Guide for Employers - A guide to pension liabilities, pension strain costs and other Costs

This guide aims to give answers to the following questions from employers:
1. What are my pension liabilities as an employer in the Fund?
2. What factors will influence my liabilities?
3. How will we pay for these liabilities?
4. What are strain costs and when will they occur?
5. How can I obtain an estimate of what a strain cost will be?
6. How will I pay for strain costs?
7. What other costs might I incur?

1. What are my pension liabilities as an employer in the Fund?
Each employer is responsible for the pension costs incurred in relation to its current and former employees. As an employer within the Fund, you are responsible for funding the pension promises you have given. Your liabilities are the statutory pension benefits that are either being built up, are deferred or are in payment for your current and former employees who are members of the Fund. When an employee joins the LGPS they begin to build up an entitlement to pension benefits. These benefits (liabilities) are funded by the employee (by way of their employee contributions), the employer (by way of their employer contributions) and by any investment returns achieved by the fund. The employee pays a fixed contribution rate, with the employer paying a varying rate dependant on the amount needed to ensure the benefits are funded. Employers' payments are covered in the LGPS Regulations. In accordance with these regulations, every three years the Fund's actuary carries out a valuation and sets the employer contribution rates for the next three years. In setting the rates, the actuary must have regard to a fund's Funding Strategy Statement (FSS). The FSS sets out the assumptions and methodologies that have been determined by the Fund after having taken the appropriate advice and carried out the necessary consultation.

2. What factors will influence my liabilities?
It is important to understand what factors can influence your liabilities, in order to allow you to manage some of the issues involved and to help you to mitigate risk where possible. Some of these factors can be within your control and you will have a direct influence over them. Others cannot generally be directly influenced by an employer but do require an awareness.

Factors within an employer's control

- *Salary growth*

As part of the Fund's valuation, the actuary will make an assumption about future salary increases. If an employer grants salary increases that are greater than the assumption used by the actuary then it will have a direct effect on that employer's individual pension liabilities. Therefore, employers should consider carefully the salary increases they award, in terms of both the number and the level of such awards.

- *Membership movements*

The actuary will also make assumptions based on the estimated number of future active contributors to the Fund that an employer will have. If there is a significant or unexpected decline in the number of active contributors then this is likely to have an impact on liabilities. Therefore, employers should consider this aspect if they are thinking about transferring large numbers of employees to another employer or pension provider, or if they are thinking of conducting redundancy exercises or similar exercises.

- *Transfers in and out*

Upon joining the LGPS, members usually have twelve months within which to elect to transfer previous benefits to count alongside the benefits they will build up in their new employment. The LGPS regulations impose a twelve-month window in which to elect but also allow the employer discretion to extend this time limit. In exercising this discretion, employers should be aware that transfers could carry a significant pension liability. Employers should consider this when making their decisions and speak to the Fund about the potential liability to be incurred before drawing up or amending their policy statement and before agreeing to a late request to transfer. Where bulk transfers of employees occur, either into or out of the Fund, significant liabilities can be incurred dependant on the terms of the transfer agreed. Employers should get in touch with the Fund at the earliest opportunity to discuss how they can best limit any increase to liabilities resulting from a bulk transfer.

Factors outside an employer's control

- *Investment returns*

The employee and employer contributions received by the Fund are invested. The Fund's actuary makes an assumption during the valuation process on the rate of investment returns. If investments outperform the assumption, then liabilities will decrease. However if investments underperform then liabilities will increase. An employer has no direct influence on this factor. However, an employer may be able to have an indirect influence by contributing to any consultations or debates on what the Fund's investment strategy should be and to any discussions regarding individual investment strategies.

- *Longevity / Mortality*

The actuary will also make assumptions on expected longevity and mortality rates of pension fund members. The actuary will use the latest information and assumptions to do this and will make an allowance for future improvements in longevity.

- *Pensions Increase*

The rate of pensions increase (currently based on CPI) will also have an impact on liabilities. As with the factors above, the actuary will make an assumption about what the future rate of pensions increase will be and so if the rate of CPI is greater than assumed then liabilities will increase.

- *Regulation changes*

In estimating future liabilities, we can only do this using the benefits structure under the current or known future changes to the LGPS regulations. If regulations change then this can have a direct and unexpected effect on pension liabilities. Although employers cannot generally have a direct influence on this, they can have an indirect influence by responding to Government consultations on regulation changes.

3. How will we pay for these liabilities?

An employer pays for these liabilities generally through their employer contribution rate. Employers are required to pay their contribution rate plus a cash lump sum amount to meet the cost of deficit recovery. However, see sections 4 to 6.

4. What are strain costs and when will they occur?

Pension strain costs (often also called capital costs) occur when there is a clear shortfall in the assumed level of funding needed to provide a particular pension benefit. Often, strain costs occur when a member draws their benefits a lot earlier than expected. The normal retirement age for all members of the LGPS is currently aligned to the members State Pension Age. Members aged 55 and over can elect to retire without their employer's

consent, although their benefits may be reduced to take account of the fact that the benefits will be paid earlier and for a longer period of time than would otherwise have been envisaged. However, the employer may be asked to consider waiving reductions which would then give rise to a 'strain cost'. In addition if a member is allowed to retire early by their employer on the grounds of redundancy or efficiency, then there is likely to be a strain cost. Again, this is because it is assumed that as the benefits are being paid earlier they will be paid out for longer and also that employee and employer contributions will not have been paid for as long as was anticipated. In the same way, pension strain costs generally always occur for ill health retirements. Benefits are generally paid earlier than expected and without reduction for early payment, and those benefits may be enhanced. Deaths can also lead to strains on the Fund, particularly when people die young in service and leave dependants who are entitled to pension benefits. If an employer chooses to augment a member's pension then there will be a strain cost for doing so.

5. How can I obtain an estimate of what a strain cost will be?

Your Pension Service calculates pension strain as part of the benefit calculation process. If you have access to Altair/ESS then you will be able to calculate an estimate of the cost yourself. Alternatively you can request an estimate.

6. How will I pay for strain costs?

Most strain costs are payable up front as a lump sum to the Fund at the point that an event occurs. However, strain costs relating to 'no fault' events such as ill-health retirements and deaths are not payable up front and instead are absorbed within the ongoing employer's contribution rate which is revalued every 3 years.

7. What other costs might I incur?

You may incur other administration related costs, such as charges for actuarial work conducted on your behalf (e.g. FRS17 report costs). Also, if you were to terminate your membership of the Fund for whatever reason then you may be liable for termination costs. Termination costs are likely to be a very large sum because of the need for the Actuary to value liabilities on a more prudent basis and to recover a revised higher deficit at the termination date. To find out more about this please refer to the Fund's Admissions and Terminations Policy.