Committee:	**Performance Select Committee**	**Agenda Item**
Date:	**21 September 2010**	**7**
Title:	**Local Government Pension Scheme**	
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Summary

1. When the Committee reviewed the draft 2009/10 Statement of Accounts in June, Members expressed concern about the increase in UDC's share of the Essex Pension Fund deficit, from £16.1 million as at 31 March 2009, to £22.7 million as at 31 March 2010.

2. UDC will be required to finance this deficit over a recovery period to be determined by the Essex Pension Fund actuary. This is subject to a formal revaluation as at 31 March 2010 (which will change the assessed deficit level), and revised assumptions about the future. Assumptions about the cost to UDC of financing the deficit have been built into the Medium Term Financial Strategy, received by the Finance & Administration Committee on 16 September.

3. The Essex Pension Fund was invited to send a representative to today's committee, but unfortunately no-one is available. Instead, they have provided additional material and explanations, set out in this report, to give Members a fuller understanding of the reasons for the pension fund deficit.

4. On 29 July, the Audit Commission published an information paper "Local Government Pensions in England". The paper is a clear and helpful analysis of the national context in which the Essex Pension Fund operates. The executive summary is reproduced at Appendix A.

5. UDC has no discretion over the operation of the Pension Fund or the information it is required to publish in the Statement of Accounts. The material in the accounts relating to the Pension Fund has been reviewed by External Audit with no issues arising.

Recommendations

6. The Committee is asked to note this report.

Financial Implications

7. There are no direct financial implications arising from the recommendation.

Background Papers

8. The following papers were referred to by the author in the preparation of this report and are available for inspection from the author of the report.

   Pension Fund report to Performance Select Committee 29 September 2009

   Audit Commission report July 2010 "Local Government Pensions in England"

Impact

Communication/Consultation	Members of this Committee were consulted on the questions to be answered in this report. The information in the body of this report has been provided by the Essex Pension Fund.
Community Safety	None
Equalities	None
Health and Safety	None
Human Rights/Legal Implications	None
Sustainability	None
Ward-specific impacts	None
Workforce/Workplace	Reforms to LGPS could involve changes to benefits scheme members and/or increases in employee contributions

Information provided by the Essex Pension Fund

1. How is the pension fund deficit calculated ?

Deficits arise when an employer's liabilities exceed assets.

The Actuary assesses the level of each Employer's assets and liabilities every three years at the triennial valuation, when details on each individual within the Fund are analysed. The triennial valuation process concludes with the setting of Employer contribution rates for the next three financial years.

The asset and liability figures used for annual FRS 17 disclosures are based on the assets and liabilities identified in the triennial valuations, however there are some key differences:

- the actuary updates the values of assets & liabilities each year between valuations using a roll forward method outlined in the CIPFA Guide “Financial Reporting Standard 17 – Guide for Local Authorities”. This approach takes into account Employee and Employer contributions received each year along with benefits paid.

- liabilities are calculated for FRS 17 using a discount rate based on AA rated bond yields. For the triennial valuation the discount rate assumption is based on the judgement of the Actuary taking into account a number of factors including the Fund’s investment and funding strategy. This tends to result in higher liabilities under FRS 17 than the triennial valuation.

2. Why has the Council’s share of the pension deficit increased?

A number of Employers have commented about the results of the 2009/10 FRS 17 disclosures. In particular, the question has been asked why deficits have increased in a year when investment returns have driven significant gains in the value of assets. Whilst there are a number of ingredients within FRS 17, the two largest are identified below.

<u>Assets</u>
Investment returns in 2009/10 were very good following a very poor year in 2008/09. The Essex Fund saw an investment return of 35.5%, and individual employers will have seen their own assets within FRS 17 rise by a similar figure.

<u>Liabilities</u>
In determining the value of liabilities the Actuary takes into account the obligation to pay benefits in respect of individual scheme members who have retired already, or will do so in the future.

In order to price these liabilities correctly as at 31 March 2010, the Actuary applies a discount factor to all future cash flows. This process acknowledges that in order to pay a set sum at a given time (e.g. £100 in 2 years time) a different and lower amount is actually required now (e.g. £92 at 31 March 2010). In other words, £100 in two years time gets discounted down to £92 for the FRS 17 disclosure. During the intervening time the value of the £92 through investment returns would be expected to reach the required amount.

