Pensions Committee

2.00 p.m., Tuesday, 15 March 2016

Investment Strategy Review – Scottish Homes Pension Fund

Item number	5.6
Report number	
Executive/routine	
Wards	All

Executive summary

This paper updates the Committee on a review of the investment strategy of the Scottish Homes Pension Fund. The review has concluded and has put forward proposals to the Scottish Government for discussion as follows:

- Changing the agreement which governs the funding and investment for the Fund;
- Removing the direct link between the funding level of the Fund at the date of the triennial actuarial valuation and the contributions required from the Scottish Government;
- Introducing a more flexible, income focussed investment strategy to reduce the requirement for regular asset sales;
- Providing a longer-term projection of Scottish Government contributions at the time of the actuarial valuation.

The Committee is asked to approve that the Executive Director of Resources concludes an updated funding agreement with Scottish Government accordingly, in consultation with the Actuary, Investment Strategy Panel and Convener of the Pensions Committee.

Links

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Report

Investment Strategy Review – Scottish Homes Pension Fund

Recommendations

1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.

1.2 That Committee notes progress on the review of the Scottish Homes Pension Fund investment and funding strategy which proposes:

- Changing the agreement which governs the funding and investment for the Fund;
- Removing the direct link between the funding level of the Fund at the date of the triennial actuarial valuation and the contributions required from the Scottish Government;
- Introducing a more flexible, income focussed investment strategy to reduce the current requirement for regular asset sales;
- Providing a longer-term projection of Scottish Government contributions at the time of the actuarial valuation.

1.3 That Committee approves that the Executive Director of Resources concludes an updated funding agreement with Scottish Government accordingly, in consultation with the Actuary, Investment Strategy Panel and Convener of the Pensions Committee.

Background

2.1 The funding arrangements and contributions from the Scottish Government for the Fund are currently determined by the 'Operation of the Scottish Executive (Government) Guarantee' ('the Guarantee').

2.2 The Actuary to the Fund assesses the value of the assets and liabilities at each triennial valuation and contributions are determined by comparing the funding level with targets set out in the agreement. Essentially, the assets and liabilities are 'marked to market' every three years. The resulting contributions by the Scottish Government depend on achieving increasing target funding levels at each actuarial valuation. The contribution calculation includes a provision to smooth contributions if the funding level fails to meet the current funding target but exceeds the previous funding target. However, contribution rates are largely dependent on current funding levels and hence depend on short-term market movements.

2.3 The equity allocation within the investment strategy is determined by the Guarantee as shown in the table below.

Equity Allocation %	Target Funding Level at 31 March	Target Funding Level %
35	2011	89.5%
30	2014	91.5%
25	2017	93.0%
20	2020	94.5%
15	2023	95.5%
10	2026	96.5%

2.4 The guarantee prescribes that the proportion of the Fund invested in equities will reduce over time and, as the actual funding level exceeds the target funding level, 'surpluses' will be locked away by increasing investment in government bonds. The monitoring of the funding level is undertaken by the internal investment team using a system provided by the Actuary. Changes to the equity exposure are undertaken in consultation with the Investment Strategy Panel.

2.5 An update on the investment strategy was provided to the Committee in December 2015. Following improvements in the funding level, in January 2015, the equity allocation was reduced from 30% to 25%. Subsequent market movements lead to a deterioration of the funding level and in October 2015 the equity allocation was increased to 27.5%.

2.6 Following further deterioration in funding level in 2016 (approximately 90.5% at the beginning of February), the equity exposure was increased to 30%.

2.7 The asset exposures at 22 February 2016 are shown in the table below.

Market Exposure	Actual Allocation (%)	Target Allocation (%)
Equities	30.9	30.0
Bonds	63.7	65.0
Property	5.4	5.0
Total	100.0	100.0

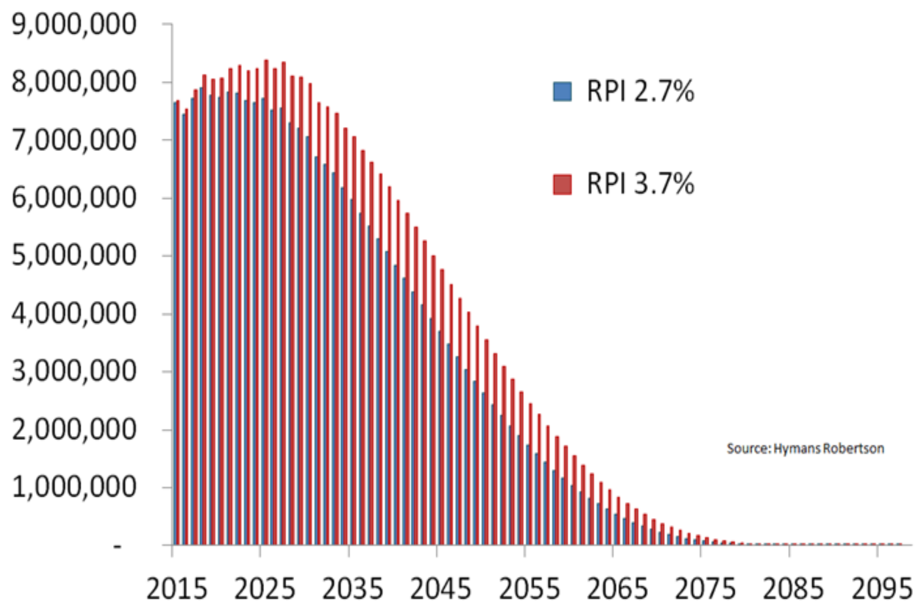
2.8 As previously reported to Committee, discussions regarding potential changes to the funding agreement were held with the Scottish Government during the 2014 actuarial valuation. Options to change the funding approach to one where contributions would be determined by fund cashflows, rather than funding level, were explored. However, the Scottish Government preferred that the 2014 actuarial valuation and contributions for the 3 years starting April 2015 are determined in accordance with the existing guarantee. However, they indicated they would be willing to explore funding options further ahead of the 2017 actuarial valuation.

