

PRIVATE AND CONFIDENTIAL

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Our Ref: E

Dear Chief Executive

SFHA Pension Scheme

Valuation Results and Benefit Review

I am writing today to set out some changes to the SFHA Pensions Committee's benefit review proposals for the SFHA Pension Scheme ('the Scheme'). These changes follow a period of consultation with you, the sponsoring employers.

The consultation period began with my letter dated 28 May 2010 which set out the provisional results of the SFHA Pension Scheme's latest valuation, the impact on contribution requirements and the initial proposals being put forward by the SFHA Pensions Committee ('the Committee').

My letter today will provide feedback on the consultation exercise, benefit and contribution proposals from the Committee (taking into account the feedback and its terms of reference) and the next stages of the benefit review.

I would like to extend the thanks of the Committee to all organisations which responded to the consultation and which sent representatives to attend the Employer Forums held in Dundee, Edinburgh and Glasgow. It is clear that a lot of thought has gone into the feedback that we received and I am grateful for this and for the lively debate among the attendees at the Forums.

Feedback on the consultation exercise

As you know, we wrote to key decision makers at all 159 SFHA Pension Scheme employers and, in terms of the feedback on the Committee's proposals, I can advise you as follows:

- 23 employers in the Scheme said the range of defined benefit (DB) options should be extended beyond the current range, 16 of whom also said that they wished to see defined contribution (DC) introduced into the Scheme.
- 24 employers in the Scheme (including the 16 noted above) said they wished to see DC offered as part of the options within the Scheme.

- 11 employers did not think that employers should be allowed to offer more than one benefit option open to staff.
- 20 employers said they wished to see the 2:1 ratio lifted, to allow employers to pass more of the cost on to their staff.

In summary, there is a sizeable minority of employers for whom the Committee's initial position statements did not provide sufficient options for future service. In addition to the feedback that we received on the Committee's position statements, there was also a view given by some employers that:

- the Committee should consider appropriate benefit options for some of the weaker employers in the Scheme (that is, those employers which may find it more of a challenge to meet their pension liabilities, either now or in the future, particularly in respect of buy-out liabilities);
- lower cost options should be available that might readily allow more employers to use the Scheme for automatic enrolment purposes;
- consideration of past and future service costs together served to confuse a number of employers. Consideration should be given to splitting future and past service costs, particularly if automatic enrolment is introduced; and
- the apparent finality of the position statements themselves suggested that the Committee was not listening to its member organisations. This was not the intention of the Committee. Instead the statements were provided to give employers a clear indication of the position the Committee intended to adopt and allow the consultation with employers to be focused.

The following sections of the letter set out how the Committee intends to offer sufficient flexibility within the Scheme to meet the majority of these employer requests, whilst still maintaining prudent stewardship of the Scheme.

In determining an appropriate benefit suite to offer the Committee has to have regard to its duty to sponsoring employers in setting benefit provision for future service. Against this, it has to balance its responsibility to ensure the viability of the Scheme and its fiduciary responsibility towards the members.

In aiming to be the leading pension scheme in Scotland for Housing Associations, the Committee's Terms of Reference (available to view at www.sfhaps.org.uk > Document Library > Pensions Committee Documents) require that it maintains benefit provision at the highest quality relative to what is affordable.

The Committee fully recognises that affordability and sustainability run together.

Whilst the majority of employers have not sought the introduction of alternative benefit options, some 31 employers advised us that they wish to see the range of options widened.

Committee proposal on benefit options

In response to the feedback received, the Committee proposes the following changes to the benefits options and contributions split:

- To extend the range of benefits which are contracted-out of the state second pension (S2P) to include Career Average Revalued Earnings CARE 80^{ths}.
- To introduce a benefit on a contracted-in basis, namely CARE 120^{ths}.
- To separate the contribution split into two distinct elements – past service (100% funded by employer) and future service (50:50 employer/employee).
- To calculate past service deficits arising after 30 September 2009 on an individual basis per employer in order to recognise the differences in liability accruing amongst employers on different benefit options.

