City of BRADFORD METROPOLITAN DISTRICT COUNCIL

Report of the Director, West Yorkshire Pension Fund to the meeting of Joint Advisory Group to be held on 25 July 2019

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Subject: Funding Strategy Statement (FSS)

Summary statement:

Following a consultation exercise with all stakeholders the current Funding Strategy Statement requires updating for two reasons.

The first affects how the funding target (liabilities) is calculated for employers subject to what we refer to as the scheduled and subsumption body funding target.

The second affects how the liabilities will be calculated for employers exiting the Fund.

Recommendations

The Joint Advisory Group approve the :

- proposed the increase of the probability of funding success to 75%.
- proposed the 1% increase to be added to liabilities on exit to take into account the potential increase in liabilities for both McCloud and GMP equalisation.
- resulting changes to the Funding Strategy Statement.

and note the postponement of the employer consultation exercise agreed in January 2019 in relation to updates to LGPS Regulation 64 pending the outcome of the national consulation and potential changes to the regulations.

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Overview & Scrutiny Area:

1. SUMMARY

1.1 The current Funding Strategy Statement requires updating for two reasons.

The first affects how the funding target (liabilities) is calculated for employers subject to what we refer to as the scheduled and subsumption body funding target (which is defined in the 2016 valuation report). This funding target applies to all long-term employers such as the councils, police and fire, academies and any admission bodies whose liabilities will fall back to one of those bodies should the admission body cease to participate in the Fund.

The second affects how the liabilities will be calculated for employers exiting the Fund.

2. CHANGES TO THE FSS

2.1 Funding target for long-term scheduled bodies

2.1.1 As set out in the Funding Strategy Statement, the discount rate (also known as the investment return assumption) is set using an approach which quantifies the level of risk (prudence) underlying the liability calculations. The lower the prudence factor, the higher the discount rate so the more the Fund relies on investment returns to meet future benefit payments, meaning employer contributions are set at a lower level than would otherwise be the case.

2.1.2 At the 2010 valuation the Administering Authority chose a prudence factor (known as the probability of funding success) which meant that the discount rate was set such that there was expected to be a nearly a seven in ten chance that the Fund would meet its solvency target over 25 years. The discount rate adopted was higher than the average across LGPS funds which enabled the Administering Authority to keep employer contributions reasonably stable despite falls in investment markets and Fund employers generally paying lower contributions than average across the LGPS. The expectation was that as market conditions improved so the level of prudence would increase. Unfortunately this wasn't possible at the 2013 and 2016 valuations - the probability of funding success was set at 69% at these valuations because increasing it would have led to more material employer contribution increases which the Administering Authority wanted to avoid.

2.1.3 The Actuary's initial advice in advance of completion of the 2019 valuation suggests that investment returns between 1 April 2016 and 31 March 2019, and the slowdown in longevity improvements, means that we are in a position that we can now be more prudent without increasing employer contributions. Whilst the valuation calculations themselves have not yet been started, our current estimate is that we can increase the probability of funding success to 75% without increasing employer contributions.

2.1.4 In the normal course of events we would not update the Funding Strategy Statement until the valuation process is well underway. However, given that our strategy affects how the Actuary carries out calculations for new employers (including academies) and exiting employers, we wish to allow for this additional prudence now, to:

a) avoid a step change for new employers when the 2019 strategy is confirmed

b) avoid calculating exit liabilities on a basis which we know is less prudent than the calculations at the 2019 valuations are likely to be for exiting employers where the liabilities after exit are being subsumed by a long-term secure employer such as a council, academy, police or fire

2.1.5 This change does not affect employers whose liabilities will become orphan on exit. It also does not affect contributions payable between now and 31 March 2020 for continuing employers, which continue to be in line with the Rates and Adjustments Certificate.

2.2 Exit liabilities

2.2.1 As you may be aware, there are a number of uncertainties which are likely to lead to higher costs for employers but which we are not yet able to quantify. We are discussing with the Actuary if and how these should be allowed for in the 2019 valuation, and the Scheme Advisory Board has issued guidance which also suggests we should reflect on what allowance should be made for these uncertainties in exit valuations. Following discussions with the Actuary, we are proposing to add an explicit margin, equal to 1% of the liabilities, in any exit valuations effective from 1 April 2019. This change will not affect any final exit valuations which have already been issued. We believe that a 1% addition to the liabilities on exit is the right approach for the Fund and will help protect the remaining employers against additional costs which arise in relation to liabilities for former employers. The reasons for this proposal are set out in paragraphs 2.2.2 and 2.2.3.

2.2.2. McCloud/Sargeant

2.2.2.1 Following the Independent Public Service Pensions Commission's review in 2011 the main UK public service pension schemes were reformed with effect from 1 April 2015 (with the exception of the LGPS in England and Wales which was reformed 1 year earlier), moving to a career average structure with pension age linked to State Pension Age. The reforms included transitional protections which applied to all active members of schemes who were within 10 years of their Normal Pension Age on 1 April 2012.

