Prepared by Audit Scotland | November 2016

Local Government Pension Scheme 2015/16

ACCOUNTS COMMISSION

1. This supplement accompanies our Financial Overview of Local Government in Scotland 2015/16.

2. There are 11 council administered Local Government Pension Scheme (LGPS) pension funds in Scotland. They range from one of the biggest pension funds in the UK (Strathclyde) to one of the smallest (Orkney). Key LGPS facts are shown in Exhibit 1.

Exhibit 1
Scottish Local Government Pension Scheme–key numbers

Membership

Active **226,000**
Deferred[1] **126,000**
Pensioner **169,000**

Assets and liabilities

Position
£34.5 billion assets
£41.8 billion liabilities (estimate)

Transactions

£1.1 billion benefits paid
£0.94 billion employer contributions
£0.27 billion employee contributions
£0.68 billion return on investments

Note: 1 Deferred pensioners are members who have left the scheme but will be eligible for benefits upon reaching retirement age

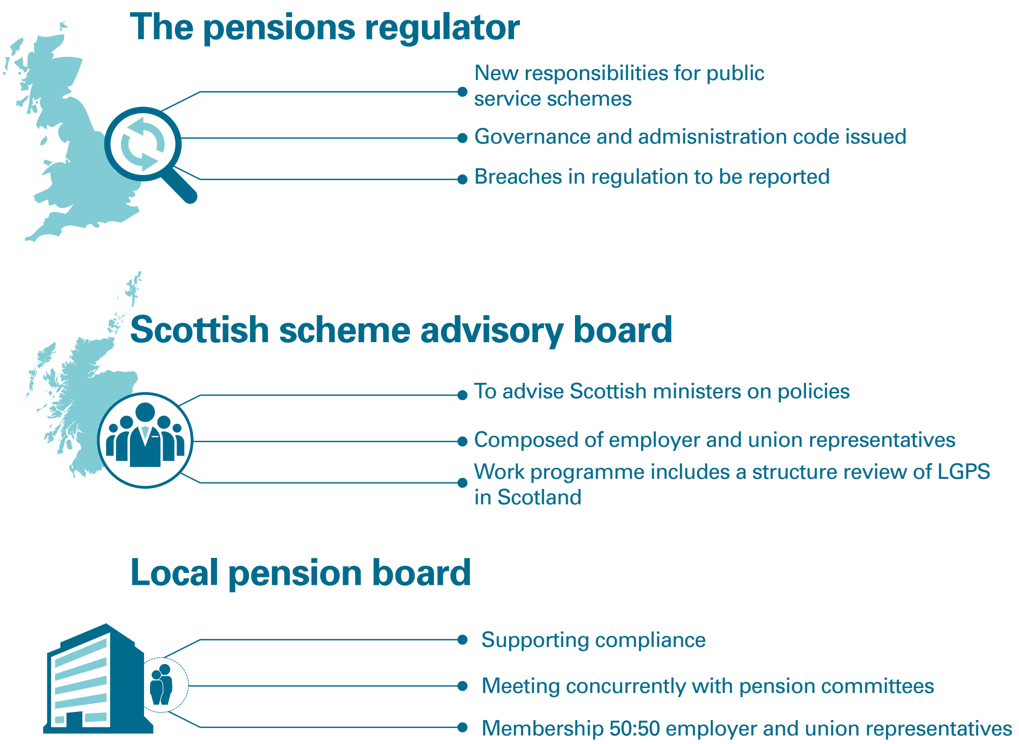
3. It has been a challenging year for the LGPS in Scotland with the introduction of the new career average revalued earnings (CARE) scheme from 1 Aril 2005, new governance arrangements at UK, Scotland and local levels and uncertainty in investment markets affecting invest returns.

4. Pension funds are required by regulation to produce an annual report and accounts and these are audited separately from the accounts of the administering council. Auditors' deemed the 2015/16 annual accounts of all 11 pensions funds to be true and fair.

Governance arrangements

5. The Public Service Pensions Act 2013 introduced significant changes to the governance framework for public service pension schemes and for the LGPS in Scotland. Exhibit 2 sets out the key changes to governance in 2015.

Exhibit 2
New LGPS governance arrangements in Scotland 2015



6. The Pensions Regulator has issued a code of practice for public sector schemes and pension funds in Scotland continue to monitor compliance with the new code assisted by local pension boards. Fund managers and advisors have a statutory responsibility to report significant breaches to the Pensions Regulator. We have not been made aware of any reports in respect of breaches in 2015/16.

