WYPF: Review of orphan exit basis

Prepared for:	City of Bradford Metropolitan District Council as Administering Authority to the West Yorkshire Pension Fund
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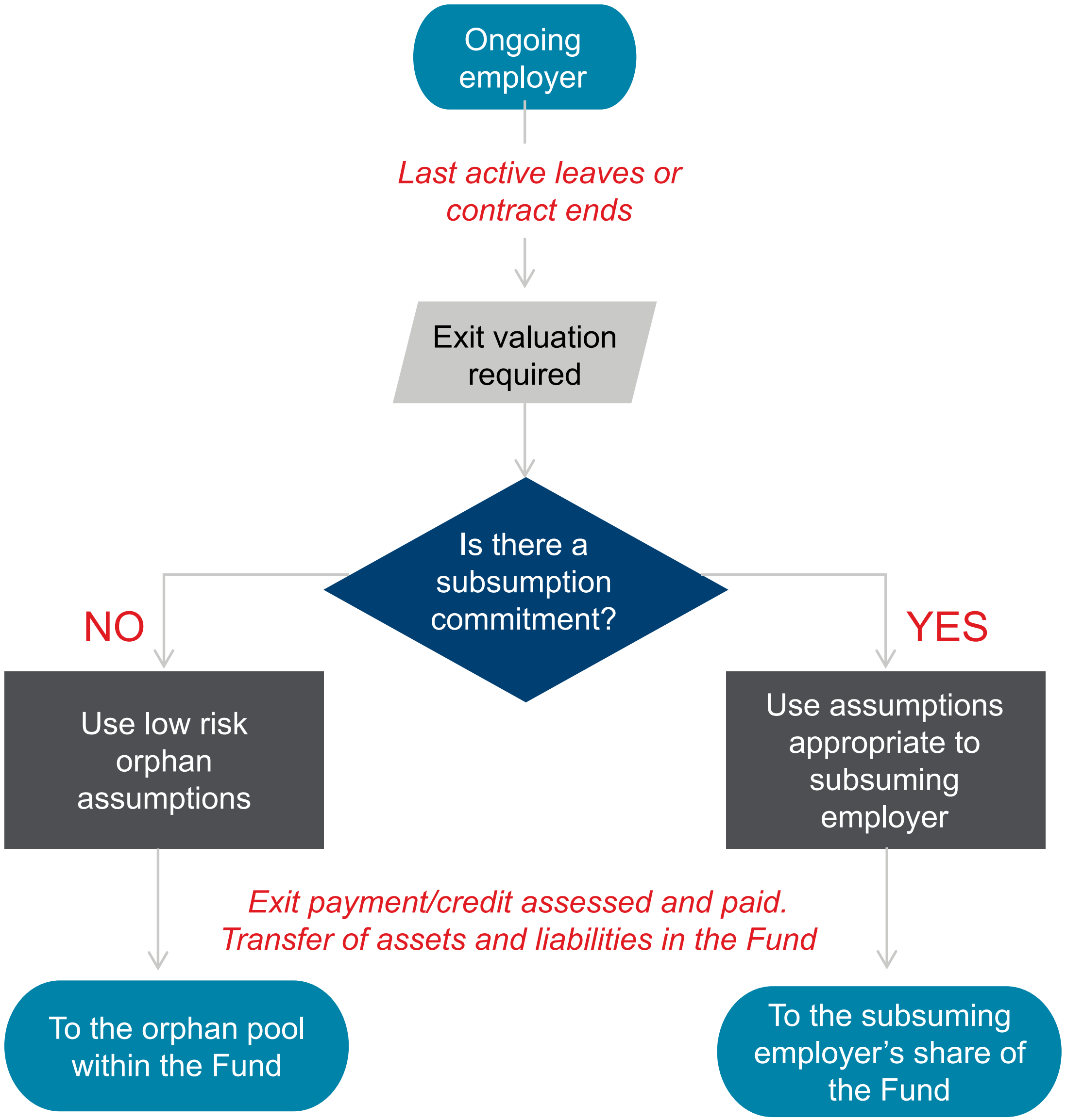
Date:	25 January 2024

What is an orphan exit?



