SOUTH YORKSHIRE PENSIONS AUTHORITY

22 November 2018

Report of the Fund Director

FRAMEWORK FOR VALUATION 2019

1) Purpose of the Report

To initiate a process of consultation on the framework within which the 2019 Valuation will be carried out.

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2) **Recommendations**

Members are recommended to:

a) Approve consultation with employers within the Fund and the Local Pension Board on the various issues for the 2019 Valuation identified in this report.

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3) Background Information

3.1 The triennial valuation of the Fund will take place based on the position at 31 March 2019. This report sets out the approach which it is proposed to take to the valuation process and identifies a number of proposals where consultation with stakeholders at an early stage would be beneficial.

3.2 The Fund embarks on Valuation 2019 looking at a significantly different context to previous valuations with very significant progress having been made towards eliminating the deficit. It is therefore important that in setting contribution rates beyond 2019 that this progress is not put at risk through over-optimistic assumptions, but equally the Fund must recognise the pressures within the financial environment in which employers are operating. This is the same delicate balance which has existed in previous valuations, although the context from a Fund point of view is, this time, perhaps somewhat more favourable. This report sets out the initial position which it is proposed to take in a number of areas.

Discount Rate

3.3 The broad methodology which Mercer, the Fund's actuary, will use to carry out the valuation is the same as in 2016 with the key assumption around the discount rate being based on an estimate of CPI inflation plus a percentage (previously an average of CPI+2.2%). Adopting this key change at the last valuation has resulted in the valuation of the Fund's liabilities being much less volatile. The final level of discount rate above CPI will be set later in the process but for the moment modelling is being undertaken based on the previous assumptions. The Actuary may ultimately recommend a reduction in the percentage to recognise the fact that there is a general presumption that we are entering a lower return environment.

Pay Awards

3.4 Other key assumptions made are around the level of pay awards, and while this has no impact on the value of the 2014 scheme liabilities the bulk of past service liabilities still relate to the previous final salary schemes. Thus the assumption about pay increases remains important. In discussion with the actuary it is clear that there is differential experience between different parts of the employer base. For local authorities pay restraint remains a significant factor, although offset to some extent by incremental drift, while in other sectors there is somewhat more freedom over pay and reward strategies. Consequently it is proposed to examine the options of using different assumptions for some groups of employers. This is intended to reduce the risk of what happens in reality at employer level and the actuarial assumptions being out of line with each other which will build up a pressure for contribution increases in future valuations. Within this it is anticipated that the assumption for local authorities will reflect some element of near term pay restraint, based on pay awards of around 2% in the earlier years.

Demographics

3.5 The actuary has to make assumptions about how long people will live in retirement. The latest data on this indicates that the rate of improvement in life expectancy is slowing materially. It is proposed to reflect this in the assumptions and also to use the Authority's own data to inform the mortality assumptions. It is anticipated that this will tend to reduce future service contributions.

3.6 The proportion of the Fund's membership who are married also impacts the valuation of liabilities as this generates entitlement to a spouse's pension. While entitlement to such a pension is somewhat wider than this (including for example civil partners) this is a reasonable starting point for approximating the position and it is intended to use local data to support this assumption.

Commutation

3.7 The other key assumption is around the degree to which members choose to convert pension to lump sum, known technically as commutation. A larger percentage of conversion to lump sum tends to reduce liabilities overall. Previously Mercer have used a standardised national assumption for this. However, there is evidence that the actual position in South Yorkshire significantly differs from this and it is therefore intended to use an assumption based on local experience in this area. Again this will tend to reduce employer contributions.

Ill Health Arrangements

3.8 Assumptions around ill health retirement and the ill health captive scheme for smaller employers will be updated for more recent information. It is also proposed to consult on ending the current process for some larger employers of making allowances for ill health retirements. This is a practice that the vast majority of funds have now abandoned.

Academies

3.9 Another area where it may be appropriate for the Authority to consult on changes is around the treatment of Academies. The work being undertaken by the Scheme Advisory Board (SAB) on Academies is pushing in the direction of a single contribution rate for academies. There are a range of technical reasons why this is wrong in principle, most particularly due to the way in which it creates cross subsidy between individual employers. However, this is the clear direction of policy and it may therefore be worth asking Academy employers whether they would be happy for SYPA to adopt an approach along the lines of the one being supported by the SAB at this valuation and thus "get in early". The timing for such a change, given the likely funding position, might well be opportune.

