2019 Valuation update

Addressee and purpose

This document has been requested by and is addressed to Oxfordshire County Council in its capacity as Administering Authority to the Oxfordshire Pension Fund ("the Fund"). It has been prepared to:

1 provide information on the initial whole fund results of the 2019 valuation of the Fund;

2 outline the proposed changes to the Fund's funding strategy as part of the 2019 valuation review; and

3 provide an update on proposed employer contribution rate changes.

It has not been prepared for use for any other purpose and should not be so used.

No liability is accepted under any circumstances by Hymans Robertson LLP for any loss or damage occurring as a result of reliance on any statement, opinion or any error or omission contained herein where the report is used by or disclosed to a third party.

Background

As the Fund actuary, we are in the process of carrying out the formal valuation of the Fund as at 31 March 2019. The actuarial valuation of the Fund on a triennial basis is a Regulatory requirement and its primary purpose is to determine contribution rates payable by participating employers for the three-year period commencing 1 April 2020. A secondary outcome is an assessment of the funding position. The valuation is carried out under Regulation 62 of the Local Government Pension Scheme Regulations 2013 ("the Regulations").

Alongside the valuation, the existing funding strategy is reviewed to ensure it remains appropriate in light of any changes to individual employer circumstances or wider regulatory, political, economic and demographic factors. The funding strategy is formally laid out in the Funding Strategy Statement ("FSS") which, under LGPS Regulations, all funds have a statutory obligation to produce.

1 Initial results of the 2019 valuation

Data

The Administering Authority supplied final membership data to us for the purposes of the 2019 valuation on 24 September 2019. The accuracy of our results is limited by the quality of the data provided. We have carried out validations on the data provided to ensure it is fit for the purposes of the valuation. We believe the membership data is fit for the purposes of this valuation.

We have based the valuation on our understanding of the benefit structure of the LGPS in England and Wales as at 31 March 2019. Details can be found at http://www.lgpsregs.org/. It should be noted that the LGPS benefit structure is currently under review following the Government's loss of the right to appeal the McCloud court case. At the time of writing we have not been provided with details for any subsequent benefit improvements and as such have not allowed explicitly for any in our calculations. This approach is in line with the advice issued by the Scheme Advisory Board in May 2019.

Assumptions and methodology

The ultimate objective of an LGPS fund is to be able to pay members' benefits as they fall due. For an open, ongoing scheme like the LGPS, the main purpose of the valuation is to set employer contribution rates that, together with future investment returns on the employer's assets, have a high likelihood of meeting this ultimate objective. The Fund's revised approach to setting contribution rates focuses on optimising both the investment and contribution strategy to meet future benefit payments and identify key funding risks. This is done by determining a long-term funding target and then assessing the likelihood of funding plans meeting that target using risk-based modelling.

The assumptions used to set the funding target for contribution rate setting purposes for the 2019 valuation were discussed with Fund Officers in August.

A secondary output from the valuation is the calculation of a funding position at the valuation date: in other words, to what extent do the assets held by the Fund at 31 March 2019 cover the accrued benefits (liabilities)? LGPS funds typically report two measures of the funding position: a funding level (the ratio of assets to liabilities) and a funding surplus/deficit (the difference between the asset and liabilities values).

A funding position is limited as it is calculated on a single set of assumptions about the future and, as such, is very sensitive to the choice of assumptions and gives no insight into the likelihood of the assumptions being borne out in practice. However, it is a helpful metric to provide a high level snapshot of the position of the Fund at the valuation date and help stakeholders understand the factors that cause pension costs to change.

To calculate a current funding level, we compare the value of the Fund's assets against a likely cost of the benefits accrued to date. The value of assets is obtained via market valuations. Placing a single value on the benefits requires assumptions about when and how much benefits will be paid and also about the investment returns we expect to achieve on the assets held.

