

# Hampshire County Council Pension Fund: Employer Workshop

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2 February 2016

# Agenda

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- Summary of proposals
- Current grouping arrangements
- Review of the groups
- Funding strategy and proposed changes
- Fund-wide changes to risk-sharing
- Options for creating new funding pools

## Summary of main proposals

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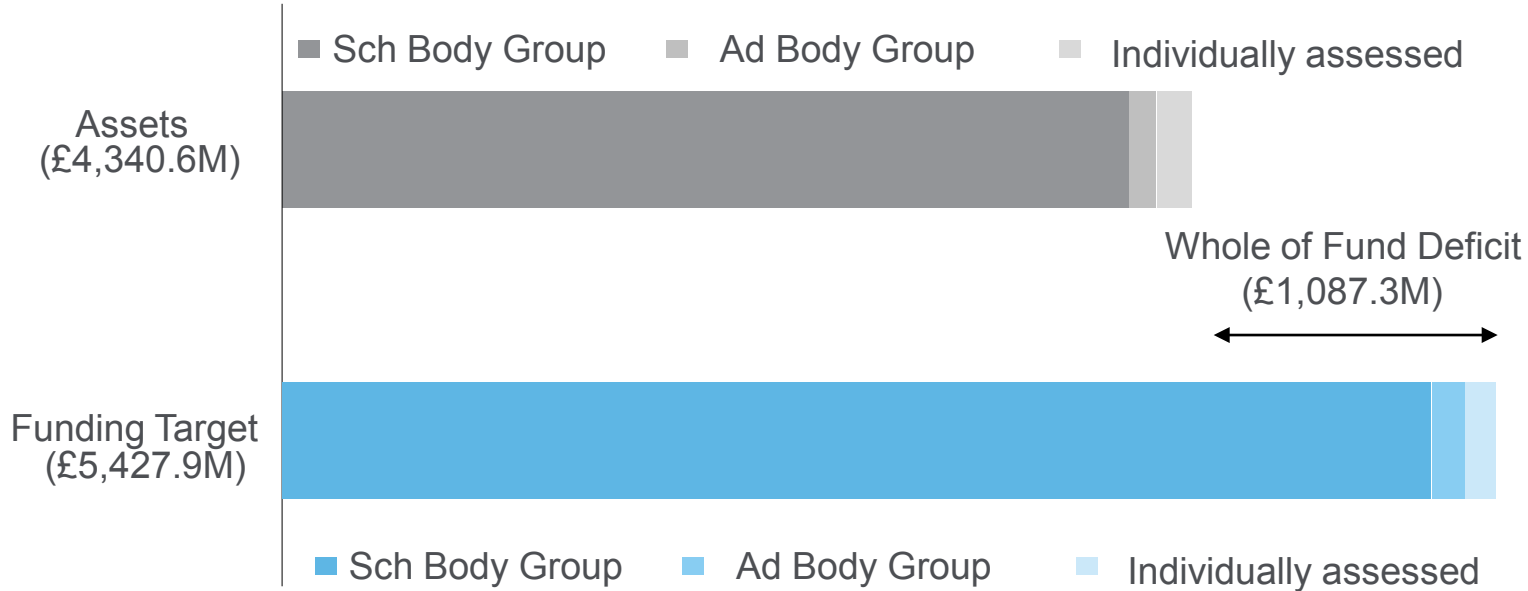
- Removal of the following employers from the Fund's grouped funding arrangements:
  - All education sector employers within the Scheduled Body Group and Admission Body Group (where they are not backed by a central government guarantee)
  - Housing Associations within the Admitted Body Group
- Assets to be allocated on a "share of fund" basis (same as FRS accounting)
- Default approach of individual funding for de-grouped employers
- Facility to adopt a weaker funding target than the "orphan" target for de-grouped employers, depending on strength of employer covenant
- Stepped implementation of any increase in employer contributions
- Open to employer proposals for new grouping / risk sharing arrangements within the sector

Consultation on changes to the Funding Strategy Statement closes 19 February

Responses to be considered at Panel & Board in March

# Current funding arrangements

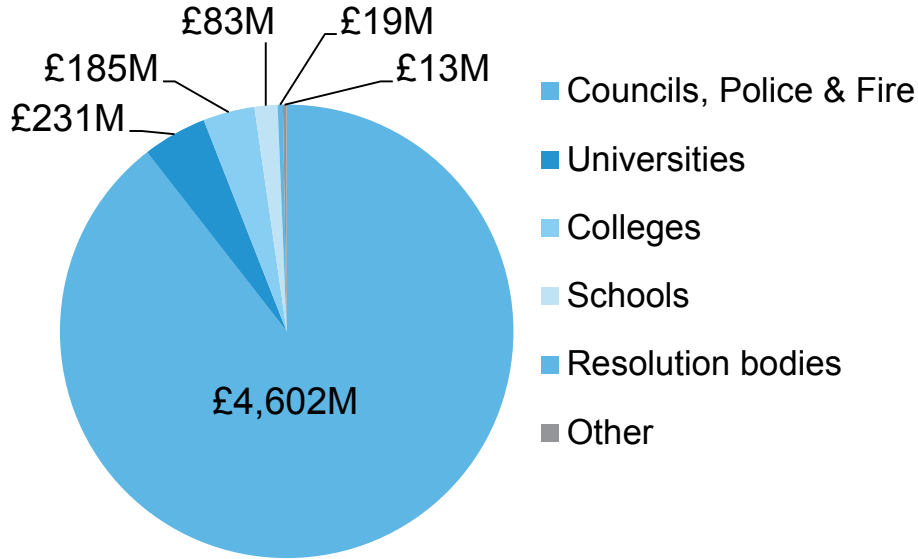
## Whole of fund position as at 31 March 2013



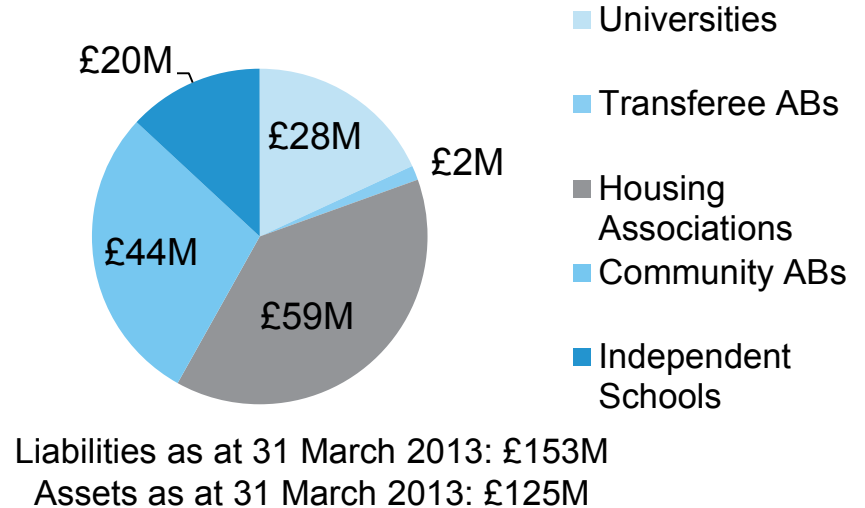
Whole of Fund funding ratio: 80.0% (Total Assets/Total Liabilities %)

