Proposed changes to the funding strategy for the Hampshire Pension Fund

Purpose of this Report

1. The purpose of this document is to set out in detail the proposed changes to the funding strategy for the Hampshire Pension Fund and to provide information on how the proposals affect different groups of employers.

Executive summary

2. Historically the Hampshire Pension Fund (HPF) has grouped employers together for funding purposes, each paying a common contribution rate and sharing risks. There is a larger 'Scheduled Bodies Group' (SBG) comprising 86% of the liabilities of the Fund and a small 'Admission Bodies Group' (ABG) comprising less than 1% of the liabilities of the Fund. This grouped funding approach is simple and works well when employers have very similar characteristics and are all long term, open bodies.

3. The grouped approach in the HPF has been under strain for over a decade as employers have diversified. There is also increased scrutiny of LGPS funds and pension costs, demanding greater transparency and flexibility for individual employers.

4. The Fund Actuary has accommodated these pressures through several complex mechanisms including:
   - layered deficit recovery plans at each valuation since 2010[1]
   - certifying additional contributions for employers who make decisions out of line with the group
   - legal arrangements to allow a material outsourcing from a unitary council.

5. The barrier to dismantling the groups has primarily been the fair allocation of any fund deficit at the point of change, particularly where a large deficit has existed. Employers in the groups share pension costs, resulting in cross subsidies between employers, both in terms of meeting the costs of future service benefits, and contributing towards the groups' deficits. When the groups are separated out, the extent of those subsidies is revealed and could impact significantly on individual contribution rates.

6. A step towards de-risking the groups was taken at the 2016 valuation when the HE/FE sector and housing associations were removed from the groups and set

[1] Prior to 2010 all employers paid a common % of Pay rate towards paying off the deficit in the groups, which was re-set at successive valuations. The change to fixed capital payment streams from 2010 helped to protect grouped employers against the actions of employers whose payrolls were falling relatively quickly which, prior to 2010, would have reduced their obligations to contribute to restoring the group's deficit.

individual rates. The purpose of that exercise was to enable the Fund to incorporate employer risk into its funding strategy, which it had been unable to do for employers participating in the groups where a common funding strategy applies for all. Contribution rates for the employers who were removed from the groups became based on an assessment of their financial strength and likely future participation in the Fund, with higher contributions set for employers perceived to be of a weaker financial standing and/or expected to exit the Fund in the shorter term.

7. As part of the 2016 reforms, ill health and death pension costs became shared across all employers in the Fund rather than just within the two groups. These can be the most material risks for smaller employers who are not grouped. Adoption of this policy helped the Administering Authority (AA) demonstrate to employers who were removed from the groups in 2016 that it was still committed to sharing some key risks at a Fund level and protecting those who may be less able to withstand them. With this Fund-level risk sharing in place the case for grouping of employers, where all risks are shared, is diminished.

8. There have been material improvements in the funding level since the 2016 valuation and this is likely to provide the opportunity (given that the deficit position is likely to be much reduced) for dismantling the existing structure and allow employers greater transparency and flexibility over their pension costs.

9. Grouped funding arrangements may continue to be attractive for some employers who operate in the same sector and share similar characteristics. In particular the payment of a common future service ('primary') rate, rather than rates which vary based on the profile (age, sex and salaries) of the employer's membership, would help stabilise contribution rates for employers across the sector.

10. If the decision is taken to dismantle the groups, the Fund Actuary is recommending four main changes:
    - create a smaller group for the academies
    - create a smaller group for the Town and Parish Councils[2]
    - calculate individual rates for all other employers currently in the SBG
    - maintain the ABG, but with individual asset allocations to employers

    These changes would be made as part of the 2019 valuation, with the first impact on contribution rates from 1 April 2020.

[2] Proposals for the Town and Parish Councils, and Admission Body Group, are to operate an alternative grouping arrangement where all risks continue to be shared but assets are allocated to employers. The principal aim is to give more flexibility to both the AA and employers around the timing of deficit payments, which were payable over 19 years for all grouped employers in the 2016 valuation.

Current structure of the HPF

11. The Hampshire Pension Fund (HPF) currently operates two main contribution groups:
    - the Scheduled Body Group (SBG), containing principally the local authorities, police and fire authorities and academies, representing around 86% of the Fund's liabilities in the 2016 valuation; and
    - the Admission Body Group (ABG), containing principally charity admission bodies, representing less than 1% of the Fund's liabilities in the 2016 valuation.

12. The groups operate such that (nearly) all funding risks are shared between the employers in the group. Grouped employers pay contributions based on their shared of the groups' payroll. Since 2010, deficit contributions have been set as monetary amounts to guard against employers under-contributing due to falling payroll.