Simplified process to illustrate the principles – in practice there may be a DDA or pass-through and the subsuming employer can elect to subsume the deficit too

FSS APPENDIX 1: Policy on New Employers, Exit Valuations and Employer Flexibilities

4.4.1 Where an employer ceases its participation in the Fund such that it will no longer have any contributing members….unless any residual liabilities are to become subsumed liabilities, the Administering Authority will act on the basis that it will have no further access for funding from that employer once any exit valuation….has been completed and any sums due have been paid. Residual liabilities of employers from whom no further funding can be obtained are known as orphan liabilities.

4.4.2 The Administering Authority will seek to minimise the risk to other employers in the Fund that any deficiency arises on the orphan liabilities such that this creates a cost for those other employers to make good the deficiency….. to give effect to this, the Administering Authority will seek funding from the outgoing employer which allows for a more prudent solvency target and gives the Fund greater certainty that the solvency target will be met over a suitable trajectory period, based on the Fund's long-term asset strategy.

Reminder of funding strategy

- Demographic assumptions set as best estimate at each triennial valuation
- Prudence concentrated in the discount rate (investment return assumption)
- Risk-based approach to setting the discount rate comprising 3 elements:

Trajectory Period

The period over which the stochastic modelling is carried out

Solvency Target

The measure of liabilities targeted at the end of the modelling period

Probability of Funding Success

The chance the assets will meet or exceed the liabilities at the end of the modelling period

Investment strategy

The Fund has always operated a single investment strategy for all employers/ liabilities

- Expected returns based on Fund's investment strategy
- Modelling to determine/quantify level of risk / prudence - "**probability of funding success**"
- Prior to 2021 applied to long-term secure employers only
- Discount rate for orphan exit basis was linked to government bond yields

2021 review of exit basis

Historic approach to orphan exits

Orphan exit liabilities were valued using a discount rate based on the yield on government bonds

