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POTENTIAL IMPACT OF REDUCED ACTIVE MEMBERSHIP OF THE LONDON BOROUGH OF BARNET PENSION FUND ("THE FUND")

This paper outlines some of the potential implications for the Fund of a significant shift in outsourcing policy by the London Borough of Barnet ("Barnet Council") which compounded with mass opt-outs expected as a result of Government's proposals to increase member contributions in the Local Government Pension Scheme ("LGPS") from April 2012 could lead to a significantly reduced active membership of the Fund.

EXECUTIVE SUMMARY

- This paper considers the potential implications of less individuals contributing to the Fund following the transfer of staff out of the Council to a contractor not offering continued membership in the Fund via Admitted Body Status (ABS).

- It does not consider the potential implications of bulk transfers of members' accrued benefits out of the Fund to an external pension arrangement. Such exercises would be expected to reduce the size of the assets and liabilities of the Fund. However, whether they would improve or worsen the funding position of the Fund would depend on the terms agreed for the bulk transfer exercise.

- For example, if the bulk exercise is carried out such that the transfer value paid out of the Fund is equal to the full funding value of the liabilities extinguished, at a time when the funding level of the Fund is less than 100%, then this could worsen the funding level. An example is provided in this paper.

- The latest actuarial valuation of the Fund as at 31 March 2010 revealed a deficit of £190 million and a funding level of 76%. Deficit contributions of 9.3% of salaries were calculated which aim to clear this deficit over a period of 15 years, which is equivalent to initial annual contributions of £14.3 million a year. Barnet Council is paying 10.6% of salaries to clear the deficit over a period of 13 years which is equivalent to initial contributions of £10.7 million a year.

- A significant shift in outsourcing policy by Barnet Council set against a backdrop of mass opt-outs expected as a result of Government's proposals to increase member contributions in the LGPS from April 2012, could lead to a significantly reduced active membership of the Fund.

- The net cash flow position of the Fund could reduce from around £22.9 million (positive) in 2010 to between £16.9 million and £25.0 million (negative) in 2012. Opt-outs as low as 40% could result in a move from the Fund being cash positive to cash negative.

- The impact of moving from cash positive to cash negative would mean that the Fund would need to hold more liquid assets (such as cash) in order to meet its ongoing expenditure which will no longer be met by contribution income and investment income alone. This would result in the Fund adopting a more cautious investment strategy and consequently reduce the expected return from its assets in the future.

- A more cautious investment strategy would lead to a lower discount rate assumption, which would increase the liabilities of the Fund. This would only be partially offset by the reduction in the liabilities in respect of those active members who become deferred members and consequently lose the final salary link to their accrued benefits.

- The combined effect of a more cautious investment strategy and the reduced discount rate used to value liabilities as the investment strategy changes over time, could result in the funding level for the Fund not improving by 2013 and actually worsening by 2016, instead of continually improving as would have been expected given the additional contributions being paid with the aim of removing the deficit. For example, an opt-out rate of 80% could see the funding level increase only slightly from 76% to 77% in 2013 before falling to around 66% by 2016.

- A Fund closed to new entrants is also likely to require this increased deficit to be met over a shorter time period than at present which would lead to higher deficit contributions.

- Notwithstanding that the cost of future service benefits is likely to reduce if the benefits provided by public service pension schemes are reduced following the Hutton Review, the level of contributions required to clear deficits – which are in respect of liabilities already accrued to date – will place a significant burden on employers (and taxpayers) in the near future. For example, an opt-out rate of 80% could result in deficit contributions increasing from the current level of around £14.3 million a year to around £30 million a year in 2013. For Barnet Council, this could almost double its deficit contributions from £10.7 million to £19.7 million a year. This is ultimately a cost to the taxpayer.

- The combined effect of further opt-outs that may result from automatic "stabilisers" implemented to fix a "cost ceiling" for employers (and taxpayers) together with the potential ineligibility of non public service employees to participate in the LGPS in the future as a result of the consultation on the Fair Deal policy, could result in a rapid decline in the active membership of the Fund. With fewer and fewer active members contributing to the Fund, the effects of negative cash flow and maturing membership would be exacerbated.

