund. Accordingly, a formal covenant assessment process has been prepared. Within the Investments Team there are officers with responsibility for monitoring the employers' financial position and to support the Investments Manager in managing the financial and liability risk.

9.2 The overriding concern of the Fund is that these organisations maintain their financial sustainability in order to contribute to their pension obligations over the long term. To support this, the Fund explores a number of options in consultation with the individual bodies to obtain greater security for the liabilities e.g. through a charge on any assets the organisation may have. The aim is to maximise the employer contributions having taken into account the employer's financial situation and at the same time, not unnecessarily increase the financial risk to the organisation represented by the pension liabilities. However, each body is treated on a case-by-case basis as their particular circumstances vary significantly, the relationship with their main funder (usually a local authority or government agency) being a major factor.

In recognition of the risk posed by the liabilities to the Fund, the on-going dialogue with all employers about the risk posed to their operations by the pension deficit has increased.

10 EQUALITIES

10.1 An equalities impact assessment is not necessary.

11 CONSULTATION

11.1 N/a

12 ISSUES TO CONSIDER IN REACHING THE DECISION

12.1 Are contained in the report.

13 ADVICE SOUGHT

13.1 The Council's Monitoring Officer (Divisional Director – Legal & Democratic Services) and Section 151 Officer (Divisional Director - Business Support) have had the opportunity to input to this report and have cleared it for publication.

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Background papers	Mercers Valuation papers Legal advice
Please contact the report author if you need to access this report in an alternative format	