WSPF – Preparation for 2016 Valuation

Pooling Arrangements (Small Scheduled Bodies Pool / Academies Pool / Small Admitted Bodies Pool)

September 2016

Background

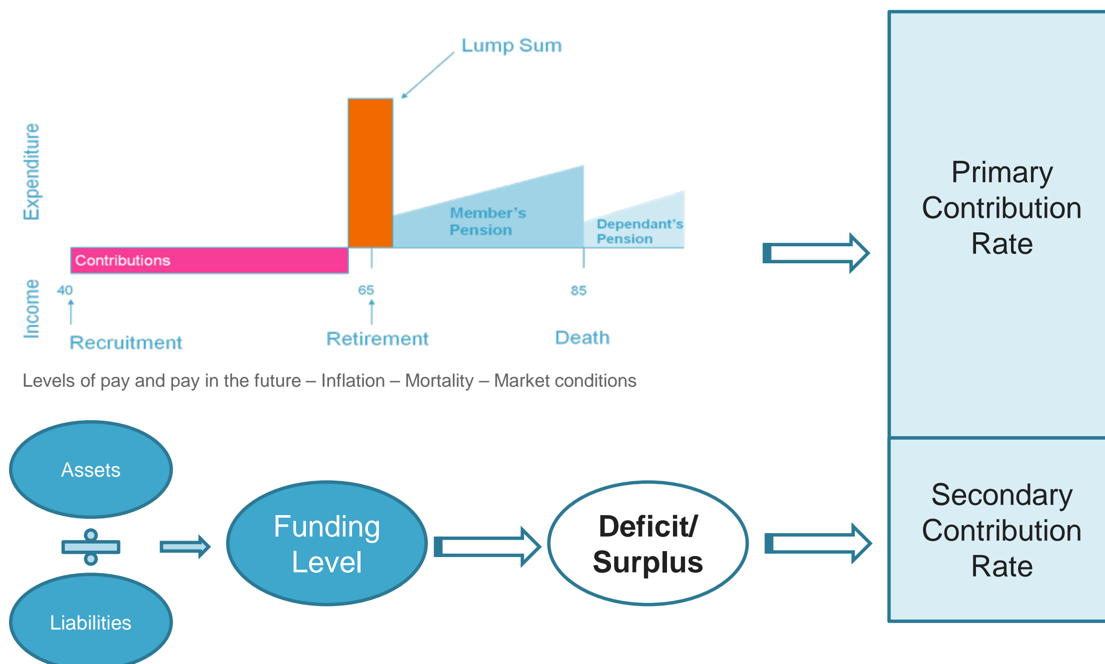
Employer Contribution Rates

When undertaking a valuation the Actuary needs to estimate how much will need to be set aside now to pay for pensions in the future. To do this the Actuary needs to perform two key calculations.

Firstly, the actuary needs to calculate how much needs to be paid to meet the value of new benefits being earned by active members. This is known as the Primary Contribution Rate.

Secondly, the Actuary needs to calculate how much needs to be paid over a given period of time in order to eliminate any shortfall in the amount that has been set aside relative to the value of benefits built up to date. This is known as the Secondary Contribution Rate.

The below illustrates how each part of the contribution rate is calculated.



There are a number of factors that influence the cost of new benefits and the value of any deficit. As such, the Actuary has to make assumptions about the following factors in order to calculate both the Primary and Secondary contribution rates.

- Levels of pay and pay in the future – The actuary makes an assumption of the rate at which salaries will grow over the working lifetime of members.
- Inflation – Pension benefits are linked to CPI. The actuary makes an assumption about the level of inflationary increases over the long term.
- Mortality – The West Sussex Fund subscribes to VitaCURVES. This modelling work provides a very detailed analysis of Fund members' expected life expectancy based on numerous factors including their location, salary and gender. As a whole, members of the West Sussex Pension Fund are more affluent and are expected to live longer than the LGPS and national average.
- Market conditions – The Actuary assumes a rate of return from the Fund's investments.