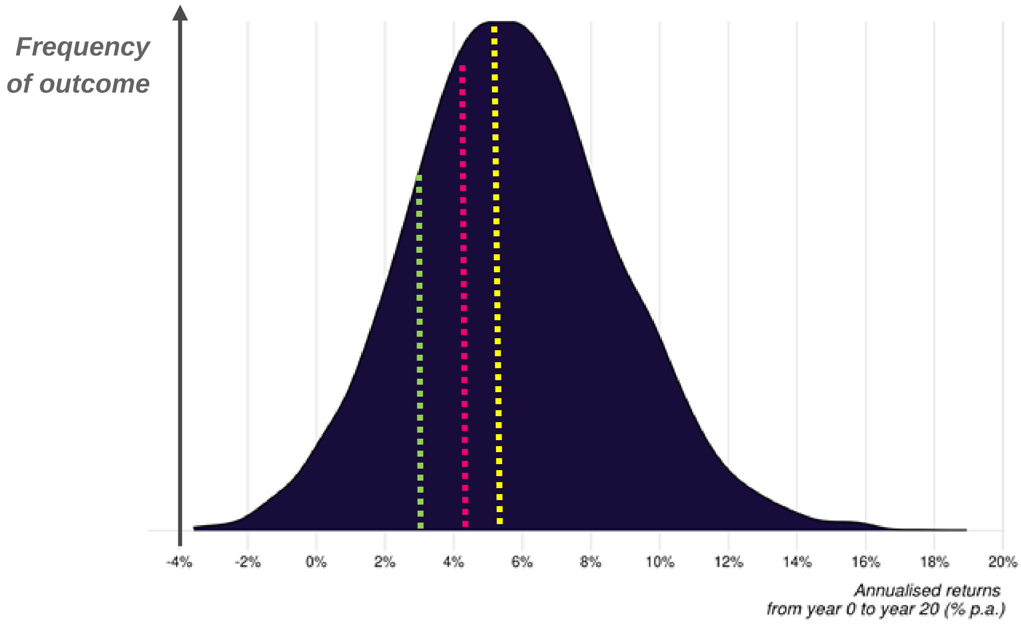
To derive an assumption about future inflation (which underlies the benefit increase, salary increase and CARE revaluation assumptions), we have compared the difference on fixed interest and index linked long term government bonds. This provides the financial market's view of long-term inflation. The tables below detail the benefit increase, salary increase and CARE revaluation rate used in the assessment of a funding position at the 2019 valuation.

Financial assumption	2016 valuation	2019 valuation
Benefit increases (p.a.)	2.4%	2.3%
Salary increases (p.a.)	3.2%*	2.3%
CARE revaluation (p.a.)	2.4%	2.3%

*Blended assumption based on of CPI until 31 March 2020, followed by CPI plus 1.5% thereafter

The choice over a single assumed return on the fund's assets is less straightforward (and therefore more subjective) due to the various different types of assets the fund is invested in and the limitation of reliable indicators about the financial market's expected long-term view.

At the 2016 valuation, an assumption based on one market indicator (a deterministic approach) was used. For the 2019 valuation we have used an assumption that reflects the range of possible future investment returns and the likelihood of the Fund's assets returning this assumption (a stochastic approach). Using the Fund's investment strategy and running 5,000 simulations of our proprietary economic model, the Economic Scenario Service (ESS), we have generated a distribution of possible future annualised investment returns over the 20 years from the valuation date:



