Division(s): N/A

PENSION FUND COMMITTEE – 19 MARCH 2010

THE FUNDING STRATEGY STATEMENT

Report by Assistant Chief Executive & Chief Finance Officer

Introduction

1. This Committee considered potential changes to the Funding Strategy Statement for the Oxfordshire Pension Fund at both its September and December 2009 meetings. At the December meeting, the Committee agreed a final approach to a formal consultation exercise, having considered issues raised by the Fund's new Actuary, as well as issues raised in discussions with the Department for Communities and Local Government.

2. Following the December Committee meeting, officers wrote to all scheme employers setting out the background to the consultation, and the detail around the 5 areas the Committee had agreed to consider. The five areas covered were:

   - Recovery Periods
   - Stepping Allowances
   - Definition of Solvency
   - Investment Strategy
   - Approach to Community Admission Bodies

3. A copy of the consultation letter, which also invited comments on any other areas of the Funding Strategy Statement, is attached as Annex 1 to this report.

Consultation Responses

4. A total of 16 responses were received as a result of the consultation letter. The responses covered the full range of employers within the Fund, including the County Council, the City and a District Council, Town and Parish Councils, a college, and a number of small admitted bodies.

5. Not all respondents felt qualified to answer each of the consultation questions. A summary of the answers provided is included as Annex 2 to this report. The range of answers is not related to the type of employer. Opinions have differed between individual employers of a similar type, as opposed to all employers of the same type having a shared view.

6. The responses to question 1 around the proposal to extend the recovery period drew a mixed response, with 8 respondents supporting an extension, and 5 respondents against. Where respondents had added narrative to their responses, it became clear that the mixed response owed something to the

way the question had been interpreted. Amongst those opposed to an extension of the recovery period, there was a view that we should not be transferring today's costs on to future generations, but rather we should be meeting the costs now before they spiral out of control. Amongst those looking for an extension to the recovery period, there was a desire to maintain stable and affordable contribution rates, and to use an extended recovery period to smooth out highs and lows in past service deficits caused by short term movements in the financial markets. As one respondent stated, there is a need to ease the burden on current taxpayers to meet a funding level that on a year to year basis is never required.

7. The responses to question 2 were more clear cut, with 10 respondents supporting a widening of the definition of exceptional circumstances whereby contribution increases can be stepped over six years, to include financial hardship. Only 3 respondents did not support the change, and one of these made it clear that they felt an extension of the recovery period was their preferred smoothing mechanism, leaving 6 year stepping as unnecessary. One respondent in supporting the widening of the definition did want to make it clear that exceptional should mean exceptional, and any employer wishing to follow the option should understand that stepping an increase ultimately led to a higher contribution rate than one required if reached in a single step.

8. The question on definition of solvency provided the clearest answer with 11 respondents against a reduction in the current funding target set at 100% of total liabilities, and only 1 respondent supporting a reduction in the target. One of the respondents against the change though was predicated on the extension of recovery periods providing sufficient mechanisms to maintain stable and affordable contribution rates.

9. Question 4 on the introduction of a dual investment strategy did not produce a consensus on the way forward. 4 respondents were in favour in principle of the introduction of a low risk strategy, but two of those stated that it was not appropriate for themselves at this time. 5 respondents did not support the change, and felt that the additional effort involved did not justify the likely take up of the option. A further 3 respondents commented that whilst the option appeared attractive on paper, they wished to understand the practicalities involved more before they could commit to supporting the proposal.

10. Question 5 did seem a reasonable consensus across all employers, with 11 respondents supporting option (b) which involves valuing all employers on an equal basis, with just 3 respondents supporting the retention of the current basis which builds in a risk premium to the results of the community admitted bodies. Those supporting the change commented that the risks involved in the change were insignificant in terms of the wider costs and risks associated with the Scheme, and that the hidden risks of option (a) were arguably greater.

11. Question 6 allowed respondents to comment on other aspects of the Funding Strategy Statement not formally identified in the consultation document. Only

3 respondents chose to add comments under this question, and none directly relate to the Funding Strategy Statement itself.