13. This grouped structure has been in place for many years. It reflects the AA's philosophy on risk sharing and helps keep contributions more stable, particularly for smaller employers.

14. However, the HPF is unique amongst LGPS funds in continuing to operate this level of grouping, and whilst this is not in itself a reason to disband the groups, there have been increasing strains on this approach over the last decade.

15. At the 2016 valuation, employers in the HE/FE sector, independent schools and housing associations were removed from the groups and set their own contribution rates based on their membership profile, financial strength and likely continued participation in the Fund. Together with the other employers who are not grouped (primarily private sector service providers and orphan bodies), these represented the remaining 13% of the Fund's assets at the 2016 valuation.

16. Since the 2016 valuation, work to assess the desirability and sustainability of the grouping approach has continued, and it is proposed that further significant changes are made at the 2019 valuation.

Reasons for change

17. Grouping employers together for funding purposes works well when employers are relatively homogeneous and make similar decisions. Grouping will always create cross subsidies but, within a similar group of employers, it can be more acceptable to share risks and costs without concerns that the actions or business strategies of some employers will create unfair costs for others.

18. The grouping arrangements have been under strain for over a decade as employers have sought to make efficiencies through outsourcing, restructuring

and creating trading companies. Whilst the Fund Actuary has been able to accommodate these different approaches, solutions are not perfect and do not fully protect other employers without either imposing severe penalties on the relevant employer or entering into complex agreements to re-allocate costs fairly. Further, with proposed new fair deal regulations which may result in outsourced staff being indistinguishable from those of the letting authority (who would be the deemed employer for the outsourced workforce), it would become increasingly difficult to sustain, and to justify, the grouped approach. This is particularly of concern as LGPS funds come under greater scrutiny and employers are under greater pressure to explain their own pension costs.

19. More employers are looking at ways in which they can improve their own funding position, such as pre-paying deficit contributions or making additional one-off contributions, neither of which are compatible with the group approach as any payments are of benefit to the group as a whole rather than the individual employer.

20. Dismantling the groups will result in ‘winners’ and ‘losers’ as it reveals the cross subsidies within the group. The losers will be those employers whose pension costs are currently being subsidised by others, either through:
    - currently paying the group future service rate if this is lower than the cost of the benefits accruing to their workforce, or
    - currently paying a share of the group's deficit contributions which is lower than the employer's share of the group's liabilities (a proxy to the risk which the employer brings to the group). A fair decision has to be made as to the allocation of any deficit when the group is dismantled. However, this effect is drastically reduced if the group is dismantled at the point it is near 100% funded.

21. There has been material improvement in the funding level for the HPF since the 2016 valuation which means that overall contributions are not expected to rise, and may even fall (but there is no guarantee of this until the valuation is complete). By taking this opportunity to dismantle the groups at the 2019 valuation employers are more than likely to find that, even if their future service rate increases as a result of degrouping (generally if their membership is older than the group average), their overall contribution rate will be stable or reduce.

Proposed changes

22. If the recommendation is made to dismantle the groups at the 2019 valuation, the Fund Actuary is proposing four key changes:
    - create a smaller group for the academies
    - create a smaller group for the Town and Parish Councils *
    - calculate individual rates for all other employers currently in the SBG
    - Maintain the ABG, but with individual asset allocations to employers[3].

    These are discussed in more detail below.

Academies and Multi Academy Trusts

23. There were approximately 93 academies in the Fund as at 31 March 2018, which is a material increase from the 2016 valuation. The number is likely to increase as more schools leave local authority control.

24. Academies are backed by a Department for Education (DfE) guarantee whereby the DfE would ultimately pay a pension liability in the event of an academy failing. It is this guarantee that meant academies were kept in the SBG when the rest of the educational establishments were removed in 2016.

25. The LGPS Scheme Advisory Board (SAB), in conjunction with the MHCLG and the DfE, has been considering whether national changes are required for the treatment of academies in the LGPS. Whilst no formal recommendations have been made, one of the DfE's long standing concerns has been the variability of LGPS contributions within and across LGPS funds. One of the recommendations made by the academies funding working group of the SAB was for academies to be pooled within each fund and therefore have a common contribution rate. Some Funds already operate this type of arrangement.

26. Academies are currently part of the SBG and therefore already pay a common contribution rate. In the absence of a decision at the national level, **the proposal is to remove the academies from the SBG and create an academies pool**. The reason for not recommending individually assessed contribution rates at this time is because there is uncertainty over the timing and contents of any future guidance from the SAB in relation to academy funding, which may encourage pooling within Funds as a preferred solution. It would put at risk the stability of academy contribution rates if academies were individually assessed in 2019 only to be pooled back at the next valuation. Under this proposal, Academies would

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[3] Proposals for the Town and Parish Councils, and Admission Body Group, are to operate an alternative grouping arrangement where all risks continue to be shared but assets are allocated to employers. The principal aim is to give more flexibility to both the AA and employers around the timing of deficit payments, which were payable over 19 years for all grouped employers in the 2016 valuation.

continue to pay deficit contributions based on their proportion of the group's payroll and would pay a common future service rate. It is likely that overall contributions would be lower than present due to the overall improvement in funding (as this will lead to lower deficit contributions).