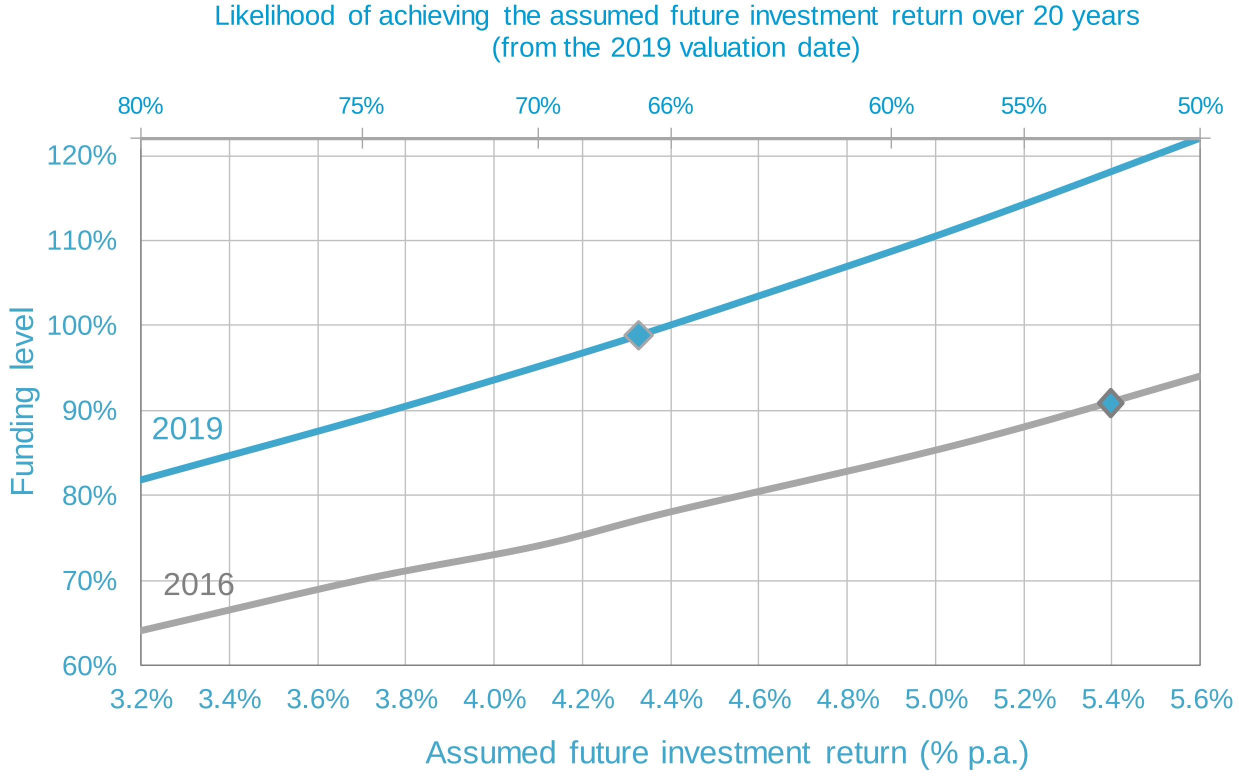
From the above, we can derive the likelihood of the Fund's investments achieving *at least* a certain level of return:

- There is a 50% likelihood of achieving at least an annual return of 5.6% p.a. over the next 20 years (i.e. 2,500 scenarios to the right of the yellow dashed line and 2,500 to the left);
- There is a 67% likelihood of achieving at least an annual return of 4.3% p.a. over the next 20 years (i.e. 3,350 scenarios to the right of the pink dashed line and 1,650 to the left); and
- There is an 80% likelihood of achieving at least an annual return of 3.2% p.a. over the next 20 (i.e. 4,000 scenarios to the right of the green dashed line and 1,000 to the left).

Funding position at 31 March 2019

Understanding the likelihood associated with certain levels of assumed future investment returns means we can better understand the Fund's funding position.

The following chart shows how the funding level varies with the future investment return assumption. For comparison, the funding level associated with the same choice of investment return assumption at the 2016 valuation is also shown.



From this chart, we can see that:

- The funding position would be 100% if we can achieve future investment returns of around 4.4% p.a.. The likelihood of the Fund's assets yielding at least this return is around 66%.
- Conversely, if future investment returns are on average 3.2% p.a. over the long term then the Fund currently holds sufficient assets to meet 83% of the accrued liabilities. The likelihood of achieving at least this level of future investment return is 80%.
- For any given expected future investment return, the funding position of the Fund has improved since the previous actuarial valuation in 2016. This is mainly a result of the strong investment performance of the Fund over the period from 31 March 2016 to 31 March 2019.