7. The Scheme Advisory Board has a comprehensive programme of work and is planning to review of the LGPS structure in Scotland during 2016-17. Its review will include consideration of collective investment vehicles and the asset pooling model adopted in England and Wales.

8. At a local level all funds introduced pension boards. The role of pension boards is to support pension committees on compliance with regulations and codes. The role pension boards can play is developing, but it is clear they can also provide a useful scrutiny function. Auditors will be expected to monitor the operation of pension boards.

The new Career Average Revalued Earnings LGPS 2015

9. A new Scottish Local Government Pension Scheme was introduced on 1 April 2015. The key changes include:

- a move to benefits being worked out using career average (CARE) rather than final salary
- pension is built up at a rate of 1/49th of annual pensionable pay
- member's normal retirement age being linked to their own State Pension Age.
- A cost-control mechanism will be implemented to make sure the Scheme remains affordable and sustainable in the future.

10. Pension funds have coped well with the introduction of the new CARE LGPS with only minor teething issues reported by auditors. However, there are ongoing challenges in relation to the new scheme as record keeping is more complex than for final salary schemes and there is greater dependency on employers for complete and accurate information. Pension calculations for existing older members will be complex as many will have benefits accrued under the new 2015 scheme (based on CARE and 1/49ths) the previous 2009 scheme (based on final salary and 1/60ths) and the 1998 scheme (based on final salary and 1/80ths).

Cost control under the LGPS 2015

11. The new LGPS 2015 includes a cost control mechanism designed to ensure that the LGPS remains affordable for employers. Under this arrangement, the Government's Actuary Department (GAD) has established a Scottish LGPS cost cap of 15.5 per cent for employers (on a whole scheme basis). If the cost in relation to future service increases by more than two per cent above the employer cost cap, then employee contributions and/or benefits will be reviewed. We understand that employer cost cap costs will next be appraised by GAD following the 2017 triennial valuation and that the earliest cost sharing could start would be 2019.

Investment returns and expenses 2015/16

12. A number of LGPS funds saw negative investment returns on their assets in 2015/16, as shown in Exhibit 3 (page 4). This was influenced by increased uncertainty in global investment markets, low inflation and low growth. The outlook for investment management remains challenging with ongoing volatility and uncertainty in global markets following important events such as Brexit and the US presidential election.

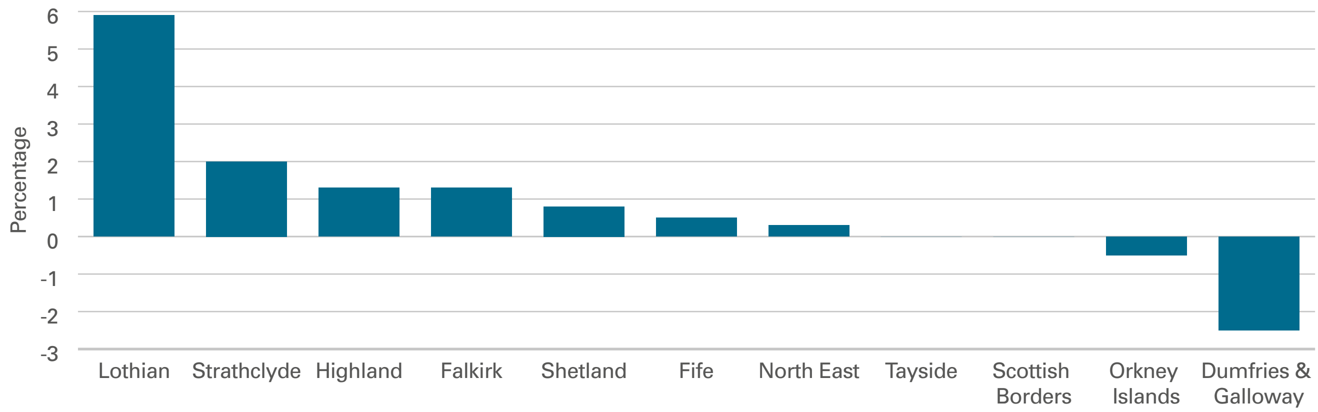
13. Although pension funds manage their investments in line with the same regulatory and governance regimes they have differing strategies and arrangements. Investment management is a complex area and funds make use of external advisers and managers. The full costs of investment management are not always fully transparent and there has been increased scrutiny and changes to guidance around accounting for these costs in recent years.

14. In 2015/16 we saw a divergence in approach by pension funds to the inclusion of investment management expenses in their annual accounts. Revised accounting guidance for 2016/17 emphasises that pension funds' financial statements should only include costs for which they are directly liable, or are within their control. The Accounts Commission is encouraged by the commitment of Scottish funds to full transparency around investment management costs charged and supports indirect expenses being reported in the wider annual report.

