Contribution Stability Mechanism 2013

November 2013

Background

The 2011 triennial actuarial valuation set employer contribution rates for the three years to 31 March 2015. Pension schemes, however, have a long-term time horizon. Lothian Pension Fund wishes both to avoid volatility in contribution rates based on fluctuations in short-term funding levels and also, where possible, to assist employers with their budgeting.

The funding objectives as stated in the Funding Strategy Statement include:

- to ensure the long-term solvency of the overall Fund and that of sub-funds;
- to minimise the degree of short-term change in employer contribution rates;
- maximise the returns from investments within reasonable and considered risk parameters, and hence minimise the cost to the employer;
- to ensure that sufficient cash is available to meet all liabilities as they fall due for payment;
- to help employers manage their pension liabilities;
- where practical and cost effective, to make allowance for the different characteristics of different employers and groups of employers.

These objectives are desirable individually, but may be mutually conflicting.

The principal issues facing the solvency of the Fund include the ability to finance liabilities as and when they arise, the rate or volatility in the rate of contribution paid by the employers, the pace at which deficits are recovered (or surpluses used up) and the returns on the Fund's investments.

The Fund therefore targets full funding on an ongoing basis over the long term with an acceptable likelihood of success and attempts to keep risks within tolerable limits, whilst ensuring contributions are as affordable and stable as possible.

An explicit commitment has been made to operate a contribution stability mechanism on an ongoing basis subject to regular reviews.

Contribution Stability

The cost of the benefits is not known in advance. The approach to funding determines the pace at which employers pay for the benefits and the ways in which the Fund ensures that it will have enough money to pay the benefits due to its members.

Accordingly, the Fund has received detailed modelling of liability and asset cashflows under a range of employer contribution scenarios from the Fund's actuary. The scenarios included consideration of different levels and duration of contribution stability.

Financial assumptions were tailored to reflect specific factors. These included the anticipated long term level and volatility of gilt yields, equity and other investment returns plus inflation. A reduction in the public sector employer workforce was also reflected. The Fund has thereby taken appropriate steps to assess the implications of potential contribution strategies to ensure compliance with professional standards, the relevant actuarial principles being prudence, affordability, stability and stewardship. The Fund can provide any employer with more detail on the actuarial modelling if required.

Risks to the Fund & Employers

The risk to the Fund in providing contribution stability is that the likelihood of achieving full funding is reduced. This has been a key consideration and the actuarial modelling has provided sufficient comfort on this matter.

The risk to employers is that, if they pay less than the theoretical contribution rates now, they would face increased pensions costs in future years, (As a reminder, however, the contribution rates agreed at actuarial valuations represent minimum contributions. Employers retain the discretion to pay more.)

Conversely, a risk facing employers should the level of stabilised contributions prove to be overly prudent, is that outlays will have been greater than actually required. In this case, employers would benefit from any accrued surplus in future years by reduced contributions.

A further risk to the Fund is the potential inability of employer(s) to finance increased pension costs in the future and stabilising contributions may increase this risk. As a multi-employer scheme, this is, in effect, a risk to all the employers in the Fund. This proposal allows for the specific circumstances of employers in an attempt to manage this risk. (See below)

Allowance for Different Employers

In parallel with the actuarial modelling, ongoing work to assess the financial security offered to the Fund by its respective employers is being undertaken. This includes guarantor and admission agreement reviews, as well as analysis of financial covenant and membership profiles. The strength of the employer covenant influences the extent to which it would be appropriate for the Fund to accord contribution stability to individual or groups of employers.

Councils and other statutory bodies have tax-raising powers, a large membership and will be in existence for a long period of time. There is therefore a low risk that such authorities will fail to meet pension obligations. Other large employers may also offer good financial security to the Fund and some employers with the Fund are guaranteed by the Scottish Government.

Employers to whom the Fund will not accord Contribution Stability:

- Employers which have closed the Lothian Pension Fund to new entrants (or are deemed by the Fund to have closed based on experience).

  As the duration of Fund membership of these employers is finite, it is not considered prudent to offer the discretion of contribution stability to these employers.

