Pensions Committee

11.00am, Wednesday, 27 September 2017

Actuarial Valuation 2017

Item number	5.11
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Executive/routine	
Wards	All
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Executive Summary

This report provides an update on preparations for the actuarial valuation as at 31 March 2017, including the responses from employers to the consultation on proposed changes to the Funding Strategy Statement, which was issued in July 2017.

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Report

Actuarial Valuation 2017

1. Recommendations

Committee is requested to:

1.1 Invite the Pension Board to raise any relevant matters or concerns which the Committee should consider;

1.2 Note the update on preparations for the actuarial valuation as at 31 March 2017;

1.3 Note the responses by employers to the consultation on proposed changes to the Funding Strategy Statement, which was issued in July 2017; and

1.4 Agree to adopt the proposed changes as the Fund progresses the 2017 actuarial valuations over the coming months.

2. Background

2.1 "The Local Government Pension Scheme (Scotland) Regulations 2014, Regulation 60 (1)" states that "each administering authority must obtain –

(a) an actuarial valuation of the assets and liabilities of each of its pension funds as at 31 March 2017 and on 31 March in every third year afterwards;

(b) a report by an actuary in respect of the valuation; and

(c) a rates and adjustments certificate prepared by an actuary".

2.2 These Regulations 2014 also stipulate the requirement on LGPS administering authorities both to "keep the (Funding Strategy) statement under review" and to consult "with such persons as it considers appropriate".

2.3 As previously reported to Committee in September 2016 and March 2017, in recognition of the affordability issues facing many employers, the Fund has, in consultation with external advisors, drawn up a funding agreement to address repayment of the debt on the exit of an employer from the Fund.

2.4 The funding agreement will be tailored to each employer, taking into consideration the employer's financial circumstances and also its ability to offer security over employer assets (where applicable). Employers will be required to submit financial information (such as annual report and accounts and cashflow information) to allow Fund officers to carry out due diligence and assess repayment proposals for affordability.

2.5 As previously reported to Committee, most recently in March 2017 and as also reported separately on this agenda, several employers have left the Fund and have indicated that they are unable to make payment of the cessation deficit in full.

A report entitled “Funding Update and Preparation for 2017 Actuarial Valuation” was considered by the Pensions Committee, at its meeting on 28 September 2016. This report provides an update on the actuarial valuation.

3. Main report

Actuarial Valuation as at 31 March 2017

3.1 Preparations for the 2017 actuarial valuation for Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund, based on data as at 31 March 2017, are now underway. Further updates will be provided to Pensions Committee, prior to final reports being submitted by the statutory deadline of 31 March 2018.

Funding position

3.2 Prior to any changes to membership data or demographic assumptions, the Fund’s actuary has cautioned that prevailing market conditions as at 31 March 2017 are expected to result in some deterioration of the overall funding position for Lothian Pension Fund and Lothian Buses Pension Fund, as compared to the last triennial valuation. The summary, as reported to Pensions Committee on 28 September 2016, remains unchanged. “Despite good growth in the investments of Lothian Pension Fund and Lothian Buses Pension Fund since March 2014, liability values have grown faster as yields have fallen.”

3.3 The funding position for Scottish Homes Pension Fund (prior to any changes to membership data or demographic assumptions) is expected to have improved since the 2014 actuarial valuation. Further detail is provided in the investment update for the Fund elsewhere on the agenda.

Contribution Stability Mechanism

3.4 On 28 September 2016, Pensions Committee approved “the continued use of the Contribution Stability Mechanism (CSM) for long-term secure employers within Lothian Pension Fund for the 2017 actuarial valuation”. It is therefore anticipated that contribution rates for those employers, which continue to meet the relevant criteria, shall increase by the maximum of 0.5% per annum for this valuation period.

Data and Assumptions

3.5 Financial and membership data was provided to the Actuary for Lothian Buses Pension Fund and Scottish Homes Pension Fund in July 2017, with data in respect of Lothian Pension Fund provided in August 2017.

3.6 The Fund has discussed key actuarial assumptions with its Actuary and a summary for Lothian Pension Fund and Lothian Buses Pension Fund, on a provisional basis, is shown below:

Assumption	**31 March 2014**	**31 March 2017**
Discount Rate		
Over 15 years fixed interest gilt yield	3.5%	1.7%
Asset outperformance assumption (AOA)	1.5% or 0.0% [1]	1.5% or 0.0% [1] [2]
Discount Rate	3.5% or 5.0% [1]	1.7% or 3.2% [1]
Long-term pay growth		
Expected long-term Retail Price Index (RPI)	3.5%	3.4%
Salary increases relative to long-term RPI	1.5%	[3]
Long term pay growth assumption	5.0%	[3]
Pension increases		
Retail Price Index (RPI) excess over Consumer Price Index (CPI)	0.8%	1.0%
Price inflation / Pension increases	2.7%	2.4%
Longevity		
Baseline mortality	Club Vita analysis	Club Vita analysis (specific bus industry data for Lothian Buses Pension Fund)
Future mortality improvements	Continuous Mortality Investigation (CMI) 2012	Continuous Mortality Investigation (CMI) 2016
50:50 membership option take-up	10%	0%

[1] Dependent on Strategy 1 or 2
[2] The Actuary is giving further consideration on the impact of the interim investment strategy for employers with maturing liabilities (as outlined in the FSS consultation below)
[3] At the time of writing, the Actuary is modelling different salary growth assumptions to inform decisions on this assumption.