# Current funding arrangements

## Scheduled Body Group



## Admission Body Group



Liabilities as at 31 March 2013: £5,133M  
Assets as at 31 March 2013: £4,050M

Figures in pie charts are liability values as at 31 March 2013

## Current funding arrangements

	Group	Individual
Future Service Rate	Average across all the group's membership SBG = 14.0% of pay ABG = 15.6% of pay	Average of employer's membership HE/FE sector range from 12.6% to 24.9% of pay
Asset / Deficit tracking	Group level	Individual level
Deficit contributions	Based on a share of the Group's shortfall (in proportion to pay*)	Based on employer's shortfall
Strain contributions	Paid in addition	Paid in addition

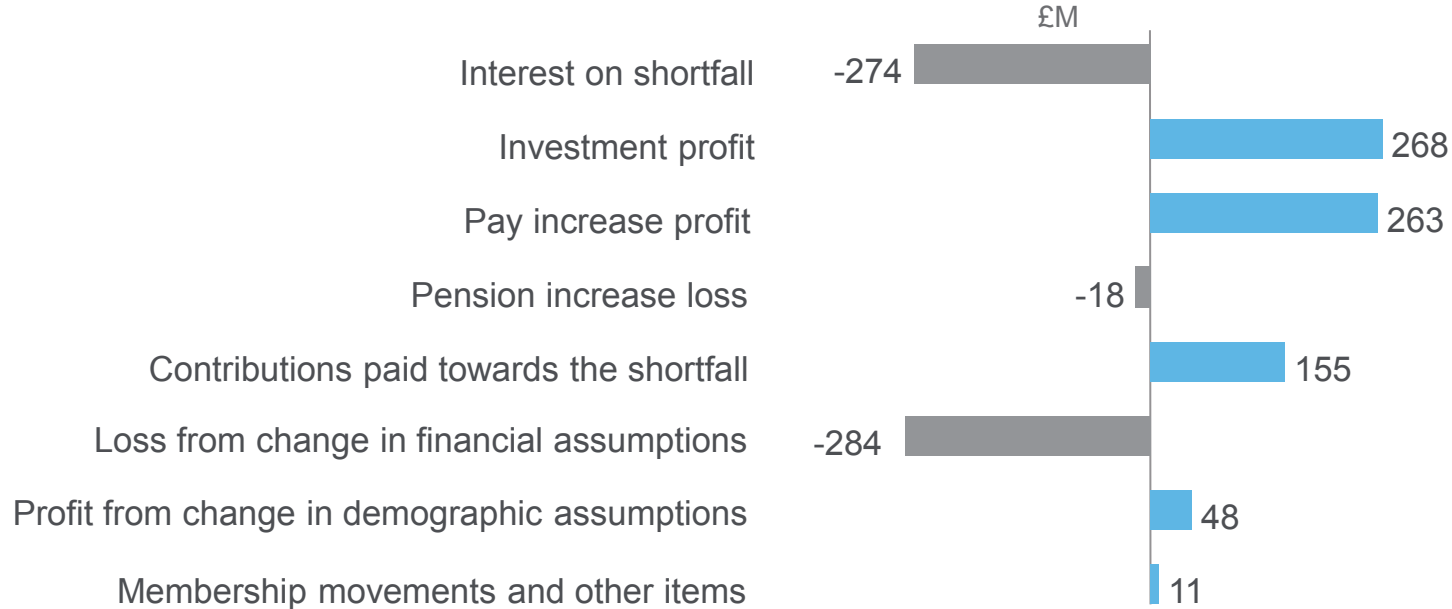
\* Layered Employer Recovery Plan

- fixes deficit contributions to protect against falling payroll

Group philosophy is that risks are shared

## What are the funding risks?

### Whole of fund experience 2010-2013



Source: 2013 valuation report

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## How are the funding risks shared?

### Group experience

- £400M increase in deficit between valuations, equivalent to 3% of pay over 22 years

Employer type	Average	Immature	Mature
Proportion of Group's payroll	1.0%	2.0%	0.5%
Proportion of Groups' liabilities	1.0%	1.0%	1.0%
If a Grouped employer:			
Deficit allocated to employer	£4M	£8M	£2M
Additional deficit contributions (22yrs)	3.0%	3.0%	3.0%
If an ungrouped employer:			
Deficit allocated to employer	£4M	£4M	£4M
Additional deficit contributions (22yrs)	3.0%	1.5%	6.0%

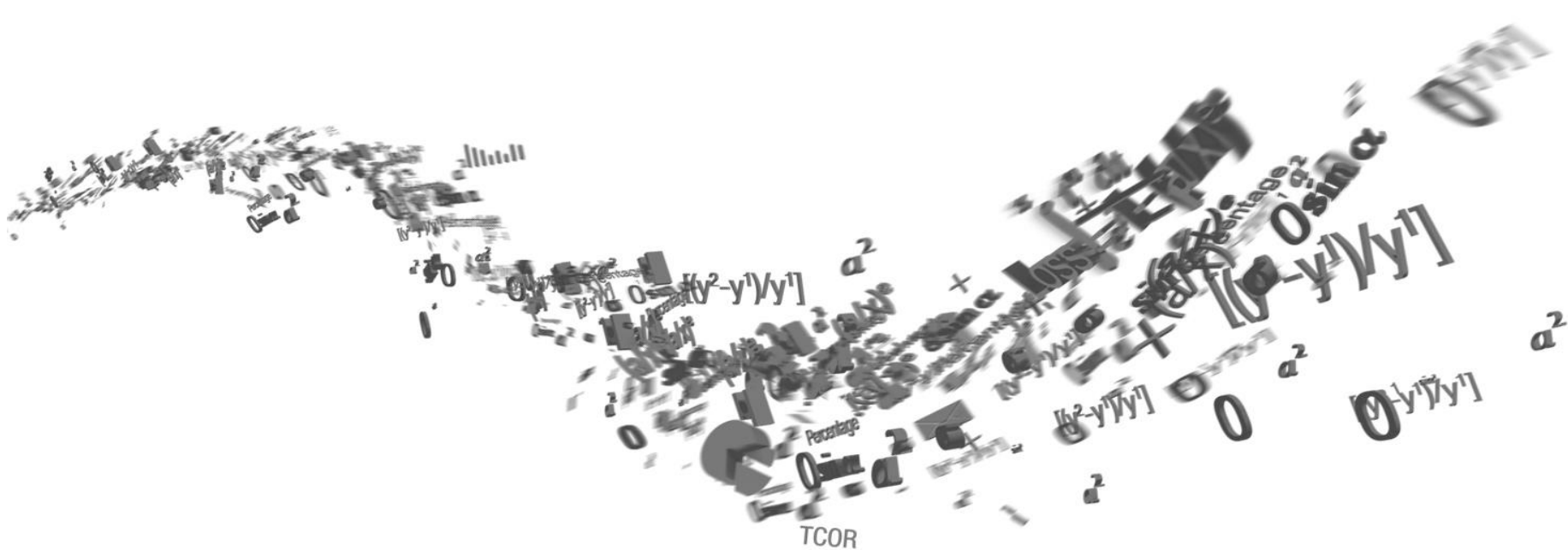


## Real life example within the Fund

	Total liabilities £Ms		Increase in Liabs 2004 - 2013
	31 March 2004	31 March 2013	
Council employer	£89.8	£146.0	63%
University employer	£71.3	£158.4	122%
Whole of Fund	£2,901.1	£5,427.9	87%

