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WYPF Funding Strategy Statement consultation 2023

Please find below our response to the Funding Strategy Statement consultation. We welcome the opportunity to engage with the Fund and agree it's an important time for review given the new funding and investment landscape created by the recent significant market changes.

Whilst the consultation communication focuses only on the exit valuation basis, we consider that the Funding Strategy Statement has to be consulted on as a whole and not just in part and so we have also raised some wider considerations. We view these as important issues, directly connected to the exit basis discussion, and we very much hope they are considered by the Joint Advisory Group.

Informed employer

We've taken detailed advice from our pensions advisers Isio. They are a firm with a specialist public services team with Local Government Pension Scheme expertise. Taking into account the investment we have made in becoming an informed employer, we believe our response should hold significant weight. Our concern is that there is a danger, nil responses are deemed to constitute a position of agreement. We do not think this is appropriate and we consider, taking into account our concerns around the quality of the consultation, that nil responses should not be counted.

Feedback on the employers' annual meeting

Thank you for the time given to preparing for and presenting at the recent annual employer meeting and signposting the consultation that was coming.

The session was useful to understand the Fund's view on the current funding position, the investment strategy, and the proposed consultation. However, we felt there was limited engagement with the audience, and limited evidence that the employers' perspectives were understood or being considered. There were a few points raised by the actuary that we did not agree with (some of which are raised later in this document), or we wanted to understand further, but did not have the opportunity to question them at the time. One thing to note is that at the end of the meeting, when employers were given the opportunity to ask questions, we don't think the Q&A and microphone facilities were switched on, which might be the reason why there were no questions or comments.

Please can we ask that the Fund considers ways this could be improved in the future, such as changing the format of the meeting, and making sure there is a facility to ask questions and to hear the voice of the employers.

We also think it would have been helpful for you to issue feedback requests and a follow up opportunity to ask questions, which would be normal practice after a webinar.

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Our response to the WYPF Funding Strategy Statement consultation November 2023

Executive summary

We strongly agree that the Fund's current exit valuation approach leads to poor outcomes in current market conditions. We are pleased this has been recognised and changes are being made. However, we are concerned the proposed changes don't go far enough.

Our strong view is that the WYPF should move back to a gilts based discount rate approach, rather than look to refine the current approach. We also consider that WYPF should adopt low-risk investment strategies for orphan liabilities and for participating employers as an option. These two changes should come hand in hand, but not changing the latter should not be a rationale for not considering the former.

We believe the current exit basis, combined with wider policies in the Funding Strategy Statement and Statement of Investment Principles are, through a number of different threads, limiting the opportunities available to employers to utilise the significantly improved funding in their participations. In particular:

- The ongoing funding approach is not being changed, even though it based on the same approach as the exit valuation approach – this hides recent funding improvements
- The policy for reviewing contributions between valuations seeks to disallow changes on account of changes to market conditions, which goes beyond the regulations and the statutory guidance
- The WYPF only supports a single investment strategy, which makes a gilts-based exit valuation approach risky and results in a proposed approach which cannot be hedged
- Partial exit, whilst possible in theory, is not in practice because the proposed exit valuation basis continues to over-charge exiting employers, to the benefit of the remaining employers. This will be the same for merging our two participations within the WYPF

We request the Fund also carries out a wider review of the Funding Strategy Statement in the context of the recent market changes, to enable employers to manage their cost and risk objectives and the Fund to meeting its cost efficiency objective. We also request the Fund reconsiders its decision to continue with a single investment strategy.

We outline our considerations supporting these views below.

1. A gilts-based approach for exit valuations

In our view a gilts-based discount rate approach remains the most appropriate method for the exit valuation and the Fund should revert back to a gilts based discount rate.

a. A gilts-based approach is in line with the pension industry standard approach for valuing "settlement amounts" and is also widely used across the LGPS, although we are aware of a recent trend towards alternative approaches used to discourage employer exits. (Note: we believe the best way to discourage employer exits would be to provide better risk management options).

b. A gilts-based approach is able to be hedged. It allows assets to be invested in a way that closely matches the funding approach. The current and proposed approach cannot be hedged.

   One of the arguments for this new approach is that it provides more stability, but this is not true. The Fund's assets and the proposed exit liabilities do not move in line and we are not aware of any investment strategy that can hedge the proposed approach. It is very important that the Fund considers what this means for employers for whom LGPS obligations often represent a very material balance sheet risk. Having an exit position that is not able to be hedged is difficult to accept due to the risk attached.

   Note that the fact that there is single-investment strategy, including for orphan liabilities, is not a reason to dismiss this argument. The decision to stick with a single investment strategy is not one we agree with.

c. The current and proposed exit valuation approach is complex and non-transparent. It is not replicable, even with the assumptions disclosed. This means that employers cannot easily understand their underlying exposure to the fund or the options available to them to manage risk. A gilts--based approach is more transparent and easily replicable and enables employers to understand and track their exit valuation.

d. WYPF previously adopted a gilts-based approach. We don't believe it was appropriate to move away from this approach and the WYPF should now consider reverting to the approach applied prior to 2021.

