City of BRADFORD
METROPOLITAN DISTRICT COUNCIL

Report of the Managing Director – West Yorkshire Pension Fund to the meeting of Joint Advisory Group to be held on 25 January 2024

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Subject: Consultation on updates to West Yorkshire Pension Fund Funding Strategy Statement (FSS)

Summary statement:

The Fund has undertaken a consultation exercise with all employers on updates to the Funding Strategy Statement as part of the review of the calculation methodology for the low risk exit basis.

EQUALITY & DIVERSITY:

None

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Portfolio:

Overview & Scrutiny Area:

1. SUMMARY

1.1 The Fund has undertaken a consultation exercise with all employers on updates to the Funding Strategy Statement as part of the review of the calculation methodology for the low risk exit basis.

2. BACKGROUND

2.1 One of the most important aspects of any Local Government Pension Fund's funding strategy is how liabilities are valued for non-tax raising employers that cease to participate in the fund. This employer exit event occurs when an employer has no remaining contributing active members (known as orphan exits) and is not expected to admit any new members in the short to medium term.

2.2 Amendments to the Local Government Pension Scheme (LGPS) Regulations between 2018 and 2020 allowed for exiting employers to potentially receive a return of surplus and introduced the need for LGPS funds to develop relatively detailed exit policies.

2.3 Following the introduction of these amending regulations WYPF (the Fund) and its actuary Aon undertook a review of how liabilities are calculated for non-tax raising employers whose liabilities become orphaned on exit.

2.4 The Fund adopted a 'Probability of Funding success' approach, moving away from the more traditional method of assuming future investment returns would be in line with risk-free UK Government Bond yields (gilts based approach). At the time this change typically reduced the value placed on the exiting employers' liabilities and therefore reduced the cost to employers of exiting the Fund. In addition the Fund operates a single investment strategy and exiting employers were previously concerned that they were asked to pay contributions assuming investment in gilts after exit when the Fund wasn't actually investing in that way.

2.5 However, due to the significant increases in bond yields over the last couple of years, the current methodology now typically places a higher value on the exiting employer's liabilities than the gilts based approach and may potentially be viewed as overly prudent.

2023 REVIEW OF LOW RISK EXIT BASIS

2.6 Following the review of the strategic asset allocation which was agreed at the 27th July 2023 Investment Advisory Panel meeting, the Fund Actuary (Aon) was asked to review the impact any changes to the asset allocation may have on the exit basis using the current methodology to see if it could justify reducing the level of prudence without adding undue additional risk for the remaining employers.

2.7 A detailed analysis was carried out by Aon investigating a number of different options. Based on the information provided by Aon and presented to the Joint Advisory Group sub-group at their meeting on 16 October 2023, it was proposed to reduce the Probability of Funding Success parameter by 5% (from 95% to 90%) since this improved the position for exiting employers without increasing the risks for remaining employers beyond the level which the subgroup felt was appropriate.

(All other parameters underpinning the discount rate remain unchanged from the 2022 valuation approach).

2.8 **Why change the Probability of Funding Success from 95% to 90%**
A reduction from 95% to 90% was suggested as it demonstrably reduces prudence (a lower Probability of Funding Success gives a higher discount rate so giving exiting employers slightly greater credit for future investment returns and thus lower exit payments) but at the same time is more prudent than the 85% Probability of Funding Success which underpins the most prudent of the three ongoing intermediate funding targets. It wasn't considered appropriate to reduce the Probability of Funding Success below 90% - to ensure there was a clear difference between the exit basis and the intermediate funding targets. (There are other parameters which influence the discount rate but the Probability of Funding Success tends to be the main area of focus in terms of quantifying the level of prudence.)

2.9 **Financial impact**
As you would expect, the reduction in the Probability of Funding Success to 90% increases the discount rate used to value the liabilities on exit and hence leads to lower liabilities relative to the existing approach of adopting a Probability of Funding Success of 95%. The effect will vary over time depending upon expected returns on assets, and the interaction and volatility of those returns, based on Aon's Capital Market assumptions, which are re-assessed every quarter. Based on back-testing carried out by the actuary we expect the discount rate could increase by around 0.6%, equivalent to a reduction in liabilities of c8%-15% depending upon the profile of the employer's membership. This is not guaranteed and the effect will vary from quarter to quarter as well as between individual employers.

2.10 **Why shouldn't the Fund move back to a gilts based approach for determining the exit basis discount rate?**
The historic approach to (orphan) exit valuations was to value exit liabilities on a discount rate based on government bond yields. WYPF's strategy is to target the eventual exit position for closed employers when setting ongoing contributions however we had feedback from nearly all of these employers when undertaking triennial valuations that this was unaffordable and as a result, in order to ensure contributions were affordable the Fund ended up compromising on the level of contributions to set for these employers at successive valuations.