FRS 17 specifies how the discount rate is calculated, and the Actuary uses the market yield on AA rated Corporate Bonds for this purpose. As at 31 March 2010 the discount rate, based on bond yields, used by the Actuary was 5.6%. Twelve months earlier it was 7.1%. This represents a very significant reduction. Lower discount rates mean that liabilities values are discounted using a lower percentage – in other words, lower discount rates mean higher liabilities. Conversely, in a year when yields rose, liabilities would fall.

Within the Essex Fund, Local Authorities have seen liabilities increase on average around 35% compared to the FRS 17 disclosures at 31 March 2009.

Impact on Deficits

Local Authority Employers entered 2009/10 with an FRS 17 deficit as assets were lower than liabilities. During the year both assets and liabilities have gone up by similar amounts. Given the respective starting positions this means that liabilities increase in cash terms more than assets. The result is increased deficits.

3. How does our deficit compare with other District Councils? e.g. is it growing at a different rate?

The changes in assets and liabilities in Uttlesford District Council's FRS 17 disclosure between 31 March 2009 and 31 March 2010 are consistent with the results observed for other Local Authorities within the Essex Pension Fund.

4. How does the performance of the Essex Pension Fund compare with other Local Authority pension funds?

As at 31 March 2010 the performance of the Essex Pension Fund together with the WM Local Authority average is set out in the table below. The WM average surveys 87 Local Authority Funds.

Annualised Investment Performance to 31 March 2010	1 Year	3 Years	5 Years
Essex Pension Fund	35.5%	0.9%	6.9%
WM Local Authority Average	35.2%	1.7%	7.1%

5. What changes in deficit levels do we forecast for the next few years?

The Actuary has reported initial results of the 2010 Actuarial Valuation. They are summarised below along with the 2007 results. These are at Fund level only.

	Assets £m	Liabilities £m	Deficit £m	Funding Level %
31 March 2007 Actuarial Valuation	3,043	3,825	782	80%
31 March 2010 Actuarial Valuation *	3,085	4,319	1,234	71%
* initial results				

A draft Funding Strategy Statement (FSS) has been circulated to all Local Authorities within Essex for consultation. When the final Valuation results are known, section 7 of the FSS (Identification of risks and counter measures) will be updated to include a chart highlighting the "funnel of doubt". This chart will illustrate the range and uncertainty in the future progression of the funding level.

A web link to link to the 2008/09 Annual Report is shown below. This includes the 2007 FSS and the "funnel of doubt" chart is shown on page 86.

http://www.essexcc.gov.uk/vip8/ecc/ECCWebsite/content/binaries/documents/2008-09_PF_Report_%26_Accounts.pdf?channelOid=null

6. If current trends continue, at what point will the Fund cease to be viable? Is there a danger of the fund failing to meet its obligations to scheme members?

Based on the current membership the Fund has liabilities to make payments until 2089. The Actuary has forecast that Fund will have positive cash flow (i.e. more income than expenditure) for the next 20 years. This forecast is based on the current arrangement whereby many Scheme Employers are paying deficit contribution over a 20 period. In a scenario where expenditure exceeds assets, the Fund would need to commence selling investments in order to fund benefit payments.

7. What options are open to the Council to fund the deficit? What will be the cost to the Council?

In light of the adverse financial circumstances facing public sector employers in particular, the draft FSS has been prepared with a view to avoid the need for any new increase in employer contributions where employers can evidence sufficiently strong covenants and financial stability. Although a formal resolution to this effect has yet to be passed by the Essex Pension Board, Local Authorities are expected to be included within this category. The FSS includes a revision of deficit recovery periods.

Responses to the draft FSS are required no later than 26 November 2010.

8. What changes are likely to emerge from the Government review of public sector pensions? What will be the effect on Councils and employees?

The Chancellor has already announced that future pension increases are likely to be linked to the Consumer Prices Index, as opposed to the Retail Prices Index. This has already been taken into account by the Actuary in producing the Initial Valuation results.

The Hutton review is expected to produce an interim report in late September and a final report in time for the Government's budget in March 2011. Ahead of any formal announcement it is impossible to say what impact there will be, however there has been some speculation that the retirement age may increase from 65 to 66.

