

Bath & North East Somerset Council		
MEETING:	AVON PENSION FUND COMMITTEE	
MEETING DATE:	27 SEPTEMBER 2019	AGENDA ITEM NUMBER
TITLE:	FUNDING STRATEGY STATEMENT 2019	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Appendix 1 – Funding Strategy Statement Appendix 2 – Comments from Employing Bodies Appendix 3 – Pension Board comments Appendix 4 – CIPFA guidance checklist		

## **1 THE ISSUE**

- 1.1 The Local Government Pension Scheme (LGPS) regulations require each administering authority to prepare and publish a Funding Strategy Statement (FSS). The FSS sets out the key assumptions which the actuary has used in preparing the actuarial valuation and, in those cases where the Administering Authority has some discretion, the policies adopted by the Administering Authority. The Committee approved a draft FSS at its meeting on 21 June 2019 which has been circulated to the employing bodies for comment.
- 1.2 An updated draft FSS is attached as Appendix 1 which, after consideration by Fund Officers and the Actuary, takes into account the comments received from the employing bodies following the consultation period. The Actuary will attend the meeting to discuss the comments and any changes to the draft FSS.
- 1.3 As the body responsible for agreeing the Funding Strategy, the Committee must consider the FSS within the regulatory framework;
  - a) Ensure that the benefits paid out in the future will be reasonably met (the Solvency Objective)
  - b) That the amount paid in annually covers the current cost of the pension benefit accrued
  - c) That current pension debt is not deferred for future generations to fund (the Long Term Cost Efficiency Objective).
- 1.4 Given the FSS includes regulatory/legal matters that are yet to be resolved/confirmed, delegated authority is requested for Officers to finalise before 31/03/20 having taken advice from the Actuary.
- 1.5 Individual employer results will be disseminated in October and November. An Investment Forum to explain the outcome at the whole Fund level to employers will be arranged for 4Q19.

## **2 RECOMMENDATION**

The Committee:

- 2.1 Notes the feedback responses received, and the proposed amendments to the FSS.**
- 2.2 Approves the FSS as set out in Appendix 1, subject to the insertion of information which can only be included when the actuarial valuation is complete.**
- 2.3 Delegates the refinement and finalisation of the draft FSS to Fund Officers, with assistance of Fund Actuary.**

## **3 FINANCIAL IMPLICATIONS**

- 3.1 The actuarial costs for reviewing the FSS is included in the 2019 actuarial valuation fee and is provided for in the 2019/20 budget.

## **4 BACKGROUND**

- 4.1 The LGPS regulations require each administering authority to prepare and publish a FSS. The key points of the regulation for the FSS are as follows:-
  - After consultation with all employing bodies, the administering authority must prepare and publish their funding strategy
  - In preparing the FSS, the administering authority must have regard to:
    - (i) FSS guidance issued by CIPFA
    - (ii) The Investment Strategy Statement (ISS) under Regulation 12 of the LGPS (Management and Investment of Funds) Regulations 2016
  - The FSS must be revised and published whenever there is a material change in either the policy on the matters set out in the FSS or the Statement of Investment Principles/ISS.
  - The Fund's actuary must have regard to the FSS as part of the valuation process.
- 4.2 The FSS sets out all the key assumptions which the actuary has used in preparing the actuarial valuation, together with the Administering Authority's policies in the areas where the Administering Authority has discretion to manage the funding position of the Fund.
- 4.3 Procedurally, the Fund's actuary cannot finalise the valuation until the FSS has been approved by the Committee.
- 4.4 There are significant outstanding regulatory /legal matters that will need to be included in the FSS as they will affect the contributions and /or funding policy (e.g. McCloud remedy and moving to 4 year valuation cycles). These may be resolved between now and 31 March 2020 when the FSS will be published. If not, how the Fund will manage such issues will need to be included in the FSS. As these are regulatory in nature, it is recommended that Officers are given delegated powers to finalise the FSS having received full advice from the Actuary.
- 4.5 Given the proposed changes to the regulations, it is reasonable to assume that the FSS will be reviewed before the next valuation in 2022. Any revisions will be brought to Committee for full consideration.

