

## Hexagon Housing Association Limited (“Hexagon”) Pension Strategy Review

### 1. Background

- 1.1. This paper has been prepared at the request of Hexagon to assist in a review of future pension arrangements.
- 1.2. Hexagon’s current pension provision is through the Social Housing Pension Scheme (“SHPS”). SHPS is a multi-employer scheme with around 550 participating employers. SHPS offers employers a choice of different benefit structures and allows employers to select the level of member contributions.
- 1.3. Hexagon currently participates in the 60<sup>th</sup> Final Salary (FS 60<sup>th</sup>) and Defined Contribution (DC) sections of SHPS. The FS 60<sup>th</sup> section is closed to new members (but employees who have joined in the past continue to earn benefits in this section). Membership of the DC section is offered to all new employees (and employees who have not previously joined a scheme) and is also used for automatic enrolment.
- 1.4. DB pension arrangements have the potential to generate funding deficits where the employer is required to make regularly payments as a result of the assets held not being sufficient to meet the liabilities. Hexagon is currently paying around £572,112 per annum in deficit payments to SHPS. As a result of a recent SHPS valuation, the total deficit payments required from Hexagon will increase by around £170,000 per annum from 2016. This is the fourth SHPS triennial valuation in a row which has seen an increase in deficit contributions. Against this background, Hexagon is carrying out a review of its future pension provision.
- 1.5. No part of the paper should be regarded as providing legal advice. Readers other than Hexagon should not rely on this paper for actuarial advice. Third parties should seek their own independent advice as appropriate.

### 2. Current SHPS Membership + Contributions

- 2.1. Based on the data provided by Hexagon as at May 2015, the current active contributory membership of SHPS is as follows:-

|                            |              |
|----------------------------|--------------|
| SHPS FS 60 <sup>th</sup> : | 58 employees |
| SHPS DC:                   | 79 employees |

- 2.2. Hexagon data as at May 2015 states a total annual payroll for FS 60<sup>th</sup> members of £2,050,676.
- 2.3 Member contributions to the FS 60<sup>th</sup> section are currently structured as follows:

| Age Group | FS 60 <sup>th</sup><br>% of salary |
|-----------|------------------------------------|
| <30       | 10.4                               |
| 30 to 39  | 11.4                               |
| >40       | 12.4                               |

- 2.4 Members have the option to pay the above contributions via salary sacrifice.
- 2.5 Hexagon’s contributions to the FS 60<sup>th</sup> section are as follows:  
7.4% of salaries + 2.5% closed scheme surcharge + Deficit Contributions

- 2.6 The latest completed valuation of SHPS was as at 30 September 2011. This valuation revealed an ongoing funding deficit across all SHPS employers (approx. 550 employers) of £1.035 billion.
- 2.7 Following this valuation, and based on its assessed share of the above deficit, Hexagon was required to increase its deficit contributions to the levels set out in the table below (amounts shown for the 2015/16 financial year).

| Tier                           | Annual Deficit Contributions (15/16) |
|--------------------------------|--------------------------------------|
| 1 & 2 (2005 / 2008 Valuations) | £397,923                             |
| 3 (2011 Valuation)             | £174,189                             |
| <b>TOTAL</b>                   | <b>£572,112</b>                      |

- 2.8 Tiers 1 and 2 above increase in April each year by 4.7% per annum and Tier 3 increases at the same time by 3% per annum. These deficit contributions are due to be paid in various tranches finishing between 2020 and 2026. The adequacy of these deficit contributions to fund the liabilities accrued is reviewed every 3 years with the next valuation as at 30 September 2014 currently underway.
- 2.9 Members of the SHPS DC section can pay between 3% and 7.4% of salary with Hexagon matching these contributions. Staff are auto enrolled into SHPS DC at the rate of 1% of salary (matched with a 1% of salary contribution from Hexagon). These rates due to rise to a total of 5% from 2017 and a total of 8% in 2018.
- 2.10 In addition, Hexagon is responsible for the funding of 135 deferred DB members (i.e. previous employees who have left service but not yet retired) and 92 pensioner DB members (i.e. previous employees who have retired and are currently in receipt of benefits).