	Pensionable pay £Ms		Increase in Pen Pay 2004 - 2013
	31 March 2004	31 March 2013	
Council employer	£15.2	£16.8	11%
University employer	£19.0	£31.4	65%
Whole of Fund	£633.7	£809.2	28%

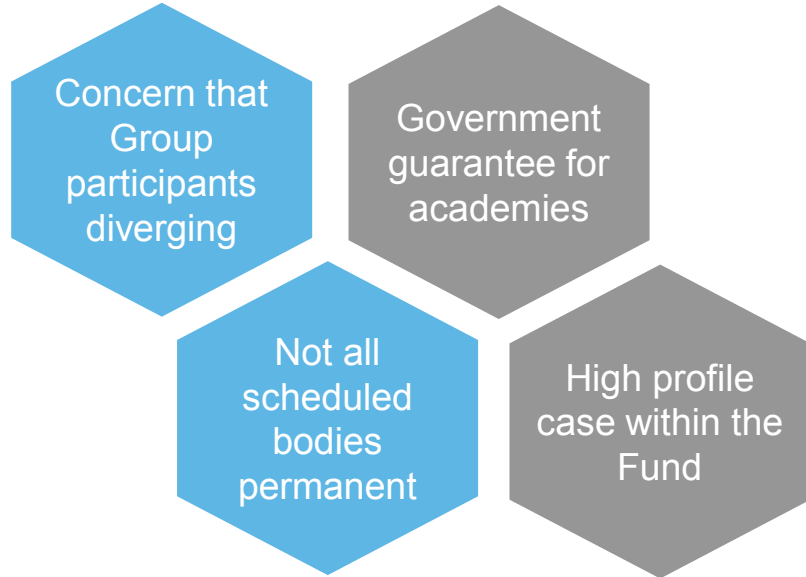
Source: Aon Hewitt, Reports on 2004 and 2013 valuations



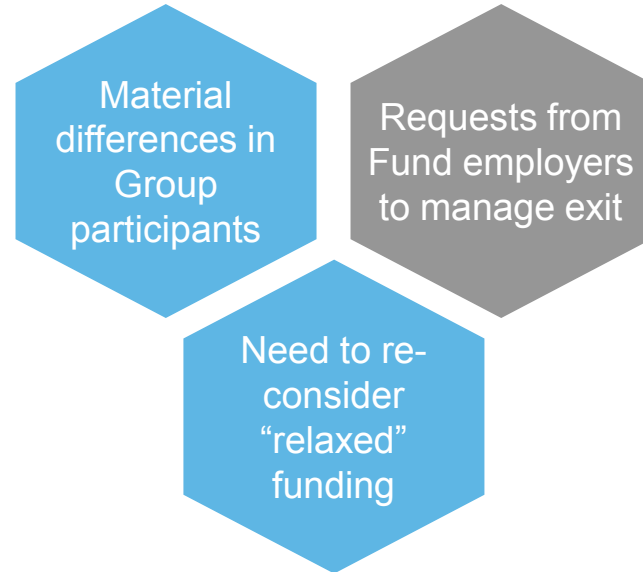
## Review of the groups

# Why review the Groups?

## Scheduled body group



## Admission body group



## Initial outcome of review of the SBG

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- All scheduled bodies admit new members
- Some / all government funded
- Some difference in profile e.g. schools/academies and colleges less mature

### Do all scheduled employers still “fit”?

- Are they classified exclusively as public sector?
- Where does their funding come from?
- How committed are they to the LGPS?
- How financially secure are they?
  - greater focus on employer covenant (SAB, tPR, Cipfa guidance on FSS)
  - Totton College

Strong reasons for re-structuring the SBG

## Initial outcome of review of the ABG

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- Greater variation between employers
  - charities, other not-for-profit, commercial organisations
  - some material difference in profile – e.g. employers not admitting new members
- Use of ‘Ongoing’ funding target (used in 2010 / 2013 valuations) only appropriate for employers guaranteed by a secure tax-raising body (“subsumption” commitment)
- For employers exiting the Fund with no guarantor orphan funding target should be used (to target exit position)
- Some employers asking to pay extra contributions to manage the exit position

Very difficult to justify continuation of ABG in its current form

### Legal advice to Administering Authority

- HCC has the statutory power to amend the funding model (via the LGPS Regulations)
- HCC must act “fairly and reasonably” and in line with its statutory powers
- changes to the Funding Strategy Statement must be made in consultation with “such persons as it [HCC] considers appropriate”
- recent Pensions Ombudsman's case (Thomas Ferens Academy v East Riding of Yorkshire Council)
  - AA has a duty of care to members and employers as a whole, not to one particular employer, to adopt policies it considers fair and reasonable
  - difficult for a Scheme Employer to challenge the funding and contribution decisions provided that the correct process has been followed and appropriate advice taken

As long as HCC has exercised statutory powers fairly  
and reasonably, successful challenge is unlikely

## Objectives of the proposed changes

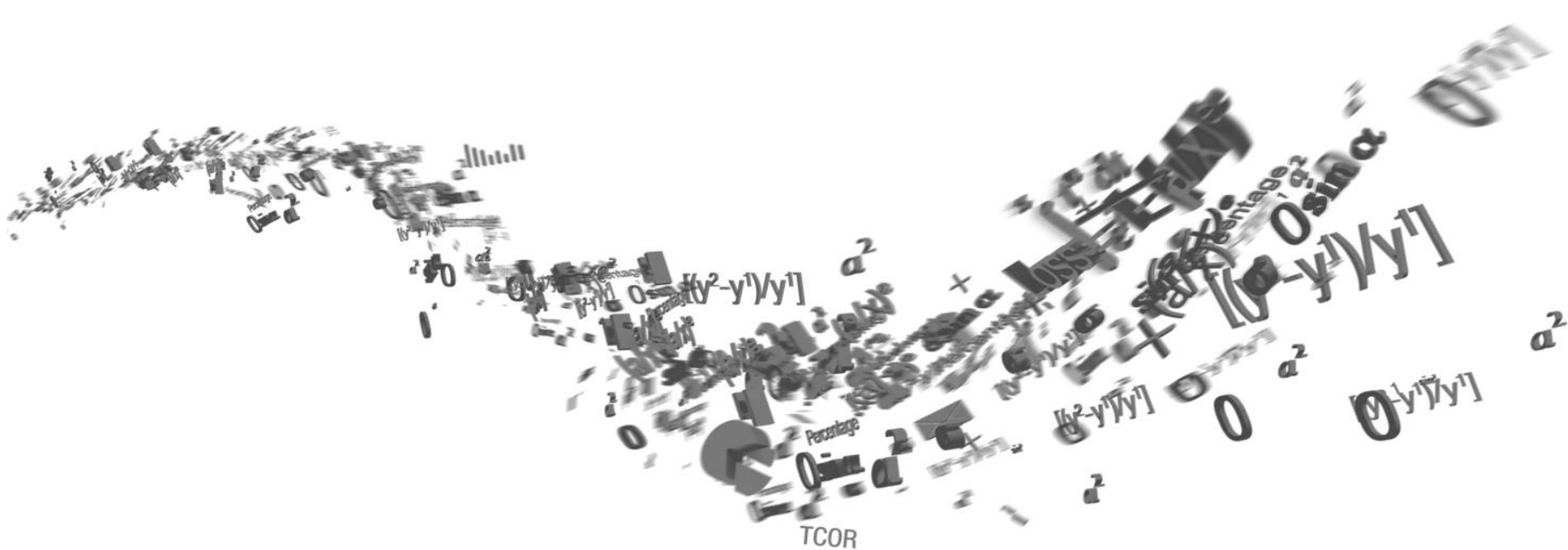
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Removing identified employers from the Groups will:

