Notice of Meeting

Surrey Pension Fund Committee

SURREY
COUNTY COUNCIL

Date & time	Place	Contact	Chief Executive
Thursday, 25 February 2016 at 12.00 pm	Ashcombe Suite, County Hall, Kingston upon Thames, Surrey KT1 2DN	Democratic Services - 020 8541 9122 Room 122, County Hall Tel	David McNulty

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This meeting will be held in public. If you would like to attend and you have any special requirements, please contact Democratic Services - 020 8541 9122 on .

Elected Members
Ms Denise Le Gal (Chairman), Mr Alan Young (Vice-Chairman), Mr W D Barker OBE, Mr Tim Evans, Mr Stuart Selleck and Mrs Hazel Watson

Co-opted Members:
Mr Tony Elias (Borough/District Representative), Ian Perkin (Office of the Surrey Police and Crime Commissioner), District Councillor Peter Stanyard (Borough/District representative) and Philip Walker (Employees)

AGENDA

1 APOLOGIES FOR ABSENCE AND SUBSTITUTIONS

2 MINUTES OF THE PREVIOUS MEETING (Pages 1 - 10)

To agree the minutes as a true record of the meeting held on 12 February 2016.

3 DECLARATIONS OF INTEREST

To receive any declarations of disclosable pecuniary interests from Members in respect of any item to be considered at the meeting.

Notes:

- In line with the Relevant Authorities (Disclosable Pecuniary Interests) Regulations 2012, declarations may relate to the interest of the member, or the member's spouse or civil partner, or a person with whom the member is living as husband or wife, or a person with whom the member is living as if they were civil partners and the member is aware they have the interest.
- Members need only disclose interests not currently listed on the Register of Disclosable Pecuniary Interests.
- Members must notify the Monitoring Officer of any interests disclosed at the meeting so they may be added to the Register.
- Members are reminded that they must not participate in any item where they have a disclosable pecuniary interest.

4 QUESTIONS AND PETITIONS

To receive any questions or petitions.

Notes:

1. The deadline for Member's questions is 12.00pm four working days before the meeting (*19 February 2016)*.
2. The deadline for public questions is seven days before the meeting (*18 February 2016)*.
3. The deadline for petitions was 14 days before the meeting, and no petitions have been received.

5 ACTION TRACKING (Pages 11 - 12)

An action tracker is attached, detailing actions from the previous meetings. The Committee is asked to review progress on the item listed.

6 ACTUARIAL ASSUMPTIONS: 2016 VALUATION (Pages 13 - 20)

Members are required to have knowledge of the actuarial assumptions to be used in the next actuarial valuation of the Pension Fund as at 31 March 2016.

7 EXCLUSION OF THE PUBLIC

That under Section 100(A) of the Local Government Act 1972, the public be excluded from the meeting during consideration of the following items of business on the grounds that they involve the likely disclosure of exempt information under the relevant paragraphs of Part 1 of Schedule 12A of the Act.

PART TWO – IN PRIVATE

The following item of business will be considered by the Committee.

8 INVESTMENT CONSULTANT INTERVIEWS (Pages 21 - 32)

This report sets out the assessment criteria for, and initial results of, the procurement exercise to appoint a firm of investment consultants for the Pension Fund.

Confidential: Not for publication under Paragraph 3
Information relating to the financial or business affairs of any particular person (including the authority holding that information)

PART ONE – IN PUBLIC

9 PUBLICITY FOR PART 2 ITEMS

To consider whether the item considered under Part 2 of the agenda should be made available to the press and public.

10 DATE OF NEXT MEETING

The next meeting of the Surrey Pension Fund Committee will be on 13 May 2016.

David McNulty
Chief Executive
Published: 17 February 2016

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Thank you for your co-operation

MINUTES of the meeting of the **SURREY PENSION FUND COMMITTEE** held at 9.30 am on 12 February 2016 at Ashcombe Suite, County Hall, Kingston upon Thames, Surrey KT1 2DN.

These minutes are subject to confirmation by the Committee at its next meeting.