### 3. 2014 SHPS Valuation – Final Results

#### Funding Deficit

- 3.1 In July 2015, SHPS published the final results of the 30 September 2014 actuarial valuation. These results revealed a significant deterioration in the scheme’s funding position with the overall deficit across all SHPS employers increasing from the £1.035 billion in 2011 to £1.323 billion in 2014.
- 3.2 The final 2014 valuation results are set out below (with the 2011 results shown for comparison).

|                | 2011 Valuation<br>(Final Results)<br>£m | 2014 Valuation<br>(Provisional Results)<br>£m |
|----------------|---|---|
| Assets         | 2,062                                   | 3,123   |
| Liabilities    | 3,097                                   | 4,446   |
| <b>Deficit</b> | <b>1,035</b>                            | <b>1,323</b>                                  |

- 3.3 In order to meet this increased deficit, SHPS are proposing to significantly increase annual deficit contributions again with effect from April 2016. The overall increase across all SHPS employers will be £31.7m per annum (an increase of

31% compared to current deficit rates). This increase will be split between employers based on each employer's share of the SHPS liabilities.

- 3.4 For the scheme as a whole (allowing for indexation to April 2016 values), the overall structure of deficit contributions from 2016 is expected to be as follows:-

| 1.4.2016               | 30.9.2020                      | 30.9.2023 | 30.9.2026 |
|------------------------|--------------------------------|-----------|-----------|
| Tier 1: 2005 valuation | £40.6m pa increasing @ 4.7% pa |           |           |
| Tier 2: 2008 valuation | £28.6m pa increasing @ 4.7% pa |           |           |
| Tier 3: 2011 valuation | £32.7m pa increasing @ 3.0% pa |           |           |
| Tier 4: 2014 valuation | £31.7m pa increasing @ 3.0% pa |           |           |

- 3.5 Hexagon's share of the above deficit contributions is will be based on its overall share of SHPS liabilities relative to other employers. As Hexagon's membership of SHPS is still accruing future liabilities (unlike a number of other housing employers), it would be expected to have an increased share of the deficit compared to the 2011 valuation (but this increase in Hexagon's deficit share is unlikely to be material over a 3 year period).
- 3.6 Hexagon have been advised that the additional deficit contributions from April 2016 will increase by £169,960.53 per annum. In addition, an increase of around £24,000 is expected as a result of indexation on current deficit payments.
- 3.7 Accordingly, Hexagon's SHPS deficit contributions from April 2016 will increase by around £194,000 per annum (subject to continuing indexation and review at following triennial valuations).

### Proposed Benefit Changes

- 3.8 In conjunction with the 2014 valuation, the following changes to members' benefits in the Final Salary sections are proposed from April 2016:-
- Increase the Normal Retirement Age from 65 to 67.
  - Reduce the cap on increases before and after retirement from 5% to 2.5%.
- 3.9 These proposed changes will affect benefits earned by members from April 2016 onwards (but will NOT affect benefits earned before this date). For example, if a member joined the scheme in 2006, the benefits earned in the 10 years up to 2016 could still be taken unreduced from age 65 but the benefits earned from 2016 onwards could only be taken unreduced from age 67.
- 3.10 Changes are subject to consultation with all active scheme members and so are not definitely confirmed to take place. However, past experience has shown that these changes are likely to be confirmed.

### Future Benefit Costs + Expenses

- 3.11 Assuming these changes are implemented then, after allowing for the change in actuarial assumptions as part of the 2014 valuation, total contribution rates are expected to increase from April 2016 by:

- FS 60<sup>th</sup>: +2.1% of salaries

- 3.12 Assuming member rates are unchanged, this means that Hexagon's benefit contribution rates will increase to 9.5% of salaries.
- 3.13 Part of the above contributions relate to the expenses of running the scheme. This is stated by SHPS as being 0.9% of salary. Accordingly, 8.6% relates to "benefit cost" and 0.9% of salary relates to expenses.
- 3.14 As part of the 2014 valuation, SHPS has stated that a change will be made to this allowance. With effect from April 2016, this 0.9% of salary expense allowance will be replaced by a monetary amount allocated in proportion to an employer's number of overall DB members. SHPS have advised that based on Hexagon's member profile as at 30 September 2014 scheme expenses from 1 April 2016 to 31 March 2019 will be £22,100 p.a.