The Committee is aware that introducing lower cost options may compel some employers to adopt these options for future service. However, it believes that extending the range thus would not have an adverse effect on the majority of employers that remain satisfied with the existing benefit options.

Adding the CARE 80^{ths} and CARE 120^{ths} options to the suite of benefits represents a change in direction from the Committee's initial position. This is in direct response to the feedback provided by your organisations.

The future service cost of the CARE 120^{ths} benefit is approximately 9.4% and its introduction has led the Committee to reconsider the contributions basis for both future service and the deficit. This is covered in the next section.

The Committee considered again whether to introduce a DC option. Were it to introduce such a section, it feels that the future contributions must be set at a reasonable minimum level to produce a reasonable fund to purchase a pension. The Committee felt that the National Association of Pension Fund's (NAPF) Pensions Quality Mark (PQM – requiring a minimum 10% combined contribution basis) would be an appropriate minimum and this was the basis used to compare DC against DB options. This basis was used for comparison purposes during the consultation period.

The introduction of DC would bring significant structural and cultural changes to pension provision within the Scheme. Whilst these changes do not in themselves preclude the decision to change, the Committee also had regard to the increased running costs which would come from setting up DC within the Scheme, as well as significant set-up costs, which would have to be borne immediately by the participating employers electing to adopt DC.

The introduction of DC would pass the funding risks associated with DB pensions (currently borne by the employers) to the members of the Scheme, all of whom would be required to make their own investment options (albeit that they would be supported by the use of default funds were they unable or unwilling to make such choices).

The Committee believes that the member benefits arising from the CARE 120ths option are likely to be higher than those from a DC option set at the higher PQM contribution levels. On balance and bearing in mind the contribution requirements of CARE 120ths versus this DC basis, the Committee proposes that CARE 120ths be offered as the lowest cost option within the Scheme.

The Scheme continues to provide extremely valuable benefits to members, including life cover and dependants' pensions. Further, in extending the benefit offering as proposed, the Committee feels it is able to address cost concerns (both for employers and employees) whilst maintaining the integrity of the benefits offered by the Scheme.

Appendix 1 provides details of the contributions required for each benefit option. The treatment of the past service deficit contribution is discussed below and must be paid in all cases. The future service contribution rate varies depending on the benefit being offered for future service.

Committee proposals on contributions split and benefit options

The introduction of new lower cost benefit options has given the Committee cause to re-examine the basis on which contributions are collected. In making these changes the Committee has to consider not only the wishes of the employers, but also the viability of the Scheme. In this respect, it is effectively exercising some of its fiduciary responsibility to the members of the Scheme.

The following changes will be made:

- Future service contributions will continue to be calculated on a percentage-of-salary basis. The share of these contributions will be split 50:50 between employers across all benefit options, though employers will be able to pay a greater proportion if they wish.
- Past-service (deficit) contributions are legally the sole responsibility of the employer. Separating payment of these contributions will facilitate a clearer understanding among employers of their responsibility to meet the past service liabilities to the pension scheme, regardless of the future service benefit option they adopt. The deficit contributions which will come into effect from 1 April 2011 will be calculated as capitalised (lump sum) amounts for each employer. They will be based on employers' individual pensionable salary rolls as at 30 September 2009, with inflationary increases in line with the assumptions set out in the valuation.
- Each employer will be advised of its monthly contribution requirement, which will increase each April, in line with the assumptions adopted for the 2009 actuarial valuation.
- At subsequent valuations, any change in the deficit position of the Scheme (either favourable or unfavourable) will be allocated among employers on the basis of their individual shares of the liabilities of the Scheme, adjusted for pensionable service accrued with different employer organisations.

Separating the payment of past service (deficit) contributions will result in employers no longer having to pay the additional past-service cost (currently 10.4%) of new staff members' salaries. In making this change the Committee is responding to two concerns raised by employers. Firstly, that application of past service cost contribution to new members is a barrier to the promotion of the Scheme to these members, whose joining helps keep the average age (and cost) of the Scheme under control. Secondly, those employers which choose to automatically enrol members into the Scheme (in any of the benefit options) would be likely to pay a disproportionate share of the deficit. Essentially they would be penalised for their continued support of the Scheme. This would clearly be unfair.