Elected Members:

* Ms Denise Le Gal (Chairman)
* Mr Alan Young (Vice-Chairman)
* Mr W D Barker OBE
* Mr Tim Evans
* Mr Stuart Selleck
* Mrs Hazel Watson

Ex officio Members:

Mr David Munro
Mrs Sally Ann B Marks, Chairman of the County Council
Mr David Hodge, Leader of the Council
Mr Peter Martin, Deputy Leader and Cabinet Member for Economic Prosperity

Co-opted Members:

* Mr Tony Elias, Borough/District Representative
* Ian Perkin, Office of the Surrey Police and Crime Commissioner
* District Councillor Peter Stanyard, Borough/District representative
* Philip Walker, Employees

In attendance:

Jason Bailey, Pensions Services Manager
Rachel Basham, Senior Manager – Leadership and Member Support
John Harrison, Surrey Pension Fund Advisor
Nick Harrison, Chairman – Local Pension Board
Kevin Kilburn, Chief Finance Officer
Neil Mason, Senior Advisor (Pension Fund)
Alex Moylan, Senior Accountant
Phil Triggs, Strategic Finance Manager (Pension Fund & Treasury)
Steve Turner, Partner, Mercer
Ayaz Malik, Trainee Accountant

76/16 APOLOGIES FOR ABSENCE AND SUBSTITUTIONS [Item 1]

No apologies were received.

77/16 MINUTES OF THE PREVIOUS MEETING 13 NOVEMBER 2015 [Item 2]

The Minutes were approved as an accurate record of the meeting, apart from a small amendment on page 16, concerning the identity of a fund manager interviewed.

78/16 DECLARATIONS OF INTEREST [Item 3]

There were no declarations of disclosable pecuniary interest.

79/16 QUESTIONS AND PETITIONS [Item 4]

No questions or petitions were received.

80/16 ACTION TRACKING [Item 5]

Declarations of interest:
None

Key points raised during the discussion:

1. In relation to A18/15, it was clarified that a report outlining the CPI plus model, economic model and gilts plus model would be presented to the committee at its next meeting on 25 February 2016. Given the importance of the paper, the Chairman agreed that the draft report should be circulated to the committee as soon as it was ready.
2. All the other actions were reported as complete and ready to be removed from the action tracker.

Actions/further information to be provided:

1. That the draft report outlining the CPI plus model, economic model and gilts plus model be shared with the committee in the week commencing 15 February 2016.

Resolved:

That the action tracker was noted and the committee agreed to remove the completed actions from the tracker.

81/16 LOCAL GOVERNMENT PENSION SCHEME INVESTMENT REFORM: NATIONAL POOLING [Item 6]

Declarations of interest:
None

Key points raised during the discussion:

1. The Strategic Finance Manager (Pension Fund & Treasury) introduced the report. He stated that since the publication of the government consultation in November 2015, Local Authorities had carried out a significant amount of work to bring forward proposals for pooling Local Government Pension Schemes.
2. The Government had set out four main criteria for administering authorities to consider when developing their criteria:
    a. Assets pools that achieve the benefits of scale
    b. Strong governance and decision making
    c. Reduced costs and excellent value for money
    d. An improved capacity to invest in infrastructure.

3. There was a discussion regarding criteria point d - the improved capacity to invest in infrastructure. The Committee expressed concern that it was not the place of Government to mandate investment of local pension funds, and that this should be reflected in Surrey's consultation response.
4. The Strategic Finance Manager (Pension Fund & Treasury) put forward the current pooling options being considered, as listed on pages 28 and 29 of the agenda papers. Surrey now forms part of the Borders to Coast Pensions Partnership (BCPP), which it had founded alongside East Riding and Cumbria. The partnership was unusual in the fact that it was not a regional collaboration (as is the case with many of the other pooling options), but a collaboration with other like minded funds.
5. One Member queried what the proposed consultancy budget provision would be used for. The Chairman responded that there were consulting firms with experience of fund mergers, taxation, legal structures and audit who would be called upon to provide advice to the pool.
6. The Strategic Finance Manager (Pension Fund & Treasury) stated that further details regarding the BCPP were included in annex 1, which had been sent to the Committee by e-mail. As not all the Committee Members had yet had time to read the annex, the Chairman agreed to adjourn the meeting for a short period to allow them to do so before continuing the debate.

The meeting was adjourned from 10.30am – 10.50am.