- 4.6 The draft FSS was circulated to the employing bodies with comments required by 22 August 2019. Those comments which have been received are summarised in Appendix 2.
- 4.7 The Pension Board have reviewed the draft FSS and conclude that it complies with the valuation. Their comments are in Appendix 3. In line with their recommendation, a checklist of compliance is provided in Appendix 4.
- 4.8 In light of some of the comments received via the consultation, some changes to the draft have been proposed. Details of the changes are set out in the next section.
- 4.9 The draft FSS for approval is attached as Appendix 1, estimates certain information that can only be confirmed once the valuation and associated analysis has been completed. Once the valuation is finalised, the FSS will be updated and published.

## **5 COMMENTS ON RESPONSES FROM EMPLOYING BODIES**

- 5.1 The consultation asked specifically for comments about:
- a) The appropriateness of the assumptions and in particular those that relate to them e.g. the pay increases you expect to award over the next few years?
  - b) In relation to the affordability of contributions and in particular whether there is any particular year over 2020/2023 which will be more challenging. This will help us form a view on any further flexibility required.
  - c) Whether the level of detail was sufficient and whether they need anything further in terms of information / meeting etc. to understand the content and implications
- 5.2 The responses are summarised by employer in Appendix 2. They highlight the severe funding pressures in the public sector that mean that increases in contributions would be difficult to fund resulting in services being cut. Specifically, the universities cited the Augar Report as creating uncertainty about future revenues, unitary authorities cited the fact that the Local Government Funding Review was only set for 1 year resulting in uncertainty about future funding streams and academies cited the September to September funding cycle, requiring flexibility. The main areas of comments on the contents of the FSS are summarised as follows:
- a) Whether the margin for prudence in the assumptions are too high in relation to:
    - (i) The long term salary Increase assumption set at CPI plus 1.5% (a long term average of 3.9% p.a.) is too high given recent pay awards have been in line with inflation at best.
    - (ii) The lower asset out performance target used in the discount rate (from CPI+2.2% to CPI +1.75% for past service liabilities and from CPI +2.75% to CPI + 2.25% for future service).
    - (iii) Longevity improvements given that the rate of mortality had increased (i.e. more deaths than previously)
    - (iv) In relation to GAD Section 13 assumptions which uses a higher discount rate.
  - b) The deficit recovery period (DRP) should not automatically reduce by 3 years. The rationale for shortening the deficit recovery period was unclear. In addition, those employers with a DRP less than 12 years challenged whether it should reduce regardless of contribution levels versus the previous valuation.

- c) Disagreement that deficit contributions should be maintained at the expected monetary amounts from the preceding valuation.
- d) Employers in surplus should be allowed greater flexibility to accelerate the runoff over 12 years.
- e) McCloud could significantly affect employer contribution rates and employers requested clarification on the how it will be allowed for.

5.3 The Actuary has responded to the comments as follows:

- a) Margin for Prudence in assumptions:
  - (i) **An overall margin for prudence** is built into the actuarial assumptions in order to ensure the Fund can reasonably achieve the solvency and long term cost efficiency objectives set out in the FSS. Equally the margin for prudence allows the Fund Actuary to aim to keep contributions as 'constant as possible' at each valuation as it can be varied within reasonable bounds depending on a number of factors. Prudence is also required under the Regulations and guidance and is important for protecting the tax payers against adverse events e.g. market or economic downturn which could mean the Fund would not meet its primary objective to meet benefits as they fall due.
  - (ii) **Long term salary assumption** – the short term pay assumption reflects the immediate issue of current and near term pay awards which can be reasonably predicted in conjunction with the employers. For the last valuation this was generally set at 1% p.a. (or higher) from 2016 to 2020 for public sector employers based on the information available at that time. However this assumption has been breached by for most employers for the period from 2016 to 2019 resulting in an increase in liabilities. Based on the recent announcements regarding public sector pay for this valuation the short term award is to be set at a minimum of 2% p.a. for the 4 years to 2023 at the Fund level but at 2%, 2.5% or 3% at employers' request. This assumption includes an allowance for average incremental increases where applicable.  
  
