West Midlands Pension Fund

Guidance for Scheme Employers on Pension Strain Costs and Managing Pension Liabilities

April 2013

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1. INTRODUCTION

1.1 Overview

This document aims to provide a broad overview of the factors which influence pension strain costs and pension liabilities in order to increase employers' awareness of these issues. It is also the intention that in highlighting these points, it will facilitate employers' management of these issues and enable them to mitigate risk where possible.

Outlined are those factors over which an employer has a direct influence and also those which cannot be influenced by the employer, but require employer awareness when considering their pension liabilities.

1.2 Background

The Local Government Pension Scheme (LGPS) is a final salary scheme with benefits defined in regulation.

The LGPS is administered locally through regional pension funds. Member benefits are paid from the pension fund held by the West Midlands Pension Fund (the Fund) on behalf of the administering authority, Wolverhampton City Council.

The Fund's actuary reviews the pension fund every three years as required by the regulations and makes adjustments to the level of employer rate contributions based upon achieving full solvency over time, and with regard to the affordability of the Scheme for employing bodies.

Under provisions of the administration regulations, employer contributions are calculated by the Fund actuary having regard to the assumptions and methodology set out in the Fund's Funding Strategy Statement (FSS). In accordance with the LGPS regulations, the FSS has been determined by the Fund's administering authority, having taken the advice of the Fund's actuary and after consultation with those parties it considers appropriate.

Consistent with the FSS, the funding objective for the actuarial valuation is to achieve then maintain assets equal to the funding target. The funding target is the present value of 100% of the projected accrued liabilities, including allowance for projected final pay. The FSS specifies a maximum period for achieving full funding of 25 years as adopted in the 2010 valuation.

For each individual employer, the funding objective, method and assumptions depend on the particular employer's circumstances and different approaches have been adopted, where applicable, in accordance with the FSS.

The level of employer rate contributions for each employer is determined using the funding objective and is made up of the following :

1) A contribution to cover the cost of future service accrual (including death benefits and expenses), known as the 'common contribution rate'.
2) An adjustment to address any imbalance of employer-specific assets relative to the funding target.
3) An allowance of the costs of future early retirements, where applicable.

1.3 Financial management

The financial management of the Fund with regards to participating employers is built on the basis of two key principles:

- Each employer stands responsible for the funding costs arising in relation to its employees, both for current employees and former employees which have now left service or retired. This means that the employer should meet the costs of any funding deficits which might arise, and equally should gain the benefit from any funding surpluses.
- In setting employer contribution rates payable to the Fund, there is a 'no cross subsidy' objective. The costs which fall on an employer should relate solely to the experience of the Fund as it relates to the employer's own membership, and the nature and profile of its own employees' (and former employees') benefit entitlements through the Fund. Factors relating to an individual employer should not impact on the costs falling on other employers.

2. PENSION STRAIN COSTS

2.1 Early retirement

The normal retirement age for all members in the LGPS is currently age 65.

Members aged between age 60 and 64 can elect to retire early and receive payment of their benefits without employer consent.

Members aged between 55 and 59 may be able to elect to retire early and receive payment of their benefits, but this is only possible with the employer's consent. Employers should maintain a policy statement specifying how they deal with such applications, a copy of which should be forwarded to the Fund.

If a member aged 55 or over loses their job on the grounds of redundancy or business efficiency, their benefits are payable immediately without any early retirement reduction.

In the majority of cases, where a member retires early on the grounds of redundancy or business efficiency or where the member retires early with the employer's consent, a pension strain cost will be payable by the employer. This early retirement strain cost reflects the additional cost to the Fund as a result of the following:

- Pension benefits become payable earlier than assumed.
- Pension benefits are paid for longer.
- Employer and employee contributions are paid for a shorter period than assumed.

Early retirement strain costs are based upon actuarial factors relating to a member's age, sex, marital status and Scheme membership.

Where an early retirement strain is likely to be applicable, the employer should contact the Fund to obtain an estimate of the cost. It is imperative that the employer provides accurate information as the costs are dependent upon on this data – for example, the member's pensionable pay and date of leaving and current hours.