7. When the Committee returned the Chairman stated that under Section 100(A) of the Local Government Act 1972, the public be excluded from the meeting as the discussion of annex 1 would involve the likely disclosure of exempt information under the relevant paragraph of Part 1 of schedule 12a of the Act.
8. The Committee had a discussion regarding the detail included in annex 1, the proposal for pooling from the BCPP.

Actions/further information to be provided:

1. That the Strategic Finance Manager (Pension Fund & Treasury) provides clarification on what the term TECKAL Company means.

Resolved:

1. That the Strategic Finance Manager (Pension Fund & Treasury) amends the BCPP proposal to include comments from the committee in reference to governance arrangements.
2. That, subject to those amendments taking place, the Pension Fund Committee approves and adopts the proposal to government reference the Border to Coast Pensions Partnership.
3. That the Pension Fund Committee approves an initial £50,000 for consultancy and advisory costs.

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82/16 LOCAL GOVERNMENT PENSION SCHEME INVESTMENT REGULATIONS CONSULTATION [Item 7]

Declarations of interest:
None

Key points raised during the discussion:

1. The Strategic Finance Manager (Pension Fund & Treasury) introduced the report, which outlines the details of a Government consultation on LGPS investment regulations and Surrey's draft response.
2. There was a debate regard point 3 in Surrey's response, specifically, 'Surrey has some concern about the broad powers being taken for the Government to direct funds' investment processes.' The Committee felt that this needed to be strengthened to reflect their *considerable* concerns in this area. It was also important to make clear that fund investments should ultimately be driven by the need to pay members' pensions, rather than directions from Government to invest in certain areas.

Actions/further information to be provided:
None.

Resolved:

1. That the Pension Fund Committee approve and agree the attached response to government, shown in annex 2, subject to the amendments raised in the discussion regarding point 3 (as detailed above).

83/16 MANAGER ISSUES AND INVESTMENT PERFORMANCE [Item 8]

Declarations of interest:
None

Key points raised during the discussion:

1. The Strategic Finance Manager (Pension Fund & Treasury) introduced the report, which provided a summary of manager issues for the committee's attention, as well as details of manager investment performance.
2. The committee had a number of questions relating to the proposal, detailed on page 53 of the agenda papers, to invest in the Secondary Opportunities Fund (SOF) III:
   a. The Vice-Chairman queried whether it was sensible to invest in funds that would not form part of the BCPP. The Strategic Finance Manager (Pension Fund & Treasury) responded that Government accepted that there would be a small number of assets that would not immediately go into the pool and that there was a period of over two years before the pool would come into operation.
   b. There was a request for information on the performance of SOF I and II, to which the Surrey Pension Fund Adviser responded that it was still early days to assess performance on such long term investments.

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c. The Chairman queried what Standard Life were investing the money in, to which the Surrey Pension Fund Adviser responded that it was unlikely they would provide a structured list. He stated that the advantage of secondary investments was that, due to their long-term nature, assets could be brought at a reduced price. However, the disadvantage was that you did not tend to have a say in which industries you were investing in.
d. The Strategic Finance Manager (Pension Fund & Treasury) clarified that Surrey had invested $20 million dollars in both SOF I and II, and that such investments had generally been very profitable.
e. The Partner from Mercer highlighted that the Surrey fund was slightly underweight in their commitment to private equity. Investing in the SOF III now would be a good way of diversifying the fund's vintage year exposure.
f. After discussion, Members and Officers agreed to support investment into SOF III. However, the Vice-Chairman requested that it be recorded in the minutes that he would prefer to know what other SOF opportunities were available.
g. The Chairman requested that Officers look to further reduce the management fee.

3. There was a discussion regarding Manager meetings and the fact that, in the past, committee members had been able to attend these and found them helpful. The Strategic Finance Manager (Pension Fund & Treasury) stated that, in future, he would ensure the dates of these meetings were circulated to committee members. However, the Chairman stressed that it was important for Members to remember that these meetings are an executive tool and that Members should only attend as observers.
4. The Senior Accountant introduced the Management Investment Performance Report. The Independent Advisor highlighted the fact that overall asset value had reduced by 5%.
5. The Independent Advisor provided an overview of the Fund Manager meetings, as detailed in annex 2. The Independent Advisor stated that the key issue for consideration of the Pension Fund Committee was in relation to the meeting held with CBRE, and whether to increase investment in property given that the fund is already overweight in this area. After discussion, the committee agreed to amend the policy allocation to property from 6.5% to 7.5%, allowing for an investment of £30miillion from pension fund cash.
6. The Partner from Mercer stated that Western may change their portfolio to tap into high yield opportunities in America. The Surrey portfolio with Western's Multi Asset Credit team would have advantage of this.

