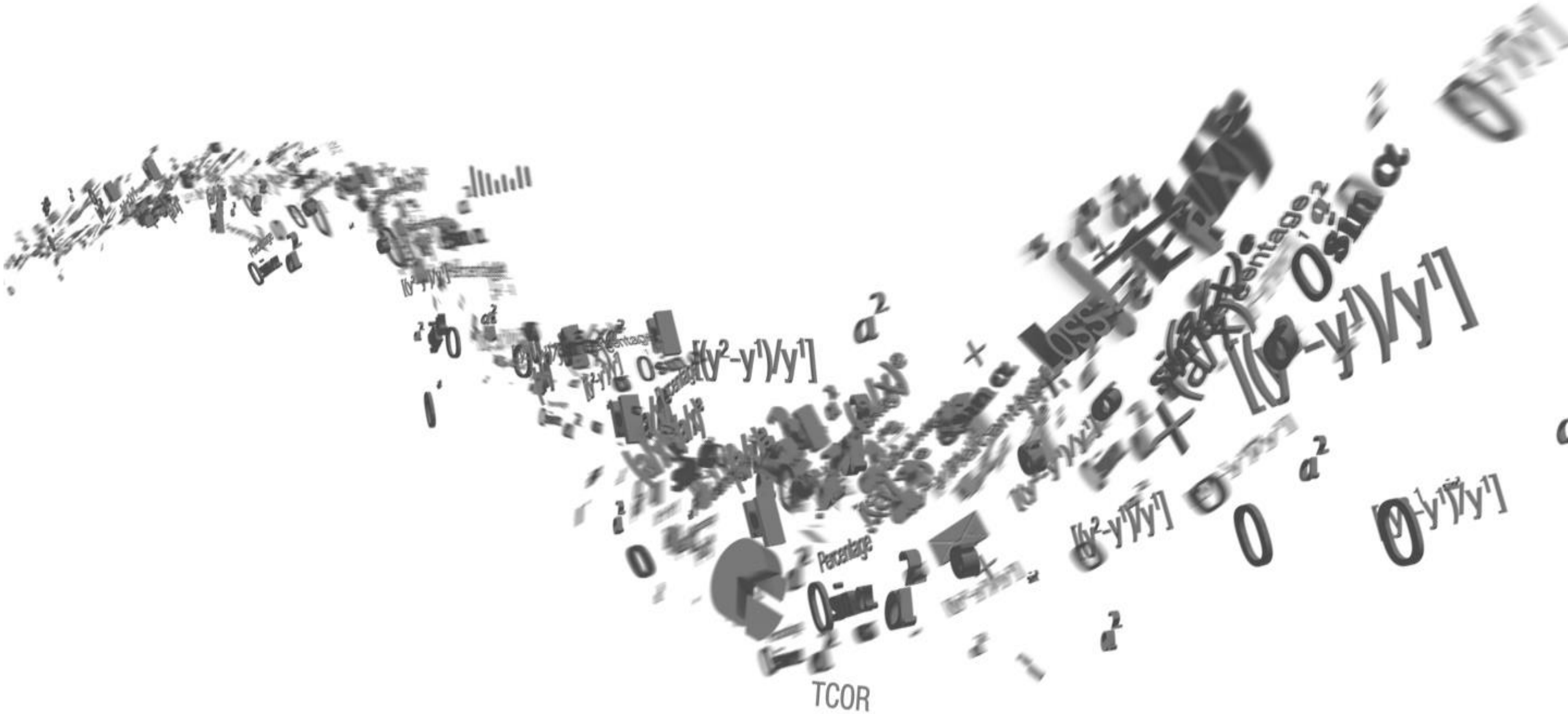

Hampshire County Council Pension Fund: Employer Workshop

Alison Murray FFA
11 February 2016

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Agenda

- Summary of proposals
- Current funding arrangements
- Review of the groups
- Funding strategy and proposed changes
- Fund-wide changes to risk sharing
- Options for managed exit
- Questions

Summary of main proposals

- 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

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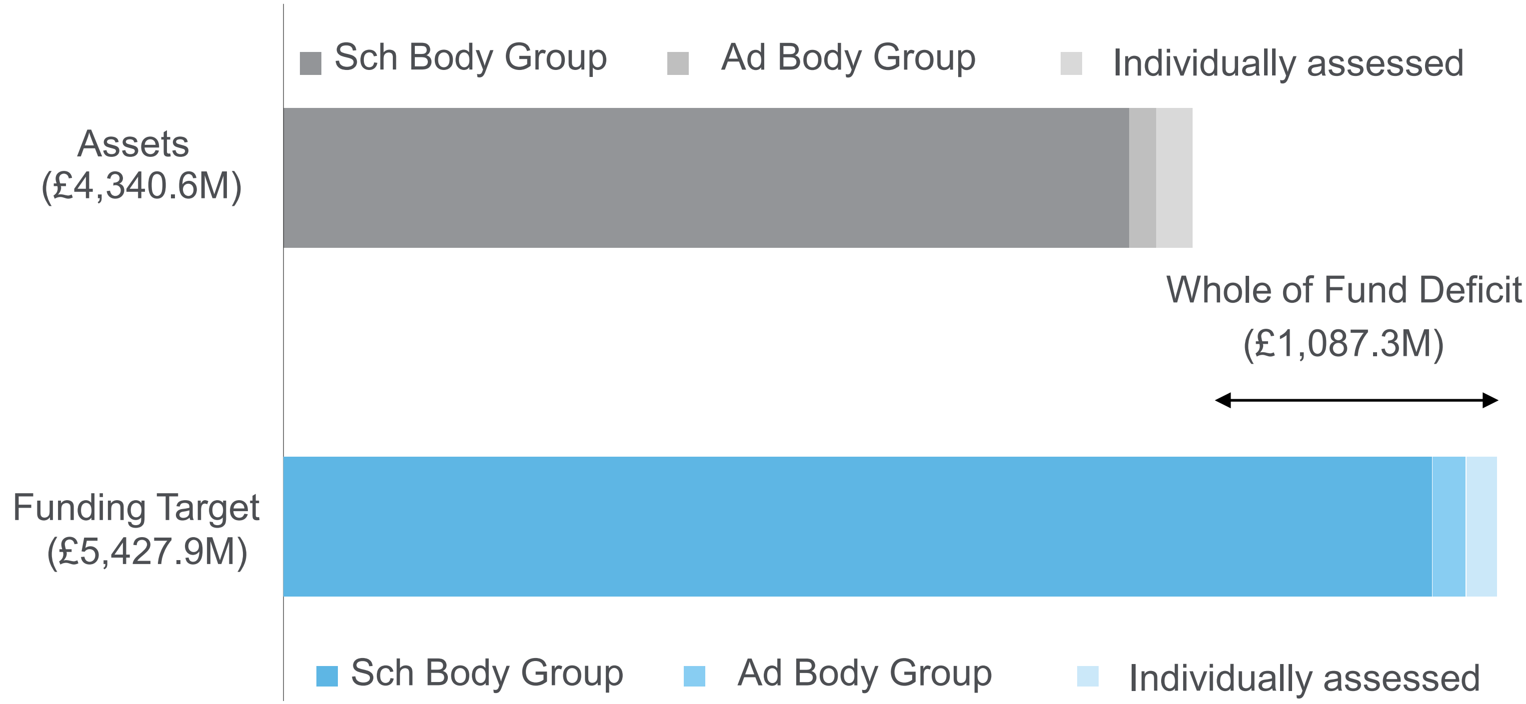
Current funding arrangements

Whole of fund position as at 31 March 2013



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

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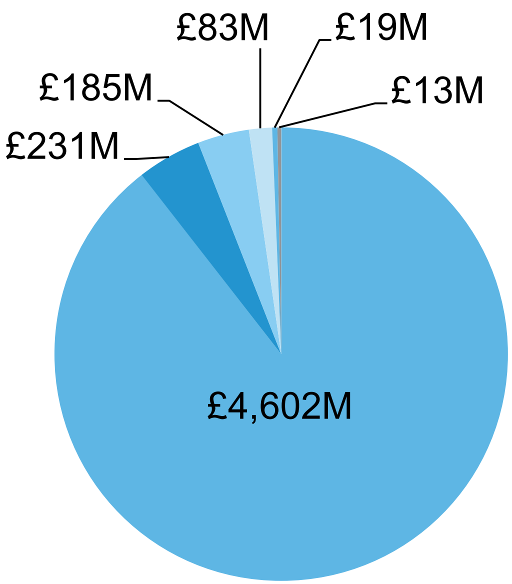
Current funding arrangements

