AGENDA ITEM **4**

Report to: Budget Panel

Date of Meeting: 14th March 2011

Report of: Head of Strategic Finance

Title: Provisional Actuarial Valuation of Watford's Pension Fund

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1. SUMMARY

1.1. This report provides the provisional results of the triennial review carried out by the actuaries to the Hertfordshire County Council Pension Fund.

1.2 Watford is required to respond back to Hertfordshire County Council agreeing to a future strategy to ensure the solvency of its Pension Fund.

2. RECOMMENDATIONS

2.1 That the Budget Panel note the provisional results of the triennial revaluation of the Hertfordshire CC and Watford Pensions Funds.

2.2 That the Budget Panel endorse the response made by the Head of Strategic Finance that Watford will continue to levy an employers contribution of 26.8% on top of gross pay for the next three years (this rate has applied since April 2009 and has no immediate budgetary implications). The yield from this on cost rate will need to be monitored throughout the three year period to ensure the total payment into the Pension Fund equates to the recommendations of the Actuaries.

3. SUMMARY OF ACTUARIAL VALUATION OF HCC PENSION FUND

3.1 The overall Pension Fund at 31st March 2010 indicates Fund Liabilities of £2,976m and a market value of assets of £2,194m. Effectively a deficit of £782m and the fact that the Fund is 73.7% funded (at the last valuation in 2007, the Fund was 84.7% funded). If therefore the fund had to be wound up to-morrow there would be insufficient assets to meet pension liabilities. Ideally the fund should be 100% (fully funded).

3.2 These initial valuation results are for the Fund as a whole. The underlying results for individual employers within the fund will differ from this overall result and will vary according to each employer's individual circumstances. In other words Watford's element of the Fund will differ from Three Rivers, Dacorum, Hertsmere etc and will be influenced particularly by past employment practices relating to early retirement and added years.

3.3 The interim results are provisional as feedback is required from each individual employing body regarding how they wish to make good identified shortfalls. Once the County Council has this information then an appropriate contribution strategy will be agreed by them with each individual employing body.

4. EVENTS SINCE THE LAST VALUATION IN MARCH 2007

4.1 The HCC overall fund as at 31st March 2007 was 84.7% funded and has therefore deteriorated during the past three years. This has largely been due to the underperformance of its investments which were seriously affected by the banking crisis and consequent global recession.

4.2 The Fund’s investment strategy has remained largely unchanged since 2007 with around 75% of the Fund invested in higher risk/ higher reward assets such as equities and property.

4.3 The Fund is gradually ‘maturing’ and means the proportion of the total membership attributable to ‘active, contributing’ members is reducing. This means that the burden on contributing members of meeting the cost of the Fund’s liabilities is becoming progressively greater.

4.4 The actuarial valuation at 31st March 2010 has allowed for anticipated changes to annual pension increases to reflect the Consumer Price Index (CPI) rather than the Retail Prices Index (RPI). This has improved the forecast funding shortfall as CPI is considered to be 0.5% per annum lower than RPI and hence will reduce future pension payments.

4.5 Longevity (mortality) is now deemed to be the second largest risk (after investment performance) in determining the solvency of pensions’ funds and assumes life expectancy (after retirement at 65) of 21 years for men and 24 years for women and provides the indicator for how many years the pension fund will be drawn down.

4.6 A review into public sector pensions is currently being carried out by Lord Hutton and could have beneficial effects upon the Fund (such as higher employee contributions and a career average rather than final salary pension). The 2010 Actuarial Valuation has made no allowance for any conclusions that may be reached.

5. CURRENT CONTRIBUTION RATES AS AN AVERAGE ACROSS HERTFORDSHIRE

5.1 Employer Contribution rates are set by reference to:

* the rate necessary to self finance existing contributors into the pension fund
* the rate necessary to finance ‘ past service deficiencies’.

5.2 The rate to self finance existing contributors is now estimated to be 17.4% on top of gross pay (it was previously 16.1%) and this deterioration is largely due to investment performance and estimates that current contributors will live longer.

5.3 Past service deficiencies relate to situations where employees were allowed to retire early (and often with enhanced additional years) or retired on grounds of ill health. The cost of these past decisions were traditionally charged against the pension fund and has had a material effect upon future pensions liabilities. In more recent history Pension Regulations have been tightened considerably with far tighter criteria regarding early retirement and additional years. In addition authorities are required to fund this pension strain either in one lump sum or over a three year period. This has ensured the impact of decisions taken by employers are financed within a short timescale and not deferred within the pension fund. For the Hertfordshire Pension Fund as a whole, the past service deficiency is now estimated to be a 9.2% addition to gross pay.

