# **Hexagon Housing Association Ltd**

# **Board of Management**

**29th September 2015**

###### Agenda Item 8

**Proposed changes to pension arrangements – proposed consultation**

**Report by the Chief Executive**

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| ***1.0*** | ***Summary*** |
|  | This report describes the existing pension arrangements within Hexagon and makes several recommendations which arise from a recent revaluation carried out by the Social Housing Pension Scheme and from a separate report received from our pension advisers, First Actuarial (see **Appendix A**).  The main proposal in this paper is that the existing Defined Benefit scheme, which was closed to all new members six years ago, is closed to existing members as well from 1 April 2016. This follows the latest pension re-valuation figures. As the proposal is subject to a staff consultation, a further interim update will be provided at the November Board, and a final report with a recommendation will come back to the Board in January 2016. |
| ***2.0*** | ***Recommendations*** |
| 2.1 | That the Board approves the **RECOMMENDATION** that we consult staff on closing the Defined Benefit (DB) Scheme to existing members and offer them the opportunity to switch to the Defined Contribution (DC) scheme which is currently available to all other staff. |
| 2.2 | That we also consult staff on a proposal to provide ‘transitional relief’ by paying a time limited additional payment of 2.6% for 3 years (up to a maximum of 10%) to all members of the Defined Benefit Scheme who switch into the DC scheme in recognition of the impact of the closure. |
| 2.3 | That the Board receives an interim update at the November Board meeting as to how the contractual position of staff features in the staff feedback before a final report with recommendations is provided for the January 2016 Board meeting. |
| 2.4 | That the Board considers the implications of the changes to the annual and lifetime allowances and the implications, as outlined in Section 4.8 of the attached First Actuarial report, when the final report is produced for the Board in January 2016. |
| 2.5 | That the Board note the remainder of the report. |
| ***3.0*** | ***Background*** |
|  | Hexagon currently operates two pension schemes, both administered by the Pensions Trust as part of the Social Housing Pension Scheme (SHPS).  The only scheme that is currently ‘open’ to both new and existing staff is the SHPS Defined Contributions (DC) scheme. Defined Contribution schemes are sometimes referred to as ‘money purchase schemes’ in that the amount of pension paid reflects the investment returns generated by the fund and is not guaranteed.  The second scheme which we operate is now a ‘closed’ scheme. It is closed because it has been unavailable for new members joining Hexagon since April 2010. This scheme is a 1/60th Final Salary scheme, sometimes known as a ‘Defined Benefit’ (DB) scheme. The scheme guarantees a pension based on the members final salary (1/60th of Final Salary for each year of contribution). |
| ***4.0*** | ***Current Membership numbers*** |
|  | As at May 2015, we had 58 active members in the final salary scheme. This reflects a decrease from the 86 members who were active in the scheme when the Board last considered the revaluation report in 2012. This is a large percentage when compared to many of our peers. In the L8, for example, percentages for SHPS members range from 5-20%  We currently have 79 employees in the SHPS DC scheme. When the Board considered the revaluation results in 2012, we only had 1 member in the DC scheme. This figure increased very significantly, as anticipated, when auto-enrolment began in May 2014. |
| ***5.0*** | ***SHPS DB*** |
|  | **Revaluation Results**  The SHPS Final Salary Scheme was subject to a triennial valuation on 30th September 2014. The results revealed a significant deterioration in the scheme’s funding position.  In order to meet the increased deficit, SHPS have proposed to significantly increase annual deficit contributions with effect from April 2016. The increase will be split between employers based on each employer’s share of the SHPS liabilities.  Hexagon’s additional deficit contributions from April 2016 will therefore increase by £169,961.  In addition, an increase of around £24,000 is expected as a result of indexation on current deficit payments. These deficit payments for Hexagon currently total £572,112 (2015/16).  The net impact of these two changes is that Hexagon’s SHPS DB deficit contributions from April 2016 will increase by around £194,000 per annum.  In addition to the increased payments, in response the growing deficit, SHPS propose that the scheme benefits will be changed to be less generous moving forward. From April 2016, the scheme will be subject to the following two changes:   1. An increase in the normal retirement age from 65 to 67 2. A reduction in the cap on increases before and after retirement from 5% to 2.5%.   In addition to the deficit contributions and the reduction in benefits, the total contribution rates for the DB scheme are proposed to increase from April 2016 by 2.1% of salaries for the Final Salary 60th Scheme which we currently run. Assuming for the moment that member rates would remain unchanged, Hexagon’s benefit contribution rates would need to increase to 9.5% of salaries (currently 7.4%).  Staff currently pay a contribution rate of anywhere of between 10.4% and 12.4% of their salary, depending on age. All members above 40 pay 12.4% and this includes the vast majority of Hexagon staff in the scheme. |
