SUPPLEMENT 2

Prepared by Audit Scotland | December 2019

Scottish Local Government Pension Scheme 2018/19

ACCOUNTS COMMISSION

1. This supplement accompanies our report *Local government in Scotland: Financial overview 2018/19*. It provides an overview of the Scottish Local Government Pension Scheme (SLGPS).

2. There are 11 main funds in Scotland, which cover all 32 councils and around 500 other employers. There are also a number of other funds – often 'Transport Funds' but unless otherwise identified, our comments refer to the 11 main funds. They range from one of the biggest pension funds in the UK (Strathclyde) to one of the smallest (Orkney).

Key messages

- SLGPS funding levels have reduced compared to last year and across Scotland the average funding level for 2018/19 is at 82 per cent. The value of scheme liabilities increased by 13 per cent, more than the growth in assets of seven per cent.
- Across the SLGPS, total contribution income from current members is increasingly less than the benefits paid. The difference is now -£75 million.
- Investment returns for each fund were between 5.3 and 8.8 per cent in 2018/19. These returns are more consistent across funds than in 2017/18.
- Six pension funds didn't meet their benchmark returns last year, but most of them exceeded their five-year benchmark.
- A decision by the Supreme Court in June 2019 (the 'McCloud Ruling') came after the unaudited accounts were prepared. Funds requested revised reports from their actuaries in order to quantify the increase in estimated liabilities as a result of the ruling. The estimated combined increase in the value of promised retirement benefits totalled around £500m.
- Management expenses are under-disclosed and there is a complex relationship between risk, return and costs.

Valuations

Funding levels, on an accounting basis, have reduced compared with last year to 82 per cent

3. Triennial valuations by actuaries provide the basis for assessing the overall position of LGPS funds (funding basis) that affect future contribution rates and investment strategies. The last triennial funding valuation was at 31 March 2017. Actuaries also prepare an annual valuation on an accounting basis. This uses a lower discount rate for long-term liabilities and produces a more cautious result than the triennial valuation. Comparing the last two accounting basis valuations (at 31 March 2018 and 31 March 2019) shows that funding positions have generally reduced. The weighted average funding level across Scotland is now 82 per cent compared with 87 per cent last year.

The value of scheme liabilities increased by 13 per cent, more than the growth in assets of seven per cent

4. The funding level compares the scheme's net assets (investments) with its liabilities (future estimates of pensions liabilities valued at current prices using a discount factor). Total assets have increased, compared with last year by seven per cent to £47.7 billion. However, the value of liabilities has also increased, to a greater extent, by 13 per cent to £57.9 billion. Key factors in the valuation of the liabilities include:

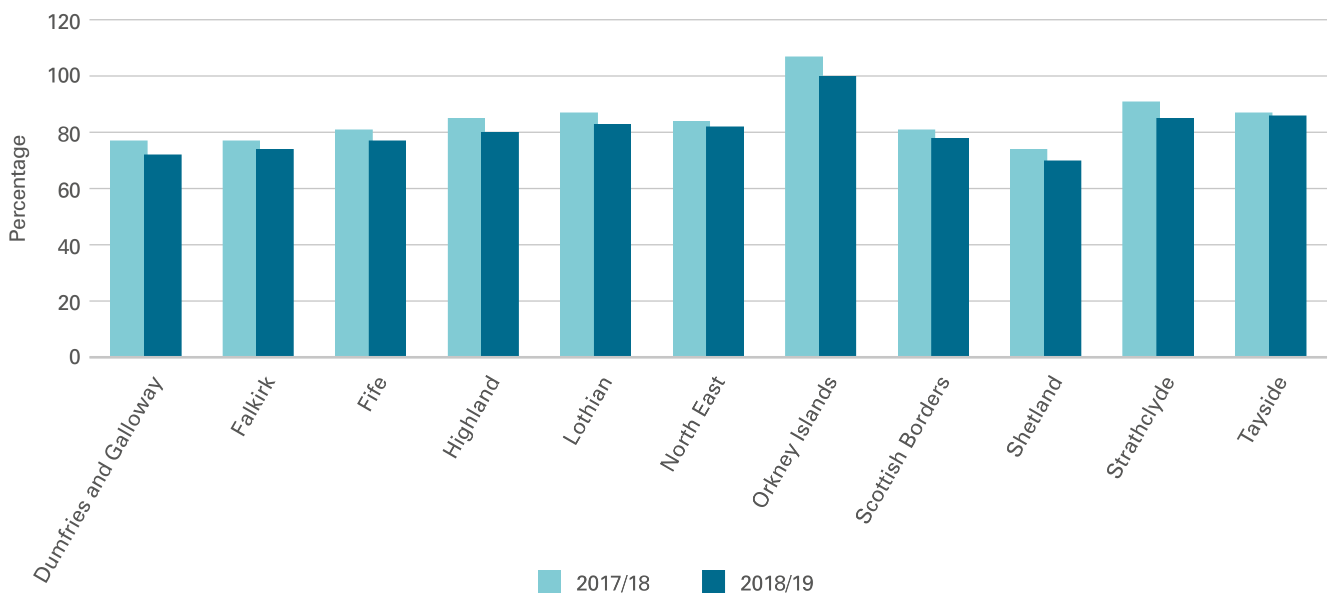
- the discount rate to convert future liabilities to current values – this is based on current 'high quality corporate bond' returns, in accordance with accounting standards
- life expectancy of members of the scheme
- inflation rate – pensions are increased annually based on the consumer prices index.

5. Typically, in 2018/19, the discount rate used in the actuaries' valuation of liabilities (2.4 per cent) was lower than in 2017/18 (2.6 per cent) (Exhibit 1), this increases the current valuation of future liabilities.

Exhibit 1

Valuation comparison between 2017/18 and 2018/19 on an accounting basis

Almost all funds identified lower funding levels this year.



Source: Audited financial statements of the pension funds 2018/19

Cash flows

Cash flows from dealing with members has become increasingly negative

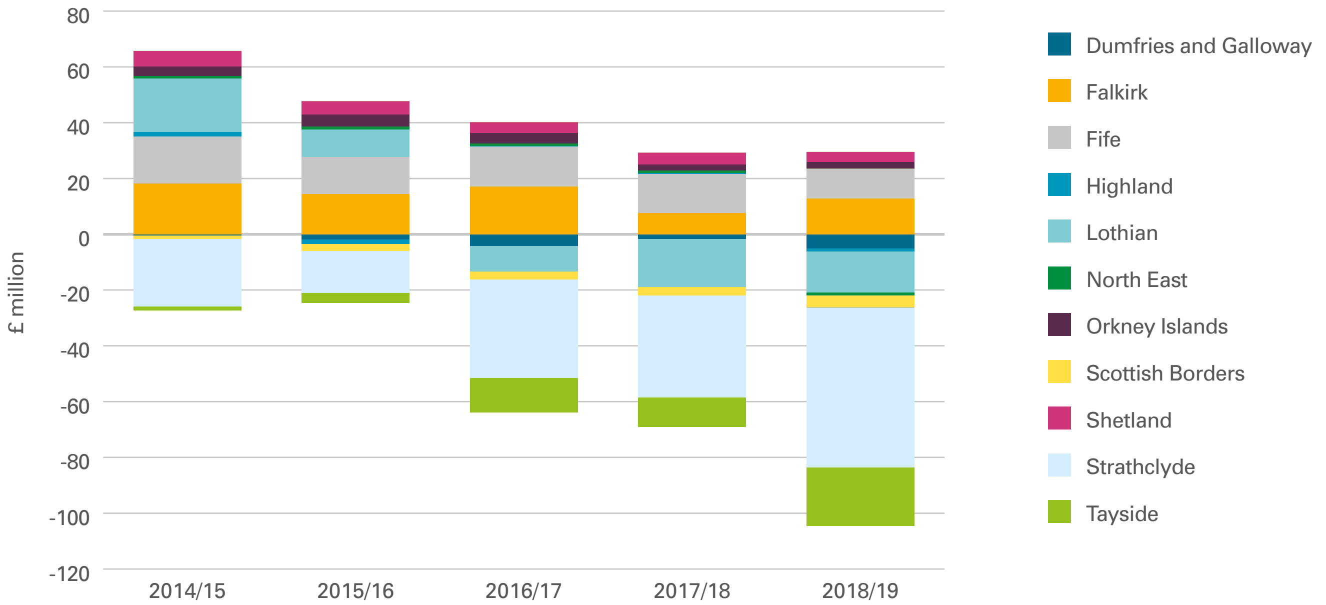
6. Membership of the SLGPS continues to grow. The numbers of both active employee members and pensioner members of the SLGPS have been increasing in recent years. This is largely a result of auto enrolment and employer severance schemes. Despite there being greater numbers of active members, this has not reversed the trend of negative cash flow from dealing with members as many of these new active members, added through auto-enrolment, are lower paid employees with lower contributions relative to pensions in payment.