5.4 The total contribution rate now necessary to enable the Fund to be fully funded is estimated to be 26.6% on top of gross pay. It would take a 20 year period before the current pensions’ shortfall was bridged although recommendations from the Hutton Review are likely to reduce this timescale.

6. WATFORD BOROUGH COUNCIL DRAFT RESULTS

6.1 The Pension Fund for Watford at 31st March 2010 indicates fund liabilities of £121m and a market value of assets of £79m. Effectively a deficit of £42m with the fund therefore being 66% funded (at the last valuation in 2007, the Fund was 78% funded).

6.2 The rate to self finance existing contributors is now estimated to be 16.9% of gross pay and is lower than the Herts average of 17.4%.

6.3 No figure is provided for past service deficiencies but the current on cost on gross pay is 26.8% and implies a past deficiency of circa 9.9% (compared to a Herts average of 9.2%). This 26.8% on cost has been in force since 1st April 2009 until the present date. There has however been an issue whereby the number of active members of the Fund have been falling due to outsourcing and employees opting out of the scheme due to its increasing cost and reduced benefits. As a consequence the HCC Actuaries recommend a hybrid scheme should operate for the next three years.

6.4 The draft discussion document for Watford suggests that the payment into the Pensions Fund for 2011/2012 should be the **equivalent** of a combination of a 15.9% on cost on gross pay combined with a fixed sum of £1.120m and that this should apply for the three year period 2011 to 2014. A calculation has been carried out (geared to Watford's current payroll) regarding the effect of this proposal. At the present time it is estimated that, in order to meet the hybrid proposal (percentage on cost plus lump sum) would require a 26.2% on cost rate (rather than the current 26.8%). There might feasibly be a slight surplus therefore by accepting a hybrid proposal but numbers of existing active contributors will be the key determinant.

6.5 It has been tentatively agreed with the Pensions Team at HCC that Watford would continue to levy a 26.8% on cost on gross pay for those employees within the Scheme (for the next three years) and that these deductions would be paid over on a monthly basis to HCC (which is current practice). There would however be a year end reconciliation and, if this was insufficient to meet the required hybrid contribution, then an additional payment would be made into the Pension Fund. Any surplus payments could be returned to Watford although in reality it would probably be carried forward to the following year. Watford would need to carry out periodic reconciliations during the year and advise Budget Panel/ Cabinet through the Finance Digest should an end of year contribution look likely.

6.6 The Council currently has an earmarked reserve of £1m as at 1st April 2010 which had been set up to meet any potential shortfall within the Pension Fund and also for possible redundancy costs as a consequence of service rationalisation. This fund would need to be accessed if any year end payment were to be required.

7. FUTURE CONTRIBUTION RATES

7.1 The essential feature of all pension funds is that they should take a long term 20 year perspective in evaluating their solvency and make plans with that horizon in mind. All local authorities within Hertfordshire have opted to adopt a 'stabilisation' policy whereby current rates will largely remain the same (albeit there may need to be a year end top up as indicated at paragraph 6.5). At the next triennial revaluation in December 2013 should the pensions deficit not have improved then a 1% per annum increase in the on cost rate would probably be imposed and would equate, for Watford, to an additional circa £110k to be added to base budgets in 2014/2015 and future years. The Council's Medium Term Financial Strategy has assumed a £110k increase in budgets in 2014/2015 as a precaution should rates need to increase.

7.2 To counter balance the likelihood of an increase in the pension fund shortfall, the whole area of public service pensions is currently being scrutinised. The Hutton Review, due to report in March 2011 might well recommend a move towards 'career average' rather than final salary. It may also recommend a further increase in employee contribution rates (on a sliding scale so that the most highly paid officers have to contribute a higher contribution to their pensions pot).

IMPLICATIONS

8.1 **Financial**

The shortfall in the pensions fund needs to be viewed over a long term timescale but plans to close the gap need to be considered now. The proposal by the HCC Actuaries to introduce a guaranteed hybrid contribution is estimated to cost no more than the employers rate currently being applied. Should it prove to be more expensive (due to falling payroll numbers) then the earmarked Pension Fund Reserve would need to be accessed. Potential increases in Watford's Pension Scheme costs in 2014/2015 have been included within the MTFS approved by Cabinet on 17th January 2011.

8.2 **Legal Issues (Monitoring Officer)**

8.2.1 The Head of Legal and Property services comments the legal implications are contained within the body of this report.

8.3. **Potential Risks**

8.3.1 The future ongoing liabilities within the Pension Fund have been highlighted as a key risk within the MTFS and Budget Process. It is important therefore that the professional advice of the actuaries to the Pension Fund should be followed and proposals within this report will ensure that this occurs.