- The main risks associated with a contractor that is granted ABS are as follows:
    - The value of a Bond established to protect the Council if the contractor ceases trading is not large enough or secure.
    - It is not necessary to secure a Bond where a contractor meets the criteria for Designated Body Status, and any pension deficit would fall back on the Council.
    - The LGPS provides for early payment of pension benefits on compulsory early retirement or redundancy. The contractor should take responsibility for any potential strain on the Fund resulting from such early retirements.
    - Contractors often negotiate caps on the level of contribution they will pay to the fund (say, 20% of salaries). The actual cost of benefits may exceed this cap.
    - A Closed ABS matures the Fund (i.e. there are no new entrants to replace the active members that are getting older and retiring/leaving the Fund). This has all the risks outlined above with a reduced active membership of the Fund.

1. BACKGROUND

The London Borough of Barnet ("Barnet Council") participates in the London Borough of Barnet Pension Fund ("the Fund") which is a Local Government Pension Scheme ("LGPS"). The latest actuarial valuation of the Fund as at 31 March 2010 showed the Fund had liabilities of around £800 million and assets of around £610 million, resulting in a funding deficit of around £190 million and a funding level of 76%.

Deficit contributions of 9.3% of salaries were calculated which aim to clear this deficit over a period of 15 years (13 years for Barnet Council), which is equivalent to initial annual contributions of £14.3 million a year based on total salaries of £154 million as at 31 March 2010. Barnet Council is paying 10.6% of salaries to clear the deficit over a period of 13 years which is equivalent to initial contributions of £10.7 million a year, based on salaries of £101 million as at 31 March 2010.

A significant shift in outsourcing policy by Barnet Council set against a backdrop of mass opt-outs expected as a result of Government's proposals to increase member contributions in the LGPS from April 2012, could lead to a significantly reduced active membership of the Fund. This paper sets out the potential implications of a year-on-year reduction of between 10% and 80% of the active membership of the Fund.

2. POTENTIAL IMPLICATIONS COVERED IN THIS PAPER

This paper considers the potential implications of less individuals contributing to the Fund following the transfer of staff out of the Council to a contractor not offering continued membership in the Fund via Admitted Body Status (ABS).

It does not consider the potential implications of bulk transfers of members' accrued benefits out of the Fund to an external pension arrangement. Such exercises would be expected to reduce the size of the assets and liabilities of the Fund. However, whether they would improve or worsen the funding position of the Fund would depend on the terms agreed for the bulk transfer exercise.

For example, if the bulk exercise is carried out such that the transfer value ("bulk TV") paid out of the Fund is equal to the full funding value of the liabilities extinguished, at a time when the funding level of the Fund is less than 100%, then this could worsen the funding level. An example is provided below.

Before bulk TV exercise:			
Assets:		200	
Liabilities:		300	
Deficit:		(100)	
Funding Level:		**67%**	
After bulk TV exercise (consider removal of assets and liabilities of 100):			
Assets:	200 less 100 =	100	
Liabilities:	300 less 100 =	200	
Deficit:		(100)	i.e. unchanged
Funding Level:		**50%**	**i.e. reduced from 67% to 50%**

3. CASH FLOW IMPLICATIONS

The potential effects of a significantly reduced active membership of the Fund on cash flow include:

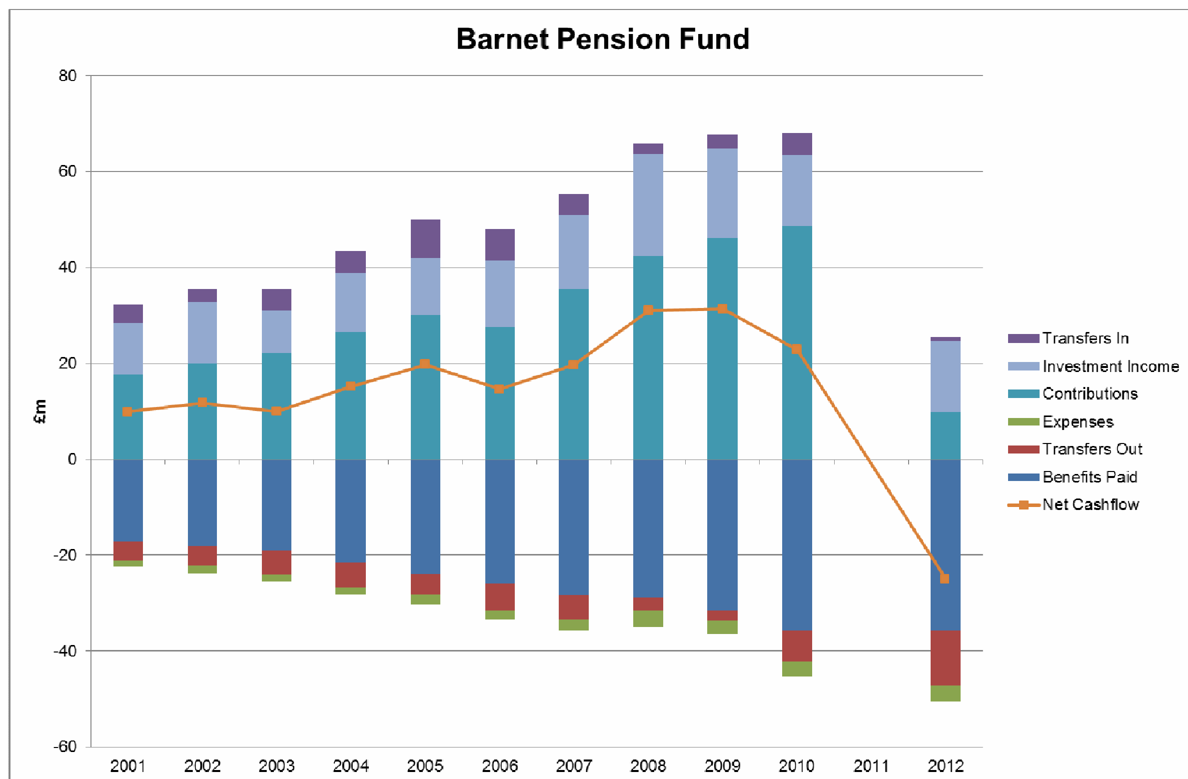
- **Cash positive to cash negative.** As funds mature and the number of pensioners increases relative to active members, net cash flow will likely turn negative.

