Division(s): N/A

LOCAL PENSION BOARD – 25 OCTOBER 2019

2019 VALUATION

Report by the Director of Finance

RECOMMENDATION

The Board is RECOMMENDED to note the latest position with regard to the 2019 Valuation, the key changes planned for the Funding Strategy Statement and to offer any comments to the Pension Fund Committee on the current Draft Funding Strategy Statement for them to consider when agreeing the final Draft for formal consultation with scheme employers.

Introduction

1. Under the current regulatory framework, the Pension Fund is required to arrange for a Valuation of the Pension Fund every three years. The latest Valuation is based on the position as at 31 March 2019, with a requirement for the Fund Actuary to produce their report and certify the employer contribution rates for 2020/21 onwards by 31 March 2020.

2. In completing the Valuation, the Fund Actuary must have regard to the Committee's approved Funding Strategy Statement which sets out the key policies to be followed in determining the approach to the Valuation. As this is the first Valuation for Oxfordshire to be completed by Hymans Robertson, they have reviewed the current Funding Strategy Statement to bring it into line with their preferred approach to the Valuation.

3. This report provides information on the work done to date on the 2019 Valuation and discusses key changes included in the current draft of the Funding Strategy Statement (Annex 1). The revised Funding Strategy Statement itself will be presented to the December meeting of the Pension Fund Committee and the Pension Board is asked to provide any feedback on the current draft to that meeting, to enable the Committee to agree a final draft for formal consultation with all scheme employers. The final Funding Strategy Statement and Valuation results will be presented to the March meeting of the Pension Fund Committee.

Progress against 2019 Valuation Timetable

The Hymans Robertson Approach

4. There have been two major workstreams involved in the 2019 Valuation to date. One focusses on the Valuation data and the other on the Valuation approach. In respect of the Valuation data, the full data file was submitted to Hymans

Robertson in the first week of August following receipt of the end of year returns from the individual scheme employers.

5. As reported within the Improvement Plan report elsewhere on this agenda, considerable effort was required to correct the data to enable it to meet the basic validation tests applied by Hymans Robertson when receiving the data. Hymans Robertson have applied further tests to the data since receipt and are working with Pension Services to resolve some outstanding queries, but generally they have reported that the data is of good enough quality for the purposes of the Valuation, and is of a high standard in comparison to that received from other Funds. Hymans Robertson do have the right to increase the employer contribution rate for any individual scheme employer where they believe it is prudent to do so given concerns about the quality of the data.

6. In terms of approach to the Valuation, Hymans Robertson operate a risk-based framework. This more formally recognises the differences in employer risk profiles and covenant when setting employer contribution rates, ensuring a clear and auditable process. This risk-based approach looks at the likelihood of each employer being fully funded in the future under a wide range of different economic scenarios (5,000 scenarios are tested), rather than being focussed on one particular set of financial assumptions.

7. The contribution strategy therefore focuses on a suitable likelihood of achieving the funding target at the end of a specified period of time. For example, the contribution rate will be set such that in 75% of the potential economic scenarios, the employer will be fully funded in 20 years' time.

8. The funding target itself is a reflection of a number of future assumptions including investment returns, inflation and life expectancy. The funding target will be set such that the total assets held will be sufficient to meet all future pension liabilities. Depending on the risk profile for the employer, the Actuary can vary the level of prudence assumed in the financial assumptions and therefore in the funding target.

9. Similarly, the Actuary can reduce the time horizon to reach the funding target where they have concerns over the financial covenant of a scheme employer, where the employer has a fixed term admission agreement tied to a service contract, or where they have closed membership to the LGPS or are looking to significantly reduce membership through out-sourcing, re-structuring the workforce etc.

10. The likelihood of achieving the funding target will also vary depending on the risk profile and financial covenant of the employer, with the likelihood of achieving the funding target set higher for those employers deemed to be weaker.

11. An important part of the Hymans Robertson approach is the introduction of a stabilisation concept whereby the maximum variation in future contribution rates can be set. Any stabilisation criteria will need to be tested against the risk-

based model to ensure that the likelihood of reaching the funding target within the given time horizon remains within acceptable levels.

Current Position for Oxfordshire

12. Hymans Robertson have tested the approach working with the main employers in the Fund (the County, City and District Councils and Brookes University). The models (based on a roll forward of the 2016 Valuation data) have looked at the contribution rate required to ensure that each employer has a 75% chance of reaching their funding target. For the Councils the time horizon was set at 20 years, whereas for Brookes University, this was set at 15 years reflecting the slightly weaker financial covenant in that the University is not a tax raising body.