The Fund will invoice the final early retirement strain cost to the employer, which is payable as a one-off lump-sum, and would be required by the Fund before paying the member's benefits.

2.2 Ill-health early retirement

Ill-health benefits can be paid at any age and are not reduced on account of early payment, and benefits could be increased to make up for early retirement.

The pension strain of ill-health early retirement benefits is largely covered through an allowance made in the actuarial valuation. The cost associated to these benefits is approximated at each triennial valuation and, if the cost is greater than that assumed by the Fund actuary, employer rate contributions may be subject to an appropriate increase.

The pension strain derived from ill-health early retirements forms part of the pension liabilities for each individual employer, and in some cases it can represent a significant financial risk to employers and one which is unaccounted for. The Fund does not currently operate a group ill-health insurance plan although the Fund's policy on this matter is regularly reviewed. With this in mind, employers may wish to consider taking out an ill-health insurance plan through an external provider aimed at limiting their exposure to risk in this area.

Below is a list of external providers who provide ill health insurance plans, however, should you have any questions in this area or require further details, the Fund would be happy to help:

- AIG
- AXA
- Aviva
- Legal & General
- Phoenix
- Scottish Widows
- Unum Provident

2.3 Death in service

If a LGPS member dies in service, as well as a survivor's pension, a lump-sum death grant of three times the member's final year's pay is paid, provided the member is under age 75 at the date of death.

In the instance death-in-service benefits are paid, these form part of the individual pension liabilities for an employer. A member dying in service is not an event which can be predicted and, therefore, it represents an element of financial risk to an employer.

The Fund does not currently operate a group life insurance policy – however, this is consistently under review. If employers wish to cover their exposure to the risk of increased pension liabilities as a result of deaths in service, they may wish to explore taking out a life insurance policy. As with ill-health insurance plans, the external providers detailed in section 2.2 provide life insurance, however should you have any questions regarding this, please contact the Fund.

3. PENSION LIABILITIES

3.1 Factors influencing employer pension liabilities

The risk to an employer associated with potential underfunding of pension liabilities derive from a number of sources. These sources can be considered in terms of factors over which an employer is able to exert an influence and those beyond an employer's control. As in section 2, early retirement, ill-health and death-in-service pension strain costs represent some of these sources and this section details the other areas which employers should devote attention to when considering financial risk.

3.2 Factors influencing pension liabilities governed by the employer

3.2.1 Salary growth

As part of the 31 March 2010 valuation, the Fund actuary made an assumption for real salary increases (salary increases in excess of price inflation) to be determined by an allowance of 1.75% per annum over the consumer prices index (CPI) inflation. This included an allowance for promotional increases.

Where an employer grants salary increases which are greater than the assumption used by the Fund actuary, it has a direct effect on that employer's individual pension liabilities within the Fund. The relationship between salary growth and pension liabilities can be further explained by the illustration below:

Salary increases

Salary £20,000 in 2010

20 years later, salary is:

1.75% pa	3% pa	5% pa
£28,296	£36,122	£53,066

A higher-salary increase assumption means the projected pension at retirement is higher and this, in turn, results in higher pension liabilities.

Employers should, therefore, give consideration to the salary increases they award, both in terms of the number and the level of such awards.

3.2.2 Membership movements

Where there is a sharp or unexpected decline in the current Fund membership for an employer this can have a significant impact on pension liabilities.

In the event of an increase in membership, benefits have to be provided from the Fund for the new members brought into the Scheme. With benefit provision there is an associated pension liability and this is based upon a number of factors such as a member's age, salary, marital status etc. The associated pension liability is also influenced by the transfer-in of any previous LGPS service (see section 3.2.3).

LGPS membership for an individual employer can decrease through transfers to alternative pension providers (transfers-out), benefits being deferred or coming into payment or through deaths in service. Where the number of active members decreases there are, therefore, less contributions to fund the individual employer's pension liabilities in the future. In addition, in the case of admitted bodies, if there are no remaining active members in the LGPS under that admission agreement, this will invoke termination of the agreement and the Fund actuary will undertake an assessment of the outstanding pension liabilities, which are payable by the employer in a one-off lump-sum. The Fund regularly monitors the level of active members for each employer. For more information, please refer to the Fund's 'termination policy'.