Actions/further information to be provided:
None.

Resolved:

1. That the report was noted.
2. That the Pension Fund Committee approve a $25m USD commitment to Standard Life Capital Partners Secondary Opportunities Fund III, subject to successful fee negotiation.

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3. That the Pension Fund Committee agrees to amend the asset policy allocation to property from 6.5% to 7.5%, allowing for a cash injection of £30million.

84/16 PENSION FUND BUSINESS PLAN 2016/17 [Item 9]

Declarations of interest:
None

Key points raised during the discussion:

1. The Strategic Finance Manager (Pension Fund & Treasury) introduced the business plan, which is revised annually. He stated that a report would come to the May meeting of the Pension Fund Committee to update Members on the implementation of the business plan.

Actions/further information to be provided:
None.

Resolved:

1. That the Pension Fund Committee adopts the attached Business Plan shown in Annex 1 in respect of the 2016/17 financial year.

85/16 PENSION FUND RISK REGISTER [Item 10]

Declarations of interest:
None

Key points raised during the discussion:

1. The Strategic Finance Manager (Pension Fund &Treasury) introduced the Pension Fund Risk Register.
2. One new risk was highlighted to the committee which concerned the implemention of the BCPP asset pool.

Actions/further information to be provided:
None.

Resolved:
That the report was **NOTED**.

86/16 CORPORATE GOVERNANCE SHARE VOTING [Item 11]

Declarations of interest:
None

Key points raised during the discussion:

1. The Strategic Finance Manager (Pension Fund &Treasury) introduced the paper which provided a summary of the Fund’s share voting process in quarter 2 and quarter 3 of 2015/16.

Actions/further information to be provided:

None.

Resolved:

1. That the report was **NOTED**.

87/16 KEY PERFORMANCE INDICATORS AND ADMINISTRATION UPDATE [Item 12]

Declarations of interest:
None

Key points raised during the discussion:

1. The Senior Advisor (Pension Fund) introduced the report, which provided an update against Pension Fund key performance indicators as well as an update of administration issues.
2. The Pensions Fund Manager highlighted some areas of concern that had impacted the operational team's performance level. Firstly, the Surrey pension team had recently inherited two administration services from London Boroughs. This had resulted in the service needing to take on new members of staff and it is often difficult to recruit senior LGPS advisors. New staff had now been recruited and the team restructured, which should have a positive impact on performance by quarter 2.
3. The service had also recently set up a Pensions Helpdesk which was averaging 1000 enquires a week, signalling an increased awareness in pensions.
4. One Member stated that, whilst he understood the difficulties in recruiting staff, there was a need to ensure that performance levels in certain areas, such as death benefits and benefit statements, were maintained as far as possible. The Pensions Fund Manager stated that he felt the restructure would offer more resilience to maintain good performance levels in these areas in the future.
5. There was also a query from a Member regarding the number of people making enquiries about transferring out of the scheme, and whether there was a possibility that the beneficiaries were being 'scammed'. The Pensions Fund Manager responded that, although the changes to pensions by Government earlier in the year did result in a number of enquiries about transferring out of the scheme, the number of actual transfers was minimal with evidence of independent advice to to each beneficiary statutorily required.

Actions/further information to be provided:
None.

Resolved:

1. That the report, including the KPI statement shown in Annex 1, was **NOTED**.

2

88/16 REVISED STATEMENT OF INVESTMENT PRINCIPLES [Item 13]

Declarations of interest:
None

Key points raised during the discussion:

1. The Strategic Finance Manager (Pension Fund &Treasury) introduced the report. Although there had been no recent changes to the Statement of Investment Principles (SIP) and Core Belief Statement, it was considered good governance for the Committee to review these documents on a regular basis.