| ***6.0*** | ***Changes to National Insurance contributions*** |
|  | Unrelated to the SHPS revaluation, pension costs for employers for all UK pension schemes will be increasing from April 2016. This is because contracting out will cease from April 2016 and employers will now have to pay higher National Insurance contributions. No decision is needed by the Board on this change as it is mandatory. These changes have been included in our revised Business Plan.  First Actuarial estimate that the additional annual cost to Hexagon as a result of the NI changes will be in the region of £42,000 per annum. |
| ***7.0*** | ***Changes to SHPS DC contributions*** |
|  | DC contributions currently have a minimum level of 1% for employers, but these costs will be increased from October 2017 and again from October 2018. These minimum contribution costs will increase to 2% from October 2017 and 3% from October 2018. They have been incorporated into our revised Business Plan.  Again, no decision is needed by the Board as this change is mandatory, as it reflects Government legislation. |
| ***8.0*** | ***Potential options for the Board*** |
|  | In response to the DB revaluation results, there are a number of options to be considered, including the following:   * Option A – stay in the Final Salary Scheme with Hexagon meeting all the 2.1% increased costs going forward; * Option B – stay in the Final Salary Scheme with the cost being split 50/50 with employees (or some other percentage which avoids Hexagon paying all the additional costs); * Option C – employees are asked to meet all of the increased costs for future service contributions (i.e. the 2.1%); * Option D – the existing Final Salary Scheme is closed and a new Defined Benefit scheme is introduced. This could be either a Career Average Earnings 60th scheme or a Career Average Earnings 80th scheme. (NB: CARE schemes base the pension on career average earnings rather than final salary and are therefore somewhat less generous and therefore less costly); * Option E – the Final Salary scheme is closed. All employees in the DB scheme are offered the option to switch to the Defined Contribution scheme which is available to all other staff. |
| ***9.0*** | ***The Risks of Staying in the DB scheme*** |
|  | The Pensions Working Group and the Directors’ Group have considered the risks of carrying on with a Defined Benefits scheme, partly in the context of advice provided by First Actuarial. Their full review is contained in **Appendix A**. First Actuarial considered the risks of staying in any Defined Benefit scheme options as “high”. They say that these are subjective risk ratings, but they rate them as ‘high’ for a number of reasons outlined below.  First, it appears that actuaries are finding it increasingly difficult to predict the level of past service deficits that need to be taken on by employers to ensure that the scheme’s assets meets its liabilities.  To put this in some perspective, this is the fourth SHPS triennial revaluation in a row which has seen an increase in deficit contributions despite the fact that that on each occasion, the actuaries have calculated that the deficit contributions should resolve the shortfall.  To put this in some further perspective, following this revaluation, Hexagon will be paying SHPS a very considerable annual deficit contribution of £766,000 on a total pension budget of £1.102m.  The scheme’s assets versus liabilities are calculated with reference to several variables including the projected performance of the Scheme’s investments, projected salary increases to members, projections on how long members are likely to live, and lastly, the rate applying to Government gilt investments.  The Pensions Group did consider whether there might be an argument for keeping the scheme open because Government gilts appear to be at an all-time historic low. Unfortunately, we have been unable to obtain any reasonable assurance which would suggest we could safely assume an improvement in the performance of the fund. This is both because predicting future gilt rates is anything but an exact science, but also because as outlined above, there are several other variables that go into the calculation of future liabilities, making predictions difficult. |
| ***10.0*** | ***The Preferred Option – Closure of the DB Scheme (Option E)*** |
