Local Government Pension Scheme 2016/17

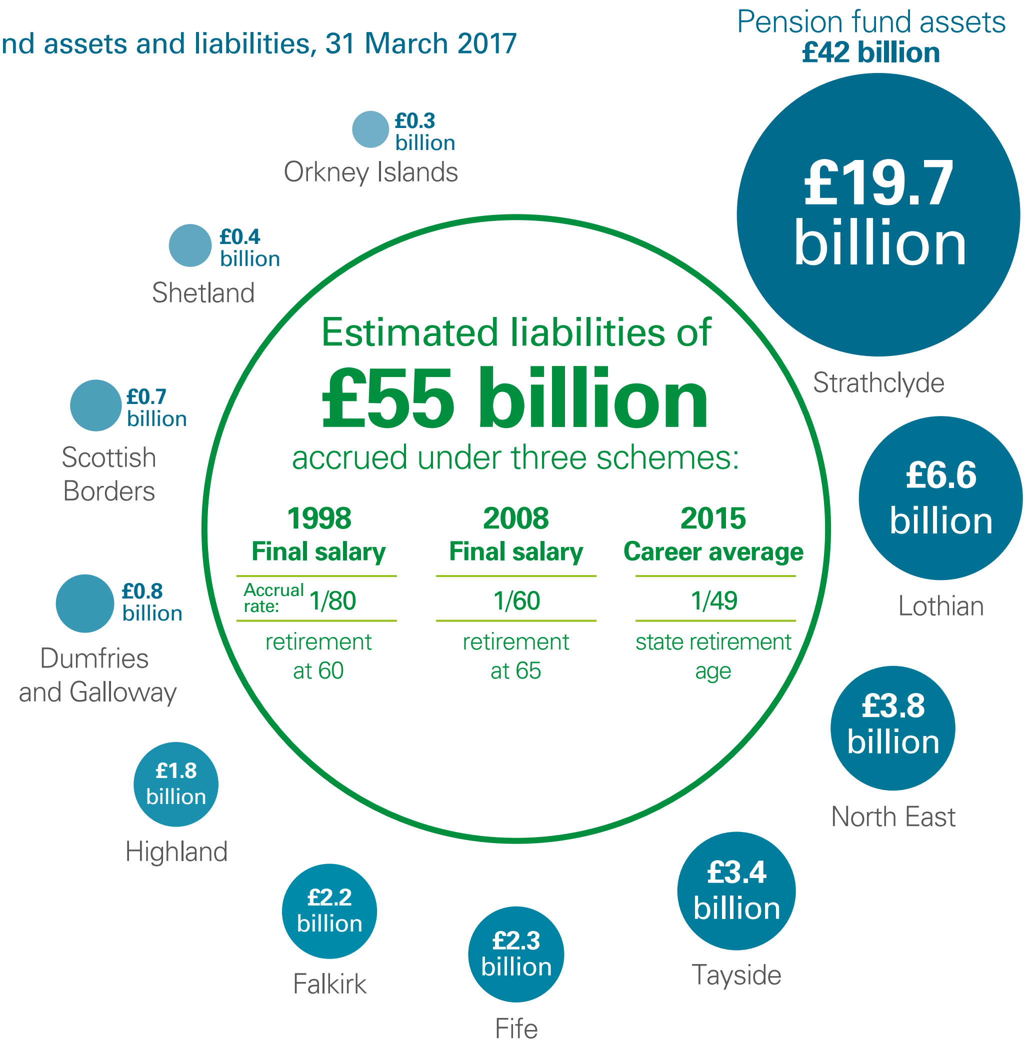
ACCOUNTS COMMISSION

Introduction

1. This supplement accompanies our Local Government in Scotland: Financial Overview 2016/17 and provides an overview of the LGPS in Scotland. We have drawn on the annual reports and accounts of the 11 pension funds administered by councils in Scotland and on the reports of their appointed auditors. In this, the first year of new five year auditor appointments, we are pleased that all 11 pension funds received an unqualified audit opinion on their accounts.

2. It was a good year for pension fund assets, which increased from £34.5 billion to £42 billion. However, the estimated value of liabilities also increased from £42 billion to almost £55 billion (Exhibit 1).