Actions/further information to be provided:
None.

Resolved:

1. That the Pension Fund Committee approved the Statement of Investment Principles shown in Annex 1.
2. That the Pension Fund Committee approved the Core Belief Statement shown in Annex 2.

89/16 EXCLUSION OF THE PUBLIC [Item 14]

Resolved:

That under Section 100(A) of the Local Government Act 1972, the public be excluded from the meeting for the following items of business on the grounds that they involve the likely disclosure of exempt information under the relevant paragraphs of Part 1 of Schedule 12A of the Act.

With the agreement of the Committee, the Chairman considered item 16 before item 15.

90/16 CATEGORISING OF EMPLOYERS BY RISK AND COVENANT STRENGTH [Item 15]

Declarations of interest:
None

Key points raised during the discussion:

1. The Senior Advisor (Pension Fund) introduced the report, before answering a number of questions from Members.

Actions/further information to be provided:
None.

Resolved:
1. That the Pension Fund Committee agreed the risk based methodology to be employed.
2. That the Pension Fund Committee approve the commissioning of a covenant specialist to carry out a review of the covenant strength of relevant employers within the fund.

91/16 PENSION ADMINISTRATION SYSTEM [Item 16]

Declarations of interest:
None

Key points raised during the discussion:

1. The Pensions Services Manager introduced the report, before answering a number of questions from Members.

Actions/further information to be provided:
None.

Resolved:

1. That the Pension Fund Committee agreed the recommendations in relation to the Pension Fund Adminstration System, as set out in the report.

92/16 PUBLICITY FOR PART 2 ITEMS [Item 17]

It was agreed that non-exempt information may be made available to the press and public, where appropriate.

93/16 DATE OF NEXT MEETING [Item 18]

The date of the next meetings was NOTED.

Meeting ended at: 3.15pm

Chairman

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Surrey Pension Fund Committee – ACTION TRACKING

ACTIONS

Number	Meeting Date	Item	Recommendation / Action	Action by whom	Action by when	Action update
A18/15	13 Nov 15	Manager Issues and Investment Performance	Director of Finance and Strategic Finance Manager (Pension Fund & Treasury) to bring a report in February 2016 outlining the CPI model, economic model and gilts model and detailing the risk s and opportunities involved.	Director of Finance, Strategic Manager, Pension Fund & Treasury	February 2016	It was confirmed at the meeting on 12 February 2016, that this report would come to the meeting on 25 February 2016.
A1/16	12 Feb 16	Action Tracking	That the draft report outlining the CPI model, economic model and gilts model be shared with the committee in the week commencing 15 February 2016.	Director of Finance, Strategic Manager, Pension Fund & Treasury	w/c 15 February 2016	
A2/16	12 Feb 16	Local government pension scheme investment reform: national pooling [	That the Strategic Finance Manager (Pension Fund & Treasury) provides clarification on what the term TECKAL Company means	Director of Finance, Strategic Manager, Pension Fund & Treasury	25 February 2016	

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SURREY COUNTY COUNCIL

PENSION FUND COMMITTEE

DATE: **25 FEBRUARY 2016**

LEAD OFFICER: **SHEILA LITTLE, DIRECTOR OF FINANCE**

SUBJECT: **ACTUARIAL ASSUMPTIONS: 2016 VALUATION**

SUMMARY OF ISSUE:

Members are required to have knowledge of the actuarial assumptions to be used in the next actuarial valuation of the Pension Fund as at 31 March 2016.

RECOMMENDATIONS:

It is recommended that:

1 The Pension Fund Committee note this report and approve a continuation of the current approach with regard to actuarial assumptions to be used by the actuary in the 2016 valuation.

REASON FOR RECOMMENDATIONS:

To comply with best actuarial valuation practice.

INTRODUCTION

1 In line with the Regulations, the Local Government Pension Scheme (LGPS) funds undergo an actuarial valuation every three years. The last triennial valuation of the LGPS assets and liabilities was as at 31 March 2013 and the next one will be as at 31st March 2016.

2 The Regulations require that an actuarial valuation should assess the liabilities of the benefits accrued and set the contribution rates required to fund any shortfall in assets and the ongoing cost of future service.