#### **4. Other Cost Related Factors**

- 4.1 When considering and planning its future strategy, Hexagon also needs to consider the following additional 'cost related' factors:
- 4.2 With effect from April 2016, contracting out ceases for all UK pension schemes. Accordingly, from this date, both members and employers of these schemes (which include SHPS Final Salary sections but not the DC section) will have to pay higher National Insurance contributions.
- 4.3 The increase is 1.4% / 3.4% of contracted out earnings for members / employers respectively on earning between the Primary Threshold and the Upper Accruals Point (£155 per week and £815 per week respectively in 2015/16).
- 4.4 We estimate that the additional annual cost to Hexagon as a result of the above NI changes with effect from April 2016 (but based on current salaries / membership) will be in the region of £42,000 per annum.
- 4.5 As at September 2013, it was estimated that Hexagon's overall SHPS deficit on a "buy out" basis was around £23.5 million. This deficit would be triggered if Hexagon had no remaining active members in SHPS. However, this figure is usually regarded as "academic" as current legal advice received by SHPS is that membership of SHPS DC protects against the payment of this liability.
- 4.6 Automatic enrolment was effective for Hexagon from 2014. SHPS DC contributions will need to increase from their current level of 1% / 1% to a total of 5% from October 2017 and a total of 8% from October 2018. This additional cost will need to be budgeted for.
- 4.7 With effect from the 31 March 2016 accounting year end, Hexagon will be required to report the value of its future SHPS deficit requirements in its balance sheet. Previously, as a result of the multi-employer structure of SHPS, it was only required to report this in the notes to the accounts.
- The actual amount to be reported will depend on financial conditions as at the accounting date but would be expected to be in the region of £4.5m to £5m. This figure will then vary in subsequent years based on both market conditions and future SHPS deficit requirements.
- 4.8 The Annual Allowance (AA) is the maximum amount of tax-free pension savings which can be made to a pension scheme in any one tax year. The AA for

2015/16 is £40,000 but this may be increased or reduced in subsequent years as a result of legislation.

The Lifetime Allowance (LTA) is the overall aggregate limit on pension savings which can be made to pension schemes over an individual's working life, above which tax charges are triggered. The current LTA is £1.25m but, again, this may be increased or reduced in the future. In fact, the LTA is being reduced to £1m from April 2016.

Hexagon needs to be aware that the provision of benefits in the SHPS FS 60<sup>th</sup> for higher paid employees carries a risk that the AA will be exceeded. Members particularly at risk are longer serving employees who are granted a pay rise significantly above inflation. Exceeding the LTA is less likely but it remains a risk for higher paid employees who have been in a final salary type arrangement throughout their career. This risk will be enhanced from April 2016 when the LTA reduces to £1m.

Even though the tax position is the responsibility of the individual employee, Hexagon will need to be aware when deciding on both its pension strategy and remuneration policy for senior employees that there may be subsequent tax consequences. We would therefore recommend that LTA and AA calculations are undertaken for members of the executive team, together with any other employees earning £60,000 or more. Results from these calculations can then be discussed with individual members on a confidential basis.

## 5. Post April 2016 Pension Costs

- 5.1 Hexagon's pension costs for the year to 31 March 2016 are expected to be as follows (based on membership / salary data provided by Hexagon as set out in section 2 of this paper):-

| Scheme / Cost Element                          | Hexagon Cost<br>year to 31 March 2016<br>£000's |
|--|---|
| SHPS FS 60 <sup>th</sup> (Benefit Rate: 7.4%)* | 152   |
| Closed Scheme Surcharge (2.5%)                 | 51  |
| SHPS DC  | 45  |
| SHPS Deficit Contribution                      | 572   |
| <b>Total</b>                                   | <b>820</b>                                      |

Note:

\* SHPS FS costs based on the membership / salary information provided by Hexagon as at May 2015. These figures have not been verified against Pensions Trust membership / salaries as at May 2015.

\*\* This includes the costs for the current DC members as well as the auto enrolment. Please note that these costs relating to auto enrolment will increase from October 2017 and again from October 2018.

- 5.2 Based on the outcome of the 2014 SHPS valuation and the additional cost factors set out in section 4 of this paper, Hexagon's pension costs are expected to increase for the year to 31 March 2017 as follows:-

| Scheme / Cost Element                          | Hexagon Cost year to 31 March 2017 £000's |
|--|---|
| SHPS FS 60 <sup>th</sup> (Benefit Rate: 8.6%)* | 176                                       |
| Closed Scheme Surcharge (2.5%)                 | 51  |
| SHPS Expense Allowance                         | 22  |
| SHPS DC **                                     | 45  |
| SHPS Deficit Contribution                      | 766                                       |
| Additional National Insurance Cost             | 42  |
| <b>Total</b>                                   | <b>1,102</b>                              |