Exhibit 1
LGPS Scotland assets and liabilities, 31 March 2017



Source: Pension Fund Annual Accounts 2016/17

3. The estimated value of LGPS liabilities is in respect of all scheduled and admitted bodies not just councils. Councils have pension liabilities associated with added years awarded on retirement that do not fall on the pension fund and are not included in **(Exhibit 1, page 1)**. Council net pension fund liabilities as at 31 March 2017 were estimated to be £11.5 billion (including unfunded liabilities).

Governance and administration

4. This is the second year of the LGPS 2015 scheme, which links pension benefits to career average earnings (a move away from final salaries under the previous LGPS schemes). We reported last year that pension funds had coped well with the introduction of the scheme and associated governance arrangements, but that the outlook remained challenging.

5. The new governance arrangements introduced under the 2015 scheme are more complex than under the previous LGPS schemes, with more stakeholders being involved. The range of stakeholders is shown in Exhibit 2 (page 3).

6. During 2016/17 the Scottish Scheme Advisory Board reported to the Scottish Minister on the future structure of the LGPS in Scotland. The report has not been made public so any proposed changes to the structure of the LGPS in Scotland are unclear. Irrespective of any proposed changes, a number of pension fund annual reports highlight plans for greater collaboration.

7. A survey[1] undertaken by the Pensions Regulator across all UK public service schemes found improvements in ensuring and demonstrating compliance with the public service code of practice on governance and administration. Auditors confirmed that LPGS pension funds in Scotland had improved arrangements and procedures in this area.

8. During the year the Scottish Public Pensions Agency (SPPA) commissioned KPMG to review governance across all public service pension schemes in Scotland.[2] One of the key issues raised by KPMG is whether there would be benefit in clarifying the role of the LGPS pension boards established under the 2015 LGPS scheme. The remit of LGPS pension boards goes beyond that for other public service schemes, requiring them to consider any pensions matters they deem relevant. The risk is that LGPS boards become overstretched and do not adequately assist scheme managers to comply with regulations and the public service code.

9. Councils rotated the chairs of their pension boards in 2016/17. They have also experienced wider changes in councillor membership of pension committees following the local elections in May 2017. Ensuring that elected members and appointed board members have the requisite skills and knowledge in this highly technical area is an ongoing challenge for pension funds.

Investment performance and pension fund assets

10. Overall, investments performed surprisingly well in a year where several high profile political events including the Brexit referendum and U.S. presidential results, affected investor confidence. The associated fall in the pound resulted in equity prices rising and this contributed to investment returns of around 22 per cent. Exhibit 3 (page 4) shows investment returns for the 11 pension funds.

11. The average return on LGPS investments in Scotland will be strongly influenced by the returns achieved by the larger funds, in particular the Strathclyde fund which accounts for almost 47 per cent of Scotland's £42 billion of LGPS assets.

1 *Public service governance and administration survey – Summary of results and commentary*, Pensions Regulator, May 2017.

2 *Scottish Public Service Pensions Governance Review*, KPMG, February 2017.

Exhibit 2

LGPS governance arrangements

UK

The Pensions Regulator

- Issues codes of practice on governance and administration
- Provides guidance and self assessment tool kits
- Undertakes governance and administration surveys
- Significant breaches of regulation must be reported

Scotland

Scottish Ministers

- Responsible for policy and regulations
- Currently considering a report on the future structure of LGPS

Scottish Public Pensions Agency

- Advise Scottish Ministers on public service policy and regulation
- Commissioned a review of governance in 2016/17

Scottish Scheme Advisory Board

- Advise Scottish Ministers on policy and changes
- Can advise scheme managers and pension boards
- Issued report to Scottish Ministers on future structure of LGPS

