

## PENSIONS ISSUE

### Issue

1. To inform MHS Board members about MHS pension issues, particularly the results of the LGPS 2004 valuation and subsequently the accounting for the LGPS deficit in the 2004/05 Accounts.

### Background

2. The MHS contributes to two pension schemes – the Principal Civil Service Pension Scheme (PCSPS) and the Local Government Pension Scheme (LGPS), operated by the London Pensions Fund Authority (LPFA).
3. PCSPS – this final salary scheme is an unfunded scheme, where the cost of contributions are met from delegated budgets and the cost of pension liabilities is met from annual Government funding. Approximately 550 MHS employees are currently members of this scheme and all new employees are eligible only to join this scheme. Until and including 2004/05, contributions have ranged from 12% to 18.5%, depending on the grade of the relevant employee. From 2005/06, the rates have increased by the Government Actuary to between 16.2% and 24.6% as a result of a predicted significant overall scheme under-funding. Further increases to between 17.1% and 25.5% are already planned for 2006/07. The Treasury has increased the FSA's baseline to cover this increase.
4. LGPS – this is a funded defined benefit scheme based on final salaries, where pension liabilities are determined by triennial valuations by the Fund's actuaries and contribution rates normally fixed for the period between each valuation. Contributions are invested in line with the scheme's investment strategy to meet future pension liabilities. The majority of MHS staff (approximately 900) are members of this scheme, largely as a result of their transfer from previous local government employment when the MHS was established in 1995.
5. Many organisations have removed defined benefit schemes because of recent poor investment performance and replaced them with money purchase schemes.
6. Pensions funding and management is a concern of the current Government and recent proposals to change some of the conditions of local authority schemes resulted in a strike mandate for public sector unions, following a ballot of their members, prior to the general election. There are also proposals to change the PCSPS to pay a pension based on an average salary during employment rather than on a final salary.

## LGPS Valuation 2004

7. The last valuation of the LGPS was concluded as at the end of March 2004, the results of which were communicated to the MHS in February 2005. A deficit of **£26 million** as at March 2004 was indicated relating to MHS' proportionate share of the scheme, having increased significantly from £4 million in 2001 due to poor investment performance and increasing pension liabilities. As a result of the growth in pension liabilities, exaggerated by the fact that the MHS operates this scheme as a closed scheme, the contribution rate has been increased from 14.3% in 2004/05 to 15.6% for the next three years. In addition, a phased repayment of the £26 million deficit has been agreed for the next three years - £160K in 2005/06, £1.6million in 2006/07 and £3.2 million in 2007/08 based on a recovery over 20 years. The delegated budget from the FSA for 2005/06 and the indicative budget for 2006/07 covers the first two years' repayments. However, the indicative budget for 2007/08 does not fully cover the 2007/08 repayment, and has a shortfall of £1.6 million.

## Financial Reporting Standard (FRS) 17 Calculation for 2004/05

8. In the preparation of the MHS Annual Accounts for 2004/05, the provisions of Accounting Standard FRS 17 have been applied, i.e. for a funded scheme that is a defined benefit scheme, a pension deficit should be accounted for and fully disclosed in the Accounts. This therefore applies to the LGPS but not the PCSPS. It is also the first time that this figure has been available from LGPS for Annual Accounts disclosure. The Standard was developed to ensure transparency on pension funding for readers of the Accounts. [Valuation methods to ensure comparability across Accounts under FRS 17 may result in a different valuation than that of the scheme's actuaries to inform contributions, which is based on the scheme's investment strategy.]
9. For accounting purposes as at 31 March 2005, the calculation received from LGPS now indicates a deficit of **£45.1 million**, having risen from **£42.6 million** as at March 2004 under this revised calculation. The effect on the operating cost statement for 2004/05 is **£2.5 million cost**, offset by **£1.5 million reduction in cost** from notional cost of capital interest credit based on the average pension liability. The previous deficit balance as at March 2004 (£42.6 million) will be restated in the Balance Sheet as a prior period figure, i.e. with no effect on the operating cost statement but resulting in an elimination of reserves, previously £5 million as at the end of March 2004.

## Future Action

10. LGPS currently estimate a **£1 million** additional operational cost for 2005/06 applicable to the pension liability determined under FRS 17.

This may be offset by a similar amount for notional cost of capital interest credit.

11. Following the conclusion of the year-end Accounts process, a review of the 2004 LGPS valuation, assumptions used by the LGPS' actuaries and the administrative and legal obligations applicable to the scheme will be undertaken, taking advice from the FSA and Government Actuaries Department. This review is planned to be completed by October 2005.
12. Options to meet future LGPS pension liabilities will be proposed and are planned to be presented to the MHS Management Board.
13. Agreement will be sought with the FSA by the end of July 2005 on how the accounting requirements should apply to the MHS resource budget and targets.

### **Conclusion**

14. The significant deficit arising from the LGPS 2004 valuation and LGPS' subsequent estimation for accounting purposes as at March 2005 and projected deterioration in 2005/06 has triggered the need for a comprehensive review of the results and the commitments to this pension scheme. Options are to be proposed for future coverage of the liabilities.
15. Board Members are asked to **note** the observations made in the paper.

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