Prospect House, Wharf Street
Blackburn, Lancashire BB1 1JD
T: 0300 555 5560
www.togetherhousing.co.uk
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i. Whilst the previous consultation resulted in an improvement in exit positions for employers, had we had the chance to respond fully at the time (noting that it was a very short consultation, with little notice, held over the Christmas holiday period) we would have disagreed with the methodology even then.

ii. We understand the consultation on the exit debt basis in 2021 was driven by market conditions at the time. The environment has now changed and the conditions that drove the previous change are no longer relevant.

In 2021, the Fund's view was index-linked gilt prices didn't represent value for money and so it wasn't appropriate to continue assuming that orphan exit liabilities would be backed by them. Whilst this may have helped reduce the cost of exit for employers at the time, we still consider it's appropriate to invest the assets in respect of settled liabilities with matching assets (i.e., an appropriate mix of index-linked bonds). Given the change in gilts prices, the Fund could now quite easily opt to back the orphan liabilities with gilts in a cost-efficient way, significantly reducing the level of risk for these liabilities.

iii. Has the WYPF considered reverting back to the gilts-based approach rather than trying to fix an approach that you believe is no longer working? The consultation, including the responses to our questions, does not provide any supporting evidence of the alternative approaches considered.

e. We are not comfortable with the fact that the Fund and Aon are presenting gilts as risky. If you invest in gilts, but do not measure the liabilities using gilt yields then this creates funding risk, but this is an entirely unnecessary risk and should not be presented as a reason not to use a gilts-based approach. Even if you choose not to offer employers a low risk investment option (which we disagree with), the orphan liabilities should be invested in a low risk way. Also, reference to the crisis faced by trust based schemes in 2022 as being evidence of gilts being risky is not appropriate. This was not about gilts being risky – if those schemes had been invested directly into gilts rather than LDI there would not have been a crisis for trust based schemes.

2. Significant prudence

The current approach results in an overly prudent basis that will overfund the Fund, overcharging exiting employers to the benefit of the remaining employers (who should not feel comfortable with this cross subsidy in their favour). We can see from the information received, that the current approach results in a single

equivalent discount rate that is significantly below gilt yields and we expect this to remain the case after the proposed changes.

We also anticipate the current approach is more prudent than current insurer pricing. It is difficult to see how the WYPF can reasonably charge more than a third-party insurer.

a. High level analysis completed by our advisors on the 31 December 2022 exit valuation we received indicated the effective discount rate using the current approach was comparable to gilt yields less 0.9%. Based on the answers to our consultation questions, we can now see this difference is 1.2%. We can see that, as expected, the difference has extended much further and was 1.95% as at 30th September 2023. (We note that we would not have this information if we were only looking at the consultation materials).

b. The consultation suggests the proposed changes reduce the discount rate by 0.6%, meaning the revised discount rate will still be significantly more prudent than a gilts-based approach. This is supported by the answers we have received to our questions.

c. We agree that, as stated in the employers' annual meeting, LGPS liabilities cannot be "bought-out", but this is not a relevant point and we feel it should not have been used to support the justification for the change to the exit valuation basis. The important and relevant point is that the Fund could purchase a "buy-in" product with a third-party insurer. This has been demonstrated by other LGPS funds.

d. A buy-in represents, save failure of the insurance provider, a complete de-risking of pension liabilities. Furthermore, a third-party insurer is going to take an approach to valuing liabilities which seeks to make profit. With the limited information they have available our advisers estimate the Fund's proposed approach is more prudent than the insurance market at the current time, reinforcing why it is not appropriate. In addition, for reasons discussed above, the proposed approach moves out of line with the cost of a buy-in policy.

Prospect House, Wharf Street
Blackburn, Lancashire BB1 1JD

T: 0300 555 5560
www.togetherhousing.co.uk

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3. Detailed methodology and review of the proposed funding approach

You have not provided details supporting the proposed discount rate change which makes it difficult to understand how it has been derived, or what supporting analysis the WYPF has completed to arrive at the proposed approach.

a. The proposal shared reduces the Probability of Funding Success from 95% to 90%. Whilst helpful to have an indication of the impact on the effective discount rate in current market conditions, it's very difficult to understand how this is derived. The response to our questions does not shed any more light on this, it confirms that advice was given to the Fund and the Fund and the actuary used that advice.

b. Crucially, no details were received of Aon's asset return assumptions on which this whole approach rides. While you have offered it as part of the answer to questions, we do not have time to review the full information shared ahead of submitting our consultation response. We would also note that these were not provided at the annual employers meeting, despite these assumptions being a crucial part of the conclusion that the funding position has not improved. Not only do we not know the assumptions, we do not know how they are derived. In the answers to our questions it states "..it is clear what the underlying parameters are..". This is not the case.

c. We've not received details of any analysis carried out to support the 5% change. How are you comfortable this reduction is sufficient? We would like to have a very clear explanation as to why the Fund believes the revised discount rate approach represents an acceptable level of prudence in current and future market conditions.