11 administering authorities

Pension Committees

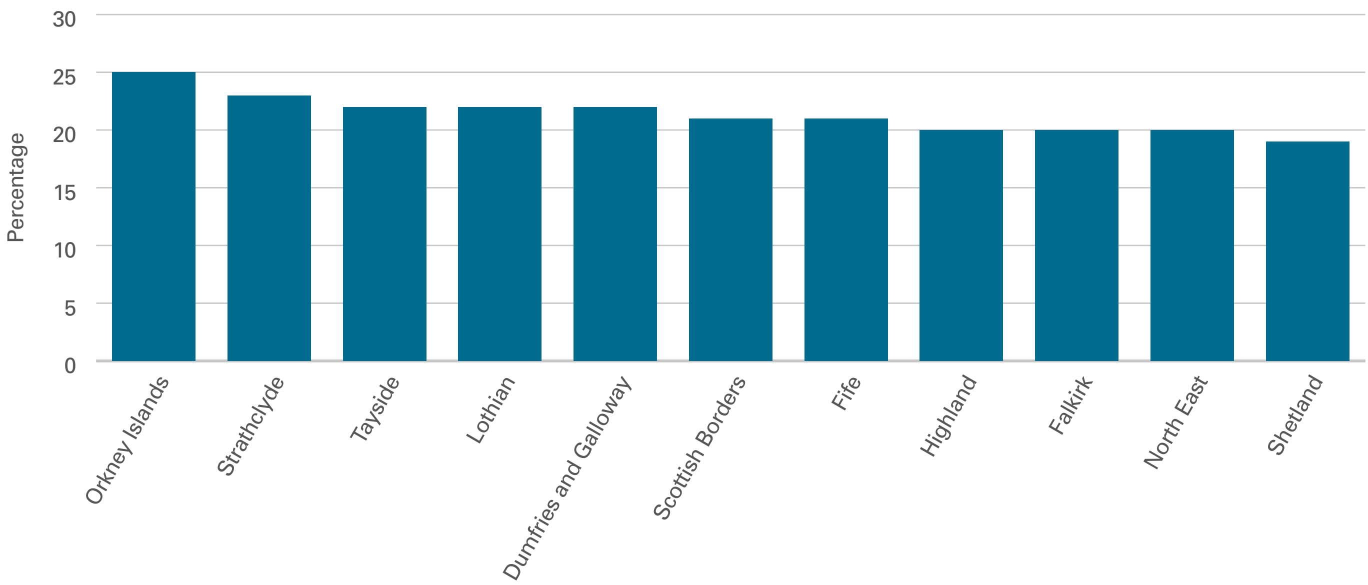
- Responsible for decisions on pension fund policy
- Composed of Councillors but may include representatives and advisors
- New members in May 2017

Pension Boards

- Supports compliance with law and regulation
- Can consider any matter deemed relevant
- Membership 50:50 employer and union representation
- May request Pension Committee to review decisions

Source: Audit Scotland

Exhibit 3
Return on investments as a percentage of opening investment assets 2016/17
Orkney had the highest investment returns in the year but is the smallest fund.



Source: Pension fund annual accounts 2016/17

12. There has been a continued interest across the pensions sector in the transparency of investment management costs. We welcome developments in this area, as even small reductions in cost arising from a better understanding and level of scrutiny can make a difference when compounded over time. In last year's supplement we expressed our support for full disclosure of costs in pension fund annual reports.

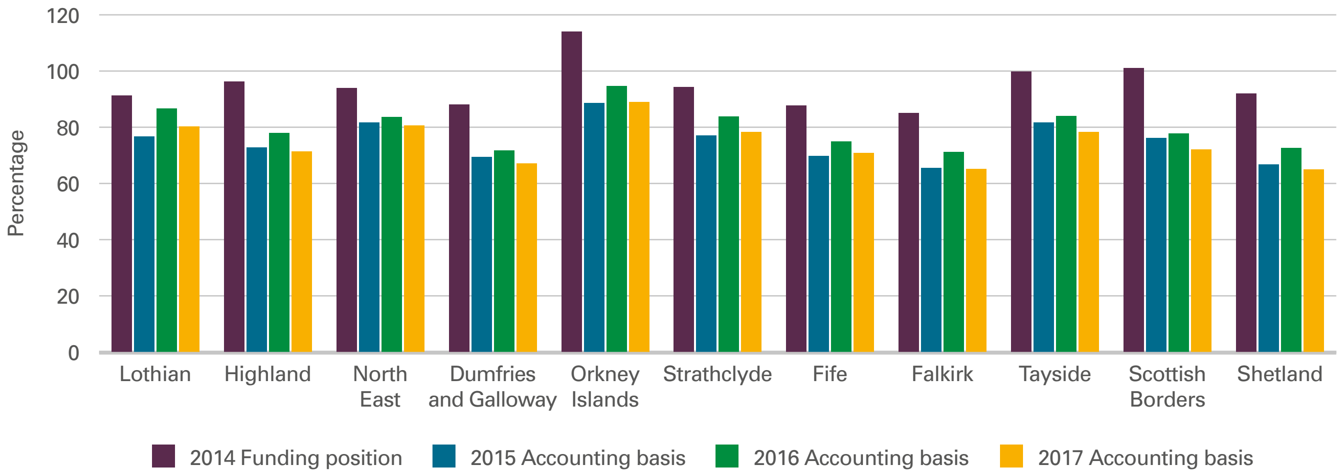
Present value of promised retirement benefits