- **Meeting scheme expenses.** A fall in active membership could increase the percentage of salaries required to meet expenses for administration and adviser costs, which are relatively fixed regardless of the number of active participants in the fund.

The chart below shows the cash flow position for the Fund over the years 2001 to 2009 and illustrates the potential implications on cash flow in 2012 based on projections incorporating assumptions about the possible effects of an 80% member opt-out.

We have assumed an arbitrary reduction in contributions of 80% resulting from immediate withdrawal in the workforce from April 2012 and have correspondingly decreased individual transfers-in by 80% and increased individual transfers out (which more often than not are taken in the months after leaving service) by 80%.

Cash flow information for the Fund was provided by UNISON for the years 2001 to 2009 with the three most recent years verified against the actuarial valuation report as at 31 March 2010 and the Annual report and Accounts for the Fund as at 31 March 2010.



Based on our simple assumptions, the chart above demonstrates that an 80% member opt-out has a significant effect on cash flow, taking the balance from a strong cash positive position to a weak cash negative position.

Extending our assumptions above to examine the effects of varying opt-out rates on cash flow, it can be shown that the overall cash flow position could become negative for the Fund for opt-out rates of 40% (or more).

Net cashflow £m *(including investment income)*		**Assumed opt-out rate[1]**							
	2010	**10%**	**20%**	**30%**	**40%**	**50%**	**60%**	**70%**	**80%**
Barnet Pension Fund	22.9	16.9	10.9	4.9	-1.1	-7.0	-13.0	-19.0	-25.0

The net cash flow position of the Fund could reduce from around £22.9 million (positive) in 2010 to between £16.9 million (positive) and £25.0 million (negative) in 2012. Opt-outs as low as 40% could result in a move from the Fund being cash positive to cash negative.

Finally, if the Fund begins to mature and the number of active members relative to pensioners declines, the cash flow position will worsen further in future years. Hutton comments in his Interim Report that "…as funds mature and pensioners increase relative to employees, cash flow will likely turn negative. The Audit Commission estimates that assuming workforce numbers stay at 2010 levels, cash flow will turn negative in 2025, or in 2016 assuming a 15% workforce reduction over the next 5 years…"

Our analysis above shows that cash flow is likely to become negative much sooner than this.

[1] In each case, we have reduced the contributions by the corresponding percentage of members leaving and we have adjusted the volume of transfers in and out accordingly.

4. PROJECTED FUNDING POSITION OF THE FUND

LIKELY LEAVERS

Members most likely to leave the LGPS as a result of an increase in member contributions. will clearly vary by individual circumstances, but from observed experience and likely expectations, the following individuals are identified as being most likely to leave:

- Leavers are more likely to be young;
- Leavers are more likely to be low paid;
- Leavers are more likely to be women;
- Leavers are more likely to be those with low promotion prospects and/or salary growth expectations;
- Leavers are more likely to be those with higher mortality.