- Reduce the risk they are unfairly subsidising other employers
- Facilitate adoption of a funding strategy that recognises differences in covenant and funding arrangements
- Ensure consistent treatment of Universities currently in the ABG or SBG
- Permit better management of route to exit for closed admission bodies



Overriding objective is to balance interests of all employers



## Funding strategy and proposed changes



# Hampshire funding strategy

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## Purpose of the Funding Strategy Statement

The purposes of this Funding Strategy Statement are to set out the processes by which the administering authority:

- Establishes a clear and transparent funding strategy, specific to the Fund, to meet employer's pension liabilities going forward.
- Aims to meet the regulatory requirement in relation to the desirability of maintaining as nearly constant a common rate of contributions as possible.
- Takes a prudent longer-term view of funding the Fund's liabilities noting that whilst the funding strategy applicable to individual employers or categories of employers must be reflected in the Funding Strategy Statement **its focus should at all times be on those actions which are in the best long term interests of the Fund.**

## Hampshire funding strategy

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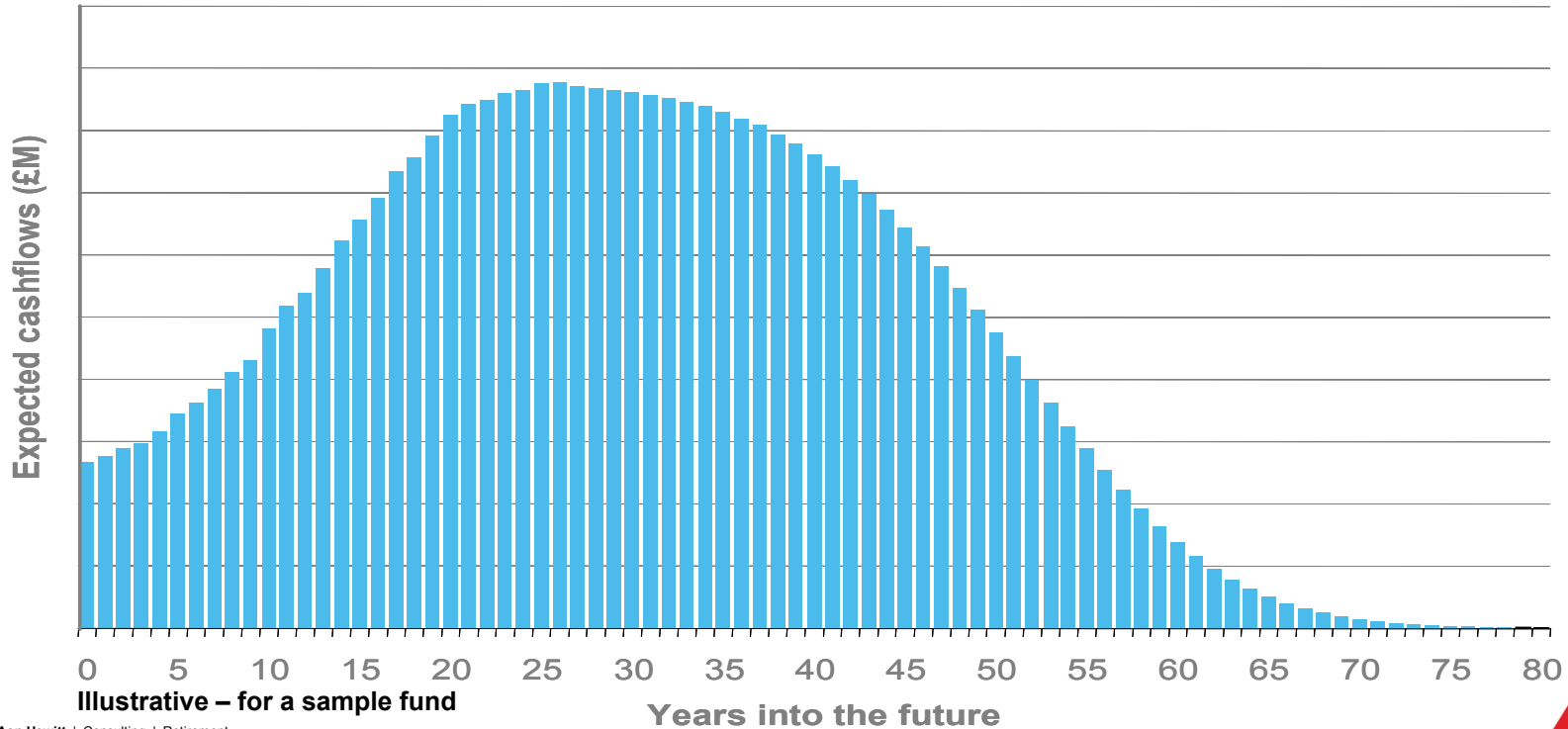
### Solvency Target and Funding Target

- For Scheduled Bodies, and certain other bodies of sound covenant whose participation is indefinite in nature..... the administering authority will generally assume indefinite investment in a broad range of assets of higher risk than risk-free assets.
- For certain Admission Bodies, bodies closed to new entrants and other bodies whose participation in the Fund is believed to be of limited duration through known constraints or reduced covenant, and for which no access to further funding would be available to the Fund after cessation..... the chance of achieving solvency will be set commensurate with assumed investment in an appropriate portfolio of Government index linked and fixed interest bonds after cessation.