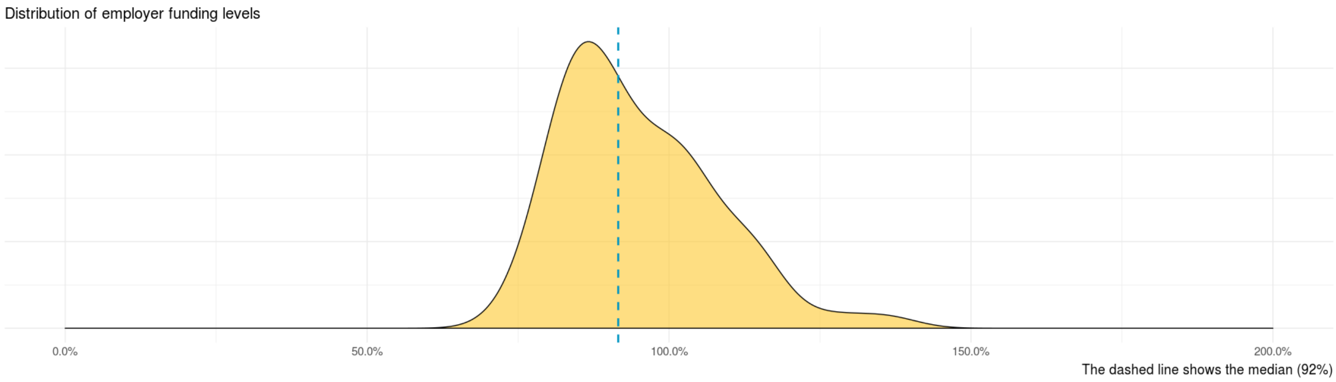
Whilst this chart gives the Fund a better understanding of the funding position than a single funding level, the Fund is still required to report a single funding balance sheet. Based on discussions with Fund Officers and the regulatory and professional requirements to include a degree of prudence in the funding position, an investment return with a 67% likelihood has been selected, namely 4.3% p.a..

Using the assumptions outlined above, the reported funding position of the Fund at the valuation date is summarised below. The asset figures are the market value of the Fund's assets as at 31 March 2019. The results at the 2016 formal valuation are shown for comparison.

Valuation Date	31 March 2016	31 March 2019
Past Service Liabilities	**(£m)**	**(£m)**
Employees	669	790
Deferred Pensioners	448	631
Pensioners	913	1,125
Total Liabilities	**2,030**	**2,546**
Assets	**1,842**	**2,515**
Surplus / (Deficit)	**(188)**	**(31)**
Funding Level	**91%**	**99%**

Employer funding results

The figures shown above are at whole fund level. The funding position of each individual employer in the Fund is tracked separately (the whole fund is the sum of these employer positions). The chart below shows the range and distribution of employer funding positions in the Fund as at 31 March 2019.



2 Key changes to funding strategy

The current funding strategy was refreshed and reviewed as part of the 2016 valuation. As mentioned earlier, the funding strategy is detailed in the Funding Strategy Statement ("FSS") which is a key document for the Fund in two ways:

1. The inputs it requires: Fund's officers, Pensions Committee and Pensions Board need to go through a process to be satisfied that the Fund will be collecting an appropriate level of contributions from each and every employer in the Fund. The FSS provides a helpful framework for organising this process and covering all the necessary areas;
2. The outputs it provides: the finalised FSS itself should be a clear and transparent reference point for the Fund's stakeholders, to provide proof that the contribution arrangements are solidly derived, fair and consistent. It will also help in any future discussions with employers, perhaps where an approach is queried or questions are raised.