3 There is a variety of differing actuarial methodologies which underpin valuation assumptions. This paper explores the assumptions that are recommended be applied to the 2016 triennial valuation.

4 It is proposed that the following assumptions are used for the 2016 valuation:

- Salary increases;
- Pension increases;
- Longevity;
- Discount rate and Asset Outperformance Assumption (AOA).

DETAILS:

Salary Increases

5 The change to the accumulation of member pension benefits from a final salary to a career average revaluated earnings (CARE) basis will gradually reduce the importance of the salary increase assumption as member benefits will be tied to consumer prices index (CPI) inflation rather than to final salary.

6 The majority of liabilities accrued to date, however, are still final salary linked benefits and, given significant accrued final salary service and built in protections as part of LGPS 2014, the final salary assumption remains of long term significance.

7 In the past two valuations, the Fund has used the market derived inflation retail prices index (RPI) value plus an additional percentage to establish a long term estimate of salary increases. RPI is calculated as the difference between the yield on long dated fixed interest gilts and long dated index-linked gilts.

Valuation	Methodology	Salary Increase Assumption
31 March 2010	RPI + 1.5%	5.3%
31 March 2013	RPI + 1.0%	3.8%

Pension Increases

8 Annual pension increases and CARE increases are determined by consumer price index (CPI) inflation. To establish a long term CPI assumption, the actuary uses a market expectation for RPI and applies a discount based upon the historical deviation between RPI and CPI.

Valuation	Methodology	Pension Increase
31 March 2010	RPI - 0.5%	3.3%
31 March 2013	RPI - 0.8%	2.5%

9 The variance between the two measures of inflation has widened with the actuary predicting a difference of 0.9-1.0%.

Longevity

10 The assumption regarding improvements in longevity are based upon latest industry standards and information derived from the Fund's membership of Club Vita (provided by the Fund actuary), such as observed mortality rates.

11 The longevity assumption is predicated upon the idea that the very strong improvements in life expectancy observed amongst those born in the 1930s will start to tail off, resulting in less rapid increases in longevity for subsequent generations.

12 The expectation is that for the longer term, longevity improvements will stabilise at one additional year for every decade.

Assumed Life Expectancy at 65	Actives		Pensioners	
	Male	**Female**	**Male**	**Female**
31 March 2010	23.9	25.9	21.9	23.6
31 March 2013	24.5	26.9	22.5	24.6

Discount Rate and Asset Outperformance Assumption (AOA)

13 The discount rate is used to place a current valuation on the Fund’s future pensions promises and is a proxy for the investment return that the Fund expects to achieve on its assets.

14 In valuing the liabilities, the scheme actuary is required to apply a suitable discount factor to future net cash outflows to define a current value of the fund’s liabilities. This enables the surplus or deficit on past service obligations to be identified so that any shortfalls are attributed to the relevant employers. There are a number of ways in which this can be done, but the three most appropriate methods are a gilts plus basis, inflation plus basis and the economic model basis.

15 For the purpose of the 2016 valuation, the two models being considered are the gilts plus and inflation (CPI) plus models.The economic model may become more relevant when the Fund next retenders the actuarial contract in 2017.

16 The choice between gilts plus and CPI plus models is important because it can drive the Fund's investment strategy. In theory, a pension fund’s investment strategy should seek to generate the most efficient possible return relative to the scheme’s liability risks.

17 The basis on which the liabilities are currently valued defines the minimum possible risk (a UK gilt is regarded as a risk free rate), so it can be seen as the starting point for strategic asset allocation decisions.

The Gilts plus model

18 The gilts plus model uses the yield on index-linked gilts with maturity similar to the average duration of the scheme’s liabilities: in the case of the LGPS , it is about 20 years. For this reason, it can be argued that the gilts valuation method most closely matches the replacement value of pension liabilities.

19 The Fund’s investment strategy invests in a much broader range of assets in the expectation that it will generate long term returns well above index-linked gilts.

20 As referred to earlier in this report, the actuary will assess AOA when determining the appropriate discount rate, but will express this as an ‘index-linked gilt yield plus x%’. Since the 2004 valuation, the Fund has adopted a AOA of 1.6% per annum.