## 6. Potential Options

6.1 Hexagon has a number of options with regards to its future pension strategy.

6.2 Hexagon's current pension strategy can be summarised as follow:-

- FS 60<sup>th</sup> closed to new entrants;
- DB member contributions - FS 60<sup>th</sup>: 10.4%/11.4%/12.4%
- SHPS DC open to new members / automatic enrolment

6.3 Hexagon needs to consider a number of questions with regards to its future pension strategy i.e.

- Should the current structure remain unchanged?
- Should FS 60<sup>th</sup> remain open for future accrual?
- Should FS 60<sup>th</sup> members be moved to a lower benefit (e.g. CARE 60<sup>th</sup> or 80<sup>th</sup>)?
- Should member contributions be increased (or reduced) in conjunction with one of the above changes?
- Should SHPS DC be used just for new members or for all staff?

6.4 In order to illustrate the potential cost impact of various options linked to the above questions, the remainder of this section sets out the projected annual cost for the 2016 / 17 financial year under a range of options. In all these options existing SHPS DC members and options for new employees remain unchanged. The options selected are as follows:

|          | Current DB Members    | Member Rates     | Employer Benefit Rates |
|----------|-----------------------|------------------|------------------------|
| <b>A</b> | FS 60 <sup>th</sup>   | No change        | + 2.1%                 |
| <b>B</b> | FS 60 <sup>th</sup>   | + 1.0%           | +1.1%                  |
| <b>C</b> | FS 60 <sup>th</sup>   | + 2.1%           | No change              |
| <b>D</b> | CARE 60 <sup>th</sup> | New rate – 8.35% | New rate – 8.35%       |
| <b>E</b> | CARE 80 <sup>th</sup> | New rate – 6.3%  | New rate – 6.3%        |
| <b>F</b> | DC                    | To be decided    | 8% (employer rate)     |

- 6.5 The above are simply a selection of the numerous options available. There are a number of different variations on the above options involving the use of different benefit structures and / or different member contribution rates.
- 6.6 In addition to the projected cost for the 2016 / 17 financial year, the table below also provides a subjective “risk rating” linked to each option. This risk rating relates to the risk of future cost increases (particularly with reference to the SHPS funding deficit) over future years.
- 6.7 The risk ratings provided below are, by nature, subjective. We would be happy to discuss these ratings with you.
- 6.8 The costs / risk ratings are summarised in the table below.

| Potential options   | Cost (£'000s) | Change in benefit cost <sup>1</sup> (£'000s) | Risk Rating  |
|---|---------------|--|--------------|
| (A) Current DB Members - FS 60 <sup>th</sup><br>Member rates - no change,<br>Employer rate – 8.6% | 1,102         | 25   | High         |
| (B) Current DB Members - FS 60 <sup>th</sup><br>Member rates - + 1%,<br>Employer rate – 7.6%      | 1,083         | 4  | High         |
| (C) Current DB Members - FS 60 <sup>th</sup><br>Member rates - +2.1%,<br>Employer rate – 6.5%     | 1,060         | -18  | High         |
| (D) Current DB Members - CARE 60 <sup>th</sup><br>Member & employer rates – each<br>8.35%         | 1,098         | 19   | High         |
| (E) Current DB Members - CARE 80 <sup>th</sup><br>Member & employer rates – each<br>6.3%          | 1,056         | -23  | High/Medium  |
| (F) Current DB Members - DC<br>Employer Rate - 8%   | 1,040         | 12   | Medium / Low |

**Note**

1. Change in benefit cost represents the difference between existing 7.4% and new employer rate. Note that expenses have been removed from the benefit rates and are now payable in addition (see sections 3.11 to 3.14).

## 7. Key Considerations

- 7.1 Firstly, it must be remembered that pension benefits are offered in order to assist staff in securing their financial future and are highly valued. As a paternalistic employer, Hexagon will need to consider the impact on staff of any changes. In addition, the provision of SHPS Final Salary benefits at their current level is likely to be a key part of Hexagon’s employee benefit package. The effect of any changes on retention needs to be considered.
- 7.2 Any change to benefits will only impact future provision. The benefits built up in the past cannot be changed and will still need to be funded. Accordingly, whatever changes are made will have no effect on the potential for deficits to arise on these past benefits already accrued.