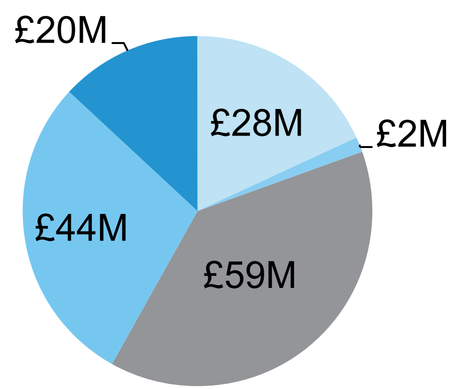
Scheduled Body Group



- Councils, Police & Fire
- Universities
- Colleges
- Schools
- Resolution bodies
- Other

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

Admission Body Group



- Universities
- Transferee ABs
- Housing Associations
- Community ABs
- Independent Schools

Liabilities as at 31 March 2013: £153M
Assets as at 31 March 2013: £125M

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

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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 HAs range from 16.9% to 21.0% of pay (2)
Asset / Deficit tracking	Group level	Individual level
Deficit contributions	Based on a share of the Group's shortfall (in proportion to pay (1))	Based on employer's shortfall
Strain contributions	Paid in addition	Paid in addition

Notes

(1) Layered Employer Recovery Plan fixes deficit contributions to protect against falling payroll

(2) These rates are for open employers. In practice for employers closed to new members the rates would most likely be higher

Group philosophy is that risks are shared

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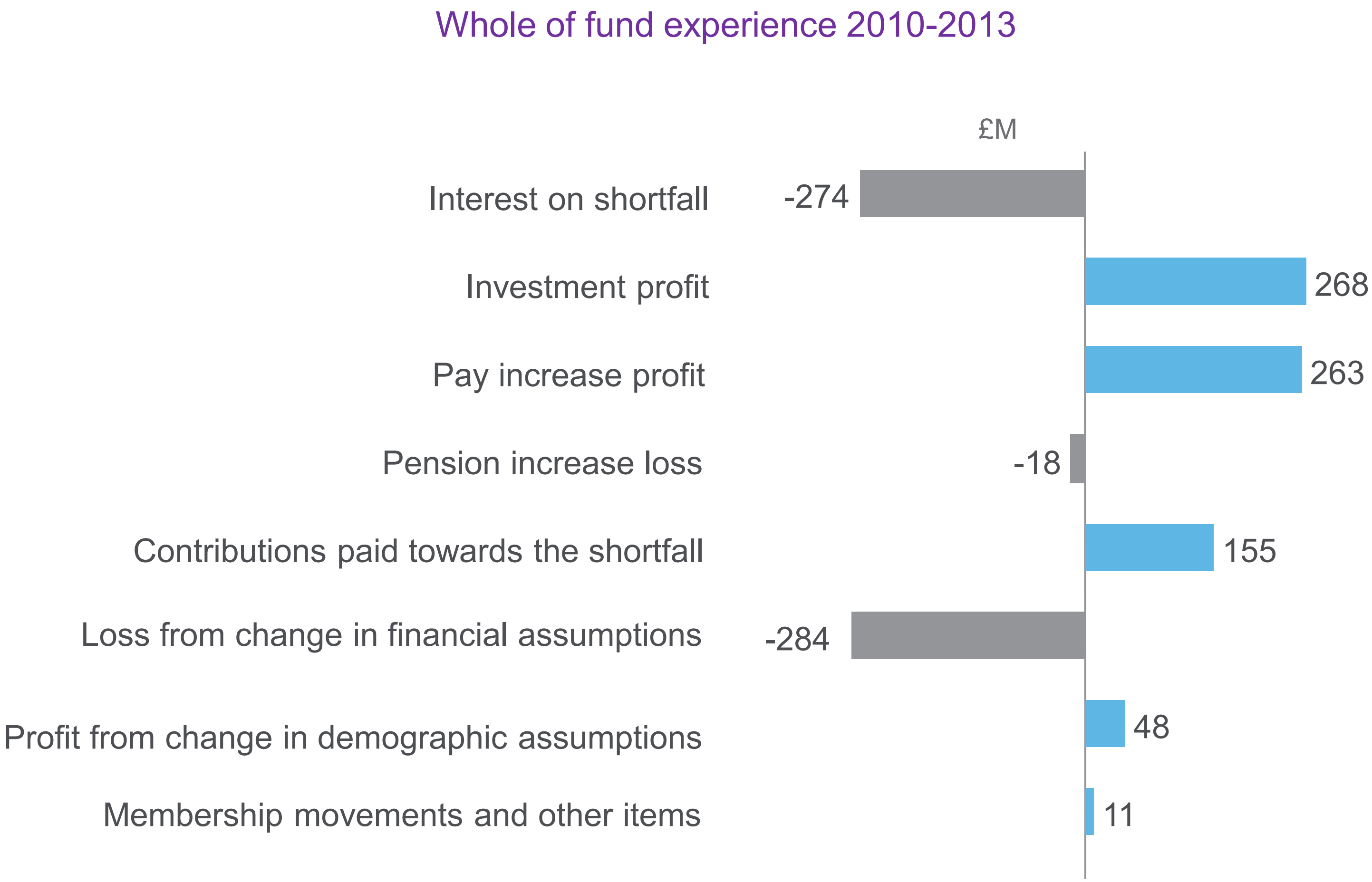
What are the funding risks?



Source: 2013 valuation report

How are the funding risks shared?

Admission Body Group experience

- £8m increase in liabilities between 2010 and 2013 due to change in financial assumptions

Employer type	Average	Immature	Mature
Average term ("duration") of liabilities	17 years	27 years	12 years
Effect of change in financial assumptions (0.4% fall in real discount rate)	7%	11%	5%
Assumed liability value	£10m	£10m	£10m
If a Grouped employer:			
Deficit allocated to employer	Depends on share of Group payroll		
If an ungrouped employer:			
Deficit allocated to employer	£0.7M	£1.1M	£0.5M

Mature employers less affected by change in financial assumptions if assessed individually

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How are the funding risks shared?

Admission Body Group experience

- £8m increase in liabilities between 2010 and 2013 due to change in financial assumptions

Employer type	Average	Immature	Mature
Assumed proportion of Group's payroll	8.75%	15%	5%
Average term ("duration") of liabilities	17 years	27 years	12 years
Effect of change in financial assumptions (0.4% fall in real discount rate)	7%	11%	5%
Assumed liability value	£10m	£10m	£10m
If a Grouped employer:			
Deficit allocated to employer	£0.7M	£1.2M	£0.4M
If an ungrouped employer:			
Deficit allocated to employer	£0.7M	£1.1M	£0.5M

Mature employers arguably under-contribute to any deficit arising between valuations

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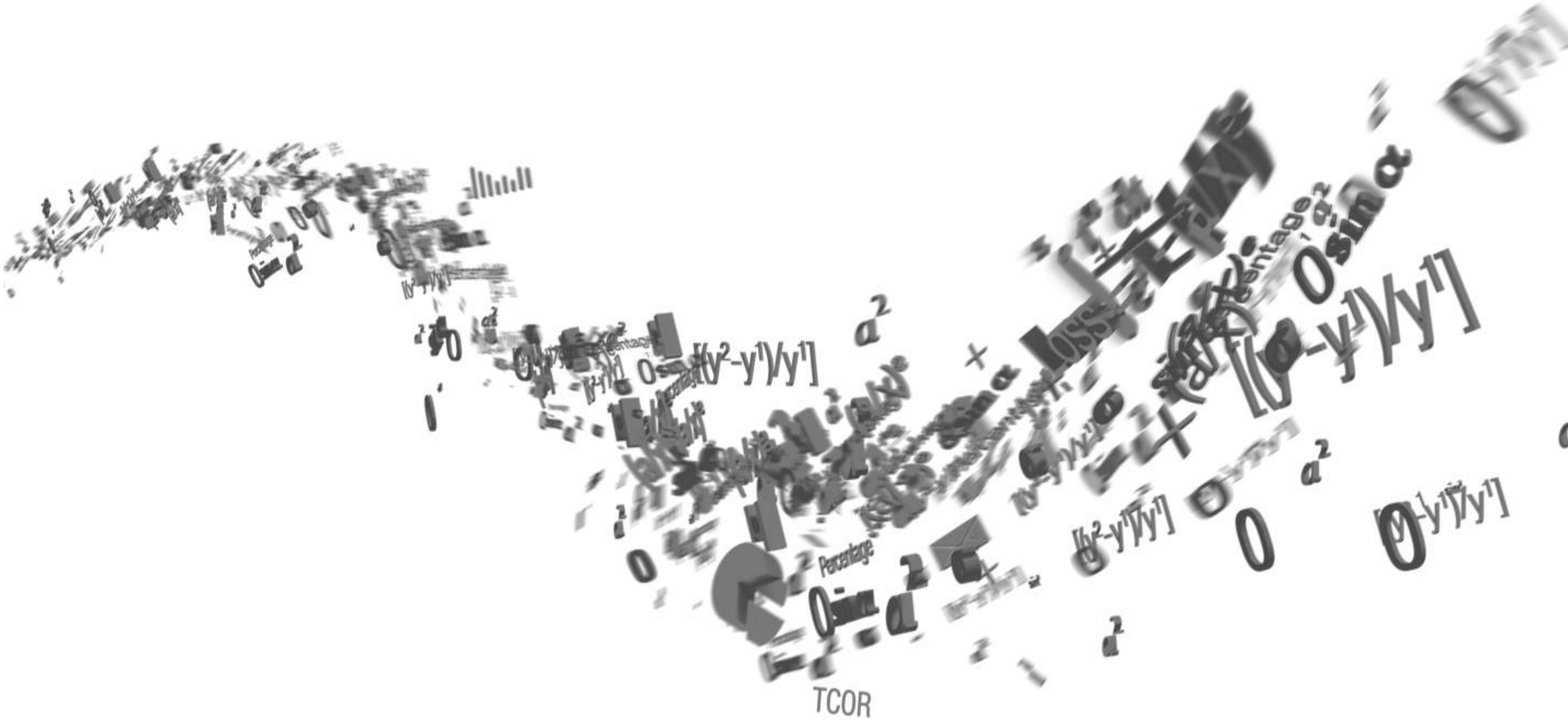