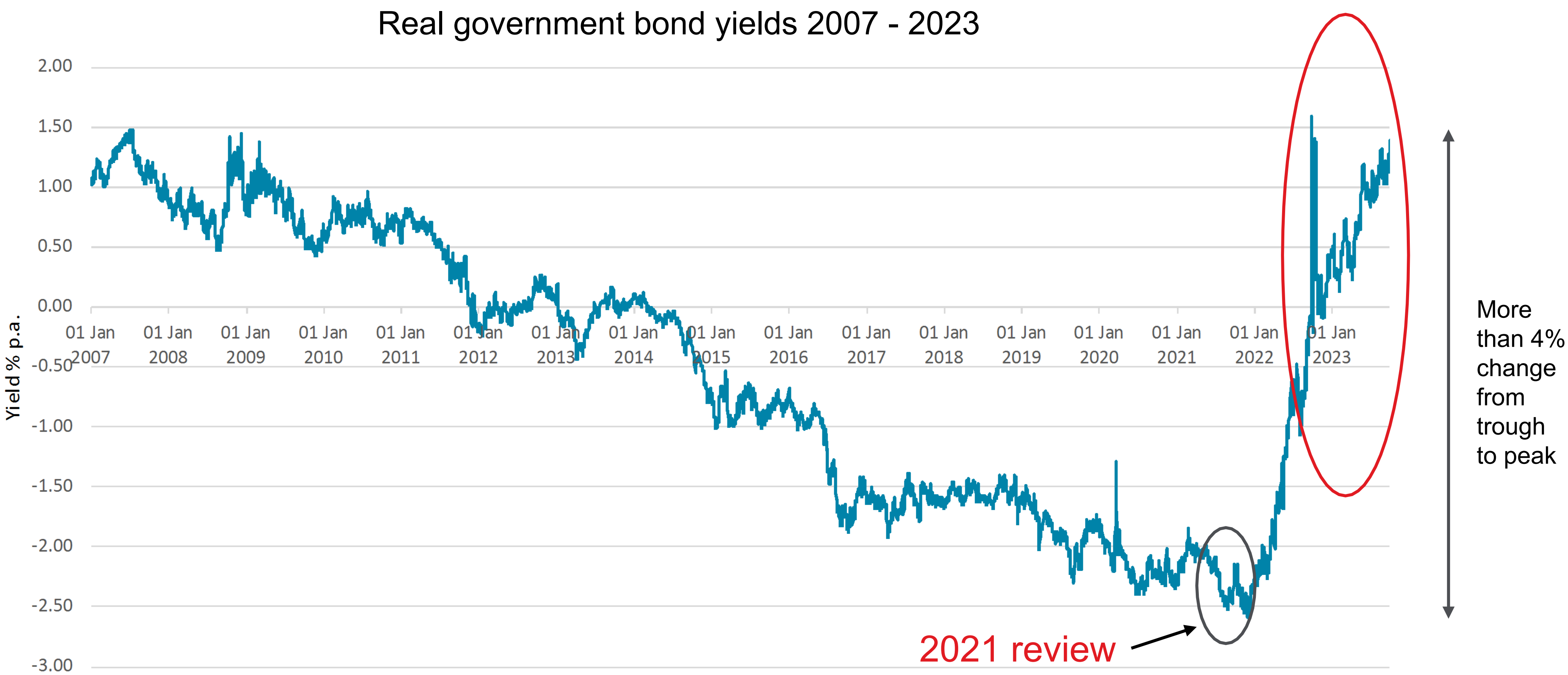
Principal objective

To reduce the risk of challenge from exiting employers through consistency in how funding targets are set, noting a Probability of Funding Success approach is adopted for the long-term secure scheduled bodies

The Administering Authority's preferred option was to set the discount rate for the orphan exit basis based on a Probability of Funding Success approach, in line with that adopted for the Scheduled and Subsumption Body Funding Target, but with additional prudence.

Government bond yields

Real gilt yields (i.e. after allowing for inflation) rose dramatically in late 2022



Liability values are very sensitive to the discount rate

A 1% change in the real discount rate changes liabilities by 10%-20%

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Key objectives for current review of orphan exit basis

Retain a probability of funding success approach
to determining the discount rate

Reflects commitment to retaining a single investment strategy

Reduce the level of prudence
acknowledging that a gilt yield linked approach would lead to significantly lower exit liabilities (noting parameters were set very prudently in 2021 when gilt yields were much lower)

Key takeaway

The Administering Authority has a fiduciary duty to all Fund employers and scheme members.

Also conscious of the need to avoid inadvertently “encouraging” employers to exit.

Options considered

Probability of funding success

95% (current basis) and 90% (slightly less prudent)

Trajectory (modelling) period

15 years (current basis) and 20 years (used for long-term employers).

Solvency target

2% (current basis), 4% (used for long-term employers) and 3%

Testing

- Discount rates generated at 31/3/2022, 31/12/2022, 31/3/2023 and 30/06/2023
- Discount rates compared with gilt yield approach at the same dates
- Effect on orphan employers as at 30/06/ 2023 also considered

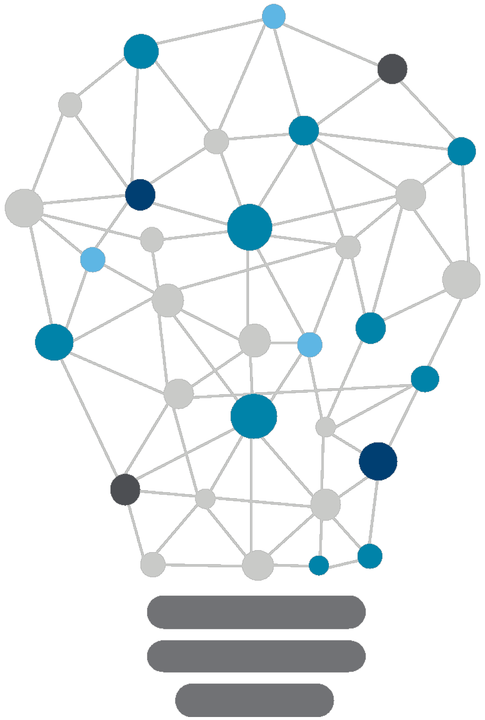
Reminder

Probability of Funding Success for most prudent intermediate funding target is 85%
Exiting employers generally have shorter-term liabilities
Asset values (and membership movements) also affects exit payment/credit due