A summary of the key FSS changes as part of the 2019 review is set out below:

Regulatory and operational updates since 2017 FSS (updates throughout document)
The following areas have been included or updated within the FSS to allow for regulatory changes since 2017:

- Allowance for new 'Exit credits' legislation (throughout)
- Noting the Valuation cycle consultation and update the Fund's policy on interim assessments (p8 and p14)
- Dealing with McCloud/cost cap benefit uncertainty (p7)
- Detailing the approach for new academies joining the Fund or moving to/from a Multi-Academy Trust (p15)
- Detailing possible employer post cessation agreements (p17)
- Due consideration being given to climate change risk (p30)
- Detailing the approach to tracking employer assets (p36)
- Detailing approach for using "pass through" arrangements for outsourced contractors (p16)
- Detail of approach to funding Guaranteed Minimum Pensions (p31)
- Option for individual employer investment strategies (p22)
- Review of approach for employer ill health early retirement risk (p20)

Change in approach for setting employer contributions (page 5 and 11)
A key change to the funding strategy is the use of a three-step risk-based framework for setting all employer contributions.

Previously, formal valuations of the Fund were a calculation exercise with contribution rates being set for all employers within the Fund based on a single set of assumptions and a mathematical formula (a "deterministic approach"). The disadvantage of a deterministic approach is that it does not allow the Fund, employer or Fund actuary to assess the risk associated with the proposed contribution rate. Risk in this context means the likelihood that the employer will not achieve their funding target over the agreed time-period.

With increased scrutiny on the LGPS, and the requirement to consider covenant strength of the employer when setting contributions, there is an increased focus on using the valuation as an opportunity to assess risk. Therefore, we intend to work with the Fund to adopt a "risk-based" approach to setting contributions for all employers for contributions payable from 1 April 2020. The risk-based approach is a “stochastic methodology”, which allows for thousands of future economic scenarios (rather than a single set of assumptions). This allows the Fund to quantify the risk of an employer not meeting their funding target, e.g. if the employer meets or exceeds their funding target in 750 out of 1,000 possible future economic scenarios, there would be an 75% chance of them meeting their funding target.

The risk-based approach sets a contribution strategy where the **likelihood** (probability) of meeting the **funding target** at the end of a specified **time horizon** is suitable for that employer. For example, each of the Councils in the Fund, has the same funding target, likelihood and time horizon, e.g. a contribution rate strategy would be appropriate and agreed if there is a 75% probability of being fully funded in 20 years’ time.

This “risk-based” approach will also be extended to all employers based on parameters suitable for each employer:

1. The **funding target** is based on a set of assumptions about the future, (e.g. investment returns, inflation, pensioners’ life expectancies). If an employer is approaching the end of its participation in the Fund then its funding target may be set on a more prudent basis, so that its liabilities are less likely to be spread among other employers after its cessation;

2. The **time horizon** required period over which the funding target is achieved. Employers may be given a lower time horizon if they have a less permanent anticipated membership, or do not have tax-raising powers to increase contributions if investment returns under-perform; and

3. The **likelihood of** achieving the funding target over that time horizon will be dependent on the Fund’s view of the strength of employer covenant and its funding profile. Where an employer is considered to be weaker then the required likelihood will be set higher, which in turn will increase the required contributions (and vice versa).

Following discussion with Fund Officers in October 2019 alongside the initial employer results, the proposed funding parameters for each employer group are summarised in the table on page 14 of the FSS.