7. Across the SLGPS, total benefits and administration costs exceed current contribution income. The difference is now -£75 million. This negative cash flow emerged in 2016/17 and has steadily grown (Exhibit 2). Seven funds now have negative cash flows compared to five in 2017/18. As funds mature, an element of pension payments is being made from investment returns, rather than being met from ongoing contributions from active members. It's important that funds manage the cash flow implications of this.

Exhibit 2

Cash flows from dealing with members in each of the 11 main SLGPS funds over the past five years

Cash flows from members are becoming increasingly negative.



Source: Audited financial statements of the pension funds 2018/19

Investment returns

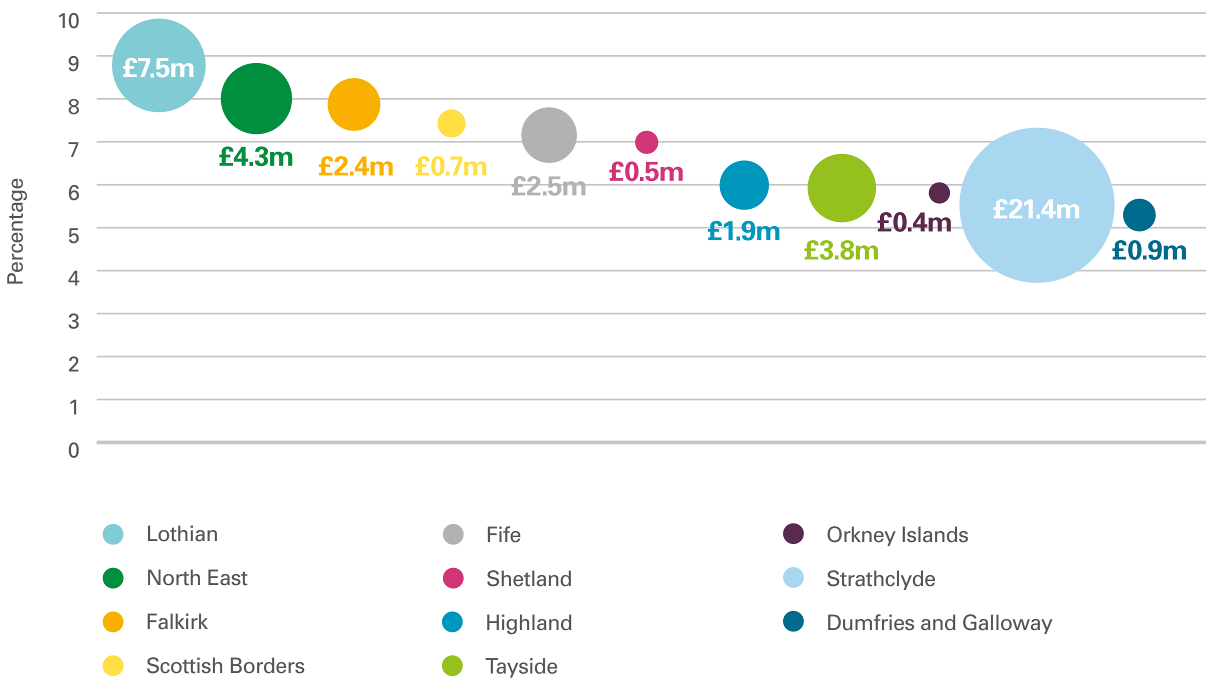
Annual investment returns were more consistent in 2018/19

8. Exhibit 3 illustrates that investment returns for each fund were between 5.3 and 8.8 per cent in 2018/19. These returns are more consistent across funds than in 2017/18.