Conclusion from results/next steps

All scenarios met your objective of reducing the prudence whilst retaining a risk-based approach

Some big surpluses
Considered too much weakening of prudence and hence insufficient protection for remaining employers



Intermediate funding target employers
only one employer likely to show a surplus on any new orphan exit basis

90% probability of funding success
(retaining 15 year trajectory period and 2% solvency target) considered most appropriate by sub-group:

- modest improvement in exit position
- protects ongoing employers
- avoids encouraging employer exit

Already orphan liabilities
c£134M of liabilities at 2022 valuation will also be impacted by any change in the orphan exit basis (will affect ongoing employers)

JAG Sub-Group agreed approach and consultation with employers closed
Full JAG now asked to approve the proposals and updated FSS

Appendix

Further detail of options considered

Options considered

Discount rates	31 March 2022	31 December 2022	31 March 2023	30 June 2023
2022 valuation	1.60%			
Current approach*	1.50%	1.90%	1.75%	1.60%
Gilt yield approach**	0.60%	3.10%	2.80%	3.30%
PoFS 90%, 15yr TP, 2% ST	2.10%	2.50%	2.35%	2.20%
PoFS 90%, 20yr TP, 2% ST	2.50%	2.95%	2.80%	2.65%
PoFS 95%, 15yr TP, **4% ST**	2.60%	3.00%	2.85%	2.70%
PoFS 95%, **20yr TP, 4% ST**	2.80%	3.30%	3.15%	2.95%
PoFS 95%, 15yr TP, **3% ST**	2.05%	2.45%	2.25%	2.15%
PoFS 95%, **20yr TP, 3% ST**	2.35%	2.80%	2.65%	2.50%

* This allows for the impact of the updated strategic asset allocation on the discount rate modelling

** The figures have been adjusted to allow for the difference between the CPI inflation rate implied by gilt yields and our long-term best estimate CPI assumption so will not match observed nominal long-dated gilt yields. The adjustment ensures the discount rates can be validly compared

PoFS = Probability of Funding Success, TP = Trajectory Period, ST = Solvency Target

High level results for groups of employers

Exit surplus/deficit (£M)	31 March 2022			31 December 2022			31 March 2023			30 June 2023		
2022 valuation	-33.3	-840.4	0.0									
	Orphan	Intermed.	Exited	Orphan	Intermed.	Exited	Orphan	Intermed.	Exited	Orphan	Intermed.	Exited
Current approach* (PoFS 95%, 15yr TP, 2% ST)	-38.3	-890.2	-1.7	-24.3	-729.5	1.9	-20.3	-716.2	4.5	-24.2	-748.4	2.9
Gilt yield style approach	-88.4	-1393.3	-17.7	26.7	-244.9	19.5	25.4	-280.5	20.1	46.3	-82.3	27.4
PoFS 90%, 15yr TP, 2% ST	-9.3	-607.4	8.0	2.6	-471.0	11.1	6.9	-454.8	13.7	3.2	-484.0	12.1
PoFS 90%, 20yr TP, 2% ST	8.3	-438.9	14.0	21.0	-298.6	17.5	25.4	-280.5	20.1	21.9	-307.7	18.6
PoFS 95%, 15yr TP, **3% ST**	-11.6	-629.5	7.2	0.5	-491.2	10.3	2.6	-496.0	12.2	1.1	-504.7	11.4

* This allows for the impact of the updated strategic asset allocation on the discount rate modelling

PoFS = Probability of Funding Success, TP = Trajectory Period, ST = Solvency Target

In practice, the assets notionally allocated to liabilities in respect of employers who have already exited would be set equal to the liabilities at each triennial valuation and the surplus of assets would be notionally re-distributed between the ongoing employers in the Fund.

Please note that these figures are projected from the results of the 2022 valuation and are therefore approximate. Since they are not based on up-to-date membership data, they become more approximate the longer the period of time that has elapsed.

Not shown all scenarios here

Only shown those we believe best meet your objectives. Full table of results shown in the report

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