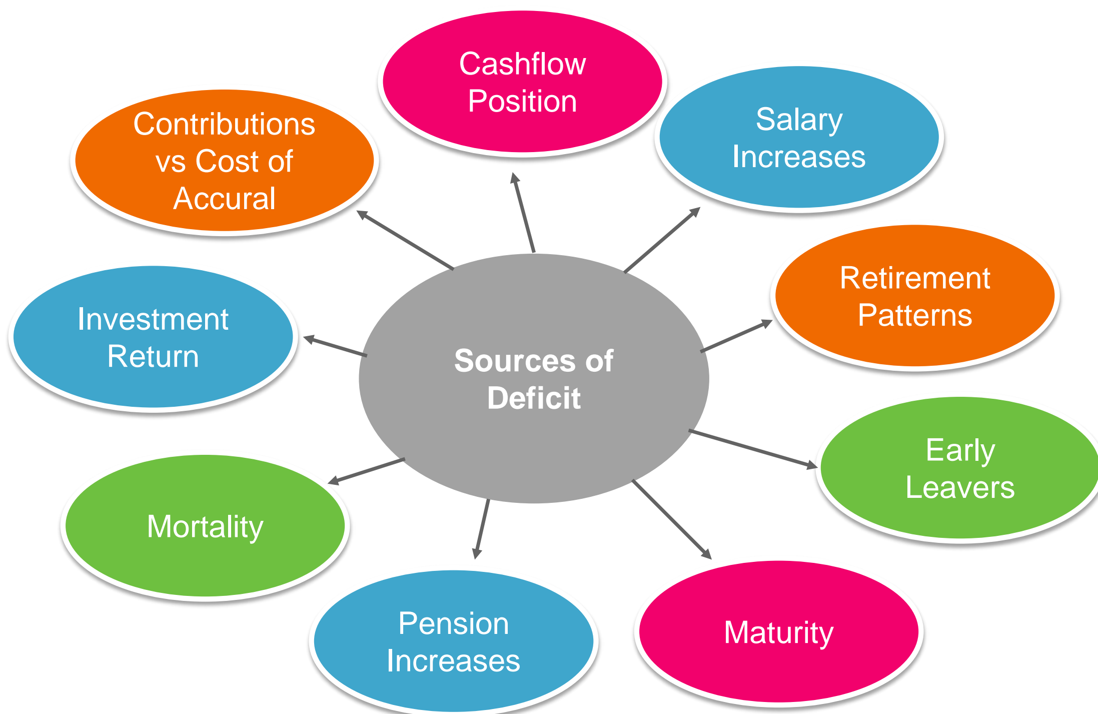
In addition to the above, the Primary and Secondary rates are also influenced by age, gender, ill health retirements, withdrawals (early leavers), assumed retirement age and marital status upon death.

All Employers are Different….

The Actuary calculates employers contribution rates with the intention that the assets built up will always equal the value of the employers' past service liabilities at a pre-determined future date. This time period will vary by employer. For Admitted bodies, this is likely to be set to the remaining working lifetime of active members while precept raising bodies usually set a period of 20 years.

However whilst the assumptions used by the Actuary are based on detailed modelling work over a long term period it is difficult to predict what actual experience will be compared to the assumptions adopted, particularly in the short term. This can mean an employer can end up with a deficit over time due to adverse actual experience i.e. a shortfall of assets relative to the value of the past service liabilities.

Some of the factors which impact on the deficit are noted below:



Size matters…

The total contribution rate for a small employer is generally more volatile than the rate for a large employer. This is illustrated in the chart below which shows the contribution rates for a large employer and for a very small employer within the West Sussex Fund. The main reasons for the differences in the volatility of rates are:

- For the larger employer the contribution rate is mainly impacted by changes in market factors.
- For a small employer, membership changes is a more significant driver for contribution rate changes. For example, if you are an employer with three members of staff and two young men leave, being replaced by an older woman, the cost of pension accrual will increase significantly. Also because pension is based on a % of payroll, a small increase in monetary terms can look significant when set as a proportion of pay for an employer with a small number of employees.

The Actuary suggests that an employer with 100 active members is a medium sized employer. An employer would need thousands of members to be immune from most changes in membership.

<u>Pooling</u>

Under the Regulations the Actuary is required to keep contribution rates as stable as possible.

By pooling small employers together the Fund can create a quasi larger employer which helps mitigate some of the risk of volatile contributions for smaller employers.

The pool needs to be large enough to make it viable.

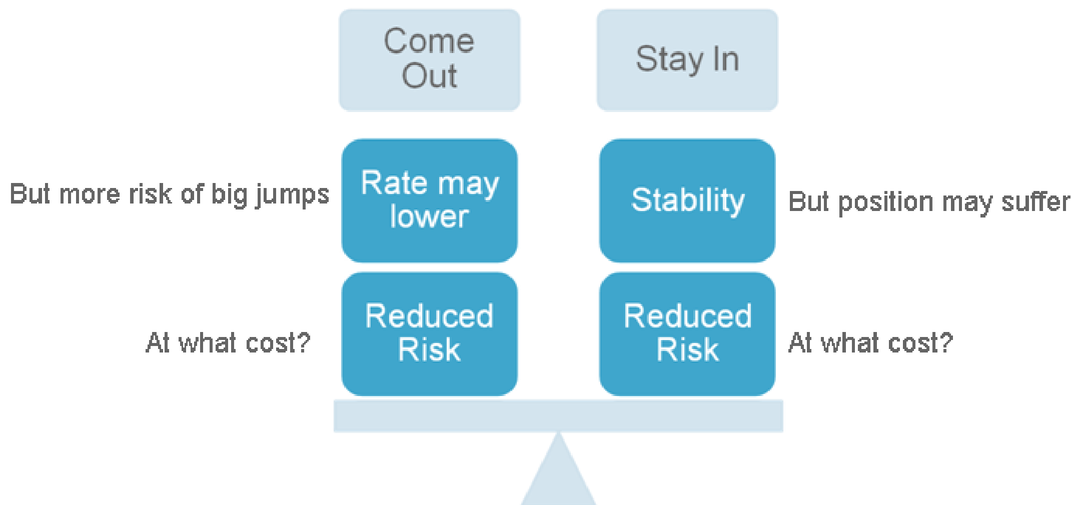
The Actuary tracks the whole pool to set the contribution rate and also tracks the experience of individual employers within the pool. The nature of a "pooled" rate will create cross-subsidies; some employers will be over-paying in respect of their individual position with others under-paying.