Exhibit 3

Annual investment returns and fund size 2018/19

Investment returns across the SLGPS were between 5.3 and 8.8 per cent.



Source: Audited financial statements of the pension funds 2018/19 (investment returns net of investment expenses/average net investments)

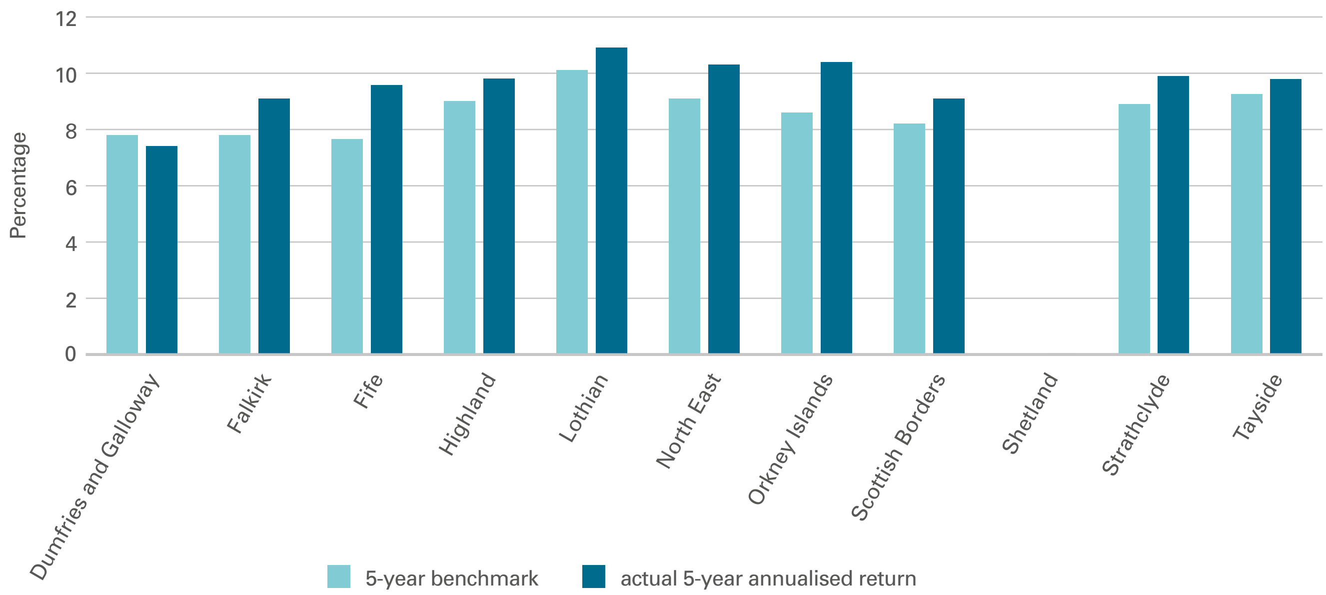
Six pension funds didn't meet their benchmark returns last year, but most of them exceeded their five-year benchmark

9. Variability of investment performance between funds can reflect differences in the type of assets that each fund holds, the way in which these are managed (passive or active) and the related risks. One way of assessing the returns in each fund is to consider how each fund has compared against its benchmarks (typically over 1 year, 3 years and 5 years). The benchmarks are set locally to reflect the different long-term investment requirements to support the future pension payments of each fund. Six pension funds reported that they had not achieved their benchmark returns over the last financial year. However, only one pension fund, Dumfries and Galloway, reported it had not achieved its five-year annualised benchmark. The five-year annualised benchmarks range from 7.8 to 10.1 per cent across the 11 main funds (Exhibit 4).