12. For the record though, 2 of the respondents used the opportunity to question the longer term affordability of the LGPS and argued for the need for further change. The three areas identified for this change were a reduction in the current accrual rate (from 1/60th of pay for each year's service to 1/80th of pay), a move to a career average scheme, and a switch to a defined contribution scheme (or at least the introduction of a defined contribution option). Given the continuing interest in the costs of the LGPS, and the likely impact of the 2010 Valuation results, these are matters likely to return to agenda after the next General Election.

13. The third respondent used the opportunity to seek better information on potential future contribution rates for employers between valuations. The request was for an annual statement from the Actuary on each employers liabilities, the cost of which to be met from the Fund itself. Whilst understandable, this request has a number of issues. Undertaking detailed forecasts for each individual employer would require significant improvements in the quality of data submissions by employers. There would clearly be significant additional actuarial costs, and even if these were to be charged initially to the Fund, these do in turn need to be recovered from the individual employers. Whilst we will work with our new Actuary therefore to improve the information flows for all employers, it is unlikely that the full request can be met.

Proposed Amendments to the Funding Strategy Statement

14. Having considered the various responses to the consultation letter, it is proposed to vary the current Funding Strategy Statement as follows:

- Recovery Period. The mixed response to the consultation question appeared to hide a reasonable consensus that whilst it is not appropriate to spread today's real costs too far into the future, the ability to smooth contribution rates by extending the recovery period to cope with increased past service deficits caused by the poor performance of the markets at the time of the Valuation is to be welcomed. Such smoothing will avoid future volatility in contribution rates where future valuations are undertaken at more normal market levels, or indeed at market highs where past service deficits are artificially reduced by unsustainable asset valuations. In this latter case it may well be appropriate to shorten recovery periods to avoid a short term and unsustainable reduction in employer contribution rates. It is hoped that there are sufficient flexibilities open to the Actuary to smooth the majority of variations in contribution rates resulting from short term movements in the financial markets. It is expected therefore that under most Valuations, the recovery period will be set at a maximum of 25 years. However it does seem sensible to leave the option to extend recovery periods in extreme cases to avoid a short term increase in contribution rates, to be reduced again when markets recover. It is therefore proposed to amend the Funding Strategy Statement to allow a variation in the recovery period, consistent with the need to maintain stability in the overall employer contribution rate in light of short term market fluctuations. It should be noted that under this amendment, the recovery period would not be extended to reduce increases in contribution rates which are deemed to be more permanent in nature, e.g. those stemming from an increase in longevity assumptions, or from a downward trend in pensionable payroll. It should be further noted that the Administering Authority retains the discretion as to the actual recovery period used in each valuation, and is not required to accept the request from any employer for any particular recovery period.

- Stepping Allowances – As with the extension of the recovery period, there is general support for the use of a six step approach to increasing contribution rates as a means of maintaining as near stable contribution rate as possible. The Administering Authority again retains the right as to when to exercise the discretion to allow an employer to step an increase over 6 years. In these circumstances it is proposed to amend the Funding Strategy Statement to widen the definition of exceptional circumstances under which 6 steps are allowed, to include exceptional financial hardship.
- Definition of Solvency – In light of the clear consultation response, it is recommended to retain the current definition of solvency as 100% of total liabilities, and no amendment is proposed to the Funding Strategy Statement on this matter.
- Investment Strategy – In light of the responses to the consultation, and the absence of any clear response for immediate access to a low risk investment strategy, it is proposed that this issue is not taken forward at this time. It is therefore not proposed to make any changes to the Funding Strategy Statement in respect of this issue.
- Approach to Community Admission Bodies – The strong consensus from the consultation exercise is to move to a single approach to valuation for all scheme employers, irrespective of whether their membership of the Fund is through an admission agreement, or set out directly in the Regulations. It is therefore proposed that the Funding Strategy Statement should be amended to remove those aspects which have provided a distinction in approach between admitted bodies and others, so that future valuations are undertaken on a single set of valuation assumptions.