2.2.2.2 All active members of the LGPS in England and Wales were only eligible to join the new Scheme for membership after 1 April 2014, but members within 10 years of normal retirement on 1 April 2012 were given an underpin (or 'better of both') promise, so their benefits earned after 1 April 2014 would be at least as valuable in terms of amount and when they could be drawn, as if they had remained in the 2008 Scheme.

2.2.2.3 In December 2018 the Government lost a Court of Appeal case (the 'McCloud/Sargeant' judgement) which found that the transitional protection arrangements put in place when the judges'/ firefighters' pension schemes were reformed were age discriminatory. The Government applied to the Supreme Court for permission to appeal the Court of Appeal judgement. On 27 June it was announced that Government had been denied leave to appeal. This potentially has implications for the LGPS and would lead to higher liabilities if it is determined that younger members were discriminated against and need to be compensated. Both the HM Treasury employer cost cap and the Scheme Advisory Board cost management process are currently paused pending the outcome of McCloud case and any benefit changes that may result, but it may recommence with potential changes to benefits then backdated to 1 April 2019.

2.2.2.4 In the case of exit valuations the LGPS Regulations (Regulations 64) require that the calculations are carried out as at the date of exit and that once an exit payment has been made the exiting employer has no further liability to the Fund. The LGPS Advisory Board's guidance of 14 May 2019 sets out that in relation to exit payments and exit credits authorities should take account of regulatory requirements, FSS provisions and discuss the approach taken with their actuaries and determine whether "a level of prudency could be included in the calculations to ensure the fund is not adversely affected by the outcome" of McCloud and if applicable Cost Cap/Cost Management.

2.2.2.5 The Government Actuary's Department has calculated that the additional liabilities from the McCloud judgement could be of the order of 0.5%-1% across the Scheme as a whole. The costs are highly dependent on the assumptions adopted, including how any compensation is applied, and to whom, the assumption for future salary growth and the membership profile.

2.2.3. GMP Indexation and Equalisation

2.2.3.1 On 22 January 2018 HM Treasury announced that the interim solution to indexation and equalisation of GMP in public service schemes, whereby the schemes would provide indexation of GMPs for members reaching State Pension Age (SPA) between 6 April 2016 and 5 December 2018, would be extended. This means that indexation of GMPs for members reaching SPA up to and including 5 April 2021 will be paid from the Fund.

2.2.3.2 On 26 October 2018 the High Court ruled in the Lloyds Banking Group case that schemes are required to equalise male and female members' benefit for the effect of unequal GMPs. It is not yet clear what this means for the LGPS - we expect HM Treasury and/or MHCLG to respond in due course. However, the Actuary advises that if the interim solution were extended such that all increases on GMP were to be paid from the Fund, this could add around 0.3% to the liabilities for a typical fund.

3. CONSULTATION EXERCISE ON THE PROPOSED UPDATES TO THE FUNDING STRATEGY STATEMENT

3.1 In accordance with Regulation 58 of LGPS Regulations 2013 a consultation exercise has been completed with elected members and employer representatives on the proposed changes to the FSS to incorporate the changes described in 2.1 and 2.2 of this report.

3.2 Two comments were received in response to the consultation. One comment was broadly in agreements with the advice received from the Funds Actuary and the updates to the Funding Strategy Statements. The second comment received asked for further information about the change in approach for setting the discount rate. Further information was supplied as requested.

3.3 A copy of the draft Funding Strategy statement can be found at Appendix A.

4. UPDATE ON THE RECOMMENDATION MADE AT JANUARY 19 MEETING TO CONSULT ON CHANGES TO THE THE FUNDING STRATEGY STATEMENT IN CONNECTION WITH REGULATION 64.

4.1 An amendment to Regulation 64 of the LGPS Regulations 2013 in May 2018 introduced the requirement that when an employer's admission in the scheme comes to an end (whether on the failure of the contractor or otherwise) and the exit valuation identifies there is a surplus the Fund must pay the surplus to the admission body.

4.2 A recommendation was approved by Joint Advisory Group in January 2019 that a consultation exercise should be undertaken to update the FSS to cater for the situation where it may not be appropriate to repay a surplus on exit. For example where it is clear that a condition of a subsumption commitment that any surplus should be retained in the Scheme Employers share of Fund.

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4.3 Before the consultation exercise was undertaken a policy consultation exercise was published by Ministry for Housing and Local Government (MHCLG) setting out proposals to improve the exit credit provision in the regulations to reflect experience since 14 May 2018. This consultation exercise is due to close on 31 July 2019.

4.4 The recommendation to consult on changes to the FSS has therefore been postponed until further information is received on the outcome of the MHCLG consultation.

5. RECOMMENDATIONS

5.1 The Joint Advisory Group approve the :

- proposed the increase of the probability of funding success to 75%.

- proposed the 1% increase to be added to liabilities on exit to take into account the potential increase in liabilities for both McCloud and GMP equalisation.

- resulting changes to the Funding Strategy Statement.

And note the postponement of the employer consultation exercise agreed in January 2019 in relation to updates to LGPS Regulation 64 pending the outcome of the national consultation and potential changes to the regulations.

6. APPENDIX

Appendix A – Draft Funding Strategy Statement