Review of the groups

Why review the Groups?

Scheduled body group

- Concern that Group participants diverging
- Government guarantee for academies
- Not all scheduled bodies permanent
- High profile failure within the Fund

Admission body group

- Material differences in Group participants
- Requests from Fund employers to manage exit
- Need to re-consider “relaxed” funding

Very few LGPS funds now operate large-scale grouping

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Initial outcome of review of the SBG

- 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

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Initial outcome of review of the ABG

- 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 with a “subsumption” commitment from a secure tax-raising body
- For employers exiting the Fund with no subsumption commitment 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

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

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Objectives of the proposed changes

Removing identified employers from the Groups will:

- Reduce the unfair / unjustified cross-subsidises between 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

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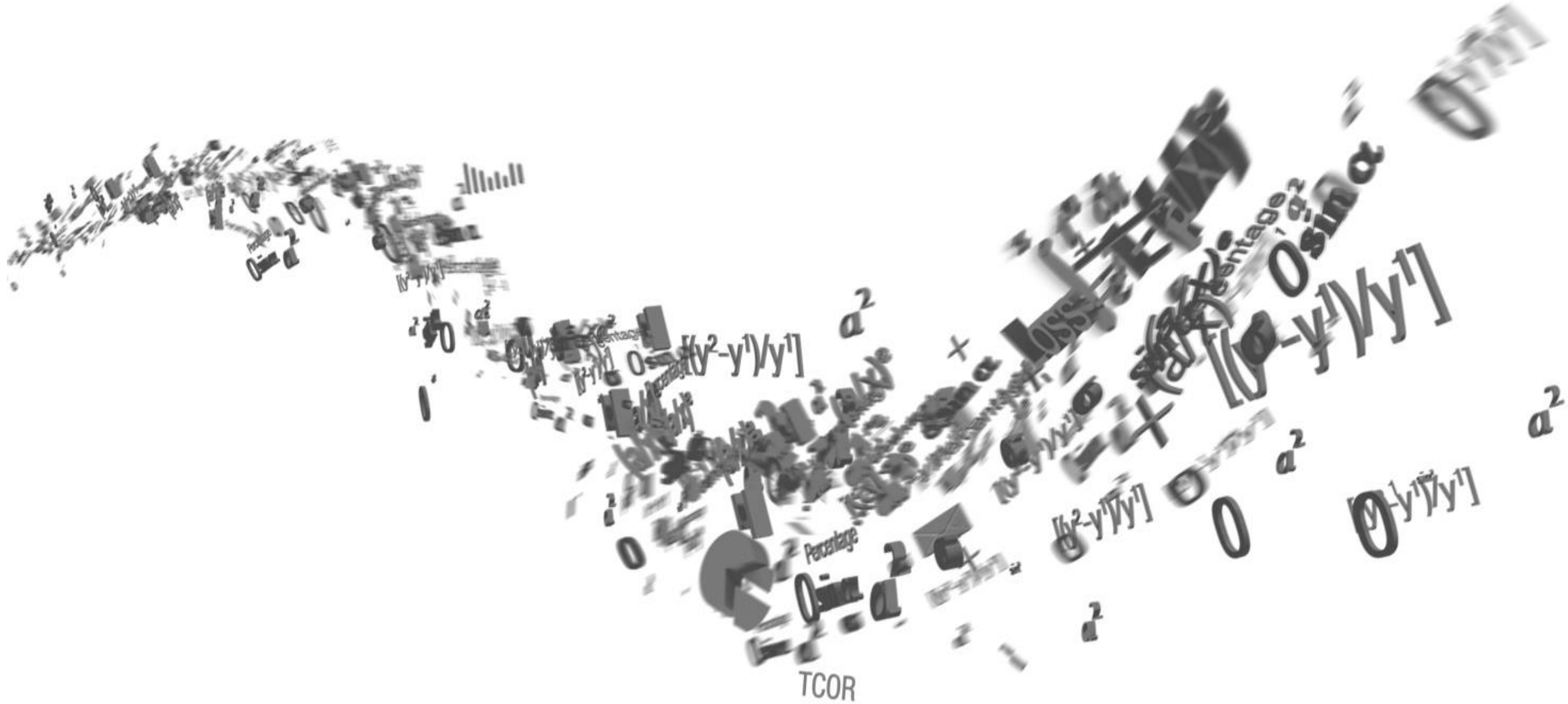

Funding strategy and proposed changes

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.

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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

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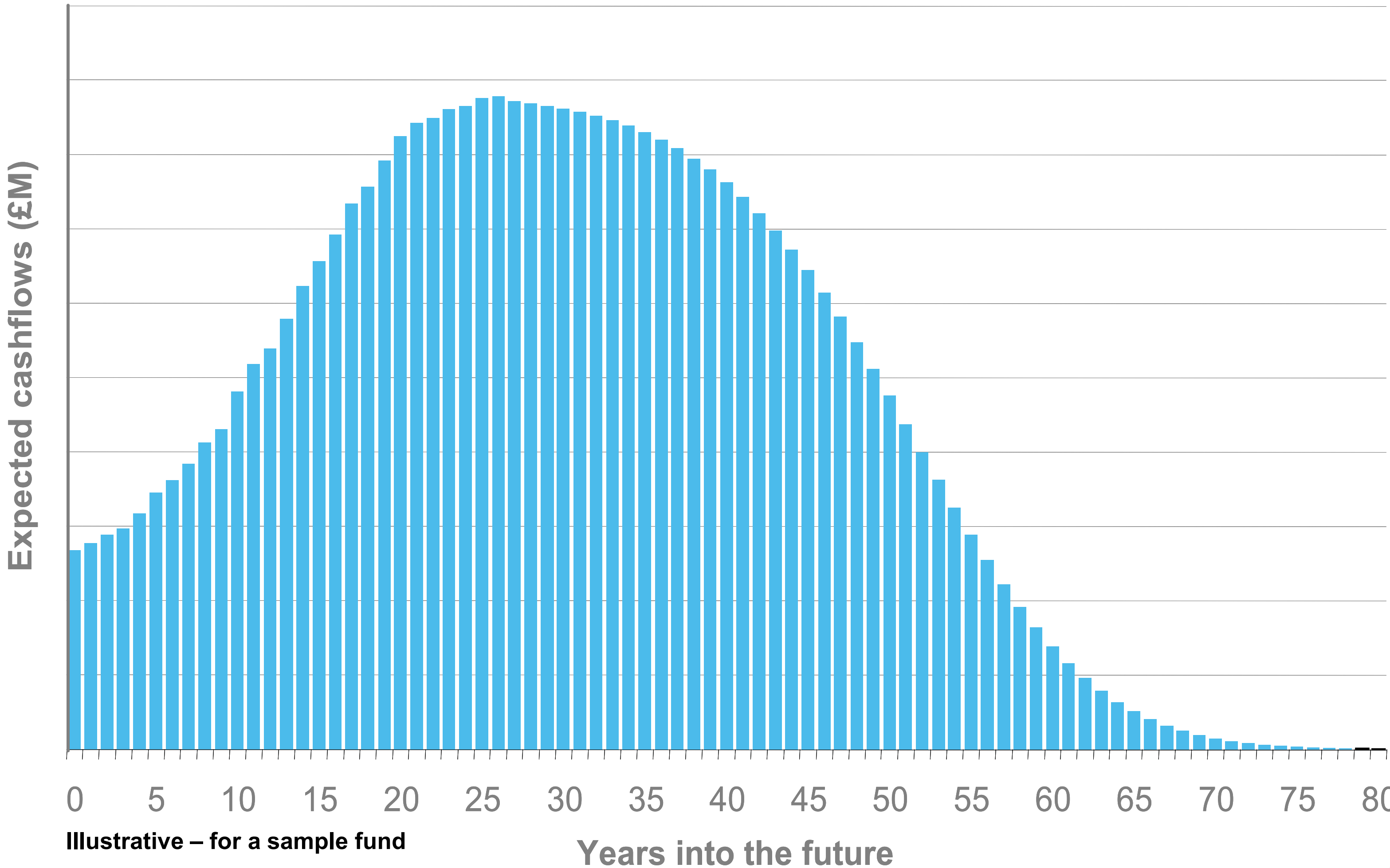
Valuing the liabilities / setting the funding target