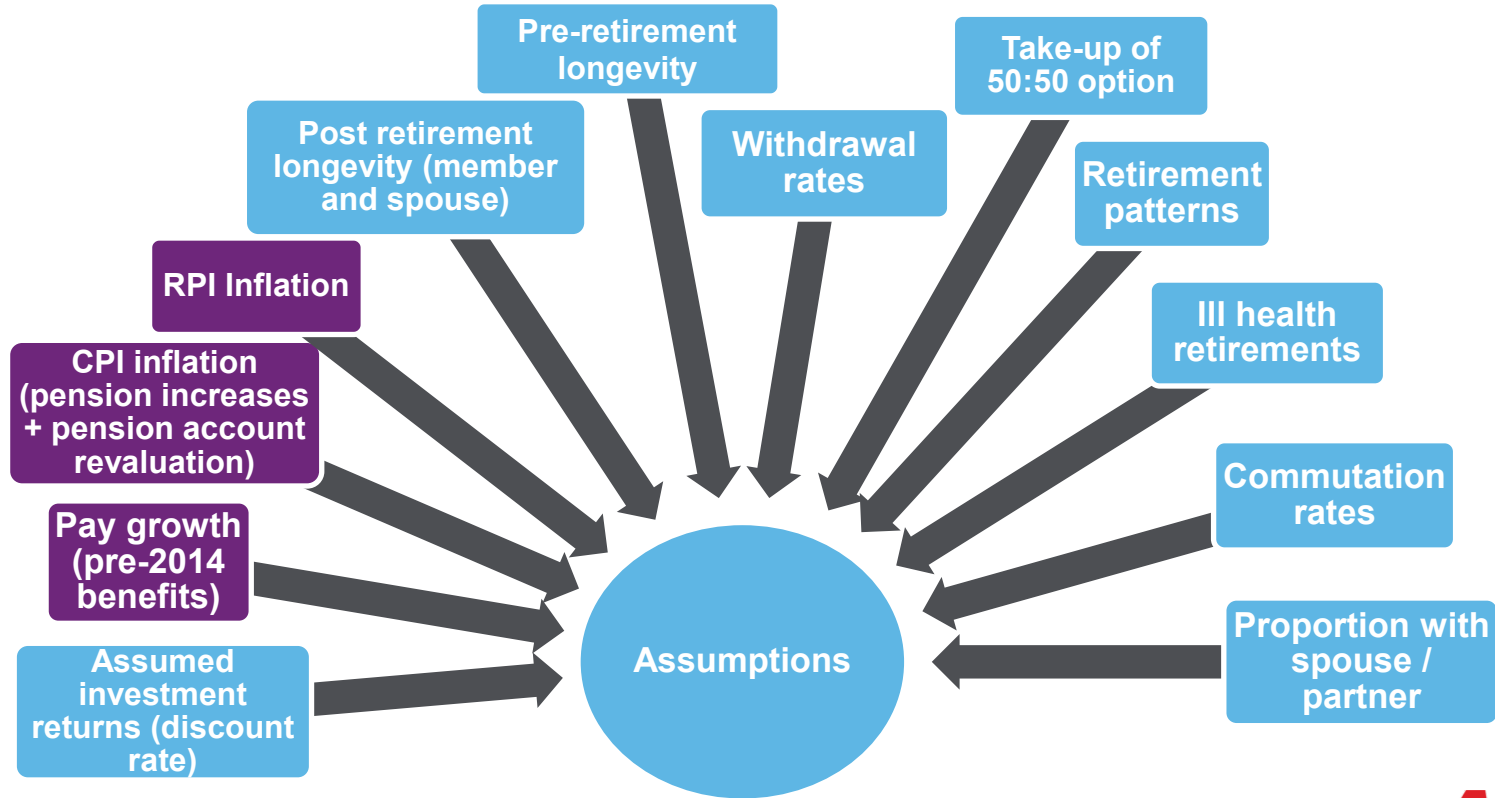
## Relaxation of contributions for community admission bodies in “extreme” economic conditions

# Valuing the liabilities / setting the funding target

## Estimating what benefits will be paid, and when

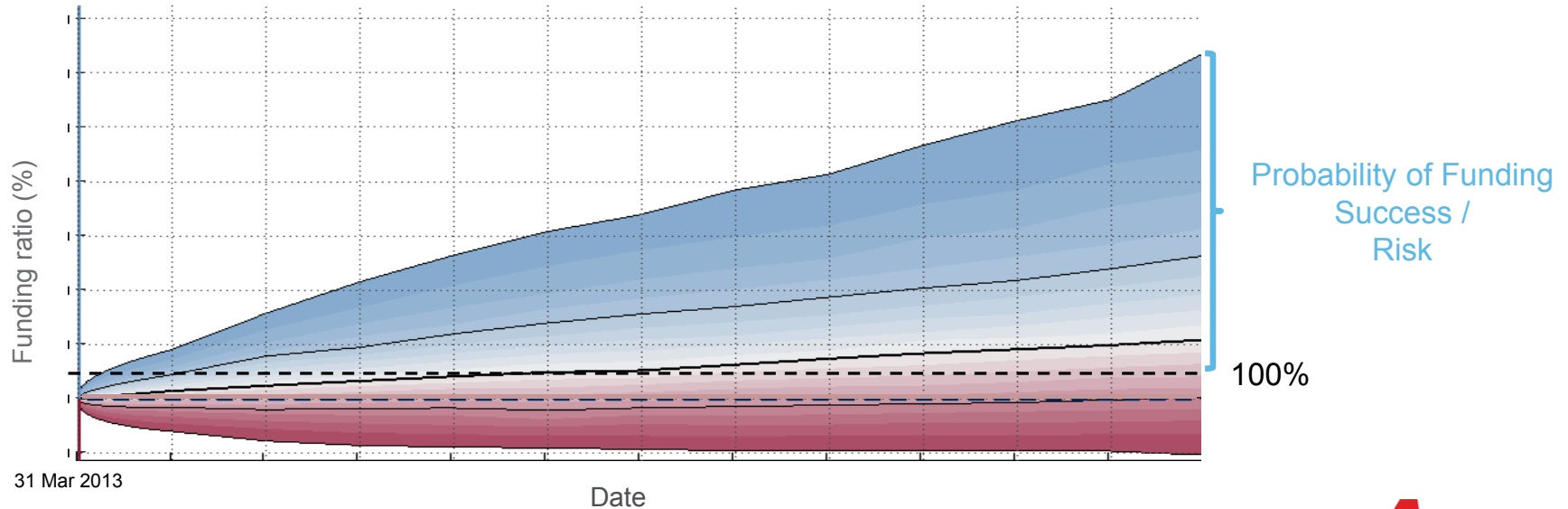


## Valuing the liabilities - assumptions



## How the ongoing funding target is set (LGPS-specific approach)

- Discount rate / investment return: 5.5% p.a.
- Pension increases: 2.4% p.a.
- Pay increases: 3.9% p.a.
- Probability of funding success: 71%



## Hampshire funding strategy

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### Cessation of participation - orphan liabilities

- Where an employer is leaving the Fund and will no longer have any contributing members, and the residual liabilities are not subsumed, the administering authority will act on the basis that it will have no further access for funding from that employer once any cessation valuation, carried out in accordance with Regulation 64 of the Regulations, has been completed and any sums due have been paid. Residual liabilities of employers from whom no further funding can be obtained are known as orphan liabilities.
- The administering authority will seek to minimise the risk to other employers in the Fund of having to make good any deficiency arising on the orphan liabilities. To achieve this, the administering authority will seek sufficient funding from the outgoing employer to match the liabilities with low risk investments, generally Government fixed-interest and index-linked bonds.

Recent case of college exiting has highlighted that this applies equally to ABG and SBG members where no government-backed guarantee in place

# Current funding approach / strategy (in theory)

Strength of funding target



Stronger – less reliance on investment returns

Weaker – more reliance on investment returns

Exit valuations (orphan liabilities)

Ongoing valuations (admission bodies - orphan liabilities)

Ongoing scheduled body valuations. Ongoing and exit valuations for admission bodies with subsumption commitment

# A risk based approach

## Proposals for 2016 valuation

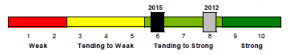
- HE/FE Employers will be required to provide financial data by 31 March 2016
  - two most recent annual accounts
  - financial forecasts
  - recent Ofsted / QAA report
- Covenant assessment will be carried out across the sector
- Option for individual employers to request their own covenant assessment

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Hampshire County Council Pension Fund  
Date: 2 February 2016  
Prepared for: Hampshire County Council  
Prepared by: Aon Hewitt

### Covenant Assessment - Sample Education Institution

**Background**  
Hampshire County Council has requested a desk top assessment of the covenant of Sample Education Institution (the "Employer") in support of the 2016 actuarial valuation. Aon Hewitt assesses the covenant to be:



**Information availability** • Financial report and accounts for the year ended 31 July 2014

**Covenant conclusion**  
**Tending to Strong (8)** – The covenant has deteriorated since the previous assessment due to the increase in pension liabilities. However, this negative development is not severe enough to merit a downgrade in covenant strength to "Tending to Weak".