13. Estimates of the present value of promised retirement benefits or 'pension liabilities' are required under both the pension regulations for funding valuations (forming the basis for employer contributions) and under accounting standards (for disclosure in the pension fund accounts). Funding valuations are carried out every three years whilst estimates of pension liabilities for accounting purposes are updated each year. Pension funds are currently awaiting their final funding valuations for 31 March 2017.

14. Accounting valuations produce higher estimations of liabilities and lower indicative funding levels as a result. Indicative funding levels on an accounting basis for 2017 are broadly similar to those in 2015 (Exhibit 4, page 5).

15. Actuaries will revisit their assumptions and use up to date data to calculate funding valuations as at 31 March 2017. It is this triennial funding valuation that will determine whether employer contributions will need to increase over the next three year period from 2018/19. Any increases for employers will be limited under the cost sharing mechanism in the LGPS 2015.

Exhibit 4
Pension fund assets as a percentage of estimated liabilities 2014 to 2017
Accounting valuations result in lower funding levels than those for funding purposes (2014).



Source: Pension fund annual reports and accounts

Cost control and the employer cost cap

16. Under Section 13 of the Public Service Pension Act 2013 (the 2013 Act) the Government Actuaries Department (GAD) will review the 2017 triennial valuation on behalf of Scottish Ministers. This review will look at the consistency with which actuaries have undertaken valuations in Scotland and their compliance with regulations. The review will also look at the solvency and long term efficiency of the funds and may make recommendations in relation to future cost sharing between employers and active members of the scheme.

17. The cost sharing mechanism in the LGPS 2015 is designed to ensure that the LGPS remains affordable for employers. Under this mechanism (GAD) has established a Scotland wide LGPS employer cost cap of 15.5 per cent. If the cost of providing benefits to members increases by more than two per cent above the employer cost cap then employee contributions and/or benefits will be reviewed.

18. GAD recently undertook a 'dry run' review[3] based on the 2014 funding valuations. This raised no concerns about the solvency or longer term efficiency of the LGPS in Scotland but did raise concerns about inconsistencies in valuations by different actuaries across Scotland's 11 pension funds. We understand that actuaries are looking to address GAD's concerns before reporting in 2018.

3 LGPS SCOTLAND Section 13 Dry Run Report.

Outlook

19. Pension funds face ongoing administrative pressures including those arising from:

- councils severances
- complexities of the new career average scheme.
- guaranteed minimum pension reconcilliations (with HMRC records)
- pensions auto enrolment.

20. To help to reduce their costs and improve services, pension funds are increasingly providing online services to employers and members through programmes of digitalisation. As services evolve pension funds will need to be alert to cyber security risks.

21. New regulatory arrangements for financial markets arising from Markets in Financial Instruments Directive (MIFID 2) will also impact on pension funds from 1 January 2018. MIFID 2 requires all local authorities to be treated as 'retail clients' by their asset managers which would severely limit the ability of pension funds to invest. However, the Financial Conduct Authority rules allow local authorities to opt up to 'professional investor' status allowing fund managers to continue to offer the full range of investments. MIFID 2 was designed to protect the interests of local authorities and care will be needed to ensure that opting up for pension investments does not expose the wider council to increased risks.

22. Delivering investment returns will no doubt remain a challenge for pension funds and pension fund managers. It is unclear to what extent further collaboration between funds will reduce costs and improve performance. It is also unclear whether the Scottish Minister will require pension funds to formally collaborate or propose any structural change following the recent report on the structure of the LGPS in Scotland.

AUDIT SCOTLAND

Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
T: 0131 625 1500 E: info@audit-scotland.gov.uk
www.audit-scotland.gov.uk