Estimating what benefits will be paid, and when



Illustrative – for a sample fund

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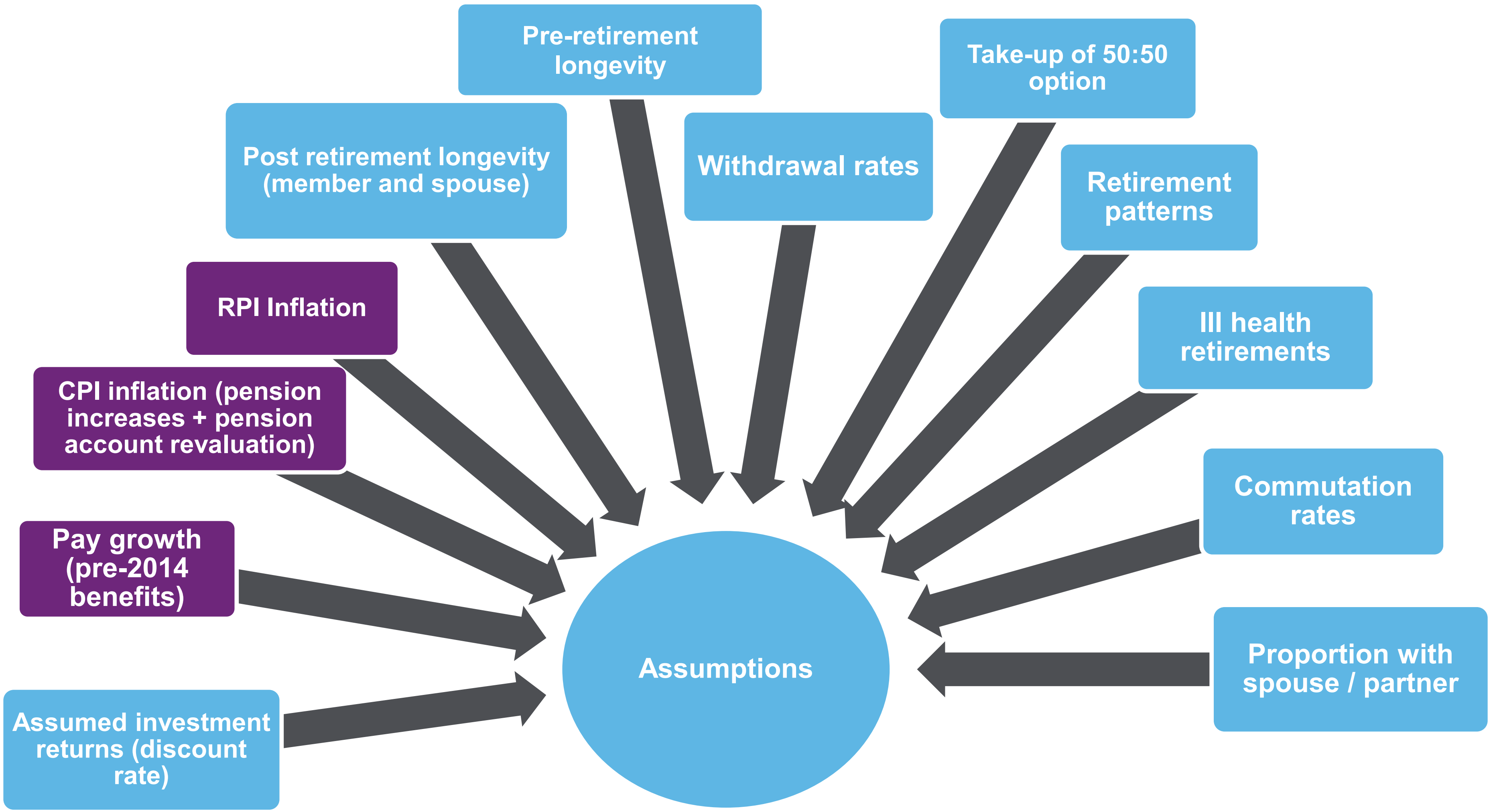
Valuing the liabilities - assumptions



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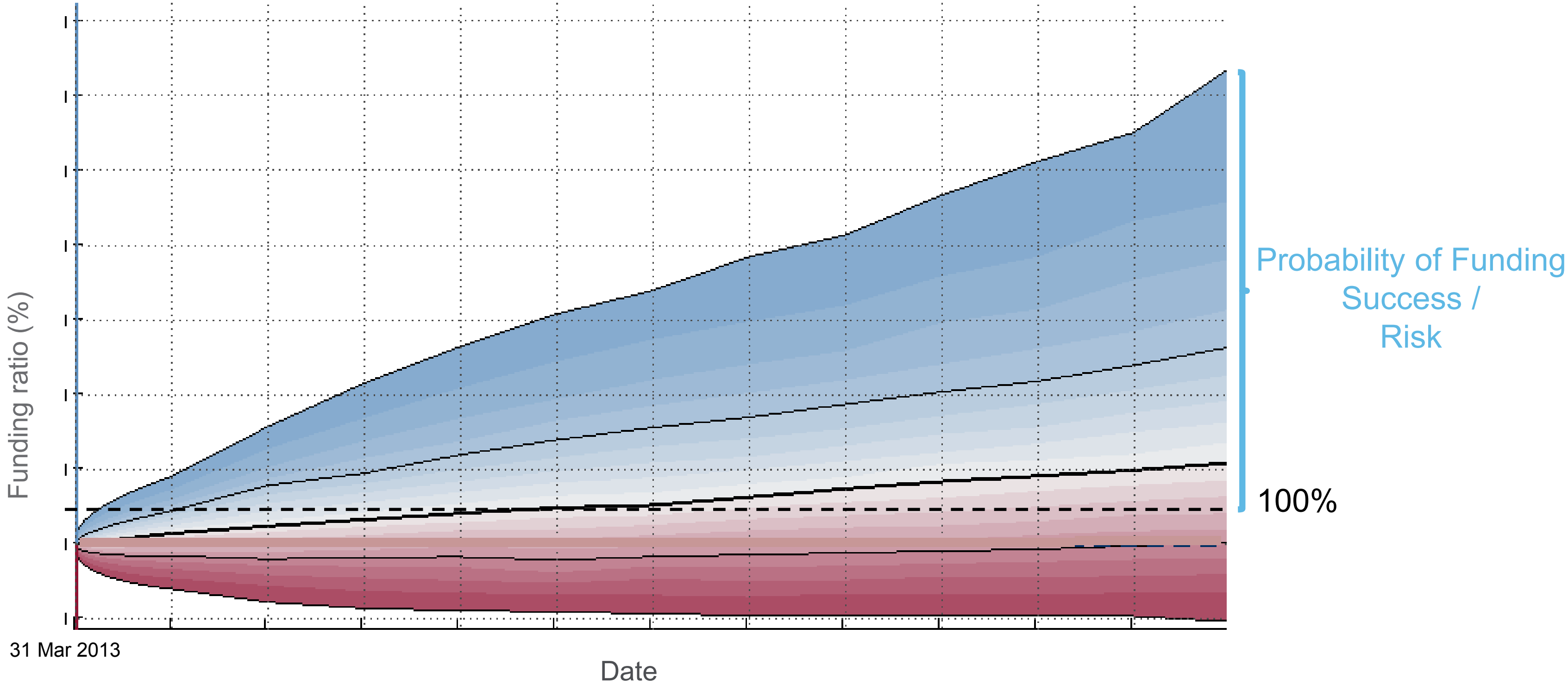
How the ongoing funding target is set (LGPS-specific approach)