As part of the actuarial valuation, the Fund actuary based employer contribution rates and past-service lump-sums on the membership data at the time (ie, 31 March 2010 in the case of the last valuation). Therefore, should significant membership movements occur between valuations, with an associated change in pension liabilities, this will need to be reflected in the rates and lump-sums calculated at the next triennial valuation.

3.2.3 Transfers-in

Upon joining the LGPS, members can normally elect to transfer previous LGPS pension rights to their new membership and in some instances can elect to transfer previous rights from a previous occupational pension scheme, a personal pension plan, a buy-out policy, a self employed pension plan or a stakeholder pension scheme.

Members' benefits will not be transferred automatically and members normally have 12 months from joining the LGPS to opt to transfer their previous pension rights, unless their employer allows them longer. As with early retirements, employers should have a policy statement covering transfers-in. Transferred-in previous pension rights cannot be directly influenced by the employer within the first 12 months, however they do have discretion over whether to allow such transfers after this period.

Employers should be aware that transfers-in, particularly those involving previous public sector rights, carry a significant pension liability, the size of which will depend on the service transferred, the member's age, salary and marital status.

3.3 Factors influencing pension liabilities not governed by an employer

3.3.1 Investment returns

The pension contributions made by employees and employers are invested by the Fund in accordance with its Investment Strategy Statement (ISS) and Statement of Investment Principles (SIP). The Fund reviews its investment strategy regularly to reflect actuarial valuations, worldwide market trends and investment opportunities. The last major review was in 2009.

As part of the triennial valuation, the Fund actuary makes an assumption on investment returns known as the discount rate. The discount rate is a yield based on market returns on UK Government gilt stocks and other instruments which reflects a market consistent discount rate for the profile and duration of the Scheme's accrued liabilities, plus an asset out-performance assumption (AOA) for the period of pre-retirement and post-retirement.

The asset out-performance assumption represents the allowance made, in calculating the funding target, for the long-term additional investment performance on the assets of the Fund relative to the yields available on long dated gilt stocks as at the valuation date. The allowance for this out-performance is based on the liability profile of the Scheme, with a higher assumption in respect of the 'pre-retirement' (ie, active and deferred pensioner) liabilities than for the 'post-retirement' (ie, pensioner) liabilities. This approach, thereby, allows for a gradual shift in the overall equity/bond weighting of the Fund as the liability profile of the membership matures over time.

Having determined the AOAs, as above, for the Fund overall, it is important to consider how the financial assumptions in particular impact on individual participating employers. As employers in the Fund will have different mixes of active, deferred and pensioner members, adopting a different pre-/post-retirement investment return approach is equivalent to hypothecating a different equity/bond mix investment strategy for each employer. Such an approach would be inconsistent with the Fund practice, as set out in the FSS, of allocating investment performance pro rata across all employers based on a 'mirror-image' investment strategy to the whole Fund (other than for any employers adopting a bespoke investment strategy in accordance with the FSS).

3.3.2 Longevity/mortality

As part of the triennial valuation, the Fund actuary makes assumptions on mortality based on the most up to date information, making an allowance for future improvements in longevity and the experience of the Scheme.

Pension liabilities are subject to longevity increases because, as members live longer in retirement, pensions are paid for longer.

Revision of the base demographic assumptions adopted for the 2010 valuation, specifically base rates of mortality, ill-health retirements and allowance for dependants' benefits, has overall acted to place a lower value on liabilities.

3.3.3 Pension increases

In June 2010 it was announced that LGPS retirement pensions would be increased annually by the change in the consumer prices index (CPI) rather than the retail prices index (RPI), and this change applied with effect from April 2011.

As a result the pension increase assumption used by the Fund actuary was modified to reflect this change and this had the effect of a reduction to pension liabilities.

3.3.4 Regulatory changes

The Fund is subject to LGPS regulatory changes which may have a direct effect on pension liabilities in the future. For instance, changes to regulations such as more favourable benefits or potential new entrants to the Scheme and changes to national pension requirements and/or Inland Revenue rules.

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