13. This work also looked at the impact of each employer making a one-off contribution to the Fund. This one-off contribution could either be viewed as a payment of contributions in advance, or an additional lump sum payment. In the case of the former, this would allow for a short-term reduction in contribution rate to assist with any cash-flow issues identified by the employer, whereas in the latter case the payment would be seen as allowing a permanent reduction in contribution rate (or a smaller increase in contribution rate, depending on the initial risk-based analysis).

14. Following this initial work, a variation to the current rates and adjustments certificate was agreed in respect of Brookes University, with the University making a one-off payment, with an immediate reduction in their contribution rate effective from 1 August 2019, in line with their new financial year.

15. Following the submission of the 2019 Valuation data at the beginning of August, Hymans Robertson have undertaken an initial run of the data to produce a whole Fund result. This suggests that there has been a significant improvement in the funding level based on better than assumed investment returns, and variations in other financial assumptions including salary increases and longevity. This though has been offset by a reduction in the assumed level of investment returns going forward.

16. These initial findings would support a general policy of maintaining employer contribution rates in line with those agreed at the 2016 Valuation. This though would not be the case for all employers within the Fund where the membership profile, risk profile or financial covenant is materially different to the Fund average.

Funding Strategy Statement

17. Officers have worked with Hymans Robertson to draft a revised Funding Strategy Statement to reflect the new risk-based approach being taken to the 2019 Valuation. The draft document (included at Annex 1) has also been expanded to produce a comprehensive document covering all aspects of employer funding, which can act as a single source of information to current and prospective scheme employers. The draft included at Annex 1 includes a

number of highlighted areas which are subject to further discussion with the Fund Actuary at a meeting with Officers on 23 October 2019, and an update from this meeting will be reported directly to the Board.

18. As well as setting out the principles of the risk-based approach, the draft document sets out some of the factors to be considered which would lead to variations between employers in terms of the funding target, time horizon or level of prudence in the likelihood of achieving the funding target.

19. Specific reference is made in the draft document to the uncertainty relating to the McCloud judgement. At the present time it is not known what form the remedy to the discrimination found by the Courts will take and therefore how benefits will need to be revalued going forward. Rather than make specific allowance within the 2019 Valuation for McCloud, it is therefore suggested that the uncertainty associated with McCloud is taken into account when setting the overall level of prudence in the calculations and in particular the level of certainty required that scheme employers will reach their funding target within the agreed time horizons.

20. Hymans Robertson have also identified several other areas which they suggested are reviewed before finalising the final Funding Strategy Statement. One of these is the pooling requirements which were initially designed as part of the Fund's risk management arrangements. Smaller employers were pooled to reduce the risk that they would face an unaffordable increase in their contribution rate from changes in their membership profile, or a high cost ill-health retirement, leaving a deficit to be met by the other scheme employers.

21. Pooling the small employers reduced the risk as all employers within the pool share the same experience, with changes in one employer not having a significant impact on the membership profile of the pool itself. The risk-based approach operated by Hymans Robertson offers alternative options to pooling to address the risk. Those employers who do not want to be linked to decisions made by other employers within their pool could opt out of the pool and mitigate the risk through more prudent assumptions elsewhere.

22. A linked issue is the ability of a scheme employer to mitigate the risk of a single high cost ill-health retirement by taking out an insurance arrangement. In many ways, pooling the small employers acts in the same way as an insurance fund. If an employer therefore wished to opt out of the pool, taken out the relevant insurance policy would be a suitable way to address the additional risk.

23. Another issue that Officers are reviewing alongside Hymans Robertson is the question of an alternative investment strategy for scheme employers. This would be appropriate where one or more scheme employers wish to take some investment risk off the table and are happy to accept a higher contribution rate for lower volatility. Similarly, if the Fund wishes to reduce the overall investment risk then one or more employers may wish to retain a higher risk strategy to help close their existing funding deficit.

24. The final issue discussed to date in the development of the Funding Strategy Statement are the risks associated with climate change associated with the pension liabilities. These include the impact of increasing global temperatures of life expectancy. At present it is proposed that these risks will be reflected in the risk-based modelling rather than a specific adjustment to the liability figures.

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