**Strengths:**

- Leading position in the UK school sector with several notable alumni
- Generated operating surplus in each of the past five years (2010 – 2014) with excellent growth prospects
- Strong coverage ratios – 1.2x operating surplus to funding deficit coverage and 1.0x net funds to exit deficit coverage
- No external debt – the Fund is the Employer's only external creditor

**Areas of concern:**

- Budgetary pressure across sixth form colleges – may lead to limited course offerings

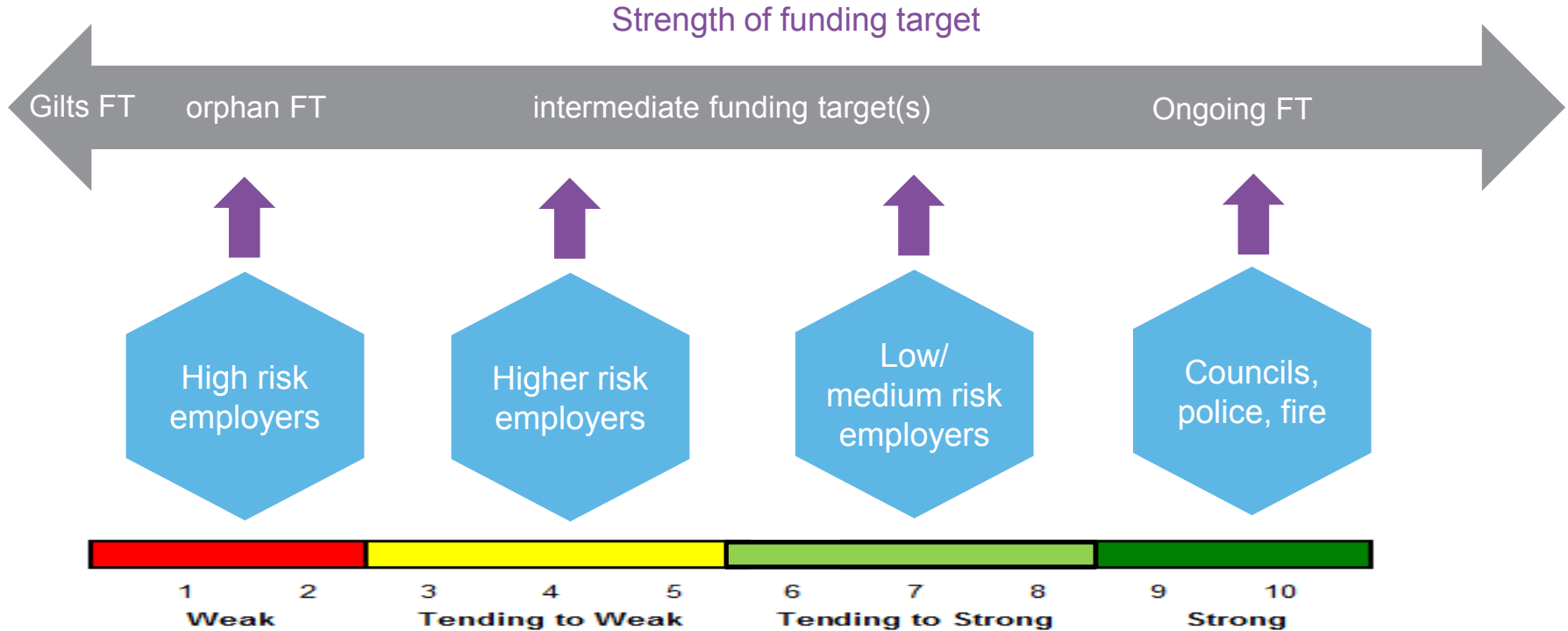
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Funding target and recovery period will be informed  
by strength of covenant



# Refined funding approach / strategy



In practice a single target preferred on efficiency grounds

## What do different funding targets mean in practice?

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### Hand-outs – individual employer data as at the 2013 valuation

- Your position as a Grouped employer
- Your position if you had not been a Grouped employer at that date (impact of ‘de-grouping’)
  - notional allocation of assets to employers in proportion to the share of the Group’s liabilities - consistent with accounting and exit valuations
- Your position if an ‘orphan’ funding target had been adopted
- Your position if you had exited the Fund at the 2013 valuation (all actives as deferreds)

## Worked example

Effect of different funding targets (as at 31 March 2013)

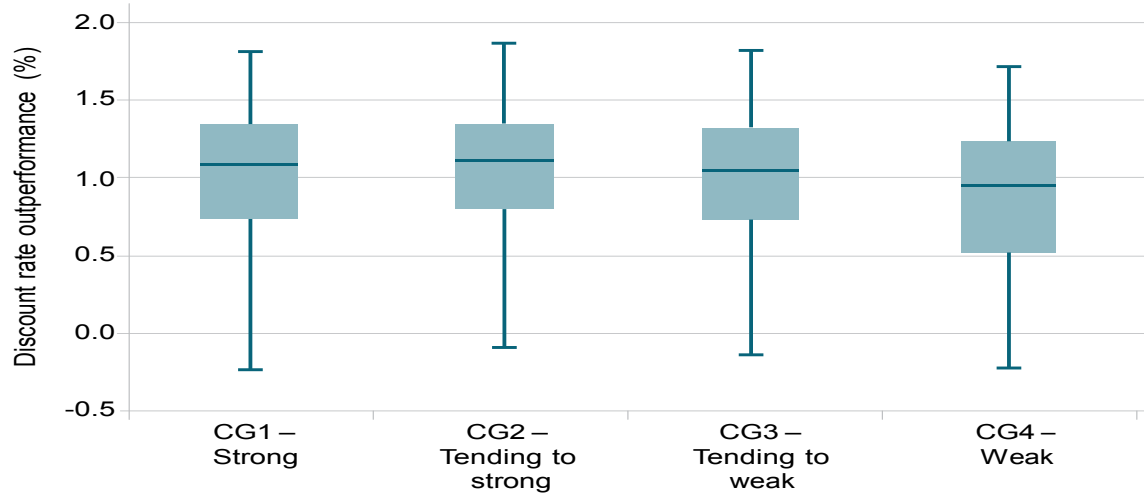
	←————— Gilts ————— Orphan ————— Intermediate ————— Ongoing —————→			
Discount Rate	3.2% p.a.	5.2% / 3.9% p.a.	TBC	5.5% p.a.
Assets	£125M	£125M	£125M	£125M
Liabilities	£234M	£206M	↔	£158M
Deficit	£109M	£84M	↔	£33M
Future service rate	-	20%	↔	12.6%
Deficit contributions p.a.	-	£4.3M	↔	£1.8M

FRS 17 (31 July 13)

Effect varies according to membership profile

# Comparison with private sector schemes

**Figure 4B: Distribution of nominal discount rate outperformance by Tranche 8 covenant group**



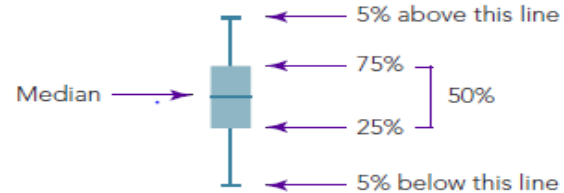
Outperformance adopted by HCC:

Scheduled body FT: 2.3% p.a.