Funding Strategy Statement – proposed revisions

Past Service Deficit – implications for previous appellants

3.7 Pensions Committee, at its meeting on 16 November 2015, noted the "financial position of some employers showed that the contribution rates as certified in the 2014 Actuarial Valuation were indeed unaffordable" and determined that "the future service rate on the gilts basis …. to be the minimum contribution in order to ensure that the accrual of new benefits does not increase the deficit on the cessation basis".

3.8 At the 2017 actuarial valuation, having due regard to the regulatory requirements to ensure the solvency and long-term cost efficiency of the fund, it would not be appropriate to perpetuate this discretion whereby no contribution is being made by these employers to any accrued Past Service Deficit. This is now particularly relevant given the additional scrutiny faced by the Fund in the form of further valuation undertaken by the Government Actuary's Department under Section 13 of the Public Sector Pensions Act.

Affordability constraints – termination of membership

3.9 In recognition of the severe financial difficulties facing many employers, particularly the charitable sector, and the desire of the Fund to avoid a future appeals process, the following stipulation within the Funding Strategy Statement is proposed, namely "In circumstances where an employer's membership of the Fund is not mandated by Regulations and that employer is unable to meet the minimum contributions as certified by the Fund's Actuary, then its membership will be terminated, with notice period of three months being applied by the Fund. At each valuation, therefore, every employer will require to confirm its commitment to meet the certified minimum contributions, otherwise, following the notice period as specified, then "Appendix C: Policy on employers leaving the Fund" will apply".

3.10 This is considered to offer a pragmatic solution to a very contentious issue and is one to which the Fund's actuary has indicated his support. Legal opinion is currently being sought.

Employer Asset Tracking (Unitisation of investments)

3.11 Lothian Pension Fund is a multi-employer fund. Historically, individual employer asset shares have been calculated triennially at formal valuations by the Fund's Actuary using an analysis of surplus technique and tracked between valuations using a cash flow or roll forward approach. In order to enhance the transparency, accuracy and auditability of individual employer asset allocations and reduce any cross-subsidy between participating employers, from the 2017 valuation, the Fund will utilise an employer asset tracking system based on cash flows. This is a form of unitisation of investments, where each investment or disinvestment of monies involves the purchase or selling of units in the fund. By sub-dividing the assets into units, the fund can more easily and accurately track each individual employer's assets. Changes in the value of the underlying assets are allowed through changes in the unit price.

3.12 Such unitisation therefore provides an efficient way of accurately apportioning assets to individual employers by allowing for employer cash flows and investment returns achieved by the Fund. In addition, this provides a mechanism for facilitating and managing a choice of investment strategies within the single Fund to meet the needs of employers with different maturity profiles, funding levels or investment objectives.

New investment strategy for employers with maturing liabilities

3.13 As Pensions Committee is aware, employers with enduring membership are assigned to a long-term investment strategy, which aims to maximise the investment return within reasonable and considered risk parameters and hence minimise the cost to the employer. Those employers whose membership is anticipated to be of a very short duration, however, are assigned to assets of 100% gilts. With unitisation, there is now scope to introduce a further “middle” strategy, that is comprising 50% of long-term assets and 50% of gilts. It is intended that those employers which have closed membership of the Fund to any new entrants, but which do not meet the criteria (as stated above) for investment in purely index-linked government bonds, will be assigned to an investment strategy balanced to this maturing liability profile. At present, this would encompass seven employers, with c£100M of assets.

3.14 The Fund may consider requests for an employer to be assigned to an alternative investment strategy to that which strict application of the criteria would indicate, but only in circumstances where this was supported by an explicit guarantor and / or where the Fund would not consider such to represent a scenario of greater risk exposure to other employer(s).

Funding Strategy Statement – consultation

3.15 Following a briefing for the Pensions Committee and the Pension Board, the Fund issued a consultation with its employers on these proposed revisions to its Funding Strategy Statement in July 2017. It can be found on the Fund’s website. http://www.edinburgh.gov.uk/lpf1/downloads/file/815/funding_strategy_statement_-_consultation_july_2017

3.16 This consultation was released at a much earlier stage in the actuarial valuation process than has historically been the case. The advantage is that requisite clarity can be attained from the Fund’s key stakeholders on the funding principles, prior to issue of draft results (minimum contribution rates) to individual employers.