Main report

3.1 The Investment Strategy Panel has undertaken a review of the investment strategy. The review included analysis of the forecast liability cashflow and the requirements of the investments of the Fund to meet the pension liability payments.

3.2 The liability projections are as follows:

Figure 1: Projected cashflows at differing inflation rates (£)



3.3 The review explored a number of investment and funding approaches and included consideration of different investment scenarios for income yield and growth of income.

3.4 The key conclusions of the analysis are as follows:

- Current bond-focussed investment strategy provides income yield of less than 2%. With a yield of less than 4-5%, the Fund is required to sell assets on a regular basis to pay pensions;
- The current strategy places a high reliance on the growth of assets and the market pricing at the point at which sales are required;
- Without significant contributions from Scottish Government, the current investment strategy is expected to be insufficient to fund the liabilities in the long-term.

3.5 The review has concluded that a less prescriptive investment and funding strategy is introduced to allow a higher-yielding investment strategy and a more flexible approach to setting contributions.

3.6 A higher yielding investment strategy would involve a lower allocation to government bonds (with a current yield of less than 1%) and increased allocation to equities, property and/or non-government bonds. Global equities currently yield approximately 3%.

3.7 Considerations for an alternative funding approach are:

- a lower allocation to government bonds means that the funding level on a particular day will be more volatile than under the current arrangement. However with a change to the funding agreement, short term market movements will not necessarily have a direct impact on the contributions required from Scottish Government;
- employer contributions could be determined by the Fund's cashflow requirements, focussing on the forecast of pension payments, administration costs and investment income. The details would be developed with the Actuary;
- the actuarial valuation could provide a forecast of contributions for a period longer than the current period of 3 years;
- a higher investment income (lower bond) focussed strategy should reduce the required contributions from Scottish Government in the long term;
- a higher investment income strategy will reduce the requirement for asset sales and hence smoothes the risk that asset sales are required after markets fall;
- if the contributions required depend on the receipt of income from investments, there is the risk that the assets do not deliver the anticipated income, for example, due to companies not paying dividends, failure of a counterparty or movements in currency. (These risks will be managed,but cannot be eliminated, by ensuring a diversified, income-focussed investment portfolio);
- currently non-property assets are managed on a passive, low cost basis and costs for some higher-yielding investments are likely to be higher. However, assumptions have been based on returns net of fees.

3.8 In practice, such an alternative funding arrangement would mean that:

- The funding level would continue to be calculated by the Actuary at the actuarial valuation.
- Regular analysis of assets and liability cashflow would be required to determine required contribution rates. This would happen every 3 years during the actuarial valuation process or more frequently if cashflow varies significantly from forecasts.
- A prudent approach to funding would continue to be taken. The Actuary would retain the right to revisit the actuarial valuation and contributions between the formal triennial cycle in the event of unforeseen experience or extreme changes in cashflow and/or investment markets.

3.9 The Actuary has confirmed he is comfortable with these high-level principles. Discussions with Scottish Government regarding alternative funding options are ongoing, including their requirement for stability or otherwise of the funding level.

3.10 It is envisaged that the next steps will be:

- Agreement in principle from Scottish Government;
- Develop the funding agreement with the Fund's Actuary;
- Agree and sign an updated funding agreement;
- Identify appropriate market opportunities and implement changes to investment strategy;
  Develop cashflow forecasts in advance of the 2017 actuarial valuation.

3.11 Committee is asked to approve that the Executive Director of Resources concludes an updated funding agreement with Scottish Government accordingly, in consultation with the Actuary, Investment Strategy Panel and Convener of the Pensions Committee.

3.12 Updates on progress will be provided to Committee.

Measures of success

4.1 The City of Edinburgh Council's primary requirement is to ensure appropriate funding arrangements for the Scottish Homes Pension Fund to ensure there are, or will be, sufficient assets to pay the liabilities.

Financial impact

5.1 The financial impact for the Scottish Government is a key consideration for the review. The conclusions propose a change to the funding guarantee which could provide greater certainty for the contributions required from the Scottish Government, but with a more volatile funding level.

Risk, policy, compliance and governance impact

6.1 The funding and investment risks are addressed in this report. The agreement and funding guarantee ensures that any contributions required for the Fund are paid by the Scottish Government.

Equalities impact

7.1 There is no equalities impact as a result of this report.

Sustainability impact

8.1 The funding approach ensures that the investments, together with contributions required from the Scottish Government, are sufficient to sustain the payment of pension liabilities now and in the future. The review of the funding aims to improve sustainability of the Fund in the long term.

Consultation and engagement

9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.

9.2 The Fund consults and engages with Scottish Government at least annually on the progress of the Fund. Scottish Government's priorities have been a key consideration of the review and discussions on the conclusions are ongoing in order to agree the way forward.

Background reading/external references

None.

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Links

Coalition pledges	
Council outcomes	CO26 - The Council engages with stakeholders and works in partnerships to improve services and deliver agreed
Single Outcome Agreement	
Appendices	None