APPENDIX 1

Report To:	**EMPLOYER FUNDING AND VIABILITY WORKING GROUP**
Date:	12 February 2016
Reporting Officer:	Peter Morris, Executive Director of Pensions
Subject:	**ADVANCE FUNDING OF PENSION CONTRIBUTIONS**
Report Summary	This report looks at the potential benefits to the Fund and employers of supporting advance funding of contributions.
Recommendations:	To support in principle the offer to employers to pay their contributions in advance.
Policy Implications:	None.
Financial Implications: (Authorised by the Section 151 Officer)	The current return available to local authorities on their cash balances is currently approximately 0.5% per annum. In the 2013 actuarial valuation the outcome assumes an investment return of 4.8% (but actual returns will be different). This provides an opportunity on a balance of probabilities for both the Fund and employer to gain if the employer pays contributions in advance and receives a discount that is less than the assumed investment return but higher than the current rate received on cash balances.
Legal Implications: (Authorised by the Solicitor to the Fund)	This is an important proposal, which has benefits to both the employer and the Fund. It is important that all due diligence is undertaken. to ensure all relevant legislative, regulatory and accounting requirements are complied with.
Risk Management:	The key risks are the incidence of investment returns and what happens if investment returns are less than assumed. Cash flows are allocated to employers as and when received. The actual Fund return will be applied to all employer (or employer pool) assets. Thus if investment returns are better or worse than assumptions, this will be picked up at the next valuation.
ACCESS TO INFORMATION:	**NON-CONFIDENTIAL**
	This report does not contain information which warrants its consideration in the absence of the Press or members of the public.
Background Papers:	The background papers relating to this report can be inspected by contacting Peter Morris, Executive Director of Pensions.

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1. INTRODUCTION

1.1 Most Fund employers are making significant reductions to their budget and all items of expenditure are subject to detailed scrutiny and review. Employer contributions amounted to £421m in 2014/15 and this is a significant item in most employers' budgets.

1.2 Some employers will have cash balances and reserves. With interest rates exceptionally low, balances will be getting an investment return/interest of approximately 0.5% p.a.

1.3 The actuarial assumption for investment returns by the Fund in the 2013 valuation was 4.8% and this reflected interest rates and a prudent assessment of expected returns in the longer term at the date of the valuation. Looking back at the history of the Fund, this is at the bottom of the range for nominal investment returns. Looking forward in the medium term, the expectation is that a low return environment will continue. The return assumption for the 2016 valuation has not been considered.

1.4 Taking the actual return earned by employers on their balances 0.5% p.a. and the prospective returns of the Fund say 4.8% p.a. there is scope to agree arrangements with employers to give them a discount on their contributions for early payment that is greater than their return on cash balances. This report examines the basic principles and risks associated with such an approach in advance of a detailed review of the legislative, regulatory and accounting requirement.

2. WHAT ARE THE RISKS (FROM THE EMPLOYER'S PERSPECTIVE) OF PREPAYMENT OF EMPLOYER CONTRIBUTIONS

2.1 The Fund cannot guarantee an investment return; the returns will be what they are and thus in practice returns will be higher or lower than the actuarial assumption.

2.2 If returns are higher than assumption, the employer will benefit from

(i) paying less in total contributions over the period of participation in the Fund because of the discount, and

(ii) funding positions will marginally improve, because the prepayment will be attracting a return higher than the discount given;

(iii) the incidence of returns also has an impact, with higher early returns being beneficial.

2.3 If returns are lower than the discount – the employer will still benefit from paying less for the agreed period. However, the funding level will marginally decline and this will be picked up at future valuations.

3. WHAT ARE THE BENEFITS FROM THE FUND'S PERSPECTIVE?

3.1 It will receive the discounted contributions earlier and if investment returns are in line or better than assumption this will make a small contribution to improving funding levels.

3.2 It should also benefit from employers being potentially a little financially stronger as a consequence.

3.3 The downside is that the administration of employer contributions will become more complex.

4. WHAT SHOULD THE DISCOUNT FOR EARLY PAYMENT BE?

4.1 In the long term, an assumed investment return of 4.8% is expected to be prudent. However, the arrangements put in place will be short term and the outlook is for a relatively low return environment. Thus there is a need for a more prudent discount rate. The appropriate rate of discount needs to be agreed with the Actuary.

4.2 The simplified implications of a 4% discount are illustrated below.

Table 1 – Implications of pre-payment of contributions

	Discount on Contributions		
Assumed period covered prepaid contributions years	**Year 1**	**Year 2**	**Year 3**
1	2%	n/a	n/a
2	2%	6%	n/a
3	2%	6%	10%

4.3 The reason why the discount is 2% in year 1 reflects that contributions are paid monthly and thus the cash benefit is based on 4% for half a year.

5. HOW WILL THIS WORK IN PRACTICE?

5.1 Further consideration needs to be given to the practicalities but it will be built around

(i) The employer will make the prepayment on 1 April

(ii) The employer will submit their normal monthly return of contributions which will reflect changes in membership such as those arising from a shrinking workforce and auto-enrolment.

6. LEGISLATIVE, REGULATORY AND ACCOUNTING ISSUES

6.1 Assuming that the principle is supported, some further work is required to ensure that there are no legislative, regulatory or accounting issues that would prevent the proposal being implemented for either the Fund and / or the employer.

6.2 An easy example is that an employer is likely to struggle to find powers that would allow it to borrow to fund the prepayment

7. SUMMARY

7.1 The idea of prepayment of contributions is likely to be attractive to some employers.

7.2 More detailed work is required on legislative, regulatory and accounting matters to confirm the feasibility and further consideration is required on the practical issues.

8. RECOMMENDATION

8.1 To support in principle the offer to employers to pay contributions in advance.