- 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%



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

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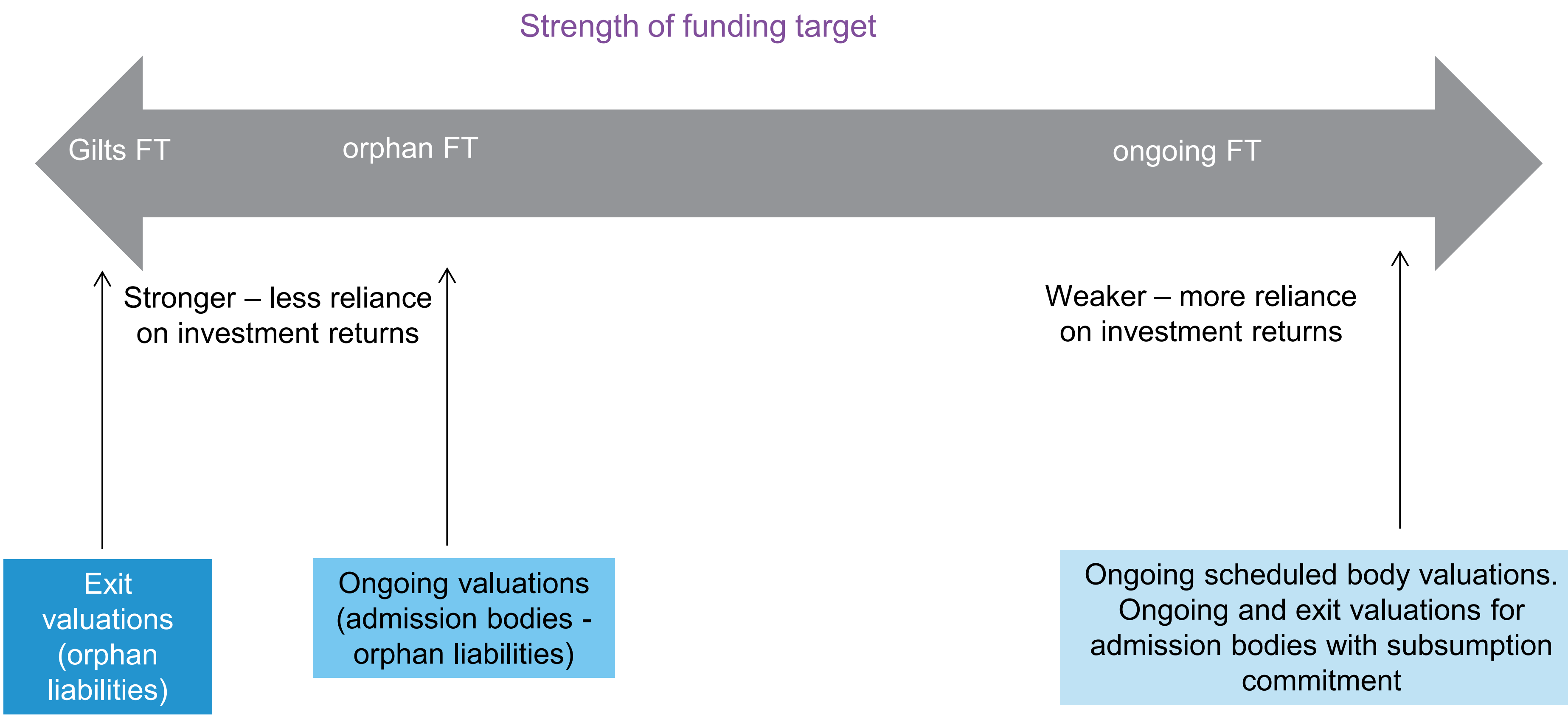
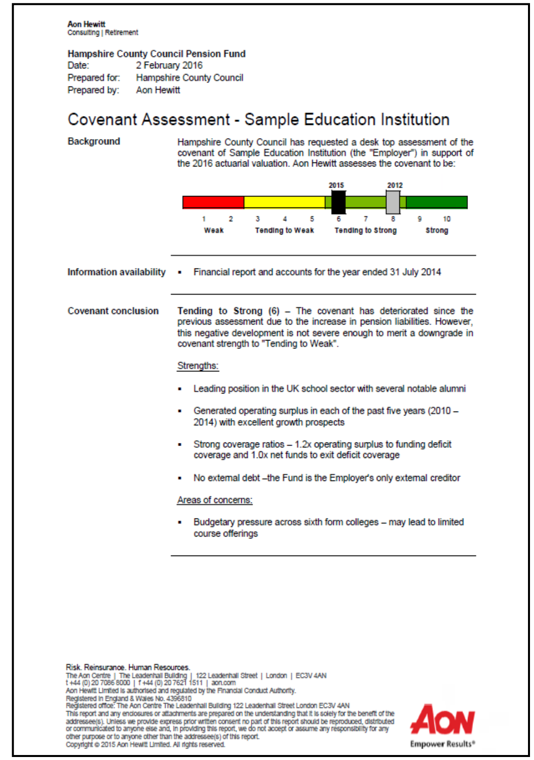
Current funding approach / strategy (in theory)



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


Aon Hewitt
Consulting | Retirement

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 (6) – 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 concerns:

- 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

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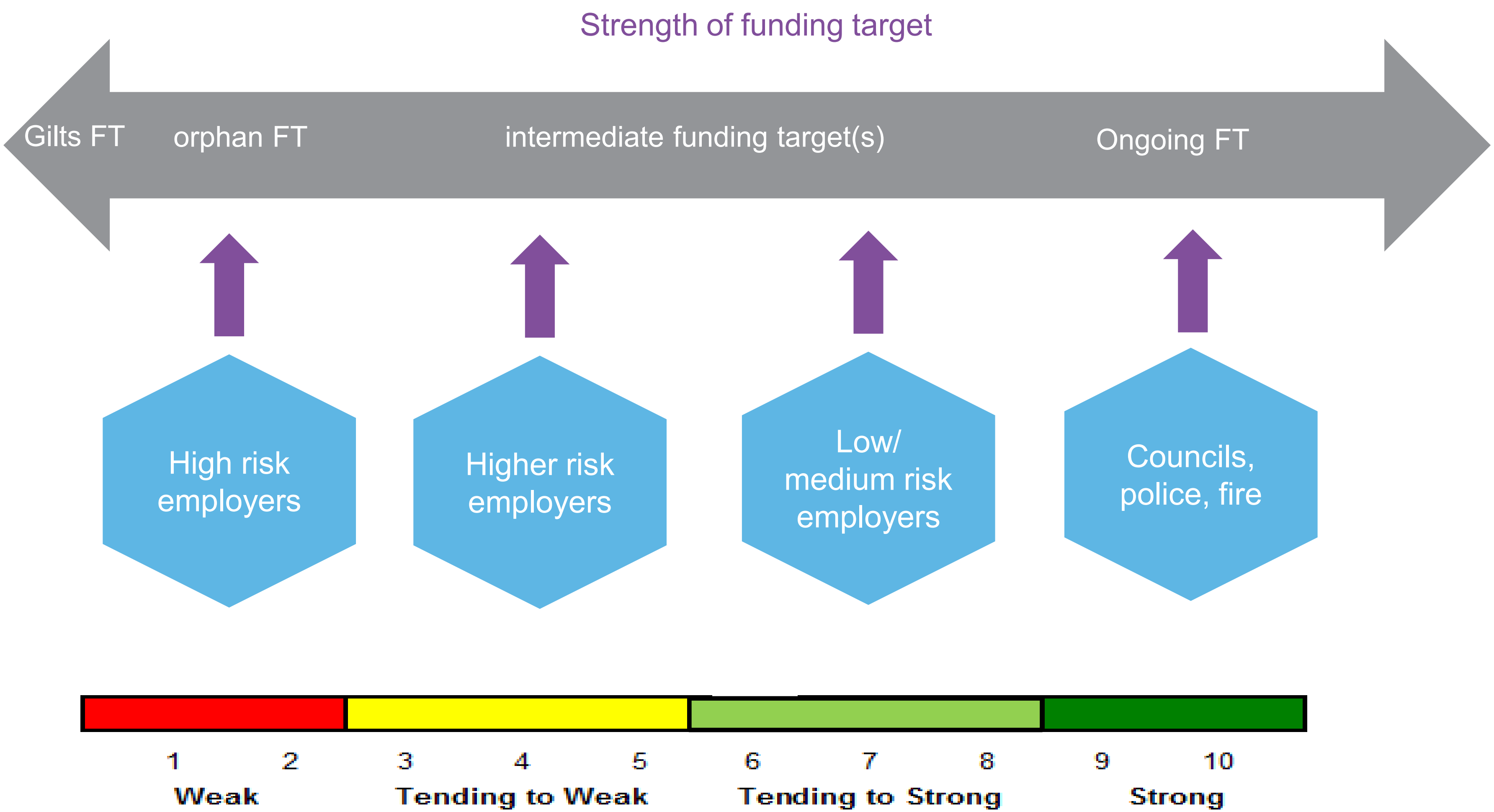
Refined funding approach / strategy



Any changes to contributions will be managed, where possible

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What do different funding targets mean in practice?