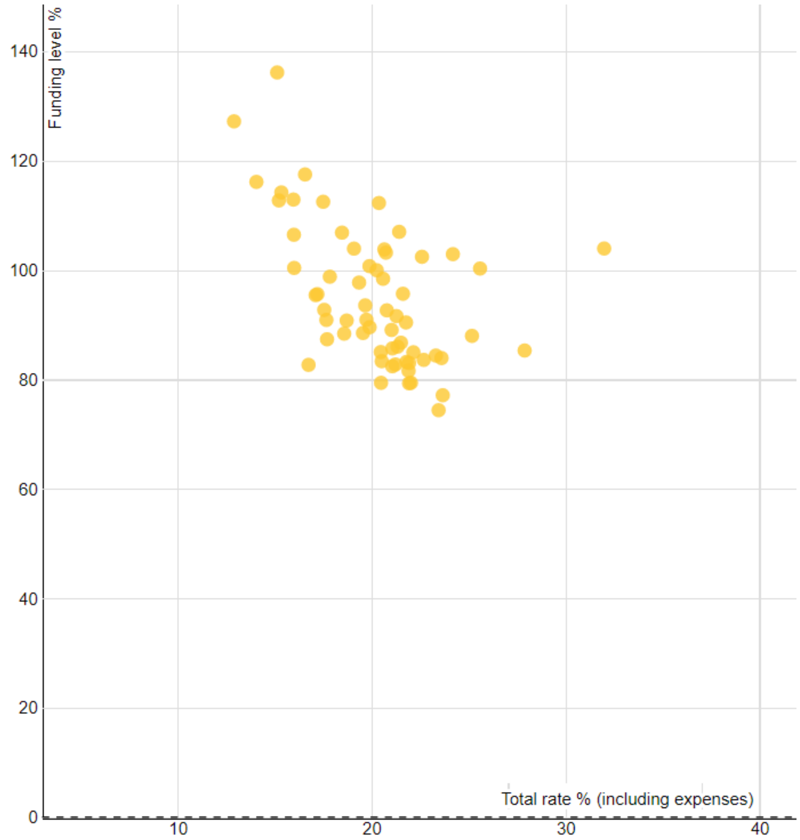
Reduction in maximum time horizon (page 13)
The FSS is proposing a reduction in the maximum allowable funding time horizon (previously refer to as “recovery period”) from 25 to 20 years.

In addition time horizons have now been set uniformly across different employer groups.

Introduction of Contribution Stabilisation (page 12-13)
In addition, it is possible to apply a “stabilisation” contribution overlay for employers . Stabilisation limits contribution rate increases and decreases to a maximum amount each year (e.g. plus or minus 0.5% of pay per annum). Modelling is used to test the robustness of any proposed stabilised overlay (i.e. to ensure stabilised contributions increases and decreases doesn’t impact on the employer’s likelihood of achieving the funding target by the end of time horizon). This provides the benefit of budgeting certainty for employers and cashflow predictability for the Fund. Within the FSS, this stabilisation overly has been proposed for long-term, secure employers as summarised on page 14 of the FSS.

3 Employer contribution rates

Based on the risked based approach for setting employer contributions the following chart and commentary summarises the changes expected from each employer groups:



The chart shows the range of employer contribution rates versus funding level (noting at the time of writing some employer results are still under review). The dispersion of funding level and contribution rates is to be expected when the different size, circumstances and covenant of each employer is taken in to account. However, the chart demonstrates that even for the most poorly funded employers, the respective proposed contribution rates have been kept affordable.

Council

Background

The Council employers within the Fund, have a long-term commitment to the LGPS and are typically large employers with the ability to raise taxes. These employers therefore have a very strong covenant. For this reason, they are generally considered to be secure and low risk.

Contribution rates

As part of reviewing the contribution plans for the Council, we have used in-depth asset-liability modelling to project forward assets and liabilities under thousands of different economic scenarios and test different combinations of contribution and investment strategies. The modelling then allows us to understand how likely the contribution strategy is to succeed (i.e. reach/maintain full funding over various time horizons) and the level of downside risk (i.e. how bad could the funding position get in a challenging economic climate).

When considering the contribution strategies to model, we are acutely aware that the financial situation of all public sector employers means that any ‘relief’ in budgets would be helpful. Given this budgetary climate and recent strong assets returns for the Fund, we have been exploring with Fund Officers whether any relief in contribution rates can be passed on to the Council. A contribution rate freeze or slight reduction is likely to be viewed as relief in this context. Of course, the Fund still needs to balance this desire against ensuring funding plans are robust and that there is sufficient likelihood to have enough money to pay members' benefits.

For most councils, the headline results of the modelling shows that there is scope to freeze employer contribution rates at their current levels for each of the three years from 1 April 2020. This has been discussed with Fund Officers and Finance Directors alongside wider considerations such as current regulatory risk, strength of employer covenant, external scrutiny, climate change risk, etc.

For councils which are more poorly funded, moderate increases in employer contribution rates have been proposed (e.g.1% to 2% of pay per annum).

