**LOCAL PENSION BOARD**

**2 DECEMBER 2019**

**REPORT OF THE DIRECTOR OF CORPORATE RESOURCES**

**PENSION FUND VALUATION**

**Purpose of the Report**

1. The purpose of this report is to inform Board of the Leicestershire Local Government Pension Scheme (LGPS) draft valuation results and the consultation with the employers on the Funding Strategy Statement.

**Background**

2. Each LGPS administering authority has a statutory obligation to have an actuarial valuation carried out every three years and all Funds in England and Wales need to have a valuation carried out as at 31st March 2019. Leicestershire County Council Pension Fund's actuarial valuation has been carried out by Richard Warden of Hymans Robertson LLP.

3. The major purpose of the actuarial valuation is for the actuary to set employer contribution rates for a three year period, that commences one year after the valuation date (i.e. for the period 1 April 2020 to 31 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. In May 2019 MHCLG launched a consultation which included a proposed change to the valuation cycle from 3 years to 4 years so that the dates of the national LGPS cost management valuation and LGPS valuations aligned from March 2024. The Fund has been informed the next valuation will take place of the 31 March 2022 regardless of the outcome of the consultation, meaning the actuary will certify three years worth of contributions for the period 1 April 2020 to 31 March 2023 in the Rates and Adjustment certificate in the Fund's 2019 valuation report. This is welcomed by the Fund.

5. 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.

6. In 2016 the valuation calculated a 76% funding level. The draft results in the 2019 valuation calculate a 89% funding level using a discount rate of 3.8%, which is significant funding improvement. In the main, this has been delivered from significant investment returns in the three years. Previously, the Fund considered using a discount rate of 4.1% for the 2019 valuation, but during subsequent valuation work, the Fund has decided to use a more prudent rate. Such investment returns are highly unlikely to recur, so the Fund will need to ensure the right balance between investment returns and employer contributions is achieved, to close the remaining deficit.

7. Whilst the fund valuation is good news, the Fund remains in deficit and work continues to close this. In addition, the Fund needs to reduce the deficit recovery period for Fund employers. This is the period of time employers have to repay their fund deficit. The maximum deficit recovery period was 20 years in the 2016 valuation and three years later, this has reduced to 17 years in the 2019 valuation for the majority of employers and 15 years for Colleges and Universities.

8. Government Actuaries Department (GAD) and Chartered Institute of Public Finance and Accountancy (CIPFA) guidance both request Funds continue to work to reduce the deficit recovery period so the move from 20 years to 17 years meets this.

**Employer Risk Profiling**

9. The Valuation has produced employers' contribution rates for all employing bodies within the Fund. These contribution rates take account of the particular circumstances of each employing body, and the rates are 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.

10. 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 a more scientific approach to employer risk profiling for this Valuation has been included. Officers have considered the risk profiles of certain Fund's employers.

11. 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, although this is managed with public sector guarantors and bonds. Deficits are not usually permitted to extend beyond the length of the contract for private sector companies. Higher risk employers

have been reviewed to ensure suitable deficit recovery periods and security is in place.

**Deficit Recovery**

12. 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**

13. 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.

14. 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.

15. 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.

16. To ensure that the contribution strategies are reasonable the requirement is for the modelling to show that:

- 75% of the outcomes will result in a fully funded position and
- The funding level in the worst 5% of outcomes does not fall below 50%

17. 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)

18. For the non-stabilised employers, their employer rates have been calculated taking into account their employer risk, agreed assumptions and for the admission bodies, their length of their main contract of service. The whole Fund results are included in Appendix A.

**Agreement of key actuarial assumptions**

19. The key financial assumptions required for the valuation are:
    - Investment returns
    - Inflation
    - Salary Growth
    - Longevity

20. 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.

21. 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:
    - Estimate the risk free rate of return – uses long-term UK government bonds yields (gilts)

- Estimate the expected return in excess of gilt yields, know and the asset outperformance assumption (AOA)
- Assess the likelihood of the AOA being met based upon the Fund's current strategic asset allocation.