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. (individual)	5.5% p.a. (grouped)
Assets	£11M	£11M	£11M	£11M	n/a
Liabilities	£19M	£17M		£13M	£13M
Deficit	£8M	£6M		£2M	n/a
Future service rate	-	24.9%(1)		17.9%(1)	15.6%
Deficit contributions p.a.	-	£0.3M		£0.1M	£0.04M

Source: Aon Hewitt, selected housing association in the Hampshire Pension Fund

(1) This rate is for an open employer. In practice if the employer is closed to new members the rate would be higher, at 20% of pay on the ongoing basis and 26.7% of pay on the orphan basis

Effect varies according to membership profile

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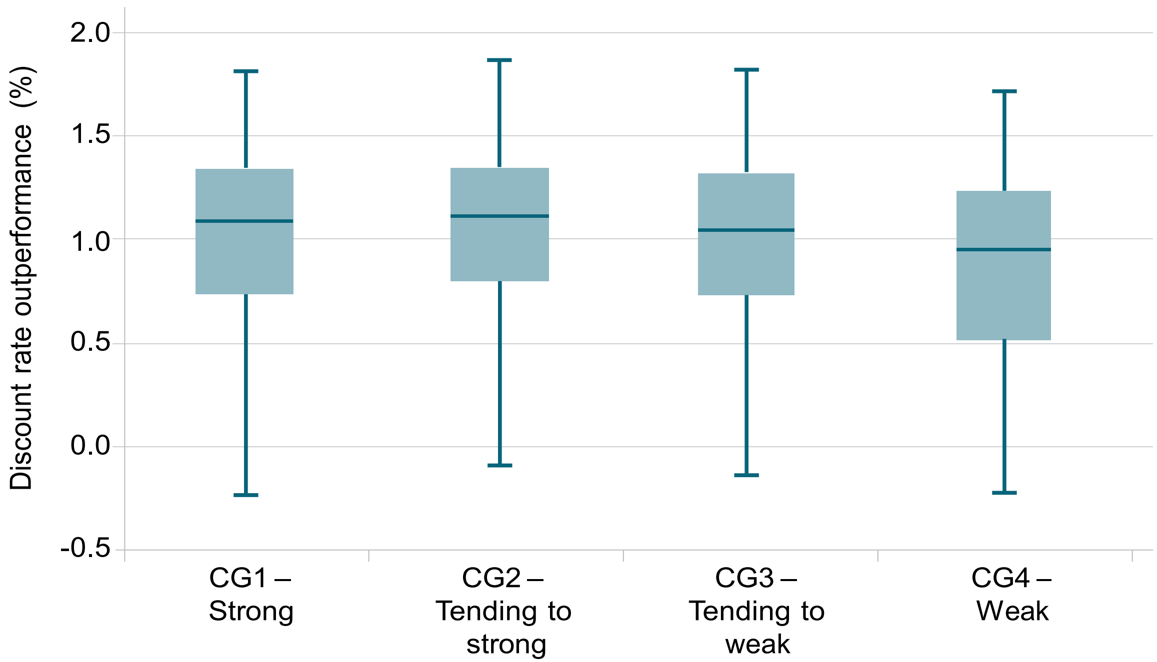
Comparison with private sector schemes

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

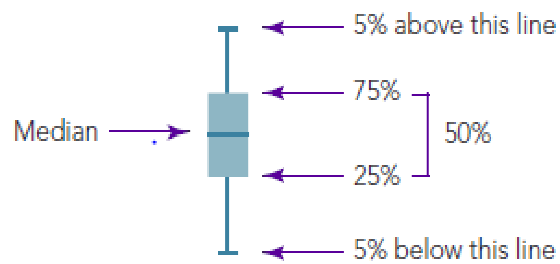


Outperformance adopted by HCC:

Scheduled body FT: 2.3% p.a.

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

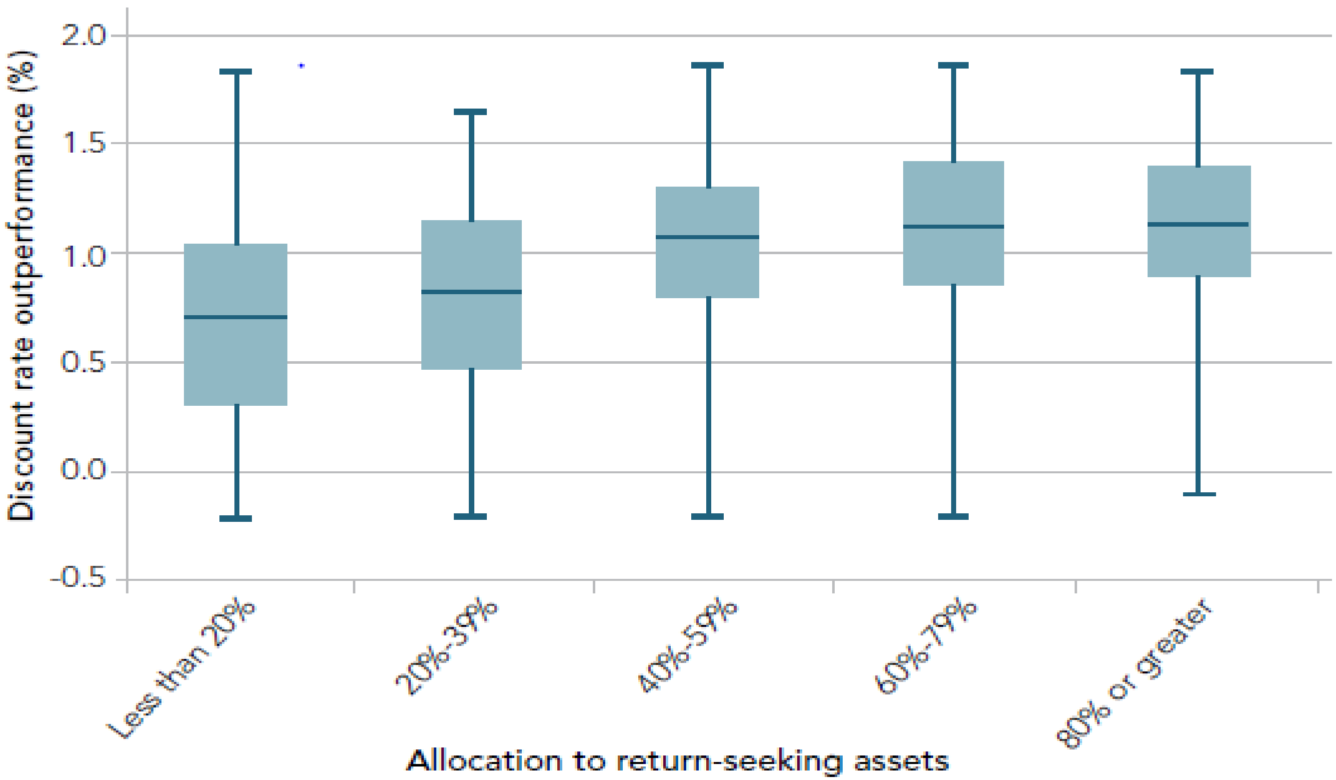
Base: All Tranche 8 valuations received up to 31 January 2015
Sources: The Pensions Regulator, Thomson Reuters, Bank of England