RECOMMENDATION

15. **The Committee is RECOMMENDED to amend the Funding Strategy Statement as set out in paragraph 14 above.**

SUE SCANE
Assistant Chief Executive & Chief Finance Officer

Background papers: Full Consultation Document (held in Members Resource Centre)

Contact Officer: Sean Collins, Assistant Head of Shared Services
Tel: (01865) 797190

February 2010

ANNEX 1

Consultation Letter

Dear Colleague

Oxfordshire Pension Fund – Funding Strategy Statement

Under the Local Government Pension Statement Regulations, the Oxfordshire Pension Fund must maintain a Funding Strategy Statement which sets out the framework for the funding of all pension liabilities. The Statement and any changes to the Statement must be agreed following consultation with all Fund stakeholders.

The current Funding Strategy Statement was agreed in February 2005, and was reviewed without change in February 2008. Three factors have now combined to suggest that we should be reviewing the statement again. These factors are:

- The potential for significant increases in employer contributions if the 2010 Valuation is carried out under the current Funding Strategy Statement,
- The growing risks associated with Community Admitted Bodies closing their membership of the fund, with unaffordable closure valuations, and
- The appointment of a new Actuary (Barnett Waddingham) to replace Hewitt Associates, following a formal tender exercise.

The Pension Fund Committee has considered the current Funding Strategy Statement in light of these factors and has identified a number of issues on which they are seeking your views. These issues are set out in the following paragraphs, with a set of consultation questions included as an annex to this letter. The Committee would welcome your views, preferably by way of response to the questions attached in the annex, on the issues raised and on any further changes you would like to see within the Funding Strategy Statement. Responses need to be sent to Sean Collins at the above address by 12 February 2010, to enable them to be reported to the Committee at its meeting on 19 March 2010, when any revisions to the current statement will be determined.

Potential Areas for Change

<u>Recovery Periods</u> – At present the Funding Strategy Statement allows any past service deficit to be recovered over a period of up to 25 years. Prior to the 2004 Valuation, past service deficits were recovered over the estimated future working life of the current scheme members. This led to a recovery period of around 13 years. The Government encourage funds to take a longer term view based on the “constitutional permanence” of the majority of Fund employers, which led to Oxfordshire determining a maximum recovery period of 25 years.

Given the constitutional permanence of local government, there is no strong argument for a maximum 25 year period as opposed to any longer period.

Increasing the current maximum period provides greater scope for smoothing potential high increases in contribution rates resulting from short term factors – indeed where the past service deficits stem from large drops in financial markets, extending the recovery period provides a better opportunity for the markets to restore balance without the need for any real increase in contribution rates. On the other hand, extending recovery periods puts off the requirement to repay costs caused by permanent changes to liabilities e.g. unexpected increases in pay, longevity or ill health retirements. Extending the recovery period out into the future increases the risks that these sorts of factors will accumulate, all driving contribution rates upwards before individual pressures are repaid, so creating bigger past service deficit problems in the future. There is also the risk that whilst local government has its permanence written into the Constitution, the long term future of the Local Government Pension Scheme itself is not so secure. Longer recovery periods will increase the costs associated with any closure of the Scheme.

It should be noted that increasing the maximum recovery period in the funding strategy statement does not itself automatically mean the recovery period is increased for all employers. The Administering Authority would still reserve the right to insist on a shorter recovery period based on the risks associated with each individual employer. Based on this provisio, and an examination of recovery periods used elsewhere in the Country, an increase in the maximum recovery period to 40 years is suggested as an option for consideration.

<u>Stepping Allowances</u> – The present Funding Strategy Statement allows an employer to step up to a new rate over a three year period. This can be extended to a maximum of six annual steps in very tightly defined exceptional circumstances. These do not include allowance for exceptional financial hardship.

