A SCHEME EMPLOYER'S GUIDE TO PENSION LIABILITIES AND COSTS IN THE LOCAL GOVERNMENT PENSION SCHEME (LGPS)

Every Scheme employer is responsible for the pension costs incurred in relation to its current and former members of the LGPS. The purpose of this guide is to set out what the liabilities are and how the costs associated with the LGPS arise and hopefully answer many of the questions that a Scheme employer will have in association with its membership of the LGPS.

What are the pension liabilities associated with being an employer in the Berkshire Pension Fund?

Every Scheme employer is responsible for funding the pension promises that it makes to its employees. A member of the LGPS is entitled to a range of pension benefits as determined by statutory regulations (the LGPS Regulations) issued by The Secretary of State for the Ministry of Housing, Communities and Local Government (MHCLG). Every Scheme member builds up benefits in line with those Regulations and it is these statutory benefits that become the employer's liabilities.

The cost of these liabilities is met by each Scheme member through the contributions that they pay, the contributions that the Scheme employer pays, both of which go into the Berkshire Pension Fund, and any investment returns achieved on those contributions by the Fund.

The LGPS is what is known as a ***'funded'*** pension scheme meaning that there is a separate fund of money set aside from all other Local Government finances, the Royal County of Berkshire Pension Fund ("the Fund"). There are three sources of money paid into the Fund, employee contributions, employer contributions and the returns realised on investments. The aim is to ensure there are sufficient monies in the Fund to meet all future and past liabilities for all Scheme members, those currently contributing (Active members), those who have contributed in the past but no longer do and have retained a benefit to be paid at retirement age (Deferred members) and those who are already in receipt of their pension (Retired members).

The amount that a Scheme member pays is set out in Regulation with employee contribution percentages ranging from 5.5% to 12.5% across 9 salary bands. The more a Scheme member earns the higher the percentage of employee contribution they pay subject to the salary bandings in force at any given time. The current bands can be found on the Pension Fund website at:

http://www.berkshirepensions.org.uk/bpf/info/11/active_members/6/pension_contributions

A Scheme employer has to pay the contribution rate certified by the Fund's Actuary at each Fund valuation (a valuation is a 'health check' to ensure that liabilities can be met). In broad terms an employer is expected to meet around 2/3rd of the Scheme's costs with the Scheme member meeting the other 1/3rd.

The employer contributions are divided into two parts, a primary rate and a secondary rate. The primary rate is used to pay for the future liabilities expected to arise in the Fund whereas the secondary rate is used to pay for the past liabilities already built up. Depending upon the level of funding at any given valuation, the Actuary will set the employer rates to reflect the Fund's need to meet the cost of all future and past liabilities.

It is important to recognise that Scheme member (employee) contribution rates are fixed (although the salary bandings increase annually in line with inflation) whereas Scheme employer contributions can and do vary. Therefore, whilst all LGPS Funds will aim to be 100% funded i.e. to have sufficient assets to meet the cost of all future and past liabilities, this will not always be the case and in times where there is a funding deficit it is the employer that has to meet the cost of any shortfall by an adjustment to their employer contribution rate. Of course, investment performance cannot be guaranteed so when returns are low, perhaps because of an economic downturn, there may be a need for employers to pay more into the Fund.

What influences can cause my liabilities to change?

The value of a Scheme employer's liabilities can change due to a number of factors, some of which are within the employer's control, some of which are not. It is important that a Scheme employer is aware of these factors so they can mitigate risk and manage their liabilities as best as possible.

Factors within an employer's control

- ***Salary growth***

As part of the valuation of the Fund, the Fund's Actuary will make certain assumptions about future salary increases. In reality, if the increases in salary differ substantially to the Actuary's assumptions, this will have a direct impact on the employer's pension liabilities. For example, if an employer awards significantly higher pay increases than those assumed by the Actuary, the employer's pension liabilities will increase as salary levels have a direct link to the value of Scheme benefits provided to Scheme members.

- ***Scheme membership movements***

At each valuation, the Actuary will look at the numbers of Scheme members by employer and make assumptions based on the estimated number of active members that the employer will have in the future. At the same time they make assumptions as to the expected number of deferred members and how many of those deferred pensions may come into payment and the expected number of retired members and how many of those payments may cease.

If there is a significant or unexpected decline in the number of active members then this is likely to have an impact on an employer's liabilities. If a large number of active members are transferred to another employer or pension provider, or the employer reduces its workforce as a result of a redundancy exercise or strategic review of the business, this can change the ratio between the employer's assets and liabilities as the amount of contributions reduces but the value of benefits increase.

Employers should consider the pension risk when looking to outsource services to the private sector. Whilst Scheme members may be able to retain their membership of the LGPS through an admission agreement with the Scheme employer's chosen independent service provider, it is normal practice for the new admission body to close the Scheme to their future employees and so the numbers of contributors will decrease whilst the numbers of deferred and/or retired members will increase.

- ***Transfers in and transfer out***

When an employee becomes a member of the LGPS, they have a 12-month window in which to elect to transfer pension rights from previous pension schemes into the Fund. If they elect to do so the money paid to the Fund by the previous pension provider buys additional benefits in the LGPS thereby increasing the employer's liabilities (although the transfer payment received meets the cost of those liabilities at the point of transfer). This is somewhat out of the control of the employer but Scheme regulations do give employers a discretion to extend the 12-month election window and this is very much in the control of the employer.