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



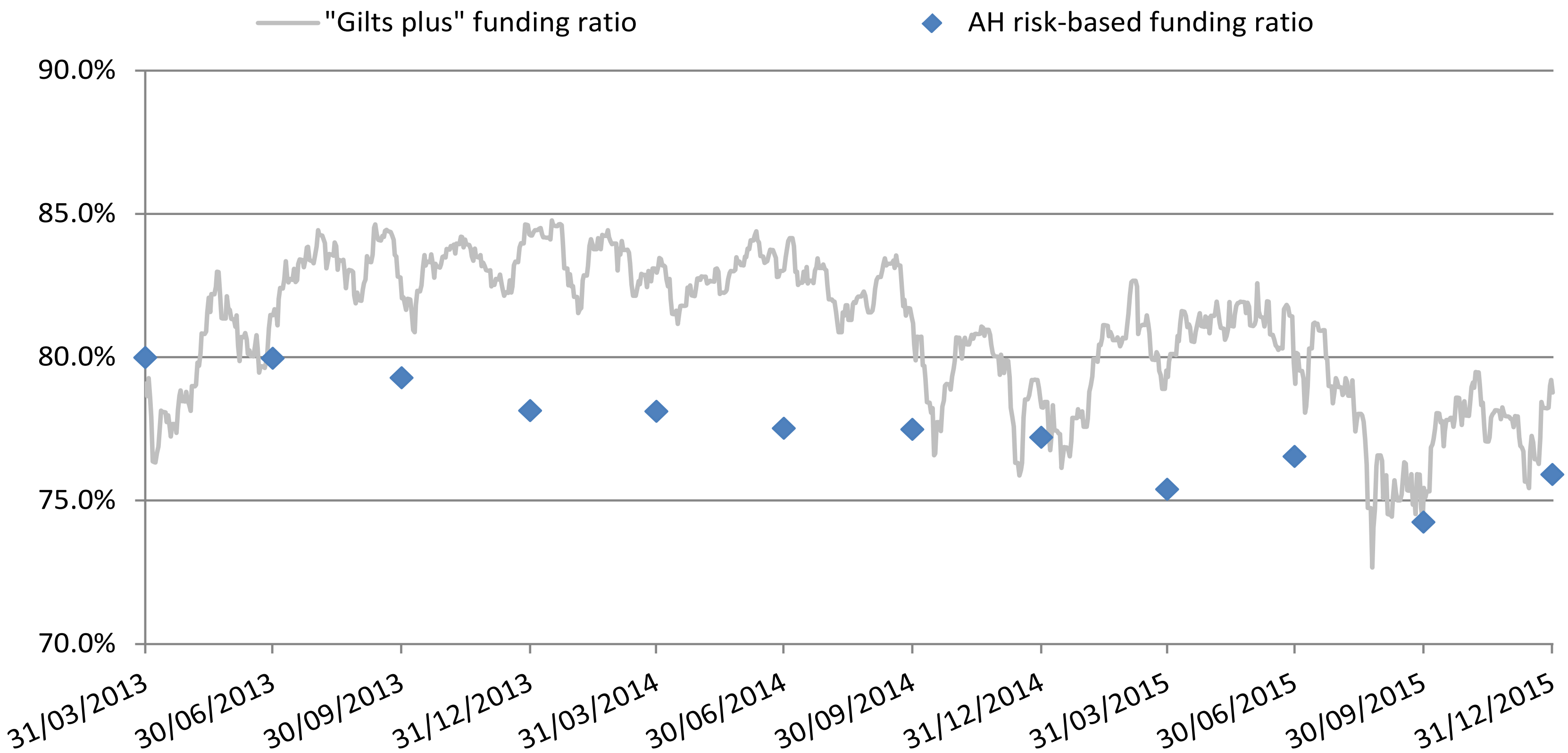
Investment strategy adopted by HCC:

c70% allocated to return-seeking assets

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

Financial pressures - movement in funding position since 31 March 2013

Progression of whole of Fund funding position



Source: Aon Hewitt, Hampshire Pension Fund, Estimated

Orphan funding target will have moved more in line with the gilts+ position

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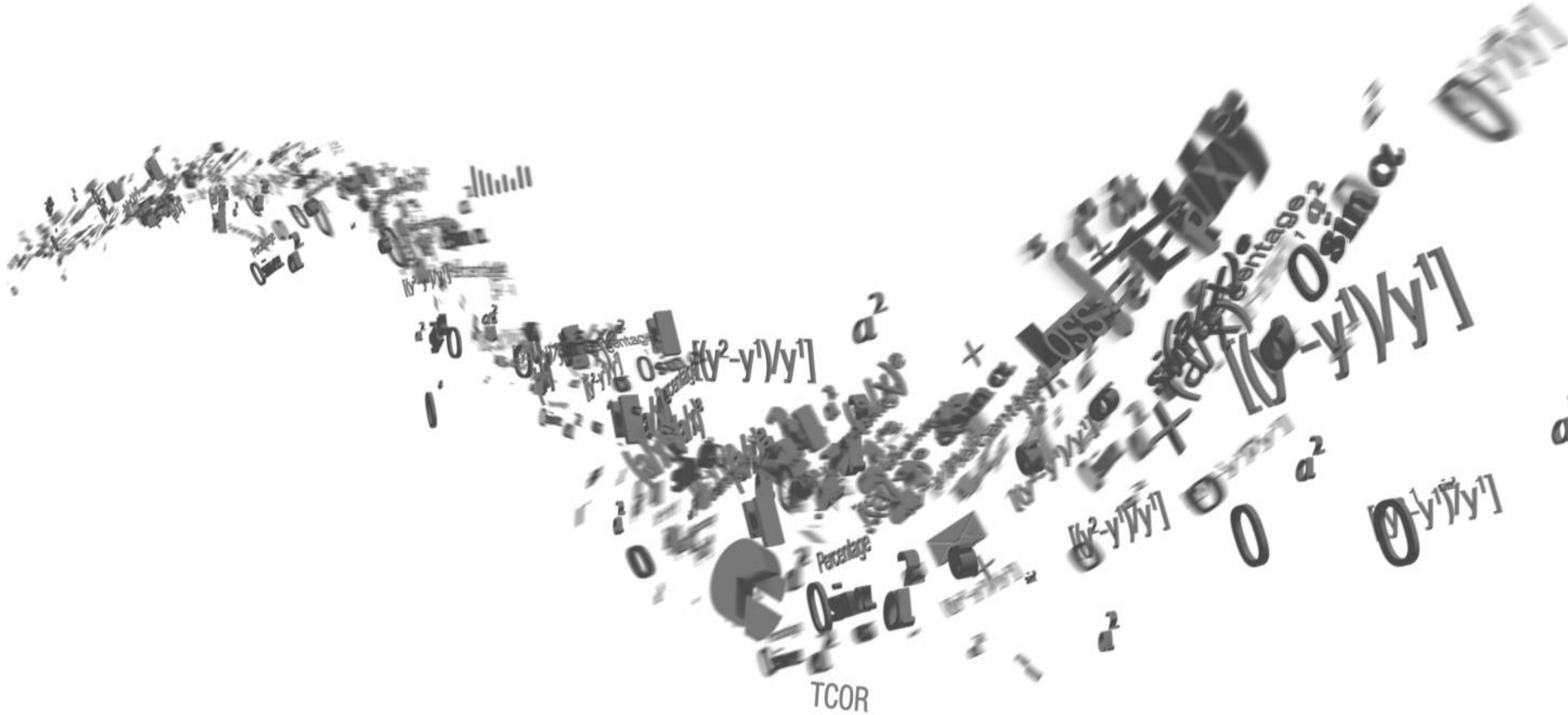