|  | Taking all of the risks into consideration, the Pensions Working Group and Directors’ Group are now **RECOMMENDING** that we consult staff on closing the Final Salary Scheme and offering the option for staff to move to the Defined Contribution scheme which is available to all other Hexagon staff members (Option E as outlined above).  The key reason for this recommendation is that the risk of future liabilities remains high and we believe that Hexagon has now reached the limit of risk we can reasonably expect to absorb going forward. This is especially true in the context of the 2015 summer budget announcement which materially reduces our ability to absorb further unbudgeted risks in the future.  Indications from First Actuarial are that many other housing associations are also considering closing the scheme. It should be noted, however, that many associations within the L8 (a comparator group of medium sized London HA’s), have considerably fewer staff in the scheme as a % of their workforce than we do, so the implications of closing their scheme may be different in terms of the risk to industrial relations, employment engagement, etc. |
| ***11.0*** | ***Transitional Relief*** |
|  | The Group recognises that there is a material risk that closing the scheme will have a negative impact on staff morale, our otherwise excellent levels of employee engagement, and possibly staff retention. The Group therefore further **RECOMMENDS** that we also consult staff on a proposal to offer staff who do move over into the DC scheme, a temporary increase to their contributions.  At the current time, contributions are 7.4%, but we think there is an argument for increasing these by 2.6% (up to a maximum of 10%) for a time limited period of 3 years. The logic of this amount is that the Finance Director estimates it would be revenue neutral in our business plan given current staff turnover assumptions.  This proposal would recognise that there is a significant change to the SHS DB pension arrangements which warrants a goodwill gesture for a fixed period.  In making this recommendation of “transitional relief”, the Group was also very mindful of the current contractual position of the 58 affected staff, which is outlined in more detail below. |
| ***12.0*** | ***Risk of Closure*** |
|  | The Pensions Working Group and Directors’ Group have carefully considered the risk of closure.  **Morale/Employee engagement risks**  As described above, the main risk is that employees that join the scheme will feel that a commitment has been broken and that they were not informed at the time they joined that the scheme would only be open for a limited period and would then be closed due to financial difficulties. This in turn may impact on morale and employee engagement.  Although that may be a material risk, we believe that with proper communication, we can to some extent, mitigate this risk by explaining clearly that the additional costs are not of Hexagon’s making and that the risks have simply become too great for us to carry on spending tenants’ rents in this manner. Nevertheless, we still expect there to be some disappointment and possible fall out from the proposals. The November interim update and January full Board report would of course attempt to summarise the feedback before a final recommendation is made.  It should be noted that in general, staff are very aware that Final Salary Schemes are an increasingly rare benefit, particularly to new employees. Whilst some employers have kept their schemes open to existing employees, a large and growing number of employers are closing schemes to new employees and the option of leaving the association to join a Final Salary Scheme elsewhere is very limited indeed.  **Contracts of employment risks**  A further risk relates to the contractual position held by the 58 staff active in the DB scheme. It appears that all current DB members may have an implied contractual entitlement to a 1/60th Final Salary Scheme. The reason for this is that prior to a change made five years ago, staff contracts made reference to a version of the Staff Handbook which outlined the Final Salary 1/60th Scheme pension arrangements.  Devonshires advised us on this point back in 2010 and we recently asked for this advice to be updated. In summary, they report that there remains a risk, but that the risk could be dealt with in a number of possible ways.  The first and most obvious way is to seek staff’s consent for the move from the DB to the DC scheme. In such circumstances, staff might reasonably expect some form of quid pro quo, hence the proposal to provide some “transitional relief” as described above.  Where consent would not be forthcoming, despite the offer of such relief, (and we might reasonably expect that it would not be agreed in either some or indeed many cases) Devonshires have laid out two further options.  The first option, which Devonshires recommend as the favoured option, would involve dismissing the staff in question and then re-employing them.  Devonshires advise that the risk of this approach is that staff may bring unfair dismissal claims whether or not they accept the new offer. However, they also advise that provided we have a sound business case, a fair procedure is followed, and the only change to contracts relates to the pension, we should be able to successfully defend any such claim.  