Risk Analysis

Risk	Likelihood	Impact	Mitigating actions
Pensions costs increase and become unaffordable	3 (worsening fund deficit means that increased contributions are possible)	3 (the sums potentially involved are considerable)	Mitigating measures by pension fund actuary. Building estimates into Medium Term Financial Strategy.

1 = Little or no risk or impact
2 = Some risk or impact – action may be necessary.
3 = Significant risk or impact – action required
4 = Near certainty of risk occurring, catastrophic effect or failure of project.

APPENDIX A

AUDIT COMMISSION REPORT – JULY 2010

LOCAL GOVERNMENT PENSIONS IN ENGLAND

SUMMARY

The Local Government Pension Scheme (LGPS) in England is the UK's largest public sector pension scheme by membership.

- The scheme has 1.7 million active members, 1.15 million members with deferred pensions and 1.1 million people receiving pensions. Nearly three-quarters of members are women.
- The scheme is comprised of 79 separate funds in England, under the control of elected members, working to a common set of regulations and a common benefit structure.
- As employers, councils have limited influence over pension costs because it is a legal requirement for them to provide pensions and they cannot adjust the benefit package.
- The employer contribution rate for the LGPS is 18 per cent on average. The rate varies in different funds, typically between 14 and 25 per cent of pay.
- Employee members contribute 5.5 to 7.5 per cent of pay, depending on earnings.

The LGPS has funds to cover about three-quarters of its future liabilities, and there is a positive cashflow.

- LGPS funds defray the cost of paying pensions. These funds cover about three-quarters of the total pension liabilities. The LGPS is the only major public service scheme with its own funds.
- LGPS funds currently have a positive cashflow: more money is going into the funds than is coming out of them.
- The LGPS assets will cover the costs of pensions in payment for the foreseeable future, given the positive cashflow and constitutional permanence of local government as an employer.
- It is likely that there will be fewer employees contributing to funds over the next few years, but this will not affect pensions in payment.
- A high proportion of the pension costs of current employees in the LGPS are paid for up-front, reducing the reliance on future generations to fund pensions in payment.

Continues…

But the current approach cannot continue indefinitely because unfunded liabilities are being deferred into the future, to make the scheme more affordable to employers in the short term.

- The cost of providing pensions for local authority employees is rising in absolute terms and as a proportion of pay because of increasing life expectancy and action needed to recover funding deficits.
- Pension funds have been affected by lower than anticipated investment returns; the value of assets today is about 15 per cent lower than anticipated in 2007.
- The cost of pensions affects the amount of money available to fund services, and influences council tax decisions: there are questions about whether LGPS benefits are affordable in the long run.
- Some of the underlying affordability issues, such as the costs resulting from future improvements in life expectancy, have already been covered by forthcoming reforms to LGPS. But the proposals will not guarantee long term sustainability.
- The LGPS needs further reform to address the growing mismatch between liabilities and the resources available to fund them.

There are radical changes that might appear attractive to policy makers, but they are not likely to serve local government well in the short term.

- Government could radically change the way pensions are delivered by:
  - Merging funds in pursuit of lower fee rates and increased strategic capacity to manage investments over the long term;
  - Reducing the target level of funding for the scheme; or
  - Taking on the whole of the liabilities and running an unfunded scheme.
- The costs of such changes might outweigh any benefit.
- Incremental reform can put the LGPS on a more secure long term footing.

Action is required now. The government should consider:

- Reviewing employee benefits. For example, a change that would make quick savings would be to raise the normal retirement age and reduce accrual rates;
- Giving more discretion to local pension funds to adjust the level of benefits they offer pension fund members; and
- Raising employee contributions. Increased could be tapered to avoid increasing opt-out rates.

Any reforms to the benefit structure should take into account:

- The nature of LGPS membership: there are high proportions of part-time and low-paid workers; and

- The interaction between occupational pensions and state benefits: this should therefore be considered carefully because around half of pensions in payment are below £3,000.

To avoid significant increases in employer contributions, action at the local level is also required.

- Most LGPS funds could improve their funding position by adjusting actuarial assumptions; but this does not address the underlying issues.
- Instead, pension funds need to focus on improving their investment performance, within acceptable levels of risk locally.
- Employers should actively limit pension liabilities though measures such as controlling wage costs.

Source: Audit Commission information paper "Local government pensions in England" published July 2010.

For access to full document follow this hyperlink.