At the time of writing, discussions with West Oxfordshire DC remain ongoing following the restructure of the majority of their staff to arm's length bodies which will not provide LGPS benefits for new members of staff.

In addition, there are ongoing discussions with various councils about the possibility of making contribution prepayments (i.e. making advance payment of a proportion future years certified contributions). When a prepayment is made the Fund has typically offered a "saving" in the overall cash cost to the employer. This is as a result of the potential to benefit from investment returns earlier that would otherwise be the case if payment of regular contributions was made.

Designating employers pool

Background

Town & Parish councils across the Fund are small employer but have varying size of liabilities and memberships. Individually, Town & Parish councils have tax-raising powers therefore could be seen as low risk.

The Fund operates a "full-risk sharing" pool for these employers (i.e. all employers funding is combined and they all pay the same contribution rate as a % of pay). This arrangement reduces the risk posed to the Fund of these very small employers. From an employer perspective, the level of cross-subsidies that exist in the pool may be outweighed by the stability of contributions afforded by being pooled together.

Contribution rates

While the funding level of the Designating employers pool has increased, the cost of paying for new benefits accrued by members has also increased. Therefore, the proposal is to hold the pools contribution rates at 21.7% of pay p.a. for the three years from 1 April 2020.

Academies

Background

As a result of the Academies Act 2010, primary and secondary schools were able to 'convert' from Local Education Authority (LEA) maintained school status to Academy status. The main reason for this was to provide the school with more autonomy. This extra degree of autonomy also applied to pensions funding.

The Fund takes the view that academies are relatively low risk as they are typically immature and very cashflow positive and have a guarantee from the Department for Education. While the extent of this guarantee has been challenged in the past, more recently there has been examples of successful calls on the guarantee in other LGPS Funds when an academy gets into difficulty and closes.

Contribution rates

To reduce contribution volatility for smaller academies, the Fund operates a "Academies Pool". Academies with less than 50 members are automatically opted into this pool unless they decide otherwise. In addition, any academy with over 50 members also has the right to opt to join the pool on a permanent basis.

All academies in the Fund (i.e. those in pool, multi academy trust and individual academies) are treated the same manner for contribution setting purposes. In addition, they are treated with the same funding parameters as council employers, with the exception of being ineligible for the stabilisation policy (primarily due to their lack of tax raising powers).

While changes at an individual academy level vary, on average employer contributions rates will increase slightly from 1 April 2020 (i.e. around 1% of pay). Despite improvements in funding levels on average across academies, this increase is predominantly as a result of increase to the cost of paying for new benefits accrued by members (i.e. the Primary Rate).

Further Education establishments

Background

In recent years, the funding arrangements for the Further Education (FE) sector has seen a significant change which has resulted in these bodies being re-classified from public to private sector employers. This change has also seen a considerable amount of uncertainty about the viability of certain establishments across England and resulted in a number of consolidations, mergers and takeovers.

Furthermore, the Ministry of Housing, Communities and Local Government (MHCLG) consulted on possible changes to the terms governing the participation of this employer group in the LGPS. Currently, FE employers must provide access to the LGPS for all staff who met the qualification criteria. The consultation proposes that this requirement is removed which gives FE employers the choice of whether it provides LGPS access to staff going forward.

However, at present FE employers in the Fund are well funded and remain committed to the LGPS in allowing new staff members to join the LGPS.

Contribution rates

The weaker covenant of the FE employers in comparison to tax-raising councils, has been taken in account by implementing a shorter time horizon over which these employers are expected to target full funding (i.e. 15 years compared to 20 years for councils).

As a result, the proposal is for contribution rates for all FE employers to moderately increase from 1 April 2020, with the expectation of Oxford Brookes University.

Due to the size of Oxford Brookes University and its risk to the Fund, fuller discussions and modelling has been conducted alongside the council employers. As part of these discussions Oxford Brookes made a £5m lump sum payment to the Fund as prepayment for future years' contributions. As a result of the payment, analysis and discussions, it has been proposed to reduce Oxford Brookes University's contribution rates for the three years from 1 April 2020.