Deficit Recovery

3.10 It may well be that some employers will remain in deficit after the valuation, although being much better funded than previously. It is likely that the employers in this position will be smaller employers with a lower level of covenant. The question arises as to whether the recovery period for such deficits should simply be brought down by three years from the previous level, or given the deficit is likely to be smaller brought down more significantly in order to fully eliminate the deficit more quickly. It is suggested that a variation on this latter approach is developed which results in no more cash (for future service and deficit contributions) being taken than was taken in the last valuation, with the recovery period being the mathematical outcome of this policy. It is not anticipated that this will impact a significant number of employers but having a policy set out in advance makes dealing with the issue easier when it does arise.

Exit Credits

3.11 Exit credits can occur where an employer is in surplus at the point of exiting the scheme. This is a particular issue in relation to the many small admissions which result from the outsourcing of cleaning and catering by individual schools and academies. Recent changes in the LGPS regulations mean that there are circumstances in which the amount of a surplus could have to be paid over to an employer on exiting the scheme. Where the employer has taken all the risk associated with participation in the scheme this is reasonable.

However, many employers delivering services under contract to a council or a school benefit from a situation where any deficit will transfer back to the council or school at the end of the contract. In these circumstances it is only reasonable that surpluses should also transfer back to the original employer. It is proposed to consult on this as an amendment to the current Funding Strategy Statement so as to provide the Authority with a clear policy position to deal with the cases that are beginning to flow through the system.

Employer Covenant and Related Issues

3.12 An increasing number of employers within LGPS are not tax raising bodies and this coupled with new insolvency regimes in the further and higher education sectors significantly raises the profile of issues of the ability of employers to meet their liabilities as a factor within the Funding Strategy Statement. We will need to develop work on an ongoing basis that:

- Assesses the risk that each employer’s participation in the Fund poses, this will probably result in a broad traffic light categorisation of employers.
- Identifies whether the allocation of assets within the overall investment strategy should be differentiated according to the risk posed by employers (thus a more risky employer might have a greater proportion of bonds within the assets allocated to it).
- Identifies whether the change in the overall funding position provides an opportunity to manage an exit for some employers for whom LGPS is no longer an appropriate pension scheme or whether there is the opportunity for the Fund to secure charges against assets which would reduce the risk posed by an employer.

3.13 This is a considerable piece of work which will take some time to develop and is likely to run over a number of valuation cycles, however, it is important to begin the process of engaging with employers to promote dialogue and understanding of the issue as part of the 2019 valuation process. In addition some changes in regulations relating to employer exits are anticipated and undertaking this work now will allow the Authority to react to these promptly.

Arrangements for recovering costs from employers

3.14 Over the years the Fund has developed a number of arrangements where costs payable by employers (such as actuarial costs for academy set up) are recovered through deficit contributions. This is a novel arrangement and with the change in the overall funding position it is opportune to review these arrangements and consider whether they remain appropriate or should be changed for a more conventional arrangement.

3.15 The next steps in the process are as follows:

- Secure feedback from employers on the broad framework of assumptions and other changes set out in this report. This will be done through a formal consultation document made available to each employer and consideration of the same document by the Local Pension Board (To end Jan 2019)
- Consider and discuss feedback with the Actuary (Ongoing)
- Present final framework for approval by the Authority (March 2019)
- Reflect assumptions etc. in the Funding Strategy Statement which will be formally consulted on in the Sept to January period 2019 with the final version approved before the end of March 2020 when the new contribution rates come into effect.

3.16 This approach is intended to begin the building of a new relationship with the Fund's employers which is based on mutual understanding of and openness about the issues faced by each side allowing us to arrive at an eventual position which is, at least, properly understood by all involved.

4) Implications and risks

- Financial – There are no immediate financial implications arising from this report.
- Legal – The relevant regulations require that the Authority consult on the content of the Funding Strategy Statement. The process outlined in this report addresses that requirement at an earlier stage than in previous valuation cycles.
- Diversity – There are no apparent diversity implications.
- Risk – By being as transparent as possible with employers at as early a stage as possible it is intended that the risk of surprises from the valuation process which create risk around employer behaviour are minimised.

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Background papers used in the preparation of this report are available for inspection at the offices of the Authority in Barnsley.