



LOCAL PENSION COMMITTEE

5 JULY 2019

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

PENSION FUND VALUATION

Purpose of the Report

1. The purpose of this report is to seek the Committee's approval of the assumptions and stabilisation approach, for scheme employers with tax raising powers, in preparation for the Leicestershire Local Government Pension Scheme (LGPS) valuation.

Background

2. Every three years each LGPS administering authority has a statutory obligation to have an actuarial valuation (Valuation) of the pension scheme. The Leicestershire Pension Fund's (Fund) assets and liabilities were assessed on the 31 March 2019 and the overall funding position calculated.
3. The main aim of the Valuation is to set contribution rates for each employer for a three year period that commences one year after the valuation date (i.e. for the period 1st April 2020 to 31st March 2023). In order to set these contribution rates the actuary must take account of a large number of factors, most of which are assumptions of what will happen in the future. These assumptions do not impact onto the ultimate cost of paying benefits they simply calculate the liability derived from these benefits, which in turn impacts the level of contributions set.
4. Throughout the Valuation process the actuary has a professional responsibility to certify contribution rates that are considered reasonable. There is also a requirement within the LGPS Regulations that there is an element of prudence built into the actuarial assumptions and that the actuary sets contributions in line with these prudent assumptions and that they are as stable as possible.
5. In 2016 the Valuation calculated a 76% funding level; this required the majority of employers to increase their contribution rates. The latest estimate from Hymans suggests a similar position for this valuation.

Employer Risk Profiling

6. The Valuation will ultimately produce employers' contribution rates for all employing bodies within the Fund. These contribution rates will take account of the particular circumstances of each employing body, and the rates will be a combination of the cost of paying for future service as it accrues, plus an adjustment for paying off the deficit over an appropriate period of time.
7. To protect Fund employers it is essential that the potential for an organisation to default on its liabilities is taken into account. To support this it is proposed to adopt a more scientific approach to employer risk profiling for this Valuation. In preparation, Officers have considered the risk profiles of the Fund's employers.
8. The level of risk, presented to the Fund, is a key determinant in the period of time that the deficit can be recovered over. For example tax raising bodies tend to be classified as low risk employers; affording them the greatest flexibility in repaying the deficit. Conversely private sector companies are classified as highest risk; deficits are not permitted to extend beyond the length of the contract. Higher risk employers are being reviewed to ensure suitable deficit recovery periods and security is in place.

Deficit Recovery

9. The repayment of the historic deficit is usually expressed as a percentage of pensionable pay, for active members. This benefits from simplicity in application, as it is in line with the contribution for future service, and comparability. However, an assumption is required on future pensionable pay. This could result in an organisation with a declining membership underpaying, hence it is recommended that where practical employers deficit repayments are set as cash values.

Stabilisation

10. To avoid large increases or decreases in employer contributions employers, who are deemed to be the lowest risk, are offered a stabilisation rate. The lowest risk category relates to employers who have tax raising powers and are legally required to offer employees membership of LGPS. The stabilisation mechanism works by limiting increases or decreases in contributions by a set amount each year. This avoids significant or sudden contribution changes and smooths the impact of any short term volatility on contributions. It also aids employers budgeting. The downside of stabilisation is that the Fund remains in deficit for longer ultimately making paying off the deficit more expensive than it otherwise would have been.
11. Hymans has a modelling tool which was used in the previous three Valuations, called comPASS, which can assess contribution rate strategies over the long-term. This allows a judgement to be made whether the strategies are likely to be sufficient to return the sub-fund of an individual employer to a fully funded position within the agreed deficit spreading period.

12. ComPASS uses 5,000 separate economic scenarios with different potential outcomes (investment returns, inflation etc.), thereby giving a very robust result. The Actuary has carried out modelling to allow the Fund to understand the long term likelihood of meeting the funding target and assess the downside risk.
13. To ensure that the contribution strategies are reasonable the requirement is for the modelling to show that:
- a. 75% of the outcomes will result in a fully funded position and
 - b. The funding level in the worst 5% of outcomes does not fall below 50%
14. All the low risk employers listed below have met the required level, assessed on an employer rate increasing by 1.0% per year using a 17 year deficit recovery period. The results mean stabilised employers should budget for 1.0% increases in their current total contribution rate each year. The Actuary has indicated that this rate could be justified for five years, not just the standard three.
- Leicestershire County Council
 - Leicester City Council
 - Blaby District Council
 - Charnwood Borough Council
 - Harborough District Council
 - Hinckley & Bosworth Borough Council
 - Melton Borough Council
 - North West Leicestershire District Council
 - Oadby & Wigston Borough Council
 - Rutland County Council
 - Leicestershire Fire Authority (civilian staff)
 - Leicestershire Police and Office of the Police and Crime Commissioner (civilian staff)
15. Full details of the Fund's stabilisation policy will be set out in the Funding Strategy Statement, a draft of which will be presented to the Pensions Committee on the 8th November.
16. The actuary will provide draft valuation results in the autumn that will allow contribution rates for non-stabilised employers to be released in November.