(Transferee) admitted bodies

Background

There are a large number of (Transferee) admitted bodies ("TABs") within the Fund who perform services that have been outsourced from the letting authority (i.e. another Fund employer). TABs are typically short-term contractors and participate in the Fund for the period of the contract. The admission terms of TABs and the LGPS regulations, mean the letting authority is the guarantor of last resort, therefore the risk in the event of a TAB becoming insolvent is lower relative to other admitted bodies.

Contribution rates

The majority of TABs are pooled with their respective letting authority for contribution rate purposes. Therefore, changes in the respective letting authority's contribution rate will equally apply to changes in the TAB's contribution rate.

(Community) Admitted bodies

Background

(Community) Admitted bodies ("CABs") are traditionally the group of employers which pose risk to the Fund in terms of their covenant. However, the size of the financial risk is small relative to the Fund and most other employers. CAB's participate in the LGPS by choice but are typically:

- Closed to new entrants with an ageing membership – ultimately, heading for cessation in a short or medium timeframe;
- Long standing employers in the Fund, often with large liabilities relative to their size;
- Employers with weaker balance sheets with little or no fixed assets; and
- Stand-alone employers with no guarantor to secure any unpaid deficit.

Many CABs could be experiencing difficulty in affording their continued participation and may be looking to exit the LGPS to use an alternative arrangement to provide staff pension which is more aligned with their business requirements or the markets in which they operate.

We have worked with Fund Officers to engage with all CABs using questionnaires and inviting them to employer forums. These employers will also be invited to one-to-one session with the Fund and us to discussion their staff pension provision plans.

Contribution rates

The Fund operates a pool for a number of the smaller CABs, which is being reviewed by Fund Officers as part of the 2019 valuation process. Currently these employers are pooled for all funding risks meaning that they share membership experience and therefore cross-subsidies exist. The employers within the pool are varied in terms of size and maturity.

We have worked alongside Fund Officers to propose contribution rates for the three years from 1 April 2020 which remain broadly in line with those currently in payment (i.e. increase/decreases of less than 4% of pay) for all CABs.

4 Next steps

Subject to agreement from the Committee of the proposed funding strategy changes we can prepare all employer contribution rates based on the draft updated FSS and issue to employers for consultation (including the Employer Forum on 17th January 2020).

Following the end of the consultation period, any comments received by employers may lead to amendments to the FSS document. The final version of the FSS should be approved by the Pensions Committee and published during March 2020.

Reliances and limitations

This paper has been prepared for the purpose of summarising the initial results of the 2019 valuation and outlining the proposed changes to the funding strategy. It has not been prepared for any other purpose and should not be used for any other purpose.

The Administering Authority is the only user of this advice. Neither we nor Hymans Robertson LLP accept any liability to any party other than the Administering Authority unless we have expressly accepted such liability in writing. The advice or any part of it must not be disclosed or released in any medium to any other third party without my prior written consent. In circumstances where disclosure is permitted, the advice may only be released or otherwise disclosed in its entirety fully disclosing the basis upon which it has been produced (including any and all limitations, caveats or qualifications).

Nothing contained within this paper affects any member's benefits. Furthermore, none of the figures should be used for accounting purposes (e.g. under FRS102 or IAS19) or for any other purpose (e.g. a termination valuation).

The valuation results are wholly dependent on the data provided to us and the assumptions that we use in our calculations.

The results contained in this document are for the Fund as a whole. It does not set out the valuation results for individual employers.

The following Technical Actuarial Standards[1] are applicable in relation to this report and have been complied with where material given the summary nature of the paper:

- TAS100
- TAS300

Prepared by:-

Robert McInroy FFA
20 November 2019
For and on behalf of Hymans Robertson LLP

Catherine McFadyen FFA

[1] Technical Actuarial Standards (TASs) are issued by the Financial Reporting Council (FRC) and set standards for certain items of actuarial work.