Exhibit 3

LGPS pension funds – Net return on investment 2015/16

In 2015/16, four funds saw negative returns on investments.



Source: Pension Fund accounts 2015/16

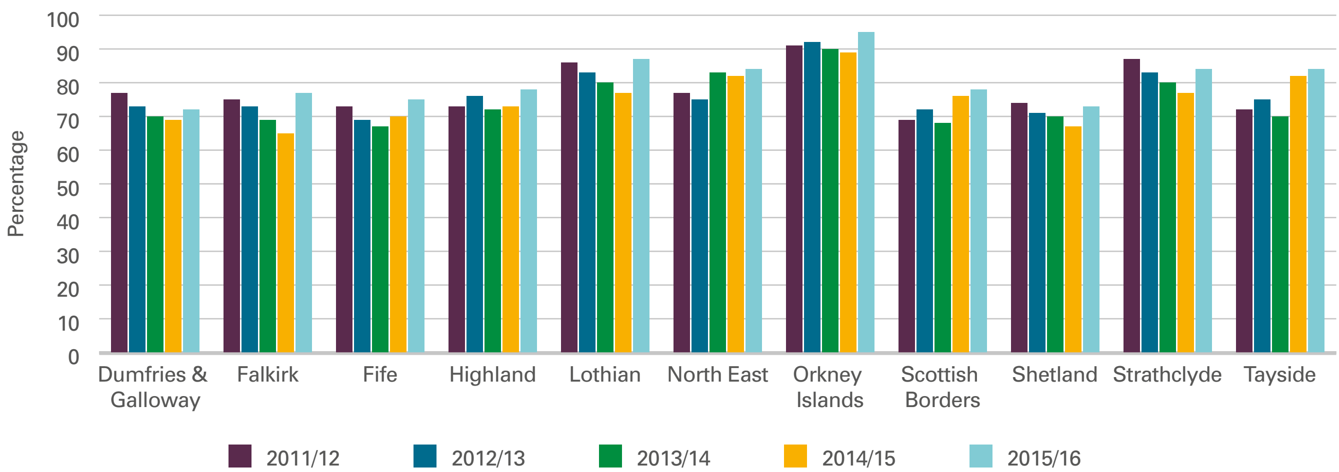
Present value of promised retirement benefits

15. Pension fund accounts include a disclosure of the present value of promised retirement benefits. This value of this liability is an estimate made by actuaries based on a number of assumptions about the future and the figure is quite sensitive to changes to those assumptions. The Liability can be compared with the assets of the pension fund at a point in time and Exhibit 4 shows the valuation of pension fund assets as a proportion of liabilities for each of the last five years.

Exhibit 4

Pension fund assets as a proportion of the present value of promised retirement benefits

The position of all funds improved in 2015/16.



Note: The Scottish weighted average is close to that for Strathclyde which is by far the biggest pension fund in Scotland and one of the biggest in the UK.

Source: Pension Fund accounts 2011/12–2015/16

16. The percentages shown in Exhibit 4 will typically be lower than those calculated by actuaries for the triennial funding valuations which are then used to set employer contributions. This is because the assumptions that can be used for accounting purposes are more tightly prescribed.

17. The overall Scottish LGPS net pension deficit at 31 March 2016 was £7.3 billion. Pension fund deficits are included in employers' accounts. Pension funds have arrangements to recover deficits over periods of up to 20 years in some cases, depending on the risk status associated with individual employers.

18. Pension deficits and employer contributions are complex areas and it can be difficult to establish differences between pension funds from their annual reports. Greater transparency and consistency of reporting in this an area would be beneficial to an understanding of the LGPS in Scotland.

Outlook

19. At a time when councils are under increasing financial pressure, administrative workloads will remain high as councils: continue to reduce their workforces and deal with auto enrolment; refine how they administer the new LGPS; embrace new online technologies to improve information flows with employers and members; deal with recent changes to pension scheme governance; and changes to the UK state pension arrangements.

20. The low inflation and low growth economic outlook together with uncertainty on the financial markets means that investment management will remain challenging at a time when investment performance is key.

21. The new cost control mechanism should help ensure that the LGPS remains affordable for employers in respect of active members although it does nothing to reduce the costs of pensions in payment and the associated deficits.

22. The Scottish Scheme Advisory Board is currently undertaking a structural review of the LGPS in Scotland. The outcome of this review is clearly of pivotal importance to the shape of the scheme and to administration costs going forward.

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