2.11 In the run up to the 2022 valuation the Fund moved away from using a gilts basis to determine the exit discount rate, triggered by very low gilt yields in 2021 and employer feedback - the Fund operates a single investment strategy and exiting employers had been complaining that they were being asked to pay contributions assuming investment in gilts after exit when the Fund wasn't actually investing in that way. The exit basis was re-structured for consistency with the ongoing funding targets, using a Probability of Funding Success approach based on the underlying investment strategy. The Joint Advisory Group has been clear in the past that the Fund should maintain a single investment strategy (although this question will be revisited at future valuations). Arguably it would unjustifiably increase risk for remaining employers if a gilts based exit basis wasn't matched by a change in investment strategy.

2.12 It should also be noted that using a gilts-based approach for calculating exit liabilities whilst also investing in gilts does not fully remove the risk of the assets not being sufficient to meet the liabilities. For example, it is not possible to accurately hedge future pension increases using UK government bonds and it is difficult to ensure the expected payments from a bond portfolio approximately match the timing of pension payments being made to members. There is also the risk of members living longer than expected, albeit this risk has not materialised over recent years.

2.13 A short presentation will be made by Aon to explain the changes at the meeting. A copy of the slides can be found at Appendix E

CONSULTATION

2.14 A consultation exercise with all WYPF employers was launched at the Employers' Annual meeting in early November which included a presentation by Aon on the proposed changes.

2.15 On the 10 November 2023 this was followed by a communication to all employers and further details of the proposed updates to the Funding Strategy Statement. The proposed changes are fairly limited, with only parts of the Funding Strategy Statement relating to the exit basis being updated.

2.16 The consultation was open for 8 weeks and closed on 5th January 2024, which given the specific nature of the proposed changes appeared an appropriate timeframe.

2.17 A copy of the Funding Strategy Statement (with all proposed changes tracked for ease of reference) can be found at Appendix A.

2.18 The Fund received 4 responses to the consultation exercise and copies of all 4 responses are shown at Appendix B, C and D. Two of the responses are supportive of the proposed changes whereas two of the responses have raised a number of matters related to the Funding Strategy, not all of which are directly relevant to the changes being considered. WYPF officers intend to discuss with these employers the matters they have raised (and has already met with one of these employers).

2.19 It should be noted that the exit basis is not directly relevant to employers that are required to admit new employees to the Scheme, such as local authorities and academy schools (albeit there is a secondary impact as all ongoing employers effectively guarantee the orphan liabilities). It is therefore not surprising that the number of consultation responses is relatively low in the context of WYPF's overall employer numbers.

2.20 All aspects of the Funding Strategy Statement, including the exit basis will be reconsidered and consulted on with employers at the time of the next triennial actuarial valuation (effective date 31 March 2025). WYPF officers and the WYPF Actuary are strongly of the view that it is not appropriate to undertake funding valuations outside of the triennial valuation cycle due to the changes in market conditions and are disappointed by the assertion in the consultation responses that this is due to resourcing considerations.

3. LEGAL CONSIDERATIONS

In accordance with the Local Government Pension Scheme Regulations (LGPS 2013):

- An administering authority must, after consultation with such persons it considers appropriate, prepare, maintain and publish a written statement setting out its funding strategy.
- The authority must keep the statement under review and, after consultation with such persons as it considers appropriate, make such revisions as are appropriate following a material change in its policy set out in the statement, and if revisions are made, publish the statement as revised.

4. OTHER CONSIDERATIONS

None

5. FINANCIAL & RESOURCE APPRAISAL

None

6. RISK MANAGEMENT AND GOVERNANCE ISSUES

None

7. LEGAL APPRAISAL

None

8. OTHER IMPLICATIONS

None

8.1 SUSTAINABILITY IMPLICATIONS

None

8.2 GREENHOUSE GAS EMISSIONS IMPACTS

None

8.3 COMMUNITY SAFETY IMPLICATIONS

None

8.4 HUMAN RIGHTS ACT

None

8.5 TRADE UNION

None

8.6 WARD IMPLICATIONS

None

8.7 AREA COMMITTEE ACTION PLAN IMPLICATIONS (for reports to Area Committees only)

None

8.8 IMPLICATIONS FOR CHILDREN AND YOUNG PEOPLE

None

8.9 ISSUES ARISING FROM PRIVACY IMPACT ASSESEMENT

None

9. NOT FOR PUBLICATION DOCUMENTS

None

10 RECOMMENDATIONS

10.1 The Joint Advisory Group approve the changes to the calculation methodology for the low risk exit basis.

10.2 The Joint Advisory Group approve the updates to the Funding Strategy Statement as set out in Appendix A

10.3 The Joint Advisory Group approve the effective date of these changes as 1 February 2024.

11. APPENDICES

- Appendix A – Draft Funding Strategy Statement circulated to all employers with tracked changes for ease of reference.

- Appendix B, C and D – Comments received from the consultation exercise on the principles and approaches set out in the Funding Strategy Statement.

- Appendix E – Copies of the slides which will accompany the short presentation by Aon on the proposed changes.