It is suggested therefore that a further option for a change to the Funding Strategy Statement is to widen the definition of the exceptional circumstances where an employer can seek approval to step up to a new rate over a six year period to include times of financial hardship. The risk of this change is that it takes the period to move to the new contribution rate over a second Valuation period, so that the employer may never reach the required rate where costs continue to rise. As stepping is a more costly option in the long run, this option runs the risk of placing increased financial pressure on an employer, rather than reducing it.

However, as with increasing the recovery period, increasing the number of steps reduces the risk of rates rising sharply in one valuation, only to drop again at the next when financial markets have recovered, and therefore would be in line with the aim of maintaining as near stable employer contribution rates as possible.

<u>Definition of Solvency</u> – The Funding Strategy Statement currently targets solvency as ensuring the Fund is in a position to meet 100% of its liabilities. The Government has previously introduced scope to target a lower funding level, and raised the issue again in their consultation earlier this year. It is therefore appropriate that the option is included in this consultation.

However, whilst the Committee felt it appropriate to include the option within the consultation, it did not support the option when raised by the recent Government consultation. As noted above, the LGPS itself can be closed by the Government of the day, and a target funding level of less than 100% will not in itself reduce the liabilities. Ultimately 100% of the liabilities will have to be met, so a solvency target of anything less than 100% therefore builds in ultimate failure. The Committee though is prepared to consider alternative viewpoints.

Investment Strategy – The current Funding Strategy is based around a single investment strategy. Given the constitutional permanence of local government, and the immaturity of the Fund (i.e. significantly more active members and contributions coming in, than deferred and retired members with benefits going out), this investment strategy is based on seeking long term high returns, whilst accepting the risks of short term losses and periods of instability in the overall funding level.

Whilst this investment strategy is seen as appropriate for the Fund as a whole, it is accepted that it is not so appropriate for all individual employers within the Fund, particularly those who do not expect/guarantee their long term membership of the Fund, or those with greater levels of maturity. For these employers, an investment strategy based on lower risk may be more suitable, though the price for a more stable contribution rate is that it will be higher than that determined under the current strategy.

Whilst it is not possible to run separate investment funds for each individual employer, the Committee are interested in your views of a dual investment strategy which does allow employers to opt into a low risk fund. At this stage a lot of the practical details of this option remain to be considered (e.g. how often can an employer switch between the main fund and the low risk option), but the Committee wish to examine the level of support for the principle.

Approach to Community Admission Bodies – Within the current Funding Strategy Statement, and the approach adopted by Hewitts, there was an acceptance that the risks associated with the Community Admission Bodies (given their lack of constitutional permanence) should be reflected in a risk premium being added to their contribution rate. This has been achieved through using less optimistic financial assumptions when discounting the value of their liabilities, as well as restricting their rights to benefit to the other flexibilities contained within the Funding Strategy Statement.

It is possible to further strengthen this approach by stipulating shorter recovery periods link to contract lengths, or the estimated future working life of their scheme members, increasing the monitoring role of the Administering Authority, with the increased ability to require an interim valuation where membership numbers appear to be declining, and depending on decisions on the investment strategy, requiring Community Admission Bodies to join the low risk fund.

The difficulty with this model, is whilst it is targeted to reduce the risk of a Community Admission Body closing with an unaffordable deficit, it is likely to increase the risk of the closure itself.

The alternative approach to Community Admission Bodies is therefore to not differentiate in any way, but to ensure valuations are completed on the same basis as for the Scheduled, Designated and Transferee Admission Bodies (where all risks are already underwritten by the sponsoring employer). In conjunction with the other options for change, this approach should provide the best opportunity for contribution rates to remain affordable to all bodies, so that membership, and more importantly, contribution payments can continue. In the event of a Community Admission Body closing and being unable to pay its closing deficit, this cost would fall to all other employers in the Fund. Whilst this option does not increase the contribution rates for any body, nor result in any subsidy in contribution rates between employers, there is a more explicit statement that the Scheduled Bodies etc are underwriting the risks associated with the potential closure of the Community Admission Bodies.