27. Pooling academies together would aid any future call on the DfE guarantee in the event of failure, because it would be clearly demonstrable that there were no cross subsidies to or from outside the academy sector.

28. However, if there is no national approach before the next valuation, the decision to maintain a group for academies would be revisited prior to that valuation in consultation with the academies and DfE.

Town and Parish Councils

29. Town and Parish Councils (TPCs) are resolution bodies who have the choice of designating membership to the LGPS and therefore participate in the Fund on a different basis to scheduled bodies who must offer the LGPS to all their employees. Therefore the membership of TPCs can be transient and result in an employer joining and exiting the Fund multiple times. This means that some TPCs join the Fund as a new employer without historic deficit contributions, whilst others continue to pay deficit contributions because they joined the SBG before the 2010 valuation when the layered deficit recovery plan was introduced[4]. More generally, the participation of 'new' (post 2010) employers in the SBG is inconsistent with the other employers in the group who all contribute towards paying off the group's deficit.

30. Although there are 60 TPCs in the Fund, they represent only 271 active employees, 154 deferred members and 157 pensioners. Membership of the SBG has ensured that TPC contributions are much more stable than if their contributions are assessed on an individual basis. It is therefore appropriate that some version of grouping is retained for TPCs. One of the risks which TPCs would have been vulnerable to if they are not grouped are ill health and death pension costs, but since 2016 these risks are shared across all employers in the Fund. The biggest remaining variable is the age of the TPC's membership which, if they only have one active member, could result in huge changes in contribution rates over time.

31. **It is therefore proposed that the TPCs will be pooled together and pay a common primary contribution rate.** However, it is also proposed that assets of the pool are allocated at employer level to enable the Fund Actuary to certify individual deficit contributions reflective of the TPC's expected future participation in the Fund, and so that exit calculations are based on the TPC's own assets and liabilities. Deficit recovery periods will be reduced, but this will be accommodated

[4] The LGPS regulations allow the Fund to suspend the requirement for an exit payment if the TPC has a further active member joining within three years of ceasing active membership, which reduces the administrative burden and potential financial implications of a pre-2010 TPC exiting the Fund.

within the overall savings likely to be generated by the improved funding position (i.e. a reduced deficit) to avoid any contribution increases.

De-group the Scheduled Body Group

32. Once academies and TPCs are removed from the SBG, the remaining employers are mainly the local councils, and associated employers such as the Cultural Trust. Under the proposals, **these employers will be given their own contribution rate at the 2019 valuation**, based on their membership profile and a share of any remaining deficit. Associated employers (including maintained schools which have a separate employer number to their local authority for historic administration purposes) would be grouped with their local authority.

33. All employers would continue to have the same funding target and deficit recovery period at the 2019 valuation, although this could be varied at future valuations.

34. As there has been a material improvement in the funding level for the HPF since the 2016 valuation, it is anticipated that overall contributions will not rise, and on balance are more likely to reduce, before allowing for any changes to the group arrangements.

35. By taking this opportunity to dismantle the SBG at the 2019 valuation, SBG employers are more than likely to find that even if their future service rate increases as a result of degrouping (if their membership is older than the group average) their overall contribution rate will be stable or reduce as a result of a significantly reduced deficit stream payment.

Alternative grouping arrangement for the Admitted Body Group

36. Work has already been carried out to secure a commitment from the relevant local authorities to subsume the assets and liabilities of the charitable employers in the ABG when they exit the Fund. This will enable the continuation of a long term funding strategy for those employers' liabilities without having to increase funding to the level required for orphan liabilities within the Fund. The two bodies without this commitment will be de-grouped at the 2019 valuation and set their own contribution rate and recovery period, based on their financial strength and likely length of participation in the Fund.

37. Due to the disparate membership profiles of employers in the group, there would be a wide range of future service rates at employer level if the group was dismantled and rates were set individually. Some employers would experience significant increases in rates and others significant decreases. Many of the employers in the group have alerted the AA to affordability constraints which would suggest that setting individual rates for some employers could have a significantly detrimental impact to their ongoing viability.

38. **It is therefore proposed that the remaining employers will be consulted on continuing to share all risks within a reformed admission body group**, so not to disturb current risk/cost sharing arrangements which currently protect a number of the employers. The proposal will be to change the operation of the group funding arrangements so that assets are allocated to individual employers at the 2019 valuation to enable different recovery periods to be used in light of different potential terms to exit (based on the working lifetimes of their active members). The aim is to avoid contribution increases and make these changes within the cost envelope provided by the improvement in the funding level since 2016.