Moving away from the basis that all contributions (including past service) should be collected by reference to a percentage of pensionable salary roll represents a significant change to the Scheme. The Committee recognises that the principle drivers in moving to lower accrual benefit options are not only to reduce current costs but to reduce the risk of building up further past service liability.

With the advent of the CARE 120ths basis, we can expect future liability to accrue among employers at very different rates from the present. This is simply because of the significant difference in scheme benefit between the final salary 60ths and CARE 120ths bases. It is therefore not reasonable to continue to pay for the past service deficit on an equal percentage of payroll basis. It is for this reason that each employer's share of *future* deficit will be individually calculated.

There is clearly support among employers to allow employers to offer more than one open option for their staff. The Committee proposes to offer this within the Scheme from April 2011. The Committee will have regard to whether this leads to any actuarial selection (bias) against the Scheme if, as expected, this option is only taken up by older scheme members.

The availability of this option means that employers will have the flexibility to allow members to choose to retain a higher benefit accrual level for future service than that adopted by their employer as its default. In return for this benefit, members (at the discretion of their employer) will be required to pay the difference in member and employer future service contribution rate.

The facility to offer more than one benefit option will not be available to those employers where there are concerns over the employer's strength (this is covered in more detail later in this letter).

Concerns about automatic enrolment, employers offering DC to their staff and the application of a loading to contributions

A number of employers have expressed concerns over the introduction of automatic enrolment (from between 2012 and 2014) and also on the possible application of a contributions loading.

Critically, when auto-enrolment comes in employers will be allowed to enrol employees who are not members of the Scheme into a DC option of their choosing (including any government scheme), sitting outside the SFHA Pension Scheme.

Taking such action would not trigger a cessation event (and the consequent requirement to pay the buy-out debt), if an employer has active members in the SFHA Pension Scheme.

However, such action may well lead to the application of a loading on future service contributions of active members. The Committee will apply a loading to contributions in all circumstances where employers have closed the Scheme to new entrants.

This is not an arbitrary measure, nor is its application governed by the Trust Deed and Rules. It is based on the advice of the Scheme Actuary. The loading is simply a reflection of the fact that where an employer closes to new entrants its members will, on average, age faster than those of the remaining employers whose leavers and retiring members will be replaced in the Scheme by generally younger members. The loading ensures that the (increasing) costs of pensions within closed employers are not subsidised by all the remaining employers in the Scheme.

The employer loading will apply if eligible members of staff cease to be offered membership of the SFHA Pension Scheme. It may also apply in future if employers offer their staff concurrent entry into the SFHA Pension Scheme and another arrangement. The Government's NEST Scheme or a Group Personal Pension arrangement are examples where the loading might apply, if offering these has the same or similar effect as closing the Scheme to new entrants. At this stage, the Committee cannot determine whether this will be the case. However, the Committee believes that the lowest accrual-rate benefit (CARE 120^{ths}), requiring a combined contribution of 9.4%, provides employers with a reasonable low-cost alternative.

Managing future contributions and concerns over employer strength

The Committee undertook an assessment of the financial strength of the employers *backing the Scheme as a whole*, in consideration of the actuarial valuation.

The Committee recognises that the potential remains for the past service deficit (and future contribution rates) for participating employers to continue to rise and for individual employers' buy-out debts to rise, at least in the short to medium term. However, the Committee believes that the range of options being offered allows employers to mitigate these risks should they wish, whilst continuing to maintain the integrity of the benefits offered by the Scheme.

Our assessment of the Scheme, both before and during the consultation exercise suggests that there are, broadly, two distinct categories of employer within the Scheme.

- One is Registered Social Landlords (RSLs), often with substantial assets that wish to be able to manage pension costs in a similar manner to other overheads (that is, looking for greater flexibility of costs/benefits, but whose viability is not threatened).
- The other category is mainly grant or subscription-funded organisations whose viability may indeed be under threat not only from pension liabilities but from loss of funding.