The combined effect of the above is that the average age of the active membership of the Fund is likely to increase and the cost of future benefits would increase.

This maturing of the active membership has implications for the investment strategy of the Fund and the discount rate used to value the liabilities. The combined effect of these effects could have a negative impact on the funding position of the Fund in the future.

INVESTMENT STRATEGY

The effect of a maturing membership may lead to the investment strategy moving from a predominantly equity-based asset portfolio (the current proportion of assets held as equities in the Fund is around 70%) to a more cautious asset portfolio, i.e. a lower holding of growth-seeking assets such as equities and a larger holding in gilts and corporate bonds aimed at backing the liabilities of pensioners and those members nearing retirement.

This, together with a greater proportion of liquid assets (such as cash) being held due to negative cash flow, could lead to a reduction in the return achieved on the Fund's assets in the future.

The impact of moving from cash positive to cash negative would mean that the Fund would need to hold more liquid assets (such as cash) in order to meet its ongoing expenditure which will no longer be met by contribution income and investment income alone. This would result in the Fund adopting a more cautious investment strategy and consequently reduce the expected return from its assets in the future.

DISCOUNT RATE USED TO VALUE THE LIABILITIES

A more cautious investment strategy could influence the choice of discount rate used to value the liabilities of the Fund. The discount rate reflects the return expected to be achieved on the assets held by the Fund and a more cautious investment strategy could result in a lower discount rate being assumed at future actuarial valuations. This in turn would result in a higher value being placed on the liabilities.

The discount rate for valuing the liabilities of the Fund is set with reference to the returns available on the actual assets held by the Fund. Therefore, a more cautious investment strategy would lead to a lower discount rate assumption, which would increase the liabilities of the Fund, all other things being equal.

This would only be partially offset by the reduction in the liabilities in respect of those active members who become deferred members and consequently lose the final salary link to their accrued benefits.

PROJECTED FUNDING LEVEL

Following the 2010 valuation of the Fund, a recovery plan was put in place and deficit contributions set with the aim of achieving 100% funding level within 15 years.

We have projected the funding level of the Fund over the next 6 years to show the funding level at the next two triennial actuarial valuations as at 31 March 2013 and 31 March 2016.

Under the existing recovery plan, the Fund would hope to see a steady increase in the funding level from 76% as at 31 March 2010 to around 82% in 2013 and around 87% in 2016 with the aim of being 100% funded by 2025/26.

We have extended our analysis to allow for changes in the investment strategy of the Fund to reflect a maturing membership and also the reduction in the discount rate used to value the liabilities as the investment strategy changes over time. The projections also allow for increased opt-outs, particularly at the younger ages.

A summary of the projected funding level based on different assumed opt-out rates is shown in the table below.

All figures shown in £m		Assumed opt-out rate[2]							
		31 March 2013				31 March 2016			
	2010	0%	10%	50%	80%	0%	10%	50%	80%
Assets	610	805	790	735	710	1,060	980	800	750
Liabilities	800	985	960	930	920	1,220	1,140	1,060	1,130
Deficit	**(190)**	**(180)**	**(170)**	**(195)**	**(210)**	**(160)**	**(160)**	**(260)**	**(380)**
Funding Level	**76%**	**82%**	**82%**	**79%**	**77%**	**87%**	**86%**	**75%**	**66%**

[2] Projections allow for a changing investment strategy and a lower discount rate assumption over time, as a consequence of year-on-year reductions in the active membership of the Fund.

The shaded columns in the table above show the estimated position assuming an opt-out rate of 80%. That is, the funding level of the Fund would expect to increase only slightly from 76% as at 31 March 2010 to around 77% as at 31 March 2013 before falling to around 66% as at 31 March 2016.

The combined effect of a more cautious investment strategy and the reduced discount rate used to value liabilities as the investment strategy changes over time, could result in the funding level for the Fund not improving by 2013 and actually worsening by 2016, instead of continually improving as would have been expected given the additional contributions being paid with the aim of removing the deficit.

For example, an opt-out rate of 80% could see the funding level increase only slightly from 76% to 77% in 2013 before falling to around 66% by 2016. Under the recovery plan, the Fund would have been expecting a steady increase in the funding level to around 82% in 2013 and 87% in 2016 with the aim of being 100% funded by 2025/26.

COST OF FUTURE SERVICE BENEFITS

A potential impact of mass opt-outs could result in the cost of future service benefits increasing as a percentage of salaries. This will be particularly the case if a significant proportion of those opting out are the younger members (as explained above), leading to an increase in the average age of the active membership of the Fund. The older the average age the more expensive benefits are to build up given the shorter time period until retirement with which to invest the contributions.