Agreement of key actuarial assumptions

17. The key financial assumptions required for the valuation are:
- a. Investment returns

- b. Inflation
- c. Salary Growth
- d. Longevity

18. Investment returns are based on two separate assumptions. The first assumption is the Fund's future investment returns for the next 20 years. This is derived in a similar way to the comPASS modelling with multiple economic projections being created. These projections are used to calculate the expected performance of each of the asset classes the Fund holds. This range of expected returns over the 20 year period is applied to the holdings in the Fund's asset allocation strategy. A similar exercise is performed during the annual review of the asset allocation strategy; this resulted in an expected return of CPI + 3.4%.

19. Beyond a 20 year time horizon uncertainty increases greatly, hence a different approach is taken. A single assumption about future investment returns is set, this is known as the discount rate. The discount rate is set independently of today's economic conditions. To make a prudent estimate of future investment returns the following steps are taken:

- a. Estimate the risk free rate of return – uses long-term UK government bonds yields (gilts)
- b. Estimate the expected return in excess of gilt yields, known as the asset outperformance assumption (AOA)
- c. Assess the likelihood of the AOA being met based upon the Fund's current strategic asset allocation.

20. The table below shows the outcome of the assessment:

Likelihood of achieving this margin from year 20	Asset outperformance assumption (% p.a.)		
	1.8%	2.0%	2.2%
Current strategy	78%	75%	72%

21. In the 2016 valuation the AOA was 1.8%, hence based upon this assessment the recommendation is to maintain the discount rate assumption of Gilts + 1.8%. A report from the Fund's actuary, Hymans Robertson, is attached as an appendix to this report. Their report provides a greater explanation of the approach adopted in deriving the assumption.

22. The inflation assumption is derived from the difference between yields on index-linked and conventional government bonds. This produces an estimate of the Retail Prices Index (RPI). However, the Consumer Price Index (CPI) is more relevant to the Fund, hence the actuary uses a standard assumption to derive the CPI figure (RPI – 1%).

23. The salary growth assumption is required due to the final salary benefits of active scheme members. The importance of this assumption is declining. In 2014 all benefits were final salary, as at March 2019 it is estimated that 60% will be final salary, with the balance being based upon career average. Note promotional increases are set separately.

24. Based upon the latest national pay award (2%) and the impact of the National Living Wage (c.0.5%) three scenarios were modelled:

Increase p.a.	CPI	CPI + 0.5%	CPI + 1.0%
Approximate change to funding level	2%	1%	0%

25. The 2016 assumption of CPI + 1% (RPI) reflected the more common used measure of local government inflation at the time. Subsequently the level of CPI has been the main consideration for items such as pay awards and tax increases. Hence the recommended assumption is CPI + 0.5%. A report from the Fund's actuary, Hymans Robertson, is attached as an appendix to this report. Their report provides a greater explanation of the approach adopted in verifying the assumption.

26. Longevity estimates are based upon modelling performed by Club Vita. This information will be available later in the valuation process.

Other Factors

27. In November 2018 the Committee received a report outlining that the LGPS "cost cap" was likely to be breached. The implication of this would be for benefits to be increased or employee contributions reduced. Prior to a decision being made on the approach the Government lost an Employment Tribunal appeal regarding the transitional provisions for a reduction in benefits. This is also applicable to the LGPS. The case is widely referred to as McCloud.

28. The implications for LGPS at this stage are uncertain, although both matters suggest the cost of the scheme could increase. The impact of these matters have not been taken into account in the modelling. If further information is available allowing a reliable estimate to be made this will be done. There is nothing to suggest that the assumptions set out above are likely to change.

Timeline

29. The timeline for providing information to employers about the valuation is as follows:

- 6 June 2019. Officers met with the low risk employers detailing stabilisation of their likely employer rates.
- 5 July 2019. Assumptions and stabilised rates to be formalised by the Pensions Committee.
- September/October 2019. Draft results received.
- 8 November 2019. Officers and the Actuary to present the full fund results and the draft Funding Strategy Statement to the Local Pension Committee.

- 18 November 2019. The Pension Fund Annual General Meeting including an employer forum. All employer results will be presented by Officers and the Actuary.
- January 2020. Pensions Committee to formally sign off the Funding Strategy Statement after consultation ends and the final valuation results.
- 1 April 2020. New employer rates commence.

30. The Fund will consult with employers before making changes to contribution rates and the Funding Strategy Statement. This process is likely to start formally after the AGM.

Recommendation

31. It is recommended that;

- a. The following actuarial assumptions be approved for use in the 2019 valuation of the Fund;
 - i. discount rate assumption of Gilts + 1.8%
 - ii. salary growth assumption of CPI + 0.5%.
- b. the contribution rate increase of 1.0% per year be used for stabilised employers from 1st April 2020.

Equality and Human Rights Implications

None

Appendices

Appendix A – Hymans Robertson – 2019 Valuation: Setting the discount rate
 Appendix B – Hymans Robertson – 2019 Valuation: Salary growth assumption

Officers to Contact

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