- Transfer Admission Bodies (i.e. Public Service Contractors)

  Such employers again have a finite duration of membership of the Fund, i.e. limited to the contract period with the awarding authority. Contractors should continue to pay contributions that target full funding by the end of the participation period.

- Community Admission Bodies included with the smaller employer "pool"

  As part of a pool of employers with similar membership characteristics, a degree of inherent stabilisation of contributions and risk mitigation is already provided. The Fund also has to consider the potential volatility in the smaller employer pool should some employers cease membership and exit the Local Government Pension Scheme.

Contribution Stability Mechanism – Proposal

What level of contributions?

- **"Frozen contribution rate until 31 March 2018 then +0.5% / -0.5% p.a."**
  i.e. contributions frozen at the total 2014/15 combined rate (as determined by Actuarial Valuation as at 31 March 2011) until 31 March 2018. Thereafter, for the next actuarial valuation period of three years, rates could only vary from this rate by a maximum of 0.5% per annum (or minimum of -0.5% per annum).
- This total rate above would be inclusive of contributions to recover the deficit in the Fund i.e. Past Service Deficit. This Past Service Deficit, however, would continue to be based on fixed monetary sum at each Actuarial Valuation. Suitable actuarial adjustment therefore would be made to the Future Service Rate to achieve requisite parity with total payable 2014/15. This is to guard against significant falls in Fund membership between actuarial valuations.

To Whom ?

- "Open" employers with individual contribution rates as at 2011 actuarial valuation:
  - Subject to assessment by Lothian Pension Fund of employer covenant as satisfactory.
  - Subject to agreement by guarantor(s) to inclusion of employer in Contribution Stability Mechanism.
  - Subject to the impact of the new Local Government Pension Scheme in Scotland from 2015 leading to a materially higher cost of future service benefit accrual as assessed by Lothian Pension Fund.

Continuing inclusion in the Contribution Stability Mechanism between actuarial valuations is subject to ongoing review. Factors which would lead to review / removal of an employer from Contribution Stability Mechanism would be:

- Significant adverse change in financial status (covenant) as assessed by Lothian Pension Fund. This could include, e.g. threatened or actual loss in funding or banking facilities / terms.
- Significant change in active membership payroll from previous actuarial valuation, e.g. payroll falls by more than 20%.
- Employer becomes closed to new entrants (or is deemed closed).

On removal from Contribution Stability Mechanism, an employer would immediately revert to the relevant rate as determined by the most recent actuarial valuation.

Duration of the Contribution Stability Mechanism

- The Contribution Stability Mechanism should be designed to cover a reasonable period of time in order to demonstrate value to its employers and meet its objectives.
- The proposal is therefore that the duration of the Contribution Stability Mechanism should be two actuarial valuation periods, i.e. the remaining period of the Actuarial Valuation as at 31 March 2011 plus six years. The Actuarial Valuation as at 31 March 2011 encompasses the current year 2013-14 and also 2014/15.
- The Contribution Stability Mechanism would therefore apply for:
    - 2014/15, as previously determined by Actuarial Valuation 2011
    - 2015/16, Actuarial Valuation 2014 – year 1
    - 2016/17, Actuarial Valuation 2014 – year 2
    - 2017/18, Actuarial Valuation 2014 – year 3
    - 2018/19, Actuarial Valuation 2017 – year 1
    - 2019/20, Actuarial Valuation 2017 – year 2
    - 2020/21, Actuarial Valuation 2017 – year 3

- However Lothian Pension Fund retains the right to review or withdraw the Contribution Stability Mechanism as protection against extreme adverse financial experience. Lothian Pension Fund shall monitor the overall funding level and theoretical contribution rate on an annual basis to ensure these remain within the acceptable parameters.

Actuarial "sign off"

- Regulations and professional standards require that the Fund's Actuary be content with the minimum level of contributions levied by the Fund. Suitable assurance has been received from the proposed Contribution Stability Mechanism from the Fund's Actuary, Hymans Robertson LLP.