   The answers to our questions suggest that this finds the right balance between exiting and remaining employers, but without any detailed explanation or quantification.

d. Presumably, there will be a need to regularly review the Probability of Funding Success in the future, given the fact that it's not resilient in the face of changing market conditions. This will add further complexity to the approach and make it even more difficult for employers to understand and track their exit position.

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4. Wider implications for the Funding Strategy Statement

a. ***Section 5. Solvency Issues, Target Funding Levels and Long-term Cost Efficiency***

The ongoing funding approach, which drives the cash contributions employers pay, adopts the same methodology as the exit valuation with a different Probability of Funding Success. The unprecedented changes in market conditions have led to the review of the exit valuation approach. We strongly believe that the Fund should also review the ongoing valuation approach. Your answer to our consultation question on this simply states that this does not need to be reviewed until 2025, by which we infer it should be reviewed. But by delaying this review opportunities to create good outcomes for your employers (including councils) are being missed.

We are concerned that the underlying reason for not choosing to review the ongoing funding position is the significant potential practical consequences for the Fund. If this is the case then the resourcing issues should be tackled head on and in a transparent manner.

b. ***Appendix 2: Policy on reviewing Employer Contributions between Triennial Valuations.***

Given the significant improvements in market conditions since the last valuation date, as part of the valuation discussions, we asked the WYPF what options were available for reviewing our contributions to take into account post valuation experience. We understand your view is that this would not result in a contribution reduction given:

- The Funding position hasn't improved under your funding strategy approach (even though we believe it has on a typical exit basis)
- You are constrained under you funding strategy by how you categorise Employers

In our view, given our position with a surplus on a very low risk basis, our covenant is now very strong, and it wouldn't be unreasonable to treat us as a lower risk employer.

Whilst the regulations on employer flexibilities are quite open, WYPF is constrained by the policies set out in the current Funding Strategy Statement. Given this was created in a very different market environment we believe that WYPF should now be reviewing these important elements of your funding policy as part of this consultation to provide better outcomes for the fund and its employers.

5. **Utilising surplus objective**

As you know we have previously discussed with the WYPF what options are available to utilise our surplus, ideally by de-risking our participation, and potentially merging our two participations. We can't meet our de-risking objectives for reasons we don't agree with, which means we have value trapped in the Fund. This issue will not be unique to us and there will be other employers in a similar position. We consider that through a combination of this consultation, and other factors that the Fund is not consulting on but should be (see above), the Fund is obstructing good outcomes from taking place.

a. Our participation has a surplus on the ongoing basis, and even has a surplus on a low-risk (gilts based) basis. In our view, if there is a surplus in the Fund an employer should be able to use this, either to de-risk their participation or reduce the level of contributions paid.

b. We are not able to utilise the funding improvements seen:

- We can't de-risk through the investment strategy, given the Fund continues with a single investment strategy and has no plans to offer any de-risked options
- We can't de-risk using partial exit, despite the fact that we believe this is possible, or by merging our participations, as it remains poor value for money with the current and proposed exit valuation basis
- We can't reduce our contributions, because, despite the adjustments to the exit valuation approach you consider the ongoing valuation approach should not be reviewed until 2025

c. We understand there are wide implications of making change, but the Fund must engage with current market conditions rather than avoid them. If additional resources are required for the Fund to deal with these, then these must be found and can be paid for from Fund assets.

d. We are concerned that the Joint Advisor Group does not deal with individual employer issues. The Fund's role is to find the best balance of funding and risk between themselves and their employers and JAG needs to listen to the voice of the employers who support their Fund.

e. We would ask again for the Fund to urgently consider whether alternative investment options could work. We appreciate that providing the option for all employers to have a be-spoke investment strategy will be complex, but we know a number of other funds within the LGPS do offer a lower risk investment strategy option as an alternative for employers.

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6. Consultation approach

We would like to feedback that the timescales for the consultation period have been very tight for employers to respond. We are also concerned about the outcome of the consultation and whether our voice will be heard.

a. The consultation spans the Christmas period. As employers we need time to understand the proposals and what is being consulted on, seek advice, discuss and agree our position internally and then draft the consultation response. Please can this be considered for future consultations to ensure all employers are given the chance to give this the time it needs. Otherwise, there is a risk to you that the consultation is not effective.

   We've raised a number of technical questions to help support our consultation response and have only just received a response on 19 December. However, given the consultation deadline, we haven't been able to fully incorporate them into our response.

   We note the Fund's query on Together's commitment to the LGPS and can confirm that Together Housing values the LGPS and we know our members value being part of this scheme. We plan to continue to offer this to our employees, including to new employees, but are keen to ensure we have a sustainable position with the right balance of cost and risks to help us do this.

b. As the Joint Advisory Group meeting is scheduled for the 25th January do you have sufficient time to review and fully consider all the consultation responses in the short amount of time between closure of the consultation and the meeting papers being finalised in advance of the meeting? This does cause us some concern.

We would like the Fund to take full consideration of the points we have raised here when making their decision and provide feedback on the points we've raised. We would welcome the opportunity to discuss this response and to present our views as part of the deliberations.

Mark Dunford

Executive Director of Finance & Commercial

Prospect House, Wharf Street
Blackburn, Lancashire BB1 1JD

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