 The long term award assumption reflects the expectation over the next few decades which is of course harder to predict with any certainty. However, it must be set to ensure it is reasonable (based on evidence) and also to meet the solvency and long term cost efficiency objective. It must also be considered in light of the short term award assumption. The long term award is set at CPI +1.5% p.a. as this takes into account annual increments, promotions and restructurings which on past evidence has caused salary growth to exceed CPI over time. For example the evidence from the scheme employers in the data from the shows that the average pay increase over the last two valuations (the period from 2013 to 2019) has been broadly CPI + 1.7% p.a. so it can be seen in times of austerity the combination of general pay awards and increments can be material.
  - (iii) **The discount rate** reflects the expected real return over CPI generated by the investment strategy as this is what determines the long term cost of the LGPS as liabilities (benefits payments) predominately are linked to CPI inflation. Fundamentally the higher this return the lower the contributions required from employers will be in the long term. Given the point in the economic cycle and strong asset growth over the last 6 years, most investment managers and advisors are reducing their expectations for real

returns. Based on analysis, since 2016 valuation the median expected real return (i.e. that the strategy has a 50% chance of at least achieving this median return) for our strategy has fallen by 0.8% p.a. to CPI + 2.7%. Over the same period nominal gilt yields have fallen from 2.2% to 1.5%. Therefore, the investment return assumptions have been reduced to reflect the lower expected returns; however the full reduction has not been implemented resulting in a lower margin of prudence. The Fund has risk management strategies in place which support a less prudent margin in this assumption. The Actuary has recommended this reduction in the discount rate to take this into account and also so that the Fund reasonably meets its Solvency and Long Term Cost efficiency objectives. This will be reviewed from valuation to valuation taking account all relevant factors.

(iv) **Longevity assumption** – there are two drivers of the mortality assumptions, the actual mortality rate for the Fund (based on actual Fund experience over the last 13 years) and the expectations of future improvements in longevity. For the 2019 valuation the actuary has used the data from the Fund (and other LGPS Funds) and the latest CMI (Continuous Mortality Index) data gathered from a wide range of pension funds (including the LGPS) and insurance companies to reset the baseline mortality rate which reflects that the improvement in longevity is slowing. For example, the valuation assumes that a male aged 45 now will live to 89.6 compared to 91.3 in 2016 which shows the slowdown in the expected rate of improvement in life expectancy based on this new data. More detail is shown in the FSS.

(v) **Comparison the GAD discount rate.** GAD's SCAPE discount rate (currently CPI+2.4% but was CPI + 3% for the 2016 valuations so shows a fall as per the Actuary's recommendation for the valuation discount rate) is used to value the liabilities of the unfunded schemes (which are funded solely by tax receipts) and bears no relevance to the discount rate used for funded schemes. It reflects the OBR's assessment of long term real GDP growth which is currently around 2.2% above CPI. GAD uses this discount rate when it reviews the LGPS valuation outcomes merely to use a consistent discount rate for comparison only, irrespective of the investment strategy or the demographic characteristics of any individual LGPS Fund. This means that at each valuation the discount rate used by the Actuary could be higher or lower than this depending on the factors noted above.

b) **Automatic 3 year reduction in DRP with 12 year medium term target.** One of the requirements under the regulations is that the funding strategy addresses intergenerational fairness and does not unreasonably defer pension costs to future taxpayers (referred to as Long Term Cost Efficiency). Therefore, the target to get to a 100% solvency must be funded over a reasonable period of time. The reduction of 3 years is simply maintaining this timeframe at this valuation.

The FSS provides flexibility to manage DRP based on the covenant of the employer. Where there is a strong covenant and a reduction in the DRP by 3 years means the employer is paying less contributions overall compared to its current funding plan then the cash saving will accrue to the employer.