22. 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% |

23. In the 2016 valuation the AOA was 1.8%, hence based upon this assessment Committee approved in July 2019, to maintain the discount rate assumption of Gilts + 1.8% p.a.

24. 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%) p.a.

25. 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 62% will be final salary, with the balance being based upon career average. Note promotional increases are set separately.

26. Based upon the latest national pay award (2%) and the impact of the National Living Wage (c.0.5%) for 2019/20 three scenarios were modelled for future salary increases:

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

27. 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 Committee approved the recommendation in July 2019 the salary assumption is CPI + 0.5% p.a.

28. Recent announcement by the main political parties suggest the National Living Wage will increase at a faster rate than previously experienced. Whilst this will be detrimental to the funding position it is not sufficiently material to require a change in assumptions at this stage of the valuation.

29. Longevity estimates are based upon modelling performed by Club Vita. From the 2019 whole Fund results the reduction in liabilities is approximately 3%.

**Other Factors**

30. In December 2018 the Pensions Board received a report outlining that the LGPS "cost cap" was likely to be breeched. The implication of this would be for scheme members 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. Until the McCloud remedy is confirmed the cost cap work has been shelved.

31. Scheme Advisory Board (SAB) subsequently confirmed in the absence of any further detail, fund actuaries should value the benefits accrued from 1 April 2014 in line with the current Regulations for the purpose of the 2019 valuations. The guidance also directed funds to consider how they manage the risk associated with the uncertainty around the actual cost of LGPS benefits due to the McCloud case (including the approach to setting employer contribution rates). At a more recent meeting MHCLG confirmed that their expectation is for each LGPS fund to explicitly state in their actuarial valuation report and/or Funding Strategy Statement how they have made an allowance for the McCloud ruling. In particular, where any employer contribution rates are being reduced from those currently in payment, Funds should be clear that they have taken account of the McCloud ruling before taking the decision to reduce contribution rates. It is expected the Government Actuary Department (GAD) will look at this when they carrying out their Section 13 valuations next year.

32. The Leicestershire Fund has agreed with the Fund Actuary to account for the potential uncertain impact of McCloud by a targeting a higher probability of success in setting employer rates. This will be clearly documented in the revised version of the Funding Strategy Statement and the actuary will consider how this is best presented in the final valuation report.

**Funding Strategy Statement**

33. The Fund's draft Funding Strategy Statement (FSS) has been amended to reflect the Fund's approach to the 2019 valuation. The key changes are highlighted in the report in yellow and relate to the following;
    - Full details of the Fund's stabilisation policy
    - Fund's approach to setting employer contribution rates
    - Fund's cessation policy

    The draft FSS includes a table detailing the Fund's framework for setting differing employer groups rates.

    The Fund started a consultation with employers on the FSS after the AGM on the 18 November, ending on the 31 December 2019. Any replies received from employers will be considered. The final FSS will be taken to the Pensions Committee in January 2020 with the final valuation results and they will also be presented to the Board. The draft FSS is attached as Appendix B

## Timeline

34. The timeline for providing information to employers about the valuation is as follows:
    - 8 November 2019. Officers and the Actuary presented the full fund results and the draft Funding Strategy Statement to the Local Pension Committee.
    - 18 November 2019. The Pension Fund Annual General Meeting and employer forum took place. All employer results were 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.

## Recommendation

35. It is recommended that the Pensions Board notes;

    (a) That a consultation with the Fund Employer on the draft Funding Strategy Statement commenced after the Leicestershire Pension Fund Annual General Meeting on the 18 November 2019;

    (b) The framework for setting individual employer rates;

    (c) The whole fund results, as detailed in Appendix A.

## Equality and Human Rights Implications

36. None

## Appendices

Appendix A – Whole fund results
Appendix B – Draft Funding Strategy Statement

## Officers to Contact

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