21 Although a gilts plus valuation basis can appear mechanistic, there is still a large element of judgment in how it is applied. The date on which the index-linked gilt yield is calculated is a single point in time (usually the close of business on the valuation date) or smoothed over a period of months. More importantly, the AOA can vary depending on the actuarial model used to assess future investment returns and the extent that expected out performance is prudently rebased.

22 It should be noted that, whilst a gilts plus assumption is currently used for measuring the funding position of the whole Fund, best estimate "stabilisation" assumptions are adopted for the purposes of determining contributions for the tax-raising bodies; which represent the majority of the liabilities within the Fund.

23 In accordance with the employer risk strategy, it is proposed that contribution rates for all employers will be managed via this "risk-based" and stabilised approach in the 2016 valuation. This will allow stable, affordable contributions to be set, based on economic assumptions and allowing for the appropriate time horizon for each employer. This approach has the effect of mitigating contribution rate volatility, sometimes attributed to a gilt plus approach.

Criticism of the Gilts plus model

24 The last ten years have highlighted a potential problem with the gilts plus basis for valuing assets. This is the implicit assumption it makes that the index-linked gilt yield accurately reflects investor expectations about the future.

25 Current demand for index-linked gilts has increased significantly and far outstrips the available supply. This has create a mismatch between index-linked gilt issuance and long-term investor demand and, as a result, the long-dated index-linked gilt market now has limited liquidity with yields well below historic levels.

26 The attraction of a gilts plus basis for valuing liabilities is that it is based on a market traded asset and should therefore reflect rational investor expectations for a risk free asset. Market distortions, such as liquidity or technical bias, have made this less appropriate, hence reducing the appropriateness of this model.

27 A gilts plus model can result in volatility when valuing Fund liabilities. However, this can be mitigated when a Fund wide stabilisation approach is adopted.

The CPI plus model

28 CPI inflation is one of the key drivers of the cash cost of LGPS pension payments, so a pension fund's strategic asset allocation should be seeking to generate positive real returns over time. An inflation based valuation in effect assumes the scheme will be able to achieve this

29 The CPI plus model is intended to represent the growth in UK Gross Domestic Product (GDP).

30 The Government Actuary Department (GAD) use CPI plus to value liabilities for their cost management valuations (currently CPI plus 3%). This model was originally intended for valuing the liabilities of the unfunded public sector schemes as government revenue, inherently linked to UK GDP growth, would be used to meet ongoing pension payments.

31 Like the gilts plus model, the actuary will apply an AOA when determining the appropriate discount rate in the CPI plus model. This will be expressed as ‘CPI plus x%’.

Criticism of the CPI plus model

32 While the CPI plus model is intended to track UK GDP growth, this does not match the Fund’s investment strategy, which has a large weighting of overseas assets.

33 Inflation measures can be quite volatile in the short term. If actual inflation is to be used, judgment will be required to determine a suitable smoothing mechanism. For example, at each triennial valuation, it may be possible to use average inflation over the previous three years.

34 Actual CPI is a backwards-looking indicator, whereas the liabilities being valued are many years into the future. It may be possible to use a prospective inflation yardstick, such as the difference in yield between index-linked and nominal gilts. However, this would also be distorted by the imbalances between supply and demand referred to earlier. Alternatively, the actuary could assume the Bank of England’s CPI target rate of 2% per annum. However, this assumes both that the Bank of England will continue to set an explicit target and that it will be successful in achieving it, something that has fluctuated over the last decade.

The Economic model

35 Although not directly relevant to the 2016 valuation, the economic model is worthy of greater scrutiny for the future. The economic model of valuing liabilities is not correlated to gilt yields or inflation measures. The hypothesis of this approach is that liabilities and assets do not move with gilts or inflation but, rather, with underlying market conditions and equity returns.

36 The economic model discount rate is most closely matched to dividend yield plus a combination of economic growth, dividend growth and capital returns.

37 Economic model advocates argue that the AOA changes in line with market conditions and the discount rate more closely reflect the expected return to be achieved from the Fund’s investment strategy.

Criticism of the economic model

38 The economic model methodology has been criticised for being too opaque and not sufficiently prudent.

Comparing the Gilts plus and CPI plus models

39 A CPI plus valuation ultimately faces the same challenge as gilts plus valuation method: a significant degree of judgment is required to set a suitable premium on top of the ‘risk-free’ valuation base used.