Exhibit 4

Comparison of five-year annualised investment returns of each fund

Most funds are exceeding their five-year annualised benchmark.



Note: Data not available for Shetland Pension Fund

Source: Audited financial statements 2018/19 and local auditor data

Investment strategies

Pension funds plan to reduce the value of their equity investments

10. In response to increasingly negative cash flow position noted above (Exhibit 2, page 3), most pension funds have been revising their investment strategies to place greater emphasis on cash-generating investments instead of value-generating investments. The actual investment portfolios are not currently consistent with these strategies. It can take some time for changes to take place. For example:

- Dumfries and Galloway Council Pension Fund reported that 'a strategy review was presented to Pensions Sub Committee on 24 May 2018 and members agreed the change in investment strategy from the current allocation to a modest switch from equity investments into alternative return-seeking assets, to improve the risk/return profile of the Fund.'
- Falkirk Council Pension Fund reported that 'the actual allocation at 31/03/2019 is at variance with the strategic allocation… Both Panel and Committee are content with this position noting … that the allocation to Other Real Assets (eg Infrastructure) and Non Gilt Debt (eg Private Debt) depends on the availability of suitable investments'.

11. Notably most Funds are 'overweight' in equities by between 3 and 18 percentage points. However, two funds did not identify their current investment allocation against their target in their accounts. Most funds appear to be targeting reduced equity investments with a target investment of between 55 per cent and 65 per cent in future.

Significant events

Amendments to the accounts arising from legal and other judgements

12. In December 2018, the Court of Appeal upheld a claim from firefighters and judges that changes to their pension schemes were discriminatory based on age. The UK Government sought leave to appeal the decision (commonly known as the McCloud Ruling) to the Supreme Court. However, this was denied at the end of June 2019, after the unaudited accounts were prepared. This ruling impacts on other public sector pension schemes, including LGPS, which have seen similar changes in their pension schemes.

13. Following the decision, Funds requested a revised IAS19 report from their actuary in order to quantify the increase in estimated liabilities as a result of the ruling. The estimated combined increase in the actuarial present value of promised retirement benefits for all 11 Funds was around £500m. These revised assessments do not impact on the primary financial statements of the Funds. However, the relevant disclosure notes in the audited accounts were updated to include the revised values of promised retirement benefits.

Lothian Pension Fund merged the Lothian Buses Fund with main fund

14. Apart from the main 11 funds, there a few other funds managed by councils, but the number of these separate funds is reducing. Following last year's repatriation of the Tayside Transport Fund, this trend continued with Lothian Pensions' Committee deciding in March 2018 to merge the Buses Pension Fund with the main Lothian Pension Fund. The merger took place on 1 February 2019 and resulted in the transfer of £0.5 billion of Buses Fund net asset values into the main fund, which at 31 March 2018, had a net asset valuation of £6.6 billion. The annual report notes that 'the merger creates a bespoke investment strategy for Lothian Buses within the Lothian Pension Fund and will not affect member benefits and is expected to result in more efficiencies leading to lower costs'.

15. A planned transfer of the assets and liabilities, along with members, of the Strathclyde Pension Fund No. 3 Fund to the Aberdeen City Council Transport Fund is expected to take place during 2019/20.

Outlook

SLGPS structural review is ongoing

16. As we noted in last year's pensions supplement, the Scottish Scheme Advisory Board (SSAB) is currently consulting on the future structure of the SLGPS. The report included four options for consideration:

- retain the current structure with 11 funds
- promote cooperation in investing and administration between the 11 funds
- pool investments between 11 funds
- merge the 11 funds into one or more funds.

17. The review is still ongoing, with the SSAB publishing consultation responses on its website including Audit Scotland's, which does not express a preference for any of the four options contained within this consultation exercise due to the important principle of the independence of the auditor of pension funds across the SLGPS.

Management expenses are under-disclosed and there is a complex relationship between risk, return and costs

18. The principle of value for money applies to all aspects of SLGPS operation, including the considerable cost of investment management and administration. The cost of investment management needs to be balanced with the potential for investment fund returns and risk which, when taken together, provide evidence of value for money.