Funding Strategy Statement – analysis of employer consultation responses

3.17 A total of 11 responses were received from employers. As anonymity was requested, these responses have not been included in this report, however a summary is provided at Appendix 1.

3.18 In summary, there is support from employers with the principles of proactively managing the risks to the Fund. Some employers highlight the difficulties of funding pensions and affordability. These issues are understood and the proposed changes to the Funding Strategy statement (FSS) are intended to better manage issues. The Fund will continue to engage with employers during the valuation process as draft results become available.

3.19 Committee is asked to note the responses by employers to the consultation on proposed changes to the Funding Strategy Statement and agree to adopt the proposed changes as the Fund progresses the 2017 actuarial valuations over the coming months.

Actuarial Valuation – Draft Timetable

3.20 At present, liaison with the Actuary is ongoing to finalise the timetable for the Actuarial Valuation 2017. The Actuary is scheduled to provide a presentation on his general findings for the Lothian Pension Fund to the Annual Employer Seminar on

2 November 2017. A prior briefing will be held for Pensions Committee and Pension Board. Separate consultation will be held for the specific Lothian Buses plc and Scottish Government (for the Scottish Home Pension Fund).

3.21 For Lothian Pension Fund, it is envisaged that draft results schedules with indicative minimum contribution rates will be issued to individual employers shortly after the seminar.

3.22 Engagement with employers will progress prior to final reports being submitted to Committee by the statutory deadline of 31 March 2018. For the Lothian Buses Pension Fund and the Scottish Homes Pension Fund, reports may be submitted to Committee in December 2017 if the process is complete.

4. Measures of success

4.1 The principal objective of the Fund is to ensure its long-term solvency. The Fund therefore targets full funding, as described in the Funding Strategy Statement.

4.2 It is the Fund's policy that the determination of any surplus or deficit on termination should aim to minimise, as far as is practicable, the risk that the remaining, unconnected employers in the Fund should have to make contributions in future towards meeting the past service liabilities of current and former employees of employers leaving the Fund.

5. Financial impact

5.1 The actuarial valuation assesses the financial position of the funds and will, once complete, have a significant impact on the speed at which participating employers pay for pension commitments. Implications of employer cessations are as detailed.

6. Risk, policy, compliance and governance impact

6.1 Regulations governing the Local Government Pension Scheme in Scotland stipulate requirements for both the triennial actuarial valuation and the Funding Strategy Statement. These will be the subject of future reports to Pensions Committee. This report is purely advisory

7. Equalities impact

7.1 There are no equalities implications as a result of this report.

8. Sustainability impact

8.1 There are no adverse sustainability impacts from this report.

9. Consultation and engagement

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

9.2 Consultation with the Fund’s employers has been undertaken on proposed changes to the Funding Strategy Statement. A summary of the responses to the consultation is provided within this report.

10. Background reading/external references

10.1 None.

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11. Appendices

Appendix 1 – Funding Strategy Statement – Feedback from Consultation

Appendix 1

2017 Actuarial Valuation and revision of Funding Strategy Statement

Feedback from consultation

Introduction

The latest actuarial valuation of the Lothian Pension Funds will be carried out as at 31 March 2017. As part of the valuation process, the Funds' Funding Strategy Statement (FSS) is being reviewed and revised. As required by Scheme Regulations, the review will be carried out in consultation with Scheme employers.

Following a presentation on proposed changes, an initial consultation exercise was carried out in the summer of 2017.

Individual responses were received from 10 employers of varying size and liability profile.

This document summarises the responses received from employers. This will be presented to the Pensions Committee in September 2017. Further consultation exercises will be carried out as the valuation process continues. The final revised FSS will be presented to the Pensions Committee in March 2018.

Key issues raised by employers

1) **Proposed introduction of a further investment strategy for employers closed to new entrants but which do not meet the criteria for the current lower-risk strategy.**

It is proposed to introduce a third investment strategy for employers who do not meet the criteria for the current strategy 2. The intention behind this proposal is to act as a transition between the current strategy 1 and strategy 2.

Responses to this employer were mixed: whilst the majority of respondents who commented felt that such a change was prudent in terms of managing risk and 'helpful in smoothing an employer's path to full cessation', others felt that without knowing the impact on contribution rates they could not yet comment. One employer suggested that such a change may be counterproductive in that the resulting increase in contribution rates may lead to contributions being '…unaffordable for the employer, who by the fact that they meet the halfway criteria are more likely to experiencing significant financial challenges.'