If the pool was to be disaggregated at a future date, the underlying individual employer positions could vary considerably.

2016 Actuarial Valuation Preparation

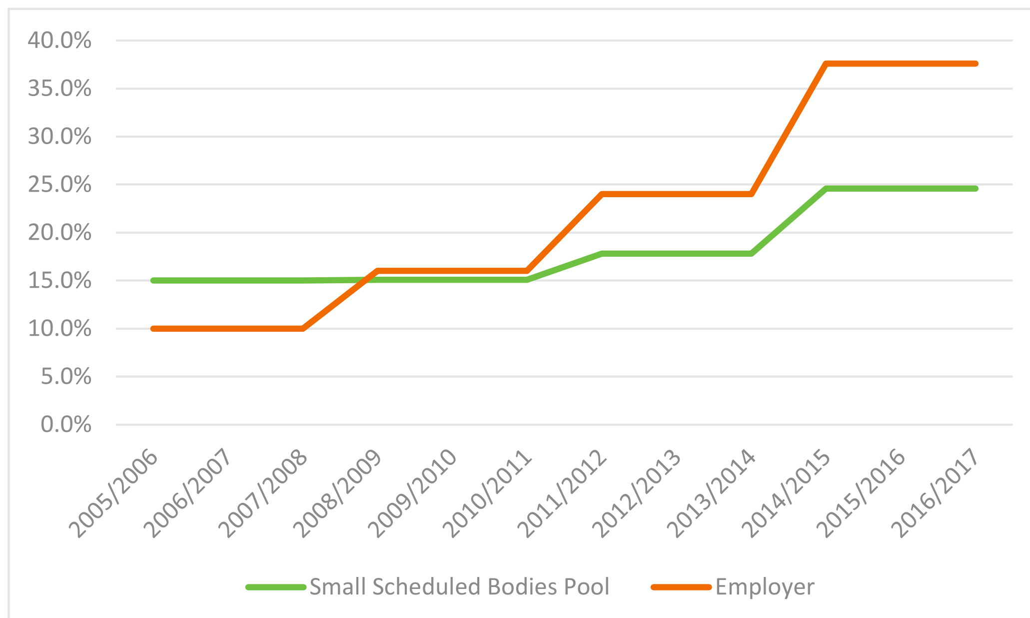
Pooling Review

As part of the preparation for the 2016 valuation therefore employers in the pools are asked to consider whether the arrangements are still appropriate.



Pooling (benefits)

By pooling, employers are able to mitigate some of the risks associated with being a 'stand alone' employer and reduce the volatility of the cost of future service accrual and any deficit funding, and therefore keep contribution rates *more* stable, as illustrated in the chart below.



If the small employer shown as the orange line had a stand alone rate they would have seen a significant increase in their contribution rate as a result of the 2007 Valuation (an increase of over 5% of payroll) and it has continued to climb by several percentage points each valuation thereafter.

In comparison the Small Scheduled Bodies Pool as a whole has seen a contribution rate increase of c.9% of payroll over the three valuation cycles.

However by paying the Small Schedule Bodies Pool contribution rate the employer will have overpaid versus their stand alone rate in some periods (2005-2008) and underpaid relative to their standalone rate in other periods (2008-2017). This underpayment could be seen as a benefit but it is important to bear in mind that the Actuary monitors each employer's individual position.

Pooling (risks and mitigations)

Risks	Mitigations
As the Actuary pools all employers experience for the pooled contribution rate, individual employers paying the pooled rate may end up in deficit or surplus without noticing. This becomes more relevant when an employer no longer has any active members – which triggers a cessation event in the Fund. This means that the Fund will require a lump sum payment for employers in deficit (on a prudent actuarial basis) to make sure all liabilities relating to the employer are covered and to cover the risk of the Actuarial assumptions differing to actual experience.	Currently pooled rates are calculated on the basis of one large employer. The actuary could, however, split the primary rate from the secondary rate. The primary rate could then be calculated and paid at total pool level whilst the deficit or surplus would reflect the employers own position.
By being in a pool each employer is reliant on the other employers to 'behave' in a similar manner for example around awarding pay increases, granting ill health retirements or being open / closed to new entrants.	Individual employers or the pool as a whole could insure against the costs associated with ill health retirement (tier 1 and tier 2). In addition, the Pension Fund has commissioned its legal advisers to provide terms of participation covering employer specific changes such as pay increases and ill health retirement. Any employer who exceeds the parameters set could then be charged.
Finally whilst a pool is usually made up of a number of similar employers, over time, some employers may experience a fall in membership while others grow considerably. If there is a large employer in the pool, decisions made by that employer would impact on the contribution rate of the rest of the pool.	The Fund will monitor these changes.