- 7.3 The materiality of any potential saving in cost should be considered relative to overall staff expenditure. The benefit package should be viewed 'as a whole' rather than looking at pensions in isolation.
- 7.4 Increasing member rates at the same time as the proposed changes to Final Salary benefits are implemented (i.e. increased retirement age and reduced cap on pension increases) will be difficult to justify. In addition, members' NI rates will increase from April 2016 making any other contribution rate increase less affordable.
- 7.5 However, Hexagon needs to consider the long term cost impact / risk of continuing with DB pension provision. In the short term, any change to benefits / contributions is likely to have minimal cost saving (and may actually cost more). However, in the longer term, the more DB benefits built up, the higher the financial risk to Hexagon.
- 7.6 SHPS' policy is to share any future deficit contributions in proportion to each employer's share of the overall SHPS liabilities. Given the experience of other employers, continuing to build up benefits in the DB sections is likely to result in Hexagon's % share of any future SHPS deficit continuing to increase.
- 7.7 A number of housing employers have already switched current DB members to SHPS DC or a similar DC arrangement.
- 7.8 With effect from April 2016, new accounting requirements are being introduced which will require Hexagon to include the present value of future deficit contributions on its balance sheet. This provision plus changes from year to year may affect the view of Hexagon's covenant and its ability to raise capital.
- 7.9 The long term cost saving of moving current FS 60<sup>th</sup> members to a lower benefit scale could be used to fund improved benefits for the majority of other staff.
- 7.10 Currently Hexagon operate an age related contribution basis for members. As all members are now over 40, Hexagon are effectively over paying by 0.4% of total DB salaries (circa £8K) per annum. If a decision is made to retain DB pension accrual we would recommend that Hexagon ceases using age related contributions.
- 7.11 The effect of automatic enrolment and the cost increases expected in 2017 and 2018 needs to be allowed for.

## **8. Member Communication**

- 8.1 During the second half of 2015, Hexagon will need to consult with staff on the proposal to increase normal retirement age and reduce the cap on pension increases from April 2016. This consultation period will need to be for a minimum of 60 days. Also, if Hexagon decides that it wishes to change members' benefits and / or contributions then consultation with all staff will be required. Again, this will need to be for a minimum period of 60 days and can run concurrently with the consultation on SHPS benefit changes.
- 8.2 Final Salary members will need to be notified of the increase in their National Insurance contributions that will take effect from April 2016.
- 8.3 Assuming changes are to take place from April 2016, SHPS require a completed form of authority by 31 January 2016. Therefore, we would recommend that any consultation is completed by 31 December 2015 to allow time to consider staff feedback.

- 8.4 If significant changes to benefits are proposed then we would recommend that the consultation process includes staff presentations to provide an explanation of the proposed changes and to give staff the opportunity to raise questions.
- 8.5 Staff 'one to one' pension sessions could also be arranged either as part of the consultation or prior to the implementation date to assist staff in understanding the changes and the decisions they will need to make in planning for the future.
- 8.6 A potential timetable for action is as follows:

| Month        | Action  |
|--------------|---|
| Jun 15       | Exec meeting + subsequent consideration<br><b>(Completed)</b> |
| Jul 15       | Final SHPS valuation results published <b>(Completed)</b>     |
| Sept 15      | Second Exec meeting / Board meeting                           |
| Oct / Nov 15 | Staff consultation period - Staff letters / presentations     |
| Dec 15       | Directors consider responses                                  |
| Jan 16       | Board decisions   |
| Jan 16       | Notify SHPS of changes  |
| Jan / Feb 16 | Staff presentations / 'one to one' sessions                   |
| Mar 16       | Member decision forms   |
| Apr 16       | Changes implemented + cost increases occur                    |

## 9. Conclusions / Recommendations

- 9.1 In view of increases to both the deficit contributions and the future service funding rates, combined with the inherent long term risks associated with Defined Benefit pension provision, we would recommend that the Final Salary 60<sup>th</sup> Section is closed to future accrual after consultation with the affected employees.
- 9.2 Following closure, employees would be offered membership of the SHPS Defined Contribution Section and we would recommend that the Board consider paying additional contributions to the affected members for a set period.
- 9.3 In addition to closure of the Final Salary Section to future accrual, we would also recommend that due to the reduction of the Lifetime and Annual Allowance from April 2016, calculations are undertaken in respect of senior employees to ensure they are aware of their tax position and whether they should take any action.

**Tony Barnard**  
**First Actuarial**  
**18 September 2015**