Although contribution rates may increase for employers who move to the proposed new strategy, this will provide the relevant employer with a more realistic idea of pension costs, reduce risk to the Fund and an opportunity to consider whether or not membership of the Fund remains affordable. A balanced but lower risk strategy also offers better alignment to a maturing liability profile.

2) Employer Commitment to Contribution Rates

It is proposed that each employer is required to confirm its commitment to meet the minimum contribution rates certified by the Actuary as part of the actuarial valuation process. If an employer is unable to meet these rates or offer suitable alternative proposal, then the admission agreement would be terminated with a notice period of three months being applied by the Fund. At the expiration of the notice period, the Fund would arrange for an exit valuation to be carried out by the Actuary and then engage with the employer on repayment of the exit payment taking into consideration the principles previously established by Pensions Committee in November 2015. In particular, to allow repayment over a longer period of time and to ensure that any repayment avoids employer insolvency.

Whilst some employers welcomed this proposal, with one commenting that doing so 'is likely to be helpful on focusing the attention of employers', another commented that clarity on what form such commitment would take would be welcome. One employer did however feel that a period of 3 months is too short to negotiate an exit and suggested extending this to 12 months.

The Fund will provide clarity on how such commitment should be provided at the time individual employer results are circulated.

The three month notice period is not intended to be the timescale for negotiating the exit: the repayment will be agreed following the exit date and after the exit valuation has been calculated. Extending the 3 month notice period to 12 months would simply lead to the employer increasing already unaffordable liabilities and it would therefore not be prudent for the Fund to extend the notice period further.

3) Future working lifetime

Employers were advised that the Fund is currently consulting with the Actuary on the definition of the Future Working Lifetime – used for determining inclusion in the current strategy 2.

Employers acknowledged that the current definition is complex and welcomed further clarity but felt that more detail was required before commenting further. One employer commented that the nature of the employer's business could be taken into consideration, not just membership information.

The Fund is continuing to liaise with the Actuary on this point and further details will be provided in due course. The Fund regularly monitors membership data and carries out work on employer covenant which measures an employer's ability and willingness to pay contributions. Data from the most recent covenant survey will be used in the 2017 Actuarial Valuation. The strength (or otherwise) of an employer's covenant is also taken into consideration when an employer exits the Fund: an *employer with a stronger covenant – perhaps with a strong guarantor or one which can offer security over assets, can be afforded a more relaxed cessation basis.*

4) Employer Grouping and the Pool

Currently, small admitted bodies are 'Pooled' for contribution rate purposes. An average contribution rate based on combined experience is calculated, with closed employers paying a premium to reflect this status. This arrangement protects employers from fluctuations in contribution rates and the impact of ill-health retirement. The consultation paper highlighted to employers that should the proposed third strategy be introduced; the pool may no longer be sustainable as closed employers would be moved from the pool to the third strategy. More detail will be available once the valuation results are available.

5) General comments

Some employers questioned the basis used in calculating liabilities when an employer exits the Fund. One respondent commented that whilst noting that the Fund's approaches to repayment of cessation debts '…are laudable, they do not address the underlying problem.' Another asked about the involvement of guarantors in the negotiation of any funding agreement on exit.

The Fund's 'Policy on Employer's Exiting the Fund' (Appendix C of the Funding Strategy Statement) has not been changed and advocates the use of a more prudent funding basis, on the advice of the Fund Actuary.

Actuarial guidance on the calculation of cessation debts has not changed since the 2014 Actuarial Valuation. The Fund must ensure the position of all contributing employers is protected and therefore there are no plans to change the prudent approach to calculating liabilities when an employer exits the Fund. It should be noted that since the last Actuarial Valuation was finalised the Fund has been working with several employers looking to exit the Fund and has been able to successfully put in place funding agreements. The Policy on Employer's Exiting the Fund' already highlights that the covenant of the employer and any guarantor is considered when calculating the cessation debt, as is the possibility to offer security over assets.

One employer commented that the timescale for provision of individual employer results (autumn of 2017) is 'restrictive to the point of making it inviable' given that budgets have already been set by this time.

The Fund recognises that budgetary timescales are not always aligned with the actuarial valuation cycle, however the dates of the valuation are set out in the Scheme Regulations and data for the preceding financial year (which is not provided to the Fund by employers until mid April) is required to be updated and cleansed by the Fund prior to submission to the Actuary. In this regard, the Fund is bringing forward the results as early as possible – previously these have only been issued in December of the valuation year. Also, the Contribution Stability Mechanism is *intended to facilitate financial planning beyond the triennial valuation cycle, although it is recognised that this is only accorded to the more secure employers with long-term duration of membership.*

In responding to the consultation some employers also provided details with regards to their own specific circumstances and the Fund will contact these employers directly to discuss the issues raised.

Lothian Pension Fund
September 2017