Nottinghamshire County Council

Report to Pensions Investment Sub-Committee

22 December 2011

Agenda Item:4

REPORT OF SERVICE DIRECTOR (FINANCE)

FUND CASH FLOW AND ASSET ALLOCATION

Purpose of the Report

1. To inform Members of the impact on the Fund's cash flow of possible reductions in active members and to consider whether changes to the Fund's asset allocation strategy are required as a result.

Information and Advice

Background

2. In June 2010 the Government commissioned former Work and Pensions Secretary, Lord Hutton, to chair the review into the long term future of public service pensions. In his final report Lord Hutton set out his recommendations on how these can be made sustainable, affordable in the long-term and fair to both public sector workers and the taxpayer. Prior to this, Lord Hutton published his interim report in which he recommended that, if the Government wished to make short term savings to meet current cost pressures, then raising contribution rates would be the most effective way to achieve that objective.

3. At the Spending Review, the Chancellor announced that employee contributions would be increased by an average of 3.2%. In recognition of the funded nature of the LGPS, the Government accepted that separate discussions should take place to see whether alternative ways to deliver some or all of the savings could be found. The savings required from the LGPS in England and Wales are £900m by 2014/15.

4. Two options have been put forward by the Government for consultation and both involve stepped increases in employee contributions combined with changes to accrual rates during the period in question. The parameters set by the Government require protection for the low paid and a limit to the increase for higher paid. More detail on these options is shown at Appendix A. The LGA has also put forward a proposal which gives an element of choice to employees. Brief details of this option are shown at Appendix B.

5. In order for any of these options to produce savings to LGPS employers and taxpayers, it would be necessary to enable employers' contributions to be reduced. However, the current regulations do not allow a downward revision of employer contribution rates between triennial actuarial valuations. It would therefore be necessary to provide a technical amendment that enables actuaries to vary rates and adjustment certificates between the 2010 and 2013 valuations and to include the proposed accrual rate changes in the 31 March 2013 valuation exercise.

6. There is concern among LGPS stakeholders (including Unions, the LGA and fund representatives themselves) that increased employee contributions may result in significant number of employees opting out. Estimates of the likely opt-out rate have varied between 1% and 40% but the actual figure will depend on the proposals adopted and the wider circumstances prevailing at the time of implementation.

7. The risk with significant opt-outs is that net cash flow from members will reduce and this may have an impact on investment strategies and asset allocation. This report attempts to outline the issues concerned and to quantify some of the possible outcomes to enable an informed discussion on whether the Fund's asset allocation strategy needs to change.

Current Strategic Asset Allocation

8. Asset allocation is the process of deciding in which asset classes the Fund should be invested and in what proportion. It is generally claimed that asset allocation is the major contributor to performance (over manager or stock selection). The relevance of different asset classes is determined by a wide variety of factors including:
    - the purpose of the Fund
    - the funding level and deficit recovery period
    - market and economic factors
    - requirements for diversification
    - the actuarial assumptions used in the triennial valuation
    - the maturity of the scheme and its cash flow position

9. At the last valuation (as at 31 March 2010) the Fund was 84% funded and employer contribution rates were set to recover the deficit over a maximum period of 20 years. Favourable investment performance can play a valuable role in achieving adequate funding but to do so, returns over the longer term need to exceed the levels assumed by the actuaries during the valuation. The following return assumptions were adopted at the latest valuation:

Equities/absolute return funds	7.5% pa
Gilts	4.5% pa
Bonds & Property	5.6% pa

10. The Fund's current asset allocation treats 'the equity allocation as a block aimed at maximising the financial returns… [and] the block of Bonds, Property and Cash is aimed at lowering overall risk (at the cost of anticipated lower return)'. The agreed allocation ranges are:

Equities	55% to 75%
Property	5% to 25%
Bonds	10% to 25%
Cash	0% to 10%

11. The relatively high allocation to equities is acceptable because the cash flow profile of the Fund is such that it is unlikely that assets will have to be realised in order to meet pension benefits. Contribution income currently exceeds benefit payments and an investment strategy review, carried out by the Fund's actuaries, found that this is likely still to be the case in 20-30 years time. However, the potential for significant changes to the active membership make it appropriate that this position be reviewed.