39. To keep the funding strategy simple, employers may be allocated into short, medium and long-term brackets for recovery plans.

40. By taking this approach, it will eradicate the issue which currently exists whereby there is an inconsistency between the amounts employers pay in deficit contributions whilst members of the fund, and the amounts they are asked to pay on exit. This is because active employers pay a share of the group's deficit contributions in proportion to their relative payrolls in the group but, as and when they exit the Fund, they are allocated a different share of the group's deficit, in proportion to liabilities. This current operation is a natural outcome of the existing grouping arrangements in which cross-subsidies are unravelled on exit. In some cases this can (and has) caused an unexpected significant exit payment for the exiting employer (to the gain of the other group employers), and in other cases it could see a lower than expected exit payment for the exiting employer (but to the detriment to the other group employers). Setting individual deficit contribution rates for ABG employers ensures the fair allocation of the total ABG deficit across its members and consistency with valuations undertaken on exit.

Employer communications

41. A workshop will be held for each of the affected employer groups, and are being arranged for 28/29 May 2019. These will be led by the Fund actuary, with the Hampshire team in attendance. Employers will be encouraged to attend their relevant session, although the workshops will be recorded and made available for employers who cannot send a suitable representative.

42. At these sessions, the Fund Actuary will provide detailed examples of how the changes would affect employers on a range of scenarios, including examples of those who would benefit from the dismantling of the groups, and those who would 'lose out' (i.e. they see an increased future service rate and/or deficit contributions as a consequence of dismantling the groups, noting that there should be an overall reduction in contributions because of the improvement in funding level) for a range of funding levels. These calculations will be based on anonymised data from the 2016 valuation.

43. It is not desirable to provide individual examples for all affected employers based on the 2016 data because:

- figures on the 2016 data are unlikely to be valid in 2019 for some employers due to material changes in membership since 2016 (in particular employers of the admission body group); would be unhelpful as an indication, and could in some cases incorrectly allocate winners and losers
- changes in assumptions and market conditions between 2016 and 2019 could lead to materially different values in 2019, even if membership data had been relatively stable
- focussing on specific numbers, which are in no way accurate, could be very misleading as they do not correspond to likely contribution rates from 2019
- it is desirable for employers to respond to the principles of the proposals, rather than based on their own position.

44. However, to reiterate, as the indications are that the funding position will be much improved compared to the position at the 2016 valuation, the expectation is that employers would not see any rise in overall contribution levels (combining both the Future Service Rate and the fixed deficit payments) and that potentially most (but not all) employers will see an overall reduction in contributions due to lower deficit payments.

45. Employers will be sent invitations to the workshops in the week commencing 29 April, and encouraged to raise any questions or make any initial comments prior to the workshops. Following the workshops employers will have a further 4 weeks to comment on the proposals prior to a report and recommendations being brought to the Pension Fund Panel and Board on 12 July. The Pension Fund Panel and Board can then decide whether or not to proceed with the proposals for the 2019 valuation. This decision is as late as it can be without compromising the valuation timetable under which initial employer results are available for the annual employer meeting and budget cycles in October.

Legal implications

46. Previous legal advice obtained from the Fund’s external specialist pension lawyers confirms that:

- the LGPS regulations give the AA the statutory power to amend the funding model
- the AA must act fairly and reasonably and in line with those powers
- changes to the Funding Strategy Statement (FSS) must be made in consultation with ‘such people as the AA considers appropriate’.

47. A recent Pensions Ombudsman case found that the AA has a duty of care to members and employers as a whole, not to one particular employer or group of employers, to adopt policies it considers fair and reasonable.

48. The main aim of dismantling the SBG and making the four proposed changes are to:

- reduce risk to all employers in the SBG by recognising existing differences between employers in terms of their participation in the Fund
- remove the cross subsidies within the groups that have increased beyond an acceptable level
- make it possible for those employers who are likely to stop contributing, to properly manage their exits
- allow employers greater transparency and control over their own pension costs, including the potential ability to pre-pay contributions or make one off contributions to improve their own funding position
- continue to operate pooling arrangements for employers where pooling is desirable, including:
    - employers in the ABG where, due to the financial constraints of employers in the community/charity sector, individual funding arrangements could put some organisations viability at risk, and
    - for employers who are homogeneous and operate within the same sector, such as TPCs and Academies, for whom cross subsidies would be secondary to a preference/desire to pay a common rate across the sector and hence be protected from potential significant employer variations.

Making these changes will bring the Fund in line with other LGPS funds who already calculate employer contributions rates on an individual, rather than grouped, basis.