Where an employer has a DRP below 12 years, the DRP will be maintained if their covenant is sufficient to support the liabilities in the longer term. However, DRPs will not be extended, even if below 12 years, unless there are exceptional circumstances.

In both scenarios and employer will be able to use a shorter recovery period (increased contributions) e.g. where its participation in the Fund is of a fixed length

- c) **Maintaining monetary amounts of contributions from previous valuation.** The funding plan is designed to ensure that over time sufficient contributions are paid in and ideally kept as constant as possible. The principle is that total contributions should not reduce unless there is a genuine saving/improvement; the split between primary and secondary contributions can be altered. Therefore, if the improvement in the funding level means that the reduction in deficit contributions is larger than the increase in future service contributions, then the employer will generally pay less unless there is a concern over its covenant and maintaining the same contributions are affordable and does not detriment the employer covenant. This is to protect employers in the Fund.
- d) **The run off of surpluses should be accelerated.** Surpluses will generally be run off over 12 years, subject to a total employer contribution of zero, to provide as constant as possible contribution rates. A deficit (or material reduction in surplus) can arise within a short period due to adverse experience e.g. market downturn and a surplus acts as a potential buffer against this so; therefore the rate at which surpluses are run down is one element of managing this risk prudentially to achieve the Long Term Cost Efficiency objective. Taking this into account means that using the 12 years is a reasonable balance as it corresponds to the target for deficits to be recovered in the long term so is equitable. If the employer is expected to exit the Fund within a shorter timeframe, then a shorter run off plan can be agreed taking into account the potential termination position of the employer.
- e) **McCloud costs.** It is not anticipated that the final remedy will be known before the valuation is completed by 31 March 2020. The FSS has been amended to set out how any potential increase in costs will be dealt with in a reasonable manner as required by the guidance from MHCLG.

5.4 In light of the responses received, the proposed changes to the draft FSS are as follows:

- a) Greater clarity about achieving solvency and long term cost efficiency
- b) Clarified the reduction in DRP by 3 years, medium term target of 12 years and how this delivers long term cost efficiency.
- c) Made it explicit that if DRP is below 12 years it will be maintained.
- d) Clarified wording on how the McCloud liabilities will be calculated and that employers will have choice to either include in contribution rate or to make a provision and pay backdated contributions once the remedy is known
- e) Included explanation of the margin of prudence in the investment return assumption used in the discount rate.

## 6 PRELIMINARY WHOLE FUND RESULT

- 6.1 The final actuarial outcome will be reported to Committee at March 2020 meeting, however preliminary whole Fund results (based on the proposed assumptions to assess solvency and future service plus updated demographic assumptions) are set out below:

	£m
Assets	4,820
Liabilities	5,078
Deficit	258
Average Funding Level	95%
Average Employer future service contribution rate	17.1% p.a.

These results will be subject to change as the valuation is completed for each employer – in particular any changes in the assumption for short term pay award and the impact of the employers moving into the lower risk investment strategy. The impact of McCloud on employer contributions over 2020/23 will be considered with individual employers as per the policy set out in the FSS.

## **7 RISK MANAGEMENT**

7.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. In addition it monitors the benefits administration, the risk register and compliance with relevant investment, finance and administration regulations. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

## **8 CLIMATE CHANGE**

8.1 The Fund is implementing a digital strategy across all its operations and communications with stakeholders to reduce its internal carbon footprint. The Fund acknowledges the financial risk to its assets from climate change and is in the process of addressing this through its strategic asset allocation to Low Carbon Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Committee.

## **9 OTHER OPTIONS CONSIDERED**

9.1 None.

## **10 CONSULTATION**

10.1 The Council's Monitoring Officer and Section 151 Officer have had the opportunity to input to this report and have cleared it for publication.

<b>Contact person</b>	Liz Woodyard, Investments Manager 01225 395306
<b>Background papers</b>	CIPFA Pensions Panel (guidance on preparing FSS) Correspondence with actuary Responses to FSS from employing bodies
<b>Please contact the report author if you need to access this report in an alternative format</b>	