DEFICIT CONTRIBUTIONS

In addition, deficit contributions – which are paid solely by employers (and taxpayers) – would be expected to increase following the 2013 from their current level for two reasons:

(i) higher than expected funding deficit revealed at subsequent valuations, and
(ii) a shorter time period over which to clear the deficit given the increase in the average age of the active membership and the significant reduction (or ceasing) of new entrants to the Fund.

An opt-out rate of 80% could result in deficit contributions increasing from the current level of around £14.3 million a year (to clear the deficit of £190 million over 15 years) to around £30 million a year in 2013 (to clear the estimated deficit shown above of £210 million over a period of around 7 years which reflects the older average age of the remaining active membership). For Barnet Council, this could almost double its deficit contributions from £10.7 million to £19.7 million a year. This is ultimately a cost to the taxpayer.

It is also more than likely that deficit contributions would have to be expressed in fixed monetary terms rather than as a % of salaries due to the significant reduction in the active membership of the Fund.

Notwithstanding that the cost of future service benefits is likely to reduce if the benefits provided by public service pension schemes are reduced following the Hutton Review, the level of contributions required to clear deficits – which are in respect of liabilities already accrued to date – will place a significant burden on employers (and taxpayers) in the near future.

5. POTENTIAL IMPACT OF FUTURE INCREASES TO MEMBER CONTRIBUTIONS AND/OR CLOSURE OF PUBLIC SERVICE PENSION SCHEMES TO NON PUBLIC SERVICE EMPLOYEES

Lord Hutton's Final Report recommends that a fixed "cost ceiling" should be introduced for all public service pension schemes. This would effectively replace the existing cap and share arrangement for the LGPS and introduces a default automatic "stabiliser" if agreement cannot be reached between stakeholders. These "stabilisers" will mean a decrease in accrual rates (i.e. a smaller pension) or that scheme members need to increase their contributions further which could lead to more opt-outs in the future.

In addition, Hutton recommended in his final report that "…it is in principle undesirable for future non-public service workers to have access to public service pension schemes, given the increased long-term risk this places on the Government and taxpayers…"

In his Final Report, Hutton noted that the LGPS has the highest number of additional organisations of any public service pension scheme. He comments that:

> "…there are more than 6,000 such bodies in the LGPS scheme, covering 23.4 per cent of LGPS members. These include contractors that take on local authority services (transferee admission bodies), charities and non-profit organisations (community admission bodies) and a range of other public sector organisations…

The results of the consultation on the Fair Deal policy, which closed on 15 June 2011, may heed Lord Hutton's recommendation and mean that future non public service employees are ineligible to participate in the LGPS or other public service pension schemes.

The combined effect of further opt-outs that may result from automatic "stabilisers" implemented to fix a "cost ceiling" for employers (and taxpayers) together with the potential ineligibility of non public service employees to participate in the LGPS and in the future as a result of the consultation on the Fair Deal policy, could result in a rapid decline in the active membership of the Fund.

With fewer and fewer active members contributing to the Fund, the effects of negative cash flow and maturing membership will be exacerbated.

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6. RISKS ASSOCIATED WITH ADMITTED BODY STATUS (ABS)

We understand that the Council is likely to favour the ABS route for contractors. The main risks with this are as follows:

- Usually a Bond is put in place to protect the Council if the contractor ceases trading. The risk is that the value of this Bond (which is difficult to calculate) is not large enough or secure if the contractor does cease trading.
- It is not necessary to secure a Bond where a contractor meets the criteria for Designated Body Status. In this scenario, if the contractor ceases trading, any pension fund deficit would fall back on the Council.
- The LGPS provides for early payment of pension benefits on compulsory early retirement or redundancy. The contractor should take responsibility for any potential strain on the Fund resulting from such early retirements.
- Contractors often negotiate caps on the level of contribution they will pay to the fund (say, 20% of salaries). This creates a risk to the council if the actual cost of benefits exceeds this cap.
- A Closed ABS has the risk that it matures the Fund (i.e. there are no new entrants to replace the active members that are getting older and retiring/leaving the Fund). This has all the risks outlined above with a reduced active membership of the Fund (such as a more cautious investment strategy leading to lower asset performance and a higher value being placed on the liabilities, together with a reduced period over which to clear the increased deficit). Also, the cost of future service benefits for an ageing active membership increases as the average age of the membership increases.

Rob Hammond
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31 August 2011