In exercising a discretion to extend the 12-month transfer window, employers should be aware that a transfer of former pension rights into the Fund can carry a significant liability. Take an example of a Scheme member who joined the LGPS only 2 years ago. The employer uses its discretion to allow their employee to transfer into the Berkshire Pension Fund benefits previously held in another Local Authority LGPS Fund and, for the purpose of illustration, let's assume this transfer provides the member with an additional 20 years of LGPS membership in the Berkshire Fund. The Scheme employer now holds a total liability equal to 22 years of LGPS membership. Whilst a transfer payment will have been received by the Fund to meet the cost of these liabilities, those liabilities have the potential to increase significantly if the member receives significant future pay rises. Also, if the employer decides to make their employee redundant at some point between the ages of 55 and their Normal Pension Age, significant employer costs are likely to arise (see section on strain costs).

Employers need to consider these implications when drawing up or amending their 'discretionary' policy statements and before agreeing to any late request to transfer from one of their Scheme members.

Factors outside an employer's control

- ***Investment returns***

As described previously in this guide, the employee and employer contributions received by the Pension Fund are invested in line with its Funding Strategy and Investment Strategy Statements. The Fund's Actuary makes assumptions during the valuation process as to the investment returns the Fund is likely to receive over the forthcoming inter-valuation period. If investments outperform the Actuary's assumptions liabilities will decrease but if they underperform, liabilities will increase.

A Scheme employer has no direct influence on investment strategy although employers can contribute to consultations and debates on what the Pension Fund's investment strategy should be.

Since 1st June 2018, the Fund's investments are managed by the Local Pensions Partnership Investments Limited (LPPI) in line with the Government's requirement to 'pool' LGPS investments.

- ***Longevity / Mortality***

The Actuary will make assumptions on the expected longevity and mortality rates (life expectancy) of Scheme members. Whether those assumptions ultimately prove to be correct will not be known for some time but the Actuary will use the most recent information available and make allowances for expected future improvements in longevity.

- ***Pension increases***

LGPS pensions are increased annually in line with the cost of living (inflation). Currently, the Consumer Prices Index (CPI) is used. Again, the Actuary will make assumptions as to the movement in the CPI index but if the rate of CPI ends up being greater than the Actuary's assumptions, liabilities will increase.

- ***Regulation changes***

Future changes to the LGPS regulations, and therefore the benefit structure of the Scheme, could clearly have a direct and unexpected impact on liabilities. Although employers cannot generally have a direct influence of this they can have an indirect influence by responding to any Government consultations on regulation changes.

How does an employer pay for their liabilities?

An employer pays for their liabilities though their employer contribution rate. In some cases, employers also pay lump sum deficit recovery amounts in addition to their certified contribution rate.

Are there any additional employer costs?

Strain Costs (aka Capital costs)

Pension strain costs (also often called capital costs) occur when there is a clear shortfall in the assumed level of funding needed to provide a particular pension benefit. Strain costs most usually arise when a Scheme employer takes a decision to make a Scheme member redundant (or to retire them early for business efficiency reasons) and the Scheme member is aged between 55 and their Normal Retirement Age.

In these circumstances the LGPS regulations dictate that the benefits paid to the Scheme member cannot have an early retirement reduction factor applied to the benefits and so the full value of the benefits calculated at the point of redundancy are paid immediately and without reduction. This places a strain on the Pension Fund and the Scheme employer has to make a capital payment to the Fund to avoid the funding shortfall. A full guide to strain costs is available from the Pension Fund website at:

http://www.berkshirepensions.org.uk/bpf/downloads/file/91/lgs44_early_retirement_capital_costs

These costs can be significant and can also arise in cases of flexible retirement and early retirement where the employer agrees to waive the actuarial reduction. Capital costs have to be paid by the Scheme employer at the point the Scheme member's benefits come into payment as a one-off payment to the Pension Fund.

Further additional strain costs will arise if a Scheme employer uses its discretion to award additional pension to the Scheme member.

In cases of ill health retirement, a strain cost is calculated but on these occasions the employer is not normally required to make a one-off payment to the Pension Fund. Instead, as part of the valuation process, the Actuary makes an assumption as to the likely number of ill health retirements and builds into the employer's contribution rate an element to pay for those anticipated costs.

Actuarial costs

Other employer costs may arise where the Scheme employer requires the Actuary to undertake work perhaps in connection with the annual FRS102/IAS19 accounting reports or a report setting out the funding requirements of a new academy or a new admission body. If a Scheme employer requires some actuarial work to be carried out on their behalf they should contact the Pension Fund in the first instance.

Cessation costs

On occasion, a Scheme employer may exit the Fund. This could be because the employer no longer employs any active Scheme members, an admission body's service contract period comes to an end or even where an admission body goes into liquidation.

The LGPS regulations require the Actuary to carry out a cessation valuation at the point of exit in order to assess the level of assets and liabilities attributable to the exiting Scheme employer. Where the liabilities are found to be greater than the assets the exiting Scheme employer is required to make an exit payment to the Pension Fund. The value of the exit payment will be equivalent to the shortfall in the assets required to meet the cost of the total liabilities and can amount to a significant sum. Where the assets are greater than the liabilities, however, an exit credit will be calculated and the equivalent amount is payable back to the exiting Scheme employer.

There is a lot to consider when a Scheme employer exits the Fund not least of all whether or not the exiting Scheme employer's liabilities will be passed onto another Scheme employer within the Fund. This is a key issue because the way in which the Actuary will undertake the cessation valuation will be different depending upon the Fund's ability to recover the deficit in the future from an alternative and existing Scheme employer. Where there is no opportunity for the Fund to recover the deficit on an ongoing basis the Actuary will value the liabilities on a more prudent basis and so the exit payment will be higher.

Others factors to consider are whether or not the exiting Scheme employer has a guarantor, this could be another Scheme employer or a Parent Company for example, or alternatively if they have some form of bond or indemnity in place to protect against an exit deficit.

It is important that a Scheme employer contacts the Pension Fund as soon as it is aware that it could become an exiting employer so that steps can be taken to consider the available options.