During the consultation exercise a number of employers indicated that their pension costs will place a financial strain on them in future years. Also, they felt that this was an issue that the Committee should address by considering the strength of the employer covenant for individual organisations. To respond to these concerns that have been flagged up by a number of employers and which are shared by the Committee, the Committee intends to introduce more detailed assessment of individual employers' covenant.

Several organisations in the Scheme do not meet the current membership criteria (RSLs with at least 100 housing units). Potentially these organisations present a higher risk to the Scheme and to other employers within the Scheme.

As part of its role in assessing the strength of the covenant (of employers backing the Scheme), the Committee will look further at the financial position of individual organisations within the Scheme.

Where concerns on viability have been raised, or there are insufficient assets to support the existing buy-out debt, the organisation will be termed 'high risk'. The Committee wants to assist these employers maintain viability and will recommend that these organisations move to the CARE 120ths option to reduce the build up of further scheme liability.

The initial assessment will be on the basis of the current entry criteria into the Scheme. Those employers, whether or not they are part of a larger group, that are not currently able to satisfy the criteria will be required to move to the CARE 120ths option for future service or provide some form of security to back up continued benefit accrual in any of the Scheme's other benefit options.

Further assessment of the financial strength of individual employers who meet the current eligibility criteria will take place during 2011.

Details of the outcome of your organisation's *initial* assessment, together with details of the proposed benefit options available to you and your staff will be provided in time for the member consultation process which must be completed by 28 February 2011.

Next steps

Each organisation must now decide on whether it wishes to offer an alternative future service benefit option. Staff should be consulted on the member contribution rate increases and/or changes to the benefit options depending on the decisions reached by individual employers.

Changing the benefit option and/or member contributions are 'listed changes' and employers with 50 or more employees are required to consult with 'affected members' (current active members of the Scheme, and any employees' eligible to join the Scheme but who have not already done so). Regardless of the statutory position, consultation is 'best practice' and all employers are recommended to undertake some form of consultation.

Before entering into any consultation process, employers should assess the position in relation to employees' Terms and Conditions of Employment, the organisation's governance arrangements and legislation.

Consultation Guidance including a consultation template, member information guides and a frequently asked questions guide will be available to download from the Scheme's website (www.sfhaps.org.uk) by 29 October 2010.

The new benefit options will be available from and changes to the contribution rates will be effective from 1 April 2011 and a decision must be submitted in writing to The Pensions Trust by 28 February 2011.

In the meantime, if you have any questions on any aspect of this letter, please feel free to contact either myself at logan.anderson@thepensionstrust.org.uk or Susan Wardlaw, the Scheme Secretary at susan.wardlaw@thepensionstrust.org.uk.

Yours sincerely



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SFHA Pension Scheme

Summary of Contributions

Benefit Option	Past Service (Employer)	Future Service (50:50 Employer/Member)		
	Past Service Deficit Contributions (a lump sum amount based on % of payroll at 30 September 2009)*	Total Future Service Contribution Rate %	Employer Contribution Rate %**	Member Contribution Rate %
Final Salary 60 ^{ths}	10.4	19.2	9.6	9.6
CARE 60 ^{ths}	10.4	17.1	8.6	8.5
CARE 70 ^{ths}	10.4	14.9	7.4	7.5
CARE 80 ^{ths}	10.4	13.2	6.6	6.6
CARE 120 ^{ths ***}	10.4	9.4	4.7	4.7

*The lump sum amount calculated as a % of payroll as at 30 September 2009 will be increased annually in line with the inflation assumption adopted for the 2009 actuarial valuation. The deficit contributions must be met by the employer and will be collected on a monthly basis.

**Employers already closed to new entrants must include the additional loading, currently 3.5%, to their contribution rate.

*** CARE 120ths is contracted-in to the State Second Pension. Full rate National Insurance Contributions are payable in addition to the employer and member contributions rates quoted above.