Fund-wide changes to risk sharing

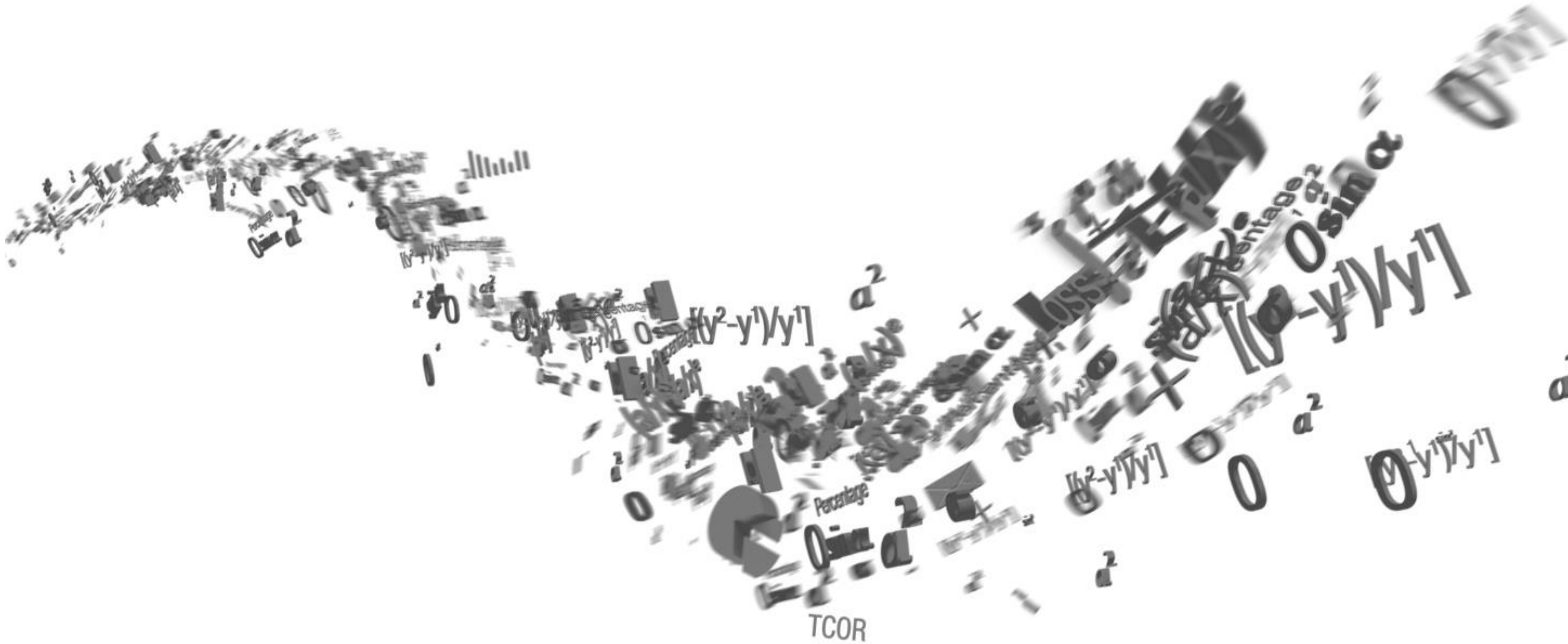
Proposed Fund-wide changes to risk sharing

- 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 managing exit

64. (1) Subject to paragraph (2A), if a person—

(a) ceases to be a Scheme employer (including ceasing to be an admission body participating in the Scheme), or
(b) is or was a Scheme employer, but………no longer has an active member contributing towards a fund (“a relevant fund”) which has liabilities in respect of benefits in respect of current and former employees of that employer,

that person becomes “an exiting employer” in relation to the relevant fund for the purposes of this regulation and is liable to pay an exit payment.

(2) When a person becomes an exiting employer, the appropriate administering authority must obtain—

(a) an actuarial valuation as at the exit date of the liabilities of the fund in respect of benefits in respect of the exiting employer’s current and former employees; and
(b) a revised rates and adjustments certificate showing the exit payment due from the exiting employer in respect of those benefits.

There is very limited flexibility in the LGPS Regulations on employer exit

64 (3) Where for any reason it is not possible to obtain all or part of the exit payment due from the exiting employer…., the administering authority must obtain a further revision of any rates and adjustments certificate for the fund showing—

(a) in the case where a body is an admission body falling within paragraph 1(d) of Part 3 of Schedule 2 to these Regulations ....the revised contribution due from the body which is the related employer in relation to that admission body; and
(b) in any other case, the revised contributions due from each Scheme employer …..

(4) Where in the opinion of an administering authority there are circumstances which make it likely that a Scheme employer (including an admission body) will become an exiting employer, the administering authority may obtain from an actuary a certificate specifying the percentage or amount by which, in the actuary's opinion—

(a) the contribution at the primary rate should be adjusted; or
(b) any prior secondary rate adjustment should be increased or reduced,

with a view to providing that assets equivalent to the exit payment that will be due from the Scheme employer are provided to the fund by the likely exit date or, where the Scheme employer is unable to meet that liability by that date, over such period of time thereafter as the administering authority considers reasonable.

Regulation 64(4) could be used to increase contributions before 1 April 2017 for closed employers

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Options for managing exit

Conditions under which HPF will consider entering into special arrangements

Condition	Effect
Open employers only eligible for grouping	Closed employers contribute on an individually assessed basis to better target exit position
Funding target moved to orphan basis	Funding target closer to gilts based exit FT (so reduced exposure on employer failure)
Additional payment / security offered in consideration for AA	Justifies time and cost of entering into a legal arrangement outside of the LGPS Regulations
Time limited legal agreement	Avoids open-ended agreement after last active has left
Same terms required for all employers	More time and cost effective – avoids multiple discussions and external advice on different terms
Agreement must be in place before valuation calculations (31 July 2016*)	Reduces time and cost associated with revising valuation calculations late in the process
Guarantors must agree	Ensures done transparently and with appropriate consultation

* To be confirmed

There may be other legal requirements in addition

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Potential benefits to housing associations

Advantages of managed exit agreement

- Avoids crystallisation of exit deficiency when last active leaves (which may not be under the employer's control)
- Permits a longer deficit recovery period*
- Possibly assists with accounting / banking covenant conditions

Advantages of individually assessed contributions

- Ongoing contributions better aligned with exit position
- Greater control over exit position (no risk sharing with other employers)
- Facilitates voluntary over-payments when affordable

* Will be individually agreed but likely to be expected future participation in the Fund plus length of legal agreement thereafter, subject to an overall agreed maximum

This is NOT advice to employers which should take their own independent advice

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Feedback – recap on proposals

- Removal of education employers and housing associations 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
- Orphan funding target to be adopted for closed employers with no subsumption commitment
- Contribution increases to be phased in gradually, where appropriate
- Alternative pooling options (not available for closed employers)
- Exit management proposals will be considered (with conditions as outlined)

Next steps

- 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

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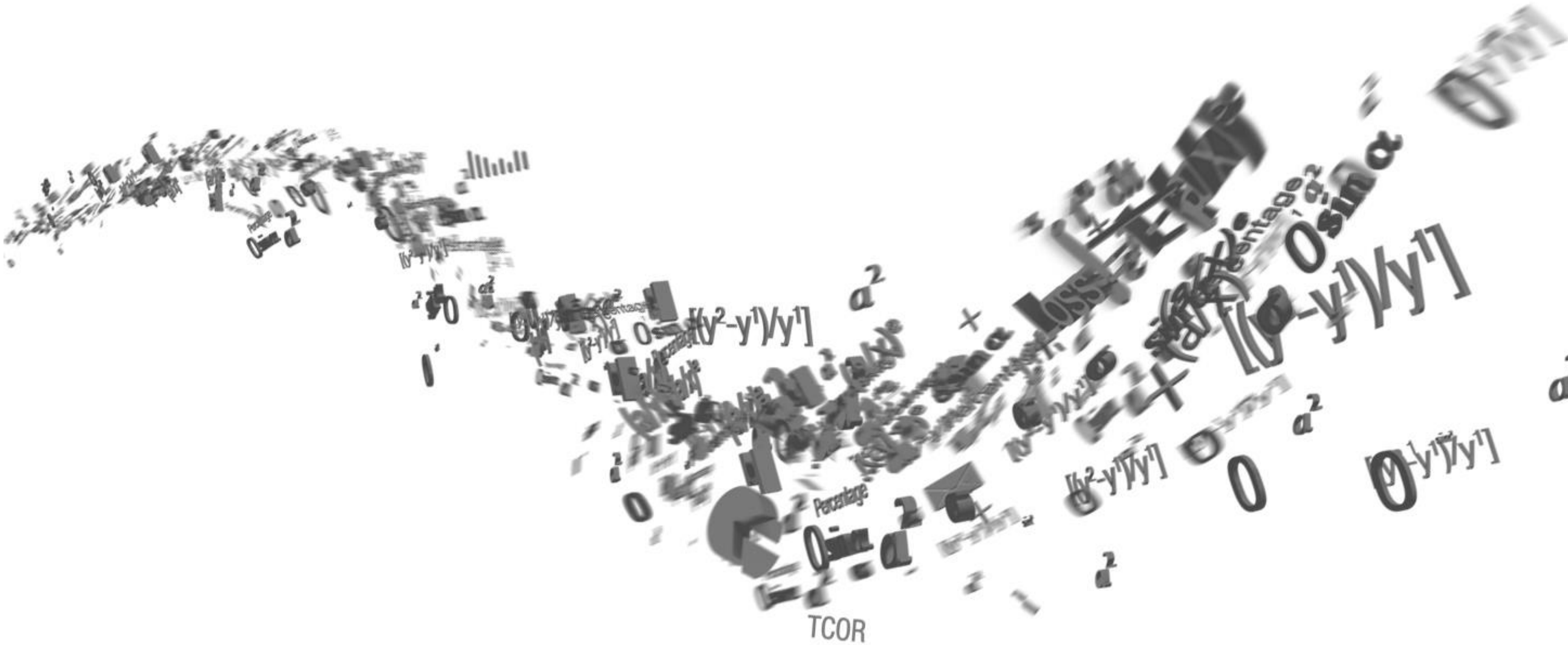

Questions?

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