19. Exhibit 5 (page 8) shows investment management and administration expenses. Across the 11 main funds, investment management expenses ranged from 0.24 to 0.83 with a median of 0.4 per cent, based on disclosures in the accounts. CIPFA guidance on investment management costs does not necessarily expect funds to include fees and expenses incurred within a pooled investment vehicle as a result of that vehicle's investment in other pooled funds in the Fund's financial statements. Therefore, the analysis is likely to understate the cost of management expenses.

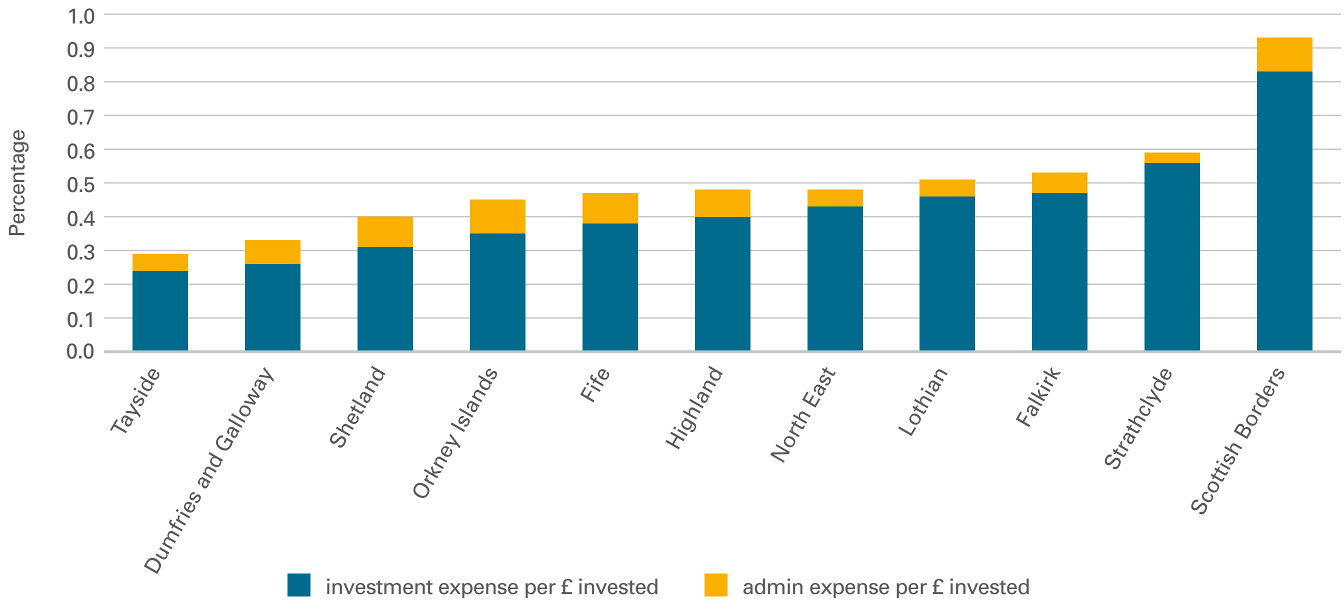
20. The margins are small, but the value of investments is significant and if the median position was achieved by all funds, this would save £36 million (16 per cent of current investment fees). However, this comparison does not take into account the complex relationship between risk and return and costs.

21. Strathclyde Pension Fund identifies that 'the level of fees and expenses paid by the Fund to individual investment managers is relative to the complexity involved in managing a particular investment asset and strategy, the associated risk and expected investment return'. Some funds will invest in passive mandates with lower investment expenses – but also lower returns and lower volatility. Some asset investment types have more significant management costs (for example infrastructure), but the extent of investment in these types of asset varies between funds according to their investment strategy.

Exhibit 5

Investment and administrative costs compared to average investment values 2018/19

Expenses are marginal but can vary according to the type of investments and mandates.



Source: Audited financial statements of the pension funds 2018/19 (investment management expenses and average assets invested)

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