A further complication, however, is that if this option is pursued, in addition to the 60 day consultation, we would need to also allow staff to serve out their notice periods. Many of the employees would be entitled to 12 weeks’ notice. In addition, if the number of “objectors” exceeds 20, we would technically need to serve notice to the Secretary of State and hold a 30 day period of collective consultation. As the new pension arrangements need to be in place before 1 April and notified to the Pensions Trust at the end of January, this timescale is challenging. It appears, however, that we may be able to provide notice to SHPS of our intention to leave the scheme after 1st April, so we are not ruling this out at present.  A second option would be to simply unilaterally impose the change. This would involve a unilateral variation to employment contracts following the 60 day consultation on the pension changes.  The risk here is that some employees may choose to resign and issue a claim for constructive dismissal. Devonshires assess this risk to be small, however they do point out that any awards made could be higher than those made for unfair dismissal, hence their preference for dismissal and re-engagement.  The Human Resources Manager has advised the Pensions Working Group that in her view, because many of the staff are long serving, she believes that the risk of resignation and a constructive dismissal claim is small.  The Pensions Working Group discussed the implementation options available in some detail. The group concluded that in the absence of feedback from the staff consultation, it is slightly premature to decide now on exactly how the changes to pension arrangements (which are also subject to consultation) should progress. The three options, namely mutual agreement, dismissal and re-engagement, or unilateral imposition will depend to some extent on the results of the consultation.  The Group did however take the clear view that the medium and long term financial revaluation risks which would arise from a decision to keep the scheme open, would be significantly greater than the short term employment tribunal risks involved in closing the scheme. This is why the final recommendation is to close the scheme, despite the HR risks identified.  The Group therefore is **RECOMMENDING** that a further report is prepared by the HR Manager for the November Board which will summarise the consultation results to that point in time. Fortunately, our November Board meeting will more or less coincide with the end of the consultation period. The logic here is that any decision taken on how we implement the changes should be informed by staff feedback. |
| ***13.0*** | ***Consultation with staff*** |
|  | In order to implement any changes to the pension arrangements, SHPS will require us to inform them by the end of January. If we do not confirm any changes, a default position would be that the employer would be responsible for all the increased costs.  Before we can inform SHPS of our decision, however, we have a statutory requirement to carry out formal 60 day consultation with our staff on the proposed changes.  With that in mind, we are **RECOMMENDING** that we consult staff on the proposals outlined above, that we bring an interim update to the November Board, and that we bring the results and final recommendations back to a full Board meeting to be held on Tuesday, 26th January 2016. |
| ***14.0*** | ***Financial implications*** |
|  | The Finance & IT Director has produced a revised Business Plan which incorporates all of the additional pension costs identified to us by the Pensions Trust. These include the new additional deficit contributions, the changes to the indexation in current deficit payments, changes to NI costs, and revised costs for auto enrolment minimum contributions. This report is covered under **Item 4** elsewhere on this agenda.  In summary, all of the increased pension costs identified in this report, are now incorporated into the plan. |
| ***15.0*** | ***Annual and Lifetime Allowance*** |
|  | In discussion with First Actuarial, it has become apparent that recent tax changes, namely the reduction of the annual allowance and the lifetime allowance from April 2016, means that longer serving employees who are granted a pay rise significantly above inflation may exceed the annual allowance. We don’t think the risks for us are particularly great, in the current climate, but they may apply to staff who are being promoted. A second risk is that higher paid employees who have been in a Final Salary scheme for many years will risk breaching the lifetime allowance.  First Actuarial recommend that Hexagon will need to be mindful of these changes, both in respect of the overall pension strategy, but also in terms of the remuneration policy for senior employees. For example, when we next recruit Director level posts, the Board will need to be mindful that an offer of a pension contribution may no longer be a relevant benefit to those we are aiming to recruit. This may in turn require a more flexible approach to the total remuneration package.  With all that in mind, we are also **RECOMMENDING** to the Board that the HR Department liaise with First Actuarial to ensure that they fully understand the circumstances that would give rise to an unexpected tax bill arising from either the annual and/or lifetime allowances changes and that this is subject to an update with clear recommendations in the January 2016 Board report. |