40 The biggest difference between the two approaches is that the gilts plus basis has an implied minimum risk strategic asset allocation (a pension fund could invest wholly in index-linked gilts with a duration that matched its liabilities). This minimum risk strategy is helpful in enabling actuarial models to calibrate liability risks with regard to specific employers. Hymans utilise this approach with regard to the various risk factors inherent along the employer spectrum.

41 By contrast, there is no equivalent minimum risk strategy for a CPI plus based liability valuation. A strategy wholly invested in long-dated index-linked gilts would provide significant protection against long-term inflation, but the value of the assets (the market price of the index-linked gilts) would not move in line with inflation in the shorter term, so there would still be scope for meaningful volatility in the funding level.

42 The gilts plus valuation methodology is widely used by corporate pension funds. This is understandable because many funds are closed to new members and are seeking an eventual ‘buy-out’ to transfer the legacy pension risk to an insurance company, effectively by buying annuities. The terms of buy-out transactions are based on gilt yields, so it is entirely rational for a pension fund on a de-risking flight path to use the same approach. This is less relevant for LGPS funds that remain open to new members and have liabilities valued on an ongoing basis, but it is entirely appropriate for valuing cessation debt. Indeed, all actuarial firms calculate cessation debt on a gilts basis, irrespective of their ongoing valuation methodologies.

Implications for strategic asset allocation

43 The gilts plus valuation methodology encourages but does not necessitate investment in liability matching assets, such as index-linked gilts as part of a leveraged strategy.

44 A CPI plus valuation methodology, by contrast, may favour a range of asset types that offer long-term inflation protection, including long-dated index-linked gilts.

45 In this context, it is worth noting that the current strategic asset allocation for the Surrey Pension Fund has very little explicit liability hedging on either valuation basis. The emphasis on riskier equity assets to generate higher long-term returns means that the funding level will be volatile on whichever basis is used.

Recommended approach

46 With the stabilisation approach that the Fund currently utilises, the argument to change the discount rate methodology to reduce employer contribution rate volatility is less compelling.

47 The existing approach of setting contribution rates through modelling potential economic scenarios rather than adopting a single set of assumptions provides a robust framework for setting stable employer contributions.

48 This allows the Fund to set stable and affordable contributions appropriate to employer circumstances, and assess the likelihood of meeting its objectives within an appropriate time horizon within the existing gilts plus framework.

49 A prudent discount rate is determined more by the AOA than either an artificially low gilt yield or inflation measure. A discount rate that more suitably reflects the the 'risk-free' return within the wider context of the investment strategy of the Fund is produced by reference to the AOA without significant bias to a gilts plus or CPI plus methodology.

50 For these reasons it is recommended that the Fund continues to use the gilts plus approach in the 2016 valuation.

CONSULTATION:

51 The Chairman of the Pension Fund Committee has been consulted with regard to the methodology used for the 2016 actuarial valuation

RISK MANAGEMENT AND IMPLICATIONS:

52 There are no risk related issues contained within the report.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

53 There are no financial and value for money implications.

SECTION 151 (DIRECTOR OF FINANCE) COMMENTARY

54 The Section 151 (Director of Finance) is satisfied that the recommended actuarial methodology is an appropriate and prudent mechanism for valuing the liabilities of the Fund.

LEGAL IMPLICATIONS – MONITORING OFFICER

55 There are no legal implications or legislative requirements associated with this report.

EQUALITIES AND DIVERSITY

56 The reporting of such information will not require an equality analysis, as the initiative is not a major policy, project or function being created or changed.

OTHER IMPLICATIONS

57 There are no potential implications for council priorities and policy areas.

WHAT HAPPENS NEXT

58 The following next steps are planned:

- Officer will continue to work with the actuary to prepare for the 2016 actuarial valuation.
- Following the valuation date (31 March 2016) the Committee will receive a report containing the final proposed actuarial assumptions to be used in the valuation.

Contact Officer:
Phil Triggs, Strategic Finance Manager (Pension Fund and Treasury)

Consulted:
Pension Fund Committee Chairman.

Annexes: None

Sources/background papers:

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