Orphan FT: 2% p.a. in service  
0.7% p.a. left service

Base: All Tranche 8 valuations received up to 31 January 2015  
Sources: The Pensions Regulator, Thomson Reuters, Bank of England

Source: tPR's Annual Funding Statement Analysis, May 2015



# It's not just down to investment strategy

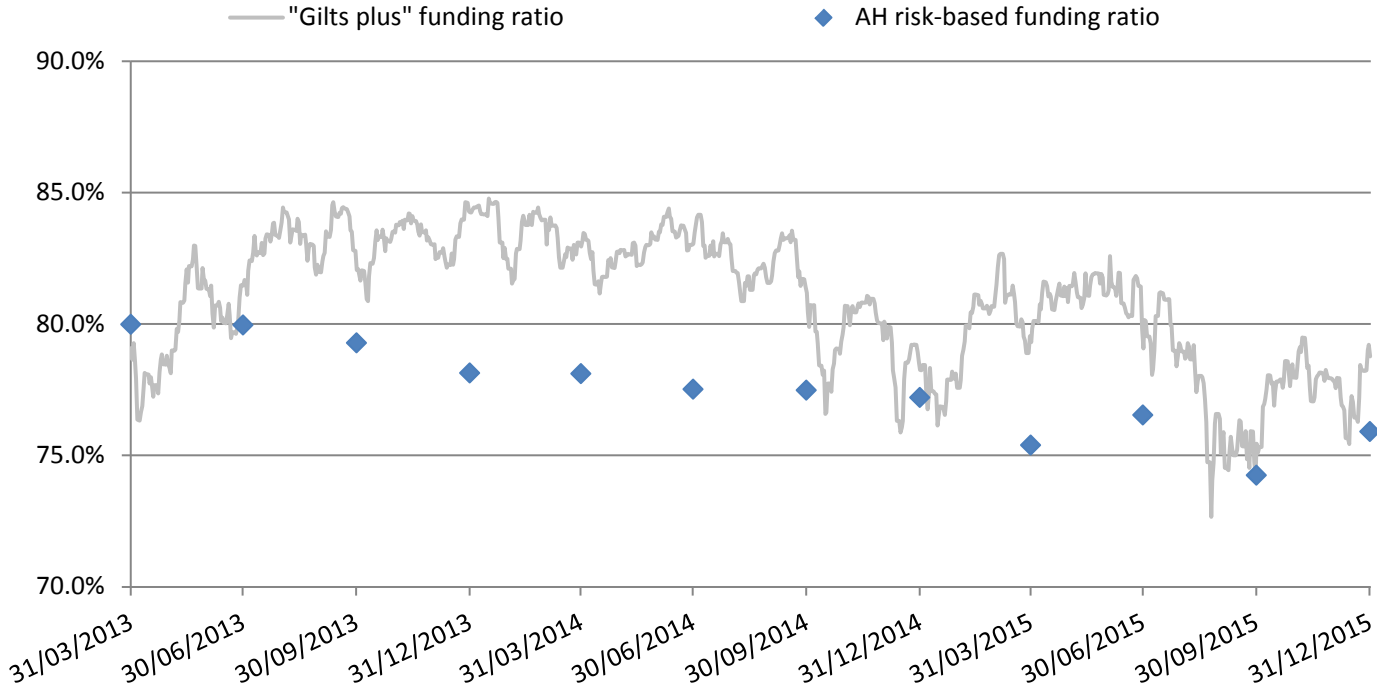
**Figure 3: Distribution of discount rate outperformance by allocation to return-seeking assets group**



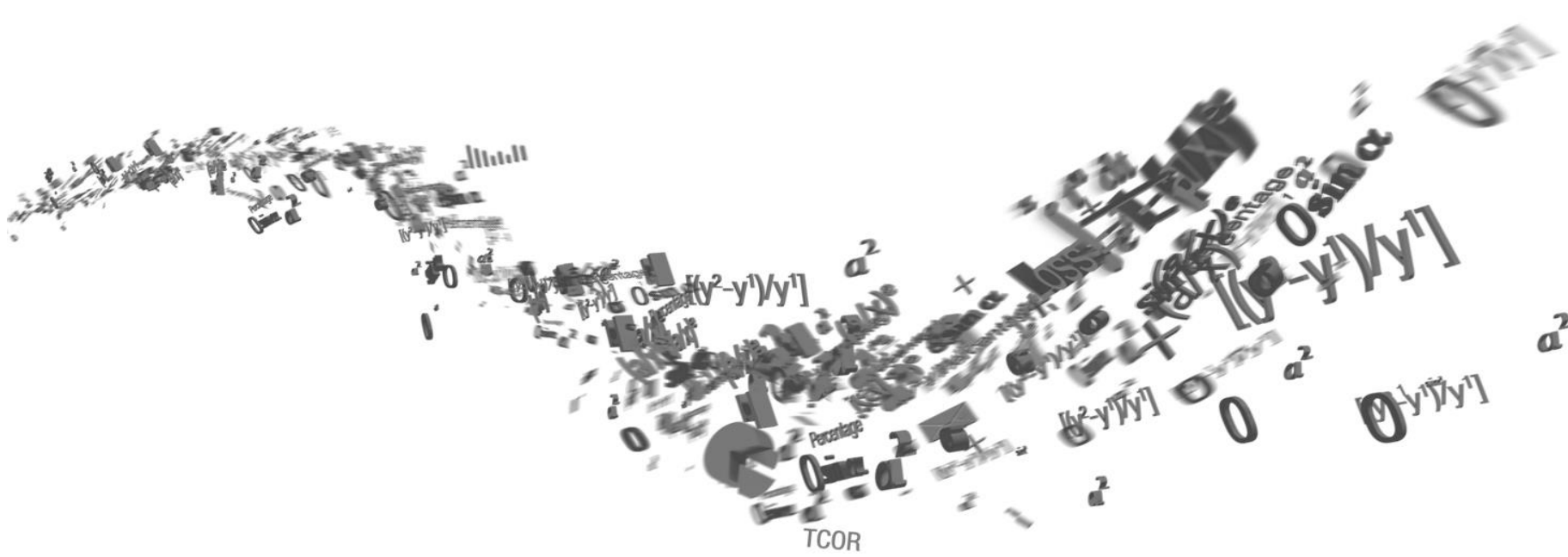
Source: tPR's Annual Funding Statement Analysis, May 2015