This latter point does need further context in that only 5% of the Fund currently work within Community Admission Bodies, and within this figure are a number of large and stable bodies who even if they were to withdraw from the LGPS are likely to be in a position to meet any closure valuation cost. The impact of a change in funding approach to the Community Admission Bodies is therefore not likely to be significant. (The 2007 Valuation calculated an average past service deficit figure of 5.3% of pensionable pay. If all 5% of the Community Admission Bodies were to close and be unable to pay their past service deficit, there would need to be an increase in contribution rates for the remaining employers of 0.3% of pensionable pay.

(Whilst not strictly relevant to the Pension Fund, respondees may wish to consider the extent to which they work in partnership with Community Admission Bodies, including providing grant funding, and therefore the wider implications of the closure of these bodies if the costs of pensions become unaffordable).

As noted above, the options outlined above are those considered by the Pension Fund Committee on which they would welcome your views. They are also happy to receive views on any further options to amend the Funding Strategy Statement which would support the sustainability of the Fund and the employers within it. Please do therefore submit responses to me by 12 February so they can be considered by the Committee.

Yours sincerely

Sean Collins
Assistant Head of Shared Services (Financial Services)

Oxfordshire Pension Fund – Funding Strategy Statement – Consultation Questions

1. **Do you support an increase in the maximum recovery period from the current 25 years? If so, do you believe that the Funding Strategy Statement should contain a maximum recovery period, and what should this be?
N.B. The Administering Authority will always retain the right to insist on a shorter recovery period based on an assessment of risk. Employers remain free to choose their own recovery period subject to the agreement of the Administering Authority, and any maximum period covered within the Funding Strategy Statement.**

2. **Do you support a widening of the definition of the exceptional circumstances which would allow an increase to a new employer contribution rate to be stepped over a 6 year period, the wider definition to include exceptional financial hardship?**

3. **Do you support any change to the definition of solvency, which currently targets a long term funding level equal to 100% of the liabilities? Where you support a change, what long term funding level do you believe the Fund should adopt as its target measure for solvency?**

4. As a matter of principle, do you believe that the Fund should offer a low risk investment strategy as an alternative to its current long term investment strategy? If such a low risk alternative was established, under which circumstances would you consider opting into the strategy, and what flexibility would you wish to have to move between low and higher risk alternatives?

5. Which of two alternative approaches to Community Admission Bodies would you favour the Fund to follow (a) an approach based on looking to minimise the risks built into the Valuation process, leading to higher employer contribution rates for the Community Admission Bodies, which in turn would reduce any deficit on closure, but potentially increase the risk of closure itself, or (b) an approach where all bodies are valued on the same basis, so that there is no risk premium built into the contribution rates for Community Admission Bodies, so that the remaining employers in the Fund under-write this risk?

6. Are there any further changes you would wish to see to the Funding Strategy Statement, to support an aim of maintaining as near stable contribution rates as possible, as well as sustaining the Fund and the individual employers within the Fund?

Completed by: ……………………………………………………………

On behalf of: ……………………………………………………………

Note: Respondees will not be individually identified in any report to the Pension Fund Committee (or elsewhere), but it may be helpful to be able to distinguish responses from different types/size of employers, particularly in respect to question 5 re the approach to Community Admission Bodies

When complete please return to Sean Collins via email at

sean.collins@oxfordshire.gov.uk

or by post to

Oxfordshire County Council, Shared Services, Unipart House, Garsington Road, Cowley, Oxford. OX4 2GQ

ANNEX 2

Summary of Consultation Responses

Question 1

Do you support an increase in the maximum recovery period from the current 25 years? If so, do you believe that the Funding Strategy Statement should contain a maximum recovery period, and what should this be?

N.B. The Administering Authority will always retain the right to insist on a shorter recovery period based on an assessment of risk. Employers remain free to choose their own recovery period subject to the agreement of the Administering Authority, and any maximum period covered within the Funding Strategy Statement.

Responses

8 respondents were in favour of an increase in the recovery period, with the majority of those suggesting 40 years as a reasonable maximum.