Cash Flow

12. The Fund's cash flow comprises two main elements – net additions from dealings with members and investment income. The position for the combined fund for the last 5 years is shown below.

	06/07	07/08	08/09	09/10	10/11
	£m	**£m**	**£m**	**£m**	**£m**
Employees Contributions	37	39	45	46	46
Employers Contributions	103	110	119	129	131
Transfers In	16	20	11	16	17
Pensions	76	83	90	98	104
Lump Sums & Other Benefits	20	22	25	29	40
Transfers Out	11	9	5	15	24
Administration Expenses	2	1	1	1	1
Net additions from dealings with members	**48**	**53**	**53**	**48**	**24**
Investment Income	77	83	85	77	78

13. Investment income is healthy and reasonably stable. The net additions from members were also stable until 2010/11. In that year, lump sum payments and transfers out increased dramatically suggesting a significant change in active members. This is backed up by the membership data as shown below.

	09/10	10/11	Change	%
Actives	42,280	39,914	-2,366	-5.6%
Deferreds	29,925	32,100	2,175	7.3%
Pensioners	25,853	26,722	869	3.4%
	98,058	**98,736**		

14. The following table shows the estimated cash flow arising from members (not including transfers in and out) for 2011/12. The subsequent columns show the potential impact of reductions in contribution income of between 10% and 25%. It can be seen that the net cash flow from members turns negative only when contributions reduce by more than 15%.

	11/12	-10%	-15%	-20%	-25%
	£m	£m	£m	£m	£m
Employees Contributions	44	39	37	35	33
Employers Normal Contributions	130	117	110	104	97
Pensions	110	110	110	110	110
Lump sums & other benefits	36	36	36	36	36
Net addition from dealings with members	**27**	**10**	**1**	**-7**	**-16**

15. If contribution income reduces to these levels, as a result of continuing workforce cuts and possible opt-outs, the Fund would need to utilise some of its investment income in order to pay benefits.

Changes to Strategic Asset Allocation

16. It is sensible to consider in advance whether changes may be required to the Fund's asset allocation. Reasons for change would include:
    - an increased focus on generating income
    - an attempt to reduce the volatility of income
    - the possibility of having to realise assets in order to meet benefit payments.

17. It should be noted that contribution income would have to reduce severely to force the Fund to sell assets. Appendix C, prepared by the Fund's independent adviser, covers these issues in more detail and will form the basis of discussion on whether changes to asset allocation are considered appropriate.

Reason/s for Recommendation/s

18. The possibility of continuing cuts in participating employers' workforces and opt-outs as a result of changes to employees' contribution rates proposed by the Government may have a significant impact on the Fund's cash flow. It is important to consider the potential effect of these changes in terms of the Fund's asset allocation strategy.

Statutory and Policy Implications

19. This report has been compiled after consideration of implications in respect of finance, equal opportunities, human resources, crime and disorder, human rights, the safeguarding of children, sustainability and the environment and those using the service and where such implications are material they are described below. Appropriate consultation has been undertaken and advice sought on these issues as required.

RECOMMENDATION/S

1) That consideration be given to whether changes are required to the Fund's asset allocation strategy.

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Option 1
This proposal to achieve the required £900m savings by 2014-15 (3 per cent of forecast pensionable paybill) comprises of two separate elements:

i) **An increase in the employees' contribution tariff from April 2012, to raise an additional £450m (1.5 per cent of pensionable paybill), and**
ii) **A change in the scheme's accrual rate from April 2013, to raise an additional £450m (1.5 per cent of pensionable paybill)**

The phased increase in employees' contribution rates would be as follows:

Tariff Band (% of membership)	Current	2012/13	2013/14	2014/15
£0 - £12,900 (8.67%)	5.5%	5.5% (0.0%)	5.5% (0.0%)	5.5% (0.0%)
£12,901- £15,100 (10.61%)	5.8%	5.8% (0.0%)	5.8% (0.0%)	5.8% (0.0%)
£15,101- £19,400 (25.20%)	5.9%	5.9% (0.0%)	6.0% (0.1%)	6.0% (0.1%)
£19,401- £21,000 (7.47%)	6.5%	6.7% (0.2%)	7.2% (0.7%)	7.7% (1.2%)
£21,001- £32,400 (31.34%)	6.5%	7.2% (0.7%)	8.0% (1.5%)	8.3% (1.8%)
£32,401- £43,300 (11.16%)	6.8%	7.5% (0.7%)	8.3% (1.5%)	8.7% (1.9%)
£43,301- £60,000 (4.18%)	7.2%	8.2% (1.0%)	8.7% (1.5%)	9.0% (1.8%)
£60,001- £81,100 (0.91%)	7.2%	8.7% (1.5%)	9.2% (2.0%)	10.0% (2.8%)
£81,101- £100,000 (0.25%)	7.5%	9.0% (1.5%)	9.8% (2.3%)	11.0% (3.5%)
£100,001- £150,000 (0.16%)	7.5%	9.5% (2.0%)	11.0% (3.5%)	12.0% (4.5%)
£150,001 + (0.05%)	7.5%	10.0% (2.5%)	12.0% (4.5%)	12.5% (5.0%)

Option 2
This proposal to achieve the required £900m savings by 2014-15 (3 per cent of forecast pensionable paybill) comprises of two separate elements. It differs from Option 1 due to a lower contribution rate increase which is offset by a greater reduction in the accrual rate:

i) **An increase in employees' contribution tariff from April 2012, to raise an additional £300m (1 per cent of pensionable paybill), and**
ii) **A change in scheme's accrual rate from April 2014, to raise an additional £600m (2 per cent of pensionable paybill)**

The phased increase in employees' contribution rates would be as follows:

Tariff Band (% of membership)	Current	2012/13	2013/14	2014/15
£0 - £12,900 (8.67%)	5.5%	5.5% (0.0%)	5.5% (0.0%)	5.5% (0.0%)
£12,901- £15,100 (10.61%)	5.8%	5.8% (0.0%)	5.8% (0.0%)	5.8% (0.0%)
£15,101- £19,400 (25.20%)	5.9%	5.9% (0.0%)	6.0% (0.1%)	6.0% (0.1%)
£19,401- £21,000 (7.47%)	6.5%	6.5% (0.0%)	6.8% (0.3%)	6.8% (0.3%)
£21,001- £32,400 (31.34%)	6.5%	6.8% (0.3%)	7.2% (0.7%)	7.5% (1.0%)
£32,401- £43,300 (11.16%)	6.8%	7.1% (0.3%)	7.8% (1.0%)	8.2% (1.4%)
£43,301- £60,000 (4.18%)	7.2%	7.8% (0.6%)	8.4% (1.2%)	8.8% (1.6%)
£60,001- £81,100 (0.91%)	7.2%	8.7% (1.5%)	8.8% (1.6%)	9.5% (2.3%)
£81,101- £100,000 (0.25%)	7.5%	9.0% (1.5%)	9.8% (2.3%)	10.5% (3.0%)
£100,001- £150,000 (0.16%)	7.5%	9.3% (1.8%)	10.8% (3.3%)	11.5% (4.0%)
£150,001 + (0.05%)	7.5%	9.5% (2.0%)	11.8% (4.3%)	12.5% (5.0%)

LGA Proposal

The key elements of the Group's proposals are:

- no increase in employee contributions for staff with full-time equivalent earnings of less than £15,000, a moderate increase for those earning between £15,000 and £21,000 of 1.5 per cent and an increase of between 2 per cent and 2.5 per cent for those earning over £21,000

- choice for employees, by giving those with full-time equivalent earnings of £15,000 or more who feel they cannot afford an increase in contributions the option of taking a reduced pension accrual rate instead for future service from April 2014. Any employees with full-time equivalent earnings of less than £15,000 who may be finding it difficult to meet the current level of contribution would have the option of taking a reduction in their contribution rate but would, as a result, have a reduced pension accrual rate for future service from April 2014

- raising the normal pension age from 65 to 66 for benefits built up from April 2014. Benefits built up prior to then would retain a normal pension age of 65