# Financial pressures - movement in funding position

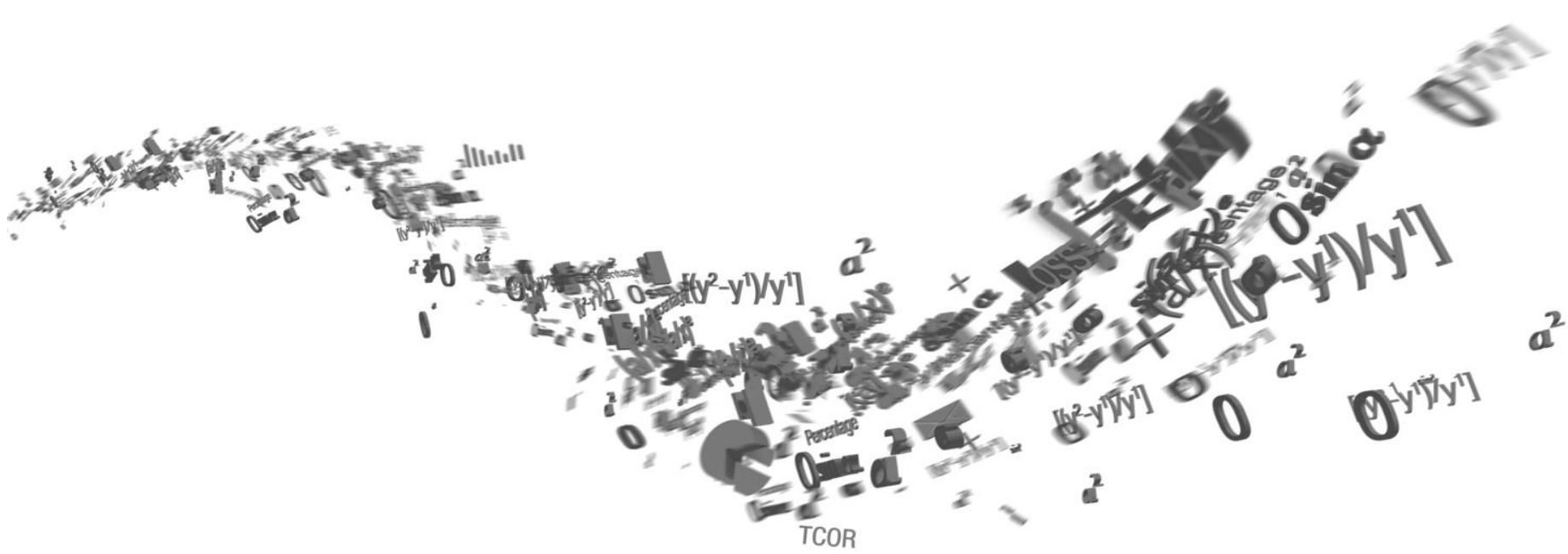
## Progression of whole of Fund funding position



Source: Aon Hewitt, Hampshire Pension Fund, Estimated



# Break



## Fund-wide changes to risk sharing



## Proposed Fund-wide changes to risk sharing

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- Lump sum death in service benefit is already shared
  - payment of 3 x Pensionable Pay on death
  - ‘premium’ is included within contribution rates

### Additional risks proposed to be shared from 2016

- Ill health early retirement
  - enhanced pension, without reduction (this can be expensive if the member is young)
- Partner’s pension on death in service
  - enhanced pension (this can be expensive if the partner is much younger than the member)

Intention is to reduce effect of ill-health / death-in-service for small employers by pooling risk

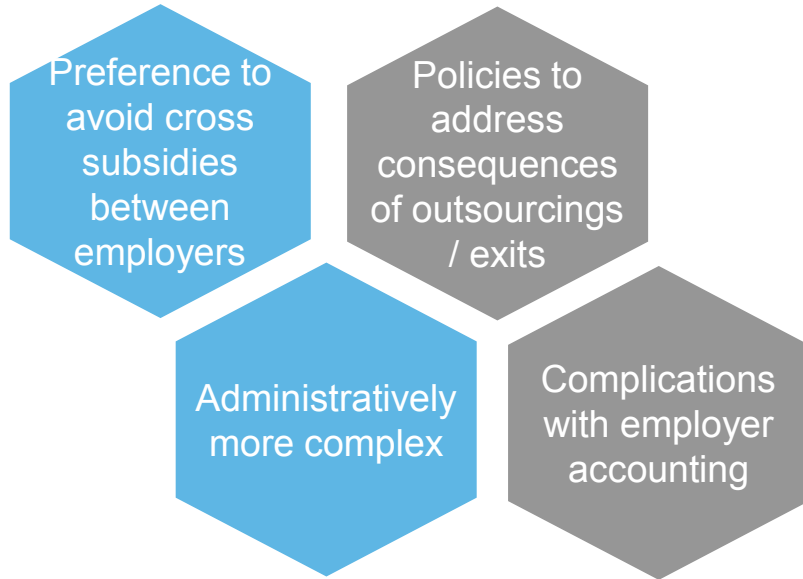


# Options for creating new funding groups

## Options for new groups

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Grouping (or Pooling) is now relatively rare across LGPS Funds



HPF is willing to administer new groups if all employers agree

## Options for new groups

### Conditions under which HPF will consider new groups

Condition	Effect
Employers share future service rate costs	All employers in the Group pay the same % of pay contribution rate for future service
Groups can only operate one funding target	Stronger employers may have a higher FT than if individually assessed Weaker employers may have a lower FT than if individually assessed
Insolvency risk is shared within the Group	Any unpaid deficiency falls to the other employers in the Group
Restrictions on joining/leaving the Group	Prevents “selection” by employers
Open employers only eligible for grouping	Enables targeting of exit position for closed employers

Any new arrangements will be documented in the FSS

## Option 1 – similar to existing Group framework

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- Assets not tracked at employer level
  - apportioned on share of fund approach for accounting / exit purposes
- Grouped employers pay a common future service rate
- All funding risks are shared
- Employers contribute towards the Group's deficiency in proportion to payroll (or liabilities)
- No facility for over / advance payments by employers
- Common recovery period applies to all employers in the Group
- Similar policies to those currently adopted in the other Groups to protect against declining payrolls (or liabilities)
- Policies needed on exit / outsourcings (can be complex)

Clarity and transparency are key

## Option 2 - alternative grouping arrangements

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### Groups with individual asset tracking, only specified risks shared

- Assets tracked at employer-level (still a notional allocation)
  - different to current approach where employers do not have a notional asset share
- Employers pay a common future service rate (next slide)
- Employers contribute towards their own deficiency
  - over-payments are possible
  - some risks are shared

Agreement required on which risks to share

## Operation of “alternative” grouping

Sharing future service costs (employers pay the same % pay contribution rate)

Group with 2 employers	Employer 1	Employer 2
Payroll over year	£1M	£1M
Future service cost of employer’s members	12%	20%
Employer pays (average Group rate)	16% (£160K)	16% (£160K)
Employer’s liabilities increase by	£120K	£200K
Employer’s assets credited with (to ensure deficit doesn’t change)	£120K	£200K

Employers treated as if the profile of their active members is identical, in line with the Group average

## Decisions required for alternative grouping – which risks to share ?

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### Other risks which can be shared

Risk
Pay increase risk
Pension increase / Pension account revaluation risk
Mortality risk

#### Notes:

- We suggest risks are shared in proportion to liabilities
- *Investment risk* is a key risk but, where assets are tracked at employer level, average Fund returns are applied to each employer's notional allocation of the Fund's assets
- *Change in financial conditions* risk (i.e. changes to the assumptions for the discount rate and inflation, causing changes to liability values) is another significant risk but, the change to the Group assumptions will apply to each employer's liabilities individually (in effect not sharing)

The same risks must be shared for all employers in the Group



## Other considerations

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### Insolvency Risk

- Totton College's exit debt was equivalent to 18% of the total 'ongoing' deficiency relating to the remaining Colleges
- If Colleges had been grouped together sharing insolvency risk before Totton's insolvency, deficiency contributions would have increased by 18%

## Feedback – recap on proposals

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- Removal of education employers from the Groups
- Assets to be allocated on a "share of fund" basis (same as FRS accounting)
- Stronger funding target for those with weaker covenant
- Contribution increases to be phased in gradually
- Alternative pooling options

## Next steps

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- Best practice indicates transparency and consultation
  - consultation on the draft FSS ends on 19 February
  - we welcome proposals for other grouping arrangements to share costs / risks
  - Panel & Board to consider responses at March meeting
- If proposals accepted:
  - contribution changes will be managed as appropriate
  - further communications as part of 2016 valuation exercise





# Questions?

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