5 respondents were not in favour of any increase in the recovery period, indicating the level of risk attached, and the unfairness of visiting the liabilities of today's employees on future employees/taxpayers as their reasons.

3 respondents felt unable to offer a view on this question.

One of the No answers did accept that in the absence of any other alternative measures, extending the recovery period should be allowed to maintain as near stable contribution rates as possible. The need to maintain as near stable contribution rates as possible was also stated as the supporting argument for one of the Yes answers, which stated that extending the recovery period should be used to ease the burden on current taxpayers to meet a funding level that on a year to year basis is never required.

Question 2

Do you support a widening of the definition of the exceptional circumstances which would allow an increase to a new employer contribution rate to be stepped over a 6 year period, the wider definition to include exceptional financial hardship?

Responses

10 respondents supported the proposal to introduce a wider definition of exceptional circumstances as a means of maintaining stable recovery rates.

3 respondents did not support the proposal, one commenting on the fact that an extension of the recovery period should alleviate the need to step over 6 years.

3 respondents felt unable to answer the question.

Question 3

Do you support any change to the definition of solvency, which currently targets a long term funding level equal to 100% of the liabilities? Where you support a change, what long term funding level do you believe the Fund should adopt as its target measure for solvency?

Responses

11 of the respondents did not support any change in the current definition of solvency which targets funding at 100% of liabilities. One of these responses though was on the basis that extending the recovery period would enable stable and affordable contribution rates to be maintained.

Only 1 respondent supported a lower target funding level as the definition of solvency.

4 respondents felt they were unable to offer an answer to this question.

Question 4

As a matter of principle, do you believe that the Fund should offer a low risk investment strategy as an alternative to its current long term investment strategy? If such a low risk alternative was established, under which circumstances would you consider opting into the strategy, and what flexibility would you wish to have to move between low and higher risk alternatives?

Responses

4 respondents gave a clear answer to support the development of a dual investment strategy, offering a low risk option. As part of these respondents, some made it clear that they felt that whilst they felt it was appropriate for the Fund to offer a low risk investment strategy, they did not feel it would be appropriate for their organisation at this point in time.

5 respondents gave a clear answer to support retention of the current single investment strategy. Responses included the concern that a dual investment strategy introduced considerable extra work for what was likely to be very low take up.

3 respondents felt that further information was required before they could offer a clear view on this proposal, including the practicalities involved on the investment side.

3 respondents offered no answer to this question.

Question 5

Which of two alternative approaches to Community Admission Bodies would you favour the Fund to follow (a) an approach based on looking to minimise

the risks built into the Valuation process, leading to higher employer contribution rates for the Community Admission Bodies, which in turn would reduce any deficit on closure, but potentially increase the risk of closure itself, or (b) an approach where all bodies are valued on the same basis, so that there is no risk premium built into the contribution rates for Community Admission Bodies, so that the remaining employers in the Fund under-write this risk?

Responses

3 respondents supported option (a), to maintain the split approach to scheduled/transferee bodies and community admission bodies.

11 respondents supported option (b) to value all bodies on the same basis. Arguments supporting the change included the view that option (b) through protecting the community admission bodies and so reducing the likelihood of closure was the lowest risk approach. It was also felt that the risk of the default of the community admission bodies was insignificant in terms of the costs of the Fund as a whole.

2 respondents offered no view on this question.

Question 6

Are there any further changes you would wish to see to the Funding Strategy Statement, to support an aim of maintaining as near stable contribution rates as possible, as well as sustaining the Fund and the individual employers within the Fund?

13 of the respondents to the consultation offered no further comment in response to this question.

2 respondents, whilst accepting the points were not directly related to the Funding Strategy Statement, made comments on the overall cost of the Scheme, and suggested potential changes to the LGPS going forward. These changes covered a defined contribution basis (or alternative option), a move to a career average scheme, and a reduction in the accrual rate.

1 respondent asked for the introduction of more regular reports from the actuary on potential changes to future contribution rates. The proposal sought an annual statement, the costs of which would be met by the Fund as a whole, rather than charges to individual employers.